Russia

Procedure for performing foreign currency operations and the mandatory sale of foreign currency proceeds: explanations of the Central Bank of Russia[1]

The Central Bank of Russia ("the CBR") has provided explanations on the following issues in an Information Letter.

1. Certain issues concerning the drafting of a transaction passport

A transaction passport must be drafted for operating lease and finance lease agreements for moveable property and vehicles classified as immovable property concluded between residents and non-residents if the indicated property is to be imported into (exported from) Russia under these agreements. If property is not imported (exported) into (from) Russia under such agreements, Instruction No.117-I of the CBR[2] provides that drafting of a transaction passport for lease and finance lease agreements for this property is optional.

A transaction passport must be drafted for insurance (reinsurance) contracts concluded between a resident and a non-resident, since insurance services are considered to be a type of international service according to the Temporary Classifier of Foreign Trade Services[3].

Failure by a resident to observe the deadlines for submitting documents to an authorized bank for the drafting of a transaction passport does not constitute grounds for refusal to draft the transaction passport.

A resident may only pay loan interest and repay the principal to a nonresident from an account opened with the bank in which the transaction passport for the relevant loan agreement was drafted.

2. Procedure for the mandatory sale of foreign currency proceeds

Foreign currency subject to mandatory sale shall be deposited in a separate personal account "Funds in foreign currency for mandatory sale" by an authorized bank no later than the day after the necessary documents are submitted by a resident[4]. A resident should submit documents on the sale of foreign currency proceeds within seven working days after the receipt of the foreign currency proceeds on the resident's account. This seven-day period is calculated without taking the term for the depositing of the funds by the bank into account[5].

Foreign currency received from a nonresident as a refund of an advance payment, as payment of a fine, as a charitable donation or as income from securities operations is not subject to mandatory sale.

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Requirements in relation to the annual report of foreign organizations operating in the Russian Federation (Moscow) for 2004

As usual, at the beginning of 2005 Interregional Inspectorate No.47 of the Federal Tax Service for the City of Moscow (formerly Interregional Inspectorate No.38 of the Ministry of Taxes and Duties) clarified the procedure for the submission of annual report by foreign organizations operating in the Russian Federation (in Moscow)[6].

[1] Information Letter No.30 of the CBR of 31 December 2004.

[2] Instruction No.117-I of the CBR of 15 June 2004 On the Procedure for Submission by Residents and Non-Residents of Documents and Information to Authorized Banks When Performing Currency Operations and the Procedure for Accounting by Authorized Banks for Currency Operations and Drafting Transaction Passports.

[3] Resolution of the State Statistics Committee No.11 of 6 February 2001.

[4] Point 3.6 of Instruction No.111-I of the CBR of 30 March 2004.

[5] Part 2 of article 21 of the Federal Law On Currency Regulation and Currency Control.

[6] Letter No.01-12/29 of Interregional Inspectorate No.47 of the RF Federal Tax Service for the City of Moscow of 12 January 2005.

Composition of annual report

The annual report of foreign organizations for 2004 shall include:

- a profits tax declaration;
- a report on the operations of the foreign organization in Russia in 2004;
- an explanatory note;
- tax declarations and tax returns on other taxes; and
- supporting documents.

When should the annual report be submitted and taxes paid?

According to the RF Tax Code, the annual profits tax declaration and the report on operations in 2004 should be submitted no later than 28 March 2005.

The tax authorities also remind taxpayers that they should pay profits tax in accordance with the tax declaration independently, no later than the deadline for submitting the tax declaration, i.e. by 28 March 2005.

Who should submit the annual report?

The tax declarations and the report on operations must be submitted by all foreign legal entities operating in Russia, regardless of their tax status or financial results in 2004. Annual report shall also be submitted by those representative offices that did not perform business activity in 2004.

It should be noted that foreign organizations that have several permanent establishments in Russia must submit annual report for each branch separately. Preparation of a single set of annual report is only possible if the activity of several branches is part of a single technological process.

In this case, a copy of the annual report shall be submitted to the tax authorities at the place of registration of each of the branches.

Profits tax declaration

The annual profits tax declaration of a foreign organization for 2004 should be submitted using the format[7] and pursuant to the instructions[8] approved by the RF Ministry of Taxes and Duties.

