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The Development of the Foreign Investment Environment in the Russian Federation

by Mark David Davis* and Robert J. Sokota**

I. INTRODUCTION

During the Union of Soviet Socialist Republic’s seventy-year experiment with communism, foreign investment in the Soviet economy was almost entirely forbidden. Influx of foreign capital was considered inconsistent with the basic tenets of the socialist command economy — principles such as central planning and regulation, concentration of all productive assets in the state, and disapproval of foreign economic entanglements. But in its final few years, the Soviet Union’s attitude toward foreign investment radically changed as these previously governing economic principles were purposefully and steadily decimated. By the end, Soviet communists were preaching a market gospel, actively encouraged individual enterprise, and openly welcomed foreign investment — all in the name of perfecting and reforming socialism.

Of course, these economic reforms were part of a broader systemic change in the entire Soviet polity — a revolution in the basic political underpinnings of the society that culminated in its total transformation. And, given the breadth and severity of the changes taking place, not every element of the society was in favor of the various aspects of reform, as the attempted coup ultimately demonstrated. Conservative elements resisted economic normalization as incompatible with socialism and Soviet power. Viewed from their perspective, it turns out they were largely right: the movement away from official xenophobia and ideology, and

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1 This article is based in part on remarks delivered by Mr. Davis at a Symposium on East-West legal developments held at Brigham Young University.


toward political normalization and freedom of economic enterprise, undoubtedly undermined the authority of the Soviet state and ordained its collapse.

The causes and ramifications of the transformation of Soviet society and economy are manifold, and will occupy the attention of many writers. This article concentrates on the development of the legal framework affecting foreign investment in the final Soviet period, and then describes the current legal regime regulating foreign investment in the Soviet Union's primary successor, the Russian Federation. Finally, the article provides some observations on the practical application of these laws in the current investment environment.

II. SOVIET LEGAL REFORM AFFECTING FOREIGN INVESTMENT

A hallmark of Soviet economic and political reform was the promulgation of steadily more progressive business and investment laws. Of course, the political transformations of the past year have rendered those Soviet laws largely moot, and more changes will come as the various commercial and investment laws of the Soviet Union's successor states are put into practice and further evolve. Nevertheless, the new economic laws all trace their common beginning to the Gorbachev reforms of the final Soviet period, giving those Soviet laws a continuing value as an aid in understanding the present.

For years, the officially accepted Soviet attitude toward foreign investment was that the country's internal economic troubles were the fault of the Western capitalists' continuing attempt to frustrate the successes of the Soviet state. This attitude was due in part to the ill-fated intervention by western troops on the side of the White Army during the Bolshevik civil war, and in part to cold-war propaganda.

Consistent with this policy of suspicion of external market intervention, foreign participation in the Soviet economy was limited either to relatively simple purchase/sale transactions or the construction of turnkey plants with no equity retained by the Western party in the constructed enterprise. Direct investment that would give a foreign entre-

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See Arthur Downey, Joint Cooperation as an Instrument of East West Trade, in Legal
preneur the right to direct an enterprise or profit from its future success was not allowed. Soviet ideological scruples prevented such foreign control for two reasons: (1) private capital was anathema, and (2) foreign private capital was worse.

Therefore, most foreign economic contact in that period consisted of buying or selling. Pepsi Cola's famous invasion of the Soviet consumer market began in 1979, and a few favored and determined Soviet-oriented businessmen like Armand Hammer worked out deals involving raw materials. Ford and Fiat helped build factories. And the United States sold a lot of grain. But expansion of trade was limited by mutual distrust, perceived disproportionate risk, export controls (limiting U.S. exports to the Soviet Union), and the scarcity of items of interest to Western traders, other than gold, oil, or raw chemicals.

A. Representation Offices

For several decades prior to the reform movement, the only way a foreign company could establish a presence in the Soviet Union was to establish a "representation office." The perception was that such an office did not create much risk of foreign economic infiltration since the office was permitted only to assist in sales or consulting on behalf of the foreign company. A firm with a representation office could not engage in production, provide services, or carry out other operations in the Soviet Union. Therefore the risk of "harm" from capitalist representation offices was small, since little real economic benefit could be derived from such an arrangement. The corollary, of course, was that little economic benefit could accrue to the host country.

Nevertheless, foreigners with a representation office had one critical advantage over local would-be entrepreneurs: Soviet citizens were not permitted to engage in any kind of private business enterprise, except for small private plot farming. A few American and other foreign companies labored through the levels of bureaucracy to establish representation offices, but expansion was difficult and rarely rewarding.

B. The Law on Cooperatives

In 1988, then General-Secretary Gorbachev dealt a serious blow to

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7 See generally, Daniel Stein, Laws and Regulations Affecting Business Activities in Eastern Europe and the USSR, in LEGAL ASPECTS OF DOING BUSINESS WITH THE USSR AND EASTERN EUROPE CORPORATE LAW AND PRACTICE 67 (Corporate Law and Practice, Course Handbook Series No. 238, 1977); Regulations on the Procedure of Establishment and Functioning of Representative Offices of Foreign Firms, Banks and Agencies in the USSR, USSR Council of Ministers Decree, no. 1074 (Nov. 30, 1989).
the existing Soviet economic system with the Law on Cooperatives.\textsuperscript{8} This law legalized private enterprise on a small scale, typically family enterprises with just a few employees. Hundreds of private cooperatives were founded, including services like restaurants, retail shops, chauffeur services, facilities for the production of agricultural, textile, and other consumer goods, and even a few private law firms and other professional consulting groups.

