

BEFL

November 2012

Industrial Facility Construction – Function Allocation, Taxation



State Regulations	3
Subjects of Investment Activity	4
Key Issues in Function Allocation between Parties of Investment Project	7
Types of Relations between Parties of Investment Project	8
Income Tax and Property Tax	14
Objectives of Investor/Developer	15
Why Choose BEFL	16

Main statutory instruments governing investment activity



- ✓ Federal Law 'On Investment Activity in the Russian Federation'
- ✓ Urban Development Code of the Russian Federation (UDC RF)

Main subjects involved in investment activity



- ✓ Investor
- ✓ Developer
- ✓ Client
- ✓ General contractor

The UDC RF regulates the organization and implementation of construction work, the control over the construction process and commissioning.

From a legal point of view the UDC RF overrides the Federal Law of the Russian Federation 'On Investment Activity in the Russian Federation' in the sphere of construction.

Investor

makes Capital Expenditures on the territory of the Russian Federation using its own and/or attracted resources in accordance with the legislation of the Russian Federation.

(Federal Law 'On Investment Activity in the Russian Federation', Cl. 2, Art. 4)

Developer

is a legal entity which, on the land plot owned by it, carries out construction, redevelopment, capital repair of facilities under capital construction, as well as performs engineering survey, drafts project documents for construction, redevelopment and capital repair of the facilities.

(UDC RF, Cl. 16 Art. 1)

Principal functions of the Developer

- ✓ The organization of the construction of facilities, supervision over the progress thereof and the maintenance of accounting records of expenditures, which are incurred in this respect, shall be carried out by the Developers.
- ✓ When construction work is performed on a contractual basis, the Developer shall be the Client in relation to the contracted construction organization.

(Letter No. 160 of the Ministry of Finance of the Russian Federation of December 30, 1993 'Statute Concerning Accounting for Long-Term Investments')

Accounting for expenditures on construction by the Developer

Accounting for long-term investments shall be carried out on the basis of actual expenditures: for construction as a whole and for each particular facility (building, installation etc.) relating to that construction.

Until work on the construction of facilities has been completed, expenditures on their erection which are recorded on the account 'Capital Expenditures' shall constitute work-in-progress. In accounting records, expenditures on the construction of facilities shall be grouped according to the technical structure of expenditures which is determined by budget documentation. It is recommended that records be maintained according to the following structure of expenditures:

- ✓ expenditures for construction work;
- ✓ expenditures for equipment installation work;
- ✓ expenditures for the acquisition of equipment to be installed;
- ✓ expenditures for the acquisition of equipment which does not require installation; tools and appliances;
- ✓ equipment which requires installation but is intended to be held in reserve;
- ✓ expenditures for other capital expenditures;
- ✓ other expenditures.

If carried out on a contractual basis, construction work and equipment installation work, when it has been performed and documented in accordance with the established procedure, shall be recorded by the Client / Developer on the account 'Capital Expenditures' at the agreed cost according to invoices of contract organizations which have been paid or accepted for payment.

In the event that a construction agreement is concluded whereby the Developer is responsible for providing construction equipment, accounting for the acquisition, installation and commissioning of the equipment shall be carried out by the Developer.

(Letter No. 160 of the Ministry of Finance of the Russian Federation of December 30, 1993 'Statute Concerning Accounting for Long-Term Investments')

Client

is a properly authorized by Investors legal entity engaged in implementation of investment projects. In so doing the Client shall not interfere in the entrepreneurial and/or other kinds of activities pursued by other subjects of investment activities unless otherwise stipulated by an agreement existing between them. An Investor can be a Client. A Client who is not an Investor shall have the rights of ownership, use and disposal of Capital Expenditures for the period and within the competence which are stipulated by a contract and/or State agreement in accordance with the legislation of the Russian Federation.

