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cutting through complexity

Main tax aspects of doing business in Russia

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International Forum on development of cooperation and organization of industrial suppliers business in Russia

Key trends and developments in the Russian automotive market

- Massive investments in main automotive clusters in Moscow/Kaluga, St. Pete, etc. are continuing with increasing collaboration between foreign and Russian suppliers and manufacturers
- New Special Economic Zones ("SEZs") are being established, e.g. recently in Kaluga, and SEZ in Kaliningrad aims for EUR 3 bln. investments over the next few years
- Access to reliable suppliers in Russia still of outmost importance, also more and more for traditional Russian manufacturers. The top global suppliers are slowly increasing there presence. Increase from appr. 40% to 60% of global top 50 over the past 2-3 years. Sufficient network of adequate tier 2-3 suppliers will be a challenge to establish
- Contract assembly by Russian manufacturers for foreign manufacturers are gaining ground
- The market for Finance&Leasing is developing positively but is still underdeveloped (only appr. 50% of car purchases in Russia are financed with loans, 80-90% in developed countries). Manufacturers are increasingly looking at establishing a captive bank structure or similar F&L support structure
- Labor shortages and increasing strength of unions create new challenges, e.g. risk of strikes, cost of relocation and accommodation, salary increases above norm, recruitment and training costs, etc.

Localization in Russia will hardly be smooth and will require revision of the standard approach

1 Achieving planned sales volume

- The largest European automotive market already after 2020
- Significant growth of localization of car components
- There is enough volume for localization of production for many categories of car components already

2 Foundation and start up of production

- Availability of well-developed car clusters
- The construction process is not transparent with regard to timing and costs

3 Structuring supply chain

- Absence of suppliers for certain types of raw materials and subcomponents
- Low quality of Russian suppliers which are not always ready to meet the requirements of the leading OES

4 Staff recruitment and integration of cultures

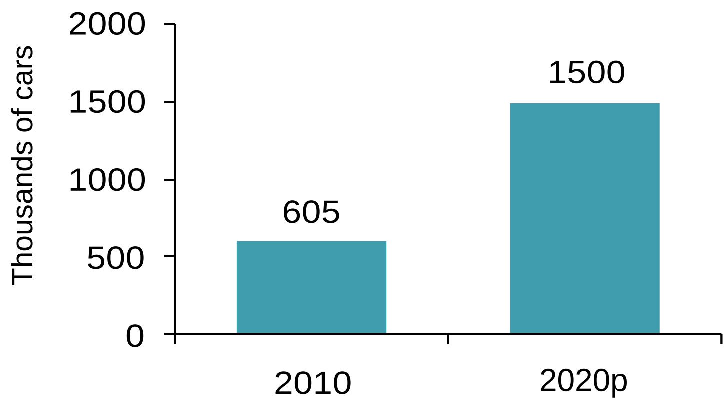
- Lack of qualified managers and workforce with experience in the industry
- Significant differences in approaches and style of work

Level of current attractiveness to foreign OES

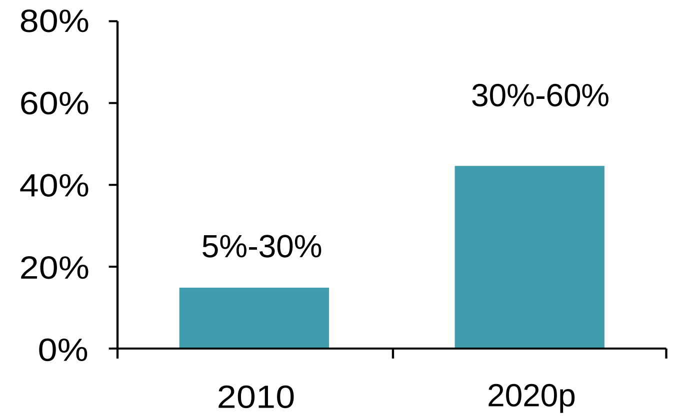
Sources: [1] KPMG interview program
[2] KPMG analysis

The demand for localized automotive components will grow significantly

Car production volumes of global OEM in Russia[(a)]



Indicative level of localization of components by global OEM



The Russian government continues to pursue the policy to encourage localization of international OES in Russia

- New regime of industrial assembly of motor transport vehicles implies prolongation of the period of favorable (duty-free) import of automotive components in exchange for stricter obligations with regard to localization of automotive components
  - Production volume of no less than 300 thousand cars
  - Growth of the share of locally produced components up to 60%
  - Localization of production of engines and transmission gearboxes, complex modules, localization of punching operations

International OEM have already expressed their interest in the new regime of industrial assembly