Some Western observers discounted the new law as merely an attempt to legalize the existing shadow economy in order to tax or control it. However imperfect and reluctant this first step may have been, the Law on Cooperatives undermined one of the basic pillars of the old Soviet system by permitting private entrepreneurship. Many private citizens began making money, some a lot of money. Yet foreign investment was still not permitted.

C. Joint Venture Decree\textsuperscript{9}

In 1987, more pillars of the old system began to fall. As part of Gorbachev's perestroika policy to improve the efficiency of the Soviet economy and introduce limited capitalist incentives, the USSR Council of Ministers passed the Decree on Foreign Joint Ventures.\textsuperscript{10} This new law radically opened the Soviet economy in two previously unheard of ways. First it permitted, and even encouraged, foreign capital investment in production and service enterprises in the Soviet Union. Second, it exempted such enterprises from state planning control.\textsuperscript{11} Enterprises established under this decree were not required to purchase their materials from the state, and were not strapped with production quotas or managerial directions from the state.\textsuperscript{12}

Although it was a dramatic departure from past economic practices, the Joint Venture Law was still a cautious step. Foreign holdings in these ventures could not exceed fifty percent,\textsuperscript{13} the management had to include a majority of Soviet nationals, and the chairman of the board and the director general had to be citizens of the Soviet Union.\textsuperscript{14} Governmental approval from the Council of Ministers of the Soviet Union was required.\textsuperscript{15} The Soviet joint venture partner had to be a government

\textsuperscript{10} Id.
\textsuperscript{11} Id. § III, art. 23.
\textsuperscript{12} See generally, Joint Venture Law.
\textsuperscript{13} Id. § II, art. 5.
\textsuperscript{14} Id. § III, art. 21.
\textsuperscript{15} Id. § I, art. 1.
agency or connected to a government agency and acting with its permission.\textsuperscript{16}

Although skeptics scoffed, the door was unlocked and opened a crack, and more fundamental and far-reaching changes came soon thereafter. Indeed, when the expected flood of foreign investment failed to materialize, the Council of Ministers passed further decrees intended to rectify shortcomings in the Joint Venture Law that had been identified by potential foreign investors (and their governments). These amendments eliminated many of the constraints on joint ventures imposed in the original decree by, for example, allowing foreign investors to hold greater than fifty percent of the ownership interests in the joint venture and allowing foreign citizens to exercise executive and managerial control over the operations of the joint ventures.\textsuperscript{17}

\section*{D. The Law on Enterprises and the Joint Stock Company Laws}

In a series of laws promulgated in 1990, the reformers normalized, at least in theory, the business laws in the Soviet Union. The Law on Enterprises\textsuperscript{18} created the right to establish private businesses,\textsuperscript{19} to trade stock,\textsuperscript{20} to own the means of production,\textsuperscript{21} and to "carry out any kind of economic activity that is not prohibited by [legislation]."\textsuperscript{22} The law permitted the establishment of business enterprises through private investment, or by privatization of existing state enterprises.\textsuperscript{23}

The Regulations on Corporations and Limited Liability Partnerships (commonly referred to as the Joint Stock Company laws) elaborated on the forms such enterprises could take, specifically including corporations\textsuperscript{24} (entities that issue ownership shares that can be publicly traded), and limited liability companies (much like closely held corporations).

These laws also effectively abolished the communist tenet that previously had prohibited wholly foreign-owned private enterprises in the Soviet Union. The regulations contemplated foreign ownership\textsuperscript{25} in either

\setcounter{footnote}{16}
\footnotetext{16}{Id. § II.}
\footnotetext{17}{USSR Council of Ministers Decree, no. 352 (Mar. 17, 1988) and no. 385 (May 6, 1989). The amended Joint Venture Law is \textit{reprinted in} 29 I.L.M. 263 (1990).}
\footnotetext{18}{USSR Law on Enterprises in the USSR, Ved. Verkh. Sov. SSSR (1990), no. 25, item 460, \textit{translated in} PARKER SCHOOL, USSR LEGAL MATERIALS, item 13 (ed. V. Pechota, 1992).}
\footnotetext{19}{Id. § I, art. 2.}
\footnotetext{20}{Id. § III, art. 12(1).}
\footnotetext{21}{Id. § III, art. 10.}
\footnotetext{22}{Id. § I, art. 1(3).}
\footnotetext{23}{Id. § I, art. 2; § II, art. 5.}
\footnotetext{24}{USSR Regulations on Corporations and Limited-Liability Partnerships SP SSSR (1990), no. 15, item 82, \textit{translated in} USSR LEGAL MATERIALS, \textit{supra} note 18, item 37.}
\footnotetext{25}{Id. art. 1.}
kind of company and permitted wholly-owned foreign subsidiaries.\textsuperscript{26} The right of foreign involvement in the economy was further specified in President Gorbachev's October 26, 1990 decree on Foreign Participation in the Economy.\textsuperscript{27}

