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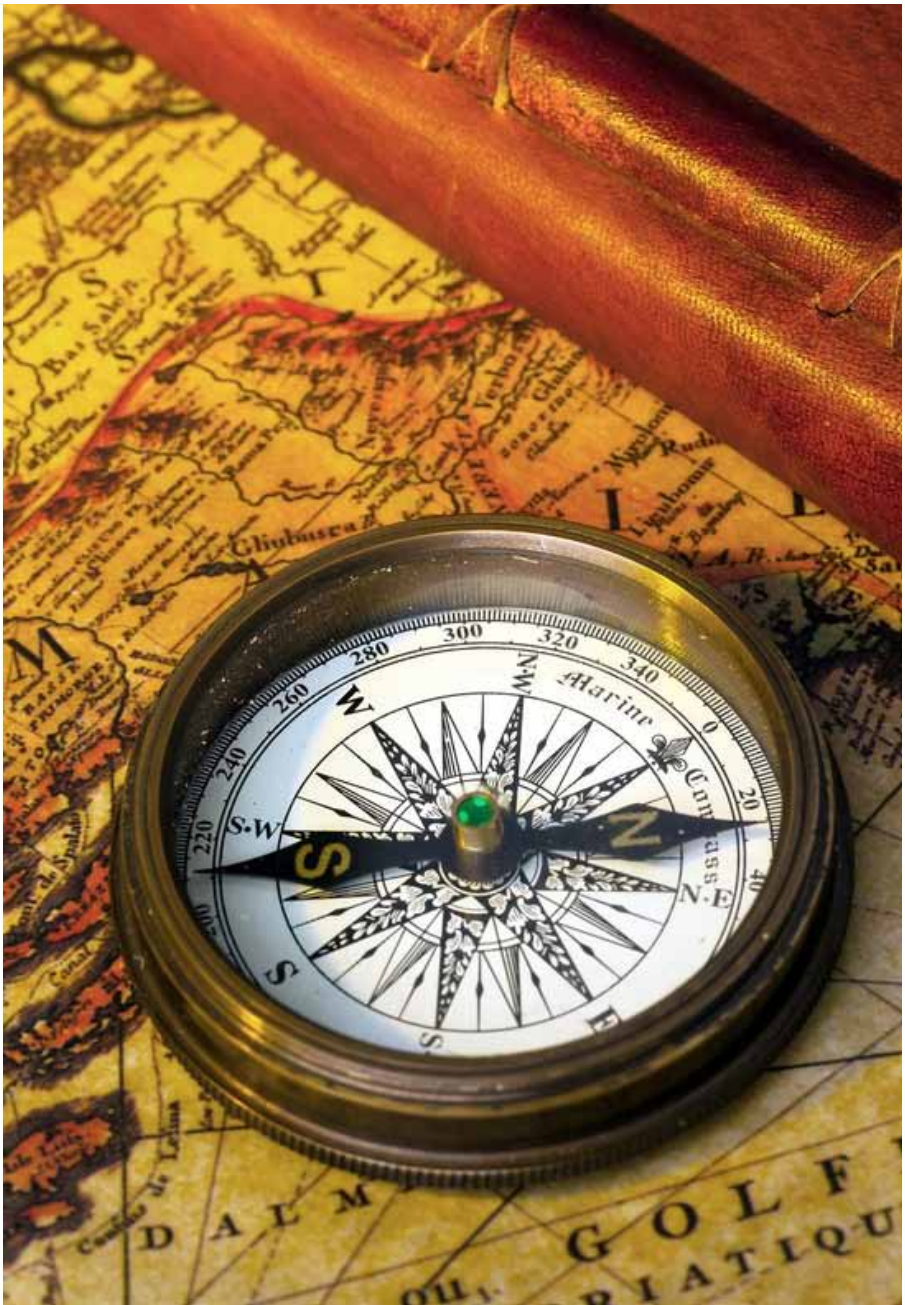
Tax and Legal Guide to the Russian Oil & Gas Sector



Energy & Resources

Contents

Overview of Russian Oil & Gas sector

Key facts and general statistics

Russia is one of the major players in the world's natural resources market. It has the largest reserves, and is the largest exporter of natural gas. It is also the world's largest producer of crude oil, and its territory contains the seventh largest oil reserves on the planet.

The energy sector is, historically, one of the main drivers of the Russian economy, amounting to roughly 25% of the country's GDP. The exports of crude oil, oil products and natural gas made up over 60% of all Russian exports in 2009. The exports of mineral products accounted for 68.8% of total exports in 2010.

The Russian oil & gas sector is also characterised by the high share of state-controlled companies and its tough administrative restrictions.

All these facts should be taken into account and an optimal strategy developed before carrying out business.

Further description and analysis of the oil & gas industry is presented in this guide.

Crude oil industry

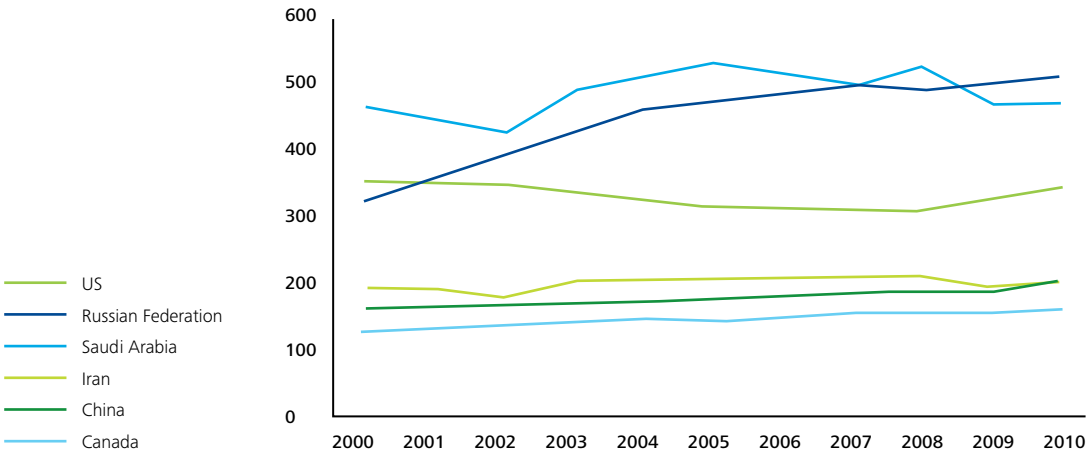
Reserves and production

Russia was the world's largest crude oil producer in 2010, with 12.9% of the world share, ahead of Saudi Arabia in second place with 12%. Although Russia's proven oil reserves accounted for only 5.6% of global reserves (compared to Saudi Arabia's 19.1%) at the end of 2010, it is expected that considerable additional reserves will be located offshore and in the less-explored areas of Eastern Siberia.

Throughout the last decade, crude oil production in Russia was generally on the increase, and the country's share in total global production grew from 8.95% (2000) to 12.9% (2010). A slight decrease in production in 2008 was primarily caused by the depletion of oil fields in the Western Siberia region. Contrary to the expectations of many experts and analysts who predicted that production would only continue to decrease, Russian production of crude oil and gas condensate increased by 1.5% to 494 MT in 2009, and by a further 2,2% to 505 MT in 2010. According to reports by the Federal Statistics Service, Russian oil production increased to 509 MT in 2011.

This recent increase in production comes as a result of beginning production on a number of new fields, especially in Eastern Siberia, such as Verkhnechonskoye field in 2008 and Vankor field in 2009. Recent and proposed developments in oil production are discussed in more detail under the "Recent and proposed development projects" section.

Top 5 Crude Oil Producting Countries 2000 – 2010, mln tons



Exports and transportation

The state-owned pipeline monopoly Transneft transfers 93% of all Russian-produced crude oil. The length of the main oil pipelines averages at 70 thousand km, and 19.3 thousand km for pipelines carrying oil products. In 2010 Transneft transferred over 466 MT of oil via its trunk pipelines. The rest is transported by oil companies themselves.

Table 1

Destination of shipments	mn t	%
Atlantic market		
Europe	170.4	77.2
North America, Atlantic Cost	11.3	5.1
Middle East and Africa	1.0	0.5
Total	**182.7**	**82.8**
Pacific market		
Asia-Pacific region	35.7	16.2
North America, Pacific coast	2.3	1.0
Total	**38.0**	**17.2**
TOTAL	**220.7**	**100.0**

Russia's crude oil suppliers to the key global markets in 2010

Ranked seventh in the world in terms of oil reserves, Russia is one of the largest oil exporters in the world. The majority of crude oil transported within Russia is moved by pipeline; however, more than half of crude oil export is transported over water, particularly from the major shipping port of Primorsk.

Historically, there are three main strategic destinations of Russian crude oil exports: Europe (Germany, Netherlands, etc.), East Asia (China and other countries in the Asia-Pacific region) and North America. The European market is the largest importer of Russian crude oil and oil products, with an 80% share, while crude oil deliveries to China and the USA cumulatively amount to less than 20%.

Further development of the transportation infrastructure is a strategic priority for market diversification, rather than increase of the transportation capacity. Some recently completed projects (including the Eastern Siberia-Pacific Ocean and Purpe-Samotlor oil pipelines), as well as some currently in development (such as ESPO–2 and Baltic Pipeline System 2) are discussed in the "Recent and proposed development projects" section of this publication.

The Eastern Siberia-Pacific Ocean (ESPO) pipeline route has been delivering oil to northern China since 2011.

Refinery sector

For decades, the Russian oil sector focused on the production and export of crude oil. However, Russia is currently working to change its export focus from raw materials (such as crude oil) to oil products.

Russia currently accounts for roughly 6% of the world's crude oil processing capacity, which exceeds domestic demand for the majority of refined products. Despite the large volumes of oil undergoing processing, the quality of oil products is low. The production structure of Russian refineries has a high share of heavy fuel oil and diesel fuel, and domestic production capacity can meet only a part of the country's demand for high-octane gasoline.

The country's largest oil companies are introducing new technologies to upgrade the existing refineries. New facilities are being installed with the goal of increasing the processing depth and producing light oil products of higher quality (specifically those meeting Euro-3, Euro-4 and Euro-5 standards). For more detailed information, please refer to the Refinery subsection of "Recent and proposed development projects".

Table 2

Russia's crude oil exports in 2009-2010				
Destination and way of shipments	**2009**		**2010**	
	mn t	%	mn t	%
Non-CIS states	**211.9**	**86.1**	**220.7**	**89.2**
Offshore shipments	**141.7**	**57.6**	**151.7**	**61.3**
Shipments via Transneft's pipeline system	117.0	47.6	125.6	50.8
Primorsk Seaport (Baltic Sea, Gulf of Finland, Russia's Leningrad Region)	70.2	28.5	70.0	28.3
Novorossiysk seaport (Black Sea, Krasnodar Kray)	33.0	13.4	32.4	13.1
Pivdenny terminal (Black Sea, Ukraine, Odessa region)	9.5	3.9	3.1	1.3
Tuapse seaport (Black Sea, Krasnodar Kray)	4.2	1.7	4.8	1.9
Kozmino seaport (Pacific Ocean coast. Primorski Kray, Russia's Far East)	0.1	0.0	15.3	6.2
Bypassing Transneft's pipeline system	24.7	10.0	26.1	10.6
De-Kastri oil terminal (Sakhalin Island, Russia's Pacific territory)	7.4	3.0	7.1	2.9
Korsakov (Sahalin region)	5.4	2.2	6.0	2.4
Varandey oil terminal (Russia's Arctic territory, Nenets Autonomous District, Barents Sea)	7.5	3.0	7.5	3.0
Vitino sea port (Russia's White coast)	2.5	1.0	2.5	1.0
Others	1.0	0.8	3.0	1.2
Druzhba pipeline	**53.3**	**21.7**	**53.2**	**21.5**
Germany	19.1	7.8	17.9	7.2
Slovakia	2.6	1.1	2.5	1.0
Czech Republic	4.9	2.0	4.7	1.9
Hungary	6.4	2.6	6.4	2.6
Poland, including shipments to Gdansk seaport	20.3	8.3	21.7	8.8
ESPO pipeline*	**1.6**	**0.6**	**15.8**	**6.4**
Shipments to Kozmino*	0.1	0.0	15.3	6.2
Other directions	1.5	0.6	0.5	0.2
Railway shipments	**9.7**	**3.9**	**9.5**	**3.8**
CPC	**4.0**	**1.6**	**3.6**	**1.5**
Other directions bypassing Transneft's pipeline system	1.8	0.7	2.2	0.9
Total Transneft's pipeline system	185.4	75.4	192.4	77.8
CIS states	**34.1**	**13.9**	**26.6**	**10.8**
Belarus	21.4	8.7	12.9	5.2
Kazakhstan	6.3	2.6	7.4	3.0
Ukraine	6.3	2.6	6.3	2.5
Total	246.0	100.0	247.3	100.0

* including combined and reversed pipeline shipments

** accounted in Russia's Kozmino seaport balance

Natural gas

Reserves and production

With respect to gas reserves, Russia is the world leader with 23.9% of the world's proven reserves as of 2010. It is the second largest producer of natural gas, having produced 588.9 BCM in 2010, accounting for an 18.4% share in the world total production.

Major gas reserves and exploration projects are situated in Western Siberia, while substantial areas of Eastern Siberia, the Far East and the Arctic remain underdeveloped due to a lack of infrastructure and severe weather conditions.

Production of natural gas has been steadily increasing, having gone from 526.2 BCM in 2001 to a peak of 601.7 BCM in 2008. This increase in production is primarily due to increasing demand and new fields having been brought onstream (including the Yuzhno-Russkoe and Zapolyarnoye fields and newly-discovered deposits on the Yamburg and Urengoy sites). The 2009 drop of 12.1% compared to the 2008 production level was primarily caused by a decrease in demand on both foreign and domestic markets. In 2010 production rose by 11.6% compared to 2009.

Today the Russian gas industry is challenged by depleting reserves in traditional fields, with a subsequent rise in gas recovery costs, and by the necessity for significant investment to develop new gas provinces

Exports and transportation

Russia remains the world's largest gas exporter. Most of the country's gas exports go to customers in Western, Central and Eastern Europe, the Baltic countries and members of the Commonwealth of Independent States (CIS).

Europe is the largest market for Russian natural gas supply, and Germany, Ukraine, Italy, Belarus and Turkey account for almost 60% of Russian gas exports in 2010. Russia exports more than 90% of its natural gas by pipeline. LNG export amounts to under 7% of Russia's overall gas export volumes, with Japan and South Korea as the major customers.

Though the Russian gas pipeline system is already well developed, there are currently several projects underway to build and develop new pipelines. This development is driven, not only by the expectation that demand will increase, but also by past disputes with transit countries over gas supply and transit prices, as well as concerns expressed by Western European countries over the security of supply.

Several new maritime pipeline construction projects have been announced. These are the recently-opened Nord Stream and the proposed South Stream pipelines, which will enable Russia to diversify its export routes to Western Europe. Gazprom is also building its relationships with China and other Asian countries in order to carve out opportunities in new gas markets. China and Russia have been negotiating a gas supply deal for several years, with Gazprom planning to supply 30 BCM of gas to China through a new pipeline. For further details on these projects, please refer to the "Recent and proposed development projects" section.

Russian plans for the future are not only focused on constructing new pipelines for gas; there are also plans in place to increase transportation of LNG. The country's first and only LNG plant was brought into operation in 2009. For further details on the LNG projects, please refer to the "Recent and proposed development projects" section of this paper.

Key players and foreign investments

The Russian oil complex is represented by 8 large vertically-integrated oil companies and a number of smaller enterprises with a very minor share of total Russian oil production. Gazpromneft and Rosneft are state-controlled companies, and produce more than 30% of crude oil in Russia between them. Russia's other largest oil producers include Lukoil, TNK-BP, Surgutneftegaz, Tatneft, Slavneft and Bashneft.

The key player in the gas industry is state-owned Gazprom, which controls about 76% of Russian natural gas production. There are also several smaller independent companies such as Novatek, Itera, Nortgaz and others.

The investment environment remains challenging due to the ineffective legislation framework and the specifics of the Russian regulatory system.

In addition, the government is reluctant to allow foreign majority control in the energy sector, especially in projects developed at the Russian continental shelf. Significant exceptions have included the Sakhalin offshore projects (developed based on Production Sharing Agreements concluded in the mid-1990s), although here too the government has reasserted state control.

Recent and proposed development projects

Upstream

Vankorskoye field

Vankorskoye oil & gas field is the biggest field to have been discovered and brought into production in Russia in the last 25 years. It is located in the northern part of Eastern Siberia, in the Turukhansky District of Krasnoyarsky Krai. Its proven reserves are estimated at over 195 MT.

Rosneft is the license holder of the field, and began operations there in August 2009 with a target for annual oil production amounting to 25.5 MT (about 5% of total Russian oil production). Vankorskoye is one of the main sources of oil to be transported through the Eastern Siberia–Pacific Ocean pipeline.

Development of the field is one of the largest projects of Rosneft and in the entire Russian oil and gas industry. The total amount of oil produced in 2010 was 12.7 MT.

Yamal

The Yamal Peninsula is one of the most strategically important oil and gas regions of Russia. Its reserves amount to 10.4 trillion cubic meters of natural gas (over 20% of current Russian proven natural gas reserves), 230.7 MT of condensate and 291.8 MT of crude oil. Currently 11 gas and 15 oil, gas and condensate fields have been discovered on the Yamal Peninsula and in its adjacent offshore areas. The most significant natural gas deposit in Yamal is Bovanenkovskoye field, with 4.9 trillion cubic meters of natural gas. In March 2012, pre-commissioning work was performed at the first startup complex on Bovanenkovskoye field.

One of the key advantages of the region is the low transportation cost, due to the closeness of the trunk pipeline system. However, construction and operational costs on the Yamal Peninsula are high due to the severe weather conditions.

