



Real Estate Investment in Russia

THE LEGAL PERSPECTIVE

Introduction

Real estate investment offers one of the most secure and effective ways to invest money. As Russian real estate legislation is less complicated than either English or German Law, it makes Russia an attractive market for real estate investment for both residents and foreign investors.

The most important legislation which regulates investment in Russian real estate includes:

- the Civil Code of the Russian Federation (the “**Russian Civil Code**”);
- the Land Code of the Russian Federation (the “**Russian Land Code**”);
- the Tax Code of the Russian Federation (the “**Russian Tax Code**”);
- the Town-Planning Code of the Russian Federation (the “**Russian Town-Planning Code**”);
- Federal Law No. 101 – FZ On Agricultural Land Transactions of 24 July 2002 (the “**Agricultural Land Transactions Law**”);
- Federal Law No. 102 – FZ On Mortgage of Immovable Property of 16 July 1998 (the “**Mortgage Law**”);
- Federal Law No. 218 – FZ On State Registration of Immovable Property of 13 July 2015 (the “**State Registration Law**”); and
- Federal Law No. 7 – FZ On Protection of Environment dated 10 January 2002 (the “**Environmental Protection Law**”).

- Under Russian law, the following rights exist over land:
- the right of ownership (freehold);
- the right to lease (leasehold);
- mortgage;
- easement;
- the right of economic management; and
- the right of administrative management.

Ownership of land as well as the other proprietary rights mentioned above must be registered with the state. These rights over land become effective only after they have been recorded in the Unified State Register of Rights to Real Property (the “**Property Register**”). The right to ownership of a building or a land plot as well as any encumbrances over such ownership right (such as a lease, mortgage or easement) are confirmed by the ownership certificate or the extract from the Property Register.

An ownership right or other proprietary rights which are recorded into the Property Register can only be challenged by judicial order.



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1. Ownership of Real Estate

There is no prejudice between foreign investors and Russian residents, and foreign investors have equal rights to acquire an ownership right to real estate (land plots or buildings). There are a few exceptions to this rule. However, these exceptions do not impact the investment market. For example, foreign investors are not allowed to acquire an ownership right over some specific land plots such as land in border areas, agricultural land or land plots within the boundaries of a port. The restriction concerning agricultural land plots is set out in the Agricultural Land Transactions Law and also extends to Russian legal entities where the equity participation of foreign nationals, foreign legal entities and/or stateless persons exceeds 50%. However foreign investors are able to lease agricultural land plots.

Under Russian law, buildings and land plots are considered to be separate immovable property and therefore can be owned by different organisations or natural persons. However the Russian Land Code provides that “buildings follow the fortunes of the land they are situated on”. In other words, a single owner who owns both the land plot and the building located on it cannot dispose of them separately.

The ownership right can be acquired from the registered owner on the basis of a sale and purchase agreement or through the construction of a new building on a land plot, which is owned or leased by a developer.

In order to be valid, the sale and purchase agreement for real estate must be concluded in a simple written form and must satisfy the following essential conditions:

- the seller must be the registered owner of the building;
- the seller must be the registered owner or registered tenant of the land plot beneath the building;
- it must contain a description of the property; and
- it must contain the purchase price.

According to the Russian Land Code the following provisions in a sale and purchase agreement for a land plot are invalid:

- the right for the seller to buy back the land plot which has been sold;
- limitations of the further disposal or usage by the buyer of the land plot which has been sold; and
- limitations on the liability of the seller for third party claims.

- In order to register the buyer’s ownership of the building and the land plot beneath it, the buyer and the seller must deliver to the Property Register the following:
- the common application for the registration of the transfer of the ownership title from the seller to the buyer;
- the sale and purchase agreement; and
- some formal documentation identifying the parties to the transaction, for example, incorporation certificates, documents confirming the authorities of the physical persons who have signed the sale and purchase agreement on behalf of the parties, corporate approvals etc.

In order to acquire the ownership of a building through its construction, the developer must be either the owner or the registered tenant of the construction site. Where the developer is the registered tenant, the lease agreement must expressly permit the tenant to construct the building on the site and to register his ownership of the building.

The acquisition of ownership through the construction of a new building requires receipt of the construction permit and commissioning permit of the new building, as these documents must be provided to the Property Register (see also section 4 “Zoning” below).

2. Public Auctions, Share Deals and Asset Deals

Real estate in Russia may be acquired from public entities (for example, the city of Moscow or Moscow Region), private legal entities (limited liability companies) or natural persons. Applicable legislation prescribes different procedures in each of these scenarios. The main difference is that the acquisition of public land is usually conducted through a public (open) auction and the price of the land plot is determined by auction procedure rather than by the contracting parties.

2.1 Acquisition of Real Estate from a Public Owner

In most cases an investor can only acquire publicly owned land for construction purposes by way of an auction. The acquisition of public land plots without an auction is possible in a few exceptional cases. For example, if the land plots are subdivided from a land plot leased for complex development or if the land plots underlie buildings and structures, the owners of such buildings and structures will have an exclusive right of acquisition over these land plots. Land plots also can be let to legal entities by decree or order of the President of the Russian Federation, the Government of the Russian Federation or the Government of a Region, which is a member of the Russian Federation, provided the land is to be used for social, cultural and utility facilities or for the implementation of large-scale investment projects, for example for the performance of international obligations of the Russian Federation.

