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Joint Ventures in the Russian Federation

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1 General background

1.1 Joint ventures under Russian law

Russian law currently does not provide a specific definition of 'joint ventures'.² In broad terms, a joint venture is a structure involving two or more independent entities that decide to work together on a specific project. Both contractual (i.e. based solely on a co-operation contract) and incorporated joint ventures are customary in Russia. However, contractual joint ventures (especially in relations between Russian and foreign partners) are relatively rare, partly due to the unfavourable taxation regime of partnerships.³ Russian law generally does not provide any limitations on the types of economic activity that can be pursued in a joint venture.⁴ However, some industries are subject to special governmental regulation that may directly prohibit or restrict foreign investment, as the section below shows.

1.2 Current trends in the regulation of foreign investment in Russia

During the past several years, the government of the Russian Federation has been closely monitoring certain industry segments that are considered

strategically important to Russian security and the economy. There has been a strong tendency towards increased regulation of foreign investors' access to the country's most attractive industry sectors, including natural resources, metals, mining and oil and gas. The state continues to maintain its influence in these spheres by controlling Russian majors like Transneft and Gazprom.

In recent years, a number of new rules have been considered for the exploration of natural resources and regulation of foreign investment in areas that Russia considers strategically important to its national interests. The main proposed legislative amendments that would impact foreign investment include provisions:

- (i) restricting foreign investors' access to the strategic subsoil deposits; and
- (ii) requiring foreign investments in strategic areas of the Russian economy to be authorised by the state bodies of the Russian Federation.

Despite the trends mentioned above, the regulatory framework has undergone some encouraging changes that can be beneficial to foreign investment:

- (i) nearly all restrictions and encumbrances on foreign currency operations, including export of capital, have been abolished;
- (ii) the new part of the Civil Code that codifies intellectual property rules has come into force; and
- (iii) the Subsoil Law has been amended to allow transfer of subsoil licences from one licence holder to another under certain circumstances.

2 Choice of corporate vehicle

Currently, the two most commonly used corporate vehicles for joint ventures in Russia that involve a limited number of parties are LLCs and CJSCs:

- (i) a limited liability company (*obschestvo s ogranichennoy otvetstvennostiyu*, or *OOO*) ('LLC'); and
- (ii) a closed joint-stock company (*zakrytoye aktsionernoye obschestvo*, or *ZAO*) ('CJSC').⁵

The choice of vehicle for the establishment of a joint venture depends on the specific circumstances and economic considerations of the parties considering entering into such an arrangement. A CJSC is generally viewed as a more appropriate vehicle for a joint venture in Russia. CJSCs offer higher protection to shareholders through a more rigid framework of formalities relating to the issuance and transfer of shares. In addition, certain disadvantageous features of an LLC (in particular, the inalienable right of a shareholder to withdraw from an LLC and have his shares redeemed, albeit only at balance sheet value) do not apply to a CJSC, making it a more attractive option for joint venture arrangements.

The main differences between an LLC and CJSC relate to the areas of decision-making, protection of shareholders against share dilution, withdrawal or expulsion of a participant from a joint venture, property contributions and administrative issues, and are explained in the sections below.

2.1 Decision-making

The LLC Law⁶ allows a simple majority to make most of the decisions at the shareholders' level, although this threshold may be increased by the LLC's charter. The LLC's charter can provide voting powers for shareholders that are disproportionate to their shareholding (for example, the charter can give participants with a 49:51 equity split equal (50:50) voting rights).

The CJSC Law⁷ sets strict requirements concerning the decision-making authority and procedure for the governing bodies of a CJSC. There is a statutory comprehensive list of shareholder-reserved matters that cannot be expanded.⁸ Subject to only a few exceptions, a minority shareholder's influence cannot be increased by delegating powers to the board of directors ('BoD') where the decision-making process is less regulated and can be tailored in a way that is more favourable for the minority. In particular, the threshold for BoD resolutions approving proposals by the management (and all other resolutions as well) can be set at any percentage, e.g. at 75% or even 100%, so that one single BoD member who has the trust of the minority shareholder can have full veto rights on all issues falling into the competence of the BoD, as it is determined by the charter.

At the shareholders' meeting a limited number of more significant decisions requires a 75% vote. However, all other decisions may be passed by a simple majority.

Furthermore, the quorum rules (which are also fixed by the CJSC Law and cannot be extended by the charter or by agreement) require the attendance of shareholders holding more than 50% of the company's outstanding voting shares to make decisions on any issue. The same quorum applies on the BoD. In the case of the BoD the charter can, however, change the quorum and increase it to, for example, 75% or even 100%, so that the BoD cannot act when a BoD member who has the trust of the minority shareholder is not present at the meeting.

2.2 Protecting shareholders against share dilution

Both the participants of an LLC and the shareholders of a CJSC are protected against dilution of their shares in the charter capital of the company in the event of a charter capital increase. In an LLC, the protection is absolute; in the CJSC, it is relative:

- (i) the LLC Law requires a unanimous resolution of all shareholders if the charter capital increase entails a disproportionate alteration of the shares of participants;
- (ii) the shareholders of a CJSC have a pre-emptive right to purchase newly issued shares placed under closed subscription⁹ in proportion to their current shareholding.

If unwanted dilution is an issue, this may arguably be the only significant advantage offered by the LLC over the CJSC.

2.3 Withdrawal of a participant

As mentioned, each shareholder may exit from an LLC at any time without the consent of the other participants. In such cases, an LLC is obliged to pay the withdrawn participant a portion of the company's net assets pro rata to his shareholding. This exit route is not available to the shareholders of a CJSC.

2.4 Property contributions

The shareholders may provide an LLC with gratuitous financial aid by means of 'property contribution'. This mechanism is not available to CJSC shareholders, which means that instead of a cash contribution the charter capital must be formally increased.

2.5 Expulsion of a participant

A participant may be expelled from an LLC pursuant to a court decision if shareholders, together holding at least 10% of the shares, initiate legal proceedings and prove that the shareholder whose expulsion is sought has grossly violated his duties or made the operation of the LLC impossible, or materially impaired its operation. If a participant is expelled, the company

must pay the expelled participant only the balance sheet value of his shares, calculated according to the company's balance sheet as of the date of the court decision on the participant's expulsion. This expulsion right is not available to the shareholders of a CJSC.

