We are pleased to announce that the International Finance Corporation now has the support to implement a project to develop leasing in the Ural region. This project will be financed by the Department for International Development of the United Kingdom (DFID). The Leasing Development Group in Russia will provide comprehensive administrative and analytical support to their colleagues in the Ural region. The geographic scope of the Ural Leasing Development Group’s activity will include the three largest industrial and financial centers in the Urals: Yekaterinburg and Sverdlovskaya oblast, and Chelyabinsk and Perm and their surrounding oblasts.

Continued on page 5
ICF’S TECHNICAL ASSISTANCE PROJECTS

In addition to investment projects, the International Finance Corporation has technical cooperation projects in a number of countries. We asked Chris Richards, Investment Officer and Senior Operations Manager for technical assistance projects in the Central and Eastern Europe Department, to tell us more about IFC’s technical cooperation activities and projects in Russia and the CIS.

- Thank you for the opportunity to talk to you and let your readers know more about IFC’s technical assistance program. Many of your readers know about our work in leasing, but may not know about the other programs we are running, and our other private sector development work may also be of interest to them.

- In addition to financing private sector projects throughout the world, the IFC also provides advice and technical assistance to businesses and governments in some countries. What is the goal of these IFC projects?

- I should start by saying that technical assistance is a very important part of the IFC’s approach to investment, particularly in Russia. In Russia this assistance is delivered through the IFC’s Private Enterprise Partnership program or PEP. PEP is managed by IFC staff here in Moscow, but supported by IFC’s international resources. These resources include technical experts from a range of different areas, including investment, technology and law.

The goal of the PEP program is threefold. First, technical assistance here in Russia works to assist the general enabling environment for business; second to promote direct investment, including by means of strengthening financial intermediaries, which by the way is the focus for our work in leasing, and finally to develop local Russian SME’s.

The Private Enterprise Partnership program, as its name suggests, is based on a partnership. One aspect of this partnership is the fact that our funding comes from a range of sources: partly from the IFC, but primarily from a number of key partner donor Governments. Key supporters of our work include the Canadian and British governments, who fund our leasing programs, and also the Dutch, Swiss, and Finnish governments.

- According to what criteria are the project areas and geographical/regional priorities chosen?

- Project areas are chosen on the basis of three factors, namely: one, their fit with the IFC’s goals in technical assistance that I just described; two, IFC’s investment priorities; and three, the priorities of the partner government providing funding for the work. When all of these factors align then we have a strong case for establishing a particular project.

For example, with the support of the British Government, through their Department for International Development, or DFID, we are establishing a leasing...
development program for the Urals that will be based in Ekaterinburg. This program fits neatly with three out of four of IFC’s goals; it will help with the general enabling environment for business in that region, it will strengthen financial intermediaries in the form of local leasing companies, and it will help local SME’s source leasing finance. The program will also help IFC identify possible leasing investments in this region. Finally, and very importantly, the Urals Leasing Development program fits with DFID’s priorities for this region.

- **How is the decision made to undertake a technical assistance project?**

  - First and most importantly, there must always be a local need and support for the project. A good example of this is, again, IFC’s leasing project in the Urals. Our Leasing Development Group had run training courses in the Urals region and had recognized that there is keen local interest in leasing as an investment vehicle. This local need prompted IFC to go to the British Government, through our trust fund program, to ask for funds for a scoping study. This study investigated in detail whether a local technical assistance project focused on leasing would be viable. A consultant in small business financing and development then spent time on the ground talking to local businesses, leasing companies, banks, and government officials. The report from the consultant was positive, and identified that an IFC project could make a real difference. Right now, and again through the support of the British Government, we are establishing an office in Ekaterinburg and hiring local experts in leasing.

- **Who develops and implements the projects? Could you give us some examples?**

  - The project development and realization process is conducted on two levels. The first level uses local PEP staff to develop the project concept, typically drawing on existing work or expertise, and usually with consultation and cooperation of local stakeholders to the project proposal. On the second level, PEP will frequently draw in expert assistance, where needed, to ensure that specialized aspects of proposal design are properly covered. My view is that it is important to get the project concept properly defined in this early stage, as this will form the basis for the project’s implementation later on. PEP and the IFC put a lot of emphasis on getting this right and that’s why sometimes, from an outsider’s perspective, we can seem somewhat slow-mo-ving, but in my experience, this is usually time well spent as it helps to prevent problems later on.

- **What donor organizations work with the IFC to conduct its technical assistance projects?**

  - Earlier I mentioned some of those donors, namely the Canadian and British governments, as well the Dutch, Swiss, and Finnish governments are important supporters of our work. The Private Enterprise Partnership is also supported by the US, Norwegian, Swedish, and Japanese governments for our work in Ukraine, Belarus, and Armenia.

- **In which countries does the Central and Eastern European Department of the IFC work?**

  - We have been talking about the IFC’s work on technical assistance, but the primary focus for the IFC’s Central and Eastern European Department, or CEU, is investment. CEU makes investments in countries in which PEP focuses; namely Armenia, Georgia, Russia, and Ukraine. CEU also makes investments in a number of countries where PEP
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**OUR PROJECT**

September-October 2001

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does not have a presence; namely the Slovak Republic, Czech Republic, Poland, Estonia, Lithuania, Hungary, and Latvia.

- **Could you tell us in more detail what kind of technical assistance projects are currently being conducted in Russia?**

- Sure. The IFC’s technical assistance work here in Russia cuts across each of the four goals I described earlier.

In the area of IFC’s goal to improve the enabling environment for business, we are working on a large corporate governance program. This Program will work directly with Russian enterprises in four oblasts to help improve their governance practices. The basis for this Program, by the way, is a similar successful activity in the Ukraine. This program will also help match outside investors with Russian companies that can demonstrate good corporate governance practices. Key partners for this work are Russia’s Federal Securities Commission, the Parliament, and the Supreme Arbitration Court, with whom the Program will work on improving relevant legislation and its enforcement. Education is also an important part of this Program, as it will introduce corporate governance curricula to a number of Russian universities.

In order to lay the foundation for foreign direct investment, PEP has also been providing direct technical assistance for three years to agricultural enterprises so as to improve the quality and reliability of their milk supplies. This attracted foreign companies working in the food processing sector. As an example, I would point to the Dutch dairy products group «Campina.» Campina has invested $50 million in a yogourt factory in the Stupino region in Moscow oblast. I recently visited this factory, and the employees there claim the demand is so high for yogourt products that they will have to increase production again. Having such a reliable purchaser of raw milk has given local farmers the incentive to improve their production quality by modernizing and also to expand their production. As a result, the Stupino region has received a major boost to the local economy.

In the area of strengthening financial intermediaries we have, of course, our Leasing Sector Development project. As many of your readers will know, IFC’s Leasing Development Group has been working with the Government and the Duma to amend the existing Law on Leasing and the recently passed Tax Code with a view to facilitating the development of a competitive leasing industry. The Group also provides training, direct consultations, and distributes specialized information on leasing. The Group also helps to identify potential investment opportunities for the private sector and IFC. To date this work has seen one new leasing company financed by IFC and Deutsche Leasing, namely Deutsche Leasing Vostok, and several new IFC investments are well underway.

Finally in the area of direct SME development, PEP has worked with ten of the larger forest enterprises in North-West Russia to help them develop business plans, and is now working to match them with Scandinavian partners to source know-how, equipment, and potential investment. This program will also work with major Finnish groups and their potential Russian partners to source investment in logging and wood processing operations in Russia.

- **In what other countries of the CIS does the IFC conduct technical assistance projects and what projects are currently being conducted?**

- Of course Russia is a big focus for the work of the Private Enterprise Partnership, but we also have a well developed program outside of Russia, which is managed through our office here in Moscow and through our sister office located in Kiev. The countries where PEP is currently operating are Armenia, Belarus, Georgia, Russia, and Ukraine.
This year, PEP is growing its activity in Azerbaijan and Central Asia (Kyrgyzia, Tadjikistan, Turkmenistan, and Uzbekistan) with the support of the Swiss government. These projects will be developed in cooperation with IFC’s department of Southern Europe and Central Asia and the department of Small and Medium Sized Business Development at the World Bank.

- And finally, what projects are being planned for the near future?

In regards to leasing, if there exists sufficient demand in the regions, we would consider establishing projects similar to the newly launched Ural regional project. This would allow the Leasing Development Group to further expand its national reach and build stronger capacity in key regions.

In Russia another focus for new projects will be the area of supply chain development, where a number of new projects are planned. These projects will work with local suppliers to improve their production practices and will strengthen their links with foreign investors.

Also, as I described earlier, PEP has built a base of expertise delivering technical assistance projects in leasing and corporate governance. PEP plans to build on this base and expand our operations into a number of new countries in this region of the world, primarily Central Asia and Azerbaijan. PEP also plans to establish projects in Georgia and Armenia.

- Thank you.

LEASING DEVELOPMENT PROJECT IN THE URAL REGION

Andrei Pisarenko,
Deputy Project Manager, IFC Leasing Development Group

Continued from page 1

The Ural Leasing Development Group’s mission includes the dissemination of leasing know-how and practical leasing experience in the Ural region, as well as the creation of a stable leasing services sector by rendering technical assistance to regional partners. Leasing development will ultimately contribute to the development of the regional private sector, the creation of new jobs, improvement of the financial situation, and increased investment.

The Group’s activities will include:

- a survey of the leasing services market and analysis of the legal base regulating leasing activity in the region;
- development and provision of training seminars for participants in the leasing services market;
- assistance to increase the flow of domestic and foreign investment into the region’s leasing sector;
- provision of consulting services to regional leasing companies and other participants in the leasing services market;
- promotion of the advantages of leasing as an effective financial instrument.

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The official opening of the Leasing Development Project in the Ural Region is planned for the third week of September, when the Leasing Development Group in the Urals Region, with the support of the Russian Leasing Development Group, will organize and conduct training seminars in Chelyabinsk and Yekaterinburg.

Subsequent editions of our informational bulletin will describe in detail the work of the Leasing Development Group in the Ural Region.

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**The Department for International Development (DFID) is an agency of the government of the United Kingdom whose work is directed toward global economic development and reducing poverty.**

DFID’s activities include providing assistance to countries with economies in transition in order to ensure that the reform process is beneficial to all layers of society, particularly those beneath the poverty line.


The main areas of DFID’s work in Russia are outlined in the «British-Russian Development Program for 2001-2005,» which provides for:

- more effective participation by Russia in international organizations;
- increasing the capabilities of state structures to conduct effective reforms that protect the interests of the poor, with such structures becoming more transparent and accountable to the public;
- the development of more effective and consistent social policy;
- increased access for average citizens to opportunities for self-employment and income generation;
- political systems to respond more adequately to people’s needs and to become more transparent, along with greater access to justice and observance of human rights.

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**PRESS CONFERENCE IN ST. PETERSBURG**

Eleonora Veitsman,
Public Relations Specialist
IFC Leasing Development Group

On July 25, 2001, the IFC Leasing Development Group held a training seminar in St. Petersburg entitled «Leasing as an Effective Means of Acquiring Fixed Assets.» ‘Petersburg Leasing’, the St. Petersburg Association of Leasing Companies, provided organizational support. The seminar also included a press conference on leasing in the Northwest region attended by local print and television media. Speakers included James Gorham, Project Manager of the IFC Leasing Development Group; A.V. Ivanov, Deputy Director of the Department of Foreign Trade under St. Petersburg’s Committee for Foreign Relations; S.A. Siling, General Director of RT-Lizing; T.G. Pozdnyakova, Manager of leasing programs at Mikrolizing (Volkhov); and L.S. Sladovskaya, Financial Director of Biostar Holding.

James Gorham, Project Manager of the IFC Leasing Development Group, noted in his opening speech that «60-70% of manufacturing equipment in the Northwest region is obsolete. It will take an enormous amount of investment to modernize the region’s manufacturing sector. Under the present circumstances, where bank loans are so hard to come by, alternative sources of finance, such as leasing, are becoming ever more important.»

The Northwest is one of the few regions in Russia where leasing has been developing actively. It
was in the Northwest that Russia’s very first leasing company, Baltic Leasing [Baltiysky Lizing], was founded in 1990. Today, the Northwest region has one of the highest concentrations of leasing companies in Russia: at the beginning of this year, the region was home to around 60 licensed leasing companies.

The Northwest's leasing companies provide a wide range of equipment, including motor vehicles, computers, construction equipment, medical equipment and retail equipment. Contracts have varied in size from a few thousand to hundreds of thousands of dollars. Leasing is expected to become ever more popular among the region’s main industries, such as energy, construction, telecommunications, fishing, mining, metallurgy, pulp and paper, logging, wood processing, light manufacturing and food processing.

Traditionally, leasing has been most common among small and medium-sized enterprises, since it is so well suited to their needs. According to T.G. Pozdnyakova, Manager of leasing programs at Mikrolizing, leasing gives SMEs access to the financing they need in order to start and develop their businesses, while other forms of financing, such as bank loans, are either nonexistent or prohibitively expensive in Russia. Mikrolizing is the only leasing company in the Northwest region that works with small and micro businesses. The company leases equipment and motor vehicles worth up to $25,000. Mikrolizing’s services have been very popular with local businesses: the company has signed 124 leases since 1997, and 58 new contracts are now in the works.

