On October 3, 2000, the State Duma conducted hearings on «The Future of Leasing in Russia,» organized by the Committee for Economic Policy and Entrepreneurship. After discussing the legal aspects of leasing with theoreticians and practitioners from the leasing industry, the Duma charted out the future development of leasing regulation in Russia.

Speakers pointed out a host of legal problems impeding the growth of Russia’s leasing industry, placing special emphasis on the shortcomings of the Federal Law on Leasing. When it was first passed into law in 1998, the Law on Leasing played a positive role in the development of leasing and gave an impetus to its wider application throughout the Russian Federation. Under Russia’s current economic conditions, however, the law has often malfunctioned, creating a variety of barriers to the normal development of leasing in Russia. The Lower House of Russia’s parliament is now considering four different bills of amendments to the Law on Leasing. According to the specialists who were invited to the hearings, none of these bills would be ideal, though each of them makes some positive and reasonable proposals. The Duma will clearly have to come up with a single, unified bill of amendments. Participants at the hearings resolved to create a working group under the State Duma’s Committee for Economic Policy and Entrepreneurship, whose main task will be just that — to draft a unified bill of amendments to the Law on Leasing.

The hearings also dealt with the question of taxation on leasing transactions. The Duma is currently considering Part Two of the Russian Tax Code (including a chapter on profit tax), which threatens to eliminate two of the tax benefits for leasing: accelerated depreciation and the freedom to choose whether to record the leased asset on the lessor’s balance sheet or the lessee’s. The Committee for Economic Policy and Entrepreneurship is expected to argue in favor of preserving these benefits.

Finally, participants at the hearings also discussed the matter of state support for the leasing industry, particularly the creation of a federal program for the development of leasing and the future possibility of including leasing projects in the federal budget.
HOW TO MINIMIZE
THE RISK ASSOCIATED WITH LEASING

Veronika Shtelmakh, Economist
IFC Leasing Development Group

This is the second part in a series of articles dealing with risk management in the leasing industry.
You can find part one in issues 9-10 (3-4) 2000.

One of the clear advantages of leasing is that the leased asset itself can serve as a partial (of full) guarantee for the leasing transaction, since it remains the property of the lessor throughout the term of the lease. As a result, leasing transactions typically require fewer additional guarantees than bank loans.

Leasing companies generally consider the leased property the most important part of the guarantee package. However, the total value of the securities varies from one transaction to the next. On the one hand, it depends on such factors as the lessee’s reputation, his financial condition, etc. On the other, it depends on the characteristics of the leased asset itself, such as its liquidity.

Liquidity of the Leased Asset

We have grown accustomed to grouping balance sheet items according to their liquidity. Cash is the most liquid form of asset, followed by marketable securities. The least liquid item on the balance sheet is generally real estate. Equipment and machinery fall somewhere in the middle, with considerable differences between sub-categories.

The liquidity of a piece of equipment depends on its characteristics: how easily it can be repossessed, dismantled, transported and sold on the used equipment market.

These characteristics determine the extent of the risks associated with a particular kind of equipment, i.e.:
• the risk that the equipment will be lost
• the risk that the equipment will not be returned
• the risk that the lessor will not be able to sell the equipment at an acceptable price on the used equipment market

How to Minimize the Risk that the Leased Asset Will Be Lost

The most effective (and perhaps the only) way to minimize this kind of risk is to insure the leased asset. An insurance policy may be taken out by either the lessor or the lessee, as agreed by the parties.

When leasing companies take it upon themselves to insure the leased asset, they usually pass the cost of insurance on to the lessee by increasing the lease payments accordingly. This results in a higher turnover tax. If the leasing company attempts to recover this tax by increasing the lease payments still further, it will have to pay more VAT on the lease payments. Therefore, leasing companies often prefer to have the lessee insure the asset himself. In such cases, the parties should stipulate within the lease agreement that the lessee assumes responsibility for insuring the asset on the lessor’s behalf. In order to be sure that lessee chooses a reliable insurance company, the lessor should also provide a list of companies that it finds acceptable. The lessor must then add the following phrase to the lease agreement: «...with one of the insurance com-
panies specified in the attached list, which is an inseparable part of this agreement."

The lessor should also stipulate within the agreement that he will terminate the lease if the lessee fails to insure the asset. Such a clause is especially important if the leased asset is a motorized vehicle.

Motorized vehicles are an extremely liquid type of asset, one that an unscrupulous lessee can easily steal or destroy. With automobiles there is also the significant risk of injury to a third party. Leasing companies are better off passing this risk on to an insurance company. Although insurance makes the transaction more expensive, it frees the lessor from major liabilities.

How to Minimize the Risk that the Lessee Will Not Return the Leased Asset

There is always a risk that the lessee will fail to return the leased asset. This is true even though the lessor retains ownership rights to the asset, since Russian legislation does not give the lessor the right to summarily repossess his property. Unless the lessee returns the property voluntarily, the leasing company will have to appeal to the arbitration courts and wait for their decision, which requires a great deal of time and effort.

Obviously there is no way to eliminate this risk entirely, but leasing companies can diminish it considerably. There are several ways to increase the likelihood that the lessee will return the leased asset: by correctly analyzing the lessee’s trustworthiness, by providing oneself with full legal protection, and by demanding appropriate guarantees.

Analyzing the Lessee’s Trustworthiness

While leasing companies are holding preliminary negotiations with potential lessees, they usually turn to specialized firms for information about the lessees’ trustworthiness (similar to the security services of banks). Naturally, a negative report about a potential lessee should dissuade a leasing company from entering into a deal. In cases where the leased asset in question is very valuable, the lessor absolutely must investigate the lessee. But for smaller transactions, the potential profits may not justify the cost of obtaining this information. In such cases the leasing company must choose whether to take on the additional costs, or whether to expose themselves to greater risks for the sake of higher profits.

Full Legal Protection

When the lessee refuses to return a leased asset that belongs to the lessor, the latter may find it useful to present a «frightening» collection of legal documents and clauses, which must be prepared in advance by the leasing company’s lawyers. It is also a good idea to draft the procedures for repossessing a leased asset, and to make sure that the lessee familiarizes himself with this document before he signs the lease agreement.

Guarantees

Standard Methods

A leasing company’s specialists should give a great deal of thought to the matter of guarantees. In most cases, the preferred form of guarantee is collateral. The lessee is usually required to mortgage his most liquid assets, which may be sold if the lessee fails to meet his contractual obligations. It should be noted, however, that in most cases the forced sale of collateral requires court approval (a lengthy procedure) and a public auction, while the debtor may ask the courts to postpone the sale for more than a year.

Nonstandard Methods

Apart from demanding collateral, leasing companies can use a variety of other means to influence lessees - some of them rather unusual. For example, if a lessor stops making payments on his telephone switchboard, the leasing company may exert its influence by having the machine shut down, so that the lessee can no longer use it. In the case of automobile leasing, lessors can control lessees by means of the state highway
inspection (this we learned from a regional leasing company): because vehicles are usually registered under the lessor’s name, it is the lessor who must take the vehicle for its state inspections; simply by failing to do so, he can prevent the lessee from using the vehicle at all, since uninspected vehicles are regularly pulled over and fined by the police. The leasing company should avoid having the vehicle inspected until the lessee has made all of his payments.

How to Reduce the Risk that Equipment Will Not Be Marketable on the Used Equipment Market

This risk is highly characteristic of leasing transactions. It varies in degree depending on the type of leased asset. In some cases, it is even the most significant form of risk, exerting a major influence on the terms of the lease agreement. The kinds of equipment most vulnerable to this risk can be categorized as follows:

• equipment that cannot be dismantled
• specialized production facilities
• equipment that cannot be sold at a reasonable price

Equipment That Cannot Be Dismantled

The equipment used in oil wells is one such example: it is basically impossible to dismantle. Therefore, the lessor should require the lessee to buy such equipment upon expiration of the lease. He must also be sure to investigate the lessee’s trustworthiness and solvency before entering into an agreement.

Specialized Production Facilities

Many kinds of industrial equipment fall into this category, since they are made to order, varying significantly in their components, their technical parameters and even their dimensions. It may be possible to dismantle such equipment, but the equipment often loses its value in the process. There can be several reasons for this: the equipment may be part of a larger production unit, designed in such a way as to be compatable with one particular unit; or the equipment may have been custom built for a single manufacturer, while no other enterprise in the whole of Russia would be interested in purchasing it.

Equipment That Cannot Be Sold at an Acceptable Price

Office equipment is the clearest example of this kind of risk, because it becomes obsolete so quickly. Leasing companies may find it easy enough to sell a used computer, but only at a loss. They cannot expect to pay off their bank loans or recover their expenses by reselling the equipment if the lease agreement is annulled in mid term.

A Practical Example

A leasing company leased some equipment to a pharmaceuticals warehouse. The equipment was highly specialized in the sense that it was fitted to a particular facility.

