



Doing business in Russia

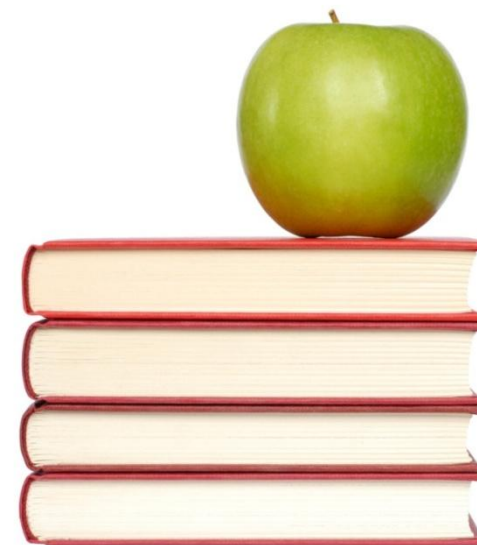
**Andrey Panin, Partner
Deloitte & Touche RCS
Russia**

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Country overview

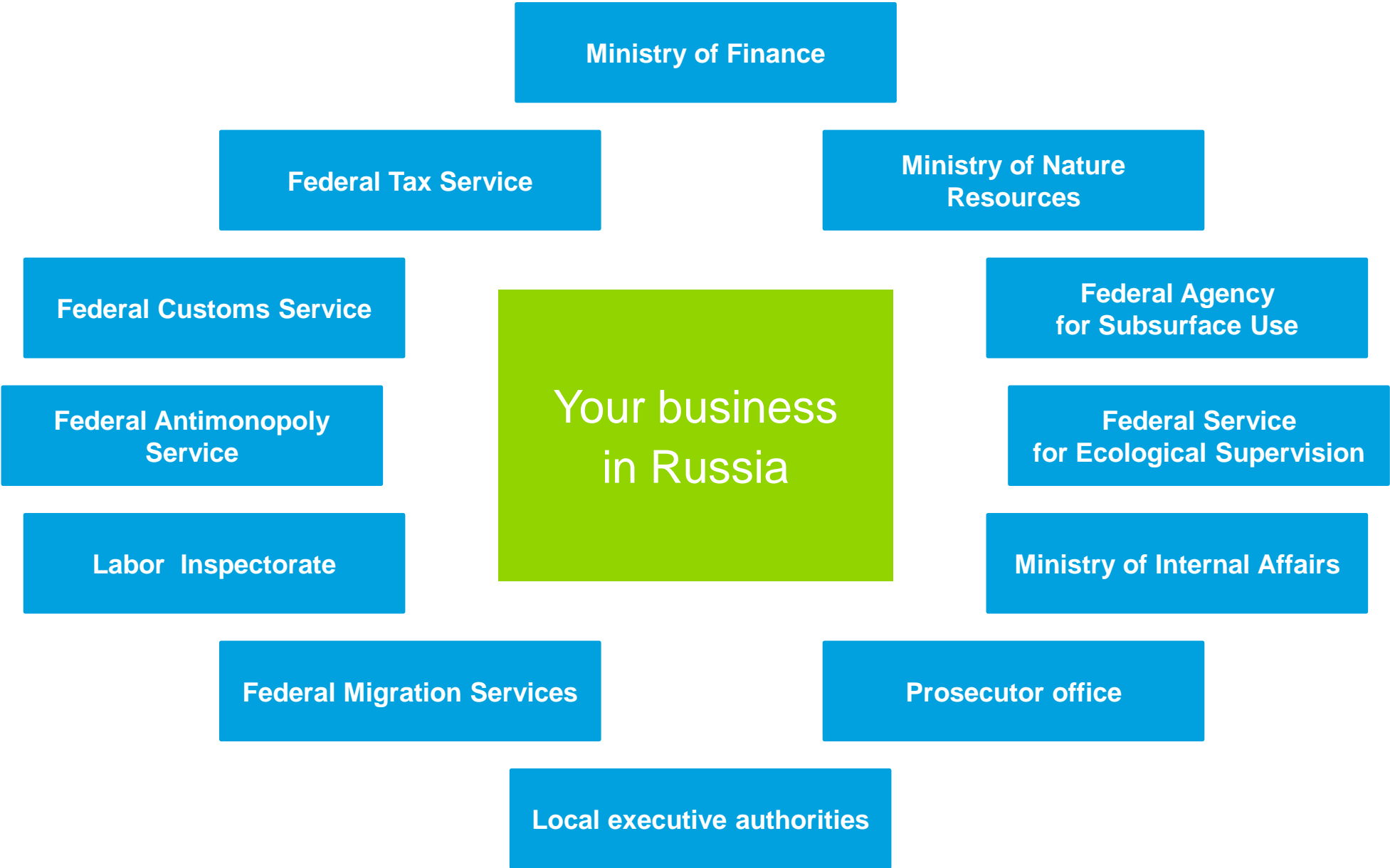
Oil and gas

Major oil and gas provinces in Russia



Country overview

Regulatory framework



Country overview

Regulatory framework

Freedom of business activity vs. specially regulated areas

- “Hidden” requirements and restrictions
- Requirements to have a special business entity
- Tax registration
- Licensing prior to commencing the work / service
- Energy and resources sector
- Foreign labor authorization

Maintaining compliance with the current legislation requirements

- Compliance with immigration legislation
- License terms and conditions
- Accounting, reporting and taxation

Supervisory activity of the authorities

- Federal Migration Service Investigations
- Labor Supervisory Inspectorate Audits
- Tax Audits
- Ecological and Technical Audits

Sanctions (tax, administrative, criminal, suspension of a company’s activity in Russia up to 90 days, deportation of a foreign national from Russia)

Country overview

Trends

Regulatory environment

- Increase of government participation in oil and gas projects
- Restrictions of foreign investments in strategic sectors (including development of oil and gas fields on the Russian shelf)
- Proposed changes to transfer pricing rules and Consolidated Corporate Group Regime
- Differentiated MET rates and tax holidays
- Major trends of the Russian tax policy for 2011-2013. The RF Tax Code will be amended in respect of activities on the RF continental shelf, exclusive economic zone and waters of the Caspian Sea to clearly define taxations rules in such cases.

Caspian Sea oil and gas projects (Russian area)

- Six major oil and gas fields are discovered in Severny block (license area of Lukoil) in 1999-2005 . Amount of oil and gas reserves are estimated as 4,7 billion barrels in total. The deposits are actively developed. 4 fields (Korchagin, Phillonovsky, Rakushechny and Sarmatsky) are targeted currently.