Pursuant to the Russian Land Code public bodies can grant a leasehold for construction for a term of 3 to 10 years. The duration of the term depends on the complexity of the building to be constructed on the leased land plot. If the tenant fails to complete the construction works within the term provided by the lease agreement, then the landlord is entitled to terminate the lease, provided that the failure of the tenant to complete the construction in time is a material breach of the lease agreement. The burden of proof for establishing material breach of the lease is on the landlord.

After construction of the building has been completed and the ownership to the new building has been registered, the tenant is entitled either to buy out the land plot beneath the building or to enter into a long term lease for 49 years. The purchase price or the rent amount (as appropriate) are prescribed by law and are non-negotiable.

2.2 Acquisition of Real Estate from a Private Owner

In relation to the purchase of real estate on the secondary market, Russian and foreign investors can acquire real estate directly through a real estate sale and purchase agreement (“**asset deal**”) or through the acquisition of a company which owns the real estate (“**share deal**”). In either case the purchase may be made from abroad by the foreign legal entity itself, through the foreign legal entity's local permanent establishment

(representative office or branch) or through a registered Russian legal entity.

The advantages and disadvantages of a share and asset deal can be summarized as follows.

In order to transfer the shares of the property-owning company the parties must execute a share purchase agreement. Any share purchase agreement must be signed in the form of a notarial deed. As the notaries in Russia are not usually willing to verify whether condition precedents have been satisfied, the parties must conclude a preliminary share purchase agreement, which creates the obligation of the parties to sign the main share purchase agreement only once all of the conditions precedents have been satisfied. A preliminary share purchase agreement must also be signed in notarial form. In contrast, a direct sale and purchase agreement for real estate can be concluded in a simple written form and usually contains the condition precedents and counter obligations for the transfer of the ownership right and payment of the purchase price.

The buyer of the shares becomes the owner of the shares as soon as it has been registered as a shareholder of the target in the Unified State Register of legal entities. The notary who has officially recorded the sale and purchase agreement must notify the Unified State Register of Legal Entities on the assignment within 2 business days of the notarization of the agreement, unless the sale and

purchase agreement provides a longer term for such notification. In the case of an asset deal the buyer acquires the ownership right to the real estate only after its state registration in the Property Register. According to the State Registration Law, the registration of the ownership title in the Property Register takes 7 working days.

A share deal requires more comprehensive due diligence, as the buyer must review not only the validity of the ownership title to the real estate, but also any previous transactions involving the company's shares, particularly if the shares have been transferred several times. In addition, the buyer must review the tax liability of the target company, the existence of any non-core assets and the existence of any employee and management claims against the target company, such as compensation claims for unused holidays or golden parachutes.

As opposed to an asset deal, a share deal will usually require antimonopoly approval. The antimonopoly clearance generally takes not less than 30 calendar days.

From a tax point of view, a share deal does have the potential to offer some benefits if the seller of the shares is a non-Russian company. The majority of Russian inbound investments are currently

routed through Cyprus because of a combination of relatively low domestic taxation in Cyprus and the favourable double taxation treaty with Russia. Other jurisdictions, such as the Netherlands and Luxembourg, are also often used to hold Russian real estate assets either in corporate or branch form.

It should be taken into consideration that under Russian tax law the transfer of shares and land plots are exempt from VAT (currently 18%, starting from 1 January 2019 – 20%). However, the selling of the buildings is subject to VAT.

2.3 Payment Terms for Share Deals and Asset Deals

Payment between two Russian companies can only be made in Roubles. If either the seller or the buyer is a non-Russian company then the purchase price can be nominated in a foreign currency.

In order to avoid currency risks, the purchase price is usually negotiated as the Rouble equivalent of an amount in Euros or US dollars to be calculated at the exchange rate fixed by any bank as at the date of payment.

In most cases payment of the purchase price under share and asset deals is made through a letter of credit. Some banks offer a letter

of credit nominated in a foreign currency, which shall be paid out in Roubles under the exchange rate on the date of payment. Such letter of credits are usually opened as an irrevocable guaranteed letter of credit. This payment tool helps avoid currency exchange risks.

In a share deal, payment of the letter of credit is done by the bank once the bank has been provided with the sale and purchase agreement in the form of a notarial deed and an extract from the state united register of the legal entities confirming that the buyer is the registered shareholder.

With respect to asset deals, the condition for payment is usually the extract from the Property Register confirming that the purchaser has been registered as the freeholder of the real estate without any encumbrances.

Under Russian law, payment of the purchase price can be also performed under an escrow agreement entered into between the seller, the purchaser and the bank as escrow agent or through a notary trust account. Since this option is relatively new, neither the banks nor the notaries have significant practical experience of them. Documents must be provided to the Property Register (see also section 4 "Zoning" below).

3. Other Rights to Property

Two other relevant rights over property are mortgages and easements.

