Russia

Russian Government Increases Export Duties on Crude Oil by 30% as from June 1, 2005

On May 18, 2005, in its Resolution No. 304, the RF Government increased the rate of customs duties by 30% for crude oil and crude oil products exported other than to CIS Customs Union members (Belarus, Kazakhstan, Tajikistan and Kyrgyzstan), from US$ 102.60 to US$ 136.2 per ton. The increase took effect June 1, 2005.

SALANS

Government Adopts New Rules on the Subsoil and Exploration

On May 12, 2005 by Resolution No. 293 On Approval of Regulations for State Supervision over Exploration, Efficient Production and Protection of the Subsoil, the RF Government adopted new rules on subsoil regulation.

It will be recalled, the use of subsoil resources in Russia is subject to state supervision. The underlying policy is to ensure compliance by all users with procedures for subsoil use, to regulate exploration, production and protection and to control the terms and conditions of licenses. Resolution No. 293, which came into effect May 16, 2005, provides that state regulatory supervision of exploration, production and protection of the subsoil is to be carried out by the RF Service for Supervision Over the Use of Natural Resources, in cooperation with the RF Service for Ecological, Technological and Nuclear Supervision and other executive agencies. The Regulations set out rules and procedures for such supervision and powers of the supervising authorities. The authorities are empowered to undertake audits, to order remedial measures, to initiate administrative proceedings for non-compliance and to suspend, limit or revoke subsoil rights.

On March 15 the RF Ministry for Natural Resources issued Orders Nos. 61 and 62, approving procedures for review of applications for land or sea exploration. These procedures came into effect May 22, 2005 and set out rules for exploration right applications, which may be submitted and approved on a non-competitive basis. Exploration rights may be granted only for those subsoil plots (or water bodies) included in lists approved and officially published by the RF Ministry for Natural Resources. Exploration rights are granted on the basis of a decision taken by a Commission to be formed by the Federal Subsoil Agency with participation of representatives from the RF Ministry for Natural Resources and from regional authorities. Since neither the RF Subsoil Law nor Orders 61 or 62 sets out the representative ratio for participants on the Commission, it appears the Federal Subsoil Agency has wide discretion to determine this ratio, which will bear on issuance of licenses since the Commission acts based on simple majority vote. The Procedure also covers *inter alia* substantive requirements for exploration applications, timing for processing and the like.

SALANS

New Russian Law on Concessions

Introduction and Legislative Background

Concessions are an effective tool for attracting private capital to infrastructure facilities. The introduction of the relevant Russian legislation has, therefore, been long awaited. In fact, the first reading of the draft law On Concessions in the State Duma dates back to 1996. It has taken the State Duma and the Government almost nine years since then to reach consensus on the new legislation. On July 6 , 2005 the State Duma, Russia's lower chamber of parliament, finally, approved the new Federal Law of the Russian Federation No. 115-FZ "On Concession Agreements" (the "Law"). On July 13, 2005 it was approved by parliament's upper chamber, the Federation Council. President Vladimir Putin signed the Law on July 21, 2005. It entered into force on August 6, 2005.

Scope of Application

The Law complements the law On Foreign Investment of June 9 ,1999 and the Land Code of October 25, 2001. It contains an exhaustive list of areas in which state concessions can be granted. These areas are:

- roads and transport infrastructure such as bridges, tunnels etc.;
- rail transport, underground and other public transport;
- pipelines, electricity and energy infrastructure, waterworks and hydraulic facilities;
- sea and river ports; sea and river vessels;
- airfields, including runways, engineering and airport infrastructure;
- facilities of a single system of air traffic;
- municipal infrastructure, inter alia, water, energy, gas supply etc.;
- health care, medical, leisure and tourism sectors; educational, cultural and sports facilities.

Initially it was intended to also include facilities for mineral resources development, but these were excluded from the list during the course of the long deliberations.

The general public is eligible to enter into concession agreements, unless the facility in question is subject to regulation under state secrecy laws or is part of the defence sector. The right to enter into concession agreements is granted through tenders. The Law contains detailed procedural provisions for holding such tenders. Of particular significance is the fact that the Law provides for equal treatment of foreign and domestic investors.

Private investors are now allowed to hold long term leases over state property that is barred from privatisation under Russian law. Investors are also allowed to carry out construction or reconstruction on real estate that is the subject of the concession agreements, provided this does not change the agreed designation of the facility.

Concession Agreement

The Law provides for the conclusion of a concession agreement between the private investor ("concessionaire") and the relevant state/municipal authority that owns the respective immovable property (facility). Under the concession agreement the concessionaire is obliged to (re-)construct and use/exploit the relevant facility in the manner specified in the agreement and receive any earnings from its use of the facility. In return for granting the concession the state/municipal authority receives a concession fee from the concessionaire.

The Law does not contain a restriction on the minimum or maximum term of concession agreements. Originally, a statutory limit of between 7 and 99 years was proposed, however, this was not included in the final version of the Law. The Law only refers to the period that is necessary for the creation or reconstruction of the concession facility and the scope and period required to recoup the concessionaire's investment. As a consequence, when negotiating concession agreements, concessionaires will need to agree clear provisions with respect to the duration of concessions and what rights of renewal will be available under the concession agreement.

The Law contains many detailed provisions on the required content of concession agreements. The following list may be of particular interest to potential investors. It should, however, be pointed out that it remains to be seen how the requirements introduced by the Law will be dealt with in practice and to what extent certain provisions can be modified by a particular concession agreement:

- Concession fees may be paid in cash, as a percentage of production or profit or can consist of a transfer of assets to the state/municipal authority.
- The concessionaire is not entitled to encumber the facility with a mortgage or to sell it to a third party.
- The risk of damage to the facility must be borne by the concessionaire unless otherwise agreed in the concession agreement. The concession agreement may stipulate the obligation on the part of the concessionaire to insure the facility at its own expense.
- The state/municipal authority is entitled to supervise fulfilment of the concession agreement by accessing the site and requesting documentation, but it may not interfere with the concessionaire's economic activities.
- The assignment of rights and obligations by the concessionaire to third parties under the concession agreement requires consent by the contracting state/municipal authority.
- Unless otherwise stipulated in the concession agreement, intellectual property arising in connection with the use of the facility is the property of the state/municipal authority. The concessionaire is, however, entitled to exclusive IP rights during the term of the concession agreement.

