



Equipment Leasing in Russia

The legal environment for leasing in Russia greatly improved with the enactment of amendments to the Financial Leasing Law¹ in 2002, and amendments to Russian tax, currency control, and customs laws in 2004. Those changes resolved most of the inconsistencies that existed in Russian legislation governing leasing, and significantly reduced administrative impediments to leasing activity. Since 2002, the Russian legislature has gradually deregulated leasing activity further, making leasing increasingly attractive to both lessees and lessors due to its economic effectiveness, flexibility, and accessibility in comparison with other capital financing methods.

This memorandum provides a general overview of the legal and regulatory framework for cross-border leasing activities in the Russian Federation, with a primary focus on cross-border financial leases. However, it is not intended to replace specific legal advice on a given transaction. We recommend that specific legal advice be obtained before entering into any leasing transaction in Russia or with a Russian counter-party.

I. Legislation Governing Leasing in Russia

General provisions governing all types of leases, including financial leases, are contained in Chapter 34 of the Civil Code of the Russian Federation (the "**Civil Code**"). In addition to those general provisions, Chapter 34 contains sections covering specific types of leases, including sections on financial leases and leases of transportation equipment.

Chapter 34 of the Civil Code describes three basic types of leases.² *Arenda* is the general term that covers all types of leasing or rental activity. *Prokat* is the term for short-term property rentals, such as rental cars or skis. The term *leasing* is used only in connection with financial leases, which includes only those transactions that fall within the Civil Code's specific definition of financial leases. Although this memorandum focuses on financial leases, the general provisions of Chapter 34 discussed below apply to other types of leases as well.

The Financial Leasing Law reiterates the general provisions of the Civil Code, but it also contains much more detailed rules on financial leasing transactions and the relationship between the parties to those transactions. In addition, the Tax Code of the Russian Federation (the "**Tax Code**") contains a number of provisions that apply specifically to leasing activities.

¹ Federal Law No. 164-FZ "On Financial Leasing" of October 29, 1998, which was significantly amended in 2002 and last amended on July 18, 2005 (the "**Financial Leasing Law**").

² Chapter 35 of the Civil Code addresses a fourth type of leasing, *naem*, which is the term for leasing of housing.



II. Financial leases

Parties to a Financial Lease

Financial lease transactions involve three parties under Russian law. As defined by the Civil Code, a financial lease transaction involves a *lessor* who undertakes to purchase non-consumable property identified by the *lessee* from a *seller* and to deliver temporary possession of that property to the lessee for the lessee's commercial use. The lessee, in return, must make the required lease payments to the lessor. Under this definition, the seller of the property must be a party other than the lessor – the lessor cannot lease out property that it already owns. The Financial Leasing Law, however, specifically provides that the lessee can be the seller (thus setting up the possibility of sale-leaseback transactions).³

The Financial Leasing Law also expressly allows a non-resident of the Russian Federation to be a party to a financial lease transaction. Although the Financial Leasing Law states that leases fall into two categories, domestic leases and cross-border leases, it does not otherwise distinguish between the two categories.

The Financial Leasing Law provides that the lessee normally should select the seller of the subject property, but the parties may agree in the financial lease agreement that the lessor should select the seller. If the lessee selects the seller, only the seller is liable under Russian law to the lessee for its performance under the purchase agreement entered into by the seller and the lessor.⁴ Nevertheless, the lessee may not terminate the purchase agreement without the lessor's consent. If the seller breaches its obligations under the purchase agreement, Russian law deems the lessor and the lessee to be joint and several creditors of the seller, *i.e.*, either may demand full compensation from the seller for its breach.⁵

If the lessor selects the seller, the lessor must notify the seller that the acquired property is intended for lease to a specific person.⁶ Both the seller and the lessor are liable to the lessee

³ Art. 4 of the Financial Leasing Law.

⁴ If the lessor and lessee are non-Russian entities, the lessor also may be liable to the lessee under the laws of another jurisdiction, depending on the terms of the purchase agreement and the laws of other relevant jurisdictions.

⁵ In the case of an award of damages for the seller's breach of the purchase agreement, the recipient thereof must compensate the other creditor to the extent required by the relationship between the two creditors.

⁶ The Federal Arbitration Court for the Far East Region found a financial lease agreement void because the lessor did not inform the seller that the acquired property was intended to be leased (April 3, 2001). This decision demonstrates the importance of fully complying with all of the technical requirements of the applicable law.



for the seller's non-compliance with the terms of the purchase agreement, and the lessee may present any claims, at its discretion, to either the seller or the lessor.⁷

Property that Can be the Subject of a Lease

Any non-consumable tangible property, other than land plots and other natural objects,⁸ may be the subject of a lease under Russian law.⁹ Under Russian law, title to the subject property of a financial lease may or may not transfer to the lessee at the end of the lease term.¹⁰

Required Provisions of Lease Agreements

The Civil Code requires all contracts to which a legal entity is a party, and all commercial transactions with non-residents, to be in written form,¹¹ which covers all commercial transactions except those between two Russian individuals. For good measure, the Financial Leasing Law specifically requires all financial leases to be in writing.