Report on operations

The format of the report on operations for 2005 is the same as that submitted for 2004. The format was approved by an order of the RF Ministry of Taxes and Duties[9] in 2004.

The inspectorate recommends that information on the operations of a foreign organization in Russia that is not subject to mandatory disclosure in the report be included in the explanatory note. It should be noted that on the whole the information to be disclosed has not changed.

Tax returns

In addition to the above, the following tax returns should be submitted with the annual report of the representative offices of foreign organizations:

- a tax return on the amounts of income paid to foreign organizations and the taxes withheld;
- a tax return on land tax;
- a property tax declaration;
- a unified social tax declaration;
- a declaration on insurance premiums for mandatory pension insurance;
- information on the amounts of income paid to Russian and foreign citizens over the past year and the amount of taxes withheld (2-NDFL);
- a tax return on environmental pollution payments.

When preparing tax returns, foreign organizations should use the new formats and follow the instructions approved by the RF Ministry of Taxes and Duties in 2004.

Submitting of the annual report in electronic form

Foreign organizations may submit annual report for 2004 to the tax authorities in electronic format, in accordance with the procedure approved by the Order of the RF Ministry of Taxes and Duties[10].

For those foreign organizations that have not switched to the submission of tax reports in elec-

[7] Order No.BG-3-23/1 of the RF Ministry of Taxes and Duties of 5 January 2004.

[8] Order No.BG-3-23/118 of the RF Ministry of Taxes and Duties of 7 March 2002.

[9] Order No.BG-3-23/19 of the RF Ministry of Taxes and Duties of 16 January 2004.

[10] Order No.BG-3-32/169 of the RF Ministry of Taxes and Duties of 2 April 2002; complete information is available at the website www.taxcom.ru.

tronic format, the Inspectorate has introduced the requirement that all tax declarations be submitted on magnetic media.

Supporting documents

A number of source documents should be attached to the annual report, including the order on the appointment of the chief accountant, the order on the adoption of the accounting policy for 2004-2005, documents supporting declared concessions and a number of other documents and statements.

Important information

Since 1 January 2005 the Taxpayer Identification Number (TIN) and Foreign Organization Code (FOC) assigned to foreign organizations prior to 1 October 2003 have become invalid, which means that previous documents confirming registration for tax purposes are also invalid. Due to this fact, the inspectorate suggests that organizations that have not yet replaced their TIN and the aforementioned documents submit all documents necessary to receive a new TIN and FOC.

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Assessment and payment of UST: explanations of the Moscow tax inspectorate

On 28 December 2004 the Moscow Department of the Federal Tax Service published a letter[11] in which it stated its position on issues of interest to taxpayers concerning the assessment of unified social tax (hereinafter "UST").

Calculation of UST on nondeductible payments to employees

The tax authorities explained that bonus payments to employees that are not stipulated by an employment contract or collective bargaining agreements shall be subject to UST if they meet the criteria on wage expenses of chapter 25 "Profits tax" of the RF Tax Code[12] (in particular, they are economically justified and documented).

According to the general rule established by chapter 24 "Unified social tax" of the RF Tax Code, payments to employees that are not deductible for profits tax purposes are not a taxable object for UST[13].

The letter indicates that if bonus payments meet the criteria on expenses established by chapter 25 of the RF Tax Code, but the taxpaying organization has decided not to include them in expenses that are deductible for profits tax purposes, UST should be charged on the amount of these payments.

Explanations were also given on the payment of mandatory pension insurance premiums by organizations that use the simplified tax system.

Specifically, organizations that use the simplified tax system are not payers of profits tax, UST and several other taxes[14], since these taxes are replaced by a single tax when using the simplified tax system. Despite the fact that these organizations are not payers of UST, they are payers of mandatory pension insurance premiums[15], the taxable object and basis of calculation of which correspond to the taxable object and tax base for UST[16]. However, organizations that have switched to the simplified tax system do not have the right to apply the provisions of the RF.

Tax Code pursuant to which payments that are not deductible for profits tax purposes are exempt from UST (and, consequently, from mandatory pension insurance premiums).

