

ALTERNATIVE FORMS OF DOING BUSINESS IN RUSSIA:
ATTRIBUTES, ADVANTAGES AND DISADVANTAGES;
REGISTRATION REQUIREMENTS

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To Our Clients and Friends:

A range of options is available to a foreign company seeking to establish and maintain a business presence in Russia, whether or not in connection with a specific investment project. The legal considerations and analytical process involved in choosing the most appropriate option (or options) are essentially similar to those involved in establishing a business presence in other countries, but with some Russia-specific aspects, as discussed below.

The main options for establishing a business presence in Russia, which are discussed in more detail in Sections II-IV, below include:

- Russia registered company (usually established as a joint-stock company or a limited liability company);
- unincorporated joint ventures (so-called simple partnerships);
- branch office; and
- representative office.

In addition to the above, a foreign company may legally buy or sell goods and services in Russia, and engage in a variety of other business activities in Russia, without establishing a formal company presence (as long as the company complies with Russian tax laws in connection with Russian-source income).

Among the above options there is no single “optimal” or “correct” form of business presence. American, European and Asian companies, including our clients, make a variety of choices depending on the circumstances and some companies operate in Russia with more than one business form simultaneously. The main factors to be considered are:

- particular activities in which the foreign company will be engaging and special regulatory framework governing such activities;
- usual structure preferred by or used by the foreign company in other countries;

- Russian corporate law requirements, including those relating to the structure and powers of the management bodies and limitation of liability of shareholders;
- tax considerations – including eligibility for special treatment under bilateral treaties; and
- currency, customs and labor laws.

In this memorandum we focus on those factors listed above which are Russia-specific. As also noted in the discussion below, the regulatory situation in Russia continues to evolve and some of the distinctions among the various forms are becoming blurred; for example, special advantages that the representative office form has enjoyed historically in Russia have eroded with tightened regulations.

Section V below is entitled “Basic Business Forms. Recap of Advantages and Disadvantages.” Some readers may find it useful to glance through that Section first, as an overview.

There is a special legal framework for certain closely-regulated sectors, *e.g.*, for establishment of financial (banking, securities, and insurance) institutions. Special government agencies are in charge of the licensing and regulation of new entrants and of monitoring companies that are subject to many regulatory requirements. There are also special restrictions and prohibitions on foreign investments in so-called Russian strategic companies (companies engaged in activities in any of 42 strategic sectors listed in the Federal Law On Foreign Investments in Commercial Entities of Strategic Importance for National Defense and National Security enacted in May 2008 (the “Strategic Investments Law”). This memorandum does not cover any of the issues related to highly regulated sectors and investments in strategic companies, but we would be happy to provide you with such analysis upon request.

This memorandum is intended only as a general introduction to the subject. Assistance should be obtained from legal counsel and/or tax advisors before applying this information to any company’s particular situation.

RUSSIA-REGISTERED COMPANY

Available Types

Joint-stock company (“JSC”). A JSC may be “closed” or “open” (sometimes referred to as a “CJSC” (in Russian, “ZAO”) or “OJSC” (in Russian, “OAO”) respectively), with the main distinction being that shares of a closed JSC are not widely held or traded and are subject to certain restrictions on transfer. Analogies to a closed/open JSC include the GmbH/AG in German law, or the close/public corporation in American law. JSCs are primarily governed by

the Civil Code and the Federal Law on Joint-Stock Companies¹ (the “JSC Law”). A closed JSC is one of the principal forms of Russia-registered companies for a foreign firm seeking an actual commercial presence; the law and practice with regard to this entity are relatively well established.

Limited-liability company (“LLC”). Russian law also provides for a limited liability company (LLC or, in Russian, “OOO”) as an alternative to a JSC. LLCs are governed by the Civil Code and the Federal Law on Limited Liability Companies² (the “LLC Law”). LLCs do not issue shares to their owners and need not meet all disclosure and other securities-related requirements set forth in the JSC section of the Civil Code, the JSC Law and various other securities regulations. Otherwise, an LLC is essentially similar to a closed JSC (*e.g.*, the maximum number of shareholders/participants in both a closed JSC and an LLC is 50). One might choose an LLC rather than a closed JSC where more flexibility is needed or sought in the company’s governance structure; this form might be particularly appropriate for single-owner companies.³ For a more detailed description of the differences between JSCs and LLCs, please see Section V.1.

