



# HOW TO INVEST IN RUSSIA

AEB



**The AEB guide to theory and practical advice  
for making an investment in Russia in 2012**

Association of European Businesses



## **Foreword by Elvira S. Nabiullina, Minister for Economic Development of the Russian Federation**

**Elvira S. Nabiullina**

Dear colleagues and friends,

I'm pleased to welcome you to yet another edition of the AEB guide, especially now that the Russian Federation has successfully completed the negotiations on its accession to the World Trade Organisation.

Effective dialogue with the business community, both foreign and Russian, is very important for us, as this results in a very welcome improvement in the investment climate. We have already achieved a lot in the past years. In 2010 and 2011 alone, we simplified procedures in the construction sector and improved migration policies; substantially reduced the costs of providing greenfield investment projects with power, engineering and communication infrastructure; adopted laws aimed at perfecting the customs administration and liberalising the procedure for foreign investment; introduced investment ombudsmen on federal and regional levels, amongst others.

This was reflected in the World Bank's international research "Doing Business", which assesses the ease with which business is done. This survey placed Russia among the top 25 countries out of the 183 studied, with regard to progress made in improving the investment climate in the past 6 years.

None of this would have been possible without the presence of the business community. We hope for a continued cooperation, with the expectation that this will result in the most comfortable conditions for doing business in Russia.

*E.S. Nabiullina,  
Minister for Economic Development  
of the Russian Federation*

## **Statement from Mr. Reiner Hartmann, Chairman of the Executive Board and Dr. Frank Schauff, CEO, Association of European Businesses**



**Mr. Reiner Hartmann**



**Dr. Frank Schauff**

Dear Readers,

Welcome to the 2012 edition of the AEB “How to Invest in Russia” guide.

What makes Russia important is its sheer size and natural resources. The Russian economy is commodity-driven: payments from the fuel and energy sector in the form of customs duties and taxes account for nearly half of the federal budget’s revenues. Russia is the largest oil producer in the world and biggest exporter of natural gas, nickel and palladium. Metals and energy accounted for more than 80 per cent of Russia’s exports in 2011. In the past decade, poverty and unemployment have declined steadily and the middle class has continued to expand. Given Russia’s size, communications are critical when it comes to successful operation on the market. Following substantial reforms and upgrades, the Russian telecom sector is now the country’s most modern industry.

Now, with Russia’s accession to the World Trade Organisation (WTO) as its 154<sup>th</sup> member, the international business community’s expectations are nothing but optimistic with regard to an improved business climate.

Perhaps the most important implication would be greater certainty in the country’s trade relations with other WTO members. Furthermore, Russia will have a seat at the table during negotiations and be actively involved in the implementation of set rules.

*Mr. Reiner Hartmann,  
Chairman of the Executive Board*

Aside from the policy implications, WTO membership is also an indication of positive economic changes to come. According to a World Bank study, in the medium term, WTO accession would increase

Russia’s Gross Domestic Product (GDP) by 3.3 per cent and, in the longer term, by 11 per cent. To a greater extent, this increase will be as a result of the measure that Russia would take to liberalise foreign investment in services. Also, the increased GDP will be in part, though small, due to a more efficient allocation of resources as a result of reduced tariffs and increased competition from imports. Improved terms of trade, including an increased demand for Russian exports will also play a minor role in increasing the country’s GDP.

In all, the prospects for 2012 and beyond are extremely promising. This edition of the “How to Invest in Russia” guide will bring you the most recent updates on greenfield and brownfield investments, joint ventures, industry specific aspects of investing, investing in the regions and the status quo on Small and Medium Enterprises (SMEs). In addition, this guide will take an inside look into investing in Russia – from the companies’ perspectives.

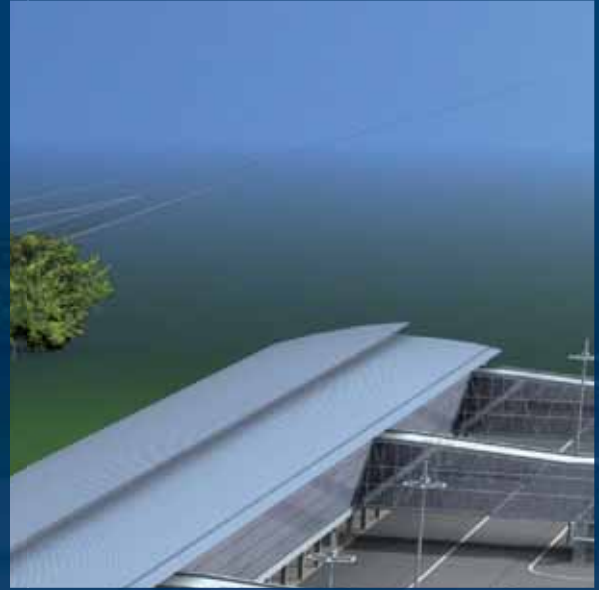
We hope this publication will serve its purpose, which is to bring more investors to Russia and promote a business environment that is beneficial to all concerned parties.

*Dr. Frank Schauff,  
Chief Executive Officer*

*The Association of European Businesses*



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**TABLE of CONTENTS**

**Foreword by Elvira Nabiullina, Minister for Economic Development of the Russian Federation** 1

**Statement from Mr. Reiner Hartmann, Chairman of Board and Dr. Frank Schauff, CEO, Association of European Businesses** 2

**PART I. RUSSIA IS THE RIGHT PLACE FOR INVESTING**

**A green light for foreign investors**

Igor Artemiev, Head of the Federal Antimonopoly Service of Russia 6

**Russia in the international trade. Today and tomorrow**

Sebastian Worsztynowicz, Head of International Business, HSBC in Russia 8

**PART II. BEFORE YOU START**

**Practical recommendations on how to set up a business in Russia**

Falk Tischendorf, Partner, BEITEN BURKHARDT Moscow  
Bilgeis Mamedova, LL.M., Associate, BEITEN BURKHARDT Moscow 13

**Russian tax law developments: what to expect in 2012**

Alina Lavrentieva, Partner, PricewaterhouseCoopers 17

**Tax implications of investment strategies in Russia**

Irina Suvorova, Partner, Head of M&A Tax, KPMG in Russia and the CIS 19

**Russia’s HR Market: Preliminary Results of 2011**

Olga Bantsekina, Chairman, Chief Representative, Coleman Services UK 23

**Recruitment as a Challenge**

Ekaterina Vilenkina, Head of External Recruitment, RUSSIA CONSULTING Group 26

**Legal aspects of investing in Russia**

Mikhail Aleksandrov, Partner, DS Law 28

**Tax and Immigration Law Changes for Investors**

Ludmila Shiryeva, Executive Director, Human Capital Department, Ernst & Young 32

**Investing in Russia: Important Aspects of Customs Union Legislation**

Wilhelmina Shavshina, Legal Director, Head of Foreign Trade Regulation, DLA Piper; Ksenia Sizova, Associate, DLA Piper 35

**Fundamentals of Intellectual Property (IP) Due Diligence to help investors to protect their IP rights when entering the Russian market with technology-based projects**

Ekaterina Tilling, Special Counsel, Head of IP, Moscow, Baker Botts LLP 42

**Russian industry: Health & Safety culture challenges for investors**

Elena Amirkhanova, Impact Assessment and Planning Practice Head Eurasia; Valery Kucherov, Performance Assurance Practice Head, ERM Eurasia 46

**Why exhibit?**

Eugen Alles, Managing Director, Messe Frankfurt GmbH subsidiary in Russia 49

**PART III. SPECIFICS OF CREATION OF JOINT VENTURES**

**Foundation of a JV in Russian jurisdiction: Pros and Cons**

Alexander Filimonov, Partner, DS Law Firm 51

<b>Financing a joint venture</b>	
Vladimir Ismailov, Visiting professor, Raytheon Professional Services	55
<b>10 Strategic Russian Tax Tips when Going Into a Joint Venture with a Russian Partner</b>	
Andrey Shpak, Tax Partner, Goltsblat BLP (part of Berwin Leighton Paisner group)	58
<b>Enforcing shareholders' agreements under the Russian law</b>	
Andrey Nosikov, Senior Associate, Private Equity Group, Corporate practice of Pepeliaev Group	60
<b>Expectation gaps when creating a joint venture in Russia</b>	
Maria Semenova, Manager, M&A Tax, KPMG in Russia and the CIS	64
<b>PART IV. REGIONAL ASPECTS OF INVESTING IN RUSSIA</b>	
<b>Investment Climate in Russia's Regions: Preliminary Survey Results</b>	
Alexander Plekhanov, Economist, European Bank for Reconstruction and Development in London	67
<b>CASE STUDY: the Kaluga region</b>	
Dmitry Abramov, Deputy Minister for Economic Development of the Kaluga Region, Head of the Investment Directorate	70
<b>PART V. PECULIARITIES OF OPERATIONS OF FOREIGN SMALL AND MEDIUM BUSINESSES ON THE RUSSIAN MARKET</b>	
<b>SMEs doing business in Russia – getting started</b>	
Chet Bowling, Managing Partner, Alinga Consulting; Alex Medlock, Managing Director, TMF Russia	74
<b>PART VI. INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA</b>	
<b>Update on Foreign Investments in Strategic Sectors in Russia</b>	
Alex Stoljarskij, Attorney, Beiten Burkhardt	81
<b>Why invest in Russian real estate?</b>	
Konstantin Lysenko, Associate Director, CBRE	86
<b>Recent changes in the Construction rules and regulations and permitting procedures that can influence direct foreign investments</b>	
Andrey Sosnovsky Ph.D., Area Director, Tebodin Eastern Europe B.V	89
<b>Pharmaceutical Industry and Healthcare System in Russia: Opportunities and Challenges of Modernisation</b>	
Andrey Meshkovsky, Member, WHO Expert Advisory Board on International Pharmacopoeia and Pharmaceutical Preparations; Alexander Bykov, GR Director, Novo Nordisk	91
<b>Project financing in Russia</b>	
Olga Grigorieva, Head of Structured and Project Finance Division, Raiffeisenbank	96
<b>PART VII: BUSINESS CASES: CREATING AN ENTERPRISE</b>	
<b>Everything you always wanted to know about how to invest in Russia* (*but were afraid to ask)</b>	
Antonio Linares, Country Manager and Managing Director, ROCA in Russia and CIS	99
<b>Practical experience of making actual investments in Russia</b>	
Nick Vince, General Director, Rockwool CIS	104
<b>PART VIII: PROSPECTS FOR THE FUTURE</b>	
<b>WTO and Russia, Investment Opportunities and Risks</b>	
Art Franczek, President, American Institute of Business and Economics	106

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## RUSSIA IS THE RIGHT PLACE FOR INVESTING

### A green light for foreign investors

Igor Artemiev, Head, Federal Antimonopoly Service of Russia



#### Mr. Igor Artemiev

Mr. Igor Artemiev is the Head of Federal Antimonopoly Service of Russia.

Mr. Igor Artemiev was born on November 27<sup>th</sup>, 1961, in Leningrad. He graduated from the Leningrad State University, Faculty of Biology. Afterwards,

he obtained his Masters from the Faculty of Law of the St. Petersburg State University. Author of 43 articles and patents, he is also the author of 6 budget and economy monographs. He also holds a Ph.D.

From 1989, Mr. Artemiev took an active part in politics in Leningrad, which later became St. Petersburg. He was elected as a deputy to the Leningrad Council and later to the Legislative Assembly.

From 1992 to 1994, he was Head of the Commission for Ecology and Communal Economy of the Leningrad Council. From 1994 to 1996, Mr. Artemiev was Chairman of the Commission for the Municipal Economy and Chairman of the Budget Committee of St. Petersburg Legislative Assembly. From 1996 to 1999, he was the Vice-Governor of St. Petersburg and Chairman of the Finance Committee of the City Administration. From 1999 to 2004, he was Head of the Economic and Political Research Fund "EPICenter – St. Petersburg", where he annually presided over the Alternative Budget of the Russian Federation. Mr. Artemiev is also the draftsman of the "Concession Agreement Statute", "United Social Tax Statute", "Derivative Financial Implements Statute", "Statute of Reductive Taxation System for Subjects of Small Entrepreneurship", a cluster of Family Business Laws, Amendments to the Criminal Code, the Criminal Procedural Code and the Civil Procedural Code of the Russian Federation.

Since December 1999, he has been a Member of the State Duma of the Russian Federation. He has held positions of Vice Chairman of the "YABLOKO" faction and Vice Chairman of the Committee for Credit Organisations and Financial Markets.

Since the 10<sup>th</sup> of March, 2004, Mr. Artemiev has been the Head of the Federal Antimonopoly Service of the Russian Federation. He was appointed based on directive № 329-p, of Prime Minister Mikhail Fradkov dated 3<sup>rd</sup> of March, 2004.

**The Russian legislation on foreign investments control has been changed. The alterations can be rightfully called liberal: their adoption reduces the scope of administrative barriers in Russia.**

The Federal Antimonopoly Service (FAS) of Russia is a federal body of executive power authorised to exercise control over foreign investments in the Russian Federation. The issues related to the acquisition of stocks (shares) of business entities of strategic importance or to settlements of transactions aimed at establishing control over such business entities are regulated by Federal Law No. 57-FZ of 29.04.2008 – "On the procedure for foreign investment into businesses that are of strategic importance to the defense of the country and State security".

Within the three and a half years of coming into force of Law No. 57-FZ, FAS received 260 petitions for the preliminary approval of foreign investors' transactions in relation to Russian business entities and 514 notifications of acquisition (holding) of entities' stocks (shares). By the end of 2011, the Government Commission<sup>1</sup> had considered 137 petitions and only 8 of them were not granted preliminary approval for transactions.

The implementation practice of Law No. 57-FZ shows that the legal control mechanisms over foreign investments in strategic business entities are applied in full measure.

At the same time, the work of FAS stressed the necessity of liberalising the state's control over foreign companies investing into strategic industries within the Russian economy and introducing a range of alterations to the investment legislation of the Russian Federation.

First of all, it was necessary to:

- reduce the number of strategic activities;
- liberalise control over foreign investments in the sphere of using land with subsoil of federal importance;
- exclude the transactions executed by international financial organisations to which the Russian Federation is a party and the transactions made

<sup>1</sup> The Government Commission for Control of Foreign Investments in the Russian Federation. The resolutions on petitions for transactions, within the framework of the law on foreign investments in strategic enterprises are made by the Government Commission. The Russian Federation Federal Antimonopoly Service (FAS), being an authorised body, evaluates submitted petitions, prepares information and analytical materials and gives proposals on possible resolutions, to the Government Commission.

by foreign companies controlled by Russian owners, from the area of state control.

Thus, for example, the practice of considering petitions submitted by foreign investors showed that many business entities exploit various radiation emitters under relevant licenses: X-ray machines, fault detectors for monitoring the manufactured products' quality, feeler gages, devices for luggage and goods inspection, etc.

Transactions made by foreign investors in relation to such business entities required preliminary approval by the Government Commission.

Therefore, in order to improve the investment climate, the Federal Antimonopoly Service, with the participation of concerned ministries and departments, representatives of foreign investors, and the expert community, have undertaken the task of perfecting the legislation of the Russian Federation on investments into strategic business entities.

This resulted in the adoption of Federal Law No. 322-FZ, dated 16.11.2011 - "On amending Article 6 of the Federal Law "On foreign investments in the Russian Federation" and the Federal Law "On the procedure for foreign investment into businesses that are of strategic importance to the defense of the country and State security" that came into force on 18<sup>th</sup> December, 2011.

Key innovations:

1) The list of activities of strategic importance has been shortened. Thus, the list does not consider the following activities as strategic:

- exploitation of radiation emitters in the civil sector of the economy by business entities for whom such activity is not a basic one;
- work of banks on cryptography and information encoding, which the Russian Federation is not a party to.

2) The transactions between organisations controlled by Russian citizens or companies, as well as the transactions by international financial organisations, to which the Russian Federation is a party (the list of such international organisations is subject to the Government's approval) are excluded from the controlled sphere. Thus, the number of persons obliged to appeal to an authorised body, with petitions for preliminary approval of transactions has been substantially reduced.

3) The criterion that defines a strategic enterprise in the sphere of subsoil management, as being controlled by a foreign investor, has been changed. Now, a foreign investor may have at his disposal 25% of the votes represented by voting stocks (shares) of an enterprise without preliminary approval, whereas, in the past, a preliminary approval was required following a purchase of 10% of the shares.

4) Transactions associated with using land, with subsoil of federal importance that do not result in raising a foreign investor's share in the equity capital of such enterprises have been excluded from the list as well.

5) Applicants who have an agreement with FAS, which guarantees the fulfillment of their commitments as stipulated by Law No. 57-FZ, enjoy a simplified procedure with regard to petitions submitted for the preliminary approval of a transaction by the Government Commission. This reduces the time for the consideration of such petitions to 2-3 months.

Therefore, the adopted changes are aimed at eliminating the administrative barriers, for foreign investors carrying out transactions in strategic spheres of Russia's economy.

Although this is not the last hurdle, it is definitely a major step in perfecting the Russian Federation foreign investments legislation.

In December 2011, in view of implementing Law No. 322-ФЗ, the FAS Russia has prepared and submitted to the Government of the Russian Federation a draft Order of the Government of the Russian Federation on Approval of the List of International Financial Organizations the transactions with which are not subject to preliminary approval according to provisions of Law No. 57-ФЗ and the Federal Law "On Foreign Investments in the Russian Federation" (approved by Order of the Government of the Russian Federation No. 119-p on 03.02.2012).

This list includes 12 international financial organizations, such as the International Financial Corporation and the European Bank for Reconstruction and Development.

Such international financial organizations are free from preliminary approval of the transactions performed by them in relation to Russian business entities by the Government Commission.

At the same time, these international financial organizations remain subject to notification procedure of informing the authorized body on the transactions committed as well as to a prohibition of establishing their control over strategic entities.

The Russian Federation Federal Antimonopoly Service is also working on amending the procedures for the preliminary approval of transactions and approving the establishment of a control system for foreign investors over strategic entities that were adopted by Order No. 838 of the Russian Federation Government dated 17.10.2009. Such changes are necessary due to the amendments introduced to the foreign investments legislation.

The Russian Federation Federal Antimonopoly Service will continue to perfect the control procedures on foreign investments into Russian business entities.



## Russia in the international trade. Today and tomorrow

Sebastian Worsztynowicz, Head of International Business, HSBC in Russia



### Sebastian Worsztynowicz

Sebastian Worsztynowicz is the Head of International Business HSBC in Russia.

Sebastian has over 12 years of Corporate Banking experience, working for top tier Global Financial institutions.

His career has been predominantly focused on Relationship Management and Managing customer facing teams. Sebastian has managed international relationships in the Diversified Industries, Telecom Media Technology and FMCG sectors, and has practical experience in Cross Border Credit, International Cash management and Trade Finance. He has worked in Poland, the Netherlands, Belgium and Russia.

After joining the HSBC Group in 2006 as Senior Relationship Manager, Sebastian was running the Warsaw Corporate Banking team for two years. Further on, he was responsible for the development and implementation of the Leading International Business strategy in Poland. He joined HSBC Russia in May 2011, where he heads the International Business team in the Commercial Banking department, looking after mid-sized and large international companies, delivering a full scope of Corporate Banking Services.

Sebastian studied Business Administration in Antwerp. He speaks fluent Polish, English, Dutch and German.

Growth in International Trade has successively outpaced global GDP for the past decades. More recently, the growth of the Emerging Markets would not have been possible without the increasing ease at which supply and demand from various parts of the world meet, agree and exchange goods, creating the global marketplace. And these new economies, which have embraced each others growing demand and create new trade corridors, like the “Southern Silk route” – connecting South East Asia, Middle East, Africa and Latin America.

There is a discussion pending, whether Russia should be counted as part of the BRIC. Despite that discussion and its outcome, the continuing growth of the Emerging Markets, and in particular China’s – as Russia’s largest trading partner – will have a significant impact on Russia’s economic per-

formance. Today, it’s the US but, in twenty or thirty years’ time, Brazil and Russia, in combination, will likely be threatening to overtake the US as important destinations for Chinese exporters. The scope for India, Brazil and Russia to trade with each other is big enough to eclipse trading relations with the US and Europe.

Looking at Russia and China, it is close vicinity, strong relations at the highest political levels, as well as historic ties that fuel the trade between the two nations. And although there is nothing left of the dominant position of the USSR over the PRC – best evidenced by the lengthy negotiations of the gas contract – with its vast natural resources Russia is poised to benefit from the opportunities China’s growth will provide.

HSBC, as the Best Global Trade Finance bank<sup>1</sup>, does extensive research and analysis of the world’s trade, as well as looks at the trends and main drivers behind it, which in turn drive the economic growth. Therefore it is interesting to have a closer look at Russia’s position in this rapidly developing environment. We’ll have a look at the findings of the “HSBC Trade Forecast\*” from the perspective of the global developments, as well as how these will impact Russia. In conclusion we’ll have a look at key industries, which will benefit most from the growing demand for resources, as well as those that present export opportunities to Russia.

### The Global Trade Forecast

The world economy is expected to slow down during 2012 as the risks of contagion from the euro crisis, the impact of natural disasters during 2011 and the sluggish growth in developed economies persists. The Trade Forecast suggests that between 2012 and 2014 world trade will continue to grow, but at a slower rate before then accelerating after the middle of 2014, leading to improved economic performance globally: a trend which will continue to 2020. From 2021 it is predicted that growth in world trade will decelerate as international trade stabilizes around the world.

The Trade Forecast predicts that world trade will grow due to stronger growth after 2014 and robust emerging economies. Emerging economy trade growth, especially in Latin America and Asia,

<sup>1</sup> GTR Awards 2011 of December 2011

will be stronger than developed world trade growth. For example, the Trade Forecast predicts that trade growth in the Asia Pacific region will be 6.50% annualized over the next five years and in Latin America will be 6.70%. This compares to the 3.78% forecast for the world as a whole.

The growth opportunities in the emerging world demonstrate the pace of change in these economies over the next five years. Trade hubs are emerging: countries that are developing or expanding their role as gateways in key trade corridors or between regions. For example Panama, ahead of the Canal widening scheduled for completion in 2014, is developing shipping lanes to Singapore and between North and South America and is forecast to expand imports by 8.80% and exports by 9.52% over the next five years.

### Share of world trade

Countries which will see increases in their share of world trade to 2026 include South Korea, which will replace the UK as the sixth largest trading nation due to trade expansion, particularly in infrastructure imports into the MENA region; Singapore, which will account for 2.40% of world trade by 2026 reinforcing its role as a major shipping hub connecting the emerging economies, and India which will grow by 0.50% to 2.25% of world trade in total. There are declines in share of world trade for many of the developed world nations. This does not suggest a decline

in the trade competitiveness of these economies but rather points to a substantial shift of the global supply chain to emerging economies. China will overtake the USA as the world's largest trading nation by 2016. It alone will account for 12.30% of world trade. Although China's imports and exports are not set to grow as fast as India's, for example, the sheer size of the trade base from which this growth is happening means that China will become the world's trade powerhouse.

**Russia is a key player in the oil sector; its two largest export sectors are crude and non-crude oil and it has markets across the world. However, there are also emerging markets in Europe and the Asia-Pacific; Sweden, for example, is expected to increase its imports of Russian non-crude oil by 16.86% annually over the next five years, Latvia by 13.72% and Belgium by 9.64%.**

### Russia's trade outlook

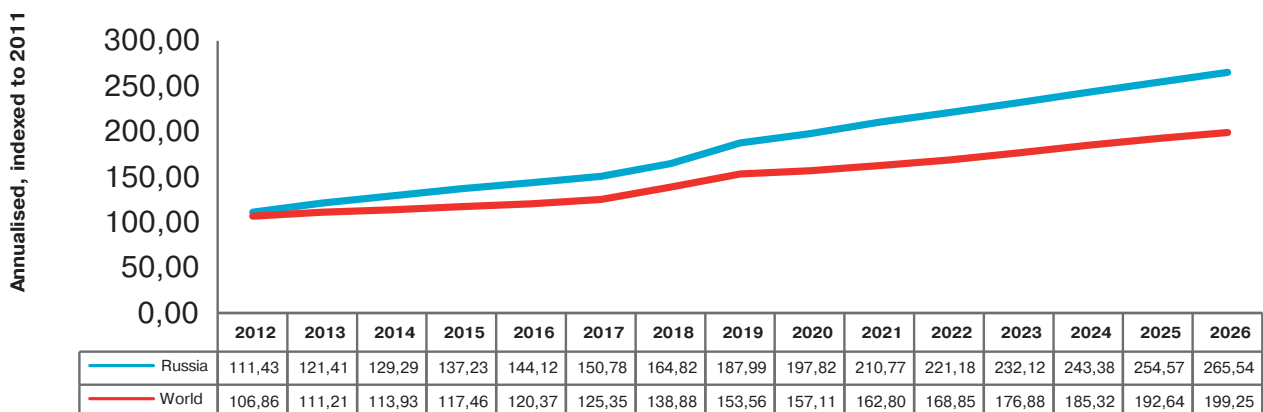
The Trade Forecast expects that Russian trade will perform increasingly better than the world average over the next 15 years. This not only demonstrates the strength of Russian trade, which is driven by exports of commodities such as oil and coal and demand for motor vehicles and technology, but also the benefits of the trade relationships that are emerging between Russia and countries within the Asia Pacific region, such as the Philippines, Hong Kong and China, which are forecast to account for accelerated world trade growth after 2015.

(See table 1 Annual growth rates year on year, Russia and World 2012-2026, power point file)

### Trade corridors and trends

As mentioned Russia's largest export partner is China, forecast to grow annually over the next five

**Table 1. Annual growth rates year on year, Russia and World 2012–2026**



years by 6.96%. Its other two largest export partners are Turkey and the Netherlands. Exports to both of these countries will grow significantly over the next five years. India is Russia's fastest growing large export partner with a forecast growth of 11.48%. This will be driven partly by growth in the export volumes of commodities and infrastructural materials such as iron and steel. Exports to Japan are set to increase by 9.70% annually over the next five years driven by exports of non-crude and refined oil, forecast to increase by 14.14% and 10.31% respectively. Growth in the export of oil is also set to drive trade with many of emerging export partners. Trade with Latvia is forecast to increase at an annualized rate of 10.66%, with exports of non-crude oil growing by 13.72% to 2016. Russia's largest import partner is China, growing by 11.00% annually over the next five years. This will mostly be driven by imports of consumer electronics and commodities. For example, electric apparatus for line telephony and telegraphy is forecast to grow by 15.20%. Russia's third largest import partner is the USA, with growth in imports predicted to increase by 8.70% over the next five years. Growth will be mainly fuelled again by consumer electronics, but imports of printing and ancillary machinery will also grow. Emerging import partners in Asia Pacific and Latin America will become increasingly important; imports from Vietnam are forecast to grow (12.37%) and from Paraguay (11.82%).

## Sector opportunities

**Oil:** Russia is a key player in the oil sector; its two largest export sectors are crude and non-crude oil and

it has markets across the world. However, there are also emerging markets in Europe and the Asia-Pacific; Sweden, for example, is expected to increase its imports of Russian non-crude oil by 16.86% annually over the next five years, Latvia by 13.72% and Belgium by 9.64%. In the Asia Pacific region Japan is predicted to import 14.14% of non-crude oil annually over the next five years, Singapore 12.49% and South Korea 11.44%. This demonstrates the importance of Asia Pacific to Russian growth. Russia's oil

sector is highly innovative and dominates global oil supply, therefore growing global demand for oil will likely fuel its economic growth. Companies will need to expand international activities by between 5.21% and 7.43% in order to take advantage of the opportunities in these sectors.

**Consumer electronics:** Russia's imports of consumer electronics are

driving the development of the economy's services sector. For example, Russia's printing and ancillary machinery sector is rapidly growing with imports forecast to grow 11.98% over the next five years, suggesting that the Russian economy is developing its service sector and improving its infrastructure to do so. As one of the largest sectors in the World in 2012 and worth an estimated \$58,571,035,394, the increase in Russia's imports suggests that the economy will greatly benefit from development in this area. The main trade corridors appearing will be with China and Japan. Another interesting large import sector is parts for radio, television transmitters and receiving equipment, forecast to grow by 6.46% over the next five years. This suggests, again, that services development will be a key national focus. In order to maximize opportunities here, businesses will need to grow above 6.46% annualized over the next five years.

**The Trade Forecast suggests that between 2012 and 2014 world trade will continue to grow, but at a slower rate before then accelerating after the middle of 2014, leading to improved economic performance globally: a trend which will continue to 2020. From 2021 it is predicted that growth in world trade will decelerate as international trade stabilizes around the world.**

**Table 2. Sector watch**

Russia's Fastest Growing Export and Import Sectors by Partner (2012-2016)					
Export Sector	Export Partner	CAGR (2012-2016)	Import Sector	Import Partner	CAGR (2012-2016)
Oils petroleum, bituminous, distillates, except crude	Sweden	16.86%	Bodies (including cabs), for motor vehicles	Slovakia	16.97%
Oils petroleum, bituminous, distillates, except crude	Japan	14.14%	Parts and accessories for motor vehicles	Slovakia	16.22%
Oils petroleum, bituminous, distillates, except crude	Latvia	13.72%	Electric apparatus for line telephony, telegraphy	China	15.20%
Oils petroleum, bituminous, distillates, except crude	Singapore	12.49%	Printing and ancillary machinery	Japan	14.76%
Petroleum oils, oils from bituminous minerals, crude	South Korea	11.44%	Parts for radio, tv transmission, receive equipment	China	14.07%
Unwrought aluminium	USA	10.71%	Women's, girls overcoats, capes, windjackets etc, woven	China	13.70%
Petroleum oils, oils from bituminous minerals, crude	Japan	10.31%	Electric generating sets and rotary converters	USA	13.46%
Petroleum oils, oils from bituminous minerals, crude	USA	9.93%	Fish, fresh or chilled, whole	Norway	13.17%
Diamonds, not mounted or set	Belgium	9.64%	Trunks, suit-cases, camera cases, handbags, etc	China	13.16%
Oils petroleum, bituminous, distillates, except crude	USA	9.35%	Parts and accessories for motor vehicles	China	13.15%



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\*Source: HSBC 'The world in 2050'

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**Metals:** Metals account for five of Russia’s top 10 largest export sectors and are expected to be areas of substantial growth over the next five years. Including unwrought steel, unwrought nickel, semi-finished products of iron and non-alloy steel, these products are integral to Russian export trade. Demand for these sectors is predominantly driven by infrastructural development. New trade corridors and opportunities for international trade are becoming apparent. Exports of unwrought aluminum to the USA are forecast to grow over the five year period by 10.71%, driven by demand for new infrastructural developments. Exports of semi-finished products of iron or non-alloy steel are to increase to Italy and Iran by an annualized rate of 9.13% and 7.89%. This provides new and exciting opportunities within a strong and highly innovative Russian sector. Companies seeking to benefit should increase their international activity by at least 4.83% over the next five years.

(See table 2 Sector watch, power point file)

**About HSBC Trade Forecast<sup>2</sup>**

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casts overall trade growth (exports, imports and total trade) globally, in global regions, and individual countries. Spanning 37 countries, it covers the top 10 sectors for exports and imports for each of these. The forecast has a special approach to understanding the drivers of trade from a business perspective, informed by: trade trends, macroeconomic and market influences trade (for example GDP, oil prices, inflation, foreign direct investment), and business environment influences on trade (including regulation, demographics, access to capital and finance). The research has been commissioned by HSBC and undertaken by Delta Economics. The economic and business narratives stem from a broader documentary search that includes material from National Statistical Offices, the World Bank and International Monetary Fund, economic blogs, the Economist Intelligence Unit, Bloomberg, the Financial Times and other professional and financial services news websites.

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## BEFORE YOU START

### Practical recommendations on how to set up a business in Russia

Falk Tischendorf, Lawyer, Partner, Head of BEITEN BURKHARDT's Moscow office  
 Bilgeis Mamedova, LL.M., Senior Associate, BEITEN BURKHARDT Moscow



#### Falk Tischendorf

Falk Tischendorf is an Equity Partner and the Head of BEITEN BURKHARDT's Moscow office.

After graduating from the Law Faculty of Hamburg University in December 1999 and completing a two year traineeship at the Higher Regional Court of Dusseldorf,

Mr. Tischendorf was admitted to the bar in Hamburg in September 2002.

Mr. Tischendorf specialises in commercial and contract law, real estate law and structuring real estate investments, as well as public procurement law and is ranked in Who's Who Legal in the fields of real estate and construction for the Russian Federation. Mr. Tischendorf is registered with the Ministry of Justice of the Russian Federation in the register of lawyers of foreign states carrying out attorney activities in the Russian Federation.

Mr. Tischendorf has authored numerous publications, such as the chapter on the Russian Federation in *Handbuch des Vertriebsrechts* (Martinek/Semler/Habermeier/Flohr, 3. Auflage, 2010), and regularly lectures at conferences in Russia and abroad.

Russia is currently in need of foreign investments and the experience of Western companies. It is well known that in many sectors, European companies substantially outstrip their Russian counterparts in terms of development; they possess state-of-the-art technologies that could enable the Russian economy embark on a course of modernisation. This means that Russia continues to offer serious opportunities for the businesses of foreign companies. How should such operations start?

The starting point differs for each company, depending on its potential and ambitions. For some companies this may mean large-scale projects, such as the establishment of production facilities in Russia. For others, it may involve the supply of corresponding industrial goods, the performance of work or provision of services in a respective area. For others still, the starting point may be the de-



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Ms. Mamedova's core activities include consulting on all issues pertaining to real estate law, commercial law, commercial activities regulation and project financing.

Ms. Mamedova also specialises in legal risk assessments on entry into various civil law contracts, as well as developing different methods for securing contractual obligations.

Ms. Mamedova has authored numerous publications and regularly lectures at conferences in Russia and abroad.

After graduating from the Moscow State Law Academy Ms. Mamedova studied at the University of Bremen in 2005-2006, obtaining an LL.M. degree. Since 2007 Ms. Mamedova has been a post-graduate student at the Moscow State Institute of International Relations (MGIMO) of the Ministry of Foreign Affairs of Russia.

velopment of a sales and distribution system for consumer goods in Russia, etc. The scale and individual specifics of a project will also dictate the corresponding individual approach, which is based on internal experience and the strategy of the individual company. Thus, the needs and conditions for setting up business in Russia are very different.

Nevertheless, irrespective of the type of investment project, there are a number of universal practical aspects that all investors should consider on each occasion. We would like to draw your attention to some of them:

#### 1. Be informed

When entering the Russian market, you need to have a clear understanding of doing business in Russia. Most investors tend to base their views on Russia on the information that they receive from the foreign mass media. In practice, this information is mostly subjective and reflects a particular political outlook.

However, as a rule, foreign companies already operating in Russia have a far more positive attitude to the country than new entrants, whose impression of Russia is formed mainly on the basis of the information provided by the Western media. The former base their opinions on facts and objective reality, and then submit them to their own analyses.

If we now go into the implementation of a specific project, it is necessary, as a first step, to identify whether this will involve interaction between the investor and the state, or will be based on business-to-business relations.

The second step is to search for information about potential partners and market conditions, and at the same time, establish some reliable contacts with regional authorities, experts and organisations that represent, promote and develop the interests of business. As a rule, experience shows that positive contacts can play a key role in the development of a business project in Russia.

If you are interested in starting up production in Russia, the proper investment site must be chosen. Russian regions have recently started becoming more proactive in their attempts to attract foreign investments; therefore, regional authorities are open to investors. It's now quite clear that investments will only go to a specific region if that region has established favorable terms and conditions for doing business and has an investment framework in place. As a result, regions may offer an investor established utilities' networks and transport infrastructure, staffing and administrative support, as well as the provision of investment concessions and preferences.

In business-to-business relations, business contacts take precedence over the deal, where appropriate opportunities to assess your potential business partner exist. For this reason, both publicly accessible and private sources of information may be used. There are now a number of sources in Russia of inter alia information about the business history of a potential partner, the negative experiences of doing business with him or any past or present litigation involving the partner. This also applies to any potential leader or CEO of your representative office or subsidiary company. Finally, it is necessary to gather information about potential competitors of your business. Today's business requires that you always stay informed and be on top of issues at all times.

## 2. Think about compliance

Unfortunately, Russia is still ranked as one of the leaders in lists of countries with high levels of corruption. Therefore, the concept of compliance has

gained particular prominence, and for many companies it has become a standard requirement.

What does compliance mean to you? Would you like to pay particular attention to compliance with respect to your business in Russia?

Obviously, each company develops its own individual norms of business ethics. To what extent could particular actions prove useful for the company if implemented, and to what extent could they prove harmful if not implemented?

## 3. How would you like to be represented in Russia?

The presence of a foreign company on the Russian market can take different forms. Generally, the form chosen depends on established business goals and the selected strategy for project implementation.

One possibility is to supply goods directly to Russian customers from abroad, which does not require the opening of a representative office or subsidiary company in Russia. This approach may be advantageous if you do not plan to have a permanent business in Russia.

Another possibility is to develop your business in Russia and expand on the Russian market. This would require your permanent activity in Russia and the establishment of a Russian subsidiary of your company.

In practice, the establishment of a wholly-owned Russian subsidiary is relevant to most companies that are involved in the sale of goods, performance of work or provision of services in Russia. The most common form of business structure in Russia in such cases is a limited liability company (Russian acronym "OOO"). The brief amount of time required to register the company and the minimum requirement for the charter capital enable foreign investors indicate their presence on the Russian market and develop their business.

However, when setting up production facilities, the situation is not as clear-cut. Frequently, in such cases, investors prefer forming a joint venture with a Russian partner. A joint venture appears preferable, particularly, in cases where the Russian partner already possesses the relevant production capacities or other resources that make it possible to implement a project as rapidly as possible and at a lower cost. The establishment of a joint venture has, nevertheless, its own advantages and drawbacks; thus, it is important to secure your interests at the very beginning in order to be protected from unfavourable developments in the future and avoid potential disputes and conflicts.

Present Russian legislation makes it possible to structure relations within the framework of a joint

venture so that the parties may determine, in detail, their rights and obligations, and structure the governance system of the company when entering into the Joint Venture Agreement.

#### 4. Pay attention to the legal requirements

The performance of any business assumes the existence of a specific legal framework. This differs from country to country. In Russia, rigid formalism is a distinguishing feature.

Consequently, before starting up a business, it is necessary to understand the mandatory requirements that effective legislation imposes on a specific activity. A number of activities, for example, pharmaceuticals, construction, etc., assume that a party has a special permit (license) or requires an access permit to carry out work, which may take several months to obtain, and stipulate that the applicant complies with the terms and conditions established by law. For example, specific standards or technical regulations can have a number of special requirements for particular kinds of goods to be sold in Russia.

In a number of instances legal mechanisms that are employed successfully in Europe may not be available in Russia, or their practical application may be complicated or fraught with material risks. Consequently, doing business in Russia assumes, above all that the business conforms to Russian legal realities.

In practice, things do not always run smoothly for the following reason: foreign investors usually have extensive experience of doing business abroad and tend to be accustomed to European public and legal realities. Accustomed to a practically focused and rational European approach, the investor may not always be willing or able to understand and accept the legal formalism frequently encountered in Russia. This can be a stumbling block for the investor, as the rules established by law represent the only legal option for doing business in Russia and for the legal protection of an investor's rights and interests.

Consequently, consideration of the mandatory requirements of effective legislation that must be met when engaging in individual types of activity is a key point.

#### 5. Protect your trademark

If you are planning to operate in Russia under a specific trademark, this trademark will have to be duly protected in Russia. First, you should review whether the same or a similar trademark is already in use in Russia, to avoid any conflict with a competitor. Subsequently, you should register all the trademarks that you want to use in the Russian market at the Russian Patent Office (Rospatent). Note that the trademark should be registered in both Latin and Russian characters. Otherwise, your trademark may be used in Russia by a third party and you will have no legal basis for protecting your rights.

#### 6. How to build a distribution system

Developing a business in Russia frequently involves the development of a distribution system. This is particularly relevant in Russia owing to the geographical scale of the country.

How can such distribution system be built?

As a rule, a product manufacturer does not engage directly in its distribution to end consumers. The following main variants are used:

- the manufacturer sells the product on a wholesale basis to distributors that sell it to the final buyers;

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- the investor establishes a so-called subsidiary “sales” company, which acts as the intermediate link between the manufacturer and the distribution network.

The reason for this structure is that Russian distributors are generally more familiar with the needs of the Russian market. Russian legislation makes provision for reaching an official agreement with distributors on certain terms and conditions regarding exclusivity and the division of a market (for example, based on the territorial principle or the composition of buyers, etc.). Such relations can be structured through the conclusion of distribution agreements on special terms, the existence of which may make such relations favorable for both parties. By these agreements it is also possible to minimise the risks for the investor.

## **7. Contract law: Take due care with contractual documentation**

Apart from establishing a subsidiary company for distribution, appropriate contractual documentation is essential to avoiding future headaches. However, as trust builds, when business relations develop between partners, it is often the case that a number of understandings are reached orally and are not confirmed by supporting documentation. This is the wrong approach to take, and may entail huge risks.

When registering contractual relations, as a first step, it is necessary to decide on the governing law. Russian legislation allows the parties to select the law that will apply to their contractual relations in cases, where one of the parties is a foreign party. However, please note that Russian law also makes a number of national mandatory provisions that must be adhered to regardless of the chosen law.

However, many foreigners are initially skeptical about Russian law. This is attributable primarily to the fact that Russian law constitutes unfamiliar territory and this unfamiliarity breeds at the very least a certain degree of caution. However, Russian law is on the contrary a more preferred option when it comes to certain aspects. For example, Russian law provides rules for license agreements; whereas, German law for instance lacks such rules.

