

Doing business in the Russian Federation



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The information contained in this publication is summarised and should be used as a general guide only. Professional advice should be sought before taking decisions based on this information.

Foreword

It is with great pleasure that we are introducing the second edition of Doing Business in the Russian Federation. We welcome the opportunity, through this Guide, to provide relevant information of the business environment in Russia to those contemplating doing business in this exciting and fast-growing marketplace, as well as to our current clients.

If you wish to have further information on doing business in Russia, you may contact us directly in Moscow or through your nearest PwC office.

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PricewaterhouseCoopers in the Russian Federation

Join us. Together we can change the world.

PricewaterhouseCoopers exists for one reason: to help companies meet business issues posed by the rapidly-changing economic conditions in Russia and world-wide. We are the largest consultancy and audit knowledge business in the world, ranking first or second in every market we operate. We are globally integrated, yet we work locally, bringing together unmatched professional knowledge and practical experience. Today, PricewaterhouseCoopers draws on the talents of more than 150,000 people in 150 countries. The firm was represented in Russia as early as 1913, and a presence was re-established here in 1989. In the last 10 years, we have established offices in Moscow, St Petersburg, Yuzhno-Sakhalinsk and Togliatti. Wherever you are, our people are always there to look after your business needs. In Russia, our clients base includes largest Russian and multinational companies, as well as government institutions. Our close contacts with economic and state bodies, at federal and local levels, let us keep up with the fast changing environment in which businesses has to work in Russia. We have over 1000 experts in Russia focused on providing you constructive and efficient advice for your specific business.

Chapter 1. General information

Geography & Climate

Russia is the largest country in the world, covering 17.1 million square kilometers – it is 70 times the size of the UK and nearly twice the size of the USA. It spans 11 time zones. Russia stretches from the Black Sea to the Pacific Ocean, from the Arctic Sea to the Altai mountains.

Russia has generally long cold winters and brief hot summers. In Moscow, January temperatures can easily drop to -20°C (-4°F) whilst in July and August temperatures of 30°C (86°F) and above are not uncommon.

Population

Of a population of about 145.5 million, nearly 80 per cent are concentrated in Western Russia. Moscow, the largest city in Europe, has a population of 11 million people, and St. Petersburg (former Leningrad) has 5 million inhabitants. Around two-thirds of the population now live in cities. The population size is currently falling. Pensioners constitute 23% of the population and the average family size is 3 people. The average life expectancy rate is much lower than that of other developed countries.

Language

Russian, (not surprisingly!), is the country's official language. It uses the Cyrillic alphabet (rather than the Latin one used by most Western countries), and contains 33 letters. However, the 120 or so nationalities of the Commonwealth of Independent States speak about 48 other languages. Those of Slavic origin (i.e. Russians, Ukrainians and Belorussians) account for approximately 75% of the total population. In Moscow or St Petersburg it is not uncommon to find Russians who speak European languages, especially English.

Living Standards

The Soviet system provided accommodation with very low rents, free social services, subsidised vacations, assisted factory canteens, shops and sports facilities. Few of these remain. Prior to price liberalisation, food, drink, cigarettes, public transport and utilities were also very cheap.

Today the recent reforms have forced a significant share of the population (especially pensioners) below the poverty line as inflation has outstripped increases in state benefits. There is a developing middle/commercial class involved in legitimate business.

Culture & Social Life

Theatre, cinema, music and arts are important parts of Russian life; as with other countries funding has fallen for these, and private sponsorship is emerging. Features of Russian culture, which are at the highest of international standards, include the Bolshoi Theatre, Pushkin Art Gallery in Moscow and Mariinsky (Kirov) Theatre and the Hermitage in St Petersburg.

Russians also spend a considerable amount of their leisure time at the homes of friends and relatives – they place much importance on friendship and family. Consequently anniversaries and birthdays are celebrated with more gusto than expatriates may be used to at home.

People

Generally, those new to Russia find its people very hospitable and warm. On visiting any Russian home, you will be very well entertained. The Western habit of only offering tea or coffee is considered unfriendly. It is polite to take something with you when you visit, for example flowers, chocolates or alcoholic spirits.

Traditionally people entertain at home. Conversations tend to be general rather than personal. Some Russian people greatly enjoy philosophising about life and will spend hours doing so. They are keen to find out about other countries.

Religion

Russian Orthodoxy is the main religion in Russian, followed to a lesser extent by Islam, Catholicism, Protestantism and Judaism. Religion has become more popular in Russia over the last few years as the Russian Orthodox Church has received official encouragement through the return of property confiscated during the Soviet period. The rebuilding of Christ the Saviour Cathedral (in Moscow) is symbolic of the restoration of the right to practice a religion in Russia, and this development has evoked much emotion amongst Russian (and foreign) people alike.

Hints for the business visitor

All foreigners arriving in Russia are required to have visas. Depending on the duration of your stay, you may apply for a *single entry* visa which allows you to enter and leave the country once and lasts a maximum period of three months, or a *multiple entry* visa which allows unlimited travel and is valid for one year. PwC staff and family members who live in Russia are normally issued with a multi-entry visa.

Unlimited foreign currency may be taken into Russia, but upon entry it must be registered with Customs. A customs declaration form must be completed and stamped by the customs authorities. Foreign currency taken out of Russia by visitors should generally not exceed the amount they brought into the country.

International time

Moscow and St. Petersburg are three hours ahead of London time and eight hours ahead of New York time. Vladivostok is six hours ahead of Moscow. Travel time to Moscow is about 3 hours and 35 minutes by air from London or Paris, 9 hours from New York, and 10 hours and 25 minutes from Tokyo.

Business hours

Offices are generally open from 9:00 a.m. to 6:00 p.m., Monday through Friday.

Statutory holidays

Official public holidays are as follows.

| | |
|------------------------------------|-------------|
| New Year Days | January 1,2 |
| Orthodox Christmas | January 7 |
| International Women's Day | March 8 |
| Spring Holiday | May 1,2 |
| Victory Day | May 9 |
| Declaration of Russian Sovereignty | June 12 |
| Conciliation day | November 7 |
| Constitution Day | December 12 |

By custom, if a holiday falls on a weekend the following Monday is taken as a holiday.

Weights and measures

Russia has used the metric system since 1927.

Dates and numbers

Russia uses the Western (Gregorian) calendar. Dates are written in the order day, month, year, e.g., 30/6/99 (30 June 1999). In writing numbers, a comma generally represents a decimal fraction, but there is no fixed rule.

Chapter 2. Doing Business

Russian Economy

It is generally accepted that 2000 was the past decade's best year for the long beleaguered Russian economy. Virtually all macroeconomic indicators showed growth and improvement in the domestic economy. Indeed, the macro data for 2000 impressed even hard-core skeptics, as GDP growth exceeded 7% and capital investment rose by 17% against the background of a flat inflation rate and a gradual 10% increase in personal income.

Last year was the second year of an economic upsurge that began in late 1998 following Russia's financial crisis, which resulted in a sharp devaluation of the national currency. It was precisely the devaluation of the ruble that created a growth impulse for Russia's export-oriented industries, such as oil & gas and metallurgy, as well as for domestic producers of import-substitution goods, primarily in retail sectors like the food industry.

By the end of 2000, however, the positive effect of the ruble devaluation had just about run out of steam, losing its strategic importance as an engine of growth due to substantial inflation in the industrial sector in 1998-1999. The rise in the Producer Price Index was spurred mainly by growing electricity and transportation tariffs, which remain a major sore spot for domestic producers due to highly power-intensive equipment and Russia's vast territory. Nevertheless, the favorable situation in world markets for Russia's major export products, such as crude oil and metals, was one of the main factors contributing to growth in the Russian economy. A surplus trade balance not only helped to boost GDP growth, but also served as the most important underlying factor promoting monetary stability. As well, significant improvement was seen in the area of inter-enterprise settlements, as demonstrated by the reduced volume of non-cash transactions.

Increased capital investment in the domestic economy was noticeable already by late 1998. Since the fourth quarter of last year, the growth rate of investment in industrial assets has significantly outpaced industrial production, acting as one of the economic upturn's primary catalysts. In 2000, capital investments grew by more than 17%, as compared to 9% growth in industrial production. The lion's share of these investments was channeled towards modernizing existing capacities and acquiring new fixed assets. During 1998-1999, companies were able to meet increased demand by putting idle and underutilized capacities into operation, thus avoiding the need for large-scale capital investments. The average industrial capacity utilization rate rose from 51% in 1998 to 65% in the first half of 2000. But, last year obsolete fixed assets began to impede Russian industry's ability to meet growing demand, thus spurring increased capital investments in equipment upgrades.

Despite the recent rise in investment activity, the mechanisms for investing in Russia's economy continue to operate at an unsatisfactory level, given that most Russian companies must still rely on internal revenues as their primary source of investment capital. About two-thirds of all investments are financed directly from out of internal corporate resources. Moreover, weakness and underdevelopment in financial markets and the banking system continue to hinder capital flow between industries. Russia's equity market still plays an insignificant role in the national economy. The market capitalization to GDP ratio in 2000 varied from 15% to 20%, which was even lower than the "crisis" values recorded in 1998 for the majority of emerging markets.

However, last year brought one important piece of encouraging news when the Duma, the Russian parliament's lower house, passed a realistic balanced budget for the first time

since 1992. Among the major positive innovations of this budget were the radical change in the formula for distributing revenues between the federal center and the regions and the reduction in the overall tax burden. The 2001 budget, which was passed in record time, stands out as a zero-deficit spending plan that was drawn up on the basis of realistic macroeconomic parameters. Yet, at the same time, the unresolved issue of the federal budget's continuing dependency on the success of Russia's efforts to restructure its foreign debt, primarily with the Paris Club of creditor states, remains a looming threat.

Currency Regulation

As a consequence of the financial crisis that hit Russia in August 1998 the country has introduced additional restrictions on foreign currency operations in Russia.

There is a strictly enforced network of laws and regulations covering currency and related issues, with substantial penalties for transgressions. There is a closed list of foreign currency operations which can be performed without obtaining a Central Bank of Russia permission. Certain operations, broadly covering loans for up to 180 days, grants, payments in relation to import-export operations with deferral of payment for no more than 90 days and non-trade transfers can be carried out without a CBR licence. For charter capital contributions made by Russian residents abroad the procedure of registration is still quite complicated. Loans for a longer period of time exceeding 180 days provided on arm's length conditions, generally require a new, simpler, procedure of registration rather than licensing, whilst nearly all other foreign currency operations may be performed only with a CBR permission.

In a move to prevent uncontrolled transfers of currency abroad the CBR has ruled that foreign currency can be purchased for the purpose of prepayment for imported goods only if an amount equivalent to the rouble value of the currency purchased is deposited with the relevant Russian bank. A deposit may be avoided if a first class foreign bank guarantee is presented and in certain other cases.

Purchase of foreign currency can be performed on authorised foreign currency exchanges provided the foreign currency is to be transferred abroad for a permitted purpose. Foreign currency purchased in Russia for roubles and not used for a permitted purpose within 7 days should be sold back on the authorised foreign exchanges. Documentary support of the purpose of the transaction in accordance with the prescribed rules is vital. Compliance with the requirements is regulated by the banks, which face significant penalties for incorrectly processed transactions. Russian legal entities, including companies with foreign participation, are required to apply to banks for conversion of 75% of their foreign currency export earnings into roubles through the authorised foreign exchanges within 7 days of the receipt of the foreign currency proceeds. This must be arranged through a bank authorised to undertake such activity. There are strict rules as to how and where the currency proceeds can be sold.

There is tight control over the receipt of foreign currency from export operations and for payments for the import of goods in foreign currency.

Within Russia, all sales (and purchases) must be made in roubles.

Foreign legal entities are allowed to maintain foreign currency and certain types of rouble bank accounts. Each type of account may be used for a specified list of operations only. Generally, proceeds from sales in roubles can be converted into another currency and repatriated, or used to fund local expenses. It is possible to receive

roubles from sales proceeds in Russia without a need to open a Russian bank account in the name of the company, through the mechanism of correspondent bank rouble accounts and have them converted into foreign currency and remitted abroad.

Since 1 January 1999 rouble payments between residents and non-residents are considered currency operations and are subject to CBR regulation.

Any operation planned should be analysed for possible foreign currency regulation constraints, as there may be potential exposure through violation of the regulations to penalties – generally at 100% of the amount of the transaction, or through a bank's refusal to process a transaction.

Types of Business entity

Foreign investors can adopt a number of different forms of business representation in Russia. These include Russian legal entities or representative offices and branches of foreign legal entities. Russian legal entities may be established in various forms including joint-stock companies, limited liability companies and partnerships.

Representative offices of foreign entities may strictly undertake only liaison and support functions, but in practice the authorities accept a much broader range of activities to be undertaken, although with the result – subject to the terms of any relevant double tax treaty – that these are taxable. In terms of taxation, there is little practical distinction between a representative office and a branch (which can certainly undertake most types of activity in Russia). However, to date, branches have not been a commonly used form of doing business in Russia.