III. LAWS GOVERNING FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION

At the same time the central Soviet government promulgated the Joint Venture and Joint Stock Company laws, the Russian parliament was debating and enacting its own series of investment and business laws. These laws generally paralleled the All-Union laws promulgated by Gorbachev and the USSR Supreme Soviet, but often differed in significant ways. The conflicts caused by the competing legislative and regulatory regimes became known as the "war of laws," because both the All-Union and Republican authorities insisted that their laws and regulations were supreme and governing.\textsuperscript{28} This situation created considerable confusion for both domestic and foreign businessmen, who attempted to conform their operations to all possibly relevant laws by obtaining the necessary approvals from officials at each competing level of government.

Ultimately, the war of laws was resolved in favor of the republics. Ironically, the irksome existence of competing, parallel laws ultimately proved beneficial. At the dissolution of the Union, the Russian Federation already had in place a considerable body of relevant law covering much of the business and investment field. Currently, the Russian Federation implements the laws of the USSR to the extent they do not contradict the laws of the Russian Republic.\textsuperscript{29}

A. The Russian Foreign Investment Law

The starting point for foreign investment in Russia is the Russian Republic Foreign Investment Law.\textsuperscript{30} Adopted by the Russian Supreme

\textsuperscript{26} Id. art. 6.

\textsuperscript{27} See Michael Gorbachev, Decree of the President of the Union of Soviet Socialist Republics Regarding Foreign Investment in the USSR (Oct. 26, 1990). These provisions were reflected in the Fundamentals of Legislation on Foreign Investment in the USSR, enacted on December 10, 1990, Ved. Verkh. Sov. SSSR (1991) no. 31, item 880, translated in USSR LEGAL MATERIALS, supra note 18, item 18.

\textsuperscript{28} See, e.g., Battle for Control of Russian Natural Resources Waged by Decrees, SOVIET BUS. L. REP., Sept. 1990, at 5. See also Russian Republic Law Claims USSR Property, SOVIET BUS. L. REP., Dec. 1990, at 8.

\textsuperscript{29} Resolution of the RF Supreme Soviet on Regulation of Civil Law Relationships during the Period of Economic Reform Ved. Vamen Sov. RF (1992) no. 30 item 1800, translated in USSR LEGAL MATERIALS, supra note 18, item 4.

Soviet in July of 1991, this law establishes an number of important investment principles and provides detailed regulations on a wide variety of the foreign investment activities. Under this law, foreign investors are allowed to acquire full or partial ownership in enterprises, either directly or through shares of stocks, bonds, and other securities. The law also confers the right to use land or other natural resources and to hold any other property not prohibited by law.\textsuperscript{31}

The law grants "national treatment" to foreign investment, requiring that the legal regulation of foreign investments in the Russian Federation be no less favorable than the regulation of investments of Russian juridical persons or citizens. The law also forbids the nationalization of foreign investments, unless the decision is taken by the Russian parliament, and then only if prompt and adequate compensation is paid in the currency in which the investment was made.\textsuperscript{32}

The Foreign Investment Law grants certain customs benefits to foreign investment. It exempts from customs duties and import taxes any property imported into the Russian Federation as the foreign investor's contribution to the charter capital of the company as well as property intended for material production of the venture. Similarly, ventures with greater than thirty percent foreign investment are afforded the right to export their products without obtaining an export license.\textsuperscript{33}

While the Foreign Investment Law is the most important legal safeguard to foreign investors, a number of other laws and regulations provide important rights and benefits.

\textbf{B. The Law on Private Property}

The Russian Private Property Law, adopted in December of 1990, permits a joint venture with foreign investors to own property necessary for the carrying out of its activities as stated in the venture's charter.\textsuperscript{34} It also allows foreign legal entities — including foreign investors not registered in the Russian Federation — to own other enterprises, buildings, structures, and other property necessary to perform its business in the Russian Federation as established by Russian law. The Property Law allows all citizens and enterprises to hold property rights in buildings, personal property, securities, and intellectual property, but stops short of providing for full ownership rights to land and to natural resources.\textsuperscript{35}

Despite longstanding reluctance to extend private ownership to land, this

\textsuperscript{31} \textit{Id.}
\textsuperscript{32} \textit{Id.} arts. 6-8.
\textsuperscript{33} \textit{Id.} arts. 24-25.
\textsuperscript{34} Law on Private Property in the RSFSR Vedomosti RSFSR (Dec. 24, 1990).
\textsuperscript{35} \textit{Id.} art. 2.
shortcoming in the law will likely be remedied by legislation in the future.

C. Law on Enterprises and Business Enterprise

The Russian Federation Law on Enterprises and Business Enterprise, adopted in December 1990, also provides many detailed provisions on private economic activity. The law guarantees a number of rights of the entrepreneur, including the right to set prices for the goods and services of the enterprise, to hire and fire employees (consistent with other labor legislation), to utilize the profits of the enterprise in the Russian Federation, and to have access to the Russian courts.

