The global community calls the 21st century the "Arctic Century". Economic, military, political and scientific interest in the Arctic is growing as Arctic ice is shrinking. Unlike the Antarctic, the Arctic zone has no special legal regime set by a special international convention. Currently, the Arctic nations (Russia, the United States, Canada, Denmark and Norway) have not signed any document regulating activity in the region, limiting themselves to a number of international declarations.

On 30 September 2013, Russian President Vladimir Putin signed law No. 268-FZ, encouraging hydrocarbon production on the Russian continental shelf. This law came into effect on 1 January 2014. Essentially, the law created a special tax regime for continental shelf hydrocarbon production projects. The law introduced a number of terms and definitions to Russian legislation that provide the basis for the legal regulation and taxation of offshore natural resource production, and a number of specific rules for the assessment of taxes on offshore operations (profit tax, VAT, MET, etc.). At the same time, the law left a number of issues unresolved, including some legal and taxation issues for Russian and foreign contractors and subcontractors participating in Russian offshore projects, a number of features in the accounting for income and expenses by participants in offshore operations and questions on transfer pricing.
Structuring operations to achieve compliance with Russian legislation and to determine the best tax position for companies operating on the Arctic shelf.

I. Structuring operations to achieve compliance with Russian legislation

Within the new law, new concepts were introduced to Russian legislation, such as "commercial production of hydrocarbon deposits", "new offshore hydrocarbon deposit", "operator of a new offshore deposit", "artificial islands" and "artificial structures and constructions"(1).

An offshore hydrocarbon deposit is defined as "a hydrocarbon deposit at a subsurface site(s) located entirely within Russia’s inland seas and/or territorial waters and/or on the continental shelf of the Russian Federation or in the Russian sector of the Caspian Sea shelf".

The term "new offshore deposit" refers to an offshore deposit where the commercial extraction of hydrocarbons begins no earlier than 1 January 2016 (2) (the "New Deposit").

The Law introduces certain conditions, all of which must be met for an entity to be recognized as the New Deposit operator. These conditions include:

- An entity carries out at least one type of activity associated with hydrocarbon extraction at the New Deposit (by itself, or by engaging contractors);
- An entity carries out activities associated with hydrocarbon extraction at the New Deposit based on an agreement with the license holder. The agreement should provide for reimbursement payable to the operator, the amount of which shall depend, inter alia, on the volume of hydrocarbons extracted at the corresponding offshore hydrocarbon deposit and/or proceeds from the sale of the raw materials.

An entity is recognized as the New Deposit operator starting from the conclusion of an operation agreement. There should be no more than one Operator at a new hydrocarbon deposit.

License holders are, in turn, resource developers therefore, it is necessary to consider legislative restrictions, i.e. (3):

- Resource developers must have operated on the Russian continental shelf for at least 5 years;
- Resource developers must be companies in which the government holds more than 50% of voting shares, either directly or indirectly, i.e. resource developers may not be private Russian or foreign companies, including those having significant offshore experience.
Apart from the fact that the technical component of the project directly impacts the price of developing the project, there are also financial obligations stipulated by the applicable tax regime and legislation that are applied depending on the company’s organizational and legal structure selected and the type of the agreement. In numerous cases, the management of these obligations makes the price competitive and the project profitable.

a) Structure as per the legislation

Form (joint venture or consortium):
- A joint venture may be established in Russia or abroad;
- The concept of a consortium is not developed in Russia, therefore, it should be modified to fit Russian legislation.

Possible corporate and contract structure:
- Holding/sub-holding;
- Joint venture;
- Operating company.

When determining the future contract and financing structure, it is also important to consider the fact that the Russian government has taken a number of serious measures to mitigate the effect of tax evasion from locating companies in jurisdictions with low tax burdens.

These measures include:
- Implementing regulation of controlled foreign companies (CFC);
- Adopting a criterion of the place of effective management of the tax resident (4);
- Extending reporting requirements of foreign affiliated companies and transactions with them or between them;
- Increasing interaction with international tax authorities for information exchange purposes;
- Developing the concept of the ultimate beneficiary and its implementation.

Necessity of involving partners to increase competitive edge

For an Arctic project to be commercially viable, and to increase its efficiency, it will likely be necessary to attract a major oil market player to increase the project’s competitiveness. Attracting partners for project implementation ensures the following advantages: a reduced final project price, access to advanced technology and equipment, guarantees, international experience, the possibility to mobilize additional resources where necessary, and the possibility for the partner to raise funds, including on more favorable terms.

Possible structures of attracting and using resources of each partner:
- Operations are conducted in Russia;
- Operations are conducted outside Russia;
- Operations are conducted in Russia by a foreign company with no permanent establishment.