- AvtoVAZ-Renault-Nissan and Sollers-Fiat alliances
- VW, Toyota, Hyundai, GM

Note: (a) not including AVTOVAZ and other traditional Russian manufacturers

Sources: [1] Development strategy for the Russian automotive industry up to 2020 года; [2] Draft changes to the regime of industrial assembly of motor transport vehicles; [3] Autostat; [4] KPMG analysis

Greenfield construction is a popular way to enter the market but takes up a lot of time

	Key ways to localize the production		
	Acquisition of a Russian OES	Creation of a JV with a Russian OES and OEM	Construction of a new production site
Advantages	▪ Fast expansion into the market ▪ Access to Russian OEM through the existing contracts	▪ Access to Russian OEMs through the existing contracts (in case of JV with OES) ▪ Simplified access to the assembly line (in case of partnership with a Russian OEM)	▪ Opportunity to create a production site in accordance with the modern technological standards ▪ Opportunity to select the location for the production site
Disadvantages	▪ Lack of technically advanced players in most of the segments	▪ Legacy of old production capacities ▪ Risk of partnering with companies of different business culture	▪ Long waiting period before the start of the production ▪ Significant investments
	Low chances to find a site for acquisition which would meet the modern production requirements	**Partnership may be a good option for a "careful" expansion into the market**	**At the moment, greenfield production projects are a preferred option for most OES despite the long time it takes**

Sources: [1] KPMG interview program
[2] KPMG analysis

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Legal forms of presence in Russia
Representative office, branch, legal entity

Legal forms of presence

Representative office

- A separate subdivision within a foreign legal entity (not having legal status of separate entity)
- Only earliest stages of business existence
- Limited to auxiliary functions, e.g. (information support, advertising, marketing activities)

Branch of foreign legal entity

- A separate subdivision within a foreign legal entity (not having legal status of a separate entity)
- Scope fully or partially matches with the scope of head office's activities and may also include representational / auxiliary functions

Russian legal entity

- Separate legal entity
- No limitations within the scope of activities allowed under the effective law
- Certain types of activities may be subject to licensing

Legal forms of presence in Russia

Comparison of Representative office, branch, legal entity (1/2)

Criteria	Representative office (RO)	Branch	Subsidiary
Contractual relationships and payments from customers	N/A	All contractual relationships and payments from customers will be executed by a Branch on behalf of the Company Russian counterparties can effect payments to a Branch both n foreign currency and in rubles	All contractual relationships and payments to customers will be executed by Subsidiary on its behalf Russian clients can effect payments to Subsidiary only in rubles
Currency control implications	N/A	Not considered as a Russian resident for the purposes of Russian currency control legislation => additional currency control formalities may be implied on a contracting party Not subject to specific requirements or limitations to foreign currency transfers made abroad or within Russia	Subject to Russian currency control rules
Customs issues	May perform customs clearance of goods imported for internal use, but there is a risk that the customs authorities would challenge the right to customs clearance	Similar to those for RO	General provisions apply Careful consideration to intra-group imports / sales due to risks of customs value adjustments
Tax reporting	There is no difference in reporting requirements (except for profits tax). There is regular tax reporting (monthly/quarterly or annual) in accordance with tax legislation requirements. Profits tax reporting is more simplified for RO and Branch comparing to Subsidiary		
Financing	Head office may provide financing without limitations	Head office may provide financing without limitations	Financing needs to be properly structured – debt vs. equity vs. other forms (e.g., financial aid)

Legal forms of presence in Russia
Comparison of Representative office, branch, legal entity (2/2)

Criteria	Representative office (RO)	Branch	Subsidiary
Repatriation of profits	N/A	Branches can transfer after-tax profit earned in Russia to their head office without paying taxes	Repatriation tools need to be properly analyzed and structures – e.g., dividends, royalties May be subject to withholding tax
Transfer pricing regulations	N/A to transactions with head office, as these do not constitute sales transactions	N/A to transactions with head office, as these do not constitute sales transactions May be applicable to transactions with related and unrelated parties	Under corresponding criteria transfer pricing regulations may apply to transactions with the parent company, other related and unrelated parties
Taxation (see other slides for more details)	Profits tax - N/A unless creating a permanent establishment Other taxes – similar to Branch and Subsidiary	Profits tax: income derived through a permanent establishment in Russia reduced on economically justified expenses taxed at 20% Allocation methodology may become subject to scrutiny by the tax authorities Possibility to deduct expenses incurred by head office and attributable to Branch in Russia Other taxes: similar to RO and Subsidiary	Profits tax - income taxed at 20%, worldwide income is taxed Other taxes – similar to Branch and Subsidiary

Main corporate taxes (1/2)

