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Doing business in Russia 2009

Tax & Legal

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Russia remains a country with huge potential for foreign investors. Virtually every sector of the economy, whether State or privately controlled, requires massive investment, and with abundant natural resources, Russia has the means to pay. The last ten years have also raised the expectations of the Russian people, and the market for consumer products and services has a long way yet to expand.

Introduction

The global economic crisis which took hold in the last six months of 2008 has had a significant impact in Russia. With stock market investor confidence already hit by the war in Georgia, falling commodity prices and Russia's structural economic weaknesses soon underpinned a more profound drop in the stock market, the ruble and industrial production.

What does this mean for Russia in 2009? Many will recall the financial crisis of 1998, when a Russian Government debt default led to a sudden ruble devaluation, and it is tempting, but misplaced, to draw parallels with today's situation. One of the market responses ten years ago was the revival of parts of Russian industry (since imported goods

became prohibitively expensive) followed by a surge of foreign investment in local production to regain market share. Might this be repeated, or are other dynamics now in play?

To be sure, the crisis – and Russia – of today are far removed from 1998. The devaluation has been gradual and at the time of writing, although local sourcing is gathering pace, consumer buying patterns do not appear to have altered significantly. Russia is much more closely integrated with the global economy than ten years ago, and a revival of global commerce will certainly help Russia's recovery, but the driving factor will be oil and other commodity prices.

Clearly Russia must compete with other emerging markets to attract foreign investors, and the relatively low level of investment in infrastructure, the slow process of removing barriers to doing business and continuing concerns over the rule of law, remain issues for new investors. There are encouraging signs already that the global crisis will provoke faster action on these types of issues.

Nevertheless, opportunities abound, and some are unique in scale to Russia. Many businesses are heavily indebted with foreign currency obligations; "distressed" assets and even entire business empires can be targeted. Growing consumer price and quality sensitivities have increased the demand for "value" concepts and brands. The Government is providing funds for significant infrastructure investment and there is a new resolve to diversify the economy – which will inevitably involve foreign know-how and equipment. The list does not end there.

Such are the headlines. Let us now look at some of the specific issues expected to influence the investment climate for the rest of 2009.

Taxation

The main profit tax rate – at 20% – is now one of the lowest amongst the major economies, with further incentives being introduced to attract investment into selected key industries. Many large capital investment projects are likely to benefit from changes to the import VAT rules. The tax administration environment continues to improve. Tax reform is back on the agenda, with measures to simplify the regime, reduce the tax burden and promote small business activity being debated. Tax consolidation, however, is no nearer to being realized.

Strategic industries

The law requiring Russian Government approval for controlling investments in "strategic" industries came into force during 2008, bringing certainty at last. Unfortunately, "national security" has been given a wide meaning, with media and aviation activity amongst the 42 designated sectors. Few investments above the control threshold have so far been approved. "Control" in the context of subsoil companies means 10% or more, which could well curb the use of foreign technology for exploration at a time when capital investment plans are already curtailed.

Finance & investment

The Russian Government has been fully supportive of the banking system during the economic crisis and no major bank seems likely to fail. The question is whether the much needed general reform of the banking sector will now be pursued. Corporate governance standards and corporate transparency have continued to improve, but mainly in the context of public offerings – which have now all but ceased – and investors in private companies must exercise caution.

Legal framework

There have been encouraging developments in a number of areas – measures to discourage corruption, protect intellectual property, simplify company law and to encourage "Public-Private Partnership" projects. The impartiality of the judiciary remains an open question, although the vast majority of tax litigation, at least, turns out in favor of the taxpayer.

Expatriate staff

The authorities' handling of immigration and work permit issues continues to be susceptible to the political climate and – in the case of guest workers from the CIS, growing job protectionism. However, well aware of its declining population and "brain drain", generous quotas for foreign specialists seem likely to remain.

WTO

Membership remains a target, but not an urgent one. The Russian Government has, in line with other countries, undertaken not to resort to protectionist measures during the economic crisis, but selective measures have already been applied.

Russia remains a country with huge potential for foreign investors. Virtually every sector of the economy, whether State or privately controlled, requires massive investment, and with abundant natural resources, Russia has the means to pay. The last ten years have also raised the expectations of the Russian people, and the market for consumer products and services has a long way yet to expand.

The challenge for the foreign investor is to determine whether the price of the "entry ticket" to Russia has come down far enough to outweigh the risks. The challenge for the Russian Government is to use this opportunity to push through the reforms necessary to significantly reduce those same risks. For both parties, the challenges promise a real opportunity that should not be missed.

The following overview of taxes and related legislation is based on the law in effect on 1 January 2009.

The US dollar equivalent of ruble amounts is based on the exchange rate on 1 March 2009, approximated to RUB 35 : USD 1.

Types of business presence

Russian legislation provides for different types of business presence of foreign companies in Russia. These are:

- Branches and representative offices
- Legal entities
- Joint Activity Agreements, also known as Simple Partnerships

This chapter includes a brief description of each of these forms.

General requirement for tax registration

Apart from the civil registration process described below for branches and representative offices of foreign legal entities (FLE), an FLE is also obliged to register with the tax authorities if it conducts, or intends to conduct, activities in Russia for a period exceeding 30 days in a year. Please refer to the chapter entitled "Taxation of foreign presences" for further details.

Branches and representative offices

According to the Russian Civil Code, both branches and representative offices are referred to as subdivisions of an FLE which are located at a place other than the head office of the legal entity. Branches and representative offices may be allotted property by the legal entity that has created them and act on the basis of regulations approved by that legal entity. The difference between a branch and a representative office lies in the nature of the activities they are entitled to perform.
A representative office can only represent the interests of the legal entity and thus normally limit their activities to those of a non-commercial nature, such as marketing or information gathering. A branch, in contrast, can perform all or part of the legal entity's functions, including (but not limited to) representation.

Because of the wide scope of their powers, branches are considered to engage in commercial activity for taxation purposes and are hence subject to profit tax. The limited scope of activities of representative offices would not normally expose them to profit tax, but some offices do in fact engage in commercial activity, including the negotiation and signing of contracts. In such cases, the office would become liable to profit tax in the same way as a branch.

Registration process

It is a legal requirement that representative offices and branches are accredited by an appropriate government organization. In the case of branches, this organization is the State Registration Chamber of the Russian Ministry of Justice. For representative offices, the organization may differ depending on the nature of the head office's activity, but it is typically either the State Registration Chamber of the Russian Ministry of Justice or the Russian Chamber of Commerce and Industry.

The registration process for both branches and representative offices includes the following stages:

- Accreditation and incorporation into the State Register of Accredited Foreign Representative Offices / Branches
- Registration with the tax authorities (regardless of whether the activities are taxable in nature or not)
- Registration with the State Statistics Committee
- Approval of the design of the organization's stamp
- Registration with the social funds

The entire process typically takes four to six weeks from the date the documents are submitted to the state authorities.

Legal entities

The two most common types of legal entity under Russian corporate law are joint stock companies, which may be either "open" or "closed," and limited liability companies. These are regulated by the law on joint stock companies (the JSC Law) and the law on limited liability companies (the LLC Law), respectively. Only JSCs are able to issue shares, which therefore renders them subject to Russian securities law and the regulations imposed by the Federal Service for Financial Markets (FSFM).

Neither shareholders of JSCs or participants of LLCs are liable for the obligations of the company, and bear the risk of losses only to the extent of the value of their contributions (i.e. limited liability).

However, there are situations in which a parent company may be held liable for the obligations of its subsidiary: a parent company which has the right to give directions binding on its subsidiary is jointly liable with the subsidiary for transactions concluded by the latter in following such directions. This liability exists regardless of the form of the commercial legal entity, be it LLC or JSC.

A similar concept applies in the case of the insolvency of a subsidiary, either a LLC or a JSC. If the parent company determined the subsidiary's actions, in the knowledge that this would result in its subsequent insolvency, the parent company bears the liability for the subsidiary's debts if the subsidiary's property is insufficient to cover its liabilities.

A Russian company cannot be owned 100% by another corporate entity (wherever incorporated) where that owner is itself owned 100% by another shareholder. In other words, a 100% holding company of a Russian company must have more than one shareholder or participant.

Open joint stock company – OJSC (Otkrytoe aktsyonernoye obschestvo or OAO)
An OJSC may have an unlimited number of shareholders. Subject to elaborate disclosure requirements, an OJSC is the only form of legal entity whose shares may be openly traded similar to a western "public" company. The minimum charter capital is set at RUB 100,000 (approximately USD 2,900). Additional obligations are imposed on OJSCs having more than a certain number of shareholders.

Closed joint stock company – CJSC (Zakrytoe aktsyonernoye obschestvo or ZAO)
The most common type of joint stock company, a CJSC, is limited to a maximum of 50 shareholders. There is no obligation for published accounts.

A CJSC is often the structure preferred by minority partners in a joint venture, as the JSC Law grants greater rights for minority shareholders than the LLC Law.

The main features of a CJSC are:

- Shares are only distributed among its founders or another predetermined group of persons. A CJSC may not conduct an open subscription of shares to an unlimited group of persons
- The number of shareholders cannot exceed 50. If the number of shareholders is more than 50, it should be reorganized as an OJSC within one year
- The minimum charter capital of a CJSC may not be less than RUB 10,000 (approximately USD 290)
- Shareholders enjoy pre-emption rights over any shares offered for sale by an exiting shareholder

Limited liability company (Obshchestvo s ogranichennoi otvetstvennostyu or OOO)
An LLC is the most flexible type of company with the least burdensome statutory obligations. The equity participation of the owners is determined by their capital contribution. The LLC's capital is divided into "units" which are not technically shares and fall outside the scope of the Russian securities law. LLCs are generally preferred as wholly-owned subsidiaries. Currently, one disadvantage of an LLC with minority participants is that a participant has the right to leave the company and is entitled to receive the actual value of his participation calculated by reference to the annual accounts (but see below for changes coming into effect on 1 July 2009). As a wholly-owned subsidiary, however, its simple management structure often makes an LLC the vehicle of choice for foreign investment.

The main features of a Russian LLC are:

- An LLC does not issue shares
- An LLC's participants contribute to the charter capital, although financing is also possible in the form of contributions by the participants to the company's property

- The minimum charter capital of an LLC may not be less than RUB 10,000
- Participants enjoy pre-emption rights over any participation units offered for sale by a withdrawing participant
- The number of participants may not exceed 50

On 1 July 2009, a new law aimed at improving the legal status and regulation of LLCs, along with that of their participants, comes into effect. In particular, the law provides that the sole foundation document of a company will be its Charter, thus eliminating ambiguities caused through the use of Foundation Agreements. The new law also precludes withdrawal from an LLC unless it is provided for in the Charter; stipulates the basis for transferring shares into the Charter capital and establishes the procedure disposing of such shares; and also requires the notarization of sales of a participation and the maintenance of a register of participants and their holdings.

LLCs founded before 1 July 2009 must bring their foundation documents into line with the new law no later than 1 January 2010.

Registration process

The registration procedure for legal entities comprises the following stages:

- State and tax registration
- Approval of the design of the company's stamp
- Registration with the State Statistics Committee
- Registration with the social funds

Due to the bureaucratic nature of registration, the entire process typically takes three to four weeks from the date the documents are personally submitted to the registration authorities by a duly authorized director of the founder. If that individual cannot submit the documents personally, the certificates issued by the state and tax authorities will be sent by ordinary post to the address of the new Russian company. Given the unreliability of the postal service in Russia, delivery cannot be guaranteed.

In addition, joint stock companies are required to register their share issue with the FSFM, which increases the time required for registration by one to two months.

Antimonopoly legislation

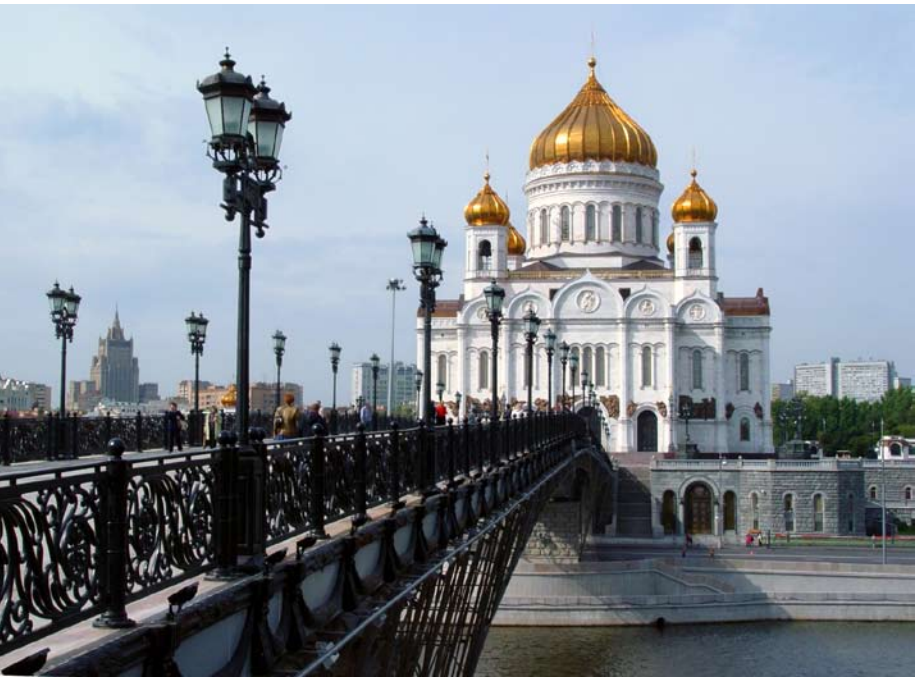
In some cases, depending on the assets or sales revenue of the founder(s), prior approval of the Federal Anti-monopoly Service may be required before a Russian company can be established. Preliminary approval by this body normally takes approximately two months.

Simple partnership or joint activity agreement (JAA)

Foreign companies are entitled to participate in a JAA with a local partner. A JAA is not itself a legal entity but represents the pooling of assets for the common conduct of business.

One of the partners is usually appointed as the party responsible for bookkeeping and statutory reporting.

Accounting environment



Overview

For historical reasons, the Russian financial reporting framework has been determined and regulated by the State, rather than being developed by professional bodies. While much of the conceptual framework and many of the underlying principles of Russian Accounting Standards (RAS) are similar to IFRS, RAS tends to be a summarized version of the corresponding IFRS standard. RAS allows for different options, but these tend to be interpreted so as to produce accounts that comply with the tax rules. In fact, the primary users of Russian statutory financial statements are the tax and other State authorities, rather than management or third parties. Thus, financial accounting is still largely driven by tax reporting requirements.

Preparation of financial statements

Every legal entity registered in Russia must prepare financial statements for each financial reporting (calendar) year ending 31 December. The format and content of the financial statements are fixed, e.g. instructions issued by the Ministry of Finance prescribe the chart of accounts along with recommended accounting entries for typical transactions. The financial statements must include a balance sheet, profit and loss account, statement of cash flows, summary of accounting policies and other supplementary accounting data.

Branches and representative offices of FLE are allowed to maintain their financial records according to the foreign country's standards, provided these do not conflict with IFRS.

There is no guidance under RAS relating to the preparation of consolidated financial statements, but these are generally only prepared for group holding companies. There is guidance requiring a parent company to prepare both separate and consolidated financial statements but it is not enforced.

Statutory financial statements must be filed with the tax authorities by 1 April following the reporting (calendar) year. Since the main purpose of financial statements has tended to be for submission to the tax authorities,

the accounting policies adopted by an entity have also tended to reflect the tax rules where such an alternative is permitted by the accounting standards or other regulations.

The financial statements of listed companies are available to the general public and such companies have additional reporting and disclosure requirements.

Audit requirements

The following types of company are required to have their annual financial statements audited by a State Licensed Auditor, i.e. an auditor holding a license issued by the Central Audit Attestation and Licensing Commission of the Ministry of Finance:

- All open joint stock companies
- Banking, insurance and investment companies
- Companies with annual revenue for the preceding financial year exceeding RUB 50 million (approximately USD 1.4 million)
- Companies with total assets as of the preceding 31 December exceeding RUB 20 million (approximately USD 570,000)

Publicly listed companies must be audited by an audit company, rather than by an individual.