After some time, the lessee found himself in financial straits, unable to meet his lease payments. He was not opposed to returning the equipment, but the problem was that the leasing company could only resell it in pieces, at a significantly lower price. After considering all of its options and conducting some market research, the leasing company decided to do something different. The company’s experts had come to the conclusion that it would be far more profitable to buy the entire facility and sell it off, along with the equipment, as a single unit (a fully equipped pharmaceutical warehouse). The advantages of this approach are obvious: the leasing company does not have to pay for disassembly, transportation, storage or renovation. This method certainly increases the risk of a non-sale, since it is harder to find a buyer for an entire facility than for a simple piece of equipment. But if it works, it will be far more profitable than repossessing the equipment and selling it off in bits and pieces.
How can leasing companies minimize the risk that they will not be able to resell a piece of equipment on the used equipment market?

The first method is to sign additional agreements with third parties (usually suppliers), buy-out agreements, or resale agreements. (In Russia, one obviously needs to verify whether the supplier or other third party is fully solvent).

The second method involves working out an effective system of guarantees. This should be done with a proper understanding of the lessee’s specific needs and characteristics, so as to make it easier for him to meet his contractual obligations, rather than forcing him to become a problematic client. For example, if the lessee is dependent on bank loans or supplier’s credit, he will need to maintain a positive credit history, so publicizing any information about his unreliability may cause serious complications for his business. It is also possible to take the lessee’s high-liquidity assets as collateral and sell them off if the lessee fails to meet his obligations.

In this article, we have only touched upon a few aspects of the risks associated with leased assets. We would like to invite all leasing companies to make further contributions to this discussion. We would be very pleased to hear about your experiences.

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Baltisky Leasing («Baltleasing»), the first leasing company ever to be registered in Russia, is celebrating its 10th anniversary this year. The company’s main founder was the Industrial-Construction Bank of St. Petersburg, or PSB. Today, Baltleasing operates not only in St. Petersburg, but in the entire Northwest Region.

In the last ten years, the company has signed over 150 lease agreements with both large and small enterprises in a wide range of industries: manufacturing, transportation, shipbuilding, retail commerce, food service, and others. The company has leased such assets as ships, helicopters, trucks, cars, production lines, bakery ovens, woodworking machines, dentist’s equipment and offset machines. Over the last several years, many companies in St. Petersburg have come realize that leasing is an effective means of acquiring new equipment and vehicles. During this same period, several of the company’s own employees have successfully defended their graduate theses in economics, including one doctoral thesis.

Baltleasing currently employs 17 people and has 50 active lease agreements. The total value of its leased assets is more than 170 million rubles. The company’s general director, Dmitry Viktorovich Korchagov, gave the following interview with the Leasing Courier.

By Viktoria Struts
**Baltleasing was a pioneer in the Russian leasing industry. What were the biggest obstacles it faced?**

When we began, there was virtually no legislative framework for leasing in this country. The ministries of economics and finance identified leasing with bourgeois market economics — something totally unacceptable under Russian conditions. Nevertheless, in 1991-92 we were able to buy four dry-cargo ships from Germany and lease them to Baltic Shipping. Incidentally, we are still the only leasing company in Russia that leases this kind of machinery.

Over the last ten years, our company, along with the rest of the Russian economy, has survived all the crises in the investment market. The hardest years were 1996 and 1998, when it became very difficult to find bank loans, since the banks were much more interested in GKO's [treasury bills]. Leasing simply wasn't profitable enough for them.

But now the situation has changed completely. Our bank has been investing a great deal in the leasing industry. This year PSB gave us our own credit line, which has doubled our volume over the last six months.

**Could you tell us a little bit about your credit history?**

Over the last ten years, we have taken out more than 150 loans from PSB, and we have paid off every single one of them on time. So the bank has come to realize that leasing is a reliable form of investment. On the other hand, there are some serious problems with the Russian banking sector in general, particularly the lack of long-term financing since the financial crisis of 1998, and leasing companies have been suffering along with the banks. PSB is trying to help us come up with a way to attract financing from abroad, and we are also hoping to sign agreements with some export insurance companies.

Until last year, PSB was our only bank, but now the Bank of St. Petersburg has also begun to finance our leases. Most of our clients are referred to us by these two banks. Our current leases average from $200,000 - 300,000 in value.

**Your company leases a wide range of equipment, from ships and helicopters to dentist's drills. Who are your clients and how do you select them?**

Our biggest clients are the construction company Mostostroy-6 (with over $2m in investments) and the state enterprise Admiralty Shipyards (Admiraltiskiye Verfi). A lot of our clients, like Baltic Bread (Baltisky Khleb), have grown over the years with our help. We are currently forming a partnership with the largest ice-cream manufacturer in St. Petersburg, Petrokhолод. And we have worked with a lot of other famous companies in the city.

We haven’t had any major problems with our lessees in terms of contract fulfillment, because we have always selected them very carefully.

We are now offering our clients a new service in conjunction with PSB: European-standard leasing, which means less red tape and less time spent on preparing the agreement. Naturally, we weren’t able to offer this kind of service until the bank gave us our own credit line. For our clients, the most appealing aspect of the new plan is that they will no longer have to provide us with additional collateral: all that we require is an advance payment and a guarantee from the vendor that he will repurchase the property. This will work especially well for automobile leasing. Baltleasing is already leasing more than 60 vehicles.
**In your opinion, what prevents the leasing industry from developing more rapidly in Russia?**

First of all, the legal framework, which is highly inconsistent and scares off a lot of foreign investors, as well as potential lessees. We need to improve the Federal Law on Leasing and all the regional legislation that affects the industry.

The second obstacle is finance: high interest rates, the lack of long-term credit and, to a lesser degree, the financial risks of investment, especially in small and medium-sized enterprise. The leasing companies that are capable of attracting large amounts of finance prefer to work with large enterprises, not startups. In many other countries, the government creates special programs to support the growth of small business, but haven't really begun to do so in Russia yet. The federal government has created a few programs to support small and medium-sized entrepreneurship, but they haven't supported them with government guarantees or significant funding.

**Your company has played an extremely active role in reforming Russian leasing legislation. Do you continue to do so?**

It's no secret that flaws in our legal framework, our customs procedures, currency regulation, accounting standards and tax policies, continue to create very serious obstacles to leasing in Russia.

We have learned by experience that we can have a real influence, not only at the federal level, but also locally. By taking full advantage of regional legislation and St. Petersburg's special investment laws, we can create a more attractive climate for both investors and lessors. In particular, we have been trying to get the local authorities to create exemptions from property taxes, profit tax and the highway tax. The investment laws of St. Petersburg give local administrations the right to provide such exemptions. We managed to unite six of the local leasing companies into one working group within the Governor of St. Petersburg's Special Council for the Promotion of Foreign Investment. Together we put together a series of regulations and amendments, which were aimed at creating a more favorable tax regime for both lessors and investors. But we realized that this working group did not fully represent the local leasing industry, and so we created a new non-profit organization, the St. Petersburg Association of Leasing Companies, which included all of the interested parties: not only the leasing companies, but also the financial institutions (banks and insurance companies). The proposals that we put forward are now being debated in various committees of the municipal government, several of which have already made favorable comments.

**What does the future hold in store for Baltleasing, and for Russia's leasing industry in general?**

We wouldn't be working in this business if we thought it had no future. The international auditing firm KPMG recently gave us favorable marks for 1998-1999, and we will now focus on getting direct loans from foreign suppliers (in the form of credit against goods), as well as loans from foreign banks.

As for what the future holds for the city of St. Petersburg, I can only say that quite a few new clients have turned to us since the beginning of 1999, and that the city's traditional industries (shipbuilding, automobiles, aviation, construction and foodstuffs) will continue to grow and make use of leasing. We see a great deal of potential in the local leasing market.

Furthermore, we plan to expand along with PSB's branch network. Last year the bank opened branches in Murmansk, Arkhangelsk and Vologda, all very promising regions, and we will extend our services to the bank's new clients in these localities. We have already begun to lease equipment and technology in Petrozavodsk, Moscow and Vologda.
At the same time, we would like to maintain our status as a lessor of ships. Russia's fishing boats are in lamentable shape, terribly worn down, while the country's shipyards, most of which are located in St. Petersburg or the Northwest Region, stand idle. Through leasing, we can bring all of the relevant parties together within one unified structure: the shipyards, the fisheries that are in such desperate need of new vessels, and their banks, with the leasing companies acting as guides to safe investment. Under this kind of setup, we will be able to optimize cash flows during the construction and subsequent operation of the vessels. Baltleasing and the St. Petersburg Shipbuilding Institute have already worked out a new program called the Russian Trawler, but we cannot implement the program until we have some guarantees regarding government quotas on the catch of fish. The program is currently being reviewed by the State Fishing Committee.

