

***FINANCIAL LEASING AS A MECHANISM OF VESSEL PURCHASE.
CASE STUDY: A RUSSIAN – NORWEGIAN PROJECT***

BY

BANTIKOVA V. ELENA

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THE TABLE OF CONTENTS

1. CHAPTER 1. INTRODUCTION	
1.1. The background of the problem	4
1.2. Problem statement	5
1.3. Research objectives	6
1.4. Research hypothesis	7
1.5. Material and methods	7
2. CHAPTER 2.	
2.1. Modern Russia.	
2.1.1. Status and general trades in development	9
2.1.2. Murmansk as one of the most important seaports in Russia	9
2.1.3. Auction	12
2.1.4. World Trade Organisation	15
2.1.5. Russian banking system	19
2.2. Offshore registration.	
2.2.1. Popularity basis	22
2.2.2. Desirable corporate characteristics	23
2.2.3. Company law	24
2.2.4. Double taxation avoidance treaties	25
2.2.5. Cyprus: profile	26
2.2.6. Cyprus: economy	27
2.2.7. Cyprus: investment climate	28
2.2.8. Cyprus: offshore sector	28
2.2.9. Cyprus: relations with the Eastern Europe	29
2.2.10. Tax treatment of Cyprus offshore entities	29
3. CHAPTER 3. SUBJECT AND OBJECT IN THE FINANCIAL LEASING AGREEMENT	
3.1. Legal basis	34
3.2. Financial leasing agreement	
3.2.1. Definition of the financial leasing	36
3.2.2. Parties in the financial leasing agreement	37
3.2.3. Rights and obligations of the parties in the financial leasing agreement	40
3.3. Payment forms	
3.3.1. General forms	42

3.3.2. Payment forms for the leasing agreement	43
3.4. Classification	
3.4.1. General	51
3.4.2. Classification in accordance with the type of financing	51
3.4.3. Composition of the participants in the deal	52
3.4.4. Type of property	54
3.4.5. Recoupment grade of the leased property	54
3.4.6. Market sector of the leasing operation	55
3.4.7. Relation to the customs, tax and depreciation exemptions	56
3.5. State regulation of leasing relations	
3.5.1. Licensing of leasing activities	57
3.5.2. Insurance of leasing activities	58
3.5.3. Leasing benefits	59
3.6. Financing of purchase of major production means	61
4. CHAPTER 4.	
DESCRIPTION OF THE CONTRACT RELATIONS IN THE NORWEGIAN-RUSSIAN PROJECTPELAGIC PURSE SEINER	
4.1. General	63
4.2. Financing of the purchase	65
4.3. Registration and ownership of the vessel	66
4.4. Agency agreements between the parties	66
4.5. Expert and broker advisor	67
4.6. Leasing payments	67
4.7. Insurance	68
4.8. Practical side of the project	69
4.9. Specification of operation expenses	
4.9.1. Variable expenses	70
4.9.2. Constant expenses	71
4.9.3. Estimation	71
5. SUMMARY	73
6. RESULTS, RECOMMENDATIONS FOR FUTURE RESEARCH	77
7. ENCLOSURE 1.	80
8. ENCLOSURE 2.	81
9. REFERENCES	82