Nevertheless, this issue should be treated with caution. In a number of instances legislation does not permit liability to be limited or allocated to a third party, and thus, any agreement of the parties in violation of such imperative requirements of the law will be null and void. Accordingly, when entering into contractual relations, it is necessary to have a clear understanding as to what is permissible under Rus-

sian law and whether the provisions of the contract are capable of protecting the interests of the party in future and preventing the onset of negative consequences for the party. In any event, the following steps should be taken when preparing a contract:

- parties have to agree on applicable law and jurisdiction (see point 8 below);
- the goal and intentions of the parties should be clearly and precisely determined;
- the arrangements of parties should be adapted to Russian law.

## **8. Enforcement through the courts: Keep the worst-case scenario in mind**

The requirement on appropriate document management is particularly relevant in cases when disputes arise. You need to take precautions with regard to potential developments tomorrow, today. Nobody is insured against the risk that difficulties in relations with partners may someday arise, for economic or other reasons.

As a result, the investor needs to protect his interests, *inter alia* in court. As a rule, the parties select the jurisdiction at the conclusion stage of the contract. Here, the following should be borne in mind.

It is often the case that the investor believes that he will receive more reliable legal protection in his country of origin than in Russia, and insists that a provision in a contract stipulate the state court of his own country as the place of jurisdiction. At the same time, however, please note that the judgments made by courts outside the Russian Federation are only recognised and enforced in Russia in cases where Russia and the corresponding country have a treaty on the mutual recognition and enforcement of court judgments. As a result, in the event of a dispute an investor may end up in a tight spot, if the investor’s country does not have such a treaty with Russia. Even if it wins a favorable court judgment in its country, the investor may not be able to enforce it in Russia, and to all intents and purposes ends up with nothing.

To avoid such an eventuality, it is recommended that you agree either on a Russian state court or an arbitration tribunal, both in Russia and abroad, as the awards of foreign arbitration tribunals, unlike the judgments of the state courts, are enforceable in Russia. In connection with this, one recommendation would be to opt for the Russian law as the governing law in order to avoid situations where a Russian judge has to make a decision according to the legal provisions of another country.

## Russian tax law developments: what to expect in 2012

Alina Lavrentieva, Partner, PricewaterhouseCoopers



**Alina Lavrentieva**

Alina Lavrentieva is a Partner at PricewaterhouseCoopers Russia B.V. Alina holds a Ph.D. in Economics and is a Certified Auditor. Alina is one of the leading specialists within PricewaterhouseCoopers Russia B.V. providing consul-

tancy services to major multinational and Russian companies; she has extensive experience and knowledge in dealing with corporate tax, accounting and related issues.

Prior to PricewaterhouseCoopers Russia B.V. Alina was the Finance Manager of a large multinational company, as well as was working for a professional firm of advisors. She is the chairperson of the Taxation Committee of the Association of European Businesses in the Russian Federation.

Alina is a regular speaker at conferences on Russian tax and related issues, both in Russia and overseas and has represented organisations such as the Association of European Businesses in the Russian Federation, Adam Smith Institute, Association of International Pharmaceutical Manufacturers in Russia and the Russian Union of Industrialists and Entrepreneurs at several conferences.

The Russian tax law underwent some significant changes last year. The most important of these was the passage of a new transfer pricing (TP) law, which took effect on 1st January, 2012. In light of these new rules, companies operating in Russia will need to review their transfer pricing approach, especially, as the new law makes some major changes in how TP is regulated compared to the old Tax Code provisions.

The main changes are:

- a reduced list of transactions subject to the Russian tax authorities' control for TP purposes;
- an expanded list of those entities that may be deemed related parties for tax purposes;
- cancellation of the 20% "safe harbour" rule and introduction of the market price range concept;
- new methods for determining arm's length prices, and fine-tuning current methods to align them with OECD transfer pricing principles;

- the possibility of correlative TP adjustments for transactions within Russia;
- the establishment of formal reporting and TP documentation requirements;
- the introduction of unilateral and multilateral advance pricing agreements for companies registered as "large" taxpayers.

Although the new law reduces the list of transactions for which the Russian tax authorities can control prices for tax purposes, at the same time, it considerably expands the list of those cases in which parties can be declared related for tax purposes. Controlled transactions may include not only certain international trade transactions, but also, in certain circumstances, domestic Russian transactions conducted by related parties.

Taxpayers must submit information to the tax authorities on their controlled transactions and substantiate the arm's length level of the prices applied. This involves preparing a standard package of documents and data, the so-called TP documentation, as defined in the new law. The law also provides for imposing penalties on tax arrears resulting from the application of non-arm's length prices. But, the tax authorities will be able to impose such penalties only from 2014, provided that no TP documentation is available. Bear in mind that the tax authorities will have to prove that prices of controlled transactions are not in line with market prices.

During the legislative process, it was assumed that the bill would bring Russia's transfer pricing rules in line with OECD TP principles. While the new law does this to a certain extent, there are still many differences. Multinational corporate groups will still have to review whether their global TP policies will work in Russia and whether they may need to adapt their documentation to meet the Russian standards.

In other developments, a new law was passed, establishing the legal status of a consolidated group of taxpayers (CGT). The new CGT regime took effect in 2012, alongside the new TP rules and can be applied by any Russian corporate group consisting of two or more companies, where one group member holds a direct or indirect equity stake of at least 90% in the charter/share capital of the other CGT members (for as long as the group applies the CGT regime). To take advantage of the CGT regime, all group members must have:

- at least RUB 10 billion in total corporate income tax, VAT, excise tax and mineral resources extrac-

tion tax (MRET) (excluding taxes paid on shipments of goods across the Customs Union border) paid during the calendar year preceding that when CGT registration documents were submitted to the tax authorities;

- at least RUB 100 billion in sales proceeds and other income, based on accounting records for the calendar year preceding that when CGT registration documents were submitted;

total assets worth at least RUB 300 billion, based on accounting records as of 31st December of the year preceding that when CGT registration documents were submitted.

Notably, transactions between CGT members are not controllable under the new transfer pricing law. This is probably the greatest benefit for those groups that have numerous intra-group transactions. But, there is one exception to this exemption: transactions involving extracted mineral resources that are subject to MRET calculated as a percentage of the value of the minerals extracted will still be controlled.

In calculating corporate income tax for CGT members, their profits and losses can be consolidated (without having to carry forward the losses of one or several of the CGT members not exceeding the profits of the other CGT members).

Overall, however, given the extensive requirements for establishing a CGT, not many companies will be able to take advantage of this option.

Taxpayers should also take note of the Russian Tax Code amendments on value added tax (VAT) that took effect on 1st October, 2011, including new provisions establishing how the VAT base should be determined if changes occur, either up or down, in the value of sold goods, work or services, or property rights. To document such operations, the law introduces a new type of VAT invoice: the adjustment (in Russian: *korrektirovochny*) VAT invoice, which serves as the grounds for adjusting the relevant tax amounts with both the seller and buyer. So, the VAT amendments set new procedures for documenting changes in the value of sold goods (work, services), as well as property rights. These procedures differ significantly from current practice. Moreover, we

assume that the new Tax Code provisions will significantly change the document flow process between those companies that currently use credit notes.

These new VAT provisions may also require adjusting certain clauses of existing contracts, as well as changing the document flow process between counterparties for specific types of operations. Additionally, companies may need to assess their available IT resources so as to ensure that the new “adjustment” VAT invoices are issued properly and on time.

Finally, employers should be aware of key changes regarding social contribution charges. The insurance contribution rate applied to the stated

cap of RUB 512,000 will be reduced from 34% to 30%, with an additional 10% charge payable to the State Pension Fund on any compensation over this cap. For certain limited categories of taxpayers, the rate on the established cap has decreased from 26% to 20% (Simplified Tax System, etc.).

Unexpectedly, the lawmakers extended the mandatory pension insurance coverage to for-

foreign nationals temporarily staying in Russia. The only exception was for “highly qualified specialists” (HQS, or foreign employees with HQS work permits) and employees with a labour contract for a term of less than six months. So, effective 1st January, 2012, the insurance part of the pension contributions (22% of earnings up to RUB 512,000 + 10% of earnings exceeding the cap) is payable for foreign employees temporarily staying in Russia and working under employment contracts for six months or more.

Overall, these amendments will place a significantly larger fiscal burden on employers with highly paid employees. So, employers should factor in the extra costs for contributions on foreign employees’ earnings (except HQS), when calculating total assignment costs and HR budgeting. Given its exempt status, the HQS regime seems to be the most cost-effective option from an immigration, tax and social security standpoint.

In general, taxpayers should pay close attention to emerging developments in Russian tax law to avoid errors, minimise risk and obtain the maximum benefit from these new opportunities.

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**During the legislative process, it was assumed that the bill would bring Russia’s transfer pricing rules in line with OECD TP principles. While the new law does this to a certain extent, there are still many differences. Multinational corporate groups will still have to review whether their global TP policies will work in Russia and whether they may need to adapt their documentation to meet the Russian standards.**

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## Tax implications of investment strategies in Russia

Irina Suvorova, Partner, Head of M&A Tax, KPMG in Russia and the CIS



**Irina Suvorova**

Irina is Partner, M&A Tax, with the Tax and Legal Department of KPMG in Russia and the CIS

Irina has extensive experience in investigating potential acquisitions and financial projections from a tax and financial perspective, including a significant number of tax due diligences in different industries in Russia and abroad

Irina worked on the structuring of in-bound and out-bound investment from a tax perspective and providing post-acquisition tax advice to foreign and Russian companies

Irina has lead several significant disposal projects which involved pre-disposal restructuring, vendor assistance and vendor due diligence

Irina has significant experience in advising on tax, currency and customs issues in Russia. Her experience includes assisting a number of companies operating in Russia and internationally to prepare for court hearings on tax and currency issues

Irina has experience in advising companies on potential IPO (primary placement of shares)

Irina graduated from Financial Academy (taxes and taxation) and Moscow Institute of Steel and Alloys (physics of metals), she is CPA, state of Oregon, certified Russian Statutory Auditor (General Audit) and a Certified Translator (Moscow Linguistic University)

In choosing an investment strategy, the investor is usually influenced by the business environment, sector preferences and appetite for risk. Although taxation is not usually viewed as a factor defining investment priorities, addressing tax issues in an appropriate and timely manner could result in significant savings.

The options available to a business considering entering a market fall under three main groups:

- Greenfield strategies, where a new business is founded and the investor chooses the location, purchases or leases land and begins construction of the production facilities;
- Brownfield strategies, where the investor purchases existing facilities, such as the land on which construction has already started and which requires additional investment;

- Acquisition strategies, where the investor purchases a business as a going concern with established production and distribution functions.

When implementing all of the above strategies, investors face specific tax issues requiring timely action and the involvement of experienced professionals. This article addresses some of the issues typical to the Russian tax environment. An awareness of the tax issues related to each investment strategy may give the investor a competitive advantage, not only through reducing risks and additional tax costs, but also by ensuring that the available tax benefits are utilized in full.

**Greenfield strategies** involve a high degree of uncertainty regarding the outcome of the investment and require attention in relation to the product portfolio and site selection, the ability to enter the market, the cost of establishing the new business and the availability of the resources required by the business (e.g. land, labour, equipment, natural resources). The investor has the opportunity to select an appropriate location, employ the right people and establish all processes properly from day one, without the involvement of Russian partners or co-investors. When implementing a greenfield strategy, the investor does not inherit any inefficiencies or historic risks; however, several bureaucratic procedures must be completed during the start-up stage, these include registering the newly established legal entity with the state; acquiring permissions, licenses and product certification; and the conclusion of contracts, with natural monopolists and the state authorities. In practice, significant administrative work should be performed within a short period of time to appropriately establish all of the business's functions. Although the establishment of tax and accounting functions is often considered to be a low priority task, tax compliance could cause difficulties for the investor as knowledge of the local market is required to select a reliable service provider (tax compliance service provider) or employ highly professional in house staff. When an investor establishes a branch, even if its activities trigger a permanent establishment in Russia, the statutory and tax reporting requirements are more relaxed than those for Russian companies. However, if licenses and permissions are required, or if the investor plans to enjoy tax concessions, the establishment of a Russian legal entity is necessary.

Greenfield strategies require that tax issues be considered when choosing the location of the busi-

ness, as the tax environment may differ in various Russian regions. Regions focus on the development of specific sectors and provide different tax concessions depending on their priorities. Most regions of the Russian Federation encourage investors to conclude investment agreements with the state authorities, stipulating that the investor is exempted from regional taxes during the investment project pay-back period, provided that the agreed amount is invested in the region. Enjoyment of tax concessions under investment agreements could involve significant time and administrative effort, and require the involvement of local consultants. As foreign investors frequently face difficulties in negotiating and concluding investment agreements, some regions, including St. Petersburg and the Moscow region grant concessions to investors, which are available based on application and do not require the conclusion of an investment agreement. The regulations on concessions are transparent and very attractive for investors, as they rule out the possibility of encountering unforeseen difficulties, as can be the case when negotiating an investment agreement.

Another opportunity to reduce tax costs is to implement a greenfield project through registration in a special economic zone (SEZ). During recent years, both the Russian government and investors have demonstrated increasing interest in SEZs. As a result, effective from 1<sup>st</sup> January, 2011, a number of technical amendments were introduced to the legislation in order to establish clear rules and extend concessions to make SEZs more attractive to foreign investors. The status of SEZ resident provides an opportunity to enjoy a reduced profits tax rate<sup>1</sup> and to deduct certain expenses for profits tax purposes, and also provides property tax exemptions (for a 10 year period starting from 1<sup>st</sup> January, 2012) and land tax exemptions. SEZ resident companies can benefit from exemptions from customs duties and customs VAT in relation to goods imported into the Russian Federation, providing that certain conditions are met. However, the number of SEZs is limited and their favorable regime is only available to investors operating in specific sectors (technical innovation, industrial production, tourism and recreation, and ports). The possibilities for tax planning with the involvement of SEZ resident companies are limited, as tax consolidation with such companies is prohibited and operations with related parties resi-

dent in a SEZ (if the amount of such transactions exceeds RUB 60 million) are recognised as controlled transactions under new transfer pricing rules coming into force starting from 1<sup>st</sup> January, 2012.

An investor could also apply for an investment tax credit, which is granted in the form of a deferral of payment of tax that is subject to interest. However, an investment tax credit is only available for certain types of investment activity (including research and development, investing in new technologies and priority regional development projects) and requires the conclusion of an agreement with the state authorities.

Consequently, the two main tax focus areas under greenfield strategies are establishing the tax function (either in house or through outsourcing) and identifying tax concessions and special regimes available to the investor, which is important for realistically forecasting the tax burden and tax cash flows of the investment project.

**Brownfield strategies**, like greenfield strategies, involve focusing on the market entry strategy, however, they also allow the investor avoid certain bureaucratic formalities. Russian partners or co-investors could participate in the investment process. From a legal perspective, a brownfield investment may be structured as an acquisition of land, property, plant and equipment (asset deal) or shares in a company owning such assets (share deal). Both options require the involvement of experts to assess the related legal risks (legal due diligence), tax risks (tax due diligence), financial risks (financial due diligence) and the market value of the acquired assets (independent appraisal).

If the investor chooses an asset deal, it is common practice for a professional appraiser to be involved in evaluating the transaction price and proposing an allocation of cost between the acquired assets. A physical stock of all of the acquired assets is highly recommended, prior to the transaction. These procedures help ensure that the investor pays an appropriate price for the existing assets.

The acquisition of assets within the Russian Federation can result in the creation of a permanent establishment of the investor in Russia, which requires registration with the tax authorities and payment of taxes on assets and profits generated in Russia, in a manner similar to that applicable to Russian taxpayers.

Under an asset deal, potential claims and historic liabilities (including those in relation to tax) are generally left with the former owners. However, certain tax risks attributable to acquired assets (such as risks relating to purchases from “bad faith” suppliers and improper customs clearance) may be inherited

<sup>1</sup> According to recent changes in tax legislation coming into force from 1<sup>st</sup> January, 2012, the profit tax rate has been additionally reduced by 2% for residents of technical innovation SEZs and recreation/tourism SEZs. This means that the statutory profits tax rate for investors would be from 13.5% to 18% depending on the legislation of the region where the SEZ is located.

by the investor. A key risk for the investors relates to purchases from “bad faith” suppliers. Under a “bad faith” supplier challenge by the tax authorities the buyer could lose the right to recover input value added tax (VAT) and deduct the value of the assets through depreciation for profit tax purposes, if the seller or its suppliers are proved to be “bad faith” taxpayers. If it is determined that the assets are purchased from “bad faith” suppliers, the investor must fully repay any refunded VAT to the budget (18% of the historic cost of the assets), and will be subject to a 20% fine and late payment interest. The profit tax risk relates to the non depreciated value of the asset, as no profit tax deductions will be available to the investor in this regard, in the future. This could have a significant adverse effect on the investor’s projected cash flows (20% of the residual tax value of the assets applying the statutory profits tax rate). To mitigate this risk the investor may perform a forensic check of the suppliers of assets prior to the purchase.

If a brownfield investment is carried out in the form of a share deal, cleaning out the target company’s balance sheet prior to the acquisition is advisable. The investor should ensure that the selling price corresponds to the market level, by determining an accurate net assets amount as a starting point

in the valuation. In this regard, it is important that all impaired assets are written off and liabilities are not understated. Although companies acquired under a brownfield strategy are not usually operational, there could be historic risks attributable to the core assets, such as tax risks relating to a “bad faith” suppliers challenge and improper customs clearance of imported assets. Therefore, in the case of a brownfield investment both asset and share deals result in comparable historic tax risks.

In summary, a proper tax due diligence and a forensic check of the suppliers of assets are advisable to mitigate the investor’s tax risks when implementing a brownfield strategy.

**An acquisition strategy** is implemented when the investor is interested in the business as a whole, rather than in particular assets. The investor could decide to involve a minority Russian co-investor or remain the sole investor. In the course of an acquisition, the investor primarily focuses on the operational and financial performance of the target company (assessment of the productivity of operations, taking into account costs in a local environment, profitability and financial viability) and integration risks (reputation, political, environmental, commercial and industry-specific risks).

Реклама

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This strategy entails less business risk than the greenfield and brownfield options, as information on historical performance, as well as strategic plans and budgets, could provide comfort in relation to the sustainability of future cash flows. Commercial and financial due diligence and valuation of the core assets are required to understand whether the investor's assessment of the business's potential are realistic and the acquisition is worthwhile. Tax and legal due diligence is required to ensure that the investor is not exposed to significant historic risks.

In practice, the acquisition of an operational business in Russia is usually structured as a share deal, unless the target company is subject to significant historic tax or legal risks, which cannot be effectively mitigated to an acceptable level through warranties and indemnities in the sale-purchase agreement (SPA). Acquisitions through asset deals are rare in Russia. Similarly, the acquisition of a business as a going concern (consisting of selected assets and liabilities, but not the whole legal entity) is also not a common method of structuring acquisitions in Russia, as the sale of a property complex is subject to Russian VAT, while the sale of shares is not.

The main disadvantage of a share deal is that the tax and legal risks of the target company are fully transferred to the investor. The historic tax risks the investor could face relate not only to the core assets (such as land, property, plant and equipment), but also to the day-to-day activities of the target company. These operational risks include those related to non-compliance with tax legislation (where additional tax liabilities could arise as a result of the understatement of taxes payable due to technical errors or omissions, or internal control weaknesses) and industry-specific risks (relating to a lack of clarity in the legislation governing specifics of the target's business). Therefore, a tax due diligence is an essential part of the preparation for share deals.

However, as a result of a share deal the investor could inherit not only tax risks, but also tax assets and upsides. In particular, in Russia, a change of ownership does not prevent the utilisation of the accumulated tax losses of the acquired company. This could be a significant advantage in relation to the acquisition of a business in the start-up phase or a business, which requires substantial investment in research and development. As such, it is important for the investor to understand whether the target company's reported tax losses are recoverable, and what impact they could have on its future tax cash flows.

The target company could have significant VAT assets, corresponding to the excess of input VAT on expenses incurred over output VAT accrued, with regard

to reported sales. As taxpayers face administrative difficulties when claiming a VAT refund from the budget, many either defer claiming input VAT for recovery in tax returns or report VAT receivable from the budget but postpone the initiation of the refund itself. In either case, the nature and aging of VAT assets should be examined during tax due diligence, in order to understand the future VAT cash flows of the target company.

The possibility of enjoying regional tax concessions is normally not affected by a change in the taxpayer's ownership, unless this is specifically stated in the relevant investment agreement, and the investor will be subject to the pre-transaction conditions. For concessions that are available based on an application, the investor is not required to observe the conditions of the relevant investment agreement and the concession may be claimed as soon as the requirements established by legislation are fulfilled. Even if the seller has not utilised a tax concession, the investor has the right to file adjusting tax returns and claim for tax refunds, if the conditions necessary to apply the concession are fulfilled.

In the worst case scenario, when the historic tax risks are so significant that the investor is not prepared to accept them, pre-deal structuring could be performed. In this case, the business is usually transferred from the target company to a new legal entity (through the sale of property, plant and equipment, transfer of personnel, and conclusion of contracts with customers and suppliers by the new legal entity). The investor then purchases shares in the new legal entity, which is free from historic tax risks generated by the operational activities of the target. However, the transfer of the business to a new company does not fully eliminate tax risks attributable to assets (such as "bad faith" suppliers' risks and customs risks) and the investor will lose the right to utilise tax assets and tax concessions applicable to the target company.

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When implementing a greenfield strategy investors should address tax matters appropriately; careful planning is required to ensure that tax concessions can be enjoyed. Tax due diligence is an effective instrument to mitigate tax risks under brownfield and acquisition strategies, which could relate not only to the operations of the target company, but also to the acquired assets. In light of the peculiarities of the local tax environment, the high level of professional expertise and extensive knowledge of industry specifics that are required to support investors entering the Russian market, in the majority of cases, the involvement of a local advisor is recommended.

## Russia's HR Market: Preliminary Results of 2011

Olga Bantsekina, Chairman, AEB HR committee and Chief Representative,  
Coleman Services UK



### Olga Bantsekina

Olga Bantsekina is the Chief Representative with Coleman Service UK Ltd. Olga has been leading the company since 2001. She has more than 15 years of experience in recruitment and HR consulting, 12 of them with Coleman. Olga

joined Coleman Service in 1998 as an Account Manager; this was shortly after Coleman started its operations in Moscow. Subsequently, she was promoted to Business Development Manager; she then went on to become the General Director. Currently, she is the Chief Representative. Since 1998, the Company has become one of the leaders on the Russian recruitment market. Prior to joining Coleman, Olga worked as a consultant for an HR audit project in DialogBank. She also worked with Manpower as an Account Manager and has experience in managing an FMCG enterprise and a small privately owned IT service company.

Olga has been the Deputy Chairman of the Human Resources committee of the Association of European Businesses (AEB HR committee) for over 5 years and the Chairman of the AEB Recruitment sub-committee. In 2010, she was elected Chairman of the AEB HR committee.

Olga holds a degree in Genetic Engineering that she obtained from the Department of Chemistry of the Moscow State University n.a. Lomonosov. She has also successfully completed several executive and educational programs on leadership, management, sales, HR, recruitment (CBSD, CCL, Thunderbird, MTI, Manpower, FGI International (Women's Leadership Program in China)... and others.

The Russian labour market has changed substantially during the last three and a half years of an overall unstable economy. The changes have been so profound that it is evident we may never return to the pre-crisis position.

Since the economy started recovering in 2010, almost all the investors on the Russian market have been experiencing its growth: businesses expanding further into the Russian regions, new companies coming to invest in Russia, new vacancies opening not only for replacement needs (as it used to be

back in 2008-09) but also for expansion purpose, the majority of the market players looking to the future quite optimistically.

All of us know that the areas which any investor has to study thoroughly and consider (preferably, before making a final decision about a project) are not limited to the general investment climate and overall economic opportunities in the country. One of the most important fields for deeper research is the labour market and human resources (HR) availability, especially with the current Russian demographic situation.

In this article I will try to give you the most general "feeling" concerning the recent HR trends in Russia. It is my sincere hope that an idea of the Russian labour market peculiarities will help you make better decisions and succeed in this competitive environment.

I will divide the trends of the labour market into three major areas — recruitment and retention; compensation and benefits; assessment, training and development — and concentrate on the most interesting trends in each of them.

The revival in the recruitment field started at the very beginning of 2010, bringing not only hope and activity to the market, but also troubles and problems to employers. We all know that the demographic situation in Russia is (and will for a certain period of time be) in a poor condition. While headcounts increased and business startups were followed by necessary team recruitment, potential candidates (those who managed to secure their jobs and held their breath during the crisis) started exploring their own perspectives and possibilities, "feeling" the market and trying to evaluate their personal position on it. Factoring in on the overall poor demography, this resulted in a quick and predictable switch back to an employees' market, when potential employees tend to dictate to potential employers the terms and conditions of their further employment contract.

When looking at the main drivers for changing jobs, these are common to Russians and have not changed significantly — money and opportunities. Coming to a potential employer, the job-seeker is usually trying to raise his basic salary by a minimum of 30 percent.

In 2011, we unexpectedly found ourselves deeply immersed in a new wave of war for talent — the relaxed times for recruiters having passed away.



Realising the poor perspectives of the nearest candidates' market due to the obvious shortage of candidates born in the early '90s, they are hunting nowadays for talented youngsters of almost kindergarten age, trying to attract them as potential future employees and "sell" their companies as potential future employers. Companies tend to be very creative in this field and readily spend budgets without even the slightest guarantee that those young people will really come to work for them. Generation Y is different, we are still studying its peculiarities, ways of behavior, attitudes, wishes and desires, self-estimations, needs and abilities. In any case, we will have to adapt our internal policies in each and every HR zone to ensure that they fit our business structures.

In general, employer-brand creating and sustaining has become critical and obvious to the majority of companies on the Russian market. And although not all of them have appropriate policies and procedures in place and an appropriate deep understanding

of how it should be done (especially Russian-based businesses), almost everyone is talking about employer branding and trying to apply these practices in the modern Russian reality.

The tough economic situation has played a tricky role (if I can use these words in a positive sense) for HR in Russia, since the crisis forced companies to involve their HR departments more deeply in strategic business planning processes and understand that without human resources no business is able to survive and develop. I believe this understanding is pretty new to the majority of Russian top executives and will have a very positive outcome not only for our HR community's further professional development, but for businesses on the whole as well.

In 2011, the increase in placements was achieved through references and headhunting, the latter techniques being used by recruitment agencies more and more often, even in their search for middle-management positions. Saving budgets on recruitment providers, which started back in 2008, has resulted in higher internal HR head counts nowadays, with internal recruiters "digging" the market themselves, using the whole spectrum of Internet resources, both existing and newly arising, and the most complicated positions being offered to providers. Internal interviewing and job

offer decision-making processes have lengthened sufficiently when compared to pre-crisis data.

Due to the lack of potential and highly professional candidates on the Russian market and because of the difficult demographic situation, companies are now paying a lot of attention to enforcing their retention policies, not only attracting future employees but ensuring they stay with the company as long as is mutually beneficial.

Key HR roles in the present reality have transferred to employees the engagement, leadership-development and talent-management fields, all of these developed policies being certain "anchors" keeping employees inside organisations, maintaining their interest and motivation for professional and career growth within companies.

In the last couple of years, one emerging trend is the rising mobility of Russians within the country. Although geographical attractiveness for relocation is rather limited to Moscow, St. Petersburg and the Southern and Central

Federal Districts, the overall trend is new and promising for the Russian labour market. Still, European and North American countries remain the most desirable places for Russian employees' labor migration.

In the compensation and benefits area, actual average salary increase will exceed inflation rates, similar to the previous year's results, but here the real figures are going to be lower than those predicted at the end of 2010. According to preliminary market analyses from different survey providers, the figures lie somewhere around 9 percent of the average salary increase - more precise data are dependent on the company's business sector, level of employee's position, region, etc. The predicted average salary increase for 2012 does not differ from that of 2011 and is equal to 10 percent.

Judging by reality (as opposed to survey data), I would say the actual salary increase in many of the companies operating in Russia was much higher than the abovementioned figures. Many current employees who were "curious" about the market situation after the crisis came back to their employers with a demand for a certain salary increase, which lay above the company's possible expectations. Still, we observed an increased number of counter-offers, where current employers were forced to do everything possible to keep high-potential employ-

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**The budgets for the assessment, training and development field have been raised for 2011 two fold, when compared with the previous period – the top three HR priorities here being performance management, leadership development and succession planning.**

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ees within their organizations, not letting them go to competitors.

Overall benefits are broadly stable over time, with a marked trend toward flexibility and compensation schemes much more “tuned” than ever to talent and potential.

Short-term incentives are nowadays well tied to performance-management systems and linked to long-term benefit programs, newly installed pension schemes and other motivational tools aimed at constant retention, involvement and engagement of existing employees.

The budgets for the assessment, training and development field have been raised for 2011 two fold, when compared with the previous period — the top three HR priorities here being performance management, leadership development and succession planning.

Full-time training and development programs are becoming more individualised and “tuned” to talents, as well as compensation schemes.

E-learning has developed significantly during the crisis, primarily due to its evident cost-saving possibilities. Furthermore, it provides different opportunities, is much more flexible and often better suits the companies’ needs.

Some legal and technical issues should be mentioned, while talking about the labour market in Russia.

First is the tax reform, which is already being labeled the “mistake of the year.” Unfortunately, its further perspectives though yet unclear, are already frightening. Although I am not a specialist in the tax area, the general HR concern for the future here is the likely return to grey salary schemes (especially, in the Russian businesses), with the purpose of diminishing the increasing income tax burden.

Migration issues have also been constantly on the agenda for all international and Russian companies with expatriates on their books. Despite all the positive changes and amendments to the Russian migration law in 2010, in the beginning of 2011, we faced new changes and amendments (registration issues), which caused another headache, not only for expatriates themselves but also to the HR departments of their companies. Notwithstanding, the very fast adoption of positive new changes in this area (bringing the situation back to normal), the feeling of uncertainty and instability with regard to the employment of foreign highly qualified personnel still exists, especially, in view of the adoption by the State Duma at its first hearing of the draft law banning outstaffing and secondment. The draft law was initiated in November 2010 by State Duma deputies Isaev

and Tarasenko and is aimed at prohibiting all forms of agency labour as well as secondment schemes in our country.

It means that not only will organisations fail to minimise their costs using agency labour (outstaffing, temporary personnel, personnel leasing), as soon as the law is adopted, highly qualified foreign employees (those working on secondment agreements) will likewise, immediately find themselves

in the Russian Federation illegally, despite all the positive changes in the migration law. It might totally ruin the investment climate in the country, especially, on the brink of the new wave of the economic crisis.

Fortunately, the Association of European Businesses has established a fruitful dialogue with the government of the Russian Federation (in particular, the Ministries for Health and Social Development and for Economic Development), and its experts from the HR committee have been working on changes to the draft law before the second hearing. From the very beginning, AEB members were in favour of legalising existing forms of agency labour and secondment in Russia in accordance with the world’s best practice and knowledge.

Thus, when investing in Russia, building new plants and factories, competing for customers and opening new regional markets for their further development, companies find themselves fighting for talent with each other, creating outstanding employer brands and trying to secure their organisations from employee losses, while the country is falling down a demographic hole. HR issues have already become hot and urgent, and this appears to be continuing for a while yet.



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## Recruitment as a Challenge

Ekaterina Vilenkina, Head of External Recruitment, RUSSIA CONSULTING Group



### Ekaterina Vilenkina

Ekaterina Vilenkina is Head of External Recruitment of the RUSSIA CONSULTING Group. Ekaterina has been working mainly in the banking area and has experience both in HR and front line banking business.

She has two diplomas – in linguistics and financial management. She worked for well known banks and investment companies: Arthur Andersen, Deutsche Bank, Renaissance Capital, AK Bars Finance. Her last employer was HSBC Bank, where she started to work as Head of Recruitment and Senior Generalist in HR, and then was transferred to Commercial Banking Department as Head of Projects.

Recruitment is the first and perhaps one of the most important objectives of any organisation, in that this process enables the procurement of an ample, reliable and adequately skilled work force. Ideally, the aim is to capture the interest of the most capable individuals who will be able to lead the organisation to new heights in business. Real life, however, is often somewhat different from this ideal.

### Recruitment Sources

The biggest recruitment challenge is the difficulty of finding adequately qualified candidates. The problem is not simply whether there is enough talent to go round – it is also an issue of whether organisations are able to reach out and capture whatever talent does exist. It is not a secret that in the recent few years some of the recruitment sources have changed dramatically – e.g. printed advertisements are losing their popularity to web recruitment, which is totally natural in our web-based environment. The biggest benefit of this method of recruitment is extending the reach of the recruitment campaigns and being able to market employer creatively on the web.

Another technological and effective source of recruitment is a central database, which allows not only to manage applicants more efficiently but also to track prospective hires even when they are not actively going through the recruitment process - for example, by keeping in contact with high-quality applicants who applied when there were no suitable

vacancies open, or for tracking and keeping contact with high-potential students in the run-up to graduation and even through their first job. This candidate relationship management approach provides a creative, proactive response to talent shortages and also makes the image of the employer more attractive to the market.

### Interviewing Candidates

After a candidate is found and identified, the next step is to efficiently manage the interview and job offer processes. Here, speed is vital, as it is important to go through the recruitment cycle quickly enough to beat competitors to job offers. If the recruitment process includes several internal interview stages (and this is almost always the case in larger organisations), irritating delays are often caused by line managers who are reluctant to promptly find slots in their “busy busy” schedules to meet the candidate. These kinds of delays can have a significant business impact, frustrating candidates and in the worst cases, opening the door to nimbler competitors who can get job offers out more quickly to top candidates.

It is strange, but not many employers use technologies, such as automated workflows, to manage the different steps of the recruitment process, though these technologies can deliver tangible business benefits and are an obvious rescue kit in situations, where your recruitment capacity is restricted. If used directly by businesses and not only by HR, they can provide line managers, with an effective application tracking tool with, let's say, an alert-triggering function that allows them to control the recruitment process for their departments directly and to reduce the time consuming communication with HR. In other words, such involvement of businesses into the recruitment process improves direct information access and gives managers better visibility into the progress of applications. A good instrument for prodding managers to better recruitment responsiveness and activity is letting them see what proportion of a process is eaten up by their own inactivity.

### Quality of Selection

Worth noting is the changing nature of recruitment. In a highly competitive market, where talent is at a

premium, organisations need to take an aggressive, professional approach to recruitment and adapt lessons learned from customer-facing functions such as sales and marketing. Recruitment should be viewed as a sales and marketing exercise, not purely an HR administrative task. You need a good corporate image, good marketing skills to identify the best candidates, and good sales skills to encourage them to join. The professionalism of recruitment – from the design of your adverts and website to the way you respond to telephone enquiries – directly influences candidates' joining decisions. HR should actively seek to learn lessons from colleagues in sales and marketing in order to improve recruitment effectiveness. Known sales techniques (e.g. SPIN selling) are worth using not only to win candidates but also to channel our customer's opinion in the direction that we think is the best (note: we all work for customers - if we are an HR service, our customers are internal departments; if we are consultants or recruiting agency, our customers are external

clients). These techniques can be obtained through specialised trainings, and of course they are automatically gained with time and experience (look at successful recruiters – they all are using them, often not even knowing that this is a professional sales approach). It is worth mentioning here one aspect of recruitment that is difficult to define or measure – the gut feeling for the right candidate. Professional recruiters and experienced managers develop this feeling with years. It's like chemistry in a romantic relationship: either something clicks or it doesn't. However, you need to be careful and not to rely solely on this personal chemistry, as there is a risk of selecting a candidate who may not at all appeal to your customer just because your customer is a different person, with his own view of the world.

## Recruitment Resources

The next two challenges are centred on financial and resource related issues: meeting salary or compensation expectations of high-quality applicants, budgetary constraints and having sufficient HR or recruiting resource. The efficiency of the recruitment methods and HR's professionalism may significantly reduce the adverse impact of these constraints.

Now, don't ask me where to find and how to identify efficient HR or recruiters for your team – alas, they are rare birds indeed, maybe like any good professional? Anyway, this is exactly what we are talking about...

## Onboarding and Retention

After the hectic rush of finding and buying the right candidate over, it would be a mistake to relax and rejoice on the good job done. There still remain onboarding (the activities that take place between receiving a job offer acceptance and getting the new hire up and running) and retention, which are often overlooked. Their importance cannot be underestimated, as our goal is not just successful hire, but long-time employment of reliable and productive professionals for the benefit of our business. If you are a recruiting agency and you are lucky to have a client with a highly professional HR, smooth onboarding on the client's side is beneficial for you too - you

will save your time and effort on guarantee cases (the guarantee period is a normal market practice - a recruitment agency undertakes to provide a free replacement for its candidate if he/she leaves the new employer within the probation period).

Smooth onboarding makes the right start for a newcomer and it convinces him/her that the decision to join this particular company was the right one. It does have noticeable effect on the future professional results of a newcomer. Good employers use carefully designed practices to adjust the recruit to the new environment and to make him/her feel comfortable and taken care of during the adaptation period. As for retention, needless to say, it is extremely important to care for the garden that you have sown. A good working atmosphere and environment in a company supported by a professional, approachable and caring HR team equipped with the most up-to-date knowledge and motivation practices are the absolute must-haves.

**Worth noting is the changing nature of recruitment. In a highly competitive market, where talent is at a premium, organisations need to take an aggressive, professional approach to recruitment and adapt lessons learned from customer-facing functions such as sales and marketing.**

## Legal aspects of investing in Russia

Mikhail Aleksandrov, Partner, DS Law



### Mikhail Aleksandrov

Mikhail Aleksandrov is a Partner at DS Law.

Specialisations: corporate and tax law, mergers and acquisitions (M&A), real estate transactions, development of schemes for project financing and legal support for these projects, public-private partnerships.

Mr. Aleksandrov also provides legal support in complex investment projects, including infrastructure projects; tax consulting; and business and tax-related arbitration disputes. Mr. Aleksandrov graduated from the Moscow State Law Academy (MSLA) in 2003, where he majored in jurisprudence, with an emphasis on finance law. In 2006, he obtained a post graduate degree from the Moscow University for the Humanities (MOSGU).

He is an honoured member of the Russian Bar Association and a member of the Association of European Businesses. In 2011 he was one of the lawyers recommended by Global Law Experts.

Mr. Aleksandrov is a regular speaker at business conferences and events, with appearances on television and in print media, as a subject matter expert.

This article will attempt to outline some of the legal issues that are of relevance to foreign business in Russia. These will be addressed from a business standpoint rather than a strictly legal one; thus, allowing all readers understand fully what these issues are.

### 1. Supply of goods

#### (a) Customs

For companies involved in import and export activities, customs is an important issue. Hard to believe, but some studies suggest that up to 80% of the cargo that crosses the Russian border is examined by the customs officers.

Local technical regulations are rather unclear and EU certificates are yet to be recognized by default. Therefore, all products should have certificates and/or declarations of compliance. Products intended for personal usage would need a so called SES-certificate (from sanitary – epidemiological services).

Those bringing in equipment that uses radio signals or transmits or stores encrypted data may need additional permits. One way of clarifying this issue would be to have all the supporting documents checked by customs beforehand; thus, avoiding a situation whereby the goods have to be first stored at a custom's warehouse. Whatever the case, if goods are being delivered to a local partner in Russia, this eases the entire process as the local partner usually takes care of all these formalities.

#### (b) Exchange control Rules

When dealing with monetary transaction that may involve a transfer of funds from abroad, a Russian company must present the "Passport of the deal" to its bank to meet the exchange control rules. To do this, the hard copy of the contract is needed. Thus, importing goods to Russia requires a supply contract to be signed prior to shipment. In light of the recent changes made, commercial transactions under 50 000 US dollars (\$) do not require this particular procedure.

### 2. Creation of a Representative office

This step is a common procedure for those companies that need "on the ground" control of their operations in Russia.

#### (a) Registration

The registration of a representative office is done by the "State Registration Chamber" (<http://www.palata.ru/en/>). To do this, the following documents must be submitted:

- a written application;
- an extract from the registry of the foreign legal entity's country of origin;
- the legal entity's charter;
- a resolution to establish a representative office in Russia;
- regulations for the representative office of the foreign legal entity in Russia;
- the certificate of solvency from a foreign bank;
- reference letters from Russian business partners – at least two;
- a certified copy of the general power of attorney (POA), with regard to the head of the Russian office, with all the requisite powers;

- a certified copy of the POA, attested by a notary and issued to the person v authorised to handle all registration matters;
- an official document indicating the representative office's legal address;
- a completed data sheet on a foreign legal entity's representative head.

All documents should be legalised by the consulate or apostilled. The fee for registering a representative office is 120 000 Roubles (RUR).

### **(b) Permitted activities and financing**

The Russian legislation makes a clear distinction between a representative office and a branch. A representative office can only be involved in marketing activities and cover all necessary expenses/expenditure incurred: it is not entitled to any revenues. Financing a representative office is very simple, all monetary transaction are carried out via any Russian bank and do not require a passport of the deal or any supporting documents other than a reference - "transfer of own fund", since the representative office is actually just a part of the company.

### **(c) Accounting and taxation**

Though the representative office does not generate any profits its accounts must be kept in accordance with the Russian Accounting Standards (RAS). The office must, likewise, pay its employees' taxes.

There are several employee taxes that must be paid, regardless of the employee's country of origin.

By law, the personal income tax is paid by the employee; this however, is calculated and withheld by the employer. Therefore, a 13% (for residents) and 30% (for non-residents) rate should be applied. For tax purposes, a resident is any person staying in Russia for more than 183 calendar days at a stretch, per year, foreign or local.

In addition to the salary, the so-called "social insurance" must be paid.

- 22% to the Pension fund;
  - 2.9% social security fund; and
  - 5.1% to the medical insurance fund.
- This makes a total of 30% which should raise back to 34% in 2014.

Given the significant difference between the RAS, GAAP and IFRS systems of accounting, some representative offices may need to convert the former to the latter two. As long as no revenues are generated, a representative office will not be treated as a permanent establishment (PE) when it comes to taxation; hence, it will not be exposed to local tax on profit.