As for Russia in general, the current volume of leasing transactions is at least as high as it was before the crisis, with about $1 billion in investments. If our legislators would make some reasonable amendments to the Law on Leasing, then leasing would take its rightful place in our country as an effective form of investment.

WHY WE DECIDED TO LEASE

Zaza Semyonovich Rizhinashvili
General Director of Eden Dentistry
St. Petersburg

With a staff of 45 people, the Eden Dental Center of St. Petersburg (est. 1997) offers its patients a full range of modern dental services, including dentures, surgery, implants, therapy, orthodontics and pediatrics.

The Center has been able to expand its services over the last few years by leasing new equipment. To this day, the Center's partnership with the Baltisky Leasing Company remains very fruitful.

It was after the financial crisis of 1998 that the Center first considered leasing. Russian purchasing power had fallen dramatically, and the Center was beginning to have financial problems, since all of its supplies — with the exception of distilled water and alcohol — were expensive imports. After «Black August,» the Eden Center had to raise its prices just to break even. It had nothing left to invest in development, so it had to look for some outside source of funding.

The Center was not likely to attract any foreign investors, since the Russian dental industry is virtually incomprehensible to the West, where dental services are vastly more expensive. No Western investor could even understand why the Center should need long-term loans at low interest rates. Unfortunately, Russian bank loans were also out of the question, since they were too short-term. Then there was the additional problem that dentistry itself is a very seasonal business, falling by almost 50% during the summer holidays, as well as a labor-intensive one that does not
bring in quick profits. Bank loans may be useful as a supplement to working capital, but they are not sufficient if what you need is to upgrade all of your equipment.

Under the circumstances, leasing seemed to be the most rational, profitable and efficient way for the Center to expand its business.

Several months after the August crisis, the Center started putting out feelers among various leasing companies, but none of them was interested in the kind of small-scale deal that the Center needed at that early stage. They immediately offered the Center wholesale equipment for $300,000-500,000 - much more than it could possibly manage at the time. A dentist's office is not a factory, after all; the Center would not be able to boost production all of a sudden to cover its expenses. What the Center needed was a gradual series of small-scale contracts that would help it expand its equipment base over the course of several years.

The Center was surprised to discover how inefficient some of the leasing companies were. Some were backed by banks that did not allow them to take any independent decisions; they could not even sign a small or medium-sized project without their banks’ approval. If the Center had signed with one of these companies, its project would have been held up by red tape for several months. From the Center’s point of view, this would have defeated the whole purpose of leasing, since what it really needed was to get its hands on some equipment and get to work as soon as possible - within two or three weeks.

Finally, the Center was lucky enough to find a leasing company that could meet all of its needs. That company was called Baltisky Leasing, and it offered the Center exactly what it was looking for: good terms, flexibility, and a quick, simplified procedure for setting up an agreement. Baltleasing's employees really valued their new customers and were not afraid to spend time explaining all the subtleties of leasing, even to people with no background in economics. They used statistics and concrete examples to demonstrate the advantages of leasing over bank loans and helped the Center come up with the best possible terms for an agreement.

In order to increase its capacity, the Center wanted to buy some additional dental equipment. Dentist's chairs alone cost $10,000, plus various accessories that raise the cost to about $15,000 - 20,000. That may be small potatoes for some larger enterprises, but for the Center it was real money. A dentist's chair usually lasts about 10 years, so if the Center could pay it off completely over a two-year lease, it would have more than enough time left over to make a profit on it. Of course there were other expenses that also had to be taken into account. Dental equipment is so high-tech that it must be constantly and properly maintained. But the depreciation rate for leased dental equipment helps keep costs down.

The Eden Center recently signed its fourth agreement with Baltleasing in less than a year. In addition to dentist's chairs, the Center is also leasing some laboratory equipment. It would never have been able to afford its new $50,000 casting machine (which is used to make the molds for dentures) if not for leasing.

Baltleasing has been very flexible about the lease payments, giving the Center payment deferrals during the slower summer months. The size of the lease payments is not the only factor that determines the Center’s pricing policies: there is also the cost of materials, salaries and depreciation allowances. But even still, the Center has been able to keep its prices low enough to attract new customers. Leasing has been such an effective way to obtain new equipment that the Center has been able not only to expand, but even to allow itself the luxury of giving its staff additional training, which has raised their qualifications. The Center has already earned itself a stellar reputation, and it is confident that its experience, expertise and modern equipment will enable it to provide its clients with the best dental service.
As of September 2000, the Russian government had issued 1,416 leasing licenses, including 116 to non-residents. Among the Russian license holders, 60% were registered outside of the «two capitals,» Moscow and St. Petersburg. The Russian Ministry of Justice’s State Registration Chamber estimates that approximately 25% of license holders have active lease agreements. Thus, there are a total of approximately 350 active leasing companies in Russia, including some 200 outside of St. Petersburg and Moscow. Many of these have been operating successfully for more than three years, which means that they have not only signed a number of lease agreements, but completed some as well.

Leasing companies in the Russian regions have had considerable success with domestic and foreign leases financed by both Russian and foreign capital. In some cases, equipment vendors have granted credit against goods, which has cost 30-70% less than commercial bank loans. Moreover, vendors have sometimes granted credit for periods of 3 to 36 months, which is comparable to the term of a lease. Thus, many regional leasing companies have learned how to structure a lease agreement to their advantage, having signed numerous profitable deals with equipment suppliers, banks and lessees.

Article 26 of the 1998 Law on Leasing allows for state support of the leasing industry. Unfortunately, lawmakers have failed to come up with specific regulations that would enable any direct action. This has spurred regulators in the regions to take their own initiative. Many regions have encouraged the growth of leasing by offering a variety of tax benefits, as well as guarantees backed by their regional governments. Some have even passed their own leasing laws. For example, the Legislative Assembly of the Chelyabinsk Region has passed a new law to create a regional leasing fund to be comprised of cash, securities and various material and technical resources. According to the new law, the leasing fund will be financed out of the regional budget. Partner companies (or organizations) will be chosen by a competition.

The regions have been especially active in passing new leasing regulations for the agricultural sector. On March 12, 1999, Novosibirsk passed a Law on Government Support of Agricultural Leasing in the Novosibirsk Region (Law #48-OZ); on November 5, 1999, Primorye adopted its own Law on the Creation of a Leasing Fund To Help Producers in the Primorye Region Obtain New Agricultural Machinery (Law #71-KZ); and on February 15, 2000, Tyumen passed a Law on the Creation of an Agricultural Leasing Fund in the Tyumen Region (Law #158).

These laws provide exemptions from regional taxes. They also give agricultural lessees the right to make lease payments in kind - that is, in produce - provided that this is permissible under the lease agreement.
And the laws stipulate various other forms of state support as well. Some of the laws have their own peculiarities. For example, the Tyumen law requires at least 5% of the leasing fund’s financing to come from the «Agriculture and Fishing» component of the regional budget.

The Republic of Tatarstan has also created an agricultural leasing fund (see Tatarstan Cabinet of Ministers’ Edict #727 on Leasing in the Republic of Tatarstan, issued on October 27, 1999). Tatagropromkomplekt Leasing Company, which is owned by the government of Tatarstan, is providing the guarantees for agricultural leases in the republic. A similar fund has also been created in the Rostov Region. This year alone, the two funds plan to purchase agricultural equipment worth a total of 750 million rubles (620m in Tatarstan and 120m in Rostov). The equipment will be leased for periods of 5-7 years, with down payments of only 10%.

Several regions have begun to offer affordable government financing for leasing investment projects through a variety of contests.

On March 20, 2000, the Republic of Udmurtia passed Edict #296, confirmed by a statute on Contest-Based Financing for Leasing Investment Projects Among Small Enterprises, according to which the region will provide funding to investment projects in the form of state credit. Loans will be granted for three-year terms at an interest rate of 1/10 of the Russian Central Bank’s current refinancing rate. In the year 2000, 10 million rubles will be allocated to leasing projects through the Udmurtia Fund for the Support of Small Business, while another 10 million rubles will be funneled through the republic’s Agency for Investment and Leasing. According to the rules of the contest, investment projects must meet each of the following criteria: a recoupment period of no more than 2 years, a lease period of no more than 3 years, a down payment of 10%, and a maximum 15% APR on the lease payments. Additional guarantees may include pledge assets (vehicles, equipment, real estate), as well as bank guarantees. Priority will be given to projects in the service sector and to family businesses, as well as to any projects that create new jobs.

The government of the Rostov Region has already held contests for investment projects to be included in its regional investment program for 2000. Projects that qualify for the program will receive state backing on loans, as well as direct preferential loans from the regional government.

In 1999, Novosibirsk passed a Law on State Support for Investment in the Novosibirsk Region, which provides for the introduction of tax rate differentiation and exemptions from regional taxes, including the regional highway fund; changes in the regional tax payment schedule; reduced rents and direct loans from the regional government. As long as these loans constitute less than 30% of the total funds required by a project, the interest rate will not exceed the refinancing rate of the Russian Central Bank. Similarly, the total sum of tax exemptions, as well as the sum of guarantees from the regional government, may not exceed half of the total value of funds used by the project.