Gazprom holds the licenses for most of the fields, and expects gas production to increase to 75-115 BCM by 2015. Therefore, the commercial development of Yamal's fields, onshore and offshore, is expected to play a significant role in the future of the Russian natural gas industry.

Trebs and Titov fields

The Trebs and Titov fields have over 200 MT reserves between them. The fields are located in Arkhangelsk Region in Nenets District, and their individual reserves amount to 78 MT (Trebs) and 132.8 MT (Titov). The first exploration wells were drilled in 2011. According to preliminary calculations, the first oil from the fields will be produced in 2014, and peak production will be reached in 2018. The maximum annual production is estimated to be 5-10 MT. One of the key advantages of the fields is their closeness to the pipeline system, resulting in lower transportation costs.

The holder of the license for these fields is one of the largest Russian oil companies, Bashneft. The license is valid for a period of 25 years, including five years of geological exploration and the requirement to process 42% of the produced crude oil in Russia at its own refinery plants and sell 15% of the produced crude oil on the domestic market.

Continental shelf projects

Shtokman

The development of Shtokman field is the first Russian gas project on the Arctic continental shelf, which has great importance, both as a significant gas reserve for international markets, and as a means of gaining experience for future offshore gas projects.

Shtokman is one of the 10 largest gas fields worldwide, with reserves amounting to 3.8 trillion cubic metres of gas and around 53 MT of gas condensate. The field lies in the Barents Sea, about 600 km northeast of the city of Murmansk at local sea depths varying from 320 to 340 m. The field is expected to become a resource base for Russian pipeline gas as well as liquefied natural gas (LNG) exports to the Atlantic Basin markets. Originally, shareholders planned to export all gas from the field as LNG, but there is now the alternative option of moving some of the gas via the Nord Stream pipeline.
The Shtokman development project envisages the annual production of 70 BCM of natural gas and 0.6 MT of gas condensate, which is comparable to the entire annual gas output of Norway, one of the largest European gas suppliers. The first stage of the project is currently at the planning stage, and involves the annual production of 23.7 BCM of natural gas and includes the construction of Startup Facilities and an LNG plant. The Startup Facilities include the full chain from the upstream gas production of 23.7 BCM annually through the transfer to the license holder of the pipeline gas and condensate as final marketable products.

The start of gas production and supply via the gas pipeline is planned before the end of 2016, with LNG to follow in 2017. The stakeholders of the project since February 2008 are Gazprom (with 51%), Total (with 25%) and Statoil (with 24%).

Sakhalin III

The Sakhalin III project will become one of the main sources of gas supply in the Russian Far East. Gazprom holds licenses for three blocks within the project (Kirinsky, Ayashsky and Vostochno-Odoptinsky) and for the Kirinskoye gas and condensate field.

The gas resources of the Sakhalin III project are estimated at 1.4 trillion cubic meters. The bulk of them are concentrated in the Kirinsky block. Gas production is expected to start in 2014.

Prirazlomnoye

Prirazlomnoye is the first Russian oil project to be started on the Arctic shelf. The field is located on the Pechora Sea shelf 60 km offshore, at a water depth of 19 to 20 metres. The Prirazlomnoye field contains 72 million tons of oil reserves, meaning an annual production level of 6.6 million tons is achievable.

Production operations in the Prirazlomnoye field are scheduled to start in 2012. The license to explore and produce hydrocarbons in the Prirazlomnoye field is owned by "Gazprom Neft Shelf".

Oil pipelines

Caspian Pipeline Consortium (CPC)

Geological exploration in the Caspian region is one of Russia's main priorities for the future development of its oil and gas industry. The CPC crude pipeline system is the only pipeline in Russia carrying oil resources from the Caspian region.

Three governments and ten companies representing seven countries are participating in the project, which is operated by two joint ventures: CPC-R (Russia) and CPC-K (Kazakhstan). CPC is unique in Russia, as it is a shipper-owned pipeline. It is financed and constructed by the group of shareholders who transport or expect to transport crude oil by this pipeline. This is radically different from the existing Russian pipeline systems owned by Transneft, which transport third-party crude oil.

In 2001 the first crude oil was transferred by CPC, and as of 2004 CPC is fully operational with an annual capacity of 22 MT. The main pipeline connects oil fields in Western Kazakhstan with a new marine terminal in Russia. CPC shipped 34.9 MT of crude oil for export through its marine terminal near Novorossiysk in 2010.

CPC expansion, which is planned to result in CPC's annual capacity being increased to 67 MT, is expected to be fully completed in 2014 or earlier, due to an expected increase in oil production in the region.

Baltic Pipeline System (BPS)

The Baltic Pipeline System is a Transneft project to increase crude oil export to the European markets, allowing Russia to reduce its dependence on routes through transit countries. BPS connects the Timan-Pechora, Eastern Siberia and Volga-Ural fields with the port of Primorsk in the Russian Gulf of Finland.

BPS became operational in December 2001 (with a capacity of 12 MT), and since 2006 it operates with a total annual capacity of 75 MT (30% of the total Russian crude oil export).

Working towards diversifying crude oil pipeline routes, Transneft has started a new Baltic Pipeline System project. A new line, named Baltic Pipeline System-2 (BPS-2), would connect the Druzhba pipeline with the port of Ust-Luga in the Russian Gulf of Finland. A branch pipeline would connect it to the Kirishi oil refinery. The throughput annual capacity of BPS-2 will be 50-75 MT. According to Transneft officials, the pipeline may be completed in 2012.

Eastern Siberia — Pacific Ocean (ESPO) Pipeline, including Purpe-Samotlor pipeline

The Eastern Siberia-Pacific Ocean oil pipeline (ESPO) will transport Russian crude oil to the Asia-Pacific markets, especially China. The pipeline is built and operated by Transneft, a 100% state-owned Russian pipeline company.

The construction of the pipeline was completed in 2009. The first stage included a pipeline from the Irkutsk region (Taishet) through Yakutia to the Amur Region (Skovorodino), with an annual capacity of 30 MT of crude oil.

In February 2009, Russia and China signed a contract to construct a branch pipeline to China (from Skovorodino) with a capacity of 15 MT. Russia will supply China with 15 MT of oil each year for 20 years in exchange for a loan worth $25 billion to Russian companies Transneft and Rosneft, to be used to develop pipelines and oil fields. The construction was completed on 1 November 2010, and since that time the pipeline has been operational.

The Eastern Siberia-Pacific Ocean oil pipeline stage 2 (ESPO-2) is an extension of the first stage (ESPO) described above.

The ESPO-2 pipeline will connect ESPO in the Amur Region (Skovorodino) with Primorsky Krai (oil port Kozmino, near Vladivostok). Until ESPO-2 is completed, crude oil is transported from Skovorodino to Kozmino by rail. The planned capacity of the pipeline amounts to 50 MT and the capacity of ESPO would also be increased accordingly. The commissioning of the ESPO-2 is planned for 2013-2014.

To increase the oil supply from Vankor field to ESPO, the Purpe-Samotlor oil pipeline was put into operation in October 2011. The new pipeline transfers 25 MT of oil to the ESPO pipeline system.

Refinery

The major Russian oil producers Rosneft, Lukoil, Gazpromneft and Bashneft are introducing the latest technologies to upgrade their refineries in order to increase the share of light oil products in the total production volume and to further increase the processing depth.

In 2008, Rosneft devised a program to modernise its refineries, which is now being implemented. The program envisages the construction of 30 new units and the reconstruction of more than 20 units at Rosneft's seven refineries. The reforming, isomerisation and alkylation units to produce the high-octane components of gasoline are being installed or upgraded. The program also includes catalytic cracking units for the production of high-octane gasoline components and to increase refining depth, and hydrocracking units for the production of high-quality components of diesel and jet fuel and to increase refining depth.

Most of the work under the program should be completed by the end of 2014. It is expected that the yield of light products will rise from 56% in 2010 to nearly 80% by 2015.

Lukoil introduced a new catalytic cracking complex to its Nizhny Novgorod refinery in 2010, which is already producing Euro-4 gasoline. An alkylation unit was installed in 2011 which enabled the production of automotive gasoline at Euro-5 standards.

Gazpromneft Omsk refinery's development plan calls for a transition to the production of Euro-4 gasoline and diesel fuel starting from 2012, and Euro-5 products starting from 2015. For this purpose, the refinery has reconstructed its L24/9 diesel fuel plant and has started the construction of a complex of diesel fuel and catalytically cracked gasoline hydrotreatment facilities.

A light gasoline fraction isomerisation plant similar to the one in Omsk will be also constructed at JSC Slavneft-Yaroslavnefteorgsintez (YANOS). YANOS was one of the few Russian oil refineries that managed to start producing low-sulphur diesel fuel in the shortest possible time. In 2008, YANOS began the production of diesel fuel with a sulphur content of 10 mg/kg in compliance with Euro-5 requirements, accounting for about 55% of the refinery's total output.

In 2010, a large-scale modernisation program was also launched by Gazpromneft at the Moscow refinery with the construction of a light naphtha isomerisation plant. The plant will produce a gasoline component with an octane number of up to 90.5 points. The plant's capacity will be 650,000 tons per year. The commissioning of the plant is scheduled for 2012.

Russia's other large oil company, Bashneft, is the leader in terms of oil processing depth. Bashneft's refining complex includes a number of processing units for deep oil refining, including those for hydrocracking, catalytic cracking, thermocracking, delayed coking, alkylation, isomerisation, hydrotreatment, etc. These units allow for the production of petroleum products meeting Euro-4 and Euro-5 standards.

In 2010, Bashneft refineries processed 21.2 million tons of crude oil, providing an average refining depth of 86.3%, the highest level among Russia's vertically integrated oil companies.

Gas pipelines

Blue Stream

The Blue Stream natural gas pipeline is a gas transmission facility which became fully operational in 2005. The Blue Stream is an alternative route from Russia to Turkey (one of the largest buyers of Russian natural gas) that crosses the Black Sea, bypassing transit countries.

In 2010 the Blue Stream conveyed 8.1 BCM of gas, while its full annual capacity amounts to 16 BCM. Implementing this project substantially increased the reliability of gas supply to Turkey. While the current supply volume is less than the full capacity of the pipeline, Russia has the ability to increase actual supply on Turkey's request.

The extension of the Blue Stream pipeline will allow gas deliveries to Central Europe, the Middle East, Israel and other countries. The Blue Stream pipeline is a complete gas transportation system that could be used for new projects, one of which could be Blue Stream-2.

Nord Stream Pipeline

The Nord Stream gas pipeline constitutes a fundamentally new export route for Russian gas to European customers, running through the Baltic Sea from Vyborg, Russia to Greifswald, Germany.

The pipeline began operation in November 2011. The Nord Stream is 1,224 km long and consists of two parallel pipelines. The first line has an annual transmission capacity of around 27.5 BCM, and the capacity of the second line is around 55 BCM. The target markets for gas supply via the Nord Stream are Germany, the UK, the Netherlands, France, Denmark and other countries. To manage the construction of the Nord Stream Pipeline, the joint venture Nord Stream AG was established in the end of 2005. Gazprom has a 51% share of the joint venture; other shareholders are Wintershall Holding (BASF AG subsidiary, 15.5%), E. ON Ruhrgas (15.5%), N.V. Nederlandse Gasunie (9%) and GDF Suez S.A. (9%).

The main advantage of this pipeline is the absence of transit countries on the way to Germany, meaning that Russia will no longer have to negotiate transit fees with them or pay in natural gas. A possible branch connection to Sweden has also been considered.

South Stream Pipeline

The South Stream is another transnational gas pipeline project to diversify the routes of natural gas supplies to European consumers. An offshore section of the South Stream pipeline will run across the Black Sea from the Russian coast to the Bulgarian coast. The total length of the section will be around 900 km. This pipeline is expected to compete with the Nabucco pipeline, although according to estimations made by Gazprom both pipelines will not be sufficient to satisfy future European gas demand.

A further pipeline route will run through Bulgarian territory, where it would divide into two directions: the first link would go from Bulgaria through Greece to Italy, and the second link would go from Bulgaria to Austria with transit through Slovenia, Serbia and Hungary, and with transit through Romania under consideration. The maximum throughput capacity of the South Stream will amount to 63 BCM per annum.

In January 2008 Gazprom and Italian company ENI set up South Stream AG to carry out marketing research, compile a feasibility study and construct the maritime part of the South Stream project. In 2010 intergovernmental cooperation agreements were signed with Bulgaria, Hungary, Greece, Serbia, Slovenia, Croatia and Austria in order to construct the onshore sections of the pipeline.

The project is currently at the stage of feasibility study acceptance; therefore, actual construction of the pipeline has yet to begin. The project is planned to become operational in 2015.

LNG

One of the most successful recent oil and gas projects in Russia was the opening of Russia's first LNG plant on Sakhalin Island in February 2009. It was built as part of Sakhalin-2, a large integrated project on the development of two offshore oil & gas fields to the north-east of Sakhalin for the production and export of crude oil and liquefied natural gas. Sakhalin's LNG plant features two production trains, each with an annual capacity of 4.8 MT, and is the sixth largest LNG plant in the world. Future produced volumes of gas have already been purchased under long-term sales contracts with Japan, South Korea, India, Kuwait, China and Taiwan (some of the contracts are for over 20 years).

Russia plans to set up two more LNG plants for its two largest gas fields, Bovanenkovskoye and Shtokman.

Legislative framework in the Oil & Gas industry

General requirements with respect to the use of subsoil resources

The legal framework with respect to the use of subsoil resources in Russia is established by the Federal Law "On Subsoil Resources" of 21 February 1992 (hereinafter – "Subsoil Law").

According to the Subsoil Law, geological surveys, exploration and extraction of minerals (including oil and gas) are performed under a license for subsoil use. This license certifies the right of a subsoil user to perform certain activities on a certain part of subsoil within a limited period of time subject to compliance with the licensing conditions (usually established by a "license agreement", an integral part of the license).

As a general rule, a license for subsoil use is granted based on the results of an auction or tender.

The Subsoil Law provides for significant limitations with respect to granting licenses for subsoil use with respect to areas of subsoil considered to be of "federal significance", including areas of subsoil:

- containing extractable oil reserves of 70 MT or more;
- containing natural gas reserves of 50 BCM or more;
- located in internal waters, territorial sea or on the continental shelf of the Russian Federation.

For areas of subsoil considered to be of "federal significance" a license may be granted only to a Russian legal entity. Upon holding an auction/ tender for the right to use such an area of subsoil, the Russian Government may also place restrictions on the participation of Russian legal entities which are owned by foreign investors in whole or in part.

For areas of subsoil located entirely or partly on the continental shelf, a license may be granted only to a Russian legal entity with no less than five years' experience in working on the continental shelf and in which the Russian Federation directly or indirectly holds more than 50% of shares. In practice, this means that these licenses are granted only to state-owned oil & gas companies (such as Gazprom and Rosneft) or, in some cases, to joint ventures with these companies (provided that the Russian Federation retains more than 50% of shares in the venture).

In most cases, foreign investors choose to obtain a license for subsoil use in the name of a Russian subsidiary company. Still, for areas of subsoil that do not fall within the category of "federal significance", a license may usually be obtained through a duly registered branch office of a foreign legal entity.

The above regulations are applicable only to companies which are directly engaged in geological surveys, exploration and extraction of minerals. Service companies do not need to obtain a license for subsoil use, although they may still need to obtain other licenses to perform certain types of activities.

Payments for subsurface use

Companies holding licenses for exploration and production are subject to the payments described below.

- Regular payments for the right to prospect and appraise oil and gas deposits. The rate of these payments is set within a range of RUB 120/sq km to RUB 360/sq km (approximately USD 4-12/sq km) of the area being prospected and appraised. For the continental shelf and exclusive economic zone, the rates vary from RUB 50/sq km to RUB 150/sq km (approximately USD 1.5-5/sq km).

- Regular payments for the right to explore deposits (i.e. the stage following prospecting and appraisal). The payment rate is set within a range of RUB 5,000/ sq km to RUB 20,000/sq km (approximately USD 170-670/sq km) of the area under exploration. Rates of RUB 4,000/sq km to RUB 16,000/ sq km (approximately USD 130-530/sq km) of the area under exploration are prescribed for the continental shelf and Russia's exclusive economic zone.

- One-time payments for the use of subsurface resources. The terms of these payments are established by the relevant licenses, but should not be lower than 10% of the estimated annual amount of Mineral extraction tax. This may potentially be one of the most significant costs related to obtaining and developing a license area.

- Fee for participation in a competitive tender/auction. The amount of the fee is determined based on the costs of preparing for, holding and evaluating the tender/ auction, together with experts' fees.

Expenses associated with obtaining a license for subsurface use, including expenses for the appraisal of natural resource deposits, feasibility studies, obtaining geological information etc., should be included in the cost of the relevant license, treated as an intangible asset and amortised on a straight-line basis over its lifespan. Expenses relating to participation in a license tender may alternatively be treated as a production and sale expense which is amortised over a period of two years at the taxpayer's request. If no license is obtained, the expenses are amortised over a period of two years following the month of the relevant tender.

Types of business presence

One of the initial stages of planning operations in Russia is choosing the most appropriate form of business presence.

The possible options include creating a Russian legal entity (either solely or as a joint venture with a Russian partner), opening a branch or representative office, registering a separate subdivision for tax purposes or performing activities through a "joint activity agreement" ("simple partnership") with local partners.

In most cases, foreign companies choose to operate through a branch office or a Russian legal entity. The most important differences between these two forms of business presence are indicated in Table 3.

In general, operations carried out through a branch office of an FLE could be more beneficial from a financial perspective since the repatriation of profits after taxation would not be subject to any further taxation in Russia.

Foreign companies may also choose to operate in Russia directly without opening a branch office. In this case, the foreign company should register a separate subdivision with the Russian tax authorities. Operations carried out through this subdivision will not allow a foreign company to obtain any licenses and permits for activities in Russia, including documentation required to authorise foreign personnel to work in Russia in most cases. Still, this option could be workable in certain situations, especially for short-term offshore projects performed by service providers.

