



ASSOCIATION OF EUROPEAN BUSINESSES
IN THE RUSSIAN FEDERATION

Presentation of the AEB guide “How to invest in Russia 2011”

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Investing in Russia? What to know before you go

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Types of presence in Russia

- There are two main alternatives for setting up a business presence in Russia, namely:
 - Russian legal entity (RLE),
 - Subdivision of a foreign legal entity (FLE).
- RLEs most commonly take the forms of closed and open joint-stock companies (CJSCs and OJSCs, respectively) and limited liability companies (LLCs):
 - Joint-stock companies (especially OJSCs) are subject to more extensive corporate regulation, so they are used when numerous shareholders are involved (e.g. in a case of a Joint Venture).
 - A form of an LLC is quite commonly used for setting up 100% subsidiaries. It generally implies simpler corporate regulation and procedures as compared to joint-stock companies.

Types of presence in Russia (cont'd)

- All types of RLE are treated as “regular” corporate taxpayers (i.e. subject to 20% profits tax).
- Subdivisions of FLEs may be created in a form of a branch or a representative office. Both will be viewed as an extension of the head office (not as a separate legal entity).
- Taxation of Branches with the status of a permanent establishment is quite similar to taxation of RLE, however, repatriation of profit from Branch to Head Office is made without restrictions.
- Partnership concept, although it is strictly speaking available, is not widely used.

Representative office of a foreign company

- Initial form of the Russian market access
- Mechanism of establishing relations, marketing, product promotion and advertising activities, import contracts support
- “Eyes and ears” of head office
- Formal limitation of representative office functions
- Taxable (PE) and non-taxable representative office (Russian legislation and international treaties)

Russian legal entity

- Expansion of operations (including geography of operations)
- Demand for production/co-manufacturing on the territory of the Russian Federation
- Licensing requirements
- Own imports
- Response to market needs: customers demand (rapid access, sales to statutory institutions), own distribution channels, tenders
- Flexibility – no functional restrictions
- Possibility of tax savings (VAT offset) or application of local tax benefits
- Tax risks associated with work via a representative office

Representative office (non-taxable) or Russian legal entity?

	Representative office	Russian company
Establishment (registration) and closure	easier	more complicated
Possibility of commercial activity	limited	not limited
Tax payment	some taxes	all taxes
Tax deduction of expenses in RF	n/a	permitted (+ restrictions)
Offset of VAT on expenses	impossible	possible (+ restrictions)
VAT on lease of premises	none (+conditions)	yes (+offset)
Tax accounting and reporting	limited	full-scale
Financing	simple	more complicated

Tax environment - overview

- Relatively new set of rules – still in state of development.
- In general built upon a typical Western European corporate taxation system: with corporate profits tax and VAT at the core.
- Moving from simplistic approaches to embracing with more advanced concepts (transfer pricing, place of management, CFC, tax consolidation, anti-avoidance mechanisms).
- Form over substance approach dominates, but more substantive approach emerges in anti-avoidance practice.
- Tax administration still one of the biggest issues and concerns.

Basics of Russian taxation

- Currently no tax consolidation, but tax consolidation rules are in development, the draft law is proposed for consideration (but only for profits tax purposes and with very high thresholds).
- Participation exemption is available and applied to dividends (not to capital gains) received at the level of a Russian holding company in case it owns not less than 50% of shares for the period of not less than 365 days (1 year).
- Thin cap rules apply to loans from **foreign** parents (owning > than 20%), their Russian affiliates or loans guaranteed by foreign parents or their Russian affiliates. Currently do not apply to sister company loans. Thin cap ratio is set as 3:1 for trading companies.

Basics of Russian taxation (cont'd)

- Controlled foreign company (CFC) legislation is not developed yet. New “tax residency” and CFC rules are announced as a trend of development of Russian taxation system.
- Limited possibilities to deduct goodwill in Russia.
- Transfer pricing rules exist, however are not well-developed:
 - neither transactional net margin method, nor profit split method exist under the current legislation;
 - transfer pricing rules are expected to be significantly amended as of 1 January 2012 and brought more in line with OECD principles.