3.1 Mortgage

The law surrounding security and pledge agreements of immovable property ("**mortgage agreement**") is governed by the Mortgage Law. The Mortgage Law provides with that the following types of property can be mortgaged:

- Land plots with some exceptions in respect of municipally-owned land plots and land plots held by the state;
- Enterprises, buildings and structures;
- Residential houses and apartments;
- Country houses, garages and other structures for personal use; and
- Aircraft and sea-going vessels, inland-navigation vessels and space objects (see also section 8.1 "real estate as security" below).

A mortgage can arise either by virtue of law or by a mortgage agreement. In both cases it is subject to state registration in the Property Register (otherwise it is invalid).

It should be noted that it is only possible to have a mortgage over buildings or structures if there is a simultaneous mortgage over the land plot on which they are situated. It is another limb of the principle that buildings follow the fortunes of the land on which they are located.

A mortgagee's rights under the obligation secured by the mortgage and under the mortgage agreement can be certified by a mortgage deed

(also known as a mortgage).

The Mortgage Law stipulates all requirements for this security.

The mortgagor continues to have use of the mortgaged property and any restriction to this rule is void. However, the mortgagor requires the consent of the mortgagee to transfer the mortgaged property through sale, donation, exchange or to contribute it to the assets of a partnership or company, unless the mortgage agreement provides otherwise.

The mortgagee has the right to assign a claim from the mortgage agreement or an obligation secured by the mortgage (main obligation) to any third party, unless any law or the contract provides otherwise.

If the main obligation is not fulfilled or is fulfilled improperly, the mortgagee can foreclose on the mortgaged property to meet the expense of the property claims. There are two types of foreclosure on mortgaged property: judicial and extra-judicial. It is a general rule that a mortgage is subject to judicial foreclosure by means of a court order. The mortgaged assets are then sold at a public auction held by the court authorities.

Extra judicial foreclosure is possible on the basis of an mortgage agreement, which is signed in the form of a notarial deed and contains a clause on the levy of execution in the out of court order. It may be implemented on the basis of executive inscription by a notary, provided that the mortgage contract was concluded in the form of a notarial deed.

3.2 Easement (Servitude)

An easement constitutes a limited right of use of another's real chattels which can be a land plot, buildings, structures or other immovable property. Under Russian Civil Code, an easement can be established in order to ensure passage through the neighbouring land plot, ensuring water supply and land reclamation, as well as other needs of the owner of the real estate.

It is possible to establish an easement by an agreement between the parties or by a court decision upon the suit of the person requiring the establishment of the easement. It is important to note that easements are preserved in the event of the transfer of the rights to a land plot encumbered by those easements.

An easement may be public or private depending on the person/entity in whose favor it is encumbered. Easements are divided into two types according to their length: temporary and permanent.

Easements should be used in a way that is least burdensome to the land plot in respect of which they are encumbered.

The owner of the land encumbered by the easement has the right to demand payment from the persons for whose benefit the easement has been created unless otherwise provided by federal law.

Easements are subject to state registration in the Property Register.

4. Zoning and Planning Law Permits

Land development in the Russian Federation requires certain documents relating to territorial planning and townplanning zoning. These documents are developed at federal, regional and local levels. However, the most important documents containing planning and zoning regulations of land in Russia are known as a Master Plan ('Генеральный план') and Land Use and Development Rules ('Правила землепользования и застройки') which are developed at a local level.

A Master Plan contains schemes on functional zones and general provisions on the territorial planning of the municipal unit. Land Use and Development Rules contain schemes on territorial zones (e.g., industrial, residential, business and administrative, etc.) and detailed rules and restrictions regarding their development (i.e. the list of permitted uses of the land for each territorial zone, the permitted height of buildings that can be placed within each territorial zone, etc.).

It took a lot of time to establish the system of planning and zoning documentation in Russia. Meanwhile the most municipal units have adopted Master Plans and Land Use and Development Rules. According to the general rule it is prohibited to issue construction permits or change the permitted use of a land plot without Land Use and Development Rules being in place.

In addition, there are certain documents which determine the layout and limits of the possible development of a particular district or even a land plot, such as a Site Design Plan ('Проект планировки территории') and a Development Plan of a land plot ('Градостроительный план земельного участка'). Such documents are usually developed upon the initiative of investors and for the purposes of a particular project.

Construction or re-construction works require the necessary permitting documents

(a construction permit). In order to obtain a construction permit, it is necessary to file with the competent authorities an application together with supporting documentation evidencing that all other requirements for the development have been satisfied (such as the acquisition of all relevant rights to the land in question, the approval of the design documentation and arrangements for the development to be supplied with utilities). Once all the necessary documents have been submitted to the relevant authority, a construction permit should be granted within 10 days. Beginning construction works without obtaining the necessary permitting documents may lead to the building being deemed to be an 'unauthorised structure'. As a general rule, a company which has built an unauthorised structure does not acquire any rights to this structure, is not entitled to enter into any transactions in relation to this structure and should demolish it at its own expense.



5. Environmental Liability

The right to a favourable environment is enshrined in the Constitution of the Russian Federation. A foreign investor, therefore, cannot ignore environmental issues in relation to their investment.

Environmental legislation in Russia is based on several principles including the presumption of ecological danger of planned economic and other activities, the “polluter pay” principle and the requirement for a mandatory environmental impact assessment when making decisions on the carrying out of economic and other activities.

