Shale gas report – Poland

Tax and accounting issues for foreign investors and service companies
The Polish shale gas tax environment is about to change dramatically. In his expose in November 2011, Prime Minister Tusk revealed that a brand new tax regime for upstream and specifically, shale gas, will be introduced very soon, most likely during 2012. The Government is currently developing the concept of taxation for shale gas (which may be a combination of basic CIT taxation, royalties and additional hydrocarbon tax).
Introduction

Global highlights
The upstream industry has witnessed a huge transformation in the last few years. Much of the turmoil could be attributed to changes in demand and unsteady prices of natural gas. As a result, the competition, especially in terms of demand for quality gas assets, has increased and major oil and gas companies have experienced lower margins.

Still, despite the current turmoil, it seems that the predictions for long-term energy demand are very promising.

According to some research agencies, global demand for energy will increase an estimated 40% by 2030. Other studies seem to support this conclusion, with ExxonMobil forecasting that natural gas demand will grow by 55% between 2005 and 2030.

Part of this demand may be covered by the recent explosion in shale gas production (often referred to as the shale gas bubble).

On the one hand, it looks very promising – the global technically recoverable shale gas resources are estimated at 188 trillion cubic meters.

Yet, while the ongoing search for shale gas has moved from North America to Europe, it is still not known whether the million-dollar investments will be recoverable.

The US and Canada example proves, however, that if shale gas can work for them, it can also possibly work for Europe.

Poland focus
Recent analyses reveal that the largest reserves of shale gas in Europe are in Poland.

Poland has reserves of about 22.45 trillion cubic meters (tcm) of shale gas, with an estimated 5.3tcm of technically recoverable shale gas reserves. Taking that into account, Poland is no doubt becoming an important point on the global energy map.

From the perspective of a country dependent on importation of natural gas, it seems obvious that diversity of energy sources is currently a hot topic. The shale gas business (and, more broadly, the upstream business) is at the centre of attention of the Polish Government and the regulators. Increased use of gas is also consistent with Poland’s plans for infrastructure development and reduced carbon footprint. Taking all that into account, it is clear that Poland’s shale gas is an appealing opportunity for international investors.

In this document, we take a brief look at Poland’s upstream environment and go through the key issues that might be relevant for new entrants and existing companies.

We start with a brief look at the business and regulatory landscape.

Bearing in mind that fiscal regimes are often crucial when assessing the profitability of an upstream business, we focus mainly on tax and accounting issues, where we look more deeply into current legislation, present unresolved issues and possible future regulations.

Lastly, in a short section, we cover the main issues that may be of importance for foreign service companies that intend to start business in Poland.

As we write, these words, it seems that the Polish shale gas bubble is “expanding” significantly. The results of the first borings in the Baltic basin were announced in June 2011 showing large saturation in the well and, on 8 September 2011, 3Legs Resources communicated that they had successfully extracted gas from one of their wells near Lebien in the Pomorze Region.
Business overview

Most of the shale gas is in the Baltic Sea basin – about 3.66tcm, about 1.25tcm within the region of the Lublin Voivodeship, or the Lublin basin, and another 0.4tcm in the Podlasie Voivodeship.

Major shale basins in Poland

Current snapshot

Unconventional gas, shale gas and coal seam gas are believed to be the key to expanding the long-term role of natural gas in the global energy mix. The “shale boom” in the US has revolutionized the gas market in North America and is expected to affect global gas markets substantially in both the medium and long term. While interest in European unconventional gas has been growing steadily in recent years, Poland has attracted the most attention.