(Federal Law 'On Investment Activity in the Russian Federation', Cl. 3, Art. 4)

Technical Client

is a legal entity performing professional activities which is authorized by the Developer and on behalf of the Developer concludes agreements for engineering surveys, drafting project documents, construction, redevelopment, capital repair of facilities under capital construction, assigns the aforementioned types of work, provides the persons carrying out engineering surveys and (or) drafting project documents, carrying out construction, redevelopment, capital repair, materials and documents necessary to perform the aforesaid tasks, endorses the project documents, signs the documents necessary to obtain a commissioning permit for a facility under capital construction, performs other functions stipulated in the UDC RF. The Developer is entitled to undertake the functions of the Technical Client.

(UDC RF, Cl. 16 Art. 1)

A subject of investment activities shall have the right to combine the functions of two or more subjects, unless otherwise established by an agreement and/or state contract they conclude.

(Federal Law 'On Investment Activity in the Russian Federation', Cl. 6, Art. 4)

In respect of defining the Client, the Federal Law 'On Investment Activity in the Russian Federation' contradicts the UDC RF.

We use the definition of the Client's functions given in the UDC RF designated as 'Technical Client'.

Key Issues in Function Allocation between Parties of Investment Project

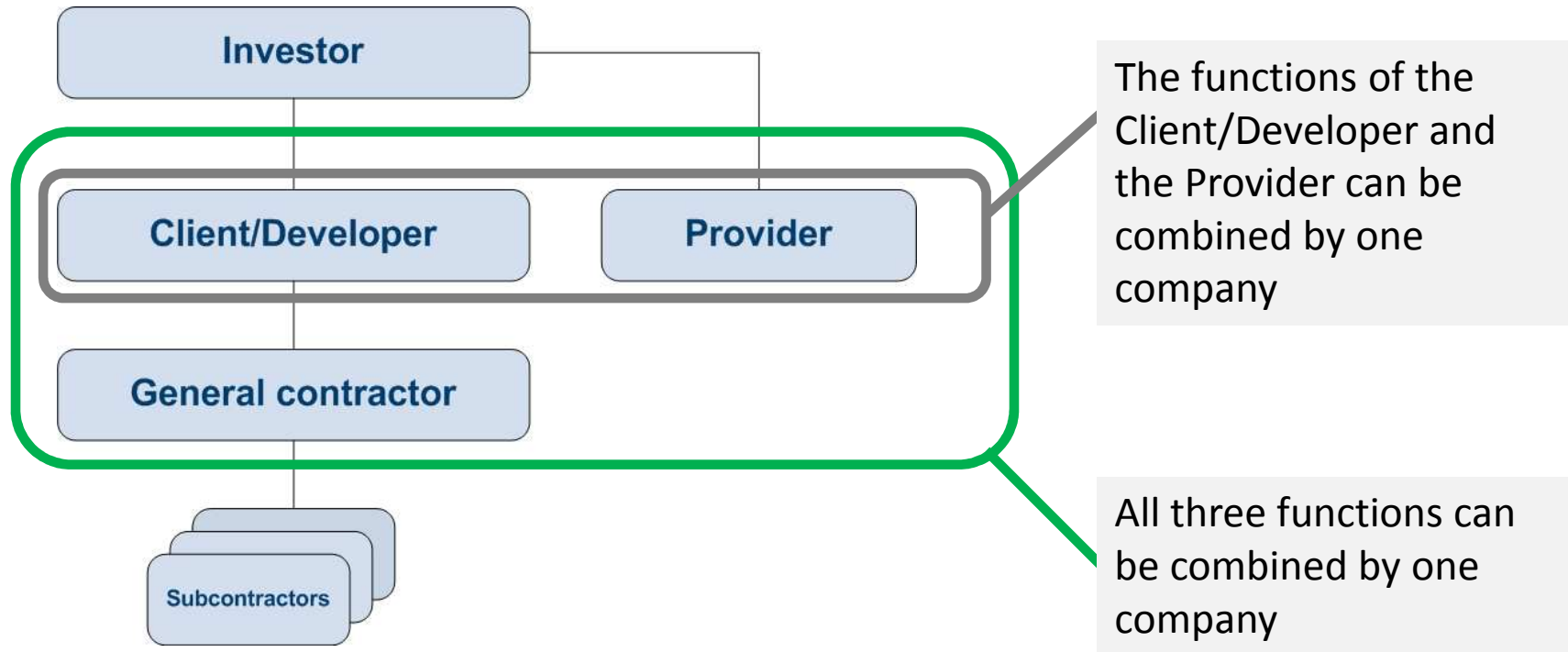
BEFL

The allocation of functions between the parties of an investment project determines:

- The way the agreement relations and interactions between the parties will develop
- Who will ascertain the compliance with all requirements of the construction legislation
- Who will supervise the construction process, commissioning production facilities and fixed assets.
- Who will provide daily management of the investment project
- Who will manage finances and control the availability and use of financing sources for long-term investments
- Taxation
- Organizing and maintaining accounting records, including the estimation of the initial value of fixed assets
- Document workflow between the parties of the investment project

Types of Relations between Parties of Investment Project (1/6)

Scheme 1



The Investor obtains the factory 'on the turnkey basis'

Types of Relations between Parties of Investment Project (2/6)

BEFL

Description of Scheme 1

The Investor finances construction within the period stipulated by the agreement, and upon completion of a construction project accepts the ready facility 'on the turnkey basis' under the Test Certificate of a Completed Construction Facility (forms No. KS-14, KS-11)

The Investor does not own the facility until the ownership is statutorily recognized

The rights to a land plot under the facility which is being constructed have to be transferred to the Client/Developer

As a rule, the funds received are regarded by the Client/Developer as 'purposive financing' (with the exception of the fee for the services of the Client/Developer) and in line with Art.146 of the Russian Tax Code (TC RF)* is not subject to VAT and is not recorded when defining the income tax base (Subcl. 14 Cl. 1 Art. 251 TC RF)*

The Investor does not participate in the process of construction, document workflow, formation of facilities under construction and VAT accounting

Commentaries

This option implies minimum participation of the Investor in the construction process

In the event of bankruptcy of the Developer, the Investor is not entitled to claim the facility under construction. To claim the allocated investments the Investor shall participate in the bankruptcy process of the Developer according to the standard procedure

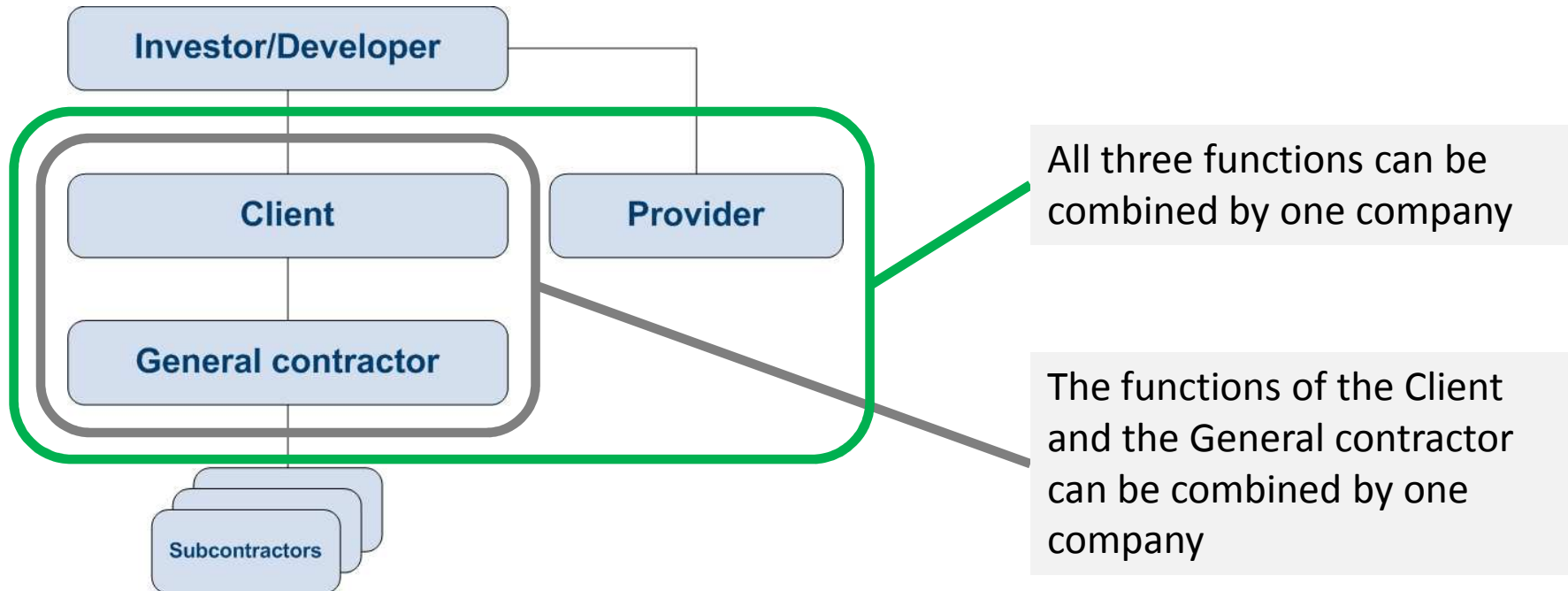
The limitations set by the lease agreement for the land plot and the Law are to be accounted for