Calculation of UST on payments to employees seconded to work in a branch of a Russian organization abroad

According to the explanations of the tax authorities, a Russian organization is required to assess and pay UST on all payments to its employees that have been seconded to work in a branch abroad, since the branch is part of the Russian organization and not an independent legal entity.

Calculation of UST when switching from the simplified tax system to the general system of taxation

The tax authorities explained that when calculating UST rates, an organization that switches from the simplified tax system to the general system of taxation during a year should not take into account the income

[11] Letter of the Moscow Department of the RF Federal Tax Service No 28-08/84326 of 28 December 2004.

[12] Articles 252 and 255 of the RF Tax Code.

[13] Point 3 of article 236 of the RF Tax Code.

[14] Point 2 of article 346.11 of the RF Tax Code.

[15] Point 2 of article 346.11 of the RF Tax Code.

[16] Point 2 of article 10 of Federal Law No.167-FZ of 15 December 2001 *On Mandatory Pension Insurance in the Russian Federation*.

accumulated by employees during the period when the simplified tax system was in use[17]. According to the tax authorities, since an organization becomes a payer of UST from the date it switches to the general system of taxation, it should calculate UST according to a procedure similar to that used by newly established organizations.

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Compensation when terminating an employment contract

In its ruling on 15 March 2005 the RF Constitutional Court (hereinafter the "Court") confirmed the right of owners and employers to dismiss the directors of companies and organizations without giving a reason. However, the Court did require owners and employers to pay compensation to those managers who are dismissed.

The inquiry was initiated by the Volkhovsky Municipal Court of Leningrad oblast and the Stavropol Municipal Court. In addition, the Court received complaints from 12 citizens who were dismissed by shareholders under article 278 of the RF Labor Code without an explanation of the reasons for dismissal and the payment of insignificant compensation. Point 2 of article 278 and article 179 of the Labor Code were considered.

Article 278 establishes that the owner or the collegial management body shall be entitled to terminate an employment contract with the director without giving a reason. The second article states that the amount of compensation for early termination of a contract with the director of a company or organization shall be established by the employment contract. The claimants also contested the constitutionality of one of the provisions of article 69 of the Law On Joint-Stock Companies.

The claimants believed that the contested provisions are discriminatory, because in effect they place the directors of organizations on an unequal footing with other categories of employees. According to the claimants, the right to terminate an employment contract early should be dependent on valid reasons related to the abilities of employees, their behavior and business necessity. The claimants insisted that a list of such reasons should be established by law.

However, the Court found these arguments unconvincing. In its ruling, the Court focused attention on the fact that "the legal status of a director of an organization differs significantly from the status of other employees" and that "federal lawmakers have the right to stipulate special rules on termination of employment contracts with directors."

The right of every citizen to work does not mean that he/she must be given a managerial position on request or that he/she cannot be dismissed from a managerial position. The special rules on termination of a contract do not represent an impairment of the right of every person to freely utilize his/her labor skills or a breach of the equality of every person before the law and the courts.

The Court ruled that point 2 of article 278 of the Labor Code and the second paragraph of point 4 of article 69 of the Law On Joint-Stock Companies are constitutional, since they do not allow the termination of an employment contract without payment of fair compensation.

The Court stressed that the RF Constitution requires that the right of the owner to terminate a contract with the director of an organization early be accompanied by adequate legal guarantees of protection from the negative consequences of loss of work and that payment of compensation should be considered a requirement for dismissal, regardless of whether or not this provision is set forth in the contract. Moreover, compensation should be increased since this issue involves termination of a contract without giving reasons, which is in contrast to the general rules.

The ruling states that the amounts to be paid may be determined by the employment contract or by an agreement between the director and owner of an organization or, in the event of a disagreement, by a court decision. On the whole the Court's decision can be considered to be balanced, since it suggests that the minimum amount of compensation be established by law, which constitutes somewhat of a compromise on the part of labor law.