As noted earlier, preliminary estimates indicate that Poland could have as much as 5.3 tcm of recoverable shale gas. The organically rich shales are deposited in three basins – the Baltic basin in the north, the Lublin basin in the south, and the Podlasie basin in the east. (see map on previous page)

The recent US Energy Information Administration report on the shale gas potential outside the US estimates that the Baltic basin holds about 14.4 tcm of risked gas-in-place and about 3.6 tcm of risked recoverable gas (about 65% of the country’s total), while the Lublin basin holds about 6.2 tcm of risked gas-in-place and 1.2 tcm of risked recoverable gas (about 28% of the country’s total) and the Podlasie basin holds about 1.6 tcm of risked gas-in-place and 0.4 tcm of risked recoverable gas (about 7% of the country’s total).1

Poland is a great net importer of natural gas. Of the 14.3 billion cubic meters (bcm) of natural gas consumed in Poland in 2010, domestic production was only 4.1 bcm, with almost all of the remainder coming from imported Russian gas.2 Polish gas production has been declining while consumption has been increasing. realizing the potential for unconventional natural gas to support its declining conventional gas production, the Polish Government has shown strong support for shale gas drilling. It has put in place very attractive fiscal terms for gas development, although infrastructure and regulatory issues remain barriers to efficient development. By mid-2011, the Polish Ministry of the Environment had granted 86 concessions for unconventional gas exploration and five exploratory wells had been completed, with as many as 15 more wells expected to be completed by year-end.3 As noted in the EIA shale gas report, the shales in the Baltic basin are being actively leased by numerous large international and smaller independent exploration companies as well as the country’s national gas entity, PGNiG. The most active company in the basin is 3Legs Resources (a subsidiary of Lane Energy Poland). ConocoPhillips has partnered with 3Legs resources to jointly evaluate the shale potential of the Baltic basin. In late September 2010, the joint venture drilled the basin’s first shale exploration wells, i.e., Lebien LE1, and Łęgowo LE1 which proved successful in September 2011. A joint venture led by BNK Petroleum plans to drill an exploratory well, also targeting the Silurian and Ordovician formations in the basin.

Talisman Energy has plans to drill three shale gas wells and perform seismic tests during the next two years. Marathon Oil has one concession in the Baltic basin in which it plans to drill one well and perform 2D seismic tests. In June 2011, Mitsui took a minority stake in 10 exploration concessions of the Marathon shale gas project that covers 2.1 million acres of Poland. Both Chevron and ExxonMobil have accumulated acreage in the Baltic basin and have reported plans to drill exploratory wells within the next year. In addition to the major exploration companies, a number of smaller firms are acquiring and testing acreage in the Baltic basin, including Realm Energy International, San Leon Energy and Aurelian Oil and Gas.

The Lublin basin is the site of modest oil and gas production from a small group of oil and gas conventional fields. As in the Baltic basin, a number of international firms and Poland’s state-owned gas company (PGNiG) are actively evaluating the Lublin basin’s shale gas potential. In early August, Halliburton completed Poland’s (and the Lublin basin’s) first shale gas well fracturing operation in the Markowola-1 exploratory well for PGNiG. Production and test results have not yet been released. At least six other exploration companies have acquired unconventional gas exploration concessions in the basin, including Orlen (largest Polish oil company), ExxonMobil, Chevron, Marathon Oil and others. In late July, Poland’s antimonopoly regulator approved the ExxonMobil, Total joint venture to use the Chelm and Werbkowice concessions in the Lublin basin.

Though no exploratory wells have yet been drilled in the Silurian shale in the Podlasie basin, it is being actively leased. ExxonMobil holds the largest lease position in the basin, with three shale gas exploration concessions.

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Regulatory environment

Operating in Poland poses several challenges for new entrants, one of the most significant being the legal and regulatory framework. The increasing number of deals concluded by global operators exposed Poland’s legislative deficiency especially in terms of licenses for exploration and production, transfer of rights, joint operation agreements and securing rights to land.

Current legislation
The exploration and production of minerals, including shale gas, are currently regulated by the Business Freedom Act and the Geological and Mining Act.

Concessions and mining usufruct agreements
The exploration and production of natural resources are licensed activities. Concessions must be obtained both for the exploration and production stages, and a detailed application has to be submitted to the Minister of the Environment. As a rule, concessions cannot be shared by independent entities.