Partnerships. The Civil Code also provides for various forms of partnerships (incorporated and unincorporated (contractual); full and limited), which have distinct legal attributes. Unfortunately, the legislation and practice (particularly that involving foreign investors) with respect to the various forms of partnerships is not yet well developed in Russia. In addition, unlimited liability of partners and certain Russian law provisions essentially allowing any full partner to bind the partnership regardless of any limitations in the partnership documents, coupled with the absence of any substantial tax privileges for partnerships, usually prevent

¹ On June 3, 2009 certain amendments were adopted to the JSC Law and Article 30 of the Securities Law (and came into force on June 9, 2009) which introduce the concept of shareholders’ agreements and establish procedure for the resolution of deadlocks related to the creation of a sole executive body. We are not dwelling on such amendments herein as this Client update is intended only to outline the general overview of the forms of doing business in Russia, but will be happy to provide you with such analysis upon request.

² On December 30, 2008 certain amendments were introduced in the LLC Law (and came into force on July 1, 2009) which substantially change the legal framework for LLCs in Russia. For the above mentioned reason we are not dwelling on such amendments herein but will be happy to provide you with such analysis upon request.

³ Note, however, that under Russian law if an LLC or JSC has only one participant/shareholder, such participant/shareholder (*i.e.*, the “parent” entity) cannot itself be a single-shareholder/participant company (*i.e.*, it must have at least two shareholders/participants).

investors from forming partnerships in Russia. Therefore, we do not further describe partnership forms here, but can do so upon request.

Legal Status

Both the JSC and LLC are limited-liability entities with legal status separate and distinct from that of their owners. Founders/shareholders of a JSC/LLC may be personally liable only under a few exceptional circumstances (*e.g.*, unratified acts prior to incorporation, actions of controlling shareholders in case of bankruptcy).

Certain provisions of the Civil Code also suggest that a parent company may, under some limited circumstances, be liable for the actions of its subsidiary. Under the Civil Code, the JSC Law and the LLC Law, liability may also be imposed on persons having the right to issue mandatory instructions to the company or in other ways determine the company's actions. At present, the provisions of the JSC Law that limit liability of the shareholders appear to be slightly more favorable than those of the LLC Law, from the shareholder's/participant's point of view.

Extent of Foreign Ownership

A JSC or LLC may have partial foreign ownership (commonly referred to as a "joint venture") or be 100% foreign-owned. Apart from certain highly regulated (*e.g.*, strategic) industries, Russian law generally does not establish any restrictions on the size of the share in the charter capital of Russia-registered companies belonging to foreign investors.

Mostly for tax and certain corporate governance reasons foreign companies from leading industrial countries often hold their Russian subsidiary or JV shareholdings through an intermediate special-purpose "offshore" company.

Companies with foreign participation generally operate within the same regulatory framework as Russia-owned companies. The Law On Foreign Investments adopted in 1999 (the "FIL") sets forth major principles of, and procedures for, protection of foreign investors investing in Russia-registered companies.

Registration; Securities⁴

A JSC or LLC (including one with foreign investments) is considered established upon registration with the local agencies of the Federal Tax Service.

⁴ See also Section VI below for detailed registration requirements.

There are additional registration/approval/licensing requirements for JSCs and LLCs that intend to engage in certain highly regulated activities (*e.g.*, banking, insurance, oil and gas development). The Law on Licensing of 2001 (effective from February 2002) generally specifies the activities that may be carried out only after the company obtains a special license.