**FINANCIAL LEASING AS A MECHANISM OF VESSEL PURCHASE.
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CHAPTER 1.

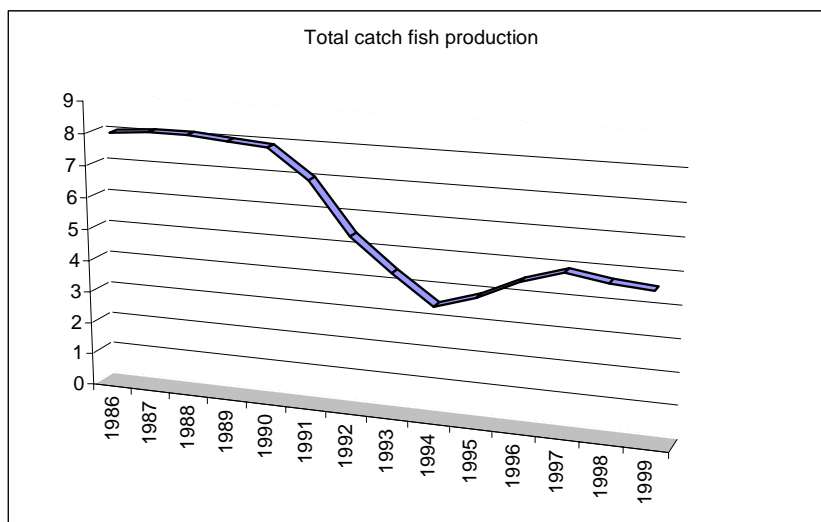
INTRODUCTION

1.1. THE BACKGROUND OF THE PROBLEM

The role of fisheries in Russia can not be overestimated. Russia is one of the top five countries in terms of fishing areas. Besides, Russia is a transition country and fisheries play a significant role in the economies of such countries. They not only supplement the agricultural food production but also benefit national economies by generating foreign currency export earnings and providing employment for a considerable number of people. In Russia fisheries sector gives employment to approximately 690 000 people (FAO 1996).

The economic and political changes, which take place in the country, have been significantly affected the branch. Economic instability, changes in ownership structure, loss of access to subsidies and the breakdown of the distribution system have caused a tremendous impact on their fisheries sector. Since the break-up of the Soviet Union, Russia has seen a significant decline in domestic seafood and fish production, a deterioration in processing plant and equipment, and a rise in prices for the majority of fish products. In general, Russia's transition to a market economy has resulted in a sharp decline in financial resources available to the owners of capital, thus affecting the industry's future development.

Fig. (1). Total catch fish production (According to the Fishery State Committee of the Russian Federation)



These figures show a significant decline in the catch over the last decade.

In particular, distant water fishing declined markedly due to higher oil prices and loss of access to distant-water fishing grounds.

The disintegration of the centrally planned economies resulted in the discontinuation of subsidies, and the breakdown of the distribution systems lead to reduced fishing operations. Situation resulted in underutilisation of the ageing fleet and reductions in their size. The Russian fishery fleet declined from 3,494 decked vessels totalling 3.52 million GRT in 1990 to 1,981 vessels totalling 2.19 million GRT in 1994 (FAO 1996). Efforts have been made to restructure and renovate the fisheries sector.

Since 1994 a vast programme of fleet renovation started. In order to speed up the renovation of its long-distance fleet, the Russian fishing companies started signing leasing contracts with West European companies.

Thus, the deep structural changes in the economy of modern Russia brought leasing on the economic and financial scene. Introduction of this investment mechanism was natural and necessary. There appeared great capital requirements in the major production means. The aging fleet and equipment had to be renovated and reconstructed. Financial resources are more than limited, the system of banks is far from being perfect that makes it practically impossible to get a large long-term loan on favorable terms or at least with reasonable bank interest.

1.2. PROBLEM STATEMENT

Capital investments in the fishing industry have declined by more than 60% only in the period 1992-1994 (FAO, Fisheries Report, 1996). During this period, fishery enterprises have endured peak inflation, with 200-250% increases in prices for productive raw materials and equipment (including fuel, cargo, fishing and processing fleet machinery, and coastal facilities). Fishing firms were unable to pay off their considerable debts, many of them became bankrupts. The most important step the industry could take to promote its own development was to obtain sufficient investment.

The most acute problem that the industry faced was ageing fleet, with such consequences, as lack of efficient new technology, machinery, navigation and

acoustic systems, that in its turn causes decline in catches, high production costs and deprives the industry of competitiveness on the world market.

Practically all the vessels owned by the Soviet Union were built in Poland, Holland, Denmark and Germany, some vessels came from the Baltic republics and from the Ukraine. When the Soviet Union became divided into a number of units, the situation for the Russian fisheries became quite complicated. The country, which had practically no shipbuilding industry, came into the situation when the vessels had to be operated, repaired and built.

Thus the problem faced by the country was the possibility of purchase of newer, more efficient vessels under the unfavourable economic conditions in the country.