Differences between RAS and IFRS

Russian legislation and regulations are very specific as to the documentation required to support a financial transaction. In practice, unlike IFRS, transactions are accounted for in accordance with their legal form, rather than their substance.

The practical application of RAS results in significant differences compared to IFRS, in particular, the following:

- Financial statements are generally prepared on a historical cost basis with only limited use of revaluations
- The fair value concept is not widely applied, except for investments in market traded securities
- Finance leases may be capitalized, but usually are not
- Assets are not normally tested for impairment (except for intangible assets)
- The useful lives of fixed assets tend to be in line with the useful lives specified for tax purposes
- The assets and liabilities of an entity which has been acquired are measured and maintained at book value as at the date of acquisition
- Goodwill on acquisition (positive and negative) is amortized over the shorter of 20 years or the life of the acquirer and is generally not subject to an annual impairment test
- Provisions (e.g. for bad debts) are generally not created
- Revenue or expenditure is only recognized after all primary documentation supporting the transaction has been received, in accordance with the tax rules
- Deferred tax is generally calculated using the income statement method, although the methodology differs
- As already noted, there is no direct requirement to prepare consolidated accounts

Harmonization of RAS with IFRS

In 2004, the Ministry of Finance of the Russian Federation issued its “Medium-term concept for the development of accounting and financial statements”. This set a target for convergence with IFRS, also requiring consolidated financials statements to be

prepared for all overseas listed companies by 2010. The banking sector already files statutory financial statements with the Central Bank of Russia (CBR) that are much closer to IFRS.

Progress towards harmonization, however, has been slow. Legislation requiring large companies to comply with IFRS has been in draft form for five years, but is currently treated as a low priority.

Accounting systems

Most companies in Russia maintain their accounting records in conformity with RAS, from which they prepare their annual statutory, RAS based financial statements. Financial records are generally maintained on local information systems, tailored to the prescribed charts of accounts and reporting formats.

An increasing number of Russian companies are now also being required to produce audited annual financial statements that comply with IFRS, US or other GAAP, in order to meet the following:

- Reporting and consolidation requirements of the foreign parent
- Reporting and listing requirements of a foreign stock exchange
- Information needs of western banks and lenders

Management reporting is generally produced in the RAS format, with quarterly or annual transformation to IFRS. Only larger companies have the in-house capabilities to perform the transformations to IFRS and this process is often outsourced to consulting firms.

Taxation of foreign presences

A foreign legal entity (FLE) which conducts activity in Russia through a "separate division", a term which includes representative offices, branches, construction sites and other places of business, for a period exceeding 30 days in a calendar year, is required to register with the Russian tax authorities within 30 days from the day of commencing activity. This is regardless of whether the activity is taxable or not. If the FLE operates in more than one location, it must register separately in each location in which it is present. Each real estate project or construction site must also be separately registered.

Although the taxation of a separate division of an FLE is similar to that of a Russian legal entity, there are a number of differences that can make this an attractive form of doing business in Russia.

Profit tax

FLEs are liable for profit tax on their business income only if their business activity creates a permanent establishment (PE). If no PE exists, foreign entities are exempt from Russian profit tax.

An FLE receiving income from a source in Russia not connected with the activity of a PE is subject to withholding tax as described in the chapter entitled “Russian-sourced income of foreign companies”. "Passive" income, such as dividends, interest and royalties are the most common types of Russian-sourcednon-business income.

The Tax Code defines the term "permanent establishment" as a branch ("filial"), representative office, division, bureau, office, agency or any other separate fixed place of activity, through which a foreign company regularly engages in business activity in Russia. The term is used exclusively for tax purposes and does not affect the legal status of an entity. The following areas of activity are expressly listed as giving rise to the creation of a PE:

- Exploration for, or extraction of, natural resources
- Construction, installation, assembly, adjustment, maintenance and operation of machinery and equipment, including gambling equipment
- Sales from warehouses owned or rented by a foreign legal entity in Russia
- Provision of services or performance of any other activity, apart from "preparatory and auxiliary" activities or activities explicitly defined as not creating a PE

A foreign legal entity may also be considered as having a PE if it conducts the activities listed above through

a dependent agent. A dependent agent represents an FLE in Russia under a contract, acts on its behalf, and has and regularly exercises the right to sign contracts on behalf of the FLE, or negotiates their significant terms.

Russian tax law specifically provides that the gathering and distribution of information, marketing, advertising, market research and the import and export of goods by a foreign company should not by themselves lead to the creation of a PE.

Russia's double tax treaties, which prevail over Russian domestic law, also include a definition of a PE. Thus, if an FLE qualifies as a resident of a country with which Russia has a tax treaty that is in force, then the definition of a PE in that treaty will prevail. A list of countries with which Russia has a double tax treaty is provided in the Appendix on pages 72-74.

Profit tax base calculation

PEs and Russian legal entities use similar rules for determining taxable profits and the calculation of taxes due. The rules on tax return filing and the maintenance of tax registers are also similar. The only major difference between a foreign entity with a PE and a Russian legal entity is the monthly advance payment of profit tax. PEs are exempt from this requirement and are thus not obliged to remit profit tax on a monthly basis.

PEs should calculate their profit tax using the direct method (i.e. gross income net of allowable deductions) to arrive at taxable income. When a foreign entity has a PE because it conducts preparatory and auxiliary activities in Russia in favor of third parties on a free-of-charge basis, the PE will be deemed to have taxable income equal to 20% of the expenses of the PE.

In addition, Russian tax law allows an FLE to allocate income and expenses to its Russian PE. In particular, where all income from activity in Russia earned through a PE is received by the head office of the FLE, the income of the Russian PE is determined by reference to the FLE's accounting policy. Moreover, in cases provided by a double tax treaty, Russian tax law also allows a deduction by the PE of overhead expenses incurred by the head office but relating to the PE, e.g. management and administrative costs, based on the FLE's accounting policy. The tax authorities may require documentary support and justification of any amounts allocated.

Russia does not impose "branch profit" tax on profit repatriated by a PE to its head office.

Property tax

The Tax Code establishes certain conditions regarding the application of property tax to FLEs which are summarized below:

- An FLE which carries out activity in Russia through a PE is liable to corporate property tax on both the movable and immovable property of the PE in accordance with the corporate property tax rules applicable to Russian legal entities (refer to chapter entitled “Property tax”)
- An FLE whose activities do not constitute a PE pays property tax only on its immovable property located in Russia. Thus, an FLE owning movable property

located in Russia that is not attributable to a PE of the FLE in Russia is not liable to corporate property tax on that movable property

- An FLE which is a resident of a treaty country can be exempt from property tax under the relevant double tax treaty provision

There are some differences in the treatment of immovable property for property tax purposes depending on whether it is owned by a foreign legal entity or a Russian legal entity. The immovable property tax base of an FLE without a PE in Russia, or which does not relate to a PE of the FLE in Russia, is determined based on the inventory value of the property rather than the average annual value.

The tax base for the year is the inventory value as on 1 January, with the quarterly advance tax payments based on one quarter of the inventory value multiplied by the applicable tax rate.

Russian-sourced income of foreign companies

As with other jurisdictions, the Russian-sourced income of a foreign entity which is not attributable to a permanent establishment (PE) may be subject to withholding tax at source. The responsibility for withholding the tax lies with the tax agent – the Russian entity or foreign legal entity (FLE) with a registered PE – which is making the payment to an FLE that does not have a Russian PE. Failure to withhold tax may lead to fines of up to 20% of the relevant amount.

Withholding tax is applied to the following types of Russian-sourced income:

- Dividends
- Income relating to distribution of profit or property, including distribution upon liquidation
- Interest on debt instruments, including profit-sharing debt and convertible bonds
- Royalties
- Income from the sale of shares of a Russian corporation if more than 50% of its assets consist of immovable property located in Russia, or from sales of financial instruments that are derived from such shares. However, income from the sale of shares or derivatives traded on foreign stock exchanges is not considered to be Russian-sourced income
- Income from sales of immovable property located in Russia
- Income from leases and sub-leases of property used in Russia (including sea and air craft)
- Income from international freight, including demurrage and other payments related to freight
- Fines and penalties due by Russian parties for breaking contractual obligations
- Other similar types of income

Income generated from the sale of goods, the performance of works and the provision of services in Russia are not subject to Russian withholding tax, provided that the activity does not lead to the creation of a Russian PE.

Withholding tax is applicable regardless of the form of payment and includes payments in kind or by means of a mutual offset of liabilities between the seller and the buyer. With respect to income from the sale of shares or immovable property, the related expenses may be deducted when determining the tax obligations of the FLE, provided that the tax agent receives documents supporting the expenses before payment is made.

The withholding tax rate varies according to the type of income, as shown in Table 1.

The issuer of securities must act as the tax agent regarding the payment of interest and dividends to an FLE, and if the issuer fails to withhold the relevant tax, responsibility lies with the broker, asset manager, nominal holder or other agent to the transaction. The broker, asset manager, etc., is also the responsible tax agent in respect of withholding tax on a capital gain derived by an FLE from the disposal of securities.

Table 1

%	
10%	Income from international freight and rental of property involved in international shipping and income from leasing and sub-leasing sea and air craft
15%	Dividends received by foreign companies from Russian legal entities, as well as interest on state and municipal bonds
20%	Royalties, interest (other than that received from state and municipal bonds), income from leasing and sub-leasing of property used in Russia, distribution of profit or property to foreign companies, including liquidation proceeds and other similar income of a FLE without a PE in Russia
20%	Profit from the sale of shares (or share derivatives) in a Russian entity, where more than 50% of the company's assets consist of immovable property located in Russia, or from the sale of immovable property located in Russia, provided that the income recipient submits documents supporting the deductibility of the expenses to the tax agent prior to his payment of the proceeds. In the absence of documentation, etc., 20% of the sale proceeds

The tax agent is not obliged to withhold tax in the following circumstances:

- The tax agent has received notification from the taxpayer that the income relates to a PE of the taxpayer in Russia, and the taxpayer has provided a notarized copy of its tax registration certificate, issued no earlier than the previous tax period
- The income is exempt from tax under a production sharing agreement
- A relevant double tax treaty provides for an exemption from withholding income tax

To claim the benefit of a double tax treaty at the time of paying the relevant Russian-sourced income, the foreign legal entity must provide written confirmation to the payer that it is a tax resident of that foreign country. The written confirmation must be provided prior to the payment date. It must also be certified by the competent foreign body and apostilled. Lastly, the Russian tax authorities may also require a legalized Russian translation of the confirmation.

If confirmation is not provided prior to payment, and the foreign company suffers a withholding rate greater than that provided by the treaty, it is possible to claim a refund within the three year period following the end of the tax period in which the payment was made. In principle, after receiving the proper documentation, the Russian tax authorities should refund any excess tax within one month of the date of the application. However, in practice this process is usually delayed significantly.

Special provisions allow banks to bypass the residence confirmation requirement for inter-bank transactions, provided that the residence of the foreign bank in a treaty jurisdiction can be confirmed by reference to a public information source.

Withholding tax rates for treaty countries

The main treaty tax rates for Russian-sourced income are shown in the Appendix on pages 72-74.

Profit tax

Taxpayers

Profit tax applies to:

- Russian legal entities
- FLE carrying out activities in Russia through a permanent establishment or receiving income from Russian sources

A Russian legal entity must be registered with the office of the tax inspectorate corresponding to the location of the company's registered address as well as at the offices corresponding to any branch or subdivision of the entity. The company is liable to pay profit tax in respect of each of these locations. Please refer to the chapters entitled "Taxation of foreign presences" and "Russian-sourced income of foreign companies" for further details about the taxation of FLE.

Tax rate

The maximum profit tax rate is 20%, comprising:

- 2%, payable to the Federal budget
- 18%, payable to the Regional budget

Regional governments have the authority to reduce their portion of profit tax by up to 4.5%. Please refer to the chapter entitled "Tax incentives" for further details.

Tax base

The tax base is defined as total income received by a taxpayer less related expenses and allowable deductions.

Income includes sales income, i.e. total proceeds from the sale of goods, works, services and property rights and non-sales income. Income received in a foreign currency must be converted into rubles using the official exchange rate set by the CBR as at the date of income recognition.

Non-sales income includes goods, works, services and property rights received free-of-charge, based on market value, except in the case of property received by a Russian company from its parent or subsidiary where the parent owns more than 50% of the subsidiary. This exemption is lost if the property (other than cash) is transferred to a third party within one year. Non-taxable income, of which the legislation provides an exhaustive list, also includes property and property rights received as a contribution to a company's charter capital, leasehold improvements made by a lessee to the lessor's property, and interest received on overpaid tax.

Deductible expenses are subdivided into sales expenses related to the core business activity of a taxpayer and non-sales expenses.

Recognition of income and expenses

There are two alternative methods for recognizing income and expenses depending on the level of income. The accruals basis must be used by taxpayers with an average income exceeding RUB 1 million (approximately USD 29,000) per quarter for the previous four quarters, while taxpayers falling short of this threshold may choose between the accruals or cash basis.

General criteria for deducting expenses

Expenses are considered deductible for profit tax purposes if they meet three general criteria: the expenses must be incurred in the course

of a taxpayer's income generating activity, be economically justifiable and supported by relevant documentation. They must not be listed as one of the specifically non-deductible expenses provided in the law. Additional deductibility criteria applying to certain types of expenses are noted below.

In practice, the tax authorities apply the general criteria very strictly, and may challenge any expense which is not directly related to the generation of income. Expenditure which indirectly benefits or promotes the growth of the business may not be considered "economically justified".

Documentary requirements are also exacting, and include both documents specified by legislation (agreement, act, invoice and VAT invoice) and other supporting materials. For overseas expenses, the documentation must be prepared in accordance with the common business practices of the country where the expenses were incurred, although this does not guarantee deductibility.

Depreciation

Depreciable property is property, both tangible and intangible, which has:

- a useful life of at least one year
- a value of no less than RUB 20,000 (approximately USD 570)

If the property does not meet these criteria, it is treated as an expense and should be included in the cost of sales. Land cannot be depreciated.

All depreciable fixed assets fall within one of ten groups described in Table 2 on page 26 and the taxpayer should determine the useful life of its fixed assets based on this classification. The useful life of an intangible asset is based on the utilization period stated in any agreement, the validity period in the case of a patent and in any other case, ten years.

Two methods of calculating the depreciation expense are available – the straight-line method or the reducing balance method. The straight-line method must be used for buildings and other structures falling within depreciation groups 8-10, while either method may be used for other fixed assets. The method chosen should be stated in the taxpayer's tax accounting policy and can be changed from the straight-line method to the reducing balance method from 1 January of the next tax year, and once every five years in the reverse case.

Under the straight-line method, the monthly depreciation is calculated as:

$$\frac{1}{\text{useful life in months}} \times \text{historic cost of the asset}$$

Under the reducing balance method, the monthly depreciation is calculated as:

Net book value of asset group x depreciation rate (%)

The net book value, on which the monthly depreciation is based, thus reduces every month. The depreciation rates for each asset group are also shown in Table 4 on page 26.

The depreciation rates are, in certain cases, adjusted by coefficients, for example:

- For leased property, up to three times the normal rate is applied
- For fixed assets which are used in a demanding environment, up to two times the normal rate is applied
- For fixed assets which are used only for scientific and technical purposes, up to three times the normal rate is applied

Taxpayers are entitled to deduct a one-time depreciation allowance of 10% (30% for asset groups 3-7) of the historic cost of fixed assets purchased or capital improvements made. The regular depreciation expense is then computed on the reduced tax base.

A depreciation charge can be deducted in calculating the profit tax liability, starting from the first day of the month following the month when an asset is put into operation.

Goodwill

Goodwill arising on the acquisition of a "property complex" – essentially a bundle of assets which have a collective purpose such as a production plant – may be recorded as an asset and written off on a straight-line basis over five years. The amount of goodwill recognized is the excess of the price paid over the net asset value of the company. If the price paid is lower than the net asset value, the buyer recognizes the difference as income at the moment the property right is registered.