### **(d) Visas and work permits**

An application for a multiple business visa or a working visa can be submitted to any Russian embassy. Usually, such visas are granted for a period of one year. The head of a representative office can come to Russia with a business visa and receive a working visa on arrival. Having received a Russian visa in any country outside Russia, you may subsequently renew it in Russia. The head of a representative office and all foreign nationals in employment at that office do not need a working permit. The number of foreign nationals to be employed should be agreed upon with the State Registration Chamber.

The representative office itself does not require a special permit to hire foreign workers. In general, rep. offices are often used by financial institutions not selling their products in Russia directly, but advertising here.

## **3. Creation of a branch**

The procedure for establishing a branch is similar to that for creating a representative office. The same applies to the issue of work permits.

### **(a) Permitted activity and liability issues**

The main difference between a representative office and a branch is that the latter can actually perform commercial transactions. Opening of a branch means that the company has full powers to execute all transactions, which the company itself can perform. The Head of a Branch acts on the basis of the regulations of the branch and the POA issued in his name. Since the branch is actually a part of the company, the company itself may be held liable for all actions of the branch. As the branch itself is a non-resident body, all the transactions with residents above the sum of \$50,000 should be performed in a manner described above.

### **(b) Accounting and taxation**

A branch is treated as PE; therefore, in terms of taxation it has the same status as any Russian company. Thus, amongst others, it has to pay Value Added Tax (VAT).

### **Value Added Tax**

Value Added Tax in Russia is set at 18%. Some categories of goods are taxed at the lower rate of 10%. The principles of VAT are identical to those in the EU; however, the procedure is complicated; to begin with, the company will need to have an original of the VAT invoice from the supplier. The VAT return should be filed quarterly, within 20 days following the end of the previous

quarter. Value Added Tax can be paid in three equal installments, after the end of the reported quarter.

### **Income tax**

Capital gains of resident corporate taxpayers operating under general tax framework are taxed as ordinary business profits at the common rate of 20%, regardless of the ownership period. Small businesses operating under a simplified tax framework only pay a 6% or 15% tax on gross receipts. Some income, like dividends may be taxed at a lower rate.

Generally, all the normal expenses are deductible; however, the administrative procedures in this regard may differ from those in Europe. In general every operation requires not only an invoice, but a signed contract and papers proving acceptance. Income tax is calculated and paid on a quarterly basis, within the 28 days, following the end of a quarter.

Russia has a wide network of Double Tax Treaties (DTT) with EU countries; thus, passive income (dividends, royalties, interest, etc.) may be taxed at an even lower rate: sometimes even at the rate of 0%. However the arm-length principle for taxation on interest may apply in certain cases. One major advantage of opening a branch, in comparison to a subsidiary, is the absence of taxation of dividends – all the income is attributed directly to the company and can be withdrawn at any time. The rules regarding personal income tax and accounting are the same as for a representative office.

Branches are commonly to start commercial operations that do not require a large number of personnel. Also, this is an option when a company is yet to decide on how long it intends to stay on the Russian market. A branch can also be easily closed, while the liquidation of a subsidiary requires additional time and cost.

## **4. Creating a subsidiary**

As an alternative to opening a branch, a subsidiary company may be created. This allows a strong presence in the market, with a limited exposure to risks. In this case, the subsidiary is fully liable for all actions, not the “mother” company as is the case with a branch or representative office.

### **(a) Registration**

There are three most commonly used legal entities: a limited liability company (called “OOO”) in Russia, Closed joint stock company (called “ZAO”), Open joint stock company (called “AO”). The third option involves attracting public investors; therefore, most companies are either ZAO or OOO.

A closed joint stock company (ZAO) is probably the most “western” in nature and can be described as a “company limited by shares”. Therefore, a lot of the rules and regulations from a legal and corporate standpoint are similar to analogous companies all over the world.

A limited liability company (OOO) is similar to an Ltd. (in the UK) or an LLC (in the US); it is the most simple and most commonly used option when opening a company in Russia. It differs from the ZAO in that the company has no shares but “right of participations”, which are in effect, “property rights”. Though in practice it makes little difference (please see table 1).

A company is incorporated at a notary and the notarised papers must then be submitted to the tax authorities, in person.

The following documents from the main company, based abroad, must be presented:

- an extract from the foreign company’s registry;
- Charter;
- the Director’s passport details;
- the company’s registered office’s official address.

If an individual wants open a company in Russia, only the apostilled and translated copy of his passport are needed. If one of the owners of this company is a foreign company, all relevant documents must be apostilled, translated into Russian and notarised (this can be done locally). The address indicated in the registration form will be the company’s official, legal address. Should the company decide to relocate, proper notification must be made to the tax authorities.

The registration process is in itself very important. Although a 100% subsidiary company may be created, only its founders may present all relevant documents, in person, at the registrar’s office. If one of the founders is another company, then a director of the “parent” company should appear in person. The same applies to the notarisation process. A director/CEO of the newly founded company must likewise, be appointed beforehand. If this person is a foreign national a work permit is required. One way of addressing this issue would be to appoint a Russian citizen as director/CEO, with a nominal share of, say, 0,01% in the company. This will allow him take care of all the registration formalities related to the employment of foreign nationals. This share may later be bought back by the company, making it a 100% subsidiary, once again.

It should be noted that ZAO also have to register all issued shares, with the Federal Commission for Securities Market (FCSM): this may take up to two month. Within this period, the company remains operational, but the shares can not be transferred to third parties.

**Table 1. OOO vs. ZAO**

	<b>OOO</b>	<b>ZAO</b>
Registration	Simple procedure	Requires registration of shares with FCSM
Share capital	10,000 RUR	10,000 RUR
Management	General meeting, Director, Board of Directors can be created	General meeting, Director, Board of Directors can be created
Registry of participants/ shareholders	All participants are registered in the state registry	All shareholders are registered in the shareholders registry, which can be kept with depository or with the company's director
Transfer of shares	Notary deed and registration with the tax authorities required to make the transfer	Transfer can be done within the registry

The registered share capital for both types of entities is 10, 000 RU rubles which is approximately 250 Euros (EUR) and the time taken to complete the registration process is five working days. Usually 100%-owned subsidiaries are opened as OOO, while JV's and/or companies who intend to transfer shares are registered as ZAO.

#### **(a) Permitted activities and financing**

A subsidiary may be engaged in all types of activities in Russia, although, some may require permits. Also, there are some strategic spheres such as insurance, banking, defense, etc. that might require special permits for a foreign-owned company. Generally, a subsidiary can be financed through debt or equity. The arm's length principle can be applied debt financing. Financing through equity may be done through share capital or capital contribution. In both cases, there are pros and cons (table 2).

Subsidiaries are most commonly financed via intra-group loans, even though "mother-daughter" loans are not tax-wise.

#### **(b) Accounting and taxation**

In general taxation and accounting procedures are similar to those for a branch. The main difference

occurs when the subsidiary's revenue exceeds 10 million RUR per quarter. One may run into difficulties during documentation of tax returns and book keeping as this involves monthly statistic reports, payroll reports, income tax returns, etc. Upon distribution of dividends the company is entitled to the withholding tax. Generally, it is set at the rate of 15%, but if DTT applies, it is usually reduced to the rate of 10%. In many cases, if the foreign investment in a Russian company exceeds a certain limit then the rate of 5% should be applied with regard to DTT.

#### **(c) Visas and work permits**

This may require some effort. A permit must be obtained for the company and employee as well. Technically, the company intending to hire foreign nationals applies for both permits. The procedure can be quite costly and time-consuming. It may take up to 3 months. The recent introduction of the Highly Qualified Specialists category for foreign employees has, however, in many cases eased the permit obtaining process.

This brief overview does not cover all the issues at hand, however, it is our hope that it will make a lot of choices easier to make.

**Table 2. Share capital vs. Capital contribution**

	<b>Share capital</b>	<b>Capital contribution</b>
Registration	Each increase in share capital must be registered with the tax authorities	No registration required
Corporate procedures	Requires decision of the General meeting	Requires decision of the General meeting
Possible tax consequences	Does not create any profit on the side of the subsidiary	Might create a profit and lead to the income tax in case a contribution is made by the shareholder, who owns less than 51% of the shares in the subsidiary
Further tax deductions	Can be deducted from the income upon the disposal of the shares	Can not be deducted from the income upon the disposal of shares
Return of the funds	Share capital might be reduced on the later stage, and thus, returned to the parent company	Capital contribution can not be returned
Possible form of transfer	Can be done as a cash transfer or in a form of a waiver of an existing debt	Can be done as a cash transfer or in a form of a waiver of an existing debt



## Tax and Immigration Law Changes for Investors

Ludmila Shiryaeva, Executive Director, Human Capital Department, Ernst & Young



### Ludmila Shiryaeva

Ludmila Shiryaeva – Executive Director, Tax & Law, Human Capital, Ernst & Young (CIS) B.V. Moscow.

Ludmila has 17 years of experience in advising clients on Russian income tax, immigration and labor law; social and pension contributions; currency and civil law; tax optimisation and planning; employment and payroll structuring; supervises the preparation of Russian personal income tax returns and deals with work permit applications for numerous corporate clients in various sectors; acts as an immigration practice leader and knowledge manager for the Human Capital group in Russia and as Chairwoman of the Migration Committee of Association of European Businesses, dealing with various issues in the immigration area, including meetings with government authorities, lobbying activities and drafting laws.

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In the past 18 months, the Russian government has adopted various changes in tax and immigration legislation which are aimed at attracting top-talent foreign specialists to work in Russia. Generally, this category includes management and highly qualified specialists of the companies doing business in Russia.

The major changes in immigration law were introduced in July, 2010. The new simplified immigration regime was established for highly qualified specialists (HQS) coming to work in Russia, and their accompanying family members. Since then, the Federal Migration Service has issued more than 14,000 HQS work permits.

These changes in immigration processes were highly appreciated and supported by the Russian and foreign businesses employing expatriates in Russia. According to the new procedure, an organisation may obtain all the necessary immigration documents for HQS personnel in one month. Under the law, Highly Qualified Specialists are defined

as foreign employees, with annual earnings of not less than 2,000,000 Rubles. The HQS expatriates and their employers may benefit from the system from various aspects, including the 90-day rule for initial immigration enrollment, absence of the quota requirement and requirement to obtain various corporate documents, including the company's permit and consent for hiring foreign labour. Moreover, the HQS work permit and the related visa are issued for a 3-year period, with possible prolongation on Russian territory of both documents.

Another benefit established for HQS expatriates relates to personal taxation; whereby, from July, 2010 qualified foreign nationals became subject to Russian tax at the rate of 13% irrespective of their tax status in Russia, under the general tax rules.

All of the above changes to immigration law were developed by the state and government authorities, including the Ministry of Economic Development, Ministry of Healthcare and Social Development, and the Federal Migration Service, with the active involvement of representatives of businesses in Russia. As a result, the law takes into consideration the recommendations of Russian and foreign investors. This was a good example of a fruitful cooperation between the state and business representatives in order to achieve the most effective results, where both legislative and practical aspects were considered in the course of drafting the law.

Furthermore, the readiness of the government and ministries in charge to continue effective dialogue with the investors was confirmed by another quick reaction and related legislative change. On February 15, 2011 the law concerning significant changes in immigration enrollment procedure came into force. Under the new law, the obligation to enroll foreigners in Russia was passed to the landlords (legal entities and physical persons). Although the intention of the legislators was to further simplify the enrollment procedure, and relieve employers from this obligation, the new requirement seemed to be not feasible from the practical standpoint. Many concerns regarding negative practical consequences of this change were shared by investors and various business associations directly with the Russian government and the President. The new law, which restored employers to the list of hosting parties for enrollment purposes was urgently adopted in March, 2011. Again, this quick reaction by the government has demonstrated willingness to work

closely with the investors and respond to their needs and concerns.

Another immigration related document came into force in March, 2011. Russia and France signed the Agreement regulating immigration and labour issues applicable to the citizens of both jurisdictions working on the territory of the other country – party of the Agreement. The document stipulates more beneficial immigration rules for the French citizens working in Russia (and vice versa with regard to Russians working in France). For example, no quotas applied to certain groups of expatriates, including those working in affiliated companies, heads of the companies, highly qualified workers and young specialists. Russian work permits issued to these groups of foreign workers are valid on

**Currently, a number of business associations in Russia, including the Association of European Businesses continue discussions with the government regarding the adverse impact that the prohibition of secondment of personnel in Russia could have not only on the investment climate, but also on the potential unemployment of a big number of locals, especially, those whose services are needed on a temporary basis only.**

the whole territory of the Russian Federation, and visas can be extended in Russia, for a period of up to 3 years. A more beneficial enrollment rule has been established for the qualified individuals, i.e. 10 days upon arrival to the country.

An analogous agreement between Russia, Belorussia and Kazakhstan, with effect from January 1, 2012, foresees a relief from the Russian work permits for citizens of the respective

countries, under the condition that they hold local employment agreements with the host companies in Russia.

Although the main trend of the legislative developments has been positive for the foreign and Russian investors, there are still areas of concern for the business.



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One of the most recent legislative developments relates to the Russian social security system. The new law effective as of January, 2012, foresees reduction of the overall social contributions rate from 34% (valid in 2011) to 30% (on the first 512,000 Rubles in earnings). However, it also establishes additional contributions payable to the Pension Fund at a 10% rate on income that exceeds the 512,000 Rubles threshold. The introduction of additional contributions leads to a significant increase in payroll costs for many employers (primarily those with a large number of highly paid employees).

Moreover, the law now imposes additional burden on employers hiring foreign nationals who are in Russia, on a temporary basis. An exception is only made for highly qualified foreign specialists who will continue to be exempt from social contributions. Therefore, the earnings of temporarily located foreign employees, who do not have an HQS status will be subject to pension contributions at the rate of 22% on the annual income up to 512,000 Rubles. Income exceeding this cap will be subject to contributions at the rate of 10%. This is in addition to temporary and permanent residents, who are currently subject to social contributions in full scale.

The provision related to foreigners would perhaps make sense if the state were prepared to provide equivalent pension benefits for all foreign, nationals working in Russia. However, foreign nationals, not holding residency permits in Russia are currently not entitled to Russian pensions.

Another serious concern relates to potential abolishment of secondment of personnel in Russia. The draft law abolishing the respective articles in the

Russian Tax Code has yet been taken up by the State Duma in a first reading and its second reading would most likely occur during the 2012 spring Duma session. Thus, the likelihood of a draft law being adopted has increased. If the law is adopted, multinational companies would not be able to continue using secondment agreements to

deploy expatriates into their subsidiaries in Russia. Likewise, recruiting firms will not be able to continue providing the core service of leasing temporary labour to clients. Currently, a number of business associations in Russia, including the Association of European Businesses continue discussions with the government regarding the adverse impact that the prohibition of secondment of personnel in Russia could have not only on the investment climate, but also on the potential unemployment of a big number of locals, especially, those whose services are needed on a temporary basis only.

Currently, the state authorities in charge and the representatives of business associations, including recruiting agencies have developed alternative proposals to the draft law, which may replace the initial text adopted in the first reading. However, it is not clear whether only recruiting agencies (duly accredited, with the state authorities) would be able to continue using the secondment structure, or other multinational companies would also be able to apply secondment, provided the necessary changes to the Labour Code are introduced.

In this regard, there is a hope that the Russian government would again take into account business concerns of the Russian and foreign investors, while making decisions on the above mentioned issues.

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**Another benefit established for HQS expatriates relates to personal taxation; whereby, from July, 2010 qualified foreign nationals became subject to Russian tax at the rate of 13% irrespective of their tax status in Russia, under the general tax rules.**

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## Investing in Russia: Important Aspects of the Customs Union Legislation

Wilhelmina Shavshina, Head of Foreign Trade Regulation and  
Ksenia Sizova, Associate, DLA Piper



### Wilhelmina Shavshina

Wilhelmina Shavshina (PhD in Law) is the Legal Director and Head of Foreign Trade Regulation at DLA Piper.

Wilhelmina is an expert in customs law, with extensive experience in customs administration, as well as the implementation of customs policy in investment activities.

Best Lawyers voted Wilhelmina Russia's best lawyer in the regulatory sector in 2011.

At DLA Piper, Wilhelmina implements the integrated support and structuring of international investment projects, cross-border transactions, advises on the issues of customs value and customs administration to the requirements of customs, currency control, tax and accounting recordkeeping, the use of simplified customs clearance procedures, and customs risk profile actualization. Wilhelmina oversees the process of customs duty rate reduction, assists in solving customs disputes and protecting right holders' interests as well as advises companies on all other aspects of customs regulation and the taxation of foreign trade operations.

Acting as a Deputy Head of the advisory council on customs regulation and a member of the advisory council on tax law at the State Duma Committee for Budgets and Taxes, Wilhelmina focuses on the legal basis of the public governance of overseas trading activity. She is also a member of the expert committee for customs tariff policy with the Industry Committee. She was actively involved in the preparation of the model CIS Customs Code under the CIS Interstate Parliamentary Assembly. She also sits as an expert on one of the commissions in the Parliamentary Assembly of the Eurasian Economic Society.

Wilhelmina is a professor (docent) at St. Petersburg State University. Wilhelmina is an associate professor at the St. Petersburg State University. With the support of the Law Faculty of St. Petersburg State University, at the initiative of Wilhelmina, a continuing education programme on the legal groundwork of foreign economic trade activity for corporate legal advisors and senior management was launched. Wilhelmina is the author of over 60 publications on customs and tax matters.



### Ksenia Sizova

Ksenia Sizova (PhD in Economics) is an Associate at DLA Piper.

Ksenia Sizova is an expert in customs legislation at the St. Petersburg office of DLA Piper.

Ksenia specializes in customs-tariff regulation of foreign trade activity, possesses profound knowledge in the sphere of customs, tax and administrative legislation in Russia, which all affect the customs sphere. Ksenia is an expert in the regulation of customs issues faced by companies with foreign economic activities. In particular, Ksenia possesses expertise in the following areas:

■ Full-scope project administration related to the application of customs-tariff and non-tariff measures regulating foreign economic trade activity, including the preparation of project feasibility studies, their approval at the respective ministries and departments as well as implementation;

■ Organizing company's interaction process with the customs authorities as regards the development of a unified position on conducting customs clearance and customs control of imported (exported) goods;

■ Preparation of requests to the customs (tax) authorities with respect to payment, and refunds (offsets) of monetary funds in relation to goods crossing the customs border;

■ Representation of foreign trade participants at court and quasi-court dispute settlement proceedings related to the application of customs and tax legislation;

■ Defense and representation of companies before the customs authorities in administrative proceedings;

■ Developing goods supply schemes on the customs territory of the Russian Federation and subsequent customs clearance.

Ksenia is the author of over 30 research articles.

When making the decision to invest in Russia, foreign investors come across a lot of questions, which require legal and economic evaluation. The creation of the Customs Union of Russia, Belarus

and Kazakhstan has changed the regulation of foreign trade; this has a direct impact on the implementation of investment projects. This article is devoted to the main provisions of the customs legislation of the Customs Union and the evolving law enforcement practice that should be taken into consideration by foreign companies investing in Russia.

## Tariff Regulation

Changes in tariff regulation that have taken place in connection with the creation of the Customs Union have affected absolutely all the companies engaged in foreign trade. This is mainly connected with the enactment of the Uniform Customs Tariff of the Customs Union and the introduction of the Uniform System of Customs Concessions & Preferences and the Uniform Nomenclature of Goods at the level of the Customs Union member states.

Tariff rates have been generally cut. To be more precise, tremendous changes have been introduced with respect to process equipment, devices and mechanisms the tariff rates for which have been brought to zero. It would be worth noting that since 1<sup>st</sup> January, 2012, the new edition of the Uniform Customs Tariff and that of the Uniform Nomenclature of Goods has taken effect (by virtue of decision No. 850 of the Customs Union Commission dated 18<sup>th</sup> November, 2011).

Technically, the uniform customs tariff rates are subject to revision on the basis of the decision of the Customs Union Commission. Any company, however, may initiate a change in the tariff rate, with respect to a particular kind of goods.

For example, in 2011 the Customs Union Commission made decisions to change tariff rates, with respect to various kinds of foodstuffs, grain, paper and cardboard, accumulators, aluminium foil, agricultural machinery, presses, and other goods.

In Russia, as is clearly shown in practice, the initiative of a tariff rate increase has been adopted primarily as a result of the initiative to protect domestic production.

At the same time, starting from 1<sup>st</sup> January, 2012 companies suffering losses from the increased tariff rate may approach the Russian federal authorities, with a counter-initiative to decrease the tariff rate, providing a calculation of the real damage suffered from the increased tariff.

Please note that according to the Protocol on the accession of the Russian Federation to the World Trade Organisation (WTO) signed in Geneva on 16<sup>th</sup> December, 2011, Russia has assumed particular commitments upon itself with respect to the Customs Union nomenclature of goods. On the

whole, tariff rates are to be cut gradually, but at the initial stage they may be increased with respect to a number of goods. We, therefore, would expect that during the ratification process, the Russian Federation should initiate negotiations with Kazakhstan and Belarus on the adjustment of import tariff

rates, with respect to such goods.

It is not clear at the moment how the future Customs Union tariff will be established: whether (i) just another tariff will be introduced in one step or (ii) the manufacturers' and consumers' applications will be collected and a new tariff established, based, thereon, in compliance with the applicable procedure. However, the earlier companies commence filing their applications to the Russian Government, while having reviewed the new trading conditions evolving due to Russia's commitments, the better.

## Tariff Concessions

With respect to tariff concessions (a complete or partial exemption from import tariffs), the legislation of the Customs Union has preserved the main types of exemptions. As before, companies will be able to take advantage of a concession if they import goods as a contribution to the authorised capital of a Russian company. A tariff exemption will also be granted with respect to vehicles transporting cargo and passengers overseas. Goods imported as free aid are exempt from tariffs upon the import thereof to Russia.

The procedure for granting tariff concessions is generally written into the legislative acts of the Russian Federation.

Alongside this, the legislation of the Customs Union has introduced an utterly new tariff concession. We are referring to an import tariff exemption with respect to equipment, their components, spare parts and raw materials that are imported in the course of the implementation of investment projects.

A similar concession was established in Russian legislation by the 1999 Foreign Investment Law, but

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it was not applied owing to the absence of a regular mechanism (the relevant regulatory acts in furtherance of the Law were not passed).

The concession being introduced is very important for business, especially, for companies that import raw materials and supplies and pay tariffs ranging from 5% to 20% of the value of the goods they import. For the time being, however, the concession is not being applied, as a lot of the issues concerning its application remain unsettled. To be more particular, the legislation does not give a clear definition with regard to projects that will fall under the investment category or if the evaluation criteria for the investment size and the foreign investor's shareholding will be put in place and so on.

### **Value Added Tax (VAT) concessions on the import of process equipment**

When importing process equipment that has no domestic counterparts to Russia, companies may claim a concession on the VAT charged by customs, with respect to imports.

The mentioned concession is granted with respect to a limited list of equipment, as adopted at the Russian government level. This list is not a

closed one and may be extended on the application of the company to the competent authorities.

### **Customs Value**

For the time being, the issue of adjustments to the customs value of goods imported to Russia still remains the most sensitive of all issues in the sphere of foreign trade administration. A change has been introduced within the framework of new legislation to the customs value adjustment rules. A series of agreements have been adopted with respect to determining and declaring customs value and exercising control. On the whole, the main principles of customs value determination and control have not undergone a drastic change. New norms, within the framework of the Customs Union regulation conform to the main principles of article 7 of General Agreement on Tariffs and Trade (GATT).

The principles of customs value control are aimed at shifting control towards the post-release stage. The customs authorities will, thus, be able within three years after the release, to check the accuracy of the customs value declared.

The Customs Union Commission has published the procedure of exercising control, which sets forth

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a clear-cut action algorithm for a customs authority to follow at the stage of customs value control. The legislation of the Customs Union provides for three possible solutions at the customs control stage: (i) to accept the customs value, (ii) to issue the decision on conducting an extra check or (iii) to issue the decision on making adjustments to the customs value.

By virtue of law, in the absence of the above-mentioned grounds, the customs authority may not adjust the customs value before the release of the goods if it has doubts as to the reliability of such a value. In such a case the customs authority is obliged to either accept the customs value declared or commence an additional check, of which it must notify the declarant within the release timelines (one day). In addition to the notice, the customs authority must furnish the declarant with a demand and a calculation of the sum of security for customs payments and release the goods immediately after the provision of security. Following the goods' release, the customs authority shall conduct an additional check, with respect to the customs value.

Accordingly, the provisions of the Law are aimed at: (i) preventing a delay in the release of goods, in the event that the customs authority has doubts as to the correctness and reliability of the customs value declared and (ii) conducting an additional check, with respect to the goods that have already been released into free circulation. An additional check may be more preferable for the company, as it will be able to have the goods released against security and then liaise with customs within the framework of the additional check (for example, provide documents, submit explanations, etc).

In the meantime, practice demonstrates that local customs are not ready to speedily process the security instruments; representatives of customs, as well as some of the importer's customs brokers unwillingly fulfil these provisions, as this would mean double work for customs and the customs broker – first, goods are released against security, then the final release of the goods is to be effected. Therefore, in this case the insistent approach of the importer and its customs broker is very important.

The decision on making adjustments to the customs value, before the release of goods is made if the customs authority is sure that the company has declared inaccurate data (including instances, when the company has chosen the wrong customs value determination method). This is drastically different

from the wording «has identified the signs of the declaration of inaccurate data». In this case, an additional check is not conducted and the company may not release the goods against security. In such a situation, even if the company does not accept the customs value adjustment, the customs authority will still have the right to make such an adjustment on its own and if the surcharges remain unpaid, the customs authority

will have the right to not release the goods.

In addition, it would be worth noting the statutory right of the customs authorities to consult the parties concerned on customs value matters. Though during such consultations the customs authority may not check documents and make any preliminary decisions on the customs value. In this regard, the practice of consultations on customs value matters has not been established yet.

In conclusion, one should note the importance of competent and professional cooperation with the customs authority at the stage of the customs value control, which usually helps to defend one's rights and to prove the legitimacy of the customs value declared either through administrative or court proceedings.

## Classification of Goods

The Customs Code of the Customs Union has preserved the opportunity for companies to obtain a classification decision on applying a uniform HS code, with respect to vehicles and equipment imported as distinct components during a certain period (within three years at most).

Accordingly, as before, companies will be able to apply to Russia's Federal Customs Service to obtain a favourable decision if the equipment being imported by them cannot be for some reason produced to the customs authority at a time during the declaration process and its shipment is spread out over time.

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**Recently, based on resolution No. 565 dated 12 July, 2011, the Russian Government has adopted the list of goods which qualify for the preferential procedure of processing for domestic consumption .**

**The idea is that imported goods that are on the list can be brought into Russia on a duty-free basis and when the procedure is complete, the companies will apply the tariff rates established for the processed products.**

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The legislation of the Customs Union has also left the companies the right to apply to customs for obtaining a preliminary classification decision which is issued ahead of the import of goods to the Customs Union. Such a decision remains effective for a period of three years and is binding on local customs.

It would be worth noting that this is the first time that Russia's legislation (the Law on Customs Regulation in the Russian Federation) stipulates that a preliminary classification decision may be issued, with respect to particular groups of goods by the regional customs department, upon the application of the party concerned. Earlier, only the Federal Customs Service of Russia had such an ability. In practice, the specified innovation should reduce the time for issuing such decisions.

### Particularities of Declaring Goods

The main rule of the declaration, as is written in the Customs Regulation in the Russian Federation Law, consists of the submission of a declaration with respect to goods in electronic form. Article 322 of the Law on Customs Regulation in the Russian Federation envisages transitional provisions, with respect to the application of this rule. Until 1<sup>st</sup> January, 2014 the customs declaration process shall be carried out in written or electronic form at the declarant's option. It would be worth noting that declarations in electronic form have become widely spread; the complete transition to electronic declaration since 2011, however, was not possible owing to the imperfections of the electronic declaration process in the customs system due to Internet outages, customs server outages and problems of logical and format control, with documents in electronic form.

As concerns the list of documents to be submitted to customs, the following should be noted. Article 183 of the Customs Code of the Customs Union sets forth an exhaustive list of documents that must be submitted together with the customs declaration. It consists of 13 points.

The specified list is considerably vague. For example, the company must submit documents on the basis of which the code of goods was declared. Which documents are meant is not clear. In this case customs may apparently require any documents which it finds necessary for confirming such information.

### Release Time

The Customs Code of the Customs Union stipulates that the release of goods should be completed by

the customs authority not later than one working day following the registration date of the customs declaration. It would be worth noting that initially, the time of release was set at three working days.

Customs officials may extend the time of release by no more than 10 working days. When working on the Customs Code of the Customs Union, the business community expressed concerns regarding the unjustified extension of the release time, which would result in considerable losses for the parties involved in foreign trade.

These concerns were factored in, when article 220 of the Law was written: it lists the exclusive instances, in which the release date may be extended. For instance, the date may be postponed if an additional check is needed to determine the accuracy of the classification code and customs value of goods. Moreover, the date is postponed if certain documents such as licences, certificates, approvals or documents confirming the data shown on the customs declaration have not been presented. The declarant may also apply to have the release date postponed.

Significant changes have been introduced to the timeframes for various procedures. The following changes have become the most significant:

- customs charges may now be paid within 4 months instead of the earlier given 15 day period;
- customs declarations are now registered within two hours of submission to the customs authorities.

### Authorised Economic Operator's (AEO)

The institute of authorised economic operators introduced by the Customs Code of the Customs Union is not a new development to the Russian customs regulation – authorised economic operators were preceded by entities that enjoyed simplified procedures, within the framework of the national legislation (article 68 of the Customs Code of the Russian Federation).

In point of fact, a new term has been introduced for the already existing group of entities, which the customs authorities trust and which may simplify customs clearance and control.

The status of an authorised economic operator gives companies the opportunity to enjoy certain privileges. These include the opportunity to store and clear imported goods within the operator's territory (warehouses), and to release and use imported goods even before a customs declaration has been submitted to that effect.

For the first time, companies can deliver imported goods directly to their warehouses (onto their premises), without submitting them for inspection



to the internal customs authority, on arrival to their point of destination.

In addition, this status allows for a special agreement between the company and the customs authority. This agreement outlines the nature of the cooperation between the customs authority and the company in question, with regard to information exchange, use of the official customs seal and other matters. A model of such an agreement has already been devised by the Federal Customs Service of Russia.

It would be important to note that this agreement may be used as a document stipulating the terms & conditions of the operator's application of the processing procedures (processing within the customs territory, processing outside the customs territory and processing for domestic consumption). Such an agreement will, thus, relieve the operator from the duty of preparing a distinct set of documents for submission to customs for the purpose of obtaining permission with respect to processing.

Should the company apply for such a status in its pre-declaration

(which involves submitting a customs declaration regarding goods to be imported prior to their arrival to Customs Union territory), the customs authority may notify the company of the customs screening, prior to the arrival of its goods. This gives the company enough time to prepare for the customs screening and schedule a time of the customs clearance of its goods.

Below we have summed up the advantages of enjoying this operator's status:

- Customs audits can be exercised once in 3 years only (other importers must submit to a scheduled annual audit);
- Reputable status vis-à-vis customs bodies. A number of largest investors (including those in the automotive, tobacco, pulp and paper sectors) are seriously considering obtaining the AEO status;
- A sufficient decrease in transport cost, making the delivery logistics more effective, when transporting goods from the Russian border directly to the locality of the operator, excluding the internal customs authorities' site;
- Reduced time and cost for port services (incurred while processing import customs declaration at port customs);
- Filing a transit declaration is easier than an import customs declaration;

- The absence of expenses related customs control operations (visual examination/inspection) carried out by customs authorities, when releasing goods in the port: loading/discharge, weighing, counting, unpacking/packing of goods, etc.;
- Goods have no restrictions and are circulated freely from the moment they are accepted from the carrier at the operator's site (even before the customs declaration has been processed);
- A significant decrease in the time needed to remove the means of identification, unload goods and accept them from the carrier, when completing the transit procedure at the operator's site in comparison with regular road transportation to internal customs check-points;
- The agreement entered into between the customs body and the AEO may be used as permission to

carry out a number of customs procedures, such as processing within the customs territory, outside the customs territory and for domestic consumption;

- The agreement entered into between the operator and the Federal

Customs Service of Russia permits such companies to use this status when carrying out similar activities in other member countries of the Customs Union.

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**It is important to note that the Law on Customs Regulation in the Russian Federation contains provisions that allow senior customs authorities to exercise departmental control over other customs divisions.**

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## Risk Exemptions

Some customs, in other countries, may have more lax rules regarding the risk profiles when it comes to companies. Being exempt from the risk profile means a company will not have to pass a customs screening; thus, allowing it to clear goods on a first priority basis.

Unfortunately, unlike in the EU, in Russia, the operator's status does not allow for such exemptions. However, in 2011, the Federal Customs Service of Russia launched this procedure on an experimental basis, excluding companies in particular regions in Russia from the risk area.

The list of companies that qualify to be considered for this category has been submitted to the Federal Customs Service of Russia for consideration. This was done on the initiative of the companies themselves, while the risk management system itself foresees such cases.

## Customs Controls

The Law aims at enforcing the main principle of customs regulation - the selectiveness of customs control. Currently, there are no set mechanisms and practices of dividing the parties to foreign trade into those whom the customs authorities trust (besides the authorised customs operators) and others.

At present, quite a lot of companies that conduct their business openly and transparently may be considered good faith parties to foreign trade by the supervising authorities. In practice, the cargo of such companies may sometimes be unjustifiably screened several times, with repeated requests to provide the same documents and show other unnecessary requirements. These, for example, include the provision of security for customs payments, the submission of an enormous number of documents regarding adjustments to the customs value of goods or the non-acceptance of the declared HS code by customs.

The Law also provides for a shift towards post-release controls (that is, the exercise of control following the release of goods). This is confirmed by an extension of the time of post-release customs control from one to three years.

The next change concerns the introduction of new forms of customs controls. The first form is the registration of goods under customs control and the operations carried out with respect to such goods; the second is the auditing of the record keeping system and accounts.

Yet another confirmation of the shift towards post-release control is the establishment since 1 February, 2012, of a distinct subdivision within the Federal Customs Service – the Chief Department for Post-Release Control.

## Departmental Control

It is important to note that the Law on Customs Regulation in the Russian Federation contains provisions that allow senior customs authorities to exercise departmental control over other customs divisions. The Customs Code of the Customs Union, however, does not make provision for such a clause.

The practice of the past years has shown that overruling decisions made by the junior customs authorities almost always lead to setbacks and inevitable losses for companies engaging in foreign trade. A striking example of this are the numerous decisions by Russia's Federal Customs Service regarding the revocation of permits with respect to the processing of goods issued to companies by local

customs. As a result, companies suffered multimillion dollar losses and were forced to seek the protection of their rights with the judicial bodies. The main reason for such adverse consequences for companies is the fact that companies do not participate in the examination of the decisions by the superior customs authorities and therefore are unable to properly protect their approach.

## Preferential Customs Procedures

Recently, based on resolution No. 565 dated 12 July, 2011, the Russian Government has adopted the list of goods which qualify for the preferential procedure of processing for domestic consumption.

The idea is that imported goods that are on the list can be brought into Russia on a duty-free basis and when the procedure is complete, the companies will apply the tariff rates established for the processed products.

The procedure will, thus, be effective only if the tariff rates for raw materials are higher than those for the processed products.

In fact, the procedure of processing is applied only in the case of a breach of the tariff escalation principles, which is recommended by the WTO. According to the principle, the higher the degree of processing, the higher the tariff. An example of a deviation from this principle is the industrial assembly scheme, where components are imported at a reduced or zero-rated tariff on the condition that they are used for their intended purpose (the manufacture of vehicles or automotive components), while raw materials for the manufacture thereof are imported at a standard tariff rate.

Alongside this, in all such cases of deviation from the tariff escalation principle, processing for domestic consumption remains vitally important for encouraging production in Russia.

The resolution specified is of great importance for stimulating the activity of production companies engaged in processing on the Russian territory, with the use of foreign materials.

## Fundamentals of Intellectual Property (IP) Due Diligence to help investors to protect their IP rights when entering the Russian market with technology-based projects

Ekaterina Tilling, Special Counsel, Head of IP, Moscow, Baker Botts, L.L.P.



### Ekaterina Tilling

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Ekaterina Tilling is recognised in Russia for her experience in Intellectual Property fields. She is highly skilled in solving IP disputes in Russian courts of all

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Ms. Tilling is recommended among the European legal experts for IP matters (The Legal 500 EMEA, 2007-2011; Chambers Europe, 2008 – 2011; PLC Which Lawyer?, 2007-2011; European Legal Experts, 2007-2011; Who is Who legal, 2009-2011). She is selected by Second Edition 2010 of Best Lawyers for Russia in the practice area of Intellectual Property and Arbitration/Mediation. Ekaterina is the winner of the International Law Office Client Choice Award for 2010 and 2011 as the best lawyer in the practice area of Intellectual Property in Russia.

Ekaterina Tilling is a Deputy Chairperson of the IP Sub-Committee of the Association of European Businesses (AEB) in Russia and is actively involved in the work of the AEB. She is the author of many IP publications in Russia and abroad (e.g., IP Review 2006, The World IP Review 2007, IP Value 2008-2011 etc.), including commentaries on Russia's key legislative acts.

### Introduction

Foreign companies are looking to expand technology investments in the Russian market, targeting software development, IT, medicine, energy and other technology-based spheres.

The base models for a standard investment project may be described as follows:

- the investor acquires the right over an off-the-shelf technology in Russia;

- the investor comes with its own technology;
- a technology is developed from scratch in Russia.

Irrespective of the model selected for an investment project, the investor needs to evaluate existing and potential risks. This is exactly why investors need an instrument enabling them to check the legal status of a target technology and determine its value. Such an instrument is IP due diligence that serves to protect the investor.

The goal of IP due diligence is to analyse how well the technology fits the investor's business objectives, whether it provides exclusivity on the market and may be effectively enforced against others.

In the case of an off-the-shelf technology that is purchased, the goal of the investor may be either to purchase or invest in a company holding a certain technology or purchase individual rights over a technology of interest for setting up its own manufacture.

In all of these cases, it is particularly important to conduct IP due diligence before purchasing technologies. Where the goal of the investor is to purchase a company, financial and corporate due diligence may be needed, too.

This article covers specifically IP due diligence, as it is of main importance in technology transactions. While a technology transaction may involve different intellectual property rights, it mostly relies on know-how and patent rights to inventions, utility models and industrial designs. This is why this article focuses on know-how and patent rights.

### Patent Rights

IP due diligence should first of all address the existence and strength of patent rights. When properly protected and used, patents can increase revenue, bar competitors from certain markets or technologies and serve as an in-kind contribution to corporate capital. If a technology is not properly protected by patent rights, the value, future competitiveness and even the survival of an investment project may be at risk.

#### ■ Territory

In checking patents one needs to take into account that under the general rule patents are protected under the principle of territoriality, i.e. patents are valid only on that territory for which protection has

been claimed and in which they were issued. In particular, for a technology to be afforded patent protection in Russia, a patent for it should be issued by the Russian Patent Office (Rospatent).

Importantly, it is sometimes impossible to prohibit the use of a technology in countries, where the technology is not protected by patents. Based on the results of IP due diligence, it may be recommended to pre-determine a list of countries of potential interest and secure due legal protection for a technology in them.

IP due diligence often uncovers assignment agreements or licensing agreements on transferring in Russia the rights over patents issued in other countries, but having no patent protection in Russia. Please note that because patents operate under the principle of territoriality such a transfer of rights can not be effected.

Thus, if an investor comes to Russia with its own technology or develops it specifically for the Russian market, to gain the rights over such a technology one may either secure its patent protection in Russia or satisfy the necessary conditions for it to be protected in Russia as know-how. The same general rule applies, where an investor gains the right over an off-the-shelf technology in Russia, i.e. one needs to satisfy itself that the technology is duly protected in Russia. For example, in Russia, unlike the U.S.A. and Japan, business methods are not patentable.

#### ■ Patentability

Irrespective of the model for an investment project, IP due diligence may establish whether technical results developed in other countries, as well as patents issued abroad are patentable in Russia.

Such a conclusion will help to decide whether patent applications need to be filed and, accordingly, whether information about a technology being patented need to be disclosed in this regard. If due diligence uncovers certain problems that may potentially result in denial to patent, it may be recommended to update technical solutions before filing applications or keep such solutions in secret and protect them as know-how.

#### ■ Coverage

In checking patents, one would specifically accentuate whether a technology or products to be made using it is/are sufficiently covered by issued patents and know-how. Legal due diligence rather frequently

shows that existing patents or know-how do not cover a technology completely or that patents are weak and may be challenged, in full or in part, by interested persons for a failure to match the patentability criteria.

In this case, the investor may encounter the risk of being unable to prohibit the third-party use of the technology in Russia.

#### ■ Freedom to Operate

A significant risk can arise that the use in Russia of a technology that is not completely covered by patents or know-how may result an infringement of the rights of other persons that may, for example, hold patents for any of its individual parts or components. Beside the fact that infringement actions are time-consuming and expensive, the risk that the use of the technology is prohibited may be revealed.

Accordingly, due diligence may involve a check for freedom to operate, i.e. for potential infringement of third-party rights by the use of a certain technology not yet protected by patents.

Such a check may cover both Russia and other countries, where the technology is planned for use. Thus, a check for freedom to operate in other countries may be needed, in particular, when the plan is to make products in Russia, but distribute them abroad.

#### ■ Effective Term

Due diligence may also reveal that the effective term of the rights being purchased is elapsing shortly and may not be extended; whereupon, the technology will become available in public domain. This fact may also significantly impact on decisions made by the investor.

### Know-how

Know-how is a very important part of any technology. There is a balance between patents and know-how. While a patent provides the exclusive right, it may in some circumstances be beneficial to protect information as know-how rather than seeking its patent protection.