The Financial Leasing Law also requires certain issues to be addressed in a financial lease agreement. A financial lease agreement must unambiguously identify the subject property and the seller.¹² A lease agreement that fails to adequately identify the subject property is deemed void under Russian law. A financial lease agreement also should indicate the amounts of the lease payments, the payment due dates, and any other conditions and obligations to which the lessor or lessee agree.

Since a financial lease under Russian law requires a seller of the subject property, the Financial Leasing Law requires a sale/purchase agreement between the seller and lessor to complement the lease agreement. The Financial Leasing Law notes that other agreements – pledges, guarantees, or financing agreements – may be part of the transaction, but none of those documents are required for a valid financial lease.¹³

⁷ Arts. 665-670 of the Civil Code.

⁸ Art. 666 of the Civil Code.

⁹ Art. 607(1) of the Civil Code.

¹⁰ Arts. 4(1) & 19 of the Financial Leasing Law.

¹¹ Arts. 161 & 162(3) of the Civil Code. Article 163(2) specifically provides that transactions with non-residents are invalid if not in writing.

¹² Arts. 15(3) & (4).

¹³ Art. 15(2).



Lease Payments

If the due dates and procedures for making lease payments are not set out in the lease agreement, Russian law will impute those terms that typically are used in leases of similar property in comparable circumstances. Lease payments may be structured as fixed sums paid once or periodically, as a fixed share of production or income derived from the leased property, they may be paid in-kind with property or services, or any other form agreed upon by the parties to a lease agreement. Unless the parties agree otherwise in a financial lease agreement, the lessee's liability for lease payments begins from the time that the lessee begins to use the leased property.¹⁴

Term of Lease

Lease Term

A lease agreement generally may run for any term to which the parties agree. If the parties fail to expressly indicate the term of the lease in the lease agreement, the lease is deemed to run for an indefinite period of time, until one of the parties terminates it.¹⁵ The Civil Code allows the possibility that maximum lease terms for particular types of leases or leases of particular types of property may be established by law, but no such limits have been established for leases of moveable property.¹⁶

Extension of the Lease Term

Unless the lease agreement provides otherwise, a lessee who has properly performed its duties by the expiration date of the lease agreement has a priority right to prolong the lease agreement for a new term. In that event, the terms of the lease agreement may be renegotiated by the parties (which potentially negates the lessee's priority rights). If the lessee continues to use the leased property after the expiration of the initial term of the lease agreement and the lessor does not object to such use, the lease agreement is deemed renewed on the same terms as the initial lease agreement for an indefinite period of time.¹⁷

¹⁴ Arts. 28(2) & (3) of the Financial Leasing Law.

¹⁵ A party could terminate the lease agreement in accordance with the terms of that agreement, or if the agreement were silent on that issue also, in accordance with the appropriate notice provisions of the Civil Code.

¹⁶ Arts. 610 of the Civil Code.

¹⁷ Art. 621 of the Civil Code.



Statutory Grounds for Lease Termination

In addition to any grounds for termination of a lease that are set out in the lease agreement itself, the Civil Code provides statutory grounds for a court to terminate a lease if one of the parties fails to perform its obligations under the lease agreement within a reasonable period of time.¹⁸ Before seeking a termination order from a court, the party seeking termination must send notice to the breaching party warning that party that it must fulfill its obligations under the lease agreement.

A lessor may ask a court to terminate a lease if the lessee:

- (1) uses the property in a way that substantially breaches the terms of the lease agreement or the designation of the property;
- (2) substantially damages the leased property;
- (3) misses more than two consecutive lease payment; or
- (4) fails to carry out major repairs to the property that are the lessee's duty.

A lessee may ask a court to terminate a lease if:

- (1) the lessor fails to provide the leased property to the lessee or creates impediments to its use;
- (2) use of the leased property is prevented by unexpected defects that were not previously known to the lessee and could not have been discovered by an inspection of the property when the parties concluded the lease agreement;
- (3) the lessor fails to carry out major repairs to the property that are its duty; or
- (4) the leased property is unsuitable for use due to circumstances for which the lessee is not responsible.