- The first production of crude oil was started in April 2010 by Lukoil on Korchagin field. The first cargo of crude oil was lifted in October 2010. Maximum production level is estimated of 2,5 million tons of crude oil and 1 billion cubic meters of natural gas per year.
- It is planned to construct facilities on Phillonovsky field till 2015, including construction of pipeline, power line and on-shore crude-oil terminals.

Country overview

Trends

Territorial issues

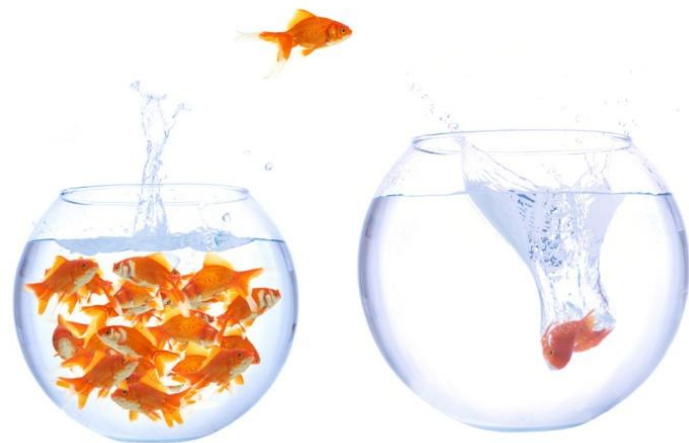
- For Russian tax purposes it is crucial to determine whether the respective activities are carried out on the territory of Russia (which includes Russian territorial waters), on the continental shelf of Russia or outside of those areas.
- There are significant difficulties in determining the above terms (territorial waters, continental shelf, etc.) in respect of the Caspian Sea because currently the legal status of the Caspian Sea is not entirely clear.
- Questions
 - Whether the Caspian Sea shall be treated under public international law as a sea, a lake or something else.
 - How to delimit the borders of the five Caspian states in terms of the seabed, water and air space, and how to respectively establish their rights to subsoil, navigation, fishing and other natural resources use as well as ecology requirements to be complied with.
- USSR - Iran agreements dated 1921 and 1940. USSR and Iran did not formally delimit the seabed and waters of the Caspian Sea. The agreement implies freedom of navigation and fishing for the States except within 10 miles national fishing areas.
- Upon disintegration of the USSR, the five Caspian states (Russia, Kazakhstan, Azerbaijan, Turkmenistan and Iran) consider execution of new agreements stipulating legal status of the Caspian Sea, and the discussion is still on-going.