Pursuant to the Securities Law, the Federal Service on Financial Markets (the “FSFM”) has adopted regulations that set forth requirements for the issuance of securities. Issuance of shares by a JSC, including issuance of shares to its founders, must be registered with the relevant state body (depending on the type of securities, either the Central Bank of Russia (“CBR”) or, more commonly, the FSFM or its local branches). Any transfer of unregistered shares is prohibited; any transactions with unregistered shares are considered void. JSCs are also subject to various disclosure and reporting requirements set forth in the JSC Law and the Securities Law and regulations. Interests in an LLC do not qualify as securities under Russian law; therefore, various securities-related registration and reporting requirements applicable to JSCs do not apply to LLCs.

Payments to the charter capital of Russian companies are made in Russian rubles or, in the case of foreign founders/shareholders, may also be made in foreign currency. Russian minimum capitalization requirements remain low by world standards: the minimum charter capitalization requirement is 100 minimum monthly wages (“MMWs”) for closed JSCs and 10,000 rubles for LLCs (about US\$ 310 as of the date of this memorandum in each case), and 1,000 MMW (about US\$ 3,100 as of the date of this memorandum) for open JSCs.

The JSC Law requires that 50% of the charter capital of the new company be paid within three months following registration and the remaining part be paid within one year following the date of registration, unless the shareholders agree on a shorter period. The LLC Law requires that 50% of the charter capital of a new company be paid as a pre-requisite to its registration and the remaining part be paid within one year following the date of registration, unless the shareholders (participants) agree on a shorter period.

Taxation

The Tax Code of the Russian Federation (the “Tax Code”) consists of two parts. Part 1 sets forth basic principles of tax legislation in Russia, including: (i) limitations on possible arbitrary interpretation and abuse by local executive and tax authorities; (ii) an exhaustive list of federal and local taxes, and procedures for their imposition; (iii) procedures for tax investigation and imposition of sanctions for tax violations; and (iv) declaration of a presumption of innocence of taxpayers and other basic provisions. Part 2 governs the terms and procedures for payment of particular taxes. At the same time, numerous (and often inconsistent) regulations issued by the tax authorities apply to the extent they do not contradict the Tax Code. In general, the Russian Government is currently aiming to reduce the tax burden on Russian companies as compared to the previous situation.

Profits tax is imposed on all Russian JSCs and LLCs, including those with foreign ownership. The maximum tax rate is 20%. There is a framework for seeking tax reductions or exemptions, mostly on the regional/local level, but these are rather difficult to obtain. Also, several regions of the Russian Federation have passed legislation that fully or partially exempts foreign investors from local taxes.

Withholding tax of 15% is imposed on dividends of a JSC (or LLC profit distributions) earned by a foreign company-shareholder. The rate of 9% (or 0% if some requirements are met) is applicable if the shareholder is a Russian company. The applicable tax rate may also be reduced by many bilateral tax treaties concluded by Russia. For example, the Russia-U.S. treaty reduces this tax to 5% (or 10% if the shareholding is below 10%). The 1998 tax treaty between Russia and Cyprus provides for a 10% withholding tax rate (5% if the shareholder investment exceeds US\$ 100,000). The treaty with the UK provides for a 10% withholding tax rate. The new treaty with Finland establishes a 12% withholding tax (5% for shareholdings exceeding 30% and US\$ 100,000).

Other taxes include VAT (currently at 18%), excise tax, property tax and various regional/local taxes that are or may be imposed.

Currency Transactions

For currency law purposes, a JSC or LLC with foreign ownership is treated in the same way as any other “resident” Russian entity. It must transact all business with other resident entities in rubles save for certain enumerated exceptions.

Russian currency law has recently been substantially amended and most of the previous restrictive requirements, including those related to capital flows from a JSC or LLC with foreign investments, or mandatory sale of foreign currency, and a few others, have been canceled. There is now no need to open any special accounts for the purposes of carrying out specified transactions, any of which can now be performed using current rubles or foreign currency bank accounts.

No limits are set forth in respect of opening foreign currency accounts, either within Russia or any other member states of OECD (Organization for Economic Co-operation and Development) and/or FATF (Financial Action Task Force on Money Laundering). The local branch of the Federal Tax Service nonetheless must always be notified about all opened (closed) bank accounts.

Salary payments by a JSC or LLC to its Russian, as well as resident expatriate employees, must be in rubles.