Remedies for Breach of a Lease Agreement

Recovery of Leased Property Upon Lessee's Breach

Perhaps the most important benefit of leasing over other forms of asset financing in Russia is the lessor's ability to recover the property in the event of the lessee's default. Only through lease financing does a provider of equipment retain the right to repossess the equipment if the lessee defaults on its obligations. While a seller of property under an installment agreement or straight financing from a credit organization may take a pledge of the property, a

¹⁸ Arts. 619, 620 of the Civil Code.



pledge does not give the pledge the right to take possession of pledged property. Instead, pledged property must be auctioned off in lengthy proceedings that can result in the pledgor receiving less than the fair market value of the property.

Because a lessor retains title to the leased property, a lessor can regain possession of the property. Unless the lessee returns the leased property voluntarily, the lessor must obtain a court order to repossess property in the event of default. Unfortunately, that process frequently is subject to abuse by disreputable lessees, but ultimately the lessor should be able to repossess the property. In any event, this process is much preferable to an auction of pledged property.

Attachment of Lessee's Bank Accounts

The Financial Leasing Law provides that a lessor has the statutory right to have funds equal to the amount of any unpaid lease payments withdrawn from the lessee's bank account without the lessee's consent.¹⁹ Central Bank rules permit banks to wire transfer funds from a customer's account without that customer's specific consent if the transfer is envisioned by Russian law or in an agreement to which the customer is a party.²⁰ No court approval is necessary for withdrawals in these circumstances. Nevertheless, some Russian courts will allow such wire transfers only when they are specifically allowed by both the financial lease agreement and the customer's account agreement with the bank.²¹ According to the Financial Leasing Law, the use of this remedy does not waive the lessor's rights to other remedies, such as early termination of the lease agreement, return of the leased property, and compensation for expenses and additional fees (such as a late fee).

Acceleration of Lease Payments

When a lessee is "substantially" late in making lease payments, in addition to its other remedies the lessor may demand that the lessee make upcoming lease payments in advance. This statutory remedy has little practical value, however, since it can be used for no more than two consecutive lease payments.²²

¹⁹ Art. 13.

²⁰ Art. 9.4 of Instruction of the Russian Central Bank "On Wire Transfers in the Russian Federation" No. 2-P of October 3, 2002, as amended.

²¹ See, e.g., Decisions of the Federal Arbitration Court of the West-Siberian Region of November 23, 2000, and November 11, 2003, and Decision of the Federal Arbitration Court of the Povolzhoskiy Region of July 16, 2002.

²² Art. 614 of the Civil Code.



Exposure of Leased Property to Lessee's Creditors

The Financial Leasing Law prohibits third party creditors of the lessee, in bankruptcy proceedings or otherwise, from claiming leased property.²³ In case of insolvency of the lessee, the lessor has the right to reclaim its property, but has no priority over the lessee's other creditors to monetary compensation.

In some circumstances, a lessor may want to obtain a pledge of other assets of the lessee to improve its priority should the lessee default on its payment obligations or become insolvent. A pledge of property does not give the lessor/pledgee the right to take possession of the pledged property, but it would give the lessor higher priority to the proceeds from the sale of the pledged property. Even in that case, however, the lessor's claim would be subordinate to those of the lessee's employees, the Russian government, and other creditors, if any, who had prior claims to the pledged assets.²⁴

Return of Leased Property

At the termination of a lease, the lessee has the duty to return the property to the lessor in the condition in which it was received, except for normal wear and tear, or in the condition set forth in the lease agreement. If the lessee fails to return the property or returns it late, the lessor may demand that the lessee make lease payments for the delay period and compensate the lessor for any losses not covered by the lease payment. If the lease agreement imposes a penalty for late return of the leased property, the lessor may recover any losses in excess of the set penalty so long as the agreement does not provide otherwise. If the lessee refuses to return the leased property, the lessor may repossess the leased property as with any other breach by the lessee, *i.e.*, with a court order.²⁵

The Financial Leasing Law further provides that the lessee bears all the expenses relating to the dismantling of the equipment for its return, along with transportation and insurance for its transfer back to the lessor.²⁶

Buyout of Leased Property

²³ Art. 23.

²⁴ Art. 134 of Federal Law No. 127-FZ of 26 Oct. 2002 "On Insolvency (Bankruptcy)" (as amended).

²⁵ Art. 622 of the Civil Code.

²⁶ Art. 13.



The parties may agree in the lease agreement that title to the leased property passes to the lessee at the end of the lease term (or sooner), provided that the lessee pays the full buyout price specified in the lease agreement. A buyout option may be set out in a supplementary agreement of the parties.²⁷

Sublease

The general lease provisions of the Civil Code provide that a lessee may sublease leased property, assign the lease agreement, or pledge the rental rights, provided that the lessor consents. However, the specific provisions of the Civil Code and other legislation significantly limit the lessee's right to sublease leased property. The Civil Code itself prohibits lessees from subleasing moveable property leased under an agreement that does not qualify as a financial lease (*prokat*).