With representative offices in practice able to engage in many kinds of trading activity, many investors opt for this form of entity at the outset, on the basis that it is easier to establish and reporting requirements are less onerous. The practical limitation on this form of entity – prohibition to make sales in roubles – no longer applies, but the nature of many investments – joint ventures, production plants, licensing, customs or privatisation issues, may mean that a Russian legal entity is the required form of entity.

'Open' and 'closed' joint stock companies have legal personality and are broadly equivalent to public and private companies respectively. The minimum 'charter' (share) capital for open and closed joint stock companies is, respectively, 1,000 and 100 times the monthly minimum wage as set periodically by the Government. The minimum charter capital of a limited liability company is 100 times the monthly minimum wage. As of 1 January 2000 the minimum monthly wage was approximately equivalent to US \$3.

Partnerships may also be formed, but under Russian law and for tax purposes these are generally regarded as separate legal entities and are taxed accordingly. Contract based agreements for joint activity do not have legal personality, and share some of the characteristics of a tax transparent general partnership, with special rules governing their tax treatment.

Formal registration requirements

The registration procedure for Russian legal entities is complex and will normally be undertaken through the federal authorities. 'Shelf' companies are generally not available and the incorporation process can take from two to three months.

Registration is also required for a branch or representative office of a foreign legal entity. Registration of a branch or representative office of the foreign legal entity is in practice always accompanied by 'accreditation' of a foreign legal entity through a variety of federal and local bodies. Accreditation confers certain benefits, including exemption from value added tax (VAT) on the rent of office space and accommodation for foreign staff. Although it is not, in theory, a legal requirement, in some parts of Russia accreditation is effectively compulsory, since the local banks and administrative authorities may not recognise the office without this form of registration.

Accrediting organisations charge a fee in the region of \$1,000 – \$2,500 depending on the period of accreditation (from a year up to three years). The registration and accreditation procedures are fairly complex, but can normally be completed within two months.

Tax and Social Fund registration requirements

Every entity must register with the tax authorities in the place of its location as well as in each tax district in which it has a branch, a representative office or immovable property and transport vehicles which are subject to taxation. A foreign legal entity is required to tax register in each tax district in which it carries out entrepreneurial activity. The simplified registration procedure is available to foreign legal entities which do not carry out activity in Russia but have property in Russia or wish to open a rouble investment account with a Russian bank. A VAT only registration of foreign legal entities is available in principle in certain situations. A foreign legal entity must notify the tax authority in each tax district in which it has a source of income. Notification should also be sent to the tax office dealing with the location in which property belonging to the foreign legal entity is situated.

Separate registrations are required with each of the four Social Funds where there is a liability in respect of the remuneration of personnel. Entities are also required to register with the State Statistics Committee.

Legal entities are required to collect receipts into a bank account in Russia, unless permission to do otherwise has been granted by the Central Bank of Russia. There are special rules for petty cash operations which should be observed by Russian legal entities, representative offices and branches of foreign legal entities.

Importance of proper advisors

Whilst it is usually possible to achieve registration with the various bodies without professional assistance, it is advisable to seek legal or other advisors to assist in the process, especially when attempting to register a representative office of a foreign legal entity outside one of the large cities, where the local authorities are unaccustomed to dealing with anything other than Russian enterprises.

Privatization

Background

Russia's privatization process began in July 1992, when President Yeltsin signed a Decree requiring all large-scale enterprises to transform themselves into joint stock companies by October 1, 1992. In less than five years, this initiative introduced private ownership into more than 14,000 large and medium-size companies and turned 40 million Russians into shareholders.

Currently about 80 percent of Russia's enterprises are wholly or partly privately owned, with about half of the labor force working for enterprises with private or mixed ownership. As a result of the privatization process, a Russian equities market was born. Shares traded in Russia today are entirely the product of Russia's mass privatization program. It started in the period April–June 1994 when minority share holdings in over 300 of Russia's largest companies were auctioned off, including Gazprom, RAO UES, Lukoil, Zil, and Norilsk Nickel. Since scale and speed were important goals of the privatization process, most enterprises did not obtain a strong strategic owner to replace the state. In fact, most were neither restructured nor provided with any cash infusion as part of the privatization process.

However, substantial blocks of assets remain to be privatized; these include land, as a number of mainly agricultural regions see privatization as a prerequisite for building an effective agricultural sector. The manner in which these assets will be divested by the State will be crucial to the future shape of Russia's equity market and economy.

Privatization program

In 1993 President Yeltsin approved the State Program on Privatization of State and Municipal Enterprises in the Russian Federation. Since its adoption, this program has been amended to account for new changes in the market environment and has set forth the goals, tasks, priorities, limitations, and procedures of privatization.

The State Committee for the Management of State Property (GKI), currently The Ministry of Property Relations of the Russian Federation, was responsible for development of the privatization program. Under the overall control of GKI and the Federal Property Fund (the actual seller of State assets), property funds were organized at each level of the government—municipal, regional and federal. The property funds managed the sales of property allocated to each government level. However, sufficiently large subsidiaries of large state enterprises were allowed to spin themselves off from their parents and undergo privatization as separate companies.

According to the State Program on Privatization of State and Municipal Enterprises in the Russian Federation, enterprises were required to produce a privatization plan, approved by the relevant property fund, incorporating one of three privatization options authorized by GKI. The vast majority of the enterprises were privatized using the first and the second options, as described below.

The first option granted to past and present employees free, nonvoting preferred shares representing 25 percent of the value of the enterprise. This option was initially popular with larger enterprises, and it also allowed employees to purchase up to an additional 10 percent of the total shares as voting common stock at a 30 percent discount from the enterprise's July 1992 book value.

Because of the existence of these nonvoting preferred shares, an enterprise's choice of the first privatization option reduced the percentage of shares necessary for voting control from 51 to 38 percent. Such distinctions between the percentage of total shares and the percentage of voting rights are often blurred by Russian companies and brokers. Preferred shares carried substantial (noncumulative) dividend obligations, usually amounting to a minimum of 10 percent of annual profits.

The number of shares (preferred or common) to be issued by all companies was defined by a standard formula: the 1992 book value of the enterprise, under Russian accounts, divided by a standard nominal value (usually 500 to 1,000 rubles). Low book values allowed workers to acquire control at very low prices. Enterprises prepared their own book values for privatization purposes and purchases. This understatement, combined with 1992/1993 hyperinflation, resulted in book values that were often a fraction of the actual value perceived by managers and outside investors and made it possible for workers and managers to acquire control of leading companies for extremely low prices.

The second option, eventually selected by 75 percent of medium- and large-scale enterprises, allowed past and present employees to purchase 51 percent of the total shares of an enterprise in a closed subscription at 1.7 times the July 1992 book value. All shares in such companies were equivalent to common voting shares. No preferred shares were issued.

Significant categories of Russian enterprises, such as telecommunications, oil and gas, and energy companies, were initially held back from privatization, but they were added in late 1993 and 1994, when "golden" shares (such shares provided a veto right on the major issues on the general shareholders meetings) were created to allow the government to retain control of enterprises considered strategic, and specific categories of enterprises were excluded entirely from privatization (e.g., minerals, forest resources companies, firms involved in precious metals). The list of enterprises considered strategic and those excluded from privatization changed considerably over time, as did their privatization terms.

Voucher privatization and the creation of the equity market

In total, 148 million Russian citizens were eligible to receive free privatization vouchers, and approximately 146 million vouchers were distributed. Unlike those of some other countries where voucher privatization has been undertaken, Russian vouchers were fully transferable, and a secondary market in vouchers began almost immediately. Privatization vouchers were bearer securities, issued free, one per recipient. Distribution of the vouchers began in October 1991, and by the end of January 1993 a Presidential Decree required all large and medium-size joint stock companies to offer at least 29 percent of their shares for sale at voucher auctions.

Closed-end voucher investment funds (voucher funds) also appeared, both issuing shares in exchange for vouchers and purchasing vouchers for cash. The 640 voucher funds accumulated 65 million vouchers; however, only four voucher funds (First Voucher, Alfa Capital, Moscow Invest, and MMM-Invest) collected more than 1 million vouchers each, and only 21 funds collected even 100,000 vouchers. In

addition, a complex network of brokers and agents or intermediaries emerged across Russia to collect vouchers from citizens for resale to investment funds and to a hierarchy of domestic and international brokers and investors.

Investment tenders and cash auctions

Parallel to voucher privatization, a series of investment tenders was held for the sale of substantial stakes in companies, potentially leading to control. With respect to competing open investment tenders, the largest bid is evaluated on the basis of the present value of promised investment in the company over the next three years.

Voucher privatization was followed by a series of cash auctions (beginning in the autumn of 1994) in which Russians and foreigners could bid for shares. These auctions were supplemented by a variety of tenders and other strategies to dispose of the state's remaining holdings. Today's policy in privatization is mostly driven by the current economic situation and budgetary needs. The government also takes into account trends in the world economy and markets. On several occasions involving large-scale actions and tenders, it has sought independent valuation and other assistance from major international institutions. The government has adopted a case-by-case approach in privatizing the remaining enterprises.

The mass privatization lasted until the end of 1994. In 1995 the State continued to sell shares, but unlike the mass privatization, mostly shares of large Russian companies such as Surgutneftegaz, Norilsk Nickel, and Lukoil, were sold to large investors.

The privatization auctions lasted during 1996 and 1997 and one of the major deals was sale of 25% shares of Svyazinvest, which is a holding company for the majority of the telecommunication companies in the Russian regions. The shares were sold for 1,8 bln. USD to a consortium of Uneximbank and George Soros.

At that time, the securities market was growing and there was a significant interest to the state owned shares in the large companies. However, after the August 1998 financial crisis and the crash of the securities market, the government privatization program was disrupted due to the virtual collapse of equity markets in Russia. As a result many privatizations were cancelled or delayed. For example, the auction on sale of Rosneft, the major current 100% government owned oil company was moved and then even cancelled due to the undervaluation of shares.

One of the major privatization deals after the August 1998 financial crisis was the sale of oil company ONAKO to TNK in the September 2000. The 85% of ONAKO shares were sold for 1,08 bln.USD.

Regulatory structure for the Russian securities market

The regulatory framework governing the Russian capital markets is new and subject to ongoing changes. Until mid-1995 no single government or independent agency was charged with overseeing the Russian equity market or regulating its participants. The Ministry of Finance was initially charged with regulating brokers (through the issuance of licenses and monitoring capitalization requirements) and registering new issues. The agency primarily responsible for the regulation of the Russian securities market is the Federal Commission on Securities and Capital Markets (hereinafter, the Commission), which was established by Presidential Decree No. 163-rp on March 9, 1993. The Commission was composed of representatives from the Russian Ministry of

Finance, the Russian Antimonopoly Committee, the Central Bank of Russia, the Russian State Property Fund, and representatives from stock and commodity exchanges. The Commission was founded to assume and concentrate the regulatory powers previously distributed among these governmental agencies and to implement them for all market participants.

In November 1994, President Boris Yeltsin issued a major Decree on securities regulation entitled "On Measures to Effect State Control of the Stock Market in the Russian Federation." The Decree was designed to empower the Commission and to create a framework for future licensing of a wide range of securities market activities. Since its creation, the Commission has been working toward establishing a regulatory framework and procedures for the capital market. This has met with varying degrees of success, but the Commission's approach of pursuing, among other matters, the issues of transparency and protection of minority shareholders' rights has been praised by market participants.

The federal law "On Securities Markets," which was intended to become a comprehensive securities code that would regulate securities, the status of stock exchanges, transfer and protection of title, and the activities of all market participants, was adopted in April 1996. The law was put into effect along with a number of other decrees issued by the Federal Commission that are designed to regulate specific areas of the securities market.

In March 1999 the Law on the Protection of Investors' rights on the securities market was adopted. This law sets forth a number of measures aimed at improving the legislative framework, setting up Federal compensation fund for the investors, providing information disclosure guidelines, and imposing penalties for the violation of the securities market regulations by professional market participants and issues of securities.

Law on privatization

In July 1997, the Law on Privatization of the State Property and on the Principals of the Privatization of the Municipal Property in the Russian Federation was adopted. Under the law the Privatization Program is a key element of the law which describes the priorities, restrictions and principles of privatisation. The Privatization Program is adopted in the form of a law and the Government of the Russian Federation shall annually submit to the State Duma the law on the amendments and addenda into the Privatization Program.

Chapter 3. Labor relations and social security

Investor considerations

- Russia's well-educated workforce is capable of assimilating modern practices.
- Typical Russian wages are relatively low.
- Hard-currency devaluation of foreign currencies is occurring in Russia's inflationary environment; therefore an indexation system may be needed when reevaluating salaries.

Labor relations

Availability of labor

The labor force in Russia is well educated and highly skilled. Technical personnel tend to be highly adept at understanding and applying Western techniques. Russian professionals are competent in their fields, but professionalism varies. Because of growing unemployment in the Russian Federation, individuals with widely varying specialties are available. Secretarial and trained staff are available (especially in Moscow), and retention of administrative staff is no longer a problem. In remote areas of the Russian Federation, greater difficulties will arise when staff are sought, because foreign language abilities and experience in foreign firms vary.