Treaty network

- Large double tax treaty (DTT) network
 - 78 effective tax treaties
 - most tax treaties follow the OECD model
- Russia has an observer status with the OECD and provides comments to the model treaty, however OECD Model Convention guidelines are not binding
- Some treaties include protocols dealing with specific matters which are ordinarily outside the scope of a tax treaty (legacy of the restrictive domestic law):
 - special clauses on “no limitation for tax deductibility of interest” in certain tax treaties (e.g., France, Germany);
 - special clauses allowing full deduction of advertising expenses in German tax treaty;
 - special clauses allowing full deduction of business expenses in French tax treaty

Thank you and good luck!

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Foreign Investments in strategic sectors in Russia

Alex Stoljarskij

Presentation of the AEB Guide

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Improving the investment climate

- The President of the RF announced different measures to improve the slowly recovering investment climate, e.g.
 - Privatization of state owned companies
 - establishment of a special sovereign fund by June 1
 - Reform of Law on Foreign Investments in strategic sectors (SSL) by May 15. First reading passed already.
- AEB involved in the legislative process of the SSL reform and invited to participate in the Duma Working Group

SSL – premises, objectives, relevance

Three premises:

1. **Foreign investor** (or group of entities)
2. intend(s) to establish **control** over a
3. Russian enterprise conducting a **strategic important activity**

Objectives:

- ensure national defense and security
- create clear and transparent legal conditions for foreign investors

Relevance:

- SSL almost three years in force, since then
 - close to 200 petitions,
 - more than 400 notices,
 - approx. 60 preliminary requests and
 - about 250 enquiries were filed.

SSL – thresholds

	Foreign private investor	Foreign state investor
General strategic enterprise	Authorization-based procedure when acquiring over 50% (and under certain conditions less than 50%)	Authorization-based procedure when acquiring over 25%; acquisition of a majority stake is prohibited
Enterprise performing field development of mineral resources Reform:	Authorization-based procedure at planned acquisition of stakes in the amount of 10% and more (exception: RF owns over 50%) Intended increase of the stake to 25%	Authorization-based procedure when acquiring over 5%; acquisition of a majority stake is prohibited Not clear yet whether increase of stake intended
General enterprise (not in a strategic sector)	No restrictions under the SSL	Authorization-based procedure when acquiring 25% and more (amendment of the law on foreign investments)

SSL – problems observed

- Vast majority of relevant sectors are subsoil of federal significance, followed by encryption, natural monopolies and mass media
- Some sectors not of any relevance yet
- Unintended application of the SSL in certain sectors (e.g. use of radioactivity in health care sector or activities using agents of infections in dairy facilities)
- Definition of “group of entities”
- Imprecisely defined understanding of “control”
- Time frame does often not correspond with business reality needs
- Legal power of decisions taken by FAS

SSL – amendments

- Banking being exempt from cryptographic activities
- Use of bacteria classified as fairly safe and application of equipment with insignificant radioactive emissions being removed from the strategic activities list
- No additional approval required to increase the charter capital of strategically important enterprises which use subsoil of federal importance, if the increase does not result in an increase in the total number of votes of the foreign investor
- Ministry of Defense instead of FSB now determining whether threat to national defense and security exists
- Time frame for approval process begins only after submission of complete set of documents
- Foreign investor may apply for extension of deadline to conclude agreement on obligations imposed on him

SSL amendments - evaluation

- Proposed changes are not conceptual, rather technical adjustments
- Provide for some clarity within the administrative process
- No real simplifications for foreign investors, codification of status quo
- Not THE positive signal to foreign investors
- Lot of issues remain to be improved:
 - definition of “group of entities” within the SSL,
 - definition of “control”,
 - reduce amount of (classified) information to be provided,
 - introduce more flexible sanctions,
 - shorten the approval procedure,
 - Effective judicial review

SSL – AEB initiatives

- Clear definition of sectors, deletion of non-important types of activities or types of activities unintended included in SSL
- Clarification that the SSL only applies if a foreign person or entity within a “group of entities” acquires direct or indirect control of the strategic target
- Elimination of contradictions to the Law on Joint Stock companies (non-fulfillment of mandatory offers)
- Introduction of a faster clearing procedure
- Introduction of a “de-minimis rule” (a threshold below which control is not obtained),
- Possible retroactivity regarding deals concluded by Russian companies having a foreign entity (subsidiary) in their “group of entities” between May 2008 until today without receipt of prior approval by the Russian Government.