There are limits on the tax benefits that regional governments may offer to their local leasing markets. These limits are defined under various federal laws and regulations.

Federal Law #1759-1 on Highway Taxes in the Russian Federation (18/10/91) states that the tax on motor vehicles must be paid into regional highway funds, but regional governments may exempt some categories of individuals, enterprises and organizations from the tax. According to Russian Government Edict #967 on the Use of Accelerated Depreciation and the Revaluation of Fixed Assets (19/8/94), financial regulators in the regions must choose whether or not to make accelerated depreciation obligatory.
The Moscow Region has provided tax benefits for leasing since 1997 under Article 45, Clauses 2-3 of Law #39/97-03 on Tax Benefits in the Moscow Region (28/7/97). According to this law, lessors do not have to pay more than 50% of the regional profit tax on any profits earned through leases of 3 years or more. Lessors also receive a 50% tax break from regional property and highway taxes. In order to claim these tax breaks, lessors must keep two sets of accounting records: one for profits gained through leases of 3 years or more, and one for revenue earned through leasing transactions. The State Tax Inspectorate of the Moscow Region defines these accounting procedures in Letter #15-27/800 of April 14, 1998.

In Izhevsk, the municipal Duma’s Statute on Tax Benefits for Organizations Involved in the Realization or Financing of Investment Projects gives tax benefits to lessors and other leasing participants that are involved in creating new production facilities, developing new technology, promoting the social or economic development of the city or protecting the environment. It also provides tax benefits to organizations that finance such investment projects for one year or more and to the insurance companies that insure them. All of these organizations are exempted from municipal taxes on profits earned through these projects, from municipal taxes on any property used for the development of these projects, and from part of the local housing maintenance and social amenities tax (equal to the ratio of revenue from investment projects to total revenue).

In Rostov, any organization that invests either its own or borrowed funds into investment projects (including leases) qualifies for exemptions of 50-100% from regional property taxes, as well as from profit tax on any profits earned through investment projects. These exemptions are granted for the entire recoupment period of an investment project, but not for more than five years.

The Irkutsk Region allows entities to claim a regional tax deduction for any profits they have invested in modernizing or upgrading their production facilities. This deduction may be claimed for the duration of the recoupment period.

The Duma of the Tyumen Region has passed a law on Investment in the Tyumen Region, which gives investors 100% tax exemptions from the following regional taxes: the tax on enterprises’ assets (if the assets were purchased for use in an investment project), profit tax, land tax and the tax on motor vehicles. However, these exemptions may not exceed 50% of the total sum of investment per year. The exemptions are granted to investment projects included in the region’s investment program, to certain high-priority sectors, and to small-scale manufacturers.

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Quite a few regions have passed special laws that aim to promote leasing. The mere fact that such laws have been enacted is already a great step forward. Some of the laws do not contain any provisions for direct action, but rather allow for the enactment of relevant by-laws, such as Krasnodar’s Law on State Support for Leasing in the Krasnodar Region (26/4/00).

Some regions have passed laws stipulating direct state support for the leasing industry. Voronezh, for example, passed a law on Measures to Support Aviation Leasing in the Voronezh Region (25/10/99). Under this law, the region provides government support to leasing companies that were at least partly founded by local aviation plants. The law exempts such companies from all regional taxes and duties during their first 5 years, and from 50% over the following five years. It also exempts them from paying the motor vehicle tax into the regional highway fund during their first 5 years, and from 50% over the following 5 years. Finally, these companies’ contribution to the regional highway fund through highway taxes is limited to 50% of the federal rate during their first 5 years, and 25% over the following five years.

Moscow also offers some tax benefits for leasing. The municipal government’s Edict #525 on Legislative Bills for the City of Moscow (7/7/98)
amends some of the city's tax laws «in the interests of promoting the development of Moscow's automobile industry, bringing high-quality Russian automobiles to the market, drawing foreign investment to the Russian automobile industry, and solving the problem of unemployment in our city.» The edict gave tax breaks to companies that were founded at least in part by the Moscow City Government and foreign investors and that are involved in the production, sale or maintenance of modern vehicles and auto parts.

St. Petersburg levies a tax of only 2% on the purchase of motor vehicles, while the Leningrad Region charges only 1%. This low tax rate has enabled automobile leasing to develop much faster in the Northwest Region than in any other region of Russia.

Novgorod has followed St. Petersburg’s example. On April 13, 2000, the region passed a law providing tax benefits to registered leasing companies that engage in certain kinds of transactions with companies in the Novgorod Region. Specifically, these companies do not have to pay motor vehicle taxes into the regional highway fund on any vehicles that are used for harvesting or transporting finished agricultural products; wild apples, nuts, and other fruits; mushrooms or medicinal plants. Since June 11, 1998, the region has also had a law on Investment in the Novgorod Region (#29-OZ), which applies to the leasing sector as well. Article 6 of this law provides exemptions from all taxes where regional governments have the power to grant exemptions (namely, profit and property taxes) as well as from taxes that are paid into the regional highway fund (the tax on vehicle ownership and the tax on the acquisition of new vehicles).

The Republic of Mordovia passed a law on April 17, 2000, on Tax Benefits for Organizations Engaging in or Financing Leasing Projects (#7-3). The law's aim is to promote investment through leasing within the republic, to create a more attractive tax climate and state guarantees for both domestic and foreign investors, to introduce new technology, to solve social problems by creating new jobs, to unite the interests of manufacturers,
consumers, banks, insurers and leasing companies, to accelerate the growth of the tax base, and to increase revenue among republic, local and municipal governments. The law applies to the leasing of non-consumable goods (excluding land and other natural resources) to individuals and entities; specifically, it applies to the leasing of whole enterprises, buildings, facilities, equipment and vehicles not intended for personal, family or household use. The law gives lessors a 50% exemption from the following regional taxes: profit tax (on any profits gained from leases of three years or more), property tax, housing maintenance and social amenities tax, and taxes on the use of land and other natural resources. It also gives lessors an exemption from taxes that are paid into the regional highway fund: a 50% exemption from the highway tax and a full exemption from the purchase tax on motor vehicles.

Mordovia's new law gives special attention to banks and other institutions that finance leasing projects. Organizations that invest either their own or borrowed funds into leasing projects for a period of at least three years are not required to pay more than 50% profit tax on any profits earned from these transactions. (Although the Federal Law on Leasing itself provides for government assistance to banks that finance leases, these statutes are in no way binding and have never been put into practice). In order to claim the tax exemption, regional lessors, banks and other financial institutions must keep two sets of accounts: one for profits earned on leases of three years or more, and one for revenue earned from leasing transactions.

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Some regions offer differentiated tax rates for investment projects in certain high-priority sectors when foreign capital is involved.

In Vladimir, for example, such tax benefits are offered and depend on the amount of foreign investment involved. Investment projects worth $10m or more are exempted from the profit tax and 50% of the federal highway tax for the duration of the recoupment period (not to exceed 5 years); projects worth $2m-10m are exempted from the profit tax and 25% of the federal highway tax for a maximum of three years; and projects worth $250,000-2,000,000 are exempted from just the profit tax for a maximum of 3 years. Specialized transportation companies are granted partial exemptions from the motor vehicle tax (50% for large projects and 25% for medium-sized projects). The region's tax benefits apply to the following high-priority industries: automobiles, nonferrous metallurgy, food processing, light manufacturing, chemicals, glass, wood processing, transportation, communications, tourism, uncompleted construction projects, and converted production facilities.

This survey of regional tax laws has shown that leasing transactions are exempted from some taxes on the local, regional and federal levels. However, due to ambiguities and inconsistencies in the Tax Code and its various interpretations, as well as to gaps in various other laws, it has been very difficult to claim any tax benefits in practice, especially in the regions. These legal inconsistencies can render some regional laws invalid, thereby impeding the growth of leasing in the regions. Take for example Udmurtia's law on the Stimulation of Investment, which fully exempts entities from the profit tax during their first two years if they earn at least 80% of their profits from leasing, as well as exempting them from 50% over the following three years. Because it conflicts with other laws, this law has been suspended.

At the same time, many regions remain very active in creating new leasing laws. The Republic of Buryatiya, Moscow and the Leningrad Region are all drafting new leasing bills. St. Petersburg is considering amendments to its current Law on Tax Benefits.

Both legislative and executive bodies in the regions have begun to exert a notable influence on the development of leasing in Russia. This cannot fail to have an impact on the general development of Russia's economy, since leasing has shown itself throughout the world to be an effective means of equipping or re-equipping businesses. Tax benefits will make the leasing industry grow faster, expand the country's tax base, and increase state revenue.