- The concessionaire's rights to the facility are subject to registration of the concession agreement as an encumbrance in the Immovable Property State Register.
- The concession relates to the facility but does not include rights to the underlying land-plot, which means that a separate lease contract must be concluded with the relevant state/municipal authority.
- Other related services in connection with the facility are not covered by the concession agreement (e.g. relating to utilities, supply or to the exercise of the concession). Careful drafting of contractual arrangements supplementing the concession agreement will be required for the purpose of regulating all related matters.
- The concessionaire is protected from subsequent legislative changes adversely affecting its position by a 'grandfathering' provision. This provision obliges the parties to amend the concession agreement to the extent necessary to maintain the concessionaire's rights and status as initially agreed.

Significance

The enactment of the Law is hoped to mark the beginning of a new era that allows for a higher degree of co-operation between the private and public sectors in Russia. The ability for a viable Russian public private partnership model to be developed is now more likely as a result of the Law. In addition alternative legal structures that have been developed over last years in order to implement various types of BOT/BOOT (build-(own)-operate-transfer) projects may now be based on a more reliable and certain legal framework. The significance of this type of legal instrument finally being available in Russia becomes clear if one looks at annual investments worldwide attracted by industrial and emerging nations through the use of concession arrangements, a figure that recent estimates suggest is more than USD 80 billion. Expert commentators have suggested that Russia may attract annual investments of up to USD 2.5-3 billion. The success of the Law will, however, depend on its smooth implementation and consistency of application by state/municipal authorities and courts together with the absence of renewed debate on the scope of the Law and the resulting legal uncertainty such debate would bring.

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Recent Developments in the Reform of the Russian Federation Anti-monopoly Legislation

Increase of Merger Control Notification Thresholds

On 7 March 2005, President Vladimir Putin signed a bill amending the Federal Law of the Russian Federation No. 948-1 of 22 March 1991 On Competition and Limitation of Monopoly Activities on Commodities Markets (the "Competition Law"). This new bill (the "Thresholds Amendment") substantially (by a factor of about 150) increased the thresholds for notification requirements. It entered into force on 21 March 2005.

- For pre-merger notifications, the worldwide balance sheet asset value of the parties involved of 200,000 times the statutory minimum monthly wage has been raised to 30 million times the statutory minimum monthly wage, i.e. from approximately US$ 727,500 to approximately US$ 109 million.
- The thresholds for post-merger notifications and other notification requirements, e.g. for the establishment of a commercial organisation, have also been raised. The previous general threshold of 100,000 times the statutory minimum monthly wage applicable to such notifications has been raised to 2 million times the statutory minimum monthly wage, i.e. from approximately US$ 364,000 to approximately US$ 7,275,000.
- The Thresholds Amendment did not introduce any other changes to the Competition Law. All other amendments will be considered as part of the general reform of the Competition Law (see below).

Despite the size of increase in the thresholds, they are still low compared to most Western European merger control regimes. They are likely to be exceeded in most cross-border transactions.

Draft Law Reforming Anti-monopoly Legislation

The Thresholds Amendment marked the first step of an overall modernisation of Russian anti-monopoly law. In December 2004, Russia's Federal Anti-monopoly Service ("FAS") published a draft law (the "Draft Law") envisaging an extensive revision of the Competition Law.

Since its introduction in 1991, the Competition Law has been amended various times, most re-

cently in October 2002. In January 2004 the Russian government announced its intention to generally reform and modernise the Competition Law. Preparation of the Draft Law was accelerated after the former Ministry of Anti-monopoly Policy was reorganised into FAS in March 2004. The Draft Law was finalised in November 2004. On 3 February 2005 the Russian government approved the core proposals contained in the Draft Law. Subsequently, the Draft Law was also discussed with research and business organisations. Since March 2005 the Draft Law has been revised again by FAS in order to incorporate changes proposed by the government and received during public discussion. The final draft was submitted by FAS to the government in May 2005 with the support of 12 of the 13 ministries and state authorities that were involved in preparing the Draft Law (only the Federal Tariffs Service did not back the legislation). The Draft Law will be introduced in the State Duma, Russia's lower chamber of parliament, for consideration later this year and is scheduled to become effective during the first half of 2006.

The main changes suggested in the **Draft Law** (as published on 16 May 2005) include the following:

- A new chapter on **state aid,** dealing with assistance provided to commercial entities by state and municipal authorities, has been included. The chapter contains definitions, general principles and prohibitions. Except where permitted by federal laws or special budget legislation, provision of state aid is subject to approval by FAS. The chapter includes complex provisions on the administrative procedure for obtaining such approval.
- The provisions on anti-competitive behaviour and unfair competition by **financial institutions,** currently regulated by a separate law on protection of competition on financial services markets, have been incorporated into the Draft Law.
- The provisions on **unfair competition** practices still form a part of the Draft Law and have not been shifted to a new separate law as was initially proposed.
- The existing special legislation on **public tendering** has been supplemented by the incorporation of public procurement rules in the Draft Law. These set out general principles and prohibitions relating to tender procedures and specify tender requirements for the selection of financial organisations that provide services to public authorities.
- The definition of a **"dominant position"** has been amended. In particular, the concept of collective dominance is introduced into Russian anti-monopoly law. Under a rebuttable presumption, oligopolistic markets exist if (i) 2 or 3 undertakings together control more than 50% of the relevant market, or if 5 or fewer undertakings control more than 70% (unless the market share of at least one of the parties is less than 5%), (ii) market shares are stable and access for new competitors is limited, and (iii) the product cannot be replaced by other products and a price increase would not result in decreasing demand. Further, the general market share threshold for the rebuttable presumption of dominance has been decreased from 65% to 50%.
- The definition of **relevant markets** has been revised. In particular, determination of geographic dimension may now extend to a world market rather than the territory of the Russian Federation only.
- A definition of **"concerted practices"** has been inserted. In the past FAS often faced difficulties in proving in court the existence of illegal concerted practices. The definition aims to clarify this concept and facilitate enforcement of the prohibition. After heavy debate with respect to the definition suggested in the first draft law in December 2004, the requirements for what qualifies as concerted practices have been revised in the Draft Law so as to exclude any parallel behaviour.
- The rules on monopolistic behaviour have been tightened by classifying certain anti-competitive activities as **violations per se,** for example setting monopolistic high prices and refusal to supply. Such activities will be regarded as anti-competitive without the possibility of obtaining an exemption. Any other behaviour is subject to a **rule-of-reason** assessment with the possibility of being exempted.
- The assessment of **vertical restraints** has been changed, with the general combined market share threshold of 35% applicable to the parties being abolished and replaced by a de-minimis rule if the market share of each of the parties is less than 5%.
- The increased thresholds of the new Thresholds Amendment are incorporated in the **merger control regime** of the Draft Law. In addition, the notification requirements for acquisitions

have been eased. An additional minimum target-size threshold of RUR 30 million, i.e. approximately US$ 1,090,000, has been included. Further, acquisitions of stakes only require notification if the acquisition results in the acquirer's total stake crossing any of the thresholds of 25%, 50% or 75% (50% and 66.6% in case of participation interests) of the voting equity of the target. Under the present law the acquisition of any additional share beyond a stake of 20% requires that notification be filed, irrespective of any actual change-of-control considerations. As under the present law, intra-group transfers will still be subject to approval. FAS has, however, indicated that such transfers may be reviewed under a simplified procedure. Further, the notification requirements have been extended to also cover transactions related to land plots if size thresholds for particular categories of land are met.

! New provisions on **exemptions** from the prohibitions contained in the Competition Law have been introduced. These establish a more detailed system of requirements for the provision of individual exemptions by FAS than the current Competition Law, and are similar to those contained in Article 81, section 3 of the EC Treaty. Further, the provisions provide for the possibility of introducing "collective exceptions", a kind of block exemption, by the Russian government for limited time periods.

! The **procedural rules** relating to notifications for merger clearance, negative clearance of agreements and exemptions have been substantially revised by various newly introduced provisions. Further, the rules for the review of violations of the anti-monopoly legislation currently set out in the Order of FAS No. 12 of 2 February 2005 which entered into force on 22 May 2005 (replacing an order dating to 1996), have been amended and codified in the Draft Law.

! The competencies of FAS with respect to enforcement of the Draft Law have been strengthened, in particular by broadening its powers to collect information, for example, by granting FAS greater access rights and the right to impose obligations on entities to disclose information about participants in offshore undertakings and the beneficiaries behind legal entities.

The Draft Law may yet be further amended before final submission to the State Duma. In particular, in the beginning of June 2005 FAS stated that it will be supplemented by provisions requiring undertakings to notify FAS about foreign-to-foreign transactions concluded abroad if such transactions relate to assets located in the Russian Federation. It is assumed that FAS intends to broaden and clarify its practice of applying the effects doctrine.

Amendments to the Code on Administrative Offences

In addition to the Draft Law, amendments to the Code on Administrative Offences (the "Code") have been prepared. These amendments will augment the present very low sanctions for violations of the anti-monopoly legislation and aim to make enforcement of competition rules more efficient.

! The current fines have been substantially increased. The amendments contain concrete proposals for the increase of each fine specified in the Code.

! A new system that is pegged to companies' turnover has been introduced for specific violations. The most crucial increases concern fines between 0.5 and 2% of a company's annual turnover in the preceding year for the abuse of a dominant position, and up to 4% of a company's annual turnover in cartel cases.

! Leniency provisions will be introduced, including the opportunity for a whistleblower to obtain full immunity from fines.

! Sanctions targeted at individuals responsible for violations will be introduced, including the removal of civil servants and individuals in executive positions in a company or members of the board of directors for a period up to 3 years.

In summary, the Draft Law maintains the basic structure of the Competition Law. It introduces a number of new concepts, although it remains to be seen how these concepts will be applied in practice, e.g. in the field of state aid or concerning the collective dominance approach as applied to Russian industry, which is highly concentrated. The Draft Law eliminates many gaps and uncertainties that exist in the Competition Law. However, various existing contradictions have not been addressed, and some new contradictions have also become apparent in the new provisions, for example in the (now even more) complex provisions on merger control. In any event, the Draft Law, supplemented by the amendments to the Code, will lead to the biggest reform of anti-monopoly legislation since its introduction.

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Special economic zones

On 22 July 2005 the President signed Federal Law No. 116-FZ "On Special Economic Zones in the Russian Federation"

The Law creates the legal framework for the establishment, operation and management of special economic zones in Russia (which is an area with a special regime of entrepreneurial activity). The zones can be established for the development of manufacturing and high-technology industries in the Russian economy, creation of new production site as well as the development of transport infrastructure. The Law envisaged two types of zones: i) industrial and production zones and ii) technological and innovative zones.

Pursuant to the Law, a resident and the governing state authority of a special economic zone must enter into an agreement. Pursuant to the agreement, the resident of an industrial and production zone, in particular, is obliged to make capital investments amounting to not less than 10 million Euro within a certain period of time; the state authority is obliged to conclude a land plot lease agreement with the resident for the purpose of such investment activity. A one million Euro investment must be made within one year from the date of such agreement.

