THE LEASING DEVELOPMENT PROJECT

An interview with James Gorham, Project Manager of the IFC Leasing Development Group

Ever since the Leasing Development Group was formed, it has continuously promoted financial leasing to Russian enterprises. How exactly has the Group set about accomplishing this task?

The Leasing Development Project began in 1997 as part of the IFC’s technical assistance program for the development of financial markets in Russia. The Project’s main objective was to act as an advisory body and help create more favorable conditions for leasing in Russia.

The first phase of our project was purely analytical as we studied the Russian leasing market, developed relationships with Russian leasing companies and relevant government agencies, and analyzed the legal and economic framework for leasing in Russia.

After we finished this initial phase, we began actively promoting leasing. In January 1999 we began publishing our information bulletin, the Leasing Courier. Later that year we started publishing our Directory of Russian Leasing Companies, where interested companies could post information about themselves - the only publication of its kind in Russia. For the past three years, the Leasing Development Group has been conducting seminars on the principles of leasing in Russia.

We have taken part in a variety of conferences and round-tables devoted to leasing. At the same time, we have helped officials and legislators draft new laws to facilitate the growth of leasing. Finally, the Group has searched for promising investment projects on behalf of the International Finance Corporation.
From 1998 - March 2000, the Leasing Development Group was financed by both the British Know-How Fund (BKHF) and the Canadian International Development Agency (CIDA). Today CIDA is the sole contributor.

By now leasing has already become a familiar part of the financial landscape in Russia. Has the Leasing Development Group changed its focus?

It’s true: many Russian businesses, especially small ones, have learned through experience that leasing is one of the most effective ways of obtaining new equipment. This is especially true given the lack of capital and affordable credit in Russia. However, in spite of the fact that leasing has gained in popularity over the last few years, our task is far from complete. We will continue to foster the development of Russian financial services, particularly leasing, and we will do so using the same methods as before: disseminating information about leasing and its advantages over other forms of investment, analyzing the Russian investment market, providing advice and contributing our recommendations to relevant legislative initiatives.

How big is the Group’s audience?

Let me give you a few statistics from some of our activities. The Group’s specialists have been conducting seminars on «The Principles of Leasing» and «Risk Management for Leasing» since 1998, and this April we plan to start offering a new seminar for lessees. Altogether, from 1998-2000 we have held 25 seminars in 18 regions of Russia that were attended by over 2,000 people.

Every year the Group publishes a general survey of leasing in Russia, as well as a detailed report about the condition of Russian leasing laws. As far as I know, we are the only organization in Russia to publish such comprehensive reports on these subjects. That is why the surveys have become so popular — not only among those who are involved in leasing directly, but also among people who want to follow developments in the Russian economy, such as state officials, academics, students and journalists. Over the years we have circulated over 10,000 copies of our reports.

What role has the Leasing Development Group played in the IFC’s investment projects?

The IFC often combines technical assistance with its investment projects. The Leasing Development Project attempts to create a more favorable climate for both domestic and foreign investment in the Russian leasing industry. At the same time, the IFC tries to show potential investors, through its own authoritative example, that investing in Russia can be profitable. Thus, the Group acts as a link between Western investors and Russian leasing companies.

To give you just one example, the Canadian Business Association in Russia (CBAR) recently
announced its plan to promote investment in the northwest region of Russia by Canadian companies. Thanks to information gathered by the Leasing Development Group, all 60 of CBAR's member companies will have access to better information about business possibilities in the region, as well as the legal aspects of doing business in Russia. At the same time, potential Russian partners of these Canadian firms can get comprehensive information about leasing and the possibilities that it affords. As part of CBAR's planned delegation to St. Petersburg in March 2001, the IFC will hold a leasing seminar for local firms that want to attract large-scale investment. The main purpose of the seminar will be to introduce Russian leasing companies to Canadian equipment suppliers, in the hope that this will ultimately give regional enterprises greater access to new sources of equipment.

Does the Group have any partner organizations that help it accomplish its mission?

We have been able to establish good working relationships with both high-level government agencies and a substantial number of companies in the field, many of which have taken shape before our very eyes: regional leasing companies, small and medium-sized businesses, leasing consultancies, etc. The Leasing Development Group provides all of these institutions with support through consultations and seminars. This kind of close cooperation enables us to keep up to date on all of the trends and problems in the Russian leasing industry.

We also work with the State Duma, the Ministry of Economic Development Trade and the Ministry of Finance, the Chamber of Commerce and Industry (including its regional branches) and the Institute of Government and Law. Officials and experts from these institutions have taken part in our conferences, round-tables and seminars.

How would you describe the prospects for leasing in Russia?

In spite of all the obstacles, leasing has taken root in Russia over the last few years and found its niche in the market. Nevertheless, as dynamic as this growth has been, the future of leasing will depend on both the general state of the economy and the stability of the legal system. Throughout the world, governments have sought to bolster leasing as a financial tool by creating special laws and well thought-out policies towards taxation, customs and currency regulation. This has not taken the form of stricter government control, but rather the opposite: as soon as a government has created a reasonable set of ground rules, it needs to let the leasing industry develop freely along market principles.

Russian legislators are now working very actively to improve the legal framework for leasing: the State Duma is considering amendments to both the Federal Law on Leasing and the Russian Tax Code, as well as developing new accounting standards for leasing transactions.

The amended Law on Leasing ought to incorporate all of the various leasing statutes that are now scattered among numerous regulations. The Law must also be brought into line with the Russian Civil Code and international norms. This is the only way to create a clear legal framework for leasing in Russia.

In order to promote the growth of leasing, the Russian government will also have to create a more favorable tax regime - one that recognizes leasing as a special tool for acquiring fixed assets. While it might seem at first glance that tax benefits for leasing will reduce the government's tax revenue, in actual fact they will stimulate the growth of industry, which in turn will generate greater tax revenue and lead to a rise in employment.

If common sense prevails and the Russian government introduces the necessary changes to its leasing regulations, then financial leasing, which has already proven itself to Russian industry, will continue to grow.

In conclusion, what can you tell us about the Leasing Development Group’s plans for 2001?

As I said earlier, we will continue all of our main programs. This year we will be holding leasing seminars in Moscow, St. Petersburg, Krasnodar, the Russian Far East and other regions. Our specialists will continue to provide
consultations, both by telephone and in person, on various aspects of leasing. The most difficult and frequently asked questions will continue to be included in the Q&A section of the Leasing Courier and on our web site at http://www.ifc.org/russianleasing.

By the end of the year, our specialists will prepare their annual reports on leasing in Russia and changes in leasing legislation. We will also continue to update our Directory of Russian Leasing Companies. In order to make our publications as complete and accurate as possible, we invite anyone with an interest in the Russian leasing industry to send us their own comments and materials.

Our goal is to make information about leasing more accessible to everyone, so we will continue to provide all of our information, including publications, seminars and consultations, free of charge. This is made possible by our sponsor, the Canadian International Development Agency.

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The Canadian International Development Agency (CIDA) is the Canadian Government’s Agency for technical assistance. In partnership with other international organizations, Canadian non-governmental organizations, private companies and individuals the Agency provides assistance to economies in transition. CIDA helps these countries to effectively redistribute their resources and create basic mechanisms needed for developing a stable market economy and a modern democracy and, in the long run, to mobilize investments and expand foreign trade. In 1995 CIDA started implementing a program of assistance to the countries of Central and Eastern Europe including Russia. CIDA’s priority lines of assistance to Russia include the transition to a market economy and the establishment of foreign trade linkages, the development of democratic institutions, the improvement of safety levels in nuclear plants and regional development.

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TRAINING NEWS

Alexei Trepykhalin, Training Manager

The Leasing Development Group held a seminar on «The Principles of Leasing» in the city of Cheboksary on December 7, 2000, on the invitation of the government of the Republic of Chuvashia. The purpose of the seminar, which was organized by the Chuvashia Chamber of Commerce and Industry, was to help local leasing companies and to inform potential lessees about the benefits of leasing as a form of investment. Topics included the following:

- The concept of leasing and its benefits. A survey of the Russian leasing market
- A survey of Russian leasing laws
- The stages of a lease. How to choose a leasing company
- The main provisions of a lease agreement
- Special aspects of executing a lease agreement
- Guaranteeing a lease agreement
- Taxation and bookkeeping for leases

Aleksandr Mikhailovich Vorotnikov, the Republic of Chuvashia’s Minister of Economics, noted in his opening speech that the Republic’s main industries — machine-building, metalworking, electric power, chemicals, and food-processing — as well as its infrastructure and agricultural sector, all need to modernize their machinery — and leasing is one of the cheapest and most effective ways for them to do so. The President of Chuvashia’s Chamber of Commerce and Industry, I.V. Kustarin, supported the minister’s statements and added that leasing is especially important to those enterprises that have already established themselves but wish to modernize their production and expand their businesses.
Leasing began to take root in Chuvashia in the 1990s, when various new government agencies began to support the growth of small and medium-sized enterprises. The Chuvashia Small Business Leasing Company was formed in June 1998 with support from the Chuvashia Fund for the Support of Small Entrepreneurship and the Chuvashia Ministry of Economics, then headed by Anatoly Gennadevich Aksakov (Chuvashia's current representative in the State Duma). The Small Business Leasing Company has been working successfully for over two years, supplying local businesses with modern equipment from many different regions of Russia. According to the leasing company’s general director, Oleg Aleksandrovich Nikolayev, the republic’s leasing market has a lot of potential but is currently hampered by the instability of Russian laws and the low level of awareness among local businessmen regarding the financial benefits of leasing.

Those who attended the seminar noted that it was an important step towards the further development of leasing in Chuvashia.

The Leasing Development Group held another of its seminars on «Risk Minimization for Leasing Transactions» in the city of Moscow from December 20-21. The seminar, which included presentations on the economic, legal and financial aspects of leasing, drew representatives of 48 leasing companies and financial institutions from 19 regions of Russia.

The greater part of the seminar was devoted to analyzing the kinds of risks associated with a leased asset and the various ways of minimizing these risks. Participants were particularly interested to learn more about liquidity and ways of reducing risks while still allowing for a reasonable payment schedule.