Regarding operations carried out through representative offices or "joint activity agreements" ("JAA"), these options are less popular and apply only to certain specific cases.

Formally, representative offices should not be directly engaged in business operations and their activity should be of a non-commercial nature (such as marketing and information gathering). A JAA is not a legal entity in and of itself, but represents the pooling of assets for the common conduct of business. One of the partners is usually appointed as the party responsible for bookkeeping and statutory reporting.

Table 3

Issue	Branch of foreign legal entity ("FLE")	Russian legal entity ("RLE")
Repatriation of profits	Not subject to taxation	Taxed as dividends
Consolidation of financial results of several business units for profits tax purposes	Impossible (each branch creating a permanent establishment for tax purposes is a separate taxpayer).	Possible (financial results of all business units within one company, including the RLE itself and its branches, may be consolidated).
Liabilities	FLE is responsible for all liabilities of its Russian branch.	As a general rule, shareholders of an RLE are not responsible for its liabilities.
Period of establishment	The maximum period is 5 years, after which the branch should be reregistered with the Russian authorities	Unlimited.
Obtaining licenses and permits	Although a branch is formally entitled to obtain most licenses and permits for operations in Russia (with a few exceptions), from a practical standpoint the process is more complicated than for an RLE.	In practice, the process could be easier compared to a branch of an FLE.
Closure	Compared to the procedure of closing an RLE, the process is simpler.	The process is quite formal and complicated and includes various stages and registration actions with the Russian authorities.

Acquisition of an existing oil & gas business

A foreign investor may choose to enter Russian oil & gas industry by acquiring an existing oil & gas business.

Acquisition may be carried out through the purchase of shares in an operating Russian company, or by purchasing a property complex required for the planned operations.

Purchase of shares in a Russian company

Such a purchase may be complicated by the Russian antimonopoly and "strategic investments" regulations.

First of all, the purchase of shares may be subject to preliminary approval by Russian antimonopoly authorities if the total assets of the investor (and its group of entities) and of the acquired company (and its group of entities) exceed RUB 7 billion (approx. USD 230 million). Approval is also required in certain other cases.

The definition of the "group of entities" provided by Russian antimonopoly regulations is rather complicated and generally includes companies and individuals affiliated with the investor and the acquired company. With respect to the purchase of oil & gas companies, Russian antimonopoly requirements apply in most cases due to the amount of total assets of the companies belonging to the group of investors and/or the target.

If the target company holds a license for subsoil use with respect to an area of subsoil of "federal significance", the Federal Law "On the procedure for foreign investments to commercial legal entities of strategic importance for national defense and state security" of 29 April 2008 (hereinafter – "Strategic Investments Law") may apply.

In this case, the purchase of 25% (in some cases 5%) or more shares in such a company by a foreign investor (or a company forming a group of entities with a foreign investor) may be subject to separate approval by the Russian Government Commission, headed by the Russian Prime Minister.

The procedure of obtaining approval is rather complicated and time-consuming. In addition, the Strategic Investments Law does not specify cases when the Government Commission may reject granting its approval. In this regard, the decisions of the Commission could potentially be rather subjective.

In spite of the complicated procedure of obtaining approval, in practice the Government Commission approves most applications. As of January 2012, out of 137 applications received by the Commission (starting from 5 May 2008, the date on which the Strategic Investments Law entered into force), only eight were rejected.

Purchase of a property complex

When property is purchased, Russian antimonopoly requirements may also apply.

The purchase may be subject to preliminary approval of the Russian antimonopoly authorities if the total assets of the investor (and its group of entities) and of the seller of property (and its group of entities) exceed RUB 7 billion (approx. USD 230 million) and as a result of purchase the investor obtains property with a balance value exceeding 20% of the total balance value of the seller's fixed and intangible assets. This requirement may also apply in some other cases.

Licensing and regulatory matters

To perform certain types of activities in Russia a company may need a special license or permit in accordance with Russian legislation. In most cases, these licenses (permits) are issued by state authorities.

The list of licenses (permits) which could be applicable to a company engaged in the oil & gas business may vary greatly depending on the details of a particular project. However, in practice the following licenses (permits) could potentially be required:

- License to operate fire-hazardous and highly explosive industrial objects;
- License to operate chemically hazardous industrial objects;
- License to collect, use, neutralise, transport and place hazardous waste;
- License to work with state secrets (in certain cases information gathered during geological surveys and exploration of mineral deposits could contain information carrying the status of "state secrets");

- Permit to perform construction work (issued by "Self-Regulated Organisations"; in order to obtain it a company needs to join such an organisation);
- Documentation required according to Russian regulations on the industrial safety of dangerous objects, such as certification of the equipment used at such objects, attestation of employees, expertise of industrial safety.

The licenses to perform certain types of activities may be required for both the users of the subsoil (holding the appropriate license to use the subsoil and directly engaged in geological surveys, exploration and extraction of minerals) and service companies.

In some cases, the operations of a company engaged in the oil & gas business may be structured in such a way where activities requiring a license may be subcontracted to third parties holding the required licenses. In this case, the company may not need to obtain these licenses itself.

Accounting environment

Overview

For historical reasons, the Russian financial reporting framework has been determined and regulated by the state, rather than being developed by professional bodies. Indeed, the primary users of Russian statutory financial statements based on Russian Accounting Standards (RAS) are the tax and other state authorities, rather than management or third parties. Currently, International Financial Reporting Standards (IFRS) are becoming increasingly important, both in terms of influencing the development of RAS and as the compulsory standards for certain types of Russian entities.

Preparation of RAS financial statements

Every legal entity registered in Russia must prepare standalone RAS financial statements for each financial reporting (calendar) year ending 31 December. The format and content of the financial statements are set by the Ministry of Finance, including the chart of accounts and recommended accounting entries for typical transactions.

The financial statements must include a balance sheet (with two years' comparatives), statements of profit and loss, changes in equity, cash flows (with one year's comparatives) and supplementary notes.

Branches and representative offices of foreign legal entities may elect not to maintain accounting records and not to prepare financial statements in accordance with RAS, provided they maintain tax records compliant with Russian tax legislation.

RAS financial statements must be filed with the tax authorities within three months after the end of the calendar year. Certain entities, including open joint stock companies, banks and other lending agencies, insurance companies, stock exchanges and investment funds are required to publish their RAS financial statements. Such companies may have additional reporting and disclosure requirements (see the section "Adoption of IFRS in Russia" for details).

RAS audit requirements

The audit of annual RAS financial statements is mandatory for:

- Open joint stock companies;
- Companies with securities traded on stock exchanges;
- Banks and other lending agencies, insurance companies, credit bureaus, pension and investment funds, securities' markets participants and stock exchanges;
- Companies with annual revenue for the preceding financial year exceeding RUB 400 million (approximately USD 13 million).

Companies with total assets as at the preceding 31 December exceeding RUB 60 million (approximately USD 2 million), publicly traded companies, banks, insurance companies, non-governmental pension funds, and companies owned more than 25% by the state must be audited by an audit firm, rather than by an individual auditor.

Harmonisation of RAS with IFRS

Significant progress is being made towards converging RAS with IFRS. During 2011, this trend saw new Russian standards on provisions, contingent assets and liabilities, segment reporting and cash flow statements coming into force, with new standards on inventory, fixed assets, employee benefits and leases expected in 2012–2013.

New procedures for revising and adopting Russian standards apply from 2013, including a requirement that they are based on the IFRS equivalent.

There nevertheless remain significant differences between RAS and IFRS, including:

- The fair value concept is not applied;
- Most financial instruments are accounted for at cost or amortized cost (less impairment provision);
- Finance leases may be capitalized or expensed by agreement of the parties to the lease contract;
- Property, plant and equipment are not impaired, but revaluation to current replacement cost is allowed;
- The useful lives of fixed assets tend to be in line with the useful lives specified for tax purposes;
- Deferred tax is calculated using the income statement method, although the methodology differs;
- Revenue and expenditure are generally recognized after primary documentation supporting the transaction has been received in accordance with the tax rules.

In 2004, the Ministry of Finance of the Russian Federation issued its "Medium-term concept for the development of accounting and financial statements", which set a target for the convergence of RAS with IFRS. Over the last two years, significant progress towards IFRS has been made, e.g., new standards on accounting for construction contracts and the correction of fundamental errors, and the new consolidation law. Already, companies in the banking sector submit financial statements to the Central Bank of Russia which are much closer to IFRS, as well as IFRS consolidated financial statements.

Adoption of IFRS in Russia

Following the formal adoption of IFRS in Russia during 2011, public interest entities (PIEs) are now required to prepare consolidated financial statements under IFRS (previously, only Russian banks were required to prepare IFRS statements). This requirement is in addition to standalone statements prepared under RAS. PIEs include companies with securities traded on a stock exchange, banks, and insurance companies. Other entities that have issued securities by way of public offering, or by means of private placements to a wide group of shareholders, are also required to prepare consolidated financial statements under IFRS.

Most PIEs must prepare their first full set of IFRS financial statements for the 2012 calendar year (with 2011 comparatives), deferred for three years in the case of issuers of traded securities which already prepare US GAAP financial statements, or which only issue bonds.

Annual consolidated IFRS financial statements must be audited, presented to the shareholders and filed with the Federal Committee on Securities Markets (or the Central Bank for banks) within 120 days after the year end. The financial statements must also be published, for example, on the internet.

Accounting systems

Most companies in Russia maintain their accounting records using IT systems tailored to the prescribed RAS chart of accounts and reporting formats. Management reporting is also often based on RAS, with quarterly or annual transformation to IFRS. Only larger companies have in-house capabilities to perform the transformation to IFRS and therefore this process is often outsourced to consulting firms, or at least performed with their assistance.

Continental shelf projects

Russian legislation provides for specific regulations with respect to the development of oil & gas deposits located offshore, on the Russian continental shelf.

The continental shelf is a seabed and subsoil of the underwater areas located outside the Russian Federation territorial sea (the external border of the territorial sea is 12 nautical miles from the seashore). The external border of the continental shelf is 200 nautical miles from the external border of the territorial sea. If the underwater continental margin extends beyond 200 nautical miles, the external border of the continental shelf coincides with the outer boundary of the underwater continental margin.

As noted above, the license for subsoil use with respect to areas of subsoil either fully or partially located on the continental shelf may currently be granted only to state-owned companies where Russia holds more than 50% of shares or, in some cases, to joint ventures involving companies matching that description. Unless a foreign investor forms such a joint venture, its operations on the Russian continental shelf may be limited to providing services to state-owned companies or joint ventures with these companies.

The continental shelf is not considered part of the territory of the Russian Federation. In this regard, work on the continental shelf entails certain tax, customs, state frontier, immigration and other complications. Related operations should be planned accordingly.

Drilling work, the establishment and use of artificial islands, installations and structures on the continental shelf must be approved by the competent Russian authorities. Such approvals should generally be obtained by the operator of the project, not by service providers. If the license for subsoil use issued to the operator already provides for the right to perform such work, the operator is not required to obtain separate approval.

Production Sharing Agreements

Russian legislation provides for the possibility to enter into a Production Sharing Agreement (hereinafter – "PSA") between the Russian Federation and an investor (including foreign legal entities).

Under a PSA, the state grants an investor exclusive rights to explore and extract subsoil resources on the specified subsoil area. The investor should perform work related to exploration and extraction of subsoil resources at its own expense and risk, either itself or through a third-party contractor ("operator" of the PSA).

The PSA provides for sharing production between the investor and the state. There are two basic approaches to sharing production:

- Establishing different procedures for sharing production during the period until the costs borne by the investor are repaid (sharing of "compensatory" production) and during the period after such costs are repaid (sharing of "profitable" production);
- Establishing a single procedure for sharing production over the entire lifespan of the project.

The PSA regime does not release the investor and operator from the general Russian licensing and regulatory requirements. The right of the investor to work on a certain area of subsoil under a PSA should be confirmed by the license for subsoil use. The PSA regime may be only applied with respect to a limited number of subsoil areas. If there is an auction to grant an area of subsoil for development under the general regime under the Subsoil Law and the auction fails (e.g. if the auction has only one participant), then the related area of subsoil is included on the list which may be developed under the PSA regime.

To conclude a PSA, another auction should be held. The SA is concluded with the winner of that auction.

The PSA model is not widely used in Russia. There are only 3 active PSAs (Sakhalin-1, Sakhalin-2 and the Kharyaginsky project), which were concluded before the current Federal Law "On PSAs" entered into force in 1996, and as such are "grandfathered". Top officials of the Russian Government have made several public announcements, stating that the Russian Federation would not enter into new PSAs.

Taxation of Oil & Gas Companies

Profit tax

Taxpayers

Profit tax applies to Russian legal entities and foreign legal entities carrying out activities in Russia through a permanent establishment or receiving income from Russian sources.

A Russian legal entity must be registered with the office of the tax inspectorate corresponding to the location of the company's registered address, as well as at the offices corresponding to any branch or subdivision of the entity. The company is liable to pay profit tax in respect of each of these locations.

As of 2012, the Tax Code introduced consolidation for profit tax purposes for taxpayer groups if all qualifying participants combined meet the following minimum requirements in relation to the preceding calendar year:

- total taxes paid of RUB 10 billion (approx. USD 330 million);
- total revenue of RUB 100 billion (approx. USD 3.3 billion);
- total value of assets (at year end) of RUB 300 billion (approx. USD 10 billion).

Please refer to the chapters entitled "Taxation of foreign presences" and "Russian-sourced income of foreign companies" for details about the taxation of FLEs and to the chapter entitled "Tax incentives" for information on profit tax reductions and exemptions.

Rates

The maximum profit tax rate is 20%, comprising:

- 2% payable to the Federal budget;
- 18% payable to the Regional budget.

Regional governments have the right to reduce their portion of profit tax by up to 4.5%.
Please refer to the chapter entitled "Tax incentives" for further details.

Tax base

The tax base is defined as the total income received by a taxpayer less related expenses and allowable deductions.

Income includes sales income, i.e. total proceeds from the sale of goods, work, services and property rights, and non-sales income. Income received in a foreign currency must be converted into rubles using the official exchange rate set by the Central Bank of Russia (CBR) as of the date on which income is recognised.

Non-sales income includes goods, work, services and property rights received free-of-charge, based on market value, except in the case of property received by a Russian company from its parent or subsidiary where the parent owns more than 50% of the subsidiary. This exemption is lost if the property (other than cash) is transferred to a third party within one year. Non-taxable income, of which the legislation provides an exhaustive list, also includes property and property rights received as a contribution to a company's charter capital, leasehold improvements made by a lessee to the lessor's property, and interest received on overpaid tax.

Deductible expenses are subdivided into sales expenses related to the core business activity of a taxpayer, and non-sales expenses.

Income from the sale of unquoted shares and participation in Russian companies, and of quoted shares in high-technology Russian companies, acquired after 1 January 2011 and held for at least 5 years, are exempt from profit tax

Assets and liabilities denominated in foreign currency must be converted into rubles. The revaluation profit or loss is included in non-sales income/expense on the last day of the reporting (tax) period or the date of disposal/settlement (whichever is earliest).

Expenses

General criteria for deducting expenses

Expenses are considered deductible for profit tax purposes if they meet three general criteria:

- the expenses must be incurred in the course of a taxpayer's income generating activity;
- they must be economically justifiable and supported by relevant documentation;
- they must not be listed as one of the specifically non-deductible expenses provided in the law.

Additional deductibility criteria applying to certain types of expenses are noted below.

Expenditure which indirectly benefits or promotes the growth of the business may not be considered "economically justified". Documentary requirements are also exacting, and include both documents specified by legislation (agreement, act, invoice and VAT invoice) and other supporting materials.

For overseas expenses, the documentation must be prepared in accordance with the common business practices of the country where the expenses were incurred, although this does not guarantee deductibility.

Depreciation

A depreciation charge can be deducted in calculating the profit tax liability, starting from the first day of the month following the month when an asset is put into operation. Examples of the useful lives of fixed assets typically used in the oil and gas industry are shown in Table 4.

In practice, the tax authorities apply the general criteria very strictly, and may challenge any expense which is not directly related to the generation of income

Table 4

Depreciation Group	Useful life (years)*	Examples of types of fixed assets	Depreciation method
1	1-2	Metal-working and woodworking tools/machines; oil and gas production equipment; construction hand tools	Straight-line method or declining balance method
2	2-3	Drilling machines; construction power tools; equipment for underground tunneling work and sampling	
3	3-5	Elevators; forestry tractors; automobiles; tank trucks; computers and peripheral equipment; office machinery	
4	5-7	Office furniture; television equipment; clocks; light trucks (with less than 0.5 ton capacity)	
5	7-10	Oil/gas collecting systems; gas pipelines; fiber-optic communication systems; heavy trucks (5 – 15 ton capacity)	
6	10-15	Oil wells; railway transport infrastructure; heavy trucks (over 15 ton capacity)	
7	15-20	Bridges; ductwork; refrigerators; drilling ships	
8	20-25	Blast furnaces; wharves; river and lake passenger vessels	Straight-line method
9	25-30	Runways; nuclear reactors; oil/gas tanks	
10	>30	Escalators; forest shelter belts	

* The exact useful life of fixed assets is determined based on their classification as prescribed by the Russian Classification for Fixed Assets.

Depreciable property is property, both tangible and intangible, which has the following characteristics:

- a useful life of at least 12 months;
- a value of no less than RUB 40,000 (approximately USD 1,300).

If the property does not meet these criteria, it is treated as an expense and should be included in the cost of sales. Land cannot be depreciated.

All depreciable fixed assets fall within one of ten groups described in Table 4, and the taxpayer should determine the useful life of its fixed assets based on this classification.

The useful life of an intangible asset is based on the utilisation period stated in any agreement or the validity period in the case of a patent. In any other cases, it is 10 years.