In particular, new developments before the date on which patent applications are filed, when their completion requires time, may be protected as know-how. Besides, developments not patentable for their failure to meet the patentability criteria, but still having commercial value for their right holder may be protected as know-how, too.

**The specifics of know-how under Russian law are that preservation of the title over know-how does not always depends on its right holder's will.**

■ **Trade-secret Regime**

As far as know-how is concerned, we note that unlike the law of many foreign countries, under Russian law, the right over know-how will not arise until its owner introduces a trade-secret regime (or so-called “confidentiality regime”), with regard to such know-how. This regime involves a set of measures to be taken that is quite complicated and is, therefore, rarely complied by companies properly.

Accordingly, the central risk normally identified in checking know-how is that because the statutory measures for applying the trade-secret regime are not complied with, the right over know-how does not exist. Moreover, even if the investor wishes to use in Russia know-how created beyond Russia and is protected under a foreign law, the mandatory provisions of Russian law still require proper application of the trade-secret regime for such know-how to be protected in Russia.

■ **Confidentiality**

The specifics of know-how under Russian law are that preservation of the title over know-how does not always depend on its right holder’s will. Thus, the key test for the title over know-how is that the right exists until information about it has not been disclosed to third parties. Accordingly, the main risk for the title is that a disclosure of know-how to third parties may occur, for instance, without the knowledge of the right holder.

Thus, the exclusive right over know-how may be susceptible if no proper measures to protect it under Russian law are taken. Besides, if a technology is disclosed in any public source in the world, including, by publishing a patent application, then since information has been disclosed to general public, this technology cannot enjoy risk-free protection in Russia as know-how. In this case, there is a substantial risk that any company will be able to use such a technology in Russia and the right holder will most likely be unable to prevent them from doing this.

**Developments created in the course of employment**

Most of technologies are created in the course of employment. Such employment developments exist in any of the above types of investment projects. IP

due diligence is designed to cover at least the following areas:

■ **Transfer of Rights from Employees to the Employer**

Where the right holder of patents and know-how of interest to the investor is a legal entity, due diligence verifies a due transfer of rights from its employees to it as employer. If creation by an employee of such developments forms part of his/her job responsibilities or there is a specific assignment in place from the employer, the exclusive rights over such employment developments are held by the employer.

The key problem, often revealed in the course of due diligence is an insufficiently specific wording of an employee’s responsibilities in relation to employment developments, which may mean that the rights

over such developments created by him/her are not transferred to the employer. In this case, entering into additional agreements with employees to ensure the proper transfer of exclusive rights shall be recommended as an option.

Such due diligence should be conducted generally, within all the

above types of investment projects. Thus, for example, even if the patentable item was developed by an independent-work contractor under an agreement with the investor, as described below, for example, by a scientific laboratory, the investor needs to check in advance that relationships between that laboratory and its employees are duly formalised for ensuring a proper transfer of rights from the employees to the laboratory, as well as needs to insert relevant warranties into such agreement.

■ **Authors’ Remuneration**

If the investor’s goal is to purchase a company together with patents and know-how owned by it, due diligence should check whether the payment of remuneration to employees who are authors of employment developments has been competently addressed. It’s important since according to the established court practice, this is the employer of such an author who is always obligated to pay said remuneration to the author for the use of a corresponding employment development, irrespective of a change in its ownership or further assignment of this patent to a third party.

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**Thus, if an investor comes to Russia with its own technology or develops it specifically for the Russian market, to gain the rights over such a technology one may either secure its patent protection in Russia or satisfy the necessary conditions for it to be protected in Russia as know-how.**

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The risk is that the author may claim remuneration over the entire effective term of a patent, and if an agreement on the amount of such remuneration has not been reached with the employer, this issue shall be solved by a court.

## Developments Created or Transferred under an Agreement

Where third parties engaged to carry out research and development work or technologies are transferred under IP-related agreements, due diligence should focus at least on the following issues:

### ■ Transfer of Rights from Developers

If a target technology has been developed under independent-work agreements (order), due diligence should thoroughly address a due transfer of rights from its developers to the client, as well as analyse the scope of the rights transferred and any restrictions arising from such agreements.

Under the general rule, IP rights over a development created under an order belong to the independent-work contractor (developer), unless provided otherwise by a contract between it and the client. If the purpose of such a contract is to transfer the right over the development to the client, this should be expressly stated in this contract.

Likewise, for example, such developer may reserve the right to independently use a technology created under the contract. Besides, if the contract involving assignment of IP rights is drafted incorrectly, such rights may be treated not as assigned but as licensed. In this case, the right holder will be the developer, while the client will only hold the right to use the technology; this right will be confined to a certain period and scope.

### ■ Requirements for the Form of an Agreement

In addition, due diligence verifies compliance with all formal requirements set forth by Russian law for an agreement.

In particular, licensing agreements and agreements to alienate rights over patents issued in Russia are subject to state registration with the Russian Patent Office (Rospatent). Failure to comply with the

requirements on mandatory registration means that agreements are invalid and that the rights over patents have not been transferred. The requirement on registration of such agreements is a mandatory provision and applies, irrespective of the applicable law.

## Conclusions

As a result, IP due diligence helps the investor assure if it is appropriate to proceed with a particular technology-based project and estimate its value. The scope of due diligence depends on the specific project. An experienced lawyer may advise the investor on the best scope of due diligence for it, based on both the primary objective of asserting rights and the prospects of further use of a technology, including through further sale of products, which are manufactured using that technology or in which it is used.

Due diligence helps generate a model for the creation and use of technologies that is risk-free to the maximum possible extent. The three key guidelines for creation of such a model are:

### ■ Structuring of IP and Perfection of Rights

Identification of IP, definition of the form of its protection and understanding how to make a “product” of IP for subsequent commercial purposes. Check-

ing of the rights over existing technologies for defects. Competent perfection of contractual relationships, with all parties involved in developments.

#### ■ Territory

Regions of presence (national and international protection of IP)

#### ■ Protection

This is important to determine a competitive environment that defines, inter alia, the form of IP protection and the regions of presence. Two key stages are implied - primary protection (title documents) and subsequent protection (against unauthorised third-party use - extrajudicial and judicial).

**In particular, licensing agreements and agreements to alienate rights over patents issued in Russia are subject to state registration with the Russian Patent Office ( Rospatent). Failure to comply with the requirements on mandatory registration means that agreements are invalid and that the rights over patents have not been transferred.**

## Russian industry: Health & Safety culture challenges for investors

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### Introduction

The existing Health & Safety (H&S) culture can be challenging for an owner of an operating industrial facility or potential investors, and call for additional expenses related to integration and mitigation of risks to reputation. Project experience of H&S consulting companies in Russia shows that production companies that possess assets constructed in the Soviet times, are still on their way to achieving H&S culture maturity.

For instance, in terms of safety, the high level of risk acceptance in Russia is leading to blindness to hazards, which could undermine attempts to imple-



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ment “safety first” and “zero harm” ideas. Another problem is lack of training, ineffective communication between line managers and workers and lack of believe that such things as culture can be ever changed.

To be fair, major international companies have been facing similar challenges on their journey towards H&S maturity. The most common and significant corporate issues are described below.

### Challenges

Key challenges on the H&S culture change journey are:

- Lack of H&S leadership among senior managers and ineffective approach to addressing challenges;
- Focus on formal compliance rather than on managing performance targets;
- Underestimation of risks and application of technical solutions to non-technical issues;

- Lack of personal motivation;
- Insufficient communication;
- Inadequate training.

### **Lack of H&S leadership among senior managers and ineffective approach to addressing challenges**

Although, it must be noted that Senior managers usually do understand the risks related to H&S; however, they sometimes have conflicting points of view on who is responsible for safety in their companies: some think that it is the "responsibility of the H&S department or person": others believe that it is the responsibility of other or more senior managers. In some cases, especially, working in challenging conditions created in the former Soviet Union, there is a tendency to 'blame culture', which can not be changed. This approach might cause ineffectiveness in the decision-making process related to taking reactive measures rather than pro-active ones, which do not solve the problems, but deal with the consequences.

### **Focus on formal compliance rather than on managing performance targets**

Large industrial corporations often rely on written procedures, which seem to cover all the aspects of the work life. An over-reliance might undermine efficient management of risks, creating a picture where everything seems to be in order and workers always observe all the necessary requirements, while the reality may vary greatly, demonstrating a lack of supervision and an insufficient analysis of the H&S information (e.g. the use of PPE rather than an introduction of measures to improve the working conditions, an insufficient analysis of the monitoring results of work place conditions, etc).

### **Underestimation of risks and application of technical solutions to non-technical issues**

Corporate level managers do not always understand the issues being faced on sites, with regard

to the identification of risks and hazards, especially, with the common practice of underreporting when it comes to minor injuries (e.g. cuts, bruises etc), or near misses. Quite often, risk identification, mitigation and management programmes are designed and implemented to meet regulatory requirements and might not deliver the sufficient level of control.

Also, in many cases, major hazards/process safety risks are not caused by technical issues, but rather, behavioural or those related to people's attitude to the work: in fact, the application of "technical" or formal compliance methods does not give the desired outcomes.

### **Lack of personal motivation**

Evidence from a number of worker interviews conducted during health & safety assessments of extractive businesses revealed instances, where so called 'command-and-control culture' discourages employees from openly questioning health and safety issues.

Another factor is that many large industrial facilities, with a long production history have a sort of "personal value" for their employees, whose parents and grandparents might have worked there as well. Such attitude might create an acceptance of unsafe conditions because "the plant must run whatever happens".

Most of the large production sites in Russia were built in Soviet times and, as such, require huge capital investment for the replacement of old equipment. The inability to improve the work place environment also undermines workers' belief that H&S first is taken seriously in harmful working conditions.

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**There is a common practice in Russia to outsource some works to contractors (e.g. construction or demolition). Although most of the jobs are highly dangerous, there is usually a lack of control over H&S management and performance, from the companies, due to the fact that "the contractor is a separate legal entity, who should deal with his own problems".**

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### **Inefficient Communication**

Based on the results of a number of H&S performance assessments, it became obvious that one of the challenges in changing H&S culture is the lack of efficient communication, e.g. between middle level managers and H&S departments, as well as corporate departments and site management etc.

In some cases, decisions being made at the top level are not reported accurately enough to the



lower levels of the organisation, alternatively, the plant's management does not give the real picture regarding H&S.

### **Inadequate training**

Many companies have systems of training in place, across all divisions, mainly in order to satisfy regulatory requirements. However, these systems might not deliver tangible results due to the fact that the questions are repetitive and might not adequately test the practical competence of the workers.

Lack of effective training also might affect H&S performance and undermine communication between line managers and workers because it is focuses on formal compliance, rather that a real understanding of the risks taken by workers.

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**Project experience of H&S consulting companies in Russia shows that production companies that possess assets constructed in the Soviet times, are still on their way to achieving H&S culture maturity.**

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### **Underestimation of contractors' H&S risks**

There is a common practice in Russia to outsource some works to contractors (e.g. construction or demolition). Although most of the jobs are highly dangerous, there is usually a lack of control over H&S management and performance, from the companies, due to the fact that "the contractor is a separate legal entity, who should deal with his own problems".

As a result, there is a very small number of key performance indicators (KPIs) in place for managing contractors, most of which show the statistics and are not indicators of real performance.

Such an attitude can affect companies' H&S culture in a number of ways. First of all, it is a reputational threat to own operations; secondly, it might be a bad example to company's employees and undermine their believe in management commitment to H&S.

### **Recommendations**

Whilst working with the leading companies and safety practitioners, recognised international environmental health and safety (EHS) consulting companies use the concept of 'integrated management' to help create an effective framework for H&S improvement. This means equal attention to procedures, engineering solutions, and to the human factor – if people clearly see and follow-through on

management commitment and investment in health and safety, more employees will be encouraged to treat this issue responsibly.

A thorough assessment of a company's safety culture assessment allows one gain a detailed understanding of how health and safety works in that company and can be a good starting point in establishing an integrated approach to move towards zero harm and a more mature safety culture.

In summary, the following recommendations can be made

- Provide strong H&S leadership, which must be shown on all the levels of management;
  - Assign clear and measurable accountability for H&S performance,
  - Implement an overall 'Zero Harm' program, with a clear focus on safety;
  - Conduct timely identification of risks and seek professional advice from consulting companies;
- Place emphasis not only on processes and systems, but on accountabilities, incentives, strategy and leadership, as well;
- Develop and implement training programmes based on safe behaviour, for both the managers (on safety leadership) and workers (on safety behaviour);
- Improve working conditions by capital investments and pro-active measures, to help to make a step change in safety performance.

There is no single solution regarding H&S culture and performance questions; it is a challenging journey to changing management systems, engineering solutions and people's attitude.

## Why exhibit?

### Eugen Alles, Managing Director, Messe Frankfurt GmbH subsidiary in Russia



#### Eugen Alles

Eugen Alles is the Managing Director of Messe Frankfurt GmbH subsidiary in Russia. He has more than 10 years of professional experience in finance and taxation law. He started his career in 1999 in financing and controlling with

SEB Invest GmbH. Eugen joined Messe Frankfurt GmbH in 2004 as the Head of Investment Controlling. After successfully beginning his career within the company, he was appointed to run the subsidiary of the Messe Frankfurt GmbH in Moscow. Eugen has been heading Messe Frankfurt RUS since 2005 as the Managing Director, being in charge of general management and operations, finance and controlling, strategy planning and development.

Born into a German family and having spent his early years in the former USSR, and later moving to Germany as a teenager, Eugen acquired a deep knowledge of both the European and Russian mentality and culture. This helps him adapt European business practices to existing market conditions in Russia. With his strong and assured management and established long term relationships with the leading Russian trade fair organisers and venue operators, Eugen is responsible for the company's consistent growth and bringing new projects onto the Russian exhibition market.

Mr. Alles is fluent in German, Russian, and English.

Despite the rapid growth of new digital marketing mediums, face-to-face human contact is still vital for building and maintaining fruitful business connections. Out of all possible ways of communication – only the presence on the trade show floors grants the opportunity to meet with customers and suppliers at the same time; thus, permitting access to thorough and timely data, creating exceptional networking opportunities and facilitating the closing of deals. Furthermore, the best events have specialised fringe programs tailored to satisfy the needs of professionals representing various industry divisions and provide assistance in entering new markets.

Nowadays, while initial research and final purchases are increasingly done online, the trade fairs

are decisive at the heart of the process of business-to-business arrangements and partnering agreements. Currently, trade shows stand out as the cost effective way for buyers to see many key companies, their latest product developments and acquire personal contacts at once, with the highest return on investment (ROI) of all marketing mediums.

Historically, the main motives of participating in conventions and trade shows are to increase the awareness of a company and or a brand, gather clues from potential buyers and generate or reinforce industry relationships or partnerships. While the last is not directly tied to potential clients, but to other exhibitors at the show to eventually facilitate in sales growth, this is an illustration of the long-term, strategic value of exhibiting at trade shows and conventions. Interestingly, survey reports also indicate that a significant 79% of the respondents believe that not exhibiting at key events in their industry may negatively impact organisational performance; thus, the vast majority (91% of exhibitors) say that conventions, trade shows and conferences will remain critical to marketing over the next five years.

Currently, when everyone is in search for new ideas, a trade show provides the perfect opportunity to new players on the market to be in the center of attention. While the number of deals closed on site has a decreasing tendency, companies calculating the ROI according to the growth in sales volume, acknowledge the efficiency of expo events. Nevertheless, contacts made at the show have to be further followed up through communication by phone and via additional meetings, amongst other means.

## Market overview

With more than 140 million consumers, a growing middle class and almost unlimited infrastructure needs, at the moment, Russia remains one of the most promising markets for international exporters, while entering the market through the trade show stays one of the most effective and low-cost ways.

In the post crisis economic environment, with a lot of marketing activities staying underfunded and many companies being especially selective with the shows they choose to participate in, the latest trend is the turnabout towards highly specialised trade shows covering specific segments, rather than full-range industry exhibitions. It is crucial to define the target audience and while the exhibition time is lim-

ited, the substantial amount of it has to be dedicated to acquiring new customers.

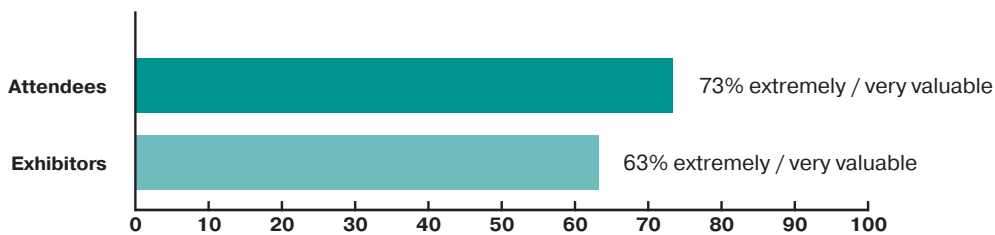
Most trade show organisers have a flexible discount policy, which gives certain advantages to early bookings and creates opportunities for a personalised approach in accordance to the exhibitor's necessities. The finest organisers also do have well established partnerships with logistics companies, who can assist in the exhibits' transportation and customs clearance, rather challenging issues for foreign companies coming into the Russian market. There is also a clear advantage of exhibiting as part of a group stand or at the national pavilion, which is made possible by numerous government

export support programs worldwide. Group stands provide sufficient space for presenting products or services and there is no danger of decreased attention for a particular featured company, while sufficient and knowledgeable staff that are ready to engage prospective clients are present.

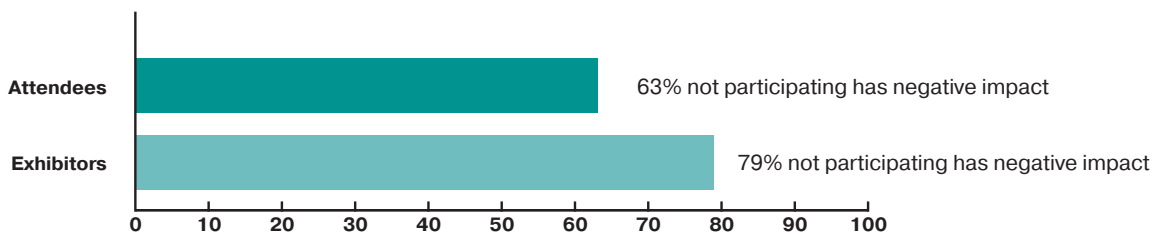
The admission of Russia to the World Trade Organisation is certainly promising for a lot of businessmen since the ratification of the agreement would inevitably result in the liberalisation of trade and further improvement of the international investment climate. Right now may be one of the best moments to think about expanding the business to the dynamic and fast-growing Russian market.

**With more than 140 million consumers, a growing middle class and almost unlimited infrastructure needs, at the moment, Russia remains one of the most promising markets for international exporters, while entering the market through the trade show stays one of the most effective and low-cost ways.**

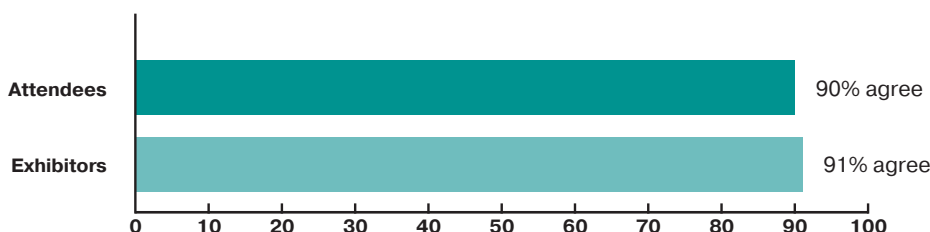
How organizations rate events (Source: «Skyline Exhibits and Expo Magazine»)



Event participation impact on future performance (Source: «Skyline Exhibits and Expo Magazine»)



Will events remain critical to organizations over the next five years (Source: «Skyline Exhibits and Expo Magazine»)



## THE SPECIFICS OF CREATING A JOINT VENTURE

### Foundation of a JV in Russian jurisdiction: Pros and Cons

Alexander Filimonov, Partner, DS Law firm



#### Alexander Filimonov

Alexander Filimonov is a Partner at DS Law firm. He specialises in corporate law and intellectual property, mergers and acquisitions (M&A), restructuring of company groups and joint ventures.

Experienced in complex legal support for investment projects, transactions to buy and sell businesses, formation and operation of joint ventures, legal support for restructuring company groups, complex Legal Due Diligence, legal support for transactions to dispose of intellectual property. Alexander graduated from the Moscow State Law Academy (MSLA) in 2003 – a jurisprudence major with an emphasis on administrative law. In 2006 he obtained an MBA from the All-Russian Academy of Foreign Trade (AAFT) under the Russian Ministry of Economic Development, alongside a PhD from the Moscow State Law Academy (MSLA). An active member of the Association of European Businesses, Alexander is also a lecturer with the Department of Trade Policy at the National Research University's Higher School of Economics (NRU HSE).

Deciding on a joint venture's<sup>1</sup> location is one of the most important steps in the planning and structuring of a joint venture. Such a decision generally depends on different factors, including but not limited to preferable tax regime, flexible corporate legislation, commercial benefits, cost of incorporation and management, nationality specifics, accounting requirements and many others.

Heretofore, Russia rarely came up as the preferred location for a joint venture, with the exception, perhaps, of specific joint ventures with Russian state companies and corporations. More often investors prefer to establish a joint venture in some European jurisdiction with a wholly-owned subsidiary in Russia that carries-on the joint business. However, looking at the legal framework in place in Russia, is this situation justifiable?

### Incorporation of a joint venture (JV) in Russia

Legal entities' types that are mainly used to form a private JV in Russia are the limited liability company (LLC) and closed joint-stock company (CJSC). Each type has its specifics that shall be properly considered with regard to its advantages or disadvantages for a planned joint venture.

As procedures and costs of their incorporation are already subject of many articles and "Doing Business in Russia" materials, I will not dwell on them mentioning only that in practice, the terms and cost of incorporating a JV in Russia are comparable to other popular European jurisdictions.

It should be noted that there are specific limitations on participation of foreign investors in Russian companies carrying on business in several spheres (e.g. banking, insurance, "strategic" spheres, etc.)

### Charter capital and internal funds

No matter what type of legal entity is chosen to form a JV, the law requires that 50% of the charter capital be paid either prior to state registration (in case of an LLC) or no more than 3 months following the state registration of the joint venture (in case of CJSC). The second 50% of the charter capital shall be paid within one year of registration with the state. Given the required minimal charter capital for an LLC or CJSC is equal to 10,000 Russian roubles (approximately 333 USD)<sup>2</sup>, this requirement can not be considered cumbersome.

Similar to many European countries, the charter capital for a JV in Russia can be secured in cash, securities, property and property rights and/or other rights that have estimated money value. All non-monetary options (except for in-kind contribution to LLC with nominal value less than 20,000 Russian roubles) require an independent appraisal first.

In the course of business of a JV the amount of its net assets shall be bigger than the nominal amount of its charter capital. If the amount of a JV net assets is less than the amount of its charter capital at the

<sup>1</sup> The term "joint venture" in this article means a "joint venture vehicle", i.e. a company holding business assets of the joint venture.

<sup>2</sup> This is a general rule that has exceptions, e.g. for banks and insurance companies.

end of a financial year following the second or any ensuing financial year when the amount of a JV net assets was less than the amount of its charter capital, the JV shall (i) decide on decrease of its charter capital, or (ii) be liquidated.

For CJSC there is an obligation to establish a special reserve fund in amount not less than 5% of the charter capital. The sums accumulated in that fund shall be used for cover of losses, bonds redemption and buy-back of own shares.

## Limitation of liability

Participants in a JV (irrespective whether it is formed as an LLC or CJSC) can enjoy so called “limited liability”, i.e. such participants could not be considered liable for obligations of a JV and their risk of losses, related to the respective JV activity, is limited to the amount of the JV’s charter capital they subscribed for. There are several exceptions from the “limited liability” principal (but in practice they apply very rarely).

## Tax efficiency

The rules of taxation for a Russian JV are generally similar to those applied to other legal entities, including, but not limited to profits tax (20%), VAT (18%), etc.

Generally a tax rate of 9% applies to dividends paid to a Russian JV from its Russian or foreign subsidiaries. However, a Russian JV could enjoy a preferential 0% tax rate on dividends paid by its Russian or foreign subsidiaries (except for those having an offshore status<sup>3</sup>) if on the date of a decision on dividend payment such JV owns more than 50% share in the subsidiary for more than 365 days.

Dividends paid to foreign participants of a Russian JV are subject to withholding tax at a rate that varies from 5% to 15%, depending on the provisions of the respective Double Tax Treaty between Russia and the country of such foreign participant incorporation or residence. If there is no Double Tax Treaty, the maximum withholding tax rate of 15% shall apply.

Moreover, when JV selling shares of Russian subsidiaries the 0% tax rate on profits could apply to such transactions if these shares remain with the JV for more than 5 (five) years and (i) were not publicly traded during the holding period; or (ii) though publicly traded, including during the holding period,

<sup>3</sup> The list of countries with offshore status was adopted by Order of the Ministry of Finance of the Russian Federation No.108H of 13 November 2007.

are shares of the innovative sector of the economy; or (iii) were not publicly traded at the time of their acquisition, are publicly traded at the time of their sale, but are shares of the innovative sector of the economy<sup>4</sup>.

## Management of JV

In accordance with the Russian legislation LLC/CJSC shall have at least two management bodies:

- 1) The General Meeting of Participants/Shareholders (GM), that decides on main business issues; and
- 2) The Sole Executive Body (the General Director), that manages day-to-day operations.

Additionally, the Supervisory Board (Board of Directors) and/or the Collegial Executive Body (Management Board) could be formed.

While the exclusive authority of each JV management body is stipulated in the respective legislation and cannot be delegated to other bodies, other responsibilities can be amended, subject to a JV’s charter (this is more so for LLCs and is quite limited for CJSCs).

Decision making procedures of JV collegial bodies (except for several procedures regarding GMs) are also quite flexible and could be agreed by the JV participants in the charter or other internal JV documents.

There is, however, a disadvantage in managing a Russian JV: the Sole Executive Body that acts on behalf of a JV, in matters including but not limited to the signature of documents and entry into transactions cannot consist of two persons. In many European countries, the opposite is the case.

## Shareholders’ Agreements

In Russia, like in many other jurisdictions, participants of a JV can enter into shareholders’ agreements (SHA)<sup>5</sup> with regard to their rights as participants of a JV (JV itself cannot be a party of SHA). Such agreements are deemed valid under the Russian law once they are presented as a single document executed in a written form.

Unfortunately, since the concept of SHA is quite new institute to the Russian corporate system, its enforceability is still in question. So far, Russian courts refuse to enforce many important provisions of SHAs<sup>6</sup>.

<sup>4</sup> That 0% tax rate will apply only to shares of Russian companies purchased after 1 January 2011.

<sup>5</sup> In LLC they are called “participants’ agreements”.

<sup>6</sup> E.g. Decision of Arbitrazh Court of Moscow of 24 November 2010, Resolution of Ninth Arbitrazh Appellation Court of 17 February

One more factor than limits the effectiveness of an SHA is the limited list of sanctions legally provided for breach of these types of an agreement.

### Limitations on share disposal

The important factors considered before going into a JV are:

- the stability of the relations between the parties involved; and
- availability of shares to third parties: this must be very limited.

Like in other holding jurisdictions, Russian corporate legislation is familiar with special measures, such as the pre-emption right of non-selling venturers to buy shares being sold to third parties. In the Russian legislation there is a possibility to provide JV itself with a pre-emption right if other venturers are not ready to buy such shares. Moreover, in LLC there is room for the prohibition of share disposal, without prior consent of other participants.

Again, there is a failure in ensuring the above limitation. Thus, the only protection for the non-selling venturer provided for by the legislation is to claim for transfer of the rights and obligations of the purchaser of the shares to such non-selling venturer. At that, such claim shall be brought to court only within 3 (three) months from the date when the non-selling venturer got to know or shall get to know about such infringing sale.

Unfortunately the Russian legislation and court practice do not allow usage of such important protective instruments as tag-along right and drag-along right.

### Distribution of profits

Profits in a Russian JV could be distributed quarterly, half-yearly or yearly, upon decision of a GM, subject to several limitations (e.g. it is prohibited to decide and pay dividends if a JV is qualified for bankruptcy or the amount of its net assets is (or can become after paying dividends) less than its charter capital).

A Russian JV incorporated in a form of an LLC can agree to different profit distribution procedures (including a non pro-rata basis). A CJSC is less flexible with regard to profit distribution, for example,

the non pro-rata distribution can be applied only to different classes of shares.

### Put/Call Option agreements

Often, especially when one of the participants of a JV is an institutional investor, the parties of a JV need special vehicles of profit/loss fixation. The key role of such vehicles is usually played by special instruments:

- “put” option, which means the right of one venturer to require the other venturer to purchase that one venturer’s shares; and
- “call” option, which means the right of one venturer to require the other venturer to sell that other venturer’s shares to the requesting venturer.

Generally within put/call option agreements venturers pre-agree on (i) circumstances which can “trigger” the relevant put/call option and (ii) price (or specific price formula) at which such put/call option shall be executed.

Such instruments can be used in Russia; however, their application is substantially limited due to the specific regulation of conditional transactions stipulating their general prohibition in situations where the conditions are dependent on the will of the parties of such transactions. Therefore, any put/call option where its “trigger” is conditional upon any of the parties of such option will could be considered as void and unenforceable.

Russian legislation provides for the possibility of a venturer to “exit” from a JV by requesting buy-out of its shares by the JV in special circumstances, including: voting against a major transaction, or against reorganization of the JV, etc. Moreover, in a JV incorporated in a form of LLC venturer can withdraw from the JV. However, the above rights are not similar to a “put” option as the parties cannot pre-agree on price or other circumstances of such buy-out.

### Deadlock resolution

Incorporating a JV its participants try to pre-agree possible settlement of so called “deadlock” (situations when the venturers fail to agree on strategy or other key issues affecting the further existence of the JV). In general practice, a deadlock can be resolved by several means:

- Pacific settlement: several procedures for resolving a deadlock that enable a JV to continue, including, but not limited to, (i) casting vote of a chairman or independent director, (ii) reference

2011 №09АП-34453/2010, Resolution of Federal Arbitrazh Court of Moscow Region of 30 May 2011 № КГ-А40/4971-11-П and Decision of Supreme Arbitrazh Court of 12 September 2011 № BAC-10364/11 with regard to case №А40-140918/09-132-894.

to arbitration or mediation, (iii) reference to an expert or special panel, etc.

- “Shoot-out procedures”: special buy/sell procedures, that in one way or another force one of the venturers to sell its shares to the other (e.g. “Russian roulette”, “Texas shoot-out”, “auction”, “Dutch auction”, etc).
- Put/call option: this instrument was discussed in previous paragraph of this article.
- JV’s winding-up: the possibility to begin voluntary winding-up on a pre-agreed conditions (e.g. on distribution of assets etc.).
- Joint sale: one venturer may initiate joint sale of all JV shares to a third party. That procedure is unusually to be used just for deadlock resolution and cover also drag-along right mentioned here-above.

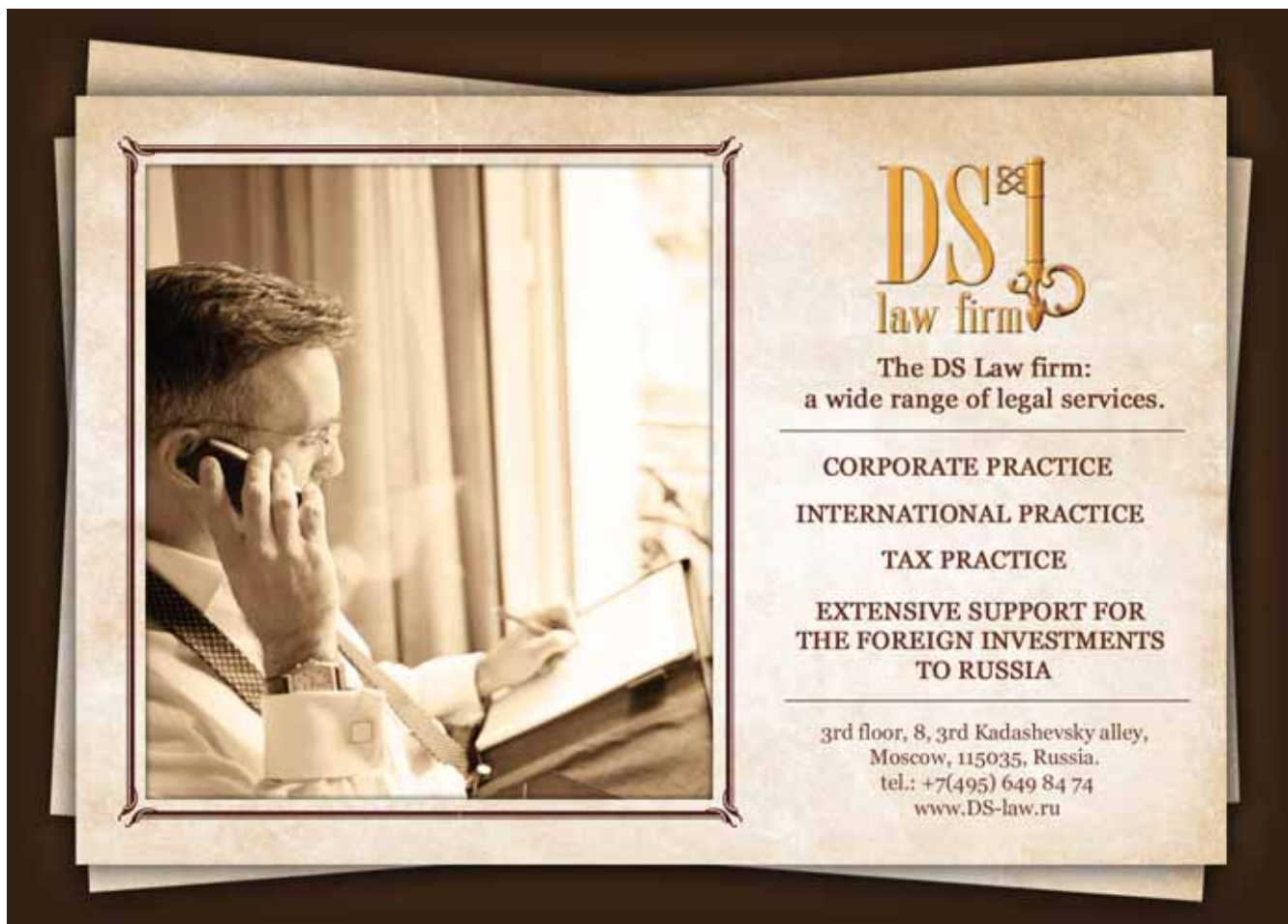
Unfortunately, the Russian legal framework does not provide venturers with the possibility to enforce all those deadlock resolution options. Thus, enforceability of shoot-out procedures and joint sale remains doubtful if not to say impossible. The possibility to use put/call options is also limited (see above).

Notwithstanding that venturers have the right to agree on their actions in liquidation, the liquidation procedure is quite formal and any agreements on change of that procedure or change in assets’ distribution proportion (especially for CJSC) could be considered as void by courts.

Therefore, it is more preferable for participants of a Russian JV to agree on pacific settlement then to try to enforce “divorce” procedures.

### Conclusion

All the above shows that Russian jurisdiction could be considered as jurisdiction for a JV, especially, for doing business in Russia or CIS countries. However, the Russian legal framework is not quite flexible for using mechanisms and procedures that are customary in other JV jurisdictions that should be taken into account before opting to incorporate a JV in Russia.



The advertisement for DS Law Firm is presented on a stack of papers. On the left, a framed photograph shows a man in a white shirt and tie talking on a mobile phone while looking at a document. To the right, the firm's logo 'DS law firm' is displayed in a stylized, golden font. Below the logo, the text reads 'The DS Law firm: a wide range of legal services.' This is followed by a list of services: 'CORPORATE PRACTICE', 'INTERNATIONAL PRACTICE', and 'TAX PRACTICE'. A bolded statement follows: 'EXTENSIVE SUPPORT FOR THE FOREIGN INVESTMENTS TO RUSSIA'. At the bottom, the firm's address and contact information are provided: '3rd floor, 8, 3rd Kadashevsky alley, Moscow, 115035, Russia. tel.: +7(495) 649 84 74 www.DS-law.ru'.

## Financing a joint venture in Russia

Dr. Vladimir Ismailov, Visiting Professor, Raytheon Professional Services



### Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is a visiting Professor, Raytheon Professional Services.

Dr. Vladimir Ismailov is teaching talent development topics for executives at Multi-national corporations and local businesses in areas of finance,

leadership and entrepreneurship as well as working together with Raytheon Professional Services on developing new trainings for employee development and talent retention.

He holds a PhD in Economics. Dr. Ismailov passed Certified Auditor of the Russian Federation exams in 1995 and US CPA exams in 2000. Dr. Ismailov has over 20 years of operational and financial management, auditing and consulting experience in several business sectors, having worked in the OEM, Telecom services sectors, Media & Information, Venture capital investments as well as in Business Education non-profit organizations in Russia, CIS, the UK, the USA and South-East Asia.

Vladimir is the author of a number of publications on general economics and investments. He was also the Chief Editor of and one of the contributors to the annual guide for investors - "How to Invest in Russia" published by the Association of European Businesses in the Russian Federation in English and German in 2007-2010. Dr. Ismailov also cooperates with major media (BBC Russia Radio, Russia Today TV, City FM Radio, Kommersant Radio etc.) in Russia and abroad as member of the panel of experts that opine on investments and the business environment in Russia. He was a member of Moscow City Consultative Council on Creating an International and National Financial Center in Moscow.

Area of expertise – International business, foreign investments in Russia, Corporate Finance, Financial management, project management, not for profit organizations management, venture capital investments etc.

While developing business plans for setting up your presence in Russia or expanding your existing business via a joint venture (that is practically the same thing), it is important to have a clear understanding about the sources of financing that are

available to companies in Russia and some "local" specifics associated with the process.

Although setting up a joint venture is not the only way to enter the Russian market, it could be a viable option for a foreign business for a number of good reasons:

- to save time;
- to gain access to a technology;
- to use highly qualified labour;
- to gain access to administrative resources;
- to comply with requirements in some industries that have imposed restrictions on share of foreign investments to access local distribution network;
- to capture a share in a sizable market etc.

There are also several aspects that could make a joint venture a less effective tool in attaining some or all of the above-mentioned goals. A Russian partner must gain or at least feel like he/she is getting something in return. It is important that the goals, benefits and risks associated with the partnership be communicated effectively. However, it is not uncommon for Russian and foreign partners to differ with regard to their concept of transparency. Based on my 20+ years of professional experience, I would never recommend entering into a 50/50 partnership without clear, defined, corporate governance. I have witnessed a number of cases, where former partners with good relations hit road blocks due to trivial issues faced when a joint venture started underperforming. A majority of cases resulted in rash decisions being made. Ignoring differences in corporate culture, business practices, ethical standards could be another reason why a solo project is the preferred option to a joint venture.

A joint venture can be financed through:

- (a) funding, while setting up a company; or
- (b) financing the operational activity (including, but not limited to operating, investing and financing cash).

In Russian corporate law, a joint venture does not exist in the separate form of a company (as was the case back in 1987). Therefore, the pros and cons of forming a joint venture can not be assessed against other legal entities. However, there are certain specifics, that make the process of setting up a joint venture in Russia more sophisticated than a regular company.

### Financing a setting up a joint venture

As I mentioned earlier, there are no differences, with regard to financing instruments, between setting up



a joint venture and a regular company – equity and debt. Examples of such financing might be:

- Equity financing (preferred shares, common shares, options and warrants etc.);
- Quasi-equity financing tools (convertible debentures, subordinated debentures etc.).

Equity funding needs to meet the requirements for minimum capital depending on the form of legal entity (LLC, Closed joint stock company and Open joint stock company). I recommend funding a Russian company through an off shore joint-venture as one of the options. First of all, managing an off shore joint-venture (not necessarily with preferred tax treatment) may be more practicable when such a jurisdiction has long standing corporate governance law. Also, having only one founder of a Russian company could be helpful later on in the life of a joint venture. For example, it is easier to divest your Russian interest in the joint venture under the off shore legislation. Another benefit of having one founder is the right to forgive a loan taken from the parent company by the Russian subsidiary, without tax ramifications in Russia. This financial instrument can only be used when the parent company has an absolute majority in a Russian subsidiary.

*Quasy-equity financing instruments*, such as convertible debentures and subordinated debentures are still rather new to Russian companies. These instruments do not have a specific definition in the legislative documents. This means that in Russia, such instruments can be regulated either by a contract or based on a foreign law. Although the use of such instruments is possible, it entails substantial fixed costs if a foreign legal entity is involved and is quite cumbersome to manage in Russia based on a contract.

Before making a decision on the preferred type of funding, one should carefully consider various aspects of the project:

- The existence of a developed market for that particular type of funding. For example, the residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) deals are just entering the Russian fixed income market;
- The existing legal framework (licensing, compliance with cross border funding regulations etc.);
- The time required to arrange the receipt of funds (some types of funding, for example, increasing the share capital, may take several months to arrange);
- The availability of internal non-cash resources to support the project (a legal department to draft the necessary documents; a finance team that can work closely with banks, a business model

and strategy that supports assumptions and scenarios, etc.);

- The presence of qualified consultants (investment bankers, lawyers, etc.) who may support the need for funding;
- The availability of a credit history, ideally supported by a credit rating and corporate governance score from a well recognised agency.

Despite the fact that *equity* and *debt financing* are very complicated areas of business management, Russian companies and even local subsidiaries of multi-national companies are moving into the corporate debt market very swiftly. Most companies used equity financing as their prime source of funding in previous years. An equity infusion normally requires substantial paperwork. A company needs to execute not just documents in order to comply with the needs of corporate governance, but also ensure that the necessary tax filings are performed. In the case of cross-border funding (for example, a parent company providing funding to its subsidiary in Russia to finance a transaction), the corporation needs to take into account the currency control regulations set by the Central Bank of Russia (CBR) that banks are required to rigorously observe.