The Enterprise Law also outlines the various business forms an investment might take. These forms build on and expand the forms that evolved under the Soviet business laws. Essentially, the full range of business forms normally available in industrialized countries to a foreign investor are now permitted. They are summarized in the next section.

D. Decree on Liberalization of Foreign Economic Activity

On November 15, 1991, President Yeltsin issued a decree Concerning the Liberalization of Foreign Economic Activity in the RSFSR which also establishes a number of important operating principles for foreign investors in the Russian Federation. Among other things, the decree provides that all enterprises registered in the Russian Federation may engage in foreign economic activity, all restrictions on barter operations in foreign trade will be abolished, the number of goods whose import and export is subject to licenses or quotas will be substantially reduced, and that all enterprises may open hard currency accounts in authorized banks.

IV. ATTRIBUTES OF A FOREIGN INVESTMENT ENTITY

A. Joint Venture in the Form of a Joint Stock Company

In the 1987 Soviet Joint Venture Law, the term “joint venture” referred to a distinct business form. But under the Russian Federation business regulations the joint venture simply signifies an agreement among investors; the business formed by the joint venture is structured as
either a joint stock company or a limited liability partnership. Since to date most joint stock companies have involved only a small number of investors, they have been structured as "closed" joint stock companies in which the transfer of stock by a shareholder in the company is subject to the approval of the other shareholders.

The minimum capitalization of a closed joint stock company is 10,000 rubles. "Open" joint stock companies generally issue stock to the public and do not restrict the transfer of stock and have a minimum capitalization of 100,000 rubles. The operation of joint stock companies is regulated by the Russian Statute on Joint Stock Corporations, approved by the Russian Council of Ministers in December 1990. At this time, however, the Russian parliament is reviewing a draft company law which may replace this decree and revise the regulation of joint stock companies.

A joint venture created in the form of a joint stock company is similar in many respects to a corporation in the United States. The entity is governed by a general stockholders meeting, a board of directors and management officials. The joint venture partners become shareholders in the company and have limited liability for the company's debts, (i.e., they are liable for the debts of the company only to the extent of their investment in the company).

The joint venture/joint stock company is a Russian juridical entity subject to all the legal rights and obligations applicable to Russian legal entities. For example, the joint venture/joint stock company has the right to plan, operate, and manage its business affairs; to own, purchase, lease or manage property in Russia; to open hard currency and ruble bank accounts; and to conduct import-export operations — all without the interference of the government.

B. Wholly-Owned Company in the Form of a Joint Stock Company

Investment may also take the form of a company wholly-owned by the foreign investor. Such a wholly-owned company has most of the same rights and responsibilities vis-a-vis the government and other enter-

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40 Under USSR law, a limited liability company was a separate business form. See USSR Regulations on Corporations and Limited Liability Partnerships, supra note 24, arts. 64-81. At present, there are no separate Russian regulations of limited liability partnerships. However, the Russian Federation is willing to register limited liability partnerships. Normally investors use the USSR Regulations on Corporations and Limited Liability Partnerships as a guide.

41 RSFSR Council of Ministers Resolution on approval of the Statute on Joint Stock Corporations, art. 7.

42 Id.

43 Id. at preamble.

44 Id.

45 Id. arts. 1, 18.
prises as does a joint venture company. The main differences concern internal management and profit distribution. The Western investor in a wholly-owned company does not have to share decision making or profits with a Russian partner. On the other hand, the Western investor cannot rely upon its partner to fulfill many of the tasks traditionally undertaken by Russian partners in joint ventures, but must create and operate the company on its own. This can be a major challenge for a new entrant to the market.

C. Branch Offices

Under Soviet law, a foreign company could not engage in substantial commercial activities in the USSR without setting up a Soviet legal entity, i.e., a corporation or venture organized under Soviet law with a Soviet legal personality. The emerging Russian law permits operation through a branch office of a foreign firm, without the creation of a Russian entity. Unfortunately, like the limited liability company, there are no detailed regulations on creating or operating such entities.

A branch office is a foreign, not a Russian, legal entity. This means that it does not have the same rights of juridical personality. A branch office cannot conclude contracts in its own name, but only on behalf of its parent company. Because a branch office of a corporation does not constitute a legal entity separate from its parent, a western company setting up a branch office in the Russian Federation is liable for the debts and liabilities of that branch to the full extent of the company's assets, not just to the extent of the branch's assets. At the same time, a branch office is controlled by the parent company and is limited in its activities to the activities of the parent.