Dividends may be paid by a Russian company to its foreign shareholders in rubles or in foreign currency. If paid in rubles, dividends are transferred to a ruble account of the non-resident and from there may be re-invested or converted into foreign currency and repatriated. Ruble profits distributed to shareholders of a JSC or LLC may be reinvested in Russia or maintained in a Russian bank account. Foreign shareholders may also use ruble profit distributions to purchase foreign currency on the Russian currency market.

As noted above, Russian LLCs or JSCs may engage in export-import operations and make payments under export-import contracts with foreign residents in foreign currency.

Labor Relations

JSCs and LLCs are subject to the full range of Russian labor laws with respect to local employees, including rules on hiring and firing, vacations, etc. The Labor Code sets forth the framework of relations between the employer and employee in the Russian Federation.

JSCs and LLCs are also obligated to pay to the state substantial “social payments” on behalf of their employees. Part 2 of the Tax Code introduces a single social tax payable by an employer (which includes payments to the pension fund, medical insurance fund and social security fund). The calculation of the social tax is based on the compensation paid to each particular employee. The greater the compensation, the lower the rate of the tax. The rate can be as high as 26% for the lowest paid employees, and the effective percentage rate decreases as compensation increases.

Accounting

JSCs’ and LLCs’ books must be kept in accordance with general Russian accounting rules. In practice, JSCs/LLCs that are subsidiaries of foreign companies may, and normally do, keep dual sets of books – one to meet the Russian rules and the other in accordance with GAAP or other rules of the foreign shareholder(s)’ home-country. Over the past few years Russia has been taking legislative and regulatory steps to make its statutory accounting standards more similar to Western (international) standards.

BRANCH ESTABLISHED IN RUSSIA

Legal and De Facto Status

While the Civil Code, FIL, certain international tax treaties to which Russia is a party, and some other laws make references to “branches,” no special rules have been enacted specifying the rights and obligations of branches, and relatively few branches of foreign companies have been registered in Russia to date. This limited use can be explained in part by the uncertainties of the legal regime applicable to branches, and in part by the availability of a representative office as a viable alternative, which is described in Section IV below.

A branch of a foreign company, unlike a JSC or LLC, is not a Russian legal entity, but an office of a foreign “non-resident” legal entity, where the head of the branch is acting on the basis of a power of attorney given to him by the head office of the foreign company. The company establishing the branch is fully responsible for all obligations of the branch arising out of its activities in Russia.

The Civil Code defines a branch as a separate division of a legal entity that is authorised to conduct some or all of the functions of the entity, including representation of its interests. Unlike the activities of representative offices (see Section IV below), Russian law generally does not limit the activities that may be performed by branches. However, foreign companies with branches in Russia often encounter practical constraints on branch operations. For example, it can be more difficult for a branch of a foreign company to obtain certain types of licenses, which may be required for the branch to conduct its business effectively.

Accreditation

Under the FIL, branches of foreign companies are to be accredited by a special body to be designated by the government (currently – State Registration Chamber under the Ministry of Justice of the Russian Federation). Accreditation procedures were adopted on December 31, 1999 by the Ministry of Justice.

According to the FIL, for accreditation of a branch the company establishing the branch must file a number of documents with the accrediting body, including the “Regulation” of the branch. A “Regulation” is similar to by-laws or charter of a company and should contain a description of the assets to be transferred to the branch by the head office, the ruble value of these assets and the timing of their contribution, as well as the management structure. This requirement is essentially the same as applies to representative offices. Generally speaking, however, branch offices are subject to more strict attention of accreditation authorities as compared with representative offices.

Taxation

If the activity of a branch constitutes a permanent establishment of a foreign company, such foreign company becomes liable to Russian taxation on the profit attributable to such permanent establishment. The Tax Code distinguishes two types of permanent establishments:

- Article 306 defines a permanent establishment as a branch, representative office, department, bureau, office, agency or another separate division, or any other place of activity of a foreign entity through which the entity regularly conducts business activity in Russia connected with: (i) use of subsoil and/or other natural resources; (ii) performance of construction, installation, assembly, presetting, servicing or use of equipment, including

gambling machines; (iii) sale of goods from warehouses located in Russia that are either owned or rented by the foreign entity, and (iv) performance of other services or conduct of other activity, unless such services or activity does not constitute a permanent establishment pursuant to the Tax Code.