Russian Taxes

Federal Taxes

- VAT
- Corporate Profit Tax

Regional Taxes

- Property tax
- Transport tax

Local taxes

- Land tax

N.B! Social security contributions are not taxes and covered by the separate Federal Law

Russian Tax System overview

Main corporate taxes (2/2)

Corporate Profit Tax (CPT)	▪ Residence criteria should be fulfilled ▪ **General rate – 20%** with exemption on certain forms on incomes. E.g., 15% on dividends received by non-residents ▪ Application of Double tax treaties could reduce withholding CPT ▪ Tax rate could be reduced to 15.5% if tax concessions are applied. For residents of Special Economic Zones the reduction could be higher ▪ Losses are carried forward within 10 years
Property tax	▪ **Maximal rate - 2.2%** (tax rate depends on tax policy of each Russian region) ▪ Starting 2013 new movable property is exempted from property tax ▪ Investment tax concession: exemption from property tax or decrease in tax rate
VAT	▪ **Standard rate - 18%**, reduced rate 10% (limited number of goods), 0% (export); some economic activities are exempted from VAT ▪ No requirements for separate registration as VAT payer
Social security contributions (SSC)	▪ SSC generally payable **at the total rate of 30%** on the first RUB 568,000 of remuneration in 2013, **plus 10%** of remuneration exceeding RUB 568,000 a year ▪ The threshold (RUR 568,000) is reviewed annually by the Russian Government

Key tax issues to be considered when structuring investments into Russia

- Tax structuring of joint investments / future income distribution – in case of a JV
- Transfer of historical tax risks / due diligence is required – in case of acquisition of a Russian business
- Specific “strict” thin capitalization rules
- Tax risks arising from transfer of technologies / know-how / trademark rights – detailed review of contract terms, recognition of tax consequences
- Income repatriation mechanisms (a possible use of hybrid instruments - ?)
- Specifics of regional tax concessions (if this is important in terms of selecting the region)
- Staff recruitment (including foreign staff) / training – structuring contractual relationship, migration aspects

Key tax issues with regard to current/daily operations in Russia (1/3)

- Selection of the form of contractual relationship for construction (investment contract vs. co-investment agreement vs. construction contract vs. simple partnership agreement, etc.)
- Accounting of infrastructure expenses / payments to the state authorities - detailed review of contract terms in order to minimize tax risks
- Practical issues regarding VAT recovery arising in the course of construction
- Import of equipment - selection of the form of the operation (acquisition / gratuitous receipt vs. contribution to share capital)
- Customs issues regarding import of parts (including the “industrial assembly” regime – with the account of the latest changes in the legislation) – documentation arrangements, etc. => options to simplify the declaration procedure?
- Tax aspects of organization of operational business structure in the RF (especially if creation of several companies in the RF is planned), including the option of application of tax concessions
- Transportation services – application of correct VAT rate / possibility of recovery?
- Transfer pricing
- Structuring of warranty arrangements
- Efficient structuring of arrangements with dealers / distributors

Key tax issues with regard to operations in Russia (2/3)
Investment tax concessions

Tax concessions

Federal level

Tax concessions stipulated by the Russian Tax Code

- ✓ Tax credits, exemption from property tax of certain items of immovable property

Special Economic Zones stipulated by the Federal Law 116-FZ

- ✓ Tax concessions for residents of SEZ are stipulated by the Russian Tax code
- ✓ 4 Types of SEZ in Russia, including Industrial SEZ
- ✓ Reduction of CPT rate 4.5%-18% off – Effective while status is applicable
- ✓ Property tax exemption – 10 years, land tax exemption – 5 years

Regional level

Investment tax concessions stipulated by the regional legislation

- ✓ Generally, reduction in profit tax rate
- ✓ Reduction in property tax rate or exemption from property tax