There are risks of transforming an investment agreement into a sale and purchase agreement (The Supreme Commercial Court Plenary Assembly Decree No. 54 of 11.07.2011). In this case the companies in the role of the Client/Developer shall incur and pay to the budget the VAT on each tranche as advances receivable and incur VAT on sales

The risk of the refusal to refund VAT is lower, as VAT will be deducted on the basis of a summary tax invoice (Art.169 TC RF)* or tax invoices drawn up by the Client/Developer

Types of Relations between Parties of Investment Project (3/6)

Scheme 2



The land plot is owned by the Investor



Investor –
Developer
(Cl.16 Art.1 UDC RF)

Types of Relations between Parties of Investment Project (4/6)

BEFL

Description of Scheme 2

The Investor/Developer acquires the ownership of the facilities under construction. The facilities under construction may undergo the state registration, a facility may be pledged if needed

The functions of the Investor/Developer may be allocated to the Client under an agreement

VAT on advance payments

- if an advance payment is received by a Russian company, the Investor is entitled to include the advance payments into VAT deductions under general conditions (Cl. 12 Art. 171 TC RF)*
- if an advance payment is received by a non-resident and the Investor has fulfilled the functions of a tax agent, the Investor is entitled to VAT deductions only after the facility is entered into records or a stage of works has been accepted (Cl. 3 Art. 171 TC RF)*

VAT on equipment that requires installation and materials may be deducted at the moment of acquisition (Cl. 1 Art. 172 TC RF)*, i.e. before installation of the equipment or application of the materials

Commentaries

The value of the facility under construction is estimated by the Investor/Developer

The rules of the document workflow between the Investor/Developer and the Client have to be established

The contractor agreement must envisage the stages of works completion and services rendered to allow earlier VAT deductions. A tax invoice for an advance payment shall be obtained

The VAT paid at the customs when importing equipment and materials can be deducted, provided the documents confirming the payment thereof are available

Types of Relations between Parties of Investment Project (5/6)

BEFL

Description of Scheme 2

VAT deductions concerning operations with facilities under capital construction, works, services

- concerning engineering services: upon accepting the services and receiving the invoice or other documents confirming the rendition of services;
- concerning the services (remuneration) of the Client: VAT deductions can be made every quarter provided there is an invoice and a report;
- concerning construction works: VAT deductions can be made as a stage of construction works is completed (if it is stipulated by the agreement) (Cl. 6 Art. 171 TC RF and Cl. 5 Art. 172 TC RF)*. The same perspective is taken by the Russian Ministry of Finance in letters No. 03-07-10/07 of 20.03.2009 and No. 03-07-10/13 of 14.10.2010



Commentaries

VAT deductions made at earlier stages of construction and assembly works (CAW) on the basis of forms No. KS-2, KS-3 and invoices drawn up monthly are subject to dispute.