However, capital markets in Russia these days demand that participants be more creative than before in order to access funding and find financial instruments that suit their needs.

### **Financing existing operational needs of a joint venture**

Limited cash resources may restrict a company's ability to meet its business objectives, and therefore, may lower returns, damage public image and negatively impact the company's value. Excess cash and/or access to inexpensive capital may represent an opportunity to increase the effectiveness of the business through a balanced investment program, ability to seize an attractive business opportunity that may present itself in the market, improve a business image and may become a good leverage tool in internal discussions amongst top managers, the board and shareholders.

Most companies in Russia are similar to companies throughout the world in trying to find a balance between various funding options and the advantages and disadvantages related to them.

### **Types of short-term financing tools**

Examples of short-term funding instruments may include:

- Cash;
- Short-term investments (deposits, loans given, shares bought for sale etc.);
- Accounts receivable;
- Accounts payable;
- Bank overdraft facilities;
- Factoring arrangements, etc.

Most companies in Russia use only the first two instruments extensively; thus, overlooking the great potential for additional cash flow through other types of short-term financing options. For example, it is hard for managers of companies working in Russia (on average, as in other parts of the world) to appreciate the advantages of micromanagement of receivables and payables. Some financing options may not be very well known to the market and/or there may be no legal infrastructure to support them. For example, factoring is still a relatively new tool in Russia and the legal framework for this instrument is still in the developmental stage.

On the other hand, the banking industry in Russia is very heavily regulated. The prime regulator for all banks is the CBR, which dictates industry rules, monitors compliance, issues and revokes banking licenses, controls cross border and capital transactions, and micromanages the foreign exchange mechanism, including exchange rates.

*Bank overdraft facilities* are very uncommon in Russia, primarily due to the underdeveloped credit risk system in Russian banks. Some local banks are not keen on implementing financial instruments that are uncommon due to a lack of internal culture and unclear regulation from the CBR.

Therefore, before choosing a short-term instrument for financing a business, it is important to assess the capabilities of the internal resources (not just financial, but also HR, IT etc.), the capability of the local management who will have to carry out daily micromanagement of the situation, as well as external factors such as the capabilities of counterparties (banks, clients, vendors etc.) and level of risk that the company is willing to tolerate.

## Types of long-term financing tools

Examples of long-term funding options may include:

- Bank loans;
- Fixed income financial instruments (bonds etc.);
- Derivatives (futures, swaps, hedging contracts etc.);
- Leasing arrangements;
- Retained earnings and reserves.

Again, only some are commonly used in Russia. Others are still a “premier league” attribute that are

used by companies that have the resources to set up the relevant legal and tax structure, hire skilful finance and executive staff who can micromanage these instruments on a daily basis.

*Bank loans* are probably the most common long-term financing tool. However, interest rates for bank loans are marginally higher than those in Europe and the United States. Another factor to consider when using a loan from a Russian bank is the requirement in relation to the accrual for bad debts that any bank in Russia must adhere to at the risk of losing its banking license. Any change in a business viability or sharp negative deviation in revenue and/or profitability may raise doubts on the bank’s side and/or result in a breach of loan covenants, and the bank will have to provide for such a loan in its balance sheet. This requirement imposed by the Central Bank of Russia requires banks to act swiftly, and thus, limits their flexibility in loan restructuring. These specifics were the most interesting aspects of the loan market during the liquidity crisis in Russia in late 2008 – early 2009.

*The bond market* in Russia has developed into a sizable tool for less expensive funding and less risky investments. Despite the crisis, or maybe because of it, the market expanded. The FinamBonds index (FB-Total) grew from 196,5722 on November 1<sup>st</sup>, 2008 to 253,7847 on October 30<sup>th</sup>, 2009. Unfortunately, the number of defaults has also increased significantly.

Local companies usually place debt and equity instruments at local exchanges (RTS and MICEX) and/or international debt and equity markets. The European capital markets were attracting a significantly larger number of equity placements than the US or any other markets. This is primarily due to the more rigorous regulations at the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) introduced by the Securities and Exchange Commission (SEC), after the well-known series of corporate fraud scandals. However, European countries are actively discussing restrictive measures against extremely active foreign investors. This primarily concerns government investments from emerging markets and Russian companies, with international business interests. This may eventually divert the interest of Russian companies to Asian markets, particularly, Hong Kong and Singapore.

Financing your business in Russia is just as challenging as in any other market. Before making a decision in favour of a particular strategy, one should fully assess the pros and cons of each scenario. Even though there are plenty of skilful advisors available in the market, the ultimate decision will be left for the owner(s) of the business.

## 10 Strategic Russian Tax Tips when Going Into a Joint Venture with a Russian Partner

Andrey Shpak, Tax Partner, Goltsblat BLP (part of Berwin Leighton Paisner group)



### Andrey Shpak

Andrey Shpak is a partner at Goltsblat BLP Tax Practice. Andrey has 15 years of experience in helping Russian and foreign multinationals streamline their tax and legal structures, assisting clients through all phases of acquisition (due diligence,

structuring, completion), as well as in preparation of sale of Russian business to foreign investors.

He has diverse experience in helping both foreign clients investing into Russia, and Russian clients investing abroad.

Andrey has also extensive experience helping clients plan and subsequently implement strategic restructurings of their Russian operations in a tax efficient manner, which often involves the need to retain various valuable tax and customs concessions that have been used historically.

### 1. Do tax due diligence carefully

Russian tax law is relatively new (with a history of just 20 years), prone to differing interpretations, and with very limited power of court precedents. In this environment proper understanding of tax risks is paramount. This is especially important if you invest under Russian law, since Russian law does not recognise most of the English-law-type tax indemnities and warranties.

### 2. Tax risks may have a significant impact on the valuation

It is common for Russian small and medium sized businesses to tolerate higher levels of tax risks as compared to a foreign investor. Factoring in these risks may have a significant negative impact on the valuation of the company by the foreign investor as compared to the Russian partner's expectations.

### 3. Factor in increased tax burden if investing into a business that currently uses simplified tax regime

In addition to different tolerance of tax risks, Russian small and medium sized business often use a

simplified tax regime, which provides significant tax benefits as compared to a regular tax regime. This regime, however, is available only to companies at least 75% owned by individuals. As a result, purchasing a significant stake in such business by a corporate entity will result in additional taxes going forward, with resulting reduced cash flow and lower valuation.

### 4. Put a lot of emphasis on actual tax litigation precedents when assessing tax risks

Unlike many other jurisdictions, tax litigation in Russia is a common occurrence, with approximately 100,000 tax-related cases decided annually. Russian tax authorities cannot issue a binding ruling or interpretation, or agree to a reduced settlement with the taxpayer. As a result, tax litigation is often the only possibility to resolve a dispute over conflicting interpretations of the tax law or fill the gaps in the tax legislation. Although technically, court precedents are not the source of law, they provide a helpful indication of sustainability of a tax position, especially, if the court ruling is made at the Supreme Arbitrazh Court level. Also, given the importance of proper evaluation of tax risks for valuation, it is important to have a realistic (rather than academic) assessment of tax risks in order to avoid unnecessary disputes with the Russian partner about risks that are purely hypothetical.

### 5. Plan for pre-sale restructuring

One of the ways to reduce the impact of historic tax risks on the transaction is to request that your Russian partner moves the business to a new legal entity prior to the transaction. Such pre-sale restructuring, however, may be subject to regulatory approvals and, therefore, additional time needs to be factored in.

### 6. Try to ask from the Russian partner at least a 4 year tax indemnity

Tax limitation period in Russia is 3 years preceding the year of the audit. Therefore, if you ask for a tax indemnity, try to ensure it covers 4 years (an additional year to handle formalities). This is not always

practically achievable, however, if you buy a stake in a small or medium sized business, as the Russian partners typically try to push for a 1 to 2 years indemnity period instead.

### 7. Debt push-down can work in a limited number of circumstances

As a general rule, pure debt-push-down (ie establishing a Russian SPV to purchase a business with subsequent merger or tax consolidation) does not work in the Russian environment. There are two main reasons for that: (a) Russian statutory accounting does not recognise goodwill upon merger, which generally results in a technical insolvency (negative net assets) upon merger of the purchased entity into an SPV; (b) tax consolidation currently is available only for the largest taxpayers, and cannot be used by medium sized businesses. However, there may be situations where debt push-down is possible. One possibility is if you invest into a business that contains several Russian entities. In this case one of the Russian operating entities can take an intercompany loan from an affiliated foreign company to purchase the other Russian operating entities, effectively achieving a partial debt-push down. Russian thin capitalisation rules will need, however, to be monitored in this case.

### 8. Properly drafted tax indemnities under foreign law are enforceable in Russian courts

Until recently there have been doubts to which extent tax indemnities and tax-related personal guarantees granted under foreign law are enforceable in Russian courts, since Russian law generally does not have the concept of a tax indemnity. However, there has been a recent case at the Supreme Court

level that enforced such tax indemnity (awarded by a foreign court in a Russia-related transactions) against a Russian individual

### 9. Be prepared to structure a transaction through a foreign SPV

A significant portion of Russia-related transactions is done via foreign jurisdiction SPVs. This is driven both by legal reasons (English law typically providing more flexibility as compared to Russian law), as

**In addition to different tolerance of tax risks, Russian small and medium sized business often use a simplified tax regime, which provides significant tax benefits as compared to a regular tax regime. This regime, however, is available only to companies at least 75% owned by individuals.**

well as by common desire of Russian sellers to obtain deferral of their personal income tax liability through use of a foreign selling entity. The most common jurisdictions are Cyprus and the Netherlands (Luxembourg will likely also become a favourite once the changes to the Luxembourg-Russia double tax treaty are ratified by

the Russian parliament). However, it is also becoming more and more common for Russian owners to sell their stake directly to the foreign investor as individuals, immediately paying their taxes, but at the same time benefiting from the use of Russian law in a transaction (that typically favours the seller).

### 10. Recent changes in the tax law make use of a Russian holding company more efficient

Domestic dividends between two Russian entities are currently exempt from taxation, provided the parent owns at least 50% of the subsidiary and holds the shares in the subsidiary at least 365 calendar days. If Russian subsidiaries are in the form of a OOO (limited liability company) then capital gains on sale of such shares realised by a Russian holding company are exempt from Russian tax as long as the shares are held for at least 5 years.

## Enforcing shareholders' agreements under the Russian law

Andrey Nosikov, Senior Associate, Private Equity Group, Corporate practice of Pepeliaev Group



### Andrey Nosikov

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Before joining Pepeliaev Group, Andrey worked in major Russian and international law firms, including at the Moscow offices of Baker Botts LLP and PricewaterhouseCoopers.

### Part 1

Foreign investors doing business in Russia have come to believe that Russian law falls short when it comes to safeguarding their interests properly. More specifically, it does not have enough flexibility to deal with the issues faced by particular businesses. It is small wonder that investors are keen to ensure that their Russian transactions are governed by more flexible foreign law. This is undoubtedly due to the fact that Russian law is still "immature" in corporate matters and far from being perfect on the protection of investments.

From 2008-2010, there was a sense that this part of the legislation had to be amended, which led to a number of consecutive legislative steps to create a favourable environment for investment in Russia.

One of these was the Federal Law No. 115-FZ, adopted in 2009<sup>1</sup>, which amended the Law On Joint Stock Companies (the "**Law**"), and set forth a whole new article 32.1. This article introduced the concept of shareholders agreements to the Russian law, marking a dramatic change in the safeguard-

ing investors' rights. At least everyone had hope. In practice, however, nothing changed. Investors continued to favour foreign law over Russian when it came to structuring their transactions. Many wondered why.

For a long time, a gap existed in the legal regulation of shareholders agreements under Russian law. To be exact, there had been no practice of trying to subject the shareholders agreements to Russian law before 2009, since all transactions were structured abroad through offshore companies, and thus, foreign law would be usually opted for by parties.

So-called "MegaFon case" was one of the most noted cases evidencing the failure to make the tool for a shareholders' agreement work even without special rules established by the legislation<sup>2</sup>.

The essence of the conflict was as follows. The shareholders of ZAO "Northwest GSM" (former name of "MegaFon") entered into an agreement on the regulation of their shareholders' rights and obligations governed by Swedish law.

Later on, the participants of a limited liability company that was party to the agreement and a shareholder of "MegaFon", filed a claim with the Arbitration court of the Khanty-Mansi region for voiding of this agreement. The reason for voiding it was that the agreement did not comply with the regulations of both Russian civil legislation and the Law. Besides, in the plaintiff's opinion, governing of the corporate relations of the Russian legal entity with the agreement subject to foreign law regulation violated the public order of the Russian Federation. The question of Swedish law application became the crucial point in this case and underlay all the following court decisions: the Khanty-Mansi region court of Arbitration allowed the claim as did the appeal and cassation instances.

The courts based their decisions on the notion that the *rights and obligations of shareholders of a Russian legal entity must be regulated solely by the Russian legislation* and the entity foundation documents. The "MegaFon" shareholders' agreement stipulated that shareholders bear an obligation to procure that the provisions of the agreement governed by Swedish law be abided by, which, accord-

<sup>1</sup> Federal Law No. 115-FZ dated 3 June 2009 - *On amending the Federal Law 'On joint stock companies' and article 30 of the Federal Law On the securities market*

<sup>2</sup> Decision of the Federal Arbitration Court for the West Siberian Circuit as of March 31, 2006 on case № F04-2109/2005(15210-A75-11), F04-2109/2005(15210-A75-11), F04-2109/2005(14744-F75-11), F04-2109/2005(14785-A75-11)

ing to the courts, is a waiver of the rights granted to them by the legislation. This is contrary to the sense of the Russian Civil Code, as well as the fundamental principles of law (public order) of Russia.

In fact, the following provisions of the shareholders agreement were considered to be void: terms of holding an annual general shareholders' meetings, order and terms of convening extraordinary shareholders' meetings, quorum and order of participation in general shareholders' meetings, quorum for adopting decisions on particular matters, obligation to observe and order of exercising preferential right to buy shares and others.

All in all, "MegaFon's" case conclusions may be narrowed down to the following: 1) shareholders agreements regulate corporate relations among Russian shareholders; 2) such shareholders are subject to Russian law; 3) shareholders agreements should not violate the mandatory rules of Russian law; 4) if such agreements violate the Russian law, then it can be recognised as void

The "MegaFon" case was the first decision that acted as a guiding line for other courts for similar cases.

Another court case that made its contribution to the practice of disputing the right of Russian legal entities to govern their corporate rights by foreign law was the case of ZAO "Russian Standard Insurance"<sup>3</sup>.

The Federal Arbitration Court for the Moscow Circuit, in its final decision on the case went even further. It emphasised that given the fact that the shareholders' agreement regulated the legal status of the Russian company, its management system, charter capital amount and its legal capacity, along with internal relations, then by virtue of clause 1202 of the Russian Civil Code (stipulating "lex societatis" clause), the law of incorporation of the legal entity is to be applied to such an agreement.

Both court decisions suggested that such lack of protectability complete with the inflexibility of corporate regulations could not favour the harmonious development of business within the Russian law. Of course, some court practice existed, but it was monotonous and could not bring considerable changes in the field of corporate disputes. Such a state of affairs entailed the intensification of pressure, by interested groups, on the authorities.

All this made the legislator understand the necessity of introducing this widely accepted concept of a shareholders' agreement into Russian law.

A new rule on shareholders' agreements, brought into the Russian legislation after a lengthy delay, gave the courts a difficult choice. On the one hand, they had to take account of the case law and administrative decisions that they themselves had developed, in many cases rejecting the possibility of regulating inter-corporate relationships by a specific agreement of the members.

On the other hand, the courts were obliged to hand down decisions in accordance with the rule in the law that provided for the members of such commercial companies to be able to execute such agreements. The result was that both investors and practicing lawyers were plunged into uncertainty. It can only be hoped that the state commercial ('arbitration') courts, most notably the Russian Supreme Arbitration Court, will resolve the inconsistency in case law<sup>4</sup>.

However, for the present moment, the nature of court practice is still rather negative for those who opt for concluding shareholders' agreements even governed by Russian law.

This can be illustrated using recent court practice.

The court case of "Verny Znak" Limited Liability Company<sup>5</sup> became prominent due to the fact that this was one of the first disputes over a shareholders' agreement governed by Russian law. The case has shown that such shareholders' agreements are still considered by the courts with suspicion. The courts in three instances declared void not only the agreements directly prohibited by the Law (for instance, a waiver of the right to vote in a way different from the one provided by the Law), but also those not stipulated by the charter<sup>6</sup>.

Consequently, the law does contain a regulation on shareholders' agreements, but it doesn't cost anything. If the decision on the "Verny Znak" case is on all fours, the risks will be way too high for the business that will have the courage to apply it.

<sup>4</sup> See, among others, Resolution No. KG-A40/3767-10 of the Federal Arbitration Court for the Moscow Circuit dated 23 April 2010, and Resolution No. F04-2109/2005(14105-A75-11) of the Federal Arbitration Court for the West Siberian Circuit.

<sup>5</sup> The fact that this court decision related to Limited Liability Company should not be a misleading point as courts tend to apply provision of the Law (as well as previous court practice on it) to the corporate relations in limited liability companies in cases when there is a need for analogy due to scarcity of practice.

<sup>6</sup> **The Supreme Commercial Court of the Russian Federation by its decision** № VAS-10364/11 as of September 12, 2011 r. denied claim for passing to the reviewing authority the decision of the Federal Arbitration Court for the Moscow Circuit as of November 24, 2010, decision of the Ninth Arbitration Court of Appeal as of February 17, 2011 and decision of the Federal Arbitration Court for the Moscow Circuit as of May 30, 2011 on case № A40-140918/09-132-894.

<sup>3</sup> Resolution N A40-62048/06-81-343 dated 26 December 2006

So far, the lack of clarifications and official interpretations of the rules concerning shareholders' agreements has meant that investors who conclude such agreements under Russian law are acting at their own peril. This state of affairs can hardly serve the purposes of creating a beneficial investment climate in Russia.

## Part 2

Among the main issues which have not been clarified, either by the courts or the legislature, which nevertheless, need clarification, are those arising from the need to ensure that shareholders' agreements are performed by the parties to them as well as the methods available to ensure that such agreements are performed.

Obligations under a shareholders' agreement, like any others, may be secured using the methods stipulated by the provisions of chapter 23 of the Russian Civil Code, namely by way of: penalty, pledge, lien, guarantee, bank guarantee and other methods provided for by the law or a contract.

In addition, the law relating to shareholders contains a specific rule which states that a "shareholders' agreement may provide for means of securing the performance of obligations, which flow from a shareholders' agreement". This rule fully complies with the provisions of article 329(1) of the Civil Code. Thus, the parties to a shareholders' agreement are entitled to stipulate in that agreement other means of ensuring the performance of obligations in addition to those listed in article 329 of the Civil Code.

Under the second paragraph of article 32.1(7) of the law on joint stock companies, the rights of the parties to a shareholders' agreement, which are based on that agreement, must be protected by the court. Such rights include the right to claim for the compensation of losses caused by a breach of that agreement, the recovery of a penalty, the payment of compensation and for other measures to be applied in connection with a breach of the shareholders' agreement.

Although it is quite clear what losses and penalty are all about, the meaning of "compensation" and its implications to its "users" in practice are still vague.

## Compensation

The law establishes that the compensation of damage is one of the measures of civil law liability, which should be given judicial protection. However, the legal nature of such compensation is not clarified by the legislature. In article 12 of the Civil Code, deal-

ing with methods by which rights are protected, compensation is only referred to in relation to moral harm. In addition, article 247 of the Civil Code establishes that, when it is impossible to place a part of shared property into the ownership of one of the co-owners of such property, that co-owner has the right to claim the appropriate compensation from the other parties that own and use the property of which the co-owner owns part.

Articles 258, 605, 709, 729, 1064, 1086 and 1099 of the Civil Code are also based on "reimbursement" being understood as a synonym for "compensation". In part four of the Civil Code, a number of provisions are found, which govern issues of compensation when a right holder's exclusive rights are infringed. Under article 1252(3) of the Civil Code, a right holder may require the infringing party to pay compensation instead of reimbursing the former's losses.

It is stipulated that the amount of compensation is determined by the court depending on the circumstances of the case, taking account of the requirements of reasonableness and justice.

Of course, there may be objections to a similar analogy since the relations that arise under a shareholders' agreement differ from the legal nature of the relations between the holder of exclusive rights and third parties. But questions associated with defining the legal nature of compensation as a means of civil law liability may be unpicked, only taking account of the civil law rules in respect of which such an institution of liability is already in force, meaning that there are court decisions on how it is applied and used for judicial protection.

As V.A. Khokhlov notes<sup>7</sup>, "there is no unanimity, either in court decisions or in legal journals," on the legal nature of compensation. "In some cases the measure of liability is regarded as being a specific type of liability on its own, while in others, compensation is equated to losses, i.e. they are treated as being the same in nature; finally the view is expressed that the relief provided by this remedy shows more of the features of a penalty or fine."

As an analysis of court decisions shows, the courts are also far from unanimous when it comes to defining the legal nature of compensation.

In one ruling, a court held that "compensation may not be treated as a fine" but is "also losses in the form of lost profit"<sup>8</sup>.

<sup>7</sup> V.A. Khokhlov Issues in practice relating to applying rules on compensation in relation to the violation of exclusive rights // The Law. 2007. No. 10., page 2

<sup>8</sup> Resolution No. KG-A40/6641-04 of the Federal Arbitration Court for the Moscow Circuit dated 24 August 2004.

In another decision<sup>9</sup>, a court ruled that “the law [author’s note - the Law on bankruptcy] does not stipulate that compensation reimburses losses in the form of a benefit not received, nor does the law state that it is a fine”. It also noted that “compensation entails the possibility of the wronged party to select one of the means of protecting its rights or to determine the amount of losses it has incurred in the form of direct harm, or to use the method established by the law of determining the amount of compensation due to it, which is in essence payment for the unjustified use of property”.

It should be noted that a characteristic of compensation is that the amount is either determined in advance in an agreement or a method for calculating the amount is stipulated.

Obviously, introducing compensation as one of the measures of the liability of a party to a shareholders’ agreement that has breached its obligations is due, among other things, to an understanding of how imperfect the devices of losses and penalties are in terms of performing the role of compensation and restitution.

The purpose of applying any means of security in shareholders agreement is that the parties perform their obligations. If they do not, they can be compelled to perform a relevant obligation by going to court. However, the Law does not meet this objective<sup>10</sup>, since it only provides for the legal protection of rights to demand that losses be compensated and that a penalty be paid. Article 396 of the Civil Code establishes a discretionary rule under which, if an obligation is not properly formed, specific performance may be demanded irrespective of whether a penalty was paid or compensation recovered. However, it is important to remember that when an obligation is not properly performed, the payment of a penalty and recovery of losses releases a debtor from specific performance of the obligation unless a shareholders’ agreement or the law provides otherwise.

In theory, an order for the specific performance of a shareholders’ agreement could be in the nature of the following:

- a decision of the relevant management authority of a joint stock company being held to be invalid with the aim of restoring it to the state it was in prior to a breach of a shareholders’ agreement;
- an order (based on the provisions of article 396 of the Civil Code) by which an obligation must be performed by the relevant party to the agreement (shareholder) or entities under its control.

In fact, both of these types of ruling cannot be handed down in practice owing to the lack in the law on joint stock companies of specific rules, which would allow such a mechanism to operate, and because there is no way to compel performance of an obligation from the standpoint of “correct expression of will”.

First and foremost, this concerns obligations which are conditional on future events, since judicial protection may only be granted when a right has been infringed. When the infringement takes place, it is necessary first to return everything to its initial state and as a result of, allow the situation to return in which a party concerned with the performance of the agreement must protect the right which has not yet been infringed<sup>11</sup>.

*Thus, we arrive at the conclusion that new problems for potential investors have resulted from the legislature’s attempt to introduce the institution of shareholders’ agreements that has proved successful in foreign jurisdictions. Principally, this has occurred because of the lack of official clarifications and judicial decisions, as well as being “due to the conservative approach of the Russian courts in terms of applying new commercial concepts”<sup>12</sup>.*

*One can still hope that giving the institution of shareholders’ agreements a formal legal basis will stimulate the development of the case law on issues concerning the application of such agreements and, as a result, additional guarantees that investors’ interests will develop on the Russian market.*

**Articles 258, 605, 709, 729, 1064, 1086 and 1099 of the Civil Code are also based on “reimbursement” being understood as a synonym for “compensation”. In part four of the Civil Code, a number of provisions are found, which govern issues of compensation when a right holder’s exclusive rights are infringed.**

<sup>9</sup> Resolution No. KG-A40/6637-04 of the Federal Arbitration Court for the Moscow Circuit dated 31 August 2004.

<sup>10</sup> See: A. Ivanov and N. Lebedeva. Shareholders’ agreements: a step forward or treading water? // Corporate Lawyer. 2008. No. 9.

<sup>11</sup> See: Ivanov and Lebedeva. Ibid, page 2

<sup>12</sup> I. Kornev and V. Arutyunyan. A shareholders’ agreement: execution, content and performance // Corporate Lawyer. 2010. No. 1.



## Expectation gaps when creating a joint venture in Russia

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Foreign investors find it difficult to run joint ventures with Russian partners, although this form of business provides a lot of competitive advantages. This article highlights some issues which could cause misunderstandings and inefficiencies in communications between Russian and foreign partners forming a joint venture.

In practice we have faced situations where joint ventures collapse due to the inability of Russian and foreign management to act as one team and effectively address integration issues. This indicates that expectation gaps and differences in execution culture can significantly reduce the advantages of a joint venture, and even lead to a decision to cancel the project. The most common reason for this is a lack of attention to integration and proper change management, resulting in local staff opposing any changes and undermining the efforts undertaken by the foreign partner's executives. Sometimes the integration process stops due to a lack of communication, where both foreign and Russian partners are unwilling to perceive the rationale of the position taken by the other party, or where resistance to change in certain areas exceeds expectations. The most notable differences relate to the attitude towards building relations with the state authorities,

the accuracy of management information and tax compliance. Although not crucial when taken alone, personal communication may also cause stress and inconvenience, which could negatively affect the expected synergies and productiveness.

### Relations with the state authorities

Russian businessmen prefer to have less formal relations with the state authorities, where information is received from insiders and documents may pass through the required approvals and registrations faster as a result of facilitation payments. In most cases these facilitation payments are not viewed as a bribe, but as a fee payable for exceptional service or a present to a friend supporting the process of overcoming red tape. The distinction between a bribe and a present may differ depending on local traditions and culture, and what is perceived as a present or a sign of personal respect by the Russian partner, could be treated as a bribe by the foreign partner.

These differences in treatment could result not only in conflicts between the partners, but also in a deterioration of relations with the state authorities, if a less formal approach is suddenly replaced with a formal one. In practice, the Russian partner in a joint venture usually takes care of the receipt of all required certificates, registrations and approvals. In this regard, the joint venture agreement should specifically state that all additional costs arising when the renewal of registrations and certificates are required, or such registrations and certificates are revoked as a result of omissions made in the past periods, are borne by the Russian partner.

However, in practice these differences may be mitigated by overall improvement of regulatory compliance, including following all legislative requirements and regulations when receiving certificates, permissions, registering assets, etc. The improvement of compliance is normally achieved by hiring additional professional staff and establishing internal control procedures.

### Accuracy of management information

Russian companies usually maintain management accounts in a form suitable for day to day analysis (e.g. on a cash basis in the form of an Excel spreadsheet) without following specific accounting stan-

dards (such as Russian accounting principles or IFRS). Similarly, internal reporting and communication may be informal, with no strict deadlines or prescribed reporting forms filed on a regular basis. Although management may consider the existing information as sufficient for its current needs, the management information could be difficult to understand for external users, including the foreign partner.

Russian companies usually do not use statutory books for management purposes; statutory information is only used to calculate taxes and to report to the state authorities. In this regard the statutory books may be prepared on a quarterly basis and not contain the required level of analytical detail. In addition, some operations may only be reflected in the management accounts and, therefore, differences could arise between the management and statutory books. Such a situation is usually viewed as unacceptable by the foreign partner, who

insists on the completeness and accuracy of the statutory books and the availability of monthly accounts prepared on an accrual basis through consistent application of the selected reporting standards. In this regard, the approach to maintaining the manage-

**Currently, most businessmen in Russia understand the importance of fluency in English when communicating with foreign partners and investors. As a rule management has fluent English and is able to negotiate issues relating to the joint activities with foreign investors in person.**

ment accounts and statutory reporting is usually subject to significant changes during integration. If the sale-purchase agreement stipulates a completion accounts mechanism for the price calculation, the advisor reviewing the completion accounts could be engaged to assist in elaborating management ac-

counts forms acceptable for both the foreign and Russian partners in the joint venture, aimed at monitoring day to day activities.

### Attitude towards tax minimization

Although the situation is currently improving, small and medium sized businesses in Russia do not view



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tax minimization or aggressive tax policies as fraudulent or dishonest behavior. Tax minimization arrangements may be viewed by some businessmen as acceptable business practices, as long as the tax authorities are unable to detect them or assess additional taxes in the absence of relevant information. As a result, Russian entrepreneurs consider using all possible opportunities to pay less tax as a solid tax strategy, provided that the detection risk is low or court practice exists, which shows that the tax authorities have a low likelihood of successfully challenging the taxpayer's position and accrue additional taxes. These attitudes could have their roots in soviet times, when the receipt of personal benefits at the expense of the state was perceived by the general public as an offence, but not a dramatic breach of ethical principles.

In contrast, foreign investors normally consider full compliance with all effective regulations as the only possible tax strategy, and any deviation is viewed as a crime irrespective of the level of detection risk. The arguments of the Russian partner that the risk of challenge is low are frequently viewed by the foreign partner as an insufficient reason to accept an aggressive tax minimization policy. This difference in views may be resolved by engaging a tax advisor and reaching agreements on the post-deal tax policy in advance. In particular, the foreign partner could require that the business discontinue all aggressive tax minimization strategies as a condition precedent to the conclusion of the joint venture agreement.

## **Communications and dress code**

A foreign investor may face a wide range of corporate cultures in Russia, from more relaxed and creative in newly established businesses, to rather conservative in companies with a substantial history or with state participation. Similarly to Europe and the US, communication patterns vary depending on the industry (e.g. being more relaxed in advertising, marketing and IT compared to oil and gas companies) and the size of the company.

Medium and small Russian businesses tend to apply a more relaxed dress code, flexible working hours and an informal communication style, where opinions could be outlined in a distinct and sometimes unpleasant manner. However, at the same time people in such companies may have closer personal relations and experience higher level of socialization compared to large business and multinational companies.

Changes to the dress code and communication patterns as a result of integration into a joint venture do not usually cause difficulties. However, country specifics should not be disregarded. In particular, in Russia the office style for female employees is less strict than in Germany and the US - women prefer bright colors – and the introduction of a uniform or strict dress code could be viewed as an attempt to limit their personal freedom.

## **Lost in translation**

Currently, most businessmen in Russia understand the importance of fluency in English when communicating with foreign partners and investors. As a rule management has fluent English and is able to negotiate issues relating to the joint activities with foreign investors in person. However, as competency in languages was not highly appreciated during soviet times, people close to retirement age and some technical specialists could have no foreign language competence and, as a result, could be incapable of reading internal correspondence and taking calls in English. In this regard special attention should be paid to the language competence of staff and their preparedness to work in a new corporate environment prior to entering into a joint venture agreement. This could be achieved by performing HR review aimed at identifying issues which could result in difficulties during integration. Such procedures could identify the need for replacement of certain key employees, hiring additional staff with the required level of skills and behaviors or elaborating a detailed developmental program for the key employees and assess the associated costs.

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Summarizing the above, the attitude of the partners and cultural differences could result in additional costs at the integration stage; therefore, they should be properly addressed at the stage when the joint venture's conditions are negotiated. The involvement of advisors at the negotiation stage (e.g., performance of HR due diligence) could give the joint venture partners an accurate understanding of the potential difficulties and related additional costs.

## REGIONAL ASPECTS OF INVESTING IN RUSSIA

### Investment Climate in Russia's Regions: Preliminary Survey Results

Alexander Plekhanov, Economist, European Bank for Reconstruction and Development in London



**Alexander Plekhanov**

Alexander Plekhanov is a principal economist in the Office of the Chief Economist at the European Bank for Reconstruction and Development in London. His main responsibilities include country work on Mongolia and Russia, analysis of the financial sector developments, and economic data management.

Alexander joined the Bank in October 2007. Prior to that he worked as an economist at the International Monetary Fund in Washington, DC, in the Western Hemisphere Department and Fiscal Affairs Department.

Alexander holds an M.Phil. in Economics and Ph.D. in Economics from the University of Cambridge and a Diplom in Mathematical Economics from St. Petersburg State University. He wrote several papers on various economic issues, including fiscal decentralization, financial deepening, commodity-based development and economic diversification.

The last few years saw relatively low levels of investment in the Russian economy and persistent net outflow of capital, which now offsets 60 to 80 per cent of the current account surplus, despite high prices of oil and other commodities. Business climate perceived as difficult is often cited as one of the causes of this trend. There is also a strong perception that business environment is far from homogenous. Instead, it varies substantially from region to region.

#### The survey

One way to assess the quality of business environment in the regions is by asking managers and owners of randomly selected firms of various sizes about problems they face in their day-to-day operations. One of the most comprehensive surveys of this kind is the Business Environment and Enterprise Performance Survey (BEEPS) conducted in a large number of countries every three to four years by the Eu-

ropean Bank for Reconstruction and Development and the World Bank. The latest, fifth, round of this survey was launched in Russia in the third quarter of 2011, in cooperation with the Ministry of Economic Development, the Centre for Economic and Financial Research, and Vnesheconombank. The survey is unique in its coverage, with 4,200 participating firms across 37 regions representing all 8 federal districts.

In each region, over 100 manufacturing and services firms, small, medium-sized and large, are randomly chosen to participate in the survey. As part of this survey, respondents – top managers of the surveyed firms – were asked the following question about each of the potential obstacles to their firm's operations: *"I would now like to ask you questions about the overall business environment in your country and how it affects your firm. Can you tell me how problematic these different factors are to the operation and growth of your business?"* The answers were given on a five-point scale: negligible – minor – moderate – major – or very severe.

While data are still being finalised, preliminary results give a useful insight into various dimensions of the regional business environment. Broadly speaking, firms want to see improvement across six major areas: physical infrastructure; skills of the workers; access to finance; law enforcement; regulatory burden (related to taxation, customs formalities; licenses and permits and so on); and the overall quality of institutions (particularly, with regard to corruption).

Deficiencies in any of these areas can severely constrain businesses, and limit improvement in other areas: new infrastructure may not be used if firms are suffocated by red tape; plentiful financing may be wasted if there are no skilled employees on the market to make the projects succeed.

#### Infrastructure

One of the key inputs into a modern economy is infrastructure. Here, unsurprisingly, the needs are large in the faraway regions, such as regions of the Far East. But the needs are also great—in fact, often greater in Central regions, where the demand for transport, power and other infrastructure is higher.

According to preliminary data, around one third of the respondents viewed problems with electricity, including connection costs, and telecommunications as major or severe constraints to operations of the firm.

Telecommunications is a particularly interesting example of how the changing economy affects demand for infrastructure. Since the late 1990s, firms' view of telecommunications has improved drastically, to the extent that the question has almost been dropped from the survey. In the 2005 round of the BEEPS, only 2 per cent of firms viewed telecommunications as a major constraint to doing business. This trend then got reversed, with a dramatic jump in the proportion of complaints about telecoms, reflecting the importance of high-speed broadband connection for the modern economy.

Improving regional infrastructure can be associated with sizable gains. In the latest round of BEEPS survey the firms were asked not only how much of an obstacle various business environment components are, but also how they think their costs would change if certain aspects of business environment were improved and no longer constrained their business. In the case of electricity, which encompasses reliability of supply, ease of connection to the grid, and pricing, Russian firms on average estimated possible cost savings at 1.6% of total costs. This number may look modest, but in fact it is very significant, given that it is applied to the entire cost base of a business.

Self-assessment of hypothetical cost-savings is, of course, merely an educated guess, but it may nonetheless be informative. In particular, these self-assessed cost-savings are markedly higher in the regions where electricity is perceived to be more problematic. In the Far East, where the majority of early participants in the survey saw electricity as a major or severe constraint to growth of their business, the estimated cost savings from sorting electricity problems out were on average 5%, or three times the country average rate.

As mentioned above, it is not only the remote or sparsely populated regions where infrastructure constraints matter. In fact, infrastructure tends to become a binding constraint in places where regional environment is otherwise perceived more favourably, as enabling business environment creates

growth opportunities and increases demand for infrastructure. Sometimes regions often perceived positively in terms of overall business environment, could have constraints on infrastructure issues like transport and electricity.

## Skills

Around one third of respondents country-wide view inadequate labour force skills as a major or severe constraint to doing business. This is a particularly difficult problem faced by Russia, as well as many other emerging markets and advanced economies – the problem of growing mismatches between the supply of skills and the rapidly changing demands of a modern innovative economy. These mismatches need to be addressed by updating and strengthening the education system and supporting training and retraining programmes, both public and private.

The early results suggest that on average, firms that are constrained by workforce skills estimate that their sales could increase by perhaps 11% if skilled labour were no longer a constraint. The skills problem also appears to vary significantly from region to region.

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**Therefore, answers to questions about the tax rates are notoriously hard to interpret. Nonetheless, the latest round of BEEPS survey registered a remarkable jump in the number of small firms that view tax rates as a major or severe constraint.**

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## Access to finance

One aspect of business environment where BEEPS results from the earlier and latest rounds of the survey do not so far reveal strong differences between the regions is access to finance. This does not

mean that access to finance is not important. To the contrary, it is viewed as a major or severe obstacle by over a quarter of firms, perhaps not surprisingly in the aftermath of a financial crisis and given that a lot of the respondent firms are relatively small businesses employing 20 to 50 people.

Moreover, the official statistics shows striking differences in the extent of financial deepening in the regions: the ratio of corporate credit (issued by bank branches in a given region) to gross regional product varies from around 3 per cent in remote regions to over 80 per cent in Moscow.

The fact that firms do not feel much more constrained by the lack of access to finance in less financially developed regions may mean that they are equally constrained, or even more constrained by other aspects of business environment, be it infra-

structure and skills, surveyed above, or excessive regulation and corruption.

## Regulation, institutions and law enforcement

In the latter area, a significant number of firms view tax administration, trade regulations and work of customs, business permits and licensing and access to land, as substantial obstacles to doing business. In most of these areas, the survey also reveals significant differences between the regions.

To improve these crucial aspects of business environment, a combination of further deregulation and enforcement at the regional level is needed. For instance, a recent survey of administrative barriers conducted by the Centre for Economic and Financial Research found that firms continue to be frequently asked by the regional and local authorities to obtain licenses, which are in fact not required by law. Most firms find it less costly to obtain these licenses than argue against such demands. When comparing the results with the earlier surveys on administrative barriers, prognosis is to some extent encouraging: the situation with “illegal” licensing has been gradually improving - but not universally, and the differences between regions remain very significant.

The survey also makes a careful distinction between tax administration, the work of tax collecting agencies, and tax rates - a most common complaint of businesses world-wide. While there is every reason to make tax administration as efficient and seamless as possible, minimising taxes is not necessarily a policy objective per se, as revenues are needed to finance improvements to other aspects of business environment, for instance infrastructure. Ultimately, what matters is not only how much businesses pay in taxes, but also what they get in return.

Therefore, answers to questions about the tax rates are notoriously hard to interpret. Nonetheless, the latest round of BEEPS survey registered a remarkable jump in the number of small firms that view tax rates as a major or severe constraint. This spike is likely to be related to the increase in the social security tax paid by small enterprises and may prove temporary if the planned partial reversal of this tax hike proves to be effective and sufficient.

Pervasive corruption also remains a major source of concern for businesses. There is anecdotal evidence that many firms, including respondents to the BEEPS survey, view corruption both as a problem and as a solution. In fact, some businesses view it more as a solution than a problem, as

**The early results suggest that on average, firms that are constrained by workforce skills estimate that their sales could increase by perhaps 11% if skilled labour were no longer a constraint. The skills problem also appears to vary significantly from region to region.**

a means of dealing with very costly and cumbersome regulation. While this may in many ways be true, corruption is only a third best solution to the underlying problem of excessive regulation. The first-best solution would be to streamline the regulation itself.

Finally, crime, competition from the informal sector, and low confidence in courts remain major constraints to growth of firms. Rule of law and faith in contract enforcement are important elements of business environment. And although these areas, as well as many other areas surveyed above, are governed by general federal legal frameworks, many modalities within these frameworks and, most importantly, the implementation and enforcement vary by region and can be improved at the regional level.

Preliminary results from the survey suggest that no region scores highly across all dimensions of business environment. If one tries to quantify the gap, the top scoring regions achieve less than two thirds of the benchmark level. Hence, all regions have a lot to learn from each other’s experiences of improving operating environment for the local businesses.

## CASE STUDY: the Kaluga region

### Dmitry Abramov, Deputy Minister for Economic Development of the Kaluga Region, Head of the Investment Directorate



#### Dmitry Abramov

Dmitry Abramov is the Deputy Minister for Economic Development of the Kaluga Region, Head of the Investment Directorate

Born on January 14<sup>th</sup>, 1976 in Kaluga.

In 1998, Mr. Abramov graduated from the North-West Academy of Public Administration (NWAPA), St. Petersburg, where he specialized in "Public and Municipal Administration" with an accent on "Human Resource Management".

Between 1998 and 2001 he completed several post-graduate courses at NWAPA.

In 2000, he attended a professional training under the project "Open World" - carried out under the US Library of Congress and the Russian leadership programme in Washington, USA.

Since 2001, he has been the Head of Department of International Liaisons and Public Relations, NWAPA Kaluga branch.