A.V. Ivanov, Deputy Director of the Department of Foreign Trade under St. Petersburg’s Committee for Foreign Relations, noted at the conference that “compared to other forms of lending and finance, leasing is the most promising and economically advantageous means of bringing investment to local producers. For this reason, the Municipal Government has attached great importance to the development of the local leasing industry. Since 1998, the Governor’s Council for the Promotion of Foreign Investment has been supporting a working group for the development of local leasing laws. Together with the local business community, the Municipal Government has worked out a leasing development program which has dramatically increased the government’s support for leasing.” In particular, the Municipal Government has exercised its right to provide certain categories of tax benefits, including exemptions from local property, highway and profit taxes. Companies may claim these benefits on the condition that they reinvest the money they save into production.

In drafting new leasing laws, the Municipal Government of St. Petersburg has drawn from the practical experience of local leasing companies and has worked closely with Petersburg Leasing, the St. Petersburg Association of Leasing Companies. Founded in 1999 by six major leasing companies in St. Petersburg, Petersburg Leasing aims to improve leasing legislation at both the local and national levels. It provided a series of recommendations to the State Duma on improving the Federal Law on Leasing and the Chapter on Profit Tax under Part II of the Russian Tax Code. In addition to its lobbying efforts, Petersburg Leasing also carries out regular training and educational programs. The Association has worked tirelessly to draw the public’s attention to the advantages of leasing as a form of investment. As part of this ongoing effort, the Association helped organize the IFC’s seminar on “Leasing as an Effective Means of Acquiring New Fixed Assets,” which was made possible by financial support from the Canadian International Development Agency (CIDA).

1 You can find out more about Petersburg Leasing in Leasing Courier #4 (16), July-August 2001.
In the preceding article, we considered the basic principles of carrying out an analysis of the liquidity and financial stability of a lessee. This article is dedicated to an analysis of profit margin and profitability.

**Profit Margin Analysis**

The profit margin of a potential lessee is one of the important factors that determines whether or not leasing is advantageous for a particular lessee. The use of tax deductions, in particular, including lease payments in production costs, allows the lessee to reduce expenditures on capital investments significantly. Minimization of expenditures occurs primarily through a decrease in profit tax payments.

**Sources of Information for Assessing Profit Margin**

The primary source of information for assessing profit margin is the Profit and Loss Statement. If it is possible to obtain information on the structure of the enterprise’s expenditures (the share of fixed and variable costs), a more informative analysis of profit margin can be obtained and the break-even point of the enterprise and the effect of an increase in sales can be determined.

**Profit Margin**

The fact that a potential lessee shows a profit is not a sufficient demonstration of the efficiency of his activity. Revenue in the relevant period must be compared with the funds spent to acquire that revenue.

Profit margin shows how much profit is derived from each dollar or ruble spent and is calculated as the ratio of profit on product sales to expenditures on product sales. Expenditures include production costs (Line 020 of the Profit and Loss Statement), commercial expenses (Line 030), and administrative expenses (Line 040). The profit margin on expenditures may be calculated from profit on sales (Line 050), pretax profit (Line 140), or net profit (Line 190).

We will consider the ratio of profit margin on expenditures with respect to profit on sales:

$$\text{Profit margin} = \frac{\text{Profit on sales (Line 050 of Form 2)}}{\text{Production costs (Line 020) + Commercial expenses (Line 030) + Administrative expenses (Line 040)}}$$

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If an enterprise does not have sufficient profits, the ‘tax shield’ from profit tax will not be of use, and the cost of financing will be higher.
**Sales Performance**

The ratio shows the share of profit in sales revenue. Sales performance can be determined with respect to profit on sales, pretax profit, or net profit in the same way as the profit margin on expenditures.

Sales performance with respect to profit on sales is calculated as the ratio of profit to turnover on sales (line 010 of the Profit and Loss Statement):

\[
\text{Sales perfomance} = \frac{\text{Profit on sales (Line 050 of Form 2)}}{\text{Sales revenue}}
\]

Since (beginning in 2000) Form No. 2 separates turnover and production costs for each type of good whose share of revenue is 5% or more, the operating profit margin of each type of good, labor, or service can be determined.

The average sales performance level or profit margin on expenditures is different for different sectors, and hence no standard exists for these indicators. What is interesting for leasing companies is not so much these profitability indicators themselves as any changes over time.

For example, a decline in a potential lessee’s profitability indicators may be a sign that in future, the leasing company will be confronted with a situation where the enterprise cannot generate the funds to make its lease payments.

If a downward trend is observed in the potential lessee’s profit margin, it is important to determine whether this trend will continue or whether the leasing project will reverse this negative trend.

During profit-margin analysis of a potential lessee it is also important to answer the following questions: Is the primary activity for which the enterprise was created profitable? From which type of activity does the enterprise derive its income, from its primary activity or from investment and other activities?

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**Break-even Point**

The break-even point shows the minimum revenue for the enterprise to make a profit (that is, where revenue is equal to expenditures).

The break-even point is calculated using the following formula:

\[
\text{Break-even point} = \frac{\text{Fixed costs}}{\text{Revenue (actual)} - \text{Variable costs}} \times \text{Revenue (actual)}
\]

Data on the actual volume of revenue and costs in the interval being analyzed are used to determine the break-even point.

A given indicator may be obtained only if the structure of the potential lessee’s costs is known, i.e., the share of variable and fixed costs.

The break-even point calculation may be represented in graphic form:

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*The profit margin level varies depending on the sector of the potential lessee, and no single standard exists for these indicators. What is important for a leasing company is profit margin behavior over time.*
The break-even point on the graph is determined by the intersection of the lines for revenue and total costs. The break-even production volume is shown on the horizontal axis in units of quantity (piece, kg, etc.), and on the vertical axis in monetary units.

If the difference between revenue and total costs for an enterprise is negative, but sales exceeds variable costs, the enterprise has the potential for profitable sales by increasing production output. If the difference between revenue and variable costs for the enterprise is negative, then an increase in the volume of sales will only lower profits further.

**If new equipment allows a lessee to reduce variable costs per unit, the lease may be profitable for both the lessee and the lessor**

A more informative indicator in profit-margin analysis is the ratio of the difference between revenue and the break-even point. This indicator is called the Safety Margin and shows by what percentage the volume of sales may be reduced while still reaching the break-even level (or by what percentage the volume of sales needs to be increased to achieve a break-even level of operation).

The safety margin is defined as the ratio of the absolute deviation from the break-even point to current revenue.

\[
\text{Safety margin} = \frac{\text{Revenue (actual)} - \text{Break-even point}}{\text{Revenue (actual)}}
\]

By carrying out a mathematical transformation of the formula, we can identify the factors that affect a change in the safety margin.

\[
\text{Safety margin} = 1 - \frac{\text{Fixed costs}}{\text{Turnover} \times \left[ 1 - \frac{\text{Variable costs per unit}}{\text{Sales price per unit}} \right]}
\]

This analysis allows us to separate out the effect of such factors as the following on the size of the safety margin:

1. **Change in the volume of product sales.**
   
   In this case, there is a straightforward relationship: an increase (a decrease) in sales volumes leads to an increase (a decrease) in the safety margin (assuming variable cost per unit is lower than sales price per unit).

2. **Change in fixed costs.**
   
   There is an inverse relationship: an increase (a decrease) in fixed costs leads to a decrease (an increase) in the safety margin.

3. **Change in the ratio of variable costs / sales price.**
   
   There is an inverse relationship: an increase (a decrease) in the ratio of variable costs / sales price leads to a decrease (an increase) in the safety margin. That is, if the rate of increase in expenditures on raw materials and other materials outpaces the rate of increase in the price of goods, the profit margin of the enterprise falls.

**Profitability Analysis**

Profitability indicators are a guide to the earning power of an enterprise’s activity. Although these indicators are of greater interest to the owners of an enterprise and to investors, they also have informational value for leasing companies, who provide financing on a repayment basis.

A number of indicators are calculated within the framework of profitability analysis, including some that may be of interest to leasing companies:

- return on assets ratio,
- return on equity ratio.
Return on Assets (ROA)

Return on assets shows the return on capital invested in an enterprise. This indicator is calculated as the ratio of net profit before payment of interest to the average value of all assets.

\[
\text{Return on assets} = \frac{\text{Net profit (Line 190, Form 2)} + \text{Interest}}{\text{Illiquid assets (Line 190, Form 1)} + \text{liquid assets (Line 290, Form 1)}}
\]

Where «Interest» is the amount of interest paid on credit corrected for the amount of profit tax. It is calculated as the interest paid out of profit + interest included in production costs * (1 - profit tax rate).

Interest paid is added to net profit because this ratio actually measures the productivity of all assets. Since interest paid, as part of the cost of assets, is an expenditure (deducted from profits), the amount of profit generated (the productivity of the assets) is artificially understated. When correcting this, part of the interest is considered to be included in production costs; hence the presence of the factor (1 - profit tax rate).

Return on assets is often calculated as the ratio of net profits to assets; i.e., changes in profit due to the interest paid or more debt are not taken into account. The method shown above does not depend on the sources of financing, and, in my view, demonstrates the productivity of the assets more accurately.

Return on Equity (ROE)

Return on equity is calculated as the ratio of net profit to equity capital (Section III, Line 490).

\[
\text{Return on equity} = \frac{\text{Net profit (Line 190, Form 2)}}{\text{Equity capital (Line 490, Form 1)}}
\]

This ratio is not corrected for interest expenses, since it characterizes the return for the owners after all expenses, including debt servicing.

Factor Analysis of Return on Equity

The return on equity indicator may be represented in the following form:

\[
\text{Return on equity} = \frac{\text{Net profit}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}
\]

This ratio was first used by the Du Pont corporation. It shows how the profit margin on sales, the turnover ratio, and the inverse autonomy ratio all contribute to affect return on equity.

After representing this ratio as the product of three ratios - profit margin, the asset turnover ratio, and the inverse autonomy ratio - the reasons for a change in return on equity can be determined. For example, a decrease in return on equity may be caused by a decrease in the profit margin, a decrease in the asset turnover rate, or an increase in the share of equity capital (a decrease in the share of borrowed funds).

When evaluating the effect of each of the three factors, the nature of the sector must be considered. For example, in capital-intensive sectors, the turnover indicator is close to unity and may not have a significant effect on return on equity. In contrast, in sectors such as trade, the asset turnover indicator is high, but the profit margin is often lower.

Effect of Leverage

Financial stability (risk) and return on equity are inversely related: the greater the internal funds, the higher the stability of the enterprise, but the lower the return on equity.
The use of borrowed funds leads to an increase in expenditures related to debt servicing; i.e., credit interest increases.

In order to analyze how effectively an enterprise manages the structure of financial resources, it is necessary to compare the return on assets with the cost of credit resources. That is, increasing the share of borrowed capital makes sense up to the moment when the return on all invested capital becomes no less than the interest rate on borrowed funds:

\[
\text{Return of equity} = \frac{\text{Return on assets} - \% \text{ interest}}{\text{Debt}} \times \frac{\text{Equity}}{\text{Leverage differential}}
\]

It is clear from the formula that if the return on assets is higher than the cost of debt, it makes sense to use borrowed funds.

By using the effect of leverage, it is possible to determine the enterprise’s optimal ratio of internal to borrowed capital from the standpoint of obtaining maximum profitability. The effect of leverage shows by what percentage the return on equity may be increased by increasing the share of debt, when its cost is equal to the interest rate at which the enterprise can borrow. It should be kept in mind that growth in the share of borrowed capital leads to a drop in financial stability, which means an increase in the risks associated with financing a given organization. Therefore, the cost of lending will increase, which in turn may lead to a drop in return on equity.

As a rule, profit margin and profitability indicators are united under one name, i.e., «profitability»-profitability of sales, of capital, etc., which in our view is not entirely correct. The effective use of assets is a genuine indicator of the profitability of the enterprise, whereas profit margin indicators characterized the ability of an enterprise to generate profit from sales of a given product or service (the enterprise as a whole could still be losing money). When calculating both profit margin and profitability indicators, the period chosen for analysis is of no small importance. It should be kept in mind that when determining profit margin, the indicators (profit from turnover or expenditures) are compared to the same period (month, quarter, or year). When calculating profitability indicators, profit is correlated with average capital for the period of analysis.

Therefore, when analyzing profitability or comparing the activity of various enterprises according to a given indicator, it is necessary to pay attention to the period analyzed. It is easier to analyze profitability annually. Converting indicators from shorter periods to an annual basis is accomplished using the multiplier \(\frac{360}{\text{Period of analysis in days}}\).

In future issues of the Leasing-Courier, we will continue the topic of the financial position of a potential lessee. In the next issue, we will consider another assessment, trend-turnover analysis.