The problem could be solved by the introduction of the new investment mechanism, financial leasing. Investments could be involved from abroad taking into consideration the dismal state of the Russian banking system and the lack of state subsidies.

1.3. RESEARCH OBJECTIVES

To consider the possibility of vessel purchase through the mechanism of financial leasing from abroad, the analysis of financial leasing will be done in my research with application to fishing vessels.

The only way to justify purchase of fishing vessels from abroad is to look upon the issue of profitability of the financial leasing arrangement for the Russian partner. Murmansk region will be taken as the basis for the research, as it is practically the most significant region for Russia in terms of fisheries and most of such leasing agreements are concluded by the companies registered there.

1.4. HYPOTHESIS

Thus, from everything what has been described above, my research hypothesis will be:

Financial leasing is a cost efficient way of organising the fishing vessel purchase in Russia, given the dismal state of the present domestic banking system.

1.5. MATERIALS AND METHODS

The source for data obtaining became the Russian and Norwegian documentary sources. Data acquisition was made from Russian and Norwegian companies involved in the branch, most of them having common projects under financial leasing agreements. That included study of the related documents and contracts, study and analysis and review of the data received from the companies and from the official publications. A great deal of data was required through non-structured interviews of the people involved in the branch and especially in this type of projects. The total number of interviewed persons is 12, which were both Russian and Norwegian managing directors, financial directors, chief book-keepers, project co-ordinators, juridical advisors and technical specialists.

To verify the research hypothesis, the following will be done:

I will look upon the leasing theory, give its definition, classification and advantages. The federal law of the Russian Federation about leasing will also be considered, inclusive the structure and content of financial leasing contract and state regulations in connection with the leasing arrangement, such as licensing, benefits etc.

I will consider the offshore registration of the leased fishing vessels, widely practised in Russia, as a way of tax reduction. In this case the offshore jurisdiction under study is Cyprus.

I will study the particular case, that is a Russian- Norwegian project under the financial leasing contract for 8 years, where the Vessel is a pelagic purse seiner / freezer trawler.

LIMITATIONS OF THE STUDIES:

Any study, which concerns fishing industry can be complicated by the problem of data and information acquiring, especially when the study relates financial issues. Secrecy is particularly hard in private companies. I faced this problem not only in Russia but also in Norway contacting and interviewing companies and persons.

CHAPTER 2.

2.1. MODERN RUSSIA.

2.1.1. STATUS AND GENERAL TRADES IN DEVELOPMENT.

Russia has always been known as a leading maritime nation. The marine boundary is equal to 38,8 thousand km, the shelf zone occupies 4,2 million km².

But lately Russia's fishing industry has been facing a period of acute crisis, with a decline in catches and output of food products and, most important of all, a decrease in the availability of fish products in Russia, something which is unjustified given the shortage of foodstuffs in general and of animal protein in particular. Together with the domestic economic difficulties of Russia's fishing industry, serious new problems have arisen in the international situation:

- Decline of basic stocks for valuable traditional products of the industry, together with a drop in catches per unit;
- Overall decline in the economic indicators of the activities of the fleet and shore enterprises;
- Intensification of uncontrolled international fishing on the high seas and, in particular, in the northern Pacific Ocean and Barents Sea;
- Use of unselective equipment and fishing techniques, etc.

As in other parts of the world, the Russian fishing industry is subject to quota restrictions. But Russia also has considerable catch-rights in the waters of many other countries, and these rights - due to lack of long-distance fishing vessels - are not being fully exploited; like most countries, Russia is also looking to process a greater share of its catch domestically. As a result, there is potentially a lot of demand for equipment to be modernized - both for long-range fishing vessels, and for processing plants on land.

2.1.2. MURMANSK AS ONE OF THE MOST IMPORTANT SEAPORTS IN RUSSIA.

The Murmansk area is one of the largest and most economically advanced regions of the European North of Russia. The area is located on the Kola Peninsula. It is washed by the Barents and the White seas and covers an area of 145,000 sq.km.