Country overview

Trends

Territorial issues

- Russia - Kazakhstan Agreement on delimitation of the seabed of the Northern part of the Caspian Sea to establish the sovereign rights to subsoil use (dated 6 July 1998 and Protocol dated 13 May 2002)
- Russia - Azerbaijan Agreement on delimitation of adjacent areas of the Northern part of the Caspian Sea (dated 23 September 2002)
- Russia – Kazakhstan - Azerbaijan Agreement on junction point of lane lines of adjacent areas of the seabed of the Caspian Sea (dated 14 May 2003)
- The agreements stipulate geographical coordinates of lane lines of the seabed areas in which the States establish their sovereign rights to subsoil use.



Latest legislative developments from Russia

Foreign Investments Restrictions in Strategic Sectors

- Federal Law «On regime of foreign investments into strategic enterprises» restricts participation of foreign investments in some strategic sectors of Russian economy.
 - The law stipulates 42 strategic sectors, including exploration and production of mineral resources located in the areas of federal significance (which contain major oil and gas deposits or located in the internal waters, territorial sea or Russian continental shelf).
 - Acquisition of shares in companies operating in strategic sectors is subject to the RF Government's approval, in particular

	Exploration/production of mineral resources on Russian shelf	Other strategic sectors
For foreign companies	10% share and more	50% share and more
For foreign states and international organizations	5% share and more	25% share and more

- The Law “On subsoil resources” also restricts obtaining a subsoil use license for the parts of subsoil of federal significance.
 - For subsoil located at the continental shelf, a license can be granted only to a RLE having the experience of working at continental shelf not less than 5 years and in which the RF directly or indirectly holds more than 50% of votes;
 - Other subsoil of federal significance, a license holder can be only a RLE. Upon holding an auction/tender for granting the right to subsoil, the RF Government may restrict participation of RLEs, which are owned by foreign investors in whole or in part.

Latest legislative developments from Russia

Mineral Extraction Tax changes

Decrease of MET rate for oil

$$\text{MET rate} = \text{Base rate (RUB 419 or 0)}^* \times \text{Price factor}^{**} \times \text{Exchange rate factor} \times \text{Depletion factor}^*$$

* To apply benefits (tax holiday, zero MET rate for heavy oil and reduced MET rate based on the depletion factor) it is not obligatory to use direct method for determination of quantity of extracted crude oil. Before 2009 companies which have no opportunity to use direct method (for which expensive measuring equipment is required) could not apply benefits.

Base rate to be increased in 2012 (USD 446) and 2013 (USD 470)

** Average price per barrel in USD of Urals blend crude oil less USD 15 (from 2009), USD 9 (before 2009)

MET rate per ton of oil within old rule (Company does not apply benefit due to indirect method)
= 419 (no 0) x (101,1 – 9) x (29,2947 / 261) x (no depletion factor) = RUB 4,331.34

MET rate per ton of oil within new rule (Company applies benefit even using indirect method)
= 419 or 0 x (101,1 – 15) x (29,2947 / 261) x 0,3 (calc by company) = RUB 1,214.75 or 0

Latest legislative developments from Russia

Mineral Extraction Tax changes

Tax holidays

- From 2009 for crude oil extracted from oilfields located in Nenets Autonomous Area, Yamal, continental shelf of Northern Polar Circle, Azov and Caspian Seas under certain conditions the MET rate for crude oil is 0 RUB. (Before 2009 tax holiday are applied only in the Sakha (Yakutia), Irkutsk and Krasnoyarsk regions only). The conditions are:
 - The period during which the relevant field has been in operation (varies from 7 to 15 years for particular areas and depending on types of license);
 - The cumulative production of crude oil has not reached certain quantity (varies from 10 to 35 million tons for particular areas);
 - Depletion factor (applied in some case in addition to the above conditions).
- Tax holidays are expected to be introduced in the Black and Okhotsk Seas. In 2009 the RF State Duma has approved the respective law at the first reading.

Expected legislation changes to become effective from 2011-2012

Proposed Changes to the Transfer Pricing Rules

- Separate chapter on transfer pricing rules will be introduced to clearly define the transfer pricing rules and prevent tax minimization schemes.
- New criteria and definitions of related parties, market prices, controlled transactions, etc.