Salary levels and benefit packages for top-level Russian specialists are becoming more comparable to those for their foreign counterparts. Russians are eager to work for foreign firms; however, many retain a casual work ethic that is not shared by the foreign employer. Furthermore, Labor Code provisions concerning sick leave, maternity leave, dismissals, etc., are viewed as very lenient by Western standards. The cost of training and replacing experienced staff can be great, and retention of staff on a long-term basis may therefore be difficult as the market for professionals grows.

Employer/employee relations

The foundation for the Russian Labor Code is the Soviet Labor Code, and employer/employee relations are heavily regulated. Considerable safeguards have been established to protect employees against wrongful dismissal, a harmful working environment and excessive working periods. Labor legislation makes it very difficult for the employer to terminate employment. Another policy from Soviet times grants liberal maternity leave of up to three years per child.

Employee training programs

The low cost of Russian labor makes the prospect of replacing expatriates with trained and skilled Russians highly expedient in economic terms. Consequently, training programs are proliferating among employers as well as through independent foreign government-sponsored initiatives. At present, employers tend to offer offshore training for future managers and skilled professionals. However, as companies expand their operations and develop staff and technical resources, employers are seeking to provide more on-site training for employees.

Working conditions

Employment contracts

A written contract of employment is the basic form of employment agreement. Contracts must be in written form and may not stipulate terms of employment less favorable than those stated in the Labor Code. Two basic types of contract are available—employment as a permanent staff member, all of whose taxes and social fund contributions are made by the employer, or as an independent contractor whose services are procured individually or through other firms or entrepreneurs and who are engaged to perform specific tasks of a limited nature or duration and for whom the employer makes only a limited number of statutory payments.

Wages and salaries

The minimum monthly wage is a coefficient used to calculate pensions, student stipends, some tax calculations, etc. The minimum monthly wage has been increased seven times since January 1996, once before the 1996 presidential elections, showing its political sensitivity. The current minimum monthly wage is 200 rubles, which is equivalent to about 7 US\$ in January 2001. However, the official minimum monthly wage used as a coefficient when calculating different payments, fines, stamp duties, etc is 100 rubles (since January 2001).

Wages in the public sector (e.g., for civil servants, teachers and academics, doctors and medical staff) are significantly lower than those in the private sector. Although employees working for foreign firms earn wages that may be considered by some as middle-class, the definition of what is middle-class is currently a matter of public debate.

Hard-currency compensation

Russian law permits Russians in certain cases to carry out operations compensated in and to possess foreign currency but prohibits over payment of salaries in Russia in any currency other than the ruble. Russians working for representative offices may be paid in hard currency on the grounds that they are employed by a foreign legal entity that is not resident for the purposes of the hard-currency regulations. Similarly, employment contracts may be drawn up by the foreign parent of representative offices, and payment may be effected from abroad. Payments in hard currency may be made only by bank transfer from abroad. If payment is made within the territory of the Russian Federation from Russian legal entities, the enterprise will be required first to make payment in rubles and then to convert it to hard currency. Where payment takes the form of business trip allowances, employers should take note of the limits deductible for tax purposes.

Other benefits

All employees are entitled under existing legislation to paid sick-leave allowances, which amount to between 60 and 100 percent of their salary, depending on the length of service, number of dependents and other factors. However, under the recent legislation the benefit for temporary incapacity to work shall not exceed a sum equal to 85 minimum monthly wages for a calendar month.

In some parts of the country private health clinics are beginning to open, and membership may be considered as one method of giving employees an additional, Western-style benefit (although it will be subject to taxation).

Historically, it has been common practice for employers to provide meals during the day due to the lack of external catering facilities readily available to employees. Day care,

housing and transportation benefits are fairly common in Russian enterprises, especially in the case of large enterprises in less-accessible locations.

Hours worked

The standard workweek in Russia is 40 hours over a five- or six-day week. Russian legislation is specific in its definitions of working hours permitted and the correct compensation for overtime and holiday/weekend work. On the eve of public holidays, work is required by law to end an hour earlier.

Paid holidays and vacations

All employees are entitled to a minimum four weeks' fully paid leave a year. Normally, vacation entitlement is granted to employees after they have worked at the company continuously for 11 months.

Russia has ten official annual public holidays (see the box at the end of Chapter 1).

Equal opportunities

The Labor Code states that "it is forbidden to reduce the pay of a worker on the grounds of sex, age, race, nationality, or religious or voluntary associations."

Health and safety

Health and safety standards are in force and should be negotiated with and approved by the workforce of the enterprise. New enterprises and machinery must pass health and safety inspections before being put into use. Legislation mandates health insurance for employees and allows for determination of responsibility and compensation for injury. In practice, Russian health and safety standards are not yet as stringent as in many countries and are not always applied as rigorously as they might be. Therefore, industrial injury is fairly common. Employer sanctions for noncompliance exist, but their enforceability is debatable.

Termination of employment

Unless otherwise stated, trial periods may not exceed three months or, if trade unions agree, six months. Trial periods are forbidden for employees under the age of 18 and for some other categories of employees. Before dismissing an employee, it is most advantageous to seek legal consultation before undertaking action due to the detailed requirements. An employee must give two weeks' notice. On the side of the employer, termination practices vary as regulated by the Labor Code.

Social security

Social security system

The Russian Federation has legislation effective from January 1, 1997 that mandates an ID system whereby all employees have a number that corresponds to an individual Pension Fund account. Initially, this causes a great deal of work for employers, because they are responsible for applying for the ID numbers and acquiring the work history, including lifetime salary paid to the individual. The individual's work history is recorded with this account number, and theoretically that individual will eventually receive a corresponding amount of money that has been contributed to the Pension Fund during the years of work service. This system is new to Russia, and it could potentially develop into a tax-tracking system.

Coverage

In theory, foreign workers are covered by the social security system, but payments to private health plans and offshore social security are more common.

Benefits

The state social security system provides pensions and maternity and unemployment benefits. At present, state benefits are very low by cost-of-living standards and are generally insufficient without an additional source of income. This is particularly the case for pensioners, who commonly continue working after reaching retirement age in order to supplement their pensions. There is considerable pressure on the government to address this issue, most especially in view of escalating unemployment and the related social implications.

Payroll costs

Because of price liberalization, government policy has been to encourage partial indexation of wages in compensation for inflation within the economy. However, pressure to increase wages has arisen from pricing wars between enterprises. Because wages remain low by the standards of other European countries, payroll costs are not a significant factor in production costs, although that could change because of uncertainty in the economy.

Foreign personnel

Visa requirement

Foreign personnel require a visa for entry into Russia (except citizens of majority of the former USSR countries and citizens of some other countries). Upon registering, they may stay freely in the country, provided their visa is valid. Visa applications must be supported by an invitation from a Russian individual or legal entity.

Foreign employment permits

On the basis of a 1993 Presidential Decree, employers must obtain a special general permit if they wish to hire foreigners. Each employee or prospective employee must receive confirmation from the Migration Authorities before being allowed to work in the Russian Federation. Although the decree states that the permit requirement does not extend to those enterprises that have “white collar” foreign managers and specialists, confirmation for each foreign employee is required, regardless of the nature of the enterprise or the employee’s position.

Living conditions

There are few if any restrictions on foreigners living in Russia; accommodations, domestic help and food may all be purchased for convertible currency or rubles, at the discretion of the employee.

Foreign citizens may now rent accommodations directly from Russians. Monthly rentals in major cities may be anywhere from US\$1,000 to US\$18,000, depending on the state of the apartment (in large cities, apartments tend to be the only choice), security, etc.

Schools and medical centers designed for foreigners and their families in Russia offer services comparable to normal Western standards but are considerably more expensive.

Chapter 4. Accounting and Audit

Accounting principles and practices

Investor considerations

- Although the Russian accounting reform is based on International Accounting Standards (IAS), Russian accounting rules are not yet in line with IAS.
- Inflation accounting is underdeveloped.
- The consolidated financial statements are treated as secondary to the stand-alone statutory financial statements of a company and are often not prepared.
- Fixed assets are often depreciated over a longer period than in accordance with IAS.
- Accounting profession is being formed.
- Accounting has become noticeably less tax-driven over the last few years.

Important aspects of Russian accounting and its regulation

One of the major differences of Russian accounting from international practice lies in understanding of the term “accounting”. In Russia it has the primary meaning of bookkeeping and the secondary of reporting. Therefore Russian accounting rules cover extensively rather bookkeeping procedures, than financial reporting rules.

Accounting in Russia is regulated by state authorities, not by professional independent organisations. Regulatory framework of Russian accounting has three levels. The first level includes the Federal Law on Accounting, Civil Code, Federal Law on JSC, etc. The second level of regulatory framework comprises Russian Accounting Standards, Chart of Accounts and other accounting regulations. The Central Bank is responsible for standard setting for banks and other credit institutions, the Ministry of Finance - for all other companies. Based on the legislation and regulations from the first two levels, accounting policies of a company are developed. Every company keeps its accounting books and prepares its financial statements in accordance with its approved accounting policies.

Although accounting procedures tend to become more harmonised with IAS, there is still a long way to go. Some significant differences still exist and in some areas there are no specific Russian accounting rules (RAR). For example, there are no rules for accounting of impairment of assets and for deferred tax; no specific rule for the classification of business combination between acquisitions and unitings of interest. The main differences between national accounting rules and IAS are presented in the Appendix 1 below.

Accounting principles and assumptions

The Russian accounting has moved a long way from a central-planning-based model toward a market-economy-based model and, consequently, toward international accounting practice.

In 1998 the Government of the Russian Federation adopted the Program of Reform of Russian Accounting in accordance with International Accounting Standards. In line with this Program new Russian Accounting Standards (RAS) are being adopted. They regulate major aspects of accounting, presentation and disclosure of information (such as

accounting policies, fixed assets, intangible assets, inventories, income and expenses, related parties, segment information, government grants and other). The new RASs have introduced fundamental accounting assumptions and requirements bringing Russian practice closer to the international practice, such as going concern, consistency of accounting policies, accrual basis, prudence, substance over form, cost-effectiveness and other. Practical interpretation of the requirements and assumptions under RAR may be different from IAS (e.g. RAR is often form-driven).

Russian statutory accounting was historically used mostly for tax reporting purposes, and tax considerations may still have sometimes significant effect on the accounting decisions.

Form and contents of statutory financial statements

The only financial statements acceptable for filing purposes are statutory financial statements. Structure, presentation, procedures for preparation, and other aspects of statutory financial statements are provided in the Russian Accounting Standard "Financial Statements of a Company." The statements are to be prepared in Russian rubles and in the Russian language. A company shall present its annual statutory financial statements to:

- stockholders of a legal entity in accordance with foundation documents;
- statistics authorities;
- the state tax authorities.

Basic annual statutory financial statements include a balance sheet, a profit and loss statement and notes to them (for example, cash flow statement and statement on changes in equity make part of notes). For qualified small businesses a simplified rules (and format) of accounting and reporting is allowed. The reporting year of a Russian company is generally the calendar year.

Chart of accounts

From 1 January 2001 the new (revised) chart of accounts has been introduced. The main categories of this chart of accounts are shown in Table below.

The chart of accounts must be applied in the territory of the Russian Federation by all commercial companies (except banks and state-financed companies) using a double-entry bookkeeping system.

Main Categories in Chart of Accounts

| <u>Category</u> | <u>Account number</u> |
|-----------------------------------|-----------------------|
| Non-current assets..... | 01-09 |
| Inventories | 10-19 |
| Costs of production | 20-39 |
| Finished goods and products | 40-49 |
| Cash..... | 50-59 |
| Settlements | 60-79 |
| Equity..... | 80-89 |
| Financial results..... | 90-99 |
| Off-balance sheet accounts | 001-011 |

Some important aspects

Balance sheet

On the face of the balance sheet all assets and liabilities should be classified into current and non-current depending on their maturity date. Assets and liabilities should be classified as current if their maturity date is within twelve months of the balance sheet date or within the operating cycle if the latter exceeds twelve months. All other assets and liabilities should be classified as non-current.

- **Receivables**

Provisions for trade debtors which have not been settled on due date and which were not secured by the appropriate guarantees (under Russian legislation such debts are classified as doubtful) are created at the reporting year-end. In the balance sheet the receivables are shown net of the provision.

- **Inventories**

Inventories shall be initially recognised at cost. The cost of inventories (by types) can be assigned by using different cost formulas in the event they are transferred for production or otherwise are disposed of. The following cost formulas are allowed: specific identification, average cost, first-in, first-out (FIFO) or last-in, first-out (LIFO). Finished goods are valued at actual cost, standard cost or direct costs. Work in progress can be valued at standard cost, direct costs, cost of raw materials and semi-finished goods, or actual cost (for unique production only).

For reporting purposes, inventories should be measured at the lower of cost and net realisable value (1) if the price of inventory decreased during the reporting year or (2) if inventory became obsolete or partially damaged.

