A REPORT ON LEASING ACTIVITY IN RUSSIA
A SURVEY OF THE LEGAL AND
REGULATORY ENVIRONMENT

INTERNATIONAL FINANCE CORPORATION

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INTRODUCTION

The following survey is the second comprehensive review of the financial leasing market in Russia prepared by the International Finance Corporation’s Leasing Development Group. The first was titled «Financial Leasing in Russia» and it reviewed the overall size, framework and particularities of today’s leasing market in the Russian Federation.

Please note that this review was prepared and published in Russian in June 2001. Since publication, several laws have been adopted and will enter into force in the near future, most importantly changes affecting profit taxes and licensing. The English version has not been adapted to incorporate these changes in the regulatory environment, and retains up-to-date information as of June 2001. The Leasing Development Group therefore encourages readers to consult its other publications, particularly the bimonthly «Leasing-Courier», which have further analysis of the effects of these changes. The Leasing Development Group’s publications are available on the Internet at http://www.ifc.org/russianleasing, or by contacting us directly.

Considering the complexities of the legal issues related to leasing transactions, it is clear that the legislative environment plays a key role in determining the growth of the leasing market in Russia. For this reason, our group has devoted considerable energy to the careful review and analysis of the legislative framework for leasing. The primary goal of this survey is to consolidate the various legal issues related to leasing in Russia in one document. We have included a review of the key legislative acts which affect the industry. Moreover, we have highlighted the problems faced by leasing companies and their clients in the everyday application of the legislation.

Financial leasing is an attractive and rapidly developing financial mechanism. It presently provides tax benefits by virtue of the ability to include the full amount of a leasing payment in the tax deductible cost base and by granting the parties the right to use accelerated depreciation. The legislation grants significant freedom to the parties to choose the terms and conditions of their agreements, which are dependent upon the respective needs of each party.

However, we believe that the legislative framework which governs leasing deteriorated during the period from 1998 through 2000. This is as a result of the adoption of the contradictory and overly detailed Federal Law on Leasing, the continued attempts by the Central Bank of Russia to control the flow of capital and the inconsistent application by financial and regulatory bodies of multiple pieces of legislation and regulations related to accounting and taxation. Nonetheless, we believe that the key regulations do provide sufficient protection to the parties involved in leasing transactions.

As this survey was being prepared, legislation related to leasing is expected to undergo two major changes. The first is that the State Duma is preparing for the introduction of Chapter 25 of the Tax Code (Profit Tax). The second is that a number of proposals have been introduced to the Federal Law on Leasing. If and when these two changes are passed into law, they will have a significant impact on the future development of leasing in Russia.
The Application of Civil Law

The regulation of leasing transactions under civil law is derived from two principal pieces of legislation: the Civil Code of the Russian Federation (henceforth «CC») and Federal Law 164-FZ «On Leasing» of October 29, 1998 (henceforth «Law»). It should be noted that, in accordance with Article 3 Clause 2 of the CC, the contents of any law that relates to civil legislation must agree with the CC. Therefore, any statutes of the Law that contradict the CC cannot be enforced.\(^1\)

Under the CC, leasing regulations take precedence over general regulations for rent. Article 625 stipulates that general rent regulations apply to all types of rent agreements (including leasing) unless the CC provides specific regulations for such agreements. Such specific regulations do exist for leasing operations and can be found within six articles of Chapter 34, Paragraph 6 of the CC (Articles 665-670). Any matters related to leasing that are not addressed in Chapter 34, Paragraph 6 of the CC are subject to the general regulations for rent.\(^2\)

Thus, for example, Chapter 34, Paragraph 6 of the CC does not provide any framework for the transfer/assignment of lease payments, the mortgage/pledge of rights under a lease agreement, responsibility for the maintenance of a leased asset, subleasing, early annulment of a lease agreement, or various other matters. All of these matters are subject to the Civil Code's general regulations for rent and articles of the Law, with precedence given to the CC.

The Concept of Leasing

Before beginning our discussion of leasing, we must first point out that the concepts of «leasing» and «rent» («arenda») are different in Russian. Internationally, there are two basic kinds of leases: operating and financial. It should be noted that the term «leasing» did not gain wide usage in Russia until the early 1990s, when the leasing market began to develop. The international term «operating lease» roughly corresponds to the Russian term «rent» («arenda»), while the international term «financial lease» more or less corresponds to the Russian terms «financial lease» («finansovaya arenda») and «leasing». In some instances, operating leases under the international term may qualify as financial leases and vice versa.

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1 Unfortunately, the Law contains a significant number of points that contradict both the CC and other legislative acts. The most important shortcomings of the Law will be discussed in this report.

2 Naturally, other general principles set forth in the CC can also be applied to leasing.
Article 665 of the CC defines leasing as a transaction in which a lessor acquires property at the request of the lessee from a vendor of the lessee's choosing and provides this property to the lessee (in exchange for payment) to be temporarily held and utilized for commercial purposes.

From this definition of leasing we can formulate the following distinguishing characteristics of a lease agreement:

- the involvement of three parties - lessor, lessee and vendor of the leased asset;
- a set of contractual relations. Leasing operations are based on at least two contracts: a sales agreement and a lease agreement. However, leasing transactions are often accompanied by other agreements as well, such as loan agreements, insurance agreements, maintenance agreements, etc.
- use of the property for entrepreneurial purposes. According to Russian law, «entrepreneurial purposes» means activity directed towards the systematic gain of profits from the use of property (in this case the leased asset);
- acquisition of property specifically for leasing. Leasing is considered a type of investment activity since financial leasing presupposes the acquisition of assets specifically for leasing. The presence or absence of investment - that is, whether the equipment is acquired specifically for leasing - determines whether an agreement is classified as a rental agreement or a lease agreement and, consequently, which tax treatment applies.

Article 2 of the Law defines leasing as follows: «leasing is a type of investment activity involving the acquisition of property and its transfer, on the basis of a lease agreement, to companies or individuals in exchange for a specified payment, a specified period and under specified conditions, as stipulated in the agreement, whereby the lessee also has the right to eventually purchase the property.» If this definition is compared to that given in the CC, the contradictions become clear:

- there is no indication that the leased asset must be used for entrepreneurial purposes.3 In our opinion, the Law's definition of leasing confuses the concepts of rent («arenda»), which does not put restrictions on the purposes, and financial leasing;
- a new qualification is introduced: the right to purchase the leased asset.4

Classification of Lease Agreements

Article 7 Clause 3 of the Law provides for the following major types of leases: financial leases, lease buy-backs and operating leases. It should be noted that the use of these terms in the Law is not in keeping with the CC. According to the

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3 We should note that Article 3 of the Law does mention the requirement to use the leased asset for entrepreneurial purposes.

4 As we shall demonstrate below, this feature cannot be considered a qualifying one, since it inherently contradicts the Law. As for the requirement of investment, it is also present in the CC's definition, since the leased asset must be acquired specifically for leasing.
CC, the term «leasing» means a «financial lease» («finansovaya arenda»). Thus the use of the term «financial leasing» («finansovy lizing») in the Law is incorrect. If we examine these different varieties of leasing, we see that the use of the term «operating lease» in the proposed classification system contradicts Article 665 of the CC, which stipulates that an asset must be acquired specifically for leasing as a required feature of a leasing transaction. By this definition, therefore, an «operating lease» cannot rightly be classified as leasing; rather, it should be considered an ordinary rent transaction. Hence, one must conclude that an operating lease can only be regulated by the general regulations for rent contained in the CC. This confusion of terms probably occurred due to an incorrect translation from English, which contains the terms «financial lease» and «operating lease». The use of the term «financial leasing» in the Ottawa UNIDROIT Convention also appears to have played a role.

Lease buy-back is defined as a type of leasing in which the vendor (supplier) of a leased asset acts simultaneously as a lessee. Some believe that a lease buy-back cannot be viewed as a variety of leasing either, since it lacks one of the defining features of a lease agreement: the lessor’s obligation to acquire the leased asset from a specified vendor in accordance with the lessee’s request. In our opinion, lease buy-back does not contradict the requirements of the CC, since the lessor does acquire the leased asset from a specified vendor in accordance with the lessee’s request; the vendor also happens to be the lessee.

The Leased Asset

According to Article 666 of the CC and Article 3 of the Law, a leased asset may be any non-consumable good, except for land or other natural objects, that is used for entrepreneurial purposes.

Non-consumable goods are those which are not completely destroyed during use and which can be used for an extended period of time (machines, equipment, buildings and other structures, electronics, etc.). Consumable goods, accordingly, are those which cease to exist as such after their use or which lose their original consumer qualities; thus, raw materials and other materials do not qualify as leased assets.

Intellectual property (computer programs, patents, know-how, etc.) is not considered a good according to Russian legislation and, consequently, cannot qualify as leased assets.

The Lease Period

Article 610 of the CC gives the parties to a lease the freedom to choose the lease’s period. The CC stipulates neither a minimum nor a maximum period for any lease agreement, including financial lease agreements. Article 610 of the CC, however, does stipulate that maximum lease periods may be established by law for

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5 In English, of course, ‘operating lease’ is for the most part applied to rental contracts with a period of more than one year. In this sense, the Russian ‘rent’ does not make any distinction between rental of more and less than one year.

6 According to Article 7 Clause 4 of the Law, the lessor may offer to obtain the right to intellectual property as an additional service.
any individual type of lease agreement. Article 7 Clause 3 of the Law stipulates that the lease period must be at least as long as the full depreciation period of the leased asset. Thus, the Law establishes not a maximum, but rather a minimum period for lease agreements. Since this regulation contradicts the CC, it cannot be enforced in practice. Currently, therefore, there are no real restrictions on the length of lease agreements. It must be remembered that if a lease period is not indicated within the agreement, then the agreement will be considered valid for an indefinite period. In such cases, all parties have the right to reject the agreement at any time with one month's prior notice (or three months' notice in the case of leased real estate).

The Ban on Simultaneously Being a Creditor and a Lessee

Article 9 of the Law stipulates that the obligations of creditor and lessee under a lease agreement may not be combined in one entity. This restriction effectively rules out the possibility of using advance or preliminary payments in leasing transactions, since these types of payment are considered types of commercial credit under Article 823 Clause 1 of the CC. The restriction does not agree with the statutes of Chapter 42 of the CC, which place no restrictions whatsoever on the subjects of loan or credit agreements. Since the law directly contradicts the CC, this restriction has no effect, and advance payments may be used.

Essential Terms and Conditions of a Lease Agreement

The CC defines the following as essential terms and conditions of a lease agreement:

• the object of the agreement - Article 432;
• a clause related to the supplier of the asset (when the lessee chooses the supplier, the supplier of the asset must be indicated in the agreement; when the lessor chooses the supplier, the agreement must contain a footnote delegating the choice of supplier to the lessor) - Article 665.

In addition, other conditions recognized as essential are those designated in the Law or other relevant legislative acts as essential for such contracts, as well as other terms and conditions which have been agreed to by the parties. According to Article 432 of the CC, an agreement is deemed valid only if it contains the above mentioned essential terms and conditions.