Leasehold improvements undertaken at the expense of a lessee, and with the lessor's approval, can be depreciated by the lessee over the useful life of the relevant assets for the period of the lease agreement.

Two methods of calculating the depreciation expense are available — the straight-line method or the reducing balance method. The straight-line method must be used for buildings, other constructions and transmission devices that fall within depreciation groups 8-10, while either method may be used for other fixed assets. The method chosen should be stated in the taxpayer's tax accounting policy and can be changed from the straight-line method to the reducing balance method from 1 January of the next tax year, and once every five years in the reverse case.

Under the straight-line method, the monthly depreciation is calculated as:

1/ useful life in months x historic cost of the asset

Under the reducing balance method, the monthly depreciation is calculated as:

Net book value of asset group x depreciation rate (%)

The net book value, on which the monthly depreciation is based, thus reduces every month. The depreciation rates shown in Table 4 are, in certain cases, adjusted by coefficients, for example:

- for fixed assets which are used in a demanding environment, belong to residents in Special Economic Zones, or are designated as energy-efficient, up to two times the normal rate is applied;
- for leased property and fixed assets which are used only for scientific and technical purposes, up to three times the normal rate is applied.

Taxpayers are entitled to deduct a one-time depreciation allowance of 10% (30% for asset groups 3-7) of the historic cost of fixed assets purchased or capital improvements made. The regular depreciation expense is then computed on the reduced tax base.

Treatment of exploration cost

- Expenses relating to the exploration and appraisal of natural resource deposits (whether or not successful) should be deducted on a straight-line basis over the 12 month period following completion of the work. Separate tax accounting is required for each exploration project.
- Expenses relating to the preparation of land plots for the extraction of natural resources and restitution work for cleaning up environmental damage caused during the construction and operation of extraction plant are deductible evenly over the two year period following completion of the work (although the expenses may no longer be deductible if the plant is decommissioned during that period).
- Expenses relating to "dry" wells should be deducted evenly over a 12-month period starting from the first day of the month following the well's abandonment. No provisions for future abandonment costs are allowed, and thus these costs are deductible only when incurred.

Goodwill

Goodwill arising on the acquisition of a "property complex" — essentially, a bundle of assets which has a collective purpose, such as a production plant — may be recorded as an asset and written off on a straight-line basis over the course of five years. The amount of goodwill recognised is the excess of the price paid over the net asset value of the company. If the price paid is lower than the net asset value, the buyer recognises the difference as income at the moment the property right is registered.

Expenses subject to limitation

The following types of expense may be deducted for profit tax purposes within certain limits:

Advertising

Expenses on advertising, including in the press, on radio and television, outdoor advertising, printing brochures and catalogues and participating in exhibitions are not subject to any limitation. Other categories of advertising expenditure may be deducted for profit tax purposes up to an amount equivalent to 1% of a taxpayer's sales revenue (net of VAT).

Entertainment

Expenses incurred on hosting clients during negotiations and those attending board meetings are deductible up to 4% of a taxpayer's total payroll cost in the reporting period.

Insurance

Obligatory property insurance premiums are deductible within certain limits. Voluntary insurance premiums are only deductible if specifically provided by the tax legislation.

R&D

The Tax Code contains a complete list of R&D expenses which are deductible. Costs for certain types of R&D are fully deductible in the period the R&D activity (or its separate stages) has been completed and (or) the act of acceptance has been signed, irrespective of the result. For some types of expenditure, the deduction is 150% in the period the cost is incurred.

Interest

The general rule is that interest charged at a rate more than 20% above the average rate charged on comparable loans made in the same quarter is non-deductible.

In the absence of comparable data, or at the taxpayer's request, the maximum rates are as follows:

- For ruble-denominated loans, the Central Bank of Russia (CBR) refinancing rate at the date when the loan is advanced, multiplied by 1.8
- For foreign currency-denominated loans, the CBR refinancing rate on the date the loan is advanced, multiplied by 0.8

Interest on foreign controlled debt is further restricted.

Thin capitalisation

The thin capitalisation rules restrict the deducibility of interest charged on "foreign controlled debt".

The rules apply to loans (and other debts):

- to a Russian company from a foreign entity which owns, directly or indirectly, more than 20% of the Russian company's share capital;
- from a Russian company, which is an affiliate of a foreign entity, to another Russian company where the foreign entity owns, directly or indirectly, more than 20% of the recipient's share capital;
- guaranteed or otherwise secured by a foreign entity that owns, directly or indirectly, more than 20% of the Russian company that received the loan, or loans guaranteed or secured by a Russian affiliate of the foreign entity.

The deductibility of interest is restricted to the extent that the controlled debt exceeds net assets by more than three times, or 12.5 times in the case of banks and leasing companies. Interest on excess debt is non-deductible and treated as a dividend subject to withholding tax. In the event that the taxpayer has negative net assets, the whole amount of interest accrued on the controlled debt will be non-deductible and treated as a dividend.

Reserves

A taxpayer may create certain types of reserves, including reserves for warranty repairs, repairs of fixed assets, R&D and for doubtful debts, subject to certain rules. In principle, a taxpayer may transfer the following tax-deductible amounts to a doubtful debt reserve:

- 50% of the invoice value for debts outstanding for between 45 and 90 days;
- 100% of the invoice value when that period is exceeded.

The total reserve for doubtful debts as at the end of the reporting (tax) period may not exceed 10% of revenue for the period. Special rules apply to banks and licensed dealers in securities.

Loss carry forward

Losses incurred by a taxpayer may be carried forward for up to ten years following the period in which the loss was incurred. Losses on certain types of activity

(e.g. securities, financial instruments) are determined and carried forward separately and may in future be offset only against profit from the same activity.

Taxation of dividends

Dividends are taxed as follows:

- 9% — at source — for dividends paid by one Russian company to another (unless the 0% rate below applies). In determining the tax base, the paying company should deduct the amount of dividends received in the same and preceding tax periods.
- 15% — at source — for dividends paid by Russian companies to foreign companies.
- 9% for dividends paid by foreign companies to Russian companies (unless the 0% rate below applies).Where a double tax treaty applies, a credit for any withholding tax suffered can be claimed against this liability.
- 0% for dividends paid by either a Russian or foreign company to a Russian company, provided that the Russian company has owned no less than 50% of the company for at least 365 consecutive days. Dividends from foreign companies registered in certain "low tax" jurisdictions are excluded from this rule.

Administration

The tax period for profit tax is the calendar year. The annual profit tax return is due by 28 March of the following year.

Taxpayers may choose to pay tax either on a monthly or a quarterly basis, provided it is applied consistently throughout the tax year. If the monthly basis applies, the tax return must be filed and the tax paid by the 28th day of the following month. If the quarterly basis applies, monthly payments are made based on one third of the previous quarter's liability, while a tax return must be filed, and the balance of taxes should be paid by the 28th day of the calendar month following the reporting quarter. In each case, the cumulative profits and payments to date are taken into account when filing each monthly or quarterly return and making the appropriate tax payment.

Certain types of taxpayer, including foreign companies using the quarterly basis, are exempted from the obligation to make monthly payments. Tax agents paying income, including dividends, to foreign companies must withhold tax each time income is paid. The tax must be remitted to the budget within one day of the payment date.

Interest applies to late paid tax.

Taxation of foreign presences

A foreign legal entity (FLE) which conducts activity in Russia through a "separate division", a term which includes representative offices, branches, construction sites and other places of business, for a period exceeding 30 days in a calendar year, is required to register with the Russian tax authorities within 30 days of commencing activity. This is regardless of whether the activity is taxable or not. If the FLE operates in more than one location, it must register separately in each location in which it is present. Each real estate project or construction site must also be separately registered. Although the taxation of a separate division of an FLE is similar to that of a Russian legal entity, there are a number of differences that can make this an attractive form of doing business in Russia.

Profit tax

FLEs are liable for profit tax on their business income only if their business activity creates a permanent establishment (PE). If no PE exists, foreign entities are exempt from Russian profit tax. An FLE receiving income from a source in Russia not connected with the activity of a PE is subject to withholding tax as described in the chapter entitled "Russian-sourced income of foreign companies". "Passive" income, such as dividends, interest and royalties are the most common types of Russian-sourced non-business income.

The Tax Code defines the term "permanent establishment" as a branch ("filial"), representative office, division, bureau, office, agency or any other separate fixed place of activity, through which a foreign company regularly engages in business activity in Russia. The term is used exclusively for tax purposes and does not affect the legal status of an entity. The following areas of activity are expressly listed as giving rise to the creation of a PE:

- exploration for or extraction of natural resources;
- construction, installation, assembly, adjustment, maintenance and operation of machinery and equipment, including gambling equipment;

- sales from warehouses owned or rented by a foreign legal entity in Russia;
- provision of services or performance of any other activity, apart from "preparatory and auxiliary" activities or activities explicitly defined as not creating a PE.

A foreign legal entity may also be considered as having a PE if it conducts the activities listed above through a dependent agent. A dependent agent represents an FLE in Russia under a contract, acts on its behalf, and has and regularly exercises the right to sign contracts on behalf of the FLE, or negotiates their significant terms.

Russian tax law specifically states that the gathering and distribution of information, marketing, advertising, market research and the import and export of goods by a foreign company should not by themselves lead to the creation of a PE. Russia's double tax treaties, which prevail over Russian domestic law, also include a definition of a PE. Thus, if an FLE qualifies as a resident of a country with which Russia has a tax treaty in force, then the definition of a PE in that treaty will prevail. A list of countries with which Russia has a double tax treaty is provided in the Appendix.

Profit tax base calculation

PEs and Russian legal entities use similar rules for determining taxable profits and the calculation of taxes due. The rules on tax return filing and the maintenance of tax registers are also similar. The only major difference between a foreign entity with a PE and a Russian legal entity is the monthly advance payment of profit tax. PEs are exempt from this requirement and are thus not obliged to remit profit tax on a monthly basis.

Generally, PEs should calculate their profit tax using the direct method (i.e. gross income net of allowable deductions) to arrive at taxable income. However, when a foreign entity has a PE because it conducts preparatory and auxiliary activities in Russia in favour of third parties on a free-of-charge basis, the PE will be deemed to have taxable income equal to 20% of the expenses of the PE. In addition, Russian tax law allows an FLE to allocate income and expenses to its Russian PE. In particular, where all income from activity in Russia earned through a PE is received

by the head office of the FLE, the income of the Russian PE is determined by reference to the FLE's accounting policy. Moreover, in cases provided by a double tax treaty, Russian tax law also allows a deduction by the PE of overhead expenses incurred by the head office but relating to the PE, e.g. management and administrative costs. The tax authorities may require documentary support and justification of any amounts allocated.

Nevertheless, the allocation of income and expenses between an FLE and its Russian PE should take into account the functions carried out in Russia, assets used and commercial risks borne. Russia does not impose a "branch profit" tax on profit repatriated by a PE to its head office.

Property tax

The Tax Code establishes certain conditions regarding the application of property tax to FLEs which are summarised below:

- An FLE which carries out activity in Russia through a PE is liable to corporate property tax on both movable and immovable property of the PE in accordance with the corporate property tax rules applicable to Russian legal entities (refer to the chapter entitled "Property tax").

- An FLE whose activities do not constitute a PE pays property tax only on its immovable property located in Russia. Thus, an FLE owning movable property located

in Russia which is not attributable to a PE of the FLE in Russia is not liable to corporate property tax on that movable property.

There are some differences in the taxation of immovable property depending on whether it is owned by a foreign legal entity or a Russian legal entity.

The immovable property tax base of an FLE without a PE in Russia, or which does not relate to a PE of the FLE in Russia, is determined based on the inventory value of the property (as determined by the relevant state body) rather than the average annual value. The tax base for the year is the inventory value as of 1 January, with the quarterly advance tax payments based on one quarter of the inventory value multiplied by the applicable tax rate.

Russian-sourced income of foreign companies

As with other jurisdictions, the Russian-sourced income of a foreign entity which is not attributable to a PE may be subject to withholding tax at source. The responsibility for withholding the tax lies with the tax agent — the Russian entity or FLE with a registered PE — making the payment to an FLE that does not have a Russian PE. Failure to withhold tax may lead to fines of up to 20% of the tax, while delay in payment may lead to late payment interest.

Withholding tax is applied to the following types of Russian-sourced income:

- dividends;
- income relating to the distribution of profit or property, including distributions due to liquidation;
- interest on debt instruments, including profit-sharing debt and convertible bonds;
- royalties;
- income from the sale of shares of a Russian legal entity if more than 50% of its assets consist of immovable property located in Russia, or from sales of financial instruments which are derived from such shares (excluding most sales on a foreign stock exchange);
- income from sales of immovable property located in Russia;
- income from leases and sub-leases of property used in Russia (including sea and aircraft);
- income from international freight, including demurrage and other payments relating to freight;
- fines and penalties due by Russian parties for breaking contractual obligations;
- other similar types of income.

Income generated from the sale of goods, the performance of work and the provision of services in Russia are not subject to Russian withholding tax, provided that the activity does not lead to the creation of a Russian PE. Withholding tax is applicable regardless of the form of payment and includes payments in kind or by means of a mutual offset of liabilities between the seller and the buyer.

With respect to income from the sale of shares or immovable property, related expenses may be deducted when determining the tax obligations of the FLE, provided that the tax agent receives documents supporting the expenses before payment is made. The withholding tax rate varies according to the type of income, as shown in Table 5. The issuer of securities must act as the tax agent regarding the payment of interest and dividends to a FLE, and if the issuer fails to withhold the relevant tax, responsibility lies with the broker, asset manager, nominal holder or other agent to the transaction. The broker, asset manager, etc., is also the responsible tax agent with respect to withholding tax on a capital gain derived by an FLE from the disposal of securities. The tax agent is not obliged to withhold tax in the following circumstances:

- the tax agent has received notification from the taxpayer that the income relates to a PE of the taxpayer in Russia, and the taxpayer has provided a notarised copy of its tax registration certificate, issued no earlier than the previous tax period;
- the income is exempt from tax under a production sharing agreement;
- the relevant double tax treaty provides for an exemption from withholding income tax.

To claim the benefit of a double tax treaty at the time of paying Russian-sourced income, the foreign legal entity must provide written confirmation to the payer that it is a tax resident of that foreign country. The written confirmation must be provided prior to the payment date.

It must also be certified by the competent foreign body and apostilled. Lastly, the Russian tax authorities may also require a legalised Russian translation of the confirmation. If confirmation is not provided prior to payment, and the foreign company suffers a withholding rate greater than that provided by the treaty, it is possible to claim a refund within the three year period following the end of the tax period in which the payment was made.

In principle, after receiving the proper documentation, the Russian tax authorities should refund any excess tax within one month of the date of the application. However, in practice this process is usually significantly delayed.

Special provisions allow banks to bypass the residence confirmation requirement for inter-bank transactions, provided that the residence of the foreign bank in a treaty jurisdiction can be confirmed by reference to a public information source.

Withholding tax rates for treaty countries

The main treaty tax rates for Russian-sourced income are shown in the Appendix.

Table 5

%	Type of income
10	Income from international freight and rental of property involved in international shipping and income from leasing and sub-leasing sea and aircraft
15	Dividends received by foreign companies from Russian legal entities, as well as interest on state and municipal bonds
20	Royalties, interest (other than that received from state and municipal bonds), income from leasing and sub-leasing of property used in Russia, distribution of profit or property to foreign companies, including liquidation proceeds and other similar income of an FLE without a PE in Russia
20	Profit from the sale of shares (or share derivatives) in a Russian entity, where more than 50% of the company's assets consist of immovable property located in Russia, or from the sale of immovable property located in Russia, provided that the income recipient submits documents supporting the deductibility of the expenses to the tax agent prior to his payment of the proceeds. In the absence of documentation, etc., it is 20% of the sale proceeds

Tax incentives

In recent years, few tax incentives have been available in Russia, but that picture is now changing, partly due to the Russian government's current modernisation agenda.

Regional incentives

Regional authorities have the right to reduce their regional allocation of profit tax of 18% to 13.5%, resulting in a minimum overall tax rate of 15.5% including the 2% Federal portion. They may also provide exemptions from property and land tax, chargeable at maximum rates of 2.2% and 1.5%, respectively. Such exemptions are normally conditional on meeting specific investment criteria in the region. The St. Petersburg, Leningrad and Kaluga regions, among many others, offer incentives of this kind, but neither Moscow nor Moscow region have followed this lead.

Special Economic Zones

The legal framework for Special Economic Zones (SEZs) provides for broader tax and other concessions.

The 24 existing zones have geographical boundaries and fall into four categories: Industrial, Innovation, Tourism and Port & Logistic. All are created for a period of 49 years. Although originally slow to take off, the infrastructure of many of the Industrial and Innovation SEZs is well advanced and approximately 250 investors, including more than 25 foreign investors, are now in place.

The potential benefits include a customs free zone, accelerated depreciation, reduced social contributions and a guarantee against unfavourable changes in tax law. Reduced rates of profit tax also apply, depending on the regional authority and type of zone, but until 2012 the overall rate could not be less than 15.5%. As of 2012, the minimum rate is 2% (the Federal portion of the tax), and 0% in the case of Innovation and Tourist SEZs.

Kaliningrad and Magadan have separate SEZ regimes where different concessions apply. The Kaliningrad region provides for 0% profit and property tax rates for SEZ residents for the first six years.

Skolkovo

The Skolkovo Innovation Centre is a site close to Moscow which aims to attract R&D activity in a number of specific technical fields. A participant is exempt from profit tax reporting until the year in which annual turnover exceeds RUB 1 billion, and is then taxable at a 0% rate until the start of the year in which profit of RUB 300 million (approximately USD 10 million) accrues. A property tax exemption applies up to the same point, while VAT starts from the quarter in which the RUB 300 million threshold is reached. The profit tax and VAT exemptions expire 10 years after becoming a participant. Social security contributions are also reduced.