**LEGISLATION NEWS**

**Licensing**

Federal Law No. 128-FZ (August 8, 2001) removed the licensing requirement for leasing activity. This law takes effect six months following the date of its official publication, on February 11, 2002.

Insofar as the licensing process is, at present, purely a formality (there are no special requirements for license applicants), cancellation of the licensing requirement should have a positive effect on the development of the leasing sector.
Taxation

According to Article 13 of Federal Law No. 118-FZ (August 5, 2000), as of July 1, 2001, there were changes to the procedure for payment of value-added tax (VAT) when selling goods (works, services) to countries that are part of the Commonwealth of Independent States (CIS), as well as the procedure for taxation of goods (works, services) originating in CIS countries when imported into the Russian Federation.

Pursuant to the law, as of July 1, 2001, goods (works, services) exported to CIS countries are taxed at a rate of 0%. Goods (works, services) imported from CIS countries are taxed at a rate of 20%.

According to Federal Law No. 55-FZ (May 22, 2001), «On Ratification of the Treaty on the Customs Union and the Single Economic Zone,» these changes do not apply to economic relationships involving entities of the Republic of Belarus.

Accounting News

Until amendments are made to the Regulation on Accounting and Bookkeeping in the Russian Federation (as approved by RF Ministry of Finance Order No. 34n dated July 29, 1998), the cost criterion should be followed when allocating assets to fixed or working capital.

The RF Ministry for Taxes and Fees, in its letter No. VG-6-02/559 dated July 19, 2001, «On Application of the Accounting Regulation ‘Recording Fixed Assets’ (PBU 6/01),» stated as follows.

Section 50 of the currently effective Regulation on Accounting and Bookkeeping in the Russian Federation stipulates that fixed assets do not include items having a useful life of less than 12 months or items whose value is not more than 100 times the statutory minimum wage. Since the adopted PBU 6/01 cannot replace the procedure established in the said Regulation, the value criterion should still be followed when allocating assets to fixed capital.

Furthermore, since tax legislation does not provide a write-off procedure for expenditures on fixed capital assets with a value of less than 2,000 rubles, for tax purposes the value of such fixed capital should be reduced by way of deducting depreciation during its service life.

ANALYSIS OF CHAPTER 25 OF THE RUSSIAN TAX CODE, «ORGANIZATIONAL PROFIT TAX»

Elena Degtiareva
Financial Analyst, IFC Leasing Development Group


On the pages of previous issues of the Leasing-Courier, we have acquainted readers with the process of adopting this chapter of the TC, which has been going on since 1998. In the original versions of the bill, leasing would have lost one of its most important advantages, the application of accelerated depreciation. A number of bills limited the right of choice to record property on the lessor’s or the lessee’s balance sheet (there were versions where it was recorded only on the lessor’s balance sheet, and versions where it was to be recorded only on the lessee’s balance sheet).

The adopted «Profit Tax» Chapter retains the key advantages of leasing and makes it an effective
source of investment finance. As before, leasing will allow enterprises to minimize their expenditures in comparison with other sources. We will consider the main provisions of Chapter 25 that concern taxation of parties to a lease agreement.

**Depreciation Policy**

The right to choose whether to record property on the lessor’s or the lessee’s balance sheet

This provision in the tax code was not adopted without one potential problem. Although a number of articles of the TC contain reference to the fact that a leased asset may be recorded on either the lessor’s balance sheet or the lessee’s (Clause 7, Article 258; Clause 10.1, Article 264), Clause 1, Article 256 establishes that depreciable property is defined as property to which the taxpayer has right of ownership. That is, according to this norm, only the leasing company would be able to depreciate property, since the lessee has rights of possession and use of a leased asset, but not ownership.

Since, in our view, the right to choose the method of recording property is stipulated by special norms applying to leasing deals, the provision of Article 256 does not apply to leasing relationships.

The definition of depreciable property should be changed in order to eliminate this contradiction within the TC.

**Original cost of a leased asset**

Clause 1 paragraph 3 Article 257 “The original cost of property constituting a leased asset is recognized as the sum of the lessor’s costs of acquiring it.”

At present, if the parties to a lease agreement have chosen to record property on the lessee’s balance sheet, the lessor enters the leased asset in the nominal sum of the lease payments, which leads to differences in taxation depending on the chosen recording method.

With the entry into force of Chapter 25 of the TC, this difference will be eliminated.

**Depreciation groups (Article 258)**

Clause 1 “Depreciable property is assigned to a depreciation group according to its period of profitable use.”

Chapter 25 of the TC proposes ten depreciation groups, and at the same time, the classification of fixed assets must be determined by the Government of the Russian Federation. It should be noted that at the time this article was being written, there was no official information on the adoption of this Resolution. Information from unofficial sources lead us to believe that the periods of profitable use will not be increased in comparison with the periods currently defined in Ministry of Finance Resolution No. 1072.

**Methods and procedure for recording depreciation amounts (Article 259)**

The Tax Code introduces two possible methods of charging depreciation for tax purposes:

- the straight-line method (the amount of depreciation is determined monthly as the product of the original cost and the depreciation rate),
- A «non straight-line» method, which is really a modified declining balance method (the amount of depreciation is determined monthly rather than yearly as the product of the residual value and the depreciation rate)\(^1\).

At the same time, the taxpayer has the right to choose the method of charging depreciation. The only exceptions are buildings, installations, and other facilities that belong to depreciation group 10 (the period of profitable use is more than 30 years), for which only the straight-line method may be applied.

The depreciation method may not be changed during the service life of the equipment.

**Straight-line method of calculating depreciation**

Using the straight-line method, the monthly depreciation rate (K) for each item is calculated using the formula $K = \frac{1}{n} \times 100\%$, where n is the period of profitable use in months.

**Modified Declining Balance method**

In the «non straight-line» method, the monthly depreciation rate (K) is calculated for each item

\(^1\) The method of charging depreciation called «non straight-line» in the Tax Code resembles the declining value method, which is used for accounting purposes. In the declining balance method, the annual amount of depreciation is determined on the basis of residual value, and at the same time depreciation is charged monthly as 1/12 of the annual depreciation amount. That is, for bookkeeping purposes, depreciation deductions each month are equal, in contrast to the «non straight-line method» outlined in the TC.
using the formula \( K = \frac{2}{n} \times 100\% \), where \( n \) is the period of profitable use in months.

Upon reaching a residual value of 20% of the original cost, the remaining value is written off using the straight-line method.

**Depreciation rate for leasing**

Clause 7. «For fixed assets under a financial leasing (leasing) agreement, the taxpayer has the right to apply a special coefficient no greater than 3 to the basic depreciation rate.»

Thus, the existing provision established by the Law «On Leasing» is maintained. In addition, an acceleration coefficient up to 3 may be applied when calculating depreciation by both the straight-line and non-straight-line methods. Fixed assets belonging to the first, second, and third groups, i.e., with a period of use up to 5 years, for which depreciation is calculated using the non-straight-line method, are an exception. If the straight-line method of charging depreciation is applied to these fixed assets, the acceleration coefficient may be applied.

As mentioned above, for non-straight-line depreciation, a residual value of 20% is written off in equal depreciation deductions over the number of months remaining before the end of the asset’s service life. If one follows the formulation proposed in the TC, the coefficient 3, which is applied to the basic depreciation rate under leasing, may no longer be used after a property value of 20% is reached.

**Depreciation of passenger cars and passenger minibuses (Article 259)**

For passenger cars and passenger minibuses with an original cost of more than 300,000 and 400,000 rubles (respectively), the basic depreciation rate is applied with a special coefficient of 0.5.

«Lessees that lease passenger cars and minibuses (as above), must also apply a basic depreciation rate with a special coefficient of 0.5.»

In our view, the following questions arise when these vehicles are leased. Is this provision applied if the leased asset is recorded on the leasing company’s balance sheet? The leasing company is not an organization that has received the vehicles under a lease. Can the coefficient 0.5 be applied together with the coefficient 3 under leasing?

**Comparing Depreciation Methods**

Let us compare the two methods of charging depreciation (straight-line and non-straight-line) under leasing by using the example of an asset with a 10-year service life (depreciation group 5 according to Chapter 25 of the TC).

For the straight-line method of charging depreciation, the monthly depreciation rate will be 0.83% (2.5% with a coefficient of 3); for the modified declining-balance method, the depreciation rate will be 1.67% (5% with a coefficient of 3) in the first month, 1.58% (4.75%) in the second month, and so on.

If service life categories similar to the currently existing ones are adopted by Government Resolution, depreciation deductions calculated using the straight-line method according to the new regulations will be the same as applying the straight-line method now. Therefore, for leasing companies and lessees who have chosen the straight-line method of charging depreciation, the full write-off period of the value of the leased asset will be unchanged.

**Accelerated depreciation of up to 3, regardless of the method of calculating depreciation - straight-line or non-straight-line - may be applied to leased assets.**

**Parties to a lease who conclude a lease agreement before Chapter 25 of the TC enters into force are granted the right to continue to apply the methods for charging depreciation that existed at the moment the agreement was concluded (Clause 8, Article 259).**

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1 According to Clause 5, Article 259, depreciation after a residual value of 20% of the original cost is achieved is based on the number of months of service life remaining. That is, without applying the basic depreciation rate to which the special coefficient 3 is applied under leasing.
As is clear from the table, using the non straight-line method, the residual value of property with a 10-year service life reaches 20% of the original value in 32 months, the same as when using the straight-line method. However, using the non straight-line method, the remaining 20% will be written off over the following 88 months (7.3 years) at 0.22% monthly. However, using the straight-line method, the property will be fully depreciated after 40 months.

The graph presented below shows a breakdown of the value of depreciation deductions over the full depreciation period.

As is clear from the graph, for equipment with a 10-year period of profitable use, depreciation is more rapid for the first 32 months; consequently, in this period, the profit tax will be lower than using the straight-line method. However, after 32 months, the equipment value is written off more rapidly using the straight-line method, and, more importantly, is entirely written off after 40 months. While it is possible that in some cases the modified declining balance method will be preferred (the financial effect will depend on the discount rate applied), we believe the straight-line method will be preferred in most cases because it corresponds better to the lease terms available on the market.
Lease Payments

Other costs associated with production and sales (Article 264)

According to Clause 10.1, costs that reduce the taxable base include «lease payments for leased property. If property obtained through a lease agreement is recorded on the lessee’s balance sheet, the lease payments are recognized as costs less the amount of depreciation charged on this equipment.»

Let us consider the following example:

The property is recorded on the lessee’s balance sheet. The lease payment is $300 (or any other currency), and depreciation is $200.

According to the new regulations, the lessee includes depreciation charges of $200 against profits, and a difference between the lease payment and depreciation of $100. That is, $300 - which corresponds to the amount of the lease payment - will be applied to reduce taxable profits.

Thus, by recording equipment on the lessor’s or the lessee’s balance sheet, expenditures to the amount of the lease payments will always be included in the lessee’s costs. In contrast to the currently existing procedure, if the leased asset is recorded on the lessee’s balance sheet, depreciation deductions are included in expenses.

This leads to the question as to what will happen if the property is recorded on the lessee’s balance sheet and the size of the depreciation deductions exceeds the lease payment in the accounting period. Theoretically, this is clear. The lessee will include depreciation deductions in his costs (since he includes property in his depreciation group and charges depreciation accordingly), and according to Clause 10.1, Article 265, he will include a negative value in his costs - the lease payment less depreciation - which together totals a value equal to the lease payment.

Let us consider the following example:

The property is recorded in the lessee’s balance sheet. The lease payment is $200 and depreciation is $300.

According to the new regulations, the lessee includes depreciation charges to the amount of $300 in the reduction of the taxable base, and a difference between the lease payment and depreciation of $-100. That is, a total of $200, which again corresponds to the amount of the lease payment, will be included in costs.

However, it is unclear how this will be applied in practice, since if the depreciation deductions exceed the lease payment, a negative value line item will be entered in the accounting reports. While in principle this should not be a problem, it is possible that this peculiarity could raise questions until some practice is established.

Beginning in 2002, regardless of the chosen recording method - on the leasing company’s balance sheet or on the lessee’s - the full amount of lease payments reduces taxable profits.
**Taxation of Interest Paid**

**Special features of classifying interest on borrowed funds as costs (Article 269)**

This article introduces limits on the amount of interest that an organization can include in expenses.

The limits are applied when both of two conditions are fulfilled: when the amount of debt of a Russian leasing company to a foreign organization exceeds the lessor’s equity by more than 12.5 times\(^3\) and when the foreign organization that granted the credit directly or indirectly owns more than 20% of the leasing company’s charter capital. This stipulation is intended to reduce the likelihood of abuse of interest deductibility for tax avoidance.