Article 15 of the Law contains a list of essential terms and conditions for lease agreements. However, not all of them can be considered essential, since both the CC and the Law contain discretionary norms concerning a majority of the essential terms and conditions listed in the Law. If these terms and conditions are not regulated within the lease agreement, they will be regulated by the statutes of the CC and the Law. Defining them as essential contradicts the logic of both the CC and the Law itself. It is unlikely that any court would declare a lease agreement invalid for failing to regulate matters that are already regulated under the CC or the Law itself.7 Of all the essential terms and conditions listed in Article 15 of the

7 This conclusion seems particularly justified in light of the views expressed by the Chairman of the RF High Arbitration Court, V.V. Vitryansky. See V.V. Vitryansky, "Financial Lease Agreements" // Special Supplement 10, pp. 85-87, in the RF High Arbitration Court Bulletin (1999).
Law, only one can really be considered essential: the precise description of the leased asset. Thus, the following cannot be considered essential:

- **The proportion of property rights transferred:**
  This is not deemed essential since the proportion of transferred rights is regulated by both Article 665 of the CC and Article 11 of the Law, the latter of which stipulates that the right to hold and utilize the leased asset is transferred in full to the lessee unless otherwise established under the lease agreement. Thus, even if the lease agreement does not regulate this matter, the right to hold and utilize the leased asset is considered fully transferred. At the same time, property rights to the leased asset, independent of any restrictions on the right to hold and utilize the asset, remain with the lessor for the entire term of the agreement.

- **The specific place and procedure for the transfer of the leased asset:**
  This is not essential because, according to Article 668 of the CC, the vendor must directly transfer the leased asset to the lessee, unless otherwise stipulated in the lease agreement. Therefore, if the lease agreement does not specifically regulate this matter, the vendor must directly transfer the leased asset to the lessee.  

- **Indication of the lease period:**
  According to Article 610 of the CC, a lease agreement may be concluded for either a definite period, as specified within the agreement, or for an indefinite period, during which any party has the right to renounce the agreement at any time after giving advance notice to the other parties. Therefore, by listing the lease term as an essential condition, the Law is contradicting a discretionary norm of the CC.

- **Procedures for recording a leased asset on the balance sheet:**
  Although the Law stipulates that a leased asset should be recorded on the balance sheet of either the lessee or the lessor, as agreed by the parties, it seems that this term can also be considered non-essential for the following reasons: the manner of recording the leased asset in the books bears no relation to the essence of the contractual obligations, and ultimately the lessor does record the leased asset on the balance sheet when acquiring it, if only temporarily. If the leased asset is then to be carried on the balance sheet of the lessee, the lessor records a corresponding asset in accounts receivable.

- **Procedures for maintenance and repair of the leased asset:**
  This term can in no way be considered essential, since the matter is regulated in detail under Article 616 of the CC and Article 17 of the Law, according to which responsibility for the maintenance of the leased asset is divided as follows: guarantee maintenance to be provided by the vendor (or the manufacturer, as stipulated within the agreement); technical maintenance and routine or medium-sized repairs to be performed by the lessee; major repairs to be performed by the lessor. These responsibilities can be divided differently if so stipulated in the lease agreement.

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* It must be remembered, however, that discretionary norms establish different procedures for the transfer of leased assets under sales agreements and lease agreements. It therefore behooves the parties to indicate clearly, within both the lease agreement and the sales agreement, where and to whom the vendor must transfer the leased asset.
• List of additional services to be provided by the lessor.
  Such a list can be a significant part of a lease agreement, but it is unlikely that any
  court will nullify an agreement for failing to include one.

• Indication of the sum total of the lease agreement and the lessor's commission,
  as well as payment schedule and procedures.
  As follows from Article 614 of the CC, if the lease agreement does not specify the
  procedures, terms and schedule for making lease payments, then the procedures,
  terms and schedules commonly applied to the leasing of analogous property
  under comparable circumstances automatically take effect. Thus, the Law con-
  tradicts the CC by defining these terms as essential.

• The obligation of the lessor or lessee to insure the leased asset, unless otherwise
  stipulated under the agreement.
  This term, in and of itself, is a discretionary norm and cannot be considered
  essential. Furthermore, insurance for leased assets is not obligatory, as confirmed
  by Article 21 of the Law.

The Vendor's Responsibility for the Leased Asset

If the lessee has chosen the vendor himself, then responsibility for any defects in
the leased asset lies with the vendor. In such cases, the lessee must address all
claims concerning defects directly to the vendor. Both Article 670 Clause 1 of the
CC and Article 10 Clause 4 of the Law stipulate that the vendor is responsible to
the lessee for all claims based on the sales agreement. It must be noted that such
a sales agreement may be regulated by both the general regulations of the CC
concerning sales agreements (Chapter 30, Paragraph 1) and the regulations of
the CC concerning the delivery of goods (Chapter 30, Paragraph 3), or, in the case
of leased real estate, by the regulations of the CC dealing with the sale of real
estate (Chapter 30, Paragraph 7).

The Lessor's Responsibility for the Leased Asset

A lessee who selects a vendor of an asset plays an important role in the sales
agreement. The responsibility for choosing a vendor may, however, lie with the
lessor, if this is provided for in the lease agreement.

If the responsibility for choosing a vendor lies with the lessee, then the lessor is
not in any way responsible to the lessee for non-fulfillment of the terms of the
sales agreement, unless otherwise stipulated in the lease agreement.

The lessee has the rights and obligations of a buyer, as if he had been a party to
the sales agreement. He may not, however, annul the sales agreement, nor does
he pay for the asset. But in all other ways, the statutes of the CC concerning buy-
ers apply to the lessee. The lessee may, for example, make claims against the sell-
er regarding the quality, integrity, or delivery of the asset, as well as any other vio-
lation of the agreement.

We have already mentioned that the leased property must be delivered directly
to the lessee unless otherwise stipulated in the lease agreement. If the property is
not delivered on time due to circumstances within the lessor's control, then the
lessee has the right to demand annulment of the lease agreement and compensation for losses. The lessor is held accountable for such delays only in the event that these delays resulted from circumstances within his control. Such circumstances include late payment for the leased asset and cases where the lessor himself has selected the asset or the vendor. In other cases, it is obviously the supplier who must bear responsibility for any delays.

The lessor and the lessee act as joint debtors to the vendor. As well, if the lessor chose the vendor, then he and the vendor are jointly responsible to the lessee.

According to Article 620 Clause 3 of the CC, the lessee may also sue for annulment of the agreement if the lessor fails to perform major repairs to the property within the time frame established in the lease agreement, or, if no time frame was given, then within a reasonable period of time.

In all of the cases listed above, the lessee must, before filing a lawsuit, send the leasing company a proposal to annul the agreement, in accordance with Article 452 Clause 2 of the CC. If the leasing company refuses or fails to respond within 30 days (if no other deadline is given in the proposal), the lessee may sue for annulment of the contract and compensation of any losses incurred.

The right to premature cancellation of the agreement is closely related to the unilateral right of refusal to fulfill obligations under the agreement. According to Article 310 of the CC, no party may refuse unilaterally to fulfill obligations under an agreement, nor may they alter these obligations unilaterally, except where specified within the relevant legislation. Neither the Law nor the CC provides for these rights within lease agreements. However, the same article does stipulate that parties may, in cases specified within the agreement, refuse unilaterally to fulfill obligations in connection with their implementation by commercial parties. Thus, the parties to a lease contract may agree that if one party fails to fulfill certain obligations, the other party has the right to refuse unilaterally to fulfill its own obligations. In this case, one must make certain that the terms of the agreement do not contradict the imperative statutes of the law.

**Lease Payments**

The lessee is obliged to make lease payments on time (Article 614 of the CC). The procedure, conditions and schedule for making lease payments must be agreed to by the parties and stipulated within the agreement. If they are not defined within

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9 A lease agreement, like any other contract, may be annulled either by consent of the parties or unilaterally. According to the general rule stipulated under Article 450 Clause 2 of the CC, an agreement may be annulled unilaterally (that is, without the consent of the other parties) only by court order in the event of substantial violations of the agreement by one of the parties or in cases specified in the CC, other laws or in the agreement itself.

10 The Law attempts to resolve this issue in its own way. Article 10 Clause 6 of the Law expands the list of grounds for the lessor's responsibility (not only late delivery, as stated in the CC, but also any other non-fulfillment of the terms of the agreement) and alters the moment from which lessor must assume responsibility (not from the moment the deadline expires, but from the moment the agreement went into effect). Moreover, the article only provides for compensation of "direct losses", in contradiction of Article 15 of the CC, which allows for compensation of both real damages and lost profit. Due to these contradictions with the CC, the above-mentioned regulations of the Law cannot be applied in practice.
the agreement, then the procedure, conditions and schedules generally applied to
the leasing of analogous property (under comparable circumstances) take effect by
default. It would clearly be expedient to specify these terms within the agreement,
since the absence of a relevant condition could make it more difficult to implement
the agreement in practice, and it is not clear whether the procedure, conditions and
schedules generally applied to the leasing of analogous property under comparable
circumstances would be advantageous to the parties. Furthermore, depreciation
deductions affect the size of the lease payments, and one of the advantages of leas-
ing is accelerated depreciation. Accelerated depreciation can only be applied, how-
ever, with the consent of all the parties as expressed in the lease agreement. The
lease agreement must also indicate the amount that the depreciation will be accel-
erated, an amount which can not exceed a factor of 3.

The size of the lease payments may be changed with the consent of the parties
when stipulated in the agreement, but not more than once per year. This prob-
lem may be solved by pegging the lease payments and the sum total of the agree-
ment to a foreign currency or to an accounting formula that will allow the par-
ties to correct for inflation, changes in tax policies, etc. Payments that are calcu-
lated in a foreign currency and paid in dollars would not be considered a change
in the lease payments, whereas some other formulaic approaches would be con-
sidered changes and subject to the once per year limitation.

If the lessee significantly violates the payment schedule, the lessor has the right
to demand early payment, but not exceeding an amount equal to two payments.
If the lessee fails to make his lease payments on time for two consecutive peri-
ods, then the lessor may annul the contract prematurely through the courts.
Upon the cancellation of the agreement, the lessor also has the right to demand
compensation for his losses (including lost profit). The lessor may only sue for
annulment of the contract after serving the lessee with a written notice, request-
ing that he meet his contractual obligations within a reasonable period. The Law
attempts to cover matters relating to lease payments in some detail, but as in
many other parts, the proposed regulations contradict the CC.

For example, Articles 27-30 of the Law contain specific rules concerning the sum
total of lease payments and the methods for calculating this total. The CC stipu-
lates that these terms are subject to the general regulations for rent stipulated
under Article 614 of the CC, if they are not covered under the lease agreement
itself. Thus, from a legal point of view, the sum total of the lease agreement and
the actual size, method and schedule of lease payments must be agreed to by the
parties and stipulated within the agreement.

One can draw a similar conclusion about Article 28 of the Law, which restricts
deferral of lease payments, even when agreed by the parties and provided for in
the lease agreement, for periods of no more than 180 days from the moment the
leased asset enters into service.11 This regulation also contradicts the CC.

11 Lease payment deferrals for periods of up to 180 days are also stipulated for international leasing
(Article 34 of the Law). This statute, however, contradicts international law. The Ottawa UNIDROIT
Convention does not in any way restrict the parties’ right to determine the schedule of lease pay-
ments or their deferral. Nor does it give participating governments the right to establish such restric-
tions under domestic legislation.
According to Articles 314 and 614 of the CC, all obligations, including the transfer of lease payments, must be fulfilled within the time frame stipulated in the agreement. The CC places no restrictions on the periods that may be established in the agreement, nor does it allow such restrictions to be established by law. In the case of lease agreements, one must take into account that the leased asset may be a piece of equipment that requires an extended period of preparation before it can enter into service or reach full capacity. For this reason, leasing companies generally defer payments on such types of equipment until they have actually entered into service or reached full capacity. It is simply not expedient to restrict payment deferrals in such cases.

