

RUSSIA / EURASIA

Executive Guide



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Russia Looks Poised to Experience Investment Surge

Investment in Russia, both public and private, is set to boom as the financial sector and the state seek to intermediate funds being generated by the natural resource sectors. *REEG* examines some of the elements such as public-private partnerships, expansion of the public sector, and opportunities within the private sector. Page 2

VAT Recovery Issues Still Loom in the Ukraine

Ukrainian taxpayers and tax authorities continue to be faced with problems regarding VAT recovery, and recent tax rules have only made the situation harder. A recent ruling by the Supreme Administrative Court of Ukraine has set a significant precedent, which could aid taxpayers in the future when they file for a VAT refund. Page 15

2007 Sees a New Government Taking Charge in Kazakhstan and Working to Make Changes

With the start of 2007, changes were in place for Kazakhstan as the new government took over and initiated new legislation, which includes measures to help further regulate Kazakh subsoil users. The government has also announced plans to conduct tax inspections of the biggest oil and gas companies, which include KMG, TengizChevroil, and Karachaganak Petroleum Operating. All of these recent developments highlight efforts by the government to make subsoil users follow rules set out in contracts. Page 12

New Law Provides Enhanced Judicial Protection of Derivatives in Russia

Significant progress for judicial protection of derivatives has been made in Russia with the advent of a new Federal law "Federal Law No. 5-FZ *On Amendments to Article 1062 of the Second Part of the Civil Code of the Russian Federation*," which came into effect on February 9, 2007. This law is important as it offers judicial protection to settlement (index, non-deliverable) derivatives. Page 5

21st Century Perestroika - The Boom in Russian Private and Public Investment

By Roland Nash
(Renaissance Capital)

Russia is in the odd position of having both a large excess supply of capital and an equally large excess demand. The corporate debt market and the ballooning money supply amply illustrate the excess supply, with Russia's largest corporates able to borrow the liquidity at 6-8% in roubles, several percentage points below inflation.

Excess demand for capital is even easier to illustrate. One way is to measure the average age of Russia's capital base, which by 2004 was estimated at over 20 years (see Figure 1-Russia's Aging Capital Base). A more graphic way is simply to attempt to drive between any two spots within central Moscow after 14.00. Or, more disturbingly, to read the headlines of air crashes, power sector failures and apartment block infernos.

In many ways, Russia has survived transition thanks to the capital base it inherited from the Soviet Union. As important (arguably) as cash generated from hydrocarbons and more important (certainly) than money borrowed from the IMF has been the ability to run down the roads, pipelines, gas fields, schools, housing and hospitals erected during the Soviet period. While a lot of it wasn't very good, investment in the Soviet Union was at times running in excess of 50% of GDP - a remarkable transfer of wealth from that generation to the current.

Not maintaining a capital base is, effectively, a one-off transfer to new owners as under investment runs infrastructure into the ground. Much of that one-off went to the private sector through privatization. But equally a great deal went to the government as they focused on current obligations (pensions, debt service, public sector wages) and trusted that public infrastructure would survive with only relatively minor maintenance payments. Eventually, of course, any infrastructure reaches the end of its useful life-span and begins to crumble.

Generally speaking, the vortex created by large excess demand and large excess supply of the same resource in the same economy generates the incentive structure that encourages its own solution. Unfortu-

nately, in the Russian context, the situation is prevented from clearing by equally enormous logistical barriers. In the private sector, the logistical log-jam is the financial sector which is still incapable of intermediating between demand and supply effectively. In the public sector, it is Russia's bureaucracy which has so far proved incapable of taking the tens of billions of dollars of resources the government raises from the hydrocarbon sector and deploying it to regenerate Russia's public infrastructure.

What is perhaps the most exciting trend in Russia

In the public sector, it is Russia's bureaucracy which has so far proved incapable of taking the tens of billions of dollars of resources the government raises from the hydrocarbon sector and deploying it to regenerate Russia's public infrastructure.

today is that both of these barriers are being dismantled simultaneously. The success of that project will determine the shape of Russia's medium term future, certainly economically, and possibly also politically. If the blockage is cleared and capital can be deployed successfully, then Russia will move from oil dependence to the sort of dynamic economy which will allow it to achieve the economic success enjoyed in South East Asia or post-war Germany. If not, then inflation and an appreciating rouble will eventually choke off recovery and leave Russia surviving on the few industries not dependent on a competitive economy. The political incentive at that point could be to find more administrative means to encourage domestic industry.

Private Sector Intermediation

In the private sector, much of the news (though not all) is very good. While the banking sector is still small, it is growing extremely rapidly. The incentive created

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Kazakhstan: Recent Changes to the Kazakh Tax Code with Respect to Taxation of Dividends

By Grigory Pavlotsky, Zoya Shashkova
(Deloitte & Touche, CIS)

According to the recent changes to the Kazakh Tax Code, starting from 1 January 2007, the domestic dividend income of legal entities should be exempt from income tax withholding at the source of payment. Previously, domestic dividends were subject to withholding income tax at a rate of 15% by the entity paying such dividends and were not subject to further taxation at the recipient level. The Tax Code in effect for 2007 exempts domestic dividends from taxation at the source of payment, while preserving the previously effective exclusion of dividends received from the taxable income of legal entities. Dividends paid to non-residents are still be subject to income tax withholding at the rate of 15% under domestic legislation.

Given that the Tax Code exempts dividends paid to Kazakh legal entities from withholding income tax, whereas dividends paid to non-residents are still sub-

ject to withholding tax, this article discusses the taxation of dividend income received by a foreign legal entity from its Kazakh subsidiaries.