- **Investments**

Investments should be carried at the cost incurred by the investor, including amounts paid to a seller under the contract, interest expense incurred prior to recognition of the acquired securities in the accounts, fees paid to intermediaries in relation to the acquisition and other similar items. Short-term foreign currency securities are shown at the exchange rate of foreign currency in terms of RR established by the Central Bank of the Russian Federation as at the balance sheet date. Long-term foreign currency securities are not revalued.

For reporting purposes investments in marketable equity stocks, that are quotable on stock exchange, and which quotations are published regularly, must be shown at the lower of book or market value.

- **Property, plant and equipment**

Property, plant and equipment shall be recognised at historical cost. To offset to a certain extent the effect of inflation on the fixed-asset base, a company has the right to perform the revaluation of the historical value of fixed assets and accumulated depreciation once a year (at the beginning of the year) or less often. Two methods of the revaluation are allowed, i.e. indexation and market valuation.

The depreciation of fixed asset items may be carried out by one of the following methods: the straight-line, diminishing balance, sum-of-the-years-digit or sum-of-the-units. However, the useful life in most cases is prescribed by government.

- **Intangible assets**

The composition of intangible assets is restricted by the relevant accounting standard. Amortisation of an intangible asset shall be charged over its useful life by:

- straight-line method;
- sum-of-the-units method; or
- diminishing balance.

An asset without a specified useful life may be amortised over twenty years, but not longer than the life of a company. Start-up expenses (if treated as a contribution of a company to the charter capital) and goodwill are included in the intangible assets and amortised on straight-line basis within twenty years. Amortisation of positive goodwill is used to allocate its depreciable amount on a systematic basis over its useful life. Amortisation of negative goodwill is accounted as operational income and form financial results of a company.

- **Legal reserve**

The legal reserve is formed to be used for a limited number of purposes (e.g. to cover the loss of the reporting year). The year-end balance of the legal reserve is carried forward into the next reporting period.

- **Finance lease**

Russian legislation provides that risks related to assets held under finance lease should be incurred by the lessor unless the lease contract provides otherwise.

For accounting purposes the finance lease contract must define whether the lessor accounts for and depreciates an asset held under finance lease and the lessee accounts for such an asset off-balance sheet, or vice versa.

Business expenses

All regular business expenses for accounting purposes are taken in full into the calculation of the profit (loss) for the reporting year. Such expenses include, for example, business travel expenses, advertisement expenses, payments made under insurance contracts and other.

In order to calculate profit for tax purposes adjustments are needed. For example, some types of regular business expenses such as payments made under some voluntary insurance contracts (including insurance of employees by an employer and insurance of professional liability), under contracts concluded in the favour an employee with non-state pension funds licensed by state, advertisement and business entertainment expenses are limited. In addition the adjustments may arise as the result of the cash basis being used for tax purposes.

Borrowing costs

Interest on loans is generally either recognised as an expense and taken in full to the profit and loss account or capitalised. The Russian accounting requires the capitalisation of borrowing costs during the construction of a non-current asset. Interest costs relating to intangibles and securities can also be capitalised up to the moment an asset is recognised in the books.

The cash flow statement

The information shown in the cash flow statement is different in many respects from a standard Western cash flow statement. For example, the cash flow statement does give a breakdown by types of activities, i.e. operating, financing and investment, but the

principles of this breakdown differ a lot from international practice. The Russian rules do not define the term “cash equivalents” and therefore cash balances per cash flow statement are reconciled to cash, rather than to cash and cash equivalents.

The explanatory notes

The explanatory notes to the annual statutory financial statements must contain essential information about the company and the financial status thereof, comparability of the information for the accounting year and the preceding years, significant accounting policies and other significant information for potential users of financial statements. Instances of non-compliance if any with the accounting rules must be reported in the explanatory notes with an appropriate explanation and discussion of the effect on statutory financial statements. The notes must also announce changes in accounting policies for the following accounting year.

The regulations prescribe the rules of disclosure that are in many respects comparable with the international practice. Those include post-balance sheet events, contingencies, related parties, earnings per share, segment information, government grants and other. However, the practical implementation and details of those rules may differ. Generally the scope of disclosure in RAR financial statements is less than in IAS financial statements, but is obviously increasing from year to year.

Consolidated financial statements

There is a requirement in Russian accounting to prepare consolidated financial statements, but they are still treated as secondary to the stand-alone statutory financial statements and are often not prepared. Consolidated accounts can be prepared under IAS or RAR. A group may prepare consolidated financial statements under IAS if the following requirements are satisfied:

- the Group must ensure the "trustworthiness" (dostovernost) of IAS consolidated financial statements;
- the disclosure notes to the IAS consolidated financial statements must cover accounting policies, including the measurement basis (or bases) different from the rules defined by the Ministry of Finance of the Russian Federation.

The decision on preparation of the consolidated financial statements under IAS instead of RAR is made by the management of the parent company or its owners/shareholders. The IAS consolidated financial statements prepared instead of consolidated statutory financial statements shall be provided to the owners/shareholders of the parent company.

Though the Russian consolidation rules introduce a procedural framework similar to the IAS, specific rules may differ (for example, in exceptional cases investments in subsidiaries and associates can be carried at cost) or may not address a number of practical issues.

Publication of financial statements

According to the Federal Law “On Accounting” and the Regulation on Accounting and reporting in the Russian Federation the annual statutory financial statements of a company shall be accessible for all interested users: bankers, investors, creditors, buyers, suppliers, etc. Those users can receive copies of the annual statutory financial statements if they have paid copying cost.

The Federal Law “On Accounting” and the Regulation on Accounting and reporting in the Russian Federation also establish the requirement of publicity of statutory financial statements for certain companies (for example, Open JSC, insurance companies). Those companies shall include publication of statutory financial statements in newspapers and

magazines that are accessible to the users of statutory financial statements, or distribute (among the users) some kind of brochures containing statutory financial statements, and also submit the statutory financial statements to regional state statistical authorities in accordance with the company's registration for further presentation to interested users.

The publication procedure for Open JSC requires publication of balance sheet, income statement and audit report. Prior to publication statutory financial statements must be approved by an AGM and audited. Depending on volume of operations and the size of a company, it may publish a balance sheet and income statement in a short form or in full.

The deadline for publication is June 1 of the year following the reporting year.

Accounting at foreign legal entities branches and representative offices of foreign companies in Russia

The Law on Accounting is applicable to foreign legal entities branches and representative offices in Russia, unless otherwise stipulated in international agreements of the Russian Federation. To set up and maintain accounting (including preparing of financial statements) foreign legal entities branches and representative offices in Russia may choose one of the following:

- rules existing in the Russian Federation (RAR);
- rules existing in the country where a foreign legal entity is located, if such rules do not contradict IAS issued by the IASC.

The choice of accounting rules by a foreign entity must be documented as an accounting policy.

If a foreign legal entity decides to apply RAR, it should fully comply with the requirements and procedures stipulated by the Law on Accounting, Regulations on Accounting and Reporting, other regulations and instructions on accounting. Under this approach accounting can be maintained under the rules adopted by the foreign company in addition to maintaining accounting under RAR.

If a foreign legal entity decides to apply rules, other than RAR, it should comply with the requirements and procedures, adopted in the country where the foreign legal entity is located.

Under any option as to accounting rules branches and representative offices of foreign legal entities must maintain tax accounting under the rules prescribed by the State Tax Service of the Russian Federation.

Trends in development of accounting

There have been sweeping changes in accounting legislation in the last few years that are part of the general process of Russia's economic transition to market values and the attempt to bring Russian accounting closer to international practice and standards.

An important tendency is that Russian accounting is becoming more independent of tax considerations. Although the influence of professional accounting organisations is strengthening the accounting profession is still in the process of formation and does not have a full set of clearly defined standards, code and objectives.

Recent developments in Russian accounting suggest that the Russian accounting system is becoming better adjusted to the market economy, the needs of potential investors, and is coming closer to international practice. The reform of Russian accounting is aimed to bring the Russian accounting closer to International Accounting Standards.

Appendix 1. Differences between Russian accounting rules and IAS

The table below is an extract from the publication “GAAP 2000 - A Survey of National Accounting Rules in 53 Countries”, which is the joint survey of the seven largest accounting firms, including PwC. This publication compares rules, that are in force for the financial period ending 31 December 2000.

| | |
|--|--------------------|
| Russian accounting may differ from that required by IAS because of the absence of specific Russian rules in the following areas: | |
| – the classification of business combinations between acquisitions and unitings of interest | IAS 22.8 |
| – provisions in the context of business combinations accounted for as acquisitions | IAS 22.31 |
| – the restatement of financial statements of a company reporting in the currency of a hyperinflationary economy in terms of the measuring unit current at the balance sheet date | IAS 29.8 |
| – the translation of the financial statements of hyperinflationary subsidiaries | IAS 21.36 |
| – impairment of assets | IAS 36 |
| – the recognition of operating lease incentives | IAS 17.25; SIC 15 |
| – accounting for defined benefit pension plans and some other types of employee benefits | IAS 19.52 |
| – accounting for deferred tax | IAS 12 |
| – accounting for an issuer’s financial instruments | IAS 32.18/23 |
| – the treatment of exchange differences resulting from severe devaluation or depreciation of a currency | IAS 21.21; SIC 11 |
| – the notion and definition of cash equivalents and detailed guidance on the preparation of cash flow statements | IAS 7.6-9 IAS 7 |
| – consolidation of special purpose entities | SIC 12 |
| – recognition of a decline, other than temporary, in the carrying amount of long-term investments, other than marketable equity securities. | IAS 25.23 |
| There are no specific rules requiring disclosures of: | |
| – a primary statement of changes in equity | IAS 1.7 |
| – a primary statement of cash flows | IAS 7 |
| – the FIFO or current cost of inventories valued on the LIFO basis | IAS 2.36 |
| – the fair value of financial assets and liabilities | IAS 32.77 |
| – related parties information except by certain reporting companies with specific legal form (joint stock companies); fellow subsidiaries under common control do not qualify for consideration as related parties | IAS 24.1-4 |

| | |
|--|-------------------------|
| – discontinuing operations | IAS 35 |
| – certain segment information (e.g. a reconciliation between the information by reportable segment and the aggregated information in financial statements, significant non-cash expenses, other than depreciation and amortization, that were included in segment expense and, therefore, deducted in measuring segment result – for each reportable segment). | IAS 14.61/67 |
| There are inconsistencies between Russian and IAS rules that could lead to differences for many enterprises in certain areas. Under Russian rules: | |
| – research costs can be capitalized | IAS 38.42/51 |
| – goodwill is calculated by reference to the book values of acquired net assets | IAS 22.40 |
| – proportionate consolidation may be used for subsidiaries in which the parent has 50 per cent or less of the voting power | IAS 27.15 |
| – revaluation of property, plant and equipment is allowed but gives different results than IAS and need not be kept up-to-date | IAS 16.29 |
| – the period of depreciation of property, plant and equipment is in a number of cases prescribed by government and is longer than the period over which an asset is expected to be used | IAS 16.6/41 |
| – finance leases are generally defined in legal terms and capitalization is allowed but not required | IAS 17.3/12.28 |
| – lessors recognize finance lease income differently | IAS 17.30 |
| – the completed contract method can be used for the recognition of revenues on construction contracts when the outcome of a construction contract can be estimated reliably | IAS 11.22 |
| – provisions can be established more widely or less widely than under IAS, and there is no requirement for discounting | IAS 37.14/45 |
| – own (treasury) shares are shown as assets | SIC 16 |
| – classification of cash flows between investing and financing activities in the cash flow statement may be different from IAS | IAS 7.6/16/17 |
| – cash flow statements reconcile to cash rather than to cash and cash equivalents | IAS 7.45 |
| – the correction of fundamental errors is included in the determination of the net profit or loss for the reporting period, but separate disclosure and pro-forma restated comparative information are not required | IAS 8.34/38 |
| – revenue recognition rules do not differentiate between exchanges of goods of similar nature and value and exchanges of dissimilar goods, and do not discuss adjustment for the amount of cash or cash equivalents transferred in exchanges for dissimilar goods | IAS 18.12; IAS 16.21/22 |
| – the definition of extraordinary items is broader. | IAS 8.6/12 |

| | |
|---|--------------|
| In certain enterprises, these other issues could lead to differences from IAS: | |
| – some parent companies do not prepare consolidated financial statements | IAS 27.7/11 |
| – in the definition of control, the ability to govern decision-making is not required to be accompanied by the objective of obtaining benefits from the entity's activities | IAS 27.6 |
| – investments in certain securities held for the short term are not required to be carried at the lower of cost and market value or at market value | IAS 25.19/23 |
| – certain subsidiaries may be excluded from consolidation beyond those referred to in IAS | IAS 27.13 |
| – a subsidiary that is a bank may be excluded from consolidation if it is dissimilar from the rest of the group | IAS 27.14 |
| – certain set-up costs that have been paid by a company's founder can be capitalized | IAS 38.57 |
| – the realizable value of inventories can be measured without deduction of costs. | IAS 2.6 |

Audit requirements and practices

Investor considerations

- An annual statutory audit is mandatory for all companies with foreign participation and for other categories of entities meeting certain criteria set by Russian legislation (see below).
- Russian audit legislation is being developed; 38 auditing standards have been issued (one of them was specially designed for banking audit).
- Russian standards on auditing and audit practices are close but not identical to the international practice.
- Licensing is mandatory for audit firms and auditors working independently.
- In order to conduct audit activities auditors should have an audit certificate.