**Control of the Leased Asset**

As owner of the leased asset, the lessor has the right to inspect the utilization of the asset, as well as the lessee's finances for activities involving the leased asset or for the fulfillment of the obligations under the lease agreement. The procedures and purposes of inspection must be stipulated within the lease agreement.

According to Article 37 of the Law, the lessee must give the lessor unimpeded access to both his financial documents and the leased asset.

The Law (Article 38 Clause 4) also gives lessors the right to audit the lessee's financial situation and to be present (without voting rights) at all meetings of the lessee's founders or managers. This statute, however, contradicts Russian corporate law (including the RF Federal Law «On Joint-Stock Companies» and the RF Federal Law «On Limited Liability Companies»), which clearly indicates who has the right to attend meetings of stockholders (or members) and managers, as well as the right to appoint an auditor or conduct an audit.

**Lessee’s Rights when the Leased Asset Is Transferred to a Third Party**

One of the most important principles in Russian legislation is that rights are inalienable. If property is transferred to a new owner, for example, all of the liabilities connected with this property, including mortgages and rental agreements (including lease agreements, which are a type of rent), remain in effect and must be honored by the new owner. This principle ensures stability and protects lessees' rights, including those stipulated in the lease agreement.

**Mortgage of a Lessee’s Rights under a Lease Agreement**

Under Article 615 Clause 2 of the CC, lessees, with the lessor's written consent, may mortgage their right to hold and utilize a leased asset during the term of the contract, as well as to contribute these rights as shares in the charter capital of a partnership or company, unless this is forbidden under other laws or legal acts. The Law does not specifically treat these statutes of the CC in relation to leasing transactions. Instead, the Law attempts to grant lessees a different right: the right to mortgage the leased asset itself with the lessor's consent (Article 14 Clause 1).

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12 Article 617 of the CC states: transferring the ownership rights of a leased property may not serve as grounds for altering or annulling a lease agreement.
This is a clear case of legislative error, where the concept of «rights in relation to the leased asset» have been substituted with «the leased asset». According to Article 335 Clause 1 of the CC, only the owner of a leased asset (or his proxy) has the right to mortgage the asset. Since the lessee does not have this right, his mortgage of the leased asset cannot be considered valid.

**Subleasing, Secondary Rent and the Cession of Rights under a Lease Agreement**

Under Article 8 of the Law, lessees have the right to sublease the leased asset with the lessor's written consent. However, the lessee retains full responsibility to the lessor for the timely and full transfer of all lease payments. The CC (Article 615 Clause 2) states that the term of a sublease may not exceed that of the principal lease agreement.

Unless otherwise stipulated in the lease agreement, termination of the agreement also entails termination of the sublease agreement. In such cases, the sublessee has the right under Article 618 Clause 1 of the CC to sign a lease agreement with the lessor for the use of the leased asset on the terms established in the principal lease agreement, but only for the period of the terminated sublease agreement.

According to Article 618 Clause 2 of the CC, if the principal lease is found to be invalid, the sublease will also be considered invalid.

Subleasing, which is a variety of subrent, must be distinguished from the cession of lessee rights and obligations under a lease agreement to a third party, which the CC (Article 615 Clause 2) classifies as secondary rent. According to the CC, subleasing is a type of subrent, a set of relations between the lessee and the sublessee, in which the latter does not have any independent rights or obligations under the principal lease in relation to the lessor. In the case of secondary rent, the lessee, with the lessor's consent, cedes his rights under the lease agreement to a third party, who then becomes obligated to the lessor (the new lessee).

Article 615 Clause 2 of the CC allows the statutes regarding subrent and secondary rent to be altered by legislation. Major changes introduced by the Law cannot, however, be implemented in practice, due to contradictions with the principles of the CC and to internal contradictions within the Law itself.¹³

**The Right to Recover Funds without Dispute**

Under Article 854 Clause 2 of the CC, the lessor may deduct funds from the lessee's account without right of dispute in cases stipulated in the Law. In particular, under Article 13 Clause 1 of the Law, the lessor has the right to deduct funds from the lessee's account, without the latter's consent, in the following instances:

- the lessee misuses the leased asset, in violation of the terms of the agreement or the stated purpose of the asset;

¹³ Among other contradictions, the Law contains certain terminological inconsistencies with the CC. The Law defines subleasing as a set of relations in which the right to utilize the leased asset is ceded to a third party. Under this definition, subleasing could also be qualified as a type of secondary rent, where the rights and obligations under a lease agreement are transferred to a third party.
• the lessee subleases the asset without the lessor’s consent;
• the lessee fails to keep the asset in fair condition, impairing its quality;
• the lessee fails to make lease payments for two consecutive periods, as defined in the agreement.

Unfortunately, due to restrictions imposed by the CC, the lessor may not unilaterally confiscate sums from the lessee in excess of two consecutive lease payments. Lessors should be allowed to demand that lessees make future periodic lease payments ahead of schedule, since the lessor would not have purchased the equipment in the first place if he had not been requested to do so by the lessee. Since the secondary equipment market is so poorly developed, the mere right to repossess the equipment and recover two lease payments does not constitute sufficient legal protection of the lessor’s interests. Leasing companies can suffer enormous losses in such cases.

Since this is an integral statute of the CC, the parties may not stipulate that the lessee pay more than the sum of two lease payments. The lessor, meanwhile, enjoys the incontestable right to deduct funds from the lessee’s account in accordance with the above-mentioned article of the Law.

At the same time, one should not exaggerate the significance of the lessor’s legal right to deduct funds without dispute, as it is not always feasible in practice. The lessee’s bank can use various pretexts to postpone or refuse outright to meet the lessor’s demands. In such cases, the leasing company can only resort to long and burdensome court proceedings. The lessor may sue not only the lessee, but also the lessee’s bank for failing to observe the statutes of the Law regarding the incontestable recovery of funds.

The Right to Repossess a Leased Asset

One of a lessor’s most important rights, guaranteed by his property rights to the leased asset, is his right to repossess a leased asset in the event of default or other contractual violations by the lessee. A leasing company’s right to repossess a leased asset differs qualitatively from, for example, the rights of a mortgage holder in relation to a mortgaged asset, in that the lessor holds the ownership rights to the leased asset and may consequently demand its return. One might, therefore, expect that lessors, being the true owners, should be able to repossess leased assets out of court whenever the lessee violates the terms of the contract.

Unfortunately, lessors are not able to do so, even though Article 13 of the Law grants them this right.14

Since repossession of the leased asset inevitably entails early termination of the lease agreement, then by virtue of Article 619 of the CC, which requires court proceedings for early termination of a lease agreement and repossession of a leased asset, any objection from the lessee will precipitate court proceedings. Currently, it takes at least three months to repossess property through the courts

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14 One might also refer to an inapplicable statute of Article 11 Clause 3 of the Law, which states that the lessor’s right to dispose of the leased asset includes his right to repossess the asset from the lessee in cases stipulated under the Law, by the procedures listed therein.
in accordance with arbitration procedures. Since the Russian arbitration courts take such a long time to process repossession claims, Russian leasing companies try to compensate by minimizing the risk of contractual violations, which in turn reduces their client base by excluding businesses that badly need investment and might otherwise qualify for leasing.

The parties to a lease can partially facilitate these procedures, when drafting the lease agreement, by writing provisos on the use of the arbitration courts. But the lessor can hardly count on the arbitration courts' decisions being implemented quickly and efficiently, since these courts' decisions are executed according to the general regulations established for writs.

The Right to Purchase

Under the Civil Code and the UNIDROIT Convention on International Financial Leasing, the eventual purchase of a leased asset is not a required feature of a leasing transaction. According to the general rules of the CC that regulate leases, either a law or a lease agreement may indicate the lessor's obligation to transfer ownership of the leased asset to the lessee upon termination of the agreement, or before its termination, upon receipt of full payment of the redemption price (Article 624 Clause 1 of the CC).

The CC's reference to legislation is extremely important here, for the reference should make the procedures established under the Law «On Leasing» obligatory. The Law stipulates that ownership of leased property must be transferred to the lessee upon receipt of the full sum of lease payments (even if this occurs before the lease term expires), unless otherwise stipulated under the lease agreement (Article 7 Clause 3 and Article 19 Clause 1 of the Law). On the basis of these articles, one might conclude that, if the lease agreement is silent on this point, then the right of ownership automatically devolves to the lessee upon fulfillment of the condition mentioned above. This assertion may be debated, however, on the basis of Article 15 Clause 6 and Article 17 Clause 6 of the Law, which state that, upon termination of the agreement, the lessee must return the leased asset to the lessor in such condition as it was received, except for normal wear and tear.

Since the CC allows the law to establish such a right, but the Law contradicts itself, it is unclear which of these articles would be enforced in actual court practice. In order to avoid this uncertainty, it is advisable to write terms concerning the purchase option into the lease agreement.

Annulment and Termination of a Lease Agreement

A lease agreement's validity terminates upon expiration of the lease period. An agreement may, however, be annulled early by the courts. The CC lists the various grounds for annulling a lease agreement, whether by demand of the lessor or the lessee. The lessor may demand that the agreement be annulled if the lessee:

- uses the leased property in such a way as to violate significantly (or repeatedly) the terms of the agreement or the property's stated purpose;
- significantly damages or degrades the property;
• defaults on lease payments for two consecutive periods;
• fails to perform major repairs to the equipment within the time frame established under the agreement or, if no time frame has been established, within a reasonable amount of time, in cases where the responsibility for major repairs lies with the lessee.

The agreement may also stipulate other grounds for annulling the agreement through the courts — for example, if the sales agreement for the leased asset has not gone into effect or was terminated prematurely for any reason, or if the lessee ceases to exist as a legal entity during the term of the contract (if either the lessor or the lessee ceases to exist as a legal entity, the agreement is terminated in accordance with the statutes of the CC).

The lessee may sue for annulment of the agreement if:
• the lessor fails to make the property available to the lessee or impedes him from utilizing the property in accordance with the terms of the agreement or the property's stated purpose;
• the property turns out to be in a condition unsuitable for use, due to circumstances within the lessor's control;
• the lessor fails to perform major repairs that are his responsibility;
• the vendor was late in delivering the property to the lessee due to circumstances within the lessor’s control.

The lease agreement may allow the lessee, as it does the lessor, additional grounds for annulling the lease agreement.

Unlike the lessor, the lessee is not obliged to serve written notice requesting the fulfillment of obligations or the cessation of violations within a reasonable time. However, in accordance with Article 452 Clause 2 of the CC the lessee may not file a lawsuit until he has informed the lessor of his intention to annul the contract, and he may only do so if the lessor either refuses to annul the agreement or fails to respond by a specified deadline. This deadline is usually indicated within the notice; if it is not, then Article 452 Clause 2 stipulates a time frame of 30 days.

The lease agreement may also provide for circumstances under which the parties may unilaterally refuse to meet their obligations, but these circumstances may not be those for which the CC stipulates annulment of the contract through the courts.