As the main rule under the Geological and Mining Act is that hydrocarbons are state owned, upstream activities require a mining usufruct. It is not clear whether such rights can be shared; however, the Ministry of the Environment has permitted transfer of shares in mining usufruct agreements (MUAs), provided that the acquirer gets only a 49% interest in the MUA. This has allowed, in practice, the existence of farm-in, farm-out agreements and joint operation agreements (JOAs).

Environmental issues and permits
Based on the Polish environmental law, exploration and extraction of hydrocarbons are an activity where an environmental assessment and a decision on environmental conditions are required before a concession is granted. Additionally, there may be the requirement to obtain a decision on environmental conditions (the issue of such a decision must be accompanied by the applicant company’s environmental impact report).

According to the scope of operations and the technology used, the concession activity may require the acquisition of additional permits and administrative decisions (including geological work permits, construction permits or waste management and emission-related decisions).

Title to land
The acquisition of seismic data and drilling of wells makes it necessary for the concession holder to exercise sufficient control over land. This may require additional agreements with land owners such as tenancy, lease or establishment of easements.

The new Geological and Mining Law from 2012
In response to recent developments in the field, there is an ongoing effort to update existing legislation. For example, the new Geological and Mining Act is expected to come into force in January 2012.

Under the new Act, concessions for the exploration and extraction of hydrocarbons are generally awarded through a tender, which ensures greater legal certainty. The winning bidder signs an agreement establishing an MUA which, from a civil law perspective, will be treated as a type of lease rather than a usufruct.

The new law regulates more precisely the situations where a concession may be transferred to other entities (the transfer may be refused in the public interest). However, farm-outs and JOAs are still not precisely regulated (assignment of a MUA etc.).

What is also important is the rising level of exploitation fees and the fact that a larger amount of the concession payments will be allocated to local governments.

Among many other things, the new law also introduces new rules on the carbon capture and storage (also licensed activities) and the ownership of geological information and data; however, it is said that many issues still remain open (such as environmental issues and water use).

New Geological and Mining Act will come into force in 2012; however, as several issues still remain unsolved, it is speculated that the Government will introduce a special act dedicated only to shale gas in the future.
Taxation issues

At the moment, Poland lacks a specific upstream tax regime or separate hydrocarbon tax. This leads to considerable uncertainty concerning the tax treatment of the upstream activities, partly manageable, however, by the institution of binding tax rulings. However, the Government is looking closely at the shale gas business, and it has announced that a special taxation scheme may be introduced soon.

That said, it must be underlined that the current level of taxation applicable to revenue from upstream activities in Poland is very attractive for investors, especially compared with other countries.

Taxation of oil and gas business in example countries (% of royalties, income tax and extraordinary profits/windfall tax)

- **Algeria**: 20%\(^{a}\), 5%-50%\(^{b}\)
- **Libya**: 38%\(^{c}\), 16.67%\(^{d}\)
- **Norway**: 44%\(^{e}\), 4.3%\(^{f}\)
- **Poland**: 28%\(^{g}\), 0\(^{h}\)
- **Saudi Arabia**: 85%\(^{i}\), 0\(^{j}\)

\(^{a}\) Can be reduced depending on zones but to no less than 10%

\(^{b}\) Depending on type of contract

\(^{c}\) CIT of 40% and jihad tax of 4%

\(^{d}\) Minimum amount; if royalties, income tax, jihad tax amount to less than 65% of profits, a surtax is charged

\(^{e}\) Offshore tax regime

\(^{f}\) Concession payments apply but they are not fiscal income

\(^{g}\) Royalties apply depending on a particular PCA (Petroleum Concession Agreement)

\(^{h}\) Regular profits are tax at 20%, oil and gas profits at 85%, natural gas activities at 30%-85%

Source: Ernst & Young Global Oil and gas Tax Guide 2011
Taxation issues

Current legislation
As a general comment, please note that both the upstream business as such and joint operations are under-regulated in Polish tax law. Therefore, our comments are based on the general CIT and VAT regulations as well as existing (although still limited) tax practice of the authorities.