Since the instability and inconsistency of Russian laws continue to cause problems for the Russian leasing industry, much of the seminar was devoted to ways of guaranteeing a lease agreement and minimizing the attendant legal risks.

The seminar’s organizers tried to draw general conclusions from the collective experience of Russian leasing companies. The speakers analyzed leases step by step, highlighting the important risks that arise at each stage and suggesting various ways of managing and minimizing these risks. Participants were given practical exercises that closely simulated real situations. By solving these exercises together, the participants were able to share their practical knowledge and experience.

Not only did participants receive training in risk management, they also had the opportunity to meet with colleagues from different parts of Russia, discuss their common problems, and establish useful business contacts. You can read the participants’ own accounts of the particular risks they faced in this edition of the Leasing Courier.

The organizers and instructors also gave individual consultations to seminar participants and distributed educational materials, including the slides and practical exercises that had been used during the seminar. These materials will soon appear under the «Training Programs» section of our website. You can also obtain hard copies of the materials by contacting the Leasing Development Group.

FUTURE TRAINING SEMINARS

The Leasing Development Group plans to hold several training seminars over the next three months.

On March 1 we will hold a seminar on «The Principles of Leasing» for the Ice-Cream Producers’ Association in Moscow. This will represent an important step in our growing cooperation with the professional associations of the Russian Chamber of Commerce and Industry.

The Group is eager to expand its educational programs into new regions where leasing has begun to catch on. One such region is
We asked the participants from our seminar on «Risk Minimization for Leasing Transactions», held in Moscow last December, to tell us about the risks that they have encountered in their businesses. In this section of the Leasing Courier, we present excerpts from these interviews, in which seminar participants explained the specific nature of the risks they encountered and how they attempt to minimize them.

Maxim Yurevich Pestov, Director, Stek Leasing Group (Tomsk):

Stek was formed in 1991 as a supplier and installer of computer software for a variety of industries: education, company management, economics, etc. Six years later, in order to expand its sales, the company formed a leasing group and obtained the necessary leasing license. Today, we sell all of our main products (mostly computers and telecommunications systems) through leasing. We finance our leases with bank loans and sometimes with our own capital. Since 1997 we have signed over $5m in lease agreements and currently have $1m in active leases.

In the beginning we were not particularly concerned about risk, since most of our clients, such as Sberbank, were large and reliable. But as our client base continued to grow, so too did the risk involved.

I think these seminars help us put our knowledge into a useful framework and give us a clearer picture of the risk involved in leasing in general.

Because our clientele is not very diversified, our first concern is portfolio risk. But we have managed to keep this to a minimum. First of all, we manufacture and sell the equipment ourselves, so it's easy for us to re-sell it if the lessee defaults. Second, we make up for rapidly falling

Correction:

In our last issue (#12) we wrote that the Knyazev bakery in Voronezh leased a Musson-Rotor 9.7 rotary oven from Samara. In actual fact, these rotary ovens are manufactured in Saratov by the Voskhod Research and Manufacturing Company. Voskhod specializes in equipment for bakeries, flour refineries, confectioneries, macaroni plants and sausage factories. In addition to rotary ovens, Voskhod also manufactures layered ovens, press mills, kneading machines, meat-smoking units and production lines for bread loaves (a total of over 50 different kinds of machinery). You can learn more about Voskhod on the Internet at http://voskhod.renet.ru or by calling the company in Saratov at (845-2) 24-27-43, 24-78-73, 24-77-21. You can also reach the company's representative office in Moscow at (095) 911-00-12.
prices on the computer market by keeping all of our leases as short as possible. When drawing up the payment schedule we try to make sure that we recover 50-60% of the contract sum within a year, while the total lease period never exceeds three years. Thanks to the specific nature of our portfolio, we never need to insure ourselves against the risk of default; we only need to insure our equipment against damage. So this is how we overcome the risk of leasing.

Natalia Viktorovna Kha-zova, Leasing Consultant, Tomsk Leasing Center (Tomsk):

The Tomsk Leasing Center was formed in September 2000 on a leasing-development grant from the Eurasia Fund. The Center does not actually lease any equipment: it only provides information and consulting services that aim to promote leasing among local businesses. We have already held two seminars on «How to Evaluate a Lease and Draw up a Successful Business Plan.»

Although several leasing companies are currently registered in the Tomsk region, only one, Stek Leasing Group, is currently active, and this particular company has already learned quite well how to minimize risk. There are also four banks in the region that have leasing subsidiaries. For the most part, these subsidiaries serve the interests of their parent banks.

What most enables leasing companies to minimize risk is the fact that they retain ownership of the leased asset for the duration of the lease — though additional collateral never hurts, of course.

I should mention the Tomsk Leasing Company. In spite of the notorious crisis of 1998 and the company’s own internal problems, it is once again entering the local leasing market and has begun to offer its clients a wide range of leasing plans. The regional government finances, or at least guarantees, most of the company’s leases, but not until each project has been thoroughly analyzed and the riskier ones have been weeded out. This is how the Tomsk Leasing Company minimizes its risks.

Speaking of the risks involved in leasing, I would like to point out that trying to eliminate these risks altogether and ensuring that you are perfectly safe at every step will get you nowhere. We have already heard complaints from clients who were unable to get support from local banks. Their main gripe with the banks was that they were totally unwilling to take any risk. Of course banks, as well as leasing companies, often have good cause to be wary of new proposals. But they must also remember that they are living in the real world, not in some kind of ideal model. I think they need to put themselves in their clients’ shoes as well; after all, their clients cannot possibly provide guarantees for every kind of risk. In my opinion, it would greatly expedite the development of leasing in the region if all of the parties involved would look for mutually acceptable compromises on the assessment of a project’s risk.

Sergei Vladimirovich Golodov, head of the Long-term Loans and Investment Department at V Bank (Moscow):

The leasing market needs reasonable resource costs. The reason why Russian banks so often refuse to give long-term loans is because they themselves do not have access to long-term resources. No one wants to risk leaving his money in a Russian bank for long, so most of the banks’ resources are not available for more than a year. You simply cannot finance serious long-term projects with these kinds of resources. You

It would be very helpful if future seminars looked at ways of evaluating collateral and its liquidity, as well as the procedures for confiscating collateral and selling it. These questions will always be current, as new subtleties creep up all the time. It would be especially interesting to discuss these questions from a practical, rather than theoretical, perspective, so that participants could share their practical knowledge and experience.
need to have a source of cheap, long-term funds - nothing but a dream for most Russian banks. While a giant like Sberbank can afford to invest in long-term projects, a small bank like ours cannot, especially since the crisis of 1998. That is why we need partners - possibly Western banks or companies - with whom to share the risks.

The biggest risk facing a bank are the borrower’s poor financial condition and his lack of liquid collateral. Even the companies that come to us in decent financial shape, with good turnover and a clean credit history, usually turn out not to have sufficient collateral to secure even a three-year loan. And what they offer is usually some kind of “conditional”, non-liquid asset that would be difficult to confiscate and sell, and in any case would barely cover the principal sum of the loan, never mind the interest. This is the problem that continues to vex Russian banks.

Oleg Vasilevich Novikov, general director of V-Register Leasing Company (Moscow):

V-Register has been in the leasing business since 1996 and has assiduously avoided any kind of narrow specialization. Most of our projects involve highly liquid and widely consumed equipment, such as automobiles and computers. At the moment we are also considering some interesting proposals for food-processing equipment. Our bank, which was founded by Agroprombank [Agricultural Bank] of Russia, has worked with agricultural producers and food-processing companies for several years and has developed many useful contacts. By sharing its knowledge of the industry with us, the bank makes it much easier for us to find reliable lessees. Our client base simply mirrors that of V Bank.

Being the subsidiary of a bank has other advantages as well. We, the leasing company, are the legal borrower, so the bank’s risk lies with us. But since we are also the bank’s subsidiary, the bank works very closely with us on every project, and this helps us avoid many of the risks that we would face if we were fully independent. For example, the bank’s financial experts can help us analyze the financial condition of potential lessees. This also means that we save on expert staff.

Working in tandem with the bank allows us to optimize our relationship with our clients. For our part, we can offer our potential clients the services of V Bank’s substantial branch network, which numbers 62 throughout Russia, including the major industrial centers.

Dmitry Valerevich Gorizontov, General Director of Petersburg Leasing Company (St. Petersburg):

Petersburg Leasing Company was established in 1997 and specializes exclusively in financial leasing. We lease a wide range of equipment, including vehicles, equipment for the machine-building and radio electronics industries, and various kinds of production equipment. We finance our leases either with bank loans or our own capital.

The biggest risk that we face has nothing to do with lessee default or deals gone wrong, but rather with the instability of Russian tax laws. Sudden changes or inconsistencies in the law can lead to situations where our clients, auditors and financial specialists each have a different interpretation of our financial agreements. Although all three parties share a common vested interest, they can’t always agree on their interpretations, so we often have to think up some kind of compromise.

The second risk that we have to deal with is the specificity of the production equipment that we lease: it is often so specialized that we simply cannot find another buyer if the lessee defaults.

When we’re dealing with expensive equipment, such as oil refinery equipment, the deal is usually backed by a large financial group that is in a better financial position to meet its obligations than a small, independent company. Working with the latter is always riskier. Over the years our deals have become more and more complex. We started out small, leasing standard automobiles; then we moved on to tractor-trailers and finally customized trucks. Most of the
manufacturing equipment we lease, like meat-packing or machine-building equipment, also has to be customized to suit each client’s needs. And the more specialized the equipment becomes, the higher the risk, since customized machinery is difficult to sell on the secondary equipment market. The only way to lower the risk is to try to sell the equipment through a specialized company that knows the used market and its potential buyers well. It might be useful to have occasional seminars on these kinds of questions and to follow trends in the secondary equipment market.