D. Representation Offices

As noted above, prior to the passage of the first joint venture law in 1987, Western investors were permitted to operate in the USSR only through representation offices, which served primarily as marketing arms of their parent companies, with limited authority to engage in commercial activity. Russian law preserves the possibility of operating through a representation office, and appears currently to permit them to engage in commerce. The continued use of this form is in doubt, however, since without the restrictions that typified the Soviet regulations on representation offices, the distinction between a representation office and a branch office vanishes. The fact that the representation office form continues to exist only by Russia's recognition of preexisting USSR law lends further

46 Foreign Investment Law, arts. 12, 16, 21.
47 Id. art. 21.
FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION

doubt to the future legal status of the business form.48

V. TAXES APPLICABLE TO FOREIGN INVESTORS

A. Enterprise Profits Tax

If a joint venture is successful, an array of taxes is potentially applicable to these foreign investment enterprises. The main income tax applied to enterprises in the Russian Federation is the enterprise profits tax.49 The Russian law does away with the preferential tax rates granted to foreign ventures under Soviet law,50 and imposes a thirty-two percent rate on all enterprise profits, whether Russian or foreign owned.51 Certain small enterprises can take an investment tax credit of ten percent of the purchase price of Russian-made capital equipment. In addition, there is a twenty percent tax rate applied to royalties and rental income. The profits tax is payable in rubles with profits in hard currency converted to rubles at the rate of exchange set by the Central Bank of Russia on the day the income was earned.52

The enterprise profits tax is, however, expected to be superseded in the future by a new income tax, under another law also adopted by the Russian Parliament in December 1991.53 On the theory that unsuccessful enterprises as well as profitable ones should contribute to the public treasury, this law imposes a tax on “gross income” (before deduction for certain expenses such as payroll), rather than on net profits. The tax rate

48 The Russian Federation has not yet promulgated regulations on representation offices, but neither has it abrogated the former Soviet regulations on the subject. As noted above, the Russian government has declared that in the absence of contradictory Russian legislation, USSR law will remain in effect in the territory of the Russian Federation, as such, USSR Council of Ministers Resolution no. 1074 still governs the creation of Representation Offices. See SP SSSR (1990), no. 1, item 8, translated in FOREIGN TRADE, Mar. 1990, at 46.


50 Soviet enterprises with greater than 30 percent foreign investment were subject to a special 25 percent tax on their profits while those with less than 30 percent (or no) foreign investment paid a 35 percent tax. USSR Law on Taxation of Enterprises, Associations and Organizations, Ved. Verkh. Sov. SSSR (1990) no. 27, item 522, arts. 2, 5, 6.

51 Enterprise Profits Tax Law, art. 5. This law also reduced in scope the former Soviet tax holiday under which enterprises with greater than 30 percent foreign investment engaged in material production, enjoyed a two year tax holiday from the time that they first declare a profit. The new tax law reportedly restricts the tax holiday to enterprises producing certain goods and having no more than a certain specified number of employees. It is not clear whether enterprises established under the prior tax law will still be entitled to the tax holiday benefits contained in that law.

52 Id. arts. 2-5. At present, the official rate of exchange of the Central Bank of Russia is close to the market rate determined by currency exchanges in Russia. Whether this rate will continue to reflect commercial reality in the future remains to be seen.

under this law is reduced to a flat eighteen percent for most firms.\textsuperscript{54}

\textbf{B. Hard Currency Withholding Tax and Forced Currency Sale}

A second important tax applied to enterprises with foreign investment is the hard currency withholding tax. The Russian Federation subjects dividends distributed outside Russia to a fifteen percent withholding tax. Unlike the profits tax, this tax is payable in the currency in which the profits were earned. However, the withholding tax may be reduced or eliminated by tax treaty. The USSR concluded such treaties with Austria, Cyprus, Great Britain, Finland, and several other countries and Russia has assumed the USSR’s treaty obligation in this area.\textsuperscript{55}

Related to the withholding tax are regulations requiring that enterprises earning hard currency sell a certain percentage of their hard currency receipts for rubles.\textsuperscript{56} All Russian enterprises, including those with foreign investment, are required to sell 50 percent of their foreign currency earnings for rubles through an authorized bank at the market rate.\textsuperscript{57} Such an enterprise may exchange the rubles back into hard currency at any time without restriction on the domestic currency exchange.

\textbf{C. Value Added Tax}

In December of 1991, the Russian parliament imposed a value added tax (VAT) on sales of goods and services within Russia.\textsuperscript{58} This tax resembles the value added taxes imposed by most European nations and replaces the turnover tax formerly imposed by the USSR. The VAT rate is 20 percent for most items (10% for basic foodstuffs). The VAT is applied to the turnover (defined as the cost of goods or services sold) of sales of goods or services on the territory of the Russian Federation.\textsuperscript{59}

\textbf{D. Export Tax}

The Russian Federation also imposes an export tax on certain goods

\textsuperscript{54} \textit{Id.} arts. 5-8. Certain disfavored activities (consulting firms, brokers, video stores, casinos) are taxed at rates as high as 45 to 70 percent. \textit{Id.} art. 8.


\textsuperscript{57} RF Central Bank Instructions no. 7 on the Procedure for Mandatory Sale by Enterprises of Part of Their Foreign Currency Earnings through Authorized Banks and Conducting Operations on the Domestic Currency Market (June 26, 1992) \textit{Ekonomika i Zhizn}.


\textsuperscript{59} \textit{Id.} arts. 4, 6.
FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION

exported from the Russian Federation. The tax is assessed in European Currency Units (ECUs) either as a percentage (ranging from 5 to 70 percent) of the customs value of the good or a flat rate per ton (ranging from 1 to 80,000 ECUs). The Russian Federation's export tariff regime is based upon a 2 column system—the base rate and a 50% higher barter rate (compensating for lost mandatory hard currency sales.)