Chapter 25 of the TC proposes the following procedure for determining the amount of interest included in costs (the maximum amount of interest on «controlled» debt that is recognized as a cost) when the two conditions above are met.

\[
\text{Amount of interest recognized as a cost} = \frac{\text{Amount of interest on controlled debt}}{\text{Capitalization ratio}}
\]

The capitalization ratio is determined in the following way:\(^4\):

\[
\text{Capitalization ratio} = \frac{\text{Unpaid debt}}{\left(\text{Internal capital} \times \frac{\text{Contribution to chapter capital}}{12.5}\right)}
\]

Let us consider an example:

The amount of interest on controlled debt = 100;
Unpaid debt = 30,000;
Leasing company’s internal capital = 1,000;
Foreign creditor’s contribution to charter capital = 25%;

Capitalization ratio = \(\frac{30,000}{(25\% \times 1,000)}/12.5 = 1.6\)

Maximum interest = 100 / 1.6 = 62.5.

That is, in this example, for total interest on controlled debt of $100, the maximum interest included in tax deductible costs is $62.5.

Any difference between interest paid and the maximum amount of interest allowed is treated as dividends paid for tax purposes and taxed at a rate of 15%.

If unpaid debt is not «controlled» (not granted by a foreign creditor owning more than 20% of the charter capital), the regulations indicated above do not apply.

In this case, interest paid is recognized as a cost, with the stipulation that the amount of interest paid does not deviate significantly (by more than 20% either way) from the «average level of interest charged on debt liability granted in the same accounting period under comparable conditions.» If there is no debt liability granted under comparable conditions, the maximum amount of interest recognized as a cost is set equal to the Central Bank refinancing rate increased 1.1 times for ruble debt or 15% for credit in a foreign currency. Since it is unlikely that a ‘comparable’ lease contract will be found (since there may be other services included, for example), the latter ceiling is likely to be the limiting factor.

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**Chapter 25 of the TC proposes a method for including interest payments in costs that differs from the currently existing method.**

Regardless of the use of the debt, interest is included in costs. At the same time, limits on interest classed as costs are introduced:

- for credits granted by a foreign dependent party owning more than 20% of the charter capital and in the case where the borrowed capital granted by this creditor exceeds internal capital by more than 12.5 times;
- for all debts, there is an upper limit for the interest rate deductible.

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**Abolition of the Exemptions on Capital Investments**

At present, enterprises making capital investments in manufacturing are granted a profit tax exemption. An enterprise can decrease its taxable profit by the amount of capital investment, as

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\(^3\) The coefficient 12.5 is set only for leasing companies and credit institutions; for all other taxpayers, the limit on the ratio of debt to equity is 3.

\(^4\) «The capitalization ratio is determined by dividing the amount of controlled debt by the amount of internal capital corresponding to the direct or indirect contribution of this organization to the charter (deposited) capital (funds) of a Russian organization, and dividing the result by 3 (for credit institutions and organizations involved in leasing activity, the result is divided by 12.5).»
well as by repaying bank credits and interest (if certain conditions are met).

That is, by borrowing to finance capital investments, organizations can currently realize significant savings on profit tax, thereby lowering their total expenditures on capital investments. In a number of cases, this exemption leads to a reduction in the effectiveness of leasing by making credit more advantageous.

The abolition of this exemption as of January 1, 2002, will have a positive influence on the effectiveness of leasing.

Sale of Assets
Determining costs upon sale of property (Article 268)
In accordance with this article, «a loss incurred in the sale of depreciable property is included in the taxpayer’s other costs in equal shares over a period defined as the difference between the period of profitable use of this property and its actual period of operation.»

This procedure will reduce the effectiveness of a leasing transaction if the term of the lease agreement is less than the period of profitable use and the lessor includes compensation of the full value of the leased asset in the lease payments, after transferring the property to the lessee on conclusion of the transaction for the nominal price of 1 ruble.

In this case, the leasing company will sustain a loss from the sale of the property that it will not be able to include in its costs as a lump sum since it has not been able to fully depreciate the asset over the term of the lease. For the duration of the lease agreement, the leasing company pays profit tax from the difference between the lease payment and depreciation (and other costs).

International Leasing
(Nonresident Leasing Company)
The tax on foreign leasing transactions (Articles 309, 310, and 284)
Contradictions exist between Clause 2 of Article 284 and Clause 1 of Article 310 relating to what tax rate is applied to the revenues of foreign leasing companies when the company has no permanent representative office in Russia.

The following rates are established in Clause 2 of Article 284: 20% from any revenues, with the exception of revenues from the use, maintenance, or leasing of ships, aircraft, or other mobile transport or containers for international transportation, to which a rate of 10% is applied.

That is, this article strictly limits the list of revenues that are taxable at the 10% rate.

At the same time, Article 310 states that the tax rate stipulated in Clause 2.2, Article 284, i.e. 10%, should be applied to revenues from international leasing operations. Thus, the question of which rate to use in this case remains open.

It should be noted that at present a 20% tax rate is applied, and not all of a lease payment is taxable (as is in the TC), but rather the taxable base comprises the lease payment adjusted for value of the leased asset, payments on the use of credit, and tax on leased property.

Thus, the adoption of the Tax Code does not eliminate the currently existing advantages provided to the parties of a leasing transaction. Nevertheless, a number of provisions change the relative effectiveness of leasing. In the next issue of the Leasing-Courier, we will assess the effect of the Tax Code on leasing in comparison with bank credits.
VAT UNDER INTERNATIONAL LEASING

VAT payments for international leasing transactions in which the lessor is a non-registered, non-resident leasing company

Stanislav Kovynev,
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When carrying out international leasing transactions in which assets are brought into the Russian Federation, value-added tax (VAT) liabilities are incurred twice. According to Article 146 of the Tax Code of the Russian Federation (hereafter the TC), the following are subject to VAT:

- import of goods into the customs territory of the Russian Federation;
- sale of goods, labor, or services in the Russian Federation1.

Let us consider the grounds and procedures for paying VAT for each of the cases listed above.

VAT when importing property into the Russian Federation

Taxable base and tax rates

In accordance with Clause 5, Article 164 of the Tax Code, when importing property that is a leased asset under a lease agreement VAT is paid at a rate of 20% from the taxable base, calculated as the sum of the customs value of the property that is subject to payment of customs duties and excises (for excisable goods). As a rule, the customs agencies use the «value of the agreement» method when assessing the customs value of property. Calculation of customs fees payable is performed on the basis of the total of nominal lease payments payable, which significantly increases the lessee’s expenses. In our view, this calculation method does not comply with the customs legislation of the Russian Federation. According to Article 2, Article 19 of the Law «On Customs Tariffs,» this method may not be used when determining customs value in cases where the buyer has limited rights to the valued asset, which is the case for leasing transactions2.

Consequently, when determining the customs value of imported property, the «value of identical goods» method must be used, or successively, the other methods stipulated by Article 18 of the Law «On Customs Tariffs.»

Procedure and date of VAT payment

The procedure and date of VAT payment depends on the customs regime under which the property is imported into the Russian Federation3:

- If the property is imported under the customs regime of release into free circulation (full importation), VAT is paid in full. The tax is paid either before or upon acceptance of the customs declaration by the customs agency carrying out customs clearance.
- If the property is imported under the temporary import regime, VAT payments are made monthly, in the amount of 3% of the sum that would have been paid in the case of a one-time VAT payment (that is, if imported normally)4. In this case, interest is not charged for the effective tax payment deferral5.

1 According to Article 148 of the TC RF, the Russian Federation is recognized as the place of sale of a service if the service is directly connected with movable or immovable property located in the Russian Federation. In addition, the basis for recognizing the Russian Federation as the place where services are rendered is the state registration of the purchaser of the service in the Russian Federation. Consequently, the transfer of assets through financial leasing (leasing) to a Russian lessee is subject to VAT in all cases.
2 The absence of the right of the lessee to dispose of property is just such a 'limitation of rights', since property rights are retained by the lessor over the entire term of the agreement.
3 Article 174 of the RF Tax Code and Russian State Customs Committee Order 131 of February 7, 2001, «On Confirmation of the Instruction Concerning the Procedure for Application by Customs Agencies of the RF of the Value-Added Tax with Respect to Goods Imported into the Russian Federation.»
4 Procedure for paying customs payments under partial exemption from payment of customs duties and taxes on temporarily imported (exported) goods confirmed on July 3, 2001, by Russian State Customs Committee Regulation 702-R.
5 Russian State Customs Committee telegram TF-9644 of April 23, 2001.
Conditions and procedures for deduction (refund) of VAT paid by a nonresident lessor

The lessee does not always have sufficient funds to pay the full amount of customs fees. In this situation, the responsibility for tax payments may rest with the nonresident leasing company with the agreement of the parties.

When the lessor pays VAT, he has the right to apply the tax deductions stipulated by Article 171 of the RF Tax Code. In accordance with Clause 4 of this Article, the amount of tax paid by a taxpayer who is a non-resident entity not registered with the tax authorities of the Russian Federation may be deducted or refunded when goods are imported for manufacturing purposes or for carrying out another of the taxpayer’s activities.

In order to invoke the right of deduction (refund) of customs VAT paid by the parties in leasing relationships, the following conditions must be observed:
1) the VAT withheld from a leasing company’s revenues obtained from financial leasing (leasing) of property must be paid by the tax agent (in this case, the lessee);
2) property imported in compliance with the lease agreement must be used in the framework of the provision of services to the tax agent who withheld the taxes, in this case, to the lessee;
3) the foreign taxpayer files with the tax authorities of the Russian Federation.

Thus, when the conditions listed above are observed, a foreign leasing company has the right to a deduction (refund) of VAT paid to the extent lease payments included VAT.

Conditions and procedure for deduction (refund) of VAT paid by a Russian lessee when importing property into the Russian Federation

In accordance with Article 171 of the TC, the lessee has the right to decrease the amount of calculated VAT by the amount of VAT paid upon importing property into the customs territory of the Russian Federation. The right to VAT offsets exists under the regime of release into free circulation or temporary import. In considering the specific characteristics of leasing relations, the position of the Ministry of Taxation and Revenue is important, since this position allows a deduction (refund) of the sum paid by the lessee when importing property into the Russian Federation even though the asset has not been entirely paid for (one of the usual tests for VAT offsets). In other words, leasing is treated as a service in this respect, not a sale.

Recording the fixed assets on the balance sheet is a condition for the use of tax deductions. The possibility of recognizing these sums for the purposes of tax deductions if the property is recorded on the balance sheet of a nonresident lessor is contentious. In this case, fixed assets are recorded on the lessee’s off-balance account, which from the point of view of the tax authorities does not constitute ‘recording’ the property. Taking into account that the Methodological Recommendations are not normative acts and their application is not mandatory, in our view, it is advisable to request clarification from the Ministry of Finance. On analyzing a previous, similar norm of the Law «On the Value-Added Tax,» specialists at the Ministry time and again noted that for VAT deduction purposes, it is unimportant whether property is recorded on balance sheets or in off-balance sheet accounts.

VAT paid by a tax agent from lease payments

Payment of VAT by a tax agent

In accordance with Article 161 of the TC RF, the lessee is recognized as the tax agent who bears the following responsibilities:
- determination of the taxable base;
- calculating and withholding the corresponding tax payable from the sum of lease payments transferable to the leasing company;
- transferring the tax payable to the government from the amounts payable to the leasing company.

In accordance with Clause 4, Article 164 of the TC, VAT is imposed at a rate of 16.67% of the total lease payment payable (that is, the equivalent of 20% VAT added to the pre-tax leasing payment). In this case, lease payments transferred to a nonresident leasing company are deemed to include VAT. Taxes are paid where the tax agent is located.

\[^6\] Clause 2, Article 171 TC RF.
\[^7\] Clause 43 of the «Methodological Recommendations for Use of Chapter 21 of the TC RF» confirmed by Ministry of Taxes and Levies Order BG-3-03/447 of December 20, 2000.
\[^8\] The same.
\[^9\] For example, RF Ministry of Finance Letter 04-03-08 of March 5, 1997.
In order to avoid subsequent disputes with the lessor in an international leasing agreement, it is advisable to settle the question of lease payment taxation from the very first, and include the relevant provisions in the text of the agreement.

**Right to apply tax deductions when VAT is paid by a tax agent**

As in the case with «customs» VAT, payment of tax by a tax agent provides him with the possibility of using the right to apply the tax deductions stipulated by Article 171 of the TC. At the same time, the right to apply tax deductions is applicable when the following condition is met: when the tax agent has withheld and paid VAT from the revenues of a nonresident leasing company.

**Procedure for deducting tax**

If the amount of tax deductions exceeds the total amount of tax owed by the taxpayer, the difference obtained is deductible (either through offsets or refunds). This difference is carried forward over a period of the three calendar months following the taxable period in which the «overpayment» of taxes occurred.

The tax authorities carry out an independent examination, and concerning taxes paid in connection with movement of goods across the customs border of the Russian Federation, with the agreement of the customs agencies and within ten days after carrying out the examination, they inform the taxpayer. After three months have elapsed from the end of the taxable period, the balance owing is refunded to the taxpayer on his written application. These sums must be refunded within five weeks from the moment the taxpayer’s application for a refund was received.