Marat Rigoyevich Ovchyan, Financial Director of Smolensk Business Development Center (Smolensk):

The Smolensk Business Development Center has been in the leasing business since 1996. It works closely with three partners: a credit cooperative, the regional Business Development Fund, and the Center for the Support of Entrepreneurship, all of which provide small loans. This partnership enables all four organizations to coordinate their efforts and optimize their current expenses, thereby keeping more funds in circulation. When we started five years ago, we had 1.5 million rubles’ worth of lease agreements. Since then our profits have enabled us to quadruple that figure.

All of the risks that were discussed during the IFC seminar apply to our business as well, but with one proviso: we are dealing with very small loans and our diffuse structure allows us to diversify the risk. All of our services are oriented towards small business. The average value of our contracts is 80,000 rubles. The fact that the loans are relatively small and short-term means that we have a high turnover rate for finance and can serve a larger number of clients.

It’s hard to specify what our biggest risks would be. Like everybody else, we suffer from the instability and inconsistency of the legal framework for leasing, especially where taxes are concerned. The unfortunate fact is that Russian laws can be interpreted at random. Even if we follow the law to a T, we know that a government official can come at any time and take a different view of things. The tax authorities in particular seem to be rather ignorant of their own laws. We can always prove our innocence in court, but that takes time, money and a great deal of effort. Should we call this kind of problem a «risk», or is it just one of those «unofficial costs» of doing business in Russia?

As for the risk of default, I think it is much less of a problem with leasing than with bank loans, since leases are always guaranteed by the leased equipment itself. Though it may be difficult to dismantle the equipment, transport it and find another buyer, the mere threat that we might come one day and repossess it usually keeps our clients in line.

In fact, we rarely confiscate equipment. We would only do so if the equipment were easy to sell on the used market and we already had another buyer. We once confiscated a pickup truck, for example. We only managed to get a third of its value, but the whole procedure took less than a day.

Another way that we guarantee our leases is by demanding additional collateral, even if it has little or no liquid value. Our clients have small incomes and are totally dependent on mini loans and affordable leases to keep their businesses afloat. Therefore, even if the collateral has no market value for us, the client may be loath to lose it, since his livelihood depends on it. When we negotiate our leases, we always try to make sure that the lease payment schedule is manageable for the client. Rather than leaving him broke at the end of the month, we want him to keep at least a half or two thirds of his revenue...
to cover his other expenses and try to expand his business. It's better for us and our clients if we can establish a friendly partnership. In order to ensure our mutual benefit, we do everything we can to help them succeed and overcome the obstacles in their path. Let me give you an example. A local safety inspectorate decided, without any grounds whatsoever, to close down one of our clients, a dairy factory situated in a remote village. We appealed to the regional safety inspectorate and insisted that they visit the site and conduct their own impartial inspection. They did so, and the dairy was promptly reopened. Who but a leasing company would take such good care of its clients? Surely not the banks. And that is exactly why many of the banks' customers end up coming to us instead.

Aleksandr Nikolayevich Kukolenko, General Director of Ural Leasing (Chelyabinsk):

Ural Leasing was formed in 1995 under the auspices of Promstroy Bank. In the early days, most of its clients were banks, but it has since become a much broader company, financing its new leases with both bank loans and its own capital. We prefer medium-sized leases, but we sometimes undertake larger projects as well - up to 5 million rubles.

There are twelve registered leasing companies in Chelyabinsk, but only three of them are active. We do not have a lot of competition. The region recently initiated a Program for Investment through Leasing, which will funnel some very substantial funds into modernizing regional industry, so we hope to get a lot of new business in the near future.

We consider our biggest risk to be lessee default. In order to avoid it, we do everything that was suggested during the IFC seminar: we analyze the potential lessee's solvency and reliability, we draft legally enforceable contracts and we require a variety of guarantees. Thanks to these measures, we have had only one case of non-payment so far, involving a lessee who had fallen a few hundred thousand rubles into debt and had been struggling for two years to keep up with his payments.

I think future seminars should devote more attention to some of the legal pitfalls of guarantees. For example, there is a lot of confusion about the legal aspects of lease agreements that are backed or financed by the government. As attractive as government backing may be, a lot of us are reluctant to get involved in such projects because the ground-rules are so unclear. Too much depends on federal and regional legislation which, alas, keeps changing. We would be very interested to hear what the legal experts and other practitioners have to say about this matter.

Valeriy Aleksandrovich Kvitko, Head of the Leasing Department at the Municipal Investment Company (Krasnodar):

We started leasing in 1998 in the name of the Moscow Leasing Company, whose local representative we continued to be until April 2000. Through us, the Moscow Leasing Company leased over 200 automobiles to local enterprises. Last April, having already gained a fair amount of experience, we obtained our own three-year leasing license and formed the Municipal Investment Company. Our founders included the Municipal Finance Department of Krasnodar and a variety of private investors. From the outset our main line of business was auto leasing, and by the end of the year we had leased 38 vehicles. Now we are just beginning to expand our portfolio with leases for dry-cleaning and auto repair equipment. Over the last three months we have signed 20 new leases worth a total of almost $80,000. About a third of
I would like to thank the IFC for its Leasing Courier, every issue of which sheds light on different aspects of leasing and helps us develop strategies for dealing with problems before they arise. I would like to see more articles about accounting. It is very difficult for leasing companies to keep track of changes in accounting regulations and general practices, as this is a full-time job. In this regard, the Leasing Courier is an invaluable resource.

these contracts are purely ours, while the remainder are still agent agreements. We are now trying to find sources of long-term funding.

We try to work with companies that we have already worked with in the past and that have good credit histories. This helps us reduce a lot of the risk. It’s probably impossible to eliminate risk altogether, but one can certainly try to minimize it.

Among the risks that we actually face, I would say that the biggest is lessee default. We have already been forced to repossess some leased equipment. As everybody knows, Russian law prohibits lessors from leasing equipment once it has already been leased, so we must try to sell repossessed assets on the used equipment market. Fortunately, automobiles are a highly liquid form of asset, so we can always find a buyer if we need to.

The second biggest risk is the instability of federal laws. As we all know, the federal government has been planning to abolish the use of accelerated depreciation. This will have a very negative effect on leasing in our region. Another problem is the Central Bank’s refinance rate: since most of our leases are financed by Russian banks, any increase in the refinance rate would hurt our lessees, possibly even ruin them and lead them to default on their agreements, which puts us at risk as well.

In order to foster the development of leasing in Krasnodar, we are trying to facilitate the creation of a more favorable legal framework in the region. Our legislative assembly has already passed a number of acts that will help stimulate leasing among regional businesses. It has also passed measures of government support for leasing, including both general measures, such as earmarking funds and providing state guarantees, and more specific ones, such as reducing payments into the regional highway fund (in the year 2000 it exempted us from the vehicle acquisition tax and lowered our property and highway taxes).

Thus, as these interviews show, everyone in the leasing business faces some kind of risk. One’s ability to overcome these risks depends on a number of factors, but most of all on one’s own awareness: knowing which problems to expect and how to avoid them. The purpose of our seminars is to explain the various risks that can arise at each stage of a lease agreement and how to minimize them. We published a series of articles on the topic of risk management in last year’s Leasing Courier (#9-10). Below we present yet another article on the subject.

HOW TO BUILD A LEASING PORTFOLIO AND MINIMIZE THE ATTENDANT RISKS

Veronika Shtelmakh, Economist
IFC Leasing Development Group

Part II of our series on leasing portfolios, continued from LC#6 (12) 2000.

The Geographical Approach

For obvious reasons, most leasing companies prefer to do business close to home. They find it daunting to set up shop in other regions unless they have local partners. The ones that can afford to do so are, for the most part, affiliated with banks or industrial groups that have their own broad networks.
When considering whether to sign a lease with a company in another region, lessors have to bear in mind that the overhead costs for «long-distance» leases are usually much higher — not only in the beginning, but for the entire duration of the contract. Consider, for example, RUST Leasing Company in St. Petersburg, which insists on conducting monthly inspections of all property offered as collateral; imagine how much these inspections would cost if the properties were located in distant regions.

How to Minimize the Risks

Leasing companies can keep their overhead down by concentrating their business in one region, thereby saving on business trips, long distance telephone calls and so on.

On the other hand, this limits the scope of the company's clientele and makes it highly vulnerable to «local risks,» such as sudden changes in the business climate within its own region. Furthermore, the arrival of new competitors in the region can drastically weaken the company's position.

The «Type-of-Company» Approach

In many regions there are leasing companies that specialize in working with small businesses. Most of these companies are financed by agencies like the regional business-development funds. But even without this kind of backing from development agencies, leasing companies do not have to limit themselves to doing business with large firms. Vladimir Aleksandrovich Kolomeitsev, head of the Moscow Leasing Company, believes that working with small businesses is ultimately no riskier than working with large ones, since it allows one to spread one's risks among a larger number of lessees.

One also has to remember that Russian small businesses are defined by the number of people they employ and their volume of shares. How much profit they earn is another matter. Some businesses that are legally defined as «small» actually generate more cash than some large but idle industrial firms. The most important thing, according to Mr. Kolomeitsev, is to measure your investment against the lessee's actual cash flow. If you do that, you can continue to work with small businesses, rather than large ones, without subjecting yourself to any greater portfolio risk.

Of course many leasing companies do subject themselves to greater credit risk by working with small and medium-sized companies. Since smaller companies tend to be relatively young, they often lack an established credit history and therefore have little access to finance.

Another important consideration when working with small businesses is the fact that, in most cases, the value of the lease far exceeds the company's current turnover, while the leased asset often constitutes the company's principal means of production. These small companies make their lease payments out of the funds they generate by using the leased equipment. This means that they will not remain solvent unless the project itself succeeds. Therefore, by choosing to do business with these companies, lessors are also taking on all of the attendant project risks.

How to Minimize the Risks

Leasing companies that specialize in working with small businesses need be especially thorough when analyzing a potential client's business plan, particularly the marketing section. After all, the sales forecast is the best starting point for calculating a lessee's potential cash flow.

The «Amount-of-Investment» Approach

Over time, most leasing companies find themselves specializing in projects of a particular scale, depending on the kinds of equipment they lease and the types of lessees with whom they work. There are several recommendations that we would like to make regarding the amount of investment involved in leasing projects.