2.6 Administrative formalities

Incorporation and management of a CJSC is more complex and requires closer regulatory supervision than incorporation and management of an LLC. A CJSC requires a larger amount of internal corporate documentation and is subject to supervision by the Federal Service for Financial Markets, including requirements for certain periodic disclosures and reporting. Such regulations do not apply to an LLC.

3 Management structure

Management structures of both a CJSC and an LLC consist of four main elements:

- (i) general shareholders' meeting;¹⁰
- (ii) BoD (optional);
- (iii) management board (optional);¹¹ and
- (iv) general director.

3.1 General shareholders' meeting

The general shareholders' meeting is the highest management body of the company. Issues that fall within the competence of the general shareholders' meeting include adoption of amendments to the company's charter, reorganisation and liquidation of the company, appointment of the members of the BoD, and other major decisions. General shareholders' meetings are held annually; extraordinary meetings may be convened as necessary. As mentioned above, the charter cannot expand the competences of a CJSC's shareholders' meeting, but it can do so for an LLC's shareholders' meeting. Nevertheless, the BoD can supervise the management quite effectively in both a CJSC and an LLC if the charter

Joint Ventures in the Russian Federation

provides for the necessary authorities. In particular, it can authorise the BoD to limit the authority of the general director (see 10.3.3 below).

3.2 Board of directors

The BoD oversees the business activities and the management of the company. The charter of a CJSC (with fewer than 50 shareholders) may allocate the functions of the BoD to the general shareholders' meeting (and have no BoD). The law does not require an LLC to have a BoD, but the charter may provide for it. However, the general shareholders' meeting can only delegate responsibility to the BoD on a limited number of matters: the right to appoint or dismiss the executive bodies of the company, approve major transactions (between 25% and 50% of the value of the company's assets) or interested party transactions, and decide questions related to the preparation and holding of the general shareholders' meeting. There is no citizenship requirement for membership of the BoD and its members do not need to be shareholders in the company. Only individuals may be elected as members of the BoD. The full BoD elects a chairman by majority vote, and may repeatedly re-elect a chair without limitation, unless the charter provides for a limitation as to the number of terms. Notably, the charter of a CJSC can provide the BoD with an almost unlimited number of additional authorities, which are not reserved by law to the shareholders' meeting.

3.3 General director

The general director acts on behalf of the CJSC or LLC and manages the day-to-day operations. The general director (or other members of the management board with powers of attorney) may not conclude major and interested party transactions without prior approval of the BoD or the general shareholders' meeting, as appropriate. The company charter and the general director's employment agreement may provide for additional instances that require prior approval of the BoD.

The appointment of the general director and the early termination of his powers (which is possible at any time and without cause) lie within the competence of

the general shareholders' meeting. The shareholders' meeting can delegate this competence to the BoD.

3.4 Management board

The charter can provide for a management board to manage the daily activities of the company, though most Russian companies do not have a management board. The appointment of the members of the management board and the early termination of their powers lies within the competence of the general shareholders' meeting, unless these powers have been delegated to the BoD. If the company has a management board, the company's general director always acts as chairman of the company's management board. He issues powers of attorney to the other members of the management board to represent the company (that is, the other members of the management board do not have a statutory right to represent the company).

4 Major and interested party transactions

Shareholders of a CJSC and participants in an LLC have various means of controlling the company's activities. In particular, they have powers to approve transactions that may potentially have a significant effect on the financial conditions of the company or impair the shareholders' rights. The CJSC and LLC Laws require corporate approvals of 'major transactions' and 'interested party transactions' (as mentioned above) and set forth the procedures for such approvals.

4.1 Approval of major transactions

A major transaction is a transaction or a series of interrelated transactions in connection with a direct or indirect acquisition or alienation or possible alienation by the company of its assets exceeding 25% of the balance sheet value according to the latest balance sheet. The CJSC or LLC charter may define other transactions that must be approved as 'major transactions'.¹² Transactions with a value between 25% and 50% of the balance sheet require approval by the BoD, if there is a BoD—otherwise approval by the general shareholders' meeting. Transactions

Joint Ventures in the Russian Federation

with a value of more than 50% require approval by the general shareholders' meeting.¹³

The following 'major transactions' are exempt by law from the requirement to receive approval as major transactions:

- (i) transactions entered into in the course of the company's ordinary business activity (applicable to both the CJSC and LLC);
- (ii) CJSC transactions that simultaneously qualify as interested party transactions; such transactions must be approved only as an interested party transaction; and
- (iii) transactions of a CJSC that is 100% owned by the general director of such company.

A major transaction must be approved prior to its execution. Post-execution approval is not sufficient. Execution in this sense means not only signing the transaction documentation, but also obtaining approval from interested parties if the documentation contains a clear condition precedent.

4.2 Approval of interested party transactions

An interested party transaction is a transaction or a series of interrelated transactions in which an insider of the company is 'interested'.¹⁴ The relevant insider is considered by law as 'interested' if he or an affiliated party:¹⁵

- (i) is a party to the relevant transaction or is involved therein as a beneficiary, representative or intermediary;
- (ii) holds 20% or more of the voting shares of a legal entity that is a party to the transaction or is involved therein as a beneficiary, representative or intermediary;
- (iii) holds a position in the management bodies of a legal entity that is a party to the transaction or is involved therein as a beneficiary, representative or intermediary; or

- (iv) is deemed interested by virtue of the provisions of the company charter.¹⁶

Approval of an interested party transaction must be obtained prior to its execution. Post-execution approval is not sufficient. Execution in this sense means not only signing the transaction documentation, but also obtaining approval from interested parties if the documentation contains a clear condition precedent.

Similar to the approval of major transactions, the CJSC Law provides for a two-level procedure for the approval of interested party transactions. If the value of an interested party transaction or a series of interrelated transactions of a CJSC equals or exceeds 2% of the balance sheet value, such transactions require general shareholders' meeting approval. Interested party transactions with a value of less than 2% of the balance sheet value only require BoD approval, if there is a BoD—otherwise approval by the general shareholders' meeting.

Interested party transactions to be entered into by an LLC must be approved at the general shareholders' meeting by a simple majority vote of all shareholders that are not deemed interested by the law. The approval of interested party transactions may be referred to the BoD's authority, except for transactions worth 2% or more of the latest balance sheet value of the company's assets.