Companies subject to statutory audit

In accordance with the Russian auditing legislation some companies are obliged to audit its annual statutory financial statements. The commercial non-governmental companies, the annual statutory financial statements of which are subject to statutory audit include:

1. All open joint stock companies.
2. Banks and other credit institutions, insurance companies commodity and stock exchanges, investment funds, financial/industrial groups, holding companies, charitable and other (non-investment) funds, etc.
3. Companies with any foreign participation in the charter capital.
4. Other companies with annual sales exceeding 500,000 times an average official minimum monthly wages for the reporting year; companies with balance sheet total assets exceeding 200,000 times an average official minimum monthly wages for the reporting year.

In addition, annual statutory financial statements subject to publication must be audited by independent auditors prior to publication.

Consolidated financial statements are not subject to mandatory statutory audit.

Objective of statutory audit

The objective of an audit as defined in Russian Standard on Auditing (RSA) is to form and express an opinion on the *dostovernost* (trustworthiness) of statutory financial statements. An auditor's opinion on *dostovernost* of statutory financial statements assesses the compliance of statutory financial statements with Russian accounting rules in all material respects. The information is considered material if its omission or misstatement could influence the economic decisions of reasonable users taken on the basis of the financial statements.

Audit standards/legislative framework

The Temporary Regulations for Conducting Audit Activity in the Russian Federation (the Regulations), adopted by the Decree of the President of the Russian Federation dd. 22.12.93 #2263, regulate the audit activity. They define audit services; establish rights, obligations, and liability of auditors and audit firms; discuss confidentiality and independence; and set forth-meaningful compliance regulations.

The Presidential Audit Committee is responsible for developing the standards, issuing methodological recommendations, organising forums for enhancing the level of professionalism of auditors, and regulating the activities of audit firms and auditors. The Committee approves RSA (till the moment 37 RSA were approved and issued; 1 audit standard was specially designed for audit of banks and credit institutions and was approved by the Central Bank Audit Committee). RSA cover the most of important audit issues and can be generally compared with the international practice. However, the practical implementation and details of those standards may differ from the international ones.

The draft of the Federal Law on Auditing is being actively discussed in Parliament (State Duma) of the Russian Federation.

Audit profession

In accordance with the Russian auditing legislation for conducting audit activities audit firms should have a special license. The Ministry of Finance is responsible for licensing of audit firms and issue special licenses for audit of insurance companies, audit of exchanges and investment institutions and audit of other commercial companies (except banks). The Central Bank is responsible for issuing of licenses for audit of banks.

In order to obtain the license the participation of audit firms or certified auditors in the charter capital of an audit firm seeking an audit license must be at least 51 percent.

In order to conduct audit activities individual auditors should have an audit certificate. Individuals applying for audit certificate must have an education in economics or law, and for at least three of the five years immediately before the certification exam the individual must have practical experience as an auditor, accountant, economist, head of a company, scientist, or economics professor.

Conclusion

In the last few years significant progress was demonstrated in the field of accounting reforms, but there is no the full set of accounting standards yet. Auditing reforms are also in process. The legislative framework for Russian audit is under development. The Law on Auditing has not been yet introduced. Standards on Auditing are being approved. Foreign investors are well advised to choose their auditors carefully so that the audit gives an accurate and objective reflection of business activities.

PricewaterhouseCoopers in Russia is very active in establishing a legislative framework that will permit the profession to function according to clearly defined standards and objectives. This is an area where PricewaterhouseCoopers has found itself readily able to give expert advice based on its experience and knowledge, of both the modern-day requirements of a fully functioning market economy and the structural problems pervading the Russian business arena.

Chapter 5. Taxation

Investor considerations

- The fundamentals of a modern tax system were introduced in 1991. However, there have been substantial changes and amendments to this system introduced by the Tax Code.
- The tax system is subject to ongoing amendments and varying interpretation.
- There is a growing body of judicial decisions to support interpretations.
- Form is critical and at times seems more important than substance.
- The calendar year is the only accepted year.
- International tax treaties are recognised.
- Transfer pricing regulations were introduced by the Tax Code from 1 January 1999 and may be further strengthened in future.
- The Tax Code is aimed at lowering the tax burden and streamlining the Russian tax system.

Tax system

Introduction

The Russian tax system continues to evolve significantly. Yet, the present tax regime remains rather complex and contradictory, with a large number of separate laws regulating some forty taxes. The first (general) part of the Tax Code, which seeks to rationalise the tax system, came into force on 1 January 1999.

Only several sections of the second part of the Tax Code are effective at the moment. In particular, the Chapters covering value-added tax, excise taxes, personal income tax, and unified social tax came into force from 1 January 2001. The Profits Tax Chapter and the Tax on Extraction of Mineral Resources' Chapter will come into force from 1 January 2002.

Another positive development is the Russian tax authorities' increasing recognition of international tax responsibilities and extension of the network of Double Tax Treaties. Together with Treaties concluded by the USSR, which Russia continues to honour, there are now 54 Treaties in force, and around 30 further Treaties are in various stages of negotiation or ratification.

Principal taxes

The structure of the Russian tax system provides revenues for three tiers of budget: federal, regional, and local. All taxes are legislated at the federal level, although regional and local governments have powers to set the rates and establish specific procedures as to the taxes that are designated as regional or local.

The following summarises the major taxes currently payable by businesses and individuals in Russia. This is not an all-inclusive list, and there are a number of further federal, regional, and local government fees on certain activities, including various stamp duties, license, and registration fees. The tax burden varies depending on

whether a local authority has followed progressive or regressive tax policies and can include various levies and duties considered advantageous for the local infrastructure (levies for support of the local police, soccer team, etc).

Federal taxes

- Profits tax
- Value-added tax (VAT)
- Road users' tax (effective until 1 January 2003)
- Excise taxes
- Personal income tax
- Unified social tax
- Customs duties
- Tax on extracting mineral resources
- Payments for the use of natural resources
- Mineral resources restoration tax (will be abolished from 1 January 2002)

Regional taxes

- Property tax
- Sales tax
- Uniform tax on imputed income for specific types of activities

Local taxes

- Advertising tax

Generally, the lower-tier authorities cannot grant concessions with respect to taxes designated to an upper-tier (i.e. regional authorities cannot grant concession on federal taxes) even though a certain portion of federal taxes is credited to the regional/local budgets. The only exception is profits tax where the regional authorities are permitted to grant concessions within the amounts allocated to the regional/local budgets. However, this provision is effective only until the end of 2001. Starting from 1 January 2002 profits tax concessions cannot be granted by regional/local authorities. The only right the regional authorities will have is to reduce the regional profits tax rate by no more than 4% for certain groups of taxpayers.

Tax year

The tax year in Russia is the calendar year. Different fiscal year-ends are not permitted.

Legislative framework**• Statute law and case law**

The legal system in Russia is based on civil law and its principles. Courts are not formally bound to follow judgements issued by superior courts. Russia only implemented tax reforms recently, and, therefore, case law at present has a limited impact on interpretation. However, we are starting to see occasions where decisions of the Higher Arbitration Court and the Constitutional Court were an important factor in interpretation and application of the relevant tax laws.

• Anti-avoidance

The existing law does not contain many anti-avoidance provisions. A major development in this area was the introduction of new transfer pricing rules which are in effect from 1 January 1999. According to these rules, tax authorities have the right to adjust prices of transactions between related parties, barter transactions, foreign

trade transactions and in relation to goods sold where the prices fluctuated by more than 20% within an insignificant period of time. If a transaction meets any of the above criteria, it may be adjusted for tax purposes if it differs from the market price by more than 20%. The specifics of Russian transfer pricing rules are that they apply not only to cross-border transactions but also to transactions within the country.

Currently, there are no rules to counter thin capitalisation, although there is a practical disadvantage for inter-company loan financing in that interest is subject to restricted deductibility. Starting from 1 January 2002, thin capitalisation rules will be introduced, according to which a proportion of the interest payable by a Russian organisation to a foreign legal entity owning (directly or indirectly) more than 20% of its charter capital may be disallowed as a deduction and reclassified as a dividend. The thin capitalisation rules will only be applicable if the taxpayer's outstanding debt owned to this foreign legal entity exceeds, by more than 3 times, the foreign company's proportionate ownership in the taxpayer's capital.

- **Form versus substance**

The common approach practised by the tax authorities is to follow the form rather than the substance of a transaction. This is a factor that has influenced wide spread aggressive tax evasion techniques based on "form-over-substance". However, the recent trend is to pay more attention to the substance of the transaction when justifying it for legal or tax purposes.

Tax administration

Investor considerations

- There are strict penalties for tax evasion.
- Tax authorities carry out field audits on a regular basis.
- The "Tax Police" bolsters enforcement.

Administration of the tax system

Taxes, duties, and fees are enacted by law and may be changed only by new laws. The Ministry of Taxes and Levies is responsible for collecting taxes and its work is closely co-ordinated with that of the Ministry of Finance, which has overall responsibility for collection of revenues to the Russian budget, as well as with other law enforcement bodies, in particular the Tax Police. The Tax Police was introduced into the Russian tax system in 1993 with an ultimate goal to expose tax infringements and investigate cases of gross tax evasion, which is a criminal offence under Russian law. This and is a powerful tool for tax administration because of the Tax Police's broad and vaguely worded powers.

Corporate taxpayers

- **Registration requirements**

Every entity must register with the tax authorities in the place of its location as well as in each tax district in which it has a branch, a representative office, other separate subdivisions, or immovable property and transport vehicles. A foreign legal entity is required to tax register in each tax district in which it carries out entrepreneurial activity for more than 30 days in a calendar year, or where it has immovable property or transport vehicles. A simplified registration procedure is available to foreign legal entities that do not carry out activity in Russia, but have property in Russia or wish to open Rouble accounts with a Russian bank. A foreign legal entity must notify the tax authority in each tax district in which it has a source of income. Notification should also be sent to the tax office dealing with the location in which movable property belonging to the foreign legal entity is situated.

- **Tax returns and assessments**

Companies are required to file reports with the tax authorities on a quarterly or monthly basis, depending on the particular tax and the company's line of business. Taxes are paid in quarterly or monthly instalments, and a final adjustment is made when the annual tax returns are submitted.

- **Tax audits**

Tax returns for Russian legal entities are audited by the tax authorities at the time they are submitted. A tax officer reviews and verifies the tax calculations on the basis of the financial statements submitted. The tax authorities do not issue tax assessments to enterprises; instead, the company must pay the amount of tax indicated in the tax return, as agreed to by the tax officer.

In addition, the tax authorities may perform field audits of companies, which will involve a thorough investigation of records and documentation underlying the tax calculations. Such audits may not last for more than three months, and may cover

only three calendar years prior to the year of the audit. Once audited, the tax authorities may not audit the same period again (although some exceptions apply).

- **Individual taxpayers**

An individual is tax resident in Russia if physically present in Russia for more than 183 days in a calendar year. Arrival and departure days are counted as one Russian day for this purpose. Subject to Double Tax Treaty protection, a resident individual is taxed on worldwide income. A non-resident is taxed on income from sources in Russia.

- **Employer's withholding obligations**

Income tax should be withheld at source by an employer who is deemed to be a tax agent, in respect of all remuneration paid to individuals (employees and individual contractors, except for those who are duly registered individual entrepreneurs). Under current rules, responsibility to be a tax agent lies with Russian entities, individual entrepreneurs and permanent establishments of foreign legal entities in Russia. In addition to withholding obligations, employers are required to provide to the tax authorities with information on income paid and tax withheld, and to notify the tax authorities about factual issues where the tax cannot be withheld.

- **Tax returns**

Individual taxpayers (i) who are self-employed, (ii) who are reimbursed by other individuals not deemed to be tax agents, (iii) who are residents receiving income sourced from outside Russia and (iv) individuals whose income was not taxed by tax agent at source are required to file an annual tax return and pay their tax. Personal income tax withheld by the tax agent is credited against the final tax liability for the year.

- **Spouses**

Spouses are liable for personal income tax separately and are required to submit their own tax declaration.

- **Exit permits**

When an expatriate individual ceases his activities in Russia, a final tax return must be submitted within one month prior to departure. A formal exit permit is not required.

Tax administration for foreign nationals

Foreign personnel are treated in the same way as Russian nationals, except insofar as they spend time in Russia without having a permanent residence, are seconded to Russia, and can benefit from a Treaty for the avoidance of double taxation.

Penalties and interest

The penalty regime has changed with effect from 1 January 1999 and has generally become less severe. The law provides for a variety of tax violations with various penalties for each violation. For example, a 20%-40% penalty is charged for underpayment of taxes. The late filing of a tax declaration carries a penalty of 5-10% per month of the unpaid tax. A number of fixed penalties are applied to a taxpayer for failure to register, failure to supply the tax authorities with required information etc. Failure to withhold tax due results in a 20% penalty for the tax agent.