**Legal Issues Pertaining to International Leasing**

International (crossborder) leasing transactions are those in which the lessor and the lessee are located in different countries. The location of the vendor is irrelevant in this case. Location means the location of a legal entity, but not of his branch or representative office, even if he is registered or accredited in another country. Consequently, if either a branch or representative office takes part in a leasing transaction, its location is defined as that of its legal founder.
The statutes of international law are always taken into account when deciding legal issues pertaining to international leasing. Since different legal systems treat the nature of leasing transactions differently, the international community has attempted to unify the main regulations pertaining to international leasing operations. The UNIDROIT Convention on International Leasing (henceforth «Convention»), which regulates matters pertaining to international leasing, was signed in 1998. Russia joined the Convention on February 8, 1998. The signatories of the Convention now include nine countries: Russia, Belarus, Hungary, Italy, Latvia, Nigeria, Panama, France, and Uzbekistan.

**General Principles for Determining the Legal Jurisdiction of a Leasing Transaction**

The body of laws that should apply to a given transaction is determined under Section VII of the Principles of Civil Law of the USSR and its Republics (1991), which is still in effect for the Russian Federation. According to Article 166 Clause 1 of these Principles, the parties' rights and obligations in an international commercial transaction are determined by the laws of whichever country the parties choose when concluding the deal or in any subsequent agreement. If the parties have not made such provisions, then the laws of the country in which the lessor was founded or has his principal place of business take effect by default. In deciding which body of law to apply, one must remember that Russia is a signatory to the Convention.

From the above, we can conclude that there are three possible bodies of law that can serve to regulate international leasing transactions:

1. **The laws of the country chosen by the leasing parties.** These laws apply if they are chosen by the parties when concluding the deal or in any subsequent agreement. No restrictions are placed on this choice. The parties may choose to apply the laws of the lessee's country or any other country.

2. **The Ottawa Convention on International Financial Leasing (UNIDROIT).** This applies if the lessor, the lessee, and the supplier are located in signatory countries of the Convention or if both the lease agreement and the delivery agreement for the leased asset are regulated by the laws of one of the signatory countries.16

3. **The laws of the lessor's country.** These apply in cases where the transaction is not regulated by the Convention and the parties have not chosen to apply any other body of law to the transaction. Thus, Russian leasing legislation would apply to international leasing transactions in which the lessor was a Russian leasing company.

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16 Even if all the conditions for application of the Convention are met, the parties are free to indicate in the delivery agreement and the lease agreement that the Convention does not apply.
Highlights of the Ottawa Convention on International Financial Leasing

Since many of the Convention’s norms were incorporated into Russian legislation, we shall now examine a few of the ways in which the Convention diverges from Russian legislation in its treatment of leasing:

- the absence of the concepts of an operating lease and lease buy-back;
- the lease agreement must generally be signed before the equipment is purchased, although it may be signed later under some circumstances. Russian leasing legislation does not address this issue at all;
- certain differences in the types of equipment that may be leased. The Convention allows for the leasing of complex equipment, manufacturing equipment, etc. The Convention does not, for example, provide for the leasing of enterprises, which is quite permissible under Russian legislation;
- the lease period. According to the Convention, the sum of lease payments must correspond to the full amount of depreciation, or a significant part thereof. The Law «On Leasing» establishes a similar requirement, but this requirement is invalid;¹⁷
- if the lessee significantly violates the terms of the agreement, the lessor has the right to demand advance payments on the lease, provided that such a right is stipulated under the agreement, or to annul the contract after providing the lessee with sufficient notice. In the latter case, the lessor has the right to repossess the leased equipment and recover any losses. The size of these losses is defined as the difference between the amount the lessor would have received if the contract had been observed and the amount he received in actual fact. It is not entirely clear what constitutes a significant violation of the contract but, nevertheless, this statute affords the lessor far more protection than enjoyed under Russian legislation;
- the delivery agreement and any amendments to this agreement that affect the lessee’s interests are subject to the latter’s consent;
- responsibility for the delivery of defective property - the lessee has the right to reject defective equipment supplied by the lessor or to annul the lease agreement, while the lessor has the right to correct the problem. Under Russian legislation, the measure of responsibility for defective property depends on who selected the vendor (the lessor or the lessee) and on the extent of the defects.

¹⁷ See the section entitled "The Lease Period".
The vagueness and inconsistency of Russia's accounting and tax laws mean there is always the danger that parties to a lease agreement and tax department officials will interpret these laws differently. Therefore, parties to a lease agreement should keep this peculiarity of Russian law in mind when applying the regulatory acts listed below.

The most important document regulating accounting procedures for leasing is RF Ministry of Finance Order 15 «On the Reflection of Leasing Operations in Bookkeeping Records» (February 17, 1997). In practice, enterprises must also refer to other regulatory acts, such as the Chart of Accounts for Financial and Economic Activities of Enterprises and Instruction for Its Application (confirmed by USSR Ministry of Finance Order N56 of November 1, 1991, ed. February 17, 1997), the Statutes on bookkeeping for revenues, expenditures, registration of principal assets, and other regulatory documents.

When drafting Order 15, Russian legislators took the following distinctive features of leasing transactions into account:

- the lessor retains ownership of the leased asset throughout the term of the lease;
- the leased asset may be recorded on the balance sheet of either the lessor or the lessee (as agreed by the parties).

Accounting for leasing operations varies depending on whether the leased asset is recorded on the lessor's balance sheet or the lessee's.

It should be noted that recording the asset on the lessor's balance sheet is more clearly described in regulatory acts. This is one reason why parties to a leasing transaction usually choose this method.

**Recording a Leased Asset on the Lessor's Balance Sheet**

If the leased asset is recorded on the lessor's balance sheet, the following accounting procedure should be used:

**The Lessor:**

- enters the asset at the amount expended on acquiring it under account 03 «Profit-Bearing Investments in Material Goods»;
- includes depreciation deductions in his production costs;
- records the full amount of lease payments received under account 46 «Sale of Goods, Labor or Services»;
- deducts and pays property taxes.
The Lessee:

- enters the leased asset in the off-balance sheet account 001 «Leased Fixed Assets»;
- includes the full amount of lease payments in his production costs.

**Recording a Leased Asset on the Lessee’s Balance Sheet**

If a leased asset is recorded on the lessee’s balance sheet, the following accounting procedure should be used:

The Lessor:

- enters the leased asset under off-balance account 021 «Leased Out Fixed Assets»;
- records a debt receivable in the sum of the lease agreement under account 76 «Settling of Accounts with Various Debtors and Creditors»;
- records the difference between the total sum of lease payments and the value of the leased asset under account 83 «Revenue from Future Periods»;
- reduces the debt receivable recorded under account 76 by the amount of lease payments received;
- writes off the difference recorded under account 83, first under account 46 «Sale of goods, labor or services» proportional to the lease payments received, and then under account 80 «Profits and Losses».

The Lessee:

- enters the leased asset in the sum of the lease payments under account 01 «Fixed Assets»;
- records a debt payable under account 76 «Settling of Accounts with Various Debtors and Creditors» (subaccount «Leasing Obligations») in the amount of the lease agreement;
- includes depreciation deductions in his production costs;
- reduces the debt payable by the amount of the lease payments (lease payments are not included in production costs);
- deducts and pays property taxes.

**Effects of Recording Leased Assets on the Lessee’s Balance Sheet**

1. The lessee’s property taxes increase

If the leased asset is recorded on the lessee's balance sheet, the asset is entered based on the total amount of the lease payments rather than the acquisition cost of the asset. Therefore, property taxes, which are calculated on the basis of the asset's book value, are also charged on this amount. Consequently, if this recording method is used, the total property tax is higher than the amount of tax paid by the lessor if the asset is recorded on his balance sheet.

2. The lessee includes depreciation deductions, but not lease payments, in his production costs

If the asset is recorded on the lessee's balance sheet, the lessee has the right to include only depreciation deductions in his production costs. Lease payments
only decrease the debt payable. In the alternative case, there would be a twofold
decrease in the taxable base.

The following feature of this recording method must be considered: if the
amount of lease payments charged in the recording interval exceeds the amount
of depreciation deductions charged, the lessee does not have the right to include
this difference in his production costs (labor, services). Thus, the difference
between the lease payments and the sum of the depreciation deductions for the
period is not tax deductible.

This situation does not arise if the term of the lease agreement equals the full
depreciation period of the leased asset and uniform lease payments are made. In
this case, the financial effect of the lease agreement will be the same as if the asset
were recorded on the lessor's balance sheet.

3. Claiming the difference between the total sum of the lease payments and the
value of the asset

The difference in the lessor's accounts between the total sum of the difference
between the total sum of the lease payments and the value of the asset will be
reflected in Revenue from Future Periods (account 83). This difference is record-
ed proportionally as lease payments are received in corresponding account 46
«Sale of goods, labor or services.» This is based on PBU 9/99 «Organizational
Revenues», which states that revenue from lease payments is recognized as a
lessor's income from conventional types of activities (if the object of the activity
is temporary possession and use of assets provided through a lease agreement).
This revenue is credited to account 46 «Sale of goods, labor or services».

Thus, Clause 6 of the Ministry of Finance's Order 15, which states that the differ-
ence recorded in account 83 «Revenue from Future Periods» is written off from
this account in correspondence with the sum of lease payments credited to
account 80 «Profits and Losses,» loses force and is no longer applied.

4. There are no bookkeeping adjustments if the leased asset is returned to the les-
sor before the lease expires

If the lease agreement has been completed without any complications and the
lessee has made all of his payments on time and either purchased the leased asset
or returned it to the lessor at the end of the lease, then no difficulties should arise
in recording the transaction.

However, if the lessee decides to return a leased asset that is not fully depreciat-
ed to the lessor upon early termination of a lease agreement, it is unclear how
the parties should record the transaction.

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1 Ministry of Finance Order 15 "On the Reflection of Leasing Operations in Bookkeeping Records,"
Clause 9.
2 Accounting Regulation "Organizational Revenues," Clause 5, PBU 9/99, confirmed by RF Ministry of
3 Chart of Accounts for Financial and Economic Activities of Enterprises and Instruction for Its Application
(confirmed by USSR Ministry of Finance Order N 56 of November 1, 1991, ed. February 17, 1997)
4 Since both documents were issued by the same body, the document issued later (RF Ministry of
Finance Order "On Confirmation of the PBU 9/99 Accounting Regulation 'Organizational Revenues'"
abrogates the previous document, as long as it does not contradict it.
This situation most frequently arises when the lessee has failed to meet his obligations and the lessor is compelled to annul the lease agreement.

Order 15 does not describe the procedures for returning property when a lease agreement has been prematurely terminated, which leads to the following questions:

- it is not clear how the lessor must write off his debts receivable recorded under account 76, or how to write off the difference recorded in account 83;
- it is not clear how the lessee must write off his debts payable.

Due to differing interpretations of accounting regulations related to leasing transactions, there is an increased risk of fines or sanctions from the tax authorities. To avoid such situations, the parties to a lease agreement should obtain official clarification concerning the application of various legislative regulations from tax or other government authorities.
Taxation is currently one of the most complex and unstable areas in Russian legislation. The partial and gradual adoption of the Tax Code, which defines the main principles of the Russian tax system, has created further complications. Part One of the Tax Code came into effect on January 1999, and on January 1, 2001, the chapter of Part Two of the Tax Code regulating the collection of value-added tax (VAT), excise taxes, personal income taxes, and the unified social tax came into effect. It should also be noted that Law 118-FZ «On the Implementation of Part Two of the Tax Code of the Russian Federation and the Introduction of Changes to Certain Tax Legislation of the Russian Federation» was ratified on August 5, 2000. Therefore, taxation of leasing operations must be governed by Part Two of the Tax Code and other relevant legislative acts, including the statutes of Law 118-FZ.