The Law defines the principles of entrepreneurial activity in special economic zones and the status of their residents (investors). It lists activities which are prohibited on the territory of special economic zones and the procedure for the allocation of land plots within the territory of the zones and the rules of their use. It also details the customs regime in the zones.

The Law does not apply to special economic zones established in the Magadan and Kaliningrad regions which operate under separate laws.

The Law will enter into force on 26 August 2005.

On 22 July 2005 the President signed Federal Law No. 117-FZ "On Amending Certain Russian Laws in Connection with the Adoption of the Federal Law on Special Economic Zones in the Russian Federation."

Following the adoption of the Federal Law "On Special Economic Zones," the Law makes appropriate amendments to the following Russian laws: the Tax Code, the Customs Code, the Land Code, the Town-Planning Code, Federal Law "On the Fundamentals of State Regulation of Foreign Trade Activity," "On Foreign Investments into the Russian Federation," and to the laws regulating special economic zones in the Magadan and Kaliningrad regions.

The Law sets out the procedure to determine the taxable base for VAT when importing into Russia Russian goods which are initially placed under the "free customs zone" regime, as well as during the transfer of such goods into the territory of the special economic zone to non-residents of such zone.

The Law also determines the rules for treating expenses on scientific research and experimental development activity carried out by companies which are residents of special economic zones as expenses for income tax purposes.

The Law enters into force on 1 January 2006.

On 22 July 2005 President issued Decree No. 855 "On the Federal Agency for the Management of Special Economic Zones."

The Decree creates the Federal Agency for the Management of Special Economic Zones, which will be within the jurisdiction of the Ministry of Economic Development and Trade.

The Decree entered into force on 22 July 2005.

White & Case LLC.

New Legislation on Registration of Legal Entities: Failure to Report Could Result in Exclusion from State Register

Legal entities may be excluded from the Unified State Register of Legal Entities (the "State Register") without the need for a court ruling, following new legislation adopted this month.

Legal entities which fail to report to the Federal Tax Service ("FTS"), and which perform no operations through their bank accounts for a period of 12 months, may now be excluded from the State Register by a decision of the FTS, without the need for a court ruling.

The new procedures are introduced under Federal Law No. 83-FZ "On Amendments to the Federal Law "On State Registration of Legal Entities and Individual Entrepreneurs" and to Article 49 of the Civil Code of the Russian Federation", and are applicable from 16 July 2005.

The FTS has the authority to propose the exclusion of a legal entity from the State Register, and is required to notify all interested parties of its decision through publication in *Vestnik Gosudarstvennoi Registratsii* magazine. Interested parties have the right to object to such exclusion within three months of the date of publication. Where objections are filed, the FTS cannot unilaterally take a decision on the exclusion of that entity from

the State Register. If no objections are received within three months, however, the FTS has the authority to take a decision on the exclusion of that entity. Interested parties have the right to appeal such decision within one year following the date on which they learned (or were deemed to have learnt) of the breach of their rights resulting from the above decision.

The new procedures have been introduced to enable the FTS to liquidate legal entities which do not appear to conduct any business activities in the Russian Federation, without recourse to court.

In order to avoid any risk of de-registration or liquidation, therefore, it is advisable that registered legal entities maintain regular reporting to the FTS, as required by current legislation.

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Period of Limitations for Void Transactions Reduced to Three Years

The period of limitations applicable to void transactions (i.e. transactions invalid on grounds provided for under laws or other legislation, without need for invalidation by a court) has been reduced from ten to three years. The move, initiated by President of the Russian Federation Vladimir Putin, is intended to lend stability to privatization transactions and civil turnover.

This development comes into force under Federal Law No. 109-FZ "On an Amendment to Article 181 of Part I of the Civil Code of the Russian Federation", dated 21 July 2005.

As previously, the period of limitations for void transactions will commence with effect from the beginning of their fulfillment. The shortened period of limitations will also apply retrospectively to those claims which would have become due under the Civil Code prior to adoption of this amendment – i.e. by 26 July 2005.

It should be added that the period of limitations applicable to voidable transactions (i.e. transactions which are considered as invalid only if they were invalidated by a court), and the period during which it will be possible to invoke the consequences of such invalidity – remains unchanged, at one year, with effect from the cessation date of any coercion or threat under which the transaction was executed, or from the day on which the claimant learned or is deemed to have learned of any other circumstances constituting grounds for such transaction to be considered invalid.

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Mortgage over Immovable Property in the Russian Federation: Recent Developments

Introduction

Until recently, when considering the security package which could support lending to an entity owning or a project involving, real estate in the Russian Federation, taking security over immovable property was often considered either uneconomic or simply unavailable.

There have been important recent legislative changes in the area of real estate finance in the Russian Federation.

At the end of 2004, a long awaited package of legislative amendments was enacted which entered into force on 1 January 2005. This resulted in significant improvements in the legal framework within which a mortgage can now be given and taken over immovable property in the Russian Federation. Amongst the improvements, the need for notarisation has been largely abolished, changes to registration requirements have made it easier for a mortgagee to transfer its interest to a third party and unfinished construction works may now form the subject of a mortgage during the ongoing construction process.

We provide this briefing by way of introduction to some of the most significant improvements. Our senior real estate or finance team members would be more than happy to discuss how any specific changes may affect your business.

Notarisation

The Civil Code of the Russian Federation (the **"Civil Code")** was amended by Federal Law No. 213-FZ (30 December 2004). This amendment abolished the requirement for notarial certification of mortgage agreements in relation to immovable property. Prior to September 2004, notary fees for mandatory notarisation were 1.5% of the value under the mortgage agreement – a significant transactional cost that can now be avoided or largely reduced.