Since 2004, Mr. Abramov has been the Chief Specialist of the Department of Investments and External Economic Relations of Directorate for Economy and Property Relations of Kaluga; Consultant of International Department, North-West Academy of Public Administration, Kaluga branch.

In 2008 he became the Deputy Director General – Head of the Department of Investment Programmes in "Kaluga Region Development Corporation".

In July 2009, he became the Director of the "Agency for Regional Development".

Since June 2011, Mr. Abramov has been the Deputy Minister of Economic Development of the Kaluga region and Head of the Investment Directorate.

"In Kaluga Region anyone can realise their interests, find new business partners, and enjoy the hospitality of the region's authorities and people"

## Russia – Kaluga region

### Key characteristics

- Total territory – 29.8 thousand km<sup>2</sup>
- Population – 1.001 mln.

- Climate – moderately continental
- Regional centre – Kaluga

The Kaluga region is situated in the very core of Russia and shares a border with Moscow. One seventh of the country's population lives within a radius of 150 km from the Kaluga region. The proximity to the capital – a major sales market for almost every product – is a definite advantage of the region. And despite the absence of export-oriented mineral deposits, the Kaluga region is one of Russia's most dynamically developing regions, with a comfortable business climate that is acknowledged by Russian and international experts: [www.investkaluga.com](http://www.investkaluga.com)

The Deputy Minister for Economic Development of the Kaluga region, Head of the Investment Directorate, Dmitry Abramov, describes the steps that an investor should take in order to launch a business in the region.

For the past 10 years or so, increasing the region's investment potential has been a major factor with regard to regional development. From 2006 to September 2011, we attracted 9.5 bln US dollars (USD) in investments to the region's economy, 5 bln of which are foreign investments. In 2010, the region alone accounted for 8% of the overall direct foreign investments in Russia. At the same time, Kaluga region's population is only 0.75% of the country's overall population and the territory – 0.2% of Russia's total territory.

The success of the Kaluga region is the success of our investors. This statement is not groundless. Companies from over 20 countries have established their production within the region. This is undoubtedly a high figure for the region that possesses no rich mineral deposits including gas, oil or gold. Our main treasure is human resources. Thanks to persistent and diligent work, we have managed to achieve impressive results, while minimising the investment risks. The investors who enter the Russian market are first of all afraid of corruption and bureaucracy. In order to address the former, we formed a joint team in our region that works for a common idea.

Existing industrial parks are to a large extent the reason why a good number of investors have chosen the Kaluga region to do business in Russia. The investors are offered an absolutely well known business product – the industrial park. This is an area zoned and planned for industrial development, usually located outside the main residential area of a

city, with good access to transportation and communication. It also has localised environmental controls that are specific to the needs of an industrial area. Around 100 companies from different countries have chosen to invest in our region, with the majority choosing to set up production within industrial parks.

Today, we can boast of an automobile cluster consisting of seven brands owned by three concerns: Volkswagen Group Rus, PSA Peugeot-Citroen & Mitsubishi, and Volvo Trucks & Renault Trucks. This cluster is currently being dynamically filled by the components manufacturers: Continental, Magna, Benteler, Visteon, Lear, Faurecia, Fuyao, HT&L, Yapp Rus, HP Pelzer Rus, Scherdel Rus, Rucker, Fuchs oil, Severstal-Gonvarri, Gestamp-Severstal, and Becema. It is not only the assembling manufacturers that have entered the region, but manufacturers with a high level of automation that produce hi-tech products, as well.

We have diversified our economy and developed other important spheres, for example, the life sciences sector. The basis of our pharma-cluster is formed by the enterprises that develop the ideas and introduce new technologies. The business partners of the region are major pharmaceutical companies: Hemofarm/Stada Group, Berlin-Chemie/Menarini (Italy), Novo-Nordisk (Denmark), Niarmedic-Plus (Russia), and a Swedish-British company Astra-Zeneca. The expected amount in investments brought in by these companies is around EUR 265-280 mln.

We do not rely on just one or two industries. The government equally supports other sectors, including construction materials manufacturing, tourism, food, pulp and agrarian complexes. We have implemented many successful projects in the abovementioned sectors – a number of them, with the participation of foreign capital.

An efficient system of work with investors has been created in the Kaluga region; it includes not only the regional authorities, but also the Ministry for Economic Development and regional development institutions. Today, we have four of such institutions; each of them handles an aspect associated with investment:

- The Kaluga Region Development Corporation – an industrial parks developer;
- The Agency for Regional Development – an organization that consults investors on any possible issues;
- Industrial Logistics – a company specialized in creation of transport-logistics infrastructure for consistent implementation of every investment project;

- The Agency for Innovation Development - leading operator for innovation and high-tech economy sector development.

I would also like to mention that for the convenience of our partners the region has its “embassy” in Moscow. It has a pretty long title – Representation of the Government of the Kaluga Region at the Government of the Russian Federation. All necessary information about the region is also available there.

We have adopted an individual approach to each investor and project, and offer comprehensive support. Therefore, interaction with investors involves negotiations, decision on the location, settlement of contract, construction, equipment delivery, production startup, in that order. We clearly understand that the time factor is very important for business; therefore, while working as a joint team with the investors, all effort is made to commence each project quickly. In our region, an investor can obtain all the necessary documents as early as during the construction phase. All these steps are conducted within the existing legal framework.

### 1. Negotiations

The first step an investor interested in doing business in the Kaluga Region should take is to commence dialogue. For this purpose, any of the abovementioned branches of the economic block can be contacted.

Our specialists will prepare an accurate and detailed report on the investment potential of the region; region’s economic status; availability of natural, infrastructural and human resources. They will then provide all the necessary information on the implementation of investment projects in the Kaluga Region and find the most attractive offers based on the investors’ requirements and preferences. They will, if necessary, organise visits to the investment areas and enterprises within the region. Each investor, regardless of the investment amount, country of origin and sector profile, will enjoy complete assistance offered by the regional development institutions at every stage of the project’s implementation.

As soon as an investor decides to invest in the Kaluga region, the project becomes a joint affair. Like the investor, we are interested in the project’s success. We value our region’s reputation as a reliable partner that fulfils its commitments. Secondly, the Kaluga region is likewise interested in profitable ventures; this is a welcome source of income. We treat all projects with equal importance and remain with the investor all the way – from the decision making process, to construction and eventually, production.



## 2. Decision on the production location

Currently, land plots are available for production activities in seven industrial parks. Their total territory is 2.7 thousand hectares (ha). Over 1.3 thousand ha have already been allocated for the investment projects. In Russia, the Kaluga region is a pioneer in this field. For business, quite familiar with this type of investment, this is a brilliant opportunity, which makes room for greenfield investment within a relatively short period of time. Various options are available in our industrial parks, including the provision of all the necessary amenities such as electricity, gas, water supply, sewage, and access to railroad and motor roads, if required. In situations where brownfield investment or temporary production is the preferred option, investors can rent industrial premises constructed under the “build-to-suit” principle. Such premises are adapted to the needs of a particular investor and makes provision for the immediate commencement of activities. The car-parts manufacturers, to a greater extent, as well as the second-level providers who followed the former to the region have found this “build-to-suit” offer suitable to their needs. For example, Visteon and Benteler have rented premises in Grabtsevo industrial park, where the Volkswagen factory is an anchor enterprise. A similar project has been implemented near the PSA Peugeot-Citroen & Mitsubishi factory. Faurecia, a French car-parts manufacturing company will soon launch its assembling process factory there as well.

In terms of brownfield investment, the Kaluga region offers several production facilities, especially for companies involved in manufacturing military-technical products. For example, CIE Avtocom, a joint Russian-Spanish venture is currently based in the Kaluga car electric equipment factory. And the companies Elikor and Scherdel who have a technological cooperation have also chosen to go brownfield.

## 3. Signing the investment contract

The contract “on attracting investments to the Kaluga region” is one of the basic documents fortifying the investor’s costs for construction that envisages various tax privileges. First of all this refers to a set of privileges in income and property taxes ranged in accordance with the volume of investments.

## 4. Construction

The individual approach to each project and the absence of bureaucratic barriers and corruption allows even large and ambitious projects to be implemented within short periods. For example, the Volkswagen plant was constructed within just one year, which is half the period initially allocated to this project. The PSA Peugeot-Citroen & Mitsubishi company came to the construction area on June 1st, 2009, and on March 9th, 2010 the first car was already released from its assembly line. It took a little more than a year to construct the factories for the Volvo and Samsung companies. The investor is completely independent when it comes to choosing sub-contractors and other partners. If you want to work with partners that you understand and want to bring to Russia together with you – you are free to do so. Despite our great

wish that the investors work with local companies, it is our principle not to recommend anyone. The logic is simple and clear: the investor’s task is to create a successful business, provide new workplaces and comply with the region’s tax system. The region’s task is to provide condi-

tions for a quick and successful startup.

## 5. Equipment delivery

The investors in Russia often suffer from difficulties with export-import operations – for example, equipment delivery. In our region, we have our own customs terminals and support programmes for export-oriented production that helps avoid unnecessary problems. Today, in addition to motor ways and railroads we also have all the necessary infrastructure for cargo handling. The aforementioned Industrial Logistics company will effectively coordinate the equipment delivery route from any point of the world to your enterprise in the Kaluga region.

Major logistics operators such as Gefco, GREEN Integrated Logistics, Rhenus Logistics, Transcontainer, etc. are successfully operating in the region. Transport-logistic terminals that are close to the industrial parks are already being constructed. These terminals allow cargo to be transferred from railroad to road transport at a low cost and with the provision for long term storage of goods. They also make provision for customs clearance and high-speed cargo processing.

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**In 2010, the region alone accounted for 8% of the overall direct foreign investments in Russia. At the same time, Kaluga region’s population is only 0.75% of the country’s overall population and the territory – 0.2% of Russia’s total territory.**

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Transportation by air via the Kaluga International Airport will appear in the nearest future. The airport is being developed on the site of the existing regional aerodrome whose function was suspended several years ago – before the investment activities began.

## 6. Production startup

Twenty three new plants have been established in various sectors in the region within the past two years. Human resources are very important to any investor. Hence, it is an issue important not only to the region, but the entire country as well. Our work outstrips the investors' demands: we also try to think ahead, hence, making provision for trainings. We have modified the education curriculum to make provision for new courses at the existing universities and vocational schools to prepare specialists that are in demand by the labour market.

The region cooperates with leading technical universities of the country. For over 50 years, the Kaluga branch of the Bauman MSTU has been educating professionals in mechanical engineering, metal work and engine construction. When we faced the need to train practical specialists, an absolutely new Education Centre for training staff for automobile industry was established. Specialists have been trained there since 2007. Centre's development is in line with the automobile factories' requirements, in Kaluga. This 7,000 m<sup>2</sup> centre with 20 laboratories and workrooms built for various purposes, graduates highly trained specialists. The training modules of the centre equipped with modern educational and production equipment allow for the simulation of the processes in an assembly plant. The equipment is similar to that installed in the leading car factories of the region.

Together with our German partners, we are creating a similar training centre to satisfy the HR needs of the pharmaceutical industry. The first group began its training in February, 2012.

Enormous work is being done to keep highly qualified professionals in the region and to organise the movement of people from regions, where there are a lot of people and few job opportunities. This task cannot be solved without developing the real estate market. Hence, we have launched a new product – "Houses for Professionals". Residential houses are being constructed near the industrial parks, in support of the efforts made by companies to provide their specialists with accommodation. Thus 1,500 houses have been built, alongside a school with a capacity for 630 kids, two kilometers away from the Volkswagen factory.

Modern hotels are also being actively built and new residential complexes continue appearing within the region. Territories are being modernised, the educational system is being perfected, the level and quality of medical services are enhanced. We continue to renovate and build new roads: small businesses are also developing intensively. All our efforts are aimed at having the quality of life in the region at par with the best European standards. Kaluga is a place where one can live comfortably, work and spend leisure time!

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## PECULIARITIES OF OPERATIONS OF SMES ON THE RUSSIAN MARKET

### SMEs doing business in Russia – getting started

Chet Bowling, Managing Partner, Alinga Consulting;  
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**Chetwynd R.F. Bowling**

Chetwynd R.F. Bowling is Managing Partner at Alinga Consulting Group. Chet holds a BA and MA in Law from the Russian People’s Friendship University and received his MBA from the Business School of Kingston University

in the United Kingdom. As the Managing Partner and a founder of Alinga Consulting Group in 1999, he has played a leading role in managing the service delivery and consulting major clients. Chet also specializes in taxation of foreign companies doing business in Russia and his experience includes advising a large US industrial gas company on a multi-million dollar equity and debt investment into Russia; providing transaction support to a French food manufacturer acquiring a factory in the south of Russia; providing tax structuring to a UK investor in the Russian agro sector.



**Alex Medlock**

Alex Medlock is based in Moscow and is Managing Director for TMF Russia and in addition as Regional Director he has responsibility for TMF’s other offices in the CIS region (Ukraine and Kazakhstan). TMF Group is a leading global provider of

out-sourcing services.

Alex is an experienced finance and capital markets professional. He has a degree in Economics and Accounting and is a qualified Chartered Accountant and a member of the Institute of Chartered Accountants of Scotland.

Alex has been working with clients in Russia and other CIS and CEE countries for over 15 years.

### SMEs doing business in Russia – getting started.

It is very well accepted that Small and Medium Enterprises (SMEs) play major roles in most developed economies both in terms of the economy itself and also social infrastructure. They help bring flexibility and resilience to the economy, especially, in times of crisis. They can be an engine of growth as very often it is they, and not the large companies, that find and commercialize the “next big thing.” We can see that one of the responses to the current Global Crisis is to try to encourage the expansion of domestic markets, which can then generate internal growth – a dynamic and thriving SME sector is an obvious driver for such growth. However, the significance of this sector is still not fully recognized in Russia and this is reflected in their level of support in Russia. But attitudes in Russia are changing and we see this in terms of increasing pronouncements of support from top politicians and government officials. In 2011, the AEB established the SME committee to help promote and protect the interests of SMEs doing business in Russia.

The major value of SMEs, and where Russia could really benefit, is the SME’s ability to empower people to make a difference in other people’s lives. Allow a person to start his own business, and he can provide for not only himself and his own family, but also create more opportunities for others to provide for themselves and their families. Also, in the last 20 years, we can see many good examples of SMEs investing in Russia and creating very successful businesses. One common characteristic of these successful businesses is that they have correctly identified their niche in the market and having identified this niche they have focused on doing what they do well. Clearly, there is strong competition, and therefore, it is important to be dominant in your niche and to maintain this by, for example, investing in your brand. The best way to achieve this, apart from advertisement and PR (more importantly, at the beginning), is to invest in the right people and as a consequence, in the quality of services or goods.

What is important to realize is the need for patience and resilience in creating a successful business in Russia and that the ‘quick fix’ may not be the best option in the long term. Of course this brings us quickly to the topics of bribery and corruption, which are regularly quoted as being the most difficult challenges faced by international investors when com-

ing to Russia. It will not surprise you that we, along with the majority of successful business owners, will strongly advise managers to adopt best practice and corporate governance. This is becoming even more important with increasing international legislation, for example, the UK Bribery Act 2010, which came into force on 1 July 2011. It was quoted to us recently that “Russia is a school of patience” and we whole heartedly agree with this.

It is also important to keep in mind that in many ways Russia is still a young country. It is very easy to see this when one steps outside of Moscow into the regions. Here, we then quickly find that the infrastructure is still very underdeveloped and indeed around 20% of the population is living on incomes below the poverty line. But we see that Russia has made significant steps forward from the almost anarchy and chaos of the early 1990s to a more established order and a developing and growing middle class, which in itself is an attractive market. We can observe that in recent years, more and more SMEs are looking beyond Moscow to the regions, as attractive investment opportunities. Indeed, we see that a growing number of regions are now very proactive in attracting foreign companies such as Kaluga, Yaroslavl, Voronezh etc. Therefore, just from the sheer size of the country, it may be very helpful to adopt a humble mindset and realize that everyday we may learn something new.

As way of introduction to what we feel are some of the most important issues for SMEs investing in Russia to consider, we would point out that the general lack of attention and support for SMEs in Russia means that owners or managers of smaller operations are often shocked by the cost of entry into the market – both in time and money. Start-up, or just general compliance, while still at a very low level of activity, is disproportionately burdensome to a small business, prompting outlays of time and money that would be better directed toward business development. Although, official support for SMEs may be limited, many owners of businesses in Russia have benefited from support from other networks, where they can discuss issues they are facing, for example, the AEB itself; local chambers of commerce or other groupings of expats. When coming to Russia, what is very helpful is becoming quickly aware of such groups and seeing if these may be of assistance to your business. What is clearly important in Russia is to have friends, but also, understand who can be your friend!

Below, we highlight some of the issues that we consider important. We have each been doing business in Russia for more than 15 years, and over this period we have seen that there are regular issues

to be addressed during start-up, and with regard to matters of ongoing compliance and financial strategy, and other challenges of doing business in Russia.

## **1. The Basics- Setting up a legal presence: Limited Liability Company (LLC); Joint Stock Company (JSC); Rep Office; Branch**

When entering the Russian market one of the first decisions for an SME will be whether to do this alone or to find a local partner and establish some form of joint venture. If you talk to owners of successful businesses in Russia you will learn that one of the most important factors in determining success is to be clear about your objectives and this is especially important in considering the legal form of presence in Russia. Another, very important factor is to start with the right people and this is especially difficult when a company is coming to Russia for the first time. Considering these points the general advice would be that whilst it is possible to establish a successful joint venture, it seems that in practice this does not often work and that the better choice is to establish an own presence. In a recent conference organized by the AEB SME committee and a number of owners of successful foreign SMEs expressed this opinion. However, the value of having a local partner that “knows the ropes” is also important.

We mentioned at the beginning that being very clear about objectives is very important in having a successful business. This is also crucial in determining the structure and form of legal presence in Russia. For example, if as an owner you plan eventually to sell the business then one should consider the requirements of a future buyer or investor. For example, we know that it is generally much easier to sell a business with a clear and transparent corporate structure. In addition, there may be tax considerations relating to an investment holding structure, which may be important in any future sale. Coming to the business itself it is worth considering as well the medium term plan, for example, in the first year you may be planning on establishing a representation but then moving quickly to a “buy sell” business model – this may impact your decision on the form of presence.

It has certainly become easier to establish a business in Russia. The timeline has shrunk considerably since the late 90s/early 2000s. Registration of a business (for the simplest LLC) used to take about three to five months; now three weeks is usually enough. The time needed to obtain a work permit has also become much shorter (shrinking from six months to two and a half). If a foreigner earns

JSC (ZAO)	LLC (OOO)
The charter capital is divided up into shares (aktsii). This makes it easier to transfer or assign shares as there is a perception of separation of investor from management of the company.	The charter capital is divided up into percentages of membership interest (dol') – i.e., there is an assumption of the member's active involvement in the company's activities.
If a shareholder decides to exit a ZAO then he can do so via the sale of his shares either to the other shareholders or to a third party. The value (selling price) of the shares is determined by the parties and is not linked by law to the net asset value of the company.	If a member decides to exit an OOO he can either sell his membership interest to another member or third party, or he can choose to sell to the company and demand that the company pay him his share of the current net asset value of the company. Such a provision must be set out in the charter of the company.
Share issues must be registered with the Federal Securities Commission (FSC). Additional start-up cost and time.	No need to register with the FSC.
Dividends are paid proportionally to the number of shares owned.	The charter may provide for dividends to be distributed disproportionately from the percentage (%) of membership (ownership).
50% of charter capital must be paid within 3 months of registration and 50% within 1 year. Minimum capital required – 10,000 rub.	50% of charter capital must be paid before registration and 50% within 1 year. Minimum capital required – 10,000 rub.
If the contribution to the charter capital is "in-kind" (property) and not cash, then an independent appraisal is required regardless of the value of such in-kind contributions. Additional cost.	Independent appraisal is not required if the "in-kind" contribution to the charter capital is less than 20,000 rub.
The General Director may be appointed by the Board of Directors if permitted by the Articles of Association otherwise by a meeting of the Shareholders.	The General Director may be appointed by the Board of Directors if permitted by the Articles of Association otherwise by a meeting of the Shareholders.

more than 2 million rubles per year, he can qualify under the Highly Qualified Specialist work permit scheme and get his permit in 3 weeks. At the same time, the rules are constantly changing, at times causing delays.

**Limited Liability Company (LLC)**

As mentioned, the easiest way to go is to set up an LLC, or OOO as it is known in Russian. Russian law allows for a single shareholder and a single executive – the General Director. Both corporate and individual shareholders are allowed. With the individual shareholder, all that is required is a notarized translation of his/her passport and a visit to the notary and the tax office. In order to complete the registration process, it is necessary to have a General Director and this brings us to often one of the first challenges, as the company may not have identified someone to fill the role. Given the wide powers and responsibilities that the General Director has in Russia (it is very difficult if not impossible to limit such powers), this is a very important decision. As an interim solution, until a suitable candidate is found, it may be desirable to outsource this function to a reputable third party. Also, at the incorporation stage it will be necessary

**Before making a commitment to set up in Russia, it is important to understand what it takes to liquidate or officially wind down the legal presence. The words from the song "Hotel California" come to mind when it comes to this issue – "you can check out any time you like, but you can never leave."**

to specify a registered address, and again, as an interim measure an out-sourcing specialist can provide a solution until premises have been found.

For a corporate shareholder the process is more complicated – the Chief Executive Officer (CEO) of the corporation must sign the application for incorporation. This can be done in the home country and sent to Russia for translation and filing. However, this is not recommended as one small error could result in having to start over, causing significant delays. If possible, the CEO should come to Russia to complete the process. If this is not possible, then a nominee shareholder (this would be the local

manager, if he is trusted or one provided by the legal firm handling the registration) is appointed and he will sign all the application documents.

It is also worth noting that the documents must be submitted in person by the Shareholder (or a Director, specified with appropriate powers in the Company Register)

to the Russian authorities or by post, however, the latter is not recommendable as it usually takes 1-2 months and is unreliable.

In addition to the above, the corporate documents (charter/by-laws, certificate of incorporation) must be legalized (apostille attached) in the

home country and then translated into Russian. Another common delay in the registration process is simply due to unfamiliarity of legal counsel of the parent company with this process of legalization.

**Joint Stock Company (JSC)**

There are some differences in the incorporation process of a JSC, known as ZAO by its Russian acronym, (see table of comparison below), for example it has the additional requirement of having its shares registered by the securities commission at incorporation. This legal form is best suited if the company is getting into a joint venture with non-affiliated partners.

**Representative Office and Branch Office**

Representative and Branch Offices are not independent legal entities, but rather “sub-divisions” of the parent company. A Rep Office can not engage in commercial activity, but a Branch may. In the past, many Rep Offices carried out commercial activities, without any negative consequences as long as they paid the relevant taxes, but it is now less common to establish a commercial Rep Office.

The “accreditation” process as it is called in Russia can take much longer for a Rep/Branch office than an LLC or JSC. This is so because the “accreditation” process (registration with the state) is separate from the tax registration process, and as such, the whole process can take 6 to 8 weeks; however, there is the possibility to opt for a “fast track” process.

There are some advantages of doing business via a Rep/Branch office, such as the ease of moving currency out of Russia and obtaining work visas for staff. However, some activities may be limited or more troublesome, such as the import of goods or certain licensed activities.

A comparison of Legal, Financing, and Tax Aspects: Russian Legal Entity (RLE) vs. Branch or Rep Office

**2. Funding your operations**

Once you have made the decision to set up in Russia, some thought should be given to funding your start up and ongoing expenses. There are a few options for financing your operations to consider:

<sup>1</sup> Applicable taxes: Profit tax (20%); Social tax (34% from 2011); Property tax (2% per year); VAT 18%.

RLE	Branch/Rep Office (B/R O)
<p><b>Legal</b> A separate legal entity that bears its own liabilities.</p>	<p>Liability is borne by the Head Office or Parent company.</p>
<p><b>Financing and Repatriation of Profits</b> The start-up activities and working capital requirements of the RLE can be financed by the following methods: Charter capital, Loans, Parent (shareholder) financing. Dividends and return of loans can be viewed as forms of repatriation. Service contracts, royalty payments and other similar transactions can also be forms of repatriation. In this arrangement, VAT and income tax withholding, as well as increased foreign currency controls when moving funds out of Russia, are a concern.</p>	<p>There is no tax due on repatriation of profits after tax<sup>1</sup>. Funds are sent to B/RO from the Head Office to finance operations à income from sales in RUR received into ruble account of B/RO à RUR converted into foreign currency and repatriated. The B/RO is responsible for filing and paying taxes. There is better control of the flow of funds when needed as there are fewer applicable foreign currency regulations.</p>
<p><b>Accounting Compliance and Tax Filing</b> In general the accounting requirements are bit more burdensome for RLE as quarterly financial statements must be prepared as well as full tax accounting, including VAT.</p>	<p>B/ROs are allowed to file and pay quarterly profit taxes. This is an opportunity for tax planning. No value added tax (VAT) accounting is necessary if there is no commercial activity and VAT is recognized as a cost. It should be noted that if a BO or RO engages in commercial activity then full tax accounting and reporting is mandatory. The accounting requirements are not as burdensome – there are no quarterly financial statements, but an annual report on activities (includes quasi financial statements). Rep Offices which do not carry out commercial activities are exempt from VAT on their rent payments.</p>
<p><b>Foreign employees</b> The RLE would need to apply for permits (for the Company and for the employee) and, in addition, register with the Migration Services to issue work visa support. It should be noted that foreign employees earning more than 2 mil. rubles (approx \$66,000) per annum can qualify for a simplified work permit procedure that is valid for 3 years</p>	<p>Current regulations require B/RO to obtain work permits for foreign employees. However, in practice some companies ignore this without serious practical consequences but there are in fact serious penalties for non-compliance. If the B/RO deals with government agencies e.g., customs, then the permit should be obtained. The procedure for obtaining work visa support is simpler – i.e., the foreign employee can be in Russia on the proper work visa even if he/she does not have a work permit. The 3-year simplified work permit only applies to Branch offices and not Rep offices.</p>

share capital; loans; parent-subsidary financing; cost + arrangements.

The statutory **share capital** for a Russian legal entity is rather small (approx. 220 Euros). There is now a draft law that will significantly increase this cost in the near future and some companies choose to put a lot more funds in at the beginning or after incorporation. This type of funding is not very attractive, as your funds are stuck in Russian rubles, with all the related currency risk. Also, having significant cash at the disposal of your local managers provides “opportunity” – one of the prerequisites for fraud.

**A loan** is a popular option because it allows for better cash flow management – cash can be sent in tranches when needed and can be re-paid if there is excess cash in the subsidiary. As such, the currency risks and risk of fraud are reduced. In addition, if structured properly, interest on the loans can be charged to profits, reducing your taxes payable. It is also important to observe the thin capitalization rules.

**Parent-subsidary financing** is a non-taxable contribution to the capital of the subsidiary by a parent owning more than 51% of the equity of the subsidiary. Apart from the benefit of managing cash flows and currency risks as with loans, this form of financing does not require statutory registration of the increased capital and increases the equity side of the balance sheet. This is also a good solution to improve your net asset position, when required by law.

**Cost+** arrangements are becoming more popular as a means of financing a local subsidiary, which is not trading locally. For all intents and purposes, such a subsidiary acts like a rep office but does not have the legal risks accruing to the Head Office. In addition, the “+” aspect is treated as taxable income, therefore, the entity is not making any loss and does not come under undue scrutiny from the tax office. Basically, the subsidiary “charges” the Head Office for all costs (rent, salary, marketing) + a markup based on their internal corporate practice and local market practice (5 to 25%). Taxes are paid to the local budget based on this “profit.”

### 3. Finding a Manager – local or expat?

Many companies enter the market, and based on bad advice, spend a lot of money only to close in 12 to 18 months. Getting good advice and information from your manager on the ground is key. Should you

hire a **local (Russian) manager**, with a clear understanding of the local culture and business ethics? In addition, he/she may be well connected, making it easier to solve problems when they arise. The disadvantage of this option is that the talent pool for managers is still relatively small in Russia and even as a SME, you will be competing with the big firms and be expected to pay top dollars to managers.

Presuming that as an SME there is no budget to import a high-level expat, along with family relocation costs, another option is to find **an expat already settled in Rus-**

**sia**, ideally, with a Russian family and looking to stay for a while. These candidates usually speak Russian and have a good understanding of the Russian culture and values. They may have good connections and have worked for startups before, so understand the needs of SMEs on a tight budget. The downside of this group of candidates is that they tend to be entrepreneurial and looking to set up their own business and may not be a long-term solution.

One other option that has become more popular is bringing **a young expat over from the home country**. Usually not married, ambitious, and looking for international experience, they are usually willing to give 2 to 3 years, with relatively low pay to gain this experience. Salary can be relatively low, but given that the personal tax in Russia is only 13%, they have more take-home pay than in Europe. In this case, the employer is expected to provide a flat for the manager, but not the expensive “Pokhovskiy Hills” type.

## 4. HR issues in Russia

As we mentioned earlier starting with the right people is crucial to your success (or failure). As a general point the labor market in Russia has changed significantly since the collapse of the former Soviet Union. We can observe that 20 years ago staffing was not a problem, but what was an issue was a shortage of skills. Now, we almost have the reverse situation, where in today’s market there is generally not a problem with skills, but there is an issue in finding available staff. So one of the key challenges for an owner of an SME entering Russia is to find talent and then to develop and retain this “top talent”.

It is generally well accepted that Russia has a very well educated work force and that many young people are innovative. One successful owner told

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**When entering the Russian market one of the first decisions for an SME will be whether to do this alone or to find a local partner and establish some form of joint venture.**

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us recently that in his view “Russia is a laboratory of ideas”. This is a good starting point for an SME as by its nature the business may be an attractive place to work but the challenge is to attract good people. We therefore find that many SMEs succeed in attracting good people by offering a good working environment; consensual decision making; attention to training and development, and maybe some form of ownership participation. With regard to talent retention and motivation, salary is still the biggest factor. However, job satisfaction and career growth are growing in significance. With regard to additional employee benefits, private medical insurance has become the norm even for SMEs. Meal allowances and compensation for use of mobile telephone are also becoming more popular. What we hear from successful SME owners is that if you show trust in people, then they will respond more than adequately.

When establishing your business in Russia it is certainly worth keeping in mind that you are a “visitor”. With this in mind you should be able more easily to create the bridge between the Russian and European cultures. For, example what may seem a small thing for a foreigner may be a very big thing for your local employees. Since the early 2000s, as Russia has become more integrated into the world economy and a younger generation has entered the work force, Russian professionals have become attuned to what “international-standard service” means. Also, we see it is generally easier to find staff with foreign language skills in addition to professional qualifications. However, as mentioned before, it is still quite a challenge to find talent. What we have been told by successful owners of SMEs is not to underestimate the importance of treating people well, being appreciative and having a good working environment. Also, be open with people and let them know what is happening and treat people with the respect that they deserve. It is as true in Russia as in many other countries that the main capital of the business is not the money but the people.

## 5. Accounting and Taxation

There are several systems of taxation in Russia. The most frequently encountered include the following:

- **General system of taxation** – may be applied by all types of legal entities. All taxes and appropriate tax rates (in case of existence of a certain tax base) will be applied.
- **Simplified system of taxation** – was implemented specifically for SMEs and can be applied by legal entities, where the total annual revenue does not exceed 60 million Rubles (this number is

not fixed and may vary from year to year). There are several other limitations, including one that says a corporate shareholder cannot own more than 25% of the shares (i.e., a 100% subsidiary of foreign legal entity does not qualify). The tax rate is 6% (if tax basis is revenue) or 15% (if tax basis is profit). Revenue and expenses are to be calculated on a **cash basis**.

Taxes and tax rates applied under the General system of taxation are:

- **Value Added Tax (VAT):** The tax base is the amount of VAT-able sales. General tax rate is 18%; for certain groups of goods – 10%; export operations – 0%.
- **Corporate Profit Tax:** The tax base is the difference between income and expense, calculated in accordance with the rules of **tax accounting**. Tax rate is 20%.
- **Property tax:** Tax base is historical cost of Fixed Assets of the company decreased by the amount of accumulated depreciation, calculated in accordance with rules of **financial accounting**. A fixed asset is an asset that costs more than 20,000 rubles (exclusive of VAT). The tax rate depends on the region of Russia, but cannot exceed 2.2%.
- **Personal Income Tax:** The tax base is all forms of compensation (with some exemptions) paid by the employer for the benefit of the employee. This is the employee’s personal obligation; the tax rate is a flat 13% for residents and 30% for non-residents.
- **Social insurance payments:** The tax base is all forms of compensation (with some exemptions) paid by the employer for the benefit of the employee. This is the employer’s only obligation; the tax rate is 30% for 2012. There is also an additional 10% for employees that earn over a certain threshold. It should be noted that recent changes to the law applies this tax to foreign employees on a work visa unless they are on the Highly Qualified work permit.

Submitting tax returns and financial statements. Local tax authority.

Every company is obliged to prepare financial statements using its accounting data. Financial statements shall include a balance sheet, Profit and Loss statement (P&L), related addenda, as well as notes to statements. Financial statements shall be signed by both the chief executive and the accountant of a company. These documents must be approved by the Meeting of Participants at the annual meeting.

Every company shall provide quarterly book-keeping reporting within 30 days upon the expiration



of the quarter and the annual bookkeeping reporting within 90 days upon the expiration of the year.

A financial year for Russian companies must be the calendar year. Interim quarterly statements shall be made containing the progressive total starting from the beginning of the financial year.

All legal entities should also submit tax returns to the local tax authority. All reporting dates for every tax declaration are strictly defined. Companies may submit all documents manually by visiting the tax office, via internet using special software, or simply sending them by post.

If the company is late in submitting even one report, the local tax authority has the right to block the company's bank account and to keep it closed until the company submits the report. The bank account may be blocked for many other reasons such as unpaid taxes, fines, penalties, etc. Very often, outstanding tax obligations exist only in the computer records of tax inspectors and not in reality. This is due to poor administration and low levels of qualification of the staff of tax inspectorates and, as result, they block the company's account without any legal basis. It can take considerable time and energy to settle this problem, so in order to avoid any interruption in the company's activity, we strongly recommend a reconciliation of all balances concerning tax obligations with the local tax authority, at least once every 6 months.

### **Financial and tax accounting.**

There is a pronounced difference between financial and tax accounting in Russia. **Financial accounting** includes all information concerning the economic activities of a company and on the basis of this information, a company will prepare financial statements – including profit and loss (P&L), Balance Sheet and Cash Flow Statements.

**Tax accounting** is being used only for calculating Corporate Profit Tax obligations. It should be noted that most Russian accountants focus on tax accounting since this is what the tax office is most interested in. As such, very often the financial statements prepared do not accurately reflect the company's financial standing.

Companies must take into account that financial results (profit) in accordance with financial accounting will differ from the profits calculated in accordance with tax accounting requirements because there are differences between methods of recognizing income and expenses for financial and tax accounting purposes. In other words, some expenses

may not be allowed as deductible expenses in tax accounting. The same may be true for recognition of income.

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**The major value of SMEs, and where Russia could really benefit, is the SME's ability to empower people to make a difference in other people's lives. Allow a person to start his own business, and he can provide for not only himself and his own family, but also create more opportunities for others to provide for themselves and their families.**

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### **6. Closing down your business in Russia**

Before making a commitment to set up in Russia, it is important to understand what it takes to liquidate or of-

ficially wind down the legal presence. The words from the song "Hotel California" come to mind when it comes to this issue – "you can check out any time you like, but you can never leave." Before investing in setting up a legal presence, be aware that closing down a legal entity or rep office can take from 6 to 12 months and can be quite expensive. The main problem is reconciling your tax records with the tax office. As mentioned, the tax administration is still quite bureaucratic and records may not be easily accessible due to technical difficulties. This can result in repeated visits to the tax office to clarify the status of taxes filed and paid.

Nearly all aspects of start up and ongoing compliance (legal and tax/financial) require either hiring one or more individuals, or outsourcing. Either way, it is a real cost when it comes to Russia and it doesn't wait for your sales to come in. For some businesses, working initially via a distributor or other partners, or simply working directly from the home office for a period – until business revenue can be more clearly projected – may be a sensible first step.

For those who are ready and committed to fully entering the Russian market, this overview has hopefully provided some basic guidelines to better prepare you for discussing the process with professional service providers. To become a successful business in Russia your company needs to develop an excellent reputation in terms of the major stakeholders - employees, customers and investors. We wish you every success for your business in Russia.

## INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA

### Update on foreign Investments in Strategic Sectors in Russia

Alex Stoljarskij, Attorney, Beiten Burkhardt



**Alex Stoljarskij**

Alex Stoljarskij is a Senior Associate with BEITEN BURKHARDT law firm in Moscow, which he joined in 2006 and an attorney admitted at the District Court of Berlin. After graduating from the University of Bayreuth with a degree in law (2002) and in economics (2003) he completed legal traineeship at the Higher Regional Court of Berlin and worked with the German Ministry of Foreign Affairs in Tashkent and in New York City. Alex is an active member of the German-Russian Chamber of Commerce and chairman of the Legal Committee of the Association of European Businesses in Russia. As a representative of the AEB he participated in the legislative process of drafting the Law regulating foreign investments in strategic sectors in Russia at the State Duma and published numerous articles related to foreign investments in Russia. Alex's clients include large and medium size corporations in the automotive, health-care, machine engineering as well as media sector where he advises in Corporate law, M&A and Joint Venture projects. He is also supporting Russian clients in expanding their business towards Germany.

Federal Law No. 57-FZ "On the Procedure for Foreign Investments in Business Entities of Strategic Importance for National Defense and State Security ("Strategic Investments Law" or "the Law") allows a foreign investor to establish control over a Russian enterprise conducting activities in a strategically deemed sector only after preliminary approval has been obtained from a Government Commission.

Actual implementation of the Law, since it came into force in 2008, as well as restrictive court practice, caused concern and criticism among foreign investors. In a bid to liberalize the Law, a number of amendments were introduced by Federal Law No. 322-FZ, which came into force on 18 December, 2011.

Actual implementation of the Law, since it came into force in 2008, as well as restrictive court practice, caused concern and criticism among foreign investors. In a bid to liberalize the Law, a number of amendments were introduced by Federal Law No. 322-FZ, which came into force on 18 December, 2011.

## I. Basic provisions of the strategic investments law

### 1. Foreign investor (or group of entities, which includes a foreign investor)

a) The concept of «foreign investor» is used in accordance with the definition provided in Federal Law No. 160-FZ "On Foreign Investments" ("The Law on Foreign Investments"). Organizations controlled by foreign investors, including organizations established in the Russian Federation, are likewise recognized as such. The Strategic Investments Law distinguishes between foreign private and foreign state investors. The latter are subject to more stringent rules in respect of the acquisition of participation interests. The term "foreign state investor" also applies to organizations that are directly or indirectly controlled by a foreign state.

The concept of "group of entities" is used in accordance with the definition provided in Federal Law No. 135-FZ "On the Protection of Competition". A group of entities is understood to mean individuals or legal entities that are perceived as a single subject of law owing to their affiliation, specified by certain criteria.

### 2. Establishment of control

a) The establishment of direct or indirect "control" over an entity of strategic importance is a key criterion for determining whether the acquisition should be subject to the Law. One of the following serves as indicia of control:

- the purchase of a "controlling interest" (usually more than 50%);
- the right to select the single executive body of a company and/or at least half the members of a collegial executive body or of the board of directors;
- the right to control the company's decisions by other means.

In respect of a foreign state investor, approval is required if the proposed transaction will result in the right to manage, either directly or indirectly, 25% participation interest of the company of strategic importance. The acquisition of over 50% by a foreign state investor is prohibited.

b) Special rules apply to enterprises, which use subsoil plots of federal significance (in other

words, major deposits). In this case, the establishment of “control” is now stipulated if the foreign private investor

- intends to acquire 25% participation interest or more
- or
- receives the right to appoint 25% or more of the members of the collegial executive body or the board of directors).

Certain exceptions are only permissible in cases where the Russian Federation owns an interest of over 50%.

While the former threshold for foreign private investors was significantly increased from 10% to 25% for, the threshold of 5% for foreign state investors remained unchanged.

### 3. Operating in a strategic sector

The Law on Strategic Investments lists 42 different types of activities that are deemed of relevance in strategic sectors such as:

- Nuclear power;
- The use of subsoil plots of federal significance;
- Data encryption technologies;
- Military technologies;
- Space exploration and aviation;
- Periodical print industry, television and radio broadcasting;
- Telecommunications;
- Natural monopolies;
- Activities stipulating the use of bacteria and other agents of infectious diseases;
- Commercial Fishery;
- Performance of work, which actively influences hydrometeorological and geophysical processes and conditions.

Both fishery and operations with hydrometeorological and geophysical processes represent sectors that have not been affected to date.

Most of the filed petitions (as of November 2011) concern investments in commodities (oil, gas and other natural resources), followed by activities related to encryption, radio and television, and also natural monopolies.

Most of the activities mentioned in the Law require a license according to the Federal Law No. 99-FZ «On Licensing Certain Activities.» Accordingly, the Strategic Investments Law states that a license to engage in an activity in a strategic sector is a sufficient criterion for the Law to apply. In these cases it is irrelevant whether turnover or market share in respect of the strategic type of activity are material or not. The possibility that such activity can (will) be performed, is sufficient.

## II. Sanctions in case of a violation

A legal transaction performed in violation of the obligation to obtain preliminary approval is null and void. Adopted decisions are held to be invalid. The parties to a transaction have to restore the original state of being, which could cause certain problems in practice.

The foreign investor forfeits the right to vote at a Russian strategic company if the transaction was performed abroad and cannot be declared void in accordance with Russian law.