Environmental law in Russia is created at both the federal and regional level. The key authorities responsible for formulating and implementing environmental policy and law at the federal level are the Ministry of Ecological Resources and the Ecology of the Russian Federation (“MPR”), the Federal Service for Supervision over Use of Natural Resources (“Rosprirodnadzor”), the Federal service for Hydrometeorology and Environmental Monitoring (“Rosgidromet”) and the Federal Environmental, Industrial, and Nuclear Supervision Service (“Rostekhnadzor”, or “RTN”).

In order to conduct certain types of business which can cause harmful pollution or environmental degradation, it is necessary to obtain a special permit or

certificates. Examples of such activities are as follows:

- industrial developments (manufacturing industries, oil and gas exploitation, mining);
- infrastructure projects (roads, settlement and housing projects, airports, electric power plants);
- urban constructions (malls, university campuses); and
- agricultural and forest activities.

Environmental offences can result in civil, disciplinary, administrative and criminal liability.

Article 16 of the Environmental Protection Law sets forth the following types of negative effect on the environment:

- emitting a pollutant and other substance into the atmospheric air;
- dumping a pollutant, other substance and microorganism into bodies of water, underground bodies of water and water collection areas;
- pollution of sub-soil;
- industrial and consumption waste disposal;
- pollution of the environment with noise, heat, electromagnetic, ionizing and other physical factors; and
- other types of negative effect on the environment.

The legal entities and natural persons which have inflicted damage to the environment by polluting, depleting, damaging, destroying it, by irrational use of

natural resources, by degrading and destroying natural ecological systems, natural complexes and natural landscapes or which have committed another violation of the environmental protection legislation must pay compensation.

Activities of legal entities and natural persons which breach environmental protection legislation can be restricted or even terminated by a court or an arbitration court.

Russian environmental legislation is complex and in many cases it differs from commonly accepted international standards. As a result, additional environmental due diligence may be required. A highly-qualified consultant will be able to consider the relevant documentation, determine which permits and certificates are required as well as communicate with the relevant governmental authorities in order to predict any potential risks connected with failure to comply with environmental law.

Usually any facility in Russia requires a permit to discharge potentially harmful fumes as well as an approval setting limits on the discharge of solid waste and effluent. Sometimes agreements for the extraction of water are required. Conducting such an activity without permission may result in the suspension of the current industrial activity of a company or a fine of up to 250,000 RUB (approximately 4,000 USD).

6. Leases

The most common form of arrangement which allows the occupation and use of real property for a limited period of time in Russia is a lease. Although all forms of lease are governed by the same provisions of the Russian Civil Code, Russian law does include specific rules in relation to leases of certain kinds of real property (for example, residential leases – known as ‘наем жилого помещения’, nonresidential leases and land leases).

6.1 Duration

In general, parties to a lease are free to agree to any length of term, but, in some cases a minimum or maximum term of lease is stipulated by law.

A residential lease may not be entered into for a period of more than five years (this rule may not apply if the residential premises are leased by legal entities). The term of a lease of non-residential premises is not limited by legislation. Currently in Moscow, office leases are usually for a term of five to seven years, and retail leases for anchor tenants are for about 10-15 years.

The Russian Land Code establishes a mandatory range of possible terms for a lease of publicly owned plots of land allocated for different purposes or to different types of tenants. In general, if publicly owned plots of land are allocated for construction, then the lease term must range from three to ten years. However, when plots of land are allocated for the construction of cables, pipelines and other conduits or for the operation of a building or another real property asset by its owner, the lease term may be up to 49 years.

If the term of the lease has not been set by the contract, the lease is considered to be for an indefinite period. Under Russian law, leases of real property entered into for one or more years must be registered with the registration authority and are only deemed to have been concluded upon state registration. A residential lease for a period of at least one year is subject to state registration as an encumbrance on the leased residential property.

6.2 Rent

Rent in commercial leases usually consists of a fixed element (generally calculated per square metre of leased area) and a variable element (usually comprising service charges, utilities consumed or, for retail leases, turnover rent). Rent for residential premises is usually established as a fixed sum for the entire premises.

Rental payments are normally subject to VAT in Russia at the current rate of 18 per cent (starting from 1 January 2019 – 20%). However, land leased from the state or municipal authorities is VAT exempt. Foreign companies acting through branches or representative offices in Russia are not charged VAT on the rent of premises in Russia if the legislation of the relevant foreign state (or an international treaty with the Russian Federation) provides for a reciprocal exemption for Russian companies and citizens.

6.3 Rent Review

According to the Russian Civil Code, as a general rule the level of rent is adjusted no more than once a year. However, parties to a lease contract may agree a more frequent indexation or fix the level of rent for the entire lease term. The amount

of rent payments for some types of property (for example, publicly owned land plots) is usually established and adjusted according to rules of statutory acts.

Indexation of the fixed rent in commercial leases can be linked to changes in market rentals for the same type of property, inflation rates or the Consumer Price Index.

Changes in the variable elements of rent depend on the nature of those elements. For instance, rent based on turnover is linked to an increase or decrease in the tenant's turnover. Service charges and utilities costs payable by the tenant are normally linked to the costs which the landlord has actually incurred.