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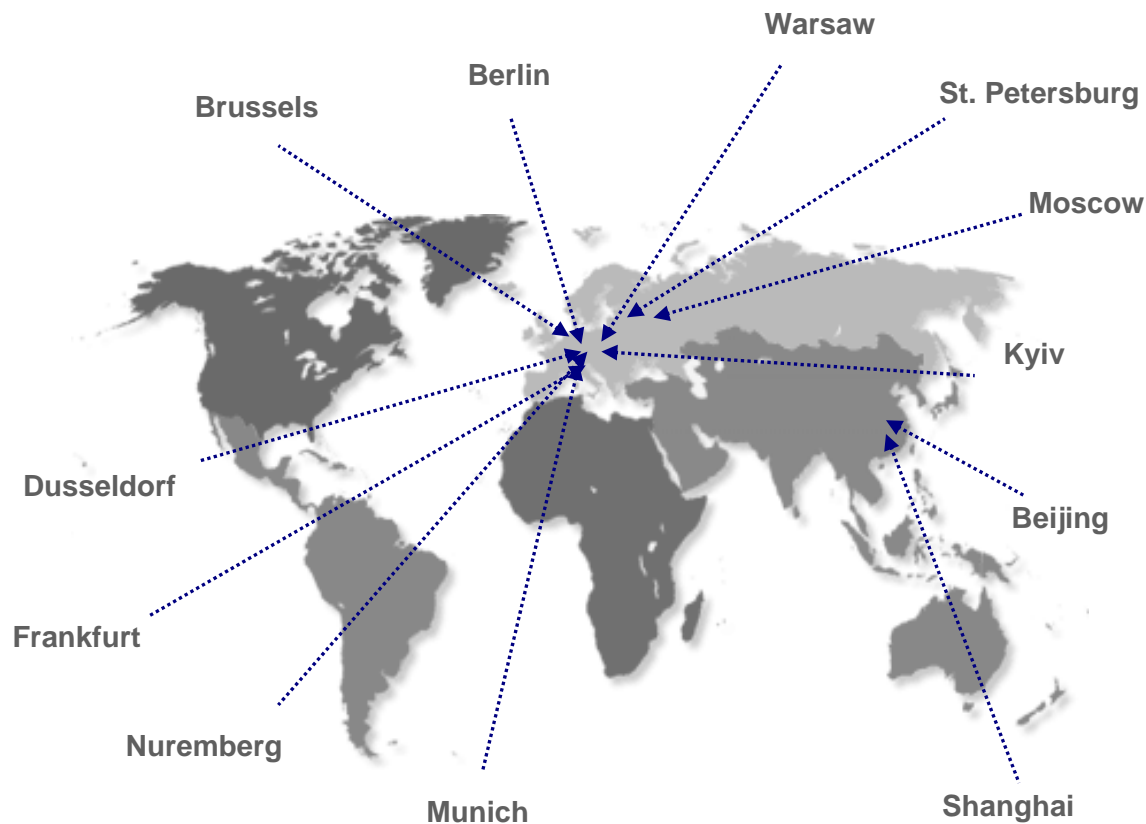
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- More than 310 lawyers and tax advisors in offices in Berlin, Brussels, Düsseldorf, Frankfurt, Kyiv, Moscow, Munich, Nuremberg, Beijing, Shanghai, St. Petersburg, Warsaw
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- Specialists in respective fields of law work in practice groups and contribute their know-how for the firm to render the best possible consultancy services
- The vast practical experience and the knowledge of other branches of law ensure precise understanding of our clients' expectations and mentality
- Three working languages – German, Russian, English and an experienced translation team