Transactions that qualify as 'interested party transactions', but are by law exempted from approval as interested party transactions include:

- (i) transactions entered into in the course of ordinary business activity of the company if they were commenced before an interested party qualified as such; these transactions must, however, receive approval at the next annual general shareholders' meeting;
- (ii) transactions entered into while the company was fully owned by the general director;
- (iii) transactions in which all CJSC shareholders are interested (not applicable to an LLC);

Joint Ventures in the Russian Federation

- (iv) transactions that are obligatory for the CJSC under the law (not applicable to an LLC);
- (v) reorganisation of the CJSC by merger or accession;
- (vi) implementation of a pre-emptive right to acquire shares issued by the CJSC and securities convertible into shares; and
- (vii) acquisition and redemption by the CJSC of outstanding shares.

4.3 Consequences of failure to approve

If a major transaction or an interested party transaction is not approved, it can be voided, but remains valid until a court declares it invalid. Court action must be initiated within one year from the moment the plaintiff learned or is assumed to have learned about the violation of the approval requirement. Every shareholder has the right to sue. In order to obtain an invalidation ruling, it seems that courts have recently tended to demand, at least in the case of major transactions, that the plaintiff demonstrate that the transaction was actually disadvantageous for the company.

If a shareholder of a CJSC votes against the approval of a major transaction with a value of more than 50% of the balance sheet value or does not participate in the vote, he is entitled to demand that the company purchase his shares. The purchase price must be determined by the BoD, if there is a BoD – otherwise by the general shareholders' meeting. It cannot be lower than the market price determined by an independent appraiser. When a transaction is submitted to the general shareholders' meeting for approval, the general shareholders' meeting is to be notified about the buy-out rights and their terms. This rule does not apply to LLCs.

5 Limitation of liability

Under Russian law, parties may limit their liability contractually if the transaction is within a civil (private) law framework. Limitation of liability in the public law

area (e.g. regulatory, administrative and criminal law, in particular) and in (public and private) employment law is customarily not possible. Limitation of liability by contract in the field of company law (which is seen as almost entirely mandatory) is also not possible.

Participants of an LLC as well as shareholders of a CJSC are, in principle, not liable for the obligations of the relevant company. Shareholders are, however, liable for the obligations relating to transactions that occurred prior to the state registration of the company. Shareholders can be released from liability only if the general shareholders' meeting approves the founders' actions after the registration of the company.

In the event of partial payment of shares by shareholders, such shareholders are liable for the company's obligations in respect of the amount of the unpaid portion.

In the event of an overvaluation of in-kind contributions to an LLC charter capital, the shareholder and the appraiser are jointly and severally liable for the obligations of the company if its assets are insufficient for three years following the state registration of the company or the charter capital increase, as the case may be.

A shareholder who is deemed to be a 'parent company'¹⁷ bears joint and several liability with the relevant company for obligations assumed under transactions that were concluded by the company in accordance with the shareholder's instructions. CJSC liability requires that the right to give instructions be provided in an agreement between the shareholder and the company or in the company charter, unless the shareholder has caused the insolvency of the company (in which case, written powers or a formal agreement are not required).

Accordingly, the principle of limitation of liability of Russian companies is rather theoretical. Assets are often held and operated by different entities. Many Russian companies are held by foreign (often offshore) entities that offer better protection against shareholder liability for their shareholders.

6 Joint venture agreements in Russia

6.1 Shareholders' agreements

To the extent that shareholders' agreements deviate from the law with regard to voting agreements (as is internationally customary), additional voting rights, quorum requirements, and the right to appoint management, are currently not enforceable in Russian courts.¹⁸ Resolutions of the corporate bodies of a company cannot be successfully challenged in a Russian court by a shareholder on the ground that a shareholder agreement has been violated. Shareholders' agreements also may not be upheld through court injunctions, so that the other shareholders may not be prevented from acting (for example, voting), even in instances of blatant violation of provisions of the agreement. Joint ventures concerning Russian companies are, therefore, often under foreign (mostly English) law and contain a clause on international arbitration. International arbitration awards are enforceable in Russia under the New York Convention of 1958 without another review of the substance of the dispute by the Russian courts. In practice, however, enforcement is often difficult and unsuccessful.

6.2 Options

Under an option agreement, one party usually has the right to demand from the other party(ies) the purchase of his shares in the joint venture company, and the other party(ies) assumes an obligation to sell and transfer the relevant shares to the calling partner ('call option') or to sell his shares in the joint venture company to the other party and the obligation of the other party to acquire the shares ('put option').

The use of options in Russian joint ventures is limited. Under Russian law, it is not clear whether a transaction may be at all conditional on the actions of one party, as would be the case with the exercise of an option. Therefore, the validity of option agreements under Russian law is unclear. In order to reduce the risk of being held invalid by a Russian court, option agreements are often governed by foreign law and contain an international arbitration clause.

6.3 Share retention agreements

Russian law generally provides that a person, including a legal entity, may undertake an obligation to perform or abstain from performing certain acts. However, it is unclear whether a negative covenant is valid. As a result, the validity of share retention agreements (in which the parties agree not to dispose of their shares in a joint venture unless special circumstances occur) is uncertain. Furthermore, even if held valid, an agreement does not guarantee that the shares will not be transferred to a third party without the consent of the other party. An escrow arrangement, under which the shares are transferred to an agent, is difficult in practice due to the complications concerning the registration of shares, and due to tax issues and a general lack of Russian legal framework in this area if the shareholder and/or the escrow agent are Russian entities. Under these circumstances, choosing foreign law and international arbitration alone is not helpful.

Shares in a CJSC and an LLC are, however, subject to a statutory proportionate pre-emptive right in favour of the other shareholders. Therefore, in a Russian joint venture with, for example, two partners, each partner can prevent the other from selling his shares to a third party. However, in a CJSC this requires that the remaining shareholder matches an offer by the third party. The right of the other shareholder to sell or be bought out on the same conditions cannot be waived before the offer has actually been received. In an LLC, the charter of the company can rule out the sale to a third party entirely, but each shareholder can return his shares to the company against redemption of the balance sheet value of his shares.

6.4 Certain provisions

6.4.1 Events of default

Russian law does not contain provisions under which corporate relations within a joint venture may be made conditional on the proper performance of certain obligations of the parties (e.g. financing obligations or a party's obligation to provide know-how) or other events of default.¹⁹ An event of default by one party that would lead to an agreed right of the other party to call for the shares of the defaulting party is unlikely

Joint Ventures in the Russian Federation

to be recognised under Russian law. Even then, such shares could only be acquired through (lengthy) court and enforcement proceedings. In particular, such proceedings would require a public auction or similar competitive sale of the assets of the defaulting party. These statutory rules that govern enforcement cannot be waived or amended by an agreement between the parties or by provisions of the charter of the joint venture company. Accordingly, the likelihood of enforcement of certain indemnification provisions would vary.