6.4 Operation Expenses

In commercial leases, the tenant is generally obliged to pay or reimburse the landlord for all operating expenses relating to the leased property (maintenance and repair of common areas, land tax, insurance, etc). Where applicable, lease contracts require the tenant to pay operating expenses in proportion to the area leased. The exact arrangements depend on the terms of the contractual agreement.

6.5 Maintenance, Repair and Renovation at end of Lease

Unless the lease specifies otherwise, the landlord is liable for capital repairs to the leased property and the tenant must carry out current repairs and bear any expenses incurred maintaining the leased property. If the tenant fails to carry out the necessary repairs, then the lessee may seek compensation and has the right to terminate the lease. Improvements to the leased

property are divided into separable and inseparable improvements. Separable improvements (for example, installing furniture) can be performed by the tenant without the consent of the landlord and remain in the ownership of the tenant. Inseparable improvements (for example, repair of the building) can be performed only with the landlord's consent and, after the termination of the lease, the tenant is entitled to compensation for such improvements, unless otherwise provided for in the lease.

6.6 Assignments/ Transfers

Generally, the tenant may assign its rights and obligations under a lease to a third party subject to obtaining the prior consent of the landlord. It is common practice for the landlord to provide prior consent on the assignment of the rights and obligation under the lease to the tenant's affiliates. According to Russian law, a tenant using a publicly owned land plot under a land plot lease contract entered into for a period of more than five years can assign its rights under the land plot lease contract without the landlord's consent, but subject to notifying the landlord.

Assignment must be executed in the same form as the initial lease. Assignment of a lease for a period of more than one year is subject to state registration.

6.7 Subleases

A tenant is entitled to sublet leased property to a third party subject to the landlord's prior consent. Any subleases are subject to the lease term under the primary head-lease and any contractual restrictions in the primary head-lease. Unless otherwise provided in the main lease, early termination of the primary head-lease entails the early termination of any sublease.

Subletting residential premises is only possible when the space requirements of occupants are taken into consideration.

Subletting a plot of land owned by a public body, which is leased for a period of more than five years, does not require landlord consent. However the tenant must notify the landlord of the sublease.

6.8 Termination

Under Russian law the landlord can terminate a lease contract following court proceedings where there has been a material breach of the contract by the tenant (for example, where the tenant fails to pay rent on two successive occasions following the expiry of the relevant payment date, or where the tenant uses the property in a way that is contrary to the conditions of the lease or the designation of the property or where the tenant allows or causing material deterioration of the property). The law also provides additional grounds for terminating a lease of land (for example, failing to use the land plot designated for agricultural production or residential or other construction for a period in excess of three years).

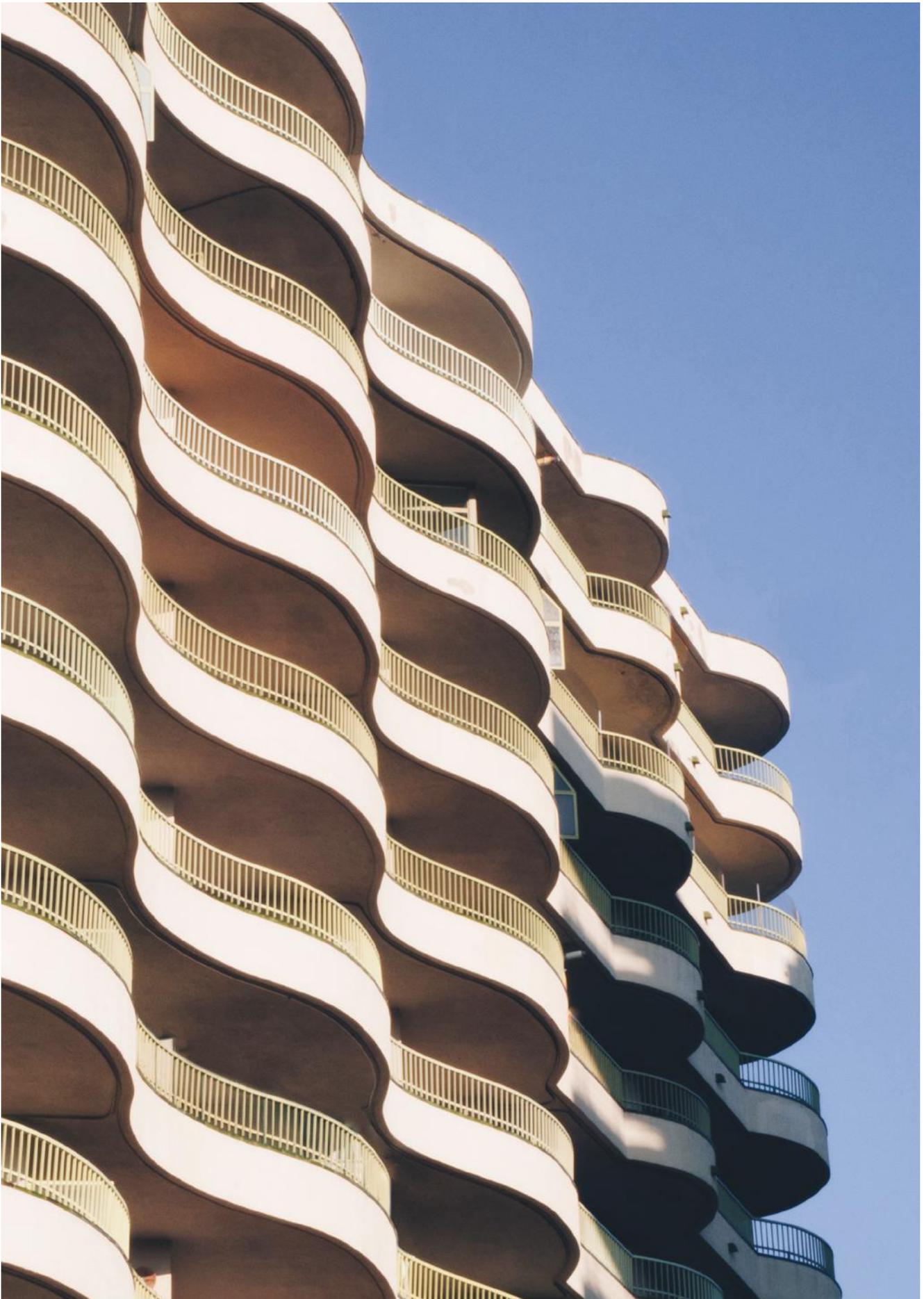
For land plots owned by public bodies, Russian law stipulates that leases for more than five years may be terminated only if:

- the tenant makes a significant breach of the contract; and
- a relevant court decision is rendered.

Furthermore, under Russian law, it is possible for a lease contract to include the right of any party to unilaterally repudiate the lease. Parties to a lease contract for an indefinite term have the right to terminate the contract at any time by giving three months' advance notice unless a different period is specified in the contract.

Generally, neither the government nor any other authority can directly require the termination of a lease in out of court order. The property itself (e.g. a plot of land) may, however, be subject to compulsory purchase, in which case, the lease may come to an end.

Residential leases can be terminated by the tenant with the consent of other persons permanently residing with him or her by giving three months' advance notice to the landlord. Either party to a residential lease is entitled to require lease termination through court proceedings in certain case, for example if the premises cease to be suitable for permanent occupation or became hazardous.



7. Real Estate Taxes

Inevitably, there are tax considerations to be taken into account in the acquisition of real estate in Russia. The extent of these tax implications depends upon whether the real estate was acquired by a foreign legal entity ("FLE") itself, through a foreign legal entity's local permanent establishment (representative office or branch) or through a registered Russian legal entity (i.e. a subsidiary of the foreign legal entity) ("RLE").

7.1 Profits Tax – RLES

Profits tax is a tax on the operating income of the relevant legal entity.

The tax base is defined as the total "income" received by a taxpayer, which includes sales income (total proceeds from the sale of goods, works, services and property rights) and non-sales income, less any related expenses and allowable deductions.

The Russian Tax Code lists the expenses that are deductible for tax purposes. Expenses are generally considered to be deductible if they meet the following criteria:

- they must be incurred in the course of a taxpayer's income-generating activity;
- they must be economically justifiable;
- they must be supported by relevant documentation; and
- they must not be listed as one of the specifically non-deductible expenses provided by law.

In practice, the tax authorities apply these criteria very strictly, and may challenge any expense which is not directly related to the generation

of income. There are also strict documentary requirements that the taxpayer must satisfy regarding contracts, invoices, VAT invoices and other supporting material.

Certain expenses, such as interest on a loan and insurance, may be deducted for tax purposes with partial limitations or restrictions.

7.1.1 TAX DEPRECIATION

Depreciable property is property (excluding land), both tangible (such as buildings, plants and equipment) and intangible, which has:

- a useful life of at least one year; and
- a value of not less than RUB 100,000.

All depreciable assets must be allocated to their relevant depreciation group and amortised over their useful lives. The taxpayer determines the relevant depreciation group by using the Classification of Fixed Assets issued by the Russian government. The tax depreciation may be calculated using either the straight-line method or reducing balance method (subject to certain restrictions).

From 2006 onwards, taxpayers have been entitled to deduct a one-off depreciation allowance equal to 10 per cent of the historic cost of fixed assets purchased or capital improvements made. The regular depreciation expense is then computed on the reduced tax base.

7.1.2 TAX RATE

The maximum rate for profits tax is 20 per cent, attributed as follows:

- 3 per cent is payable to the Federal budget; and
- 17 per cent is payable to the Regional budget.

Regional authorities may reduce their portion of profit tax by 4.5 per cent.

7.1.3 LOSSES

Enterprises may carry forward tax losses for up to ten years.

7.1.4 PROFIT TAX

Different tax rates are applied depending on the source of income derived from a real estate asset (i.e. whether it is from a direct purchase, lease or share deal).

Rental income from real estate is subject to Russian withholding income tax at a rate of 20 per cent.

No double tax treaty protection is available for income related to the sale or lease of real estate.

Russian-sourced income of an FLE which is not attributable to a local permanent establishment may be subject to withholding tax. The responsibility for the withholding tax lies with the RLE who is making the payment (known as the "tax agent").