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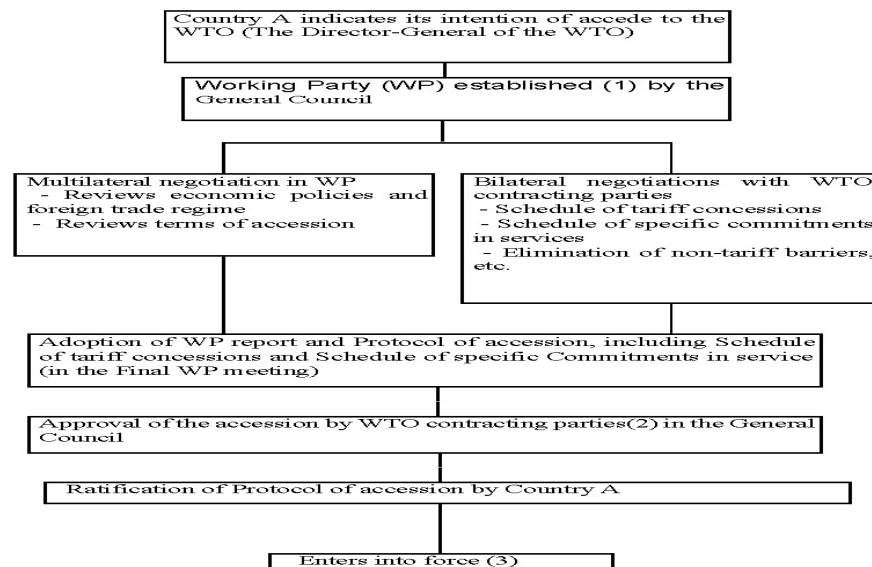
Thank you for your attention!

WTO and the Customs Union and their effect on the Russian Economy



ART FRANCK, President The American
Institute of Business and Economics

WTO ACCESSION PROCESS



(1) WP reviews economic policies and foreign trade regime (including tariff system) of country A, then creates protocol of accession, which prescribes the country's terms of accession.

(2) Decision on accession is taken by the Ministerial Conference according to the Agreement of Establishing the WTO. General Council acts for the Ministerial Conference in the intervals between meetings of the Ministerial Conference. Approval is made by consensus. If consensus is not reached at the meeting of the Council, it shall be decided by a two-thirds majority of voting the members.

(3) Normally, Accession enters into effect on the 30th day after acceptance of the protocol by the applicant country (noted in the protocol).

Part III Chapter 2 Accession of Russia

[Example] Mongolia

October 1991: Indicated its intention to accede to GATT
October 1991: General Council decided to establish WP

WP June 1993
February 1994
May 1994
November 1994
June 1996

Bilateral negotiations held with the US, EU, Japan, etc. during this time

Adoption of WP report and Protocol of accession in the final WP meeting

July 1996: General Council
- Adopted WP report, Protocol of accession and Decision on accession
- Approved Mongol's accession to the WTO

December 1996: Protocol of accession was ratified by Mongolia.

January 1997: Mongolia acceded to the WTO

Tariffs example

Some Estimates of the Impact of Accession

In a 2004 modeling exercise aimed at estimating sectoral effects of accession, Jesper Jensen, Thomas F. Rutherford, and David Tarr projected patterns of medium-term sectoral gains and losses that are of interest.⁵ They postulated 50% tariff cuts (more than are likely; see **Table 1**), as well as reductions in the use of anti-dumping measures against some Russian exports. By their estimation, the tariff cuts will boost imports, cutting balance of trade surpluses and leading to some depreciation of the real exchange rate; that in turn will differentially assist export volume growth according to the competitiveness of each sector. One result is that sectors that already have relatively high ratios of exports to output will experience positive effects on output. This is chiefly the case for ferrous metals, non-ferrous metals, and chemicals but also, in a more limited way, for oil extraction, oil processing, gas, and coal. Some losers will be food processing, mechanical engineering, textiles and clothing, and building materials. These sectoral effects were projected against a background of a modest aggregate positive effect on GDP (+3.3% in the medium term).

TABLE 1 Weighted-Average Tariff Rates for Commodity Groups, Manufacturing Sector (Weights Based on Import Data for 2000)

Commodity group	Actual, Jan. 2001	Initial binding	Final binding
Chemicals	8.48	10.22	6.09
Timber, paper, and pulp	8.73	14.62	7.85
Textiles and footwear	11.69	18.31	12.37
Precious stones and precious metals	20.00	25.00	20.00
Metals and metal products	11.35	19.29	11.70
Machinery and equipment	9.48	14.83	8.75
Gypsum, glass, and ceramics	15.51	20.18	14.39
Leather and fur products	14.94	21.13	13.25
Other	18.04	20.20	16.43