When deciding upon the minimum value of their projects, leasing companies generally aim at least to recoup their operating expenses. As for setting a maximum value, we can cite as an example one of the leasing companies that we helped found, which limits the share of borrow-
ers in its leasing portfolio: one borrower must not constitute more than 20% of the company's portfolio, while one group of companies must not constitute more than 25% of its own capital.

**The IFC's Recommendations**

The International Finance Corporation has been in the leasing business for over twenty years, during which it has taken part in 67 leasing projects in 36 countries. One of the lessons that it has learned over the years is the importance of limiting the share of one company or group of companies in a leasing company's portfolio, as well as limiting the range of equipment that the leasing company leases.

**Restrictions on Industries or Types of Equipment**

Some of the leasing companies that the IFC has financed in the past have specialized in particular types of equipment (e.g., medical equipment). But this has been more the exception than the rule. The IFC generally prefers to invest in more diversified companies, where no single industry constitutes more than 25-30% of their leasing portfolios.

The IFC usually places clear restrictions on the types of equipment that its leasing companies may lease. Leased assets must be entities that are easy to identify and repossess and that can be sold on the second-hand market or leased again upon expiration of the original lease. If leasing companies wish to lease any kind of specialized or quickly-obsolescent equipment, they must exercise extreme caution. Most of the leasing companies financed by the IFC do not deal in real estate.

**Restrictions on Suppliers**

Not only does the IFC avoid investing in any leasing companies that have direct affiliations with equipment vendors, it also requires its leasing companies to diversify their pool of suppliers. The charter of one IFC-founded leasing company in Latin America actually required it to limit the share of individual suppliers in its leasing portfolio to 50% by the end of the first year and 40% by the end the second.

**Restrictions on the Value of Leased Property**

When the IFC invests a new leasing company, it often writes the following clause into its charter: the value of a lease must not exceed 40-50% of the lessee's total assets.

Naturally each investment project has its own special features. For each new leasing company, the IFC creates a new operating agreement to regulate its daily activities. On the whole, the IFC's approach to building a leasing portfolio is to maximize diversification in terms of both the types of equipment that are leased and the lessees themselves.

**Specialization or Universality?**

As we mentioned at the beginning of this article, Russian leasing companies are not always free to choose strategies for building their lease portfolios. The composition of their shareholders and their sources of funding play a major role.

However, the Russian leasing market also has its share of independent leasing companies that have chosen narrow specialization as their development strategy. It is worth noting that several of these companies are now planning to diversify their portfolios. They are clearly trying to conduct a policy of «reasonable diversification», which would enable them to expand their pool of clients and lower their portfolio risks without driving up their overhead expenses by requiring additional staff and training programs.

Both specialized and universal leasing companies must be constantly vigilant about the development of their portfolios. They should evaluate the current composition of their portfolios, keep an eye on market trends, and make predictions about the development of their particular industries. That way, by detecting unfavorable market trends, a leasing company can try to adjust the composition of its leasing portfolio and avert some of the risks.

*The author would like to thank all of the leasing company directors who were so kind as to answer questions about their businesses. We are especially grateful to Laurence Carter, Principal Investment Officer and Co-Chairman of the IFC Leasing Development Group, for shedding light on the IFC's investment policies toward leasing companies. Special thanks also go out to I.M. Chuvilyova, Head of the credit analysis department of RG Leasing, for helping prepare this article.*
Until the beginning of 2001, all lease payments from small businesses were exempted from VAT. This was originally meant as a tax break. But at the same time, leasing companies were not allowed to claim tax refunds for the VAT they paid when purchasing leased assets, and this raised a leased asset’s book value. Naturally, leasing companies passed this expense on to their lessees in the form of higher lease payments. As a result, the tax break for small businesses simply wasn’t working; on the contrary, it was actually raising the cost of leasing. As of January 1, 2001, when Chapter 21 (“Value-Added Tax”) of the Russian Tax Code went into effect, lease payments from small businesses became subject to VAT. However, it remains unclear whether this applies to lease agreements that were signed prior to December 31, 2000. Are lease payments under these agreements subject to VAT if the lessee is a small enterprise? Can a leasing company claim a VAT refund on leased assets purchased prior to December 31, 2000?

As this article went to press, we had not yet received any official answers to these questions from the tax authorities.

Since there are two issues involved (VAT refunds and VAT levied on lease payments), we might assume the following possibilities:

1. Small-business lease payments on leases signed prior to December 31, 2000, will be exempted from VAT; but leasing companies will not be able to claim VAT refunds for purchased assets (i.e., the old rules still apply to active leases signed prior to December 31, 2000).

2. Lease payments will be subject to VAT, and leasing companies will not be able claim VAT refunds for purchased assets.

3. Lease payments will be subject to VAT, but leasing companies may claim VAT refunds for purchased assets.

As the matter stands today, there are no clear grounds for applying the VAT regime that was current when the lease was signed. However, one possible justification for doing so is Article 9 of Federal Law #88-FZ on State Support for Small Entrepreneurship in the Russian Federation (June 14, 1995). This article stipulates that “in the event that changes in tax law create less favorable conditions for small businesses, the latter may, during the first four years of their operation, follow the tax regime that was in effect at the time of their foundation.” Thus, if a small enterprise has been in business for less than four years and can prove that a 20% increase in its lease payments has a negative effect on its financial situation, it may claim the right to continue under the old tax regime. However, one has to admit that this is hardly likely to succeed.

The second possibility is that the new tax regime will be applied to old leases and lessors will not be allowed to claim VAT refunds for purchased assets.

A change in tax laws may serve as a justification for altering the terms of a lease agreement, since it is clearly a significant change in circumstances. Since the leasing company will have to pay VAT out of the lease payments it receives, it has the right to increase the sum of these payments by the sum of VAT.

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1. Article 5, Clause 1, Paragraph Ya of Law #1992-1 on Value-added Tax (Dec. 12, 1991)
2. Chapter 21, Article 151 of the Tax Code does not list lease payments by small businesses as one of its tax-exempt transactions.
However, this could be damaging to the lessee. It will only be acceptable to the lessee if it does not actually raise his cash outflow; that is, if the VAT he pays to the lessor will reduce his overall taxes. But in most cases, small businesses produce goods that are subject to relatively low VAT, such as food products, children's clothing, etc. For them, raising the lease payments by the sum of VAT will make the lease more expensive and possibly lead them into insolvency.

The third possibility is that VAT will be charged on leased payments, but the lessor will be allowed to claim VAT refunds for purchased assets. However, because the lessor will already recover (either partially or fully) the VAT that he paid to the equipment supplier by raising the sum of the lease payments, he should not be eligible for a full VAT refund. He should only be allowed to claim a refund for the amount of uncompensated VAT.

The question is how to define uncompensated VAT.

Let's consider an example of each of the options described above and try to determine how much VAT the lessor should be allowed to claim.

Let's assume that the lessor has purchased a piece of equipment for $1,200, including $200 in VAT. A lease is signed for a four-year period, beginning on 1/1/99, for a sum of $1,800. The turnover tax is 1%; the profit tax, 35%; and the depreciation rate, 25% APR. The asset is recorded on the lessor's balance sheet. This example does not take into account overhead expenses or the use of the leasing company's own capital.

**Option 1: Applying the old VAT regime**

The lessor's total cash inflow over the next two years consists of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease payments over 2 years</td>
<td>$900</td>
</tr>
<tr>
<td>Turnover tax (1% * 900)</td>
<td>-9</td>
</tr>
<tr>
<td>Property tax (2% * ((600+300)/2 + (300/2))</td>
<td>-12</td>
</tr>
<tr>
<td>Profit tax (35% * (900 - 600 - 9 - 12))</td>
<td>-97.65</td>
</tr>
<tr>
<td><strong>Total cash inflow over the next two years</strong></td>
<td><strong>$781.35</strong></td>
</tr>
</tbody>
</table>

If we apply the VAT regime that was in effect prior to January 1, 2001, the lessor's total cash inflow for the next two years will be $781.35.

**Option 2: The lease payments are increased by 20%**

If the lease payments are increased by the amount of VAT (20%), the lessor will simply end up paying this amount to the government, so his cash flow will not change (it will remain at $781.35). However, since the leasing company is now paying more VAT, it will be able to get quicker VAT refunds for assets purchased under other agreements. This would obviously be more advantageous to the leasing company.

As for the lessee, he would not be any worse off as long as he could get a full and timely refund on the VAT he paid through the lease payments. Otherwise, a 20% increase in his lease payments would obviously be detrimental to his business.

**Option 3: Lease payments are subject to VAT, and the lessor may claim VAT refunds for purchased assets.**

The tax authorities may decide to allow leasing companies to claim a partial refund on VAT paid to equipment suppliers. In that case, it will be necessary to define exactly how much VAT is refundable.

The logical solution would be to allow lessors to claim VAT refunds equal to the proportion of lease payments yet to be received. In this example the sum of VAT was $200. Over the last two years the leasing company received only half of the lease payments. Thus, it should be allowed to claim one half of the VAT, or $100.

Since the lessor receives a $100 refund on VAT, the lease payments should be reduced accordingly. The lease agreement should be adjusted and the lessee’s debt should be reduced to $800 (900-100) excluding VAT, and $960 including the tax.

Now let's see what happens to the leasing company's tax flow.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease payments over 2 years</td>
<td>$960</td>
</tr>
<tr>
<td>VAT on the lease payments</td>
<td>-160</td>
</tr>
<tr>
<td>VAT refund towards residual value ((1,200-600) * 16.67%)</td>
<td>+100</td>
</tr>
<tr>
<td>Turnover tax (1% * 800)</td>
<td>-8</td>
</tr>
<tr>
<td>Property tax (2% * ((500 + 250) / 2 + (250 / 2))</td>
<td>-10</td>
</tr>
<tr>
<td>Profit tax (35% * (800 - 500 - 8 - 10))</td>
<td>-98.70</td>
</tr>
<tr>
<td><strong>Funds accumulated over the next two years</strong></td>
<td><strong>$783.30</strong></td>
</tr>
</tbody>
</table>
Thus the leasing company's total cash inflow will be $783.30, as compared to $781.35 under the old tax exemption. If the leasing company is able to recover the full amount of VAT paid on the lease payments ($160), his situation will actually improve.