Under the Tax Code, permanent establishments (e.g. branches) of foreign legal entities should not be deemed tax resident in Kazakhstan; however, the taxa-

The Tax Code in effect for 2007 exempts domestic dividends from taxation at the source of payment, while preserving the previously effective exclusion of dividends received from the taxable income of legal entities.

tion regime applicable to permanent establishments is essentially the same as for Kazakh residents. Thus, starting from 2007, dividends paid / attributed by a

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Tax Code Changes *(from page 3)*

Kazakh company to a branch of a foreign legal entity should not be subject to income tax withholding at the source of payment (in the same manner as dividends paid to Kazakh legal entities). At the branch level, dividends received from a Kazakh subsidiary (of the same foreign entity which maintains the permanent establishment) should be included in the gross annual income of the branch with the subsequent exclusion of dividends received upon calculating taxable income. Please note that, for these provisions to apply, the dividend income should be connected with the activities of the permanent establishment in Kazakhstan.

Furthermore, under the Tax Code the base for the so-called "branch profits tax" (otherwise referred to as "tax on the net income of a permanent establishment") should be the after-tax income of a permanent establishment.

According to the Tax Code, such after tax income should be calculated as the taxable income less corporate income tax accrued with respect to this income.

According to the non-discrimination provisions of most of the tax treaties to which Kazakhstan is a party, nationals of a Contracting State shall not be subjected in the other Contracting State to more burdensome taxation than the taxation of the nationals of that other State in the same circumstances.

As taxable income of a permanent establishment is calculated in accordance with the provisions of the Tax Code attributable to resident entities, it appears that dividend income should not be included in the taxable base for branch profits tax either. However, the branch profits tax issue needs to be investigated further.

To summarize, it appears that the Tax Code in effect from 1 January 2007 provides that the dividend income of a permanent establishment of a nonresident should be taxed in the same manner as dividend income of a resident entity; i.e. dividends should not be subject to income tax withholding at the source of payment and should not otherwise be included in the taxable income of a permanent establishment subject to corporate income tax and subsequent branch profit tax.

With respect to the dividends payable to non-residents without a registered permanent establishment in Kazakhstan, these remain subject to income tax with-

holding at the domestic rate of 15%. This rate may be reduced under an applicable double tax treaty.

Given that dividends payable to resident companies should now be exempt from income tax withholding in Kazakhstan, it would be worthwhile considering whether it would be possible to apply the non-discrimination clause of the relevant double tax treaty to eliminate the income withholding tax due upon the remittance of dividends to residents of treaty countries without a permanent establishment in Kazakhstan.

According to the non-discrimination provisions of most of the tax treaties to which Kazakhstan is a party, nationals of a Contracting State shall not be subjected in the other Contracting State to more burdensome taxation than the taxation of the nationals of that other State in the same circumstances.

The nondiscrimination clause further stipulates that the taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorable than the taxation levied on enterprises of that other State carrying on the same activities. As the Tax Code provides for the exemption of dividends distributed to permanent establishments of foreign legal entities from taxation in Kazakhstan in the same manner as for domestic enterprises, it appears that the requirements of the non-discrimination clause of double tax treaties would be met.

As for the income withholding tax due upon the remittance of dividends to a resident of a treaty jurisdiction without a permanent establishment in Kazakhstan, it is unlikely that such income could be exempt from taxation in Kazakhstan based on the non-discrimination clause of a double tax treaty, due to the fact that such non-residents could not be deemed to be operating in Kazakhstan through a fixed place of business.

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Russia Enacts Law on Judicial Protection of Derivatives

By Anton Selivanovsky
(Baker & McKenzie, Moscow)

Federal Law No. 5-FZ *On Amendments to Article 1062 of the Second Part of the Civil Code of the Russian Federation*, dated 26 January 2007 (the "Law"), came into effect on 9 February 2007. Its purpose is to give judicial protection to settlement (index, non-deliverable) derivatives. Following its rejection by the Federation Council, the law was put to a revote in the State Duma, and 399 out of 450 Duma deputies supported it.

Since 1998 up until the recent introduction of the Law, it had been the view of Russia's supreme judicial authorities that claims arising out of derivatives in the absence of an obvious economic objective to the transaction could be classified as forms of betting. Accordingly, no judicial remedies were available in connection with claims arising out of derivatives.

The legislators chose to add a new clause to Article 1062 of the RF Civil Code (which is dedicated to claims made in connection with wagering and betting), giving judicial protection to claims if they meet the following criteria:

1) the claims arise out of participation in transactions that impose an obligation to make monetary payments on at least one of the parties;

2) the amounts to be paid depend on changes in prices of commodities and securities, the exchange rate of a particular currency, interest rates, inflation, or any indices calculated on the basis of the above, or on any other circumstances as may be provided by law and which may or may not arise; and

3) at least one of the parties to the transaction is a legal entity possessing a license authorizing it to engage in banking transactions, or a license to engage in professional activities on the securities market; with respect to transactions concluded on a stock exchange, at least one of the parties is a legal entity possessing a license authorizing its holder to participate in stock exchange transactions.

Moreover, the Law specifically provides that claims involving individuals based on the above-mentioned transactions are subject to judicial protection only if such transactions were made on a stock exchange. Also, according to the Federal Law *On State Regulation of Activities in Arranging and Conducting Gaming and On Amendments to Certain Legislative Acts of the Russian Federation* (No. 244-FZ, dated 29 December 2006), any activities connected with the arranging and conducting of games based on chance (of which betting is one)

with the participation of individuals require a license, which might also apply to derivatives.

The legislators chose not to introduce uniform definitions of "derivative", "derivative financial instrument" or "time transaction". Various legislative acts (the Tax Code, laws with respect to investments and pension funds, etc.) use varying terminology and regulate the legal relations to which they apply.