Expenses subject to limitation

The following types of expense may be deducted for profit tax purposes within certain limits:

Advertising

Expenses on advertising, including in the press, on the radio and television, outdoor advertising, printing brochures and catalogues and participating in exhibitions are not subject to any limitation. Other categories of advertising expenditure may be deducted for profit tax purposes up to an amount equivalent to 1% of a taxpayer's sales revenue (net of VAT).

Entertainment

Expenses incurred on entertaining clients, hosting receptions and holding directors' board meetings are deductible up to 4% of a taxpayer's total payroll cost in the reporting period.

Insurance

Obligatory property insurance premiums are deductible within certain limits. Voluntary insurance premiums are only deductible if specifically provided in the tax legislation.

R&D

Costs for certain types of research and development are fully deductible over one year, starting from the month when the R&D activity was completed, irrespective of the result. As of 1 January 2009, 150% of the cost of some types of R&D expenditure are deductible in the period they are incurred.

When the R&D activity is performed in a Special Economic Zone, the expenditure is immediately deductible.

Interest

The general rule is that interest charged at a rate more than 20% above the average rate charged on comparable loans made in the same quarter is non-deductible. In the absence of comparable data, or at the taxpayer's request, the maximum rates are as follows:

- For ruble loans, the CBR refinancing rate at the date when the loan is advanced, multiplied by 1.1
- For foreign currency loans, 15%

However, for the period from 1 September 2008 to 31 December 2009, the multiple for ruble loans has been increased from 1.1 to 1.5, and the maximum rate for foreign currency loans increased to 22%. Interest on foreign controlled debt is further restricted – see below.

Thin capitalization

The thin capitalization rules restrict the deducibility of interest charged on "foreign controlled debt". The rules apply to loans and other advances:

- To a Russian company from a foreign entity which owns, directly or indirectly, more than 20% of the Russian company's share capital
- From a Russian company, which is an affiliate of a foreign entity, to another Russian company, where the foreign entity owns, directly or indirectly, more than 20% of the recipient's share capital
- That are guaranteed or otherwise secured by a foreign entity that owns, directly or indirectly, more than 20% of the Russian company that received the loan, or loans guaranteed or secured by a Russian affiliate of the foreign entity

The deductibility of interest is restricted to the extent that the controlled debt exceeds net assets by more than three times, or 12.5 times in the case of banks and leasing companies. Interest on excess debt is non-deductible and treated as a dividend subject to withholding tax. In the event that the taxpayer has negative net assets, the whole amount of interest accrued on the controlled debt will be non-deductible and treated as a dividend.

Reserves

A taxpayer may create certain types of reserves, including reserves for warranty repairs, repairs of fixed assets and for doubtful debts, subject to certain rules. In principle, a taxpayer may transfer the following tax-deductible amounts to a doubtful debt reserve: 50% of the invoice value for debts outstanding for between 45 and 90 days and 100% of the invoice value when that period is exceeded.

The total reserve for doubtful debts as at the end of the reporting (tax) period may not exceed 10% of revenue for the respective period. Special rules apply to banks and licensed dealers in securities.

Loss carry forward

Losses incurred by a taxpayer may be carried forward for up to ten years following the period in which the loss was incurred. Losses on certain types of activity (e.g. securities, financial instruments) are determined and carried forward separately and may in future be offset only against profit from the same activity.

Taxation of dividends

Dividends are taxed as follows:

- 9% – at source – for dividends paid by one Russian company to another Russian company (unless the 0% rate below applies). In determining the tax base, the paying company should deduct the amount of dividends received in the same and preceding tax periods
- 15% – at source – for dividends paid by Russian companies to foreign companies
- 9% for dividends paid by foreign companies to Russian companies (unless the 0% rate below applies). Where a double tax treaty applies, a credit for any withholding tax suffered can be claimed against this liability
- 0% for dividends paid by either a Russian or foreign company to a Russian company, provided that the Russian company has owned no less then 50% of the company for at least 365 consecutive days and the shares cost at least RUB 500 million (approximately USD 14 million). Dividends from foreign companies registered in certain "low tax" jurisdictions are excluded from this rule

Tax administration

The tax period for profit tax is a calendar year. The annual profit tax return is due by 28 March of the following year.

Taxpayers may choose to pay tax either on a monthly or a quarterly basis, provided it is applied consistently throughout the tax year. If the monthly basis applies, the tax declaration must be filed and the tax paid by the 28th day of the following month. If the quarterly basis applies, monthly payments are made based on one third of the previous quarter's liability, while a tax declaration must be filed, and the balance of taxes paid, by the 28th day of the calendar month following the reporting quarter.

In each case, the cumulative profits and payments to date are taken into account when filing each monthly or quarterly return and making the appropriate tax payment.

Certain types of taxpayer, including foreign companies, using the quarterly basis are exempted from the obligation to make monthly payments.

Tax agents paying income to foreign companies must withhold tax each time the income is paid. The tax must be remitted to the budget within three days of the payment date. Tax withheld on dividends must be remitted to the budget within ten days of the payment date.

Table 2

Depreciation group	Useful life (years)	Types of fixed assets	Monthly depreciation rate for the reducing balance method %
1	1 – 2	Metal-working and wood-working tools / machines; oil & gas production equipment; construction hand tools; etc.	14.3
2	2 – 3	Drilling machines; construction power tools; medical tools; perennial plants; etc.	8.8
3	3 – 5	Elevators; forestry tractors; automobiles; computers and peripheral equipment; office machinery; etc.	5.6
4	5 – 7	Office furniture; television equipment; clocks; light trucks (less than 0.5 tons capacity); certain non-residential real estate; etc.	3.8
5	7 – 10	Oil / gas collecting systems; gas pipelines; fiber-optic communication systems; musical instruments; heavy trucks (5-15 ton capacity); certain non-residential real estate; etc.	2.7
6	10 – 15	Oil wells; railway transport structures; certain residential real estate; heavy trucks (capacity over 15 tons); etc.	1.8
7	15 – 20	Bridges; ductworks; refrigerators; drill ships; certain non-residential real estate; etc.	1.3
8	20 – 25	Blast furnaces; wharves; river and lake passenger vessels; certain non-residential real estate; etc.	N / A
9	25 – 30	Runways; nuclear reactors; oil & gas tanks; certain non-residential real estate; etc.	N / A
10	> 30	Escalators; forest shelter belts; subway cars; certain residential and non-residential real estate; etc.	N / A

Tax incentives

Overview

In recent years, few tax incentives have been available in Russia, but that picture is now beginning to change. Regional authorities have the authority to reduce their regional allocation of profit tax of 18% to 13.5%, a minimum overall tax rate of 15.5%, including the Federal portion. They may also provide exemptions from property and land tax, chargeable at maximum rates of 2.2% and 1.5%, respectively. Such exemptions are normally conditional on meeting specific investment criteria in the region. Both St. Petersburg and the Leningrad Region offer incentives of this kind, but neither Moscow nor the Moscow Region have followed this lead.

Special economic zones

The legal framework for special economic zones (SEZs) governs more extensive tax concessions. The zones have a geographical boundary and are of four types: industrial, research and development, tourism and port. All are created for a period of 20 years, except for ports, which are for 49 years.

The tax benefits vary according to the type of zone. An industrial zone, for example, may provide a reduction in profit tax of up to 15.5% and exemptions from property and land tax, similar to regional incentives, but also provide accelerated depreciation, a customs free zone and a guarantee against unfavorable changes in tax law.

So far, only a few SEZs have been created, mainly in relation to research and development activity in St. Petersburg and the Moscow Region. Many others, in all parts of Russia, are currently under consideration.

In addition, there are separate legal regimes for SEZs in Kaliningrad and Magadan, where different concessions apply.

Innovation

With a view towards encouraging research and development activity, a number of profit tax and VAT concessions are available. From 1 January 2009, certain types of research and development expenditure qualify for a 150% profit tax deduction.

Software companies

Export oriented software developers may qualify for reduced Unified Social tax liabilities, as shown in Table 4 on page 48, as well as an immediate profit tax deduction on computer equipment.

Capital investment projects

The existing import customs duty and import VAT exemption for goods imported as in-kind charter capital contribution is expected to end during 2009 when a list of technological equipment (for which no equivalent is produced in Russia) qualifying for an import VAT exemption is approved by Government resolution. At the same time, the 0% customs duty rate for 900 types of technological equipment remains in force. Thus, many capital investment projects may qualify for both import VAT and customs duty exemptions without the need for a charter capital contribution.

Value added tax

Taxpayers

VAT applies to companies, (including representative offices and branches of foreign companies), entrepreneurs and any person importing goods into the Russian Federation.

Companies and entrepreneurs may apply for exemption from VAT if their aggregate revenues for three consecutive months, excluding VAT, are below RUB 2 million (approximately USD 57,000). In addition, businesses which apply certain special tax regimes, such as the simplified tax system (available only to relatively small businesses), are outside the scope of VAT unless they import goods into Russia.

Special rules for VAT calculation apply to investors and operators acting under certain production-sharing agreements (PSAs) as well as to certain suppliers to PSAs.

VAT registration

Russian legislation does not provide for separate VAT registration. Therefore, when foreign companies with a presence in Russia register with the Russian tax authorities, they register for all taxes including VAT.

Taxable supplies

VAT is charged on the majority of sales of goods, works and services supplied in Russia, including those supplied free of charge. VAT is also imposed on most imports into Russia. The transfer of property rights and certain self-supplies, such as the transfer of goods and services produced by a taxpayer for internal consumption, are also subject to VAT.

Place of supply rules

These rules are used to determine whether or not goods, works or services are supplied in Russia and are thus subject to Russian VAT.

Goods are considered to be sold in Russia if they are located in Russia and are not being transported outside the country, or are located in Russia when they are dispatched.

Services and works are generally deemed to be supplied at the place of business of the supplier unless another special treatment is applicable. In particular, special treatment applies to:

- Services related to immovable property and movable property which are deemed to be supplied where the property is located
- Cultural, sports, arts, educational or tourism services which are deemed to be supplied at the location where the services are physically carried out
- Transportation and freight services which are deemed to be supplied in Russia if the point of departure or destination is located in Russia, and if these services are supplied by Russian entities or entrepreneurs
- Leases of movable property, except for motor vehicles; provision of personnel, provided that they work at the place of business of the service buyer; consulting, legal, accounting, engineering, advertising, marketing, information-processing, research and development, and software development, modification and adaptation services, as well as the transfer of rights to intellectual property. These services are deemed to be supplied at the place of business of the buyer

The place of business is defined as the place where the company is registered. If the company does not have State registration, the place of business is the location of the company's management and executive body, the place indicated in the company's incorporation documents as its place of business, or where the company's permanent establishment is located (if the services are connected with the activity of that establishment).

If goods, works or services are deemed to be supplied outside the Russian Federation in accordance with the above rules, they are outside the scope of Russian VAT.

VAT rates

There are three different rates of VAT depending on the nature of the supply:

- The 0% rate applies, in particular, to the sale of goods exported outside of the Russian Federation, as well as to works and services directly connected with exported and imported goods (such as transportation, freight forwarding and other similar services, with the exception of the railway transportation of imported goods). A 0% rate also applies to the transport of passengers and baggage where the point of departure or destination is outside Russia. In addition, the 0% VAT rate applies to the supply of goods placed under a free customs zone regime and certain supplies related to space exploration. Taxpayers must prove that they are entitled to apply the 0% rate by collecting certain documents listed in the Tax Code. These should be submitted to the tax authorities within a specified period
- The 10% rate applies to certain foods, children's goods, medical and pharmaceutical products, and certain books and periodicals
- The 18% rate applies to all other taxable sales of goods, works and services. There are specific procedures and exceptions with respect to transactions with Belarusian vendors and customers

VAT exemptions

Activities which are exempt from VAT include:

- Lease of office space and accommodation to accredited foreign representative offices and foreign individuals
- Medical services and the sale of certain medical equipment
- Banking and insurance services
- Operations with securities and derivative financial instruments
- Interest on monetary loans
- Warranty services, including the cost of spare parts
- Gambling
- Licensing or assignment of certain intellectual property rights
- Assignment of debts arising from loan agreements
- Sale of land and residential buildings and premises or any interest in such property

The free-of-charge supply of goods for advertising purposes is exempt from VAT provided that the total acquisition or production cost does not exceed RUB 100 per unit (approximately USD 3).

The import of goods used for international cooperation in the exploration and use of outer space, as well as

under service agreements relating to space launches are also exempt from VAT.

A VAT exemption on the import of certain technological equipment (including components and spare parts) is being introduced. The exemption only applies to equipment having no equivalent produced in Russia and which is included in a list approved by the Russian Government. Until the Government resolution approving the list comes into force – expected during 2009 – the previous exemption for imports of technological equipment as a contribution to charter capital remains in force.

Revenue earned from the supply of international telecommunication services to foreign customers is not subject to VAT.

Special VAT exemptions apply to the organization and running of the 2014 Winter Olympic Games in Sochi.

Taxable base

VAT liability arises at the earlier of the following two dates:

- The date of shipment or transfer of goods, works, services and property rights
- The date of payment or partial payment for a future shipment of goods, performance of works, provision of services or transfer of property rights

No VAT applies to advances or partial payments received for either future supplies of most zero-rated goods, works and services, for future supplies of goods, works and services with a production cycle in excess of six months or for future VAT exempt supplies.

Taxpayers receiving any advances or partial payments for the future shipment of goods, works, services or transfer of property rights should calculate their VAT base twice. The first time, the calculation must be performed when the prepayments are received. The second calculation should be performed when the goods are dispatched, works performed, services rendered or property rights transferred. Thus, VAT accounted for on prepayments may subsequently be offset against the full amount of VAT due after the goods are shipped or the works, services or property rights are transferred.

On the date of the shipment of goods, performance of works, rendered services or transfer of property

rights, VAT should be applied to the full transaction cost (excluding VAT). In some cases, prices may be adjusted to market levels for tax purposes in accordance with transfer pricing rules.

Manufacturers and trading companies calculate their taxable base as the sales price of goods sold, including excise tax if applicable. For agents and entities selling on a commission basis, the taxable base is defined as the commission or fee income. For import purposes, the taxable base is determined as the customs value plus import duties and excise tax, where applicable. Construction work carried out using a company's own labor is also subject to tax based on the expenditure incurred.

In addition, various other payments are subject to VAT. These include any funds received in addition to sales revenue and related to VATable sales, as well as interest (or discounts) on promissory notes received as consideration for VATable supplies made, and interest on trade loans with rates in excess of rates set by the CBR. Certain insurance premiums are also subject to VAT.

Input tax

The VAT payable to the authorities is determined as the difference between the VAT accountable on transactions subject to VAT, including those subject to the 10% or 0% rates ("output VAT"), and the VAT incurred on purchases subject to VAT ("input VAT").

A 'credit', 'offset' or 'recovery' is thus generally obtained for input VAT incurred.

Since 1 January 2006, taxpayers have had the right to claim the offset of VAT without having paid their suppliers. Prior to that date, payment to suppliers was a mandatory condition for such a claim. Confirmation of VAT having actually been paid is required for claiming the offset of VAT paid upon import of goods into Russia, VAT accounted for by tax agents, as well as VAT on business trips and entertainment costs.

From 1 January 2009, taxpayers are entitled to claim an input credit for the amount of tax included in advance payments made to suppliers, provided that a VAT invoice is obtained from the supplier and the advance payment is contractually provided for. Inputcredit should be reversed by the customer when the right to VAT recovery on the purchases arises, or when the advance payment is returned.

VAT invoiced by contractors for capital construction and installation work may generally be offset when such work is included in accounting records, rather than when the entire construction project has been completed. VAT incurred on construction for own use may be offset in the same tax period that it is charged. The accrual on this work must be performed during every tax period.

Input VAT incurred on purchases of fixed assets can be offset only when the assets are booked in the accounts. Input VAT incurred on non-production expenses cannot generally be offset. VAT incurred on business travel, entertainment and certain advertising expenses can only be offset within set limits.

Input VAT cannot generally be offset when incurred for exempt activities, and should instead be capitalized, i.e. included as part of the cost of goods, works, services or property rights purchased. VAT incurred on purchases made in connection with the sale of goods, works and services deemed to be made outside Russia cannot be offset and must also be capitalized.