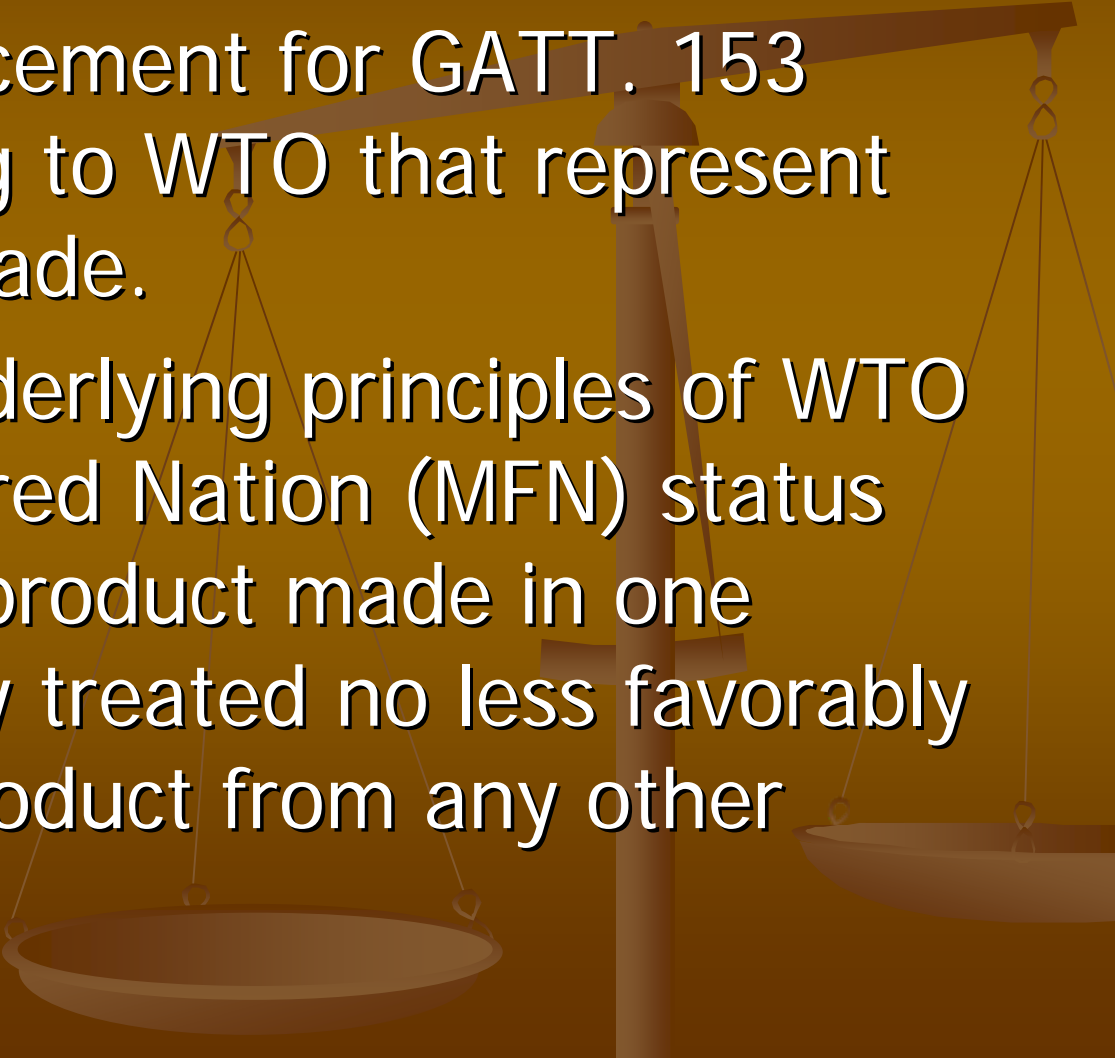
NOTE: Initial binding is the maximum average rate to which the country commits itself at the time of entry to the WTO; final binding is the maximum average rate to which the country will be committed after a six- to eight-year implementation period.

SOURCE: Jesper Jensen, Thomas F. Rutherford, and David Tarr, "Economy-wide and Sectoral Effects of Russia's Accession to the WTO," World Bank Policy Research Working Paper, no. WPS 4015, 2004, http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000090341_20060921134111.