Social insurance concessions

Reduced rates of social insurance contribution ranging from 14-26% (compared to the 30% standard rate), and the exemption of earnings exceeding the cap, may apply to Russian companies/individual entrepreneurs ("IEs") working in the following areas:

- software development (more than 30 employees);
- engineering (more than 100 employees);
- where the taxpayer is resident in an Innovation or Tourism SEZ;
- production and publication of mass media;
- agricultural production where the taxpayer qualifies for the unified agricultural tax regime;
- taxpayers engaged in the production and social spheres applying the simplified taxation regime.

Imported equipment

There is an import VAT exemption for "technological equipment which has no equivalent produced in Russia", according to a government-approved list.

The equipment listed generally also qualifies for a 0% rate of customs import duty. The customs import duty exemption for certain equipment imported as in-kind charter capital contribution remains in effect.

Other incentives

- Certain types of research and development expenditure qualify for a 150% profit tax deduction.
- Export oriented software developers may apply an immediate profit tax deduction for computer equipment.
- Accelerated depreciation is available for certain leased assets, and those used for research and development or with a high energy efficiency rating.
- The profit tax rate for priority medical and educational activity meeting certain criteria is 0%. The same applies to certain agricultural producers until the end of 2012
- Other forms of federal and regional support, including interest subsidies, investment tax credits and grants, may be available for certain investment projects.

VAT applies to companies, including representative offices and branches of foreign companies, entrepreneurs and any person importing goods into the Russian Federation

The rules applying to goods imported from other member states of the Customs Union are covered below. Companies and entrepreneurs may apply for exemption from VAT if their aggregate revenues for three consecutive months, excluding VAT, are below RUB 2 million (approximately USD 67,000). In addition, businesses which apply certain special tax regimes, such as the simplified tax system (available only to relatively small businesses) and the unified agricultural tax regime are outside the scope of VAT unless they import goods into Russia.

VAT registration

Russian legislation does not provide for separate VAT registration. Therefore, when foreign companies with a presence in Russia register with the Russian tax authorities, they register for all taxes including VAT.

Taxable supplies

VAT is charged on the majority of sales of goods, work and services supplied in Russia, including those supplied free-of-charge. VAT is also imposed on most imports into Russia. The transfer of property rights and certain self-supplies, such as the internal consumption of goods and services produced by a taxpayer where the associated costs are not deductible for profit tax purposes, as well as construction for own use, are also subject to VAT.

Place of supply rules

These rules are used to determine whether or not goods, work or services are supplied in Russia and are thus subject to Russian VAT. Goods are treated as being sold in Russia if they are located in Russia and are not being transported, or are located in Russia at the moment of dispatch. 'Russia' for these purposes includes offshore platforms and other installations on the Russian continental shelf and exclusive economic zone.

Work and services are generally deemed to be supplied at the place of business of the supplier unless another special treatment is applicable. In particular, special treatment applies to the following:

- Services relating to immovable property and movable property which are deemed to be supplied where the property is located
- Cultural, sports, arts, educational or tourism services which are deemed to be supplied at the location where these services are performed
- Transportation, freight and associated services which are deemed to be supplied in Russia if the point of departure or destination is located in Russia, and provided that these services are supplied by Russian entities or entrepreneurs
- Leases of movable property, except for motor vehicles; provision of personnel, provided that they work at the place of business of the service buyer; consulting, legal, accounting, audit, engineering, advertising, marketing, information-processing, research and development, and software development, modification and adaptation services, the transfer of rights to intellectual property. These services are deemed to be supplied at the place of business of the buyer
- Certain work and services relating to the geological study, exploration and production of hydrocarbons on the Russian continental shelf and exclusive economic zone are deemed to be supplied in Russia

The place of business is defined as the place where the company is registered. If the company does not have state registration, the place of business is the location of the company's management and executive body, the place indicated in the company's incorporation documents as its place of business, or where the company's permanent establishment is located (if the services are connected with the activity of that establishment).

If goods, work or services are deemed to be supplied outside Russia in accordance with the above rules, they are outside the scope of Russian VAT.

VAT rates

There are three main rates of VAT depending on the nature of the supply.

The 0% rate applies, in particular, to the sale of goods exported outside the Russian Federation (including export sales of oil, gas condensate and natural gas).

The 0% rate also applies to a list of services which includes, in particular:

- transportation of passengers and baggage where either the point of departure or destination is outside Russia;
- international transportation of goods, where either the point of departure or destination is located outside Russia, including certain freight forwarding services;
- certain pipeline transportation services with respect to exported and (or) imported goods, as well as certain services relating to the arrangement of pipeline transportation;
- certain cross border railway transportation services and services relating to such transportation, including some types of provision of railway rolling stock and/or containers;
- certain services rendered at sea and river ports relating to the transshipment and storage of goods moved across the Russian border as well as certain services rendered by inland waterway transportation companies with respect to exported goods;
- processing services rendered with respect to the goods placed under the customs processing regime;
- transportation of exported or imported goods by sea vessels and mixed navigation vessels performed on the basis of time charter agreements.

In order to confirm the 0% rate, a set of documents is prescribed for each type of service.

The 10% rate applies to certain foods, children's goods, medical and pharmaceutical products, and certain books and periodicals.

The 18% rate applies to all other taxable sales of goods, work and services. Particularly, domestic sales of oil, gas condensate and natural gas are subject to the 18% VAT rate.

There are also computed VAT rates (10/110 and 18/118) applied to certain transactions such as the receipt of advance payments and other payments connected with settlements for supplies, as well as to certain types of transfer of property rights.

Recent amendments to the Tax Code introduced a closed list of work and services relating to the geological study, exploration and production of hydrocarbons on the Russian continental shelf and exclusive economic zone that are subject to Russian VAT, allowing for the recovery of corresponding input VAT.

VAT exemptions

Activities which are exempt from VAT include, in particular:

- lease of office space and accommodation to accredited foreign representative offices and foreign individuals;
- medical services and the sale of certain medical equipment;
- banking and insurance services;
- sales of "FITTS" (financial instruments of term transaction — broadly, financial derivatives);
- stock lending (including interest) and "repo" transactions;
- interest on monetary loans;
- warranty services, including the cost of spare parts;
- gambling;
- licensing or assignment of certain intellectual property rights;
- assignment of claims arising from loan agreements;
- sale of land and residential buildings and premises or any interest in such property;
- certain research and development activity.

The free-of-charge supply of goods for advertising purposes is exempt from VAT, provided that the total acquisition or production cost does not exceed RUB 100 per unit (approximately USD 3). The import of certain types of equipment is exempt from VAT, in particular "technological equipment which has no equivalent produced in Russia" according to a government approved list, and certain medical equipment. Special VAT exemptions apply to the organisation and conduct of the 2014 Winter Olympic Games in Sochi and to participants in the Skolkovo Innovation Centre. Revenue earned from the supply of international telecommunication services to foreign customers is not subject to VAT.

Taxable base

VAT liability generally arises on the earlier of the following two dates:

- the date of shipment or transfer of goods, work, services and property rights;
- the date of payment or partial payment for a future shipment of goods, performance of work, provision of services or transfer of property rights.

No VAT applies to advances or partial payments received for future supplies of most zero-rated goods, work and services; for future supplies of goods, work and services with a production cycle exceeding six months; or for future VAT-exempt supplies. Taxpayers receiving advances or partial payments for the future shipment of goods, supply of work or services, or transfer of property rights, should calculate their VAT base twice. The calculation must be first performed when the prepayments are received and again when the goods are dispatched, work or services performed or property rights transferred. Thus, VAT accounted for on prepayments may subsequently be offset against the full amount of VAT due after dispatch, etc. On the date of the shipment of goods, performance of work or services or transfer of property rights, VAT should be applied to the full transaction price (excluding VAT).

Manufacturing and trading companies calculate their taxable base as the sales price of goods sold, including excise tax (if applicable). For agents and entities selling on a commission basis, the taxable base is defined as the commission or fee income. For import purposes, the taxable base is determined as the customs value plus import duties and excise tax (if applicable). Construction work carried out using a company's own workforce is also subject to tax based on the expenditure incurred. In addition, various other payments are subject to VAT. These include funds received in addition to sales revenues and relating to VATable sales, as well as interest (or discounts) on promissory notes received as consideration for VATable supplies, and interest on trade loans with rates in excess of rates set by the Central Bank of Russia. Certain insurance premiums are also subject to VAT.

Input tax and rules for offset

The VAT payable to authorities is determined as the difference between the VAT accountable on transactions subject to VAT, including those subject to the 10% or 0% rates ("output VAT"), and the VAT

incurred on purchases subject to VAT ("input VAT"). A "credit", "offset" or "recovery" is thus generally obtained for input VAT incurred. Taxpayers are entitled to claim an offset of VAT without having paid their suppliers. Confirmation of actual payment of VAT is required in order to claim an offset of VAT paid upon the import of goods into Russia, VAT accounted for by tax agents, as well as VAT on business trips and entertainment costs. Taxpayers are entitled to claim an input credit for the amount of tax included in advance payments made to suppliers, provided that a VAT invoice is obtained from the supplier and the advance payment is provided for contractually. The input credit should be reversed by the customer when the right to VAT recovery on the purchases arises, or when the advance payment is returned. VAT invoiced by contractors for capital construction and installation work may generally be offset when such work is booked in the accounts, rather than when the entire construction project has been completed. VAT incurred on construction for own use may be offset in the same tax period that it is charged. Input VAT incurred on purchases of fixed assets can be offset when the assets are booked in the accounts. Input VAT incurred on non-production expenses cannot generally be offset. VAT incurred on business travel, entertainment can only be offset within set limits. Input VAT cannot generally be offset when incurred on exempt activities, and should instead be capitalised, i.e. included as part of the cost of goods, work, services and property rights purchased. VAT incurred on purchases made in connection with the sale of goods, work and services deemed to be made outside the Russian Federation cannot be offset and must also be capitalised.

VAT incurred on purchases and expenses which relate to both VATable and non-VATable activities must be apportioned. Only the part which is deemed to relate to VATable activities may be offset as input VAT.

That part which is deemed to relate to non-VATable activities must be capitalised. Taxpayers must maintain separate accounting records for VATable and non-VATable operations. Failure to do so may result in the disallowance of VAT, either as an offset or as a deduction for profit tax purposes. There is no requirement for separate accounting records for periods when the total expenditure on purchase, production and / or supply of non-VATable goods, work, services and property rights does not exceed 5% of the total such expenditure. Subject to the above condition, taxpayers have the right to offset the full amount of input VAT invoiced by suppliers in the relevant tax periods. Input VAT relating to zero-rated supplies should also be separately accounted for. Input VAT relating to a zero-rated supply can be claimed when the tax point for the supply occurs, i.e. generally on the last day of the tax period in which all the documents required to support the zero VAT rate have been collected.

To substantiate the claim for the recovery of export-related input VAT, exporters are generally required to collect and submit to the tax authorities the following documents: contracts, customs declarations and shipment documentation confirming the export of goods outside Russia.

Foreign entities that are not registered in Russia for tax purposes have the right to offset input VAT paid to their suppliers in Russia only when they have registered with the tax authorities. Tax registration usually gives rise to other tax implications, such as the risk of creating a permanent establishment for profit tax purposes.

In some cases, input VAT offset in previous periods should be reversed partially or in full. These cases include in-kind equity contributions to the charter capital of a legal entity, situations where a taxpayer starts using assets (the input VAT on which has been previously offset) for non-VATable or zero-rated transactions, situations where supplies are funded by advance payments, and situations where taxpayers receive federal subsidies to cover the VAT-inclusive cost of goods, work or services or to cover VAT due on the import of goods. Any excess of input VAT over output VAT should be reimbursed to the taxpayer by the tax authorities or offset against the taxpayer's future VAT or other federal tax liabilities. Generally, VAT reimbursement or offset should only be made after the tax authorities have undertaken a "desk audit" (please refer to the chapter entitled "Tax administration") and confirm the legitimacy of the input VAT claimed. If no violations are identified in the course of this tax audit, the excess of input VAT over output VAT should either be offset against the taxpayer's current VAT and other federal tax liabilities or refunded in cash after the taxpayer has submitted a written application. If the VAT reimbursement is denied, there are special rules and procedures for taxpayers and the tax authorities to follow in order to resolve the dispute.

The following categories of taxpayers may apply for an accelerated VAT refund procedure:

- corporate taxpayers whose aggregate liability for VAT, excise duties, profit tax and mineral extraction tax for the three calendar years prior to the year in which the refund application is made is not less than RUB 10 billion (approximately USD 333 million) and the entity was incorporated at least three years prior to the date the refund application is made;
- taxpayers which submit a bank guarantee from a bank approved by the Ministry of Finance.

The period for obtaining a VAT reimbursement under the new procedure has been reduced to 11 working days starting from the day the application is filed with the tax authorities. Desk audits may still be conducted.

VAT invoices

A VAT invoice serves as the basis for the offset of input tax invoiced by suppliers. The Tax Code requires that certain specific information is shown on a VAT invoice. In particular, VAT invoices must be issued in Russian and must bear the original signatures of both the head of the company and the company's chief accountant. Electronic invoicing is permitted in principle but currently not applied in practice due to the absence of electronic forms of VAT invoices awaiting formal approval by the authorities.

Errors in VAT invoices which do not relate to the identification of the supplier, buyer, costs of goods (work, services or property rights supplied), as well as the VAT rate and amount, are not grounds for denying a VAT recovery, thus formalising the approach already applied by most arbitration courts.

From 1 October 2011, "amending VAT invoices" were introduced. These should be issued by a supplier to the buyer when there is a change in the value of goods, work or services supplied or property rights transferred, including a change in the price or adjustment to the quantity etc. supplied.

Where the value of the supply increases, the supplier must account for the additional VAT, while the buyer is entitled to offset VAT based on the amending VAT invoice. If there is a decrease, the converse applies.

Reverse charge

If foreign companies without Russian tax registration supply goods, work or services in Russia and these supplies are deemed to be made in Russia according to the place of supply rules, the remittance of VAT is made through a withholding mechanism. The tax-registered buyer of these goods, work and services is required to act as a tax agent, i.e. to withhold VAT from the amount payable to the foreign supplier and remit that tax to the tax authorities.

The rate of withholding is 18/118 of the gross invoice, equal to 18% of the net payment. Having withheld and paid the VAT to the tax authorities, a Russian buyer can then offset this VAT against its output VAT under the general rules for offsetting input VAT. In practice, this mechanism operates in a similar way to the European "reverse charge", although in Russia withholding VAT is only recoverable to the extent that it has been paid by the tax agent to the tax authorities. Commissioners and agents with a Russian tax registration which supply goods, work, services or property rights in Russia on behalf of their unregistered foreign principals and participate in settlements should account for Russian VAT as tax agents. Russian VAT should be added by commissioners to the net value of the goods at the appropriate VAT rate and remitted to the Russian tax authorities. Commissioners do not have the right to claim the offset of VAT paid on behalf of foreign principals.

Payments and filings

The VAT reporting period is the calendar quarter. A VAT return should be submitted and the tax should generally be paid in three equal installments by the 20th day of each of the three consecutive months following the reporting quarter. VAT withheld from payments to foreign legal entities for work or services rendered in Russia should be remitted to the tax authorities at the same time as making these payments.

Customs Union

There are special rules applying to transactions involving tax payers of the member states of the Customs Union (Russia, Belarus and Kazakhstan). Goods exported from one member state of the Customs Union that are destined for another are subject to the 0% rate, subject to confirmation by a specific list of documents. The tax base for imported goods is defined, and the import VAT rates must be the same as those applicable to domestic transactions within the importing member state. VAT must generally be payable by the 20th day of the month in which the imported goods are booked in the importer's accounts. The place of supply of work and services is also subject to confirmation by a specific list of documents. Unlike the usual Russian place of supply rule noted earlier in this chapter, design services are deemed to be supplied at the place of activity of the recipient of the service.

Transfer Pricing

Overview

After many years of discussion, new transfer pricing rules came into effect from 2012. The new rules are substantially based on the OECD Transfer Pricing Guidelines and it is therefore likely that both taxpayers and the tax authorities will rely on the practice and experience of countries with transfer pricing regimes based on similar principles. Compared to the old rules, the following key changes have been introduced:

- extended definition of related parties;
- amended list of controlled transactions;
- introduction of new transfer pricing methods (now five corresponding to the OECD approach);
- introduction of requirement to prepare and retain TP documentation;
- opportunity for largest taxpayers to enter into an advance pricing agreement with the tax authorities;
- introduction of "corresponding adjustments";
- introduction of separate transfer pricing audit and penalty (please refer to chapter entitled "Tax Administration" for further details).

Related Parties

There are 11 categories of related party, with ownership of more than 25% being one of the main criteria for recognition as such. A court can recognise parties as being related on grounds which are not specified in the law, while taxpayers may likewise claim to be affiliated on other grounds.

Transfer Pricing Methods

The permitted transfer pricing methods are:

1) Comparable uncontrolled price;
2) Resale-minus;
3) Cost-plus;
4) Comparable profitability;
5) Profit-split.

The law provides detailed guidelines on how to apply each method. CUP remains the primary method and may be applied where information concerning at least one comparable transaction is available. In some cases the resale minus method is the primary method, for example in the case of resale of goods. The application of two or more of the methods listed is permitted.

Controlled Transactions

Transfer pricing control may be applied to a single transaction, or group of similar transactions, of the following types:

Cross-border transactions

- with related parties, including supply arrangements with third-party intermediaries;
- with goods traded on commodity markets, e.g. crude oil or precious metals, and those with offshore residents of certain "low tax" jurisdictions, if the transaction amount exceeds RUB 60 million (approximately USD 2 million). The parties in this case need not be related.