Since 1998 up until the recent introduction of the Law, it had been the view of Russia's supreme judicial authorities that claims arising out of derivatives in the absence of an obvious economic objective to the transaction could be classified as forms of betting.

The emergence of credit and weather derivatives in Russia depends on the enactment of another law, which is to list circumstances (underlying assets) in respect of which parties may envisage the emergence of claims. □

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Update of Russian Legislation

By Eric Michailov
(White & Case LLC, Moscow)

BANKING

Subordinated instruments

On 20 February 2007 the Central Bank issued Directive No. 1793-U amending its Regulation No. 215-P "On the Method of Calculation of the Net Worth (Capital) of Lending Organizations."

The Directive was registered with the Ministry of Justice on 7 March 2007.

Further to the recently adopted Federal Law No. 247-FZ, dated 29 December 2006 (discussed in our update for 25 December 2006 – 14 January 2007), the Directive addresses the concept of subordinated instruments and the procedure of their inclusion in, or exclusion from, the net worth (capital) of a lending organization.

A credit (deposit, loan, or bond loan) may qualify as a subordinated instrument (which may be included in the net worth (capital) of a lending organization, subject to a few exceptions) if it meets certain criteria, in particular, if a credit (deposit, loan) agreement or registered bond issuance terms provide that an early repayment (payment) of the credit (deposit, loan), in total or in part, the interest or bonds, as well as early termination of this agreement and/or its amendment are not allowed without the Central Bank's consent.

A credit (deposit, loan, bond loan) may also qualify as a subordinated instrument if the respective agreement or the registered bond issuance terms contain one of the following terms:

- a lending organization may initiate early repayment (payment), in total or in part, of the credit (deposit, loan), the interest or bonds, as well as early termination of this agreement and/or its amendment to this effect ("early repayment of the debt") not earlier than five years from the date of the inclusion of the respective subordinated instrument in the net worth (capital) of a lending organization; or

- early repayment of the debt is only allowed if, after the conclusion of the agreement (registration of the bond issuance terms), Russian legislation is amended to worsen the terms of the agreement (the bond issuance terms) for the parties.

Early repayment of the debt is subject to the preliminary consent of the Central Bank's territorial department; it may refuse to provide its consent on the grounds set out in the Directive.

The subordinated credits (deposits, loans, bond loans) granted to Russian lending organizations decrease the net worth (capital) of the lending organization that grants these credits (deposits, loans, bond loans), except for the acquired bonds that meet certain criteria.

The Directive also addresses the equity investment of lending organizations in the context of their net worth (capital). In particular, equity investment in the charter capital of a Russian lending organization, which is an open joint stock company, does not decrease the net worth (capital) of the investing lending organization, if this investment meets certain criteria.

The Directive entered into force on 14 March 2007.

Insurance of bank deposits

On 13 March 2007 the President signed Federal Law No. 34-FZ amending the federal laws "On Insurance of Individual Bank Deposits in the Russian Federation" and "On Payments by the Central Bank to Individuals in Connection with Their Deposits with Bankrupt Banks That are not Members of the System of Mandatory Insurance of Individual Bank Deposits in the Russian Federation."

The Law increases the insurance compensation guaranteed to individual depositors at banks participating in the system of mandatory insurance of individual bank deposits from 190,000 rubles (approx. US \$7,270) to 400,000 rubles (approx. US \$15,300). Compensation is paid if a banking license is revoked or if the Central Bank introduces a moratorium for the satisfaction of creditors' claims.

Similarly, the Law increases the amount of compensation to be paid to individual depositors of bankrupt banks not participating in this system.

The Law will enter into force on 26 March 2007.

Share acquisition

On 21 February 2007 the Central Bank issued Instruction No. 130-I "On the Procedure for Obtaining the Central Bank's Preliminary Consent for Acquisition and/or Receipt into Trust Management of Shares (Participation Interest) in a Lending Organization."

The Instruction was registered with the Ministry of Justice on 14 March 2007.

According to the federal laws "On the Central Bank of the Russian Federation (Bank of Russia)" and "On Banks and Banking Activities," the acquisition, or receipt into trust management, of more than 20% of shares (participation interest) in a lending organization by a person or a group requires the Central Bank's preliminary consent.

The Instruction sets out the procedure for obtaining this consent. In particular, it classifies the consent depending on the range within which the shares (participation interest) may be acquired and/or received in trust (e.g., more than 20%, but less than 25% of shares). The Instruction lists the documents required for obtaining the consent and the requirements for the acquirers.

A preliminary consent which was issued before the Instruction's entry into force is effective for 12 months from

the date of its issuance. The acquisition of additional shares (participation interest) in the lending organization will require new preliminary consent, which must be obtained in accordance with the Instruction.

The Instruction will enter into force ten days after the date of its official publication and invalidate certain provisions of the Central Bank Instruction No. 109-I, dated 14 January 2004.

CURRENCY CONTROL

On 17 February 2007 the Government adopted Resolution No. 98 approving the Rules for the submission of information and documents to the currency control agents by residents and non-residents.

The Rules set out the terms and procedure for the submission of information and documents to the currency control agents (except for authorized Russian banks) by residents and non-residents.

Both residents and non-residents must submit documents and information related to currency operations, upon request, to the professional participants in the securities market (which are not authorized banks), registrars, and customs and tax authorities. These must be submitted within the term set out in the relevant request. This term may not be less than *seven working days* from the day when the request was received.

The Resolution entered into force on 21 March 2007.

OIL EXPORT DUTY

On 20 March 2007 the Government adopted Resolution No. 164 approving new rates of export customs duty on crude oil and crude-oil products exported beyond the borders of the Russian Federation to countries outside the Customs Union.

