

"The Legal Framework For Leasing In Russia During 2007"

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The legal and tax environment for leasing in Russia has been stable in recent years and numerous new leasing companies have been created. Among recent transactions the EBRD lent \$92 million to Meridian Leasing to finance its acquisition of 12 Boeing 757-200's to be leased to VIM-Avia. The planes are to be used 85% for international charter flights, and 15% internally within Russia. John Deere announced that Deere Credit, Inc. would lend \$25 million to Rosagroleasing pursuant to a credit agreement guaranteed by the US Export-Import Bank to support the leasing of John Deere equipment to Russian customers. Several Russian leasing companies announced new issuances of debt securities on the Russian capital market to raise funds to support their leasing activities, or continued to successfully service such debts, including OAO RTK-Leasing, OOO Progress-Neva Leasing, and OAO Finance Leasing

Equipment vendors are reporting that there is commercial pressure from their customers for lease financing to be provided. The lowering of individual and corporate taxes in Russia is causing more Russian companies to choose to operate in a transparent, tax-paying manner. A new premium is being placed on legitimate tax savings that may be obtained through leasing transactions.

Attention in Russia continues to be focused on the issue of how to address Russia's need for extensive capital investment in many industries. Lease financing is expected to play a significant role in providing all types of equipment, including aircraft, trucks, buses, agricultural equipment, telecommunications equipment, manufacturing equipment, oil field equipment, computers and ATMs.

Planning Points for Cross Border Leasing Transactions

Leasing and currency licenses are no longer required by either party to a transaction involving cross-border leasing to a Russian lessee. The principal legal issues that need to be analyzed in the context of cross-border leasing concern (i) consistency with new currency legislation, i.e., the necessity to open special accounts and keep mandatory reserves for several kinds of currency operations to be performed in the course of cross-border leasing transactions; (ii) customs clearance; and (iii) planning for payment of import VAT.

Customs issues remain among the most significant practical issues for leasing foreign-made equipment into Russia. Indirect taxation of leases, i.e., VAT, continues to be rather costly, and cross-border leasing continues to be impeded thereby. However, trends in taxation are looking positive. VAT has been reduced from 20% to 18%, having favorable consequences for Russian leasing businesses. In practice, it remains difficult for leasing

companies to obtain reimbursement of VAT, and difficulties are encountered in offsetting VAT from lessees against previously paid VAT. The latest judicial decisions in Russia are mostly connected to reducing the possibility of fraudulent VAT reimbursements, which, in practice, created unfair competition for leasing companies abiding by applicable tax laws.

More important than these legal and tax concerns, however, may be that foreign equipment manufacturers are manifesting dissatisfaction with cross-border leasing services. This is particularly the case when a foreign lessor shifts many risks inherent in a cross-border transaction to the foreign equipment manufacturer by means of guarantees and buy-back arrangements, causing foreign equipment manufacturers to question the value of the services provided by cross-border lessors, which should continue to provide a stimulus to domestic leasing within Russia.

Planning Points for Domestic Leasing Transactions

A captive leasing company in Russia offers a favorable resolution of several of the regulatory issues that impede cross-border leasing. In domestic leasing transactions, the lessee makes ruble denominated payments to a captive leasing company in Russia. The amount of rubles paid may be indexed to the scheduled lease payments stated in the equivalent amount of dollars or euros. In the case of a domestic leasing company, import VAT would not remain as a potentially unrecoverable expense. The captive Russian leasing company could verify that customs declarations are made properly and import duties are properly paid, thus avoiding a host of problems that plague cross-border leases.

Another important trend for the domestic leasing market is subsidization for small leasing enterprises out of the federal budget. See Government Decree of December 9, 2005 #755.

Tax Planning for Leasing Transactions

The primary tax planning point about leasing transactions in Russia is that leasing payments are deductible in full by a lessee. Lease expenses are fully included in the cost of the production of goods, i.e., fully deductible for profits tax purposes. Further, equipment subject to a finance lease may be depreciated up to three times faster than is otherwise allowed. See Article 259(7) of the Tax Code.

Different treatment has been given to property taxes on equipment to be leased out. Initially, the Ministry of Finance in August 2004, in Letter No. 03-06-01-04/16, declared that a leasing company is not required to pay property tax on equipment that is intended to be leased out to customers of the leasing company, as opposed to equipment used in a leasing company's own business. However, in 2006 the same authorities expressed the opposite view, considering such equipment to fall within the definition of a company's "own funds" under the Russian accounting standards and therefore to be subject to property tax. See Ministry of Finance Letter of June 2, 2006 #03-06-01-04/113.

The Civil Code and the Leasing Law

There have been no changes to those provisions of the Civil Code of the Russian Federation, that govern rentals in general (Articles 606 - 670), or those that govern leasing in particular (Articles 665 – 670). The Russian Leasing Law was last significantly amended as of January 29, 2002. Amendments made at that time removed a number of inconsistencies that the former version of the law had had with the provisions of the Civil Code with respect to leasing, and this allowed the carrying out of leasing transactions in a friendlier and less uncertain legal framework.

Repossession of Leased Property

As in other jurisdictions, leasing offers the fundamental advantage, as compared to lending funds to purchase an asset and taking a pledge of the purchased asset, that the lessor retains ownership of the asset involved and may repossess the leased property in the event of a default. In contrast, if the delivery of equipment is financed by a loan and a pledge of the equipment, in the event of a default, the pledged equipment must generally be sold at auction after court proceedings. Though Russian law provides for the possibility of an “easier” sale of pledged assets, in practice it may face substantial difficulties and in many cases will lead to high costs.