Moreover, the cooperation scheme to be ultimately applied by the parties intending to commence an upstream business in Poland might not constitute a typical consortium or joint venture, particularly in the exploration phase. Our tax comments refer to the current tax practice regarding consortium or joint operations, based on our experience and the approach of the tax authorities expressed in binding tax rulings.

Direct tax comments
• As stated, there are no rules in the Polish CIT provisions specifically governing upstream business or joint operations.
• Corporations operating in Poland, in the form of a company or e.g., a permanent establishment of a foreign entity (PE), are subject to CIT on their Polish-source revenue at a rate of 19%. The 19% rate applies to any type of income, including that from oil and gas activities.
• Poland does not apply ring-fencing in determining an entity’s corporate tax liability in relation to its oil and gas activities. Profit from one project can be offset against losses from another project held by the same Polish legal entity, and, similarly, profits and losses from upstream activities can be offset against downstream activities undertaken by the same Polish entity.

Joint operations
• The Polish CIT Act outlines a general rule on the allocation of profits (i.e., revenues and costs) applicable among others to a joint undertaking. Assuming that cooperation is considered a joint undertaking within the meaning of the CIT Act, the CIT settlements between the parties should be established in line with the above-mentioned provision and the general CIT rules.
• The revenue generated within a joint undertaking should be allocated to the parties according to their shares in the undertaking, as declared in the agreement. The above rule should be applied accordingly to tax-deductible costs, costs not deductible for tax, tax exemptions and tax reliefs. In the case in hand, this rule affects the recognition of revenues (and costs), in particular during the exploration and production phase.
• At the moment, the tax authorities tend to accept that upstream cooperation should follow the CIT rules applicable to joint ventures.
• What is still unclear is the point of revenue recognition for the operators where non-operators provide extra funding for the operations, in excess of their participation interest.

Tax deductible costs
• There are no straightforward rules regarding recognition of exploration expenses. In fact, exploration expenses might consist of various groups of costs that should be analyzed item by item.
• As a general principle, expenses and tax losses on transactions related to oil and gas exploration may be offset against non-oil-and-gas-related taxable revenues.
• Depending on the type of costs, they could be either (i) capitalized and then recognized for tax purposes via depreciation write-offs over the expected lifetime of the project – if they involve the development of fixed assets, (ii) treated as a tax-deductible cost when incurred. And if the project is “liquidated” before the end of the previously expected lifetime, (iii) the costs can be written off in full or (iv) expensed.
• Given the above, costs should be divided to determine the correct tax treatment of different types of expenses, i.e., whether they should be capitalized or treated as tax-deductible costs when incurred.
Depreciation rules
• Tax depreciation does not follow accounting rules. Depreciation of wells – 4.5% p.a., machinery and equipment depending on their classification – from 7% to 18% p.a., accelerated depreciation is available for machinery and equipment, but not for wells.

Tax losses
• The nature of the shale gas upstream activity assumes a non-profitable period at the beginning of the business.
• There is a five-year statute of limitation for tax losses and only up to 50% of a tax loss for a given year can be offset at one time.
• Tax losses generated by a PE might be offset in Poland only against the PE’s taxable incomes generated there. Potential utilization of tax losses generated by the Polish PE should be considered at the level of the HQ’s tax residency country.
• Reduction of a tax loss in the first year of the business activity is possible through e.g. capitalization of most tax costs to the value of the fixed assets. The taxpayer is entitled to choose one of the depreciation methods provided in the regulations. The method once chosen is applicable throughout the depreciation period. Therefore the choice of the proper depreciation policy must be made at the beginning of the activity.

Incentives
• R&D relief applies to expenses for innovative technologies that can be classified as intangibles and 150% of expenses can be deducted from the taxable base.