As we mentioned at the beginning of this article, we have still not received any official response to these questions from the tax authorities. Option 2 (increasing the lease payments by 20% and not allowing lessors to claim VAT refunds on purchased assets) is based directly on the statutes of Chapter 21 of the Tax Code, which has already gone into effect. If this option turns out to be profitable to the lessee, and the lessor decides to claim a VAT refund (Option 3), he will first have to obtain permission from his local tax authorities. Option 1 (applying the old tax regime to leases signed prior to December 31, 2000) cannot be ruled out, but it does seem the least realistic of the three and would also have to be sanctioned by the local tax authorities.

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TAX NEWS

Property Tax

On December 14, 2000, the Ministry of Justice registered Order BG-3-04/389, “Amendments and Additions to Instruction 33 of the Russian State Tax Service, Entitled ‘Regulations Governing the Calculation and Payment of State Property Tax by Organizations’ (June 8, 1995)” (November 15, 2000). This order expanded the taxable base for property tax, effective January 1, 2001, to include enterprises’ capital investment (account 08, excluding investment in plots of land and natural resources, as well as expenditures on the formation of main herds of dairy, feed or draft cattle). All of the Instruction’s amendments were aimed at refining and clarifying the existing regulations for calculating the taxable base for profit tax. Among other things, the amendments confirm an entity’s right to use the results of voluntary revaluations of fixed assets (in accordance with the Accounting Standards of 6/97) when calculating the taxable base for property tax. We should note that this statute...
on revaluation was also contained in an earlier letter from the Ministry of Finance (Letter BG-6-02/288 of April 17, 2000).

Value-Added Tax

On January 1, 2001, a number of amendments to Chapter 21 of the Russian Tax Code went into effect. These amendments, passed under Law #166-FZ (henceforth Law) on December 29, 2000, change the regulations for calculating and paying value-added tax. For the most part, these amendments are of a purely technical nature, but there are several points that demand careful scrutiny.

Article 145, Clause 1 of the RF Tax Code. The Law gives a more concrete definition to the VAT exemption stipulated under Article 145. According to the new version of the Tax Code, companies do not qualify for the exemption unless their revenue for the last three consecutive calendar months was no greater than 1,000,000 rubles (not including VAT and sales tax). The tax authorities consider the exemption valid from April 1, 2001, on the basis of financial results from January - March 2001.

Article 145, Clause 6 of the RF Tax Code. If a taxpayer exceeds the limitations stipulated under Clause 1 of Article 145, he loses his right to claim a VAT exemption and must pay the tax beginning with first day of the month in which he exceeded these limits until the end of the exemption period. The new version of Article 6, unlike the old one, does not allow leasing companies to recapture their VAT exemptions by paying the necessary penalties and fines.

Article 163, Clause 2 of the RF Tax Code. The tax period for taxpayers whose monthly revenue does not exceed 1,000,000 rubles for three consecutive months (not including VAT and sales tax) has been increased to 3 months.

Article 167, Clause 1 of the RF Tax Code. For entities that choose to assume their taxpayers' obligations from the moment of shipment and invoicing, these obligations now take effect on the earliest of the following dates:

1) the day when goods are shipped or services rendered
2) the day when payment is received

The Minimum Wage

The new legal minimum wage was to go into effect as of January 1, 2001, in accordance with Federal Law 82-FZ on the Minimum Wage (June 19, 2000).

The new minimum wage, for the purpose of calculating taxes, duties, fines and other payments in accordance with Russian legislation, as well as for calculating stipends, benefits and other obligatory social payments or for calculating payments under any civil obligations, is now 100 rubles per month.

The new minimum wage for the purpose of regulating actual wages and defining the size of temporary unemployment benefits or workers' compensation is 200 rubles as of January 1, 2001, and 300 rubles as of July 1, 2001.

BOOKKEEPING

The New Accounts Plan

Russian Ministry of Finance Order 94n (Oct. 31, 2000) introduced a new Accounts Plan for bookkeeping and an Instruction for Its Implementation, effective January 1, 2001. Clause 2 of the order allows organizations to switch over to the new accounts plan at any time during the year 2001 as soon as they are prepared to do so. However, in Letter 16-00-13/09 of December 5, 2000, the Ministry of Finance explains

Note:

1 Article 3 of the Law stipulates that it was to go into effect on January 1, 2001, which contradicts Article 5, Clause 1 of the Tax Code.
2 Tax Ministry Order #BG-3-03/447 (Dec. 20, 2000) confirms the Methodological Recommendations for the Implementation of Chapter 21 of the RF Tax Code. The tax authorities' position is laid out in Clause 2.8 of the Methodological Recommendations. In our opinion, it is not well grounded.
3 The tax period for all other taxpayers, as stipulated under Clause 1 of Article 163, is one calendar month.
that if an organization had not switched over to the new plan by January 1, 2001, then it must wait until January 1, 2002, to do so.

Stanislav Kovynyov, Attorney  
IFC Leasing Development Group  
Elena Degtyareva, Financial Analyst  
IFC Leasing Development Group

LICENSING

On February 1, 2001, the Russian Government passed Order 80 on Confirmation of the Statutes for Leasing Licenses in the Russian Federation. Thus, after a hiatus of nearly one year, the government has finally resumed issuing leasing licenses.

The most important points in the new regulations include the following:

• The licensing agency will henceforth be the Ministry of Economic Development and Trade
• Leasing licenses will be granted not only to residents of the Russian Federation, but also to foreign entities
• Licensing fees have been revised: 300 rubles for the application, and 1,000 rubles for the license itself
• Licenses will be granted for five years unless the licensee requests a shorter term
• The information contained in the license register will be made available to any interested party (for a fee of 10 rubles) over the course of three days

The new Statute on Leasing Licenses generally duplicates the regulations stipulated under the Federal Law on Licensing for Various Types of Activity.

We should add that with the expiration of Russian Government Edict 167 on Confirmation of the Statutes for Leasing Licenses in the Russian Federation (Feb. 26, 1996), lessors no longer need to have at least one active lease agreement, nor to engage in leasing as their “primary activity”, in order to obtain a leasing license.

Olga Shishlyannikova, Attorney,  
IFC Leasing Development Group

*The statute is rather ambiguous, however, as it contradicts a whole range of other laws, about which we have written in previous issues of the Leasing Courier.*

FINANCIAL LEASING OF REAL ESTATE

Stanislav Kovynyov, Attorney  
IFC Leasing Development Group

Transactions involving real estate have always been subject to stricter legal control than those involving any other type of property. Financial lease agreements are no exception. In this article, we will examine some important aspects of leasing real estate: in particular, the questions of registering property rights and taxation. (This article uses the English term «leasing» to represent the Russian term «finansovaya arenda (lizing)». This should not be confused with a premises lease agreement which is translated to Russian as a «dogovor arendy».)

But before we address those issues, we would like to focus briefly on some of the more general leasing regulations that have special importance for real estate. One such regulation is Article 665 of the Russian Tax Code, which stipulates that a lessor must purchase the leased asset from a vendor of the lessee’s choosing. This means that leased real estate must be purchased on the basis of a sales agreement, which precludes the possibility of a barter agreement and, more importantly for the real estate market, prevents leasing companies from undertaking their own building projects or investing in the construction of new properties.

The second regulation that has an important bearing on the real estate market, due to the generally higher costs of real estate, is Article 7 of the
Law on Leasing. This article stipulates that the duration of a lease must be equal to or greater than the depreciation period of the leased asset. Considering that it takes a piece of real estate at least ten years to depreciate, even with an acceleration factor of 3, it is highly unlikely that any leasing company would want to invest in such a long-term project under current Russian conditions. However, the legality of the regulation is in any case rather doubtful, as it contradicts the provisions of the Russian Civil Code (Article 610), which take priority over all other civil regulations. According to the Civil Code, the law may only establish the maximum term of a lease, whereas Article 7 of the Law on Leasing attempts to establish a minimum term.

Now let's turn to the topics raised at the beginning of this article.

Official Registration of Property Rights to Real Estate

First let us look at the different terms that are used in various Russian laws to refer to the same legal concepts. Each of the following terms refers to the registration of property rights and transactions involving real estate: «official registration of real estate» (Article 131 of the Russian Civil Code and Article 20 of the Law on Leasing), «official registration of property rights to real estate and their limitations» (Article 131 of the Russian Civil Code and the Law on Official Registration of Property Rights and Transactions Involving Real Estate), and «official registration of leases on real estate» (Article 609 of the Russian Civil Code). Clearly, each of these terms refers to the same thing: official registration of property rights and transactions involving real estate. But the terminology used in the Law on Official Registration of Property Rights and Transactions Involving Real Estate (henceforth «Law») is the most precise and complete.

There is another important point that we should make regarding official registration of leases on real estate. Because they are covered under Chapter 34, Paragraph 4 of the Civil Code, ordinary rent agreements (dogovory arendy) for buildings and structures do not need to be registered unless they exceed one year in duration. Financial leases, on the other hand, must be registered regardless of their duration (Article 609, Clause 2 of the Russian Civil Code), as neither the Civil Code nor the Law on Leasing makes any provisions to the contrary.

Article 8 of the Law on Official Registration gives regional judicial bodies the authority to register property rights and transactions involving real estate within their jurisdictions. In Moscow, for example, this body is the Committee for Official Registration of Property Rights and Transactions Involving Real Estate, while in the Moscow Region it is the Moscow Regional Registration Chamber.