Voluntary notarisation remains available and in practice is still often advisable to facilitate both registration and enforcement of the mortgagees interest. This process continues to provide registration authorities, courts and other third parties with an increased sense of faith in the validity of executed agreements. With fees for voluntary notarisation decreasing now from approximately 0.3% to 0.15% of the value under the mortgage agreement this transaction cost is significantly reduced and in the context of specific transactions, often considered worth incurring.

Registration

The mandatory requirement to register a mortgage agreement in the Unified Register of Rights to and Transactions with Immovable Property (the **"Register")** remains unchanged. Where the parties have opted for voluntary notarisation however, registration is facilitated as either party may apply for registration of the mortgage, whereas without notarisation a joint application would now be needed.

Lenders, who wish to preserve the option to transfer their interest under a mortgage, will also find simplified procedures. When entering into a mortgage security, lenders are advised to obtain a mortgage deed, issued by the mortgagor and certified by the registration authority. Once certified, this deed enables the mortgagee (and any transferee in turn) to transfer its interest under the mortgage, without further reference to the relevant registration authority. At any point, a transferee can apply to the registration authority to have its interest noted on the Register. Registration must then be completed within one day of the application.

The rights of all parties are now also improved by the opportunity to claim full compensation for losses resulting from mistakes (actions or omissions) made by the relevant registration authority. Compensation may also be claimed in certain cases where rights to residential property are lost because a third party, acting in good faith, has acquired those rights in priority to an otherwise legitimate claim.

Unfinished Construction Works

Of particular interest to those involved in construction and development projects is the Civil Code amendment also contained in Federal Law No. 213-FZ, 30 December 2004. This provides that objects of unfinished construction can now form the subject of an immovable property mortgage.

Previously, unfinished construction could only be secured where the building works had been suspended and the agreement with the general construction contractor terminated. This amendment presents a major new alternative to investors as it reflects that an object can be registered and a mortgage can be created, despite the ongoing nature of the construction project. This is expected to make previous case law to the contrary redundant.

Whilst the new law is silent on what constitutes unfinished construction, recent statements made by members of the Supreme Arbitrage Court indicate that the object and the respective mortgage can be registered once foundations have been completed.

The status of these mortgages initially granted over unfinished construction work is further clarified in the summary of court practice issued by the Supreme Arbitrage Court (SAC No. 90) on 28 January 2005 (the "Supreme Arbitrage Court's Practice Summary"). This clarification provides that these mortgages will continue to encumber the title to the relevant works following completion and registration of these works.

Mortgage by Operation of Law

Lenders providing funds for real estate related projects may now obtain a mortgage without having to conclude a mortgage agreement with the borrower. Federal Law No. 216-FZ (30 December 2004) has amended the Mortgage Law to the effect that a mortgage will be implied, by operation of law, upon registration of the ownership or lease rights to a land plot acquired in a transaction financed by a third party lender. Further, where a third party finances the acquisition or construction of a building, a mortgage over the ownership or lease rights will be created by operation of law when title to the completed structure is registered in the name of the acquiring party, or upon notification of the agreed financing project to the registration authority.

Whilst this mortgage by operation of law generally improves the position of lenders, there will be situations where the lender and borrower do not wish to create such a mortgage. Here careful drafting and structuring will be required.

A final point of importance in this area – the previous legislation provided that by taking security over a land plot, a mortgage was not automatically implied over any buildings and structures erected on that land. Article 340(4) of the Civil Code now reverses this assumption. Amended Article 6 (6) of the Mortgage Law further supports this new approach by providing that a mortgage of immovable property extends to any inseparable improvements of that property unless the parties specifically state otherwise in their mortgage agreement.

Leasehold Rights

In order to create a mortgage over a structure or construction works on a land plot, a mortgage must also be created over the rights held in the underlying land plot. The Civil Code and the Land Code of the Russian Federation contain conflicting provisions about whether or not a landlord's consent to mortgage is required where the rights held in a state or municipally owned land plot are leasehold. Disputes previously arose about the need to obtain such consent. The Supreme Arbitrage Court's Practice Summary provides clarification of this obligation

to seek consent to mortgage. It confirms that consent from state or municipal landlords should only be required where (i) a lease is for a term not exceeding 5 years, (ii) the land leased is agricultural or (iii) it is only the lease right that will be mortgaged without any structures on that land plot or such structures being specifically excluded from the security.

It is important to note that in practice however, lenders may still seek landlord's consent as a matter of prudence and some registration authorities still require such consent despite the Supreme Arbitrage Court's views.

Law on Construction Participation

A new Construction Participation Law (Federal Law No. 214-FZ, 22 December 2004, in force since 1 April 2005) has been enacted to facilitate the creation of a mortgage security where various investors lend into a joint development entitling each lender to become the owner of a part of the construction upon completion. This legislation provides for the registration of a Joint Construction Agreement, signed by all parties to the lending. Once registered, a mortgage security is created by operation of law and provides all lenders with a direct security against the real estate asset.

Whilst originally driven by the need for a mechanism to deal with the many residential investors lending into large residential developments, this option also provides developers with access to greater liquidity for the purposes of financing a wide range of commercial projects.

Enforcement of Security

Finally, we would like to highlight amendments to the Civil Procedural Code (Federal Law No.194-FZ, 29 December 2004) which remove previous restrictions on the enforcement of a mortgage over residential real estate where it comprised the only dwelling of an individual or his or her family members. Whilst certain restrictions do remain, it is now much easier to evict a resident of mortgaged property on the enforcement of that mortgage.

Conclusion

Lenders into projects involving valuable Russian based real estate assets, are increasingly looking to Russian law mortgage as a valid security when structuring their proposed investments.

With transaction costs significantly reduced and the range of registration and enforcement alternatives enlarged, the package of legislation and clarification by the Supreme Arbitrage Court's Practice Summary has been an important development in the area of real estate finance.