Almost all its territory is in the Polar Circle. The longest distance from the north to the south is 400 kilometers and from the west to the east is 500 kilometers.

Its geographical position exerts a substantial influence on the industrial potential. The region lies at the junction of international marine trading routes and offers year round navigation. Murmansk Marine Trading Port is the largest ice-free port of Russia located in the Polar Circle. Since the loss of the Baltic ports the value of the ports in the Murmansk region has considerably increased; they now provide about 15 % of the total turnover of goods in the Russian ports. Its geographical position as well as the raw mineral and fish catching industries, have created a large industrial complex in the region. The region provides 14% of the Russian food fish production.

Fig.2 Murmansk region fishery industry as a percentage of the Russian fishery industry. *The fishery industry in the Murmansk region of Russia, EASTFISH, Fishery Industry Profile, vol.27, Copenhagen, FAO, July 2001, p.54*

	1995	1996	1997	1998	1999
Industrial output	13,4	12,2	10,3	13,3	14,0
Fish catch	11,3	10,4	9,8	9,5	14,5
Commodity output of fish products (excluding cans)	13,3	13,3	11,4	9,2	12,9
Canned fish (including canned seafood)	5,8	5,8	8,3	5,3	3,0
Average number of the industrial and production personnel	11,3	10,5	14,0	10,2	11,0
Investments in a fixed capital (flow)	18,3	19,3	43,9	13,9	17,9

Export of fish, fish products and seafood	14,8	10,1	12,5	11,1	...
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Since 1999 certain positive trends have been apparent in the Murmansk region fisheries industry.

- Russian vessels slowly began to supply domestic processing enterprises with fish
- Turnover of fish and fish products at Murmansk marine port increased
- The fishery industry share in the total industrial output of the region increased
- Investments in the fishery industry in the region increased

Despite the improved situation, management problems in the industry persist and prevent further development. About 10 years ago, the Ministry of Fisheries was replaced with a Department. Later, at the request of fishermen, the Fishery State Committee of the Russian Federation was recreated, but so far the regional industry functions with no real development strategy. There no precisely defined targets nor the ways to achieve them.

As of today it is difficult to define the administrative structure of the Murmansk regional fisheries industry or, in fact, that of the whole Northern Basin. Sevryba, the enterprise which used to coordinate the activity of the fishing companies in the Northern region in the past, was turned into a joint-stock company and then stopped existing at all.

Example of free-quota distribution shows the meaning of the Murmansk region for the fishery sector of the whole country.

A: Russians' distribution of the Cod quota in 1999 / Northwest Russia for the Barents Sea (http://www.intrafish.com/intrafish-analysis/rusland_06-12-2000_eng/print.php3)

- Murmansk (49%)
- Karelen (13%)
- Archangelsk (16%)
- Unions of private fishing enterprises (17%)
- Other (5%).

The results of quota sharing for this year also prove that Murmansk region is of greatest importance when it comes to fishery sector in the Russia. The Russian State Fishery Committee has issued an order (#64) on the allocation of the 2002

industrial (free) and scientific quotas to be harvested in international economic zones and in the Russian national fisheries areas. The Atlantic-Scandinavian herring in the North-Eastern Atlantic - Norwegian economic zone 85,000 tonnes, Icelandic, Faeroes, Jan-Mayan zones - 22,640 tonnes. The biggest shares went to the Murmansk fisheries (35,275 and 9,396 tonnes respectively), Kaliningrad (24,480t and 6,521t), Arkhangelsk (13,685t and 3,645t). Blue whiting in Norwegian economic zone - 50,000 tonnes. Murmansk: 20,750t, Kaliningrad: 14,400t, Arkhangelsk: 8,050t. Greenland halibut in areas under NAFO (Northwest Atlantic Fisheries Organization) regulation - 3,379 tonnes industrial quota and 400 tonnes scientific quota. Murmansk: 1,402t, Kaliningrad: 973, Arkhangelsk: 544t. Blue whiting and mackerel in the Faeroes economic zone - 105,000 and 10,000 tonnes respectively. Murmansk: 43,575 and 4,150, Kaliningrad: 30,240t and 2,880, Arkhangelsk: 16,905t and 1,610t.