Domestic related party transactions

- If transactions between two related parties in 2012 exceed RUB 3 billion (approximately USD 100 million; reducing to RUB 2 billion in 2013 and RUB 1 billion in 2014).
- If transactions between two related parties in a calendar year exceed RUB 60 million and one of the following applies:
  - Mineral Extraction Tax is being paid at the ad valorem rate;
  - one of the parties is exempt from, or pays 0% rate, profit tax;
  - one of the parties is a resident of a special economic zone.
- If transactions between two related parties in a calendar year exceed RUB 100 million (approximately USD 3.3 million) and one of the parties pays unified tax on imputed income or unified agricultural tax.

The transfer pricing rules do not apply to transactions between companies which are members of a consolidated taxpayer group.

Sources of information

The information required to determine the market price profitability should be obtained from official and publicly available sources, for example domestic and foreign stock and commodity exchanges, customs data relating to Russian overseas trade and other official domestic or foreign sources of information. The law specifically provides that for the purposes of determining the profitability range, the accounting and statistical data of foreign organisations may be used only if Russian sources do not exist or are unavailable.

Transfer Pricing Documentation

Companies must retain specific transfer pricing documentation if the total amount of revenue from all controlled transactions with the same counterparty in 2012 exceed RUB 100 million (approximately USD 3.3 million, reducing to RUB 80 million in 2013. No limitation applies from 2014). Furthermore, such companies must file a notification with the tax authorities about their controlled transactions during a calendar year no later than the following 20 May. The tax authorities may request transfer pricing documentation relating to a taxpayer's controlled transactions during a calendar year no earlier than the following 1 June. A taxpayer is obliged to file documentation with the tax authorities within 30 days after receiving their request. Documentation should be prepared in Russian.

3.5. Mineral Extraction Tax

Mineral extraction tax (MET) is imposed on legal entities and private entrepreneurs for the extraction of minerals, including oil and gas, from the subsurface and from production waste. In order to be permitted to extract minerals commercially, an appropriate license should be obtained.

Object of Taxation

The Tax Code defines taxable products as commercial minerals extracted from:

- subsoil deposits on the territory of the Russian Federation;
- subsoil deposits under jurisdiction of Russia; (i.e., exclusive economic zones and continental shelf);
- waste products or losses (subject to certain conditions).

Tax Base

MET is determined on the basis of either the physical quantity of the mineral resources extracted or their physical quantity and value. Value is determined based on the quantity of minerals extracted and their selling price, net of VAT, customs duties and levies, and less transportation expenses. If no sales of a particular mineral resource were made during a tax period, taxpayers should calculate the value of the extracted minerals based on their production cost. The value must be calculated based on the tax accounting records maintained for profit tax purposes and the procedures provided by tax legislation.

For gas condensate, MET is computed on the value of minerals extracted. For oil, natural and associated gas, MET is based on the volume of minerals extracted.

Under the **Direct** method the actual quantity of extracted minerals is determined by means of measuring devices and equipment.

Under the Indirect method the quantity of extracted minerals is determined by means of calculation on the basis of previously obtained information on the level of content of the extracted commercial mineral in the raw materials recovered from the subsurface (waste, losses). The information on the level of content of mineral is generally identified in the phase of prospective geological examination and follow-up exploration.

The Indirect method can only be applied when the actual quantity of extracted minerals cannot be determined (e.g., a taxpayer does not have relevant measuring equipment).

The selected method of determining the quantity of extracted commercial minerals should be stated in the tax accounting policy of a taxpayer, and should be applied by the taxpayer for the entire duration of activities involving the extraction of commercial minerals.

Table 6

Type of Mineral Resource	Object of taxation
All Mineral Resources, except Crude Oil & Natural Gas	• Value • Volume × Sales Price; or • Expenses related to extraction.
Crude Oil & Natural Gas	Volume (physical quantity) which is determined by either: • Direct method; or • Indirect method.

Tax Period

The tax period is a calendar month.

Tax rates

The rate of tax varies according to the type of resource.

Crude oil

For oil, the MET rate for 2012 is RUB 446 per ton (approximately USD 15) and RUB 470 per ton (approximately USD 16) for 2013. The rate is adjusted using a coefficient reflecting changes in the world oil price, RUB/USD fluctuations and the level of depletion of the relevant field.

The coefficient is determined according to the following formula: (P-15)*R/261*D, where P is the average price per barrel of Urals blend crude oil (USD per barrel) for the tax period and R is the average monthly RUB/USD exchange rate as established by the Central Bank of Russia, and D is the depletion factor, determined by the taxpayer.

Table 7

Example: MET rate against Price factor*					
Urals price USD/bbl	40	60	80	100	120
Exchange rate	29	29	29	29	29
MET rate (RUR/ton)	1239	2230	3221	4212	5203
MET rate (USD/bbl)	5.5	9.9	14.3	18.7	23.1

* The calculation is relevant for 2012

A special regressive coefficient applies for blocks depleted by more than 80%.

Factors affecting applicable MET rate are summarised below.

MET rate = Base rate x Price factor x Exchange rate control x Depletion factor

A 0% MET rate is applied in following cases:

- for extraction of oil with viscosity exceeding 200 mPa/sec per ton of extracted oil;
- for extraction of oil from fields located in the following areas, subject to certain cumulative production and development period constraints (per ton):
  - the Republic of Sakha (Yakutia), Irkutsk and Krasnoyarsk regions (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 10 years, and the cumulative production of oil has not reached 25 million tons)
  - areas located to the north of the Arctic Circle (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 10 years, and the cumulative production of oil has not reached 35 million tons)
  - areas of the Sea of Azov and the Caspian Sea (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 7 years, and the cumulative production of oil has not reached 10 million tons)
  - areas of the Black Sea (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 10 years, and the cumulative production of oil has not reached 20 million tons)
  - areas of the Sea of Okhotsk (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 10 years, and the cumulative production of oil has not reached 30 million tons)
  - areas above latitude 65 North located fully or partially within the Yamalo-Nenets Autonomous District, except Yamal Peninsula (if the field in question has been in operation under a license for use of subsoil resources, search for mineral deposits, exploration and production for a period no longer than 10 years, and the cumulative production of oil has not reached 25 million tons).

Natural gas

The current tax rate for extraction of natural gas is RUB 251 per 1,000 cubic meters. A specific rate of RUB 509 per 1,000 cubic meters is applied to Gazprom and its 50% (or more) affiliates. For associated gas (gas extracted via an oil well) the rate is RUB 0.

The existing tax rate for extraction of natural gas will be increased with the further annual adjustment to the forecast rate of inflation (the planned increase will be by 5.6% in 2013 and by 4.9% in 2014). Therefore, 2013 rate will be RUB 265 per 1000 cubic meters, 2014 rate will be RUB 278 per 1000 cubic meters.

The MET tax rates are summarised in Table 8.

Table 8

Type of mineral resource	Tax rate (RUB)		
	2012	2013	2014
Crude oil	446	470	TBD
Gas condensate	556	590	647
Natural gas (per 1000 cubic meters)			
Gazprom and 50% or more affiliates	509	582	622
Other producers*	251	265	278
Associated gas and standard losses of mineral resources	0% or RUB 0 per unit of measurement		

* The Gazprom rates are adjusted by co-efficients of 0.493, 0.455 and 0.447, respectively.

Employment

Russian employment law applies to all employment relationships in Russia, including those involving Russian and foreign nationals.

Overall, the current employment law of Russia is based on provisions of USSR employment regulations and provides a lot of benefits and guarantees for employees.

The most important guarantees are:

- exhaustive list of cases when it is permitted to conclude a fixed-term labour contract;
- rather complicated procedure of terminating the labour contract at employer's initiative;
- obligatory provision of annual paid vacation of at least 28 calendar days;
- additional payments for overtime work, work at weekends and public holidays;
- additional guarantees and compensations for certain categories of employees (for example – for those working under the "shifts" (rotational) method, pregnant women, etc.).

It is important to note that, according to Russian labour law, salary should be paid to employees at least twice per month in Russian rubles.

Violation of the Russian employment regulations are considered as an administrative offence and may result in the following types of liability:

- administrative fine of up to RUB 50,000 (approximately USD 1,700) for an employer;
- administrative fine of up to RUB 5,000 (approximately USD 170) for the company's officials;
- suspension of the activities of the employer for a period of up to 90 days according to a court decision.

It is also worth mentioning that there is no legal concept of "secondment" under Russian civil and labour legislation, and although not specifically restricted by law, in practice the authorities may question the motives of the parties entering into secondment arrangements and request detailed information.

Visa and other immigration requirements

Before a foreign national can work in Russia as an employee, both a work visa and a work permit must be obtained. A work visa differs from a business visa in that a work visa allows a foreign national to be employed in Russia for one year (or up to three in the case of highly qualified specialists — see below), while a business visa merely confers the right to visit Russia for business purposes. Work permits for foreign employees are obtained by employers from the Federal Migration Service (FMS).

A work permit may currently be obtained through two different procedures.

General procedure

The general process, applied to all foreign nationals coming to Russia under a "visa procedure" (generally from non-CIS countries) by default, is fairly time-consuming and includes the following stages:

- reserving a quota for employment of foreign nationals for the following calendar year (a limited list of work positions is exempted from this procedure);

- obtaining a decision from local employment authorities on the "expediency" of employing foreign nationals, rather than Russian citizens;
- obtaining "corporate" permission to employ foreign personnel by the employer from FMS (valid for the period up to 1 year);
- obtaining individual work permits for each foreign national from FMS (valid for the period up to 1 year).

A work permit obtained under the "general procedure" allows a foreign national to work only in the Russian region where the work permit was obtained.

Highly-qualified specialists (HQS) procedure
HQS are defined as foreign nationals with experience, skills or achievements in a particular area who receive remuneration from their local employment of no less than RUB 2 million per annum (approximately USD 67,000).

Eligible employers include Russian legal entities and registered branches of foreign legal entities.

The benefits of the HQS procedure include:
- no quota restriction applies;
- employer does not need to obtain "corporate" permission to recruit and employ foreign personnel;
- work permits may be valid for a period of up to 3 years (and may be extended for a subsequent 3 years);
- work permits may be valid in more than one region of Russia.

The HQS regime imposes certain additional obligations on the employer, such as filing quarterly reports with the FMS regarding remuneration paid to HQS employees.

Liability for violating the immigration legislation
There are significant fines for violating immigration law.

If an employer lacks the required permission to employ foreign personnel, employs them without a work permit or fails to notify the FMS, tax authority or employment authority about the employment, the employer may be subject to an administrative fine of up to RUB 800,000 (approximately USD 27,000) per foreign national employed, or the suspension of its activities for up to 90 days according to a court decision.

For the same violation, the employer's officials may be subject to an administrative fine of up to RUB 50,000 (approximately USD 1,700).

The foreign national can also be fined up to RUB 5,000 (approximately USD 170), depending on the type of the offence, and may be deported from Russia.

Personal Income Tax

Taxpayers
Both Russian tax resident and non-resident individuals are subject to Russian income tax. Neither domicile nor citizenship are relevant. Russian tax residency is established if an individual is physically present in Russia for at least 183 calendar days during a 12 month rolling period. This 12 month period is not interrupted by brief trips outside Russia (i.e., lasting less than six months) for the purposes of medical treatment or study. A final determination of an individual's tax residency status is made based on whether 183 or more days have been spent in Russia in the calendar year. Individuals are taxed according to their status as follows: tax residents are taxed on their worldwide income, while tax non-residents are taxed only on their Russian-sourced income, irrespective of the nature of the income received.

Income tax rates
Different tax rates apply to residents and non-residents.

Residents
There are three different personal income tax rates that may apply to income earned by a Russian tax resident individual:
- a 13% rate applies to most types of income, i.e. other than those subject to an alternative rate;
- a 9% rate applies primarily to dividends received from Russian or foreign corporations;
- a 35% rate applies to certain prizes, insurance receipts and bank deposit interest in excess of specific limits, as well as to income deemed to be received on low-interest loans (except those used to acquire real estate).

Non-residents
A 30% rate applies to non-residents on all types of Russian-sourced income. Passive income (e.g. investment income) is Russian-sourced if it is paid/ due to be paid from a source located in Russia. Earned income (e.g. from employment) is Russian-sourced if

the duties for which it is received are performed in Russia. Dividends paid by Russian organisations to non-residents are taxed at a 15% rate, withheld at source.

Highly-qualified specialists

As mentioned above, a new immigration regime was introduced during 2010 for "highly qualified specialists", being foreign citizens with experience, skills or achievements in a particular area who, under their (local) employment arrangements, receive remuneration of no less than RUB 2 million per annum (approximately USD 67,000), or lower in certain cases.

A highly qualified specialist is eligible for the standard personal income tax rate of 13% on remuneration from that employment, even before becoming a Russian tax resident. The employer of a highly qualified specialist is obliged to register the individual with the Russian tax authorities.

Taxable income

Taxable income is defined as gross income less allowable deductions and exemptions. For personal income tax purposes, gross income is defined as any economic gain in cash or in-kind that is actually or constructively received by a taxpayer and which is subject to the taxpayer's discretionary disposal.

Taxable income includes, but is not limited to the following:

- compensation for employment and hired services, in cash or in-kind;
- "imputed income", such as any benefit from low-interest loans or discounted goods, work or services and securities;
- payments made by an employer on behalf of an individual employee;
- payments made by an employer on behalf of an individual employee for: (i) utilities and communal services; (ii) periodicals and subscriptions; (iii) meals;
- housing costs paid by an employer for the benefit of an employee;
- the value of property transferred by an employer to an employee, net of any price paid by the employee;
- payments over and above the statutory limits for various state benefits, work related damages, redundancy payments and reimbursable transportation and business trip expenses;
- voluntary pension premiums paid by an employer on behalf of its employees to foreign plans that are not licensed in Russia;
- certain voluntary medical insurance premiums paid by an employer on behalf of its employees to foreign plans may be treated as taxable;
- gifts made to an employee, in cash or in-kind, with a value exceeding RUB 4,000 (approximately USD 130) per year;
- the proceeds, or in some cases the gain, from the sale of certain types of property;
- the fair market value of property received upon liquidation of an enterprise, less the total amount of charter capital contributions made by an individual;
- the fair market value of certain property distributed during the liquidation of an enterprise as a result of privatisation;
- pension income payable to individuals from private retirement pension funds in certain circumstances;
- certain gifts received from individuals.

Deductions and exemptions

The 13% tax rate applies to taxable income after the following four types of deduction:

- Standard tax deductions;
- Social tax deductions;
- Property deductions;
- Professional tax deductions.

These deductions are not available to non-residents.

Exemptions

Income which is not taxable includes the following:

- the reimbursement of certain expenses incurred for business trips and supported by documentation;
- certain cash and in-kind distributions in accordance with legislation, e.g. per diems, special uniforms, footwear, etc.;
- gifts received from an employer up to a total value of RUB 4,000 (approximately USD 130) per year;
- employment severance payments (other than for unused vacation) up to a cap, for managers and chief accountants, of three times average monthly salary for the preceding year (or six times in certain parts of Russia);
- foreign currency compensation paid to certain state employees working abroad;
- the value of additional shares or replacement shares issued as a result of the statutory revaluation of fixed assets and foreign currency items. This includes the value of shares issued as a result of a merger or reorganisation;

- interest and other receipts from Russian federal and regional bonds and other securities;
- income received from the sale of residential and other property (other than securities) owned for three years or more;
- bank interest within limits. For interest on Rouble deposits, the rate should not exceed the refinancing rate of the Central Bank of Russia plus five percentage points. For interest on foreign currency deposits, the rate should not exceed 9% per annum;
- state allowances, including maternity leave and unemployment benefits;
- state pensions and private pensions in certain cases;
- some types of state and private individual insurance payments;
- certain property received as a gift or by inheritance.

Treaty relief

Russia has signed a number of bilateral double tax treaties which offer protection against individuals' income being taxed in two or more countries. The provisions of these and other international treaties signed by Russia generally override Russian domestic law. In practice, however, the Russian tax authorities often deny the benefit of a treaty despite the submission of extensive documentary proof of tax residency in the other treaty state.

Assessment and collection procedures

Tax returns

Individuals must calculate their income tax liability and file income tax returns in the prescribed format if:

- income was received from an individual;
- income was received from sources outside Russia (in the case of a Russian tax resident);
- income tax was not withheld at source;
- income was received from gambling;
- income was received from the sale of property, with certain exceptions.

Individual entrepreneurs and private notaries must also file personal tax returns.

Filing procedures

Where tax has been withheld in full at source by a tax agent, individual taxpayers do not need to file a tax return. However, a tax return will be required if the taxpayer is applying for a tax deduction or has other sources of income subject to a filing obligation. An individual who is required to file an income tax return must do so no later than 30 April in the year following the tax year. The return should be filed with the tax inspectorate handling the individual's place of registration.

Tax withholding

The most common type of income payment subject to withholding is salary/remuneration paid to employees of tax agents. Income tax computed and withheld by an employer must be remitted to the budget according to one of the following schedules:

- no later than the day when the payroll amounts are transferred to the employees' bank accounts;
- no later than the day of actual receipt of the payroll amounts by the employer from a bank, where payment is made in cash;
- the day following the day of cash payment;
- the day following the day of tax withholding, if income was paid in-kind or is imputed income.

Ultimately, it is the individual taxpayer who is solely responsible for meeting his income tax obligation.

The law specifically prohibits an employee's income tax obligation from being met out of funds belonging to another party. If an employer pays tax on behalf of its employee from its own funds, this may not be treated as fulfillment of the individual's tax obligations.

Social insurance contributions

Overview

Social contributions are payable in respect of individuals engaged under employment or civil contracts, to the following four funds:

- State Pension Fund;
- Social Insurance Fund;
- Federal Obligatory Medical Insurance Fund;
- Local Obligatory Medical Insurance Fund.

The State Pension Fund and Social Insurance Fund are responsible for the administration of the contributions. The obligation to pay insurance contributions falls wholly on the employer, irrespective of an individual's tax status. Although this obligation extends beyond Russian employers to include foreign companies, there is no mechanism for foreign companies to pay insurance contributions in the absence of a Russian representative office or branch. Failure to pay insurance contributions may result in penalties.