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Securities

On 22 June 2005 the Federal Service for the Financial Markets ("FSFM") issued Order No. 05-22/pz-n amending Regulations No. 04-1245/pz-n "On Activity Related to Organization of the Trading Process on the Securities Market" dated 15 December 2004.

The Order was registered by the Ministry of Justice on 29 June 2005.

The Order introduces the simplified listing requirements for issuers incorporated by way of reorganization.

Pursuant to the amendments, securities of a reorganized entity can be included in quotation lists without meeting the mandatory capitalization requirements (applicable to shares) and monthly trading volume requirements.

Thus, under the amended Regulations, securities of a reorganized entity may now be included in quotation lists without three-month "off-list" trades, if the following two conditions are met:

- securities of the predecessor of a reorganized entity were listed on a stock exchange; and
- less than three months have passed since the date of the issuer's reorganization.

Pursuant to the Order, securities can only be included in quotation lists of the same or a lower tier as the predecessor's securities were included to. Securities placed via an open subscription ("public offering") can be included in the quotation list "B" without compliance with the monthly trading volume requirement, if less than three months have passed from the date of the registration of their placement report. Bonds can be included in quotation lists without compliance with the monthly trading volume requirement listed in the same or a higher tier.

For listing purposes, the calculation of the term of an issuer's "existence" shall include the period of the predecessor's existence.

Following the recent amendments to the Securities Market Law (for more details see our update for 7-13 March 2005), which abolished the requirement to register with the FSFM lists of securities admitted to trade at stock exchanges, the Regulation has now been revised accordingly to reflect these changes. Due to these revisions, a stock exchange must now notify the FSFM on the admission of securities to or exclusion of securities from trading no later than on the day following the day of adoption of the relevant decision by the stock exchange.

The Order will enter into force on 15 July 2005.

Amendments to the Tax Code

In early June the latest amendments were introduced to the Tax Code.[1] These amendments (hereinafter the "Amendments introduced significant corrections to chapter 25 "Corporate profits tax". Below we provide an overview of the most significant amended provisions of the Tax Code, before and after the Amendments.

The amendments to chapter 25 were primarily aimed at eliminating legislative gaps in previous versions of the Tax Code, and also at harmonizing financial and tax accounting, in order to simplify the calculation of profits tax. The majority of the amendments enter into force from next year, but some of them apply to legal relations arising from 1 January 2005, or even from 1 January 2002. Some of the amendments enter into force from 1 January 2007. We would like to remind you that in accordance with point 2 of article 5 of part one of the Tax Code, legislative acts on taxes and duties that worsen the position of the taxpayer cannot apply to legal relations that arose before these acts entered into force, and in such cases they may be disputed in court by taxpayers whose rights have been violated.

1. Income

1.1. Recognition of income

Before: Income was determined on the basis of source documents and tax accounting documents.

After: Other documents that may be used to confirm the taxpayer's receipt of income have been added.[2] This may mean that during audits the tax authorities may use a broader range of evidence of unrecorded income in order to charge additional taxes.

2. Expenses

2.1. Documentation of expenses

Before: Expenses supported by documents drawn up in accordance with Russian law were considered to be documented.

After: It will now be sufficient to have documents that indirectly confirm that expenses were incurred (including customs declarations, business travel assignments, travel documents, reports on work completed under contract). Also, if expenses are incurred abroad, documents drawn up in accordance with normal business practices of the foreign state may be used.[3] This change is truly revolutionary, but it remains to be seen what sort of disputes with the tax authorities will arise as a result.

2.2. Procedure for recognizing expenses

2.2.1. Procedure for allocating direct expenses

Before: Direct expenses included in the value of work in progress included only material expenses (only the price of acquisition of materials and parts), wage expenses and depreciation. This created considerable difficulties for taxpayers, who used a considerably broader list of expenses to determine the value of work in progress for financial and management accounting purposes.

After: The taxpayer can now determine its own procedure for classifying expenses as direct and indirect and for the distribution of expenses on WIP, finished products and shipped products. This procedure should be established in its *accounting policy* for tax purposes. The established procedure should be applicable for at least two tax periods.[4]

Note that the amendments indicate that if it is not possible to allocate direct expenses to a specific production process, expenses should be distributed using *economically justified indicators*. Thus, while they have relieved taxpayers of the burden of additional calculation due to the difference between allocating expenses by period in tax accounting and financial accounting, the legislators have in fact now obliged taxpayers to provide an economic justification for any selected procedure for expense allocation. In accordance with this same logic, additions have been made to the procedure for determining expenses on *trading operations*. The most substantial change is that the procedure for determining the cost of acquisition of goods should be defined in the accounting policy (for application during at least two years)[5] (enters into force from 1 January 2005). This provision is especially important for trading companies that perform pre-sale preparation of goods; previously the cost of work and services on preparing goods for sale (including assembly, packaging, etc.) could not be included in direct expenses, which was contrary to the economic sense of these expenses (enters into force from 1 January 2005).

2.2.2. Possibility of deferring expenses to other periods

Before: Companies whose expenses could not be clearly related to income for a specific period could allocate income independently, taking into account the matching principle.

[1] Federal Law No.58-FZ of 6 June 2005 *On the Introduction of Amendments to Part Two of the Tax Code of the Russian Federation and Certain Other Legislative Acts of the Russian Federation on Taxes and Duties.*

[2] Point 1.2 of article 248 of the Tax Code.

[3] Point 1 of article 252 of the Tax Code.

[4] Point 1 of article 318 and point 1 of article 319 of the Tax Code.

[5] Article 320 of the Tax Code.