The Duma is currently reviewing the Chapter «On Profit Tax» of the Tax Code. Until this chapter goes into effect, the Law «On the Tax on Profits of Enterprises and Organizations» remains in force as long as it does not contradict Part One of the Tax Code.1

**Tax advantages currently available to parties to a leasing transaction**

Leasing currently enjoys the following tax advantages over bank loans, internal funds, etc. for equipment purchases:

a) the parties to a leasing transaction may apply accelerated depreciation at an acceleration rate of up to \(3\);2

b) the lessee may include the full amount of the lease payments (if the property is recorded on the lessor’s balance sheet) or depreciation deductions (if the property is recorded on his balance sheet) in production costs, thereby reducing his taxable profits;

c) the lessor may include all interest paid on loans used for leasing transactions3 in his production costs, thereby reducing his taxable profits. If, on the other hand, a company purchases equipment for its own use, it may not claim this benefit.

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3 Interest that has been paid on bank loans used to finance leasing transactions may be included in production costs at a value no greater than the Central Bank’s rate increased by three percent for loans in rubles, or LIBOR plus three percent (but no higher than 15%) for loans in foreign currency.
**Profit Tax**

The current total rate of profit tax paid by leasing companies may not exceed 35%. This total includes a federal rate of 11%, a regional rate of 19%, and a local rate of 5%.

**Rules for Charging Depreciation**

The RF Ministry of Finance and the RF Ministry of Taxation and Revenue have recently been trying to differentiate accounting and taxation standards. One instance of this tendency that has a direct bearing on leasing transactions is RF Ministry of Finance Order 26-n of March 3, 2001, «On Confirmation of PBU Accounting Regulation ‘Registry of Fixed Assets’ (6/01).» According to this statute, companies may choose among the following methods for charging depreciation deductions: (1) the straight-line method (which companies used previously), (2) the declining balance method, (3) the sum-of-years digits method, and (4) the unit of production method. The method most appealing to leasing companies is the third, since the term of profitable use can be determined according to legal restrictions on the use of the property (for example, the term of the lease). If they could use this method, the parties to a leasing transaction could fully depreciate the leased property over the term of the lease, thereby avoiding the problems that arise when registering a not fully depreciated asset in the books.

For tax purposes, depreciation deductions are charged as before: that is, uniformly (straight-line method) from the original value of the property, according to established norms. These norms, established under Resolution 1072 of the USSR Council of Ministers (October 22, 1990), are now outdated, and the need to replace them has long been discussed.

**Surplus Accounting Profits**

If a leased property is recorded on the lessor's balance sheet, then in some cases the lessor may end up with a taxable accounting profit that exceeds economic profits. This can be caused by the following factors:

- the part of the lease payment that compensates for the value of a property is greater than the depreciation deductions for a given period, and
- losses resulting from the sale of a fixed asset at less than its residual value do not reduce the lessor's taxable profits.

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4 This rate is set by regional governments and may not exceed 19%.
5 This rate is set by local government representatives and may not exceed 5%.
7 RF Government Resolution 552 "On Ratification of the Statute Concerning the Composition of Production and Sales Expenses To Be Included in Production Costs, and on Regulations for Calculating Financial Results for the Purposes of Profit Tax", Clause 2.4
8 "A negative result from the sale of fixed assets or their gratuitous transfer does not lower an enterprise's taxable profits for tax purposes" (Clause 2.4 of RF State Tax Service Instruction 37, "On Regulations for the Calculation and Payment of Tax on the Profits of Enterprises and Organizations" (August 10, 1995).
Why does the portion of the lease payment that compensates for the value of a property sometimes exceed the depreciation deductions for a given period?

For tax purposes, companies are required to charge depreciation in a uniformly linear fashion, so that the amount of the depreciation deduction is the same each month. If the lease period coincides with the full depreciation period, and the payments are charged uniformly, then the part of the lease payment that compensates the value of the property equals the depreciation deduction for that period. In most cases, however, the lease payments are scheduled in such a way as to cover the principal sum of the lease payments during the first two years of the agreement, in which case the part of the lease payment that compensates the value of the property is significantly larger than the depreciation deduction for a given period. This is due to the fact that most leasing companies rely on bank loans, which rarely exceed the term of the lease agreement. In most cases, bank loans are issued for no more than two years, while the full depreciation period for leased property, even when using accelerated depreciation, usually exceeds three years. Lease agreements are generally signed for three-year periods, and if the lessee decides to purchase an asset that has not been fully depreciated upon completion of the transaction, the lessor may end up with a surplus accounting profit subject to taxation.

Under Russian tax law, a leasing company must include within its taxable profit the difference between the amount of compensation for the value of a property (that is, the part of a lease payment that compensates the principal sum of the loan) and the amount of the depreciation deduction. If property remains on the leasing company’s balance sheet for the entire period of the lease and fully depreciates, then the leasing company ultimately compensates for this surplus profit by continuing to deduct depreciation. If, however, the lessee elects, upon completion of the agreement, to purchase (at a nominal price) a partially depreciated asset, then the leasing company sells the property for less than its residual value, since the lease payments have fully covered the value of the property over the term of the contract. In such transactions, the leasing company bears a loss. If a property’s residual value could reduce the amount of taxable profit, then there would be no excess tax. But, as we mentioned earlier, a loss from the sale of a fixed asset does not lower an enterprise’s taxable profit base.

In order not to register inflated profits, leasing companies usually extend the lease until the property is fully depreciated.

It is worth noting that a Regulation of the Supreme Arbitration Court (No. 8497/99 of September 12, 2000) confirms that firms may reduce their taxable profits by the amount of their losses from the sale of fixed assets. The Supreme Arbitration Court’s argument is that, according to Article 2 of the federal law «On Profit Tax», the gross profit of an enterprise is subject to taxation. The gross profit is reduced (or increased) in accordance with regulations established by this article. Gross profit is defined as the total profits from revenues from all sales of goods and services, fixed assets (including land), other property of the enterprise and revenues from incomplete operations minus the expenses expended on these operations.

In this respect, the norm foresees that gross profit includes all profits and any losses from the sale of fixed assets and other property.
The fact that losses from sales of fixed assets cannot be deducted from profits is established by an instruction letter, meaning that the instruction letter goes beyond the law. The Court has therefore come to the conclusion that this portion of the law is incorrect.

The tax authorities have been asked for further explanation of this point.

**Value-Added Tax (VAT)**

Leasing operations are taxed at a rate of 20%. The parties to a leasing transaction are generally subject to value-added tax. The amount of VAT payable is defined as the difference between the amount of tax received from the buyer for the sale of goods, labor or services, and the amount of tax actually paid to suppliers for material assets. In the case of leasing transactions, VAT is paid on the difference between the amount of tax received from the lessee as part of the lease payments, and the amount of tax paid on the acquisition of the leased property. This procedure is referred to as the use of VAT offsets, since VAT is intended to be a tax on final consumption.

It often happens that leasing companies pay out more VAT upon acquiring property than they receive in lease payments during a given tax interval. The same situation may arise for the lessee, for example, upon the sale of certain goods, labor or services, which are taxed at a rate of either 0% or 10%. In this case, the difference goes toward the payment of other taxes or duties to the federal budget. If the taxpayer has still not been fully compensated for VAT payments at the end of three months by these tax offsets, the difference must be returned to him. If it is not, interest is paid to the taxpayer on the sum at the Central Bank's refinancing rate. This is a general statute with no particular reference to leasing companies. However, it should be noted that leasing companies are concerned that, in practice, the government will not compensate them for this difference due to continuing budget difficulties in the RF.

**Changes in the Taxation Procedure for Small Enterprises' Lease Payments**

Before passage of the Tax Code, small enterprises' lease payments were fully exempt from VAT. This exemption was meant to help small enterprises, but in actual fact it usually raised the cost of leasing transactions. The lessor included VAT paid on the acquisition of a leased property within the property's book value and received no VAT offset, thereby raising the cost of the lease agreement.

With the enactment of Part Two of the Tax Code on January 1, 2001, this pseudo-benefit has been abolished.

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9 Organizations and individual entrepreneurs have the right to be released from their tax obligations if in the three preceding consecutive calendar months the total amount of turnover from the sale of goods, labor or services of these organizations, not including VAT and sales tax, does not exceed 1 million rubles. RF Tax Code, Part Two, Article 145.

10 RF Tax Code, Part Two, Article 173, Clause 1.

11 RF Tax Code, Part Two, Article 176, Clauses 2 and 3.

12 RF Law "On Value-Added Tax" (December 6, 1991), Article 5, Clause 1 "ya".
**Turnover Taxes**

Turnover from the sale of goods, labor or services is the sole taxable base for the highway tax. For a leasing company, turnover consists of the full amount of lease payments.

The federal highway tax rate is currently 1%.\(^{13}\) As of January 1, 2003, this tax will be abolished.\(^{14}\)

Before 2001, the total turnover tax rate was 4%. Turnover taxes significantly increased the cost of a leasing transaction, resulting in serious harm to companies in financial difficulty, since they were required to pay 4% of their sales volume (that is 4% of the full sum of lease payments in the case of leasing companies), even if they were operating at a loss.

The recent lowering of the turnover tax rate and plans for abolishing it are examples of positive changes in the tax environment.

**Property Tax**

Property tax must be paid by whichever subject of the transaction records the leased asset on his balance sheet. Local governments determine the actual tax rate, but this rate may not exceed 2% of the average annual value of the property.

Recording property on the lessee’s balance sheet increases the property tax dramatically, since the book value of the asset that is recorded in the balance sheet is actually the value of the property plus the leasing company’s margins (see section on Accounting for Leasing Transactions) instead of simply the book value of the asset.

**The Tax Code and Its Effect on Leasing Activity**

It was assumed that the Tax Code would bring order to all the existing legislative and regulatory acts concerning taxation, and that it would ease the tax burden and increase the level of protection for taxpayers. So far, however, the gradual implementation of the Tax Code has only brought more ambiguity and increased the risks to the participants in leasing transactions.

To date, the first part of the Tax Code has been fully implemented, as well as the section of Part Two regulating payment of VAT, excise taxes, personal income taxes and the unified social tax. The Duma is currently reviewing the Chapter «On Profit Tax», which will define the rules and regulations for depreciation of property for tax purposes and the procedure for calculating the profit tax base. The following items pertaining to leasing transactions can be distinguished in the most recent versions of this chapter that have been sent to the Duma for review:


1) parties to a leasing transaction are granted the right to use accelerated depreciation for tax purposes, although the depreciation mechanism varies;
2) parties to a leasing transaction retain the right to choose on whose balance sheet they enter the leased property;
3) a restriction on deducting interest on funds borrowed from off-shore company owners (founders) has been established, which is important for certain leasing companies, since these parties are sometimes their major creditors.

Although the statute on restricting the deduction of interest on borrowed funds is an inconvenience for leasing companies, the tax regime as a whole remains favorable for them. In particular, the parties to a leasing operation have the right to use accelerated depreciation and lease payments to reduce the lessee's taxable profits. They also have the right to choose on whose balance sheet they record equipment, which gives them considerable flexibility in tax planning.