In the domestic debate, claims are frequently made about large-scale job losses following early accession to the WTO. These are probably exaggerated. The Centre for Economic and Financial Research (CEFIR), a Moscow think-tank, calculated in 2002 that a 1% cut in all tariffs on imported manufactures would create employment problems in only two to four regions.⁶

⁵ Jesper Jensen, Thomas F. Rutherford, and David Tarr, "Economy-wide and Sectoral Effects of Russia's Accession to the WTO," World Bank Policy Research Working Paper, no. WPS 4015, 2004, http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000090341_20060921134111.

⁶ Akhmed Akhmedov et al., "Russia's Accession to the WTO and the Consequences for the Labor Market," CEFIR, 2002, <http://www.cefir.ru/>.

- 
- The World Trade Organization establishes a framework for trade policies for its member countries. It was established in 1995 as a replacement for GATT. 153 countries belong to WTO that represent 93% of world trade.
 - Some of the underlying principles of WTO are : Most Favored Nation (MFN) status that requires a product made in one member country treated no less favorably than a “like ” product from any other country.

- WTO provides a mechanism for binding dispute resolution. Some recent disputes between the EU and US are :
 - EU's ban on hormone treated beef from the US
 - EU's ban on bananas from South America
 - High tariffs by the US on Steel imports
 - Subsidies for BOEING



- Russia applied to GATT(WTO predecessor) in 1993.
- Since the Russia has adopted many reforms such as a New Customs Code and many tariff reductions .
- Russia came close to joining WTO in 2006.
- It looks like Russia may join WTO in 2011



Benefits to Russia

- The World Bank estimates that Russia's GDP will increase 3.3% in the medium term and 11% in the long term.
- Minimize discrimination against Russian producers on World markets.
- Access to WTO dispute resolution
- Improve climate for FDI
- Increase competitive pressures on domestic producers to be efficient and innovative . Average tariffs will decrease from 10.1 % to 7.1%

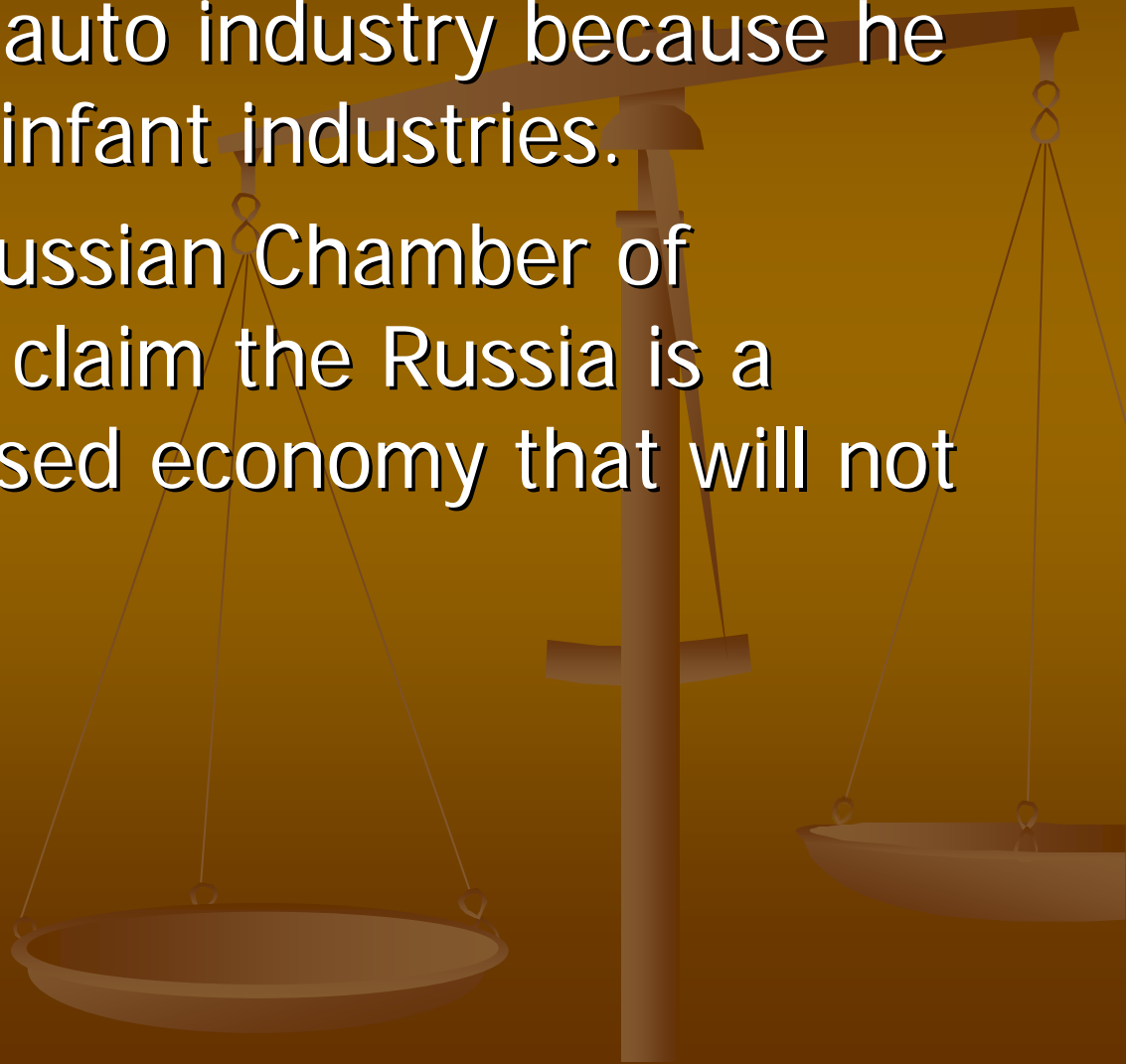
Some Industry Sectors that benefit from WTO accession