2.1.3. AUCTION

On December 27, 2000, the Russian Federation adopted Decree #1010, regarding a fishing quota auction - a new strategy for distributing quotas.

Why Auction?

Previous to Decree #1010 adoption, the Russian Federal Department of Fisheries allocated quotas to fishing companies through regional administration fishery committees, basing on a special application that did not require a fee. When regional governors opposed federal policy, the Russian Federal Department of Fisheries would often discriminate against these regions by cutting quotas. Regional fisheries committees allocated a solid portion of quotas by the "to the best friend" scenario or used quotas to apply pressure on persecuted companies. Firms not connected to the fishing business used bribes or friendly relations to obtain quotas for cost-effective species fishing -- crab, shrimp, scallop -- and sold to fishing companies after adding a considerable margin. The Russian Federal Department of Fisheries has determined that the federal government should control industrial fishing and charge for usage of sea resources. According to Decree 1010, a company is admitted to auction provided: it pays taxes regularly, has a license for industrial fishing, owns or rents fishing vessels and has fish processing facilities. *

*Decree of the Government of the Russian Federation, no.1010 of 27.12.2000 "About water biological resources quota for inland, territorial waters, continental shelf and EEZ of the Russian Federation".

During the last two years, fishing companies were unable to meet allocated quotas, due to use of obsolete fishing equipment, aging fleet, diesel supply shortage, fish stock decreases, and fish smuggling. In 1999, Primorsky Krai fisheries reported harvested 1.2 million tons, in 2000 - only 950,000 tons, or 80% of the 1999 catch ("Primorskie news", 2001). In 2000, the reported Pollock catch in the Barents Sea decreased to one half of allocated quotas (Fish express, 2001). But mostly, Russian fisheries' inability to meet quotas is due to fish smuggling. Companies dodge paying taxes and customs duties, and obtain higher margins by relocating uncontrolled catch to foreign vessels at sea.

In 1999, it is estimated that Russia lost \$700 million to the black market for fish. According to Decree 1010, before a Russian fishing company sells harvested valuable species to a foreign firm, it should bring its vessel to a domestic port for customs clearance. Also, the coast guard will take a more active role policing coastal waters. Since last year, a satellite tracking system is being systematically installed on every fishing vessel to monitor its contacts with foreign vessels at sea in order to stop illegal offload of the catch. It is hoped that quotas auctioning will ban corruption and create transparency in the fisheries industry.

Yet, according to Decree #1010, fishing companies can get free quotas, provided they do not sell their catch abroad and supply the domestic fishery market with raw material and processed products. But few companies want to work for the domestic market, because smuggling provides much higher profits. RFE fishing companies have protested against auctioning quotas and applied to the Russian Federal Department of Fisheries to ban auctions. They stated that quotas auctioning would result in skyrocketing of fish retail prices, double taxation of fishing companies, bankruptcy of small fishing companies, sales of vessels and collapse of fishing industry. The strike has largely failed, however, and 22 companies participated in the first auction.

Auction - When and Where?

The first in a series of quota auctions was held on February 17, 2001 at the European-Asian Stock Market. The first auction in the series was closed to foreign participation and sold quotas for a total of 100,000 tons allowable catch of pollock in the Okhotsk Sea zone and a total 20,000 tons allowable catch of herring in the Barents Sea zone. On February 17, only 54 bids (at about \$3 million total) out of 220 bids were sold. The remaining 166 bids were auctioned on February 27. With participation of Japanese and South Korean companies on March 23, the last 56 bids

for Pollock and herring fishing that remained from February 17 and February 27 auctions will be sold.

Experts explain that all bids were not sold on the first date and were split into three actions due to a lack of experience in auctioning quotas and that the event was announced too late in the fishing season. Many fishing companies kept away as they were not sure if they would cover the purchased quotas before the end of the fishing season.