The Resolution lowers the rate of customs duty payable on crude oil and crude-oil products extracted from bituminous formations (TN VED 2709 00) exported outside the countries which are members of the Customs Union (i.e., Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan). The new rate is set at USD 156,40 per ton (the previous rate was USD 179.70).

The new rate applies as of 1 April 2007.

CONSTRUCTION

On 5 March 2007 the Government adopted Resolution No. 145 approving the Regulation "On Organizing and Conducting State Expert Review of Design Documentation and Engineering Survey Reports."

According to Article 49 of the Town-Planning Code of the Russian Federation, design documentation for construction and engineering survey reports are subject to complex state expert review. The Regulation sets out the procedure for this state expert review.

In particular, the Regulation sets forth (i) authorities that are competent to conduct state expert review, (ii) documents that must be submitted for state expert review, (iii)

the procedure for state expert review, (iv) requirements for state experts who may carry out state expert review and (v) fees for state expert review.

The Resolution entered into force on 23 March 2007 (save for the provisions regarding the status of state experts which will apply from 1 January 2008) and invalidate Government Resolution No. 1008, dated 27 December 2000, regarding the similar matter.

LAND

On 5 February 2007 the President signed Federal Law No. 11-FZ "On Amendments to Article 16 of the Federal Law 'On Turnover of Agricultural (Farm) Land'."

According to Federal Law No. 101-FZ "On the Turnover of Agricultural (Farm) Land," dated 24 July 2002 ("Law on Agricultural Land"), land lease agreements can be concluded only in respect of agricultural land plots, but not in respect of shares in the joint ownership right thereto. In this respect, the Law on Agricultural Land requires to replace lease agreements in respect of land shares concluded prior to 28 January 2003 (the date of entry into force of the Law on Agricultural Land) with lease agreements in respect of agricultural land plots. Such replacement was to be completed by 28 January 2007.

The amendments now postpone the deadline until 27 January 2009.

The Law entered into force on 20 February 2007.

On 28 February 2007 the President signed Federal Law No. 21-FZ "On Amending Article 61 of the Land Code."

According to the previous version of Article 61 of the Land Code, the federal or regional governmental authorities must compensate losses caused by their unlawful acts. Pursuant to the amendments, the municipal authorities also must provide compensation for losses caused by their unlawful acts.

The Law entered into force on 14 March 2007.

FOREIGN CITIZENS

On 14 February 2007 the Government adopted Resolution No. 94 approving the Regulation "On State Information System of Migration Records."

The Resolution was adopted pursuant to Federal Law No. 109-FZ "On the Migration Record of Foreign Citizens," dated 18 July 2006 (discussed in our update for 10-23 July 2006).

The Regulation sets forth the procedure for establishing and compiling a centralized state database for keeping records of foreigners residing in or visiting Russia. The Federal Migration Service will operate the database.

In particular, the Regulation lists the governmental bodies that must provide information on foreigners for the database. It also stipulates, among other things, the terms of access to the database and protection of its contents.

The Resolution entered into force on 1 March 2007.

On 17 February 2007 the Government issued Resolution No. 97 establishing when foreign citizens may work

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Russian Legislation *(from page 7)*

outside the region where they have received work permits or temporary residence permits.

Pursuant to Federal Law No. 115-FZ "On the Legal Status of Foreign Citizens in the Russian Federation," dated 25 July 2002, the Resolution establishes when a foreign citizen may work outside the constituent entity of the Russian Federation where the foreigner has received a work permit or a temporary residence permit.

A foreign citizen who is in Russia on a temporary basis, having obtained a work permit, or a foreign citizen who temporarily resides in Russia may work outside the region where the work permit was issued or the region of his or her temporary residence if:

- the foreigner is on a business trip, provided his or her business trips do not add up in total to more than 10 days of the work permit's valid time period (or 40 days of a 12-month period for foreigners with temporary residence permits); or

- the foreigner performs his or her job duties en route or performs a job requiring travel to different places, provided (i) this is envisaged by the employment agreement and (ii) the employee's work outside the relevant region does not last for more than 60 days of the work permit's valid time period (or 90 days of a 12-month period for foreigners with temporary residence permits).

The Resolution authorizes the Ministry for Public Health and Social Development to approve a list of jobs and works that foreign citizens may perform outside the region where they have received work permits or temporary residence permits.

The Resolution entered into force on 21 February 2007.

MIGRATION POLICY

On 3 March 2007 the President signed Federal Law No. 26-FZ "On Ratification of the Agreement between the Russian Federation and the European Community on Readmission."

The Law ratifies the Agreement between the Russian Federation and the European Community on Readmission, signed in Sochi on 25 March 2006 (the "Agreement").

The Agreement seeks to establish effective procedures for the identification and return of persons who do not, or no longer, fulfill the conditions for entry to, presence in, or residence on the territories of the Russian Federation or one of the Member States of the European Union, and to facilitate the transit of such persons. The Agreement will apply to the territories of the Russian Federation and the Member States of the European Union, except for Denmark.

The Law entered into force 18 March 2007.

FIRST READING

Bank for Development and Foreign Trade

On 14 February 2007 the State Duma adopted in the first reading Draft Law No. 388174-4 regarding establishment of a Bank for Development and Foreign Trade (the "Development Bank").

The draft law envisages the establishment of the Development Bank in the form of a state corporation. The Development Bank will seek to encourage the country's economic development. In particular, it will stimulate investment and support the export of goods (works, services).

The amendments will enter into force if adopted by the State Duma in three readings, approved by the Federation Council and signed by the President.

Subsoil

On 13 March 2007 the State Duma approved in the first reading Draft Federal Law No. 370920-4 "On Amendments to Article 10 of the Federal Law on Subsoil."