Expenses were recognized only in the reporting period in which they were incurred. In practice this meant that if a taxpayer had no income in a specific period, it could calculate the share of past or future income relating to this period and transfer it to the appropriate period. The transfer of expenses was not possible. Therefore, companies that in their initial period of operations had not yet concluded sales contracts and thus had no opportunity to determine the share of income relating to this period (for example, construction companies) could deduct expenses incurred during this period only by carrying losses of this period forward. Of course, this led to losses due to the deferral of the deduction of expenses.

After: One of the most significant amendments is the fact that in cases where a taxpayer cannot determine the period to which expenses should be allocated based on the terms of a transaction and where no clear identification can be made between income and expenses, the taxpayer should determine the distribution of expenses independently.[6] This means that expenses in the above example (or, for example, expenses on software) can be accounted gradually and carried forward to future periods, regardless of the date on which they were incurred. Companies will no longer incur losses due to the inability to correctly match income and expenses, and many of the differences between financial and tax accounting related to this will disappear.

2.2.3. Surpluses identified during a stocktake

Before: There was no indication how to determine expenses related to materials in the form of surpluses identified during stocktakes or obtained on the disassembly or demolition of fixed assets being taken out of service. The tax authorities were convinced that expenses on such materials did not exist and thus should not be deducted for profits tax purposes, despite the fact that their value was included in taxable profits as income when they were identified.

This approach led to double taxation of income obtained from these materials: first when the materials were identified and later when products manufactured with them were sold.

After: The amendments indicate that the cost of the given materials are deductible in the amount of profits tax calculated on the relevant income.[7] Although this is good news for taxpayers that follow this position, it does not fully eliminate the double taxation.

2.2.4. Discounts

Before: The deduction of discounts provided to customers before the expiration of the tax period, for example, for exceeding a specific volume of purchases, has been a traditional source of conflict with the tax authorities, since it was not clear whether these discounts should be considered a reduction in income, a write-off of debt, or an expense. In the context of the definitions given by the Tax Code, these discounts were neither the first nor the second.

After: Discounts provided by a vendor to a customer after meeting certain contractual terms, specifically volume of purchases, will now be posted to non-sales expenses.[8]

3. Amendments affecting groups of companies in the process of reorganization or which are planning reorganization

3.1. Value of assets obtained as payment of a contribution to charter capital

Before: Taxpayers independently resolved the issue (unregulated by the Tax Code) of how the value of assets transferred as a contribution to charter capital should be determined in the tax accounts of the recipient. An approach similar to that used for financial accounting purposes, wherein assets were appraised by agreement with the founders on the basis of market value, has traditionally been disputed by the tax authorities.

However, court decisions on such disputes tended to favor taxpayers. There was no indication at all on determining value when a foreign organisation or individual contributed assets. After all, such founders do not keep tax accounts, and therefore it was even more difficult to use an approach similar to that used with Russian taxpayers.

After: The omission has been corrected. For profits tax purposes, assets obtained in the form of a contribution to charter capital will be taken at their book value as given in the tax accounting of the transferring party. In addition, the receiving party should document the value of the contributed assets; otherwise, the value will be taken as equal to zero.

When a foreign organisation or individual contributes an asset, its value will be recognized as equal to documented expenses on its acquisition, taking accrued depreciation into account, but not more than the market value of this asset as confirmed by an independent appraiser[9] (enters into force from 1 January 2005). The upshot is that in addition to documents on the acquisition of assets, founders will now also have to obtain an opinion from an independent appraiser.

The opportunity to post to expenses the value of depreciable property re-

[6] Point 1 of article 272 of the Tax Code.

[7] Point 2 of article 254 of the Tax Code.

[8] Point 1, sub-point 19.1 of article 265 of the Tax Code.

[9] Sub-point 2, point, article 277 of the Tax Code.

ceived as a contribution to charter capital is also confirmed by the indication that if used fixed assets are received, their service life is determined on the basis of the data of the previous owner[10] (enters into force from 1 January 2005).

3.2. Determining the value of shares (holdings, equity interests) received as a result of reorganization

The amendments also exclude the possibility for companies to increase the tax value of shares during reorganization, since:

1) when reorganizing through a merger, takeover or restructuring:[11] the value of the shares received by shareholders of the company being reorganized will be recognized as equal to the value of the converted shares of the company being reorganized pursuant to the data of the shareholder's tax accounting;

2) when reorganizing through a spinoff or division: the value of shares of each newly created company will be recognized as equal to the value of the shares belonging to the shareholder in the company being reorganized, according to the data of the shareholder's tax accounting, pro rata to the relative amount of the value of the net assets of the created company to the value of the net assets of the company being reorganized (enters into force from 1 January 2005).

3.3. Income from equity participation

Before: On withdrawal from a business entity (partnership), property and proprietary rights received up to the limits of the initial contribution of the participant in the business entity or partnership were not taken into account when determining the tax base.

After: The new version of the Tax Code exempts the entire contribution,[12] i.e. when withdrawing from a company (partnership) any additional contributions made will also be exempt. (enters into force from 1 January 2006).

3.4 Reorganization expenses

Before: The previous version did not indicate how the companies being created through the reorganization should account for the reorganization expenses. Due to this fact, there were doubts about whether the reorganized companies could (or whether it would be economically reasonable to) deduct expenses that had not been fully deducted before reorganization.

After: The expenses of newly created and reorganized companies that are the successors of the companies being reorganized are the expenses incurred by the latter according to the data and documents of their tax accounting[13] (enters into force from 1 January 2005).

3.5. Determining the tax base for securities transactions

The method for determining the estimated sale price of shares that are not circulating on the organized securities market has been changed completely.

Before: The most popular method among the tax authorities was determining the estimated price of shares using the issuer's net asset value per share.

After: From 1 January 2006 taxpayers will be able to hire an appraiser to determine the estimated price of a share or to determine the estimated price independently. In the latter case, the method used must be set forth in its accounting policy.[14]

3.6. Determining expenses on the sale of proprietary rights (holdings, equity interests)

Before: There was no procedure for determining expenses when selling proprietary rights, which represented a considerable gap in legislation.