The Financial Leasing Law provides only that the written consent of the lessor is mandatory before the lessee may sublease the leased property.²⁸ Unlike other provisions of the Civil Code and the Financial Leasing Law, the provisions allowing the lessee to sublease the leased property do not specifically indicate that the parties can agree otherwise. Consequently, the enforceability of a provision that prohibits the lessee from subleasing the subject property is uncertain. Moreover, while the lessor's consent is required before the lessee can sublease leased property, we cannot preclude the possibility that a court would hold that the lessor cannot withhold consent arbitrarily. Although we are unaware of any Russian court that has held that a lessor cannot withhold its consent to a sublease without good reason, certainly many foreign courts would take that position.

Accordingly, there is some risk that a lessee under a financial leasing agreement could sublease the property to a third party. Under the circumstances, we believe that the best way to control that risk is to put a provision into a financial lease agreement providing that the lessee can sublease the property only with the consent of the lessor, and then refuse to consent to any proposed sublease unless the lessor is convinced that its interests are not prejudiced by that sublease.

If leased property is subleased, the lessee remains liable to the lessor under the original lease, while the lessee's right of claim against the seller passes to the sublessee.

²⁷ Art. 624 of the Civil Code.

²⁸ Art. 8 of the Financial Leasing Law.



Duty to Repair

Unless a lease agreement provides otherwise, the general provisions of the Civil Code require the lessor to make major repairs of leased property at its own expense, while the lessee must maintain the property in proper condition and make repairs other than major repairs at its own expense.²⁹ This general provision applies to equipment leases that do not qualify as financial leases, but it does not apply to financial leases. Instead, the Financial Leasing Law provides that all repairs of the property lease under a financial lease are the responsibility of the lessee unless the agreement specifies otherwise.³⁰

Liability for Defects

Under Russian law, the lessor is liable for defects in the leased property that wholly or partially hinder the use of the property, even if the lessor did not know about those defects when it entered into the lease agreement. Upon discovery of such defects, the lessee may (1) demand that the lessor correct them, (2) request replacement of the property, (3) withhold from lease payments the amounts incurred by the lessee to correct the defects (after notifying the lessor thereof), or (4) demand early termination of the contract. The lessor is not liable, however, for defects of the property that were expected at the time the lease agreement was signed, or defects that were known to the lessee or that should have been discovered by the lessee at the time of inspection or transfer of the property.³¹

If the lessee's actions or inactions cause the loss of the leased property or the loss of its functionality, the lessee remains liable for its obligations under the financial lease agreement, unless the agreement provides otherwise.³² Under the Financial Leasing Law, the lessor has the right to monitor the lessee's observance of the terms of the lease agreement and other accompanying agreements. The lessor also has the right to exert financial control over the lessee's activities with the leased property pursuant to procedures set out in the lease agreement. The lessee is required to provide the lessor access to its financial documents and to the leased property for these purposes.³³

²⁹ Arts. 615, 616 of the Civil Code.

³⁰ Art. 17(3) of the Financial Leasing Law.

³¹ Art. 612 of the Civil Code.

³² Art. 26.

³³ Arts. 37 & 38. The lessor may also forward written inquiries requesting information necessary to exercise financial control, and the lessee is required to respond to such inquiries. Art. 38 (3).



Licensing and Registration Requirements

Since early 2002 financial lease activity is no longer subject to licensing under Russian law.³⁴ A lease agreement for movable property, as opposed to one for real estate, aircraft and certain vessels and spacecraft, is not subject to state registration under Russian law.

III. UNIDROIT Convention on International Financial Leasing

In 1998, Russia acceded to the UNIDROIT Convention on Financial Leasing of May 28, 1988 (the "**Convention**"), which came into force on May 1, 1995.³⁵ The Convention applies to leases when (i) the lessor and the lessee have their places of business³⁶ in two different countries, and (ii) either those two countries (and the country in which the seller has its place of business) are parties to the Convention or both the financial lease agreement and the purchase agreement are governed by the law of a country that is a party to the Convention.³⁷ The Convention applies only to cross-border financial leasing of equipment, excluding equipment used primarily for personal purposes.³⁸

In acceding to the Convention, Russia reserved the right to apply its own civil legislation instead of Article 8(3) of the Convention. That article prohibits the parties to a financial lease transaction from eliminating the lessor's duty to warrant the lessee's quiet possession of the leased property from third party claims arising out of intentional or grossly negligent acts of the lessor. Accordingly, Article 8(3) of the Convention does not apply to leases governed by Russian law.

When the criteria above are met, the Convention applies to a financial lease unless *all* of the parties to the transaction – including the seller – agree to exclude its application.

³⁴ RF Federal Law "On Licensing of Certain Types of Activities" No. 128-FZ of August 8, 2001, abolished the licensing requirement for financial leasing that had been imposed by the former licensing law.