The recent reform of the Law “On the Protection of Competition” (the so-called 3rd Antimonopoly Package), effective from 7 January 2012, introduced amendments to the Russian Code on Administrative Offenses. Now a fine is stipulated for the lack of approval in the amount of 500,000 to 1,000,000 rubles (and also for the non-submission or submission of false information further to a request from the Federal Antimonopoly Service – FAS)

## III. Consequences for foreign investors

Any participation of a foreign investor in a strategic company in the amount of 5% and more has to be declared to FAS within 45 days. According to the latest amendments to the Russian Code on Administrative Offenses, a fine is payable for the late submission of a declaration in the amount of 250,000 to 500,000 rubles.

A company may decide to implement certain reorganizational measures (e.g. separation from the “strategic” part of the company, if this part of the business is not of interest to the foreign investor) prior to the conclusion of an agreement on the purchase of a controlling interest. However, if the strategic part of the company is separated solely for the purpose of avoiding the application of the Law, FAS holds the position that in such cases it will want to review the deal and collect information. This is all the more so, if the renewal of the strategic activity in future appears possible. It remains unclear, however, which criteria is used by FAS to determine whether the separation from the strategic activity occurred definitively or only temporarily.

Another practical consequence is that the deadline for the adoption of a decision by the Government Commission (three months – or in exceptional circumstances six months) only starts to be counted as of the complete submission of all documents. Numerous petitions filed at present are incomplete. FAS may demand additional documents in order to clarify all the facts of the case or the relations of the participants and identify the final beneficiary.

Within the framework of a Due Diligence, it is necessary to verify at the beginning of the transaction structuring whether the Strategic Investments Law is applicable.

A share purchase agreement should contain a condition precedent regarding the receipt of approval from the government commission. The agreement should also stipulate provisions for instances where such consent is not received

It may well be impossible to quantify how many deals have been put on hold – or abandoned – as a result of this legislation. At the same time, however, despite the positive outcome of the decisions adopted by the Government Commission so far (Status as of November 2011), where 129 out of 137 filed petitions were approved and only eight were dismissed, one should not ignore the fact that the adoption of decisions on investments and capital flows into the Russian economy has slowed in recent years. The approval process (let the significant costs for legal advise aside) can take so long that an envisaged deal loses its economic appeal and momentum, while at the same time, a vast amount of information (as well as confidential company secrets) has to be submitted by the applicant to the federal authorities.

## IV. Reform of the strategic investments law

### 1. Exclusion of international financial institutions

International financial organizations established in accordance with international treaties, of which the Russian Federation is a member or International financial organizations with which the Russian Federation has concluded international contracts, are now excluded from the application of the Law. This amendment was long awaited and does not provoke any further questions.

Government Resolution No.119-p dated 3 February, 2012 approves the list of international financial organizations excluded from the Law. This includes for example:

- International and European Banks for Reconstruction and Development;
- International Bank for Economic Co-Operation;
- International and European Investment Banks;
- Black Sea Trade and Development Bank;
- Eurasian Development Bank, etc.



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## 2. New threshold values for the use of natural resources

The aforementioned increase in the threshold for enterprises in respect of the operation of subsoil plots of federal significance – from 10% to 25% of votes attributable to voting shares (interests) and the right to appoint now up to 25% (instead of 10%) of the members of the collegial executive body or the board of directors was also a long-awaited change, which will serve stimulating foreign investments in this area. This change can indeed be cited as a significant liberalization of the Strategic Investments Law and deserves to be recognized as such.

## 3. Approach to “purely Russian” legal transactions

An exception is further made for transactions concluded between companies under the control of the Russian Federation or Russian citizens. This refers to companies and Russian citizens that are deemed Russian residents in accordance with Russian legislation on taxes and duties (with the exception of Russian citizens, who have dual nationality). However, in the adopted version, this rule actually exempts foreign investors under the control of the Russian Federation or under the control of citizens of the Russian Federation and has no bearing on foreign investors that are not under such control.

Let us assume that this norm, which was introduced by Presidential Decree, has a different meaning and that the word «between» refers only to the control of the acquiring side, and also, that this provision was possibly intended as a solution to issues arising from a very controversy court practice relating to the definition of «group of entities, which include a foreign investor».

If a foreign investor under the control of a Russian beneficiary can purchase any shareholding in a strategic enterprise (including the subsoil user) without prior approval pursuant to the procedure prescribed by the Law from the foreign investor of a group of entities under the control of another Russian beneficiary, then respectively, transactions within the group of entities under the control of the

Russian beneficiary, in respect of subsoil of federal significance, can also be implemented without the prior approval of the Government Commission.

Consequently, this rule removes the administrative barriers preventing the beneficiaries from withdrawing Russian assets in offshore accounts, which is at loggerheads with the position of the government, which wants to reduce the possibility of transferring assets to offshore jurisdictions.

FAS is already aware of difficulties in this regard and is currently working on amendments to these newly introduced amendments which means that we may soon expect further developments in regulating relationships and agreements within a group of entities, which include a foreign investor.

## 4. Exclusion of certain activities previously deemed strategic

As mentioned earlier, owing to the verbatim interpretation of the Law by the authorities and courts, the Law was applied in situations where national security and defense were not endangered in any way.

Consequently, the legislator decided to rule out certain activities. In future, a foreign investor does not have to undergo the approval procedure if the investor acquires a controlling interest in an enterprise that uses equipment that issues insignificant radioactive emissions in the civilian sector, unless it is the main area of activity of the acquisition target. Medical institutions that use such devices (e.g. X-Rays) are herewith finally excluded from the application of the Law.

The application of encryption systems will continue to be of strategic importance. However, an exception will be made for banks in this area, as the use of encryption technology is not a core activity itself for banks, but is essential for the provision of certain financial services.

Contrary to general expectations, the use of bacteria in the food industry sector classified as fairly safe was not excluded, as the Head Physician of the Russian Federation opposed said exclusion. However, FAS states that it is continuing work in this area, as acquisitions of dairy plants or breweries, which naturally acquire licenses to use bacteria and

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**The recent reform of the Law “On the Protection of Competition” (the so-called 3rd Antimonopoly Package), effective from 7 January 2012, introduced amendments to the Russian Code on Administrative Offenses. Now a fine is stipulated for the lack of approval in the amount of 500,000 to 1,000,000 rubles (and also for the non-submission or submission of false information further to a request from the Federal Antimonopoly Service – FAS)**

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currently fall under the Law, are not a target of the Strategic Investments Law.

## 5. Other innovations

Furthermore, the amendments specify that no additional approval is required to increase the charter capital of strategically important enterprises, which use subsoil of federal importance, if the increase does not result in an increase in the total number of votes of the foreign investor.

Most of the other innovations concern primarily procedural issues and have no effect on the overall approval process. It is worth mentioning here, however, that if the Government Commission approves a deal under certain conditions, which have to be fulfilled by the foreign investor, FAS can now conclude a corresponding agreement with the foreign investor that regulates its obligations without forwarding the agreement for a second time to the Government Commission for approval. Officials claim that this will reduce the whole process significantly, taking into account the fact that the Government Commission meets approximately once every three months.

## V. Evaluation

At first glance, the list of activities in strategic sectors would appear to have clearly defined boundaries. However, the list of activities contains a different level of detail, which leads to varying interpretations among market participants, the state officials involved and naturally the courts. This also results in uncertainty and unpredictability, which contravenes the explicitly stated goal of providing clear “rules of the game” for foreign investors.

We can still identify instances where the Strategic Investments Law has not been harmonized with the Law “On Licensing Certain Activities» in respect of certain types of activities. For example, while activities in the nuclear power sector requiring a license are named identically as in the corresponding law regulating licensing in this field, activities in the aviation sector or space sector have not been clarified, which provides room for (different) interpretation.

Furthermore, some issues remain unregulated by the Law, but result in certain complications in practice. The establishment of new companies is not regulated in the Law as such. Consequently, it is possible that a foreign-controlled Russian subsidiary performing a strategic activity could be established in future. Verbatim, the Law would not be applicable, as it only mentions instances relating to the “acquisition of a participation interest” and not the incorporation of a fully or co-owned subsidiary.

At the same time, however FAS states that the Strategic Investments Law may be applied during the receipt of a respective license for the performance of “strategic” activities. However, it remains unclear how the Law would be applied in this case, as at present there is no corresponding legal mechanism that would allow for such application.

The inflexible approach on penalty sanctions is another issue that should be reviewed. It is not always in the interests of the Russian Federation to consider every deal performed in violation of the Law as null and void. There could be instances where it would make sense to allow for a post-approval process.

In conclusion, most of the amendments are desirable and necessary. However, we have been waiting for a long time for declared concessions for foreign investors making investments in Russia.

Before introducing amendments to existing legislation to enforce the new legislation, it would be good to see that a comprehensive assessment has been performed in respect of the consequences and impact that such new legislation has on the legislation in force. Such an assessment should be prepared by independent institutions and make it possible to avoid certain contradictions in the legal framework and unexpected results in practice.

It would probably be wishful thinking to assume that the approval procedure per se will be shortened significantly and that the amount of documents and comprehensive information deemed necessary may be reduced. By elaborating a simplified and more time-effective approval procedure, both the Russian State and foreign investors would benefit from the stimulation of the flow of foreign direct investments. Nevertheless, it is good to see that at long last the vast majority of deals reviewed by the Government Commission have been approved. Against the background of the prevailing government policy of modernizing the Russian economy and liberalizing access for foreign investors, we hope to see further changes that make it possible to quickly transfer investments into attractive industries, even if they are subject to the Strategic Investments Law and require a certain level of government attention and review from the perspective of state security.

## Why invest in Russian real estate?

By Konstantin Lysenko, Associate Director, CBRE



### Konstantin Lysenko

Konstantin Lysenko has over 17 years real estate and corporate finance experience. Before joining CBRE Capital Markets in October 2007 Konstantin was the CFO of Kalinka Realty (Moscow residential real estate brokerage and investment

firm) where he has gained deep understanding of the residential real estate development business and brokerage operations. Prior to that, he was holding executive positions in Norman Asset Management Ltd (the retail development group) and simultaneously was the CEO of the project company for the regional retail center development in Yaroslavl successfully launching Real', anchored hypermarket center "Vernisage". His corporate finance experience includes work in Credit Suisse, Nafta Moskva and Uralsib. In real estate Konstantin has an extensive experience in development, finance and brokerage operations. Konstantin has graduated from the Moscow Finance Academy in 1995 with the diploma in international economics. Konstantin is the member of RICS.

Rather than enumerating reasons why companies need to drop what they're doing and invest in Russian real estate, I have a simple, if somewhat unexpected message for foreigners: don't come to Russia unless you really need to. Instead of buying property because you've always believed that Russia's underdeveloped market makes it a gold mine, stop and think about what kind of business you really want to start here.

In other words, if your company has developed a long-term strategy for producing a niche product that will generate revenue, particularly, given that Russia has just joined the WTO, then, by all means, it's time to consider picking the right real estate asset for your needs – and this article will provide some tips for doing that.

### A different playing field

The latest wave of political uncertainty isn't the problem – it's the outdated hypothesis that Russia, as a BRIC country, will lay golden eggs no matter what you do here. Post-crisis economic realities

have changed the country. As a result, the focus has shifted from investing in real estate assets for short-term speculative reasons, like buying into a portfolio of development projects, to developing a business strategy that will bring long-term value in a volatile environment.

Let us look at some of the changing realities.

Prior to the crisis, during the first decade of the millennium, some 70% of Russia's institutional commercial real estate market was dominated by foreign players. This significantly helped to set up an efficient and transparent business structure. But after the shake up of 2008 and 2009, the picture transformed considerably. During the crisis, many foreign businesses packed up and left for home markets. Local capital – having learned all it could from foreign business – took over. Now, in terms of transaction volume, 70% of the market is dominated by domestic players.

That has markedly changed the playing field for foreign investors. Where a foreign company could once count on virtually guaranteed success, it is no longer king of the hill. Foreign capital can complement Russian business through joint ventures and by contributing know-how. Or it can expand into niche markets. But it can no longer take the central positions that it once held.

Simply put, Russia's market is over-invested. There are enough players, there's enough capital, and the real estate market is developing to accommodate business needs.

The retail sector is one example of how these changes are taking effect. Just two or three years ago, it was still believed that Russians had an insatiable demand for shopping, ensuring success for any quality retail project. But it turned out that the Russian market wasn't big enough for two major French retailers, Auchan and Carrefour. Auchan established itself on the Russian market in 2002, expanding its business to include nearly a hundred stores now. But when Carrefour entered the market in June 2009, it was forced to pull out just four months later, citing nearly a 3% drop in revenues. Slow decision making and an inability to expand its business to a larger scale made it impossible for Carrefour to survive and prosper.

This is helpful to consider when you plan your strategy – whether your business is selling groceries, building tractors or making hamburgers. The market is no longer about creating a real estate as-

set – today; it’s more about production assets and generating operational profits.

**Local realities that can make – or break – your business**

One feature in particular has consistently attracted investors to Russia’s market – though businessmen rarely point to it publically. The truth is, despite perennial complaints of red tape, there is considerably less regulation in Russia, particularly when it comes to building a facility in the regions. Companies all over the world like being able to come into a market, meet with the prime minister, the governor, or the mayor and agree the particulars of an industrial site. In France or in Italy, these negotiations could be prolonged by a number of regulations that simply don’t exist in Russia – or are easily overlooked if they do.

Take, for instance, the political scandal over suburban Moscow’s Khimki Forest, where a government-backed consortium led by French construction giant Vinci began building a new highway to connect Moscow and St. Petersburg. Residents and environmental groups staged massive protests in the forest – many of them were suppressed

by police, and plans were temporarily suspended. But eventually the Supreme Court and the public body headed by President Medvedev decided to go ahead with the project as planned. The decision was difficult and had considerable political risks as local residents and environmental activists unleashed an efficient and widely publicised campaign to stop the highway.

This case shows how easy it is for developers and investors to achieve success when they are committed and know what they are doing.

But on the other hand, in a market with few entry barriers, the investor can find himself in a very competitive environment. Russian business only favors the winners – and to become one you will need to focus 100% on your Russian project.

Think of the land runs in the American West towards the end of the 19th century. Russia’s market saw something very similar about 20 years ago. Today, the assets that were grabbed in the post-Soviet era require expertise, capital and attention from those who know exactly what they’re doing.

So before you bring your tractor factory to Russia, consider the region not just in terms of real estate plots for your enterprise, but the market for your product. Don’t get seduced by the outdated

Реклама



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idea that your money will get you anything you like – Russia no longer needs investors as much as it needs people willing and capable to produce something of value.

## Planning your real estate strategy

Once you are confident about your business strategy in Russia, you will need to extrapolate that strategy towards real estate investment. Depending on what product or service you are selling, you will need to choose from an office center in a large city, or an industrial, logistics and retail facility in the regions. The key factor is that whatever real estate facility you are investing in – whether as a dweller or an investor – it must be located close to your customer or resource base. At the same time, you need to be absolutely certain that you will also find the workforce you need to get the industry or business you are funding off the ground. While securing locations for their properties, investors in several industries are already taking advantage of regional programs that can work with their businesses to facilitate infrastructure and industrial development. These programs are already successfully in place in Central Russian regions like Lipetsk, Voronezh, Vladimir, Ulyanovsk and Kaluga. The advantages offered in these areas include pre-fabricated real estate products that can save you time and resources in developing your facility, making the task of agreeing on infrastructure and utilities far simpler than in Moscow. Generous investment into infrastructure and an efficient business approach by the Kaluga regional government, for instance, have already helped companies ranging from Volkswagen and Volvo to Samsung and L’Oreal to succeed in its industrial parks.

If your consumer or resource base forces you to operate in more remote areas, finding the right real estate solution will take some expertise and consideration. Investors will have to either acquire an existing property, building the facility from scratch, or redevelop an existing building to suit their needs.

Because the supply side of the property market is still underdeveloped, finding the right property can turn out to be difficult and costly. Regardless of the sector, an office, retail or logistics building nominally in the Class A category could actually wind up costing more than an analogous property in Europe – while its characteristics place it firmly in the Class B range. Simply put, you could be getting less for more money. As a result, most investors opt to build properties from scratch or renovate existing facilities.

Finding a sturdy Soviet-era facility and renovating it – particularly in the industrial sector – may be one solution in cases where quality space is not available. The advantage to this approach is that your business can have a ready-to-use property a lot faster – but not necessarily cheaper – than if you built from scratch.

If your business is investing the time and resources to build or renovate a property, it is not enough to simply construct a box where your company will work for the next 10 or 15 years. Your business also needs an exit strategy, and it is wise to start thinking ahead about creating an asset that can be sold for leaseback, refinanced, or otherwise disposed of with an economic benefit for your business. That will mean that some more work will need to go into planning the financial and corporate structure of the project. For instance, it will be easier to sell the property as a whole business – in other words, if the legal entity that owns the property is sold part and parcel with the building. It goes without saying that a tax-efficient project will be easier to sell or refinance for better value than a project where this issue has not been considered.

The bottom line – one that is often forgotten when investing in Russian real estate – is that your property is merely a continuation of your business. The value you will get from your real estate depends on the strategic viability of your business as a whole. When investing in Russian real estate, think business – not property.

## Recent changes in the Construction rules and regulations and permitting procedures that can influence direct foreign investments

Andrey Sosnovsky Ph.D., Area Director, Tebodin Eastern Europe B.V.



### Andrey Sosnovsky Ph.D.

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Experience: Researcher at the V.M. Glushkov's Institute of Cybernetics of the Ukrainian Academy of Science (1985-1987), Professor and leading Researcher at the Department of Computer Science, Ukrainian Academy of Science (1987-1994), founder and Director of consultancy firm 'Kyiv Management Konsult' LLC (1995-1996), and investment and consultancy firm 'KMK Investment Management LLC' (1996-2000); Head of Consultancy Department (2000-2001) and Managing Director (2001-2009) of Consultancy and Engineering Company 'Tebodin Ukraine' CFI; Managing Director, Chairman of the Management Board of 'Tebodin Ukraine' and 'Tebodin Eastern Europe B.V.' (2009-date).

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ment of the legislation in the field of construction and construction related activities. A review of the legislation replaced extremely regimented and government controlled permitting procedures, and transferred significant regulatory powers based on the self-regulation principles to other market players.

As a Consultancy and Engineering Company that renders services related to implementation of large-scale industrial projects, we feel there is a need for improvement in the Construction Regulations and we welcome positive changes in this regard. Issues covered below we consider the most promising steps towards the liberalization of legislation for construction related activities.

Of particular interest is the fact that since January 2010, the system of licensing procedures in construction has been replaced with a regulatory approval system, which means that non-profit organizations involved in surveying, design and construction are authorized to issue permits for construction related activities instead of government bodies.

It does not mean that the process of company registration and obtaining permits for design and construction activities no longer has any obstacles. On the contrary, there are still many bureaucratic procedures, but the process itself has become more logical and simplified.

According to the new rules, the procedures for performance assessment of the employees of design and construction organizations have changed significantly. Further harmonization of laws and regulations on the assessment of employees is also taking place. For example, under consideration is a draft of a Decree on the introduction of companies' internal assessment, which is an equivalent of the assessment performed by the government bodies. If this decree comes into effect, it will obviously be a huge step towards liberalizing the construction legislation.

It is important to note the positive changes in labor regulations for foreign citizens. In order to guarantee the compliance with European and International construction standards and also sharing of experience, foreign workers can now be engaged to this effect (including citizens of non-CIS states) by means of simplified procedures due to significant changes in the immigration law (introduction of the highly-qualified employee status). What does it mean? Some of these changes include such "minor" things as

Ambitious programs for attracting foreign investment in Russia, especially, in its production sector, resulted in a significant liberalization and improve-

- obtaining a working permit for a period of up to three years instead of passing through the tedious annual procedure;
- simplification of the registration procedure when crossing border;
- removal (almost complete) of quotas for highly-skilled workers;
- last but not least, the possibility of obtaining residence permits not only for the workers, but for their family members as well.

Moreover, the Ministry of Education jointly with representatives of the construction and design community approved the procedure for validating foreign degrees and advanced training certificates by Russian supervising authorities such as Rostechnadzor. As a Dutch (and multinational) company we have felt the positive effect of such innovations. These are some of the most obvious positive examples of changes in the labor legislation.

Energy efficiency and energy audits of the enterprises represent a separate important field of activities. As of 2010, according to the new legislation, this function has been assigned directly to the market players and is managed based on the self-regulation principles. As of 2013, measures for energy efficiency and the related design activities will be compulsory for both the design and construction on most of the projects.

Nowadays, the harmonization of construction terms and definitions is taking place at all the levels of legislation; for example, following the approval of the revised SNiP "Organization of Construction", which gives definition to the "Technical Client", on November 28, 2011, this term was then introduced to the Town-Planning Code of the Russian Federation. A distinct classification of the construction parties has been set at the level of the federal law, putting an end to the previously existing confusion in terms and definitions and unnecessary detalization of parties' roles in the contracts.

In order to attract private investments, including foreign ones in the development of production facilities, the state monopoly on expert review of design documentation has been eliminated. The Regulation on non-governmental expert assessment of design documentation comes into effect as of 1 April, 2012. Procedures for performing non-governmental expert assessment of design documentation, as well as procedures and conditions of obtaining the status of expert organization will be described in more details in the corresponding regulations. Meanwhile, one can say with confidence that the principle of self-regulation and self-organization of the market players willing to perform non-govern-

mental expert assessment will be used as the basis. This innovation can result in a reduction of the assessment's duration, and consequently, a reduction of the construction and commissioning period. It is well known that the government's expert assessment period is strictly fixed at three months, even though the review itself often takes much less time. The change is literally revolutionary!

In addition, significant changes have been introduced into the structure and procedure of claims by construction (design) organizations, which should attract investors as all the participants of the construction process will have a clear understanding of the liability limits at different project stages. Professional indemnity is nowadays multi-level and cross-point: all the parties of the construction process are to some extent liable for the defects in their work which makes them act in a more disciplined manner.

All the above mentioned changes in the legislation have been introduced not only to attract private, notably, foreign investments in the construction sector but also to minimize the role of the state. This trend helps to solve another challenge that most investors willing to start their business in Russia frequently face – corruption.

In conclusion, one can say that law makers chose the way of detailed description of competences of all the parties taking part in the construction activities in exchange for substantial exclusion of government bodies from most of the construction related procedures or reduction of their power of control over permits (sometimes making them the same as those of the other parties).

As an active market player we cannot ignore all these positive changes. Our top managers and I personally, welcome these revolutionary steps and are very grateful for them. The process has not been completed yet, but all the changes already introduced make business procedures and the implementation of long term investment projects in Russia much easier.

## Pharmaceutical Industry and the Healthcare System in Russia: Opportunities and Challenges of Modernisation

Alexander Bykov, Director of Governmental Affairs & Market Access Department, Novo Nordisk; Andrey Meshkovsky, Member of the WHO Expert Advisory Board on International Pharmacopoeia and Pharmaceutical Preparations



### Alexander Bykov (MD, PhD)

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Before joining Novo Nordisk in 2010, Alexander Bykov since 1997 held positions of Market Access Manager in Servier, Governmental and Public Affairs Manager in Sanofi-Aventis, Health Economics Manager in Sanofi-Synthelabo CIS & Eastern Countries Area and Health Economics and External Affairs Manager in Merck Sharp and Dohme Idea, Inc.

He also has a vast professional record in international organizations and pharmaceutical associations (American International Health Alliance, Inc., Technical Assistance to the Commonwealth of Independent States and Association of International Pharmaceutical Manufacturers).

Alexander Bykov also worked in the healthcare system from 1982 through 1995 – as Associate Professor in the Clinical Pharmacology Department and as Deputy Dean of Faculty for Advanced Education of Physicians at the the Russian State Medical University.

A transition to the innovative model of pharmaceutical and medical industry development is one of the priority areas of the Russian economy modernisation programs. The importance of this task is conditioned not only by the necessity to provide Russian people with the high-quality medicines and medical products. The pharmaceutical and medical industries are actually among the most hi-tech sectors of the economy, where competitive capacity depends on the innovation level of the products manufactured. That is why their development may become a kind of a locomotive for the Russian economy overall.

The Russian government emphasised many times that the country's pharmaceutical and medical industry requires fundamental upgrading, in fact, the creation of a new sector of the economy, which would be attractive for investments and capa-



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sor, working for many years by now in the field of pharmaceutical quality assurance systems. A. Meshkovsky formerly worked at the World Health Organization Headquarters in Geneva as an officer of the Pharmaceutical Programme. Presently he is also an associated member, Executive Committee, Industrial Pharmacy Section of FIP (International Pharmaceutical Federation).

ble of generating innovations and creating efficient jobs. Most importantly, this sector would be ready to manufacture competitive, safe, high-quality and affordable products for the Russian patients and healthcare. The federal target program "Development of the Pharmaceutical and Medical Industry of the Russian Federation until 2020 and Further Period" rests on these provisions as well.

Shaping an investment climate and favorable business environment is a strategic goal in Russia's modernisation: – as the Russian Federation President, Vladimir Putin stated in his speech at the Russia-2012 Investment Forum, "We need to go up a 100 steps from the 12<sup>th</sup> position to 20<sup>th</sup> with regard to business environment conditions".

Market liberalisation is among the factors of dynamic market development and the creation of optimum conditions for investment. The accession of Russia to the WTO is a very important and positive for Russia, as it encourages harmonisation between regulatory documents and international norms and rules, including the customs and tax legislation. Most importantly, this accession will enable Russia to integrate into the global community and play a key role on the global market. Although one must remember that this is a long-term process and one cannot expect immediate results. The transition economies may require several years for complete

integration; however, the end result guarantees a breakthrough and the formation of a completely new market that ensures a standard quality and an availability of medical services.

Russia has absolute advantages. The Russian market is vast and very promising, although complicated. The Russian market is one of the few markets in Europe, where the gross domestic product keeps on growing (and where the gross domestic product per capita is from four to eight times higher than in China and India), along with the commercial activities (the “western” companies’ sales in Russia exceed those in China and India by 8-15 times). Only the Russian market is a European market among the rapidly developing markets of the BRIC countries. The market in Russia is especially profitable, because consumers, business and the state understand the value of the product quality and are ready to pay a high price for high quality. Again, the Russian market is currently favourable in terms of innovations and has good prospects for the development of innovative business activities.

As a matter of fact, such adverse factors, as corruption, bribery and abuse of official position exist in Russia as well, but their scale and impact are quite comparable with the situation in China and India. The level of corruption in relationships between the government and business entities has been annually decreasing over the last decade (also in part, due to the implementation of requirements of the international treaties or existing practices like the Foreign Corrupt Practices Act (FCPA)). Although, unfortunately, we have to admit that as far as the governmental bodies on the federal and regional level are concerned, the level corruption is yet to decline significantly, and this is really a serious problem.

Despite the minor changes witnessed at the end of 2011 mostly within the political environment and affecting to a lesser extent business stability (which is something that most companies have got used to), no serious political risks in Russia are foreseen. The long-expected accession of Russia to the WTO and the growing expenses from the state budget make the Russian market one of the most attractive in 2012, and risks in the country are rather economic than political.

Currently it is apparent both to the state and the Russian society that the presumption of bona fides of business is required. The stigmatisation of certain types of social life and the economy results in the excessive supervision, control, bans, agreements and approvals, and bureaucracy. Ideally, entrepreneurs and investors should participate actively in formulating the requirements with regard to the customs, tax

and other procedures. In fact, a partnership project of the state, business and society is needed.

Pharmaceutical companies can make a considerable contribution to the development of Russia’s economy, if the federal and regional legislation ensures equal conditions for all market participants by means of an open, honest and free competition. This will create a favorable environment for the development of the national pharmaceutical manufacturing industry, inter alia, with using foreign capital.

As it was frequently stated in the informational materials provided by the AEB Health and Pharmaceutical committee, regulatory changes have had an ambiguous impact on the international pharmaceutical companies operating in Russia over the last two years. The lack of a dialogue with the business community has led to unilateral measures and actions being taken by the state (such like no-innovation-oriented pricing and prejudices against interaction with physicians, difficulties related to conducting clinic research and launching new medicines on the market). Nevertheless, many pharmaceutical companies overcame these difficulties in 2011.

According to data from various sources, the Russia’s pharmaceutical market volume in 2011 reached almost 23 billion USD, and expenses for medicine consumption per capita reached 138 USD per person in 2010 (the highest figure among the CIS countries).

The dynamics of the Russian pharmaceutical market looks quite optimistic. The pharmaceutical market sectors are facing stable development as well. The market recovery in 2011 was conditioned both by the state measures aimed to ensure availability of the socially important products (that is, price regulation) and by the improvement of the macroeconomic situation, which boosted the consumer trust level.

Given the fact that the population of Russia is over 140 million people and per capita, income is highest among the CIS countries, and the vast wealth in natural resources, experts opine that the prospects for the Russian pharmaceutical market are very high. It is evident, therefore, that Russia’s pharmaceutical sector is of great interest to the multinational pharmaceutical companies.

Most of the pharmaceutical companies that are members of the AEB Healthcare and Pharmaceutical committee are sure that the situation on the Russian pharmaceutical market will get better, especially with the state’s implementation of the medication insurance program, in the next two years. This has led many pharmaceutical companies to the localise their production, as this is a prerequisite to

becoming a bona fide participant in the future state programs.

The vast import substitution process in the expensive medicines segment started since 2010. That is why the definition of a pharmaceutical product classified as a “product of the Russian origin” is important. It leads to preferences being given in the amount of 15% of the contract price, when orders are placed by the state and municipalities. This status is also important to foreign companies, when choosing the model for localising medicines manufacture in Russia.

The Pharma 2020 Program assumes considerable state financing: about 6.2 billion USD in total. The private-and-state partnership within the framework of this program implies co-financing by the business, which must contribute at least 25% of costs for research and development, obtaining licenses and setting up production.

This program includes a number of indicators than must be achieved by 2020: within the framework of the Program medicines’ production output must reach 765 billion RUR (25.5 billion USD). Of them, the share of the Russian output in monetary terms will reach 50% of total sales of medicines and

90% of the essential and vitally important drugs list (EDL) .

Last year’s specific feature was the increased influence of the Federal Anti-monopoly Service of Russia (FAS) on the pharmaceutical market. This was aimed at forming a unified legal framework for anti-monopoly regulation within the pharmaceutical sector, conducting joint investigations, establishing a unified law-enforcement practice, increasing responsibility for misinformation with regard to technical features and characteristics of medications, and setting of criteria and time-frame for the evaluation of commercial partners.

As 2012 is the year of the election , it will become a unique crucial point for the Russian market, and will define a course of pharmaceutical market development for the next decade, at the very least.

Nevertheless, the members of the AEB Health and Pharmaceuticals committee suppose that among the risks, which may hinder the investment potential of the Pharma 2020 Program, are weakness or current lack of the mandatory basic technical elements in Russia, which underpin the modern pharmaceutical industry, regulatory procedures and the research and development of medicines in the



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developed and many developing countries. It is especially critical for those investment projects, aimed at developing and putting innovative medications into practice.

The absence of a clearly formulated political declaration on the harmonisation between the Russian and international approaches is of special concern. It may mislead the pharmaceutical market entities with regard to the vector of its development and become a serious risk for the implementation of the Pharma 2020 Program.

Investments in healthcare may be of different types. These include not just the joint production of advanced medicines and medical products, but joint research on innovative medicines and support of hi-tech healthcare branches, state-of-the-art scientific developments, etc.. The prospects of these activities are infinite and unlimited. Given these facts, the effective implementation of joint projects is imperative to ensuring positive results regarding cooperation between business and science. The Russian government plans to create infrastructure conglomerates to unite efforts of the scientific, educational, research and development and manufacturing organisations – pharmaceutical and biotechnological clusters and free economic zones. However, one must not forget that the development of innovative medicines is economically justifiable on a global market scale, whereas, it will not be of great use to the market of one country.

Another weakness of Russia's pharmaceutical sector is the existing educational framework. The curricula of pharmaceutical and medical high education are undeniably out-of-date and fall behind the developed countries and even many developing ones. The model of high pharmaceutical education does not meet the modern standards and the existing system calls for transformation without delay. One way of addressing this issue is by increasing participation of the Russian higher education institutions and other stakeholders' parties in the activities of the sector's international organisations - World Health Organisation (WHO), International Pharmaceutical Federation (FIP), Pharmaceutical inspection cooperation scheme (PIC/S), International Conference on Harmonisation (ICH), etc.

The leading pharmaceutical companies can play a key role in providing Russia's regions with the necessary modern medical and pharmaceutical products due to their research potentials, scientific experience and the advanced medical "know-how". Resting upon the strategy of long-term and mutually beneficial cooperation with the Russian partners, the members of the Association

of European Business energetically contribute to the upgrade and development of the research and manufacture capacities of the Russian pharmaceutical industry. They invest in the establishment of the joint pharmaceutical manufacturing enterprises in Russia and set-up of powerful modern technology production lines, inviting Russian scientists to participate in the development of new medicines. Participation in such research programs allows Russian researchers and their colleagues from other countries join the frontiers of modern medicine, with dozens of patients receiving free treatment based on the modern methods of pharmaceutical drug therapy

The establishment of the Customs Union of Russia, Belarus and Kazakhstan is an important event, which will have an impact on Russia's pharmaceutical market. The single customs space has been existing since 1 July 2010 along with the Customs Code of the Customs Union, the provisions whereof have a direct effect. The Customs Codes of the member-countries of the Customs Union are effective unless they do not contradict the Customs Code of the Customs Union, which becomes the main economic integration mechanism for Russia, Belarus and Kazakhstan. Draft rules on Good Laboratory Practices (GLP) and Good Clinical Practice (GCP) (December 2010, Republic of Belarus), Good Manufacturing Practice (GMP) (March 2011, Russian Federation), Good Distribution Practice (GDP) and Good Pharmacy Practice (GPP) (April 2011, Republic of Kazakhstan) will be developed alongside documents regulating the circulation of medicines in the Customs Union countries. A working group has been formed to prepare a draft Agreement on the Procedure for the Mutual Recognition of Registration Certificates for Medicines Produced by the member-countries of the Customs Union in consistency with the Good Manufacturing Practice standards (GMP) (December 2012, Republic of Kazakhstan). The Customs Union Committee is also working towards the establishment and maintenance of a system of national inspections, a mutual recognition with regard to manufacture and other stages of medicines' circulation, as well as the exchange of reports on the results of such inspections.

The developments related to manufacturing medicines for the treatment of socially significant diseases are of special interest today, along with the medical-social and social-economical aspects of treatment and prevention of such diseases. Diabetes and its related complications is one of these diseases. The growing number of patients having diabetes requires a modern approach to treatment,

especially, to the provision of modern medicines, first of all, insulin preparations.

As experience demonstrates, formulating a pharmaceutical drug provision policy requires the concentration of resources on the provision of modern and highly efficient medicines. It is required to ensure state support to the Health Technologies Assessment (HTA) and granting a due status thereto, so as to achieve well-grounded and transparent decision-making regarding the choice of vitally necessary medicines and the unbiased and evidence-based criteria.

At the end of 2011, the influential Russian delegation representing various business circles in Russia, visited the manufacturing and research sites in Denmark, where modern hypoglycemic pharmaceutical drugs are produced. The delegation's members, whose activities are directly related to the development of the healthcare and pharmaceutical industry (The Chamber of Industry and Commerce of the Russian Federation, Association of the Russian Pharmaceutical Producers, Union of the Professional Pharmaceutical organizations, Nation Health League, Center of Social Investigations of the Institute of Economics and the Institute of Investigations in Pharma-economy and Healthcare)

had an opportunity to discuss the organisation of healthcare systems of Denmark and the North European countries.

During the discussion, special attention was given to the implementation of research, medical and social initiatives, as well as and to public private partnership in the field of healthcare. The Russian delegation's participants also discussed possibilities of a partnership between the both parties in modernising Russia's pharmaceutical industry and implementing GMP standards. Danish and Russian specialists also discussed possible areas and topics of cooperation between the Danish pharmaceutical industry and organisations represented by the Russian delegation.

We see establishing close contacts with the federal and regional authorities as a factor that will encourage mutual understanding between the Russian healthcare organisations and the international business community. In our opinion, this is in line with the interests of both parties and will promote the development of a business partnership in the field of pharmaceutical activities' regulation at the federal and regional levels and will help improve the investment climate and offer patients high-quality medicines.

Реклама

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## Project Financing in Russia

Olga Grigorieva, Head of Structured and Project Finance Division, Raiffeisenbank



### Olga Grigorieva

Olga Grigorieva is the Head of Structured and Project Finance Division, Raiffeisenbank

Olga Grigorieva is the Head of the Structured and Project Finance division, ZAO Raiffeisenbank, involved in origination, structuring and monitoring of project and object financing in Russia. The commercial real estate sector is the most represented in this regard. This includes trading centers, offices, warehouses and hotels in Moscow and Russia's regions.

Olga joined the bank in 2000. Prior to heading the Structured and Project Finance Division in 2009, she was the Deputy Head of the Syndicated lending and Securitization department of ZAO Raiffeisenbank. Olga's experience includes huge number of successfully closed local and international syndications for media, retail, transportation, natural resources and commercial real estate companies, as well as Russian financial institutions, debt finance and the arrangement of residential mortgage securitization.

Olga graduated from the State University of Management, with a degree in Bank Management. She also holds a PhD in Economics.

This is the most common definition of project financing: financing which is to be repaid at the expense of a cash flow generated by the project financed. As a rule, project financing means financing large investment costs (improvement of the existent plant, creation of additional capacities), financing creation of a plant, green field construction, as well as refinancing costs incurred by investors for creation of a facility steadily generating a forecast cash flow.

There are over 60 types of project financing methods (instruments), which are divided into two main groups: debt and equity. Concerning project financing provided by Russian commercial banks, debt financing prevails; usually, it is provided as a long-term bank credit.

Project financing is still relatively new to the Russian market. Having appeared in the late 1990s, it started developing alongside Russia's banking system, in response to objective demands for structural reorganization of the country's economy and

fundamental modernization of its technical basis. First experience was gained with the participation of international financial institutions (IFIs), the most active of which were the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC). IFIs are still very important players in the development of project financing in Russia in all industries (the power industry, telecommunications, transportation, infrastructure, water industry, other sectors of the economy). And this is very important not only for commercial banks, who by participating in a credit together with IFIs, learn to analyze and structure project financing (in other words, operations performed by IFIs have a certain demonstration effect), but also for borrowers who/which learn from the long-term foreign experience to implement projects in a more efficient way, with a strong accent on quality. International Finance Corporations ensure highly skilled project appraisal, authorize financing of the project, ensure effective management of project implementation on their own or via a third party - an inspector, and may partially cancel the creditor's risk of borrower's non-payment.

Having gained their first experience from IFIs, Russian banks began organizing project financing on their own. Lately, state Russian banks even started offering quasi-subordinate (when the maturity date is after the date of repayment of a credit provided by other commercial banks) or mezzanine financing of projects that are important for the development of a certain industry or region of Russia. On the one hand, this is one of the types of state support of investing in the real economy; on the other hand, this is a high-yielding banking product for state banks.

Besides, participation of subsidiaries of foreign banks in Russia had a certain effect on the development of project financing in the country. The experience of shareholders was moved to Russia and modified, taking into account the existent juridical base and economic needs.

The experience is passed on to Russian banks via syndicated lending, another young type of lending in Russia. A more experienced bank adopts the leading role in project analysis and shares the results of its work with other creditors. As a matter of fact, syndicating project financing results not from the leading bank's desire to share its experience, but from its desire to share the risk. The amounts

involved in industrial, and especially, infrastructure project financing are usually large. Sometimes, a credit amount may even exceed the standard risk per one borrower or group of related borrowers of a bank (N6). This is why credit syndication for the purpose of project financing is very common. However, as a rule, this does not mean a general, wide syndication, but rather, a club-deal credit with a small number of foregone creditors. Although abroad, the former is usually the case, especially when it comes to the syndication of infrastructure projects.

Since the state has always played and plays an important part in the Russian economy, private-public partnership may become one of the top-priority directions for the development of project financing in Russia. The most essential directions of private-public partnership include the development of concessionary mechanisms, development of technology parks, business incubators and special economic zones, development of venture financing, formation of financial development institutions (a national bank for development and a national export credit agency).

What is project financing in Russia today? It is real financing offered by many commercial banks. It is popular financing, as the number of investors interested in the development of business in Russia is on the increase, the Russian market is rapidly developing, the scale of the market and the range of opportunities for potential investors are much wider than in Europe, the interest in attracting investment in Russia makes the state create attractive conditions for such investment. As a result, there is the demand promising a high yield to creditors.

One cannot say that the number of developed and high-quality projects is large, but every bank is looking for its own industrial niche, adequate to its range of activity. Large-scale industrial projects in the oil and gas industry, metallurgy, chemistry, transportation usually require organizing a syndicate and respectively, participation of big players. But in industries such as the food industry, telecommunications, engineering, information technologies and real estate every bank can find its projects.

There is a special type of project financing: financing construction of real estate, both commercial (offices, warehouses, shopping centers, hotels) and residential (apartment houses, villa communities) real estate, and refinancing capital in respect of existent commercial real estate. It is one of the simplest and most popular types of project financing provided by Russian banks in Russia these days. Pretty often 90% of the project financing credit portfolio is represented by real estate market financing.

Probably, one may wonder if refinancing costs, capital with respect to a commercial real estate item that has been constructed, is indeed project financing? In my opinion, this type of financing precisely corresponds to the definition given at the beginning of the article. The source of credit repayment is a cash flow formed as a result of renting out a real estate item. The Russian commercial real estate market is now at a very advanced stage of development. The dynamics of the development of the Moscow commercial real estate market very closely matches the curve of development of the commercial real estate market in large cities and capitals of Western Europe. There is statistics and history, steady and constant demand and supply. This is why this type of project financing is developing in the most rapid manner and is extremely popular with commercial banks.

