

 **HOW TO INVEST IN RUSSIA**

THE AEB GUIDE TO INVESTING IN RUSSIA



**MAXIM ORESHKIN**

Minister of Economic Development
of the Russian Federation

Dear Colleagues,

Creating favourable conditions for doing business is one of the key factors to increase investment activity. Therefore, over the last couple of years we managed to carry out a series of ambitious reforms and improve business regulation along with development of new promotional projects for investments. As a result, Russia jumped up to the 35th place in the WB Doing Business Report rating 2018. The country has improved its position by more than three times since 2011.

Recently, we have designed a series of measures (under implementation now) to improve the efficiency of public services in key areas. We expand the practice of new PPP agreements and special investment contracts signings, coupled with other attractive conditions and opportunities for potential investors. By the aid of the measurements taken the stability of macroeconomic conditions is ensured; and further growth of economy is increased.

The work to improve investment environment in Russia is carried out side by side with the business community including the Association of European Businesses. This approach allows us to estimate costs and benefits of our decisions in an unbiased and accurate manner, to mitigate risks and thereby to evaluate their impact on business climate in the country.

We stay open for cooperation and ready to foster successful implementation of new projects proposed by foreign investors in Russia.

**THOMAS STAERTZEL**

Chairman of the Board,
Association of European
Businesses

**FRANK SCHAUFF**

Chief Executive Officer,
Association of European
Businesses

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Chairman, Finance and
Investments Committee,
Association of European Businesses

Dear Readers,

Welcome to the 2017 edition of the AEB "How to Invest in Russia" guide.

It could be said that the past year has been one in which all expected outcomes have been turned on their heads by events that could not have been predicted with any degree of probability. The emergence of a populist, anti-globalisation and protectionist movement has caused fundamental changes across most of the Western markets with a significant knock-on impact to the emerging markets. The full impact of these events is still unclear, but from a Russian perspective, these have not been of use, particularly in relation to the investment climate and the risk perspective on Russia from Western institutions.

However, it is not all doom and gloom for the Russian economy, and this year has seen very substantial progress in inflation targeting. The Central Bank, having taken the bold decision to allow a free float of the rouble, concentrated on using relatively high interest rates to control demand and to curb inflation, which has now fallen to a 25-year record low of 4.4%.

In addition, the government continues to focus on improving the practical environment for investment. The World Bank report 2018 on the ease of doing business now ranks Russia at 35 out of 189, a substantial improvement from its 2014 ranking at 92. Improvements have been made in setting up businesses, registering contracts and connecting to utilities. This is in line with its stated objective of reaching 20th position by 2020. The Central Bank has continued to clean up the banking environment and has implemented the Basel 3 recommendations.

The recent decision by the USA legislature to codify and tighten the sanctions against Russia is unhelpful, and by potentially targeting the European Union's business interests, may cause a rift to open up between the allies. This has the potential to significantly worsen an already damaged investment climate.

The AEB states its position in favour of the de-escalation of conflict and remains against economic sanctions, or limitations on free trade or investment.

Apart from the direct impact of sanctions, which reduce GDP growth, increase the country risk premium, create pressure on long-term funding and fuel inflation, there are the indirect impacts of higher interest rates, capital and intellectual flight, and a loss of confidence by domestic investors and consumers. Given the political nature of the drivers, it is no longer possible to forecast how long these negative influences will last and how deeply they will impact the economy.

However, the Russian economy of 146 million people will continue to present tremendous opportunities for investors who are prepared to accept the risks involved in working here. The emergence of a new middle class over the past 20 years, with a massive increase in disposable incomes, has driven the recent retail boom.

This, the current edition of the "How to Invest in Russia" guide, will bring you updates on investment climate, tax and legal aspects, outsourcing, localisation and regions. In addition, it provides an inside look at investing in Russia from the companies' points of view.

We would like to thank all the authors who helped by making their valuable contributions to this guide and sharing their knowledge of the Russian market and their experience of running a business here. Also, we are most grateful to the Ministry of Economic Development of Russia and the Federal Antimonopoly Service who have supported the guide over the years.

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

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Part I.

Russia is the Right Place for Investing

New vector of development of the foreign investments legislation

The Federal Law No. 165-FZ of 18.07.2017 "On Amending Article 6 of the Federal

Law 'On Foreign Investments in the Russian Federation' and the Federal Law 'On Procedures for Foreign In-

vestments in the Business Entities of Strategic Importance for Russian National Defence and State Security" came into effect on 30 July 2017.



ANDREY TSYGANOV

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Andrey Tsyganov holds a Specialist in Economics degree cum laude from Lomonosov Moscow State University, and a PhD in Economics.

He has been working in the antimonopoly supervision since 1990. Andrey has been participating actively in legislative work. He is one of the principal authors of Russia's antimonopoly legislation.

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ALEXANDER POROSHIN

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In 2015 Alexander graduated cum laude from the International Energy Policy and Diplomacy Institute, MGIMO University with a degree in Jurisprudence.

He came to the FAS Russia in 2014, first as an intern, then as a staff member of the Legal Division and the Division for Considering Pre- and Post-Merger Notifications. In 2016 he received a commendation letter from the Head of the FAS Russia.

At present, Alexander heads the newly created Division of Investment Analytics, which inter alia carries out monitoring of foreign investments in the Russian Federation and develops proposals on improving Russian legislation on foreign investments.

This law introduces key changes into the Russian legislation on foreign investments. Adoption of these amendments has long been necessitated by the widespread practice of the Governmental Commission on Control over Foreign Investments in the Russian Federation (the Commission) and the Federal Antimonopoly Service of the Russian Federation (the FAS Russia) as an authorized body, and the new realities of entrepreneurship activities by all economic entities.

In particular, the Federal Law No. 57-FZ of 29 April 2008 "On Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defence and State Security" (the Law No. 57-FZ) sets a comprehensive list of activities that are of strategic importance for defence and security of the state.

Law enforcement authorities carry out ongoing monitoring of the most significant economic transactions for any potential breach of national security, and in some cases of projects



with foreign investors such threats are found. Meanwhile, since the company does not carry out any strategic activities listed in the Law No. 57-FZ, the Commission cannot use the mechanisms of preventing such threats as prescribed in the Law No. 57-FZ.

A very important amendment introduced in the new law is the opportunity for the Chairman of the Government of the Russian Federation who also chairs the Commission to consider as falling under Law No. 57-FZ all transactions carried out by foreign investors in relation to busi-

ness entities not directly involved in strategic activities but such activities are in fact of special importance for national defence and state security.

These companies may therefore include business entities that carry out activities in the areas significant for the state, as in economic, food, military, ecological, informational, energy and technogenic safety and security.

As an example, this will apply to foreign investors acquiring city-forming enterprises or large timber, waste

processing or oil transportation enterprises, since each of these types of activities can threaten ecological safety and may potentially represent a risk of a technogenic disaster.

The above-mentioned law allows the Chairman of the Commission to determine the necessity of considering those or other deals by foreign investors at the session of the Commission upon the motivated request of authorized state bodies.

Obviously, this new provision does not make it necessary to coordinate all the deals settled by foreign investors

in potentially significant areas for the state and allows to consider all possible new deals in a special order as prescribed by the law. This in turn will limit the administrative load on the business as a whole.

Moreover, in practice this will allow to carry out the necessary control over foreign investments on developing and unstable markets, such as critical IT technologies, medications and medical projects, infrastructure projects, etc.

Further, depending on the results of working with use of new provisions, we believe it is necessary to gradually transit from the exhaustive list of strategic activities to the areas of great importance to the state with setting possible foreign investment control thresholds, depending on the volume of invested resources as is the case with Spain or Canada. This experience, however, will need more diligent analysis on the part of the FAS Russia and the Government of the Russian Federation and weighing all pros and cons.

The new level of control over foreign investments will allow the Commission and the FAS Russia to analyse in details the deals by foreign investors that can potentially threaten national defence and security. This will also make it possible for the authorities to determine and prevent such threats in due time.

To this end, attention must be paid to another important amendment. Now the Commission will not be limited to an exhaustive list of obligations that the foreign investor must meet to receive preliminary approval of the deal.

The essence of these obligations is that the foreign investor may receive preliminary approval of the deal that could potentially threaten defence and security of the state, when such influences are counter-balanced by such measures as continued provision of products and services within the scope of the government's defence order, carrying out protection of state secrets, execution of the business plan for a strategic company, maintaining mobilisation capabilities, etc.

Additionally, as practice shows the list of obligations as established by Law No. 57-FZ in separate cases is not enough to eliminate current risks, and therefore prevents preliminary approval of foreign investor's deals by the Commission, in particular when such transactions are carried out on dynamically developing markets.

Over the past ten years of applying Law No. 57-FZ, however, only very few transactions were denied preliminary approval (a total of 13 deals out of more than 450 considered by the Commission). The number of such cases can even be reduced further, if the expressed ban on transactions is replaced by a dialogue with the foreign investor, and more reasonable conditions for approving the deal are found.

Therefore, there should be no talk of assessing this measure as a barrier-making or opportunity-reducing mechanism. To the contrary, these measures will improve the situation and allow foreign investors to negotiate with competent Russian authorities should the deal require special consideration.

As the experience shows, control over foreign investments is a widespread

international practice, which is most broadly applied in the United States of America.

The American legislation provides notice-filing mechanism for foreign investments. Foreign investor may choose to file an initiative notice to the Committee on Foreign Investment in the United States (CFIUS) and in case of acquisition of more than 10% of voting shares of an American company foreign investor files a proper notice to the US Department of Commerce.

Meanwhile, under the American legislation, control over foreign investments can be exercised by the authorities in relation to any mergers and acquisitions (being planned or already completed), which could result in foreign control of any person engaged in interstate commerce and which can affect the US national security interests.

According to the analysis of the deal, completed by CFIUS, the President of the United States, whose duty is to assess the degree of influence of the transactions on the national security, may either allow, postpone, block or unwind the deal, as well as provide remedies in the cases when he or she should feel the country's national security is threatened.

Of principal importance is the fact that the list of remedies is not limited to any legislation, and may include all the necessary actions to neutralise the threat to the national security that a particular business deal poses.

In practice, approximately 10 cases out of 150 involves remedies, among them – divestiture, reporting all industry inci-



Law enforcement authorities carry out ongoing monitoring of the most significant economic transactions for any potential breach of national security, and in some cases of projects with foreign investors such threats are found.

dents, limiting access of foreigners to production, etc. Only once in CFIUS history, the President ordered to unwind the acquisition of four US wind energy companies by Ralls Corpora-

tion (USA), owned by two citizens of the People’s Republic of China.

This leads us to a point that the Russian legislation on foreign in-

vestments is on par with the international practice. In the future the amendments that had been made will allow to achieve more successful results in the sphere of finding deals that could potentially threaten safety and security of the country and to adopt more flexible approaches to preventing such threats, and will also serve as a base for future liberalisation of the law on foreign investments. These measures could include transition from the exhaustive list of strategic activities to areas that are of special significance for the state, or establishing thresholds of control over foreign investments depending on the volume of invested resources. ■

The warming of the investment climate in Russia

Results of the AEB Annual Survey “Strategies and Prospects for European Companies in Russia”



ALEXANDER DEMIDOV
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Dr. Alexander M. Demidov is a well-known Russian sociologist, one of the founders of the public opinion studies and market research in USSR/Russia. In 1991 Alexander Demidov founded GfK Rus, the Russian branch of GfK SE, and since then he has been Managing Director, CEO of the company. Since 2005, he has been the head of Joint Department of Applied Sociological Research with GfK Russia at the Faculty of Social Science of the Higher School of Economics.

Alexander is one of the best Top-250 top managers in Russia according to the joint rating by Kommersant newspaper and Association of Managers.

The AEB has published the results of the 10th AEB Annual Survey “Strategies and Prospects for European Companies in Russia”, which gives an overview of the attractiveness of the Russian investment climate and highlights the

key challenges and strategies faced by European companies doing business in Russia. The survey was conducted in April 2017 in tandem with the International Institute of Marketing and Social Research GfK Rus.

According to the AEB survey, in 2017 the number of European companies that expect the Russian economy to grow in the short- and long-term perspective significantly increased from last year, and the number of businesses planning to invest in Russia doubled.

Against the backdrop of the improvement in the current state of the business environment and positive expectations regarding doing business in Russia, the comprehensive AEB-GfK Index rose 21 points from 2016 and stands at 141 points out of a possible 200 (in 2016 it stood at 120 points, and in 2015 at 106). The index shows positive expectations and has now approached the level it was in 2013 (144). The lowest index was registered in 2015 (106).

“For the first time since the beginning of the crisis, European companies are truly positive about the prospects for the Russian market,” said Alexander Demidov, CEO of GfK Rus.