³⁵ RF Federal Law No. 16-FZ of February 8, 1998 "On the Accession of the RF to the UNIDROIT Convention on International Financial Leasing." The Convention entered into force for Russia on January 1, 1999.

³⁶ If a party has a place of business in more than one country, the place of business which has the closest relationship to the relevant agreement and its performance should be used. Art. 3(2) of the Convention.

³⁷ Arts. 1(4) & 3(1) of the Convention. Only 19 countries are signatories of the Convention, including France, U.S., Belgium, Uzbekistan, Latvia, Italy, Hungary, etc. The UK, Germany and Spain, of larger Western European countries, have not ratified the Convention.

³⁸ The definition of equipment under the Convention includes plant machinery, capital goods and other equipment. Art. 1(a).



Alternatively, the parties may agree to derogate from any provisions of the Convention, with two exceptions.³⁹ First, the Convention prohibits a provision in the agreement that would allow the lessor to recover substantially greater damages than those necessary to place the lessor in the position in which it would have been had the lessee fully performed its obligations.⁴⁰ Second, the Convention prohibits the lessor from enforcing an acceleration clause for payment of future lease payments when the lessor has terminated the financial lease agreement. In that event, the value of those future lease payments will be taken into account when computing the lessor's damages.⁴¹ Russian law generally is more favorable to the lessor on both of these points, which may suggest that the parties should opt out of the Convention and choose Russian law as the governing law for a financial lease.⁴² That decision, however, must consider a number of other factors.

For the purpose of the creditors' right to the lessee's assets, the Convention applies the law of the country where the equipment is located or, in the case of equipment normally moved between countries, the law of the country where the lessee has its principal place of business. Consequently, when the Convention applies and the property is located in Russia, Russian law will determine the rights of the lessee's creditors to the leased property.⁴³

Russia generally has succeeded in bringing its legislation governing financial leasing in line with the Convention. Consequently, the rights and duties of lessors and lessees under the Convention are more or less identical to their rights and duties under the Russian law. Choosing Russian law to govern a financial lease agreement may therefore be a reasonable decision. In addition, choosing Russian law has a practical benefit if the lessor needs to repossess property located in Russia, because Russian courts have limited experience applying the Convention or laws of other jurisdictions. Moreover, even if the parties choose the law of another jurisdiction to govern their agreement, Russian courts often decide that Russian law must be applied to certain issues.⁴⁴

³⁹ Art. 5 of the Convention. Actually, *three* provisions of the Convention are mandatory unless the parties opt out, but the third is Article 8(3), the application of which Russia excluded when acceding to the Convention.

⁴⁰ Art. 13(3)(b) of the Convention.

⁴¹ Art. 13(4) of the Convention.

⁴² See Art. 622 of the Civil Code, discussed in Subsection on the Return of the Leased Property in Section 1(A) of this memorandum.

⁴³ For a discussion of the creditor's rights to the leased asset and other assets of the lessee, see the last paragraph in Subsection (ii) of Section 1 of this memorandum.

⁴⁴ Art. 1192 of the Civil Code.



IV. Tax Issues

The 2002 amendments to the Financial Leasing Law were enacted to bring the leasing legislation into compliance with the Tax Code, which already provided preferential treatment for lease transactions. Amendments to the Tax Code specifically related to leasing were enacted on June 6, 2005, to take effect on January 1, 2006.

Profits Tax Considerations

Depreciation

Under the Financial Leasing Law, the lessor and the lessee may choose which of them will record the leased property on its balance sheet, which determines which party is entitled to take profits tax deductions for depreciation of the property.⁴⁵ The decision as to whose balance sheet leased property will be recorded on for Russian tax purposes is not affected by the laws of other jurisdictions. Consequently, even if a foreign lessor must record the property on its balance sheet under the laws of its jurisdiction, a Russian lessee still may record the property on its books for Russian tax purposes. For leases other than financial leases, however, the parties have no choice; only the party that has title to the asset, *i.e.*, the lessor, may take depreciation deductions for profits tax purposes.

Russian tax law provides a significant incentive to financial leasing in the form of accelerated depreciation for property that is the subject of a financial lease. A taxpayer can depreciate leased property for Russian profits tax purposes at three times the standard rate of depreciation applicable to that type of property.⁴⁶ This benefit is available to either the lessor or the lessee, depending on whose books the property is recorded on. This benefit is not available to assets acquired in any other way, and thus has induced some Russian companies to set up their own leasing companies specifically to take advantage of the accelerated depreciation allowance.

Deduction of Lease Payments

The lessee is entitled to deduct its lease payments in determining its profits tax liability.⁴⁷ If a financial lease specifies that the leased property should be recorded on the lessee's balance

⁴⁵ Art. 31 of the Financial Leasing Law, Art. 258(7) of the Tax Code.