According to Articles 16-18 and 26 of the Law, the parties to a lease on real estate must submit the following documents to the registration agency:

1. Applications from both the lessor and the lessee. If the lease agreement has been notarized, the application should be submitted by one of the parties only.
2. Copies of documents verifying the lessor’s property rights to the leased asset (certified by the entity’s chief executive officer).
3. At least two copies of the lease agreement.
4. Power of attorney for the person who will be responsible for submitting and receiving all registration documents, or a document verifying authorization from the entity’s chief executive officer.
5. The lessor’s and the lessee’s constituent documents.
6. Proof of payment to the registration agency (Russian Government Order 248 of Feb. 26, 1998, sets the maximum registration payment at 50 times the current minimum wage).2

1 There are those who believe that an acceleration factor may only be applied to the «active portion» of fixed assets, which would preclude its use for real estate. In our opinion, this point of view is obsolete, since it is based on regulations that were adopted before the Law on Leasing went into effect. The Law on Leasing allows for the use of accelerated depreciation without any restrictions whatsoever.

2 In order to register a lease for a plot of land on which a building or structure stands, the parties must also submit a survey of the property’s boundaries, indicating the portion of land included in the lease.
Although Article 17 of the Law prohibits the registering agencies from demanding any other document than those listed above, nevertheless many of them also require the following:

- a letter from the State Committee for Statistics confirming receipt of codes
- a certificate of registration with the local tax authorities
- the lessor’s leasing license

Provided that all of the documents are in legal order, the registering agency must register the lease within one month and record it in the unified state register of property rights to real estate.

**Taxes on Financial Leases for Real Estate**

Current tax regulations for financial leases involving real estate do not give clear answers to some questions which, in our opinion, are of crucial importance. As a result, certain questions may arise over the term of the lease; if the parties could resolve these issues before they sign the lease agreement, they could avoid incurring additional expenses later. In particular, we should draw your attention to the danger of having a surplus tax base due to the high value of real estate.

According to Russian law, a leased asset may be recorded on either the lessor's balance sheet or the lessee's. This choice has serious consequences for both parties in terms of profit tax. Let's consider a hypothetical lease. For the sake of simplicity, let's assume that neither party has any income or expenses other than those arising from the lease.

**Option A: The leased property is recorded on the lessor's balance sheet**

According to Government Order 552 (Aug. 5, 1992), depreciation charges on new fixed assets may be included in production costs, thereby reducing the lessor's taxable base. Considering the relatively insignificant value of depreciation charges for valuable assets with long depreciation periods, let’s take the following numbers as an example and see what happens to the lessor’s tax situation:

- the property is valued at $10,000
- the depreciation rate is 1.2%
- the acceleration factor is 3
- the term of the lease is 5 years

In this example, the annual depreciation charges come to $360, while the lease payments cover $2,000 worth of the property’s value. Thus, the leasing company’s revenue will exceed its expenditures by $1,640 during each fiscal period. This sum will be subject to profit tax, currently set at 30%. In all likelihood, tax expenditures will be included in the lease payments, thereby raising the cost of the lease.

**Option B: The leased property is recorded on the lessee’s balance sheet**

According to Russian Ministry of Finance Order 15 on Bookkeeping for Lease Agreements (Feb. 17, 1997), lessees may include depreciation charges, but not the full sum of the lease payments (as stipulated under Article 2, Subclause Ch of Government Order 552), among the expenditures that reduce their taxable base. Consequently, the lessee finds himself in a similar situation to the one above: the lease payments significantly exceed the sum of expenditures that he may include in his production costs. Thus the lessee’s taxes may also increase dramatically.

It is therefore very important for the parties to calculate their expected income and expenditures for the coming fiscal periods before fixing the lease payment schedule and deciding on whose balance sheet to record the leased property.

**Conclusion**

Although current Russian legislation does not give any clear answers to the questions posed in this article, it does give lessors and lessees the freedom to choose the most optimal arrangements for leasing a piece of real estate, based on their financial circumstances, their practical needs and their mutual advantage in terms of cash flow.
RUSSIAN PRESS DIGEST

The city of Samara hosted a conference on The Prospects for Leasing in the Volga Region. The conference was organized by the Samara Regional Department for Economic Development and Investment, the Samara Regional Department for Small-Business Development, and the joint-stock company IRM Center. The conference was devoted to both the practical and the theoretical aspects of leasing on the Volga, such as government regulation, tax laws, accounting standards, sources of long-term finance, risk management and insurance. Regional governments, leasing companies, financial institutions, insurance companies, and corporate and private investors all sent representatives, as did a number of equipment manufacturers and buyers from the automobile, construction, and timber industries. More than 50 leasing companies from Togliatti, Cheboksary, Samara and Moscow took part in the conference.

Volzhskaya Kommuna [Volga Commune], Samara December 1, 2000

Russia's domestic airlines should use Russian planes, announced Aleksandr Akimov, general director of Domodedovo Airlines, at a press conference on the creation of Russia's first air carriers' alliance. According to Mr. Akimov, the absence of normal leasing mechanisms prevents Russian airlines from acquiring new aircraft. A new Il-96 costs around $25m. Leasing companies have proven willing to finance the production of new airplanes, but the high cost of bank loans in Russia adds around $35m to the cost of each aircraft over the term of a seven-year lease. These costs are ultimately passed on to passengers, many of whom are forced to choose cheaper modes of transportation. Flying half-empty planes dramatically increases the cost of service. At the same time, Aeroflot, which leases foreign aircraft at discounted rates, can afford to operate loss-making flights on the domestic market. Boeings and Airbuses now fly to Omsk, Novosibirsk, Vladivostok and Perm. The lease payments on these aircraft go to foreign companies, while Russian aviation languishes without capital. Over the last five years, the Voronezh Aviation Plant has sold only one Il-96. Since 1992, it has produced only four Tu-204s, which were supposed to replace the old Tu-154s.

ITAR-TASS December 6, 2000

Rostselmash has signed a deal with the government of Tatarstan to supply the republic with 200 Don combines. The popular harvesting machines, which are expected to arrive in Tatarstan by March 2001, will be distributed by state-owned Tatagropromkomplekt Leasing Company. Tatarstan managed to negotiate the lowest price ever paid for the combines, in part by placing their order during the winter season, when demand for farm machinery is relatively low. The republic plans to negotiate a contract for yet another 200 harvesters, but not until later this spring.

Vremya i dengi [Time & Money], Kazan December 7, 2000

The Russian government has approved a new plan to regulate the civil aviation industry. This announcement came from Yury Koptev, general director of the Russian Space and Aviation Agency. Russian Information Agency Novosti reported that the plan dealt with three important questions involving state support for the Russian aviation industry. The plan calls for increased funding for research and development centers, which no Russian aviation company can presently afford without some kind of outside support. The government's plan also calls for more state support for aviation leasing.

RIA Novosti December 7, 2000

The government of Tatarstan has decided to stop giving direct subsidies to regional manufacturers; henceforth, it will only give bank loans, announced Prime Minister Rustam Minnikhanov. The government is prepared to help regional companies acquire new technologies and modernize their facilities, but only by giving them loans on favorable terms from a special business development fund. Tied credit for agriculture is a thing of the past. In the year 2000, the government of Tatarstan invested
2.3 billion rubles in regional agriculture, gave 4.8 billion rubles in tied credit and leased around 3,000 piece of agricultural equipment to regional farms. No other industry enjoyed this kind of support in Tatarstan last year. At the same time, the government has discovered that regional farmers who received tied credit in the form of fuel and fertilizers were selling these materials to farms in other regions and receiving grain, meat and milk in return. The region’s farmers have not been very conscientious about paying back their loans, either. According to Primer Minister Minnikhanov, only 70% of the tied credit has actually been paid back so far. From now on, only credit-worthy farms (around half of the total) with sufficient collateral will be eligible for loans from commercial banks. Twenty percent of the region’s farms will never be able to pay back their current loans, and it is high time for them to be dealt with by the republic’s Bankruptcy Committee.

Vremya Novostei
December 7, 2000

The government of the Novgorod region has revealed its small-business development plan, «Small Business: Stage Four», for the years 2001-2003. According to Novogordskie Vedomosti, a regional newspaper, the government’s plan, which calls for the formation of new marketing companies, business incubators and leasing centers, as well as consulting services and financial support for small businesses, looks quite impressive compared to programs in other regions: more than 20% of the region’s allocations go towards developing small businesses. The new program will place special emphasis on developing economically promising districts and zones. The program’s other priorities include helping small businesses obtain loans and new technologies, holding a competition for (as well as financing) leases in the agricultural sphere, creating a high-tech bank, financing small businesses and providing mini loans to the most promising projects.

Regions.Ru Information Agency
December 9, 2000

Delta Leasing (The US-Russia Investment Fund) has agreed to finance an equipment lease for a new coffee shop to be opened by the ROUZ Company (part of the PaBL Investment Group). According to Pavel Matskin, PaBL” general director, TUSRIF will invest $50,000 in the project. This is already the second time that PaBL has succeeded in attracting investment for its projects: in early 2000 the company was able to obtain a lease for credit card-printing equipment. The new coffee shop, which will seat up to 50 people, is expected to open on the Griboyedov Canal in St. Petersburg during the first quarter of 2001. «The shop might also serve as an informal basis for a stock market club,» says Mr. Matskin.

Delovoy Peterburg, St. Petersburg
December 9, 2000

Uralsibots Bank is prepared to help the Uralmash factory obtain new equipment. The bank’s subsidiary, Uralsibvest Leasing Company, will finance the plant’s lease on a new Penzokompressmach compressor. The new piston compressor will replace the factory’s currently obsolete one and enable it to save vast amounts of electricity. Uralmontazhnadzadka [Urals Assemblers] will install the new equipment, which is expected to arrive in December 2000. The new system should be up and running by February 2001.

Delovoy Kvartal, Yekaterinburg
December 7-13, 2000

On December 14, 2000, the KamAZ plant shipped six new KamAZ-65115 dump trucks under lease to coal-mining firms in the Kuzbass region. The 15-ton trucks’ new design expands their cargo volume to 10.3 cubic meters. This agreement marks the entry of KamAZ’s leasing subsidiary, Avtopromlizing, into the Russian truck market. The leasing company is backed by some of the largest financial institutions in the Republic of Tatarstan, including Tatfond Bank, Avers Bank, The National Bank of the Republic of Tatarstan and Kontinent-Polis Insurance Company. KamAZ has announced its intention to sign several more promising lease agreements, and it has already signed leases for 170 trucks for the first quarter of 2001. These leases are for one-year terms with down payments of 25-30%.