- Article 306.9 of the Tax Code provides that a foreign entity shall be deemed to have a permanent establishment in Russia if such entity conducts activity envisioned above through a person who, pursuant to a contract with this foreign entity, represents its interests in the Russian Federation, acts in Russia in the name of such foreign entity, has and habitually exercises the authority to conclude contracts or to negotiate their material terms (including price and delivery terms) in the name of such foreign entity that are binding on such foreign entity.

Pursuant to the Tax Code, a foreign entity shall not be deemed to have a permanent establishment in Russia if it carries on business in Russia through a broker, commission agent, professional securities market participant, or any other person or entity acting within its principal (ordinary) course of business.

Permanent establishments are taxed at the same 20% profit tax rate that applies to Russian legal entities.

Like other business entities operating in Russia, a branch is required to register with the tax authorities and file periodic tax reports, even if the branch does not constitute a permanent establishment.

Currency Transactions

A Russian branch is treated as a “non-resident” for currency law purposes and therefore, has more flexibility in carrying out operations with foreign currency.

Labor Relations

A branch is subject to the same Russian labor regulations as are resident entities (JSCs and LLCs). See Section II.7 above.

Accounting

According to the Law On Accounting adopted in 1996, branches of foreign companies are subject to Russian accounting rules, unless an applicable international treaty provides otherwise. At the same time, the Order of the Ministry of Finance issued on July 29, 1998 allows branches and representative offices of foreign companies to apply accounting standards used by their head offices, provided that such standards do not contradict “international financial accounting standards.”

REPRESENTATIVE OFFICE

Types; Legal Status

The rep office form was created in the Soviet period, when foreign companies were not permitted to establish a subsidiary or otherwise directly invest in the Russian economy. The rep office form was designed to allow leading foreign companies to have a Russian outpost to facilitate commercial ties with USSR trading partners, while imposing special controls and restrictions to limit the foreign firm's contacts with the Soviet economy and society. This form has survived to date, and continues to be utilized as a convenience for many foreign companies that wish to have an on-the-ground Russian presence without subjecting themselves to the full range of Russian regulations imposed on JSCs or LLCs. One reason that rep offices have been a popular investment form for foreign investors in Russia is that rep offices have traditionally enjoyed significant tax, customs, currency and other benefits. However, these benefits have been significantly reduced, as further discussed below.

The establishment and maintenance of rep offices are still governed by a Soviet-era Council of Ministers decree of November 30, 1989, as refined in later instructions issued by accrediting agencies, other acts and practice. Although the FIL does not mention rep offices, it did not rescind the November 1989 decree or otherwise clearly remove or restrict the rep office form as an option.

The Civil Code defines a rep office as a separate division of a legal entity whose function is limited to representation of the interests of such legal entity, for example, by means of assisting in establishing relations with Russian partners (*e.g.*, gathering information for the foreign head office and promoting, facilitating, and otherwise assisting the business of the foreign head office). In principle, a rep office is not supposed to engage in commercial activities. However, in practice, the prohibition against engaging in commercial activities generally is not strictly enforced. As a result, many rep offices are actively involved in commercial activity. As long as rep offices carrying out commercial activity comply with Russian tax regulations, legal challenge by Russian authorities has been rare; we are not aware of any formal proceedings challenging the existence or operations of such offices. (See Section 3 "Taxation" below.) It remains to be seen whether this situation will change.

Accreditation

Rep offices are established by filing an application for accreditation with the State Registration Chamber under the Ministry of Justice of the Russian Federation ("GRP") or the Chamber of Commerce and Industry of the Russian Federation ("TPP"). Accreditation is granted for a period not exceeding three years and can be extended upon expiration. All accredited rep offices (including those accredited with TPP) should be included in the all-Russia register of representative offices and branches of foreign companies maintained GRP.