6.4.2 Deadlock resolution

Russian law does not easily allow for contractually agreed mechanisms to resolve deadlock that occurs when the partners of a joint venture fail to reach an agreement on a particular matter. When a partner or group of partners refuses to vote in favour of a resolution put forward by another partner or group of partners, usually a shareholders' agreement establishes the procedure to resolve the deadlock. Procedures vary, but can include enlisting an expert whose opinion is to be binding on the partners, using call and/or put options and other exit provisions. The uncertainty regarding the enforceability of shareholders' agreements generally, and option agreements in particular, means that there is a higher risk that a deadlock may effectively block the joint venture's operation.

6.4.3 Indemnification

The enforceability of indemnification provisions is unclear. In the Russian civil law context, the rules that are similar to 'indemnification' (as this concept is understood in English law) are scattered throughout the civil legislation. In this respect, different types of damages which are the subject of an indemnification provision may fall under different sets of statutory rules. This can result in some contractual provisions being denied enforcement. For example, categorising a particular right as insurance by a Russian court can result in the application of insurance legislation. Since insurance activity may only be effectuated by licensed insurers, etc, the relevant contractual indemnification provision may be held invalid. It can also be construed to be a gift, because Russian law may not provide for

restitution of the loss concerned. Gifts are prohibited between Russian companies, and agreements with a promise to make a gift are unenforceable. If the indemnification concerns losses incurred by fines concerning illegal behaviour of the company, an equalising payment by a shareholder, especially if it is to be made to the company, may be seen as an attempt to undermine regulatory fines.

6.5 Conclusion

As shown above, under Russian law, exit instruments generally used for the termination of international joint ventures established under foreign jurisdictions, are mostly not applicable to joint ventures incorporated in Russia. Furthermore, Russian legislation does not set forth specific methods or instruments for terminating joint ventures (either for local or for international joint ventures).

7 Offshore joint ventures

7.1 Structure

Owing to limitations that Russian law provides for joint venture agreements that are customary internationally, it has become common to structure joint ventures between a foreign investor and a Russian partner, and even between Russian partners without a foreign participation, in relation to the control of Russian operating assets, as a holding company in an offshore jurisdiction or in other foreign jurisdictions. Both alternatives are referred to here as 'foreign holding structures,' and when speaking of companies incorporated abroad in order to implement the structure, the term 'foreign holding company' is used for the purposes of the text that follows.

The foreign holding structure is most frequently implemented in the following way: prior to closing the joint venture agreement, title to all shares in the joint venture company incorporated in Russia is transferred by the shareholders to a foreign holding company, and the partners of the joint venture become shareholders of the foreign holding company. As a result, the foreign company is the sole shareholder in the Russian operating company,

Joint Ventures in the Russian Federation

and the shareholders in the foreign holding company, the partners of the joint venture, own the shares of the Russian operating company indirectly. The partners of the joint venture may thus benefit from the advantages offered by foreign corporate and civil law with respect to the indirect participation in the Russian company.

7.2 Advantages

The purpose of implementing a foreign holding structure is to secure the ability to deal with corporate governance issues in a manner closer to international standards. By contrast with (direct) shareholders of a Russian company, the shareholders of the holding company abroad can enter into legally binding shareholders' agreements, option agreements, or other internationally recognised methods of arranging their internal relations to the extent that this is possible under the jurisdiction of the country in which the parties have chosen to incorporate the foreign holding company. These agreements may then deal with issues such as:

- (i) nomination of the general director or other members of the company's management;²⁰
- (ii) nomination of members of the BoD;
- (iii) events of default and solutions to deadlock situations;
- (iv) options, retention agreement, tag-along and drag-along rights (concerning the shares of the foreign holding company);
- (v) security assignments of shares and escrow arrangements; and
- (vi) generally any issues that can, under the laws of the country where the holding company is incorporated, be made the subject of an agreement between the shareholders.

Also, certain other practical advantages may derive from the use of a foreign holding structure:

- A foreign holding company is often more attractive to foreign banks in matters relating to financing of the joint venture company, because, among other reasons, it broadens the scope of security mechanisms and enhances enforceability. For example, the creation (and enforcement) of a pledge and the assignment of shares in the foreign holding company may enable the banks to enforce effectively against the Russian assets held by the joint venture company by attaching the shares in the foreign holding company.
- The indirect shareholding in the Russian joint venture company can reduce the risk of the partners to the joint venture bearing shareholders' liability for the joint venture company's obligations under Russian law.
- The use of a foreign holding company may add significant flexibility to an initial public offering at a later stage of the investment project. The majority of IPOs of Russian issuers occur, technically, via legal entities that reside outside of Russia. The same applies to debt issuances such as bonds and notes.

If shares are acquired in the offshore holding company, the restrictions of Russian anti-monopoly legislation apply in a similar way to a direct acquisition of shares in the Russian joint venture company. Therefore, anti-monopoly issues should not be seen as an advantage in implementing an offshore holding structure. The chain of control needs to be made fully transparent to the Federal Anti-monopoly Service of Russia ('FAS') (and to other regulators, if applicable).

7.3 Management

It should be taken into account that neither of the joint venture partners is directly represented in the Russian joint venture company. As a result, reliable corporate representation of the offshore holding company (i.e. representatives that act strictly in accordance with the constituent agreements of the joint venture, the joint venture agreement and resolutions of the partners) is a requirement for a successful implementation of the foreign holding structure. If the foreign holding

Joint Ventures in the Russian Federation

company is a serviced entity, requisite agreements with the service providers need to be in place. Each shareholder and the company should have separate representation.

Shareholders' decisions on issues concerning the business of the Russian company need to be translated into execution at the level of the Russian company that is conducting the business and that owns the assets in Russia. Execution depends on the reliability of the members of the management of the holding company and on that of the Russian company. The management of the foreign holding company acts as the sole shareholder of the Russian company and needs to report decisions to the Russian company. The joint venture partners, as shareholders of the foreign holding company, have no direct legal means to enforce the decisions. They can only act via the management of the foreign holding company. The management of the Russian company needs to follow these resolutions and, in cases where differences of opinion occur, the enforcement of the intentions of the foreign holding company may eventually have to rely on Russian state courts. It is crucial that the parties structure and manage a foreign holding structure properly and in full compliance with Russian law requirements in order to be able to seek the support of the Russian courts, if necessary.