Financing
• Financing of the upstream operations in the form of equity (share vs. supplementary capital) vs debt is a matter of arbitrage.
• Interest paid (compounded, i.e., added to the value of the principal) on the debt constitutes a tax-deductible cost and generates tax losses in the start-up phase. At the same time, the lender’s country may treat interest as taxable income on an accrual basis. In the case of debt financing, financing through an SPV located in a favorable tax regime is recommended.
• Thin capitalization restrictions (debt-to-equity ratio 3:1, with mother and sister companies being qualifying entities) are to be monitored to prevent any tax ineffectiveness. As a rule, a 2% transfer tax is chargeable on the debt unless specific exemptions apply (shareholder’s debt is not subject to transfer tax).
• As a rule, equity financing is subject to a 0.5% transfer tax on a share capital increase. An increase of supplementary capital is not subject to transfer tax, but supplementary capital is not included for thin capitalization purposes.

Shareholding – structuring
• The shale gas upstream assumes a long-term profitable activity. For foreign investors, a relevant structuring is required to ensure effective distribution of dividends and capital gains. For non-EU investors, investing in Poland through investment vehicles (e.g., Cyprus) is worth considering.
Indirect tax comments

General rules
Poland has generally adopted the main rules of the EU VAT regulations, when it comes to the definitions of a taxable person, rates, scope of taxation and deductibility. Therefore, Polish VAT system is to a large extent harmonized with the EU VAT system.

The VAT rate in Poland is currently 23% and is expected to rise in the coming years, depending on the amount of public debt (if the amount of public debt exceeds the threshold of 55% of GDP VAT will automatically rise by 1%).

VAT applies to the following transactions:

• Supply of goods and rendering of services within the territory of Poland for consideration
• Receipt of services subject to reverse charge by a taxable person in Poland
• Export/import and intra–community acquisition of goods for consideration/Intra–Community supply

A foreign business must register for VAT in Poland when it supplies goods or services where the place of supply is Poland.

Poland refunds VAT incurred by businesses that are not established nor registered for VAT in Poland via a direct refund (a claim is allowed to the same extent as a Polish taxable person). Please note, however, that entities from certain countries, e.g., the US and Canada, are not entitled to a direct refund for foreign entities (i.e., without registration in Poland).

It should be verified, therefore, whether the upstream operator, has a fixed establishment for VAT purposes in Poland due to its activity. The answer will probably be yes, but even if not, the VAT registration should be seen as practically the only way of recovering the input VAT.

Joint operations
In Poland, there are no specific rules on the treatment of a consortium or other joint operations from the VAT perspective, so the general VAT rules apply. The primary question is whether the transactions within the joint operations should be viewed as a supply of goods and services subject to VAT, taking into account the role of the partner in the joint operations, or whether the settlements between the partners do not constitute VAT transactions. From that perspective, there are strong arguments to claim that the settlements between the partners of a consortium should be viewed as taxable transactions. We know of several rulings for our clients and generally the tax authorities’ practice confirms that VAT is applicable to settlements within joint operations.

There are also arguments for the other approach, i.e., that the settlements between the partners should be viewed as operations beyond the scope of VAT. This option would be more applicable for a situation where the role of the partner is very limited, i.e., the partner only provides the financing of the joint operations and shares in the financial result.

Cash calls – in principle, advance payments for specified goods or services are subject to VAT. Consequently, it must be clarified with the tax authorities whether the payments made by the partner to the operator constitute advance payments or not, especially since the current practice of the tax authorities in this respect is not unanimous. The wording of the agreement between the parties will be important in this respect.

Classification of the operator’s supplies to the partner – from a VAT perspective, all transactions must be classified as a supply of goods or supply of services (essentially, anything that is not a supply of goods is a supply of services). For services, it is crucial to determine whether they follow the main business to business (B2B) rule, i.e. are taxable where the recipient is established or whether they can be classified as connected with immovable property located in Poland or supplied to a Polish fixed establishment – which are always subject to VAT in Poland.

Timing of recovery of Polish VAT – if the operator or partner purchases goods or services subject to Polish VAT from suppliers, it must be analyzed whether they will be in a position to recover input VAT through an ongoing “offset” against output VAT. It should be analyzed 1) how frequently the operator will charge the partner and 2) how quickly they can recover input VAT (180, 60 or 25 days).