On the other hand, the Court ruled that article 279 of the Labor Code is unconstitutional. This is due

[17] Pursuant to article 241 of the RF Tax Code, UST rates decrease as aggregate income accumulated by an employee for the year increases.

to the fact that it grants the parties to an employment contract the right to determine the amount of compensation to be paid to the director of an organization in the event of early termination of the employment contract, and therefore grants the owner the legal right to pay a minimal amount or not to pay at all if compensation is not stipulated by the contract. Pending the introduction of the necessary amendments to effective legislation, the compensation paid to a dismissed manager may now not be lower than that which is stipulated for termination of an employment contract for reasons beyond the director's control.

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Federal Law "On the Transfer of Lands and Sites from Category to Category"

Federal Law No. 172-FZ "On the Transfer of Lands and Sites from Category to Category" (the "Law") came into force on January 5, 2005. Passed by the State Duma on December 3, 2004 and approved by the Federation Council on December 8, 2004, the Law was published in Parlamentskaya Gazeta No. 28 on December 28, 2004.

A follow-up to the Land Code of the Russian Federation and the Federal Law "On Implementation of the Land Code of the Russian Federation", the Law finalizes procedures for the transfer of land plots and sites between various categories at the federal level; its principle purpose being to define the respective powers of the federal, constituent, and local authorities, and to provide a uniform mechanism for altering the status of land plots throughout the entire territory of the Russian Federation. This move is to be welcomed by all project developers frustrated by frequent and extensive delays in reclassification under the previous system.

Previously, federal legislation offered virtually no regulation of such procedures. The few applicable legal provisions governing land transfers from category to category were contradictory, resulting in local governing councils being obliged to spend an inordinately long time on their assessment.

All too often, the continual confusion on what were the appropriate actions in such matters caused a number of problems, including an unwarranted contraction of lands reserved for agricultural production operations, chaotic site development, and irrational land usage.

The Law now clarifies the limits of jurisdiction vested in government authorities at every level in respect of each category of land. It stipulates procedures for the transfer of sites between different categories prior to their apportionment among federal, constituent, and local authorities.

The Law also establishes finite periods for the decision-making process regarding petitions filed for the transfer of a land plot from one category to another, and stipulates the documents required in support of such requests. The Law also includes an extensive list of grounds for rejection of such petitions.

It should be noted in particular that the transfer of a land plot from one category to another is now deemed as having been completed upon an appropriate record having been made in the Unified State Register of Rights to and Transactions with Immovable Property. The title documents for sites transferred are not required to be re-issued in such cases.

Given the current pressures in many regions of Russia for re-categorization of land in certain areas to facilitate development, the adoption of a uniform mechanism at the federal level to allow the transfer of sites between categories is certainly a significant step forward in making the land market in Russia more transparent. Since all future developments will be affected by the Law, its practical implications are likely to be significant.

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New Russian Town Planning Code

The new Russian Town Planning Code, which came into force late last year[1] ("the Code"), is, unlike its predecessor, a highly practical and user-friendly document, in which almost every chapter outlines appropriate procedures and clearly defines the liabilities of relevant parties in each situation described. The Code will affect all real estate developments. Develo-

[1] Town Planning Code No. 190-FZ, dated December 29, 2004, was passed by the State Duma on December 22, 2004 and approved by the Federation Council on December 24, 2004. It took effect on December 30, 2004 when it was published in Rossiyaskaya Gazeta (except for a number of articles which are to come into force on a phased basis).

pers, real estate lenders, investors and occupiers will all need to be familiar with its implications.

Participants in construction projects will be pleased to note the revised procedures for obtaining building permits, as well as a newly introduced commissioning authorization, now required for all building projects. The Code now gives clear guidance on a definitive list of documents required in such cases, as well as covering lead times for permit issuance. It includes a complete list of the grounds for refusal of such permits and authorizations, and now provides a definition of the term "developer" which more readily suits the realities of the modern day construction process rather than reflecting the customs and practices of the Soviet era.

Government appraisal of designs and related documents. The Code now includes a specific chapter on new requirements for Government review and appraisal of designs for proposed projects and related documents. Certain projects are excluded from this, notably capital construction projects. Under a separate provision, designs and documents may now be reviewed by a duly accredited non-governmental institution.

Area planning. The Code pays considerable attention to the question of territorial planning, with a specific chapter covering the liabilities of federal, constituent and municipal authorities in the execution of documents relating to proposed projects. For the first time, major developments in residential locations are subject to approvals procedures requiring the involvement of the local community.