**Taxation of International Leasing Operations**

*Registration with the Tax Authorities*

Accounting procedures for foreign leasing companies are set out in RF Ministry of Finance Order AP-3-06/124 «On Confirmation of the Regulation Concerning Registration of Foreign Companies with the Tax Authorities». According to this Regulation, foreign leasing companies must file with the RF tax authorities on an «authorization basis» in the following cases:

- if they do business in Russia through a branch office, a representative office or other separate departments;
- if real estate or vehicles are leased (by location of the real estate or where the vehicles are registered, including those attached to real estate);
- if they open bank accounts in Russia (by the bank's tax filing location).

In all other cases, the lessor files on a notification basis. Foreign leasing companies also file by notification if they import a movable leased asset into Russia that is subject to property taxes in the Russian Federation. The lessor must notify the tax authorities in the place where the movable asset or payment source is located and to the Ministry of Taxation. Notification must be sent within a month of the first lease payment, or if an advance was received, the date the advance was paid.

**Profit Tax**

If the Russian party to an international leasing transaction is a leasing company, then profit tax must be paid according to general procedures. Article 12 of the law on profit tax stipulates that any profit received outside of the Russian Federation must be included in the tax bearer's profits, subject to Russian taxes, and entered into the books when the size of the tax has been determined. Any profit tax paid in accordance with foreign legislation may be credited, but not in excess of the tax calculated for the same taxable base under Russian legislation. Thus the possibility for double taxation on revenues received abroad is eliminated.
If the Russian party to an international leasing transaction is a lessee, then the following points must be noted. The profit tax levied on foreign legal persons with representative offices in Russia is virtually the same as the tax on Russian enterprises.

If a foreign leasing company does not have a representative office in Russia, then it must follow the following statutes. According to Clause 5.1.8 of State Tax Service Instruction 34 «On Profit and Income Tax for Foreign Legal Entities» (June 16, 1995), leasing revenue received from sources within the Russian Federation must be included in the foreign legal entity’s income, subject to income tax at the source of payment. Revenue from leasing operations is calculated on the basis of the entire sum of lease payments minus the amount of compensation paid for the value of the leased property, the amount of compensation paid for the use of borrowed funds towards the purchase of the leased property, and the amount of tax paid on the leased property. Revenue from leasing operations is taxed at a rate of 20%.

According to Clause 5.2 of the above-mentioned Instruction, the tax on a foreign company’s income from leasing operations must be withheld by the person who is the source of this income (in this case, the lessee) in the currency of the lease payments and upon transfer of each payment. The lessee is responsible for withholding the full amount of the tax from the foreign leasing company’s revenue; in the event that the lessee transfers payment to a foreign leasing company without withholding tax, the full amount of the tax will be withheld from his own revenues.

As indicated above, these tax regulations apply to all foreign leasing companies that do not have representative offices in Russia. If the lessee acts through a representative office, then the lease payments will be included in the representative office’s taxable base and subject to profit tax.

International or bilateral agreements or treaties ratified by the USSR or the Russian Federation may establish other tax procedures for foreign leasing companies. This is particularly true when bilateral taxation treaties (so-called ‘double taxation agreements’) are in force. If, for example, a leasing company has permanent residence in Canada, does not have a representative office in Russia, and leases movable property (equipment, machinery, computers, etc.) to a Russian lessee, then its revenue from sources within the Russian Federation is subject to taxation in Canada. In this case, the leasing company has the right to a refund of taxes withheld by the lessee. The leasing company may also petition the tax agency in the location where revenue is received for permission not to withhold taxes at the source of payment (the lessee).

**VAT Refunds**

Before the section of Part Two of the Tax Code regulating payment and reimbursement of VAT was implemented, parties to international lease agreements had to deal with ambiguities surrounding the reimbursement of VAT paid in such transactions.

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15 In transactions involving Russian leasing companies, lease payments received are also exempted from VAT.

16 See the Russian-Canadian Agreement on the Elimination of Double Taxation and the Prevention of Income Tax Evasion (October 5, 1995).
Now, however, according to Article 172 of the RF Tax Code, Part Two, VAT paid by the lessee upon bringing fixed assets into the Russian Federation may be offset against other VAT payments once the assets are recorded on the balance sheet. It should be kept in mind that the date the leased property is recorded in on-balance or off-balance sheet accounts is considered the recording date for the purposes of applying VAT.\(^{17}\)

In order to obtain reimbursement for VAT paid on lease payments under an international leasing transaction, foreign leasing companies must issue an invoice and provide other documents confirming actual payment of the tax amounts.\(^{18}\) Thus, there should, in principle, be no difficulty obtaining reimbursement for VAT paid on lease payments to a foreign lessor.

**Property Tax**

A foreign leasing company is responsible for property tax, if, according to the terms of the lease agreement, it records the leased asset on its balance sheet.\(^{19}\) The basis for determining the value of the property for tax purposes is the residual value, determined from the original cost (acquisition cost), with consideration for wear and tear according to the laws of the leasing company's country of permanent residence. For tax purposes, depreciation charges may not exceed the following amounts in one year:

- **a)** for buildings and other facilities - 5%;
- **b)** for light vehicles, office furniture and equipment, computers, information systems and data processing equipment - 25%
- **c)** for other property - 15%.\(^{20}\)

Just as with profit taxes, other payment rules for this type of tax may be stipulated by international agreements of the USSR and the Russian Federation.

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\(^{17}\) RF Ministry of Finance Letter N 04-06-05 of November 12, 1999.

\(^{18}\) RF Tax Code, Part Two, Article 172, Clause 1.

\(^{19}\) RF Law 2030-1 "On Property Taxes of Enterprises" of December 13, 1991 (with subsequent changes and additions), Articles 1 and 2.

Russian currency regulations presently stipulate a set of restrictions on currency operations that also apply to lease agreements. In particular, the following are deemed to be operations involving the movement of capital or operations requiring authorization from the Central Bank of the Russian Federation (CB): granting or accepting deferral of payments for a term of 90 days or more for the export and import of goods, labor or services and granting or accepting financial loans for a term of 180 days or more. These restrictions apply to payments in both Russian rubles and foreign currencies.

At the same time, Article 34 of the Law stipulates that:

- without the permission of the CB to engage in currency operations involving the movement of capital, the lessor may accept monetary investment from non-residents for the purpose of acquiring leased assets for a period of more than 180 days, but not for longer than the term of the lease agreement (it should be noted that only resident lessors enjoy this right);
- without the permission of the CB to engage in currency operations involving the movement of capital, leasing companies may pay interest on payment deferrals granted by the vendor of a leased asset, regardless of when the asset was received;
- the movement of a leased asset across the Russian border for use under a lease agreement of 180 days or more and payment of the full amount of a lease agreement in a period of more than 180 days do not qualify as operations involving the movement of capital, in accordance with Russian currency legislation.

These statutes of Article 34 of the Law contradict existing Russian currency regulations, particularly RF Law 3615-1 «On Currency Regulation and Control» (October 9, 1992) (henceforth Law «On Currency Regulation»). The Law «On Currency Regulation» stipulates (in the preamble) that it alone defines the principles of currency operations in the Russian Federation; the powers and functions of the regulatory agencies and inspectorates for currency operations; the rights and obligations of legal entities and individuals in relation to the possession, use and distribution of currency; and the responsibility for violations of currency regulations.

The parties to a leasing transaction must bear in mind these contradictions, which we shall now examine in greater detail.

**Borrowed Funds (Loans, Credit)**

According to Article 1 Clause 10 «d» of the Law «On Currency Regulation», the act of granting or accepting financial loans for a term of 180 days or more is considered a currency operation involving the movement of capital. Article 6 Clause
2 of this law states that residents must follow the procedures established by the CB when engaging in currency operations involving the movement of capital. Thus it is the prerogative of the CB, and not of any other legislative act, to establish procedures for currency operations involving the movement of capital.

**Loans in Foreign Currencies**

The procedures for receiving loans from non-residents are currently regulated by the Statute 129-P «On the Issuance of Permits by Regional Offices of the CB to Resident Companies Engaging in Various Currency Operations Involving the Movement of Capital» of December 21, 2000 (Statute 129-P) of December 21, 2000, and the part of the Statute «On Procedures for Accepting Financial Loans and Credit in Foreign Currency from Non-Residents for Periods of 180 Days or More», confirmed by RF Central Bank Letter 527 (October 6, 1997) (Statute 527) concerning «registration-based» loan agreements. Thus, if the conditions of the loan agreement fall under the authorization procedures stipulated in Statute 129-P, then the resident borrower (whether lessor or lessee) must obtain the necessary authorization from the CB, regardless of Article 34 of the Law.

**Loans in Russian Rubles**

The procedure for ruble loans and payments between residents and non-residents is currently regulated under Russian Central Bank Instruction 93-I «On Procedures for Opening Authorized Non-Resident Bank Accounts in Russian Rubles and Conducting Operations on These Accounts» (October 12, 2000). According to this Instruction, residents may receive ruble credits or loans from non-residents using funds from Type «K» or «N» ruble accounts opened in accordance with the above Instruction and the laws of the Russian Federation. Thus, residents receiving credits or loans from non-residents for a period of more than 180 days must have authorization from the CB.

**Deferral of Payments for Equipment Purchased by Russian Lessors**

Under Article 1 Clause 9 «v» of the Law «On Currency Regulation», dividends, interest, and other income from investments, loans or operations involving the movement of capital may be transferred to or from the Russian Federation without the authorization of the CB. Thus, leasing companies do not need authorization from the CB to pay interest on deferred payments. This agrees with the above-mentioned statute of Article 34 of the Law.

However, according to Article 1 Clause 10 «g» of the Law «On Currency Regulation», any deferral of foreign-currency payments for the import of goods, labor or services is considered a currency operation involving the movement of capital and requires authorization from the CB. Let us consider the following two possibilities:

- payment is made before the goods are fully imported to the RF;
- payment is deferred until after the goods have been fully imported to the RF.
In the first case, the Russian lessor must obtain authorization from the CB to defer foreign-currency payments to a foreign vendor for longer than 90 days if the goods have not been fully imported. The application procedures for this authorization (license) are defined in the regulations of the CB, particularly Letter 12-524 of October 6, 1995, which lists the documents that must be submitted with the application. It should be noted that this list is quite extensive, but not exhaustive; that is, the Central Bank may ask for additional documents or information in order to clarify certain points. Moreover, it takes one to three months, on average, to process the application, even though the regulations stipulate a maximum period of 30 days. Naturally, this makes it less appealing to sign an international lease agreement that defers payment until the property has been imported to the Russian Federation.

One must also remember that, if there are any delays in the delivery of an asset beyond the 90-day limit (even if only by a day or two), the leasing company must apply to the Central Bank for the necessary license.

In light of the above, the simplest solution is to obtain a payment deferral for longer than 90 days, with payments made on the imported goods only after they have been fully imported into Russia. According to Statute 39 «On Changes to the Procedures for Certain Currency Operations in the Russian Federation», confirmed by CB Order 02-94 of April 24, 1996 Russian residents do not need a license to transfer foreign currency out of the Russian Federation, or into currency accounts held under the name of a non-resident in an authorized bank, when paying for imported goods after they have cleared customs, regardless of the amount of time that has elapsed between clearing customs and transfer of payment.

**Payments in Rubles**

Another way for resident lessors to circumvent licensing policies at the Central Bank is to pay for imported equipment in Russian rubles. One must bear in mind, however, that, according to the changes introduced into the Law «On Currency Regulation» on December 29, 1998, payments between residents and non-residents in Russian rubles qualify as currency operations. The State Duma is reviewing a bill, under which the distinction between current operations and operations involving the movement of capital, which until now has only applied to transactions involving foreign currency or securities valued in foreign currency, would in future be applied to payments between residents and non-residents in Russian rubles. If this bill passes the Duma, Russian lessors will also need a license from the CB in order to make payments in Russian rubles.