7.4 Taxation

In most cases, a foreign structure, even in an offshore jurisdiction, does not offer the foreign (non-Russian) partners tax advantages over a direct investment in Russia. It is, however, important to avoid a situation that may endanger the legality of the structure on the ground that the Russian partners or their predecessors have not complied fully with applicable Russian tax legislation in connection with the transfer of their shares in the Russian company to the foreign holding. A transfer of shares below market value can endanger the validity of the transfer. Although there are currently no Russian requirements concerning the substance of a foreign holding (meaning that it has a real management and is not a mere letter box company), these requirements are almost certain to be expected in the future and it may be advisable to take them into account now.

7.5 Interested party transactions

If the foreign holding company is the sole shareholder of the Russian company, this eliminates the restrictions of (and the protection afforded by) the limitations of the provisions on major transactions and interested party transactions. These provisions require at least two shareholders in the Russian company in order to be applicable.

7.6 Enforcement

The foreign holding structure also resolves the issues around effective (i.e. extrajudicial) enforcement by a shareholder or third party as regards the shares of a defaulting shareholder (to the extent that the laws of that country are effective). No further enforcement is required in Russia when the indirect shares are transferred in accordance with the laws of the jurisdiction of the holding company.

7.7 Frequently used jurisdictions

The most widely used jurisdictions for the establishment of a foreign holding company to hold shares in a Russian joint venture company are Cyprus, the Netherlands, and Luxembourg. These jurisdictions have double taxation treaty reliefs and favourable domestic tax regimes (e.g., in Cyprus, there is a 10% corporate income tax rate and tax exemption for dividends and capital gains generated from shareholdings in Russian companies, as well as for outbound dividends; Luxembourg and the Netherlands offer participation exemption for received dividends and capital gains under certain conditions). The choice of jurisdiction for the foreign holding company may have an impact on a number of factors, in particular, tax and labour issues (co-determination, workers councils), the flexibility to move from one jurisdiction to another, and the costs of administration.

7.8 Termination

Since Russian restrictions and regulations do not apply to a foreign holding company, the partners of the joint venture may generally use all internationally accepted exit instruments to terminate the joint venture, subject to possible restrictions which may

Joint Ventures in the Russian Federation

exist under the foreign jurisdiction chosen for the establishment of the holding company.

8 Other legal issues

8.1 Competition law compliance

The Russian Competition Law regulates the following acquisitions:²¹

- (i) acquisition of more than 25% of the voting shares in a CJSC and one-third of the shares in an LLC, provided that before such acquisition the acquirer did not own voting shares or owned less than 25% of the voting shares of the CJSC or one-third of the shares of the LLC;
- (ii) acquisition of more than 50% of the voting shares in a CJSC or shares in an LLC, if the acquirer already owned between 25% and 50% of the voting shares in the CJSC or between one-third and 50% of the shares in the LLC;
- (iii) acquisition of more than 75% or two-thirds of the voting shares in the CJSC, provided that the acquirer already owned between 50% and 75% of the voting shares in the CJSC or between 50% and two-thirds of the shares in the LLC;
- (iv) acquisition of more than 20% of the main production assets and/or intangible assets of a company;
- (v) acquisition of more than 10% of the assets of a financial institution;²² and
- (vi) acquisition of rights to determine the commercial activity of a company or financial institution, or to perform the functions of its management authority.

Each of the transactions or actions listed above may require prior FAS approval if certain monetary thresholds²³ established by the Competition Law are met, or if one of the participants to the transaction/action is included in the Register of Business Entities

with a Share of the Relevant Commodity Market Exceeding 35 Percent.

The FAS approves the establishment of a company if the charter capital of a newly established company is paid with shares or assets of another company (and provided that the newly established company obtains rights to more than 25% of the voting shares of the CJSC or more than one-third of the shares of the LLC, or more than 20% of the assets of such company, or more than 10% of the shares of such financial institution).²⁴

8.1.1 Abuse of a dominant position

A business entity is deemed to have a dominant position within a certain commodity market if its market share exceeds 50% (except for cases when the FAS specifically establishes that, even with a market share of more than 50%, a particular entity is not dominant). Entities with a market share of less than 50% but more than 35% may also be found by the FAS to have a dominant position on a certain commodity market based on particular criteria characterising that market. Generally, a business entity with a market share of less than 35% cannot be considered to have a dominant position.

A business entity with a dominant position is prohibited from certain actions (or failures to act) that result in, or may result in, the restriction or elimination of competition on the commodity market. Such actions include, inter alia, setting and maintaining high or low monopoly prices for goods, inducing a party to enter into a contract with disadvantageous conditions or conditions not related to the subject-matter of the contract, and creation of discriminatory conditions in the market.

8.1.2 Agreements or concerted actions limiting competition

Agreements between competing business entities ('horizontal' agreements) are prohibited by the Competition Law. The Competition Law establishes a list of agreements prohibited per se (i.e. the negative effect of which is presumed). Agreements

Joint Ventures in the Russian Federation

that lead or may lead, inter alia, to presumed negative effects include setting or maintaining prices, tariffs, discounts, surcharges, or premiums; economically unjustified refusals to enter into contracts with certain sellers or buyers; the division of the commodity market by territory, by the volume of sales or purchase of goods, or by composition of sellers or buyers in the commodity market.

The Competition Law permits the conclusion of agreements between non-competing entities, except for financial institutions ('vertical' agreements), such as dealership or distribution agreements. Vertical agreements are permitted if they are franchising agreements or agreements that involve companies with a market share of less than 20% of any commodity market, and provided that such vertical agreements may not lead to negative consequences that are prohibited per se.

8.1.3 Unfair competition

Unfair competition occurs when the activities of business entities contradict customary business practices and the requirements of reasonableness, honesty and fairness, and have inflicted or may inflict losses on other competitor business entities, or have damaged or may damage their business reputation. The Competition Law prohibits acts of unfair competition, including, inter alia, the dissemination of false, inaccurate, or distorted information. It also prohibits misleading consumers as to the nature, methods or place of the production of goods. Other prohibitions include improper comparisons by a business entity of its products with those of its competitors and the circulation of goods through the illegitimate use of intellectual property.