E. Excise Tax

The Russian Federation also instituted an excise tax on the sale of certain products within the Russian Federation. This tax replaces the highly unpopular sales tax formerly imposed by the USSR, and is imposed mostly on luxury and “vice” type goods—jewelry, caviar, leather goods, automobiles, fur, tobacco, vodka, and other alcoholic beverages.

F. Personal Income Tax

Personal income tax is levied on individuals with Russian income, whether or not they are residents of Russia. In addition, the worldwide income of Russian residents is subject to the tax. Income tax rates are steeply progressive, reaching as high as forty percent. Expatriate employees or investors who reside in the Russian Federation more than 180 days are taxed as if they were residents.

G. Currency of Tax

The Russian Federation Ministry of Finance allows all enterprises with foreign investment to pay their taxes in rubles (other than withholding taxes imposed on repatriated profits), regardless of the currency in which the profits were earned.

H. Negotiation of Special Concessions

What is written in the taxes laws, however, may not actually control the tax status of a Russian joint venture. If a proposed project is very large or important to the Russian government, an investor may be able to negotiate special tax concessions with the republic Ministry of Finance. And even smaller ventures can obtain preferential tax treatment since local governments may be able to grant tax concessions up to their allo-

63 Enterprise Profits Tax Law, art. 2(5).
cation of tax payments to the Russian Federation.64 Thus, if a venture will materially benefit a certain locality of the Russian Federation, an investor may be able to use the same strategy played so successfully by many foreign investors in the U.S.—offering to locate in certain areas if special tax concessions are granted.

I. Free Economic Zones

Foreign investors can also reduce their tax burden by investing in an enterprise located in a free economic zone (FEZ) of the Russian Federation. There are a number of FEZs in the Russian Federation, including St. Petersburg and Zelenograd. One of the most prominent is the FEZ of Sakhalin. The Regulations of the Free Economic Zone of Sakhalin (Sakhalin FEZ Law) provide for a tax rate of not greater than 20 percent for enterprises with greater than 30 percent foreign investment engaged in the exploitation of natural resources, and a tax rate of not greater than 10 percent for all other enterprises with greater than 30 percent foreign investment.65 The Sakhalin FEZ Law also provides enterprises with greater than 30 percent foreign investment (except for enterprises involved in raw material activity and fishing and fish processing) with a 5 year tax holiday.66 The law provides a number of additional tax benefits including a partial tax exemption for reinvested profits and an elimination of any excess profits tax.

VI. PRACTICAL PROBLEMS FACING FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION

A. Currency Convertibility

Independence and reform has not yet resolved what has long been the primary difficulty confronting potential foreign investors in the Russian Federation: the lack of currency convertibility on the world markets. While the ruble is now internally convertible, thus allowing foreign investors earning rubles to convert such earnings into freely convertible currency, many foreign investors still prefer to avoid dealing in rubles.67

The method that has been traditionally most favored is for the investor to participate in a manufacturing venture that produces goods that can be sold on the world market, thereby generating hard currency ex-

64 Decree on RSFSR Law on Enterprise Taxes (Dec. 1, 1990), art. 10, reprinted in FBIS-Sov-91-008 (Jan. 11, 1991). While local governments clearly had the authority to grant such concessions in the past, it is not clear whether they will have this power in 1994 and beyond.
65 RSFSR Council of Ministers Resolution on Regulations of the Free Economic Zone of Sakhalin SPRSFSR (1991) no. 7, item 359.
66 Id. art 19.
port earnings. (Indeed, the hope for such lucrative exports was a main
impetus for allowing foreign investment in the first place). Alternatively,
the investor could take his "dividends" in kind with distributions of the
venture's product, which the investor could export and sell for hard cur-
rency on the world market. The problem with both scenarios is that it
assumes that the venture will manage to produce and market a high-
quality, exportable product — which explains why so few joint manufac-
turing projects have successfully generated foreign currency earnings.

A second, but increasingly less used method, is countertrade. The
investor agrees to take as payment a product different from that pro-
duced, typically a commodity or raw material which can be exported and
sold on the world market. The difficulty with countertrade has always
been finding a reliable supply of an exportable commodity. However,
some ventures whose activities generated rubles were able to invest their
rubles in a second venture in Russia that was intended to produce hard
currency.

Rather than try to devise methods of converting ruble profits, many
ventures have avoided the currency convertibility problem by selling
services for hard currency to the international community and to tour-
ists. Some of the most successful ventures include restaurants, airline
support operations, communications systems, consulting firms, and ho-
tels which raise their hard currency requirements directly from their
customers.

Such hard currency transactions were nominally outlawed by
RSFSR law in mid-1991, but the prohibition was widely ignored. How-
ever, in an effort to bolster the ruble, President Yeltsin decreed in No-
vember, 1991, that after July 1, 1992, all transactions taking place on
territory of the Russian Federation must be conducted in rubles. At
the same time, the decree also provides foreign investors the right to
purchase foreign currency in order to transfer profits abroad. It also pro-
vides that the rate at which foreign currency will be purchased and sold
will be determined on the basis of supply and demand at currency auc-
tions, stock exchanges, and the inter-bank market.