- Autos
- Aviation
- Chemicals
- Banking
- Insurance
- Telecommunications



Resistance to WTO

- Derispaska and auto industry because he claims they are infant industries.
- Primakov and Russian Chamber of Commerce who claim the Russia is a commodities based economy that will not benefit .



Issues Russia needs to resolve to join WTO

- Sanitary and Phytosanitary issues ie pork and chicken
- Enforcement of Intellectual Property Rights
- State owned Industries
- Protectionist Tariffs
- Jackson Vanick



EurAsEC integration development



Belarus



Kazakhstan



Kyrgyzstan



Russia



Tajikistan

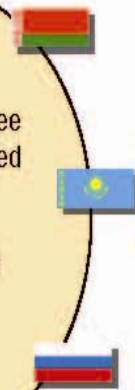
Free trade regime

- abolition of customs duties and other restrictive measures concerning goods originating from the territory of the member-states of the Customs Union



Customs Union

- Establishing of Single Customs territory on which free movement is provided for goods either originating from its territory or imported from the third countries that have entered into free circulation



When all the formalities are completed



Common economic space

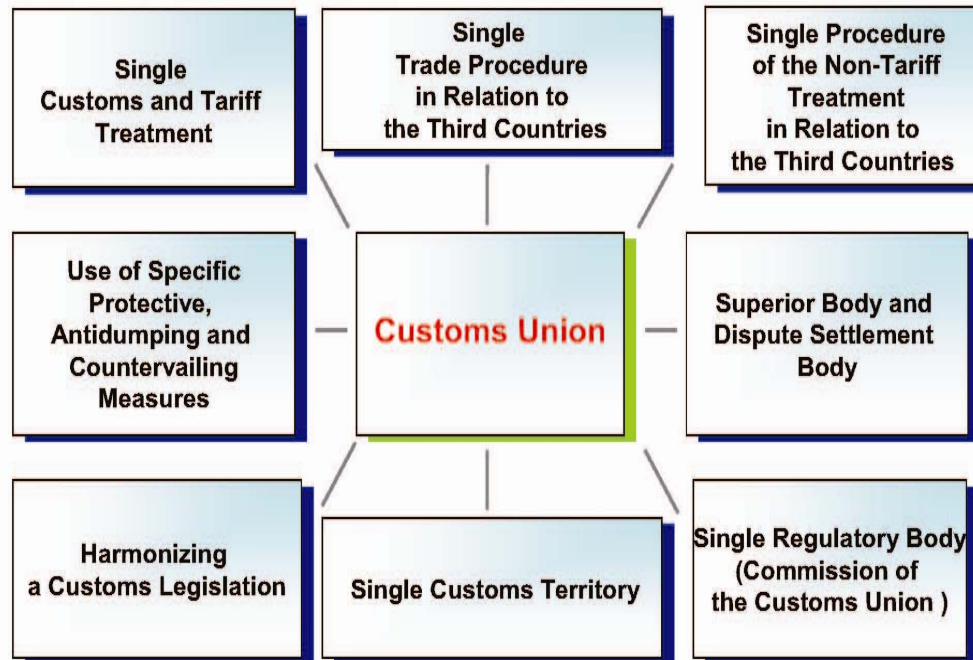
- Free movement of:
- goods
 - services
 - capital
 - labor