In the more settled legal environment for leasing transactions since early 2002, leasing has begun to realize its promise to be a growing and flexible means of financing the acquisition of many types of equipment needed by Russian industry. Foreign leasing companies and banks may have certain advantages over their Russian competitors due to their experience with such transactions and access to relatively inexpensive sources of capital. However, Russian leasing companies welcome joint lease/sub-lease transactions in which they assume responsibility for activities in Russia, and provide guarantees of lease repayments to a foreign partner.

Anti-trust Regulations

Until recently, Russian anti-trust legislation was based upon a “two-sectors” model, which provided for separate regulation of the trade and financial markets. Leasing business was defined to be within the financial market for the purposes of anti-trust legislation.

Special attention to a leasing company by anti-trust authorities would commence if it has a “dominant position” and holds more than 10% of the nationwide market for leasing services, or more than 25% of a regional market. A leasing company is deemed to be present on the nationwide, Federal market if it has business in at least two subjects of the Russian Federation. Regulations provide “the mere fact that a leasing company is dominant is not a violation of the law.” See Federal Anti-Monopoly Service Order #19 of September 23, 2005. Antitrust authorities would consider the business activities of the company more carefully to prevent misuse of its advantages from being in a dominant position. Such issues could become of importance in case a dominant leasing company

seeks to acquire another leasing company, in which case approval of the anti-trust authorities would be required.

A new anti-trust law was scheduled to first come into force as of October 26, 2006. The new law abolishes the previous situation in which there were separate laws for trade and financial markets. A transition period is expected to be announced and some of the criteria in the existing regulations will remain applicable.

Unresolved Russian Legal Issues Concerning Securitization of Lease Receivables

As demand grows in Russia for leasing services, Russian leasing companies are now confronting a new series of legal and tax issues related to how to finance the growth of their operations. There are limits to the amount of capital that may be raised from shareholders, by conventional loan financing, or by conventional bond issuances.

One of the main techniques for refinancing leasing companies in the US and Europe is through the securitization of lease receivables. However, to date, it appears that no true securitization of lease receivables has been accomplished in Russia due to a large number of unresolved legal issues. The following is a brief summary of some of the legal and business issues that have yet to be resolved. These issues are common to the securitization of other types of receivables, including the securitization of mortgage receivables. Accordingly, it may be that the leasing industry will eventually follow in the footsteps of the Russian mortgage industry, which has an even more pressing need to undertake the legislative and regulatory work necessary to resolve, e.g., the following issues:

1. The originator of the lease receivables is a Russian company. Should the special purpose vehicle ("SPV") that is to issue asset-backed securities ("ABS's"), in this case, lease-backed receivables, be Russian or foreign?
2. Should the intended purchasers of ABS's to be Russian or foreign?
3. Since lease receivables are ruble denominated, how is the risk of currency fluctuation to be addressed if the investor is foreign? Swaps? Synthetics?
4. Are lease receivables indexed to the exchange rate of dollars or euros?
5. What type of legal entity may issue ABS's? An advantage of the securitization process would be to bypass the Russian banking system as much as possible; thus requiring an issuer to be a bank with a general banking license would be counterproductive.
6. How can different tranches of ABS's be issued, keeping in mind that according to current Russian securities legislation ABS's are regarded as "issuable securities" and as such should grant to investors equal scope of rights within the same issue?

7. Is there a "true sale" of receivables to the SPV? What law should govern the sale? In the alternative, is there to be a "pledge" of receivables, as in a synthetic structure? What are the procedures and costs involved to enforce a pledge? How should the requirement under Russian law for periodic updating of lists of pledged assets be satisfied?
8. If there is to be a sale of receivables, how much gain is required to be recognized on the sale for tax purposes and for accounting purposes? Under IAS, less gain is required to be recognized than under GAAP. Would VAT apply to the sale?
9. What are the risks associated with bankruptcy of the originator, and of the service provider? How is the situation different if there is only an assignment or pledge of receivables, and not a sale?
10. What type of legal entity should be used for the SPV - a joint stock company ("JSC") or a limited liability company ("LLC")? The use of trusts is not developed under Russian law.
11. What would be the tax treatment of the SPV? No exemption from profit taxation for pass-through entities is currently available, though, presumably, income from lease receivables and expenses related to interest on bonds issued to investors may be closely matched.
12. How much debt may be issued by a Russian SPV? Normally, a guarantee allows the charter capital limitation to be exceeded. Attention must also be paid to the thin capitalization rules in Russian tax law.
13. With regard to collection issues, it is doubtful whether reliable escrow accounts may be established under Russian law. No reliable pledge of bank accounts is possible under Russian law. Questions exist regarding the enforceability of amended account agreements to grant rights to third parties to amounts on deposit.
14. Issues concerning the overall reliability of the Russian legal system and the integrity of the courts would also impede investor confidence among those who may buy lease-backed receivables.

Potential Solutions for Russian Securitization Transactions

1. Issue lease-backed securities from a foreign legal entity.
2. Investment fund shares may be utilized, with assets segregated for investors.
3. Development of legislation to facilitate "synthetic securitizations" would be helpful.

4. Passage of a myriad of legal reforms to facilitate traditional securitizations by addressing the legal issues discussed above would be of great assistance.

In sum, the Russian leasing industry has become well established, is poised for further growth, and is attracting significant new foreign investment, particularly to leasing companies that service airlines. The attention of leading Russian leasing companies is turning to the securitization of lease receivables and other techniques for raising capital to finance expansion. While traditional securitization transactions by Russian leasing companies are today hampered by a number of Russian legal and tax issues, increasing amounts of capital may nonetheless be raised by Russian leasing companies on the Russian domestic bond market and through innovative uses of foreign special purpose vehicles.