According to the opinion of top managers of European companies doing

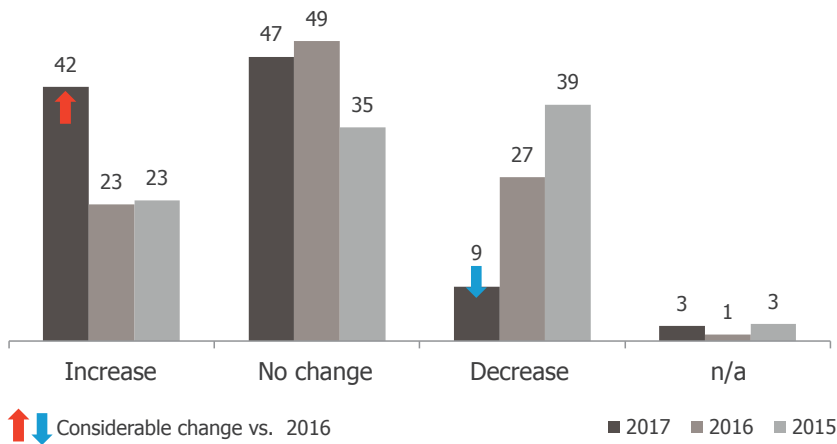
business in Russia, the performance of the Russian economy in Q1 2017 met or even exceeded their expectations. 32% of respondents say that the economic situation on the Russian market was better than expected. In 2016, only 17% shared that opinion.

Furthermore, the number of European companies which referred to the positive market dynamics as a main driver of decisions with regards to their business in Russia grew from 38% to 56%. The potential of the market was acknowledged by 73% of respondents in 2017 (up from 60% in 2016).

As to the performance results of European companies in Russia in Q1 2017, it seems that the results reported by the majority of them met or failed to meet expectations. The number of companies which reported performance results in Q1 2017 that were “worse than expected” grew from 21% in 2016 to 25% in 2017, while the number of companies which reported results that were better than expected decreased (from 21% in 2016 to 14% in 2017).

One of the possible reasons for the worse than expected performance results could be the lack of investment, and it seems that European companies intend to change this

► Investments, %



situation. In 2017, the number of companies planning to boost investment in Russia almost doubled: from 23% in 2016 to 42% in 2017.

What is hindering the growth of investment in Russia?

The AEB Annual Survey also highlights the key challenges faced by European companies doing business in Russia and looks at the major risk factors associated with the Russian economy and doing business in Russia for European companies.

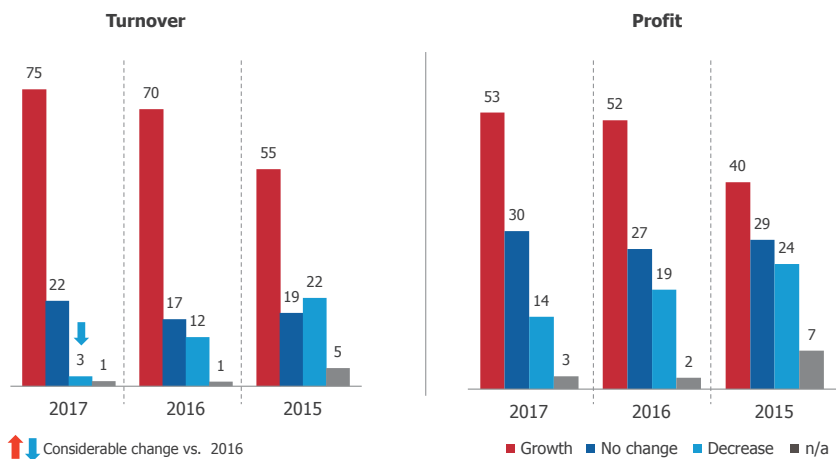
And although most of the survey respondents mentioned that the economic situation in Russia had improved, the economic climate in Russia remains challenging. The main factors that are adversely affecting the Russian economy are sanctions against Russia (77% of respondents), Russian sanctions against the EU and US (60%), and also the price of oil (54%).

European companies have been affected by a number of factors:

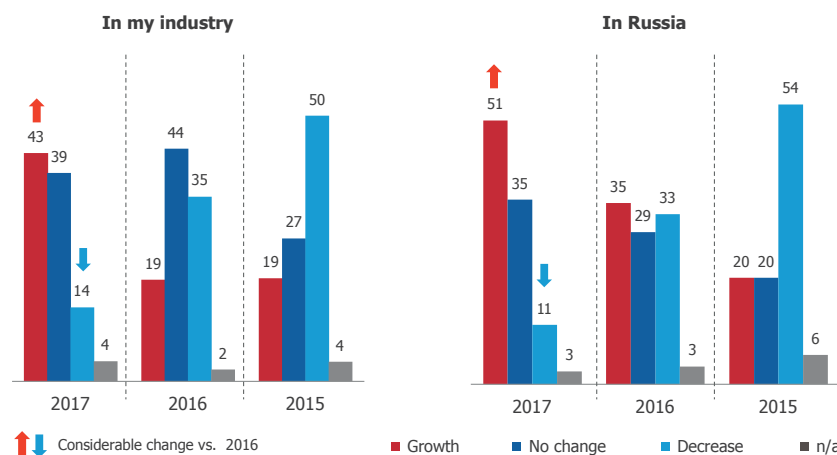
- 66% of companies said that the sanctions against Russia had a negative impact on their performance in Russia;
- 39% said that the price of oil adversely affected the performance of their companies in Russia (down from 63% in 2016);
- 39% said that Russian sanctions against the EU and US negatively affected the performance of their companies in Russia.

The financial conditions in which the AEB member companies operate are still quite acceptable. The main problems

► Turnover and profit within the next 3 years, %

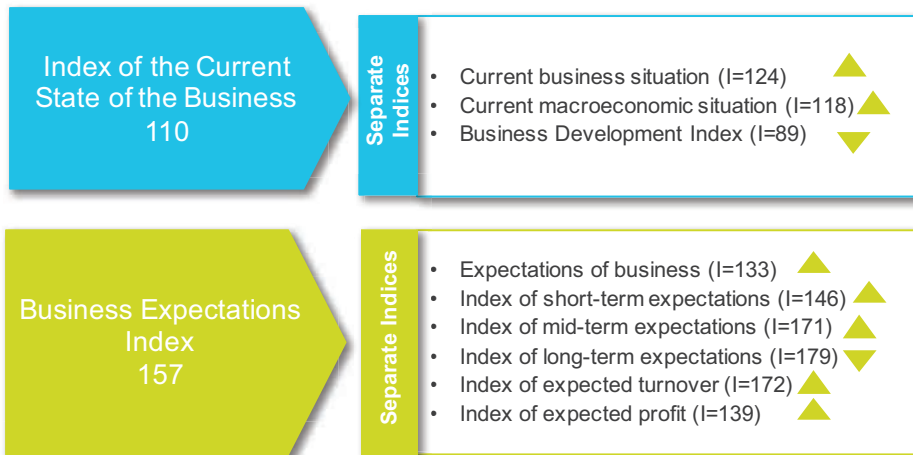


► Investments in my industry and in Russia on the whole, within the next 2-3 years, %

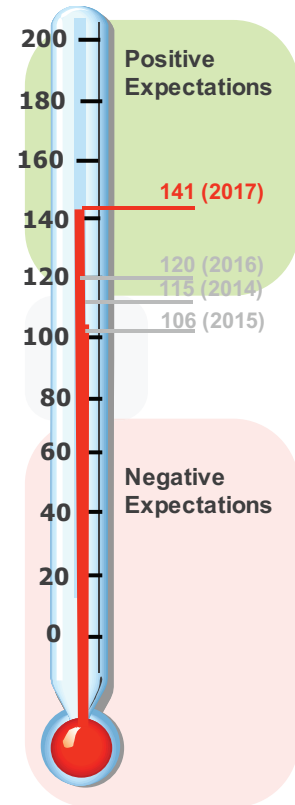


► **AEB-GfK Barometer: Business Confidence in Russia**

Compound Index



AEB-GfK Index, 2017

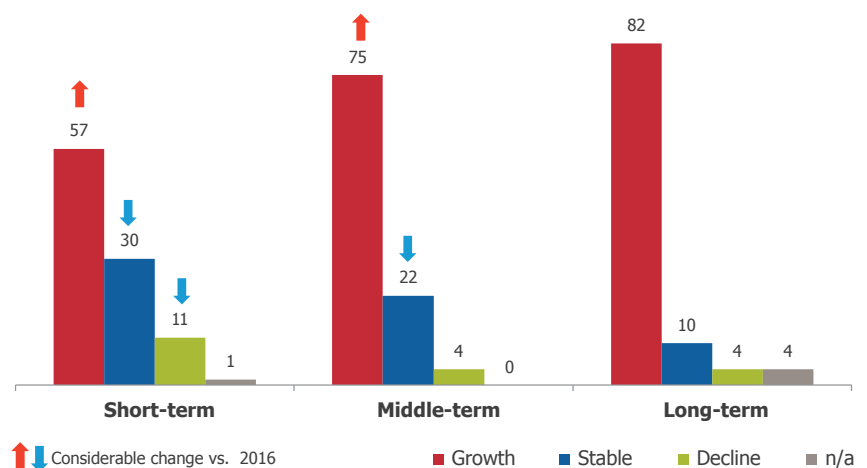


related to financing remain the high interest rates and restricted access to bank loans. Also, this year we can see the emergence of problems such as the limited number of financial instruments proposed by banks. The number of companies which mentioned this problem doubled from 2016.

Regulatory restrictions are a major barrier to doing business (60% of companies mentioned regulatory restrictions as the main barrier to doing business). Also, a considerable number of European companies mentioned that they faced problems such as the lack of modern production facilities and lack of high quality materials from suppliers.

The business culture and business environment of the country were

► **Perspectives of the Russian economy within the next 10 years, %**



given a modest rating. Dealing with the legislative, customs and tax authorities was rated somewhat negatively. The negative factors for doing business in Russia include

red tape and corruption, and the majority of AEB members do not expect improvement of the situation with corruption, red tape and taxes within the next two years

A strong Nordic bank

Danske Bank is a Nordic universal bank with strong local roots and bridges to the rest of the world

In Russia Danske Bank is present since 2007 as a 100% Danske Bank A/S owned subsidiary and has strong local expertise.

Danske Russia offers wide range of cash management, treasury and financing products for corporate clients of Danske Bank Group. Located in Moscow and St. Petersburg, the bank can meet your banking needs across all of Russia.

Our Essence

We help businesses achieve their goals. No matter what situation a business is in, we have usually seen something similar before. We use our experience to provide value-creating advice and targeted solutions to business customers.

Our customer promise

We help customers be financially confident and achieve their ambitions by making daily banking and important financial decisions easy.

Our vision

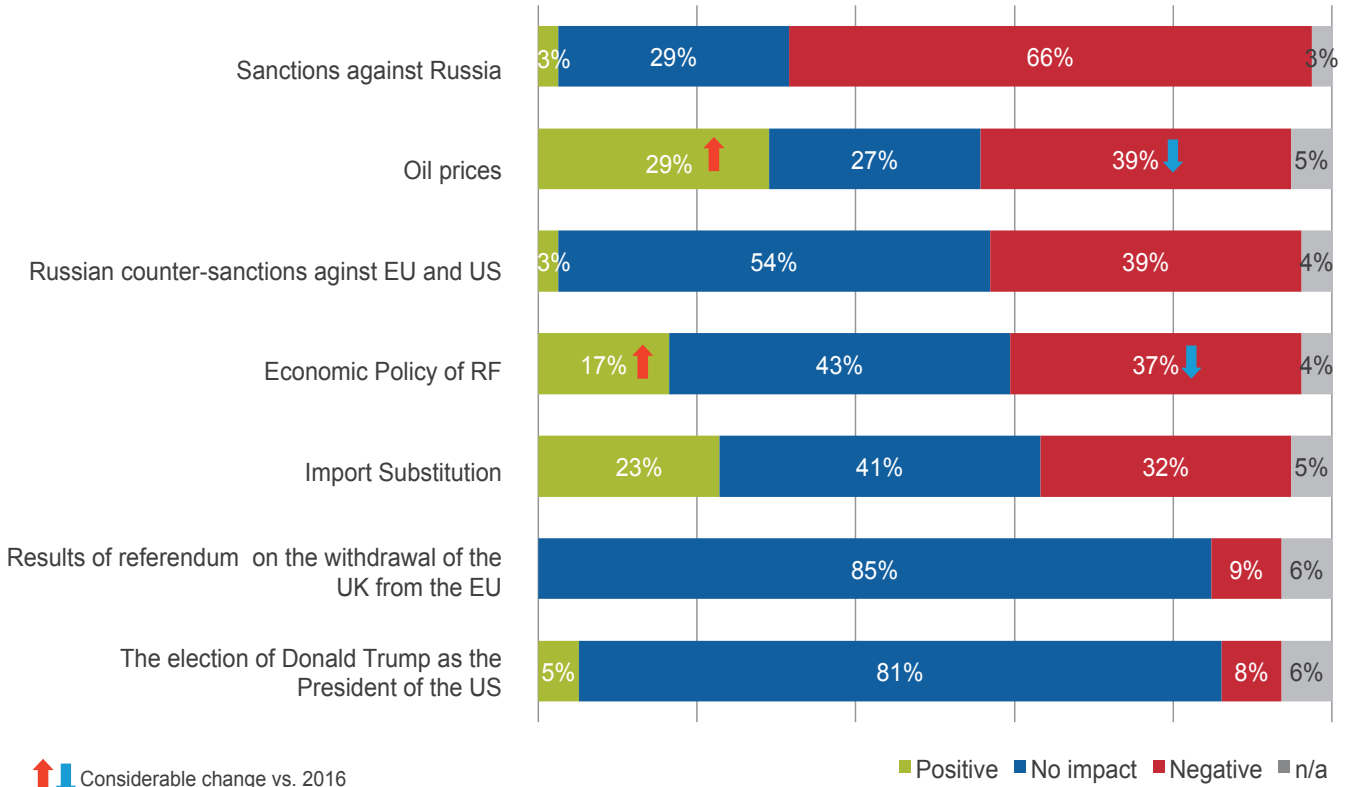
Our vision is to be recognised as the most trusted financial partner.