⁴⁶ Art. 259 of the Tax Code. This provision of Art. 259 governing specifically lessor/lessee relationships will take effect on January 1, 2006. Until then, the general rule applicable to all parties claiming depreciation is that it accrues from the first day of the month following the month when the leased object was put into operation.

⁴⁷ Art. 28(4) of the Financial Leasing Law.



sheet, and the lessee therefore takes depreciation deductions on that equipment, the lessee tax deductions for its lease payment expenses must be reduced by the amount of depreciation deductions taken.⁴⁸

Russian Profits Tax Withholding

Russian law provides that income from leasing property that is located in Russia is Russian source income.⁴⁹ If a foreign lessor operates through a branch in Russia, the net income of that branch will be taxed at the standard profits tax rate of 24%. If a foreign lessor does not operate through a branch in Russia, a Russian lessee must withhold Russian profits tax at the rate of 20% from lease payments to that foreign lessor unless an applicable double tax treaty exempts lease income from Russian tax.⁵⁰ Most tax treaties that Russia has signed with other countries exempt income from leases of moveable property from Russian tax so long as the foreign lessor does not have a permanent establishment in Russia.⁵¹

Value-Added Tax

Russian value added tax ("VAT") applies to lease payments at the standard rate of 18%. When the lessor is a foreign entity with no presence in Russia, a Russian lessee must withhold Russian VAT from payments to the foreign lessor.⁵² This withholding system is not a reverse charge mechanism as is used in other jurisdictions that impose a VAT. Under the Russian system, the Russian lessee is required to withhold 18% of the amount of any lease payment due to a foreign lessor. Therefore to ensure that the foreign lessor receives the full amount due, the lease agreement should state that the amounts of the lease payments indicated therein do not include Russian VAT, and any invoice sent to the Russian lessee should be grossed up by 18%.

Assets Tax

⁴⁸ Art. 264 of the Tax Code.

⁴⁹ Art. 309 of the Tax Code.

⁵⁰ Art. 311 of the Tax Code.

⁵¹ See, e.g., Art. 21 of the Convention Between the Government of the Russian Federation and the Government of the Republic of Austria For the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital. Article 21 of the Russia – Austria treaty derives from the OECD Model Tax Treaty, which is the basis for most double tax treaties that Russia has signed.

⁵² Art. 312 of the Tax Code. VAT applies to leasing because under Russian law it is considered a type of "service" for the tax purposes.



Another important consideration in deciding whether to record property on the balance sheet of the lessor or the lessee is the Russian Assets Tax. Russian assets tax is imposed on the moveable and immovable property, including leased property, that is recorded on an organization's balance sheet.⁵³ Thus for finance leases, the decision as to which party will record the leased property on its balance sheet determines which party will incur Assets Tax liability on that property.

This decision is even more significant for cross-border financial leases. The Assets Tax applies to foreign entities only if they conduct activities in Russia through a permanent establishment.⁵⁴ If a foreign lessor does not have a permanent establishment in Russia, then it is not subject to tax on leased property located in Russia. If the lease agreement specifies that the property should be recorded on the foreign lessor's balance sheet, then the Russian lessee also is not liable for Assets Tax on the leased property, meaning that the leased property escapes Russian taxation.

The down side of specifying that the property will be recorded on the foreign lessor's balance sheet is that doing so eliminates the ability of the lessee to take advantage of the accelerated depreciation benefit, and eliminates the possibility of a double-dip on depreciation deductions. Consequently, the net profits tax and asset tax effects need to be considered before deciding which party's balance sheet should show the leased property.

V. Custom Law Considerations of Cross-Border Leasing

The adoption of a new Russian Customs Code⁵⁵ (the "**Customs Code**"), which became effective on January 1, 2004, had a positive effect on cross-border leasing by adopting international standards and simplifying customs clearance procedures. Under the Customs Code, leased property may be imported into the territory of the Russian Federation under two different customs regimes, depending on the desired consequences and the circumstances of a lease transaction: a permanent import regime called "clearance for internal consumption," or a temporary import regime.

Permanent Import

⁵³ Art. 372 of the Tax Code.

⁵⁴ Art. 373 of the Tax Code.

⁵⁵ Enacted by Federal Law No. 61-FZ of May 28, 2003.



“Clearance for internal consumption” is a custom regime under which imported goods⁵⁶ are released into "free circulation" without any obligation to be re-exported.⁵⁷ This regime requires full payment of customs duties and fees and VAT at the time the property enters Russia.⁵⁸ Custom duties rates vary from 5-30% of the value of the property being imported (with the rates for various types of containers being 15 or 20%), and VAT at the rate of 18% is assessed on the value of the property as increased by the applicable customs duties.