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**PRODUCTION OF PELMENI IN SMOLENSK**

Valentina Viktorovna Lomovtseva

Chairman of the Board of OAO Smolensk Business Development Center (leasing company)

Continued from page 1

As a native of the Urals, where the secret of preparing pelmeni has been handed down from generation to generation, Aleksandr Nikolaevich Diev had long dreamed about setting up production in the Smolensk area. In many respects, leasing helped Aleksandr Nikolaevich’s dream to become a reality.

In 1998, A.N. Diev applied to the leasing company Smolensk Business Development Center with the intention of leasing a facility for producing pelmeni. At that time, the new entrepreneur had neither the funds, the business experience, or the knowledge of administrative procedures required, the Center considered this transaction to be risky and declined to lease him equipment. The unsuccessful attempt to obtain financing from the Center did not stop Aleksandr Nikolaevich. He found the funds necessary for acquiring pelmeni production facilities by selling his own apartment.

In spite of having decided against financing this lease, the Smolensk Business Development Center provided the entrepreneur with considerable technical support. Together with Aleksandr Nikolaevich, employees of the Center carried out an analysis of pelmeni production equipment available on the market and ended up choosing equipment manufactured in China. They also provided help in finding the necessary location, negotiating with the owners of the premises for a reasonable rental rate, clarifying the procedure for obtaining product certificates, and drawing up a preliminary marketing plan for selling his pelmeni through a chain of stores in Smolensk, Safonov, and Vyazmi.
Within a few months after acquiring the facilities, Aleksandr Nikolaevich began making pelmeni. Besides himself and his wife Tatiana, three other people were also involved in production. The average monthly turnover of the firm was no more than 40,000 rubles. Under these conditions, Mr. Diev understood that the only way to survive in the competitive Smolensk market for prepared foods was to increase capacity and reduce production costs. However, Aleksandr Nikolaevich lacked the funds to grow his business further. Therefore, at the beginning of 1999, he again applied to the Center for help in broadening and rationalizing the organization of his business. Employees of the Center analyzed the market, determined the degree of product competitiveness in comparison with similar ones, and analyzed his current expenditures. Their analysis showed that he needed to acquire additional equipment to reduce costs. The equipment needed included the following: refrigerators for storing raw materials, freezers for storage of finished product, and a vehicle for purchasing meat directly from the producers, i.e., regional farms.

In April-May, A. Diev acquired a UAZ car and four freezers through leasing. He acquired the remaining equipment (refrigerators, a second facility for producing pelmeni, a warehouse and manufacturing equipment) with his own funds, and reinvested most of his revenues into developing his business. By October 1999, Aleksandr Nikolaevich, together with his wife, were owners of a solid business with monthly sales of more than 500,000 rubles and 20 employees. The healthy turnover allowed them to meet their obligations to the leasing company painlessly. At present, Mr. Diev has a 15-20% share of the local pelmeni market, and his products are in high demand from the residents of Smolensk, thanks to the quality, the original Urals recipe, and affordable prices. Not long ago, Aleksandr Nikolaevich received his first orders for delivery to stores in neighboring regions-Kaluga, Tver, Moscow, and Leningrad oblasts.

Aleksandr Nikolaevich has no intention of stopping there. In the near future, he plans to expand beyond the Russian border. He is planning to create an affiliate in Hungary for producing pelmeni, since the viability of his company’s strategy for the Hungarian market has already been confirmed by his own studies.

«STOMATOLOG» PRIVATE DENTAL CLINIC, NIZHNY NOVGOROD

By Viktoria Struts, LC editor

Stomatolog Dental Clinic was founded in 1989 as a private enterprise under the auspices of one of Nizhny Novgorod’s district hospitals. It became fully independent in March 1992. «We started from scratch,» explains the clinic’s general director, Marina Urutina. «Back then nobody had even heard of leasing. Bank loans were the only source of funding. Avtogaz Bank gave us a $10,000 loan to refurbish two offices and buy some Russian dental equipment: dentist’s chairs, sterilizing equipment and some work materials. We paid off the loan within 18 months, as we had promised.» The following year, the clinic took out a second loan to buy four new pieces of dental equipment.

In addition to this expansion, however, the clinic needed more funds to train its personnel, since it had always aspired to provide the highest level of service.
along with the most advanced technologies. In the end it was leasing that enabled the clinic to allocate its resources in such a way that it could afford both training and new equipment.

Russian banks were refusing to give long-term loans, and they were requiring their borrowers to provide significant guarantees. Opportunity for All, a non-governmental leasing agency, was able to offer Stomatolog a more affordable solution. Through leasing, the clinic was able to acquire an expensive piece of digital X-ray equipment. These machines enable dentists to obtain precise images of a patient’s teeth within seconds, making it possible to prescribe and monitor effective treatment.

«We could not have bought that machine with our own money, nor could we have provided enough guarantees to obtain a bank loan, since the equipment cost around $20,000» recalls Ms. Urutina. «At the same time, we also needed money to train our staff. It was then, back in 1994, that we first turned to the leasing company. Before they wrote up the agreement, they spent a great deal of time explaining the nature of leasing to us, telling us how we could benefit from it, how to approach the lease agreement and how to do our taxes.» After these detailed consultations, the partners came up with an appropriate payment plan and signed a lease for the American-made digital X-ray machine, the first of its kind in Nizhny Novgorod. Within two years, the clinic had paid off the lease without any difficulties.

With the working capital that it saved through leasing, Stomatolog invested in retraining its personnel (15 dentists and dental assistants), and since then it has strived to maintain their high qualifications. Stomatolog’s specialists undergo training at some of the leading dental clinics in Russia. They also take part in conferences, both national and international, where they share know-how and discuss the latest trends in dental science and treatment.

In 1998, Stomatolog signed a two-year lease with the Nizhny Novgorod Leasing Company. This time the clinic obtained two pieces of deluxe dental equipment (valued at $19,000 each) from Slovakia. This equipment provides maximum comfort for both doctors and patients: a comfortable design, lower vibration, better lighting, and so on.

After Russia’s financial crisis, however, it became clear that Stomatolog would no longer be able to meet its lease payments, since the contract had been based on a dollar equivalent and the exchange rate had changed several-fold. «After considering our financial situation, we decided to ask the leasing company for a one-year extension,» explains Stomatolog’s general director. «They agreed, and the lease was rescheduled. Under the new payment schedule we expect to finish paying off the lease by this October.»

Stomatolog obtained by leasing two pieces of deluxe dental equipment which provides maximum comfort for doctors and patients
Thanks to all of the new equipment and Stomatolog’s high degree of professionalism, the clinic has managed not only to expand its services, but also to improve them; it now offers a five-year guarantee on all of its dental work. At the same time, the clinic has kept its rates down in order to stay within the price range of ordinary working people. The clinic has also been very active in promoting preventative medicine. Drawing from the experience of Western dentistry, it has developed a special program for children. It teaches them how to take care of their teeth, using the best modern products, and even how to chew correctly.

Stomatolog now employs around 40 people. It plans to expand even further, restructuring its whole organization: new branches are scheduled to open in other parts of the city. This will require additional equipment, which Stomatolog plans to acquire through leasing.

Dear readers,
«Leasing-Courier» strives to cover the full diversity of leasing activity in the country, including both theoretical and practical aspects. Therefore, each issue of «Leasing-Courier» includes stories on leasing companies active in various Russian regions. Today we include an interview with the General Director of a recently established leasing company whose plans include entering the world market for leasing services.

If you have interesting experience in the field of leasing, we invite you to describe that experience in «Leasing Courier». We would also like to note that the Leasing Development Group continues to gather information for its guide to Russian Leasing Companies, an updated version of which will be appearing in the coming months. The electronic version of this guide, which is accessible on our internet site (http://www.ifc.org/russianleasing), is updated regularly. If you would like to have your company included in this guide, please complete and return the form that is published in each issue of «Leasing-Courier.» The guide is distributed free-of-charge.

KNK-LEASING

Grigory Yuriyevich Vorobeichuk, General Director of KNK-Leasing, speaks with «Leasing-Courier» editor Victoria Struts.

- Mr. Vorobeichuk, when was your company established, and who are its founders?

  - KNK-Leasing was registered as a limited liability company in early 2001. Its founders are legal entities and individuals, on a 50/50 basis.

- What is the source of the company’s financing?

  - Thanks to its substantial charter capital ($4.5 million), KNK-Leasing is able to purchase equipment primarily with its own funds. Additionally, the company has reached agreement for credit lines with several domestic banks, including Moscow Neftekhimichesky Bank and First OVK Bank. Similar negotiations are also under way with Bashkreditbank and MDM Bank.

- KNK-Leasing is a young company. It is perhaps early to discuss results, so let’s talk about the company’s plans.

  - Initially, KNK-Leasing will primarily lease equipment to oil-extracting enterprises working in the Republic of Komi who are actively developing new deposits. Obviously, development of new oil reserves will require not only specialized drilling equipment, but also transportation, communications, and other equipment. We identified this leasing market as being one with great potential.

  In its first few months of operation, the company has established relationships with lessees and suppliers that, fortunately, already have experience working with leasing companies. All the same, I must acknowledge the support provided by Dr. V. V. Devyatov - an experienced specialist in the sphere of oil-extraction technology, who has worked with us on specific projects. Thanks to this support, KNK-Leasing employees have quickly mastered the specific issues related to supplying equipment in this field and have managed to develop a well-balanced investment budget.

  In addition, the management of KNK-Leasing is now significantly expanding the scope of the company’s activity. We are entering the leasing market...
for aircraft (Tupolev) and tractor-trailers (KAMAZ) in several Middle Eastern and African countries: negotiations are under way with representatives from Yemen, Botswana, and Sudan. As is well known, the Russian company KAMAZ has made quite a name for itself in Africa and has long been selling its vehicles there, although sales volumes have not been great due to limited purchasing power. Leasing in this case could help to increase sales of Russian equipment abroad.

Negotiations are now under way for the purchase of four TU-204 and two TU-214 airplanes from Russian manufacturers with subsequent lease on a joint-usage basis. The number of leased aircraft is likely to increase in the future. Thus, the company’s activity is strategically directed toward export-oriented leasing. In other words, we are talking about leasing Russian-manufactured equipment and technologies to foreign lessees.

KNK-Leasing has implemented projects for the lease of various types of oil-extraction equipment: self-contained power stations, drilling rigs, oil-stratum hydro-fracking units, oil well acid-treatment units, equipment for transporting oil and oil products (oil-tanker trunks), tractors, boilers, and many other types of equipment.

- Could you list the company’s main customers and which types of equipment enjoy the greatest demand?

- As I already said, we try not to limit KNK-Leasing’s activity to just one area or sphere. Along with a number of oil-exploration and oil-extraction companies in the Republic of Komi (such as Tebukneft, RKM OIL, Ukhtaneft, Pechomneftegazrazvedka, and Komineftegeofizika), our customers include, for example, a mineral water producer in Sarov (Nizhny Novgorod oblast), a poultry farm in Novgorod (Velikiy), and others.

LESSOR’S OPINION

Export-Oriented Leasing: Just a Catchy Phrase or a Promising Field?

Why is there no export-oriented leasing among the wide variety of leasing transactions in Russia? According to KNK-Leasing’s specialists, such transactions can only be executed reliably by specialized leasing companies, which did not exist in this country until recently.

Specialization includes:
1. Company personnel
   The company needs to have specialists in various areas, including international law, international trade, the equipment to be leased, and international finance.
2. Documentation
   Documentation must be in the language and in accordance with the standards of the country of the lessee.
3. Accounting and financial reporting
   It is absolutely mandatory that parallel books be kept in accordance with the standards of the country of the lessee.

This list is far from exhaustive, but it is more than sufficient to demonstrate what specialization requires. And what is a leasing company’s compensation for overcoming all these problems? Without going into details, we feel that the compensation is more than adequate.

So then it is just a matter of the little things: resolving objective difficulties and overcoming the psychological barrier.

KNK-Leasing invites all those who are interested in promoting their goods in foreign markets to explore partnership opportunities. We are hopeful that the methods our company offers will help our potential partners to significantly boost sales volumes.

G. Y. Vorobeichuk,
KNK-Leasing general director
Despite the fact that the company has only been in existence for a half a year, more than 30 leasing contracts have been concluded in this time. The size of these contracts is in the range of 800,000 to 28 million rubles, with terms of 3 to 8 years.

The equipment your company leases to oil extraction enterprises is highly specialized, so I cannot help but bring up the question of risk. «Leasing-Courier» is constantly looking at this subject and describing the ways risk can be minimized. How does KNK-Leasing avoid risk?

We utilize the traditional means of avoiding risk: secured delivery, insurance, and pledges. For example, an oil company that produces 300-500 metric tons of oil annually is an extremely reliable guarantor, since it has ruble proceeds from domestic oil sales and hard-currency proceeds from exports. A profitable company of this sort is fully capable of providing the necessary guarantees for the equipment leased. With other enterprises, we work out a system of insurance or guarantees (third-party pledges or bank guarantees). As collateral, we accept securities, promissory notes, or company shares.