The first four chapters of Part Two of the Russian Tax Code have now been adopted. The new chapters, which deal with value-added tax, excise taxes, income tax on entities and the social tax, will go into effect on January 1, 2001, unless stipulated otherwise. The most important new clauses for the leasing sector are those which deal with value-added tax. Significant changes include the following:

• Individual entrepreneurs will now be subject to VAT (Article 143 of the RF TC).

• Tax exemptions will be offered to some taxpayers (with the exception of those paying excise taxes and those paying VAT on imported goods) depending on their revenue from sales during the following three tax periods (calendar months). An enterprise will qualify for exemptions if its total revenue from the sale of goods, labor and services (before VAT and sales tax) is less than 1 million rubles (Article 145 of the RF TC).\(^1\)

• Small enterprises will no longer enjoy special exemptions from VAT on leased assets (Article 149 of the RF TC).

• As of January 1, 2002, all medical equipment, both domestic and foreign, will be subject to VAT unless it is included in a special list of exceptions compiled by the Russian government (Article 149, Clause 2, Subclause 1 of the RF TC).

• Taxpayers will now enjoy the right NOT to claim VAT exemptions, but only for periods of 1 year or more (Article 149, Clause 5 of the RF TC).

• The VAT exemption for imported goods that are invested into charter capital will now be limited to manufacturing equipment (including components and spare parts) (Article 150, Clause 1, Subclause 7 of the RF TC).

• Companies will be allowed to defer payment of VAT when importing the following kinds of leased assets: pedigree cattle, agricultural machinery and manufacturing equipment that is used exclusively for organizing and modernizing production facilities. Payment may be deferred until the lessee records the assets on his balance sheet, but not for more than six months (Article 151, Clause 1, Subclause 7 of the RF TC)\(^2\)

• The new code introduces the concept of a zero rate of VAT. This makes it possible to claim an exemption from VAT and deduct VAT paid to the supplier for resources used in the production and sale of goods, labor or services that are subject to the zero tax rate (Article 164, Clause 1 of the RF TC).

• VAT must now be paid no later than the 20th day of the following month (Article 174, Clause 1 of the RF TC). This means that taxpayers will no longer be required to make advance payments on VAT.

• The minimum revenue qualifying an enterprise for quarterly (rather than monthly) payment of VAT has been raised considerably (Article 174, Clause 6 of the RF TC)\(^3\).

• Branches must pay VAT at their principal place of business regardless of whether they earn revenue from sales. The share of VAT that such organizations must pay at their principal place of business should correspond to current procedures for the distribution of profit tax (Article 175 of the RF TC).

In addition to these amendments to the Tax Code, various other tax laws have also undergone important changes. The most noteworthy include:

• Highway Funds

  - As of January 1, 2001, there will no longer be any tax on fuel, lubricants or the acquisition of new vehicles, while the highway tax will be reduced to 1%.

  - As of January 1, 2003, the Federal Law on Highway Funds in the Russian Federation will no longer be in effect. Consequently, there will no longer be any highway tax from that day forward.

\(^1\) Unfortunately, it is not clear from the text whether sales revenue must be less than 1 million rubles for one tax period or three. It is also not clear what consequences result from exceeding this limit.

\(^2\) The wording of this clause leaves something to be desired, as it fail to take into account Article 64 of the RF TC, which establishes the procedures and conditions for tax deferral.

\(^3\) The new minimum is 1 million rubles per month.
FOREIGN LEASING LAW

Olga Shishlyannikova, Attorney
IFC Leasing Development Group

The Concept of Leasing

Under a financial lease agreement, the lessor must acquire ownership of an asset specifically requested by the lessee, from a vendor of the lessee’s choosing, and allow the lessee temporary use and possession of the asset for business purposes in exchange for payment (Article 665 of the RF Civil Code).

Russia has still not settled upon a final, legal definition of leasing or its place within civil law. This is especially important because transactions must meet the precise, legal definition of leasing in order to qualify for favorable tax, customs and currency regulations. Unfortunately, Russian civil law tends to conflict with tax and accounting regulations in its definition of leasing.

In Great Britain, leasing is defined as a form of rent in which the rented property is fully amortized. Britain actually has a closer equivalent to leasing, as it is commonly understood around the world, in purchase by installment. The two concepts, leasing and purchase by installment, are very narrowly defined and extremely important for tax purposes, as the classification of an agreement determines which party has the right to claim tax benefits.

It is no longer possible to doubt the potential of Russia’s leasing market or its importance for Russia’s economy as a whole. But Russian businesses are still in dire need of foreign-made equipment, which means that they very often have to turn to foreign leasing companies. Since crossborder leases are generally governed by the laws of the lessor’s home country, we should take a closer look at the leasing laws of some other nations.

Foreign leasing laws might also serve as a useful model for Russia.

This article will not attempt to provide a full-scale analysis of any country’s leasing laws, nor a broad survey of any particular areas of leasing legislation around the world. Instead, it will try to focus on some of the more important and interesting features of leasing legislation in a few countries.

- Local Taxes
- The housing maintenance and social amenities tax will be abolished as of January 1, 2001.

- Profit Tax
- Profit tax will increase on January 1, 2001. Agencies of local self-government will be allowed to establish additional profit taxes of up to 5%.

- Regional governments and agencies of local self-government will be allowed to exempt some categories of taxpayers from regional and municipal profit tax.

4 This includes Moscow and St. Petersburg.
In the United States, leasing is generally defined as the renting of an asset for some specified portion of its service life. Lease agreements fall under the jurisdiction of general regulations for sale, rent and finance. For tax and accounting purposes, rent agreements are divided into two categories: operating leases (renting assets) and leases (conditional sale of assets). An agreement is considered an operating lease if the lessor does not transfer all of the rights and liabilities associated with the leased asset to the lessee. In order to qualify as a straight lease (conditional sale of assets), an agreement must meet the following criteria:

- the lessee assumes ownership of the leased asset by the end of the lease term
- the rental agreement allows for redemption of the asset at a preferential price
- the lease term equals at least 75% of the asset’s service life, or the total lease payments equal at least 90% of the asset’s real market value

Under American civil law, contracts have to meet certain other criteria as well in order to qualify as leases. For example, the lessor may not choose, manufacture or supply the leased asset, and he must purchase the asset strictly for the purpose of leasing it.

Polish civil law also distinguishes between two forms of lease: the operating lease and the financial lease. Contracts are classified as operating leases if they meet any of the following criteria:

- the lease has no specified duration
- the lease has a specified duration, but the lessee does not have the option of purchasing the asset or, if he has this option, the lessor may revoke it at any time
- If, the first two conditions are not met, and if the leased asset in question is either movable or real property with a lease period that equals at least 40% of the standard depreciation period for the given asset, it is an operating lease if the value of the lease payments is considerably less than the net value of the leased asset.

Any lease agreement that does not meet these requirements is considered a financial lease.

The Leased Asset

The leased asset under a lease agreement may be any non-consumable good used for business purposes, with the exception of land and other natural resources (Article 666 of the RF Civil Code).

Which kinds of assets may be leased under a lease agreement? The question has become very important in Russia, where several government agencies are trying to expand the list of leasable assets. A look at foreign laws reveals that most countries merely limit the use of leasing to moveable property. Some countries also impose additional restrictions depending on the parties involved in a transaction.

Canadian law places no general restrictions on the types of movable assets that may be leased. However, certain types of financial institutions, including banks, insurance companies and trust companies, are prohibited from participating in leases involving certain types of vehicles and household goods. Canadian law allows for real estate leasing (usually land rights, including buildings), but it stipulates different leasing regulations for real estate than for movable property.

In Great Britain, only movable assets may be leased.

According to German law, any kind of asset may be leased, but leases tend to involve equipment that may be leased for extended periods of time (medium-term and long-term leasing).

Under Czech law, any kind of asset, whether movable property or real estate, is leasable.

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1 In the United States, leasing is regulated independently by the states, not the federal government, so it can vary from one state to the next.

2 Canada consists of 10 provinces. All of them, with the single exception of Quebec, are governed by common law. When we speak of Canadian law in this article, we are referring to the jurisdiction of common law and to the general principles applied at the federal level. As for leasing legislation in the province of Quebec, it has a great deal in common with Russian law.
Lease Participants

The lessor: an entity or individual who acquires an asset under the terms of a lease agreement, using either his own or borrowed funds, and allows the lessee to enjoy temporary use and possession of this asset in return for a specified payment, under specified conditions and for a specified period, at the end of which the lessor may or may not transfer ownership of the asset to the lessee;

The lessee: an entity or individual who, under the terms of the lease agreement, uses and possesses the leased asset for a specified period, under specified conditions and in return for a specified payment (Article 4, Clause 1 of the RF Law on Leasing).

An analysis of leasing laws in other countries reveals that Russia is one of the few nations in which leasing companies are required to obtain special leasing licenses.