Main tax issues concern:
(i) tax treatment of joint operations
(ii) timing of revenue recognition,
(iii) treatment of buy-in payments
(iv) asset recognition (e.g., dry wells) and
(v) VAT treatment of flows between the partners
Other taxes

- **Real estate tax (RET)** applies to all construction and buildings as well as land. What is important is that the tax rate is 2% p.a. of the initial value for tax depreciation purposes. Therefore, RET can be a significant component of the costs of CAPEX heavy business, so the identification of objects subject to RET is quite important. This said, it must be underlined that the application of RET to underground construction in mines has been the subject of an ongoing dispute with the tax authorities (where a recent ruling of the Constitutional Tribunal has been issued). The dispute may partly be settled by the new Geological and Mining Act from 2012 but close monitoring is required.

- **The Polish Excise Duty regime** will be applicable to natural gas from October 2013, when the excise duty exemption is due to expire. Gas will be dutiable at the rate of PLN1.28 (EUR 0.33 )/1 gigajoule (GJ ). It is yet unclear what the exact taxation regime will be – the amendments are currently under development at the Ministry of Finance and a change of the law should be closely monitored. Judging from the current changes concerning coal and coke (where exemption expires at the end of 2011), a large scope of exemptions for different industries is expected as is a heavy administrative burden for companies included in the gas trade.

**Binding rulings**

The current Tax Code provides for the possibility of applying for a ruling to the Minister of Finance. Companies rely on such rulings to secure their tax position in Poland. It takes three months from the day when the application is submitted to the Minister of Finance to obtain the individual binding ruling (this is a statutory deadline).

The ruling can be issued in respect of the activities already conducted or future activities. Obtaining a favorable ruling protects the taxpayer against negative tax and penal (personal liability) consequences if the tax authorities change their position on the tax treatment of activities performed by the taxpayer (it is possible that the ruling may be subsequently changed by the Minister of Finance or challenged in the course of a tax audit).

If a favorable ruling is issued and subsequently the tax authorities change their position:
1. The taxpayer does not have to pay the relevant tax.
2. The taxpayer does not have to pay default interest (if the ruling is obtained before a given transaction).
3. There is no personal penal responsibility of the company’s employees.

**Rates of Excise Duty for energy products in the EU Energy Directive compared to those applicable in Poland**

<table>
<thead>
<tr>
<th>EU Directive</th>
<th>Business use/ non-business use</th>
<th>Poland (irrespective of use)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity (EUR*/MWh)</td>
<td>0.50/1</td>
<td>5.10</td>
</tr>
<tr>
<td>Natural Gas (EUR/GJ)</td>
<td>0.15/0.30</td>
<td>0.33</td>
</tr>
<tr>
<td>Coal and coke (EUR/GJ)</td>
<td>0.15/0.30</td>
<td>0.33</td>
</tr>
</tbody>
</table>

*Exchange rate at PLN3.9/EUR.
Taxation issues

Unresolved issues
Before upstream operations in Poland are started, special consideration should be given to:

- A tax-efficient setup of the operations, which takes into account the Polish loss carry forward restrictions (special purpose vehicles (SPVs) vs. joining different projects or revenue streams)
- Efficient tax loss planning – especially in the exploration phase
- Point of recognizing revenues from joint operations (cash calls vs. monthly billing etc.)
- Differences between tax and accounting treatment (assets recognition and value, concessions, capitalization of costs, segregation, cost of financing)
- Tax treatment of cooperation between operator or non-operator(s) under joint operation schemes – Joint Operation Agreement (JOA), Farm Out Agreement (FOA); including:
  1. Treatment of the initial “buy in” for tax purposes
  2. Approach to revenues (gross vs. net approach)
  3. Treatment of a split of an MUA for tax purposes
  4. Correct VAT approach (e.g., cash calls, billings)

Several planning techniques are available – including a tax-efficient setup of business in Poland and planning concerning taxation of upstream operations (point of revenue recognition, treatment of flows within JOAs, cost segregation etc.)

General tax planning ideas
There are a number of general planning ideas that can be considered.

1. Tax loss planning
   This includes efficient cost segregation techniques, depreciation planning, SPV planning, bond stripping, etc.