In my view, when a leasing company is self-financed, it is important to maintain a reasonable balance when it comes to minimizing risk - after all, if you reduce risk to zero, then the transaction is not attractive for either party. If, on the other hand, a company's financing comes from bank loans, then it simply applies those standards which the bank stipulates to the borrower.

On what basis is your work with equipment suppliers carried out?

The company actively cooperates with the leading domestic aviation manufacturers, tractor-trailer makers, and manufacturers of oil extraction and refining equipment. And cooperation does not simply mean acquiring the equipment. For example, oil-extraction enterprises make use of a wide range of high-tech and extremely specialized equipment, various components and elements of which are frequently non-standard. They have to be manufactured by special order using several source factories. It is therefore essential that leasing company specialists be highly qualified to be able to put together a complete unit from these components which can then be delivered to the lessee. Furthermore, this equipment requires constant ongoing technical control and maintenance. By providing a full range of support to developers of new oil-extraction technologies, KNK-Leasing is able to offer to lessees not just equipment, but also the latest technology - in particular, a unique branched-hole horizontal drilling method, equipment for which is now available for lease. Therefore, cooperation between equipment developers and suppliers and the leasing company continues for as long as the equipment is being used.

Does KNK-Leasing work with foreign suppliers?

Yes. In addition to its fruitful cooperation with domestic manufacturers, the company also makes some purchases abroad. As a rule, this is equipment for which there is no analog in Russia. For example, we have purchased two self-contained power stations from the American firm Caterpillar - these are unique units that turn the «waste products» from oil extraction into an energy source. During drilling, an oil well produces not only oil but gas as well - it is this so-called 'incidental' gas that these power stations run on. The use of these power stations not only allows for wells to function autonomously and provides for significant energy savings - the whole process is made more environmentally sound since the gas is not released into the atmosphere or burned off, as was previously the case.

Another example - an analytical research laboratory, also for use in oil extraction. There is currently a project in the implementation stage for its acquisition from the French company Streamline Enterprises. The laboratory is designed to measure the composition of various solutions used in oil-well drilling.

Earlier you said that KNK-Leasing is trying to enter the international market, offering Russian equipment for lease. What steps have
already been taken in this direction, and which equipment do you feel will turn out to be the most competitive?

- Yes, it is our goal to become a specialized export-leasing company. However, before undertaking deliveries abroad, a great deal of preparatory work must be done: market research, networking, etc. KNK-Leasing is now a constant presence at trade shows. We have established contacts with potential customers for domestic equipment in a number of Scandinavian, African, and Asian countries.

Russian equipment really is in demand abroad, which means that it is fully up to world standards. Of course, this is not true across the board, but the list of competitive equipment is still quite extensive. This includes transportation, equipment for oil and natural gas extraction, and high-intensity metal-working machinery. Let’s not forget that in recent years Russian manufacturers have one way or another learned new technologies, thereby making it possible to increase considerably the competitiveness of the products they make. And if we take into account the price/quality relationship and add to that leasing possibilities, this makes domestic equipment quite attractive when compared with that produced in other countries.

LEASING IN KAZAKHSTAN

Leonid Prilutsky,
General Director of «INFONALADKA»,
Doctor of Economics

A seminar entitled «Contemporary Financial Instruments and Methods in the Republic of Kazakhstan» was held July 19-27, 2001 in Cyprus by the nonprofit partnership «Working Group for Development of the Market for Promissory Notes, Derivatives and other Securities in the Republic of Kazakhstan» and the Investconsulting company. Participants in the seminar considered a variety of issues related to the legal and economic environment for leasing in Kazakhstan, outlined some of the obstacles to the development of leasing and made recommendations for their elimination, analyzed Russian leasing legislation and compared it to that in Kazakhstan, and examined international leasing transactions between Russia and Kazakhstan. Seminar participants showed interest in establishing closer ties with Russian equipment manufacturers and leasing companies.

LEGAL SUPPORT FOR LEASING

The development of leasing in Kazakhstan is in many ways similar to that in Russia, albeit with a slight time lag.

Leasing legislation

The first regulation for leasing relationships in Kazakhstan was Government Decree #1851 (December 23, 1995), «On Agricultural Leasing»). This document had much in common with Russia’s Temporary Regulation on Leasing, but unlike the latter governed leasing relationships only in the agricultural sector. The Kazakhstan budget provided for a special leasing fund to finance equipment replacement using financial leasing.
According to Kazakh leasing companies, leasing in Kazakhstan was in an embryonic state prior to the year 2000. What was needed was legislative support for leasing operations in the Civil Code or the adoption of a special leasing law.

This event would be more than two years in coming. July 1, 1999, saw the adoption of a section of the Civil Code, in which paragraph 2 (Leasing) of Chapter 29 (Property Hire (Lease)) contains eight clauses dedicated to the leasing contract.

According to the Civil Code, «pursuant to a leasing contract, the lessor undertakes to acquire property from a supplier specified by the lessee and to provide this property for the lessee’s temporary possession and use for entrepreneurial purposes in exchange for payment. The leasing contract may stipulate that the supplier and equipment to be acquired are to be chosen by the lessor.»

Leased property may consist of buildings, structures, machinery, equipment, inventory, means of transportation, land plots, and any other non-consumable item. Securities and natural resources may not be leased.

Unlike the Russian Civil Code, the Kazakh Civil Code provides for the leasing of land, which should obviously facilitate the development of real estate leasing.

On the whole, the other clauses of the Civil Code are similar to those in the Russian Civil Code, and the additions concern provisions defining the essential terms for a leasing contract and leasing payments.

The effective term of the leasing contract must be not less than 80% of the depreciation of the leased asset.

The next stage in the development of regulatory support for leasing was the Law on Financial Leasing #78-II of July 5, 2000 (hereinafter, Leasing Law), after which many banks came to view leasing as a new financial instrument and set about forming leasing subsidiaries.

Analysis of the Leasing Law

The Leasing Law introduces the concept of financial leasing, defines the subject matter of leasing, the forms and types of leasing, and the legal foundations for leasing operations. It also outlines the rights and obligations of the lessor and lessee, the essential terms of a leasing contract, the procedure for transferring the risk of accidental loss, undisputed repossession of the leased asset, and various other issues.

Compared to its Russian counterpart, the Kazakh law is compact (26 articles, compared to 39 in the Russian one), and does not deal with the issues of taxation, currency, and customs regulation, which are defined by the relevant legal acts. Greater attention is placed on protecting the rights of the lessee, and there are fewer contradictions with the Civil Code.

According to the Leasing Law, financial leasing is a form of investment activity whereby the lessor undertakes to acquire possession from the seller of the leased asset stipulated by the leasing contract and to provide it to the lessee for the specified payment, term, and conditions for temporary possession and use for entrepreneurial purposes. At the same time, the period for which the leased asset is turned over to the lessee must be not less than 80% of the depreciation term. The leased asset becomes the property of the lessee upon expiration of the leasing contract’s effective term, or prior to the agreement’s expiry provided that the lessee has paid the full amount contemplated by the leasing contract, if provided for by the leasing contract.
The rights of ownership and temporary possession and use of the leased asset are treated in the traditional fashion. The lessor is the owner of the leased asset throughout the term of the leasing contract, whereas the lessee is entitled to possess, use, and derive income from the use of the leased asset.

The Leasing Law provides for the mandatory state registration of leasing contracts. In particular, leasing contracts for movable property are to be registered with the authorities responsible for registering liens on movable property.

Leasing activity is not subject to licensing, except for bank leasing, in which case the bank must obtain a license to conduct leasing activity as a separate banking operation.

A separate clause provides protection of the lessee’s right of possession and use of the leased asset on an equal level with protection of ownership rights.

The second chapter, which governs the legal framework of leasing relationships, contains detailed descriptions of the rights and obligations of the lessor, lessee, and seller of the leased asset. Unlike in Russian legislation, a great deal of attention is given to the rights and obligations of the lessee. A few of the lessee’s rights are as follows:

- to cease lease payments in case of a serious breach by the lessor of the terms of the leasing contract until the lessor has made good on its obligations to the lessee;
- to demand the return of lease payments and other amounts paid in advance in the event of the lessor’s unilateral termination of the leasing contract;
- to refuse acceptance or demand replacement of the leased asset, or to annul the leasing agreement in cases where the leased asset is not delivered, is delivered with a substantial delay, or is delivered with irremediable defects hindering use of the leased asset for its intended purpose;
- to claim damages in case of the lessor’s non-fulfillment of the terms of the leasing contract;
- to demand an appropriate reduction of the lease amount and lease payments if the conditions for use contemplated by the leasing contract have worsened considerably by virtue of circumstances for which it is not responsible.

The Leasing Law treats the parties’ liability and risks of accidental loss of the leased asset in the traditional fashion. Thus, all claims regarding the leased asset’s quality are sent by the lessee directly to the vendor; the lessee has the rights and bears the obligations of the buyer, except for the obligation to pay for the leased asset, as if it were a party to the sales contract. The risk of accidental loss of or damage to the leased asset passes to the lessee when the latter receives the leased asset, unless otherwise provided by the contract.

A leasing contract may be terminated via court proceedings at the request of either the lessor or the lessee.

The leasing contract may be terminated at the lessor’s request, and the leased asset returned to the lessor at the lessee’s expense, in the following cases:

1) if the lessee significantly damages the leased asset;
2) if the lessee uses the leased asset in violation of the terms of the leasing contract or the intended purpose of the leased asset, despite a written warning from the lessor regarding the cessation of such activities;
3) if the lessee misses two or more consecutive payment deadlines pursuant to the leasing contract.

The leasing contract may be terminated at the lessee’s request, and the leased asset returned to the lessor at the latter’s expense, in the following cases:

1) if the lessor fails to provide the leased asset or hinders the use of the leased asset in accordance with the terms of the contract;
2) if the leased asset has defects hindering its use that were not specified in the leasing contract;
3) if the lessor has missed the deadline for delivery of the leased asset.

In addition, the Leasing Law provides for the lessor’s right to demand the uncontested return of the leased asset:
The Leasing Law defines the essential terms of the leasing contract as follows:
1) subject matter of the contract;
2) name of the seller of the leased asset, with indication of who chose the seller;
3) conditions and terms for the transfer of the leased asset to the lessee;
4) amount and frequency of lease payments;
5) value of the leased asset;
6) effective term of the contract;
7) terms for the transfer of the leased asset to the ownership of the lessee, if such transfer is contemplated by the contract;
8) description of the leased asset;
9) maintenance and repair procedures for the leased asset;
10) insurance of the leased asset;
11) assignment to one of the parties of the obligation to register the leased asset in the name of the lessor;
12) procedures for the lessor to monitor the lessee’s performance of its obligations under the leasing contract;
13) liabilities of the parties.
Without these terms, a leasing contract is deemed to have not been concluded.
More than likely, this long list of essential terms reflects lawmakers’ desire to prevent possible future disputes between the parties to leasing transactions. Nevertheless, the Leasing Law gives a more extensive list of essential terms than the Civil Code.

1) if the lessee’s use of the leased asset does not comply with the terms of the leasing contract or the leased asset’s intended purpose;
2) if the lessee restricts the lessor’s access to the leased asset;
3) if the lessee misses two or more consecutive lease payment deadlines as established by the leasing contract.

It is not difficult to see that the grounds for in-court and uncontested demand of the leased asset by the lessor coincide to a great extent.

Uncontested seizure of the leased asset is effected in the form of an order in accordance with the Civil Procedural Code of the Republic of Kazakhstan. However, the lessee is entitled to a 10-day period after receiving a copy of the court order in which to submit to the court issuing the order its reply to the claim filed for seizure of the leased asset.

The lessor and lessee are entitled to assign all rights belonging to them under the contract to third parties subject to the mutual agreement of the parties.

The Leasing Law does not avoid the subject of lease payments. They are calculated to include compensation (amortization) for all or a significant portion of the leased asset’s value at the time of execution of the leasing contract, specifically:
• compensation of the lessor’s expenses for acquisition of the leased asset and any other expenses directly related to the acquisition and delivery of the leased asset, as well as to putting it into working order for use according to its intended purposes pursuant to the leasing contract;
• the leasing fee.

It is not clear from this definition what happens to expenses for technical service and ongoing maintenance of the leased asset when these are handled by the lessor, as is contemplated under a blanket lease. Are they part of the compensated expenses or the lessor’s fee? A similar question arises with insurance payments when these are handled by the lessor.

The closing provisions of the Leasing Law specify that leasing activity is subject to the legal and economic regime for conducting investment activity, as contemplated by the Republic of Kazakhstan legislation on foreign investment and state support for direct investments. The inclusion of this provision was meant to activate the replacement of the capital base with the help of leasing.

The Kazakh Leasing Law, like its Russian counterpart, is not without contradictions with the Civil Code, although there are significantly fewer in our opinion. The Civil Code contains no restrictions on the term of a leasing contract, while the Leasing Law states that it must not be less than 80% of the term of depreciation. The Civil Code gives five essential terms for a leasing contract, while the Leasing Law gives thirteen.
ECONOMIC ENVIRONMENT FOR LEASING ACTIVITY

The existence of a legal basis for leasing activity is a necessary condition for the development of leasing, but it is not a sufficient condition. The existence of any activity depends to a great extent on the economic environment, and first and foremost the tax, currency, and customs regulations.