Any VAT incurred on purchases and expenses which relate to both VATable and non-VATable activities must be apportioned. Only the part which is deemed to relate to VATable activities may be offset as input VAT. That part which is deemed to relate to non-VATable activities must be capitalized.

Taxpayers must maintain separate accounting records for VATable and non-VATable operations. Failure to do so may result in the disallowance of VAT, either as an offset or as a deduction for profit tax purposes. There is no requirement for separate accounting records for periods when the total expenditure for production of non-VATable goods, works, services and property rights does not exceed 5% of the total production expenditure. Subject to the above condition, taxpayers have the right to offset the full amount of input VAT invoiced by suppliers in the relevant tax periods.

Input VAT related to zero-rated supplies should also be separately accounted for. Input VAT relating to a zero-rated supply can be claimed when the tax point for the supply occurs, i.e. generally on the last day of the tax period in which all the documents required to support the zero VAT rate have been collected.

To substantiate the claim for the recovery of export-related input VAT, exporters are generally required to collect and submit to the tax authorities the following documents: contracts, customs declarations, bank statements confirming the receipt of export proceeds and shipment documentation confirming the export of goods outside Russia.

Foreign entities that are not registered in Russia for tax purposes have the right to offset input VAT paid to their suppliers in Russia only when they have registered with the tax authorities. Tax registration usually gives rise to other tax implications, such as the risk of creating a permanent establishment for profit tax purposes.

In some cases, input VAT offset in previous periods, should be reversed partially or in full. These cases include in-kind equity contributions to charter capital and situations where previously purchased assets start to be used in the performance of non-VATable transactions.

Any excess of input VAT over output VAT should be refunded to the taxpayer from the budget. VAT refunds should only be made after the tax authorities have undertaken a 'desk audit' (please refer to the chapter entitled Tax Administration) and confirm the legitimacy of the input VAT claimed. If no violations are identified in the course of this tax audit, the excess of input VAT over output VAT should either be offset against the taxpayer's current VAT and other Federal tax liabilities or refunded in cash, following the taxpayer's written application. If the VAT offset is denied, there are

special rules and procedures for taxpayers and the tax authorities to follow to resolve the dispute.

VAT invoices

VAT invoices – "schet-facturas" – serve as the basis for the offset of input tax invoiced by suppliers. The Tax Code requires that certain specific information is shown on the schet-facturas. In particular, VAT invoices must be issued in Russian and must bear the original signatures of both the head of the company and the company's chief accountant. Electronic invoicing is not yet permitted.

Reverse charge

If foreign companies, which do not have a Russian tax registration, supply goods, works or services in Russia and these supplies are deemed to be made in Russia according to the place of supply rules, the remittance of VAT is made through a withholding mechanism. The tax-registered buyer of these goods, works and services is required to withhold VAT from the amount payable to the foreign supplier and remit the tax to the budget.

The rate of withholding is 18/118 of the gross invoice, equal to 18% of the net payment. Having withheld and paid the VAT to the authorities, a Russian buyer can then offset this VAT against its output VAT under the general rules for offsetting input VAT. In practice, this mechanism operates in a similar way to the European "reverse charge".

Commissioners and agents with a Russian tax registration that supply goods, works, services or property rights in Russia on behalf of their unregistered foreign principals should account for Russian VAT as tax agents. Russian VAT should be added by commissioners to the net value of the goods at the appropriate VAT rate and remitted to the Russian budget. Commissioners do not have the right to claim the offset of VAT paid on behalf of foreign principals.

Branches

Due to the fact that branches of Russian companies are not considered to be independent taxpayers for VAT purposes, supplies between branches are not taxable transactions, provided that the expenses incurred in making the supplies are deductible for profit tax purposes.

FLE with several offices or branches in Russia are entitled to nominate a "reporting" office or a branch to be responsible for all VAT reporting and payment obligations.

Payments and filings

The VAT reporting period is the calendar quarter. A VAT return should be submitted and, starting from the third quarter of 2008, the tax should generally be paid in three equal installments by the 20th day of each ofthe three consecutive months following the reporting quarter.

VAT withheld from payments to FLE for works or services rendered in Russia should be remitted to the budget at the same time as making these payments.

Property tax

Overview

Property tax is a regional tax, thus its application is governed by regional regulations, as well as the Tax Code.

Taxpayers

The following entities are subject to property tax:

- Russian entities
- Foreign entities which act through permanent establishments in Russia and / or own immovable property in Russia
- Separate subdivisions of Russian legal entities having separate balance sheets. Separate subdivisions are required to remit property tax to the regional budget relating to each separate subdivision

Tax base

Property tax is levied on both movable and immovable property. Property subject to tax comprises Fixed Assets and "Profitable Investments in Property" as classified under Russian Accounting Standards, and property provided for temporary use, in trust, contributed under a simple partnership (joint activity) agreement, or received under a concession agreement. Land, water and other natural resources are not subject to property tax.

The tax base is the average annual residual value of taxable property (i.e. cost less depreciation), calculated in accordance with Russian accounting principles. The average annual value is calculated by taking the sum of the residual values of the related property on the first day of each month of the tax period and the last day of the tax period divided by the number of months in the tax period plus one.

For details on how property tax applies to FLE, please refer to the chapter entitled “Taxation of foreign presences”.

Tax allowances

The property of religious organizations and various types of public organization is tax exempt.

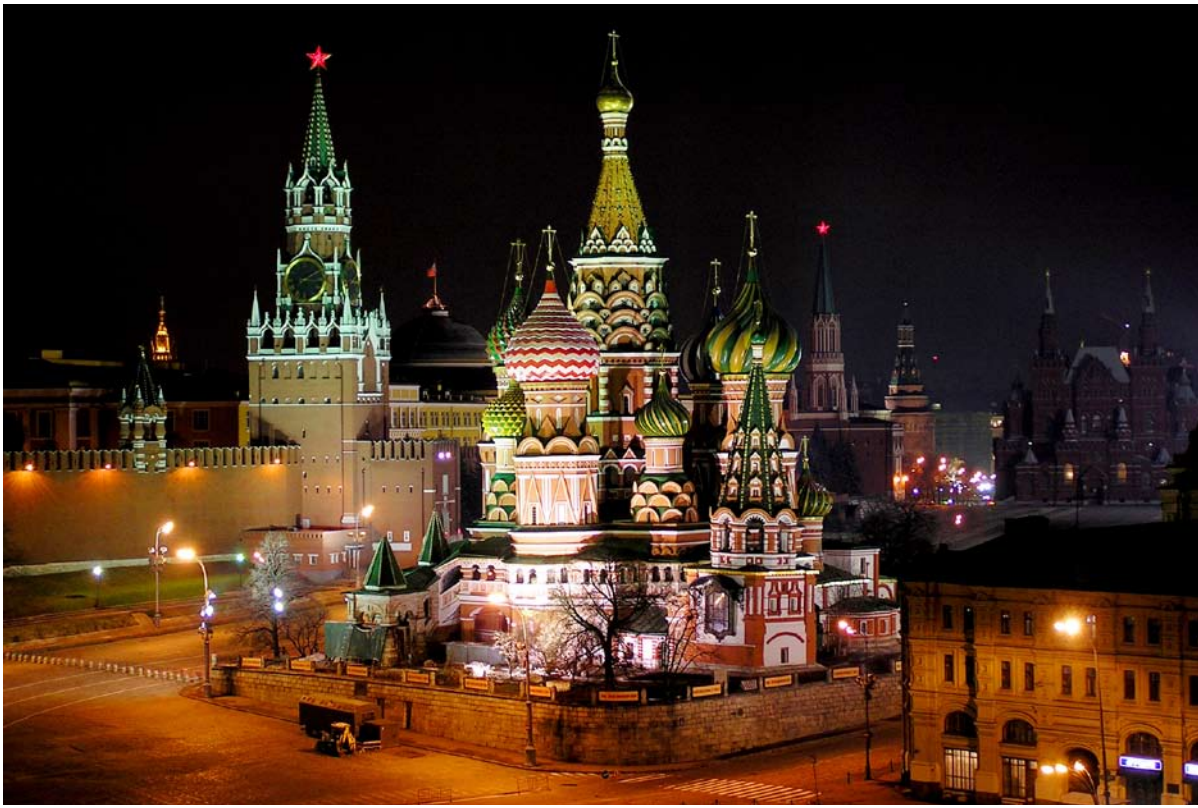
Tax rates

Tax on property is a regional tax with the maximum rate set by the RF Tax Code at 2.2%. The maximum rate is currently imposed in the majority of Russia's regions, including Moscow and St. Petersburg. However, a reduction or exemption is offered by some regional authorities, often conditional on an investment in the region.

Tax payments

The tax period is a calendar year. Nevertheless, advance tax payments must be calculated and paid based on the results of each calendar quarter. Advance payments are computed by multiplying the average net book value of taxable property for the reporting period by one quarter of the applicable tax rate. The total amount of tax due for a tax period is determined by multiplying the tax base for the tax period by the tax rate for the entire period less the advance payments remitted for each quarter to date.

Taxpayers must file quarterly tax returns within 30 days after the reporting period. Annual tax returns should be filed no later than 30 March following the reporting period. Regional authorities have the power to amend

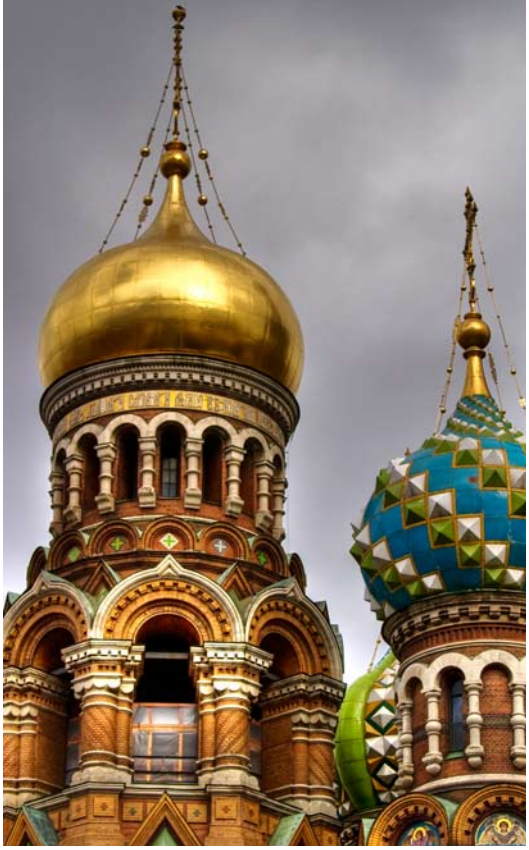


the tax payment deadlines. Some authorities exempt certain categories of taxpayer from quarterly advance payments.

Property located in other regions

When an entity owns taxable immovable property located in a region other than that where it is registered, for example in a subdivision with a separate balance sheet, it is required to pay tax to the budget at each property location. The tax rates and the filing and payment procedures are governed in accordance with the law of that particular region.

Other taxes



Excise tax

Taxpayers

Excise tax is payable by companies and individual entrepreneurs on the sale of excisable goods in Russia, or imported into Russia.

Excisable goods

The primary categories of excisable goods are cigarettes and tobacco products, motor vehicles, ethyl alcohol and certain spirit-based and oil products. For the latter, please refer to the chapter entitled Specifics of Oil and Gas taxation. There is no excise tax on natural gas and crude oil.

Export of excisable goods

Since Russia generally applies the "destination principle" in assessing consumption taxes, exports of excisable Russian goods outside Russia are free from excise tax. To obtain this exemption, a taxpayer must comply with certain customs export procedures and present documentation evidencing the export of the goods.

Tax rates

Tax rates vary depending on the category of excisable goods. The rates are periodically adjusted by the tax authorities. The tax base is determined by either the quantity of excisable goods or the value of such goods depending on whether the tax rates are specific (i.e. a fixed amount per unit) or ad valorem (a percentage of the sales price).

Excise tax should be charged at the date of sale, which is generally deemed to be the date when the goods are dispatched.

A producer of excisable goods may deduct for profit tax purposes the excise tax paid on the purchase or import of excisable goods used in the production of those goods. Otherwise, excise tax is non-deductible.

Payments and filings

The tax period is the calendar month. Deadlines for tax payments and submission of tax returns vary. They primarily depend on the category of excisable goods. Excise tax reporting and payments must be made at the location of the taxpayer and at any separate sub-divisions which carry out transactions subject to excise tax. Certain alcohol and tobacco products, both domestic and imported, require an advance payment by means of an excise stamp, which must be attached to each excisable item prior to its sale at the place of production prior to sale.

Land lax

Overview

Land tax is a local tax, thus its application is administered by local regulations, as well as the Tax Code.

Taxpayers

Land tax applies to legal entities and individuals which own land or have a permanent right to its use. Legal entities and individuals which apply special tax regimes, use land under lease agreements, or free of charge, are not subject to land tax.

Tax base

The tax base is the cadastral value of the land as determined on 1 January of the reporting year. The cadastral value for a specific plot is determined in accordance with the Russian Land Code. In the case of joint ownership, the tax base is determined for each taxpayer's share of the land.

Tax allowances

Religious, historical or cultural sites, as well as land used by the State, enjoy exemptions from land tax.

Tax rates

Local authorities set the land tax rate. Under the Tax Code, these rates may not exceed the following limits:

- 0.3% of the cadastral value of land which is either (i) used for agricultural purposes, or (ii) occupied by residential properties or utilities
- 1.5% of the cadastral value of other land

In Moscow the following tax rates are applicable: 0.3% for agricultural land, 0.1% for land used for residential purposes, and 1.5% for land used for any other purposes

Tax calculation, payments and filing

Although the tax period for land tax is the calendar year, most taxpayers must report and make advance tax payments on a calendar quarterly basis. Individual taxpayers, however, do not have to make advance payments unless they are entrepreneurs. Also, regional authorities can exempt certain other categories of taxpayer from remitting quarterly advance payments.

The amount of advance tax payable is derived by multiplying one quarter of the applicable tax rate by the cadastral value of the land subject to taxation determined as of 1 January of the current tax period. Taxpayers making advance tax payments within the current reporting year must file the tax return with the local tax authorities no later then the last day of the month following the reporting period. Annual tax returns must be filed no later than 1 February of the following year.

Regional authorities have the right to amend the deadlines for tax payments, including advance payments. In Moscow, taxpayers must remit the land tax no later than 1 February of the following year.

Transport tax

Overview

Transport tax is a regional tax, so its application is governed by regional regulations, as well as the Tax Code.

A region may only impose this tax if its legislation contains transport tax provisions in line with the Tax Code.

Taxpayers

Entities and individuals which are registered owners of "transport vehicles" are subject to transport tax.

Transport vehicles are not limited to cars, motorcycles, motor scooters or buses, but include other transport vehicles, such as aircraft, helicopters, yachts, snowmobiles, etc. However, aircraft, ships and river vessels owned by companies whose main activity is the transportation of passengers or freight are exempt, as are vehicles used in agricultural production.

Tax base and rates

The tax base for transport vehicles subject to transport tax depends on the type of the vehicle. The tax rates vary by region, but are subject to the limits set out in the Tax Code. For example, for motorized transport vehicles the range is between RUB 5 and 50 (approximately USD 0.15 and 1.5) per unit of horsepower.

Tax payments and filing

Although the tax period for transport tax is the calendar year, most legal entities must report and make advance tax payments on a calendar quarterly basis. Regional authorities can exempt certain categories of taxpayer from advance tax payments.

The amount of advance tax payable is calculated by multiplying the tax base by one quarter of the applicable tax rate for the current tax period. Filing and payment deadlines are set by the regional authorities, but usually advance tax returns must be filed with the local tax authorities no later than the last day of the month following the reporting period and annual tax returns no later than 1 February of the following year.

Individual taxpayers are required to pay transport tax annually on the basis of notifications issued by the tax authorities in the location where the transport vehicle is registered.