Vremya i Dengi, Kazan
December 15, 2000

The State Duma has agreed to fund a leasing program for Russian civilian aircraft. Due to the government’s budget surplus for the year 2000, the Duma amended its aviation bill to provide $220m in long-term state guarantees on leases for Il-96-300 and Tu-334 aircraft.

ITAR-TASS,
December 20, 2000

The Vologda region took first place in Russia in terms of leasing purchases in the year 2000. The region spent 260 million rubles to procure more than 1,000 tractors and combines (just two years ago
it procured no more than 120 tractors). Nearly all of the machines have been paid off in full, with payments comprising about 90% of the allotted funds. Agropromsnab, which supplies machinery to the region's farms, has begun to sign leases not only with the large collectives, but also with private farmers. The Vologda chapter of the Russian Association of Farmers and Agricultural Cooperatives has been helping local farmers purchase new equipment.

SeverInform, Vologda December 25, 2000

A new Tu-204 aircraft has arrived in Krasnoyarsk from Ulyanovsk. The plane, christened Ivan Yarygin, is the second aircraft in Krasnoyarsk Airlines' fleet to receive its own name. Both planes were acquired under four-year leases. Next year the airline plans to name a new plane after a yet unnamed illustrious woman from the city of Krasnoyarsk. In all, the company plans to lease 8 more aircraft.

Vsya Rossiya - Novosti Regionov [All Russia - Regional News] December 27, 2000

In the year 2001 the leasing fund for agricultural machinery will be increased by 10-12% to 13.5-14 billion rubles, announced Viktor Limarev, general director of Rosagrosnab, at a conference on «The Main Trends in Agricultural Development Policy for the Year 2001.» According to Mr. Limarev, the federal government will invest 2.8 billion rubles in leases for machine-building equipment.

Kommersant, January 18, 2001

Belarus and the Novgorod region plan to form a joint international leasing company. Belarusian Prime Minister Vladimir Ermoshin signed the protocol on economic cooperation during his recent visit to Novgorod as part of an official Belorussian delegation. The new agreement calls for greater bilateral trade and commercial ties. The Belorussian premier stated his dissatisfaction with the current level of trade: over the course of nine months last year, Belorus imported $13m in goods from Novgorod while exporting only $8m. The prime minister noted that under current conditions, where neither side has much free capital and their tax, banking and customs laws are not unified, the most secure form of cooperation would be to form an international leasing company involving both Belorussian and Novgorod manufacturers and consumers. He added that two Russian banks have already entered negotiations over the proposed new company. After all, Belarus already has some experience with leasing: it currently leases equipment in regions near the Ural Mountains.

Novgorodskie Vedomosti, Novgorod January 23, 2001

The North Caucasus Branch of Sberbank plans to invest 60 million rubles over the three years in leases for agricultural equipment in the Stavropol region. The region's state leasing fund will also contribute 10 million rubles to cover interest on loans. Another 30 million rubles from state coffers will go towards straight purchases of new farm equipment.

Stavropolskaya Pravda, Stavropol January 23, 2001

The Pskov Regional Board of Agriculture continues to introduce high-tech fodder-production equipment on local farms. Poor climatic conditions over the last several years have prevented local farmers from producing enough quality feed. Agricultural specialists have therefore suggested introducing Permtekhmash-Agro fodder machines. These machines make it possible to produce high quality feed regardless of the weather and to store it for up to one year without any decline in quality. They work by processing and storing green fodder in plastic packaging, where it retains a humidity level of up to 55%. Last year one of these machines was leased to Pobeda Farms in the Pskov district, and another to Udarskoye Agricultural Institute in Velikie Luki. Pskovskiy Farms in Pskov received a similar unit manufactured by Klaas. More fodder machines will be introduced to the region's farms in 2001: the regional government will buy three machines for a total of 10,170 rubles.

SeverInform, Vologda January 24, 2001

The Russian Ministry of Agriculture plans to hold a competition among leasing companies for the right to lease agricultural equipment to Russian farms in 2001. Under the terms of the contest, the winner (or winners) will earn the right to 3 billion rubles (5.5 billion including additional revenue) in federal funding for agricultural leases. The contestants must be able to guarantee the loans and contribute their own capital to the leasing program. Rosagrosnab is one company that has recently leased agricultural equipment with federal support. The Ministry of Agriculture believes that the competition will raise the level of competition in the agricultural leasing market and help attract new companies.
to the sector. The winners will be those companies that offer the most advantageous terms. Most of the program's funds will go towards providing Russian farms with new tractors and harvesters. Some 300 million rubles may be used for other kinds of equipment, added the ministry. According to market research conducted by Rosagrosnab, 12 billion rubles' worth of equipment was leased to Russian farms between 1994-2000.

Polit.ru Information Agency, January 25, 2001

The government of the Samara region has announced a competition among leasing companies for the right to receive state loans towards 5-year leases on grain harvesters, tractors and other farming equipment for regional farms. All legally registered leasing companies with leasing licenses will be allowed to participate in the contest. The selection criteria will be as follows:

- Positive financial results for at least the last two years
- No tax arrears or debts to non-budgetary funds
- No overdue debts on state loans
- No salary arrears
- Working capital commensurate with the leasing company's expected contribution to leasing projects
- Highly liquid guarantees in the form of bank guarantees, collateral, etc.
- The ability to execute the terms of the government contract ahead of schedule
- The leasing company's total investment in the Samara region, including the amount of capital invested in long-term loans
- The leasing company's proposed rates of interest on leases
- The professional qualifications of the leasing company's staff (education, licenses, work experience)
- Ability to insure leased assets at minimal cost and to a satisfactory degree
- Efficiency

The competition will be held on February 26, 2001. Contact tel. 32-14-95, 33-42-40.

Volzhskaya Kommuna, Samara January 27, 2001

FOREIGN PRESS DIGEST

Siberian and Ukrainian grain harvesters are to be leased in Kazakhstan. Farmers in the Kustanay region of Kazakhstan have signed a lease for 300 combines from Siberia's Krasnoyarsk Plant. In 2001 a joint venture will be formed to provide maintenance and repairs. A similar deal is in the works with manufacturers from Ukraine. The latter have already prepared a shipment of components for NAN combines, for which an experimental assembly line will be opened at the Petropavlovsk Small Cylinder Engine Factory in early 2001. If the Kustanay farmers are satisfied with the machines, a joint venture will be formed to oversee assembly, maintenance and repairs. After two consecutive years of good harvest, the farmers have managed to save up enough capital to purchase some new equipment, if only to lease. They have already paid off most of their leases from last year. According to Erbolat Bazilzhanov, head of the Ministry of Agriculture's Technology Department, Kazakh farmers have begun to shift their orientation from American machinery to CIS brands, which are not only cheaper, but also more familiar to local mechanics.

KazAAG Information Agency, Astana December 1, 2000

During the Russian premier's recent visit to France, Russia's space and aviation agency, Rosaviakosmos, and the EADS European Space and Aviation Corporation signed several agreements aimed at expanding their cooperation. More specifically, the agreements provide for joint projects to modernize the MiG-29 and market it to developing countries, to develop new kinds of helicopters and to promote the commercial use of Russia's Soyuz rocket launcher. The package also calls for further cooperation between EADS member Airbus Industrie and Russia's Aeroflot and other companies. Under the new agreement, Russian aviation firms will help produce parts for Airbus planes. Meanwhile, Aeroflot will lease 30 new airplanes from the European consortium.

ITAR-TASS December 18, 2000

Belarus' transportation industry has received a major boost from the national government. Order 706 of the President of Belarus (Dec. 22, 2000) reduces tariffs on leased rolling stock imported prior to January 1, 1999, allowing lessees to redeem these vehicles at a substantially lower cost. The same order also introduces favorable amendments to the president's Decree on Leasing of Nov. 13, 1997. The new decree promises state support for enterprises that engage in the transportation of passengers or freight. Tatyana Korsakova, head of the financial department at the Belorussian Truckers' Association, explains that the new decree will solve the current problems
with redeeming leased vehicles. From now on, lessors will only have to pay slightly more than 6% of the established customs rate for vehicles (previously they had to pay 50% of the standard rate). The new regime will benefit not only firms, but also the government. It will certainly do wonders for the transportation industry.

**NOVOSTI BELTA Belorussian Telegraph Agency**
January 5, 2001

**D**uring its first session of the new year, the government of Kazakhstan summed up the year 2000 and outlined the cabinet’s plans for the next twelve months. Prime Minister Kasymzhomart Tokayev emphasized that 2000 was the most successful year in the country's post-independence history. The reason for this growth was not just the high price of oil, but also the improved performance of the government and the Central Bank. Kazakhstan will do everything it can to encourage these positive trends and foster the country's economic development. The government, already in the middle of a two-year plan for economic development, must now try to introduce effective measures for carrying out the new tasks assigned to it by the president at the end of last year. Among other things, the government has been called upon to provide affordable loans to Kazakh farmers, to initiate a leasing program with one billion tenge in federal funds, and to launch an effective campaign to protect crops from locusts and other pests.

**Kazakhstanskaya Pravda, Almaty**
January 11, 2001

**A** joint Chinese-Moldavian assembly plant for mini tractors will open in 2001 in the Moldovan city of Cahul. The investment project, which has already been signed for a 20-year term with possible extensions, will aim to supply mini tractors to farmers in both Moldova and the rest of Europe. The new plant, built on the existing Cahul Zidarul Joint-Stock Company, will assemble an annual total of 20,000 mini tractors manufactured in the Shandong province of China. The joint venture will be exempted from all local and national taxes for the first five years, while farmers in the Cahul district will be able to acquire some of the tractors under lease.