Today, we can talk about certain formed standards for project financing of commercial real estate:

- The volume of financing is limited by two indicators: (1) the loan to value / LTV ratio (the credit amount to the market value of a real estate item exclusive of VAT) which, as a rule, should not exceed 0.7, or the loan to costs / LTC ratio (the credit amount to the size of the real estate item construction budget) which also, as a rule, should not exceed 0.7; and (2) the debt service cover ratio / DSCR (the net operating income to the amount of debt service per one period) which should be not less than 1.25. Not only do these ratios limit the credit amount, but they must be observed on any day throughout the duration of the credit agreement;
- A special purpose vehicle (SPV) acts as the borrower, functioning only in relation to the financed real estate item. It means the bank via the relevant clauses of credit documentation imposes restrictions on other activities of the borrower, the owner of the facility, restricts the issue and receipt of loans and credits from other banks;
- The bank finances real estate item construction only when the borrower's own capital is completely used;
- The average maximum period of credit depreciation today is about 13-15 years; although, it may vary depending on the quality of the facility, the tenant pool, the average duration of lease agreements, conditions of termination of the lease agreements, etc. Provided that, the legal credit period is 5-10 years, which means that the repayment schedule structure will include the last payment of 30-50% of the credit amount. It should be mentioned that Russian banks offer a longer

credit period (7-10 years), while foreign banks offer a shorter credit period (5-7 years), which is determined by the restriction imposed by foreign banks on the standard risk for Russia.

- The credit currency corresponds to the currency in which the rent is nominated in the lease agreements, at least in respect of the larger rentable area of the facility. If there are big differences, the same should be hedged against;
- Construction analysis is performed by inspection companies, which do not depend on the borrower or on the creditor. The appraisal of the facility is usually also conducted by independent appraisal companies; although, certain large banks have their own appraisers. The requirement for the appraisal by independent appraisal companies is to conduct the appraisal at least once in two years;
- In the event of construction financing, it is often the case that a certain percentage of preliminary lease agreements made by the start of financing or by the time the facility's readiness is at 50% is required. In the event of construction of a facility for certain anchor tenants such preliminary lease agreements shall be made with the anchor tenants;
- A standard credit security list includes the pledge of rights to rent the land or title to the land (if the land is owned), pledge of borrower's holdings or shares, suretyship or guarantee of a borrower's shareholder/member (this usually is also an SPV, which carries out no activity). Upon completion of construction or in the event of refinancing of owner's expenses for an existent commercial real estate item the pledge of the real estate item and pledge of rights under lease agreements is added.

As a result of the 2008-2009 crisis, the approach to the credit amount for commercial real estate project financing has changed. Previously, the maximum amount was dictated by the LTV ratio; today, the main ratio with regard to the credit amount is the DSCR, for a given maximum depreciation period. When appraising a real estate item, appraisal companies, among other things, have started to give more weight to the income and comparative appraisal methods: previously the cost method was more important.

The last amendment to the Instruction 110-II of April 20, 2011, which partially entered into force on October 1, 2011, and partially, on July 1, 2012, had a significant impact on construction costs refinancing. This amendment affects the capital adequacy ratio. Credits (assets) used by the borrower, particularly, but not exclusively, to extend or repay loans of third parties (not lending institutions) or to

purchase real estate, are weighed with the 1.5. factor in order to calculate the capital adequacy ratio, which means that from the viewpoint of capital such credits are 1.5 times more expensive than other credits. And the purpose "repayment or extension of an intra-group loan" in the event of refinancing of an existent real estate item is the most popular factor with regard to credit purpose. The conclusion suggests itself, that the state regulator encourages banks to finance real estate construction. However, at the same time, the problem remains, because upon completion of construction the cost of the facility rises significantly, the forecast cash flow prepared at the stage of construction turns into the actual flow, which may be evaluated less conservatively and less realistically (the actual percentage of rented out spaces, actual rent rates with the approved indexation are included). Respectively, the owner can and wants to top up the credit amount, which again will be possible only via extension or repayment of an intra-group loan.

We would also like to emphasize the importance of financial, technical and marketing consultants, auditors, appraisal companies, companies supervising (initially and subsequently) project financing in project financing in Russia. The use of highly specialized consultants enables banks to focus on a project from the financial analysis standpoint, while at the same time, reducing its labor costs. Today, such consultants are widely represented on the Russian market; there is stable demand and wide supply, which certainly stimulates the development of project financing.

In conclusion, it should be mentioned it that despite all the difficulties, project financing is becoming more and more developed. The state supports this dynamics, developing the concession law and the private-public partnership sector. During the crisis, banks tested their project financing credit portfolios and made sure that well-structured transactions were not as affected as other corporate portfolios. The cause and effect of this is the fact that today, banks in Russia devote a lot more time to risk assessment and risk management issues than 10 or 20 years ago; besides, now, they do so with considerable experience.

## BUSINESS CASE. CREATING AN ENTERPRISE

### Everything you always wanted to know about how to invest in Russia\* (\*but were afraid to ask)

Antonio Linares, Country Manager and Managing Director, ROCA in Russia and CIS



#### Antonio Linares

Antonio Linares is the Country Manager and Managing Director of all the subsidiaries of ROCA in Russia and CIS. In his role as Country Manager and Managing Director, he has been in charge of several greenfield projects and acquisitions in Russia. He also has significant experience in all financial, tax and legal matters, as well as in logistics, customs and labor, both in Russia and abroad. In the seven years since the set up of the local ROCA structure in Russia, he has built a team that has quadrupled ROCA's performance, making it a leader amongst its peers. Within ROCA he also held different responsibilities in Corporate Development and Marketing. Prior to coming to ROCA, he was the Regional Director of one of the Top 10 Spanish construction companies, where he completed several projects in Public Civil Works and Real Estate. Mr. Linares also has experience in Engineering and Project Management in countries such as Spain, Turkey and Chile, with a specialization in the Cement Industry. Antonio is a Civil Engineer, with an MBA from FPC-UPC of Barcelona. He also has an in-depth knowledge of Finite Elements, a field he researched extensively and based his research paper on, while at the Institute of Fundamental Technological Research in Warsaw, under the EU program – Tempus Phare.

Getting started is always the most difficult step with writing these lines, as with many other things in life, including setting up a business; that is why it took me quite a while to think of what a person like me would have expected from an article like this when I first started out in Russia. In the following lines, I will try to highlight facts that I would have liked to be made aware of when we started on what has been and still is the exciting adventure of investing in Russia.

#### The prejudice

As an appetiser, let me start with an affirmation that could sound a bit provocative: investing in Russia is no more difficult, or at least not much more, than investing in any other place. Yes, certainly, many of you are already remembering the most corrupt countries' rankings, and Russia's most persistent presence, and wondering if this is worth the read. I can only ask for your patience. I proceed to elaborate: what does an easy country mean? If the attributes that define easy are: a firmly established legal system, public safety, stability, certainty, a developed and demographically significant middle class –in other words: consumers, then I can assure you that this is hardly the case in any country with an emerging economy. Generally, when a country shows steady growth or development, such a phenomenon is fueled by scarcity or shortages, and a subsequent rise in demand. Usually, many of the the causes behind the drastic rise in the demand of consumer products are at the same time the reasons behind the witnessed legal and financial hurdles/obstacles. In other words, emerging economies bring about an emergence of some less desirable attributes as well, particularly, when it involves foreign investment. However, in exchange, they offer markets with high growth potential, and therefore, with less competition: more time to rise, establish and develop. Yes, I agree, paradise would be a country with an insatiable need for the supply of bathroom appliances – sorry that is my sector – and impeccable legal and financial systems, political stability, citizen satisfaction, as well as standard infrastructure and enough manpower, and if possible, without competitors during the time needed to develop, grow and consolidate. If such a country exists, believe me I would be the first person on a plane headed in that direction. On the other hand, what is our understanding of a stress free investment climate? Take for example countries like Germany, France and Austria, whom no one really sees as investment unfriendly. How many foreign investors do such countries entertain and how easy is it in reality to invest there? Undoubtedly, even such countries are not without their fair share of obstacles when it comes to investment - a very saturated

market, possible prejudices -a Spanish or French company in Germany, what for? Not to mention the language barrier, in most cases. These same difficulties apply to these countries as well. And all this, without mentioning protectionism – oops, I forgot that protectionism no longer exists; now that we are all a big and happy WTO family.

To sum it all up - what is the difference between Russia and for example, Latino-American or Asian countries? The language may be a bit more difficult to learn – ok, maybe just for me, more public safety and a longer and colder winter. What factor unites them all? A market hungry for consumer products, in some cases, the lack of manpower, while in others, personnel just qualified enough; difficulties in obtaining licenses and permits, a less than well defined legal sector and insecurity. Yes, when running an investment we have to be careful, but where we do not have to?

## The difficulties

Of the difficulties I have mentioned above some are not worth elaborating on. Even if the harshness of the winter does get to one at times, we will not change it. But I will attempt to describe, a phenomenon that often condemns projects before they are born. A company that is interested in investing begins its journey with what one may call the “trial” phase. This involves extensive travel, data collection and subsequent analysis. Depending on the expert level of the analyst assigned, the accuracy of the data/results presented may vary. Once the analyst has completed the initial collection of information, the first bifurcation comes out: he may have done it right, or may have done wrong (let’s skip intermediate for simplification purposes). But, do not be afraid, after this first bifurcation everything comes back into the mainstream. If the analyst has done his work right, no one will trust the results; anyway, he was just an analyst and what does he know that we don’t? If the analyst has done it wrong, no one will trust the results either; anyway, he was just an analyst and what does he know that we don’t? How do sometimes companies overcome this initial hurdle? Many times, this is achieved by going ahead with the strategy developed prior to the initiation

of phase one of the investment process -actually we live in the information age, and now, everyone can access a huge lot of information on a country or region by just going to the CIA World Factbook, reading a newspaper, or better still, just “googling” it: people in HQ might be convinced that they know better than the analyst, at the end they read an article in The Economist) Ultimately, prejudices often prevail. And the question comes: why to send someone to know matters “hands in” if you do not plan to acknowledge the specifics of the country where you want to invest?

I believe we can now go ahead and review the essence of doing business in Russia. Let us start with the feasibility study, based on a structure that should certainly be familiar to many:

## 1. Cost

### a. Human Resources (HR)

The dimensions of Russia make difficult to classify the HR environment as homogeneous, on the contrary it is diverse and unique in its own way. It depends strongly on the region (Oblast) or republic being analysed. In some areas, the large presence of foreign investors has led to a lack of qualified personnel and to an increase in wages difficult to afford and with little relation with productivity or performance. In others, without an industrial base, the situation is more stable. Also, Russia’s hidden unemployment distorts the labor market. Changing the situation would require carefully measured

steps, to avoid social discontent. Civil service sector is overstaffed and changing this would be difficult to manage in cases such as Defense and Interior – what to do with policemen and soldiers unemployed. In addition to that, productivity is very low in many Russian companies. Still, it is possible to achieve reasonable levels if you bring in qualified staff and find yourself in a region that makes room for stable employment. It is very important to be patient and make a continuous educational effort to compensate the lack of references of the majority. In the so called “western” countries, labor relations have been governed by shared and stable standards and values for generations. In Russia, on the other hand, there have been dramatic changes and now coexist very differ-

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**This is a market that values and appreciates brands. A market in which the distribution sector is still being invented and in which you must pay attention everyday to what is happening around, if you do not want to miss a train, and even if you do pay attention you will surely miss some.**

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ent forms of labor relation, which sometimes can make the employee to be lost between contradicting messages. The solution comes with a permanent educational effort and with compensating the lack of durable references with discipline, internal communication efforts and transparent HR policy.

### b. Energy

Yes, it is true - Russia is the great Western Energy reserve. And yes, it means that costs were and still are very competitive when compared with European prices. Unfortunately, this advantage is being fast lost with each year. The subsidy on domestic consumption is decreasing year by year, with price increases well above inflation and the virtual disappearance of the distinction between commercial and industrial rates for the domestic market. In addition, energy infrastructure is in very poor condition and requires significant investment. These investments are neither fast enough nor adequate in number to guarantee demand saturation. In some cases, the impact of made investments can neither be tracked nor identified. Many situations have witnessed the investor come to the rescue –willingly or not. In general, paying for gas and electricity is a long and expensive procedure, if due process is followed, and more so, if done wrong or without following the proper channels. Having the support of the Administration is a condition necessary, but not sufficient. Unfortunately, the monopolies that control gas and electricity exert their power without much hesitance or remorse and do not have the industrial development of the country as one of their main priorities.

### c. Others

One may consider it a bit uncouth that those issues that do not concern labor or energy are placed in the “others” category. However, the bulk of the “other” investment issues suffer from a number of problems with a common denominator – the lack of competition. There is a certain lack of industry diversification, with very few SMEs trying to fight an adverse and costly environment. It also accounts for the outdated, in many cases, infrastructure –including in this category buildings, equipment, utilities, railways and roads, and less than optimum customs

procedures. These are some of the reasons why many of the Russian companies have opted for the vertical integration process when it comes to business, focusing on the production of finished and auxiliary products from packaging to plastic injection. Some companies, particularly in the regions, also choose to integrate certain employment benefits such as feeding and medical services into their structure rather than outsource these services, as the latter may end up costing considerably more or not reaching the quality required. In summary, issues in the ‘others’ category result primarily from the absence of a developed and competitive local industry which ultimately forces many companies to have to –import and often pay expensive for what cannot be found local.

## 2. Fiscal environment

The Russian tax system is the result of stresses in different directions, on the one hand the inertia of the past, on the other, the desire to reduce pressure brought about due to fraud: all this, without forgetting a certain will to move towards modernisation, as it is best understood. The summarised result (there are other minor taxes) is described below:

Taxes described in this table summarise the main tax burden that follows a company in Russia. What this simple table does not include are the many other documents necessary to register transactions, the legal contradictions and, in many cases, the excessive and overlapping rules that create gaps that are later filled up with jurisprudence. Undoubtedly, all of this creates uncertainty and difficulties when faced with making a decision: even a company that strives to comply fully with the current legislation will face situations where a decision will need to be made with regard to what rules should be disregarded. However, experience shows that if one acts in good faith, problems that may arise will not be material. Of course, unless the sector in which one decides to invest in is considered, by the government, or by any other administration or group with resources to exert just that right amount of pressure, to be strategic or one of particular interest, in which case, the outcome is a whole different story.

Denomination	% Federal	% Regional	% Total
Corporate tax	2%	18%	20%
Tax assets		2.2%	2.2%
VAT	18%		18%
Income tax (staff)		13%	13%
Labor costs (company)		30–10%	30–10%

Also, size and visibility goes a long way. Generally, a company of certain standing and importance, with the support from the international business community may have little cause for alarm.

### 3. Legal environment

Much of what was highlighted in the last section could also be applied to the legal environment. In Russia, the problem is not the absence of the rule of law, on the contrary, it is the absolute rule of a law that is contradictory and in a permanent state of 'under construction'. The amendments made, though sometimes resulting in an improved investment climate, often do not completely eradicate an existing problem, and even less so, take into account or anticipate future obstacles. There are countless examples, in which a rule is developed or adopted, but the body meant to effect it has not been established or the technology that allows its implementation has not even begun to develop. In the end, you better put yourself in the hands of God and just in case, as the joke says, in those of a good lawyer. It should be noted that there is a general positive trend towards improvement; and if you tackle a problem head on, you usually find an acceptable solution.

### 4. Market

This is where Russia has a competitive advantage; although, having read this far, I suspect that many have decided to follow Dante's advice and abandon all hope. For those of you who have chosen to press forward, thanks, welcome and congratulations, because here comes the great part. This article is but an abstract simulation of the obstacles that one may face when trying to carve a niche for oneself on the Russian market. Those that have come this far can now claim the coveted price – the market. It is a market where the average price of many consumer goods is much higher than their equivalent in countries with a much higher purchasing power. The local industry is still underdeveloped, while consumers are more and more demanding. This country shows that if initial difficulties are overcome with effort, comprehension and respect for the difference, there is a market waiting for us.

This is a market that values and appreciates brands. A market in which the distribution sector is still being invented and in which you must pay attention everyday to what is happening around, if you do not want to miss a train, and even if you do pay attention you will surely miss some. A market that is not suitable for those who appreciate a stable en-

vironment, with few surprises. In any sector, terms like 'the traditional channel' become meaningless: the country rebooted only very recently and some programs have not finished uploading. However, those with an optimist's view on situations will see that this is a golden opportunity to participate in the creation of a new system and be part of the result. If done well, with the avoidance of major and crippling mistakes, the result can be solid and durable.

### 5. Investments

It is time to ask the ultimate question: do we take the risk of investing? By now, your team has given you detailed information about the country. If you decide to go ahead and build a factory from scratch do not assume that it will take less than two years. If you do things right, it will be expensive and will take two years. If you do things wrong, it will be even more expensive and will take the same two years. In all, depending on luck, timing and adherence to due process, expect to have a factory in two years, give or take a couple of months. The result – a timely completion or the alternative, depends in several factors:

- Your region of choice;
- The construction company of choice: a construction company you trust, with a strong presence in your region of choice is the best way to go. However, go easy on the trust issue as all construction companies, regardless of their country of origin obviously know their business better than any investor, and there is a lot on money at stake here;
- The quality of the Project;
- The time you are willing to spend in discussing non-essential aspects;
- The relationship with the administration;
- Patience: loosing your temper only equals more problems, which inevitably means - more money;
- Availability of the basic amenities: electricity, water, telecommunications, gas, etc.

With regard to permits and licenses bear in mind that you are dealing with a country that has an overstaffed and underpaid civil service sector. The salaries of the civil servants are considerably lower than those offered by the private sector. Many believe that this is due to an uneven and inefficient allocation of state resources: hard to pay to so many, when a few take the bulk. In other words, you have to knock on many doors and get many signatures; there are no shortcuts, only hard work. You will come across many supposedly well connected people; however, it is best that your own team takes the time to build valuable relationships. Sometimes,

these supposedly well connected people become part of a problem rather than the solution.

Other alternatives to successfully setting up production in Russia include:

1. **Brownfield investment:** where you can buy an industrial building with sufficient gas and electricity quotas for your needs.
2. **Acquisition:** buy a company operating in your sector and reform or rebuild it. It is a quick way to enter the market.
3. **Joint Venture:** Not my preferred option in Russia nor any other country. You might understand my reasons, especially, if you have been in one.

## 6. Logistics

Perhaps prior to reading this article, many took a good look at the nearest available map to see exactly where Russia is. Regardless of accuracy, all will agree that Russia is far from being the smallest country in the world. In fact, it is quite vast. Well, get ready, because this is where you will do business and be successful at it. There are many solutions depending on your business structure and sector. Bear in mind that the roads are bad, winter is hard and the solution by which everyone has to come to live to Moscow so you could have them close does not work. True, when you look at the size and growth of Moscow and at the road conditions as we move away from it might appear to you that that is the solution being implemented. There are also people who propose to put a zipper at the Urals and close the eastern part of the country. Sorry, the answer is no, there is life in the East of the Urals, and market, and sales.

A last thing to bear in mind regarding logistics: railway transportation is very important here. Please, do not dismiss it as an option, without having carefully studied the alternatives. It is important if you expect to do business in Russia, and even more so if you want your suppliers and target consumers to include members of the CIS countries.

## 7. Conclusions

- 1) Do not be surprised, Russia is different from what you might expect. That is why it is called Russia and not, let us say, Albacete. Do not expect Russia to adapt to you, it will not work.
- 2) Do not be afraid. There is always a solution. With the right strategy and available finances, there is always a solution. Respect: Show respect and ask to be respected. Do not make it an ego contest: this is not your country, you will lose.

- 3) Learn: Leave behind all prejudices, assumptions and presumptions: listen and learn from those around you. Many people come here and leave, having listened only to themselves.
- 4) Choose a competent team and make sure that you can trust it, and then trust it
- 5) Use the support provided by different organizations: embassies, business associations (a good example is the AEB). You will gain presence and decrease the risk of being harassed.
- 6) If you do not speak Russian, be very careful in choosing an interpreter, take your time. If you do not speak the language, your translator is your link with the world. He or she should be able to interpret not only the meaning, but also the right tone and emotions. A good interpreter does not guarantee the success of the project, but a bad one might ruin it.
- 7) Get ready for an exciting journey and enjoy it when you arrive. The journey may be difficult, there may be detours and curves and you could get dizzy.
- 8) Do not give bribes. If you follow due process, they do not work. If something goes wrong, they can not remedy the situation; even if you do, it is only temporary, with even bigger problems to follow as a result.

## Epilogue

At this point, I only hope that this article has encouraged those with growing export activities, who are beginning to entertain the possibility of investing in Russia, to go ahead and do so. I have seen many companies develop a market, achieve a significant share and... full stop. A competitor comes and takes it all. Export is a very good first step to getting a general feel for the market and acquiring financial and social capital. Finally, in many cases, the secret to success is being present on the market.



## Practical experience of making actual investments in Russia

Nick Vince, General Director Rockwool CIS



### Nick Vince

Nick Vince is the Managing Director, ROCKWOOL Russia Group.

Date of birth: 18.01.1955

Nick Vince was born in Oxford, Great Britain.

He graduated Newcastle-upon-Tyne University, with BSc Hons in Marketing.

He is also an elected Fellow of the Chartered Institute of Marketing (FCIM).

Nick started his career in Massey Ferguson – world-leading producer of tractors.

He joined group of companies of ROCKWOOL in 1990 as Business Development Director in UK.

Later he became Technical Director responsible for the UK factory.

During 1999-2004 Nick Vince was a Managing Director of ROCKWOOL Poland.

From mid 2004 he moved to the Netherlands to become World Wide Managing Director for the Grodan Group (Horticultural substrates for commercial green house growers of flowers and vegetables).

Since 1<sup>st</sup> of January 2006, Nick Vince is a Managing Director of ROCKWOOL CIS responsible for Russia, Belorussia, Ukraine, Kazakhstan, and Moldova. Including 4 factories and 6 companies.

His is married with 3 adult children and his hobbies include competing in motorsport 4x4 off road Extreme Winch challenges.

**Company:** Rockwool is the world's number one manufacturer of stone wool insulation, and is quoted on the Danish stock exchange. We melt rocks at 1500 degrees Celsius and spin the molten lava into wool (hence the name Rockwool) the process is heavy manufacturing that is not dissimilar to a steel works. All the Rockwool Russian factories run 24 hours a day 7 days a week 365 days a year, and the products are used for Thermal insulation, also Fire protection and Acoustics.

**Business in Russia:** We have been active since 1970s when we started to export products from Denmark primarily for marine applications, later we established a sales office in Moscow.

In 1998/99 we made quite a brave move to purchase an old Soviet factory originally build in 1956 on the outskirts of Moscow.

In 2005 Rockwool built a new factory on a brown field site in the Leningrad oblast between Saint Petersburg and the Finish border.

In July 2010 Rockwool purchased a relatively new factory in Chelyabinsk oblast in the Urals. In the last 18 months since the acquisition we purchased more land to double the size of the site and have installed additional technology to increase the output of the factory by more than 50%. The total investment is close to 50 mln. euro.

Over the last three years we have also been constructing a new factory on a 48 Ha site in the Special Economic Zone of Alabuga in the Republic of Tatarstan Republic in the Volga Region which will be the world's highest output stone wool production line. Its has commenced production, making the first batch of finished products on the 19<sup>th</sup> of January, 2012, which was considerably ahead of schedule. The factory is now fully commissioned and shipping products to our customers. This is an investment of 115 mln. euro.

Today Rockwool has 7 sales offices in cities across Russia and a total of 1500 staff.

**Company values:** The other relevant thing to know about Rockwool is it is a totally "white" company, which passionately lives up to its Danish values and ethics. In this regard there are no judgment calls to be made. The company is totally white and there are no shades of grey. This can sometimes be a challenge when competing in the construction industry in Russia. Additionally, if you want to commission a Rockwool factory you need to receive permissions from 13 different authorities. These permissions and approvals can either come fast, or they can come slow, and a white foreign company that lives to its values has no way to influence these things.

**Check list:** When considering to either build a new factory, or to acquire an existing one, we have a check list of more than 20 things that we seek. This includes roads and railway connections, a good local labour pool, no immediate residential neighbors, adequate gas and electricity supplies, absence of any soil pollution, clear ownership of the assets, and ideally such additional niceties as adequate hotels, reasonable distance from an airport, and tax concessions etc. However top of our list, and of para-

mount importance is supportive business-orientated authorities.

Regional variation: In our experience the attitude to foreign investment by oblast Governors is highly variable around Russia. Some Governors of the Oblasts or the President of a Republics are interested in the jobs, taxes and positive impact on the local economy and community that the investment of a factory will bring, and some appear not to be.

If a Governor is business orientated, and welcomes your company and all of his officials are aware of this, then things will go in a normal way without bad surprises. However, if the administration is not supportive, then there can be many difficulties and challenges along the way, both in building and commissioning and later in the operating the factory.

The additional benefit of having business-orientated supportive local authorities if you are building or buying a factory is that you can introduce them to senior management from your company's foreign head office. This will go a long way to giving them the confidence to approve the investment and allaying some of their fears and concerns that inevitably occur as a result of sometimes less than flattering Western press coverage that Russia receives.

I won't name the regional authorities we have met where we quickly understood that they were not seriously interested in a major foreign investment. However I will share with you the positive experience that we have had in the Republic of Tatarstan and the Chelyabinsk Oblast where President Minnikhanov and Governor Urevich have so far both delivered exactly what was promised, as a result we have enjoyed the freedom to operate on the basis that we also live up to everything we promised them, and of course also adhere to all Russian regulations.

Before we took the decision to invest 115 mio euro in a new factory in Tatarstan I personally called the General Directors of 8 other substantial businesses that were already operating in the Republic to check their experiences of dealing with the authorities. Without exception they confirmed what President Minnikhanov had said to us, that his administration is "open for business" and takes a positive and constructive attitude to encouraging foreign investment.

Construction of the new Rockwool factory in SEZ Alabuga, Tatarstan has been completed and is now fully commissioned.



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## 8. PROSPECTS OF INVESTING FOR THE FUTURE

### WTO and Russia, Investment Opportunities and Risks

Prof. Art Franczek, President, American Institute of Business and Economics



#### Art Franczek

Art Franczek a Professor of Accounting is currently the President of the American Institute of Business and Economics in Moscow (an English language MBA program that was founded in 1989). He holds degrees in History and Political Science

in addition to an MBA, CPA and a Masters of Taxation. In addition to managing AIBEc he teaches courses in IFRS, Taxation and Cost Management. He has served as a consultant for the Russian Central Bank (IAS 39), the World Bank (on implementing IFRS in Russia), The Bank of Albania (implementing IFRS and IAS 39) and has written many articles on IFRS, Customs and Taxation issues in addition to a book on IFRS. Art is also co-chair of the Customs Committee at Am Cham and was awarded co-chair of the year.

Prior to coming to AIBEc Art served as a business consultant in Togliatti after working for many years as a Corporate Tax Manager for a Fortune 1000 company.

Since the Gorbachev era Russia has aspired to be a member of WTO (formerly GATT). In 1990 Russia achieved observer status and it formally applied in 1993. Predictions of Russia's accession were made in 1998 only to be derailed by the economic crisis in August. In 1999 accession hopes were again dashed by the NATO bombing of Serbia. The 2001 accession of China to WTO along with Kyrgyzstan and other CIS countries applied pressure on Russia to become part of the club. In 2006 Putin was planning to showcase the US/Russia accords (one of the final obstacles to WTO accession) at the G-8 Summit in St. Petersburg. This effort was thwarted when Russian meat inspectors discovered that US meat workers didn't wear slippers (topichky). The press announced that 2008 was Russia's year for WTO accession. Plans changed when Russia and Georgia entered into a conflict. John McCain wanted to ban Russia from WTO and the G-8 as a result of this conflict. Accession plans were again delayed when Putin announced that Russia would enter WTO as part of the Customs Union. Finally, by July 23, 2012

the Duma must vote to approve the WTO Working Party Agreement (no amendments are allowed). A month after the Duma approval Russia will officially become a member of WTO.

During the past 18 years there has been strong opposition to WTO among leading Russian Industrialists. Oleg Derispaska the owner of auto, aluminum and airplane opposed accession because he considered his companies to be infant industries that would be greatly damaged by Russia's accession. The Russian Chamber of Commerce resisted WTO accession because 80 percent of Russia's exports are natural resources that enjoyed easy access without WTO protection. Agricultural industries were concerned that WTO would cause subsidies to be limited. Russia also used Sanitary and Phytosanitary (SPS) regulations to limit meat and poultry imports in addition to banning Georgian wine and water. Joining WTO is likely to hurt less-competitive domestic manufacturing industries that have failed to keep up since Soviet times, such as food processing, textiles and construction materials. In addition many companies who currently receive subsidies from the government would no longer receive them under WTO rules.

WTO accession would benefit Russia in several ways. For example, discrimination against Russian companies would be minimized. The Russian steel industry which loses 2.5 billion dollars due to anti-dumping cases would gain access to WTO mechanisms for settling trade disputes. WTO accession would provide external support for many internal reforms in the area of trade. Competitive pressures on local producers would encourage them to become more efficient and innovative. Evidence suggests that FDI would increase significantly after WTO accession. In China's first year after accession FDI increased 18% and China's WTO membership greatly contributed to China's near double digit growth over the last decade.

Russia is a large export market for European pork. For the last 18 years Sanitary and Phytosanitary (SPS) rules have been used to occasionally ban or limit imports from the EU. The Russian inspectors sometimes claim that pork from the EU is unsafe because of the risk of swine flu. Russia's WTO agreement would require that Russia develop and apply international standards on SPS measures through



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membership and active participation in the Codex Alimentarius, the World Organization for Animal Health(OIE) and the International Plant Protection Convention. In other words, Russia would be required to use scientific rather than arbitrary methods to determine the safety of imported meat and poultry. The 1000 page agreement on tariffs provides for a 0% tariff rate on pork with a quota of 400,000 metric tons of pork from the EU, this quota expires in 2020 at which time the tariff on pork will be 25%.

One of the most contentious areas of tariff negotiations was regarding civil aircraft. Tariffs on wide body aircraft will be reduced from 20% to 7.5% in the four years following accession. Russia plans to import 1000 new commercial aircrafts over the next two decades, so companies like Airbus may reap substantial benefits.

Proctor and Gamble, which has four plants and 4000 employees in Russia and imports huge amounts of raw materials and ingredients is most enthusiastic about Russia's membership in the WTO. Scott Miller, director of global affairs says that the "Market barriers will be substantially lower and the tariffs will come down and be more predictable."

A central issue during the last 18 years has been Intellectual Property Right protection. The WTO agreements require that Russia fully apply the provisions of the WTO agreement on Trade-related Aspects of Intellectual Property Rights, including provisions for enforcement without recourse to any transition period. Russia would investigate and prosecute companies that illegally distribute objects of copyright or related rights on the internet. Russia also agrees to join the Information Technology Agreement, when it enters WTO.

The IT industry will significantly benefit from WTO accession as Russia will remove restrictions on imported digital (cryptographic) equipment, and will also zero out import duties on high tech goods. These provisions will help companies like Nokia and Phillips. In addition, telecom companies will be able to own a majority interest in Russian telecommunications companies.

The Foreign Banking sector will be limited to 50% of the entire system, while banking branches will not be allowed. However, insurance companies

would be able to establish branches nine years after accession. Russia will be obliged to reduce its average import duty from 10% to 7.8%; this should be good for EU exporters.

In 2007, Russia increased the export duty on timber to 25% to 80%. This issue significantly affected Finland's lumber processing industry. After intense negotiations Russia agreed to establish export quotas and export duties of 13%-15%. Russian over flight charges have been the subject of major disputes between the EU and Russia. The EC says European airline have to pay roughly 320 million euros per year to fly over Russian territory, and most of that money goes to Aeroflot. As part of the EU's support for Russia's WTO accession, Russia agreed that any over flight charges be cost related and transparent.

Russia's accession to WTO boosts EU retailers because as changes in customs procedures take effect, shipped goods will subsequently experience a reduction in fees and processing times when crossing the border. Foreign brands will be able to penetrate the market at a much cheaper and faster rate.

Since 2005, auto producers were able to receive significant reductions in customs duties if they had a production capacity of 2500 vehicles and had at least 30% local content. In February of 2011, Russia provided reduced import duties for companies that had a capacity of over 300,000 vehicles and 60% local content. Under WTO rules, these legislative changes were considered to be a violation of Trade-Related Investment Measures (TRIMS). After a heated negotiation, Russia agreed to end this local content program by 2018. The EU, a major auto parts supplier to Russia, further negotiated to minimize the adverse affect of this program by

obtaining a commitment that Russia would provide EU companies with compensation for any adverse impact. In addition, the tariffs on auto imports will be reduced from 30% to 12% after 12 years.

During the accession negotiations, the EU had concerns about the Russian government policy on subsidizing natural gas prices for domestic

users. The EU argued that such subsidies gave Russian producers in energy-intensive industries such as steel and aluminum an unfair competitive advantage. Russia agreed to price natural gas at market prices to

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commercial users, but could still subsidize prices to households and other non-commercial users.

In 2012, The Customs Union (Belarus, Kazakhstan, and Russia) is scheduled to become a Common Economic Space in which there will be a free flow of goods, services and money between member companies. It is important to note that in the WTO working party agreements, Russia has agreed to harmonize its WTO agreements with those of the Customs Union.

There several estimates of the economic benefits the Russia would accrue after it accedes to WTO. The most widely quoted is from a World Bank Study that was commissioned by the Economic Ministry in 2007. The World Bank estimates that Russia would gain 3.3 % in GDP in the short term and 11% in the long term after the WTO benefits have been phased in. Sergei Guryev explains that the short run benefits include static benefits due to trade operations, while the long run benefits are due to the improved investment climate, and are therefore, much larger. A November 2011 study by Uralsib says that WTO accession will have a minimal impact on GDP simply because cost advantages like cheap energy and labor have long expired. The legendary Maxim Medvedkov says that in a worst case scenario Russia might lose 0.5% in GDP because of uncertainty over Gazproms transport networks.

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**WTO accession would benefit Russia in several ways. For example, discrimination against Russian companies would be minimized. The Russian steel industry which loses 2.5 billion dollars due to antidumping cases would gain access to WTO mechanisms for settling trade disputes.**

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An almost forgotten agreement would oblige Russia to publish all legislation affecting trade in goods, services or IPR, prior to their adoption and would provide a reasonable period of time, no less than 30 days for members to comment. It should also be noted that after Russia accedes to WTO it plans to join the OECD and its anti-corruption. WTO, ITA, TRIPS OECD and AIE will all provide tools to improve the business climate in Russia.

August 23, 2012 (projected date) will mark the beginning of a new business environment in Russia. We can expect the new WTO rules based procedures to be used fervently by both the Russian government and EU companies. As Vladimir Putin said "The WTO is an instrument. Whoever knows how to make use of it will become stronger."

#### **Some useful websites on Russia's WTO Accession**

- Terms and Conditions of Russia's Accession (Russia's Final Working Party Report, Final Goods & Services Schedules)  
<http://www.ustr.gov/node/7301>
- RF Ministry of Economic Development Section on Russia's WTO Accession  
<http://www.economy.gov.ru/minec/activity/sections/foreignEconomicActivity/wto/>

## ABOUT THE ASSOCIATION OF EUROPEAN BUSINESSES (AEB)

The AEB was established in 1995 on the initiative of several European companies registered in the Russian Federation, Ambassadors of EU member states and the Head of the Delegation of the European Commission to the Russian Federation. The AEB is an independent non-commercial association with a membership of more than 650 companies

AEB membership is made up of enterprises and entrepreneurs from the member states of the European Union (EU) and the European Free Trade Association (EFTA), which have business activities with and in the Russian Federation. These members form the AEB General Assembly (GA), which determines the overall strategy and policies of the association.

The mission of the AEB is to represent and promote the interests of its members by supporting them in doing business with and in Russia through quality lobbying, information support, and through activities aimed at improving the Russian trade and business environment in conformity with internationally accepted business principles and promoting integration and partnership between the European Union and Russia.

The AEB conducts lobbying activities through its committees and working groups, which cover a wide spectrum of industries and sectors, including Finance and Investment, Visa Task Force, Energy, Customs & Transport, Machine Building and Engineering, Safety, Health, Environment and Security and, Finance and Investments – to name but a few.

The committees work closely with the Russian and European authorities, for instance by holding public and closed meetings with government representatives and submitting comments and amendments to draft laws.

The AEB also offers informational support to the European business community via its website and publications, press campaigns, surveys and legislative and business alerts.

The Association works hard to support its members wherever they are located in Russia by hosting regional presentations, business missions and maintaining regional representations, such as Krasnodar Steering Committee and a local presence in Yekaterinburg.

## ABOUT THE FINANCE & INVESTMENT COMMITTEE OF THE ASSOCIATION OF EUROPEAN BUSINESSES

Since 1995, the AEB, (formerly the European Business Club), has evolved from an informal business organisation into an influential group that improves the business and trade environment of European business in the Russian Federation.

The three main functions of the AEB are effective lobbying, quality information, and valuable networking. The AEB is a forum for dialogue between international businesses and the Russian Government. The AEB participates in lobbying in the Duma and in the Federation Council.

Over the last ten years, the AEB's lobbying initiatives have included a wide range of issues of importance to its members including: small- and medium-size business issues; transport and customs; alcoholic beverages import; visa issues; taxation; corporate governance issues; and anti-monopoly issues, making it a significant voice in policymaking in the Russian Federation.

Furthermore, the AEB participates in dialogue with administrative bodies to promote AEB member interests. These organisations include: the European Union; Industrialists' Round Table (IRT); Foreign Investment Council (FIAC); EBRD; OSCE; IFC; IMF; and the Federal Anti-monopoly Service.

The mission of the AEB Finance Committee is to improve the investment climate in Russia by integrating the information and discussion related to the critical finance issues that are of prime importance for foreign companies working in Russia. These include accounting, auditing, and financial reporting; capital markets; ratings standards; and investment, corporate finance, and venture capital. To achieve these objectives, the Finance Committee serves as a forum for discussion, lobbying and information network for the exchange of ideas concerning finance issues among finance officers, accountants, auditors and policy makers in the Russia Federation.

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<input type="checkbox"/> CATEGORY D / Категория Д	<1 million/миллионов	750 euro/евро
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(AEB members that are Legal Entities registered in an EU / EFTA member state or Individual Members –  
EU/EFTA citizens) in writing/**

Заявление любого юридического лица из страны, не входящей в Евросоюз/ЕАСТ, и желающего стать членом АЕБ,  
должно быть письменно подтверждено двумя членами АЕБ (юридическими лицами, зарегистрированными  
в Евросоюзе/ЕАСТ, или индивидуальными членами – гражданами Евросоюза/ЕАСТ)

**Individual AEB Membership is restricted to EU / EFTA member state citizens, who are not employed  
by a company registered in an EU / EFTA member state /**

К рассмотрению принимаются заявления на индивидуальное членство от граждан Евросоюза/ЕАСТ,  
работающих в компаниях, страна происхождения которых не входит в Евросоюз/ЕАСТ

**Please bear in mind that all applications are subject to the AEB Executive Board approval /  
Все заявления утверждаются Правлением АЕБ**

**3. CONTACT PERSON / INDIVIDUAL MEMBER / КОНТАКТНОЕ ЛИЦО / ИНДИВИДУАЛЬНЫЙ ЧЛЕН**

Title, First Name, Surname / Ф.И.О:	
Position in Company / Должность:	
E-mail Address / Адрес эл. почты:	



<b>4. COUNTRY OF ORIGIN / СТРАНА ПРОИСХОЖДЕНИЯ</b>	
<b>A. For a company / Компаниям:</b> Please specify <b>COMPANY'S</b> country of origin / Указать страну происхождения компании <sup>1</sup>	
<b>or B. For an individual applicant /</b> Индивидуальным заявителям: Please specify the country, of which you hold <b>CITIZENSHIP</b> / Указать гражданство	
<p><b>Please note that only EU / EFTA members can serve on the Executive Board and the Council of National Representatives/</b> Внимание! В Совет национальных представителей и Правление могут быть избраны члены, представляющие страны Евросоюза или ЕАСТ.</p> <p><b>Please fill in either A or B below/</b> Заполните только графу А или В</p>	

<b>5. COMPANY DETAILS / ИНФОРМАЦИЯ О КОМПАНИИ</b>			
<b>Company present in Russia since:</b> _____ / Компания присутствует на российском рынке с: _____ г.			
<b>Company activities/</b> Деятельность компании	<b>Primary /</b> Основная:	<b>Secondary /</b> Второстепенная:	
<b>Company turnover (euro)/</b> Оборот компании (в Евро)	<b>In Russia /</b> в России:	<b>Worldwide /</b> в мире:	<input type="checkbox"/> Please do not include this in the AEB Member Database/ Не включайте это в справочник АЕБ
<b>Number of employees/</b> Количество сотрудников	<b>In Russia /</b> в России:	<b>Worldwide /</b> в мире:	<input type="checkbox"/> Please do not include this in the AEB Member Database/ Не включайте это в справочник АЕБ
<p><b>Please briefly describe your company's activities (for inclusion in the AEB Database and in the AEB Newsletter) /</b> Краткое описание деятельности Вашей компании (для включения в базу данных АЕБ и публикаций АЕБ)</p>			

<b>6. HOW DID YOU LEARN ABOUT THE AEB / КАК ВЫ УЗНАЛИ ОБ АЕБ?</b>	
<input type="checkbox"/> <b>Personal Contact /</b> Личный контакт	<input type="checkbox"/> <b>Internet /</b> Интернет
<input type="checkbox"/> <b>Media /</b> СМИ	<input type="checkbox"/> <b>Event /</b> Мероприятие
<input type="checkbox"/> <b>Advertising Source /</b> Реклама: _____	<input type="checkbox"/> <b>Other /</b> Другой: _____

**Signature of Authorised Representative of Applicant**  
Company / Подпись уполномоченного лица заявителя:

**Signature of Authorised Representative of the AEB /**  
Подпись Руководителя АЕБ:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_  
Date/Дата:

\_\_\_\_\_  
Date/Дата:

<sup>1</sup> Location of a parent company or of the main shareholder / Местонахождение головной конторы или основного учредителя.