Tax concessions stipulated for residents of techno parks located in the regions

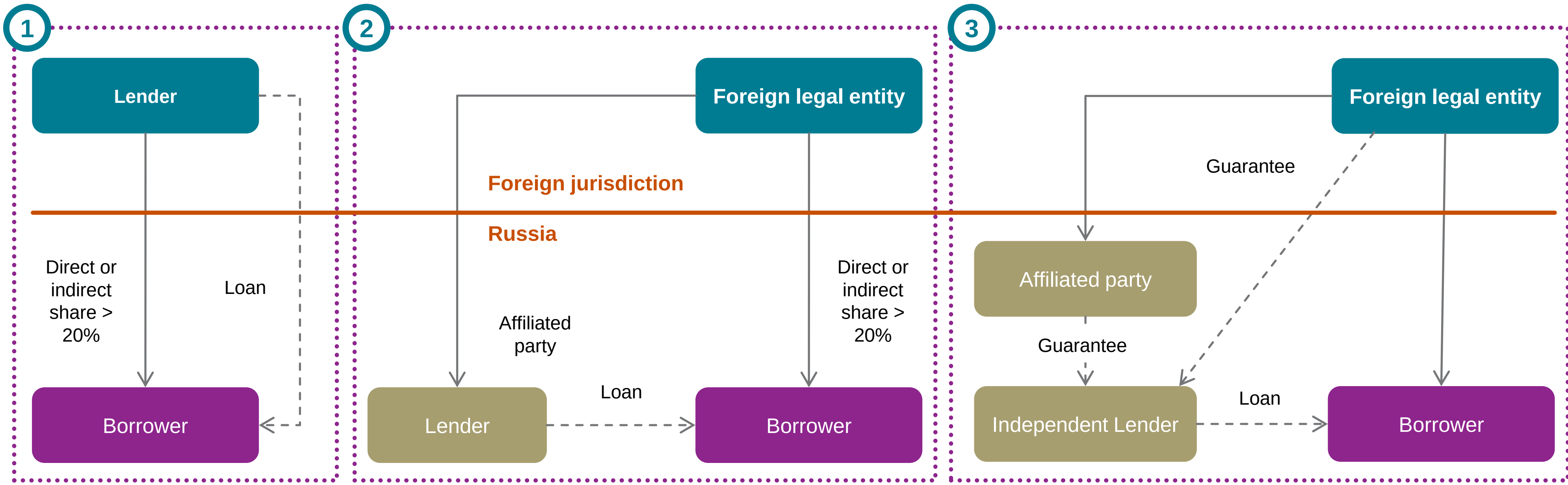
- ✓ Generally, reduction in profit tax and property tax rates. Applicable not for all regions; usually – for support of small- and mid-size enterprises

The opportunities are widely used by car manufacturers and automotive components producers

N.B.! Investment tax concessions generally may be applied by Russian Legal Entities, not by Representative offices or Branches

Thin capitalization rules

Three situations when thin capitalization arises:



Limitation on interest if debt to equity ratio > 3 (for bank and leasing companies >12.5)

Thin capitalization rules

Thin capitalization rules are applied to controlled debt due to:

- foreign company that directly or indirectly owns more than 20% of the charter capital of the borrower
- Russian company that is affiliated with such foreign company
- debt guaranteed by foreign shareholder or its Russian affiliates

Implications of the use of thin capitalization rules

- The maximum amount of deductible interest expense for profits tax purposes is calculated
- The difference is treated as dividends:
- **Does not decrease the profits tax base**
- **Subject to withholding tax**

!

Main trends of the tax practice:

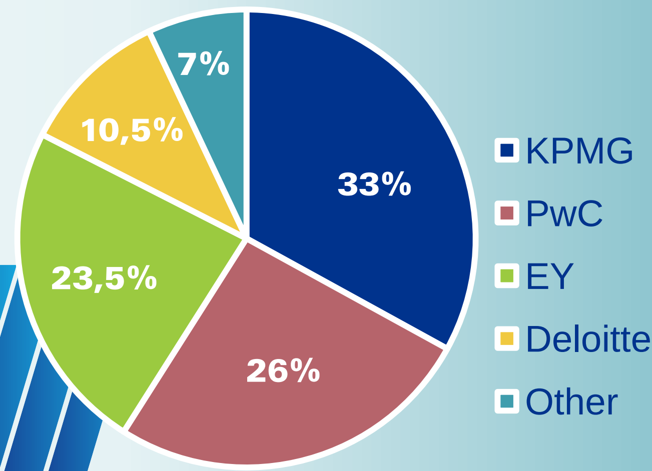
- DTT provisions with respect to nondiscrimination/unlimited deduction of interest do not affect the ability to apply the thin capitalization rules
- Challenging of loans from foreign “sister” company

KPMG in Russia

No.1 Audit Firm in Russia 2009–2012 гг.	No.1 Audit & Advisory Firm in Russia 2011 г.	KPMG's Valuation team: Winner of the Big Consulting'12 Award in the Public Opinion nomination 2012 г.
Tax Firm of the Year in Russia 2012 - 2013 гг.	European Energy Tax Team of the Year 2011 г.	Audit Company of the Past 5 Years by Financial Elite of Russia Awards 2010 г.
Best Reporting Accountant 2010 г.	No.1 Reporting Accountant in Russia by number of transactions and overall value 2010 г.	Insolvency Advisory Firm of the Year in Russia 2010 г.

Audit market share – Top-100 Russian companies*

#1 Audit firm



** Source: Expert-400 Rating, 2013*

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