In Great Britain, leasing companies do not have to meet any special requirements in order to engage in leasing. However, some restrictions do apply to lessors that fall under the jurisdiction of British banking laws. These lessors must demonstrate a sufficient sum of capital.

In Canada, leasing companies are not required to hold special licenses. However, restrictions do apply to some kinds of financial institutions, such as banks, insurance companies and trust companies. For example, insurance companies may not participate in leases which they have insured against risks. Foreign banks doing business in Canada must obtain government permission before signing any kind of lease agreement (incidentally, they also need permission for many other kinds of transactions). Banks, insurance companies and trust companies are strictly prohibited from leasing vehicles under 21 tons and from participating in any way in the maintenance, service, installation, or repair of a leased asset.

In Germany, lessors do not have to obtain a special leasing license.

The Czech Republic does not have any general licensing requirements for leasing, but foreign leasing companies with representative offices in the republic must obtain government approval before entering into any lease agreements on Czech territory.

To be continued in the next issue.

Some of the information in this article was taken from materials prepared by the Canadian firm Macleod Dixon.

Banks, insurance companies and trust companies are also strictly limited in their ability to invest in leasing companies. They are generally prohibited from investing in such companies unless they assume managerial control. Depending on the nature of the investment, they may also be required to obtain government approval.

LEASING IN UKRAINE

This article is based on materials from the IFC’s Small Business Support Project in Ukraine.

The infrastructure of Ukraine’s leasing industry has really taken shape over the last four years. Leasing is especially common for trucks, farming equipment, and food-processing plants. It is also very popular among small businesses.

In terms of their organizational structure and range of services, Ukrainian leasing companies can be divided into the following categories:

• holding companies created by large Ukrainian and foreign banks
• specialized commercial leasing companies,
some of them founded in part with foreign capital
• branches of industrial, transportation of
commercial enterprises that engage in
leasing.

Ukrainian leasing companies can also be
classified into three groups according to
their sources of funding (the size of which
also determines the scale of their leasing
projects). First, there are state enterprises
that specialize in leasing agricultural equip-
ment. These companies receive rather gen-
erous support from the State Leasing Fund.
An alternative to these state-owned compa-
nies are the private firms working in the so-
called free economic zones (SEZ). Because
they receive some concessions from the
government, these companies are able to
provide leasing services at prices not much
higher than those offered by the state enter-
prises. However, these companies are
restricted to working in the free economic
zones. Finally, the third category of leasing
companies are essentially subsidiaries of
commercial banks. In order to minimize the
credit risk, these banks often either form
their own commercial structures (industrial
finance groups) or become joint sharehold-
ers. However, Ukraine’s draconian tax laws
and the instability of its legal system seri-
ously hinder the activities of these leasing
companies.

Leasing really began to take off in Ukraine in
1997 with the creation of Ukrlizing, the All-
Ukrainian Leasing Association, which joined
the European Federation of National Leasing
Associations, or LEASEEUROPE. Ukrlizing is
made up of experts from Ukraine’s leasing and
financial spheres, including more than 120 col-
lective and individual members: banks; finance
companies; leasing and insurance companies;
higher education establishments; leasing
funds and other institutions. In addition to pro-
viding market research and consulting ser-

tices, the Association operates its own infor-
mation projects, as well as leasing and busi-
ness programs, and proposes amendments to
Ukrainian laws.

The biggest obstacles to leasing in Ukraine
are the shortage of bank loans and the flawed
legal system.

Among the economic factors hindering the
development of Ukraine’s leasing market are:
• High interest rates and the lack of long-term
loans for leasing. From the banks’ perspec-
tive, the long-term nature of leasing makes it
a risky proposition: bankers are afraid that
lessees will simply disappear within a year or
two without paying back their loans. It is this
kind of fear that has thwarted the govern-
ment’s efforts to promote investment in the
manufacturing sector.
• A limited pool of solvent and financially stable
lessees capable of using equipment effective-
ly and making lease payments regularly. Not
only the banks, but also the enterprises them-
selves are wary of long-term transactions,
fearing that constantly changing laws and an
unstable economy will undermine the longevi-
ty of their businesses.
• The lack of tax benefits for leasing.

Leasing in Ukraine is currently subject to a
mass of regulations, the most important being
the Ukrainian Law on Leasing, which was
passed by the Supreme Rada (council) in
December 1997. Other regulations pertinent to
leasing can be found in the Law on Taxation
and Enterprises’ Profits, the Law on Value-
Added Tax, the Ukrainian Civil Code and a host
of other by-laws.

However, in spite of this cornucopia of
legal documents, leasing practitioners have
not found the legal system particularly con-
ducive to leasing. The gravely flawed Law on
Leasing limits the viability of leasing and
undermines most of its economic advan-
tages, yet the law has never been reformed
in any significant way (except for one
amendment in 1999 which gave resident
lessees the freedom to conduct hard-curren-
ty transactions under crossborder leases
without having to obtain individual licenses
from the Ukrainian Central Bank). A bill of
amendments to the Law on Leasing has now
finally been submitted to the Supreme Rada.
The bill’s authors hope to redress the following flaws in the original law:

1. The definition of financial leasing fixes the leased asset's period of use to its depreciation period. Given Ukraine’s current regulations for depreciation, this makes leases too long and, consequently, economically unattractive. In practice, this forced correlation between an asset's period of use and its depreciation period can also cause a perfectly legal lease agreement to end up in conflict with new laws, and therefore invalid, several years after it is signed.

2. By defining lease participants in terms of entrepreneurial entities, the Law seriously limits the number of parties that may participate in leasing transactions and effectively bans cross-border lease agreements with non-residents.

3. By failing to address the concept of subleasing, the Law on Leasing limits both economic freedom and the access of non-residents to Ukrainian markets. When subleasing does take place (which is not directly prohibited under the Law), the Law fails to provide any regulations to govern such transactions or to define the rights and obligations of the parties.

4. The Law fails to provide the lessor with any legal grounds for making demands of the supplier in terms of the quality, assembly or maintenance of the leased asset.

5. The lessee has no legal right to defend the leased asset from third parties.

6. The only case in which the lessor may repossess the leased asset without approval from the courts is if the lessee fails to make two consecutive lease payments. However, there are many other ways in which the lessee may violate the terms of the agreement and subject the lessor to risk or losses.

7. The Law does not make it clear what the taxable base for VAT should be if the lessee assumes ownership of the leased asset upon expiration of the lease. The tax authorities are likely to take the original book value of the asset as its taxable base for VAT.

This is far from being a complete list of the statutes that require clarification or amendment. There are so many problems with the Law on Leasing that the entire document needs to be overhauled. Between June and September of this year, the Ukrainian parliament voted six times on a bill of amendments to the Law on Leasing. Unfortunately, the results have not been very encouraging. The Communists, true to their traditions, voted against the bill, because they saw it as the first step towards the leasing of land. The deputies also voted against subleasing on the grounds that chains of «intermediaries» would make leasing more expensive. Many were reluctant to give lessors the right of summary repossession of their leased assets, fearing that they would take advantage of lessees.

The authors of the bill admit that even if they succeed in reforming the Law on Leasing, the leasing industry would not benefit unless the tax laws were reformed as well. Clearly the process of legislative reform in Ukraine is far from complete.

Nevertheless, both Ukrainian and foreign experts see promise in Ukraine’s leasing market. Among the factors stimulating the market’s development are the following:

• Leasing’s attractiveness as a financial tool for upgrading or modernizing production facilities, especially where long-term loans are difficult to find. For example, about 70% of Ukraine’s vehicles and 80% of its farm machinery are in need of replacement. Every year, about 70-90% of new trucks in Ukraine are obtained through leasing.

• The fact that Western financial institutions are willing to provide cheaper loans for leasing transactions.

• The growing pool of solvent buyers.

• The existence of tax benefits for leasing.

Leasing is expected to take root in the manufacturing sector, telecommunications and transportation (truckinng and passenger service).
On September 21, 2000, the IFC Leasing Development Group held a seminar in the city of Voronezh entitled «Principles of Leasing in Russia.» The seminar was made possible by the generous support of ReLizKom Closed Joint Stock Company and the Voronezh Region's Department for Business Development. The seminar had the following goals:

1. To support local leasing companies and attract new lessees.

2. To showcase potential lessees and provide them with useful information.

3. To bring participants up to date on recent changes in leasing legislation, as well as changes that are likely to occur in the future.