Defining the responsibilities of the partners:
- Allocation of risks and responsibilities between the partners;
- Functions performed by the parties;
- Establishment of a partnership;
- Shareholder agreements.

b) Possible financing structure

Aspects of the financing structure:
- Internal/external (bank) financing and its structure;
- Financing of operations: contribution to the charter capital/borrowing/attracting funding from the client;
- Borrowing restrictions: transfer pricing with respect to borrowings, limitations of the amount of interest deducted and application of thin capitalization rules.
c) Building commercial relations with contractors and subcontractors taking into account regional specifics

Deposit development projects in hostile Arctic conditions require unique types of equipment and highly qualified specialists with relevant experience. Current practice demonstrates that these types of equipment and specialists are often borrowed from foreign partners.

The procedure for transferring equipment and other property to Russia should be examined in detail before the start of the project. The most appropriate means of transferring equipment or other property to Russia depends on:

• Project type (for example, a production-sharing agreement, like Sakhalin-1, has additional restrictions and obligations for its participants that differ from the general legislation);
• Equipment needed (the use of certain types of equipment, such as equipment containing isotopes, may be subject to special regulations);
• Form of participation in the project (service contract; engineering, procurement and construction contract (EPC); subcontractor; operator).

It is also important to establish proper document flow between all subcontractors to avoid legal problems (non-performance, delays), tax issues (impossibility to recognize expenses for profit tax and VAT purposes) or other adverse consequences.

The contents of a contract may be very important for customs clearance and may affect the final cost of importing equipment to Russia. It is also important to consider that additional requirements may be imposed with respect to attracting local service providers.

Foreign contracting organizations (contractors and suppliers) should be highly aware of the possible risk of creating a permanent establishment in Russia for tax purposes.

A practical tip is to distinguish between supplying organizations and subcontracting organizations on the grounds below:

• Removing risks of the supplier and subcontractor from the major operating company;
• Ensuring compliance with Russian legislation (customs regulations or requirements for attracting local suppliers and contractors);
• Organizational and management reasons, and reasons related to expenditure efficiency;
• Possibility of ensuring efficient operations and transfer of the title to goods and services (work), which may reduce tax costs.

The procedure for selecting contractors or subcontractors for a project that also involves cooperation with foreign companies may include a study of the following issues:

• Interaction between contractors, subcontractors and suppliers in Russia and abroad; efficiency of working processes; document flow harmonization;
• Localization of a project developed abroad so that it complies with Russian legislation;
• Check of contractors and suppliers. Attracting “bad faith” suppliers and contractors may lead to additional tax liabilities;
• Possible necessity of attracting local suppliers and contractors.

d) Use of staff

Key requirements of Russian legislation regarding employment of foreigners should be carefully observed, including the process of receiving individual work permits and work visas for foreign employees and notification of the tax authorities and the Federal Migration Service. Risks of non-compliance with Russian migration legislation may lead to serious consequences: fines of up to RUB 800,000 for each breach; in case of suspected non-compliance — up to 90 days of deportation/disqualification of breaching employees. Temporary business interruption is also possible.
There are several options for employing foreigners:

**Staff engagement — direct employment**

**Advantages:** compliance with the requirements of migration legislation; if the employee has no other income, there is no need to file a tax return; a clear mechanism for recognizing payroll expenses; a transparent taxation mechanism; compliance with the tax legislation.

**Concerns:** lack of a labor contract abroad may disqualify the employee from participating in retirement and insurance plans of his or her country of residence; difficulties with payment of salary in foreign currency.

**Staff engagement — combined with secondment**

**Advantages:** possibility for the employee to participate in retirement and insurance plans of his or her country of residence; possibility for the Russian organization to receive a work visa and a work permit; secondment contract is an additional source for settlements with the actual employer.

**Concerns:** employees are required to declare income; risk of inclusion of income received abroad in the PIT tax base in Russia; restrictions on the use of the secondment contract in Russia.

**Staff employment — double employment without secondment**

**Advantages:** possibility for participation in social programs in his or her resident country; possibility for the Russian company to receive work permits and visas; confidential salary.

**Concerns:** presence of foreign employees may cause the risk of creating a permanent establishment; risk of inclusion of income received abroad in the PIT tax base in Russia; individuals are required to file a tax return.

When considering possible options for attracting project staff, it should be noted that a local labor contract is the most convenient. Additionally, employees cannot obtain a work permit without concluding a local labor contract, which makes such a labor contract a must in case of secondment, which sometimes results in multiple employment.

It is also worth noting that on 5 May 2014, Federal Law No. 116-FZ was adopted, which introduced to the Russian Labor Code the following amendments, which prohibit secondment as a general rule.

Pursuant to the law, which came into effect on 1 January 2016, secondment will be permitted only if one of the following conditions is met:

- The receiving party is an affiliate of the sending party;
- The receiving party is a joint-stock company, and the sending party is a party to a shareholder agreement on exercise of rights certified by shares of this joint stock company;
- The receiving party is a party to a shareholder agreement concluded with the sending party;
- The sending party is an accredited private labor agency.

Extension of legislative regulations to cover artificial islands still remains a topical issue, along with the issue of applying Russia’s sovereignty and, consequently, Russian migration rules.