State duty

The Tax Code provides an exhaustive list of state duties. For this overview we consider only the major types of state duty imposed on legal entities. Cases in which state duties are imposed include:

- An individual or a legal entity initiates a court action
- The state registration of a legal entity or an entrepreneur, and on the accreditation of branches and representative offices of a foreign legal entity
- The State registration of issues of shares, including certain securities placed through subscription
- The State registration of a mutual investment fund
- Obtaining a license to conduct certain activities
- Services provided by notaries
- Vehicle registration

Other

Investors should note that additional taxes, levies and fees may arise depending on the region. These include, for example, license fees for the use of sub-soil resources, pollution levies and timber duties.

Customs duties

Overview

Import customs duties are levied based on the classification code and country of origin of the goods imported. Import customs duty rates are normally expressed as a percentage of the value of goods imported, known as "ad valorem" duties. However, they may also be expressed as a set monetary amount per unit or kilogram – "specific" duties. Finally, they may be expressed as the greater or the sum of the two – "combined" duties.

Several "ad valorem" rates of import customs duties are currently applicable in Russia – in the majority of cases 0%, 3%, 3.5%, 5%, 10%, 15%, 20% and 25%. Certain goods are exempt from import customs duty. The rate of import customs duty depends on the exact nature of the goods being imported. Goods are classified according to the Russian Nomenclature of Foreign Economic Activity (the "Russian Harmonized System") into ninety-seven groups. The Russian Harmonized System is based on the International Harmonized System.

Basic import customs duty rates are not constant and may vary depending on the country of origin of the goods, type of goods and occasionally on other factors. Countries are classified into five groups for the purposes of applying import duty rates shown in Table 3.

Exemptions

There is currently an import customs duty and import VAT exemption for certain "technological equipment" imported as an in-kind charter capital contribution. The import VAT exemption is expected to be replaced in 2009 by another exemption – please refer to the "Tax incentives" and "Value added tax" chapters for further details.

The customs import duty exemption for certain types of technological equipment remains in effect.

Export customs duties

Export customs duties are currently levied on some goods and on raw materials, e.g. oil, metals, timber.

Table 3

Group	Duty
Most favored countries	Basic rate of duty applies
Developing countries	75% of basic rate applies
Less developed countries	Exempt from import duties
CIS countries	Exempt from import duties
Non-favored nations	Double the basic rate

Special customs regimes

There are a number of special customs regimes that provide for either full or partial exemption from import customs duties and VAT. For example, full relief may be granted on goods which are imported into Russia to be processed and which are subsequently exported.

Goods may also be imported under a temporary import regime. As the name suggests, this regime allows for either full or partial exemption from import duties and VAT for certain goods which are temporarily imported into Russia. Once the specified time period (usually two years) has expired, the goods must either be exported from Russia or transferred to a different customs regime.

The customs free zone regime may be applied within certain special economic zones, resulting in an exemption from import customs duties and taxes on imported raw materials, components, etc. until the processed products are moved out of the zone.

Taxation of individuals

Personal income tax

Taxpayers

Domicile and citizenship are irrelevant for Russian tax purposes. Both Russian tax resident and non-resident individuals are subject to Russian income tax.

Russian tax residency is established if an individual is physically present in Russia for at least 183 calendar days during a 12 month rolling period. The 12 month period calculation is not interrupted by brief trips (i.e. lasting less than six months) outside Russia for the purposes of medical treatment or study.

The Ministry of Finance has confirmed that a final determination of an individual's tax residency status and ultimate tax liability will be made only after the end of each tax year, taking into account the number of days spent in Russia during the previous year ended 31 December. Tax residents are taxed on their worldwide income, while tax non-residents – those who do not meet the test noted above – pay tax only on their Russian-sourced income, irrespective of the nature of the income received.

Income tax rates

Different tax rates apply to residents and non-residents.

Residents

There are three different personal income tax rates that may apply to income earned by a Russian tax resident individual.

- A 13% rate applies to most types of income, i.e. other than those subject to an alternative rate
- A 9% rate applies primarily to dividends received from Russian or foreign corporations
- A 35% rate applies to certain prizes, insurance receipts and bank deposit interest in excess of specific limits, as well as to income deemed to be received from low-interest loans (except those used to acquire real estate)

Non-residents

A 30% rate applies to non-residents on all types of Russian-sourced income. Passive income (e.g. investment income) is Russian-sourced if it is due / paid from a source located in Russia. Earned income (e.g. from employment) is Russian-sourced if the duties for which it is received are performed in Russia.

Dividends paid by Russian organizations to non-residents are taxed at a 15% rate, withheld at source.

Taxable income

Taxable income is defined as gross income less allowable deductions and exemptions. For personal income tax purposes, gross income is defined as any economic gain in cash or in-kind that is actually or constructively received by a taxpayer and that is subject to the taxpayer's discretionary disposal.

Taxable income includes, but is not limited to the following:

- Compensation for employment and hired services, in cash or in-kind
- "Imputed income", such as any benefit from low-interest loans or discounted goods, works or services and securities

- Payments made by an employer on behalf of an individual employee
- Payments made by an employer on behalf of an individual employee for: (i) utilities and communal services; (ii) periodicals and subscriptions; (iii) meals; (iv) nursery or school fees and other similar payments
- Housing costs paid by an employer for the benefit of an employee
- The value of property transferred by an employer to an employee, net of any price paid by the employee
- Payments over and above the statutory limits for various State benefits, work related damages, redundancy payments and reimbursable transportation and business trip expenses
- Certain voluntary medical and pension premiums paid by an employer on behalf of its employees that do not meet specific requirements
- Gifts made to an employee, in cash or in-kind, exceeding RUB 4,000 (approximately USD 110) per year
- the proceeds, or in some cases the gain, from the sale of certain types of property
- The fair market value of property received upon liquidation of an enterprise, less the total amount of charter capital contributions made by an individual
- The fair market value of certain property distributed during the liquidation of an enterprise as a result of privatization
- Pension income payable to individuals from private retirement pension funds in certain circumstances;
- Certain gifts received from individuals

Deductions and exemptions

The 13% tax rate applies to taxable income after the following four kinds of deduction:

- Standard tax deductions
- Social tax deductions
- Property deductions
- Professional tax deductions

These deductions are not available to non-residents.

Standard deductions

A standard monthly deduction of RUB 400 (approximately USD 11) is given to a taxpayer for each month that his accumulated income during the calendar year to date does not exceed RUB 40,000 (approximately USD 1,100). An additional monthly deduction of RUB 1,000 (approximately USD 30) is given in respect of each dependent for each month that accumulated income during the calendar year to date does not exceed RUB 280,000 (approximately USD 8,000).

Standard deductions of RUB 500 and 3,000 (approximately USD 14 and USD 90, respectively) are also available for certain categories of individuals.

Social deductions

A social deduction of up to RUB 120,000 (approximately USD 3,400) may be claimed for the following:

- Payments for the education of the taxpayer at a licensed educational institution
- Payments for medical expenses made to a Russian medical institution for the benefit of a taxpayer and his immediate family, including premiums paid for voluntary individual insurance of a taxpayer and his immediate family
- Contributions made to licensed Russian non-state

pension funds for the benefit of the taxpayer or his spouse, parents and disabled children
- Contributions made under pension insurance contracts with licensed Russian insurance companies for the benefit of the taxpayer or his spouse, parents and disabled children

In addition to the RUB 120,000 limitation, the following deductions are available:
- Payments for the education of the taxpayers' children up to the age of 24 at a licensed educational institution, subject to an annual limitation of RUB 50,000 (approximately USD 1,400) for each child
- Charitable donations (in cash only) to scientific, cultural, educational, health or social security organizations that are partially or wholly financed from federal, regional or local budgets; and to religious organizations, but limited to 25% of the taxpayer's total income taxable at 13%
- Costs of "expensive" medical treatment (as defined) for the benefit of a taxpayer and his family

In practice, the time and effort required to assemble the necessary supporting documentation to substantiate any claim may outweigh the potential benefit.

Property deductions

There are two types of property-related tax deduction, one relating to the sale of property (including residential real estate) and the other to the purchase of residential real estate.

For sales of property, the amount of deduction available will depend on the type of property and the holding period. For property owned for three years or more, other than securities, a full deduction is given – thus the disposal is tax exempt. Where the ownership period is less than three years:
- The deduction from the proceeds realized from the sale of residential real estate is the greater of: an amount up to RUB 1 million (approximately USD 29,000) or the documented cost of the property
- The deduction from the proceeds realized on the sale of other property, except securities, is the greater of: an amount up to RUB 125,000 (approximately USD 3,600) or the documented cost of the property

Sales of securities, units in investment funds and fixed-term financial instruments for which securities are an underlying asset, are subject to special rules. In essence, the taxable income is the sales proceeds less documented costs.

When a taxpayer purchases, or participates in the construction of, residential real estate, a one-time deduction of up to RUB 2 million (approximately USD 57,000) is allowed in the year of acquisition for amounts spent on construction or acquisition. Interest on a loan used to finance the property is also deductible without limitation. Any part of the deduction not fully used in a calendar year may be carried forward indefinitely.

Where the taxpayer is an employee of a Russian company, residential property deductions on purchases may be claimed through the payroll. In all other cases, including other property transactions, deductions must

be claimed via the annual individual income tax return. Again, special rules apply to transactions with securities.

Professional deductions

Professional deductions are generally allowed for an individual who is engaged in commercial activity as an individual entrepreneur. Qualifying expenses are those which directly enable an individual to derive his income from that commercial activity. The deductibility of professional expenses is subject to various limitations similar to those provided for legal entities. The expenses claimed must either be fully supported by proper documentation or a deduction limited to 20% of the taxpayer's commercial income can be claimed instead. There are also deductions that apply specifically to an author's income.

Exemptions

Income which is not taxable includes the following:

- The value of additional or replacement shares issued as a result of the statutory revaluation of fixed assets and foreign currency items. This includes the value of shares issued as a result of a merger or reorganization
- State allowances, including maternity leave and unemployment benefits
- The reimbursement of certain expenses incurred for business trips and supported by the proper documentation
- Certain cash and in-kind distributions in accordance with legislation, e.g. per diems, special uniforms, footwear, etc.
- Gifts received from an employer up to a total value of RUB 4,000 (approximately USD 110) per year;
- Foreign currency compensation paid to certain State employees working abroad
- Interest and other receipts from Russian federal and regional bonds and other securities
- Bank interest within limits. For interest on ruble deposits, the rate should not exceed the refinancing rate of the CBR plus five percentage points. For interest on foreign currency deposits, the rate should not exceed 9% per annum
- State pensions and private pensions in certain cases
- Some types of State and private individual insurance payments
- Certain property received as a gift or by inheritance

Treaty relief

Russia has signed a number of bilateral double tax treaties which offer protection against individuals'

income being taxed in two or more countries. The provisions of these and other international treaties signed by Russia generally override Russian domestic law.

In practice, however, the Russian tax authorities often deny the benefit of a treaty claim despite the submission of extensive documentary proof of tax residency in the other treaty state.

Assessment and collection procedures

Tax returns

Individuals must calculate their income tax liability and file income tax returns in the prescribed format if:

- Income was received from an individual
- Income was received from sources outside Russia (in the case of a Russian tax resident)
- Income tax was not withheld at source
- Income was received from gambling
- Income was received from the sale of property, with certain exceptions

Individual entrepreneurs and private notaries must also file personal tax returns.

Filing procedures

An individual who is required to file an income tax return must do so no later than 30 April in the year following the tax year. The return should be filed with the tax inspectorate handling the individual's place of registration. The return must include all income received by the taxpayer during the tax year, listed by item, source, monthly amount and date.

If a foreign national leaves Russia prior to the end of the calendar year, he must file a departure return covering the income received up to the date of departure. The return must be filed no later than one month prior to departure.

Even when income is exempt under a double tax treaty, Russian legislation requires the filing of the relevant claim and supporting documents.

The total amount of tax due based on a tax return must be paid no later than 15 July of the following tax year. Or, in the case of departure / repatriation, within 15 days after submission of the tax return. Overpaid tax may be either reimbursed (usually a difficult and time-consuming procedure) or credited against any future tax liabilities.

Tax withholding

The most common type of income payment subject to withholding is salary / remuneration paid to employees of tax agents. If the tax on earned income was properly deducted at source and remitted to the relevant authorities, the employees are not required to file income tax returns, unless they claim property deductions or have other income subject to a filing obligation.

Income tax computed and withheld by an employer must be remitted to the State according to one of the following schedules:

- No later than the day when the payroll amounts are transferred to the employees' bank accounts

- No later than the day of actual receipt of the payroll monies by the employer from a bank, where payment is made in cash
- The day following the day of cash payment
- The day following the day of tax withholding, if income was paid in-kind or is imputed income

Ultimately, it is the individual taxpayer who is solely responsible for meeting his income tax obligation. The law specifically prohibits an employee's income tax obligation from being met out of funds belonging to another party. If an employer pays tax on behalf of its employee, this may not be treated as fulfillment of the individual's tax obligations.

Unified social tax and other payroll contributions

Overview

Russian employers are liable for unified social tax (UST), pension insurance contributions and accident insurance contributions with respect to payments to their employees. There are currently no corresponding employee obligations.

The requirement to remit UST is extended beyond Russian employers to include foreign companies. However, mechanisms for paying the contributions only exist for Russian legal entities or FLE that have a Russian representative office or branch. Failure to meet UST obligations may result in penalties.

Pension contributions are payable to the Pension Fund only for individuals eligible for a Russian State pension, i.e. Russian citizens and foreign individuals possessing a residence permit.

Rates

UST is calculated for each employee individually on a regressive basis as shown in Table 4 on page 48. Pension contributions are based on a similar regressive scale to that for UST, at rates up to 14%, depending on age. However, because the amount of pension contribution is deducted from the calculation of the Federal part of the UST, with only the net amount paid to the Federal budget, the total employer liability for both UST and pension contributions should not exceed that calculated by reference to the 'Total' column of Table 4.

In addition, employers must pay accident insurance contributions on behalf of their employees. The current rates for insurance contribution vary from 0.2% to 8.5% of gross payroll, depending on the degree of inherent risk in the occupation. Each industry falls under one of 22 categories of risk. Each company is assigned a rate based on the relevant industry. The rate applicable to office personnel is typically 0.2%.

Taxable income

The taxable base for UST is calculated based on remuneration in cash or in kind. The following are examples of payments which are not subject to UST:

- Payments connected to the transfer of property rights or any other proprietary rights
- Payments relating to the use of property such as residential real estate rental and car rental

- State allowances, including maternity leave, unemployment benefits and sick leave
- Redundancy payments within certain limits, including compensation for unused vacation time
- Business travel expenses within the statutory framework
- Professional training expenses
- Payments and reimbursements, regardless of their form, that are not deductible for profit tax purposes
- Imputed income when an employee has received a loan from his employer on preferential terms
- Certain insurance contributions

Payments and reporting

The tax period for UST is the calendar year. UST is payable on a monthly basis no later than the 15th day of the following month. As noted above, the Federal budget part of the payment is net of the pension contribution.

Reports should be filed with the tax authorities by the following dates:

- Quarterly advance payment reports are due by 20 April, 20 July and 20 October of the tax year
- The annual UST return is due by 30 March of the following year

The UST tax return must be prepared in duplicate; one form is submitted to the tax authorities and the other to the Pension Fund prior to 1 July of the following year.

Pension and accident insurance contributions are also payable on a monthly basis. The due date usually corresponds to the date when the bank receives the salary funds, but should not be later than the 15th day of the following month. The filing deadlines for quarterly advance payment reports and annual returns are the same as for UST.

Taxpayers (employers) are also required to file reports with the Social Fund on a quarterly basis by the 15th day of the month following the reporting quarter.