The following topics were discussed at the seminar:

- The concept of leasing and its advantages. A survey of the Russian leasing market
- A survey of Russian leasing laws
- Leasing licenses
- The different stages of a lease. How to choose a leasing company
- The main features of a lease agreement
- Various aspects of implementing a lease agreement
- Guaranteeing a lease
- Accounting methods for leasing
- Taxes in the context of leasing
- Additional agreements supporting the lease agreement

The Registration Chamber of the Voronezh Ministry of Justice has registered six leasing companies over the years, but only two of these companies currently have active agreements. The first, ReLizKom, opened for business in 1997. The regional government has tried various means of promoting the development of leasing. On October 25, 1999, the regional Duma passed a Law on Measures to Promote the Development of Aviation Leasing in the Voronezh Region. The law seeks to foster leasing as a way to boost the sale of aviation technology and stimulate investment in regional aviation plants. The law also attempts to make use of statutes of the Federal Law on Leasing that promise federal aid for leasing development in the regions. Apart from such large-scale projects as aviation leasing, the region has also witnessed a growing number of leases among small businesses. Throughout Russia, regional governments are seeking to promote leasing among small businesses as part of the Federal Program for State Support of Small Enterprises for 2000-2001. In a region like Voronezh, leasing seems particularly promising in such industries as construction, transportation, printing and, above all, food processing. Small businesses have proven themselves quite adept at processing and packaging grains, dairy products and vegetables, as well as at baking bread, at sufficient levels to meet the region's everyday needs.

The seminar also included a press conference with local print and television media. The speakers tried to draw attention to the region's successful leasing projects and to leasing in general, to identify some of the obstacles to leasing in the region, and to inform the Voronezh community about the high potential for their region's leasing market.
PROJECT NEWS

The Leasing Development Group welcomes two new specialists:

Elena Degtiareva is our new financial analyst. Elena graduated from the Higher School of Economics, having specialized in finance and credit. Since 1997 she had worked for ALT Research and Consulting (St. Petersburg), first as a finance and investment consultant and then, for the past eight months, as the director of ALT’s Moscow subsidiary.

Stanislav Kovynyov has joined our project as an attorney. Stanislav graduated from the Sverdlovsk Law Institute. He has worked as a consultant on legal and tax matters since 1994.

PRESS SURVEY

EVENTS IN THE RUSSIAN LEASING MARKET

Among the Leningrad Region’s 6,854 private farms, only 300 are stable and earning a profit. It is these farms that will qualify for government support, announced Governor Valery Serdyukov. So far this year the Leningrad Region has allocated 784,000 rubles to regional farms, double the total for all of 1999. The Leningrad Region has a special leasing program for farming equipment which has brought 83 million rubles in new machinery to regional farmers this year. This includes 170 tractors, 110 automobiles, 30 fodder-harvesting machines, 4 combines and several milk tankers. Over the past 5 years, the region’s farmers have leased and subsequently purchased 450 pieces of machinery valued at 196 million rubles.

Sankt-Peterburgskie Vedomosti
(St. Petersburg)
August 1, 2000

So far this year, Buryatiya’s farming industry has received 154m rubles in loans, including 56.5m to be spent on agricultural produce and 10m on fuel for local farms. 87.5m in preferential loans are being used to help prepare for fieldwork in the spring. Agroizing Leasing & Investment Company is leasing 66 tractors, 33 sowing machines, 5 mills and 4 loaders to local farmers. Additional loans are still being made to help local farmers prepare for next year’s harvest.

Vsya Rossiya (All Russia) News Network
August 2, 2000
The president of Tupolev, Aleksandr Polyakov, has announced that the company will sell 6 medium-range Tu-204 aircraft in 2000. Three of the planes will go to Egypt’s Cairo Air, while the rest will be sold to various Russian airlines. According to Mr. Polyakov, there is a high demand for Tu-204s, but Russian airlines cannot afford them under current economic conditions. One solution, believes Mr. Polyakov, would be to create an aviation leasing company that could lease the planes to domestic airlines.

ITAR-TASS
August 3, 2000

Two farms in the Republic of Komi, Severyanin (Ukhta) and Vychegda (Ust-Vym region), have acquired new fodder-processing machines under via leasing. According to the vendor, Komiagropromtekhnika, the lease package includes every kind of equipment the farmers will need to process their fodder. This universal equipment was produced in Perm with some parts imported from Italy. Altogether the machinery will cost each farm 1.9m rubles, to be paid over the next three years. Five farms in the Republic already have similar machinery, according to Komiagropromtekhnika.

Kominform
(Syktyvkar),
August 15, 2000

Transaero Airlines has announced its first purchase of an A-310 aircraft since the financial crisis of 1998. After the crisis, the company was forced to reduce its fleet by nearly half, including most of its large, long-range aircraft. The company will lease the new Airbus directly from the manufacturer, Western Europe’s Airbus. The aircraft holds up to 180 passengers, 30% more than the Boeing 737s that currently make up the bulk of the company’s fleet. In future, says the chairman of Transaero’s board of directors, Aleksandr Pleshakov, the company plans to lease a second Airbus as well. Not only will these aircraft be used for currently existing flights, they will also enable Transaero to extend its service to new destinations.

Vremya Novostei
August 21, 2000

The administration of the Frunze District of St. Petersburg has agreed to lease some specialized boats to the Khorezm Region of Uzbekistan that will enable the latter to clean the Amudarya and Syrdarya Rivers. The vessels will be built by a subsidiary of the Northern Shipyards Shipbuilding Plant, most likely in Urgench, the capital of Khorezm, where the cheaper labour and lower transportation costs will make the project more attractive. St. Petersburg is also expected to begin supplying Uzbekistan with electrical technology, metal and welded structures.

Delovoy Peterburg
August 22, 2000

Nizhny Novgorod has formed 5 committees this year to organize a competition among regional enterprises for the right to receive automobiles and equipment via leasing. The committees have already received applications from 78 leasing projects, including 51 for automobiles and 6 for various kinds of equipment.

Biznes dlya vsekh (Business for Everyone)
August 23, 2000

Krasnoyarsk’s machinery makers have announced a competition entitled «Best Performance on the Best Combine,» to be held in the 14 regions of Russia where Krasnoyarsk combines are currently in use. Farmers in the Chelyabinsk Region have leased 300 combines from Krasnoyarsk and are already using them to gather their harvest. Combine operators in Chelyabinsk are among the many contestants with a chance of winning a Niva car in the competition.

Ural-Press-Inform (Krasnoyarsk)
August 29, 2000
A new government program entitled Civil Aviation Development for 2000-2015 could solve many problems in the Russian aviation industry, believes Yury Koptyev, director of Rosaviakosmos. According to Mr. Koptyev, the program, which will receive 40% of its funding from the government and the rest from private sources, is intended to strengthen state support for projects involved in the development or production of new aircraft. The program will also aim to promote leasing as a way for Russian airlines to obtain these new aircraft. Among Russia's 300 aviation companies, only 14 earn revenue from freight service. Mr. Koptyev emphasized that Russian airlines do not have the resources to purchase new aircraft and are therefore faced with the following choice: either to continue leasing Western airplanes, thereby decisively undermining Russian aviation manufacturers, or to develop a Russian leasing system at low interest rates (no more than 6%).

Novosti Russian Information Agency
August 30, 2000

ROS_BANK has begun to finance leasing. The bank will help leasing companies purchase new vehicles for subsequent leasing. It will finance up to 70% of a vehicle's value for periods of up to two years. Leasing is especially attractive to companies involved in highway construction, mining and metallurgy, as well as organizations wishing to create or expand their own fleets of automobiles.

Novosti Russian Information Agency
September 8, 2000

Samara. It will soon be possible to buy VAZ automobiles on deferred payment plans in every region of Russia. According to the Volga Plant's public relations department, the company has developed a leasing plan for organizations and a credit plan for individuals. Explanatory documents are already being distributed throughout the company's network of dealerships. Organizations will be required to make 50% down payments, with the remaining value to be paid to the bank over a period of one or two years. Individuals will be able to take out bank loans for the full value of a car, paying them off with interest over the period stipulated within the lease agreement. The new deferred payment plans are expected to boost sales during the off season.

ITAR-TASS
September 14, 2000

Since the beginning of this year, Nizhgorod's Fund for the Support of Entrepreneurship has leased 61 automobiles and 6 production lines worth over 9 million rubles. According to Vladimir Bulanov, director of the Department for the Support and Development of Entrepreneurship, the leased equipment has included wood-processing machinery, ironing and drying machines and refrigerators. The Nizhegorodsky Leasing Company has leased an additional 13 pieces of equipment. Mr. Bulanov also noted that one of the Fund's main goals is to create a guarantee fund that would make it easier for small businesses to obtain loans. In fact, the Fund has already signed an agreement with NBD Bank to create such a guarantee fund for small businesses. Under this agreement, NBD Bank will grant loans to small businesses backed by 50% guarantees from the fund. The bank has already financed 19 projects valued at 6.1m rubles under the new program, while the fund has provided 2.8m rubles in guarantees.