8.2 Labour law compliance

Employment relations in Russia are primarily regulated by the Russian Labour Code,²⁵ which defines in detail the terms and conditions of employment. Its rules are compulsory for all employers in Russia, both Russian and foreign, and supersede contrary provisions in existing employment contracts. The employer and employee must execute a written

employment contract setting out the basic terms and conditions of employment. If an employee starts working with the express or implied consent of the employer, but without a written contract, the Labour Code recognises the existence of an employment contract between the parties even though it has not been entered into in writing. The written employment contract should include defined terms as set forth in art 57 of the Labour Code:

- (i) the names of the employer and employee;
- (ii) the position to which the employee has been appointed;
- (iii) the required qualifications;
- (iv) the place of work;
- (v) the date of commencement and term of employment, if applicable;
- (vi) the working hours, if they are different from the ones established by internal regulations;
- (vii) the rights and duties of the employer and the employee;
- (viii) the terms of payment;
- (ix) the amount of annual paid leave, any restrictions on when such leave may be taken, and any provisions for compensation during such leave (if they are different from the organisation's internal regulations for annual paid leave);
- (x) benefits and compensations (if different from those required by law and internal regulations); and
- (xi) types and conditions of social insurance directly associated with labour activities.

Provisions of an employment contract are invalid if they attempt to exclude or restrict the employee's rights as defined by the Labour Code. In the event of a dispute, the employer bears the burden of proof for establishing the essential terms and conditions of the

Joint Ventures in the Russian Federation

employment contract.

Employment contracts may provide for an indefinite period or a fixed term of up to five years. Fixed-term contracts may be used only where an indefinite term contract is inappropriate, based on the nature of the work and the working conditions. Article 59 of the Labour Code introduces a non-exhaustive list of instances in which fixed-term employment contracts may be concluded, including contracts for chief executive officers, their deputies, chief accountants, and temporary and seasonal employees. If the employer fails to terminate a fixed-term contract and the employee continues to work after the term has expired, the contract is deemed to be for an indefinite period.

An employment contract may be terminated at the initiative of the employee or the employer, upon the expiration of the term of the contract, upon the transfer of employment, or due to circumstances beyond the parties' control.

Under Russian labour legislation, a non-Russian citizen working in Russia must have an individual work permit, and employers may employ foreign citizens only after obtaining a permit for temporary employment of foreign citizens. The government sets annual quotas limiting the number of work permits, which determines the number of invitations to foreign citizens and work permits for foreign citizens who enter Russia under the non-visa regime.

Neither Russian labour law nor migration law recognises the notion of 'secondment' of personnel. However, this does not mean that secondment is not possible in Russia, but rather that secondment arrangements need to be adapted to the existing structure of relations between the Russian company and its personnel. A foreign citizen working in Russia is subject to the regulation of Russian law.²⁶ Therefore, if an individual provides services on a long-term basis to a Russian company, such individual will be considered either a staff employee or an independent contractor. In both cases, a contract should be entered into between the Russian company and the foreign citizen: an employment contract (for an employee) or

a civil-law agreement (for an independent contractor). The contract regarding work in Russia should be arranged irrespective of the existence of a foreign-law contract with the principal employer outside of Russia. The foreign-law contract and the Russian-law contract should be carefully drafted so as not to contradict each other and not to trigger any adverse tax implications.

8.3 Currency control regulations

For currency control purposes a Russian joint venture company (e.g. an LLC or a CJSC) is considered a Russian resident, and the section below outlines the main currency regulations in Russia.

Most of the cumbersome currency control regulations in Russia have been abolished over the past few years. Generally speaking, currency transactions between Russian residents and non-residents may be performed without limitations, including payment of dividends by the Russian resident to its foreign shareholders in foreign currency (eg US dollars or euros).

In particular, payment settlements in connection with loans granted by non-residents to Russian residents (and vice versa) no longer have licence or mandatory reservation or special account requirements. The same is true for payment settlements between residents and non-residents in connection with securities. Such settlements may be performed in rubles or foreign currency. Russian residents may also open accounts in any country, but in doing so must notify Russian tax authorities.

There are also restrictions on borrowing money: Russian residents must repatriate foreign currency loans (i.e. have the loan credited on their accounts with Russian banks). If they want to receive foreign loans on accounts with banks outside of Russia, (i) such accounts must be opened in OECD²⁷ or FATF²⁸ member states; and (ii) such foreign currency loans must be obtained from non-resident organisations that are agents of foreign states (like EBRD, IFC, OPIC), or from residents of OECD or FATF member

Joint Ventures in the Russian Federation

states; and (iii) such loans must have a term of more than two years.

Foreign currency transactions between Russian residents are prohibited except in a limited number of cases. All agreements and payment obligations can, however, be denominated in foreign currency, so long as the payment is made in the equivalent ruble amount.

Russian residents are also required to repatriate into Russia any foreign trade related currency proceeds.

8.4 Intellectual property

Under Russian law, rights to some intellectual property (trademarks, computer programs, databases, etc) are subject to state registration. An agreement for the disposition of rights to such intellectual property (assignment, licensing or pledge) is also subject to state registration. An agreement concluded without the relevant state registration is void. In the event of continuous or serious breaches of intellectual property rights, and at the request of the public prosecutor, Russian courts may liquidate a legal entity found liable for the relevant breaches.

8.5 Taxation issues

8.5.1 Thin capitalisation rules

Debt financing of a Russian company through shareholder loans is subject to Russian thin capitalisation rules. Pursuant to these rules, the debt obligations of a Russian company are considered 'controlled debt' if they are:

- (i) owed to a non-Russian company (a 'foreign controlling shareholder'), which directly or indirectly²⁹ owns more than 20% of the shares of the Russian borrower;
- (ii) owed to a Russian company affiliated with such foreign controlling shareholder; or
- (iii) secured, by way of surety, guarantee or in any other manner by the foreign controlling shareholder or any of its Russian affiliates.

To the extent that the 'controlled debt' of a Russian borrower owed to the foreign controlling shareholder exceeds that foreign controlling shareholder's share in the Russian borrower's equity by more than three times, interest on such excessive debt is re-characterised as a constructive dividend. As such, it is not deductible for Russian profit tax purposes and is subject to Russian withholding tax on dividends (at the rate of 15%). It is not clear whether the adverse tax impact of the thin capitalisation rules can be overridden by the Russian double taxation treaties applicable to non-Russian partners.