The statutory withholding tax rates are as follows:

- 15 per cent on dividends and other profit distributions received by FLEs;
- 20 per cent on all types of income subject to withholding tax. This may include the proceeds of sale received from the sale of shares in an RLE where more than 50 per cent of the company's assets consist of real estate in

Russia or the proceeds from the sale of real estate in Russia, if documents supporting the related expenses have not been provided, or the recipient of the income has elected not to deduct the related expenses (note that there may be an exemption according to provisions of a relevant double tax treaty); and

- 20 per cent on profit from the sale of shares in RLEs, where more than 50 per cent of the company's assets consist of real estate in Russia, or from the sale of real estate in Russia, provided that the recipient of the income submits documents supporting deductible expenses to the tax agent prior to receiving the same. A relevant double tax treaty may provide for a reduction in or exemption from withholding tax (typically of 5 to 10 per cent on dividends and of 0 per cent on other types of remitted income) and may, with the exception of the US and UK treaties, override the 50 per cent real estate company capital gains tax provision noted above to facilitate a tax-free sale.

7.2 VAT

VAT is charged at a standard rate of 18 per cent (starting from 1 January 2019 – 20%) on the sale of goods and services (including rental income from a building) supplied in Russia. VAT is also applied when goods and services are supplied free of charge and is also imposed on most imports into Russia. The transfer of property rights are also subject to VAT. The sale of shares and land plots are however exempt from VAT.

The VAT actually payable to the Federal budget is the difference between the VAT receivable on transactions subject to VAT ("output VAT") and the VAT incurred on purchases subject to VAT ("input VAT"). Since 1 January 2006, taxpayers have been entitled to offset their VAT before paying their suppliers.

VAT invoiced by contractors for capital construction and installation work may generally be offset when such work has been recorded in their accounts, rather than when the construction project has been completed.

VAT incurred on construction for a company's own use may be offset once it has been charged and paid to the Federal budget. The accrual and payment of VAT on this type of work must be recorded and accounted for in every tax period.

Input VAT incurred on the purchase of fixed assets can be offset only once the assets have been recorded in the company's accounts.

7.3 Property Tax

Property tax is levied on both moveable and immovable fixed assets. In the case of FLEs which do not carry out commercial activities in Russia through a local permanent establishment, it will be the real estate located in Russia and owned by the FLE which is subject to property tax. Land, water and other natural resources are not subject to property tax, but buildings located on land are subject to property tax. From 1 January 2014, the basis for property tax for commercial property has been the cadastral value of the real estate asset.



8. Real Estate Finance

A lender to an investor looking to acquire or develop real estate, will typically insist on the full package of security instruments available under Russian law. This includes pledges of shares, suretyships and parent guarantees, bank guarantees, pledges of assets and rights, mortgages of real estate and pledges of lease receivables.

Under Russian law, a mortgage offers one of the most effective forms of security.

Mortgages are regulated by special legislation, primarily contained in the Law on Mortgages and, to the extent not regulated by this law, in the Russian Civil Code. A mortgage allows the mortgagee to receive compensation for the debtor's default under a principle secured obligation, with priority over unsecured creditors. A mortgage is an encumbrance on the property and limits the mortgagor's right to the free use and disposal of such property. For example, the mortgagor may only dispose of the mortgaged property with the consent of the mortgagee (unless the mortgage agreement provides otherwise). As a general rule, if the property changes hands and the mortgage has not been discharged, the mortgage will remain in place over that property (see also section 3.1 Mortgage above).

There are no particular restrictions on payments made to foreign lenders under a security document or loan agreement. However, certain currency control regulations must be complied with when proceeding

with payment, for example a transaction passport and other currency control documents must be completed and submitted to the bank.

8.1 Real Estate as Security

The following real estate assets which are registered on the Property Register can be mortgaged to a lender:

- plots of land;
- buildings;
- premises which form part of buildings;
- facilities that have been registered as real property (e.g. water and sewage pipelines, fences etc.); and
- registered 'incomplete constructions' (incomplete buildings where development was suspended and which have been registered as such in the Property Register).

A mortgage can also be created over other objects regarded as real estate under Russian law, including 'enterprises' (portfolios of real estate assets), aeroplanes and boats.

It is also possible to create a mortgage (pledge) over a lease. A pledge over leased land is common in practice, particularly when the building situated on the land in question has also been mortgaged. Pledges over leases of buildings alone are rarely considered to be good security.

8.2 Trading of Debt

Debt may be traded between lenders. As a general rule and unless the agreement states otherwise the secured debt can be assigned either by:

- assigning or novating the debt itself, in which case the mortgage follows the secured obligation; or
- assigning the mortgage agreement, in which case the secured obligation follows the mortgage (although this option is rarely used in Russia and may raise additional questions regarding any other security securing such debt).

If the mortgage is certified by a mortgage deed (zakladnaya) the debt can only be assigned by a transfer of the mortgage deed.

8.3 Corporate Governance

Russian law does not recognise concepts regarding 'financial assistance' rules or 'corporate benefit' rules.

Under corporate law provisions, certain transactions are subject to corporate approval by a company's general meeting of shareholders or the board of directors. In particular, such approval is required:

- for major transactions, ie where the value of the property exceeds 25% of the company's assets; and
- for related party transactions.

Additional restrictions may be set out in the company's charter.