The proposed amendments extend the period for conducting geological studies in respect of subsoil plots under internal seas, territorial seas, the continental shelf and the exclusive economic zones of the Russian Federation from five to eight years.

The amendments will enter into force if adopted by the State Duma in three readings, approved by the Federation Council and signed by the President.

TAX

Value added tax (VAT)

On 16 January 2007 the Presidium of the Supreme Commercial Court issued Resolution No. 9010/06.

The Presidium of the Supreme Commercial Court considered a tax dispute in which the tax authority denied the input VAT offset claimed by a leasing company in respect of acquired fixed assets that were transferred to a lessee under a leaseback. The tax authority's position was upheld by the courts of three instances. In particular, the courts concluded that for the leasing company, the leaseback was not economically justified as it generated a very moderate net income (in the amount of the difference between lease payments (at a rate of 9%) and interest expenses (at a rate of 6-8%)), and if compared with the annual inflation rate of 7.5-8% for 2006, it was completely a loss-making transaction.

Although this tax dispute was not ultimately resolved and was sent to the court of first instance for new consideration, the Presidium made a few very important (and generally positive) statements.

First, the Presidium noted that leaseback is provided for under Federal Law No. 164-FZ "On Financial Leasing", dated 29 October 1998, and has both rational economic grounds and business purposes for the parties to the transaction that do not imply *unjustified tax saving/ben-*

RUSSIA

efit. In the dispute under consideration, the tax authority failed to prove that the leaseback lacked reasonable economic and other purposes.

Second, the Presidium stated that this *real business transaction* was recorded for tax purposes in accordance with its *actual economic substance* which entitled the leasing company to claim input VAT offset (subject to fulfillment of other conditions for the offset).

Third, the entitlement and the conditions for the input VAT offset are explicitly provided for under the Tax Code and do not depend on the profitability of the taxpayer's operations in a particular tax period.

Fourth, tax violations solely on the part of the counterparty provide insufficient evidence that the leasing company received *unjustified tax savings/benefits* in the form of the input VAT reimbursements.

Although the Resolution was issued in relation to a specific matter, it may serve as a guideline for the lower courts when dealing with similar matters.

Profit tax

On 6 February 2007 the Supreme Commercial Court issued Resolution No. 13225/06.

The Supreme Commercial Court held that a tax agent is not subject to tax liability for non-withholding of withholding income tax if a residency certificate was obtained after the transfer of income to the foreign company but prior to the tax audit.

Although the Resolution was issued in relation to a specific matter, it may serve as a guideline for the lower courts when dealing with similar matters. □

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RUSSIA

Boom *(from page 2)*

by largely unleveraged households willing to borrow at 14% in roubles to finance mortgages, small and medium sized enterprises able and willing to borrow at 15% and consumers prepared to borrow at up to 30% to bring forward growing wages is driving banks and investment funds able to finance at 6-8% to build out infrastructure at an incredible speed. A scalable 1000+ bps spread in a rapidly growing economy where sovereign risk is measured at 100 bps in a world where risk is priced at its lowest level in decades can incentivise some pretty ambitious expansion plans. There remains a log-jam in the private sector, but it is being removed at an astonishing speed. Everything from home improvement loans to venture capital is booming (see figure 3-Banking Sector-Growing Rapidly), driven by financial institutions from Sberbank to Citigroup.

Unfortunately the rate of growth carries its own inefficiencies. Increasing financial intermediation by in excess of 80% per annum requires a very robust financial infrastructure. First rate personnel, state-of-the-art IT systems and reliable information are required for efficient decision making. In Russia, much of the financial build out is being done on the run. The price being paid for branch networks (4-6 times book) and qualified personnel (ask Goldman) amply illustrates how valuable parts of the financial infrastructure are becoming. In this kind of environment, when financial

intermediation is growing so rapidly through relatively weak systems, mistakes are inevitable. Some of this can be seen in the growing NPLs of the increasingly competitive consumer finance organizations. Less obviously, is the likely short-cuts being made on risk systems and liquidity measurement which will only become visible should liquidity dry up.

But despite the inevitable teething troubles, the financial revolution currently engulfing Russia's private sector is an incredibly powerful force for improving the economy. SMEs are becoming less capital constrained from expansion and can therefore grow. The wealth generated from lowering the cost of capital by 1000 bps for much of the non-traded economy will be enormous. After all, much of the trillion dollars of value created in the equity market since 2000 was because of falling spreads. Already in 2006, the average Russian increased his wealth by roughly USD8000 because of housing price increases. The average annual income during the same period was USD4000.

Public Sector Intermediation

What is less clear is the benefit of intermediating the value created by commodity producers through the public sector. Perhaps the biggest single surprise success story of the Russian government since the reforming of the tax system in 2000-2003 has been the rules-based, efficient accumulation of the USD100 bn stabi-

Continued on page 10

Boom (from page 9)

lization fund. But not spending money, while politically difficult, is logistically a lot easier than spending it effectively. Now, perhaps because of elections, but at least as much because of the obviously crumbling public infrastructure, the government is beginning to spend it.

There are four principal strategies through which the public sector will intermediate funds - through the budget, through the stabilization fund, through public-private-partnerships (PPPs) and through state dominated national champions.