Interest for late payment is charged at a rate no higher than 1/300 of the rate of the Central Bank of Russia (55% as at 1 January 2000, 45% as at 24 January 2000, 38% as at 7 March 2000, 33% as at 21 March 2000, 28% as at 10 July 2000, 25% as at 4 November 2000) per day. The amount of underpaid tax, and interest for late payment,

can generally be collected by the tax authorities without agreement of the corporate taxpayer or a court decision. However, collection of penalties requires the ultimate agreement of the taxpayer or a court decision.

Appeals

In cases of an overpayment of tax, the taxpayer may apply for a refund of the amount overpaid.

Appeals against decisions of the authorities may usually be made to the next highest tax authority or through the courts. More and more taxpayers are challenging the authorities with relatively positive requests.

Taxation of corporations

Investor considerations

- Currently, taxable profit is generally based on accounting profit after adjustments. Starting from 1 January 2002, it should be calculated based on separate tax accounting records.
- Tax accounting requirements are introduced from 1 January 2002.
- The profits tax rate is reduced from 35 percent to 24 percent from 1 January 2002.
- Loss carry forward is available, subject to certain restrictions.
- Depreciation is usually tax deductible within norms.
- Some items of expenses, commonly thought of as deductible, are either limited as deductions or not deductible.
- Thus far no withholding tax or restrictions apply to the transfer of funds between a representative office or branch and the home office.
- Tax consolidation between different legal entities is not permitted.

Corporate tax system

The present tax system is new, and many tax issues encountered in longer-established systems have not yet arisen or been resolved in Russia. Therefore, many concepts familiar to foreign business people and tax specialists are unknown in Russia. As new concepts are introduced or discovered by the Russian authorities, they are often applied differently than in the West. With the influence of foreign investors and advisors, the system and rules are settling into more “normal” interpretations, but not without some awkwardness along the way. However, this general lack of understanding and misinterpretation can often be used to the investor’s advantage, especially since the Russian tax system values form over substance.

The best recipe for success in such an environment is to keep transactions simple, be responsive to change in all aspects of business operations, and have strong tax and legal assistance.

• Corporations and shareholders

Corporations and their shareholders are separately taxed. All corporations are subject to a flat-rate profits tax of up to 35% (for banks, insurance companies, and entities involved in intermediary operations a higher rate of up to 43% is applied), with the exception of dividends received. Starting from 1 January 2002 the profits tax rate for all taxpayers will not exceed 24%. Dividends received are currently subject to a 15% withholding tax in the hands of the payer irrespective of whether dividends are paid to a Russian or foreign legal entity, and whether the source of dividends is a Russian or foreign legal entity (though no procedure for collection of this tax exists with respect to dividends received from foreign corporations). Starting from 1 January 2002, different rates will be applicable to dividends received from Russian companies by Russian companies and Russian individuals who are tax resident of 6% and in other cases 15%. Dividends received by foreign shareholders can be reduced or even eliminated under the provisions of a relevant Double Tax Treaty.

- **Taxable entities**

The corporate income tax system distinguishes between resident legal entities and representative offices/branches of foreign corporations. Partnership profits are taxed in the hands of the partners.

- **Territoriality**

Russian legal entities, with or without foreign shareholders, branches and representative offices of foreign companies, undertaking activities which are not protected under the terms of a relevant Double Tax Treaty, are subject to corporate tax in Russia on profits, including capital gains. A Russian legal entity is taxable on worldwide profits and a foreign legal entity on income and profits from sources in, or from activities performed in Russia.

Basis

Legal entities are generally subject to profits tax on income generated from the sale of goods, services or works, sale of property and any other income (receipts) unless it is specifically exempt from taxation.

All Russian legal entities are required to keep accounting records according to the prescribed Russian Accounting System. Historically the principal purpose of the accounting system was to establish the tax base, and while this is changing, it is still the case that few adjustments are required to adjust accounting profit to taxable profit.

From 1 January 2002, in addition to the Russian Accounting System, Russian legal entities are required to maintain a Tax Accounting System. It is stipulated that the tax base will be determined directly from the Tax Accounting System.

Sales income for tax purposes may currently be computed either on a cash or accruals basis (subject to an annual election), but from 1 January 2002 only very small taxpayers will be allowed to use the cash basis. Therefore, the accruals basis becomes compulsory beginning 1 January 2002. Expenditures are generally allowed on an accruals basis; if the revenue is recognised in accordance with the cash method for tax purposes, the expenditure is adjusted accordingly. The accounting year is the calendar year.

Before 1 January 1999, branches of Russian legal entities which had bank accounts and maintained separate balance sheets were considered separate taxpayers with no possibility for consolidation for tax purposes with the head office or other branches. After introduction of the first part of the Tax Code, the tax in relation to branches is not calculated separately, but instead, a proportion of the overall tax liability should be distributed to the local budget.

The statutory accounts of a Russian open joint stock company, a legal entity with turnover or assets in excess of a certain amount, and companies in certain industries must be independently audited.

Deductible expenses

Under the current rules, expenses are deductible if they are specifically listed in the relevant legislation. The list of deductible expenses covers major types of expenditure. There are burdensome and not always well defined requirements for documentation of expenses incurred, and insufficient documentation or non observance of legal requirements for preparation of such documentation may often be a reason for the disallowance of expenses for tax purposes.

The Profits Tax Chapter of the Tax Code makes a significant step forward in respect of improvement of deductibility rules for tax purposes. The new rules significantly broaden the list of deductible expenses. Starting from 1 January 2002, companies will be able to deduct expenses incurred for the purpose of carrying out activities aimed at deriving profits, which should be economically justified and supported with relevant documentation. The Tax Code establishes a list of non-deductible (or partially deductible) expenses and defines certain types of expenses subject to amortisation. There are still a number of restrictions on the tax deductibility of expenses, including (but not limited to) the following:

- insurance premiums are deductible within certain limits; not all types of voluntary insurance are deductible;
- expenditures for entertaining may only be deducted up to a limit expressed as a percentage of payroll ;
- certain types of advertising expenses are deductible up to a limit expressed as a percentage of turnover;
- interest on loans may be subject to limitation in certain cases;
- business trip per diem expenses are only deductible within specified norms.

Depreciation for tax purposes

On 1 January 1998 a new depreciation regime for fixed assets was introduced, but only for accounting purposes. It allows companies to determine the useful life of a fixed asset and depreciate it in accordance with one of the four allowed methods, including straight-line and reducing balance methods. However, in accordance with the existing tax rules, depreciation for tax is calculated under a statutory code, on a straight line basis, and generally with assumed asset lives significantly longer than is generally the case in most jurisdictions. A new procedure for calculation of depreciation expenses allowed for deduction, which significantly differs from the existing one, will come into force from 1 January 2002. For instance, the new rules provide for the possibility to use either the straight-line or reduced balance method. Depreciable property will be classified into 10 groups depending on the assets useful life determined in accordance with the Classification of fixed assets to be approved by the RF Government.

Intangible assets are amortised over the life of the asset. If the useful life of the asset cannot be ascertained, the amortisation period for profits tax purposes is ten years. Tax depreciation is calculated on a monthly basis from the month following the date on which the asset is placed in servicing until the date of its disposal, when it is written off or fully depreciated.

Rate

Profits Tax currently consists of three elements:

- The Federal portion of 11%,
- The Regional portion of up to 19% (up to 27% for banks, brokers, insurance companies and intermediary activities);
- The Local portion of up to 5%.

With effect from 1 January 2002 the distribution of tax between budgets will become as follows:

- The Federal proportion of 7.5%;

- Regional proportion of up to 14.5% (but not less than 10.5%);
- The Local proportion of 2%.

Timing of profits tax payments

Profits tax is payable on a year to date basis, either quarterly with monthly advance payments, or monthly. Companies may choose between paying profits tax monthly, on the basis of actual profits or quarterly with monthly advance payments. Under the monthly payments system, reports are filed by the 20th (30th - from 1 January 2002) of the month following the reporting month and the tax must be paid by the 25th (30th - from 1 January 2002) of the month following the reporting month. Currently, under the quarterly system a report on the estimated profit of the company for each quarter must be filed before the beginning of the quarter, with a quarterly return of actual results filed by the end of the month following the quarter. Advance monthly tax payments should be made by the 15th of each month based on an estimate, with a balancing payment made within 5 days after the due date for filing the return, on the basis of cumulative year to date results. A final annual return should be filed by 30 March following the accounting year, and the balancing payment shall be made no later than 10 days after the due date for filing the annual return. Interest at the CBR rate shall be paid in respect of the difference between the actual tax and the advance tax paid.

Starting from 1 January 2002, under the quarterly system, monthly advance payments, calculated based on the profits of the previous quarter, should be paid by the 15th day of each month. The quarterly and annual payments should be made by the 30th day after the end of a particular quarter and by the 31st of March of the following year respectively. The quarterly and annual returns should be filed within the same deadline.

Small businesses do not need to make advance tax payments.

Since 1 April 1999, representative office and branches of foreign legal entities are to follow broadly the payment schedule as that established for Russian legal entities, though the annual tax return is due by 15 April. The final payment should be made by 25 April of the year following the reporting year. (starting from 1 January 2002 the annual tax return of a foreign legal entity will be due by 31 March).

A foreign legal entity which has no presence in Russia, but has a source of income in Russia, must file a notification of this income with the tax authorities, irrespective of whether a claim is to be made under a Double Tax Treaty for exemption or reduction of tax.

Losses carried forward

Currently, enterprises are entitled to carry losses forward for five years following the loss year. Losses should be decreased by the amount of any expenses exceeding statutory norms. Losses are not indexed to reflect inflation. Taken together with the capital investment allowance (see further below) and other tax incentives, a loss brought forward from an earlier year cannot reduce the tax liability by more than 50%. Losses cannot be transferred to related Russian companies, as there is no consolidation for tax purposes.

With effect from 1 January 2002, losses may be carried forward for 10 years. However, the amount of losses utilised in a particular year cannot exceed 30% of the tax base calculated in the reporting period. Taxpayers are allowed to carry forward the

total amount of loss calculated based on tax rules. In case of a reorganisation, losses of the “old” company may be utilised by its successor.

General reliefs

There are a number of profits tax reliefs, the main granted at the Federal level. However, the majority of them will be revoked from 1 January 2002, in particular:

- The capital investment relief;
- The new production facilities relief (exemption for profits earned through new production facilities created before the enforcement of the Profits Tax Chapter will be valid until the end of the payback period, but no longer than 3 years);
- small enterprises relief (the concessions granted before the enactment of changes in profits tax legislation are valid until expiration of the period for which they were granted);
- concessions established by the current law for educational institutions, mass-media companies, and manufacturers of medicines.

The right of the regional and local authorities to grant profits tax concessions with respect to the portion of profits tax payable to their budgets is also restricted. Such tax reliefs may be established only with respect to the 'regional' profits tax rate which cannot be decreased by more than 4%. The profits tax reliefs made available to taxpayers by regional and local administrations based on relevant investment agreements as of 1 July 2001 should continue to be valid for the period such concessions were initially granted, or, if such period is not determined, within the payback period of the investment project but no more than 3 years.

Special provisions

Certain types of businesses, for example gambling, are taxed under separate rules and generally are not subject to the general profits tax provisions. Local authorities have the right to introduce tax on imputed income in their territories for legal entities and individual entrepreneurs carrying out activities in certain industries, including retail sales of fuel and lubricants, retail sales to the general public and transport services, provided the number of employees in the organisation does not exceed a certain threshold, as well as certain other criteria are met. The rate of the tax is established at 20%. The imputed income is determined in accordance with special formulae. Payers of the tax on imputed income are relieved of payment of most other taxes.

Small enterprises meeting certain requirements may apply a simplified system of taxation and accounting, and pay a unified tax on income and a reduced number of other taxes.

Taxation of foreign corporations

Investor considerations

- Conducting business through an agent may create a taxable permanent establishment in Russia.
- Dividends and interest paid to foreign corporations are taxed at source.
- No withholding tax or restrictions apply to transfers of funds between a representative office or branch and the home office.
- Sale of goods into Russia requires careful planning.
- Commercial business operations of representative offices and branches are subject to profits tax.

Tax registration requirements

If a foreign legal entity carries out or intends to carry out, an activity in the Russian Federation for a period exceeding 30 days, it is required to register with the tax authorities at the place where the activity is conducted, regardless of whether the activity is taxable. The legislation does not even require that the activity be a business activity. In addition, if the foreign legal entity has activities in several regions throughout Russia, a separate tax registration in each region is required.

Tax concepts

Foreign corporations are subject to corporate income tax on the income generated from sources in Russia. In general, taxation of business profits is limited to those attributable to a permanent establishment ("PE"). A PE is broadly defined in the profits tax law as "a branch, division, office, bureau, agency, or any other place through which a foreign legal entity regularly carries on its business activities in Russia." However, provisions in Tax Treaties with the Russian Federation may contain a different definition of a PE that provides relief.