Birzha (Nizhny Novgorod)
September 14, 2000

Aldanlesprom, a wood-processing plant in the Republic of Yakutia, has a new lease on life - thanks to its new lease on some Japanese-made TANAKA equipment. The small factory in the city of Tommota had not been able to compete with its larger rivals and was on the verge of collapse when a corporation by the name of Railroads of Yakutia (Zheleznii dorogi Yakutii) took it under its wing. The corporation helped Aldanlesprom
lease some high-tech Japanese wood-processing equipment, as well as four powerful Finnish logging machines. The factory was able to hire 64 new workers. The fact that a railroad runs through Tommota means that Aldanlesprom, which produces international-standard timber, can reach both domestic and foreign buyers and significantly reduce their production costs. The company has already signed deals with Sakhamebel' (Sakha Furniture), Tabaginsky Timber Factory and the Yakutia Ministry of Agriculture. In the future, the company would like to start producing railroad ties, not only for its own railroad, but also for the Russian Ministry of Communications.

Yakutiya (Yakutsk)
September 14, 2000

So far this year, the Perm Region's Leasing Committee has provided regional farms with 95.5m rubles worth of machinery and spare parts, including 81 combine harvesters, 54 tractors, 31 pick-up attachments, and numerous automobiles, fodder-production lines and other pieces of farm equipment. Priority has been given to technology that raises productivity, such as combined tilling and sowing apparatus (APK-3.8, Ob-4, Lider-4), German-made Smaragd cultivators, and sprinkler systems made with Agro-Patrul-03 parts. In order to improve seed quality in the region, the Committee has also provided local seed-growing farms with 10 Claas combines, 5 of which were purchased second-hand. This year the Perm Region has leased some specialised production equipment, which should produce enough of the material in 2001 to meet the needs of the region's farmers at significantly lower prices. Finally, the region has leased 4 sets of German-made Westfalla cattle-breeding equipment. At the federal level, 12 Yenisey grain harvesters, 93 tractors, and various other kinds of machinery worth a total of 38m rubles are being leased to the region's farmers this year. The Department of Agriculture and Foodstuffs is leasing the equipment through Permagrosnab (Perm Agricultural Equipment) and Tsentralny Agrosnab (Central Agricultural Equipment). The subleases were awarded to these companies as prizes in a regional leasing competition.

Zvezda (Perm)
September 28, 2000

According to the Russian Ministry of Agriculture, the Russian Agricultural Bank has earmarked 70m rubles in loans for Russian farming. The bank, which has been called upon to help implement the government's Program for Preferential Loans to Agricultural Producers and Improvement of the Leasing Industry, has 375m rubles in charter capital. The federal government has already earmarked 1 billion rubles in subsidies for low-interest loans in 2001. This is expected to attract 9 billion rubles in low-interest loans to agriculture and the food processing industry next year.

Novosti Russian Information Agency
October 5, 2000

FOREIGN PRESS DIGEST

The government of India plans to invest $2.2 billion in civil aviation, including a new aviation plant for passenger aircraft and programs to sell or lease the new planes abroad. Foreign investors have been showing more and more interest in the Indian market, investing about $2.5-3.5 billion per year over the last few years, setting up joint ventures, and giving commercial and long-term loans to Indian businesses through international financial institutions. The total influx of foreign capital to India has reached $8-9 billion per year. A large part of these funds has gone towards regional energy and social welfare projects and the development of regional infrastructure.

ITAR-TASS Planeta
August 31, 2000

Leasing will enable the Kostanay region of Kazakhstan to upgrade its farm machinery. According to Umirzaka Shukeyev,
Kostanay’s akim, the region will need 1,500 new combines to replace its aging fleet, 80% of which is more than 10 years old. Mr. Shukeyev has said that leasing would be the best way to acquire the new machines, especially since the region has already had some experience leasing American John Deeres. So far this year, the region has already leased 100 new Russian Yeniseys, with 50 new Don-1500s on the way. The region plans to buy mostly Russian-made machines, since they are quite similar to their American and German counterparts, yet considerably cheaper. Through leasing, the region should be able to upgrade its entire fleet within 4 or 5 years, says Mr. Shukeyev.

KazAAG Information Agency (Kazakhstan)
August 14, 2000

The Latvian company Hanza Leasing has seen its lease portfolio increase by 35% during the first six months of 2000. The company’s director, Artis Birkmans, says that his company’s success has been based on the growing popularity of leasing, as well as general improvements in the local economy. Vehicles account for the largest part of the company’s lease portfolio, totaling 28m lats, or 55% of its total volume. During the first six months of 2000, the company leased 763 passenger cars valued at 13.2m lats. Industrial equipment valued at 9.9m lats comprised another 19% of the company’s lease portfolio.

Baltic News Service (Riga)
August 22, 2000

When are lease agreements subject to anti-monopoly laws?

According to Article 16 of the Russian Federal Law on the Preservation of Competition in the Financial Services Market, any deal involving the sale of more than 10% of a financial institution’s assets (this includes leasing companies) is subject to anti-monopoly regulations. Thus, if a leased asset constitutes more than 10% of the lessor’s assets, the deal will fall under the jurisdiction of the anti-monopoly authorities.¹

If the leasing company’s charter capital exceeds 5 million rubles, it will need prior approval from the anti-monopoly board for every lease agreement. If the leasing company has less than 5 million rubles in charter capital, then either it or the lessee must notify the anti-monopoly authorities within 30 days after an agreement is signed.² The list of documents that must be submitted along with the notification can be found under Article 19, Clause 2 of the RF Law on the Preservation of Competition in the Financial Services Market.

QUESTIONS & ANSWERS

¹ This regulation only applies to lease agreements. Purchase agreements for leased assets fall under the jurisdiction of Russian antitrust law #946-1 on Competition and the Prevention of Monopolies in Commodities Markets (22/03/91).

Can cash serve as collateral on a lease?

No. Neither cash nor bank accounts may serve as collateral, since one of the key features of a pledge agreement is the ability to sell the pledged asset. This conclusion is based on Articles 334, 349 and 350 of the Russian Civil Code and Instructional Letter #26 of the Presidium of the RF Supreme Arbitration Court, entitled «How Arbitration Courts Implement the RF Civil Code's Mortgage Regulations» (15/01/98).

According to Article 334 of the RF Civil Code, when a debtor fails to meet an obligation to his creditor, that creditor may seek compensation by selling any pledged asset that served as a guarantee of the unfulfilled obligation. Articles 349 and 350 of the Civil Code stipulate that this sale must be executed by public auction.

Since cash cannot be sold by public auction, it fails to meet one of the principal requirements of a pledge agreement: the ability to sell the pledged asset.

What are the procedures for paying VAT when the lessee is a sole proprietor?

The leasing company. Since the lease payments will be subject to VAT, the leasing company should calculate and record VAT as usual, as if the lessee were paying the tax.

That is to say, any VAT that the leasing company has to pay when purchasing the leased asset should be deducted in full from the amount of VAT it has to pay into the state budget (which is calculated as the different between the amount of tax received and the amount paid).¹

The lessee. Article 2, Clause 1 of the RF Law on Value-Added Tax (06/12/91) lists all of the parties that must pay VAT but does not make any mention of ‘sole proprietors.’ In other words, sole proprietors do not have to pay VAT. This means that sole proprietors cannot claim tax refunds for VAT that was added on to the lease payments. However, this VAT can be deducted from the taxable base for total income tax.²

It should be noted that the Law on Value-Added Tax will no longer be in effect after January 1, 2001, when it will be replaced by Part Two of the Russian Federation Tax Code, particularly Chapter 21 on Value-Added Tax. Article 143 of this chapter recognizes sole proprietors as VAT payers and allows them to claim refunds on this tax.

¹ Article 7, Clause 2 of RF Law #1992–1 On Value–Added Tax (06/12/91).
² Article 3, Clause 2 of Federal Law #222–FZ on Simplified Tax and Accounting Procedures for Small Enterprises (29/12/95).
Can the lessee include insurance payments in his production costs if the leased asset is recorded on the lessor’s balance sheet?

Under a lease agreement, insurance may be paid by either the lessor (with compensation through the lease payments) or the lessee.

According to the Statute on the Composition of Expenditures, voluntary insurance payments on vehicles and property may be included in production costs. However, the total sum of these deductions may not exceed 2% of sales volume. Since the Statute on the Composition of Expenditures does not stipulate which rights (ownership or possession and use) the insurer must have in relation to the insured property, it follows that the lessee may include insurance payments in his production costs.

It should be noted that the Ministry of Finance has its own opinion on this matter: that voluntary insurance payments may be included in production costs if the leased asset is recorded on the lessor’s balance sheet. Although the Ministry’s letter on this subject is not binding, one would be well advised to reach an understanding with the local tax authorities beforehand.

\(^3\) Clause 2, Paragraph R of the Statute on the Composition of Expenditures for the Production and Sale of Goods, Labor and Services That May Be Included in Production Costs and on the Procedures for Calculating Financial Results for the Purpose of Profit Tax, confirmed by RF Government Order #552 of 05/08/92.

\(^4\) RF Ministry of Finance Letter #04-07-04 of 05/02/98.