In October 1992, Yeltsin revoked this provision and authorized the
sale of goods and services for foreign currency in accordance with Cen-
tral Bank Rules. On January 20, 1993, the RF Central Bank issued

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68 For example, as part of its profits from the sale of Pepsi Cola in the Russian Federation, PepsiCo may take Russian mushrooms for use by its Pizza Hut subsidiary outside Russia.
69 Examples the authors have encountered in their work include reinvesting ruble profits in the construction of office space that would be rented to foreign companies, and purchasing a distillery to produce and export beer.
70 Decree Concerning the Liberalization of Foreign Economic Activity, supra note 38.
71 Id.
72 President Decree no. 1306, Oct. 27, 1992.
instructions authorizing the sale of certain goods and services for foreign currency, including hotels, bars, restaurants, traveller's insurance, transportation of non-Russians, international transportation, international communication, business, etc. An enterprise wishing to engage in foreign currency transaction must obtain a special permit from the RF Central Bank.\textsuperscript{73} It is unclear whether the Russian Federation will push for greater convertibility of the ruble. Bilateral investment treaties concluded between the Soviet Union and western nations contain guarantees of convertibility.\textsuperscript{74} The Russian government has vehemently requested help from the West in establishing a ruble stabilization fund to speed up convertibility, but the timing and implementation of free convertibility are still hotly debated topics. While President Yeltsin's Decree Concerning the Liberalization of Foreign Economic Activity\textsuperscript{75} and the move towards internal convertibility are significant steps toward the development of a freely convertible ruble, the future will depend upon the government closing the gaping budget deficit and instilling the public with confidence in the stability of its future value.

\textbf{B. Registration of Investment Ventures}

One of the most difficult tasks in investing in the USSR was registering the joint venture. The USSR Ministry of Finance — the institution registering enterprises with foreign investment until the end of 1990 — often held up registration applications for months, was known to insist on apparently arbitrary procedures or provisions, and could reject applications without explanation or because it disagreed with the likely value or success of the proposed venture.

Under new Russian law, the arbitrariness is largely abolished. Registration applications are now filed with the Russian Agency for International Cooperation and Development (RAMSIR) and with local registration authorities.

With the application for registration, the venturers must include a number of supporting documents, including the venture's charter (articles of incorporation and bylaws), the joint venture agreement between the partners, an excerpt from a trade register of the foreign investor's country of citizenship establishing the investor's judicial status, documents showing the credit worthiness of the foreign investor, and a copy of the decision of the Russian entity agreeing to enter the joint venture. If the venture is involved in construction related activities, certain environmental and safety approvals may be required. And if the venture is a

\textsuperscript{73} RF Central Bank Instruction no. 11, Jan. 11, 1993.

\textsuperscript{74} See e.g., Treaty between Federal Republic of Germany and USSR Concerning Encouragement and Reciprocal Protection of Investment (June 13, 1989), art. 5.

\textsuperscript{75} Supra note 38.
joint stock company with more than one founder, the minutes of the founding conference may be required.

Properly preparing, certifying and translating these documents can be frustrating. Moreover, given the lack of government officials at the local level experienced in processing registration applications, registering a new company can still take weeks, or even months. But by following the rules, investors can normally obtain successful registration of a venture with relatively little bureaucratic resistance.

C. Finding the Right Russian Partner

Although wholly-owned foreign corporations are now allowed in the Russian Federation, most investors still prefer to form joint ventures with local partners. Having a well-connected local player involved in the success of the project can be an invaluable asset, especially in a society where both economic and governmental institutions are in such a state of confusion and change. On the other hand, choosing an inadequate joint venture partner can cause a venture to fail. Not surprisingly, finding a suitable partner can be a complicated and difficult task.

Finding a competent Russian partner that is engaged in the same or similar line of business is the ideal, since such a partner will know how the business operates locally and, just as important, will have good contacts with suppliers and government officials in charge of regulating that particular industry. However, in creating an alliance with such an entity, an investor should insist on assurances in the joint venture contract that each partner will deal exclusively with the other, and that neither party can set up a competing business venture. Because Russian entrepreneurs typically do not have a highly-developed notion of conflicts of interest principles, they may not consider it improper to use ideas and business methods learned through the joint venture in future competition against the joint venture itself.

An ideal partner would also have either a specialized skill or access over resources necessary for the venture’s success. Unfortunately, a foreign investor will find that many prospective Russian partners will claim to control such assets. Therefore, it is essential that the foreign investor investigate the prospective partner to ensure that he actually has the capabilities claimed. Conflicting claims to property ownership, land use, and resource allocation can be difficult to resolve. More than one optimistic investor has concluded an agreement with an entity or agency only to find, many months and many dollars later, that the partner did not in fact control the property, authority, or usage rights promised. An investor should examine the charter of his prospective partner to see if the promised rights and property are allocated to him in that document. It is also essential, but not necessarily sufficient, to inquire with government
officials at various levels to determine the prospective partner's legitimacy.