8.4 Priority of Security

Under the Mortgage Law it is not possible for an existing secured debt to be subordinated to a newly created debt. The seniority of secured debt is set out by mandatory provisions of Russian insolvency and pledge/mortgage law and is based on the date of registration of the mortgages. These rules cannot be varied or excluded by agreement of the parties.

The seniority of pledges may be adjusted by an agreement between pledgees or an agreement between one, several or all of the pledgees and the pledgor. In any case such agreements must not affect the rights of third parties which are not a party to the agreement.

8.5 Applicable Law

Under Russian law, agreements which relate to real estate located in Russia must be governed by Russian law. This rule also applies to mortgages.

Where the real estate asset which is the subject of a mortgage is situated in another country, Russian courts will recognise the parties' choice of governing law. In the absence of such choice the courts will generally apply the law of the country in which the asset is located.

In general the registration authorities must register a mortgage within 9 business days from the date of the parties' application or within 5 business days if the mortgage agreement has been notarized.

8.6 Enforcement of Security

A mortgagee is entitled to enforce a mortgage if the debtor under a secured obligation is in default. Events of default can be set out in both the loan agreement and the mortgage agreement. Typical events of default include:

- non-payment of interest or principal loan repayments; and
- insolvency.

Enforcement of security is not possible if the breach is insignificant and the amount of outstanding debt is disproportionate to the value of the mortgaged asset. For example, it would be considered disproportionate if the amount of debt is less than 5% of the total value of the mortgaged assets and the payments due are outstanding for less than three months.

Continuing obligations must be breached more than three times within a twelve month period in order for it to be possible to enforce security (unless otherwise stipulated in the mortgage agreement).

In the case of a mortgage of an enterprise (a portfolio of assets), enforcement is only possible after the expiry of one year from the date of completion of the mortgage agreement.

The mortgage can be enforced either by means of a court order or, if the parties so agree in the mortgage agreement, out of court. The latter option is not available if the asset which is subject to the mortgage is an undeveloped parcel of agricultural land, state owned property, a property of special historical or cultural importance or falls within certain other categories specified by law.

As a general rule, after the mortgage is enforced, the mortgaged assets are sold at public auction. If the parties to a mortgage agreement are legal entities or private traders, then the mortgagee can take possession of the asset at the price determined by an independent appraiser and then offset the sale proceeds against the secured debt. This option is not available in the same cases as listed above where out of court enforcement is not permitted.

In the event of judicial foreclosure, pledged property can still be disposed of at a public auction or, if the pledgee and the pledgor so agree or the law specifically prescribes, by way of (i) the pledgee retaining the pledged property or (ii) selling it to third parties at a price below market rate. In the event of an out of court foreclosure, the pledged property can be disposed of at an auction held in accordance with the Russian Civil Code or the agreement between the pledger and the pledgee. Furthermore, if the pledgor is a business entity, the parties to a pledge agreement can agree that the disposal of the pledged property will be performed by the pledgee retaining the pledged property or by selling it to third parties (as described above).

8.7 Non-insolvency Procedures

If a company meets the legal criteria for insolvency, the shareholders of that company may provide support by granting the financial aid required to fulfil the company's obligations. This is known as 'sanitation' ('санация'). However, sanitation does not affect the rights of a mortgagee.

8.8 Effect of Borrower's Insolvency

The treatment of mortgages during the insolvency process varies depending on the stage in the insolvency proceedings. For example, the 'supervision' stage creates a moratorium which completely prevents any creditors (including mortgagees) from enforcing their security. During the 'financial rehabilitation' and 'external administration' stages a creditor can only enforce the security in court and only if the debtor cannot prove that such action will prevent it from becoming insolvent again.

Under insolvency legislation any transaction (including a mortgage) by a borrower can be rendered invalid by the court in certain circumstances, such as when it constitutes a transaction at undervalue. Generally, in order for this to happen, the security must have been created within a certain time period before the commencement of the insolvency

process. Such time period varies depending on the circumstances, but can be up to three years.

8.9. Order of Payment in the Event of Insolvency

In the case of insolvency, secured creditors have priority over unsecured creditors, but not for more than 80% of the sale price (if the mortgage secures a credit facility) or 70% of the sale price (if the mortgage secures other debtors' obligations). If several mortgagees have security over the same real estate asset, in general, they will rank in priority according to the date of registration of the mortgages.

There are certain prior claims which apply to the proceeds of sale from the realisation of assets which are subject to a mortgage. These include:

- 15% of the sale price (if the mortgage secures a credit facility) or 20% of the sale price (if the mortgage secures other debtors' obligations) is set aside for compensation for death or injuries, unpaid wages, and other similar claims; and
- the costs of the insolvency process which are also met from the sale proceeds.

Unsecured creditors rank behind secured creditors and rank equally between themselves (the *pari passu* principle).

The cash collected from the sale of pledged property is to be distributed between the co-pledgees proportionately to their secured claims unless otherwise agreed. A joint pledgee who receives cash from the disposal of the pledged property is obliged to pay what is due to the other joint and several pledgees in equal shares, unless an alternative arrangement has been made between them.



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This guide was written predominantly by Ivan Gritsenko of our Real Estate practice group.

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