Table 4

Tax base per employee (RUB)	Federal Budget	Social Fund	Medical Fund	Total
Up to 280,000	20%	2.9%	3.1%	26%
From 280,001 to 600,000	RUB 56,000 + 7.9% over RUB 280,000	RUB 8,120 + 1% over RUB 280,000	RUB 8,680 +1.1% over RUB 280,000	RUB 72,800 + 10% over RUB 280,000
Over 600,000	RUB 81,280 + 2% over RUB 600,000	RUB 11,320	RUB 12,200	RUB 104,800 + 2% over RUB 600,000

Special reduced UST rates apply to Russian companies working in the Information Technology sector, subject to meeting certain criteria. The reduced rates are as follows:

Taxable base per employee accrued from the start of the year	Total
Under RUB 75,000	26%
RUB 75,001 – 600,000	RUB 19,500 + 10% of the amount exceeding RUB 75,000
Over RUB 600,000	RUB 72,000 + 2% of the amount exceeding RUB 600,000

Employment

Overview

Russian employment law applies to all employment relationships in Russia, including those involving Russian nationals, foreign nationals, stateless persons, international organizations, and Russian and foreign legal entities.

An employment relationship is defined in the Russian Labor Code as the personal performance of a labor function by an individual in return for remuneration. Employment relationships should be distinguished from civil law service agreements. If a civil law service agreement includes aspects that could actually be construed as an employment relationship, the mandatory provisions of Russian employment law will apply.

Employment contract

As a general rule, employment relations are based on a contract concluded between an employer and an employee. An employment contract must contain certain provisions set out in the Labor Code, which is essentially designed to protect the rights of employees.

The general power to sign an employment contract lies with the General Director of the employer. Employment contracts with the employees of branches and representative offices of foreign companies are usually signed by the head of that branch or representative office acting under a power of attorney granted by the foreign head office.

Duration of employment contracts

Employment contracts may be concluded for either an indefinite or fixed term, although fixed-term agreements are only permitted in specific situations provided in the Labor Code. An employment contract is considered to be concluded for an indefinite term if no time period is indicated in the agreement. Employees are entitled to conclude employment contracts with several different employers.

Probation

The probationary period under a contract may not exceed three months. For company heads and their deputies, chief accountants and their deputies, and heads of branches, representative offices and other subdivisions of legal entities, a longer probation period may be established but should not, in any event, exceed six months.

Salary and bonus payment

The monthly salary of an employee may not be set below the minimum wage established by federal law (currently RUB 4,300 or approximately USD 120).

Salary must be paid in monetary form, in rubles, and in no less than two monthly installments on the dates established by the employer's internal polices and in the employment contract.

Working hours and time off

A standard working week is 40 hours. Overtime work should not exceed four hours in two consecutive days and is limited to 120 hours per year. Minimum annual paid vacation is 28 calendar days. An employee is entitled to receive pay during periods of sickness,

and the employer is compensated for this with a reduction in the amount of unified social tax liability. Sick pay is currently limited to RUB 18,720 per month (approximately USD 500).

Women are entitled to 70 calendar days' maternity leave prior to giving birth and 70 calendar days afterward. Pay during this period is currently limited to RUB 25,390 per month (approximately USD 700). In addition, women are entitled to leave until the child reaches the age of three years (unpaid for the second 18 months) and during this period the employee is entitled to resume her job.

Procedure for termination of employment contracts

An employment contract can be terminated at any time by mutual agreement of the parties, and with two weeks' written notice by the employee alone. The specific grounds for termination by the employer are listed in the Labor Code and some of these are described below. In the event that employment is terminated due to staff redundancy or liquidation of the employing company, the employee must be personally notified in writing at least two months in advance. In the event of staff redundancy, the employer must offer the employee another position that corresponds with that employee's qualifications, assuming a vacancy exists.

If employment is terminated due to the employee's unsuitability for the job, this must be confirmed by an internal review committee formed specifically for this purpose. However, this option should be approached with caution since it is often successfully contested in court.

If unsuitability arises due to the employee's poor health, the employer should transfer that employee (subject to his or her consent) to another position within the company more suitable in terms of health requirements. If the employee rejects the transfer, or if there is no such position available, the employment agreement can be terminated.

During the probation period, employment can be terminated due to an employee's unsatisfactory performance. Three days' written notice, describing the nature of the fault, must be given. The employee has the right to challenge this decision in court. The employee is also entitled to terminate the contract during the probationary period with three days' written notice.

Liability for violation of the Labor Code

Violations of the Labor Code are subject to the following:

- A RUB 30,000-50,000 (approximately USD 850-1,400) fine for a legal entity
- A RUB 1,000-5,000 (approximately USD 30-140) fine for the company's officials
- Suspension of the activities of the legal entity for a period of up to 90 days

Violations of the labor legislation by a company official who has been previously penalized for similar offences may result in suspension for a period ranging from one to three years.

Work visas and work permits

Before a foreign national can work in Russia as an employee, both a work permit and a work visa must be obtained. These documents may be valid for up to one year. A work visa differs from a business visa in that a work visa allows a foreign national to be employed in Russia, while a business visa merely confers the right to visit for business purposes. Work permits for foreign employees are issued through the employer by the Federal Migration Service (FMS).

As compliance with the procedures for employing foreign staff is often burdensome and time-consuming, foreign investors who intend to use such staff in their Russian activities should be aware of the overall cost of the process.

The procedure for obtaining a work visa is different for a Russian company and for a branch or representative office of a foreign company. A Russian company must be registered with the FMS in order to invite foreign nationals and a work visa can be issued only after the work permit is received. This contrasts with a branch or representative office, which can obtain a work permit and work visa simultaneously, due to the fact that the latter is processed by the relevant accreditation authority.

A Russian company or branch or representative office of a foreign company can employ a foreign national only if:

- The employer has obtained a permit to employ foreign nationals
- In the case of “visa nationals” (i.e. foreign nationals requiring a visa), the employer has obtained an individual work permit for the employee (“visa-free nationals” are covered below)

The requirement to obtain a work permit does not apply to certain categories of foreign employee, for example employees of foreign equipment manufacturers who are performing installation services in Russia, permanent residents, journalists, etc.

The work permit process for a visa national includes obtaining the following:

- Quota for employing foreign nationals
- Confirmation from a local employment center
- Permission from the FMS
- Individual work permits for each foreign national

In addition, the employer should notify the state authorities (the tax authorities within ten days and the State Labor Inspectorate and employment center within a month) of concluding an employment agreement with a visa national.

The immigration law provides for a simplified system of issuing work permits to visa-free nationals. This system enables the employee to personally apply for a work permit, and the employer's obligation is limited to notifying the local FMS body, tax authorities and employment center.

Liability for violating the immigration legislation

There are significant fines for violating immigration law. Where the employer lacks the necessary permission to employ foreign nationals and employs them without a work permit or fails to notify the FMS, tax authority or employment center about the employment, the employer risks fines of up to RUB 800,000 (approximately USD 23,000), or the suspension of its activities for up to 90 days. The employer's officials face fines of up to RUB 50,000 (approximately USD 1,400).

The foreign national can also be fined up to RUB 5,000 (approximately USD 140) (depending on the type of offence) and may be deported.

Secondment

Work permits are not available for foreign nationals working under secondment arrangements. The FMS has stated that this is due to the absence of any reference to such arrangements in Russian legislation. For a work permit application to be processed, only employment contracts concluded directly between an employee and local employer (Russian company, branch or representative office) can be considered.

Currency control

Overview

The national currency of the Russian Federation (RF) is the ruble. Historically, strict currency control regulations had been used to protect the ruble against devaluation and discourage "capital flight". Later, the CBR and the Federal Government began a program of currency liberalization, with the latest amendments introduced on 30 October 2007.

Nevertheless, while the ruble's exchange rates with foreign currencies are free-floating, it is not yet a fully convertible currency, and several important requirements remain.

Legal definitions

Several key terms must be defined when describing the Russian currency environment.

Russian currency is defined as CBR banknotes and coins in circulation, cash legal tender within Russia, including banknotes and coins withdrawn from circulation but still exchangeable and ruble funds in Russian bank accounts.

Foreign currency is defined as foreign banknotes, treasury notes and coins in circulation, and cash legally tendered within the territory of the issuing foreign country (or group of foreign countries), including banknotes and coins withdrawn from circulation but still exchangeable. Foreign currency also includes funds in bank accounts denominated in foreign currency and international monetary or payment units.

Internal securities are defined as securities issued in Russia and which either have a Russian currency nominal value or certify the right to receive Russian currency. External securities are securities that do not qualify as internal ones.

Residents are defined as follows: (i) individual citizens of the RF, except for those who are considered to be living permanently abroad; (ii) foreigners and individuals without citizenship who live permanently in the RF on the basis of residency permits; (iii) legal entities duly registered under Russian law; (iv) branches and representative offices of FLE registered under Russian law (v) diplomatic representatives, consular offices and other official representatives of the RF, located outside the RF as well as permanent representations of the RF under international or intergovernmental organizations; and (vi) the RF, and regions and municipal units of the RF.

Non-residents are defined as (i) individuals not defined as residents; (ii) legal entities and other organizations registered under the legislation of a foreign country and located outside the RF; (iii) organizations (that are not legal entities) registered under the legislation of a foreign country and located outside the RF; (iv) diplomatic representatives, consular offices and permanent representative offices of foreign countries under international and intergovernmental organizations accredited in the RF; (v) international and intergovernmental organizations, their branches and permanent representative offices in the RF; (vi) branches and representative offices of legal entities or other organizations located in the RF and registered under the law of a foreign country.

Authorized banks are RF incorporated credit institutions which are licensed by the CBR to undertake foreign currency transactions and CBR licensed Russian branches of foreign credit institutions which are also entitled undertake foreign currency transactions.

Currency transactions are acquisitions, exchanges, payments and imports / exports, which involve currency valuables, rubles, or internal securities.

Regulations on currency operations

Between Residents

With some exceptions, payments between residents can only be made in rubles. One important exception is that residents may borrow from, and repay, Russian banks in foreign currency.

Between non-residents

Non-residents have the right to open and operate both foreign currency and ruble bank accounts in an authorized bank. Non-residents are permitted to make payments between themselves in a foreign currency without restriction, but ruble payments may only take place through bank accounts opened with authorized Russian banks. Transactions involving internal securities between non-residents are permitted but subject to compliance with Russian anti-monopoly and financial market legislation.

Between a resident and a non-resident

The general rule is that there are no restrictions on currency operations between residents and non-residents, unless they are specified in the law on currency control and by the currency control authorities.

Currency restrictions which remain are:

Transaction passports

The CBR continues to monitor currency transactions involving loans, the import or export of goods and the provision of services and intellectual property between residents and non-residents through the obligatory use of transaction passports. This involves filing documentation relating to the transaction with the payer's bank.

Another form of control is the currency operation certificate provided to authorized banks by residents when performing currency operations.

Foreign bank accounts

Residents are required to notify the local tax authorities on opening or closing an account in a bank located outside the RF, but starting in 2008, residents no longer need to submit account statements showing balances at the beginning of each calendar year. Resident Russian legal entities must supply reports showing the movement of funds to and from their foreign bank accounts.

Import and export of foreign currency

Residents and non-residents may import foreign currency into Russia without restriction, although both resident and non-resident individuals must file a written customs declaration upon importing foreign (or Russian) currency in cash, travelers' checks, or internal or external securities when the value exceeds USD 10,000.

Resident and non-resident individuals may export foreign currency (as mentioned above) up to USD 3,000 without submitting a customs declaration and up to USD 10,000 with a declaration. Exports of over USD 10,000 are permitted up to the amount indicated in the relevant customs declaration evidencing the original import or transfer into the RF or acquisition in the RF.

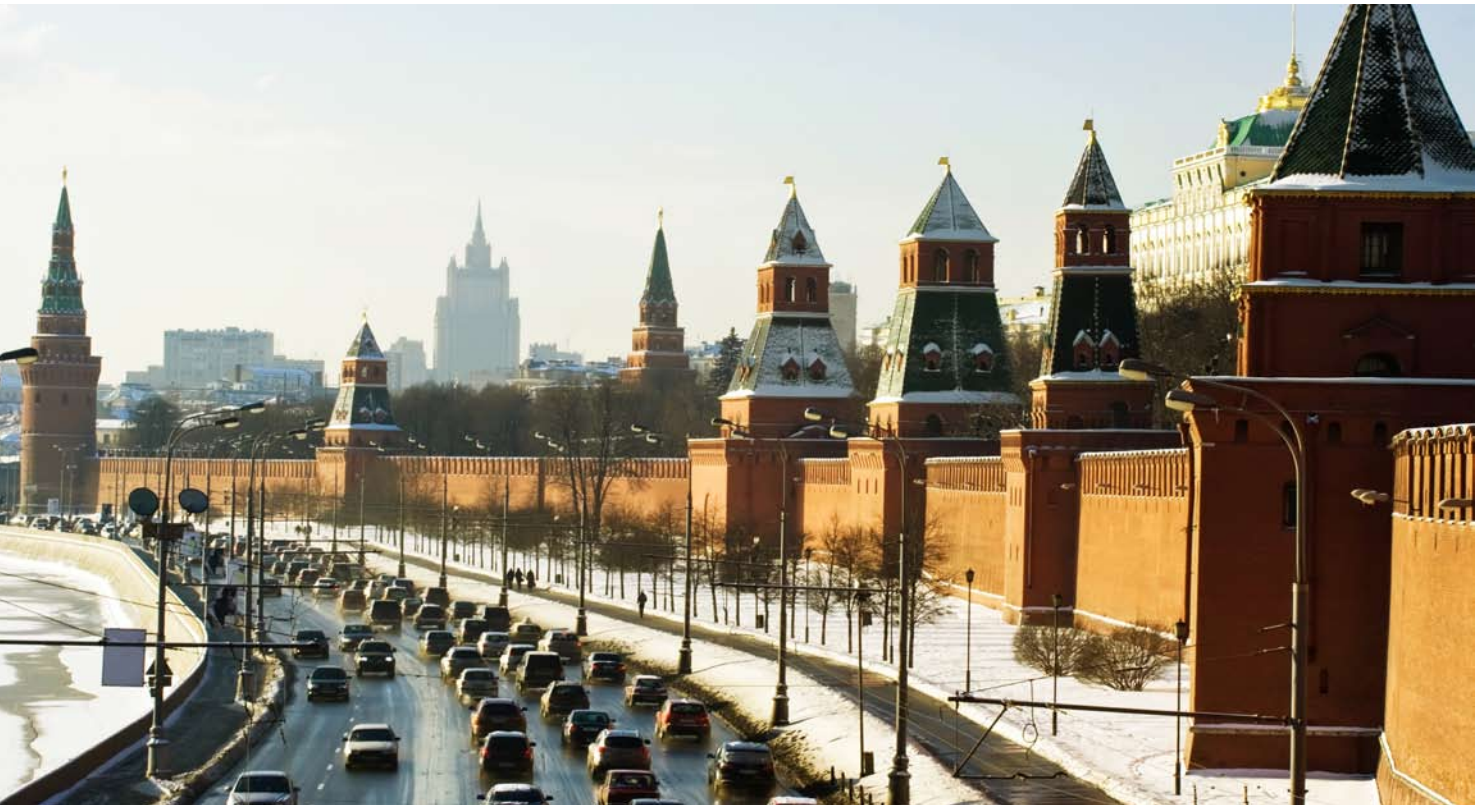
Repatriation of foreign currency

Residents engaged in international trade or commercial activity must repatriate all rubles and foreign currency received from such activity to their Russian bank accounts, subject to certain exceptions.

Liability for infringements

Severe administrative fines apply for the breach of currency control rules, ranging from 75% to 100% of the amount of the relevant operations. Criminal liability may apply to residents failing to repatriate foreign currency exceeding RUB 5 million (approximately USD 140,000) to the RF. Violation may result in the imprisonment of the head of a legal entity for up to three years.

Transfer pricing



According to the current transfer pricing rules in the Tax Code, the tax authorities can review taxpayers' prices in the following situations (referred to as "controlled transactions"):

- A transaction between related parties
- A transaction involving the "barter" of goods or services
- A cross-border transaction (i.e. a "foreign trade transaction")
- A "significant fluctuation" in the level of prices used by the taxpayer for identical or similar goods, works, or services over a short period of time. A significant fluctuation is defined as a difference of more than 20%

If the tax authorities determine that the taxpayer's price differs from the "market price" by more than 20%,

they have the right to adjust the turnover for profit tax and VAT purposes and assess additional tax liabilities and interest based on the market price. Adjustments may be made even where both parties to a transaction are registered as taxpayers in Russia. It is also important to note that the "market price" concept differs in some respects from the OECD "arm's length" concept. Under the Russian "market price" concept, a transaction between unrelated parties may still be deemed to be a "controlled transaction" because of price variation.