From 1 January 2012, pension contributions are due in respect of most foreign employees, with exceptions made for those holding a Highly-Qualified Specialist work permit.

Rates

The base for calculating insurance contributions is calculated separately for each employee. Prior to 2012, earnings above an annually adjusted cap were not subject to contributions. From 1 January 2012, earnings above the cap are subject to additional Pension Fund contributions of 10%. At the same time, earnings up to the cap are subject to an overall rate of 30%, reduced from 34%. The rates, caps and maximum contribution liabilities for each employee are shown in Table 9.

Table 9

	2011	2012
State Pension Fund	26%	22% + 10% of remuneration exceeding cap
Social Insurance Fund	2.9% of remuneration up to cap	2.9% of remuneration up to cap
Federal Obligatory Medical Insurance Fund	3.1% of remuneration up to cap	5.1% of remuneration up to cap
Local Obligatory Medical Insurance Fund	2%	0%
Total	**34%**	**30% + 10% of remuneration exceeding cap**
Cap in RUB / USD 000s	463/15.4	512 / 17.1
Maximum liability per employee in RUB/USD 000s	157.4/5.2	153.6 / 5.1 + 10% of remuneration exceeding cap

Property tax

Property tax is a regional tax; thus, its application is governed by regional regulations, as well as the Tax Code.

Taxpayers

The following entities are subject to property tax:

- Russian entities;
- foreign entities which act through permanent establishments in Russia or own immovable property in Russia;
- separate subdivisions of Russian legal entities having separate balance sheets.

Tax base

Property tax is levied on both movable and immovable property. Property subject to tax comprises "Fixed Assets" and "Profitable Investments in Property" as classified under Russian Accounting Standards, and property provided for temporary use, in trust, contributed under a simple partnership (joint activity) agreement, or received under a concession agreement. Land, water and other natural resources are not subject to property tax.

The tax base is the average annual residual value of taxable property (i.e., cost less depreciation), calculated in accordance with Russian accounting principles. The average annual value is calculated by taking the sum of the residual values of the relevant property on the first day of each month of the tax period and the last day of the tax period divided by the number of months in the tax period plus one. For details on how property tax applies to FLEs, please refer to the chapter entitled "Taxation of foreign presences". The property of religious organisations and various types of public organisation is tax exempt.

Tax rates

The maximum rate of tax according to the Tax Code is 2.2%, and this is the rate currently imposed in the majority of Russia's regions, including Moscow and St. Petersburg. However, a reduction or exemption is offered by some regional authorities, often conditional on investment in the region.

Tax payments

The tax period is a calendar year. Nevertheless, advance tax payments must be calculated and paid based on the results of each calendar quarter. Advance payments are computed by multiplying the average net book value of taxable property for the reporting period by one quarter of the applicable tax rate. The total amount of tax due for a tax period is determined by multiplying the tax base for the tax period by the tax rate for the entire period less the advance payments remitted for each quarter to date. Taxpayers must file quarterly tax returns not later than 30 days after the reporting period. Annual tax returns should be filed no later than 30 March following the reporting period. Regional authorities have the power to amend the tax payment deadlines. Some authorities exempt certain categories of taxpayer from quarterly advance payments. Interest applies to late payment of tax.

Property located in other regions

When an entity owns taxable immovable property located in a region other than that where it is registered, for example in a subdivision with a separate balance sheet, it is required to pay tax to the budget at each property location. The tax rates and the filing and payment procedures are governed in accordance with the law of that particular region.

Other taxes

Transport Tax

Transport tax is a regional tax, thus its application is governed by regional regulations, as well as the Tax Code. A region may only impose this tax if its legislation contains transport tax provisions in line with the Tax Code.

Taxpayers

Entities and individuals who are registered owners of "transport vehicles" are subject to transport tax. Transport vehicles are not limited to cars, motorcycles, motor scooters or buses, but include other transport vehicles, including aircraft, helicopters, yachts, snowmobiles, etc. However, aircraft, ships and river vessels owned by companies whose main activity is the transport of passengers or freight are exempt, as are vehicles used in agricultural production.

Tax base and rates

The tax base for transport vehicles subject to transport tax depends on the type of the vehicle. The tax rates are set out in the Tax Code, with those for motorised transport vehicles ranging from RUB 5 to 50 (approximately USD 0.15 to 1.50) per unit of horsepower. Regional authorities have the authority to increase or reduce these rates by a multiple of not more than 10 for certain types of motorised transport vehicles.

Tax payments and filing

Although the tax period for transport tax is a calendar year, most legal entities must make advance tax payments on a calendar quarterly basis. Regional authorities can exempt certain categories of taxpayer from advance tax payments. The amount of advance tax payable is calculated by multiplying the tax base by one quarter of the applicable tax rate for the current tax period. Filing and payment deadlines are set by the regional authorities. Legal entities must file an annual tax return (and pay the balance of tax) no later than 1 February of the following year.

Individual taxpayers are required to pay transport tax annually on the basis of notifications issued by the tax authorities in the location where the transport vehicle is registered, but not earlier than 1 November of the following year.

Land tax

Land tax is a local tax, thus its application is governed by local regulations, as well as the Tax Code.

Taxpayers

Land tax applies to legal entities and individuals who own land or have a permanent right to its use. Legal entities and individuals who apply special tax regimes, use land free of charge, or under lease agreements, are not subject to land tax.

Tax base

The tax base is the cadastral value of the land as determined on 1 January of the reporting year. The cadastral value for a specific plot is determined in accordance with the Russian Land Code. In the case of joint ownership, the tax base is determined for each taxpayer's share of the land. The tax base of land formed during a tax period is the cadastral value on the date of its cadastral registration.

Tax allowances

Religious, historical or cultural sites, as well as land used by the state, enjoy exemptions from land tax.

Tax rates

Local authorities set the land tax rate. Under the Tax Code, these rates may not exceed the following limits:

- 0.3% of the cadastral value of land which is either (i) used for agricultural purposes, or (ii) occupied by residential properties or utilities;
- 1.5% of the cadastral value of other land.

In Moscow, the following tax rates are applicable: 0.3% for agricultural land, 0.1% for land used for residential purposes, and 1.5% for land used for any other purposes.

Tax calculation, payments and filing

Although the tax period for land tax is a calendar year, most taxpayers must make advance tax payments on a calendar quarterly basis. Individual taxpayers, however, do not have to make advance payments unless they are entrepreneurs. Also, regional authorities can exempt certain other categories of taxpayer from remitting quarterly advance payments.

The amount of advance tax payable is derived by multiplying one quarter of the applicable tax rate by the cadastral value of the land subject to taxation, as determined on 1 January of the current tax period. Legal entities and individual entrepreneurs must file an annual tax return (and pay the balance of tax) not later than 1 February of the following year. Regional authorities have the right to amend the deadlines for tax payments, including advance payments, but individuals need not pay the tax before 1 November of the following year.

In Moscow, legal entities and entrepreneurs must pay the land tax no later than 1 February, and individuals no later than 1 December, of the following year.

Excise tax

Taxpayers

Excise tax is payable by companies and individual entrepreneurs on the production of excisable goods in Russia, or when excisable goods are imported into Russia.

Excisable goods

For oil products the categories of excisable goods are gasoline, motor oil and diesel. There is no excise tax on natural gas and crude oil.

Excise tax is imposed on the following transactions with oil products performed in Russia:

- Sales of self-produced excisable oil products
- Transfers of excisable oil products which are produced at a processing facility under a tolling agreement to the owner
- Inter-divisional transfers of self-produced excisable oil products within a company for the purpose of producing non-excisable products
- Transfers of self-produced excisable oil products for processing on a tolling basis
- Import of excisable oil products

Table 10

Type of excisable good	Rate (RUB per ton)*			
	1 January – 30 June 2012		1 July – 31 December 2012	
Gasoline/Diesel fuel	Gasoline	Diesel Fuel	Gasoline	Diesel Fuel
Below class 3	7,725	4,098	8,225	4,300
Class 3	7,382	3,814	7,882	4,300
Class 4	6,822	3,562	6,822	3,562
Class 5	6,822	3,562	5,143	2,962
Motor oil				6,072
Straight-run gasoline				7,824

* Progressive rates applied to gasoline and diesel fuel depending on their ecological standard.

Import and export of excisable goods

Since Russia generally applies the "destination principle" in assessing consumption taxes, exports of excisable Russian goods outside of Russia are free from excise tax. To obtain this exemption, a taxpayer must comply with certain customs export procedures and present documentation evidencing the export of the goods. A separate procedure for payment of excise taxes is established for goods imported into Russia from Customs Union member states.

Tax rates

Tax rates vary depending on the category of excisable goods. The rates are periodically adjusted by the tax authorities. The tax base is determined by either the quantity of excisable goods or the value of such goods depending on whether the tax rates are specific (i.e. a fixed amount per unit) or ad valorem (a percentage of the sales price).

Excise tax should be charged at the date of sale, which is generally deemed to be the date when the goods are dispatched. A producer of excisable goods may deduct excise tax paid on the purchase or import of excisable goods used in the production of those goods. Otherwise, excise tax is non-deductible. The excise tax rates applicable to oil products are shown in Table 10.

Payments and filings

The tax period is the calendar month. Deadlines for tax payments and submission of tax returns vary, depending primarily on the category of excisable goods. Excise tax reporting and payments must be made at the location of the taxpayer and at any separate sub-divisions which carry out transactions subject to excise tax. Certain alcohol and tobacco products, both domestic and imported, require an advance payment by means of an excise stamp, which must be attached to each excisable item at the place of production prior to its sale.

Customs payments

Overview

A Customs Union between Russia, Belorussia and Kazakhstan has been in operation since 2010. The member states have adopted a common classification for goods — the Harmonised System of the Customs Union (based on the International Harmonised System) — and common import customs duty rates — the Unified Customs Tariff — for goods imported from third countries. Import customs duties are levied based on the classification code and country of origin of the goods being imported. Import customs duty rates are normally expressed as a percentage of the value of goods imported, known as "ad valorem" duties. However, they may also be expressed as a set monetary amount per unit or kilogram — "specific" duties. Finally, they may be expressed as the greater or the sum of the two — "combined" duties. Several "ad valorem" rates of import customs duties are available in Russia — in the majority of cases 5%, 10%, 15%. Certain goods are exempt from import customs duty. The rate of import customs duty depends on the exact nature of the goods being imported. Goods are classified into 97 groups according to the Harmonised System of the Customs Union. Basic import customs duty rates are not constant and may vary depending on the country of origin of the goods, type of goods and occasionally on other factors. Countries are classified into five groups for the purposes of applying import duty rates, as shown in Table 3. Import VAT and excise tax (if applicable) is also levied upon import of goods into Russia.

World Trade Organisation (WTO)

The negotiations on Russia's accession to the World Trade Organisation (WTO) have been completed and, subject to Russian ratification, the country could become a full member of the organisation by mid-2012. Thereafter, Russia must follow WTO rules as well as the terms and conditions of accession as agreed during negotiations.

Exemptions

There is an import VAT exemption for "technological equipment which has no equivalent produced in Russia" according to a government approved list. The equipment listed generally also qualifies for a 0% rate of customs import duty. The general rule is for each shipment to be considered on a standalone basis and so when technological equipment comprises more than one shipment, a special procedure may be applied to classify the equipment under the tariff code applicable to the assembled whole, with the import VAT and customs duty rates determined accordingly. There is also customs import duty exemption for certain equipment imported as in-kind charter capital contribution, but this is rarely used in practice.

Export customs duties

Export customs duties are levied on exports of oil, natural and petroleum gas and oil products. The duties on crude oil and oil products are adjusted by the Russian government on a monthly basis to reflect price movements in the European oil market. The flat rate on crude oil cannot exceed the maximum rate shown in Table 11.

Table 11

Urals prices (P), USD per ton	Maximum export duty rate
< 109.50	0%
109.50 – 146.00	35%*(P-109.50)
146.00 – 182.50	12.78+45%*(P-146.00)
> 182.50	29.20+65%*(P-182.50)*

* A reduction from 65% to 60% is planned.

The rate of export duty on natural gas is currently approximately 30% of the customs value. No duty applies to the export of liquefied natural gas. The rate on propane, butane, ethylene, propylene, butylene, butadiene and other liquefied gases is USD 201 per ton from 1 January 2012.

Special customs procedures

There are a number of customs procedures (regimes) that provide for either full or partial exemption from import customs duties and VAT. For example, full relief may be granted on goods which are imported into Russia to be processed and which are subsequently exported. Goods may also be imported under a temporary import procedure. As the name suggests, this procedure allows for either full or partial exemption from import duties and VAT for certain goods which are temporarily imported into Russia. Once the specified time period (usually two years) has expired, the goods must either be exported from Russia or transferred to a different customs procedure.

The customs-free zone procedure may be applied within certain Special Economic Zones, resulting in an exemption from import customs duties and taxes on imported raw materials, components, etc. until the processed products are moved out of the zone. Moreover, goods produced in Special Economic Zones from foreign goods may be exempt from customs duties and import VAT provided that a certain level of product localisation is met. The required level of localisation varies according to the type of goods and operations.

Currency control

Overview

The national currency of the Russian Federation (RF) is the Russian ruble. Historically, strict currency control regulations had been used to protect the ruble against devaluation and discourage "capital flight". Later, the Central Bank of Russia (CBR) and the federal government began a programme of currency liberalisation, with the most significant amendments introduced during 2003.

Legal definitions

Several key terms must be defined when describing the Russian currency environment. Russian currency is defined as CBR banknotes and coins in circulation, cash legal tender within Russia, including banknotes and coins withdrawn from circulation but still exchangeable and ruble funds in Russian bank accounts.

Foreign currency is defined as foreign banknotes, treasury notes and coins in circulation, and cash legally tendered within the territory of the issuing foreign country (or group of foreign countries), including banknotes and coins withdrawn from circulation but still exchangeable. Foreign currency also includes funds in bank accounts denominated in foreign currency and international monetary or payment units. Internal securities are defined as securities issued in Russia and which either have a Russian currency nominal value or certify the right to receive Russian currency. External securities are securities that do not qualify as internal ones.

Residents are defined as:

(i) individual citizens of the RF, except for those who are considered to be living permanently abroad;
(ii) foreigners and individuals without citizenship who live permanently in the RF on the basis of residency permits;
(iii) legal entities duly registered under Russian law;
(iv) branches and representative offices of Russian legal entities located abroad;
(v) diplomatic representatives, consular offices and other official representatives of the RF, located outside the RF as well as permanent representations of the RF under international or intergovernmental organisations; and
(vi) the RF, and regions and municipal units of the RF.

Non-residents are defined as:

(i) individuals not defined as residents;
(ii) legal entities and other organisations registered under the legislation of a foreign country and located outside the RF;
(iii) organisations (that are not legal entities) registered under the legislation of a foreign country and located outside the RF;
(iv) diplomatic representatives, consular offices and permanent representative offices of foreign countries under international and intergovernmental organisations accredited in the RF;
(v) international and intergovernmental organisations, their branches and permanent representative offices in the RF;
(vi) branches and representative offices, standalone or autonomous subdivisions of foreign legal entities or other foreign organisations located in the RF.

Authorised banks are RF incorporated credit institutions which are licensed by the CBR to undertake foreign currency transactions and CBR licensed Russian branches of foreign credit institutions that are also entitled to undertake foreign currency transactions. Currency transactions are acquisitions, exchanges, payments and imports/exports that involve currency valuables, rubles or internal securities.

Regulations on currency operations

Between residents

With some exceptions, payments between residents can only be made in rubles. One important exception is that residents may borrow from, and repay, authorised banks in a foreign currency.

Between non-residents
Non-residents have the right to open and operate both foreign currency- and ruble-denominated bank accounts in an authorised bank. Non-residents are permitted to make payments between themselves in a foreign currency without restriction, but payments in rubles made in Russia may only take place through bank accounts opened with authorised banks. Transactions involving internal securities between non-residents are permitted but subject to compliance with Russian antimonopoly and financial market legislation.

Between a resident and a non-resident
The general rule is that there are no restrictions on currency operations between residents and non-residents.

Currency restrictions
Transaction passports
The CBR continues to monitor currency transactions involving loans, the import or export of goods and the provision of services and intellectual property between residents and non-residents through the obligatory use of transaction passports. This involves filing documentation relating to the transaction with the bank.

Foreign bank accounts
Residents are required to notify the local tax authorities on opening or closing an account in a bank located outside the RF. Resident Russian legal entities must supply reports showing the movement of funds to and from their foreign bank accounts.

Import and export of foreign currency
Residents and non-residents may import foreign currency into Russia without restriction, although both resident and non-resident individuals must file a written customs declaration upon importing foreign (or Russian) currency in cash, travellers' checks, or internal or external securities when the value exceeds USD 10,000. Resident and non-resident individuals may export foreign currency up to USD 10,000 without submitting a customs declaration and above USD 10,000 with a declaration. Exports of over USD 10,000 are permitted up to the amount indicated in the relevant customs declaration or other relevant document evidencing the original import or transfer into the RF or acquisition in the RF.

Repatriation of foreign currency
Residents engaged in international trade or commercial activity must repatriate all rubles and foreign currency received from such activity to their Russian bank accounts, subject to certain exceptions.

Liability for infringements
The most severe administrative fines apply to the breach of repatriation requirements and for undertaking illegal currency operations, ranging from 75% to 100% of the amount of the relevant operations. Criminal liability may apply to residents failing to repatriate foreign currency exceeding RUB 30 million (approximately USD 1 million) to the RF. This violation may result in the imprisonment of the head of a legal entity for up to three years.