Taxation of leasing operations

The main law governing taxation is the Law on Taxes and Other Mandatory Payments to the Budget, #2235 of April 24, 1995 (hereinafter, the Tax Law). This law is analogous to the Russian Tax Code. Among the 19 taxes, fees, and other mandatory payments, we will focus on the three fundamental ones:
- income tax on legal entities;
- value-added tax;
- property tax on legal entities.

Income tax on legal entities

The Kazakhstan income tax on legal entities is analogous to the Russian profit tax. Pursuant to the Tax Law, for tax purposes financial leasing operations are viewed as a purchase of fixed assets by a lessee. At the same time, the lease of fixed assets subject to depreciation constitutes leasing if it meets one of the following conditions:

1) the lease term is greater than 80 percent of the operating life of the fixed assets;
2) the lessee has the right to purchase the fixed assets for a set price;
3) the depreciated value of the leased assets upon expiration of the lease is less than 20 percent of their value at the start of the lease;
4) the floating (discounted) value of payments for the entire lease period is more than 90 percent of the value of the leased assets.

Since leasing is viewed as a purchase for tax purposes, leased assets are carried on the lessee’s balance sheet, as established in Article 207 of the Tax Law.

The property is reflected on the lessee’s balance sheet based on the value of the leasing contract, since pursuant to Article 20-9 of the Tax Law, «compensation (interest) on property received under lease increases the value of the given property.»

Leasing companies are granted an exemption with respect to income tax. Compensation (interest) earned by organizations by leasing fixed assets for a contractual term of more than three years is fully exempt from payment of this tax. Russian leasing companies can only dream of this.

The income tax rate for legal entities is 30%.

The lessor’s fee is fully exempt from income tax provided that the leasing contract term exceeds three years.

Compensation (interest) on loans taken to acquire the leased asset is assigned to the lessor’s expenses. In all fairness, it should be noted that interest on loans used to purchase capital assets, unlike in the Russian legislation, is also expensed or, in the language used in the Kazakhstan legislation, it is deductible from taxable income.

Compensation (interest) for loans is deductible within the limits for the reporting period according to the official refinancing rate of the National Bank of the Republic of Kazakhstan plus 50% for loans in Kazak tenge, and according to LIBOR plus 100% for loans (borrowings) in foreign currency. A fee amount in excess of the said limits is attributed to net income.

In Kazakhstan, leasing transaction participants cannot use accelerated depreciation for the leased asset, as they can in Russia.

Kazakh legislation does not grant exemptions for the depreciation or accelerated depreciation of leased property, which reduces the relative attractiveness of leasing compared with other means of acquiring property.

There is no right of choice as to whether the asset is carried on the balance sheet of the lessor or the lessee: the leased asset is carried on the lessee’s balance sheet based on the value of the leasing contract.

1 These conditions coincide to a great extent with those by which leasing is characterized as either financial or operational in the international standard for accounting for leasing operation (IAS 17).
We feel that the major advantage of leasing in Kazakhstan is the longer term of the leasing contract and its greater accessibility as compared with credit. The average depreciation norms for equipment in Kazakhstan amount to 5 to 8 years. Taking into account the possibility of applying accelerated depreciation with a coefficient of 2 in the first year, given that these assets will be used in entrepreneurial activity for at least three years, leasing companies will have to conclude leasing contracts with a term of 3.5 to 5.5 years in order to fulfill all the conditions specified in the Leasing Law and the Tax Law.

**Value-added tax**

According to Article 57-3 of the Tax Law, turnover from the provision of financial services (including the leasing of fixed assets) is exempt from VAT. For turnover that is exempt from VAT, the value-added tax on fixed assets that is payable to suppliers and in customs processing does not go toward a credit, but rather increases the book value of these fixed assets (Art. 64-1 of the Tax Law). Since July 1, 2001, the value-added tax in Kazakhstan has been charged at the rate of 16%; prior to that the rate was 20%.

Russia has been through this «pseudo-benefit,» and it is, fortunately, no longer present in the Russian Tax Code. Its application worsens the lessee’s financial situation, inasmuch as the drain on its monetary resources only increases in the presence of this VAT exemption.2

Kazakh leasing companies are well aware of this and are requesting its repeal.

**Customs regulation**

Customs legislation in the Republic of Kazakhstan is governed by the Law on Customs #2368 (July 20, 1995). Article 149 of this law gives a list of goods that are exempt from customs duties. This list includes goods that may be used by leasing companies as a leased asset.

In particular, means of transportation performing regular international shipments of cargo, baggage, and passengers, or goods imported into the customs territory of Kazakhstan for subsoil users’ own needs (without subsequent sale) for oil extraction (when contracts have been concluded by the Government or another competent authority) with domestic or foreign subsoil users.

Exemptions are also granted for temporarily imported and temporarily exported goods. Such goods may be eligible for complete exemption from customs duties, or for payment on an installment basis. The list of temporarily imported and temporarily exported goods that are fully exempt from customs duties and taxes is approved by the Government of the Republic of Kazakhstan. The maximum term for temporary import and export of goods may not exceed two years.

For each month or incomplete month, the amount due is three percent of that which would have been payable if the goods were released into free circulation or exported.

If the total amount of customs duties and taxes paid in the case of temporary import or temporary export equals the amount of customs duties and taxes payable at the time of import or export if the goods had been released into free circulation or exported, the goods are deemed to have been imported.

**Currency regulation**

The Republic of Kazakhstan Law on Currency Regulation, #54-I of December 12, 1996, divides currency operations into current currency operations and currency operations involving the movement of capital. Current currency operations may be conducted by residents without restriction. Currency operations involving the movement of capital require a license from the National Bank of the Republic of Kazakhstan.

Operations involving the movement of capital include:

- investments;
- transfers in payment of property and other real estate rights;
- settlements related to the crediting of export-import transactions for a term of more than 180 days;
- granting and receiving loans for a term of more than 180 days.

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1 This issue was analyzed in greater detail in «Leasing-Courier» #2, 2000.
Should a Kazakh company receive a Western loan for a term exceeding 180 days, that company would have to obtain a license from the National Bank. If a lessee concludes an international leasing contract, then it will not need to obtain a license from the National Bank, since the list of operations involving the movement of capital says nothing about receiving a payment deferral.

Thus, the Kazakh currency and customs legislation grants no special benefits for leasing.

**KAZAKHSTAN LEASING COMPANIES**

As in Russia, Kazakhstan’s first leasing companies were established under the auspices of banks with sufficient funds to finance such projects. These included “ATF-Leasing” (founded by the “Almaty Trade-Finance Bank”) and “BTA-Leasing” (founded by “Bank TuranAlem”). At the developmental stage, the main clients of these leasing companies were the banks’ corporate clients. Equipment suppliers are both Kazakh and foreign companies, including Russian ones. The main customers for leasing services from these companies are in the fuel and energy sector, metallurgy, transport, trade, and agriculture.

Kazakh leasing companies have shown a great interest in Russian equipment. In particular, BTA-Leasing is interested in supplies of KAMAZ combines and vehicles. Grain from Kazakhstan could be used as collateral in these transactions. The transactions could involve Russian leasing companies as part of a subleasing structure, where the Kazakh leasing company would act as lessee of the equipment, which it would then sublease to the end user. At the same time, plans can be developed to take into account the particularities of the tax, customs, and currency regimes in both countries so as to minimize expenditures for all parties to the transaction.

**EVENTS IN THE RUSSIAN LEASING INDUSTRY**

**COMMERCIAL BANK LOANS FOR LEASING PROJECTS**

St. Petersburg Bank has added Petroconsult to its list of partner companies in the Russian leasing industry. Leases financed through this new partnership will be one-and-a-half to four years long. Lessees will be asked to provide guarantees on 30% of the value of each contract in the form of liquid assets. Payment schedules will vary from case to case. Petrokonsalt will record the leased assets on its own balance sheet, pay the relevant taxes and assume responsibility for debt management on each project. Last year, St. Petersburg Bank granted 57 million rubles in loans to Russian leasing companies.

_Ekonomika i vremya (St. Petersburg)_
July 25, 2001

Avanguard Bank plans to increase its investment in leasing projects to as much as $50 million by the end of this year. The bank will finance leasing projects through its leasing subsidiary, Rus’ Leasing. Avanguard is particularly interested in leasing equipment to manufacturers in the military-industrial complex, as well as the logging, food-processing, textile and gold-mining industries. The bank has been leasing equipment to gold-mining firms since late 2000 and has invested more than $2 million in the industry so far.

_Finansovaya Rossiya_  
_July 5, 2001_

Alfa Bank has received a loan of 5.3 million Euros from Bankgesellschaft Berlin (BB), backed by a guarantee from the German insurance company Hermes. The loan has enabled Alfa Bank to purchase 6 million Euros’ worth of Claas machinery from Germany, which it will lease to Belregiongaz via its leasing subsidiary, Alfa-Lizing. Alfa Bank is the first Russian bank to
receive long-term (three-year), commercial export credit, backed by a guarantee from Hermes Insurance Company, since the financial crisis of 1998. Hermes has agreed to insure 85% of the value of this contract.

VolgaNet Monitoring Service
July 12, 2001

Sberbank’s Northwest Branch has granted a three-year, 34.5 million ruble loan to the St. Petersburg Model Printing Press to finance the company’s lease on a new set of printing equipment. According to Sberbank’s press service, St. Petersburg Model Printing Press will lease the new equipment through Sberbank’s leasing subsidiary, Globus-Lizing. Sberbank Northwest has also granted a loan for an undisclosed amount to Nefrit-Keramika (Leningrad region) to finance its lease on an Italian ceramic-tile production line. This equipment will enable Nefrit-Keramika to boost its production volume by 170%.

Delovaya panorama (St. Petersburg)
July 22, 2001

Vneshekonombank (VEB) and the state-owned State Investment Corporation (Gosinkor) have signed a partnership agreement aimed at drawing more domestic and foreign investment to the Russian economy. According to this agreement, Gosinkor will assist VEB with some of its major projects, including the development of the military-industrial complex, aviation leasing, and housing projects for military servicemen. Gosinkor’s chairman, Vladimir Chernov, announced that his organization would take responsibility for organizing and coordinating these projects, as well as providing guarantees. Mr. Chernov invited both Russian and foreign financial institutions to join the new partnership.

RIA Novosti
July 10, 2001

Avangard Bank is continuing to develop leasing projects in a variety of Russian industries. In September 2001 the bank plans to begin financing the construction of a new malt factory, including a total investment of $25 million in equipment leases. The bank also plans to invest up to $25 million in equipment leases at the Belarusian Metals Factory. In addition, Avangard plans to invest around $20 million in the Russian fishing industry through leasing projects in Kaliningrad, Murmansk and the Russian Far East. The bank has already provided one Far Eastern company with a new import-ed seiner, as well as starting construction on the company’s new fish-processing plant.

Finansovaya Rossiya
July 10, 2001

AVIATION

Novosibirsk’s Siberia Aviation (Sibair) plans to join forces with Aeroflot to compete in a government tender for leasing projects. One possibility currently being considered by the companies is to send their joint leasing company to participate in the tender. In the meantime, Siberia Aviation is putting the finishing touches on its merger with Vnukovo Airlines. The merger should be completed by February or March 2002, once the companies finish their last round of shareholder meetings and confirm their liquidation balance-sheets. The newly formed Siberia Aviation Company will then begin to negotiate a possible merger with Aeroflot.

In addition, Sibair has worked out a joint project with Ernst&Young to upgrade twenty of its Tu-154 aircraft. The two companies will found an aircraft leasing company specializing in leasing Tu-154Ms; Sibair will contribute planes to the newly-formed company for upgrading and the new company will lease the planes to Sibair and other airlines. Siberia also plans to lease some new Tu-204s and Tu-214s to expand its current fleet; it also hopes to lease up to 15 new Il-86s by the end of 2002. Thus, in contrast to its potential partner, Aeroflot, which generally prefers to use imported aircraft, Siberia Aviation intends to lease only Russian planes. Nevertheless, the two companies’ different philosophies should not stand in the way of their merger, which fits neatly with the Russian aviation authorities’ plans to reduce the total number of Russian carriers, partly through mergers and acquisitions.

Izvestiya Moskva
July 26, 2001

Russia and Egypt might begin to work together in the field of aircraft construction, announced an Egyptian delegation after completing its tour of the Gorbunov Aviation Plant in Kazan. Egypt’s extraordinary and plenipotentiary ambassador to Russia and the wealthy businessman Ibrahim Tiamel inspected the production line for Tu-214s and suggested the possibility of launching a joint venture to produce the aircraft. The Egyptians would like to build the first batch of aircraft using imported engines, and then to switch over to the latest engines from the Kazan Motor
Plant. Russia’s Aviastar and Egypt’s Chiroka Aerospace International have already agreed to finance the construction and delivery of 200 aircraft. The two companies also plan to form a joint leasing company to lease the new aircraft. If the deal goes through, it will become one of the largest foreign investment projects in Russia today.