Consolidated Corporate Group Regime

- To be applied to companies of holding structures having agreed to calculate, report and pay profits tax on consolidate basis. Not to be applied to companies which are residents of special economic zones or applying special tax regimes.
- The rules on calculation of consolidated profits tax includes taxation of losses, reserve funds, taxation within liquidation process, etc.

The proposed changes are stipulated within the tax policy of Russia for 2011-2013 approved by the RF Government. The Law re Transfer Pricing is at the stage of the second reading in the RF State Duma. The Law re Consolidated Corporate Group Regime are prepared in the Ministry of Finance and discussed now. Date of submission to the RF State Duma for approval is not announced.

Choosing the right business vehicle

Options

- Russian legal entity (RLE)
 - Russian subsidiary (Limited Liability Company/Joint Stock Company)
 - Joint Venture with a Russian partner
- Commercial/non-commercial subdivision of a foreign company (FLE)
 - Tax registration
 - Branch or Representative office
- Joint Activity Agreements, also known as Simple Partnerships (SP)
- Choosing the form of conducting business in Russia is a management decision to be taken by companies, however, certain differences of tax and legal regime should be taken into account.



Choosing the right business vehicle

Comparison of the options

Criteria	RLE	v s	FLE
The period of registration	Generally, is not limited.		Up to 5 years, after expiration of this period the registration shall be prolonged with relevant Russian authorities.
Liability of the parent company for the obligations of the vehicle	As a general rule, the parent company (shareholder or stockholder) is not liable for the obligations of the subsidiary legal entity.		The parent company (head office) is liable for all obligations of the branch office.
Obtaining various permitting documents (licenses, permits, approvals)	Generally, the process is less complicated than for a FLE.		Generally, the process may be more complicated than for a RLE. Depending on the types of works conducted, obtaining relevant permitting documents may be even impossible in some cases.