There is no provision in Russian tax law enabling the other party to a transaction to make a “corresponding adjustment”, for example to increase the cost of purchased goods by the same amount as the seller has been required, under these provisions, to increase the price.

Russia uses methods of market price determination similar to those described in the OECD guidelines: (i) the comparable uncontrolled price method; (ii) the resale price method; and (iii) the cost plus method. However, there is a strict hierarchical order for applying the methods (as shown above): if one method cannot be used (e.g. due to absence of comparables or information about relevant prices) the next must be used instead.

When determining the market price for comparable transactions, the tax authorities often encounter difficulties, in particular due to the lack of official data regarding market prices. In some cases, courts may deem as sufficient a document issued by the regional statistical board stating that no information about the market prices for particular kinds of goods, works or services is available. However, the tax authorities may try to undertake a more comprehensive search for comparables, requesting data not only from the statistical authorities, but also from the customs authorities, chambers of commerce and local administrations responsible for price monitoring and regulation. Often, however, it is difficult for the tax authorities to assess the impact of variables such as volume discounts, credit terms and quality differences in determining market prices even for commodities like metals and crude oil. It is even more challenging to address issues such as interest rates on intra-group loans, transactions involving intellectual property or intra-group services.

The obligation to prove that prices do not meet the market price benchmark is the responsibility of the tax authorities. However, litigation on transfer pricing is becoming increasingly common, and the taxpayer still has to be prepared to provide the tax authorities or the courts with evidence that their market price estimations are reasonable.

Russia's transfer pricing rules are currently under review and during 2009, the Ministry of Finance plans to introduce its proposed changes to the Tax Code to the State Duma for review and approval. The new rules are not likely to take effect earlier than 1 January 2010.

Tax administration

Overview

The key principles of the Russian tax system, including types of taxes, the list of rights and obligations of the tax authorities and taxpayers, as well as procedural aspects of tax administration, are set out in Part I of the Tax Code of the Russian Federation. Some of the most significant provisions of Part I include the following:

- All contradictions, ambiguities and questionable issues in the tax legislation which cannot be resolved must be interpreted in favor of the taxpayer
- Tax legislation which increases tax rates or introduces new taxes or sanctions cannot be applied retroactively
- There is a presumption of innocence on the part of the taxpayer, placing the burden of proof on the tax authorities
- The tax authorities are required to maintain the confidentiality of information regarding taxpayers
- Tax legislation which mitigates a tax liability and (or) reduces a tax burden may come into legal effect through a simplified tax regime (where such a regime is specifically provided by law)

Administrative structure

The Russian tax system is administered by the Federal Tax Service. This broadly consists of inspectorates, which carry out day to day operations such as tax registrations, tax audits and tax collection, and tax directorates, which supervise the tax inspectorates and perform various other functions. The jurisdictions of both these bodies are based on geographical boundaries (e.g. city or district).

The registration of a Russian legal entity includes de facto registration with the tax inspectorate office covering the company's registered address. In addition, a company must also initiate tax registration at the actual branch, subdivision or property (real estate and transport vehicles). After tax registration, the tax authorities will issue the taxpayer with a certificate of registration and a tax identification number (TIN), which must be used on official documents (tax returns, invoices, payment orders and reports).

Tax audits

The tax audit is the main method applied by the tax authorities to control the accuracy of reporting, calculation and payment of tax. Tax audits have been criticized for the serious impact they can have on the conduct of a taxpayer's business, for example, the impact of the imposition of multiple audits, repeat requests for documentation and the technical weakness of some tax claims.

According to the Tax Code, the tax authorities are authorized to conduct two types of tax audit with regard to taxpayers – individual and corporate, and tax agents: desk and field tax audits.

Desk tax audits

A desk tax audit is conducted on the tax authorities' own premises on the basis of tax returns filed by taxpayers. It must be conducted within three months of the date when the tax return is filed. Filing of an amended tax return during the desk tax audit should lead to the termination of the initial tax audit and the initiation of a new audit with respect to the amended tax return (within three months from the amended tax return's submission).

During the audit, the tax authorities may request the following from the taxpayer:

- Documents that should be submitted together with the tax return
- Documents supporting the taxpayer's right to a tax exemption
- Documents supporting the right of the taxpayer to recover input VAT
- Documents supporting the calculation and payment of tax relating to the utilization of natural resources

Where errors or contradictions in data are detected in the documents, the tax authorities are obliged to inform the taxpayer accordingly, note the correctness or otherwise of the tax return and request from the taxpayer explanations or make due corrections. A taxpayer is entitled to present documentation to the tax authorities in support of his explanation as to the accuracy of the tax return. If after reviewing the explanations, the tax authority finds that the taxpayer committed a tax offence or any other violation of the tax legislation, they must issue a tax audit report.

The subsequent procedure for consideration of the desk tax audit results is similar to that for field tax audits.

Field tax audits

Field tax audits (sometimes referred to as documentary audits) are conducted at the taxpayer's premises and are initiated by a decision of the head (or deputy head) of the tax office at which the taxpayer is registered. In the event that the taxpayer is unable to provide accommodation for the tax officers, the field audit is carried out at the tax office.

The Tax Code allows the tax authorities to take the following action during a field audit:

- Access the taxpayer's premises on presentation of identification and the document authorizing the field audit
- Examine the premises and property of the taxpayer in the presence of witnesses
- Request explanations and supporting documents from the taxpayer

- Examine witnesses
- Seize documents and other evidence (subject to obtaining an order upon the resolution of the tax official conducting the audit, certified by the head (or deputy head) of the tax authority in the presence of the taxpayer and witnesses)

Duration and suspension

The duration of a field tax audit cannot exceed two months, although in "exceptional cases" it can be extended for up to six months. The audit period starts running from the day when the decision initiating the field tax audit is issued and ends on the day when a memorandum on audit completion is issued.

A tax audit can be suspended for an aggregate period of up to six months (with the two month period extended), but only based on the decision of the head (or deputy head) of the relevant tax office. During the suspension, the tax authorities may:

- Request information and documents regarding the activities of the audited person from its contractors or others
- Obtain information from foreign state authorities based on Russia's international treaties
- Examine experts
- Translate foreign language documents submitted by the audited entity

Tax audit report

A tax audit is completed with the issue of a memorandum. No later than two months after the issue of this document, the tax authorities must issue a tax audit report which should reach the taxpayer within five business days. The report must contain the audit findings, specifying what provisions of the Tax Code have been violated – or the absence of a violation. If the taxpayer disagrees with the facts, conclusions or suggestions set out in the tax audit report, he may file a written objection together with supporting documents, within the next fifteen business days. Starting from the day the objection is filed, the head (or deputy head) of the tax office has ten business days to review the audit report and the taxpayer's objection. While the taxpayer must be notified of the place and time of this review, the absence of the taxpayer or his representative does not invalidate the review. Based on this review, the tax authority issues a decision – either to hold the taxpayer liable for the tax violation (or not) or to order additional tax control measures within one month. The latter decision is issued if it is necessary to obtain additional evidence of the tax violation. Where the tax audit relates to the recovery of VAT, the tax authorities should also issue a decision to reimburse VAT (or not) which may be challenged by the taxpayer in the same way as the main decision.

Decision enforcement

Subject to the nature of the decision, the tax authority will then issue a request to pay the tax, interest and penalties, stating the payment deadline. The request cannot be issued by the tax authority earlier than 10 days after the taxpayer actually receives the decision, and the payment deadline cannot be less than 10 days from the date the taxpayer actually receives the request. If the taxpayer fails to make the payment by the deadline, the tax

authority has two months in which to issue a decision to collect the outstanding liability from the taxpayer's bank accounts. In practice, the tax authority normally issues a decision to freeze the taxpayer's bank accounts at the same time, followed by a collection order to the bank either by paper or electronically. The bank should then freeze any payment transactions up to the amount indicated in the decision sent to the bank. If the tax authority fails to issue a decision to collect taxes, interest and penalties within the required two month period, it can still file a claim with the court within six months of the payment deadline.

If a taxpayer's cash funds are insufficient to cover the demands, the tax authorities can collect the shortfall from the taxpayer's other property, including seizure of property, subject to following the relevant law on enforcement of court judgments. A decision to take such action must be issued within one year of the payment deadline.

In addition to the above powers, the tax authority also has the right to issue an order prohibiting the taxpayer from disposing of its property, up to the amount of the outstanding liability. The order is valid until the liability is paid (either voluntarily or compulsorily) or cancelled by a higher level tax authority or by a court decision.

Notwithstanding the above, a taxpayer has the right to challenge any decision of the tax authority before a higher level tax authority or in court and to take measures to protect its assets from confiscation. The decision of the tax authority may be challenged in court only after challenging it before the higher level tax authority.

Limitations on tax audits

The Tax Code includes a number of provisions limiting the powers of the tax authorities in relation to tax audits. Field tax audits may be initiated only with respect to the three year period immediately preceding the year in which the audit takes place. In principle, a taxpayer can only be held liable for a tax violation, including tax underpayments, in respect of tax returns relating to the three year period up to the date of the decision. However, the period may be extended if the taxpayer "deliberately hindered" the conduct of the tax audit. There is no time limit for desk tax audits.

The tax authorities cannot conduct more than two field audits within each calendar year with respect to a particular taxpayer, except by a decision of the head of the Federal Tax Service.

Furthermore, the tax authorities cannot conduct more than one field tax audit with respect to the same taxes and for the same tax period, with the following exceptions: where the taxpayer files an amended tax return reducing the amount of tax due; where a higher level tax authority reviews the audit of a lower level tax authority (unless a Court has ruled their findings unlawful), and where a company has been reorganized or liquidated.

Sanctions provided by the Tax Code

The Tax Code sets out sanctions which may be imposed on taxpayers for tax violations. The general rule is that

penalties may be collected by the tax authorities without recourse to the courts. The tax authorities have the right to reduce or increase the amount of the penalty, if any mitigating or aggravating circumstances exist. The courts also have this right.

The Tax Code establishes the following penalty rates for the most common tax violations:

Failure to register with the Tax Authorities
Conducting business activity without registration is subject to a penalty of 10% of the revenue arising during the period the entity was not registered, but not less than RUB 20,000 (approximately USD 570). Failure to register for a period exceeding 90 days is subject to a penalty of 20% of the revenue received during that period, but not less than RUB 40,000 (approximately USD 1,100).

Full or partial non-payment of tax
Full or partial non-payment as a result of decreasing the tax base or incorrect calculation is subject to a penalty of 20% of the unpaid tax amount. If the default is deliberate, the penalty is 40% of the unpaid tax amount.

Failure to file tax returns
Late filing of a tax return is subject to a penalty of 5% of the tax due according to the return for each full or partial month from the official filing date, subject to a minimum penalty of RUB 100 (approximately USD 3). If the return remains unfiled for more than 180 days, the penalty is 30% of the tax due, increasing by 10% for each additional month of delay.

Gross violation of accounting regulations
Such violations may result in the following penalties: (i) RUB 5,000 (approximately USD 140), if the violation is limited to one tax period; (ii) RUB 15,000 (approximately USD 400), if the violation occurred in more than one tax period; (iii) 10% of the outstanding tax amount, but no less than RUB 15,000, if the violation results in an understatement of the tax base.

Failure by a tax agent to withhold or remit tax
Such failure may result in a penalty of 20% of the tax

to be remitted. Failure to provide documents Failure to provide documents or other information required by law to the tax authorities may result in a penalty of RUB 50 (approximately USD 1.5) for each document not provided.

Criminal Sanctions

The Criminal Code provides for five types of tax crime which are described below. In each case, only the relevant individuals / officers are subject to criminal liability, and not the legal entity itself. Criminal intent, according to the definition provided in the law, must be proven.

Tax evasion committed by legal entities

The Criminal Code provides criminal sanctions where a " large scale" or "very large scale" amount of tax is involved, as determined by a complicated set of criteria. Liability can arise for deliberately including false information in tax returns or documents required by law, resulting in an underpayment of tax or levies, as well as for failure to file tax returns or to submit the required documents. Penalties range from RUB 100,000 to 500,000 (approximately USD 2,900 – 14,000), or imprisonment of the company's CEO, Chief Accountant (or employees fulfilling these roles), or any other official of the legal entity who has falsified documents or concealed property from which tax payments should be made, for a period of up to six years. A ban from holding certain posts or performing certain activities for a period of up to three years may also be ordered.

Evasion of tax payments by individuals

The same crime committed by individual taxpayers may also be subject to criminal sanction as follows: a penalty ranging from RUB 100,000 – 500,000 or imprisonment for a period of up to three years.

Failure to fulfill tax agent obligations

A tax agent's failure to calculate, withhold and remit taxes and fees to the relevant budget can result in criminal liability if committed on a "large scale" or "very large scale". The sanctions applied to tax agents are similar to those provided for legal entities.

Concealment of money or property by legal entities or individual entrepreneurs

Concealment by a legal entity or individual entrepreneur of money or other property required for tax collection is a tax crime. In this case, the officials of the legal entity or individual entrepreneurs accused of the concealment are held liable for a criminal violation, with penalties ranging from RUB 200,000 – 500,000 (approximately USD 5,700 – 14,000) or imprisonment for up to five years. A ban from holding certain posts or performing certain activities for a period of up to three years may also be ordered.

Evasion of customs payment

Evasion by a legal entity or individual entrepreneur involving amounts of duty of RUB 500,000 (large scale) or RUB 1,500,000 (very large scale) may result in penalties ranging from RUB 100,000 to 500,000, or mandatory work of 180 to 240 hours, or imprisonment for a period of up to five years. A prohibition from holding certain posts or performing certain activities for a period of up to three years may also be ordered.

Oil and gas taxation

Overview

Russia accounts for an estimated 6-7% of the world's proven oil reserves and for around 25% of global natural gas reserves. Energy accounts for some 30% of Russia's GDP, and in 2007, the export of crude oil, oil products and natural gas comprised more than 64% of the value of its exports. Since energy and mining have been the main drivers of Russia's overall economic recovery in recent years, tax revenue derived from activities in the natural resource industries deserves special attention.

Profit tax

The following provisions of the profit tax legislation must be followed by companies engaged in activities related to the exploration and production of natural resources:

- Expenses associated with obtaining a license for subsurface use, including expenses for the appraisal of natural resource deposits, feasibility studies, obtaining geological information etc., should be included in the cost of the relevant license, treated as an intangible asset and amortized on a straight-line basis over its useful life. From 1 January 2009, expenses related to participating in a license tender may alternatively be treated as a production & sale expense and amortized over a period of two years, at the taxpayer's request. If no license is obtained, the expenses are amortized over a period of 60 months following the month of the relevant tender
- Expenses relating to the exploration and appraisal of natural resource deposits should be deducted on a straight-line basis over a 12-month period, following completion of the work. Expenses related to the preparation of land plots for the extraction of natural resources and restitution work for cleaning up environmental damage caused during the construction and operation of mining assets are recoverable evenly over the 60-month period following completion of the work (but not beyond the period of operation). Expenses relating to the unsuccessful development of natural resources should be deducted, starting from the month following the month of official notification of termination of site development activities to the State Fund of Subsurface Resources
- Expenses relating to "dry wells" must be deducted evenly over a 12-month period following the abandonment of the well. No provisions for future abandonment costs are allowed, and thus these costs are deductible only when incurred. Examples of the useful lives of fixed assets typically used in the oil and gas industry are shown in Table 5.

Export sales of oil, gas condensate and natural gas are subject to VAT at a rate of 0%, provided that compliance requirements are met. Domestic sales of oil, gas condensate and natural gas are subject to an 18% VAT rate.

Mineral extraction tax

Mineral extraction tax (MET) is imposed on legal entities and private entrepreneurs for the extraction of minerals, including oil and gas from the subsurface and from production waste. In order to be permitted to extract minerals commercially, an appropriate license must be obtained.