2. Tax-efficient setup of joint operations
   Within the degree of flexibility permitted by the tax authorities’ current approach, it is possible to obtain favorable binding rulings (e.g., cash calls as operations beyond VAT).

3. Tax-efficient setup of operations in Poland
   This implies:
   - Efficient profit distribution
   - Financing (debt push-down techniques)
   - Tax consolidation
   - Use of partnerships
   - Tax free step-up
   - Polish CIT-exempt structure

4. Cost segregation techniques
   - Setup of an investment (taking into account a possible exit); an SPV or existing company, tax step-up, equity vs. debt financing
   - Review of a business plan or model of the investment for tax purposes (e.g., financing options, working capital considerations in terms of VAT)
   - Tax point of costs in the planning phase (CAPEX vs. OPEX)
   - Selection and assignment of accounting depreciation rates
   - Types of financing (general vs. specific project financing) and how it is reflected in P&L for accounting purposes (IAS 23)
   - Setting up the values of assets to optimize the RET liability
Service companies – tax remarks

From the perspective of foreign service companies cooperating with shale gas operators, it is crucial to properly assess the degree of presence needed not only for CIT purposes but also for the purpose of VAT recoverability. Attention must therefore be made to the tax-effective setup of operations in Poland and the choice of business form.

The crucial aspects to be taken into account by a foreign company planning to work with major oil and gas operators in Poland are:

- **Tax-efficient setup of Polish operations** — operations of the services companies in Poland as a rule will create a tax presence in Poland; as such, income generated in Poland will be subject to Polish 19% CIT rate. Operations may be set up in the form of PE, registered branch or a subsidiary (LLC, joint stock company) or alternatively a partnership. Depending on the investor country, distribution of profit may be a decisive factor in choice of business form. Irrespective of the form, the same CIT rules still apply, and income will be subject to 19% CIT.

- **VAT presence in Poland** — it must be analyzed whether the service company has a fixed establishment for VAT purposes in Poland due to its activity. If the answer is no, it should be found out whether it should register for VAT purposes. This potentially may be the only way of recovering the cost of input VAT.

- **Recoverability of Polish VAT** — if a service company purchases goods or services subject to Polish VAT, please note that it must be registered for VAT purposes in Poland in order to recover Polish VAT (via a Polish VAT return); alternatively, a direct refund for foreign entities will have to be applied (where some restrictions apply as mentioned before). Additionally, a VAT registration may be necessary in order to account for the output VAT due on the supplies of goods and services to upstream operators (certain supplies may be treated as subject to VAT in Poland as services connected with immovable property, rather than subject to the main B2B rule).
Accounting issues

Currently, Poland lacks specific accounting guidance for the oil and gas industry. In particular, there is no guidance for upstream activities and joint operations typical for this phase of work, especially if they do not have the form of an incorporated entity.

The application of general accounting rules specified in the Accounting Act leads to much uncertainty about the accounting treatment of particular business solutions.

Current legislation
Polish accounting is regulated by the Accounting Act of 29 September 1994 (the Act). The Minister of Finance has also issued several regulations covering specific accounting areas such as financial instruments, consolidation, and accounting for banks, insurance companies, investment funds and pension funds. At the moment, however, there is no specific accounting guidance for the oil and gas industry.

In 2002, the Polish Accounting Standards Committee was established to prepare and issue standards as additional guidance to the Act. Before 1 July 2011, six standards had been issued. None of them relates to topics specific to the oil and gas industry.

The Committee has also issued four standpoints (not a standard) on topics related to accounting and bookkeeping and none of the topics are specific to the oil and gas industry.

Polish Accounting Regulations (PAR) therefore consist of the Accounting Act and other laws issued based on the Accounting Act, including standards and standpoints.

The amendments to the Act, which came into force on 1 January 2005 and 2009, permit some Polish entities to apply IFRS as adopted by the EU as their primary basis of accounting, rather than applying the accounting principles set out in the Act. Their annual financial statements will then be subject to audit every year.