**Lease Payments**

Russian lessees may make lease payments to foreign lessors in foreign currency or in Russian rubles.

**Payments in Foreign Currency**

Payments made under a lease agreement are considered payments for imported services in accordance with an agreed schedule. Given the long-term nature of
leasing transactions, it is unlikely that any lease agreement would be concluded for a period of less than 90 days. Consequently, according to existing currency regulations, Russian lessees must obtain permission from the CB to make lease payments under international lease agreements.

As noted above, Article 34 of the Law stipulates that payments on leases of six months or more are not considered currency operations involving the movement of capital. Unfortunately, this statute is difficult to implement in practice, since it contradicts existing currency laws. Several leasing companies did send inquiries to the Central Bank, however, and were told that, according to Article 34 of the Law, the procedures for current currency operations should apply to leasing transactions. Given the current confusion, it is advisable to obtain permission.

Payments in Rubles

The analysis and conclusions contained in the previous section under «Ruble Payments» apply equally to ruble payments made by Russian lessees to foreign lessors under international lease agreements.

Import and Export of Leased Assets across the Russian Border

According to Article 34 of the Law, the import and export of a leased asset across the Russian customs border under a lease agreement of six months or longer does not qualify as an operation involving the movement of capital. It should be noted that the import and export of equipment does not, in and of itself, constitute a currency operation in the sense of the Law «On Currency Control». Article 1 Clause 8 of this law only applies the distinction between current currency operations and operations involving the movement of capital to operations involving foreign currency (or securities valued in foreign currency) only.

In order to avoid confusion, the Law «On Leasing» should be made to correspond with the Law «On Currency Control».

Repatriation of Lease Payments from Russia by Non-Resident Leasing Companies

As follows from the above, non-residents may receive payments for equipment supplied to Russian lessors, as well as lease payments from Russian lessees, in either Russian rubles or foreign currency.

For payments in a foreign currency, the resident must transfer funds from an account in an authorized bank to the non-resident’s foreign bank account. If payments are made in Russian rubles, non-residents must change them into foreign currency in order to repatriate them.

The sale of foreign currency to non-residents is currently regulated under Russian Central Bank Instruction 93-I «On Procedures for Opening Authorized Non-Resident Bank Accounts in Russian Rubles and Conducting Operations on These Accounts» (October 12, 2000). This instruction gives non-residents the right to
purchase foreign currency without restrictions on the domestic currency market through authorized banks, using funds from their Type K ruble accounts; at the same time, significant restrictions, stipulated in Clause 3.8 of the Instruction, are placed on foreign currency acquired using funds from Type N accounts.

The non-resident must purchase foreign currency at the exchange rate set by an authorized bank.

In order to expatriate foreign currency purchased on the Russian market, non-residents must open hard-currency accounts in authorized Russian banks in addition to maintaining their ruble accounts. The procedure for opening and maintaining hard-currency accounts is essentially the same for both residents and non-residents. After purchasing foreign currency with funds from their ruble accounts, non-residents must deposit the currency in their Russian hard-currency accounts, from which they may transfer the currency to their foreign bank accounts. The procedures described here agree completely with the Law «On Currency Control», particularly Article 8 Clause 3, which states that non-residents may transfer or export currency valuables from the Russian Federation if these valuables were obtained within the Russian Federation on the principles established by Russian law.
CUSTOMS REGULATIONS
FOR LEASING OPERATIONS

Import and Export of Leased Assets

Current Russian customs laws stipulate that goods imported to the Russian Federation under lease agreements may be imported under either of two customs regimes: one for the release of goods into free circulation (import), and one for the temporary import of goods (temporary import). If the goods are taken out of the customs territory of the Russian Federation under a lease agreement, then the corresponding regime for export or temporary export apply.

Import

Under the treatment for the release of goods into free circulation, the person who imports the leased asset must also pay all customs duties, fees and value-added taxes in full. Russian customs duties generally vary from 5% to 25% of the asset's customs value.

Export

Goods may be exported upon payment of export duties and other customs fees, on the condition that all economic policies and other requirements stipulated under Russian customs legislation have been observed. Export duties generally apply only to oil and gas and other natural resources. Value added tax is not applied to goods exported, or, if VAT has already been paid, the VAT is subject to refund in accordance with Russian tax laws.

Temporary Import and Export of Goods

Leased assets may also fall under customs regulations for temporary importation or exportation of goods. When this regime is applied, the temporarily imported or exported goods are partially exempted from customs duties and taxes. Temporarily imported or exported goods must be returned in identical condition, except for normal wear and tear.

Under the regulations for temporary import and export, customs duties must be paid for each full month or part thereof at the rate of 3% of the sum that would have been paid if the goods had been released into free circulation or exported under the customs regime for exports. The sum of customs duties and taxes is calculated in US dollars, using the customs, tax and duty rates in effect on the date a customs declaration indicating use of the temporary import or export regime was received. The periodic customs payments calculated under these procedures must be paid in advance within the period established by the customs agency. The customs agency may not demand payment of more than
three periodic payments at one time. Payments are made according to the dollar exchange rate in effect on the date of payment.

The sum total of customs duties and taxes levied on temporary imports or exports with partial exemptions from customs duties and taxes should not exceed the sum of customs duties and taxes that would have been paid at the time of import or export if the goods had been released into free circulation or exported under the export customs regime. If these sums are identical, then the assets are treated as if they were released into free circulation or exported under the regulations for exports. This is hardly likely, however, if one considers that the maximum period for applying this customs regime is two years. Consequently, the amount of customs duties and taxes paid equals 72%.

When the deadline for returning the temporarily imported or exported assets expires, the assets must be reclassified under a different customs regime or transferred to a temporary storage facility. When the assets are re-exported or reclassified under a different customs regime (i.e., formally imported), the periodic customs payments that have already been made are not reimbursed. But if imported assets are reclassified under the regulations for goods released into free circulation (formally imported), or if exported assets are reclassified under the export regulations, then the sum of periodic customs fees already paid would be credited towards the payment of customs duties and taxes under the new classification.

Payments are calculated on the basis of the customs duties, taxes and foreign exchange rates in effect on the date the customs declaration requesting treatment for free circulation or export was received. The asset’s customs value is the value as of the date the asset was placed under the temporary import or export regime. Interest is charged at the Central Bank rate for any payment deferrals on customs duties or taxes that were granted during the period that the asset fell under one of the two regimes. If the payment of customs duties and taxes was deferred while the goods remained under the temporary import regime, interest is charged at the rate established by the Central Bank. Interest is calculated using the dollar exchange rate effective for the date when the customs declaration was received (RF State Customs Committee Letter 05-11/5175 of March 20, 1997). It should be noted that according to RF State Customs Committee Telegram TF-9644 of April 23, 2001, interest is not collected until further orders from the Russian State Customs Committee are received.

Using the Temporary Import and Export Regime in Practice.

The problem with this customs regime for leasing transactions is that the maximum period for temporary import or export of goods cannot exceed two years, while lease periods are generally longer. Furthermore, this regime can only be used with the permission of the Russian State Customs Committee.

It would make sense to change the customs legislation, especially Chapter 11 of the RF Customs Code, to allow the period for temporary importation of leased assets to equal the period of the lease agreement. The State Customs Committee could solve this problem by issuing a decree, increasing the period for the temporary import and export regime for leased assets.
**Other Matters Pertaining to the Importation of Leased Assets to Russia**

The basis for calculating all customs duties, excise duties and customs fees is the customs value of an asset, defined according to the RF Law «On Customs Tariffs». In practice, the customs agencies base their assessment of the asset’s value on the value of the agreement. This method dramatically increases the customs value of a leased asset compared to its market value, since the value of a lease agreement includes not only the actual value of the asset, but also various other payments (such as the cost of training the lessee’s personnel or maintaining the leased asset, not to mention the customs fees themselves).¹

However, according to Article 19 Clause 2 of the RF Law «On Customs Tariffs», the customs value of an asset may not be calculated on the basis of the contract value in cases where the buyer has only limited rights to the asset. Such limited rights are, indeed, a feature of leasing transactions, since the lessor does not have the right to dispose of the leased asset and may also be restricted in his right to possess or utilize the asset. Therefore, the customs agencies must use other methods to calculate the customs value of leased assets.

**Defining the Customs Value of an Asset**

When the customs value of an asset leased under an international (cross-border) lease agreement is calculated on the basis of the contract value, the sum total of the lease agreement increases significantly for the lessee. In order to solve this problem, the Russian State Customs Committee will need to issue a decree bringing the procedures for calculating the customs value of imported leased assets in line with the procedures for calculating the customs value of exported goods.²

**Preferential Treatment and the Payment of Customs Fees**

Article 34 of the Law effectively established a new tax treatment for leased assets transported across the Russian customs border under international lease agreements. It was assumed that customs payments would be made together with lease payments. Russian legal practice dictates, however, that these regulations be written into special legislation. It is unlikely, therefore, that leasing companies will be able to claim the benefits stipulated under the Law in actual practice. This point of view has been corroborated by the RF State Customs Committee's Letter 01-15/14858 of May 24, 1999, in which it was stated that Article 34 of the Law cannot be applied in practice since it contradicts Part One of the Russian Tax Code.

In order to correct this situation, either the customs regulations should be made to agree with Article 34 of the Law, or vice versa.

¹ See Article 27 of the Law.
The Absence of Discounts for Leasing Transactions

A fundamental problem hindering the development of leasing in Russia is that equipment imported to Russia under lease agreements do not enjoy any discounts or benefits (such as those provided for equipment added to the productive assets of enterprises) over ordinary imports. Clause «о» of Article 35 of the RF Law «On Customs Tariffs,* which applies to goods imported under production-sharing agreements, does provide for customs discounts for imported leased assets. These discounts do not apply to all lease agreements, however, but only to leased equipment imported as part of a production-sharing agreement.

The development of leasing on an equal basis with other forms of investment may depend on the creation of a system of customs benefits for leasing transactions, as stipulated under Article 35 of the RF Law «On Customs Tariffs» (May 21, 1993).4

Returning Leased Assets to the Lessor

Upon expiration of a lease agreement, the leased asset must be returned to the lessor, unless otherwise stipulated within the agreement.

When a leased asset that was previously taken out of Russia as an export is returned to a Russian lessor, the leasing company may bring the asset into Russia under the re-import customs procedures. These procedures are exempted from duties and tax. In order to qualify for the re-import procedures, the assets must be brought into Russia within ten years after export, and they must be in the same condition as they were during export, except for normal wear and tear. If assets are re-imported within three years after export, the Russian customs agency must refund all export duties and taxes that have already been paid (although these are unlikely in the case of a lease agreement), while the person re-importing the goods must refund any sums received as payment or as a result of other benefits granted during export (the Russian government may require interest to be paid on these returned sums, calculated according to the Central Bank rate).

Re-Export of Leased Assets from the Russian Federation

There are, however, a variety of technical problems with the re-export of leased assets from the Russian Federation. A leased asset that was imported under the procedures for release into free circulation can only be exported under the procedures for exports, which means that customs fees must be paid, as stipulated under Article 98 of the Russian Customs Code.