8.5.2 General tax considerations

As a Russian legal entity, the joint venture company is subject to the general Russian tax provisions:

- (i) VAT at the rate of 18% on the domestic sale of goods and provision of services (and 0% on export sales of goods) with input VAT offset under certain statutory conditions;
- (ii) profit tax at the rate of 24% on taxable income less deductible business expenses, depreciation of fixed assets and loss carry-forward (available over 10 years);
- (iii) property tax at the rate of 2.2% on the average annual book value of fixed tangible assets (other than land);
- (iv) unified social tax assessed on the individual employee's annual payroll at a regressive rate schedule varying between 26% and 2% (the 2% rate applies to the annual payroll in excess of 600,000 rubles (approximately US\$24,000)).

Furthermore, the joint venture company will be required to act as a tax agent and withhold certain taxes from the incomes of certain recipients (in particular, individual income tax from employees' salaries, or income tax from certain incomes of foreign companies or shareholders generated from the payment of dividends or interest and royalties).

Russian tax laws do not provide for the concept of fiscal consolidation or group relief for losses. Thus,

Joint Ventures in the Russian Federation

each partner in the joint venture will be treated as a separate taxpayer, without the possibility of offsets of their profits and losses (however, each separate taxpayer is allowed to carry forward losses over 10 years). A 9% tax on dividends will, for example, be levied on dividends distributed by the joint venture company among its Russian shareholders³⁰ in addition to the 24% profit tax paid by the joint venture company itself.

Foreign shareholders in Russian joint venture companies would primarily be subject to the following Russian withholding taxes:

- Dividends distributed to a foreign company are subject to a 15% withholding income tax; this tax may be reduced pursuant to a double taxation treaty (if applicable).

- Capital gains realised by a foreign company upon sale of the shares in a Russian company are subject to a 24% withholding income tax if Russian real estate makes up more than 50% of the Russian company's assets; this tax may also be reduced or eliminated pursuant to an applicable double taxation treaty.

Russia has double taxation treaties with over 60 countries. Many of the treaties follow the OECD Model Tax Convention and usually grant a full exemption for interest, royalties and capital gains and reduce, to 5% or 10%, the tax on dividends from substantial shareholdings (usually of at least 25–30% and in values exceeding €75,000 or US\$100,000).

Summary table

No	Form of JV	Limited liability	Tax transparent	Retained control over own resources	Management structure	Administrative burden	Ease of exit/unwinding
1	Limited liability company	Yes (of participants).	N/A.	Yes.	General meeting of participants (obligatory). General director—the CEO (obligatory). Management board (optional). Board of directors (optional).	Reasonable amount (state registration).	Shareholder can exit at any time and reclaim his contribution. There are no means to restrict this right.
2	Closed joint stock company	Yes (of shareholders).	N/A.	Yes.	General meeting of shareholders (obligatory). General director—the CEO (obligatory). Management board (optional). Board of directors (optional).	Significant amount (state registration; state registration of share issuance; disclosure obligations).	Exit by way of selling shares. This right can be restricted in the charter (as opposed to an open joint stock company, where there are no means to restrict this right).

Joint Ventures in the Russian Federation

1. With contribution from Anna Maximenko, associate, White & Case.
2. In 1987, a decree of the Government of the USSR introduced the term 'joint venture' to define a special kind of legal entity which was to apply to any undertaking 'between Western and Soviet partners'. The decree was in force until the new Civil Code took effect in 1995.
3. For example, where a foreign partner participates directly, it would not be eligible for tax benefits under Russia's double taxation treaties.
4. The first privately owned businesses in the Russian Federation, formed in the late 1980s, were limited to the service and manufacturing sectors. These included co-operative restaurants, shops and manufacturing plants that were incorporated in the form of joint ventures.
5. The number of participants in an LLC and shareholders in a CJSC is limited to 50. An open joint stock company ('OJSC') does not restrict the number of shareholders in any way. Even though the OJSC may be an option, particularly if it is intended to list the company on a stock exchange, the stricter disclosure requirements and the inalienable right of shareholders of an OJSC to sell their shares to third parties mean that this company form is rarely used for joint ventures.
6. Federal Law No 14-FZ On Limited Liability Companies, dated 8 February 1998 (the 'LLC Law').
7. Federal Law No 208-FZ On Joint Stock Companies, dated 26 December 1995 (the 'JSC Law').
8. The complete list is as follows: amendment of the charter; reorganisation; liquidation, appointment of a liquidation commission and approval of interim and final liquidation balance sheets; approval of the number of members of the board of directors, election of such members and early termination of their powers; approval of the number, nominal value, category (type) of, and rights accruing to, the company's authorised shares; approval of the charter capital increase by issuing ordinary and/or preferred shares through close subscription; approval of the charter capital decrease by decreasing the nominal share value; establishment of the sole and collegiate executive bodies and early termination of their powers; approval of the external auditor; announcement of dividends based on results of the first quarter, half a year and nine months of a financial year; approval of the company's statutory annual financial statements and approval of distribution of profits and losses statement; distribution of profits (including payment of dividends) in respect of a relevant financial year; approval of the procedures for holding a general shareholders' meeting; approval of the number of members of a tallying commission, election of its members and early termination of their powers; splitting or consolidation of shares; approval of interested party and major transactions (subject to certain exceptions); approval of a transaction or a number of interrelated transactions worth 10% or more of the balance sheet value of the company's assets; acquisition by the company of its own issued and outstanding shares (other than for decreasing the charter capital); approval of the charter capital decrease by the company's acquisition of its own issued and outstanding shares for reducing the total amount of shares by way of redemption; approval of the company's participation in holding companies, financial and industrial groups, and other associations of commercial organisations; approval of internal regulations for the functioning of the company's bodies, including, among others, general shareholders' meeting, board of directors, and internal audit commission (internal auditor); approval of the issuance, through closed subscription, of bonds and other securities convertible into shares; approval of the issuance, through open subscription, of bonds and other securities convertible into ordinary shares comprising more than 25% of the previously issued ordinary shares; payout of compensation and/or reimbursement of the relevant expenses to members of the board of directors, and determination of the amount of such compensation and/or reimbursement; transfer of the powers of the sole executive body to a management company or individual manager and early termination of its powers; increase in compensation payable to members of the governing bodies; establishment of the conditions for terminating their powers, including determining or increasing the compensation payable to such members in the event of termination of their powers; payout of compensation and/or reimbursement of relevant expenses to members of an internal audit commission (internal auditor); and determination of the amount of such compensation and reimbursement; extraordinary audit of the company's financial and business activity by the internal audit commission (internal auditor); reimbursement of relevant expenses incurred by the shareholders who have convened an extraordinary general shareholders' meeting; issuance of bonds and other securities (that are not convertible into shares) through open or closed subscription; issuance, through open subscription, of the bonds and other securities convertible into ordinary shares that comprise no more than 25% of the issued and outstanding ordinary shares; issuance, through open subscription, of bonds and other securities convertible into preferred shares; approval of a transaction or a number of interrelated transactions worth 10% or more of the balance sheet value of the company's assets in accordance with the JSC Law.
9. A CJSC may not issue shares through open subscription.
10. Russian corporate legislation refers to stakeholders in an LLC as 'participants', and to stakeholders of a joint-stock company as 'shareholders'. There are also different definitions for an equity stake in the company: in an LLC it is called a 'participatory interest', whereas in a CJSC it is referred to as a 'share'.
11. Establishment of a management board is compulsory for Russian banks.
12. This rule does not apply to limited liability companies.
13. In the case of an LLC the charter may refer approval of transactions worth between 25% and 50% to the BoD; otherwise the general shareholders' meeting is competent.
14. Such insiders include:
 - (i) a member of the BoD of the company;
 - (ii) a person fulfilling the functions of the general director of the company (including an external manager or management organisation);
 - (iii) a member of the management board;
 - (iv) a shareholder of the company having, together with its affiliates, 20% or more of the voting shares/participatory interest in the company's charter capital; and
 - (v) a person having the right to give the company mandatory instructions. (Item (v) does not apply to an LLC.)
15. The 'affiliated parties' are determined by reference to the anti-monopoly legislation, which provides a detailed definition of the scope of persons considered as 'affiliated parties'. These are mainly individuals and legal entities which control or may determine the activity of the company, including inter alia, members of the board of directors, members of the management board and the general director; entities belonging to the company's group; entities controlling more than 20% of the company's shares, etc.
16. This rule does not apply to limited liability companies.
17. A shareholder or a participant is considered a parent company of a CJSC or an LLC if it can, as a result of a dominant shareholding or under any agreement with a CJSC/LLC or otherwise, determine decisions taken by the CJSC/LLC. If there is, however, a BoD with a majority of independent members, even if the BoD members have been appointed by a dominant shareholder, the shareholder is not deemed to be determining decisions taken by the BoD.
18. This conclusion is supported by recent court decisions, in particular the prominent case of *OAO Megafon*, in which the Russian state courts took a conservative view of shareholders' ability to regulate their relationship outside of, or in addition to,