**Determining the best tax position for companies operating on the Arctic shelf**

Depending on the contract and financing structure selected, project participants should pay special attention to the regulation of organizations’ operations at new offshore deposits in terms of taxation. Some of the key legislative changes in this area that are applicable to Arctic offshore projects are presented below.

**For the operator and the license holder**

**Profit tax:**

- The restriction on the period of tax loss transfer is removed within each license area.
- There is an option to apply accelerated depreciation and depreciation premiums for fixed assets used in the development of offshore hydrocarbon deposits.
- An option is granted to make a tax-deductible provision for expenses related to the liquidation of the offshore project for corporate profit tax purposes.
- If a decision is made to discontinue work at a subsurface site due to economic inexpediency, the entire amount of losses incurred on mineral resource development (or any part of them) can be allocated to any new offshore deposit at the same subsurface site.
- If a decision is made to terminate the right to use
subsurface resources, the taxpayer may treat the entire amount of expenses incurred for mineral resource development (or any part thereof) as expenses associated with New Deposits that the taxpayer is developing at other subsurface sites.

- Companies performing exploration activities on the continental shelf can recognize R&D costs at a rate of 1.5.
- Taxpayers may include in expenses the full amount of accounts receivable in respect to loans, borrowings, or other debt (including accrued interests) written off as a result of debt relief or due to other reasons, if these amounts were provided to the operator or license holder to finance hydrocarbon production at a new deposit.
- If the New Deposit operator is a foreign entity carrying out operations in Russia through more than one division, such an entity may determine the tax base for the group of these divisions as a whole. All the divisions included in such a group should apply a unified accounting policy for taxation purposes.
- The license holder may include in other expenses the amount of actual costs as reimbursement of expenses for mineral resource development previously incurred by the former license holder in order to obtain the license.

**Transfer Pricing.** The law stipulates that transactions between the operator and the holder of the license to develop a new offshore deposit concluded in the course of hydrocarbon extraction with respect to the same deposit should not be subject to transfer pricing control in Russia.

**MET rates for new offshore deposits.** For the Arctic category – 5%, for the high complexity category – 10%, for entities without the right to export LNG produced by natural gas extracted at the new offshore deposits – 4.5% for the Arctic category, for natural gas – the Arctic level – 1% before the expiration of 180 calendar months but no later than 31 March 2042, high complexity category – 1.3%. The Law establishes a MET rate of zero for mineral production at hydrocarbon deposits with a tax base determined in physical terms, provided certain criteria are met (5).

**VAT.** The 0% VAT rate is applied to work (services) related to the carriage and transportation of hydrocarbons produced on the continental shelf abroad. The Law provides for situations in which the goods presented by hydrocarbons produced at the hydrocarbon offshore deposit (as well as products of its technological conversion, i.e. stable gas condensate, LNG) are deemed to be sold in the Russian Federation. VAT on the acquisition of services related to minerals exploration and production on the continental shelf may be recovered from the RF budget only if the service recipient is an RF tax resident.

**Property tax, transport tax.** Facilities located at the continental shelf are exempt from corporate property tax (6); offshore fixed and floating platforms, offshore mobile drilling rigs, and drilling vessels are exempt from transport tax.

**Custom duties.** The Government also offered tax holidays for export duties for the period from 31 March 2032 (Categories 1 and 2) to 31 March 2042 (Categories 3 and 4).
Conclusions and pending issues

In conclusion, we would like to note that the new legislative regulations introduced by the Russian Government have really ensured a favorable taxation regime for operations on the Arctic shelf.

Another advantage is a new structure of interaction between Russian oil companies and foreign investors that can be implemented in practical terms.

However, there are a few issues that, in our opinion, were not considered in the legislation and are currently pending.

- The key issue is how the legislation is implemented in practice, whether it efficient enough, taking into account privileges provided for the operator and license holder but not provided for contractors and subcontractors. The Law does not define the legal regime and specific taxation issues for Russian and foreign contractors and subcontractors involved in Russian offshore projects.
- Another question is how the legislation will be applied in the period prior to the confirmation of resources at a new offshore deposit.
- There is also no clarity on the technical procedure for the transfer of losses and recognition of expenses should the decision be made to discontinue work at the subsurface site. If no New Deposits are established at the subsurface site, does this mean that the taxpayer will lose the expenses incurred for mineral resource development?
- It remains unclear how the expenses incurred by the operator in respect of hydrocarbon extraction activities at the New Deposit be treated in the event that it prematurely loses its operator status.
- A final issue is whether amendments to customs legislation can be regarded as a full-value tax incentive. Will companies planning to produce hydrocarbons on the RF continental shelf be able to make use of this incentive to the full extent, considering that, under favorable conditions, practical offshore hydrocarbon production may only commence in 10 years?

(2) Including offshore hydrocarbon deposits with no commercial production commencement date as of 1 January 2016.
(3) Clause 3 of Article 9 of the RF Law “On Subsoil”
(5) Subparagraph 1, paragraph 1 of Article 342 of the RF Tax Code
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