Table 5

Depreciation group	Useful life (Years)[1]	Types of fixed assets	Depreciation method
1	1 – 2	Oil & gas production equipment, construction hand-tools	Straight-line or declining balance methods
2	2 – 3	Drilling machines, construction machines, construction power tools	
3	3 – 5	Elevators, automobiles, tank trucks, computers and peripheral equipment, office machinery, etc.	
4	5 – 7	Technological pipelines (i.e. pipelines within larger facilities)	
5	7 – 10	Main gas pipelines, branches of main pipelines, heavy trucks. Fiber-optic communication systems	
6	10 – 15	Oil wells, railway transport structures, heavy trucks (over 15-ton capacity)	
7	15 – 20	Bridges, ductworks, refrigerators, drill ships	
8	20 – 25	Blast furnaces, wharves, river and lake passenger vessels	Straight-line method
9	25 – 30	Runways, oil & gas tanks	
10	> 30	Escalators and buildings	

[1]The exact useful life of fixed assets is determined based on their classification as prescribed by the Russian Classification for Fixed Assets.

MET is determined on the basis of either the physical quantity of the extracted mineral resources, or their physical quantity and value. Value is determined based on selling price, net of VAT, customs duties and levies, less transportation expenses. If no sales of a particular mineral resource were made during a tax period (month), taxpayers must calculate the value of the extracted minerals based on their production cost. The value must be computed in accordance with the tax accounting records maintained for profit tax purposes and the procedures stated in the tax legislation.

For gas condensate, MET is computed on the value of minerals extracted. For oil, natural and associated gas, MET is based on the volume of minerals extracted.

The rate of tax varies according to the type of resource. For oil, MET is calculated at the rate of RUB 419 per ton (approximately USD 12), and adjusted using a coefficient reflecting changes in the world oil price and RUB / USD fluctuations. The coefficient is determined in accordance with the following formula: (P-15)*R/261*D, where P is the average price per barrel of Urals blend crude oil (USD per barrel) for the tax period, R is the average monthly RUB / USD exchange rate as established by the CBR, and D is the depletion factor, determined by the taxpayer. A special regressive coefficient applies for blocks depleted by more than 80%.

A 0% MET rate per ton applies to oil extracted from fields located in the following areas, subject to certain cumulative production and development period constraints:

- The republic of Sakha (Yakutia), Irkutsk and Krasnoyarsk regions
- Areas located to the north of the Arctic Circle
- Areas of the Sea of Azov and the Caspian Sea
- The Nenets Autonomous District and the Yamal Peninsula in the Yamal-Nenets Autonomous District

A 0% MET rate per ton also applies to high viscosity oil. For other hydrocarbons, MET is calculated at the rates shown in Table 6.

Excise tax on oil products

Excise tax is applicable to certain transactions with oil products. Currently only gasoline, motor oil and diesel are subject to excise tax. Oil, gas condensate and natural gas are excluded from excise tax. Excise tax is imposed on the following transactions with oil products which are performed in Russia:

- Sales of self-produced excisable oil products
- Transfers of excisable oil products to the owner, which are produced at a processing facility under a tolling agreement
- Inter-divisional transfers of self-produced excisable oil products within a company for the purpose of producing non-excisable products
- Transfers of self-produced excisable oil products for processing on a tolling basis
- Import of excisable oil products

Where excisable products are exported as described in the first two bullet points above, they are exempt from excise tax. To obtain this relief, all necessary supporting documentation prescribed by the tax legislation must be submitted to the tax authorities.

The excise tax rates applicable to oil products are shown in Table 7. They are assessed on a monthly basis.

The taxpayer may offset excise tax paid in respect of excisable oil products if such oil products are used as raw materials for the production of other excisable oil products. Offsets can be made on condition that the taxpayer submits certain documents to the tax authorities following prescribed procedures.

From 1 January 2009, any goods which are derived from blending other excisable goods are not subject to any further excess duty, provided that the excise tax which would otherwise have been applicable is less than

Table 6

Type of mineral resource	Tax rate
Gas condensate	17.5%
Natural gas	RUB 147 per 1,000 cubic meters
Associated gas and standard losses of mineral resources	0% or RUB 0 per Unit of measurement

Table 7

Oil product	Rate (RUB per ton)[1]
Gasoline under 80 octane	2,657
Gasoline over 80 octane	3,629
Diesel fuel	1,080
Motor oil	2,951
Straight-run gasoline	2,657

[1] Effective from 31 January 2009 to 31 December 2010. From 1 January 2011, progressive rates will apply to diesel fuel and motor oil, depending on quality.

Table 8

Urals prices (P) (USD per ton)	Maximum export duty rate
< 109.50	0%
109.50 – 146.00	35%*(P-109.50)
146.00 – 182.50	12.78+45%*(P-146.00)
> 182.50	29.20+65%*(P-182.50)

or equal to the excise duty applicable to the goods / materials used for blending.

Special rules apply to straight-run gasoline. If a producer and processor hold special certificates for the production and processing of straight-run gasoline, the producer assesses excise tax, but does not charge it to the processor. The producer is entitled to offset the excise tax assessed provided that the required filings are made with the tax authorities. These certificates are issued by the tax authorities, provided the taxpayers have appropriate straight-run gasoline production and processing capacities and that a processing agreement is in place. Different tax payment and tax return submission deadlines apply.

Export customs duties

Export customs duties are levied on exports of oil, natural gas and oil products. The duties on crude oil and oil products are adjusted by the Russian Government on a monthly basis to reflect price movements in the European oil market. The flat rate on crude oil cannot exceed the maximum rate shown in Table 8. The rate of duty on natural gas is currently approximately 30% of the customs value. No duty applies to the export of liquefied natural gas.

Payments for subsurface use

Companies holding licenses for exploration and production are subject to the payments described below.

- Regular payments for the right to prospect and appraise oil and gas deposits. The rate of these payments is set

by the administration of the State Fund of Subsurface Resources within a range of RUB 120 / sq km to RUB 360 / sq km (approximately USD 3-10 / sq km) of the area being prospected and appraised. For the continental shelf and Russia's special economic zones, the rates vary from RUB 50/sq km to RUB 150 / sq km (approximately USD 1.5-4 / sq km)

- Regular payments for the right to explore deposits (i.e. the stage following prospecting and appraisal). The payment rate is also set by the administration of the State Fund of Subsurface Resources, within a range of RUB 5,000 / sq km to RUB 20,000 / sq km (approximately USD 140-570 / sq km) of the area under exploration. Rates of RUB 4,000 / sq km to RUB 16,000/ sq km (approximately USD 110-450 / sq km) of the area under exploration are prescribed for the continental shelf and Russia's exclusive economic zones
- One-time payments for the use of Subsurface Resources. The terms of these payments are established by the relevant licenses, but should not be lower than 10% of the estimated annual amount of MET. This may potentially be one of the most significant costs related to obtaining and developing a license area

- Charge for geological information concerning Subsurface Resources. This charge is set by the Russian Government. It is required to be at least RUB 10,000 (approximately USD 290), but should not exceed the amount of expenses funded from the state budget in the geological exploration of such mineral deposits.
- Fee for participation in a competitive tender (auction)
- Fee for issuing a license

Production sharing regime

Legislative framework

Production Sharing Agreements (PSAs) are governed by Federal Law No. 225-FZ on PSAs dated 30 December 1995. Under this regime, the Russian Government grants an investor the exclusive right to prospect, develop and produce mineral resources from a subsurface area for a certain period of time. The investor guarantees the development of such mineral deposits at his or her own risk and expense.

By committing to share the production of mineral resources with the State under the terms of a PSA, the investor becomes entitled to a share of the minerals extracted. In accordance with the amendments and additions to Law No.65-FZ on PSAs dated 6 June 2003, a PSA may currently be created only if certain terms are met. Specifically, a PSA may be put in place where a tender was previously held and later declared invalid due to the absence of investors interested in the opportunity under the general tax regime. This PSA legislation has proved a significant obstacle to the creation of new agreements.

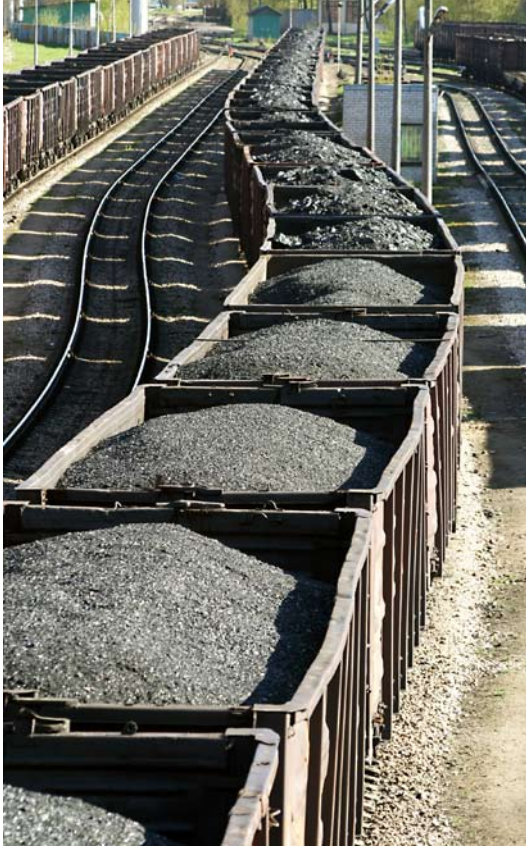
PSA tax regime

The PSA tax legislation provides for two methods of determining tax liabilities on production sharing; the standard method and the direct method. Under the standard method, the investor is subject to MET on minerals extracted under the PSA. Once the value of the minerals produced, net of MET, has been reduced by the "compensatory production" and the amount of exploration, production and other reimbursable expenses, the remaining profits, "profit production", is shared between the state and the investor in accordance with the PSA terms. The investor is subject to profit tax in respect of its share of the profits. The share of compensatory production should not be more than 75% (90% in the case of extraction on the continental shelf) of the total volume of production.

Under the direct method, there is no division of minerals produced into compensatory production and profit production. The investor is eligible for a share of up to 68% of the total quantity of minerals produced under the PSA. The investor is exempt from profit tax, MET, water tax and land tax. Under both methods the investor is exempt from customs duties in respect of goods imported or exported under the PSA, as well as from property and transport taxes in respect of fixed assets used under the PSA.

PSA investors are obliged to account for VAT. However, under PSAs signed prior to the enactment of the 1995 law on PSAs, a VAT exemption may apply to investors and in some cases contractors.

Mining taxation



Overview

Taxpayers engaged in the extraction of minerals other than oil and gas are in principle subject to the rules outlined in the previous chapter. Certain additional specifics are summarized below.

Sales of precious metals by mining companies or companies producing such metals from scrap and waste to the State Funds for Precious Metals and Stones, and to the CBR and authorized banks, are subject to VAT at a rate of 0%. Input VAT relating to production is generally recoverable, assuming the conditions provided in the Tax Code for VAT recovery are satisfied. The recovery is usually effected by offsetting the input VAT against other taxes payable to the Federal budget.

The tax legislation provides a VAT exemption for the following transactions:

- Sale of scrap and waste of ferrous and non-ferrous metals
- Sale of ore, concentrates, other industrial products, scrap and waste containing precious metals for the production of other precious metals
- Sale of precious metals and precious stones by companies other than mining companies or companies that produce metals or stones to the State Funds of Precious Metals and Stones
- Sale of precious metals and precious stones by the CBR and authorized banks
- Sale of raw precious stones for processing and subsequent export sale, excluding unprocessed diamonds
- Sale of unprocessed diamonds to processing companies

If a VAT exemption applies, the input VAT relating to the production cannot be recovered but is deductible as an expense.

Mineral extraction tax

Corporate entities and individual entrepreneurs engaged in mining are subject to the mineral extraction tax (MET). The tax base is the value of the mineral resources extracted, based on their quantity and either the sales price net of VAT, customs duties, and customs clearance fees, (reduced by freight costs and refining costs) or the costs of production, as per the tax accounting records maintained for profit tax purposes.

Generally, the cost of production measure is only used if there are no sales.

The value of precious metals recovered from natural or man-made deposits should be determined on the basis of the taxpayer's sales prices for chemically pure metals during the current month, or the preceding month – in the absence of sales during the current month.

The rates of MET are shown in Table 9.

Table 9

Type of mineral resource	Tax rate
Coal, lignite and anthracite	4%
Standard ores of ferrous metals	4.8%
Concentrates and other intermediate products containing gold	6%
Concentrates and other intermediate products containing precious metals (other than gold)	6.5%
Standard ores of non-ferrous metals (other than nephelines and bauxites)	8%
Diamonds and other precious and semi-precious stones	8%

Table 10

Type of mineral resource	Tariff code under the Russian harmonized System	Export customs duty Rate
Coke and semi – coke manufactured from coal, lignite or peat	2704 00	0% or 6.5%
Unrefined nickel	7502	5%
Precious stones (excluding diamonds)	7103-7104	6.5%

Appendix

Withholding tax rates (%) under Russia's double taxation

Country of recipient	Dividends			Interest	Royalties
	Major shareholding	Minor shareholding	Ownership % for "Major shareholding"		
Albania	10	10	0	10	10
Armenia	5	10	0	0	0
Australia	5	15	10	10	10
Austria	5	15	10	0	0
Azerbaijan	10	10	0	10	10
Belarus	15	15	0	10	10
Belgium	10	10	0	10	0
Bulgaria	15	15	0	15	15
Canada	10	15	10	10	10
China	10	10	0	10	10
Croatia	5	10	25	10	10
Cyprus	5	10	0	0	0
Czech Republic	10	10	0	0	10
DPR of Korea	10	10	0	0	0
Denmark	10	10	0	0	0
Egypt	10	10	0	15	15
Finland	5	12	30	0	0
France	5 / 10	10 / 15	0	0	0
Germany	5	15	10	0	0

Country of recipient	Dividends			Interest	Royalties
	Major shareholding	Minor shareholding	Ownership % for "Major shareholding"		
Greece	5	10	25	7	7
Hungary	10	10	0	0	0
Iceland	5	15	25	0	0
India	10	10	0	10	10
Indonesia	15	15	0	15	15
Iran	5	10	25	7.5	5
Ireland	10	10	0	0	0
Israel	10	10	0	10	10
Italy	5	10	10	10	0
Japan	15	15	0	10	10
Kazakhstan	10	10	0	10	10
Korea	5	10	30	0	5
Kuwait	5	5	0	0	10
Kyrgyzstan	10	10	0	10	10
Lebanon	10	10	0	5	5
Lithuania	5	10	25	10	5 / 10
Luxembourg	10	15	30	0	0
Macedonia	10	10	0	10	10
Malaysia	15	15	0	15	10

Country of recipient	Dividends			Interest	Royalties
	Major shareholding	Minor shareholding	Ownership % for "Major shareholding"		
Mali	10	15	0	15	0
Mexico	10	10	0	10	10
Moldova	10	10	0	0	10
Mongolia	10	10	0	10	20
Montenegro	5	15	25	10	10
Morocco	5	10	0	10	10
Namibia	5	10	25	10	5
Netherlands	5	15	25	0	0
New Zealand	15	15	0	10	10
Norway	10	10	0	10	0
Philippines	15	15	0	15	15
Poland	10	10	0	10	10
Portugal	10	15	25	10	10
Qatar	5	5	0	5	0
Romania	15	15	0	15	10
Serbia	5	15	25	10	10
Singapore	5	10	15	7,5	7,5
Slovakia	10	10	0	0	10
Slovenia	10	10	0	10	10
South Africa	10	15	30	10	0

Country of recipient	Dividends			Interest	Royalties
	Major shareholding	Minor shareholding	Ownership % for "Major shareholding"		
Spain	5 / 10	10 / 15	0	5	5
Sri Lanka	10	15	25	10	10
Sweden	5	15	100	0	0
Switzerland	5	15	20	10	0
Syria	15	15	0	10	18
Tajikistan	5	10	25	10	0
Turkey	10	10	0	10	10
Turkmenistan	10	10	0	5	5
Ukraine	5	15	0	10	10
United Kingdom	10	10	0	0	0
United States	5	10	10	0	0
Uzbekistan	10	10	0	10	0
Vietnam	10	15	0	10	15

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