Urban development zoning. The Code marks the first attempt by the federal government to establish uniform procedures for land use and development, including the approval of corresponding rules and related amendments. Federal and constituent authorities now have the right to take legal action to challenge land use and development rules[2] where these are inconsistent with federal legislation. The Code also covers procedures for the establishment of various land use zones, and provides classifications of various categories. The Code now establishes town planning procedures governing the legal treatment of land plots as well as all subsoil and related properties used in the process of, or for the purposes of their development, as well as for the operation of newly-built facilities.

Territory planning. In addition to area and urban development planning, the Code introduces specific regulation of residential developments and housing estates, including designs, land survey docuents, urban development plans, and procedures for approval of territory planning records.

Architectural design, construction, and reconstruction of capital buildings. The Code also defines the jurisdiction of the various agencies and parties involved in engineering investigations of construction projects and architectural esign. Importantly, it prescribes — at the federal level — the documents to be prepared for a capital construction project.

In common with many other federal laws, the Code provides for specific regulation (in a number of respects) in two constituent territories of the Russian Federation — Moscow and St. Petersburg — as the only cities of federal stature.

It is expected that further legislation and amendments to the Code will include a number of laws and regulations concerning its implementation. Nonetheless, while the Code has by no means addressed every controversial issue relating to construction projects in Russia, it should have considerable influence in streamlining and unifying building activities throughout the country in providing a clearer and better-controlled regulatory environment.

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[2] Applies to both newly-made rules and those enacted before the Town Planning Code came into force.

LUKOIL Overseas Kumkol B.V. and Turgai-Petroleum filed for arbitration with the Arbitration Institute of the Stockholm Chamber of Commerce with the preliminary amount of claims against PetroKazakhstan Inc. being $100 mln.

Turgai-Petroleum is a 50/50 joint venture between LUKOIL Overseas Kumkol B.V. and PetroKazakhstan Inc., engaged in oil production in Kumkol field located in the Southwest of the Republic of Kazakhstan. A portion of the crude oil production is delivered to Shymkent Refinery owned by PetroKazakhstan Oil Products (PKOP), a subsidiary of PetroKazakhstan Inc.

Pursuant to the arrangement between the shareholders, the crude oil was to be paid for by PKOP at market prices determined on the basis of a formula agreed to by the shareholders.

However, in 2003-04 PKOP paid for the Turgai-Petroleum's crude oil at prices, which were established by PKOP unilaterally. PKOP ignored repeated demands by LUKOIL Overseas Kumkol B.V. and Turgai-Petroleum to audit the pricing mechanism. Attempts of LUKOIL Overseas Kumkol B.V. to resolve this issue by negotiations with PetroKazakhstan Inc. were not successful.

Accordingly, LUKOIL Overseas Kumkol B.V. and Turgai-Petroleum initiated an arbitration proceeding under the rules of the Arbitration Institute of the Stockholm Chamber of Commerce. The claimants seek that PKOP pay to Turgai-Petroleum the difference between the market price of crude oil delivered in October 2003 to November 2004 and the price actually paid. According to preliminary estimates, the damages suffered by Turgai-Petroleum amount to US$ 100 mln.

Since the beginning of 2005 there have been numerous lawsuits between Turgai-Petroleum and subsidiaries of PetroKazakhstan Inc. which established the following: Turgai-Petroleum has no outstanding obligations vis-a-vis PKOP to supply oil to the Kazakhstan domestic markets, Turgai-Petroleum has the right to independently export oil, and PKOP must enter into a tolling agreement with Turgai-Petroleum.

The results of such lawsuits have established the foundation for successful damage claims by Turgai-Petroleum and LUKOIL Overseas Kumkol B.V. against PetroKazakhstan Inc. and it subsidiaries in the amount of several hundred million US dollars.

Stockholm arbitration is the opening stage of the aforementioned process and LUKOIL Overseas Kumkol B.V. intends to consistently protect the legitimate interests of Turgai-Petroleum in Kazakhstan and international tribunals.

LUKOIL Overseas Holding Ltd.