The profits tax law (and the Profits Tax Chapter of the Tax Code) provides that a foreign legal entity is also considered as having created a PE if it conducts business activity in Russia through a representative. This is defined as a Russian legal entity or individual that represents the interests of the foreign legal entity in the Russian Federation on the basis of a contract, acts on behalf of that foreign legal entity, and has authority to conclude contracts in the name of that foreign legal entity or to negotiate significant terms of contracts.

Representative offices and branches are subject to tax on substantially the same basis as Russian legal entities, although where it is not possible to calculate profit directly, for example, because services are provided without charge to another group company, a deemed profit, as 25% of costs attributable to such activities, is generally used as the tax base. After introduction of the first part of the Tax Code on 1 January 1999, in relation to transactions between related parties for tax purposes, market price of the relevant goods or services may be imposed. Among significant changes introduced starting from 1 January 2002 is the sharp limitation on application of the deemed method of calculating profits. In accordance with the Tax Code, the deemed method can be used for determining the tax base only in cases where a foreign legal entity conducts free-of-charge preparatory and/or auxiliary services for third parties resulting in creation of a PE. In such cases, the tax base has been set at 20% of the PE's expenses on such activities.

Income of a PE may be reduced by the amount of expenses incurred by this PE. The Tax Code does not specifically provide for the deductibility of expenses incurred abroad by a head office with respect to its PE in Russia (though most DTTs provide such possibility). The composition of profits tax deductible expenses is determined according to the procedure established for Russian entities.

In addition, the requirement to maintain tax accounting is also applicable to representative offices and branches of foreign legal entities.

Income from subsidiaries

Withholding tax rates where a foreign legal entity has no presence in Russia and is not protected by a double tax treaty are as follows:

- 15% in relation to interest, dividends, and income from participation in enterprises with foreign investments. The withholding tax rate applicable to interest payments will be increased to 20% with effect from 1 January 2002;
- 6% in relation to freight income. This rate will be increased to 10% starting from 1 January 2002;
- 20% in relation to other income from Russian sources.

These rates may be reduced under the terms of a relevant Double Tax Treaty. Currently a special application should be submitted to the Russian tax authorities. Treaty protection should be claimed within one year of the period to which it relates in respect of a refund, or before the income is paid for preliminary exemption. Starting from 1 January 2002 provisions of the relevant Double Tax Treaties may be applied without obtaining advance permission from the Russian tax authorities. It can be done based on a confirmation of tax residence to be provided by a foreign legal entity to the Russian tax agent.

Taxation of shareholders

Investor considerations

- Dividends are paid from profits after tax and are taxed at source.
- There is no separate capital gains tax in Russia; instead, capital gains are treated as part of business income.
- Securities issue tax is payable upon application to register new stock issues.
- There are no special company reorganisation provisions.

Domestic shareholders

- **Dividends**

All dividends paid to a resident corporation from Russian subsidiaries and other corporations in Russia are subject to a 15% withholding tax (the tax rate will be decreased to 6% starting from 1 January 2002). This tax is withheld at source by the payer. Russian source dividends are exempt on receipt. Payments to Russian resident individuals are also subject to a withholding tax at a flat 30% rate (6% starting from 1 January 2002).

- **Capital gains**

Capital gains of a resident business entity must be included in its worldwide income, which is subject to corporate income tax. Losses from the sale of securities are deductible only to the extent of gains earned on the same class of securities (although certain exceptions apply for banks, brokers, and other financial institutions). Currently, capital losses on the sale of fixed assets are tax deductible (although in practice the tax authorities apply the opposite position). Starting from 1 January 2002, losses from the sale of fixed assets may be deducted for profits tax purposes in equal installments during the remaining economic life of the asset sold. There is no separate capital gains tax.

The capital gains of resident individuals are included in their aggregate taxable income and are subject to 13% personal income tax, subject to specific property deductions.

Foreign shareholders

- **Dividends**

A 15 percent tax is levied on all dividends paid to non-resident corporations, unless a Double Tax Treaty provides otherwise. Non-resident individuals pay tax at a flat rate of 30%, also subject to the applicable Double Tax Treaty benefits.

- **Capital gains**

Capital gains attributable to a PE of a foreign legal entity in Russia are treated as part of business profits and are taxed at the regular profits tax rate. Otherwise, a 20% withholding tax should be withheld from the capital gains earned by a non-resident company from the disposal of Russian assets. Non-resident individuals are subject to a 30% tax on the capital gains earned. However, provisions of a Double Tax Treaty may establish more favorable treatment of capital gains.

Reorganisations

The tax system does not currently include specific provisions with respect to corporate reorganisations. The Profits Tax Chapter of the Tax Code contains a limited number of rules related to profits tax consequences connected with reorganisations (e.g. loss carry forward).

Taxation of foreign operations

Investor considerations

- Resident companies are taxed on their worldwide income.
- Foreign representative office/branch income is taxed at the corporate income tax rate.
- Credit relief is available for foreign tax paid, up to the amount of the Russian tax liability.
- No credit is given for the underlying tax on dividends.
- Foreign exchange losses are deductible for tax purposes.

Branch income

Resident Russian companies are taxed on their worldwide income. Worldwide income includes the profit and losses of foreign branches. Branch profits are attributed to the Russian entity and are included in the taxable income for the accounting year in which they are earned. Corporate income tax paid abroad is creditable against the amount of tax due in Russia (on worldwide income) provided the necessary paperwork evidencing payment of taxes is available and up to the amount which would have been due on the same amount under Russian rules. The credit equals the amount of foreign tax paid up to the amount of the Russian tax liability.

Income from subsidiaries

Dividends received from foreign subsidiaries are not taxable income in Russia. Tax withheld on dividends received from abroad is not creditable.

Liquidation proceeds

Gains (excess over nominal value of shares) from liquidation of foreign subsidiaries are aggregated into taxable income/deductible expense.

Interest, royalties and capital gains

Interest, royalties and capital gains are included in taxable income. Taxes paid abroad on these types of income are creditable against the Russian tax liability up to the amount which would have been due on the same amount under Russian rules.

Foreign exchange gains and losses

Foreign exchange profits and losses are included in the taxable income/deductible expense.

Double taxation relief

Russian law establishes the priority of international Treaties over domestic legislation and many Double Tax Treaties signed by Russia establish a more preferential treatment of various transactions as opposed to domestic law.

Taxation of individuals

Investor considerations

- Worldwide income of Russian residents is taxable at a flat rate of 13% (except for dividends and other minor exceptions).
- Income received by non-residents from sources within Russia is taxable at 30%.
- Russian payroll taxes are substantially reduced from 1 January 2001.

Territoriality and residence

For both Russians and foreigners, tax residence in Russia is determined by the number of days in the calendar year in which a person is present in Russia. For personal income tax purposes, an individual is considered resident if physically present in Russia for 183 or more days in a calendar year.

Russian residents are liable to tax on their total worldwide income received in a calendar year. Non-residents are taxed on income received from sources in Russia.

Some Tax Treaties provide for longer periods of exemption from Russian income taxation on Russian-sourced income of foreign residents. Consequently, the details of any applicable Tax Treaty should always be examined.

Method of calculating tax

After 1 January 2001, a flat rate of 13% applies. Higher rates are established for dividends (30%), income received by non-residents in Russia (30%) and income received from certain insurance and bank schemes aimed at reducing payroll taxes (35%).

Benefits in kind are treated as taxable income valued at market prices. For example, this includes the provision of a car for private purposes. The benefit of receiving a loan at an interest rate lower than three fourths of the Central Bank of Russia re-financing rate for Rouble loans, or 9% for foreign currency loans, is included in taxable income and taxed at 35%.

Allowances and exemptions deducted or excluded in arriving at taxable income include the following:

Personal allowances. Monthly deductions of an amount equal to RUR 400 are allowed in relation to a taxpayer's income which does not exceed RUR 20,000; similar deductions of RUR 300 are available in relation to his/her dependants.

Exemptions:

- most statutory allowances;
- pensions;
- compensation for labour injury within certain norms;
- statutory redundancy payments;
- expenses in carrying out employment duties, subject to certain modest limits;
- statutory and a number of voluntary insurance benefits including voluntary medical insurance;

- interest up to specified rates of return on bank deposits with a Russia located bank, the excess being taxed at the 35% rate;
- proceeds from sale of a personal residences within a limit of RUR 1mln and of other property within RUR 125,000 if the said property was owned by the taxpayer for less than five and three years respectively. If the disposed property was owned by the taxpayer for more than five or three years respectively, income received from such a disposal is fully exempt from personal income tax. At the taxpayer's request, actual expenses may be deducted from proceeds instead of applying the above deduction.
- some other.

Deductions

- the amount spent (subject to a maximum of Roubles 600,000) on the purchase or construction of a residence (plus interest repayments on bank loans taken for that purpose), only once in a lifetime;
- amounts paid for charitable purposes to certain cultural, education or health organisations;
- education costs related to the taxpayer (and his/her children) and medical costs related to the taxpayer or his/her family up to the maximum of Roubles 25,000.
-

Expatriate tax regime

Expatriates are normally paid abroad in foreign currency. In calculating the Russian tax liability, the foreign currency amount must be converted into Roubles using the exchange rate applicable on the date the income is paid.

Payroll taxes

With effect from 1 January 2001, a unified social tax was introduced. The tax is levied on total income payable to employees and contractors at regressive rates from 35.6% (for low-income employees) to 5% (applies to annual incomes in excess of Roubles 600,000). The "top" rate will be decreased to 2% with effect from 1 January 2002. Special procedures may apply to expatriates.

Value-added tax

Investor considerations

- VAT is payable at a standard rate of 20% on most goods, including imported goods, and services. A 10% reduced rate applies to a limited range of basic food items and children's goods.
- Export of goods and services is exempt, with a right to input credit.
- Until 1 July 2001, exports to and imports from, the CIS are not considered exports and imports for Russian VAT, except for a few CIS states which have concluded bilateral agreements with Russia, which provide for an earlier date of application of export-import regime for VAT.
- Relief is available from import VAT for technological equipment, related components and spare parts contributed to charter capital.
- VAT accounting is extremely complex.

- Non-tax-registered suppliers of goods and services are subject to Russian VAT collectible via a "reverse charge" withholding mechanism applied by a resident agent.
- Some supplies are exempt from VAT, but recovery of input VAT may be restricted.
- Adhering to the invoicing procedures is critical for input VAT recovery.

Scope

Sales of goods and services on the territory of Russia, and imports of goods into Russia, are subject to value added tax ("VAT"). Exports of goods, and certain services, are exempt from VAT. VAT is accounted for by vendors of goods or services and importers of goods. Until 1 July 2001, exports to and import from, CIS countries are not considered exports and imports for the purposes of Russian VAT. Accordingly, Russian entities selling to the CIS are required to charge Russian VAT on such sales, and on the other hand, input VAT paid to suppliers from other CIS countries is allowed to be recovered.

For cross-border services there are special tests determining whether they are provided within or outside Russia. Services of a consultancy nature or related to patents, licenses or similar rights, rendered to an entity which has a place of economic activity in Russia are subject to VAT. Services related to property located in Russia are also subject to Russian VAT.

Supplies which are subject to VAT are often made by entities which have no presence or tax registration in Russia. In this situation, the recipient of the service must withhold VAT from the payment, although this VAT may normally be credited by the payer as input tax, provided certain requirements are met.

Branches are not independent VAT taxpayers. The VAT chapter introduced a procedure for distributing VAT between different budgets with effect from 1 January 2001: the tax liability for a branch is determined as a portion of the overall company's liability based on the proportion of the branches' payroll/fixed assets in the payroll/fixed assets of the company as a whole.

Rates and tax base

Value added tax is charged at the rate of 20% on most goods and services, and 10% on a range of basic food products and goods for children. VAT is calculated on one of the following bases:

• Imports

VAT is charged at the applicable rate on the value applied for customs purposes (including freight, insurance and other costs incurred prior to the customs border), increased by any applicable import and excise duties. Qualifying medical goods and contributions of technological equipment, related components and spare parts to the charter capital of a company are exempt from import VAT.

• Manufacturing, wholesale trade, retailers and service operations

VAT is charged to customers at the applicable rate and paid over to the authorities net of input VAT paid on purchases and expenses incurred in connection with carrying out VATable activities. Input VAT is only credited if the goods and services are actually received and respective VAT, including import VAT, is paid. For a limited number of

transactions, VAT is charged at 16.67% (or 9.09%) on the difference between the gross VAT-inclusive sales and purchase price or customs value. The examples include sale of buildings, imported goods exempt at import etc. VAT reverse-charge, which applies to payments due to suppliers not registered in Russia, is withheld at source also at the rate of 16.67%.

- **Interest on Loan Finance**

Interest on loans is exempt from VAT.

- **Input tax**

VAT on expenses incurred in connection with performance of activities subject to VAT, as well as VAT on purchased or imported fixed and intangible assets, is creditable. Credit for input VAT in respect of certain business trip and entertainment expenses is limited by reference to the same limits as for the profits tax deduction. If sales are exempt from VAT, as a general rule, the relevant input VAT is not credited but added to the relevant expense. Refund of input VAT is normally available in relation to exported goods and some export services. VAT on capital construction is allowed for credit starting from 1 January 2001.