The accreditation procedure that applies to rep offices is essentially the same as applies to branches.

Taxation

Rep offices are subject to the same tax treatment as branches – *e.g.*, if the activity of a rep office constitutes a permanent establishment of the foreign company, such foreign company becomes liable to Russian taxation on the profit attributable to such permanent establishment (see Section III.3 above).

A rep office should not be subject to profit taxation as long as it does not engage in commercial, profit-making activities.

Currency Transactions

Like a branch, a rep office is treated as a “non-resident” for currency law purposes. This status provides certain freedom in respect of operations with foreign currency.

Labor Relations

As an arm of a company operating on the Russian territory, a rep office is subject to Russian labor laws. This includes an obligation to make payments of social tax on compensation payments to Russian employees. The rules for such payments on compensation payments to expatriate employees are the same as those for JSCs/LLCs and branches (see Sections II.7 and III.5 above).

Accounting

Like branches, rep offices are technically required under applicable legislation to maintain full Russian accounting records, although the Ministry of Finance has issued regulations allowing branches and rep offices of foreign companies to apply accounting standards used by their head offices, provided that such standards do not contradict “international financial accounting standards.”

BASIC BUSINESS FORMS: RECAP OF ADVANTAGES AND DISADVANTAGES

JSC or LLC

Advantages

- Limited shareholders’ liability, with certain statutory exceptions.
- Ability to undertake any commercial activity in Russia not prohibited by law.
- Substantial legal basis and relatively well established practice.

- Shareholders/participants are allowed to enter into shareholders' agreement (Russian law explicitly recognizes and protects the concept of shareholders' agreements).
- Greater ability to obtain certain licenses.

Disadvantages

- Taxation of both the JSC/LLC (based on profit) and the parent company (based on profit distributions) under Russian law (the latter possibly reduced by treaty).
- Certain restrictions on use of foreign currency.
- Required adherence to Russian accounting and other standards.
- Required registration of stock issuance (for JSCs) and adherence to other corporate formalities.

JSC/LLC Distinction

See Section II.1 for a brief discussion of the relative merits of JSC vs. LLC, which may be elaborated depending on a potential foreign investor's specific context.

In addition to the general differences set forth in Section II.1 above, when choosing between an LLC and a closed JSC, the founders should be aware of the following key differences:

- LLCs do not issue shares and, therefore, are not required to register them, which makes the registration procedure of LLCs much quicker and less complicated;
- LLCs are not required to comply with a variety of mandatory disclosure requirements envisaged for JSCs;
- LLC's charter may provide for disproportionate distribution of profits to its participants;
- LLC's charter may prohibit participants from selling their interest in the LLC to third persons, while a closed JSC's charter may not prohibit shareholders from selling their shares to third persons so long as existing shareholders have been given a preemptive right to purchase such shares first;
- the LLC Law requires notarization of any transaction related to the disposal of an interest in the LLCs to any person other than to another participant or the LLC itself; while disposal of shares in JSCs does not require notarization;

- the LLC Law allows participants holding at least a ten percent interest in the company to seek a court order for the exclusion of any participant breaching its obligations or otherwise impairing the operation of the company. No exclusion of shareholders is allowed under the JSC Law;
- an LLC participant can exit the LLC at any time and require redemption of its interest by the LLC if such right is provided for by the LLC's charter; generally no such exit is allowed in a closed JSC; and
- corporate governance procedures (re-distribution of authority, increasing voting thresholds, etc.) in an LLC are generally more flexible than in a closed JSC.

Accredited Rep Office

Advantages

- Provides vehicle for conducting basic representation activities where actual Russia-based commercial activities are not contemplated in a form that is clearly understood in Russia (as opposed to the branch form).
- Not subject to the full panoply of legal/administrative requirements (*e.g.*, accounting rules) applicable to JSCs/LLCs.

Disadvantages

- Unlimited liability of the parent company.
- Normal three-year term of accreditation (but renewal is a routine procedure).

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For further information about the alternative forms of doing business in Russia and all associated issues, please do not hesitate to contact us.

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