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► Influence of various factors on my company's business



(62%, 58% and 52% of companies respectively).

As to the effect of external factors on the Russian economy and performance of European companies in Russia, the survey found that the results of the referendum on the withdrawal of the UK from the EU and the election of Donald Trump as the US President have had a minimal impact on the performance of companies in Russia (85% and 81% of companies said that these events did not affect their performance).

37% said that the economic policy of the Russian Federation adversely affects the performance of companies in Russia (compared to 49% in 2016). At the same time, the major-

For the first time since the beginning of the crisis, European companies are truly positive about the prospects for the Russian market.

ity of the companies (68%) do not expect that Russian economic policy will change after the 2018 elections.

About the survey

In 2017 the survey "Strategies and Prospects for European Companies in Russia" was conducted by the AEB for the 10th time. It has been carried out jointly with the International Institute of Marketing and Social Research GfK Rus since 2011. The current survey was conducted through online and face-to-face interviews with the top managers of AEB member companies in March-April 2017. The survey involved 79 AEB member companies.

The AEB survey is a highly valuable source of first-hand information that gives an overview of the attractiveness of the Russian investment climate and highlights the key challenges and strategies faced by European companies doing business in Russia. ■

Part II.

Localisation

and Investments

Special investment contracts

The number of challenges faced by foreign investors in Russia should be reduced through the conclusion of special investment contracts that secure a stable legal environment for the investor and can ensure his treatment as a Russian producer. The main idea of this paper is to provide guidelines to foreign investors on such special investment contracts. Specifically, the scope of this paper will be confined to an explanation of how to apply for a special investment contract and tips to assist investors in its negotiation and conclusion to the benefit of the investor.



BILGEIS MAMEDOVA

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Dr. Bilgeis Mamedova is a Partner in the Commercial Law Practice Group at BEITEN BURKHARDT's Moscow office. Her core activities include consulting on the market entry, set up of production facilities and localisation issues.

Bilgeis also has extensive experience in the areas of international and Russian contract law, securities and project financing in Russia.

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

Bilgeis graduated from Moscow State Law Academy. She obtained an LL.M. degree at the University of Bremen and a Ph.D. at the Moscow State Institute of International Relations (MGIMO) of the Ministry of Foreign Affairs of Russia.

Why a special investment contract?

A special investment contract is an investment agreement between the Russian government and the investor¹. Under the contract the investor shall establish or upgrade its production facilities in Russia, and the Russian government shall grant the investor certain benefits. These benefits may include tax incentives or the securing of set tax and legal frameworks for the investors for the entire duration of the special investment contract². However, from the investor's perspective, the most important benefit arising from the special investment contract is the "Made in Russia" certificate which is issued for the products manufactured by the investor in Russia, provided that the products are covered by the special investment contract.

The "Made in Russia" certificate is important due to the Russian government's recent policy of import substitution, and enables the investor to participate in state procurements as well as in procurements performed by state-owned companies in those cases when Russian-made products will be

privileged. The issue is that many companies with production facilities in Russia are unable to receive a "Made in Russia" certificate for their products, especially if they only have knockdown assembly facilities. An assembly plant in Russia is not sufficient to receive a "Made in Russia" certificate. Moreover, the requirements on local content and technology transfer must be met. However, the requirements established by law cannot usually be met within the established timeframes. Therefore, investors need a grace period. At present this grace period can only be provided by a special investment contract. Thus, a special investment contract empowers the investor to start production and to immediately receive a "Made in Russia" certificate for the first three years, even if the manufactured products do not meet the localisation requirements. After the grace period, the required degree of localisation must be achieved.

Application for a special investment contract

Once the investor has decided to apply for a special investment contract, it will submit an application. The

¹ For the purposes of this paper, we consider in particular those special investment contracts that are concluded on the federal and not regional level.

² Special investment contracts will be concluded for a maximum period of ten years.

consideration of the application and conclusion of a special investment contract is within the competence of the Russian Ministry of Industry and Trade.

A well-conceived application for a special investment contract has particular relevance not only for the approval of the investment project by the Russian Ministry of Industry and Trade, but also for the further negotiation of the special investment contract.

The application form and the documents to be attached thereto are stipulated by law³. One of the key documents to which the investor should pay special attention is the business plan of the project, including its financial model. When drafting the business plan, it is recommended that the UNIDO or EBRD international business planning

targets, tax withholdings, risks, etc., where both economic indicators and established legal requirements must be taken into account. Otherwise, the business plan will not meet the requirements and may be rejected.

When preparing the business plan, it is also important to understand that the investment under a special investment contract must amount to at least RUB 750 million. That being said, the investor is basically allowed to independently determine what the indicated investments will be used for under the localisation project and by which deadlines. In principle, the investments can be performed throughout the entire effective term of the special investment contract. True, the specific amount to be spent on each individual investment target must already be indicated when submitting the application. In order to

application, while maintaining the overall amount of investments.

It is also important to note that the investor will have to resolve a fair number of practical issues that usually arise in order to properly draft the documents: in particular, how to account for investments already made, how to separate products manufactured under the special investment contract from the investor's current business activity, how to report the profit for the period when the project begins to generate operating profit, taking into account the established degree of localisation of certain products, etc. The answers to these questions will make it possible to duly draft the application. Therefore, once you know what key questions need to be answered, you have to act and find a solution. This is not an easy task, particularly if you do not have extensive experience. In any case, you will need to resolve the key issues before you begin negotiations with the Russian Ministry of Industry and Trade. While having a solution is essential, it is also important to maintain some flexibility at this stage. The negotiations with the Russian Ministry of Industry and Trade may introduce new ideas that need to be incorporated into the application. This is an important stage, because it helps to ensure that the documents are arranged in a logical and legally compliant way. Please also note that the special provisions of the special investment contract must already be included in the application.

Once the application is prepared, it is first sent by the investor with all attached documents to the Industrial Development Fund. The Industrial

From the investor's perspective, the most important benefit arising from the special investment contract is the "Made in Russia" certificate which is issued for the products manufactured by the investor in Russia.

standards or the Vnesheconombank recommendations on drafting a business plan be used as guidelines. Regardless, the business plan should contain special sections on localisation of production (in particular, a localisation schedule), local content, investment

give the investor the required flexibility, considering the long-term nature of the project, it is possible to introduce a special provision in the application granting the investor the right to change the amount of investment and the investment targets indicated in the

³ Resolution No. 708 of the Government of the Russian Federation dated 16 July 2015 "On Special Investment Contracts for Certain Industrial Sectors".



Drafting and negotiating a special investment contract

Since the Interdepartmental Commission also approves the essential terms of the special investment contract, the draft special investment contract should be prepared prior to the final approval of the investment project. When drafting of the special investment contract, the following issues must be considered directly.

Special investment contracts are governed by Russian law, with the State Commercial Court of the City of Moscow having jurisdiction. The template of a special investment contract is established by law⁴. However, the provisions of the contract can and will be amended proceeding from the specifics of the investment project.

The obligations of the investor under a special investment contract will be covered, first of all, by the business plan submitted in the application. On the approval of the investment project, the business plan will be attached to the contract as an integral part thereof. Despite the fact that the business plan is usually considered merely a possibility, it turns into an obligation of the investor under the special investment contract. From this standpoint, the best course of action is to focus not only on scrutinising the drafting of the business plan, but also on the negotiation of a “legal buffer” for those cases when business expectations are not met for reasons beyond the investor’s control.

The template of the special investment contract shall be amended in line with the regulation on local content and the

Development Fund is an intermediary between the investor and the government, and gives preliminary approval and provides its comments on and recommendations for the application. A number of questions that arise during the preparation of the documents may also be promptly discussed with the Industrial Development Fund, which can apply its experience in approving special investment contracts with other investors to help the investor to find solutions to certain issues.

After the preliminary approval of the investor’s application by the Industrial Development Fund, the application and all attached documents are sent to the Russian Ministry of Industry and Trade. This is considered the official submission of the documents. The considera-

tion of the documents in the Russian Ministry of Industry and Trade generally takes several months (even up to six months) and requires regular working meetings. Based on the results of the consideration of the application and the documents, the Russian Ministry of Industry and Trade issues a preliminary decision to approve or reject the investment project.

The final approval of the investment project and the special investment contract is in the competence of the so-called Interdepartmental Commission. This commission includes the representatives of nearly all key ministries (the Ministry of Economic Development, Ministry of Finance, Ministry of Energy, etc.), as well as representatives of professional associations and public organisations.

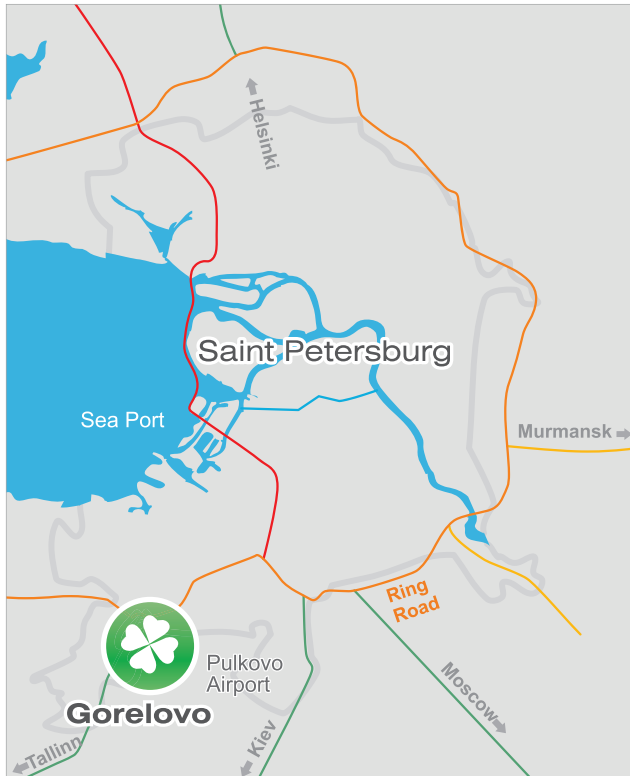
⁴ Resolution No. 708 of the Government of the Russian Federation dated 16 July 2015 “On Special Investment Contracts for Certain Industrial Sectors”.



YIT Industrial Park Greenstate

We are 100% committed

The Project of YIT Corporation in Saint Petersburg, the Industrial park Greenstate, opens its wide and reliable opportunities for manufacturers and property investors in North-Western Russia



At the very end of 2006 the Finnish construction company YIT Corporation has made a decision to start the development of its own industrial park on the southern boundaries of Saint Petersburg. The industrial park Greenstate with a total area of 114 hectares was found with the purpose to build up new industrial enterprises and logistic centers on it. Today Greenstate is one of the most developed industrial parks in Russia with completely ready engineering infrastructure and all required utilities. The project of YIT is comfortably located close to the crossing of the City Ring Road and Tallinn motorway. Due to the remarkable location of the industrial park as well as high professional competence of the personnel and possible guarantees of the international YIT Corporation, Greenstate offers excellent opportunities for the production companies willing to place their facilities in the region because YIT's solutions allow reducing risks of the Russian investment project and accelerate the launch of new production facilities.

Several significant projects are already allocated in the industrial park Greenstate, for instance, modern logistics center, the plant and office building of Siemens Gas Turbine Technologies, production project of SMC Pneumatik, meat processing plant of the Finnish Atria Group, production and logistics of bakery ingredients of Trier SPb (Ireks) Company and a number of small enterprises of international and Russian companies.

It is reasonable to attend to the fact that Saint Petersburg and its region with the total population of 7 million is the second largest city in Russia and the fourth in Europe. Due to the highly developed system of maritime, motor-, air and railway traffic Saint Petersburg has convenient connections with Europe and all the Russian regions, which makes the city more attractive for investors.

NOTE! The Industrial Greenstate is listed in the Register of Russian industrial parks of the Ministry of Trade and Industry of Russian Federation.

Welcome to the YIT Industrial park Greenstate!