D. Sourcing Materials

Although recent reforms succeeded in wholly destroying the old command economy, they have not been able to establish a workable alternative. The legendary scarcity and poor quality that were the legacy of the Soviet Union have been just as endemic in the early post-communist era, making it imprudent to rely on the market alone for materials sources.

Because an effective Russian market for industrial goods is still a dream for the future, a venturer should consider locking in a supply of necessary goods by making the source of the necessary commodity a joint venture partner. This provides incentive to the supplier by giving it a direct stake in the venture's success. Alternatively, a venture must try to establish long-term supply commitments with manufacturers and customers.

E. Labor Concerns

A foreign-owned enterprise has the right to make labor-related decisions, but not without restrictions. General requirements governing employee safety, leave, and pensions apply. An agreement with the relevant labor union will often be required. In order to prevent disputes, the charter documents or company operating procedures should include details on hiring, firing, job descriptions, and salary levels. In addition, enterprises should conclude employment contracts with each Russian employee and clearly explain to him the condition of his employment. Finally, if the enterprise plans to fire an employee or otherwise take disciplinary action against him, the enterprise should carefully document the reasons for its actions to minimize conflict with the union or government officials regulating employment practices.

F. Decentralization and Confusion

The radical economic reforms of the last few years offer vastly increased potential opportunity and flexibility. In the short term, however, they also have increased uncertainty. Where once there was a single All-Union authority, each independent republic is now responsible for its own policies. And even within the Russian Federation, the central authorities are devolving considerable authority downward to more local levels.

The dismantling of the Soviet bureaucracy will take time, and in the

76 See Foreign Investment Law, arts. 33-34.
meantime contradictory regulations and laws may exist simultaneously at different levels of government. The validity of government guarantees previously issued becomes uncertain.

Because of the regulatory and economic confusion, many foreign investors have been tempted to entrust their Soviet, or Russian, counterparts with the responsibility of developing and maintaining contacts with relevant government officials. However, by giving a partner this responsibility, the foreign investor risks becoming overly dependent upon his or her partners. In addition, given the current desire of governmental ministries and agencies to attract foreign investment, the foreign participant might be able to secure benefits and guarantees that the local partner could not.

The decentralization of the former USSR also leaves in doubt the regulatory authority of each level of government. While the so-called "war of laws" between the central union authorities and the republics has been decided in favor of the republics, this has not resolved all of the jurisdictional conflicts within the former USSR. Now the fight is likely to be between the republic authorities and local government officials.\(^77\)

By law, local governments wield significant influence in the areas of taxation, land use regulation, and registration of enterprises. It is important to remember, however, that the lines of regulatory authority in the former USSR are often blurry. Thus, local government officials may claim regulatory powers in areas which are not clearly designated to them by law. While such problems may be unavoidable, they can be minimized by maintaining good relations with officials at all levels of government.

VII. FOREIGN INVESTMENT TO DATE, AND PROGNOSIS FOR THE FUTURE

The volume and number of foreign investment ventures established so far is not insignificant, but it does not appear that the level of foreign investment is yet enough to have had a significant economic impact. However, the symbolic value of these ventures is great, and a number have made visible impacts on the service and consumer markets in the former Soviet republics.

While foreign investment has slowed during the economic and polit-

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\(^77\) The term local government refers to the governmental subdivisions of republics or autonomous republics. The higher levels of local government are oblasts, krays, autonomous oblasts, or autonomous okrugs. These divisions are in turn divided into rayons and cities, which form the middle level of local government. Moscow and St. Petersburg are two cities that wield local government power equivalent to an oblast or okrug. Rayons are divided into village or settlement councils in the countryside and into microrayons in the cities. Councils and microrayons make up the lowest level of local government.
ical uncertainty that have accompanied the dissolution of the Soviet Union, there has been considerable interest expressed in the Russian Federation's privatization program. The official plan's first step in the privatization of a broad range of industries, including most wholesale and retail shops, service companies, agricultural and food processing industries, trucking firms and construction companies, is well under way. Larger scale industrial enterprises are now being privatized, but with more governmental regulation.

The potential opportunities for investors are unprecedented, but the involvement of foreign capital in the privatization program is still somewhat uncertain. Given the extremely low value of the ruble compared to western currencies, there is a concern that foreign investors could buy an enormous share of the Russian industrial base at unfairly low cost. Accordingly, there are a number of limitations on foreign involvement in privatization auctions, and in most cases foreign investors can buy shares in privatized industries only with permission of the Russian government. Nevertheless, the possibility of participation in existing enterprises may give new incentive to foreign investment.

In summary there is no doubt that the business environment in the Russian Federation and the other former constituents of the Soviet Union is vastly better than it was in 1987. While difficulties and challenges are still many, a lack of statutory or regulating authority is no longer an obstacle to foreign involvement in the economy. Laws on the books now permit, and even favor, foreign investment. The basic panoply of legal protections generally available to investors in other parts of the world are now present in what was once the Soviet Union.

Law does not, of course, lead society. The political and social revolution now taking place will determine the ultimate direction of investment opportunities in the Russian Federation. Previously unthinkable possibilities now exist, and are expanding. Overall, the trend is good, and the potential is immeasurable.

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80 Id. art. 2(2), 2(3).

81 Id. art 9.