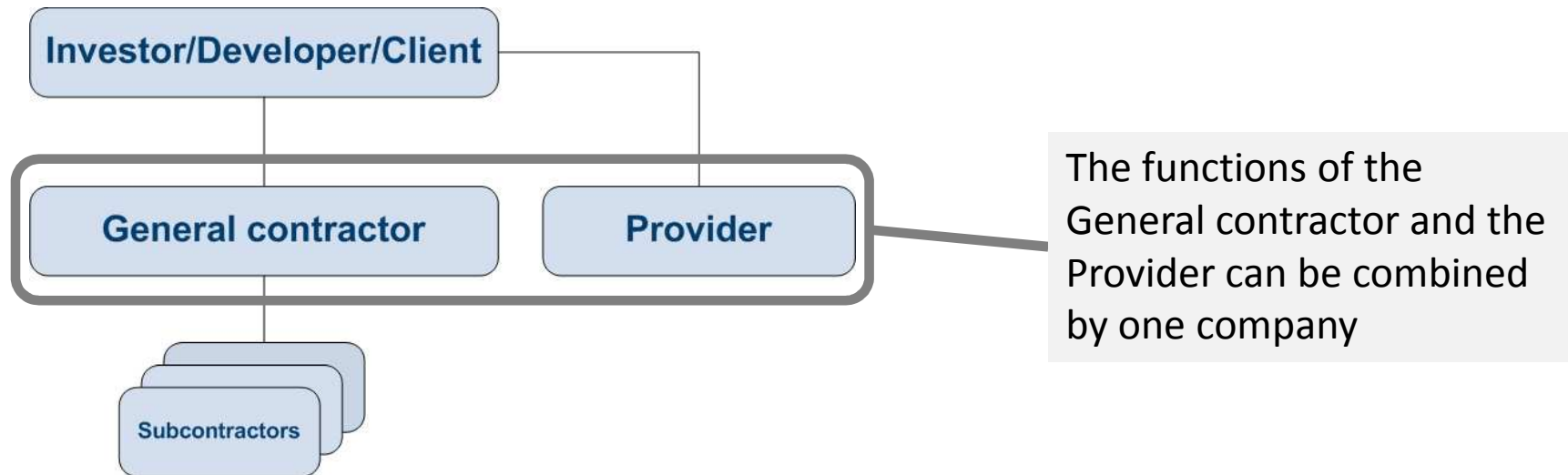
A stage is a completed cycle of CAW, all essential terms of an agreement are to be clearly set out for each stage.

Due to the ambiguous court practice this issue requires a more profound analysis with regard to documents which formalize the relations between the parties of an investment project.

If the agreement does not include the stages of CAW, VAT deductions from advance payments can be made in the process of construction (provided the advance payments are stipulated by the agreement and the General contractor (Contractor) is the resident of the Russian Federation), but the monthly drawn up certificates of services rendered are not signed and the cost of works is not recorded by the Developer on account 08 'Capital Expenditures'.

Types of Relations between Parties of Investment Project (6/6)

Scheme 3



Description of Scheme 3

In addition to the description of scheme 2:

The Investor performs all the functions of the Client

Commentaries

Supervising the amount of work done and the accuracy of documenting a facility construction; acquiring primary permission documents at the pre-project stage; having the documents approved; technical supervision; commissioning and accepting a facility etc.