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timeline for localisation. This is a government regulation⁵, but also involves a fair amount of initiative on the part of the investor. The investor's primary obligation is to comply with the mandatory regulations on the percentage of local content and the technical processes to be performed in Russia. At the same time, however, the investor decides on the product portfolio and is not ultimately prevented from modifying, updating and replacing the products under a long-term investment project based on research and development or due to market conditions. However, it is important to identify such issues at the

Trade might propose that a penalty be introduced to the special investment contract for the breach of the localisation clause, even if such a penalty is not explicitly stipulated by the law on special investment contracts. In particular, a penalty may be established for those cases when an investor fails to meet the established percentage of local content. Should this be the case, the penalty will be calculated proceeding from the investor's turnover from the sale of products manufactured under the special investment contract that do not meet the local content requirement. It is particularly critical for investors to ensure that

points from the beginning. There are always differing positions followed in the end by a compromise between the parties. When negotiating a special investment contract, the negotiating process is made more difficult by the fact that the investor is working with the state, represented by the Russian Ministry of Industry and Trade. A number of Ministry departments are involved in the approval process: the sectoral department (for example, for the automotive industry, the machine tool industry, etc.), the legal department, the strategic development department, etc. Each department considers the draft special investment contract from the standpoint of its own competence. Furthermore, the essential terms of a special investment contract must also be approved by an Interdepartmental Commission made up of the representatives of various ministries and sectoral organisations that have their own positions and competence on key issues. As a result, the approval process is conducted in several rounds, and requires, at the very least, intensive legal work, negotiation and coordination skills.

The template of a special investment contract is established by law. However, the provisions of the contract can and will be amended proceeding from the specifics of the investment project.

very beginning and stipulate special provisions in this regard in the special investment contract.

To ensure that the investor duly performs its obligations under the special investment contract, the Russian Ministry of Industry and Trade puts the investor under surveillance. This is usually performed on an annual basis, with the investor submitting annual reports and supporting documents to the Russian Ministry of Industry and Trade. Therefore, investors must also be aware that the Russian Ministry of Industry and

the penalty clause is negotiated in good faith, in order to make it feasible for the investor. Generally speaking, the liability and termination clauses lead to the most discussion. An in-depth substantiation of the investor's position from the legal and economic standpoint is required in order to reach a compromise.

The drafting and approval of a special investment contract takes time. On the one hand, a special investment contract, like any other agreement, must be negotiated. In B2B practice, the parties probably never agree on all

In summary, a special investment contract will establish stable frameworks for the investor in the Russian market, and shield him for a long period from the unpredictable measures taken by the government. It can apply to the entire range of the investor's activities, and serve as a foundation for successful cooperation between the business and the state. At the same time, the investor must first manage to conclude the special investment contract on conditions that enable him to implement the project in an economically reasonably and legally precise way. ■

⁵ Resolution No. 719 of the Government of the Russian Federation dated 17 July 2015 "On the Criteria for Classifying Industrial Products as Industrial Products that do not have Russian-Made Equivalents".

Data protection and localisation of personal data

Andrey Korolev, Head of Legal at TMF Group Russia, says companies that did not act on the country's personal data law amendments may now be feeling the effect.



ANDREY KOROLEV
Head of Legal, TMF Group

Andrey is Head of the Legal Department and Client Portfolio Director – Structure Finance at TMF Group in Russia. Andrey has been working in TMF since 2007.

He is currently supervising corporate secretarial, administrative, legal and structured finance services. Also, he is responsible for internal legal compliance of TMF Group entities in Russia.

Andrey graduated from Bauman Moscow State Technical University and Lomonosov Moscow State University.

When it was first announced, Russia's requirement for the personal data of its citizens to be housed in-country raised many questions and doubts. However, companies that did not act may now be feeling the effect.

The amendments to Federal Law No. 152-FZ "On Personal Data" came into

effect on 1 September 2015. They obliged personal data operators to process the personal data of Russian citizens using servers located in Russia.

Since they were first passed, the requirements have raised a lot of questions from both operators and ordinary citizens – primarily due to the vague wording of the law, the absence of the court practice, and even partially contradictory clarifications from the regulatory authorities.

Nevertheless, the direct interpretation of the law required operators – particularly foreign companies whose data centres are historically located outside of Russia – to transfer their servers to process the personal data of Russians in Russia, or, for firms considering entering the Russian market, to plan measures in advance. Moreover, the latest changes in Russian data and Internet regulations provide an understanding of the main trends and likely further development of Russian legislation.

A tale of two approaches

Almost two years since the law took effect, there have been two particularly high-profile approaches to these requirements.

Google reportedly completed the transfer¹ of its Russian user data to

servers in Russia prior to the new law's introduction. With a representative office in Russia, the new requirements directly affected Google's interests.

The business and employment-oriented social-networking site **LinkedIn**, on the other hand, does not have representation in the Russian Federation and has not transferred data processing to Russian servers. It continues to operate its data centres in the USA and at the end of 2016, following a suit filed by the Russian regulator, had its website blocked in Russia² due to violation of the Law.

In its defence, LinkedIn representatives argued that the Law defies the principle of "extraterritoriality", since the social network does not have a representative office in the Russian Federation. They also highlighted that citizens provide their personal data voluntarily. However, the courts did not take these points into account.

TMF Group's experience

As an operator of personal data, TMF Group paid close attention to the matter of compliance from the moment of the draft law's introduction. Due to the complexity of the project, work to transfer servers began more

¹ http://www.rbc.ru/technology_and_media/10/04/2015/5522a9f69a794752a5f478fa

² <https://themoscowtimes.com/articles/linkedin-finally-blocked-in-russia-56206>



than one year before the law's enforcement.

We conducted a legal analysis, established relations and made numerous inquiries to the Russian regulator in order to determine how the new requirements were applicable to external service providers such as ourselves; if there were any particularities or exceptions from the point of view of the data type, IT infrastructure, etc.

The project of transferring data to Russian servers can be divided into organisational and technical measures:

- **Organisational measures** included adoption or adaptation of existing internal company policies on confidentiality and data protection, and a renewal of threat classifications.

- **Technical measures** included the development of data centres that met business requirements, implementation of the software and hardware parts and integration with existing IT infrastructure.

TMF Group's Russian data centre is fully operational and meets the company's requirements for data processing and the provision of disk space for

our clients. The process of transferring databases to Russia took around one year to complete, and it is an experience we are always happy to share with our clients.

Trends in Russian data regulations

Some trends, which may point to the further development of laws on personal data protection, have emerged since the Personal Data Protection Law suffered amendments in 2015. In mid-2016, a new set of amendments³ emerged. This set was later called "Yarovaya's Law" or "Yarovaya's pack-

³ Federal Law No. 374-FZ dated 06.07.2016 "On amendments to the Federal Law "On Combatting Terrorism" and certain legislative acts of the Russian Federation concerning the establishment of additional measures for combatting terrorism and ensuring public safety" and Federal Law No. 375-FZ dated 06.07.2016 "On amendments to the Criminal Code of the Russian Federation and the Criminal Procedure Code of the Russian Federation concerning the establishment of additional measures for combatting terrorism and ensuring public safety".

age". Regarding information processing, the law imposed requirements for mobile-service providers to store phone calls and messages for a long period of time, as well as subscriber information including the receipt, transfer, delivery and processing of messages, phone calls, photos and videos. Moreover, service providers have to decrypt encrypted traffic through the provision of encryption keys to the corresponding governmental bodies. Internet service providers have an obligation to store the content that users share with each other. The enforcement of this law means the creation of data storages, which would contain and process huge amounts of information.

Moreover, after the President of the Russian Federation signed the law, it was found that there is no need for equipment for the data storage of such volumes, not only in Russia but worldwide.⁴ Indeed, the implementation of such a requirement could lead to more than massive losses for mobile-service providers, which would affect the final price of mobile services for subscribers.

Despite the confusion the enforcement of this law causes, mobile-service providers who do not comply with the law face an administrative penalty; and the fine for violation is up to 1 million RUB.

As this article was written, the State Duma adopted a law⁵ prohibiting services for interlock bypass to provide citizens of Russia access to banned websites – usually done by intermediaries using foreign servers. The docu-

ment also prohibits browsers from providing links to such servers.

Also, different services (e.g. anonymizers), networks (e.g. virtual private networks, or VPNs), programmes (e.g. Tor and Opera) and search systems cannot provide Russian citizens access to banned websites. The Ministry of the Interior and the Russian Federal Security Service will supervise such services and nets. If a service, website or programme is found to be allowing Russian citizens access to blocked websites via foreign servers, the Federal Service for the Supervision of Communications, Information Technology and Mass Media, or Roskomnadzor, will send a request to the owners to cut-off access to the websites. If the owners do not comply with the request within a month, Roskomnadzor will start blocking their servers. The state body will create a special list of blocked websites, and grant the owners of anonymizers and VPN-networks access to it so they can monitor whether or not they allow access to blocked content themselves.

Legal entities in violation of the law face a penalty of 500 to 700 thousand RUB.

Companies using their own VPN and other means of interlocking avoidance are exempt, so long as the users of such systems are pre-defined and the VPN is used for technical purposes for activity facilitation.

The Federation Council approval and the signature of the President are still pending.

Points to note

These particularities may be useful for companies looking to introduce similar IT solutions in Russia:

- Both hardware and software parts of a data centre should consist of equipment that properly protects the data; and this protection should correspond to the private threat model of a particular operator. The list and approach to this correspondence should be defined in accordance with internal company by-laws and the relevant Russian legislation.
- If the data centre uses components that allow data encryption, then certification by the Federal Security Service is required in order to bring it to Russia. If these components were not certified by the producer, the company would need to obtain independent certification. This process may cause a lengthy delay.

The amendments to the Law on Personal Data have thrown Russian operators a dilemma, and understandably so: with the vague wording of the law, it is necessary to define the approach to interpretation. One approach is more conservative and leads to higher expenses or even makes functioning in the country impossible. The second approach is more flexible.

Taking into account the recent trends in Russian court practice and overall tendencies in legislation, it is prudent to say that within a conservative business risk assessment, all operators working with Russian user data are best to pay close attention to the data localisation requirements. ■

⁴ <http://www.newsru.com/russia/14jul2016/zakonyarovoy.html>

⁵ [http://asozd2.duma.gov.ru/main.nsf/\(Spravka\)?OpenAgent&RN=195446-7](http://asozd2.duma.gov.ru/main.nsf/(Spravka)?OpenAgent&RN=195446-7)

Living with sanctions



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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.

Art has been a member of the AEB since 1996.

The differences of opinion with regard to Russia's 2014 involvement in Ukraine caused the US and EU to impose sanctions against Russia. In March of 2014, SDN sanctions were imposed against individuals who were thought to be involved in the Ukraine conflict. These sanctions blocked the property the listed individuals have in the EU and the US and banned them from receiving visas. Names are added to the SDN regularly as sanctions are increased. In July of 2014, the SSI

or sectoral sanctions were imposed. These sanctions targeted Russia's energy, defence and financial industries, including VTB, Bank of Moscow and other banks. The SSI sanctions also limited the issuance of new debt to 30 days maturity (down to 14 days maturity under the new law). The maturity on debt from energy companies was reduced from 90 to 60 days under the new law. The sanctions on the energy sector limit the importation of high-tech drilling equipment for a list of Russian oil companies and their subsidiaries. Sanctions on doing business in Crimea were also imposed in December of 2014. These sanctions create a virtual embargo on business transactions in Crimea for both the EU and US. The Magnitsky sanctions (2012) were imposed in the US on individuals thought to have participated in human rights abuses. BIS sanctions are imposed on the import of dual-use goods and have strict requirements to obtain a license for Russian companies to import these goods.

The EU and US sanctions are almost identical with one major exception – the EU sanctions must be renewed every 6 months by the consent of all 28 member of the EU. The US sanctions were based on executive orders and could be lifted by the President. This changed in August of 2017, when Congress passed legislation requiring the President to receive Congressional approval to lift sanctions on Russia. Another difference is that while Igor Sechin is on the US SDN list, he is not included on the EU

list. Recently, ExxonMobil was fined 2 million dollars for signing contracts with Sechin. The EU recently imposed sanctions on three Russian companies and three individuals, including the country's Deputy Energy Minister, in response to the illegal delivery to Crimea of gas turbines manufactured by Siemens. Currently, the EU has 153 people and 40 entities on its sanctions list. Penalties for the violation of sanctions are severe. A couple of years ago, BNP Paribas was fined 8.9 billion dollars by the US for falsifying documents of bank transactions with Iran.

In 2015, the IMF issued a report entitled "Impact of Sanctions", in which it said that sanctions would impact growth negatively in the short-term via weaker investment and consumption. Model-based estimates suggest that sanctions and counter-sanctions could initially reduce real GDP by 1-1 ½ percent. In 2015, prolonged sanctions could lead to a cumulative loss over the medium term of up to 9 percent of GDP, as lower capital accumulation and technology transfers weaken already declining productivity growth.

The authorities put together a comprehensive policy package around three main pillars: 1) accelerating the move to a floating exchange rate regime and provision of FX liquidity; 2) stabilising the banking system; and 3) providing some fiscal stimulus while limiting wage indexation in order to contain second-round effects of the depreciation on inflation.