**MOLDPRES National Press Agency**
January 15, 2001

**U**kraine's national leasing funds will finance the construction of 330 Ukrainian grain harvesters and 100 tractors in the year 2001, announced Ukrainian Prime Minister Viktor Yushchenko at an assembly of the Farmers and Landholders’ Association. The government has already allotted the necessary funds, and all of the contracts have already been signed. The government’s confidence in the national leasing fund is based on the latter’s improved performance over the past twelve months, explained the prime minister. While the leasing funds paid back only 4% of their loans in 1999, they returned as much as 60% in 2000.

**UNIAN Information Agency, Kiev**
January 24, 2001

**A**zerbaijan has received yet another shipment of agricultural equipment on an ongoing grant from the Japanese Bank for International Cooperation (JBIC). The JBIC program, which aims to boost Azerbaijan's agricultural output, includes a leasing program for local farmers. Since it began in 1998, the program has provided Azerbaijani farmers with around 300 pieces of agricultural machinery worth some $11 million. The JBIC gave $3.5 million to the state of Azerbaijan in 1998, the same amount in 1999, and another $4 million during the first quarter of 1991. The latest shipment of machinery included 28 combines worth around $1.1 million. Total shipments for the year 2001 will amount to some $3.5 million. Credit recovery so far is around 33%.

**Trend Information Agency, Baku**
January 26, 2001

**U**kraine plans to lease military technology in Sierra Leone. One month ago Ukraine deployed a large peacekeeping unit to the African nation. The Ukrainian garrison consists of over 800 personnel specializing in automobile and armored vehicle maintenance and military transport, as well as organizing the UN's training center in Sierra Leone. As strange as it may sound, peacekeeping has become a profitable business for Ukraine, which is currently leasing as many as 220 military vehicles and armored personnel carriers to the UN peacekeeping force in Sierra Leone. According to the UN, Ukrainian military technology offers the best balance between cost and quality and is well suited to local conditions.

**Den’, Kiev**
January 26, 2001

**S**ince the Estonian Union of Leasing Associations was first formed five years ago, leasing has become an inseparable part of Estonia’s finance market and an immensely popular financial tool among Estonian entrepreneurs. Leasing companies first appeared in Estonia in 1994 and were founded with Estonian capital.
Questions and Answers

Since the financial crises of 1997 and 1998 most of Estonia's leasing companies have been controlled by banks with access to foreign capital. According to the Estonian Union of Leasing Associations, the year 2000 will be remembered for exceeding all forecasts for growth in the leasing industry. Five leasing companies - Hansa, Liising, bhisiising, Sampo Liising, Nordea Finance Estonia and Siemens Finantseeringud - hold 99% of the Estonian leasing market, which reached 8.8 billion kroons in the year 2000. Sales volumes for the Union's members rose to 4.6 billion kroons, a 40% increase over 1999. Estonia's overall leasing volume rose by 49% over the last twelve months, while bank loans rose by only one third. According to Union's executive director, sales volumes will continue to grow in the year 2001.

Olga Shishlyannikova, Attorney, IFC Leasing Development Group, answers questions sent in by our readers.

Belarus has begun to ship agricultural equipment to Russia under previously signed lease agreements. One of the recipients, Agropromsnab Leasing Company in the Volgograd region, has already received 90 pieces of machinery worth a total of 40 million rubles. The leasing company, which is implementing the federal government's agricultural leasing program in the region, will lease the new machinery to local farmers. All of the equipment will be paid off within 5-6 years. By the end of 2001, Belarus will deliver some 64 million rubles' worth of agricultural equipment to the Volgograd region. Another lease agreement between Agropromsnab and Rosagrosnab will bring an additional 100 million rubles' worth of domestic and foreign-made equipment to the region by the end of the year.

Regions.Ru
Information Agency
January 30, 2001

If a surety or bank guarantee stipulates that it is valid until the lessee has effectively fulfilled all of his obligations under the lease agreement, would the courts consider the security or guarantee to have a fixed and agreed term of validity?

No. According to Article 190 of the Russian Civil Code, an agreement's term of validity must be defined by a calendar date or expiration of a fixed period of time expressed in years, months, weeks, days or hours. A term of validity may also be defined by an event which must inevitably occur at some time in the future, such as the beginning of a season. As the lessee's fulfillment of the terms of the lease is neither a fixed date nor an inevitable event, it cannot be considered a binding term of validity for a surety or bank guarantee.

Failure to establish a legally binding term of validity for a surety or bank guarantee has the following consequences:

• According to Article 367, Clause 4 of the Russian Civil Code, a surety ceases to be valid within one year after the onset of the guaranteed liabilities if no other term of validity has been established and the creditor has not filed any claim against the guarantor.

• According to Article 374, Clause 2 and Article 376, Clause 1 of the Russian Civil Code, a bank guarantee is not considered valid unless it has a fixed term of validity.

Can a leasing company refuse to sell a leased asset to a lessor upon expiration of the lease, even though the lease agreement stipulates «the lessor's right to purchase the leased asset,» if the agreement fails to state its purchase price?

If the lease agreement contains a provision for purchase of the leased asset, then it is considered a preliminary sales-purchase agreement. According to Article 429, Clause 1 of the Russian Civil Code, a preliminary agreement binds the signatories to sign a subsequent agreement under the
terms stipulated therein. The preliminary agreement, in turn, must contain all of the essential provisions of the subsequent principal agreement (Article 429, Clause 3 of the Russian Civil Code).

Since a price is not considered an essential term for a sales agreement,1 its absence from a preliminary agreement (or corresponding clause of a lease agreement) has no effect on the validity of the agreement itself. If the price was not indicated in the preliminary agreement (or corresponding clause of the lease agreement), it must be determined in accordance with the regulations stipulated under Article 424, Clause 3 of the Russian Civil Code. Thus, if the parties failed to agree on a purchase price when signing the lease agreement, then Russian law would define the price as that which is normally charged for equivalent goods under similar circumstances.

We should add that the exact wording of the provision on the purchase of the leased asset can play a major role in the courts' decision as to whether the purchase price was fixed in the preliminary agreement. Thus, if the agreement stipulates that the lessee has the right to purchase the leased asset at its residual value, then the purchase price is considered fixed. In practice, the signatories to a lease often stipulate the lessee's right to purchase the leased asset «at a price agreed upon by the parties.» This phrase must be considered binding, and it obliges the parties to include the same provision in the principal (sales-purchase) agreement. Thus, if the parties cannot agree on an actual purchase price, their disagreement may be heard in arbitration court.

Apart from fixing the purchase price, it is also important when signing the preliminary agreement (that is, the lease) to establish the time period for concluding a sales-purchase agreement. According to Article 429, Clause 4 of the Russian Civil Code, the preliminary agreement should indicate the time period during which the parties are obliged to sign the principal agreement. If it fails to do so, then the principal agreement must be signed within one year after the preliminary agreement. Thus, unless the lease agreement stipulates an exact date or some other concrete time for signing the principal agreement, then the sales-purchase agreement must be concluded within one year. Otherwise the lessee will lose his right to purchase the leased asset, as stipulated under the lease agreement, within one year from the date he signs the lease agreement (Article 429, Clause 6 of the Russian Civil Code).

1 Except in the case of sales agreements for real estate.

How should a leasing company record VAT if the asset is recorded on the lessee’s balance sheet?

As far as recording VAT is concerned, the lessor can divide a lease into three stages:

- The asset is purchased: VAT is included in the total cost of the asset
  - D08 K60 (1000) - acquisition of property
  - D19 K60 (200) - VAT is recorded
  - D03 K08 (1000) - property is posted
  - D68 K1 (200) - VAT is deducted

- The asset is transferred to the lessee’s balance sheet: VAT is charged upon transfer
  - Lease payments are received: VAT is charged and paid out of the lease payments

Let's see how this would look in a hypothetical example. We'll assume that the asset costs $1,200 (including $200 in VAT), while the lease is valued at $1,800 (including $300 in VAT).

1. The asset is purchased
   When purchasing the leased asset, the lessor records VAT in account 19 and deducts VAT after the asset has been paid for and transferred:
   D08 K60 (1000) - acquisition of property
   D19 K60 (200) - VAT is recorded
   D03 K08 (1000) - property is posted
   D68 K1 (200) - VAT is deducted

2. Property is transferred to the lessee’s balance sheet
   There are two possible ways to charge VAT when transferring an asset to the lessee's balance sheet.
   1. VAT charged on the sum of the lease payments is recorded in full under account 76 (sub-account VAT charged), while the lessor’s fee is recorded under account 83 excluding VAT
1. Asset is transferred under lease
D47 K03 (1000) - asset is transferred under lease
D76/2 K47 (1800) - indebtedness on the lease payments is recorded with VAT included
D47 K76/VAT(300) - VAT is charged on the sum of the lease payments
D47 K83 (500) - the difference between the value of the lease agreement (excluding VAT) and the value of the property (excluding VAT)

2. VAT charged on the sum of the lease payments is recorded under account 76 as compensation for VAT paid when purchasing the asset, while the lessor’s fee (including VAT) is recorded under account 83:
D47 K03 (1000) - asset is transferred under lease
D76/2 K47 (1800) - indebtedness on the lease payments is recorded with VAT included
D47 K76/VAT(200) - VAT is charged on the asset’s value
D47 K83 (600) - the difference between the value of the lease agreement (including VAT) and the value of the property (including VAT)

3. Lease payments are received
In accordance with the two options suggested above, we can also propose two ways to record VAT on the lease payments:
1) D51 K76 (1800) - lease payments are received over the duration of the lease (including VAT)
D76/VAT K68/VAT (300) - VAT is charged for payment to the state
D83 K80 (500) - the difference between the lease payments and the asset’s value
D68/VAT K51 (100) - VAT is paid to the state
2) D51 K76 (1800) - lease payments are received over the duration of the lease
D76/VAT K68/VAT (200) - VAT is charged for payment to the state as part of taxes on the purchase of the asset
D83 K80 (600) - the difference between the lease payments and the asset’s value
D80 K68/VAT (100) - VAT is charged on lessor’s fee for payment to the state
D68/VAT K51 (100) - VAT is paid to the state