Income Tax

- ✓ The objects of constructions shall be recognized as depreciated property whose value is amortized by imposing depreciation charges (Art. 256 TC RF)*;
- ✓ The term of beneficial use shall be defined by the Investor on his own as on the date of putting the object of the depreciated property into operation with regard to the [classification](#) of the fixed assets endorsed by the Government of the Russian Federation (Cl.1 Art. 258 TC RF)*;
- ✓ The Investor has the right to include in expenditures for an accounting (taxable) period capital investment expenditures in an amount not exceeding 10 % (not exceeding 30 % in case of fixed assets belonging to the third to the seventh depreciation groups) of the historical value of fixed assets (Cl.9 Art. 258 TC RF)*.

Property Tax

- ✓ The objects of taxation for the Investor shall be the immovable and movable property which is recorded on the balance sheet as fixed asset items in compliance with the established bookkeeping procedure (Cl.1 Art. 374 TC RF)*;
- ✓ The tax base shall be assessed as the mean annual value of the property deemed the object of taxation. While the tax base is assessed the property deemed the object of taxation shall be taken into account at its balance value formed in compliance with the established bookkeeping procedure approved in the accounting policy of the Investor (Cl.1 Art. 375 TC RF)*;
- ✓ Tax rates shall be set by laws of Russian regions as not exceeding 2.2 % (Cl.1 Art. 380 TC RF)*;
- ✓ As the tax is being instituted, the laws of the Russian regions may also make a provision for tax privileges and the grounds on which taxpayers may use such privileges (Cl.2 Art. 372 TC RF)*, e.g. for persons registered and implementing investment projects in the Russian Federation under investment agreements made between the Investors and the Government of a Russian region.

**Information referred to the TC RF is provided by www.russian-tax-code.com*

Often while constructing industrial facilities the Investor undertakes the functions of the Developer to protect the investments. In this case the Investor/Developer has to:

1. When concluding agreements, meet all the necessary requirements to the crucial aspects of interactions between the parties and comply with the conditions which will allow the Investor to reduce tax risks and to have an opportunity of a VAT refund in the process of construction;
2. Develop the criteria of documenting the completed work in view of the accepted principles and legal conditions, link them to the conditions of financing (payment installments, terms of execution of the letter of credit etc.);
3. Work out the recommendations on a more precise and unified identification of the future objects of accounting and taxation to properly execute the rights to the real estate assets and impose depreciation charges;
4. Develop the accounting policy of the Investor and regulations of the in-house accounting for the facilities under capital construction;
5. Develop the regulations of document workflow between the Investor and a person (persons) performing the functions of the Client, the General contractor and/or Contractors, and technical control, which will allow: :
 - ✓ not only to control the process, but also estimate the value of the objects according to the principles of accounting and taxation;
 - ✓ to formulate the requirements for drawing up invoices by the third party, which will be accounted for by the Investor, and other documents, related to VAT deductions;
 - ✓ to execute the rights of the Investor to receive a VAT refund in the process of construction, not upon its completion;
6. Choose and introduce an IT-system to manage document workflow and keep accounting records;
7. Organize the system of in-house archive storing of the primary documents.

- ✓ We know the key processes of constructing industrial facilities
- ✓ We have experience in developing and introducing document workflow between the parties of an investment project
- ✓ We controlled the accuracy and completeness of estimating the primary value of industrial facilities under construction
- ✓ We are familiar with the ins and outs of registering ownership rights to large industrial facilities
- ✓ We supported mergers and acquisitions of business structures in the sphere of metal, chemical, agricultural and food industries
- ✓ We have extensive knowledge on financial and legal due diligence of holdings, large industrial companies
- ✓ We performed valuation of fixed assets in order to prepare a report for the IFRS
- ✓ We have a successful practice of protecting our clients' interests in tax disputes relating to VAT refund on investments in various areas of business
- ✓ We provided consultancy to companies on drawing up documents to substantiate the amounts of depreciation charges and amounts of VAT refund on construction works

V. A. Novoselov

Email: v.novoselov@befl.ru

Phone: +7 (910) 748 21 56

V. D. Demidov

Email: demidov@befl.ru

Phone: +7 (910) 201 08 33