This year only 353 lots out of a total of 482 were sold in the third Far Eastern Russian quota auction. The first two (of crab and Alaska pollack) had been very successful, netting US\$ 137.7 million for the national budget. During the third auction the only quota to sell 100% was halibut. 129 lots of cod and shrimp were not sold. The auction realized a disappointing 503.46 million rubles (US\$ 16.5 million).

This poor result has given rise to various speculations - from conspiracy theorists' rumors about a company plot to demonstrate the auction system's inefficiency to the government, up to the banal explanation that the Far Eastern fisheries' financial means were exhausted by the first two auctions.

Quotas for 104,000 tonnes of different fish species to be harvested in Russian Far Eastern waters were auctioned in the fifth auction on the 5th of march, 2002. The total starting value was RUB 218 million (US\$ 7.28 million). 80 fisheries participated in the bidding, which was restricted to Russian companies. Right from the start, prices went sky-high. The price for Alaska pollock jumped eight-fold while bidding went on. To the end it gave USD 888 per tone. It is necessary to notice that after the January auction, Russian entrepreneurs complained that harvesting pollock becomes unprofitable at an auction price of USD 600 per tone.

High auction price involves the next problem, the fishery sector in Russia faces. The issue is that companies participating in the auctions in most cases are connected to foreign companies investing in the quota purchase. So it is inevitable that Russian companies show increased debts on credits from foreign partners. To compensate for this they have to increase export. There was carried an inspection by the auditors from the Russian Federal Audit Chamber in February 2002 with the aim of assessing the efficiency of the newly established quota auctions and their impact on federal and regional budgets. The preliminary results published show that export was increased to 110,000 tones of fish and seafood in 2001 (20,000 tones more than in 2000). Exports thus became 48% of the total output compared to 42% in 2000. (Fish express, 2002).

No final decision can be taken now. And it is difficult to be one hundred per cent sure if quota auctions are exactly what Russia needs now. But what is absolutely clear that is the impossibility to survive under the present conditions for many smaller and poorer fishing companies.

2.1.4. WORLD TRADE ORGANISATION

Russia's State Fishery Committee, the state official institution, governing the sector, is stepping up preparations to prepare the Russian fishery for joining the World Trade Organization (WTO). However, industry insiders doubt if this can really be achieved in the near future.

The topic of whether the national fishery is ready to join the WTO was central to discussions during several extended meetings of the State Fishery Committee Board this year.

The quality of fish products was cited as the most disturbing issue. "It is senseless to start competing other WTO members with Russian fish foodstuffs at such low standards of quality," said Vitaly Karchinsky, vice-director of "Natsrybresoursy" (National Fish Resources – State Committee division).

The Russian market is still awash with inferior seafood products. The industry attributes this to the fact that a lot of small processing enterprises with low technological and sanitary standards were set up in Russia and other ex-Soviet republics. Their output is popular because their prices are very attractive.

At the meeting there were announced the results of inspections of the St.Petersburg market in 1999-2000. From 40% to 100% of frozen, fresh, smoked and salted fish inspected failed microbiological tests.

The modern Russian quality control system is based on random selection of samples to be examined. Most of processing enterprises do not have their own quality control laboratories, and inspections are made by governmental bodies, which quite often suffer from a lack of professionals.

It was announced at the meeting that a new sanitary regulation for seafood is currently being drafted. Quality control will be based on Hazard Analysis and Critical Control Points (HACCP) principles.

Meanwhile, industry insiders expressed skepticism about Russia's readiness to join the WTO. They mean that Russian output could not compete with the West. If Russia wanted to be an equal partner to other WTO members, it needs 3-4 years of

intensive preparations, to modernize both the fleet and coastal processing, that requires investments of several billion dollars.

According to the preliminary data (final statistics will be published at the end of the financial year in April) presented to the meeting, the national fishery caught 3,670,000 tones of fish and seafood in 2001 - a 9.1% decrease compared to 2000 (Fish express, 2002)

As positive signs, the Committee cited a 6.5% increase in tinned fish output and 16.9% growth of fishery goods export. All that produced RUB 10 billion incomes for the federal budget from the national fishery (as taxes and payments at quota auctions).