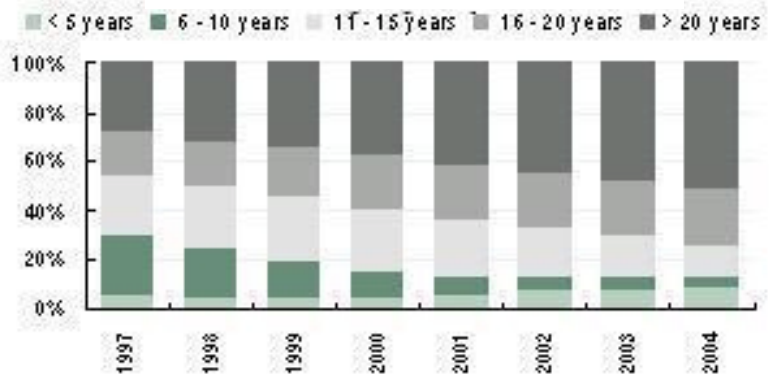
Budget

The most obvious, but least ambitious is directly through the federal budget. Expenditures are set to grow from USD157bn in 2006 to USD275 bn in 2008 (16-18% of GDP). Within this increase, a proportion will be spent on four heavily publicized 'National Projects' orchestrated by First Deputy Prime Minister Dmitri Medvedev and another part allocated to an Investment Fund to be run by the Ministry of Economics, Development and Trade. The four national projects have been allocated RUB217 bn (USD8 bn), much of which will be spent on health (see figure 4-Planned Spending on the National Projects). The Investment Fund receives RUB70 bn (USD2.5 bn) per annum to be spent on projects accepted by the Economics Ministry and is generally parceled out in the form of public-private-partnerships (see below).

Stabilisation Fund

So far, the stabilisation fund is invested in much the same way as are international reserves, in short-dated non-Russian government securities (for the most part euro and dollar treasuries). However, this year it was

Russia's Aging Capital Base



Source: <http://www.riep.ru/>

decided that when the fund reaches the equivalent of 10% of GDP (roughly USD125 bn), it will be split into two. The accumulated fund will be effectively renamed the 'reserve fund' which will continue to be invested in the same way. Any additional funds above 10% of GDP (roughly USD3 bn a month) will be placed into a second fund called the 'fund for future generations'. Currently there is debate about whether such a fund should be invested internationally (Finance Ministry proposal) or domestically (just about everybody else). The fund should reach 10% of GDP some time in the third quarter, roughly 6 months before presidential elections, creating a considerable political imperative to spend the money domestically.

Public-Private-Partnerships

PPPs are the great white hope of the government in the quest to regenerate infrastructure. Private groups tender projects to the Economics Ministry which throws in some public money, largely from the Investment Fund, to the successful applicants. So far, 10 projects have been accepted ranging from tunnels under the Neva in St. Petersburg to toll roads between Moscow and Novorossisk. Other plans include reconstructing sewerage plants in Rostov-na-Danu, and more ambi-

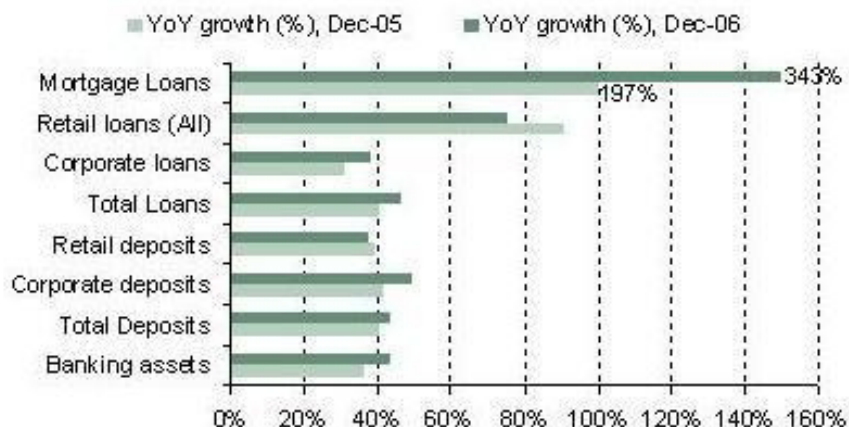
tious schemes to upgrade local urban infrastructure across Russia. From the ten projects so far chosen, the official target

Planned Spending On The National Projects (Rub, bn)

	2006	2007 plan
Education	25.28	31.18
Healthcare	88.4	120.5
Housing	35.4	46.2
Agriculture	16.2	18.7
Total	165.28	216.58

Source: PNP Council

Banking Sector – Growing Rapidly



Source: CBR

for private money to be invested is RUB770 bn (USD30 bn), leveraging the public sector allocation roughly 20 times. Aside from the sums involved, the most hopeful aspect of the PPPs is that there is at least some market discipline at work. While inflationary pressure from the spending is inevitable, PPPs may well prove to be the most effective means of allocation public money.

Investment By National Champions

The largest element of public sector spending could well come from the country’s national champions. The investment targets of public entities are sky-rocketing. Between 2006 and 2008, Transneft plans capex of USD14 bn compared to USD6 bn over the three previous years as it builds out its pipeline network. Between 2007 and 2009, Gazprom plans capex averaging USD20 bn a year compared to USD12 bn over the previous three years. As UES raises funds through the IPO process, the power sector should see investment grow from USD3 bn and USD7 bn in 2005 and 2006 to USD20 bn and USD29 bn in 2007 and 2008. As investment switches from brown field development to green field, the oil sector should see investment grow from a total of USD8 bn and USD10 bn in 2005 and 2006 to USD17 bn and USD18 bn in 2006 and 2007. The increase in total capex among the national champions is clearly in the tens of billions per year starting this year. Changes of this magnitude will have a substantial macroeconomic impact.

The numbers involved in the expansion of public sector investment are clearly large. State plans are not always fully executed, but even so, the increase in investment will be several percentage points of GDP per annum. Given the rather mammoth social problems facing Russia, from a declining population to power

sector shortages, it is very clear that funds have to be allocated to the public sector. The problem is that Russian state run institutions do not have a particularly good track-record at spending money effectively. Pumping several percentage points of GDP into the economy in the midst of an already roaring domestic economy risks inflation and asset price bubbles.