Radio Rossii
July 6, 2001

The Kazan Aviation Plant (KAPO) has leased one of its Tu-214 aircraft to Dalavia Airlines. The deal was put together by the Financial Leasing Company (FLK). Leasing Tu-214s is FLK’s biggest project to date. The company was able to secure funding for the project from the governments of Tatarstan and Khabarovsk. Dalavia’s new Tu-214 is equipped with two PS-90A engines from Perm Motors. It has a seating capacity of 164 passengers and a flight range of 7,200 km. The aircraft complies with all international safety and environmental standards and can fly to any country in the world. Negotiations are also under way to lease Tu-214s to Transaero and Novosibirsk Airlines, as well as the Airlines of the President of the Russian Federation.

ITAR-TASS
July 12, 2001

Aeroflot Russian Airlines has put forward a business plan aimed at creating a new airline in Ireland over the next year and a half. Having failed to acquire Ireland’s Virgin Express, Aeroflot now intends to create its own airline within Ireland. This would enable Aeroflot to achieve two goals at the same time: to obtain a license for internal European Union flights and to create a foreign base for registering leased aircraft with minimum taxation. According to the combined data of several Russian aviation leasing companies, Ireland is one of the best places to register leased aircraft. By registering an airplane in Ireland, a Russian buyer can lower its total cost by at least 10%, since Ireland, unlike Russia, does not levy highway taxes, property taxes, notary fees or state registration fees. In Ireland, leasing companies pay no more than 10% of their profits in sales tax, profit tax and property tax combined (compared to a total of 36-40% in Russia). Shareholders in the new company will be required to invest «several million dollars» in the project (the exact sum will be determined by Aeroflot’s board of directors, which must first decide how many aircraft to include in the new carrier’s fleet). Aeroflot is not expected to obtain shares in the new company, but it will act as the managing company.

Vedomosti
July 26, 2001

The Russian government will earmark 5.08 billion rubles in federal funds for the Russian aviation industry in the year 2002. Most of these funds (more than four times more than in 2001) will be used to finance a vital program for aviation leasing. The government will provide 4 billion rubles in loan subsidies and state guarantees for leasing transactions. Several projects are already under way, for the first time in many years, to purchase state-of-the-art Il-96-300s, Tu-204s and Tu-214s for Russian airlines. The leases will be signed for periods of eight to ten years, during which the government will subsidize the difference between the lending banks’ rather high rate of interest (24%) and the rate that the airlines can realistically afford to pay (12-13%). The government has already earmarked 1.03 billion rubles for this purpose.

Vremya-MN
July 27, 2001

AGRICULTURE

Gazprom Bank’s leasing subsidiary, Energogazlizing, will lease 12 Same Deutz-Fahr grain harvesters worth more than 3 million euros to Lipetsk Agrosnabservis (Lipetsk Agricultural Supply Service). Traktorexport Joint-Stock Company helped put the deal together. Gazprom Bank will provide a letter of credit for the machinery, which will in turn be backed by a guarantee from Commerzbank AG of Germany. Commerzbank will not require Gazprom Bank to provide a deposit for the corresponding sum. According to agricultural experts, the grain harvest in the Lipetsk region will exceed 100 kilograms per hectare this year. Since farmers in the region are in urgent need of more grain harvesters, Gazprom Bank plans to develop similar leasing projects in the future to bring more agricultural machinery to the region.

Finansovaya Rossii
July 27, 2001

Siburash Holding, which includes the Krasnoyarsk Combine Factory, has announced the second interregional Mekhanizator-2001 Competition. Prizes will be awarded in two categories: «Most Grain Harvested with a Yenisei Combine» and «Best Machinery Maintenance.» The Chelyabinsk region now has 300 Yenisei combines, which it acquired under lease from the Krasnoyarsk factory last year. The Southern Urals region will lease an additional 300 Yeniseis on the same terms in preparation for this year’s harvest.

Ural-press-inform (Chelyabinsk)
July 27, 2001
The Jewish Autonomous Oblast has received twenty-four MTZ-82 tractors under lease from Belarus with financial backing from Rosagropromsnab (Russian Agricultural Suppliers). The tractors are now being held at Birobidzhan Agrompromsnab in the regional capital. Each MTZ-82 tractor will cost 390,000 rubles. Having already made a 25% deposit, the new owner will be able to pay off the rest of the sum in regular, even installments over the next five years.

Birobidzhanskaya zvezda (Birobidzhan) 
June 28, 2001

Farmers in the Kuban region have received more than 410 pieces of agricultural machinery through local leases. The government of Krasnodar Krai, which is historically often referred to as ‘Kuban’, passed a series of measures to allocate funds to Krasnodar Agrompromsnab (Krasnodar Agricultural Suppliers) in order to help regional farmers obtain much-needed machinery and prepare for the winter crop. The Lesselmash Factory of Apsheronsk has shipped out fifty-seven BDT-7K disc-harrowing attachments, while local farmers have already received cultivators from the Gryazinsk Cultivator Factory and the Krasny Aksay Plant in Rostov-on-Don, as well as SZP-3.6 sowing-machines from Novosibirsk and rollers from the city of Mozhga. More shipments are expected from other factories. Local farmers are receiving all of this equipment under lease for a period of three years.

Kubanskiye novosti (Krasnodar) 
July 20, 2001

The Tyumen region has invested another 50 million rubles into its Regional Leasing Fund. The additional funds will make it possible to obtain 61 Niva grain-harvesting combines. The region also hopes to receive funding through the Federal Leasing Program for an additional 75 grain harvesters, as well as 30 tractors and more than 200 other pieces of agricultural machinery. Local farmers will also be able to lease 111 tractors and 311 other pieces of machinery as part of a new program for the introduction of energy-saving technology in the crop-growing industry. Some of this equipment, worth a total of 47.3 million rubles, has already been delivered to local farmers. The regional government hopes to use leasing to modernize agricultural machinery throughout the region over the next few years. As much as 90% of farming equipment is obsolete in some districts.

Tyumenskiye izvestiya (Tyumen) 
July 25, 2001

The Republic of Mariy El now has its own GSM-900 cellular network. The network’s creator, Martelkom, obtained all of its equipment through leasing. Germany’s Alcatel was able to deliver and assemble the equipment in record time: it took only seven months in all. The network currently has a capacity of 5,000 subscribers, but it will be possible to expand the system later. Promsvyaz Leasing Company, which financed the project, expects to recoup its investment over the next three years.

Moskovsky komsomolets in Marly El (Yoshkar-Ola) 
July 19, 2001

Ukrainian International Airlines (MAU) continues to upgrade its fleet. The company has signed an agreement with the international leasing company GECAS for a new Boeing 737-300, released in 1997, which has a seating capacity of 132 passengers, including both business and economy classes. MAU will also lease a new Boeing 737-500 with a seating capacity of 108. At the same time, as part of its ongoing expansion program, MAU expects to receive a new Boeing 737-700, which it ordered several years ago. According to the airline’s press service, its passenger volumes have increased 20% during the first half of this year.

UNIAN Information Agency 
July 12, 2001

Automobile leases have increased by 48% this year in Lithuania. According to market research company Auto Tyrimai, 1,537 automobiles were leased during the first half of 2001, which represents a 48% increase over the first half of 2000. Auto Tyrimai points out that even though total new car sales have fallen by 6% this year to 3,532, a larger number of cars have been sold to local buyers, who have begun to make greater use of leasing plans. During the first half of this year, Hanza Lizingas leased the most cars (614), followed by VB Lizingas (609) and LZUB Lizingas (170).

Baltic News Service (Vilnius) 
July 17, 2001

Sibmaslohing plans to lease 100 tractors worth a total of $2 million to Kazakhstan this August. One hundred T-4 tractors have already
The lease agreement provides for the right of the leasing company to change the amount of the lease payments as a result of a change in the Central Bank refinancing rate. The lessee’s fulfillment of its obligations is secured by a third-party pledge. Would a change in the lease payment amount as a result of a change in the Central Bank refinancing rate be grounds for termination of the pledge agreement securing the leasing transaction?

Yes, the circumstances described above would in fact be grounds for termination of the pledge agreement unless the pledge agreement specifically states that the party securing the lease agreement agrees to bear liability in the event of a change in the Central Bank refinancing rate. In other words, the pledge agreement itself must specifically outline the guarantor’s agreement to any ‘additional’ liabilities.

According to Article 367.1 of the Russian Civil Code, a pledge agreement is terminated if the lessee’s obligations change resulting in increased liability or other unfavorable consequences for the party securing the lease agreement without the latter’s consent.

Arbitration Court decisions involving disputes connected with the application of this rule have tended to relieve the party securing the lease agreement of additional liabilities arising from unilateral changes by the creditor (the leasing company, in our case) of the amount of the debtor’s obligation, unless such changes were provided for by the pledge agreement.

In particular, applying section 6 of the High Arbitration Court Presidium’s Informational Letter #28 of 01/20/98 to leasing relationships leads to the
How does one account for interest on funds borrowed by a leasing company in order to acquire an asset that will subsequently be leased?

Bookkeeping and taxation of interest on loans taken out by a leasing company for the acquisition of an asset that will subsequently be leased varies depending on when the fixed assets are reflected in the books.

Accounting Regulation 6/01 on Accounting for Fixed Assets stipulates that interest accrued on borrowed funds before the fixed assets are recorded in the books, if such funds were borrowed for the acquisition, construction, or manufacture of the asset, constitute current expenditures for the acquisition of fixed assets and are included in the initial value of the fixed assets being acquired.

The operation involving interest accrued to the creditor prior to receipt of the asset should be reflected in the books as follows:

- D08 K60 - acquisition of fixed assets
- D19 K60 - reflection of VAT
- D08 K92 - interest accrued prior to equipment being put into production
- D01 K08 - fixed assets reflected in the books
- D68 K19 - VAT offsets for budget settlements

After the asset is reflected in the books as a fixed asset, interest on the funds borrowed by the lessor for leasing is allocated by the leasing company to expenses. The basis for this is Government Regulation #552 of 08/05/92 on Adoption of the Regulation on Production and Marketing Expenditures to Be Included in Expenses (Cost of Production) of Goods (Works, Services).

This operation is reflected in the books as follows:

- D01 K08 - fixed assets
- D80 K92 - loan interest accrued

Meanwhile, for tax purposes, bank interest payments are permitted within the following limits:
- Central Bank refinancing rate, plus three percentage points (for loans obtained in rubles),¹
- 15% (for loans obtained in foreign currency).²

When an advance payment is made against future lease payments, is the lessee entitled to a refund of the VAT paid as part of the advance? Should the leasing company pay the VAT from the advance upon receipt?

Application of tax deductions by the lessee

According to Article 172 of the Russian Tax Code («Tax Deduction Procedure»), the deduction only applies to VAT charged to and paid by the taxpayer when acquiring goods (works, services) after the said goods (works, services) have been recorded in the books. Tax deductions are made on the basis of invoices presented by sellers when a taxpayer acquires goods (works, services) and documents confirming the actual payment of the tax amount.

¹ At Present, the RF Central Bank refinancing rate is 25%.
² Russian Finance Ministry Letter #50 of 28.05.96, Russian State Tax Service Letter #VG-6-05/294 of 29.04.96, Russian Ministry for the Economy Letter #SI-176/6-204 of 28.05.96, Russian Central Bank Letter #030-12/342 of 29.04.96; and Instruction #62 of 15.06.00 on the Procedure for Calculation and Payment to the Budget of Tax on the Profits of Enterprises and Organizations.
Therefore, the following conditions must be fulfilled for a VAT refund (write-off, reimbursement):
- VAT has been paid,
- the seller has presented an invoice (in the established manner),
- the acquired goods (works, services) have been reflected in the books.

The parties to the lease agreement must specify the lease payment(s) to which the advance applies. For example, the lease agreement may stipulate that the advance is to be credited against the first lease payment. In this case, the lessee will be able to deduct VAT paid as part of the advance in full once the first lease payment comes due. If the agreement stipulates that the advance is to apply in equal shares to each lease payment throughout the term of the agreement, then the lessee will be able to take the tax offsets in equal shares as each lease payment comes due.

Payment of VAT by the leasing company

Pursuant to Article 162.1.1 of the Russian Tax Code, the taxable amount is calculated with consideration for advances and other payments obtained against future deliveries of goods, performance of works, or rendering of services.

Therefore the leasing company, having received an advance payment, must pay VAT to the budget. Pursuant to Article 174 («Tax Payment Procedure and Deadlines») of the Russian Tax Code, VAT is paid based on the results of each tax period not later than the 20th day of the month following the close of each tax period.

\[\text{Article 169 («Invoices») of the Russian Tax Code; Russian State Tax Service Letter #VG-6-03/404 of 05.21.01 on the Use of Invoices for VAT Settlements.}\]