Russian law or the company charter. In this case, the shareholders of a Russian joint stock company, that owned in aggregate more than 97% of the company's shares, entered into a Swedish law governed shareholders' agreement, in which they agreed on certain issues including in relation to the management of the company, the execution of their voting rights and the transfer of shares in the company. In particular, the parties attempted to regulate the exercise of their voting rights; the appointment of members of the BoD; and to restrict the free disposal of their shares (by having the right of first offer to other parties in cases of proposed transfers to a third party); a tag-along right; and a prohibition on any transfer of shares to any person directly or indirectly competing with the company. A shareholder applied to the Russian courts requesting the invalidation of these provisions of the shareholders' agreement. The claim was fully satisfied based on the belief of the court that the shareholders' agreement violated the company laws.

19. An event of default usually obliges the breaching partner to sell his/her/its shares in the joint venture to the other partner at a specified price (which may be a more effective penalty when compared to possible damages).
20. Western models for monitoring the CEO's (general director's) activities by all shareholders (e.g. the 'four-eyes principle' of control, in which a second CEO (general director) is appointed, thus enabling both partners of the joint venture to control the day-to-day activities of the company) are impossible under Russian corporate law.
21. Federal Law On the Protection of Competition which entered into force in October 2006 (the 'Competition Law').
22. A financial institution is defined by the law as a company rendering financial services: a credit organisation, credit consumer co-operative (an association of individuals for mutual financial support), insurer, insurance broker, mutual insurance society, stock exchange, currency exchange, pawnbroker's office, leasing company, non-state pension fund, management company of an investment fund (including mutual fund), management company of a non-state pension fund, specialised depository of an investment fund (including mutual fund), specialised depository of a non-state pension fund, and professional participant in a securities market.
23. Merger or accession of companies will require prior FAS consent if the aggregate book value of assets of the merging/acceding companies and companies of their respective groups exceeds RUB 3 billion (approximately €83 million) or the aggregate sales revenue of such entities exceeds RUB 6 billion (approximately €167 million). Acquisitions will require prior FAS consent if the aggregate book value of assets of the acquirer, the company whose shares or assets (or rights with respect to which) are acquired, and the companies of their respective groups exceeds RUB 3 billion (approximately €83 million) or the aggregate sales revenue of such entities exceeds RUB 6 billion (approximately €167 million) and provided that the aggregate book value of assets of the company whose shares or assets (or rights with respect to which) are acquired and companies of its group in any of the above cases exceeds RUB 150 million (approximately €4 million). Monetary thresholds for transactions/actions involving financial institutions are established by governmental resolutions depending on the type of financial institution involved.
24. Prior FAS approval is required if the aggregate book value of the founders of a company, the company whose shares are contributed to the charter capital of a newly established company, and companies of their respective groups exceeds RUB 3 billion (approximately €83 million), or the aggregate sales revenue of such entities exceeds RUB 6 billion (approximately €167 million).
25. Labour Code of the Russian Federation No 197-FZ dated 30 December 2001 ('Labour Code').
26. This position of the migration authorities has been explicitly expressed at several seminars and round-tables held on the issue of the employment of foreign personnel.
27. Organisation for Economic Co-operation and Development.
28. Financial Action Task Force.
29. According to section 1(1) of art 20 of the Russian Tax Code, an indirect shareholding in the chain of companies is determined as a product of direct shareholdings of one company in the other.
30. As of 1 January 2008, dividends received by Russian corporate shareholders are subject to a 0% profit tax, provided that such dividends are received on a shareholding (i) of at least 50%, (ii) with the acquisition value of more than 500 million rubles, (iii) that, at the time of distribution, has been held for at least 365 days, and (iv) been held in a company resident in a jurisdiction which is not blacklisted by the Russian Ministry of Finance.

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