Tax administration

Overview

The key principles of the Russian tax system, including types of taxes, the rights and obligations of the tax authorities and taxpayers and procedural aspects of tax administration, are set out in Part I of the Tax Code of the Russian Federation. Some of the most significant provisions of Part I include the following:

- all contradictions, ambiguities and questionable issues in the tax legislation which cannot be resolved must be interpreted in favour of the taxpayer;
- tax legislation which increases tax rates or introduces new taxes or sanctions cannot be applied retroactively;
- there is a presumption of innocence on the part of the taxpayer, placing the burden of proof on the tax authorities;
- the tax authorities are required to maintain the confidentiality of information regarding taxpayers;
- tax legislation which mitigates a tax liability or establishes additional benefits for taxpayers have the retroactive effect.

From 2012, the Tax Code has introduced the concept of a consolidated group of taxpayers, one member of which is responsible for calculating and paying profit tax on the basis of joint business activity

Although Russian court decisions are not formally regarded as law, taxpayers are strongly recommended to take court precedent into account, since many of the basic Russian tax principles, terms and definitions have been developed by the courts (e.g. "substance over form", limitation of the period during which a tax authority's decision can be challenged in court, "mala fide" taxpayers). Furthermore, the legal position expressed in resolutions of Russia's Supreme Arbitration Court is binding on inferior courts if the Court specifies that fact in the resolution.

Special rules apply to the audit of such groups for profit tax purposes, as well as the payment of tax and penalties, which are beyond the scope of this chapter.

Administrative structure

The Russian tax system is administered by the Federal Tax Service. This broadly consists of inspectorates, which carry out day to day operations such as tax registrations, tax audits and tax collection, and tax directorates, which supervise the tax inspectorates and perform various other functions. The jurisdictions of both these bodies are based on geographical limits (e.g., city or district). The registration of a Russian legal entity includes de facto registration with the tax inspectorate office covering the company's registered address. In addition, a company should be also tax registered at the place of location of its separated subdivisions or property (real estate and transport vehicles). After tax registration, the tax authorities will issue the taxpayer with a certificate of registration and a tax identification number (TIN) which must be used on official documents (tax returns, invoices, payment orders and reports).

Tax audits

The tax audit is the main method applied by the tax authorities to control the accuracy of reporting, calculation and payment of tax. Tax audits have been criticised for the serious impact they can have on the conduct of a taxpayer's business, for example, due to the imposition of multiple audits and repeat requests for documentation and the technical weakness of some tax claims.

According to the Tax Code, the tax authorities are authorised to conduct the following types of tax audit with regard to taxpayers (individual and corporate) and tax agents: desk and field tax audits and transfer pricing audits.

Desk tax audits

A desk tax audit is conducted at the tax authorities' own premises on the basis of tax returns filed

by taxpayers. It must be conducted within three months of the date when the tax return is filed. The filing of an amended tax return during a desk tax audit should lead to the termination of the initial tax audit and the initiation of a new one with respect to the amended tax return (within three months of the amended tax return's submission). During the three month period, the tax authorities may request the following from the taxpayer:

- documents that should be submitted together with the tax return;
- documents supporting the taxpayer's right to a tax exemption;
- documents supporting the right of the taxpayer to recover input VAT;
- documents supporting the calculation and payment of tax relating to the utilisation of natural resources.

Where errors or contradictions in data are detected in the documents, the tax authorities are obliged to inform the taxpayer accordingly, note the correctness or otherwise of the tax return and request from the taxpayer explanations or make due corrections. A taxpayer is entitled to present documentation to the tax authorities in support of his explanation as to the accuracy of the tax return. If after reviewing the explanations, the tax authority finds that the taxpayer committed a tax offence or any other violation of the tax legislation, it must issue a tax audit report. The subsequent procedures are similar to those for field tax audits, and are described below.

Field tax audits

Field tax audits (sometimes referred to as documentary audits) are conducted at the taxpayer's premises and are initiated by a decision of the head (or deputy head) of the tax office at which the taxpayer is registered. In the event that the taxpayer is unable to provide accommodation for the tax officers, the field audit is carried out at the tax office. The Tax Code allows the tax authorities to take the following action during a field audit:

- access the taxpayer's premises on presentation of identification and the document authorising the field audit;
- examine the premises and property of the taxpayer in the presence of witnesses;
- request explanations and supporting documents from the taxpayer;
- examine witnesses;
- seize documents and other evidence, subject to the issue of an order initiated by the tax official conducting the audit and certified by the head (or deputy head) of the tax authority in the presence of the taxpayer and witnesses.

Duration and suspension

The duration of a field tax audit cannot exceed two months, although it can be extended for up to six months in "exceptional cases". The audit period starts running from the day the decision initiating the field tax audit is issued and ends on the day a memorandum on audit completion is issued. In practice, field tax audits are very rarely completed within two months, since the tax authorities often suspend the audit process. This can occur for an aggregate period of up to six months (with the two month period extended), but only on the basis of a decision by the head (or deputy head) of the relevant tax office. During the suspension, the tax authorities may:

- request information and documents regarding the activities of the audited entity from its contractors or others;
- obtain information from foreign state authorities based on Russia's international treaties;
- examine experts;
- translate foreign language documents submitted by the audited entity.

Tax audit report

A tax audit is completed with the issue of a memorandum. Not later than two months after the issue of this document, the tax authorities must issue a tax audit report which should reach the taxpayer within five business days. The report must contain the audit findings, specifying what provisions of the Tax Code have been violated — or the absence of a violation. Documents evidencing the tax offence must be attached to the report. If the taxpayer disagrees with the facts, conclusions or suggestions set out in the tax audit report, he may file a written objection together with supporting documents within the next 15 business days. Starting from the day the objection is filed, the head (or deputy head) of the tax office has 10 business days to review

the audit report and the taxpayer's objection. While the taxpayer must be notified of the place and time of this review, the absence of the taxpayer or his representative does not invalidate the review. Based on this review, the tax authority issues a decision — either to hold the taxpayer liable for the tax violation (or not), or to order additional tax control measures within one month. The latter decision is issued if it is necessary to obtain additional evidence of the tax violation. After additional tax control measures are conducted, the taxpayer has the right to meet with the tax authority to discuss the additional findings.

Where the tax audit relates to the recovery of VAT, the tax authorities should also issue a decision to reimburse VAT (or not), which may be challenged by the taxpayer in the same way as the main decision.

Decision enforcement

Depending on the nature of the decision, the tax authority will then issue a request to pay the tax, interest and penalties, stating the payment deadline. The request cannot be issued by the tax authority earlier than 10 business days after the taxpayer receives the decision (presumed received within 6 business days after being sent by registered mail), and the payment deadline cannot be less than 8 calendar days from the date the taxpayer actually receives the request. If the taxpayer fails to make the payment by the deadline, the tax authority has two months in which to issue a decision to collect the outstanding liability from the taxpayer's bank account(s). In practice, the tax authority normally issues a decision to freeze the taxpayer's bank accounts at the same time, followed by a collection order to the bank either on paper or electronically. The bank should then freeze any payment transactions up to the amount indicated in the decision sent to the bank. If the tax authority fails to issue a decision to collect taxes, interest and penalties within the required two month period, it can still file a claim with the court within six months of the payment deadline.

If a taxpayer's cash funds are insufficient to cover the demands, the tax authorities can collect the shortfall from the taxpayer's other property, including seizure of property, subject to following the relevant law on enforcement of court judgments. A decision to take such action must be issued within one year of the payment deadline. In addition to the above powers, the tax authority also has the right to issue an order prohibiting the taxpayer from disposing its property, up to the amount of the outstanding liability. The order is valid until the liability is paid (either voluntarily or compulsorily) or cancelled by a higher level tax authority or by a court decision.

Notwithstanding the above, a taxpayer has the right to challenge any decision of the tax authority before a higher level tax authority or in court and to take measures to protect its assets from confiscation. The decision of the tax authority may be challenged in court only after challenging it before the higher level tax authority.

Limitations on tax audits

The Tax Code includes a number of provisions limiting the powers of the tax authorities in relation to tax audits. Field tax audits may be initiated only with respect to the three year period immediately preceding the year in which the audit takes place. However, if the taxpayer files an amended tax return during a field tax audit, in respect of a period which does not fall within those three years, the return period may also be audited. In principle, a taxpayer can only be held liable for a tax violation, including tax underpayments, in respect of tax returns relating to the three year period up to the date of the decision. However, the period may be extended if the taxpayer "deliberately hindered" the conduct of the tax audit. There is no time limit for desk tax audits.

The tax authorities cannot conduct more than two field audits within each calendar year with respect to a particular taxpayer, except by a decision of the head of the Federal Tax Service. Furthermore, the tax authorities cannot conduct more than one field tax audit with respect to the same taxes and for the same tax period, with the following exceptions: where the taxpayer files an amended tax return reducing the amount of tax due; where a higher level tax authority reviews the audit of a lower level tax authority; and where a company has been reorganised or liquidated. If a taxpayer succeeds in challenging audit findings in court, the higher level tax authority has no right to repeat the audit.

Transfer pricing audits

From 2012, business transactions between interdependent persons are subject to transfer pricing audit carried out at the tax authorities' premises.

The grounds for undertaking an audit are the following:

- Statement of controlled transactions filed by the taxpayer
- A tax authority notification stating that unreported controlled transactions have been identified during a desk or field audit
- Identification of unreported controlled transactions during a repeat field tax audit conducted by the Russian Federal Tax Service

The audit must be scheduled not later than two years after receiving the statement or notification, and as a general rule the duration of an audit may not exceed six months. Further, the audited period may not exceed the three calendar year period preceding the year of the audit. The fact that an audit is in process does not prevent the tax authorities from conducting a desk or field tax audits for the same period in respect of other tax matters.

Deviations from market price that cause an underpayment of taxes are stated in a tax report issued by the tax authorities. The taxpayer can then provide its objections to the report within 20 business days from the day of receipt. Consideration of the tax report/decision is subject to the same rules as for desk and field tax audits. Underpayments of tax detected during a transfer pricing audit may only be collected by court judgment.

Sanctions provided by the Tax Code

The Tax Code sets out sanctions which may be imposed on taxpayers for tax violations. The general rule is that penalties may be collected by the tax authorities without recourse to the courts. The tax authorities have the right to reduce or increase the amount of penalty if any mitigating or aggravating circumstances exist. The courts also have this right. The Tax Code establishes the following penalty rates for the most common tax violations.

Failure to register with the tax authorities

Conducting business activity without registration is subject to a penalty of 10% of the revenue arising during the period the entity was not registered, but not less than RUB 40,000 (approximately USD 1,300).

Full or partial non-payment of tax

Full or partial non-payment as a result of decreasing the tax base or incorrect calculation is subject to a penalty of 20% of the unpaid tax amount. If the default is deliberate, the penalty is 40% of the unpaid tax amount. Underpayment of tax as a result of applying non-market prices is subject to a 40% penalty of no less than RUB 30,000 (approximately USD 1,000).

Failure to file tax returns

Late filing of a tax return is subject to a penalty of 5% of the unpaid tax due according to the return for each full or partial month from the official filing date, subject to a minimum penalty of RUB 1,000 (approximately USD 30).

Gross violation of accounting regulations

Such violations may result in the following penalties:

(i) RUB 10,000 (approximately USD 330), if the violation is limited to one tax period;

(ii) RUB 30,000 (approximately USD 1,000), if the violation occurs in more than one tax period;

(iii) 20% of the outstanding tax amount, but no less than RUB 40,000 if the violation results in an understatement of the tax base.

Failure by a tax agent to withhold or remit tax

Such failure may result in a penalty equal to 20% of the tax to be remitted.

Failure to provide documents

Failure to provide documents or other information required by law to the tax authorities within 10 business days from receiving the request may result in a penalty of RUB 200 (approximately USD 6) for each document not provided.

Criminal sanctions

The Criminal Code provides for five types of tax crime which are described below. In each case, only the relevant individuals/officers are subject to criminal liability, and not the legal entity itself. Criminal intent, according to the definition provided in the law, must be proven.

The limitation period for tax crimes committed by individuals is either 2 or 6 years depending on the gravity of the crime. For tax crimes committed by legal entities, the period is either 6 or 10 years, also depending on the gravity of the crime.

From 1 January 2010, pre-trial detention for an alleged tax crime is expressly forbidden. However, imprisonment may still arise in practice since other crimes, to which this restriction does not apply (e.g. fraud, illegal business activity), may be prosecuted at the same time.

Tax evasion committed by legal entities
The Criminal Code provides criminal sanctions where a "large scale" or "very large scale" amount of tax is involved. "Large scale" is defined as tax of RUB 2 million over three financial years (assuming this exceeds 10% of otal taxes due), or more than RUB 6 million. "Very large scale" is RUB 10 million over three financial years (assuming this exceeds 20% of total taxes due) or more than RUB 30 million.

Liability can arise for deliberately including false information in tax returns or documents required by law, resulting in an underpayment of tax or levies, as well as for failure to file tax returns or to submit the required documents. Penalties range from RUB 100,000 to 500,000 (approximately USD 3,300 – 17,000), or imprisonment of the company's CEO, Chief Accountant (or employees fulfilling these roles), or any other official of the legal entity, or its external advisor, who has falsified documents or concealed property from which tax payments should be made, for a period of up to six years. A ban from holding certain posts or performing certain activities for a period of up to three years may also be applied.

A legal entity's officials are exempt from criminal liability for tax evasion if it is a first time offence and the full amount of tax arrears, interest and penalty has been voluntarily paid.

Evasion of tax payments by individuals
The same crime committed by individual taxpayers may also be subject to criminal sanction. In this case, "Large scale" is defined as RUB 600,000 over three financial years (assuming this exceeds 10% of total taxes due), or more than RUB 1,800,000, and "very large scale" is RUB 3 million over three financial years (assuming this exceeds 20% of total taxes due) or more than RUB 9 million. Penalties range from RUB 100,000 to 500,000 or imprisonment for a period of up to three years.

An individual is exempt from criminal liability for tax evasion if it is a first time offence and the full amount of tax arrears, interest and penalty has been paid voluntarily.

Failure to fulfill tax agent obligations
A tax agent's failure to calculate, withhold and remit taxes and fees to the relevant budget can result in criminal liability if committed on a "large scale" or "very large scale". The sanctions applied to tax agents are similar to those provided for legal entities.

Concealment of money or property by legal entities or individual entrepreneurs
Concealment by a legal entity or individual entrepreneur of money or other property required for tax collection is a crime. In this case, the officials of the legal entity or individual entrepreneurs accused of the concealment are held liable for a criminal violation, with penalties ranging from RUB 200,000 – 500,000 (approximately USD 6,700 – 17,000) or imprisonment for up to five years. A ban from holding certain posts or performing certain activities for a period of up to three years may also be applied.

Evasion of customs payment
Evasion by a legal entity or individual entrepreneur involving amounts of duty of RUB 500,000 (large scale) or RUB 1,500,000 (very large scale) may result in penalties ranging from RUB 100,000 to 500,000, mandatory work of 180 to 240 hours, or imprisonment for a period of up to five years. A prohibition from holding certain posts or performing certain activities for a period of up to three years may also be ordered.

Production Sharing Agreements

PSA tax regime

The PSA tax legislation provides for two methods of determining tax liabilities on production sharing: the standard method and the direct method. Under the standard method, the investor is subject to MET on minerals extracted under the PSA. Once the value of the minerals produced, net of MET, has been reduced by the "compensatory production" and the amount of exploration, production and other reimbursable expenses, the remaining profit (profit production), is shared between the state and the investor in accordance with the PSA terms. The investor is subject to profit tax in respect of its share of the profits. The share of compensatory production should not be more than 75% (90% in the case of extraction on the continental shelf) of the total volume of production. Under the direct method, there is no division of minerals produced into compensatory production and profit production. The investor is eligible for a share of up to 68% of the total quantity of minerals produced under the PSA. The investor is exempt from profit tax, MET, water tax and land tax.

Under both methods, the investor is exempt from customs duties in respect of goods imported or exported under the PSA, as well as from property and transport taxes in respect of fixed assets used under the PSA.

PSA investors are also required to account for VAT.

"Grandfathered" PSAs

All of the PSAs currently in effect ("Kharyaga", "Sakhalin-1", and "Sakhalin-2") were concluded before the PSA regime described above came into force. For these PSAs a special "grandfathering" approach is included in the legislation, which generally provides that the PSA provisions apply even though the legislation covering those aspects has changed. For example, the profit tax rate established for investors under "Sakhalin 2" is higher (at 32%) than under the general tax regime. In addition, VAT and customs duty exemptions may apply to investors and, in some cases, to contractors.

Appendix

Withholding tax rates (%) under Russia's double taxation treaties

Country of recipient	Dividends			Interest	Royalties
	Major shareholding	Minor shareholding	"Major shareholding" criteria		
Albania	10	10	N/A	10	10
Algeria	5	15	25%	0/15	15
Armenia	5	10	USD 40,000[1]	0[2]	0
Australia	5	15	10% & AUD 700,000	10	10
Austria	5	15	10% & USD 100,000	0	0
Azerbaijan	10	10	N/A	10	10
Belarus	15	15	N/A	10	10
Belgium	10	10	N/A	0/10	0
Botswana	5	10	25%	10	10
Brazil	10	15	20%	15	15
Bulgaria	15	15	N/A	15	15
Canada	10	15	10%	10	0/10
China	10	10	N/A	10	10
Croatia	5	10	25% & USD 100,000	10	10
Cuba	5	15	25%	10	5
Cyprus	5	10	USD 100,000[3]	0	0
Czech Republic	10	10	N/A	0	10
Denmark	10	10	N/A	0	0
Egypt	10	10	N/A	15	15

[1] Substituted by "major shareholding" criteria of 25% according to a Protocol signed but not yet ratified.

[2] Changed to 10%, except for interest paid to Russian or Armenian public authorities or central banks, according to a Protocol signed but not yet ratified.

[3] EUR 100,000 according to a Protocol signed but not yet ratified.

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DISCLAIMER

Data per BP Statistical Review unless otherwise is noted.

Oil production data includes crude oil, shale oil, oil sands and natural gas condensate.