What is encouraging is that there appears to be rather more imagination and care going into spending plans than we had feared. While there are dangers with PPPs, national projects and investment by national champions, they are considerably less

than if the federal budget and stabilization fund were simply allocated to pre-election popular spending. Although there may well also be some of that, the majority of the funds appear to have allocation strategies which are remarkably sensible given the constraints of the justifiably infamous Russian bureaucracy.

Investment, both public and private, is set to boom as the financial sector and the state seek to inter-mediate the funds being generated by the natural resource sectors into the rest of the capital constrained economy. The investment is eminently necessary. As a percentage of GDP, total investment in Russia is still only around 19%. When Korea, Japan and Germany went through their restructuring, investment was between 25% and 40% of GDP. Investment at that level was enough to compensate for an appreciating currency and underpinned multi-decade high growth rates.

If Russia is to maintain its impressive recovery and to allow the diversification of its economy, it needs to improve investment rates towards these levels. As the financial and public sector logjams are being dismantled, that investment is beginning to take off. Because of the inefficiencies inherent in a rapid build-out, risks exist in both the financial and (particularly) public investment programmes. But, at the very least, the economy is going to enjoy a large investment boost in coming years, with particularly positive implications for all firms involved in infrastructure development from steel to cement. □

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New Kazakh Government Signals Policy Changes

By Irina Denisova

A new Kazakh government came into office at the beginning of 2007. It is already clear that this new generation of Kazakh leaders intends to correct the mistakes in oil and gas policy emerging over the past several years and introduce a new strategy for developing the sector. Astana is reconsidering the principles governing its relationship with foreign oil and gas investors.

The Kazakh government promises that 2007 will produce a number of actions directed toward toughening the operating conditions of foreign extracting companies working in the country. The changes will concern practically all sectors—ecological, tax, export-import and others. On March 1, 2007, Kazakh authorities will begin selective tax inspection of the largest

The structure of the new government clearly shows that the president has considerably enhanced the economic influence of power structures and Kazakh financial and industrial groups centered about capital oil lobbyists.

subsoil users. In total, there are 32 companies included in the country's oil and gas market, including the national holding KazMunayGaz (KMG).

In January 2007, Nursultan Nazarbayev required the resignation of the entire government led by Prime Minister Danial Akhmetov and has appointed a new one. The newly appointed Prime Minister Karim Masimov has moved quickly to oversee the departments representing power structures in the country. After the first two months of operations, the Masimov government has already adopted several important legislative initiatives, including a strengthening of controls over Kazakh subsoil users and oversight of export and import matters.

The regrouping of forces within the government almost certainly means that authorities are preparing for a serious campaign directed toward investors. Most likely, in 2007 subsoil users are going to receive an increase in tax claims from the state, lawsuits and other legal proceedings.

Over the past several years, the economic situation has markedly changed for the better and that gives Astana confidence and an opportunity to change the tone in dialogue with foreign investors. Kazakhstan has decided that it has already paid in full to the oil com-

panies that came into the country during the 1990s. Then authorities gave them rather preferential taxation and guaranteed conditions of contracts. However, now the sentiment among officials is that all of them should work in the republic based on present and not former concessionary terms. Practicing a new approach to foreign investors is a main task of the Masimov government.

Stabilizing the Country

Experts identify the main reason for Akhmetov's departure is a distinct need for economic diversification. Nazarbayev has put forward a goal of having Kazakhstan as one of the world's 50 most competitive nations, and to achieve this objective every possible effort will be undertaken. The president has delegated tasks in the development of the processing sector and changes in the oil and gas sector of the country as a whole to the leadership of Masimov. Akhmetov's "technical" government did come close to attending to these problems.

The structure of the new government clearly shows that the president has considerably enhanced the economic influence of power structures and Kazakh financial and industrial groups centered about capital oil lobbyists. In the opinion of Michael Vinogradov, head of the analytical department at the Propaganda communication technologies, Masimov's appointment means a strengthening of Timur Kulibayev's position. Kulibayev is the board chair of KMG and deputy executive director of the Samruk state holding. He is an attractive figure for foreign figures as well as for a significant part of the Kazakh political elite. Masimov is an old colleague and partner of Kulibayev.

The appointment of Marat Tazhin, the former secretary of the Kazakh Security Council, as Minister of Foreign Affairs, indicates that experts in defense and security will now oversee state relations with foreign companies. Imashev Berik, former deputy head of the Administration of the President, is the new secretary of the Council.

In the oil and gas sector, Baktykozha Izmukhambetov retains the post of the main state managing director as Minister of Energy and Mineral Resources. The post represents a not well organized but influential group from Western Kazakhstan where the main oil deposits and industries are located. As a whole, the structure of the new government reflects that Astana's short-term policy will focus on the further strengthening of the state's position in the oil and gas sector, with the supporters of Masimov influencing more strongly its development than those of Akhmetov.

Behind the Changes

The realignments occurring in the Kazakh government do not portend anything good for the foreign companies working in the republic. One of the main negative policy trends lately is a change in the balance between the state and investors in oil and gas, along with a reduction in the participation of western companies in development of the Kazakh deposits as a whole. The principal struggle involves strengthening the control and supervision of the extracting companies, as well as identifying and punishing especially malicious violators. The principle of the new prime minister —“More does not mean better,” means he considers results more important than the number of companies participating.

At the end of the first quarter, the government has declared it will carry out tax inspections of the largest oil and gas companies. Among them will be KMG, TengizChevroil, the consortium developing the huge Tengiz field, Karachaganak Petroleum Operating (KPO) and the consortium Agip KCO, the operator of the North Caspian project. Carrying out and controlling the inspections will be the new specialized department working with subsoil users of the tax committee at the Kazakh Ministry of Finance. The department came into being in October. Previously, the interregional tax committee located in the same ministry carried out similar functions. The new department will keep the same status and powers, but will now be over-

seeing 200 others subsoil users. If field developers continue systematically to violate the tax laws, the department threatens to send the inspection results to the government and recommend suspension or withdraw of licenses.