The CB withstood the call for currency controls in spite of a rouble rate of 84 to the dollar in late 2014. An informal capping of the rouble at around 60 encouraged the increase in localisation that took place in subsequent years. It is important to remember that most of the negative effects on the Russian economy were a result of the drop in oil prices from \$100/b in 2013 to a low of \$27/b in January of 2016. The oil price drop was due to OPEC's increase in production in order to drive US shale producers out of business. The subsequent recovery of the oil price to the \$50 range was because of a tenuous agreement between Russia and Saudi Arabia (and other countries) to cap oil production.

In 2015, the International Monetary Fund issued a report entitled "Impact of Sanctions", in which it said that sanctions would impact growth negatively in the short-term via weaker investment and consumption.

Russia drove this agreement with aggressive diplomacy. In spite of sanctions, oil production is increasing.

Over the last couple of years, the effects of Russian sanctions have significantly diminished. This has been one important factor in the recent Russian stabilisation. Cautious investors scared off by sanctions are beginning to return and Russian firms have succeeded in bringing in financing that can be shifted to some of the state-owned firms directly targeted

by sanctions. This is a loophole in the sanctions on Russia. For example, the 2017 Eurobond issuances are expected to be almost triple the 2016 amount. Also, in 2016, capital flight was the lowest since the financial crisis in 2008 and one tenth of the 2014 record. Russian economic growth is expected to rebound to 1.3 percent in 2017 and 1.4 percent in 2018 and 2019. Russia has expanded its already massive energy output by 4.4 percent between January 2014 and January 2017, drawing in critical new revenue streams for state budgets. In February 2017, Moody's upgraded Russia's outlook to "Stable" from "Negative", the rating it had been given in April 2016.

In response to the sanctions imposed on Russia by the EU and US, Russia enacted an import ban on most foodstuffs from the EU, US and other countries. In conjunction with this ban, Russia established a policy to support import substitution (localisation). This programme provided for 2059 individual projects in 19 economic sectors and is planned to be implemented between 2016 and 2020. The aim is to (increasingly) produce up to 800 selected products in Russia. The total cost of the import

substitution programme is estimated at EUR 35 billion (about 3% of GDP), with the process being accompanied by the Government Commission on Import Substitution. Important measures involve restrictions and requirements on public procurement, the costs of which have risen by 40% as a result. With regard to domestic agricultural products, general preferential treatment is accorded, i.e. a 15% pricing preference over foreign goods for public procurement purposes.

The Russian Agricultural Minister Alexander Tkachev recently said that the food embargo had resulted in a reduction of food imports from \$60 billion in 2014 to \$20 billion by the end of 2016. He also said that Russian products accounted for 80-90% on store shelves, although Russia needs to improve the quality of its locally-produced food. After Russia acceded to the WTO in August of 2012, the production of local food products significantly decreased because of foreign competition; for example, the production of pork decreased by 40% in 2013. It is evident that Russia intended to effectively suspend WTO rules on food in order to allow local food production to stabilise. Both the EU and the US are critical of Russia's import substitution policy because they say it violates the principle of free trade.

In late 2016, the World Bank said that import substitution had a limited impact on economic growth. However, in that same report it said that the agriculture sector grew by 3.6% in 2016 while the economy as a whole had a -0.2% growth rate. Between 2007 and 2016, pork production grew by 1000 percent and dairy production grew by 200 percent. In addition, Russia



recently became the world's largest exporter of wheat, and agricultural exports have surpassed arms as Russia's second-leading export. Russia is also adapting to the food embargo by negotiating numerous free trade agreements with Asian and Latin American countries under the EEU.

Europe is a main consumer of natural gas supplied by Russia's Gazprom. In 2016, the company supplied 34% of natural gas to the EU, with countries like Germany consuming 55%, the UK 30% and France 28% (Financial Times). The completion of Nord Stream 2 could double Gazprom's

export capacity, meeting increased demand while bypassing Ukraine. Fifty percent of the EUR 9.5 billion cost of Nordstream 2 will be financed by Royal Dutch Shell, Austria's OMV, France's Engie and Germany's Uniper and Wintershall.

The new sanctions law passed by the US Congress and signed by the President contains several provisions that address Russian gas production.

Section 223 was added to the bill at the insistence of oil companies and is very significant because it restricts US firms from partnering with sanc-

tioned firms on projects in which Russians own at least 33 percent. The effect of this provision would allow BP's joint venture with Lukoil to pursue a big offshore natural gas project because Lukoil owns only 10 percent. The language of the bill also ensures that Chevron's pipeline through Russia and Kazakhstan would not be affected.

Section 232 drives a major wedge between the EU and the US, i.e. the President *may* impose sanctions on persons or companies who invest in Russian pipeline projects in coordination with our allies. For now,

Trump might not be inclined to invoke this provision but a President Pence may have a different point of view in the future. A central issue is that the imposition of these sanctions may be considered as secondary or extraterritorial sanctions. Whereas primary sanctions apply restrictions directly to US persons and companies, secondary sanctions leverage the strength and role of the US financial system to target businesses and persons outside the typical jurisdiction of the US. Generally, these types of sanctions focus on blocking or restricting foreign banks' access to the US financial system. This could be a huge problem for oil companies who generate most of their revenue in dollars. Juncker is

of technical differences in the ways that the two jurisdictions framed their economic sanctions. Among the most notable differences are the grandfathering provisions in the EU sanctions regime. This means that companies can continue to perform contracts that were concluded prior to the imposition of the original sanctions. BP was allowed to retain its 20 percent stake in Rosneft. Statoil was allowed to keep its joint venture with Rosneft that develops tight oil. ENI was allowed to continue actively working on a host of projects begun before 2014. In contrast, Exxon was turned down by Trump's Treasury Secretary when it asked for a waiver to continue a Black Sea drilling project that was signed in 2012. The grandfathering

bill also states that it is US policy to oppose the Nordstream 2 pipeline.

Russia and its partners are regularly finding loopholes around the sanctions. A couple of years ago, Moscow and Beijing agreed to a 150 billion Yuan currency swap, allowing companies such as Gazprom to trade commodities in roubles and yuan, steering clear of US financial regulations. In order to obtain access to Arctic drilling equipment and expertise, Rosneft acquired 30 percent of North Atlantic projects from Statoil. Statoil bypassed sanctions on the development of shale gas by redefining it as limestone (NYT). Many analysts are convinced that sanctions generally are not effective – with the exception of Iran and N. Korea, where UN sanctions were also imposed. In fact, the opposite result has occurred. In 2014, during the annexation of Crimea, Putin's popularity rose from the low 60s to the mid-80s and has stayed there ever since.

In 2016, the World Bank said that import substitution had a limited impact on economic growth. However, it said that the agriculture sector grew by 3.6% in 2016 while the economy as a whole had a -0.2% growth rate.

suggesting that he might invoke an EU regulation (Council Regulation 2772/96), which says that no decision based on extraterritorial laws is enforceable in the EU. However, this provision represents a huge risk for investors because of its uncertainty and unpredictability.

Although policy leaders attempted to harmonise US and European sectoral sanctions, there are a number

practice represents a major competitive advantage for EU oil firms and creates an incentive for sanctions arbitrage practices.

The sanctions bill also states that it is US policy to prioritise the export of US energy such as LNG in order to create American jobs. Recently, the US began exporting LNG to Poland and Lithuania at a price slightly higher than gas from Gazprom. The

A number of experts have suggested that the Trump administration may apply sanctions to "the letter of the law", while other analysts say that the EU sanctions are not being enforced as robustly as their US counterparts. In the final analysis, the new US sanctions create uncertainty for investors and this will be the "new normal" for the foreseeable future.

As businesspeople, we meet regularly with Russian officials in every sphere of government. It is well understood that our main goal is to encourage cooperation for our mutual benefit, in spite of the difficulties caused by the sanctions regimes of the US and EU. I am reminded of the words of Nietzsche: *That which does not destroy us only makes us stronger.* ■

“Made in Russia” – how to achieve the status of a local producer



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He is the former Chair of the Legal Committee of the AEB (2010-2013) and a frequent speaker on conferences devoted to Russian-German business relations and cross-border legal topics.

I. Advantages in procurement for local producers

Russia still struggles to exploit its full deposits and is highly dependent on the export of energy resources and import of foreign goods. Since the imposition of sanctions in 2014 by the USA, Canada and the EU, Russia was forced to change its industrial policy more rapidly. Russia's markets are longing for investments, job creation, know-how, sustainable growth, the search for new resources and investments for modernisation.

For that reason, the Russian government constantly works on supporting local producers and stimulating foreign investors to develop the production of their goods in Russia. As an incentive for the development of local production, the government established restrictions with regard to certain types of foreign goods for participation in state procurements (“restrictions”). As a result, certain types of goods produced in Russia (or “made in Russia”) enjoy an advantage over goods imported from foreign countries in state procurement.

Depending on the industry, the form of restriction for participation in state procurement may differ. At the moment, there are three *main forms* of such restrictions:

- prohibition against participation (certain foreign goods cannot participate in state procurements at all);

- limited participation (certain foreign goods cannot participate in state procurements, if the same kind of goods are produced in Russia);
- advantages in procurement (Russian goods have a 15% price preference over foreign-made goods).

All restrictions on participation in state procurements are established by several separate Decrees of the Russian government and only with regard to certain types of goods in different industries: machine products, textile products, software, radio-electronic products, pharmaceutical products, medical products, etc.

The lists of such goods are identified by the Russian government in such Decrees by the use of the codes under the Russian Classification of Product by Economic Activities (“RCPEA”). Therefore, to determine whether Russian legislation contains any restrictions on state procurement in a specific situation, it is required to clarify the RCPEA codes of the product which would be supplied (sold) in state procurement.

In most cases, the Decrees of the Russian government also specify:

- the localisation requirements which must be applied to determine origin of goods (*see Part II below*);
- the document, confirming “made in Russia” status for the purposes of participation in state procurement (*see Part III below*).



II. Localisation requirements

To obtain the status of a local producer, the goods shall comply with the localisation requirements (localisation criteria) established by Russian legislation. Otherwise, the producer would not be able to obtain the relevant documents confirming “made in Russia” status.

At this moment, localisation requirements are contained in two essential documents:

- Decree of the Government of the Russian Federation No. 719 of 17.07.2015 (“Decree No. 719”);

- The Agreement on Rules for Determining Country of Origin of Goods in the CIS of 20.10.2008 (“CIS Agreement”).

Decree No. 719

Decree No. 719 is one of the most important documents in the sphere of localisation in Russia. It contains a detailed description of localisation requirements with regard to certain goods in different industries, which must be followed in order to obtain “made in Russia” status. Generally, according to Decree No. 719, a company – in order to be regarded as a local producer – must:

- be a tax resident of the Eurasian Economic Union;

- have the rights to design and technological documentation required for the production and modernisation of the relevant goods;

- have at least one service centre within the EAEU (if applicable);

- perform a minimum volume of production operations in Russia and/or use spare parts produced in Russia.

Decree No. 719 establishes the minimum volume of production operations with regard to each type of goods. It is important to mention that for some types of goods of the Decree No. 719 stipulates a gradual increase of the localisation level. For example,

starting from 1 January 2016, to obtain a document verifying the local status of an agricultural tractor, it is required to confirm that at least 13 production operations from the list of operations provided in Decree No. 719, including the production, assembly and welding of the frame, subframes (if applicable), are performed in Russia, from 1 January 2018 – at least 14 operations, from 1 January 2020 – at least 15 operations.

Compliance with the localisation requirements specified in Decree No. 719 is confirmed by the inspection certificate (*see Part III below*).

Although the Russian Government regularly adds new types of goods with localisation requirements to Decree No. 719, the list of goods provided in Decree No. 719 does not cover all types of goods with regard to which Russian legislation has established restrictions for participation in state procurement. For that reason, in some cases the localisation criteria stipulated by the CIS Agreement are applied.

CIS Agreement

The CIS Agreement establishes common rules for determining the origin of goods for customs purposes in the Commonwealth of Independent States.

In comparison to Decree No. 719, the CIS Agreement:

- establishes general rules for determining the country of origin (“substantial transformation” criteria);
- covers many more goods than Decree No. 719;
- uses tariff codes under Foreign Economic Activity Commodity Nomenclature (“FCEAN”) in the CIS for the identification of goods.

Generally, the CIS Agreement is applied in those cases when Decree No. 719 does not contain localisation requirements with regard to certain goods.

Compliance with the localisation requirements specified in the CIS Agreement is confirmed by the ST-1 certificate (*see Part III below*).

In most cases, Decree No. 719 establishes more severe localisation requirements. Therefore, usually after new items were added to the list of

provided to the state buyer by the producer of goods (or its distributors) who is/are participating in the particular state procurement.

As a general rule, compliance with the localisation requirements is confirmed by:

- inspection certificate;
- ST-1 certificate.

Both documents mentioned above are issued for a one-year period by the relevant Chamber of Commerce and

To obtain the status of a local producer, the goods shall comply with the localisation requirements. Otherwise, the producer would not be able to obtain the relevant documents confirming “made in Russia” status.