- **General exemptions**

Apart from the export VAT exemptions and certain import exemptions already described, exemptions apply to insurance and banking operations with some exceptions, circulation of securities, medicines and medical services (subject to restrictions from 2002), letting of accommodation to accredited representative offices of overseas companies resident in certain countries included in a special list etc. In these cases, normally no input VAT credit is available. VAT exemption with respect to operations subject to licensing under the domestic law is available once a relevant license is obtained.

The taxpayer has a right to waive certain VAT exemptions, on an annual basis.

Tax returns and timing of tax payments

VAT is generally paid on a monthly or quarterly basis depending on the quarterly sales figure. The deadline for submitting the tax returns is 20th of the month following the expired tax period.

Other indirect taxes

Investor considerations

- Import tariffs (custom duties) apply to most goods.
- Excise taxes apply to the production and importation of cars, tobacco, alcohol, gasoline, lubricants and jewellery.
- An excise tax is levied on sales of extracted oil and gas.
- Road users' tax is payable by all companies.
- Sales tax of up to 5% is levied in most Russian regions.

There are a number of significant taxes charged in relation to sales and property, and taxes specific to certain industries or activities. Some of the taxes are legislated by the Federal government, but the actual rates are set at the regional level within certain limits. Local jurisdictions may introduce a number of additional taxes which are listed in the law.

Customs duties

Rates generally range from 5% to 30% of the customs value of goods that are liable to import duties. Duties must be paid before or at the moment of customs clearance. The base rates specified in the legislation apply to countries which have been granted Most Favoured Nation regime. Some goods from "developing" and goods from "least developed" countries may be imported at 75% of the base rates or zero rates, respectively. Goods imported from other countries, or goods for which the country of origin cannot be identified, will be subject to duty at double base rates. Customs codes classification follows the world-wide harmonised system of tariff headings.

Foreign nationals may temporarily import goods which are neither for production nor other commercial activity but for personal use, and are intended to be re-exported, without payment of duties. There is an up to one year duty free temporary import limit in respect of cars.

Goods (equipment) may be imported temporarily, normally for a period of up to two years, in which case the periodical customs payments are charged at 3% per month of the total amount of customs payments that would be payable should the goods have been imported for free circulation. On re-export of the goods, the periodical customs payments made are not refunded. If the goods initially imported temporarily are declared for free circulation, the periodical customs payments made can be credited against the customs payments due.

An exemption from customs duties is granted for foreign investor's in-kind contributions of production fixed assets to the charter capital of a Russian company with foreign investments within the period of formation of charter capital.

Sales tax

Regional authorities have the right to introduce a sales tax. It has been introduced in many regions including Saint Petersburg and Moscow, in the latter since 1 July 1999. Sales tax is levied on the sales price (including VAT and excises) of goods, works and services sold retail or wholesale for cash. The tax rate is established by regional legislation but shall not exceed 5%. The tax is not levied in relation to banking, insurance services, securities, real estate, children's goods, bread, milk, medicine and

certain other goods and services of primary need. Regional authorities may exempt other goods and services from this tax.

Road users' tax

Road users' tax is based on turnover from sales of goods and services net of VAT. Its current rate is 1% of the company's sales or trade margin. Commencing from 1 January 2003 road user's tax will be abolished.

Excise taxes

Excise tax is levied at variable rates on a range of consumer goods (e.g. wine and spirits, beer, tobacco, light vehicles and motorcycles, jewellery, etc), as well as gasoline, lubricants and certain mineral resources (specifically oil and gas)). The tax applies to sales of goods produced or processed in Russia (except for certain sales), importation of excisable goods, contribution of excisable goods into charter capitals, use of excisable goods for the own needs of their manufacturer, as well as certain other operations. If a company uses one type of excisable goods as a raw material for manufacturing another type of excisable goods, it can recover excise on its raw materials provided that certain conditions are met. Goods imported to Russian under the regime of Production Sharing Agreements and sales of oil and gas extracted under this regime are exempt from excise tax.

Imported excisable goods are generally subject to excise at the moment of importation, while exports are generally exempt from excise. However, until 1 July 2001, exports to and imports from CIS are not considered exports and imports for Russian excise purposes, except for few CIS states which have concluded bilateral agreements with Russia, providing for an earlier date of application of export-import regime for VAT and excise purposes.

For most excisable goods (including excisable goods imported to Russia) the excise tax rate is set at a fixed Rouble amount per unit of measurement. This is considered a relaxation of the tax burden, since the excise legislation does not provide for adjustment of these rates depending on the fluctuation of the Rouble exchange rate. However, the Rouble-denominated rates for local goods have been generally increased as compared to the 2000 rates. Currently, the excise duty rate defined as a percentage of the product value is set only for jewellery and gas.

Generally excise tax is payable by the manufacturing (extracting) company. Alcoholic goods may be sold under the newly-introduced regime of excise warehouse, under which the burden of excise tax is split between the manufacturing and trading companies. Certain excisable goods (wine and spirits, tobacco products) can be sold in the territory of Russian only if they are stamped with excise stamps.

Tax Treaties

Investor considerations

- Russian tax authorities do not have extensive experience with the interpretation and application of Double Tax Treaties.
- Russia honours Treaties concluded by the former USSR until they are replaced by new Treaties.
- Tax Treaties that are presently concluded with Russia are based on the OECD Model Treaty.
- Withholding taxes on interest, dividends and royalties are substantially decreased by Tax Treaties.
- Starting from 1 January 2002, advance clearance is not required to apply Treaty rates.

Tax Treaty policy

Russia currently honours the Tax Treaties signed by the former Soviet Union until new Tax Treaties are drawn up and is continuing its program of renegotiating existing Treaties and entering into new treaties. All of these tend to follow the guidelines of the tax convention model of the Organisation for Economic Co-operation and Development ("OECD"), although the UN Model Convention for developing countries has influenced them.

Withholding taxes

Unless otherwise provided under a Tax Treaty, a non-resident foreign legal entity is subject to a 15 percent withholding tax on Russian-source interest (20% from 1 January 2002) and dividend income, and a 20 percent withholding tax on income from copyrights, licenses, services it provides in Russia, and some other items, unless these services are connected with a permanent establishment. Income from freight is taxed at 6 percent (10% from 1 January 2002).

Application for reduction or exemption of a withholding tax rate may be made in advance in respect of some types of income. Otherwise, tax must be withheld and a refund procedure followed. Treaty benefits claimed by any entity or person with respect to withholding taxes must also be approved by the tax authorities; the procedures for this approval are complicated.

The advance application requirement should not apply from 1 January 2002. Instead, a tax residence certificate of the foreign company should be made available.

No withholding tax applies on the distribution of profits of a representative office or branch (i.e. branch profits tax).

Permanent establishment

A permanent establishment is generally defined by Treaty agreements as "a fixed place of business through which the business of a resident of another country is wholly or partly carried on." In the absence of a Treaty, domestic law defines a permanent establishment as "a branch, division, bureau, office, agency, or any other permanent place of regular business activity related to the acquisition of income on the territory of

the Russian Federation or abroad.” A distinct similarity in the definitions of permanent establishment under existing Treaties and under domestic law tends to mean that few, if any, Treaty benefits are available in relation to the taxation of profits.

Some Treaties provide additional deductions when determining the amount of business profits taxable by the Russian Federation.

Personal services

Most income from freelance activities is not taxable in Russia if an individual from a Treaty country spends less than 183 days in Russia and/or does not derive income through a fixed base in Russia. Employment income is generally taxable, unless the individual spends less than 183 days in Russia during the tax year and remuneration from a non-resident employer is not borne by a permanent establishment of that employer in Russia.

Elimination of double taxation

The elimination of double taxation generally takes the form of a credit for taxes paid to other countries. With effect from 1 January 2001, for personal income tax, such credit is granted only if a relevant Double Tax Treaty, which contains such a provision, is in place.

Competent authority/mutual agreement

A taxpayer who believes that the actions of one or both of the contracting states result, or will result, in double taxation may, regardless of the remedies provided by the domestic law of those states, present the case to the competent authority of the contracting state of which the person is a resident or citizen. The competent authorities of the contracting states may communicate directly to reach an agreement.

Because of the different interpretations of Treaty provisions by the various tax authorities, there is a lack of confidence in this mechanism for dispute resolution.

Chapter 6. Banking and Finance

Banking and Finance

Investor considerations

- The monetary system has been relatively stable after the 1998 crisis, and over the last 18 months inflation has been on the decline.
- The banking sector and the insurance industry are under capitalized.
- The Central Bank regulates all activities of the banking industry.
- State owned banks dominate the industry.
- A large number of foreign banks have established their presence in the market, their activities are largely restricted to Moscow and St. Petersburg.
- The financial position of banks is not accurately reflected in statutory financial statements.
- Domestic capital markets are in the developmental stage.
- Exchange restrictions and controls exist relating to converting Russian Roubles into other currencies. At present, the Russian Rouble is not a convertible currency outside of the Russian Federation.

Banking environment

The economy of the Russian Federation continues to display characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible outside of the country; a low level of liquidity in the public and private debt and equity markets; and high inflation.

Additionally, the banking sector in the Russian Federation has been particularly impacted by adverse currency fluctuations and economic conditions post 1998 financial crisis. Furthermore, the need for further developments in the bankruptcy laws, the absence of formalised procedures for the registration and enforcement of collateral, and other legal and fiscal impediments contribute to the difficulties experienced by banks currently operating in the Russian Federation.

Banking system

The operations of commercial banks are regulated by the Constitution of the Russian Federation, federal laws, the Civil Code, the Civil Procedural Code, Presidential Decrees and regulations of the Central Bank. Banks are issued different types of licenses permitting them to carry out a range of banking activities depending on the type of licenses held.

Traditional banking services such as account maintenance and settlement operations are widely available however certain services/products are not widely available e.g., mortgage lending and leasing, due to the lack of a regulatory framework and low levels of demand.

Typical services offered by commercial banks include:

- lending
- foreign exchange operations
- trade finance
- operations with securities, including bonds, shares and bills of exchange

Although the banking sector was one of the first to be demonopolized at the start of market reforms in early 1990s and the number of commercial banks topped 1,300 at the end of 2000, the banking industry remains heavily undercapitalized. The vast majority of these 1,300 banks are small, undercapitalized and limited in the range of services they provide.

State-owned Sberbank, which has assets of \$19.5 billion, has a significant competitive advantage over its competitors merely due to its size and extensive branch network. As a result it dominates the market.

A number of the more entrepreneurial banks have developed into holding companies for financial or commercial conglomerates, which comprise significant holdings in financial institutions and industrial enterprises. These banks are increasingly active in purchasing industrial enterprises

Central Bank of Russia

The Central Bank of Russia enjoys independent status. The Law on the Central Bank approved in 1990 and amended in 1997 mandates the bank to:

- prevent major fluctuations of foreign exchange rates and maintain the ruble's purchasing power against other currencies;
- supervise the banking system; and
- ensure timely execution of payment orders.

The Chairman of the Central Bank is nominated by the Russian President and appointed by the parliament.

The Central Bank owns controlling stakes in a number of domestic banks, among them Sberbank and Vneshtorgbank, (which are also used somewhat to implement monetary policy), and a number of foreign institutions, including London-based Moscow Narodny Bank, Paris-based Eurobank and Ost-West Handelsbank in Frankfurt.

International banks

As of September 2000, foreigners owned stakes in 127 banks, including 22 banks over which they had full control. In 1998, foreign owners had full control over only 10 banks. In the past two years, foreign banks have been actively increasing their presence in the local market.

Currently there is a cap on foreign capital participation in the banking industry, set at 12 percent. Russia's bid to the World Trade Organization contains a proposal to raise cap on foreign banks' share to 20%.

Accounting and reporting standards

Accounting standards used in the banking industry differ substantially from both International Accounting Standards and the US GAAP. Statutory financial reporting and accounting is performed in accordance with Central Bank Regulations. The financial position of banks is not accurately reflected in statutory financial statements. The most significant differences are in the areas of loan provisioning and valuation of securities and investments.

The Central Bank is working toward the introduction of international accounting principles and standards within the banking sector

Insurance

The insurance market is in its infancy stage. Aggregate assets of 1,200 operating insurance companies amount to roughly \$2.5 billion, or approximately 1% of the GDP.

The industry is regulated by the Law on Insurance, approved in 1992 and amended in 1999, Chapter 48 of the Civil Code "On insurance" and a number of other laws and regulations adopted by the parliament and the government.

Foreign capital participation in the insurance industry is capped at 15%.

Investment banking and operations with securities

Due to capital scarcity, asset management, portfolio management and investment advisory services remain underdeveloped.

Securities placements – ADRs and Eurobonds - in the international markets are usually carried out by large Western investment banks jointly with local partners.

Brokerage activities, operations of investment companies, depositories and registrars are licensed by the Federal Securities Commission.

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