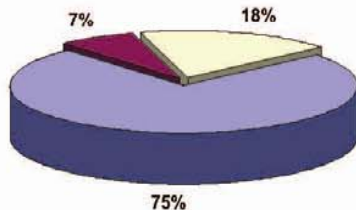
When all the formalities are completed



The Basic Components of the Customs Union



Common Customs Tariff



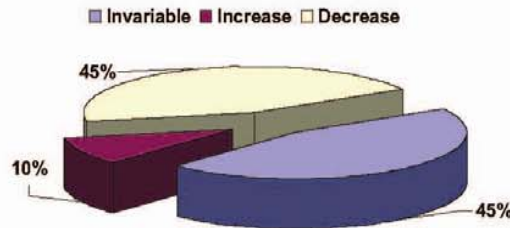
For Belarus

Increase:

- ▶ certain meat products
- ▶ finished preserved meat products
- ▶ certain positions for metals
- ▶ motor cars

Decrease:

- ▶ articles of apparel
- ▶ carpets
- ▶ footwear of leather and textile
- ▶ machinery and mechanical appliances
- ▶ pharmaceutical substances



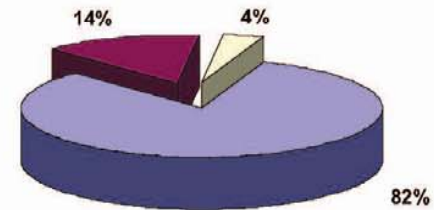
For Kazakhstan

Increase:

- ▶ group for means of transport (including vehicles)
- ▶ Wood
- ▶ refrigerating equipment
- ▶ pharmaceutical preparations
- ▶ electro-mechanical domestic appliances
- ▶ footwear and the articles of apparel

Decrease:

- ▶ several agricultural products
- ▶ hides and skins
- ▶ optical medical or surgical instruments and appliances



For Russia

Increase:

- ▶ certain meat products
- ▶ finished preserved meat products
- ▶ yeast
- ▶ certain articles of apparel and clothing accessories

Decrease:

- ▶ exotic fruit concentrates
- ▶ infant food
- ▶ materials for photography
- ▶ wool and fabrics
- ▶ pharmaceutical substances
- ▶ parts of footwear
- ▶ electro-mechanical appliances

Provisions of the customs legislation aimed at improving foreign economic activity

7

Customs Code of the Customs Union

- common conditions for customs transit
- mutual recognition of measures for ensuring payment of customs duties
- introduction of the institution of the authorised economic operator
- reduction of the list of documents for exports (from 14 down to 7)
- reduction of deadlines for release of goods for exports from 2 days to 4 hours
- differentiated size of guarantee payment for production and non-production authorised economic operators
- Possibility to apply the customs procedure of temporary import for scientific and commercial samples

Federal Law «On customs regulation in the Russian Federation»

- exhaustive list of cases for the extension of deadlines of goods release
- simplified procedures in exports
- direct regulation of application of special simplifications by the Law norms
- simplified procedure for international exchange of scientific and commercial samples
- no guarantee payment for customs duty payments when importing technological equipment
- exhaustive regulation by the Law of the procedure of institutional appeal
- transitional provisions allowing “to smooth” as much as possible the introduction of new rules

Possible risks in conducting foreign economic activity⁸ in the conditions of the Customs Union

Lack of detailed clarifications on the application of the new customs legislations on the spot



Change of rights and obligations of persons involved in the customs sphere

Tuning of information and administrative interaction between customs services of Belarus, Kazakhstan and Russia

- Bringing information to the knowledge of officials of local authorities
- «Hot lines» of federal executive bodies
- Information placed on internet sites of power bodies and on-line consultations
- Dissemination of information and documents to participants of foreign economic activity

“crossing the river by feeling for
the stones.” (摸着石头过河)