Decree No. 719, localisation requirements must be applied according to Decree No. 719 instead of the CIS Agreement.

III. Documents confirming “made in Russia” status

If, in your specific situation, Russian legislation establishes advantages in state procurement, it is better to obtain “made in Russia” status with regard to the produced goods in order to be able to operate on the same conditions as a local producer.

“Made in Russia” status is confirmed by special documents, which must be

Industry (“CCI”) on the basis of an application from the producer after a detailed analysis of a huge package of documents. A visit to the production premises in Russia by the CCI’s experts may be required.

However, in some cases, the annual inspection certificate and ST-1 certificate are not enough. One must obtain additional documents in order to be admitted to state procurement, for example:

- a single act of expertise, which is issued by any CCI directly to the participant of the state procurement (e.g. distributor) on the basis of the



annual inspection certificate or ST-1 certificate obtained by the producer (in the machine industry);

- confirmation or notification issued by the Ministry of Industry and Trade (for radio-electronic products).

The type of confirming document and the procedure of its issuance may differ depending on the form of advantage, the industry and the localisation requirements established with regard to the relevant goods. For that reason, it is important to carefully analyse which type of document is required in each specific situation.

In some cases, “made in Russia” status for purposes of participation in state procurement can be confirmed by other documents: special investment contract and declaration of the participant of state procurement.

IV. Special investment contract

The special investment contract (SPIC) is a new form of public contract that an investor can conclude with the Russian Federation, constituent entities of the Russian Federation, or municipalities. Usually, it provides the investor with special treatment in exchange for certain investment activities. This

special treatment includes, besides tax benefits, subsidies and additional support for the producer.

The contracting party under a SPIC can be the Russian Federation (federal level), constituent entities of the Russian Federation or municipalities (regional level), or a SPIC can be signed as a trilateral agreement.

These are the general terms of a federal SPIC:

- maximum term is 10 years;
- the minimum amount of investments is 750 million roubles (approximately 11 million euros).



Additional criteria for a SPIC may be established for specific industries. Constituent entities of the Russian Federation are also entitled to stipulate other minimum requirements at the regional level.

Although a SPIC is a type of investment instrument, it also can be regarded as a form of localisation of production. For example, to confirm the “made in Russia” status of certain types of goods in the machine industry, it is possible to provide a copy of the special investment contract to the state buyer, if the SPIC concluded with the Russian Federation contains

A special investment contract provides the investor with special treatment in exchange for certain investment activities.

the obligation of the producer (investor) to follow the localisation requirements specified in Decree No. 719 or CIS Agreement.

All in all, the SPIC is “soft localisation”, because the investor has more time to achieve the required levels of local manufacturing under such an agreement.

V. Conclusion and recommendations

The status of local producer could be demanded in certain cases of participation in state procurement and is usually not necessary when it comes to selling goods on the private market. However, taking into account that state procurement is a huge part of the Russian economy, foreign producers often decide to develop local production in order to participate in state procurement.

The localisation requirements, the documents confirming the status of a local producer and the procedure of its issuance, are regulated by several legal acts at different levels (federal laws, Russian government decrees, CCI orders), so each specific situation requires an individual approach.

Before organising local production, a company should analyse whether there are any restrictions on participation in state procurement for foreign-made goods and whether it is possible to comply with all applicable localisation requirements. Such an analysis should be initiated by determining the codes of the goods under RCPEA and FCEAN and clarifying regulations.

It is important to remember that regulations in the sphere of localisation of production change quite often, so it is vital to regularly review them. ■

Part III.

Before You Start

Legal issues you should be aware of before you start investing in Russia

Notwithstanding the fact that in recent years the Russian economy has been



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affected by a number of negative aspects, such as falling oil prices, Russian rouble depreciation, sanctions imposed by the United States and the EU, Russian countersanctions, and the overall political tensions that are leading to a certain degree of economic decline, Russia still remains attractive for foreign investments. Moreover, experience has proven that those investors devoting their time to learn about the specifics of the Russian market, working hard to establish business relationships of trust and, most importantly, planning long-term investment strategies succeed in Russia.

In light of the Russian government continuing efforts to improve the country's investment climate, in particular, but not limited to, implementing measures that simplify certain administrative procedures, reforming customs procedures, developing tax incentive systems, and by using other legal instruments, we would like to draw the reader's attention to some legal issues that a foreign investor should be aware of before investing in Russia, and that if not taken into consideration, may cause complications in the future.

Step 1: Where to invest?

Despite the fact that the Russian government encourages foreign investments in the Russian Federation,

there are certain restrictions for foreign investors established by Federal Law No. 57-FZ, dated 29 April 2008 "On the Procedure for Making Foreign Investments in Companies of Strategic Importance for National Defence and State Security".

The Law provides a list of 45 activities of strategic importance within the following areas: security and defence, nuclear industry, natural resources, geophysical and hydrological processes, activities connected with encryption devices, media, and monopolies. Foreign investments in the mentioned areas are either prohibited – if as a result of such investment, the foreign investor gains control over companies of strategic importance, or such transactions require prior approval by the Russian Federal Antimonopoly Service.

Step 2: Choosing an investment approach

Before entering the Russian market, a foreign investor should decide on the investment approach: either starting a business from scratch via establishing a business presence in Russia, or establishing a joint-venture with a Russian partner, or acquiring an existing business in Russia.

Direct investments by **establishing a business presence in Russia** is the most common approach used by

foreign investors through establishing either a representative office or a branch of a foreign legal entity, or a Russian subsidiary.

A *representative office* is not considered a legal entity under Russian law; therefore, it does not enjoy the rights and obligations of a legal entity: it cannot conduct business, enter into commercial agreements or possess its own property and assets; it acts in the name and on behalf of the foreign company; it is generally used for local market-research purposes, marketing and promoting the foreign company's business, and other supporting activities. All assets are owned by the foreign company and all commercial agreements are executed by the foreign company directly.

A representative office is easy to operate and finance, since it is not subject to strict currency control when transferring money from/to the foreign company. A representative office has simplified accounting and bookkeeping.

An alternative to a representative office is a *branch* of a foreign company. The difference is that a branch has all of the functions of a legal entity: it can conduct business in its own name, enter into commercial agreements and possess its own assets. **The big disadvantage** of a branch is that the foreign company remains liable for all the debts of the branch. However, **the big advantage** is that there is no double taxation, as received income is considered to be the income of the foreign company, thus there is no tax on dividends.

Both forms are subject to accreditation by the Russian Federal Tax Service. The accreditation and incorpo-



ration procedure can take about two months.

Incorporating a Russian subsidiary may be done in the form of a limited liability company or a joint-stock company.

- Establishing and operating a *limited liability company* (an **LLC**) is one of the most common business structures used by foreign investors in Russia, in particular due (but not limited) to the following advantages: an LLC is a legally independent entity, i.e. it may conduct business in its own name,

enter into commercial agreements, possess its own property and assets; a shareholder of an LLC is not liable for its debts – the liability is limited to the amount of the capital contribution (with a few exceptions when, for example, the shareholder by its actions led the company to bankruptcy); a participatory interest (i.e. a share) in an LLC is a property right and is not considered to be a security under Russian law; therefore, it does not need to be registered (unlike a JSC).

- As an option, a foreign investor may establish a *joint-stock company* (a **JSC**),



Experience has proven that investors who plan long-term investment strategies, succeed in Russia.

which is similar to an LLC – it is a legal entity and enjoys most of the advantages as described above. A JSC can be public or private. A public JSC can trade its shares publicly, and therefore, is required to comply with strict legal requirements as to the structure of management bodies, compulsory reporting, corporate relationships of the shareholders and a number of other requirements. A private JSC is more flexible in terms of management and operations, more like an LLC.

However, if comparing an LLC and a JSC, it is worth mentioning that an LLC is a much more flexible form: many provisions regarding corporate governance, relationships between the shareholders and the company and between the shareholders, etc. established by the law may be set differently in the charter.

The main advantage of the above-described options is that the investor creates a new business with no uncertain or unclear background and controls the new business.

In some cases, the investor might deem it more expedient to invest in a **joint-venture** with a Russian partner. This might be the case when investing in a production or construction activity where a number of strict legal requirements should be met, such as, for example, obtaining permits and licenses that can be much more easily achieved by a Russian partner understanding the specifics of the exact industrial sector and the Russian market overall. A Russian partner may bring the necessary experience, knowledge, connections and sometimes even premises required for business operations. However, being, on the one hand, a possible valuable asset, on the other hand, it is always a challenge to find a trustworthy partner in any country, and Russia is no exception.

Furthermore, a direct investment may be done by **acquiring assets or shares in an existing Russian business**. Compared to the above-mentioned options, this one is the most risky and the most costly investment; however, if the existing busi-

ness is proven to be solid, such an investment might turn out to be the most profitable (in terms of a quicker return on investment).

Investing in an existing business will require that the investor carry out thorough pre-transactional due diligence. The investor should examine, analyse and understand the business to be acquired. For example, among the most common risks are the existence of “hidden” debts and tax claims; therefore, it is important to include indemnity provisions in transactional documents obliging the seller to compensate the buyer in case any of the mentioned risks arise. If the findings of due diligence reveal serious risks of buying the company’s shares, then it is worth considering an acquisition of the company’s assets (property) with a further transfer of the respective assets to a newly-created entity.

Step 3: Managing the business

The management structure of the business depends on the form of the

entity. As mentioned above, an LLC enjoys a more flexible scheme – it has two main bodies: general shareholders' meeting (GSM) and a CEO. As an option, an LLC may have a board of directors (BD) and a management board. The same applies to a private JSC. As to a public JSC – it should have three mandatory bodies: GMS, BD and a CEO. Furthermore, current Russian law provides that *a company instead of a single CEO may have two or more directors with distribution of competencies among them.*

Recent amendments to Russian corporate law provide for the notarial certification of most corporate actions. In cases where the shareholders of a Russian company are located in different countries, the simultaneous presence of all shareholders for a general meeting might be complicated. Therefore, in order to simply ease the management of the business and in view of future sale, it might be worth considering the creation of a company through a special purpose vehicle (SPV), for example, in Cyprus.

Step 4: Hiring staff

Dealing with Russian labour and migration laws is a separate and very important issue to be taken into consideration by a foreign investor.

A foreigner coming to Russia for work is required to obtain a work permit. Therefore, at the moment of establishment of a new company, a foreign national cannot be appointed as the CEO, since a work permit should be obtained on behalf of the existing employer – the company.

Russian law divides foreign employees into highly-qualified specialists (**HQSs**)

and ordinary employees. A HQS is a foreign national who has experience, skills or achievements in a certain area and receives an annual salary in Russia of no less than RUB 2,000,000. The work permit for HQS may be issued for up to three years (ordinary foreign employees – for one year); the term for its obtainment is shorter compared to other foreign employees (3-4 weeks instead of 4-5 months).

In all cases of hiring employees in Russia, it is highly recommended for a foreign investor to seek the prior assistance of a labour law professional, since Russian labour laws are mainly aimed at protecting employees; and employees today know their rights and easily apply to court in case of any violations thereof (the most common cases involve wrongful dismissal).

Step 5: Choosing a taxation scheme

This step might require a separate discussion. In a nutshell, however, the following should be noted by a foreign investor.

General tax treatment consists of the Corporate Income Tax (general rate – 20%), Personal Income Tax (general rate – 13%), VAT (general rate – 18%, for some types of goods or services – 0% or 10%). Also, the business is required to pay the insurance contributions on the employees' salaries (general rate – 30% up to a certain limit (RUB 876,000 in 2017), which is subject to annual indexation. After the limit is reached, the contributions are paid at 15.1%). No contributions are paid on the salary of HQSs.

Although Russian tax rates might look quite low compared to many Western

jurisdictions, there are various **pitfalls** in the Russian tax system. For example, the tax base for corporate income tax is calculated as income less incurred deductible expenses. The Russian Tax Code provides for a list of expenses not recognised as deductible; all other expenses are recognised as deductible, provided they are economically feasible, supported with the relevant documentation and aimed at deriving profits, which is not always easy to prove, thus many expenses are not recognised as deductible.

Russian entities are taxed on their worldwide income. Foreign legal entities that have a permanent establishment in Russia in terms of tax law or receive income from Russian sources are taxed on the respectively received income.

The Russian tax system provides a number of special tax regimes that exempt small/mid-size businesses from some taxes (a corporate income tax, property tax and VAT) and numerous tax incentives, "tax holidays" and the easing of some tax accounting and reporting requirements.

Final important note

Being new to the Russian market, a foreign investor should engage professionals to assist during the creation of the business, as well as further when carrying out and promoting the business. It is very important to engage professionals (lawyers, business consultants, accountants, auditors) with practical knowledge of the specific business the investor is entering who are competent and able not only to evaluate risks, but also to suggest solutions in specific situations. ■

Tax and legal implications of your first steps in Russia

When starting activities in Russia, foreign investors face multiple choices relating to election of the form of legal presence, location and contractual framework. Some of these choices could trigger adverse tax and compliance implications that are difficult to predict at the beginning. This article is an attempt to outline the obstacles a foreign investor could face due to improper set-up.