Temporary Import

The Customs Code provides a temporary import regime under which foreign goods can be imported and used in Russia for a limited period of time, with full or partial exemption from customs duties and fees and VAT. The temporary import of goods is allowed subject to the condition that the goods may be identified by the customs authorities at the time of their export out of Russia; temporarily imported goods must remain unchanged other than natural wear and tear or loss under normal circumstances of the goods’ transportation, storage and use.⁵⁹ Russian customs authorities generally demand a guarantee from the lessee that it will re-export the goods at the end of the temporary import term.

If the parties to a cross-border lease want to use the temporary import regime, the lessee will need to import the property since a foreign organization cannot import goods into Russia in its own name. Moreover, temporarily imported goods may be used only by the entity in whose name they were imported, and the use by another party may require the permission of the customs authorities.

Generally, goods can be imported under the temporary import regime for a maximum period of two years,⁶⁰ but the Russian government may set shorter or longer maximum terms for certain types of goods.⁶¹ At the end of the temporary import term, the goods must be exported back out of Russia or switched to another customs regime, such as the permanent import regime

⁵⁶ As discussed in Section 3 of this memorandum, “goods” for the purpose of the Customs Code are all movable property moved across the customs border of the Russian Federation. Art. 11(1)1.

⁵⁷ Art. 163 of the Customs Code.

⁵⁸ Art. 164 of the Customs Code.

⁵⁹ Arts. 209-211 of the Customs Code.

⁶⁰ The Customs Code provides that goods classified as main production goods can be imported under the temporary import regime for a period of 34 months if the goods are used by a Russian entity that does not own them. Art. 213(1) of the Customs Code.

⁶¹ Art. 213(1) of the Customs Code.



discussed above. The customs authorities can extend the term of a temporary import if the importer has not violated the terms of the importation regime.

When property is imported under the temporary import regime, the importer normally must pay a monthly fee equal to 3% of the customs value of the property.⁶² That fee is not refundable if the property is re-exported, but if the customs regime is switched to free circulation, those payments are credited against the customs duties then due. The total of all of monthly fees is limited to the amount of customs duties, fees, and taxes that would have been due if the property had been imported for free circulation. Accordingly, the obligation to make these payments ends if the property remains in Russia for more than 34 months (since $3\% \times 34 = 102\%$).

If goods that had been temporarily imported are switched to the free circulation regime, the applicable customs duties are based on the customs value of the goods at the time they were imported under the temporary import regime,⁶³ while the applicable rates of customs duties and taxes are those in effect at the time the of the change of customs regime.⁶⁴ As noted above, monthly payments during the period of temporary import are fully credited against the duties, fees, and taxes payable upon the change of regimes.

The Customs Code allows the temporary import of goods with full exemption, that is without monthly fees, in three circumstances. Goods imported in connection with international aid can be temporarily imported with full exemption, as can goods imported in connection with cultural, scientific, sports, and tourism activities. The third type of goods that can be temporarily imported with full exemption are containers, pallets, and other reusable packaging.

Russia has signed the Convention on Temporary Admission of June 26, 1990, which allows signatories to impose some additional requirements with respect to temporary import of goods under certain circumstances.⁶⁵

⁶² Art. 212 of the Customs Code.

⁶³ The customs value of the goods may be reduced if the declarant submits to the customs authority documentation proving decrease in value and/or quantity due to natural wear and tear or natural loss under normal circumstances of goods' transportation, storage and use. Art. 214(2) of the Customs Code.

⁶⁴ Art. 214 of the Customs Code.

⁶⁵ Under the Convention, each contracting country has the right to refuse temporary import to containers, pallets or packaging which are the subject of lease concluded by an entity that is resident in such country. Also the minimum period for the re-exportation of "goods imported in connection with a commercial operation," which covers containers under certain circumstances, is six months from the date of temporary import. Arts. 4 & 6 of Annex B.3.



VI. Currency Control Issues Affecting Cross-Border Leasing

Russian currency control issues regulations must be considered in cross-border leasing transactions with a Russian lessee irrespective of the currency in which the lease payments are effected.⁶⁶ The Currency Law,⁶⁷ which came into effect in June 2004, substantially liberalized Russian currency regulation. As a general rule, currency operations between residents and non-residents can be carried out without the onerous permit and licensing requirements that once were necessary.⁶⁸ A limited number of restrictions, several of them relevant to lease transactions, remain, but even the remaining restrictions are effective only until January 1, 2007.⁶⁹

Purchase of Foreign Currency

A Russian lessee needing foreign currency to make lease payments to a non-resident lessor can purchase that foreign currency only through an authorized Russian bank.⁷⁰ The Currency Law authorized the Central Bank of Russia to establish the procedures for the purchase and sale of foreign currency by resident legal entities, including requiring residents to use special accounts for those transactions and deposit funds in a reserve account for up to 60 days before making a purchase of foreign currency.⁷¹ While the Central Bank has exercised its authority to require special accounts and reserve deposits in some situations, it has not done so with respect to residents' purchases and sales of foreign currency.