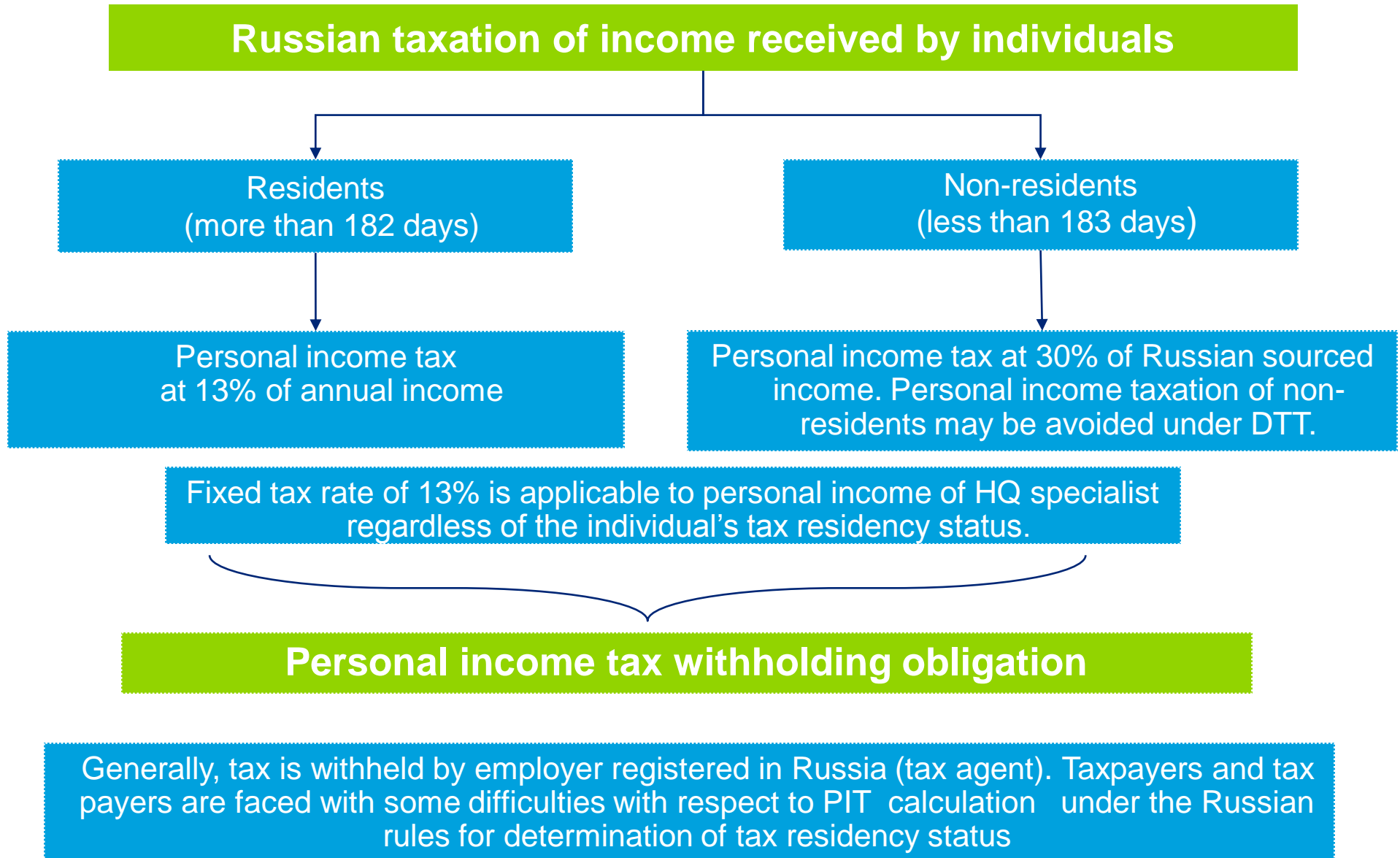
Choosing the right business vehicle

Comparison of the options

Criteria	RLE	v s	FLE
Liquidation process	The liquidation process is more complicated and time-consuming than for a branch office of a foreign legal entity and usually takes at least 1 year in practice.		Generally, the process of liquidation is easier than for a Russian legal entity and may take 1-2 months in practice.
Tax registration	Statutory tax registration is required.		Tax registration is required when: <ul style="list-style-type: none"> • Legal registration (branch, representative office) • Performance of activity (construction site, working place) • Property
Profits tax consolidation	Profits tax consolidation is allowed. No group loss relief is allowed.		Profits tax consolidation is not allowed. No group loss relief is allowed. Allocation of Head Office expenses may be applied.
Profits repatriation	Dividends distribution is subject to income withholding tax at 9 or 15% (tax relief is provided by DTT).		Profits repatriation is non-taxable.
Funding	Funding of a RLE needs proper structuring (e.g., due to thin cap rules for loans).		Transfer of funds within a FLE is straightforward and does not give rise to any tax liabilities.

Tax treatment of operations in Russia

Tax treatment of personnel



Tax treatment of operations in Russia

Tax treatment of income generated Russia

Permanent Establishment of Taxpayers – Organizations



*General profits tax rate is 20%.

Tax treatment of operations in Russia

Tax treatment of income remitted back to Azerbaijan

	Local legislation	Russia – Azerbaijan DTT
Dividends*	15%	10%
Interest **	20%	10%
Royalties	20%	10%
Other income	20%	Exempt

*Dividends v s **Interest

Formalization of profits distribution and fixed payment dates are required.

Possibility to decrease a RLE or PE's Profits tax base.

Allocation of net profits generated through a PE to its Head office is free.

"Thin-capitalization" restrictions on loans provided by a FLE to related RLE.

Transfer pricing limits for deductibility of interest costs.

Significant exchange rate differences could affect profits tax calculation (for loans nominated in foreign currency).

Tax treatment of operations in Russia

Importation and exportation of goods and equipment

- **Customs Union of Russia, Belarus and Kazakhstan**
 - Common regulation of trade with third countries
 - Common customs tariff regulation and non-tariff regulation (e.g. licensing, quoting)
 - Common customs procedures
 - Technical regulation (e.g. conformity regulation and sanitary measures)
- **Stages of formation:**
 - 1 January 2010 - Introduction of the Common tariff and non-tariff regulation
 - 1 July 2010 - Entry into force of the Customs Code of the Customs Union
 - 1 July 2010 - Goods originating in Russia, Belarus and Kazakhstan and goods that have been imported into Russia, Belarus and Kazakhstan from other countries and released for free circulation are transferred between these three countries without undergoing customs clearance
 - 1 July 2011 - Transfer of the customs control to the external border of the Customs Union
- **Export customs duties** for goods exported to third countries are currently levied only on some goods and raw materials, e.g., crude oil (USD 423,7 per ton), oil products (USD 197,9 per ton), etc. Reduced export customs duties are applied, inter alia, for crude oil exported from the Northern part of the Caspian Sea (USD 191 per ton).
- **Russian VAT** (sales of goods for export from Russia to third countries) is subject to 0% rate in general and subjected to proper specific documentary supporting. Goods exported inside the Customs Union are subject to the 0% VAT rate, subject to confirmation by a specific list of documents.