Revisions will also strengthen purchases and sales. This will take place through amendments of the law “About State Control over Application of Transfer Prices.” Inspections of transactions on importing equipment subsoil users in West-Kazakhstan and Atyrau areas where the current main oil extractions exist, have shown that in some cases the price exceed market price ten times. This practice allows operators to increase the amount of compensated expenses, together with a production share, while at the same time reducing the taxation base.

The prime minister explains these and other measures as attempts to force subsoil users, both local and foreign, to observe precisely those rules incorporated in contracts. “Execution of contract conditions by subsoil users as a whole is now at an unsatisfactory level.” Masimov says. “It is a question, first of all, of prolonging exploration terms, delaying the beginnings of commercial operation of deposits and overestimation of operating expenses. We talked about it a lot because it results in causing big damage to the state and people,” Masimov said at the Ministry of Energy and Mineral Resources (MEMR) in February and called on ministry employees to be “more rigid and to defend more precisely the state interests” in such cases. □

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Latest Changes Affecting Real Estate and Construction in Ukraine

By Serhiy Piontkovsky
(Baker & McKenzie, Kiev)

Privatization of objects of unfinished construction is carried out together with land plots

In order to implement the Law of Ukraine On the State Budget for 2007, dated 19 December 2006, the State Property Fund has adopted Order No. 25 On Privatization of the Objects of Unfinished Construction together with Land Plots, dated 15 January 2007. The order authorized the regional departments of the State Property Fund to carry out privatization of the objects of unfinished construction together with the underlying land plots starting from 11 January 2007, pursuant to the procedure approved by the Cabinet of Ministers of Ukraine.

New cap for infrastructure development charges

The Cabinet of Ministers of Ukraine has adopted Regulation No. 40 On Capping Customers' Funds Used for the Development of the Engineering, Transportation and Social Infrastructure, dated 24 January 2007 (the "Regulation"). The Regulation invalidates earlier Regulation No.1930 dated 30 December 2000, which provided a 25% cap on such infrastructure payments.

Under the Regulation the maximum infrastructure charge is: (i) 20% of the value of construction of non-residential buildings; and (ii) 10% of the value of construction of residential buildings or buildings of cultural, educational, medical and health - improvement institutions.

The infrastructure charge is not paid by customers in the event of:

- i. construction being financed from state and local budgets;
- ii. construction of social residential buildings;
- iii. construction of residential buildings located on a land plot acquired at auction, provided that the land price included the cost of the engineering network installation;
- iv. new construction to replace facilities damaged or demolished as a result of acts of God.

The Regulation becomes effective from the date of its adoption 24 January 2007.

For further information, please contact Serhiy Piontkovsky, who is at the Kiev office of Baker & McKenzie. He may be reached by phone at: +380 44 590 0101 or via email at Serhiy.Piontkovsky@bakernet.com. Copyright Baker & McKenzie 2007. Reprinted with permission.

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Different Aspects of Value Added Tax Recovery in the Context of Court Practice in the Ukraine

By Grigory Pavlotsky and Yevgen Shyrynos
(Deloitte & Touche, CIS)

VAT recovery issues, its lawfulness, and related potential irregularities nowadays remain one of the most significant issues for both Ukrainian taxpayers and the tax authorities.

According to the statistics, only 60% of the VAT that was claimed by taxpayers for recovery within the last six months was actually refunded by the budget. Additionally, there are often significant discrepancies in the amount of VAT refunded in various regions and industries.

In some cases, tax authorities unjustifiably refuse to refund VAT by applying newly enacted tax rules which significantly worsen taxpayers' positions.

In one such case, the tax authorities challenged the amount of VAT claimed by a taxpayer for recovery and initiated a court hearing in order to reduce the VAT refund. The Commercial Court supported the taxpayer's position, confirming that the amount of VAT recovery was reasonable and rejected the tax authorities' claims.

The VAT Law effective at the date when the Court Decision was issued obliged the tax authorities to submit, to the State Treasury, the calculation of the VAT refund within five business days after completion of the administrative and judicial proceedings. In spite of the fact that the Commercial Court Decision had come into force, the tax authorities refused to provide the State Treasury with the relevant calculation of the VAT refund. The tax authorities based their position on the fact that, immediately after administrative and judicial proceedings, amendments to the VAT Law were introduced which denied taxpayers the right to claim a VAT recovery in the particular circumstances.

The Supreme Administrative Court of Ukraine ("SAC of Ukraine") in the Decision dated 7 June 2006 disagreed with the tax authorities.

In accordance with the article 58 of the Constitution of the Ukraine, law and other legal acts have no retroactive force, except in cases where they mitigate or annul a person's obligations. According to the VAT Law now in force, this particular taxpayer actually did not have the right to a VAT refund. However, the SAC of Ukraine ruled that, at the moment when VAT return was filed by the taxpayer, the VAT Law allowed the taxpayer to claim a VAT refund and the taxpayer has a

In some cases, tax authorities unjustifiably refuse to refund VAT by applying newly enacted tax rules which significantly worsen taxpayers' positions.

right to the refund in the amount approved by the ruling of the Commercial Court. The taxpayer properly filed a VAT return in a timely manner with all the required calculation for a VAT refund.

The ruling of the SAC of Ukraine established an important precedent demonstrating the possibility to apply the provisions of Article 58 of the Constitution of Ukraine to civil, commercial and tax relationships.

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