As an alternative, a non-resident lessor may open a ruble account in Russia and receive ruble lease payments into that account. The lessor thereafter would need to convert the received rubles into foreign currency and transfer those funds to its account abroad. While no Russian currency law restrictions would affect that payment structure, it adds administrative burdens (including registration with the Russian tax authorities) and shifts currency conversion costs to

⁶⁶ For a detailed definition of “non-resident” see Article 1.7 of the Currency Law.

⁶⁷ Federal Law No. 173-FZ “On Currency Regulation and Currency Control” of October 12, 2003 (as amended) (the “**Currency Law**”).

⁶⁸ Exceptions to the general rule are contained in Articles 7, 8 and 11 of the Currency Law. Art. 6 of the Currency Law.

⁶⁹ Article 26.3 of the Currency Law. It is not unlikely, however, that the expiration date for the exceptions to the generally liberal regime will be extended further.

⁷⁰ Art. 11 of the Currency Law.

⁷¹ Art. 11(3) of the Currency Law.



the lessor. Nevertheless, competitive demands are increasingly compelling foreign companies to accept ruble payments in many fields, and foreign lessors are not exempt from that pressure.

Reserve Requirements for Advance Payments

The Currency Law authorized the Russian government to require residents to deposit funds in a special reserve account when they make a prepayment in connection with foreign trade activity.⁷² Foreign trade activity includes the import and export of goods, services and intellectual property.⁷³ In the leasing context, this provision authorizes the Russian government to require a resident lessee to maintain a reserve deposit until the non-resident lessor fulfills its obligations (*i.e.*, transfers the subject property to the lessee). The Currency Law limits the possible length of the reserve deposit to two years, and the amount to not more than 50% of the prepayment made.

On May 16, 2005, the Russian government exercised this authority and issued Resolution No. 302, which requires residents to maintain reserve deposits for purchases of imported services, but in the amount of only 10% of the advance payment and for only 15 calendar days. The resident must deposit the required reserve 180 days after transferring the prepayment to the nonresident.

The Government did not apply Resolution No. 302 to all foreign trade activity, but instead limited it to imports of services and intellectual property. Whether Resolution No. 302 applies to cross-border leases therefore depends on whether a lease is considered a "service" for this purpose. In at least two other instances, Russian law identifies leases as a service, and the Tax Code also treats leasing as a service.⁷⁴ In response to an official inquiry, an agency of the Ministry of Finance has advised us that a lease is a service for currency control purposes, which is consistent with other provisions of Russian law. We therefore conclude that advance lease payments are subject to a reserve requirement, but only if the leased property does not enter Russia within 180 days of that payment.

Transaction Passport

⁷² Art. 7(4) of the Currency Law.

⁷³ Federal Law No. 164-FZ "On the Fundamentals of State Regulation of Foreign Trade Activity" of December 8, 2003, as amended, Art. 2.

⁷⁴ The lease of immovable property and vehicles is classified as a service under the Interim Classifier of Services in Foreign Trade (as amended by Resolution of the State Statistics Committee of Russia No. 11 dated February 6, 2001), and financial leasing is defined as a financial service for the purpose of Federal Law No. 117-FZ dated June 23, 1999, "On the Protection of Competition in the Financial Services Market" (as amended).



Under Russian currency law a resident lessee must execute a “transaction passport” to be able to make payments to a foreign lessor under a lease agreement. Transaction passports are necessary for accounting and reporting purposes in any event, but are indispensable for making foreign currency payments for goods or services.⁷⁵ Transaction passports are prepared on the basis of the supporting documents for the transaction,⁷⁶ which include the lease agreement.

* * * * *

We hope that the above information is helpful. If you have any further questions or comments, please do not hesitate to contact John Sheedy, Christian Moore, or Irma Foley at our Moscow office.

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Orrick’s Russia practice provides a wide range of legal services in industries ranging from natural resources and infrastructure to telecommunications, banking, capital markets and private equity. Based in Moscow, London and Washington, D.C., the firm’s Russia practice lawyers advise and represent clients in M&A, private equity, and capital markets and other financing transactions, as well as dispute resolution, consumer protection, employment law, and intellectual property matters.

⁷⁵ Art. 20 of the Currency Law.

⁷⁶ Central Bank Instruction No. 117-I of June 15, 2004, and Regulation No. 258-P of June 1, 2004, set out the procedures for preparation of transaction passports.



About Orrick

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