Tax treatment of operations in Russia

Importation and exportation of goods and equipment

- **Import customs duties** are levied based on the classification code and country of origin of the goods being imported.
 - “Ad valorem” rates of customs duties set as a percentage (5%, 10% and 15% in the majority cases) of value of goods or “Specific” and “Combined” duties.
 - Basic import customs duty rates vary depending on the country of origin of the goods, type of goods and occasionally on other factors (from exemption for less developed and CIS countries to doubled basic rates for non-favored countries).
- **Import VAT** (10% or 18% depending on the type of goods) is generally applied when importing goods in Russia.
 - For transactions involving taxpayers of the member states of the Customs Union tax base for imported goods and the import VAT rates must be the same as those applicable to domestic transactions within the importing member state.
 - Equipment: Import VAT exemption applied upon importation of technological equipment which has no equivalent produced in Russia according to the list issued by the Russian Government. Major types of technological equipment are subject to 0% import customs duty rate. Import customs duty exemption is provided upon importation of certain goods related to fixed production assets as in-kind charter capital contribution of a foreign investor.
 - Certain customs procedures (regimes) provide for either full or partial exemption from import customs duties and taxes (e.g. temporary import).
- **Excise tax** (if applicable) is also levied upon import of excisable goods into Russia.

Tax treatment of operations in Russia

Importation and exportation of goods and equipment

- **Activity in the Caspian sea** – to consider if the area of activity is within the Russian territory or the territory of the Customs Union or third country.
- The following issues require separate consideration:
 - whether importation of goods to/from area would be subject to customs payments;
 - whether the full customs clearance requirements and control would apply to the respective activities.



Tax treatment of operations in Russia

Value added taxation

Taxpayers	RLEs, FLEs registered in Russia VAT withholding mechanism by tax agents
Subject to VAT	Sales of goods, works, services in Russia (exported goods deemed to be supplied in Russia). Place of supply rules are applied to determine if services are provided in Russia. Free of charge supplies Internal constructions and supplies within company Import VAT
Rates	18% Usually 10% Food, children goods, medicines, printed magazines/books 0% Export of goods and related services. Other specific cases 15,25% Enterprise as a complex asset
Output/Input VAT	Taxpayers charge output VAT for sales and recover input VAT for purchases.

Legal environment

Currency control

- Liberalization of currency control rules. Some requirements were canceled, but others exist and applied to residents (e.g., RLEs). FLEs being non-residents are not subject to currency control.
- Foreign currency transactions between RLEs are generally not allowed subject to certain exemptions. Transactions between RLEs and FLEs are generally permitted.
- RLE may receive sales proceeds in foreign currency only in certain cases (e.g., export of goods; sale of works / services to foreign legal entities). Export proceeds must be repatriated to Russia. Although there are certain exemptions, for example:
 - if export proceeds are used for loan repayment under loan agreements concluded with non-residents from OCED;
 - if export proceeds are used to pay to non-residents for costs for construction abroad Russia.
- RLE may not freely repatriate foreign currency to the foreign shareholder (with some exceptions, e.g., dividends, loans repayment, etc).
- Paperwork and other: Passports of transaction for cross-border transactions; Sale/purchase of foreign currency through authorized Russian banks only;
Obligatory notification to Russian authorities about any bank account opened by RLE overseas.

Legal environment

Immigration and labor law

Compliance with Russian Labor Law and Choice of employment structure:

- Expatriates' Employment Authorization
 - Quota for employment of the expatriates
 - Framework employment permit for a company
 - Individual work permits for the individuals
 - Benefits for Highly Qualified Specialists
- Entry Visa and Purposes of Entry
 - Work visa
 - Business visas
 - Challenges in the entry visa regulations
 - Sanctions for Work Permit, Visa and Personal Registration Violations
- Other rules
 - Labor documentation in respect of an employee
 - Local payroll requirements
- Challenges in compliance with Russian immigration, labor and tax issues
- Secondment arrangements
 - Dual employment
 - Direct employment
 - Transformation of secondment arrangement into service agreement



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