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branch in the territory of the Russian Federation.

The representative office is a separate division of the legal entity located beyond its place of residence, which represents the interests of the legal entity and performs their protection. The branch is a separate division of the legal entity located beyond its place of residence and performing all of its functions or part thereof, including the functions of representative office.

The representative office and the branch are subdivisions of such legal entity, but not separate legal entities. Both could perform representation functions of the legal entity in Russian territory, but only the branch is entitled to perform all or part of the legal entity's commercial activities. A foreign legal entity is allowed to establish an unlimited number of representative offices and branches in the Russian territory.

A subsidiary of the foreign company is a Russian legal entity distinct from its parent company. Although Russian civil law recognises several legal forms of entities, two of them are of particular interest for foreign investors: joint-stock company (AO) and limited liability company (OOO).

Consequently, the major legal set-up options for the foreign investor are the following:

- representative office;
- branch;
- Russian subsidiary.

As practice shows, foreign investors normally appoint a corporate lawyer to advise on the possibilities of incorporation in Russia. However, such a lawyer does not possess any information on the client's anticipated business strategy in the Russian market. As a result, the choice of legal presence could be made without taking into account the foreign investor's business strategy and lead to the need to switch from one form of legal presence to another. Consequently, the investor could incur additional costs and face tax inefficiencies.

For example, if the foreign investor established a branch and thereafter decided to commence the importation of goods for re-sale purposes, it could face restrictions and difficulties at customs, because branches could be limited in importing goods into Russia for re-sale purposes, while subsidiaries are allowed to. Consequently, in this case the investor could be forced to establish a subsidiary and after that de-register

Entrance "menu": what is offered to a foreign investor?

A foreign legal entity is allowed to establish a representative office or a

the branch (if there will be no need for keeping it) and therefore incur excessive expenses relating to state duties, notary and lawyers' fees. Additionally, this switch could restrict the possibility of the investor to carry forward the accumulated tax losses, as the branch is not allowed to shift them to the newly-established subsidiary.

On the other hand, the foreign investor could decide to establish a Russian subsidiary and never commence importation or production in Russia, thus experiencing excessive tax and compliance burden. In particular, a Russian subsidiary engaged exclusively in marketing and representation

tions with the foreign investor's strategy in Russia.

In particular, the Russian market penetration process could be divided into the following stages:

- **Market entry and preparatory stage**, where only preparatory and auxiliary activities are performed in Russia, such as gathering information about the market and potential competitors, increasing awareness of the foreign investor among the core audience, etc.

- **Client acquisition and contracting stage** that is aimed at establishing contacts with potential clients, negotiating and signing contracts.

ing any sales and/or profit in Russia. In case the legal presence is in the form of a representative office or a branch, no profits tax and VAT obligations will arise in Russia.

In case the branch or representative office extends its activities to the **client acquisition and contracting stage**, such activities could result in the creation of a permanent establishment (hereinafter, PE) in Russia.

According to the Tax Code of the Russian Federation (hereinafter, the "RF Tax Code"), a foreign company is deemed to have a PE in Russia if it performs regular activity of a commercial nature in Russia (except for

► **Table 1. Tax and legal framework for Russian market entry**

	Market Entry & Preparatory Stage	Client Acquisition & Contracting Stage		Landing and Localisation Stage
Key activities	Representing the HQ, information gathering; market research; limited brand promotion	Direct client search; contacting clients; contract negotiation		Importing goods; localisation of production
Legal form	Representative office / Branch	Branch	Russian subsidiary	Russian subsidiary
Tax position	No VAT; no profits tax	No VAT; profits tax (if permanent establishment is formed)	Vatable and/or nonVatable sales; profits tax	VAT; profits tax

activities for the benefit of its foreign parent could face an unclear VAT position relating to service fees receivable from the foreign parent and therefore generate VAT risks in Russia.

How to match strategic choices with a suitable legal form

The solution to overcome the inefficiencies mentioned above could be the alignment of the legal presence choice and the resulting tax implica-

- **Landing and localisation stage** when core activities such as importation of goods and/or production commence.

Each of the above stages could require different legal form and trigger specific tax implications (please refer to Table 1.).

At the **market entry and preparatory stage** the foreign investor is subject to minimal regulatory requirements and it is not generat-

ing any sales and/or profit in Russia. activity of a preparatory or auxiliary nature) and has a separate subdivision or any other place of business in Russia. The foreign company's activity in Russia could also be treated as leading to forming a PE in case such foreign legal entity has a dependent agent in Russia. According to the RF Tax Code, a dependent agent is a legal entity or individual empowered to act on behalf of this foreign legal entity in Russia and actually executing its authorities to conclude

agreements or negotiate material terms of agreements resulting in legal consequences for this foreign company. Foreign legal entities whose activity in the Russian Federation creates a PE are subject to profits tax with regard to profits attributable to the Russian PE.

In case a foreign legal entity is planning client acquisition and contracting in Russia and decides to establish a Russian subsidiary, such subsidiary could be treated as a dependent agent of the foreign legal entity, thereby triggering the PE implications. If the Russian PE is created, the foreign legal entity will be liable for profits tax in Russia in the part of its income attributable to the Russian PE. However, please note that Russian tax legislation is unclear on the methodology of profits tax calculations in case of a PE triggered by a dependent agent being a Russian subsidiary. In this regard, the tax authorities are currently reluctant to assess additional profits tax on such grounds.

In case the Russian subsidiary renders services to its parent relating to client acquisition, it could be subject to Russian VAT.

Under the Russian place of supply rules, advertising, marketing, consulting, data processing and some other services are considered as supplied in the territory of Russia if the buyer of these services has its place of activity in Russia. If the buyer of the services mentioned above (the foreign legal entity) does not have any place of activity in Russia, these services are considered to be supplied outside Russia and are not subject to Russian VAT. However, services in respect of which the Russian Tax Code does not provide for specific place of

supply rules are generally treated as “other services” (for example, contract negotiation, representation with the state authorities, etc.). Such services are deemed to be supplied in Russia if rendered by a supplier having its place of activity in Russia and therefore are subject to Russian VAT.

For the **landing and localisation stage**, a Russian subsidiary is normally required due to the regulatory restrictions mentioned above. The Russian subsidiary in this case should be paying VAT and profits tax as well as other applicable Russian taxes. At the same time, the Russian subsidiary could be entitled to tax concessions depending on the scope and volume of its activities in a manner similar to Russian legal entities established by Russian investors.

Summarising the above, the legal form that suits the best could be attributed to each stage of the foreign investors’ market penetration (please refer to Table 2. The legal form choice matrix).

Consequently, when deciding on the form of legal presence in Russia, not only regulatory aspects should be considered; instead, the decision should be based on understanding of the following:

- whether the representatives in Russia will be engaged in client acquisition and contract negotiation;
- whether importation for re-sale is anticipated.

Another area of concern affecting the legal framework could be financing and profit repatriation.

The foreign legal entity could transfer cash to its representative office or its

branch without any formalities and currency control implications. Such cash transfers, as well as the transfers back from the representative office (the branch), are not subject to any taxes in Russia. However, all transactions between the representative office (the branch) and its counterparties being Russian legal entities are subject to currency control that imposes additional documentary formality (passport of deal) for transactions exceeding USD 50,000.

On the contrary, any transfers from the foreign parent to the Russian subsidiary require legal formalization (either in the form of a contract or resolution supporting the contribution to assets or capital). Cross-border transactions between the foreign parent and the Russian subsidiary are subject to currency control (see above). Distribution of dividends by the Russian subsidiary is subject to a 15% withholding income tax, unless reduced or eliminated under a double taxation treaty.

Life after the set-up: how to keep going efficiently

An optimal set-up structure does not guarantee tax efficiency and ability to adhere to regulatory requirements. The major reason for this is that the business reality differs from the expected strategy pattern. In practice, the foreign investor could face adverse tax and regulatory implications in the following cases:

- **“Stuck in the middle” case** where the investor anticipated a quick landing, but was forced to extend the preparatory or client acquisition phase. In this situation, the set-up in the form of a Russian subsidiary could result in additional compliance burdens and/or VAT risks relating to the unclear VAT treatment of services rendered to the parent.

► **Table 2. The legal form choice matrix**

	Market Entry & Preparatory Stage	Client Acquisition & Contracting Stage	Landing and Localisation Stage
Key activities	Representing the HQ, information gathering; market research; limited brand promotion	Direct client search; contacting clients; contract negotiation	Importing goods; localisation of production
Russian subsidiary	Possible, but triggers excessive compliance requirements	Not advisable due to permanent establishment risks	Suits the best
Branch	Suits	Suits the best	Not advisable as import through the branch could be limited to goods for internal consumption
Representative office	Suits the best	Possible, although not in line with the legal framework	Not possible

• **Strategy change case** could also lead to a situation where the selected legal form is no longer supporting the business model. For example, the Russian subsidiary could cease the importation of goods and switch to purely representation functions due to unfavourable economic conditions. In such a situation, the Russian subsidiary’s liquidation and registration of a representative office or a branch could result in a reduction of both tax risks and compliance efforts.

In some cases, two legal forms of presence in Russia (the branch and the Russian subsidiary) could be a solution, where the investor is planning to land/localise with one product and search for clients for other products or for the benefit of other group companies. However, under this scenario, the Russian tax implications for the both entities should be thoroughly examined.

Another point of concern after the set-up could be establishing the proper transfer prices in transactions between the foreign parent and the Russian sub-

siary. If financial or other conditions of the transaction between the foreign parent and its Russian subsidiary differ from the conditions that would be established in the comparable arm’s-length transactions between unrelated parties, the Russian tax authorities could arrive at taxable income of the Russian subsidiary as if it were at arm’s length. Unlike some countries, the cost allocation from the foreign parent to the subsidiary is not allowed for profits tax purposes in Russia.

Similarly, it is important to ensure the market level profit allocation to the branch forming a PE in Russia. Although it is allowed to allocate expenditures incurred abroad to the Russian PE for profits tax purposes, provided the respective double taxation treaty allows for such allocation, the PE’s profit should correspond to the market level.

Consequently, periodical revision of the choices made at the set-up stage are advisable. Such revision should be made considering both the cur-

rent business model in Russia and recent changes to legislation.

Summarising the above, the following could be recommended to the foreign investor:

- Base the set-up decision on a complex analysis involving legal, regulatory and tax expertise. Such analysis should include an understanding of business strategy and scale of activities, financing and profit repatriation options, approach to transfer pricing. As practice shows, an optimal decision could only be achieved by engaging a multidisciplinary team of tax and legal professionals.
- Scan the local environment for tax concessions and favourable tax regimes in advance.
- Adopt a disciplined approach to tax reporting and payment from “day one” in Russia. For this purpose, outsourcing of tax accounting and reporting could be a good solution at the preparatory and client acquisition stages.
- Perform regular tax health checks covering such areas as PE and transfer pricing issues and the VAT treatment of cross-border transactions. ■

Outsourcing keeps your costs down – “safe methods to market entry”

There is no doubt that Russia has always been – and always will be – an interesting market. More than 140 million consumers, almost 25 million of whom live in Moscow and Moscow Region. This was true before the crisis and is

true now. The economy is growing again and Russia has become – virtually unnoticed – an exporting country. Not just of raw materials, oil and gas. But also in high-tech areas, automotive, medical equipment, etc. Just to be complete, Russia has also become the largest exporter of grain.

The relatively weak rouble and the economic crisis, in tandem with sanctions and anti-sanction policy, has changed economic circumstances completely.

Russia was always considered as an interesting market, but never as a country where a company could build production capacities for export. Too expensive. Too much bureaucracy. Too many uncertainties. Over the last 10 years, many companies have built up local production facilities to deliver to the local market. Suddenly, these companies had to find new markets abroad in order to sell their overproduction. Local demand has dropped dramatically and will not reach the pre-crisis level soon.

And they will keep these markets. A new economic picture. And new chances for small and medium companies in all areas. Service industry and supply chain.

The potential for small and medium companies in all industries is exceptionally high! But many of these com-

panies are afraid of the complexity of legal, tax, labour and accounting rules.

Outsourcing – the right instrument to start doing business in Russia

So how? Accounting, payroll, bureaucracy and paperwork, language and personnel issues. How to find the right people, how to adjust to changing laws and requirements? Too much risk and too many uncertainties for many companies.

Over the last 10 years, many service providers developed in all areas to support new market entries and start-ups. Interim management, accounting, payroll, tax services, bank services, outstaffing, etc. Anything specific compared to other countries?

Maybe yes. The reason for that is mainly that the Russian school system still teaches too specifically. It is still difficult to find an engineer with good technical knowledge and language skills. The same is true in many professional areas. Accountants who are skilled in their field but also fluent in a foreign language are still rare. Salary levels of such multi-skilled staff is therefore far above average.

One of the major mistakes that many, especially small and medium companies, make is that they intend to handle everything themselves. But to



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find an accountant who speaks perfect English but also has impeccable accounting skills is a challenge. And many have prioritised language, as Russian bookkeeping is quite a challenge and in many aspects different from international standards. And what happens, if the one and only accountant gets sick or leaves the company. Pretty often a disaster.