After: It has been clearly established that when selling proprietary rights (holdings, equity interests) a taxpayer has the right to deduct the purchase price of these proprietary rights (holdings, equity interests) and any expenses associated with their purchase and sale from the income on these transactions[15] (enters into force from 1 January 2005).

4. Amendments concerning companies performing capital investments

4.1. Expenses on the purchase of leased property

Before: Previously companies that leased out property under a contract that stipulated that this property be accounted on the balance sheet of the lessee discovered that the Tax Code did not determine how they were supposed to deduct the value and other expenses on the purchase of leased property for tax purposes.

After: Pursuant to the amendments, expenses on the purchase of leased property are recognized in those reporting periods in which lease payments are stipulated, in an amount pro rata to the amount of the leasing payments[16] (enters into force from 1 January 2006).

4.2. Capital investments in leased property

Before: Prior to the entry into force of the amendments, the tax authorities took the view that ex-

[10] Point 14 of article 259 of the Tax Code.
[11] Point 4 of article 277 of the Tax Code.
[12] Sub-point 4 of point 1 of article 251.
[13] Point 2.1 of article 252 of the Tax Code.
[14] Point 6 of article 280 of the Tax Code.
[15] Point 1 and sub-point 2.1 of article 268 of the Tax Code.
[16] Point 8.1 of article 272 of the Tax Code.

penses on capital investments in leased property that were not compensated by the lessor (so-called non-severable uncompensated improvements to leased fixed assets) are not deducted from the profits tax base of the lessee and are included in the income of the lessor.

After: The amendments resolve this issue in favor of the taxpayer. It was indicated that these capital investments are deducted for tax purposes through depreciation for the entire effective term of the lease agreement. The amount of annual depreciation is calculated taking into account useful life, as determined pursuant to the Classification of fixed assets.[17] The corresponding income of the lessor is not included it its profits tax base.[18]

4.3. Accelerated deduction of expenses on capital investments

Before: Several years ago the tax concession on capital investments in basic production assets, under which capital investments were deductible up to 50 percent of the taxable profits for the period, was abolished.

After: Although the old tax concession has not been reinstated, taxpayers have been given the right to include capital investment expenses in expenses for the current period. This deduction is granted in an amount not exceeding 10 percent of the initial value of fixed assets and expenses on completion of construction, equipping, modernization, installation of additional equipment and partial liquidation of fixed assets, during the period in which depreciation begins or the initial value of the relevant fixed assets changes (due to additional construction, depreciation, etc.). However, these expenses are not taken into account when calculating depreciation on these fixed assets.[19] Thus, this amendment does not reduce taxable profit for all periods taken together, as was the case prior to the abolition of the abovementioned concession, but instead makes possible the accelerated deduction of expenses associated with capital investments, which is undoubtedly in the taxpayer's favor.

5. Tax base on REPO operations with securities

Before: The version of the RF Tax Code in effect prior to the amendments defined a REPO operation as a transaction involving the purchase/sale of issuable securities with subsequent mandatory repurchase. The price and number of the securities was to remain unchanged until the completion of the REPO transaction (i.e. until the date of performance of the second part of the transaction). Thus, if the price of the second part of REPO transactions could not be determined at the time of their conclusion, they were not recognized as REPO transactions by the tax authorities, being classified instead as either two purchase-sale transactions or as a purchase-sale transaction with a reverse fixed-term transaction (forward contract). As a result, the rules established by the RF Tax Code for securities operations and for fixed-term transactions were applied when assessing profits tax.

After: Pursuant to the amendments, a REPO transaction is understood to mean two related transactions. A clear definition of the relationship between the transactions is given, and the possibility to change the number and price of securities prior to the performance of the second part of a REPO is established. This definition of REPO transactions should allow taxpayers to avoid in part disputes with the tax authorities when classifying a transaction as a REPO transaction. The period between the date of performance of the first and second parts of a REPO established by the contract has been increased. Now this period should not exceed one year. In addition, the procedure for extension has been abolished. All of this will have a positive effect on the options of the participants to the transactions. The procedure for regulating mutual claims in case of undue performance of the second part of a REPO has been established.[20] The concept of an uncovered position has been introduced to secure the possibility to track the obligation on repurchase of securities under the second part of a REPO in tax accounting.

The conditions on opening and closing of a position and the procedure for determining the tax base for operations involving the opening of an uncovered position have been established.[21] However, even the new version of the RF Tax Code fails to give clear explanations on determining the value of securities for tax purposes if they are sold between the performance of the first and second part of a REPO operation by the buyer under the first part of the transaction.

6. In addition

One of the corrections that makes life easier for taxpayers is the provision that stipulates that if a taxpayer has several separate divisions in one constituent subject of the Russian Federation profit does not have to be distributed separately to all of them (enters into force from 1 January 2005).

The provision limiting the aggregate amount of losses that can be

[17] Point 1 of article 256, point 1 of article 258 and point 2 of article 259 of the Tax Code.

[18] Sub-point 1.32 of article 251 of the Tax Code.

[19] Point 1.1 and 2 of article 259, point 5 of article 270 and point 3 of article 272 of the Tax Code.

[20] Point 6 of article 282 of the Tax Code.

[21] Points 9 and 10 of article 282 of the Tax Code.

deferred will be abolished from 1 January 2007. In 2006 taxpayers will only have the right to defer losses in an amount not exceeding 50 percent of the tax base.

As can be seen from the material above, for the most part the amendments should make life easier for taxpayers. However, the consequences of applying certain provisions (such as, for example, the expansion of the list of documents confirming income and the elimination of the possibility for taxpayers to increase the value of securities when making a contribution to charter capital and during reorganization) remain to be seen.

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