Moreover, foreign lessors have no real means of controlling the export of the leased asset, whether the asset was imported under the procedures for imports or

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3 See RF State Customs Committee Letter 01-33/1827 "On Goods Imported as Contributions to Charter Capital" (January 25, 1999) and RF Tax Code, Article 150, Clauses 7 and 1.
4 Article 34 stipulates that a customs benefit is a benefit provided either on condition of reciprocity or unilaterally, for the transportation of goods across the Russian customs border, and taking one of the following forms: refund of previously paid duties, exemptions from duties, lowered duties and discounts for preferential imports.
for temporary import, since all of the customs documents must be drawn up by the same person who imported the assets.

Russian customs laws should be amended to allow lessors the right to export leased assets under re-export procedures. It would also help to set up procedures that would allow leasing companies to control the export of leased assets independently of the person who imported them.
ANTI-MONOPOLY REGULATIONS FOR LEASING OPERATIONS

By Russian law, some leasing transactions are subject to anti-monopoly regulations.

According to Article 18 of the RF Law «On Competition and the Restriction of Monopolistic Activities on the Commodities Market (March 22, 1991) and Article 16 of the RF Federal Law «On the Preservation of Competition in the Financial Services Market» (June 23, 1999) one must inform and receive prior authorization from the Ministry for Anti-Monopoly Policy and the Support of Enterprise (MAP) or its territorial branches before engaging in certain types of leasing operations or sales transactions for leased assets.

It should be noted that Russian anti-monopoly legislation applies equally to resident legal persons and foreign companies doing business in Russia.

Anti-monopoly regulations for leasing may be satisfied either by obtaining prior authorization from MAP before concluding a transaction, or by informing MAP after concluding the transaction, depending on the value of the parties' assets.¹ The petition for prior authorization or notification of a completed transaction must be submitted by the person who acquires the leased asset; that is, by the lessor under a sales agreement, or the lessee under a lease agreement.²

It is not clear from the current anti-monopoly legislation how a party to the leasing transaction should know the correlation between the book value of the leased asset and the book value of his counter-party's principal production assets or total assets. As a result, the person acquiring the leased asset may be held accountable for violations committed through no fault of his own. Russian anti-monopoly laws should be changed so that the petition for prior authorization or notification of a completed transaction is submitted by the party whose balance figures cause the transaction to fall under anti-monopoly regulations. MAP must be informed of a completed transaction in the following cases:³

Sales agreements for leased assets:

- the book value of a leased asset that is the vendor's principal means of production exceeds 10% of the book value of the supplier's principal means of production and non-material assets; and

¹ According to the Anti-Monopoly Law, a party must obtain prior authorization from MAP, regardless of the value of the asset, if he has more than a 35% share in the market for that good.
² Clause 4.3 of the Statute "On Procedures for Submitting Petitions to the Anti-Monopoly Agencies in Compliance with Articles 17 and 18 of the Law "On Competition and the Restriction of Monopolistic Activities on the Commodities Market" (confirmed by MAP Order 276 of August 13, 1999).
³ Article 18 Clause 2 of the Anti-Monopoly Law and Clause 3.1.2 of the Statute on Procedures for Submitting Petitions.
- the value of the assets on both the supplier's and the lessor's balance is between 50,000 and 100,000 times the minimum wage.4

**Lease agreements:**
- the book value of a leased asset that is the leasing company's principal means of production exceeds 10% of the book value of the lessor's principal means of production and non-material assets; and
- the value of the assets on both the lessor's and the lessee's balance sheet is between 50,000 and 100,000 times the minimum wage (this currently amounts to 4,175,000 to 8,350,000 rubles). Notification must be submitted to MAP 15 days after the deal is concluded.5

If the value of the assets on both the supplier's and the lessor's balance sheet (for sales agreements) or both the lessor's and the lessee's balance sheet (for lease agreements) is greater than 100,000 times the minimum wage, then the parties must obtain prior authorization from MAP.

Under current legislation, many leasing transactions are subject to anti-monopoly laws. Far fewer transactions fell under the purview of anti-monopoly laws before the financial crisis of August 17, 1998, but after the ruble fell dramatically and the minimum wage changed only slightly in response, the number grew significantly.

It is absolutely essential to change Russian anti-monopoly legislation so that the book value of assets is defined not only by the size of the minimum wage, but also takes inflation into account.

**Antimonopoly regulation of leasing transactions as a form of financial service**

As follows from Article 3 of the Law «On the Preservation of Competition in the Financial Services Market,» a lease agreement is regarded as a transaction for rendering financial services.6 As a result, a lease agreement falls under two antimonopoly regulations. Therefore, when concluding leasing transactions, the parties must adhere to the statutes of this Law and RF Government Resolution 194 «On the Conditions for Antimonopoly Control of the Financial Services Market and Confirmation of the Procedure for Determining Turnover and Market Limitations on the Financial Services of Financial Organizations» (March 7, 2000). Of all leasing transactions, only those in which more than 10% of the assets of a leasing company are acquired as a result of one or more transactions involving cession of rights of claim fall under double antimonopoly regulation.

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4 By RF Federal Law 82-FZ "On the Minimum Payment for Labor" of June 19, 2000, the minimum wage for calculating amounts not involving payment for labor was set at 100 rubles on January 1, 2001.

5 Article 18 Clause 5 of the Anti-Monopoly Law.

6 As follows from Clause 25 of the List of types of financial services subject to anti-monopoly regulation and the composition of assets of financial organizations acquired by cession of rights of claim for calculating turnover of a financial service (confirmed by MAP RF Order 212 of March 3, 2001), both the transfer of property for the purpose of leasing and the acquisition of property for future leasing are classified as financial services rendered within a leasing transaction. In our opinion, this position is unjustified and contradicts the norms of the above-mentioned law.
Unfortunately, it is impossible to make a definite conclusion about what is meant by the acquisition of the assets of a financial organization in a leasing transaction: either the transfer of the leased asset for temporary holding and use or the purchase of the leased asset by the lessee. Therefore, leasing companies must either resolve this problem themselves or by means of written consultation with the antimonopoly authorities.

The process for obtaining authorization depends on the amount of a leasing company's charter capital. According to Clause 3.4 of the Statute on the procedure for authorizing completion of a transaction involving the acquisition of assets or shares (share of charter capital) of financial organizations, the person acquiring the assets of a leasing company applies to the antimonopoly authorities for authorization.

Prior authorization from MAP for concluding a transaction must be obtained when acquiring more than 10% of the book value of a leasing company's assets if the company's charter capital exceeds 5 million rubles. All necessary documents are submitted to the federal antimonopoly authorities, who must advise the parties of their decision in writing within 30 days.

If the leasing company's charter capital is less than 5 million rubles, the lessor informs the federal antimonopoly authorities of completion of the transaction within 30 days of its completion.

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8 This is formulated in RF Government Resolution 194, Clause 4 (March 7, 2000) and differs somewhat from the formulation fixed in FZ RF "On the Preservation of Competition in the Financial Services Market."
9 The list of necessary documents given in FZ RF "On the Preservation of Competition in the Financial Services Market," Article 17, Clause 2 is quite extensive.
LICENSING OF LEASING OPERATIONS

Leasing licenses are currently regulated by Federal Law 158-FZ of September 25, 1998, «On the Licensing of Various Types of Activity» (Licensing Law) and RF Government Resolution 80 of January 2, 2001, «On Ratification of the Statute ‘On Licensing of Financial Leases (Leasing) in the RF’ (Statute).» The licensing of various economic activities is a natural function of government agencies.¹ Several issues pertaining to leasing licenses require further explanation.

The License's Term of Validity

According to the above-mentioned regulatory acts, licenses are issued for a period of five years. Licenses may be issued for shorter periods (but not for less than one year) upon the request of the applicant. However, some leasing transactions require longer terms than the maximum term of the license. What should a leasing company do if its license expires before the end of a lease? What happens to active leases when the leasing company’s license expires?

Since the legislation currently in force does not provide any answers to these questions, it is very possible that the license will expire before the company has obtained a new license or an extension to the existing one, which means that during the period in which there is no license, the lease agreement will be considered an ordinary rental agreement. The consequences of this could be fines imposed by the tax authorities for unlawful use of benefits.

License Inspection

The Statute grants licensing authorities the right of control over the license holder's observance of licensing requirements. Therefore, it should be taken into account that a license can only be annulled by a court decision. The following are grounds for legal action by the licensing body or government authorities:

a) discovery of false or distorted information in documents submitted for obtaining a license;

b) repeated or gross violations of licensing requirements by the license holder;

c) illegal issuance of a license.

While the court is reviewing the case for annulling the license, the licensing body has the right to suspend the license. The following instances may also provide grounds for suspension of a license:

a) the licensing body or other government bodies identifies violations of licensing requirements by the license holder that may result in

¹ Leasing licenses are currently issued by Ministry for Economic Development and Trade.
harm to citizens’ rights, legal interests, morals or well-being, or to the country’s defense capacity or national security;

b) the license holder fails to abide by the decision of the licensing body obliging him to end these violations.

**Licenses for Subleasing**

Russian legislation does not indicate whether or not a lessee acting as a lessor under a sublease must obtain a leasing license. According to the Licensing Law, any organization that engages in leasing in the capacity of a lessor must obtain a leasing license. But one of the defining characteristics of a leasing transaction is that the lessor purchases the leased asset with his own or borrowed funds. According to Article 3 of the Federal Law «On the Preservation of Competition in the Financial Services Market» (June 23, 1999), leasing is a type of financial service; that is, a type of service that involves the investment and use of legal or natural persons' monetary assets. This element is absent in the case of subleasing, since the lessee does not invest any funds in the asset. From this we conclude that a license is not necessary for subleasing.

**Leasing Licenses for Foreign Leasing Companies**

According to Article 6 Clause 3 of the Law «On Leasing», non-resident leasing companies must also obtain a leasing license. This requirement has no justification in economics or international law or leasing practice. In our opinion, the requirement also contradicts Article 161 of the Principles; Article 1 Clause 2 of the Law on Licensing; and Article 2 of the Federal Law «On Foreign Investment in the Russian Federation», all of which stipulate that a foreign legal entity's legal capacity should be defined according to the laws of the country where he is established. In spite of these contradictions, the requirement that non-resident leasing companies be licensed is confirmed in the «Statute on Licensing». Accordingly, if non-resident companies engage in leasing activities in the Russian Federation without a license, there will inevitably be negative consequences for the parties to a lease agreement.
One of the most important incentives for signing a leasing deal is the presence of a favorable legal climate and, above all, favorable tax conditions for leasing. The abrogation or even the reduction of benefits usually leads to a drastic fall in the number of leasing transactions. The preservation of existing benefits is one of the most important strategic tasks for the development of leasing in Russia.

Another important task is to legitimize the benefits stipulated under the Law: it is essential to take into account and examine critically all the statutes of the Law that are aimed at providing leasing with benefits in the sphere of economic regulation of commercial activities, especially those benefits connected with taxation, customs and currency regulation. The outcome of this work should be the amendment of all corresponding tax, customs and currency regulations.

Finally, the third task is to eliminate existing contradictions in leasing legislation, which would promote the growth of leasing in Russia. The Law must be amended so that it no longer contradicts the Civil Code. The amended Law should focus on regulating relations between the parties to a leasing transaction. At the same time, the amended version of the Law, based on the principle of free contractual relations, should not restrict relations between the parties in as much detail as the current version.

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1 Thus, due to the cancellation of many tax and accounting benefits, as well as the introduction of other restrictions, the volume of leasing transactions in many Western European countries has fallen significantly.