Russia's outsourcing industry has, therefore, expanded its service portfolio in recent years. And while the field is still not covered by Russian law, one can find professional outsourcing companies for virtually all major foreign languages. Outsourcing is commonly used to outsource certain business processes to external service providers. This may be typical in areas supporting core operations,

such as IT, HR processes, payroll, accounting and management.

The main advantage of outsourcing, besides the guarantee of having the outsourced services in experienced hands – therefore alleviating the foreign investor's need to worry, is the lower cost of operations and workforce. Another main advantage is higher flexibility and lower risks. The reasons for that are also associated with Russian employment law, which offers very little flexibility to lay-off employees.

How to set up a company in Russia

The most common structure for starting operations in Russia is a limited liability company – in Russian, "OOO". There is still the possibility to set up a representative office or a branch,

but the costs for running this operation are more or less the same. To set up a limited liability company, the foreign investor needs the following:

- legal address;
- managing director;
- chief accountant;
- bank account;
- base capital of RUB 10,000.

The legal address may be the first issue to be tackled, since a confirmation letter from the landlord is required. If the managing director is Russian, there are no restrictions. If the managing director is expected to be a representative from the foreign company, this person first needs a work visa before he can become the general manager. In many cases, the managing director also holds the official position of chief accountant.



Foreign investors want to have the key manager involved not in daily paperwork, but in achieving success for company operations.

Many service providers therefore also offer for the start-up phase legal addresses as well as Interim Management until the company is set up and this position is taken over by a fulltime employee.

Interim Management

The position of the General Manager in Russia is very powerful. He is also busy with lots of administrative work and this can lead to some conflicts in correctly understanding priorities. Foreign investors want to have the key manager involved not in daily paperwork, but in achieving success for company operations. Therefore, in some cases, it may be deemed appropriate to give the services of Interim Management in combination with accounting to an outsourcing service provider. This guarantees that all bureaucratic and administrative work is legally correct from start-up. On the other side, the foreign company can concentrate on its main business activities.

Classical services offered for accounting and tax reporting are:

- accounting for fixed assets;
- accounting of intangible assets;
- accounting of materials receipts and writing them off for expenses;

- accounting of production, general and sales expenses;
- accounting of goods and finished products;
- accounting of cash transactions;
- accounting of banking transactions;
- preparing and sending payment orders and another required bank documentation;
- accounting of settlements with counteragents and accountable persons;
- salary calculation, assessment of required taxes and contributions in regard of labour compensation;
- accounting of settlements of labour compensation;
- accounting of settlements of taxes and insurance contributions;
- statement of financial results;
- preparing and sending reports to tax authorities and extra budgetary funds;
- other bookkeeping transactions, as required for the completeness of accounting.

Costs

The reasons for outsourcing professional services in Russia are not entirely different from other countries and

the costs are comparable. One of the main reasons described above is the difficulty in finding experienced personnel with language skills. This may well lead to the phenomenon in which, for example, the costs of a fully-employed chief accountant with foreign language knowledge is costlier than the costs from an outsourcing provider.

The same is true for Interim Management. The total costs, for instance, for a Sales Manager and a Technical Manager plus the costs for Interim Management may still be less than for a General Manager employed full-time.

General

As in all service fields, costs vary widely among the various small, medium and larger service providers. And the decision as to which is the right one is the same in all businesses and in all countries. Russia is not any different here. As an important recommendation, we can state that whatever activities are passed to an external company, the legal basis and the contractual outlines should be checked carefully. ■

Part IV. Facilitating Entrepreneurship in Russia

Regions and economic zones and ratings

With foreign companies once again looking to set up or expand business in Russia, choosing a region where to locate tends to be a much more complex question than a decade ago. In the past, this question did not appear to be an easy one, having to choose from over 80 regions – some of which are bigger than any European country – spanning 11-time zones. In reality, however, there used to be,

at a maximum, a handful of regions that were actually worth looking at. Nowadays, unless the choice is obvious for internal reasons (such as, for example, proximity to the single biggest customer), it is much more difficult to make a choice between the multitude of regions vying for investor attention and money.

There are multiple reasons for the increase in complexity. First, there is the

need to consider more regions, looking beyond the typical initial footholds in or around Moscow and St. Petersburg. Second, the regions, spurred on by the federal government, are actively trying to improve their offering for investors, including more programmes and incentives. At the same time, differentiation between the regions can be less obvious due to the limits of the existing frameworks for those programmes and incentives. Factor in the



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lingering lack of trust in statistics and public data, and it becomes understandable why even the large multinationals with a long history of doing business in Russia sometimes prefer to look for an unbiased opinion on the matter from consultants.

Whether or not companies choose to ask for outside help in choosing a region, there is one important point to remember throughout the regional selection process: ultimately, what you need to end up with is a suitable site, a land plot – rather than a region. Since diversity in the quality of available land plots – both across and within regions – can be staggering, it is typically unwise to try to find “the right region”. You might end up missing a great site just across the non-existent regional border. Rather than spending inordinate time and effort in

trying to choose “the right region”, the high-level regional selection problem should be solved through a desktop-based approach focused on excluding the “wrong regions”, i.e. those that will deliver inferior results regardless of the exact location of the site.

This approach should involve a high-level consideration – preferably using some sort of a weighted average model – of the following four groups of factors:

Group 1: Ratings and rankings

Regardless of the country, regional ratings and rankings typically suffer from the same limitations: a large number of generalizations, assumptions and subjective interpretations of data. Still, they offer a potentially valuable initial “helicopter view” that spans the

entire country. A good regional rating or ranking system tries to overcome the shortcomings outlined above by using an integrated approach that allows at-a-glance comparison of a large number of regions by simultaneously accounting for a multitude of factors objectively and realistically. One of the most prominent recent attempts to approach that ideal is the National Ranking of the Investment Climate in the Russian Federation (NRIC), coordinated by the Federal Agency for Strategic Initiatives.

The NRIC’s value proposition is based on a combination of strong partners, a drive to remain unbiased, and a reasonable methodology. Key Russian business associations (the Russian Union of Industrialists and Entrepreneurs, the Chamber of Commerce and Industry of the Russian

Federation, OPORA Russia and Business Russia) are actively involved, ensuring that the ranking has a reputation for being representative. The project is independently funded, and the diverse ranking committee is selected to minimise bias: Russian and international businessmen, development funds, sociologists and economists are all among the key participants. As of 2017, more than 50 factors in each region are assessed and taken into account to arrive at a final ranking, with statistical data tempered by the expressed opinion of real businessmen and sector experts. For example, when assessing the efficiency of registration procedures, the ranking takes into account both the statistics (average time spent by the applicants and the average number of steps that have to be taken) and the level of satisfaction of the applicants with the entire process. The ranking currently functions as a key government tool to stimulate the regions to improve the investment climate across Russia, and, as such, provides a good starting point for the overall comparison of all the participating regions for investors.

However good a particular ranking may be, it is necessary to consider the results of others as well. It is critical to double-check or fine-tune the conclusions, and it is important to select the right set of ratings or rankings for a specific project. Additional rating or ranking systems that can be used include: established projects, such as RA Expert's Investment Appeal Rating; more recent initiatives, such as the Rating of the Investment Attractiveness of Industrial Parks and Special Economic Zones; ratings and rankings that compare ecological situ-

ations; and even some informal ratings and rankings that can be constructed from various web sources. An example would involve ranking the regions according to the expat opinion of life in these regions, which may well be an important part of the equation, depending on the specific nature of your project.

Group 2: Investor-specific considerations

Some of these are obvious, such as the potential logistics routes, along with the costs of raw and packing materials, as well as shipping costs for finished goods. Ideally, these should be quantified for comparison, even if this is on a scale from one to five. Another set of potential logistics questions involves the level of accessibility for foreign managers or specialists, if these are to be present on-site frequently. Most regions of Russia have no direct scheduled flights from European hubs, and many have a surprisingly low number of daily connections even from Moscow.

The next group of questions deals with prior experience or existing knowledge within the company. Are there any facilities used by other divisions of the company that are located in the same or neighboring regions? Are there any potential economies of scale from being located close to the existing distribution centre or another division's facilities? Or, conversely, are there any risks from concentrating so many of the company's production assets in one region? How good is the working relationship with the administration? Are there any biases among the decision-makers in the company that either need to be accommodated or addressed in order for the comparisons to be both objective and acceptable?

Group 3: Success stories

These are especially important if the company currently has no experience or foothold in the regions, and if management views official statistics with suspicion. Under such circumstances, it is critical to identify whether there are other multinationals present. If so, how long have they been working in the region? Could there be synergies, or are they direct competitors? In the latter case, it is especially important to weigh the potential advantages of the region (as may be indicated by the presence of the competitor) versus the potential risks of enhanced competition for the same resources, including a qualified labour force, suppliers, utilities, and even administrative attention and help.

Group 4: Potential cost-saving/enabling mechanisms

Most potentially attractive regions offer programmes or mechanisms that are supposed to help investors through various tax deductions and other perks. Depending on their applicability to the project and the expected level of impact, these may or may not be factors in the regional selection process. Some of the key mechanisms available across the Russian regions today include both the better-known industrial parks and special economic zones (SEZ), as well as the slightly less common advanced development zones (ADZs) and special investment contracts (SPICs). Focusing on ADZs and SPICs provides an opportunity to illustrate some of the details of these programmes: these are to be considered in order to decide whether they can be used as regional selection factors.

Key advantages of ADZs are fairly well-known, and include:

- corporate income tax rate reductions;
- a special index for calculating the mineral extraction tax;
- a significant reduction in social contribution rates;
- exemptions from land and property taxes.

An important, and somewhat overlooked, aspect of federal legislation is that a private company may not only join an existing ADZ, but can initiate the creation of a new ADZ with relevant favourable amendments to regional legislation. This may bring a valuable benefit, providing the following points are taken into account:

- Outside the Russian Far East, the ADZ must be located in a so-called “monocity,” characterised by an underdeveloped social and economic environment. Unless the company is looking to locate in the Russian Far East, only regions with monocities may offer this programme to the investor – and each such monocity should be pre-screened for basic suitability criteria.
- Any investment that was made in a project prior to joining/initiating an ADZ is unlikely to be counted towards the minimum investment amount required to become an ADZ resident, so it is important to make a decision on whether to apply for a programme as early as possible.
- If there is a very limited timeframe for establishing a factory, the length of the initiation process for the ADZ might be an issue.
- Based on the experience of companies that have already gone through the process of joining or initiating an ADZ, there are other aspects that need to be looked at during the later stages of analysis. For example, if the investor started the construction pro-

cess before becoming a resident of an ADZ, they may need to consider undertaking certain restructuring steps before joining the ADZ.

Some of the key offers from a SPIC include, in the best case, the following benefits for the duration of the contract:

- federal and regional profit tax discounts;
- property tax discounts;
- preferences for participation in government procurement programmes;
- other non-tax benefits and incentives listed in federal and regional legislation.

Similar to the case of an ADZ, there are a number of issues to consider in order to decide whether the applicability of the SPIC and its potential impact support using it as a regional selection factor:

- There are a number of requirements that the investor is supposed to meet, including “proving” the amount of money to be invested (typically from RUB 750 million in case federal-level benefits are expected, but it may be lower or higher if a regional SPIC is being considered), and justifying to the Ministry of Industry and Trade that the project is indeed focusing on modernising/creating an industrial asset.
- As with ADZs, there is a risk that no prior investment in the same project can be counted towards the minimum investment amount. Further, an in-depth analysis is required in order to determine whether investment in intellectual property can be counted towards that minimum amount.
- Since the basic split between the federal and regional parts of the profit tax is 2% federal to 18% regional, the federal discount provides a relatively small gain in comparison with a regional one. In order to ensure that the potentially

larger regional profit tax discount and other regional-level benefits are achievable, it is crucial to check that these benefits are specifically mentioned in regional legislation as applicable to entities signing a SPIC.

- Again, based on current experience with SPICs, there are other aspects to be analysed at later stages, including whether to structure foreign investor participation by finding a local partner or by setting up a Russian entity, as well as ensuring profit distribution.

Depending on the specific nature of the investment project, analysis of all factors in all four groups may not be required. An approach that combines desktop analysis and a few strategic sessions to calibrate the findings may enable the selection of a manageable subset of 2-5 regions based on a limited subset of factors. This outcome would be perfectly reasonable for the regional selection stage.

The in-depth work starts at the next stage of the business location process: finding, assessing and comparing actual land plots across their relevant physical and legal characteristics, exact location, existing and planned infrastructure or lack thereof, and specific regional and local legislation and administration. These tasks require going far beyond desktop research, as much of the crucial information can only be obtained “on the ground”, in meetings with regional and local counterparties. Hence, the correct regional comparison approach focuses on efficiently limiting the number of regions to explore at the next stage, thereby ensuring the process is cost-effective, manageable and can be completed within a reasonable amount of time. ■

For notes



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