In areas not regulated by the Act or National Standards, reference to IFRS can be made by entities applying PAR as their primary basis of accounting. Care should be taken as some IFRS practice or guidance may be contradictory to the guidance contained in the Act and in such a case cannot be applied.

<table>
<thead>
<tr>
<th>Entities allowed to apply IFRS</th>
<th>Stand-alone/separate financial statements</th>
<th>Consolidated financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Entities listed on a regulated market in Poland or in other European Economic Area (EEA) countries.</td>
<td>Choice</td>
<td>Required</td>
</tr>
<tr>
<td>2. Entities that have applied for permission to be listed on a regulated market in Poland or other EEA countries.</td>
<td>Choice</td>
<td>Choice</td>
</tr>
<tr>
<td>3. Entities that are part of a group where the parent prepares consolidated financial statements for statutory purposes in accordance with IFRS as adopted by the EU.</td>
<td>Choice</td>
<td>Choice</td>
</tr>
<tr>
<td>4. Branches of foreign entrepreneurs</td>
<td>Choice</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Major accounting issues center around:

- Asset recognition and measurement (full cost method and successful efforts method)
- Impairment of assets
- Accounting for different types of joint operation agreements (initial buy-in payment, participation in costs or revenues in different phases of the project)

**Accounting issues**

There are no specific regulations in PAR that directly relate to the oil and gas industry. As those upstream activities were not very common in Poland until recently, the existing accounting practice that could be relied on is also very limited. However, some practice in accounting may be observed.

With respect to the exploration and evaluation phase (E&E):

- There is common practice within entities directly involved in E&E activities to account for such activities as “construction in progress” under non-current assets.

Recognition of E&E expenditures under intangibles is limited due to the definition of intangibles under PAR that permits only property rights to be accounted for as intangibles.

The definition of property, plant and equipment under PAR is quite strict and states that these should be tangible non-current assets and their equivalents, with expected useful lives exceeding one year, that are complete, usable, and intended for the entity’s own use. It is debatable whether the farmee’s asset that represents the underlying (partially) undeveloped interest acquired at cost meets the definition of property, plant and equipment.

Another approach would be to present E&E expenditures as non-current prepayments. This is possible due to the fact that the definition of assets in PAR is similar to the one in the IFRS framework and, therefore, if a given expenditure meets the capitalization criteria provided in IFRS, it may generally be recognized as an asset under PAR, unless this is specifically prohibited by PAR.

It may, however, be argued that only the successful efforts method is allowable under PAR, as there is no specific guidance for recognizing impairment of E&E assets.

PAR generally do not permit capitalization of administrative expenses or other general overheads in the cost of an asset.

Capitalization of borrowing costs may also be an issue: their accounting treatment depends on the classification of an E&E asset. Classification of E&E assets as prepayments would prevent capitalization of borrowing costs, whereas classification under property, plant and equipment theoretically permits capitalization of funds borrowed specifically for the E&E asset. The ability or requirement to capitalize borrowing costs may depend on the specific facts and circumstances and needs to be analyzed case by case.

If there is a legal requirement to restore the land after the E&E phase, a provision for the costs of restoration needs to be recognized during the E&E phase at the amount of the expected costs.

Accounting for upstream expenditures after the E&E phase depends on the choice of the accounting policy in the E&E phase i.e. the entity either transfers the items previously recognized under prepayments to property, plant and equipment or continues to recognize them under prepayments. Both property, plant and equipment and prepayments are subsequently depreciated or amortized. If there is a legal requirement to restore the land after the development or extraction phase, a provision for the costs of restoration should be recognized at the amount of the expected costs.

**Unresolved issues**

As presented above, the existing accounting guidance and practice are very limited; they do not provide any clear accounting guidance or solutions for the issues discussed above.

Various accounting approaches may be applied to account for different types of joint operations agreements.

On the other hand, accounting for certain transactions may not allow for a choice of accounting policy.

Therefore, careful analysis of the planned structure of the joint operation and of the related agreement is required in order to avoid any unexpected accounting implications.
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