In spite of several positive signs in the development of the fisheries sector, it still cannot be described as stable. The decline and wear and tear of the Russian fleet, a lack of working capital, a decline in productivity of labour, rising prices for raw materials and coastal processors running under-capacity can be cited as reasons for the instability.

The instability can also be explained by the ongoing internal power struggle in the "old" systems.

Examples of actual matters that illustrate the internal tug-of-war in Russia are:

- The conflict surrounding the Chairman of the State Russian Fisheries Committee (Goskomribolovstvo), Jurij Sinjelnik. He has been accused by the fishing industry in Northwest Russia of having exploited his position to the advantage of his home province Kaliningrad. Under Sinjelnik, Kaliningrad has strengthened its quota rights for herring and cod.
- Leasing agreements that in the short-term involve a Western company receiving Russian fish in return for the Russian vessel companies have their trawler fleet modernised. Around 40 such agreements have been entered into since 1990. The government pact prohibiting bare-boat charter led to leasing agreements which basically show no difference from bare-boat charter arrangement.

Bare-boat charter/ leasing became a necessary measure to acquire new vessels thus renewing the fleet. One alternative to the leasing arrangement is "building quotas". In practice it is a system where the Russian boat builders are allocated a set annual quota in order to finance a new construction. The quota arrangement will be considerably different from today's regime with annual allocations. But the Act is a

long way from being signed and sealed because of all the instability, power struggle, little confidence in Russian regulations and administration and other issues described above.*

There is a great deal of disagreement about how large the actual trawler fleet is. An estimate from the Barents Secretariat shows that in total there are 17 fishing vessel companies in Karelea, 25 in Arkhangelsk and 17 in Murmansk. The total fleet in Karelea is 68 vessels, of which 50 are medium-large. In Murmansk the fleet consists of 280 vessels plus 28 bareboat-charters. Two thirds of the vessels are medium-large or large. In Archangel there are 65 fishing vessels. The situation for the fleet is that large segments are due for replacement. It has been implied that as much as 60 per cent of the Russian vessels are due for the wrecking yard. Only one new vessel has been built in Russia since 1990, and two factory ships have been added (Sevryba). In order to renew the fleet it has therefore been necessary to use leasing.

REGION	FISHING VESSEL COMPANIES	TOTAL FLEET
Karelia	17	68
Arkhangelsk	25	65
Murmansk	17	280

Such leasing contracts are very popular with the neighbouring Norway.

The dependence between the Norwegian fishing industry and the Russian fleet has been heavily reinforced. Approximately 70 per cent of the Russian cod quota is currently landed in Norway. One of the most important reasons for the increasing percentage of the Russian quota that's landed in Norway, is the large number of leasing agreements.

*Aleksander A.Makarov, Russian Fish Report, Issue no.10 (61), october 2001, EASTFISH, Copenhagen, Denmark, page 18.

Fig.3. Russian cod landed in Norway (in tonnes). (Norwegian Fisheries Directorate)

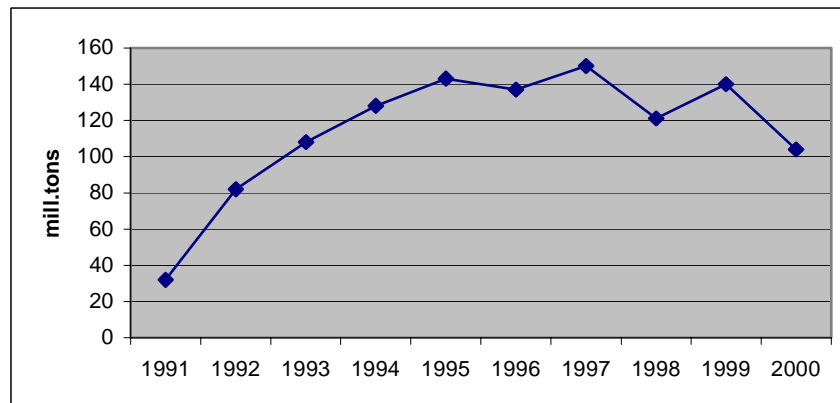
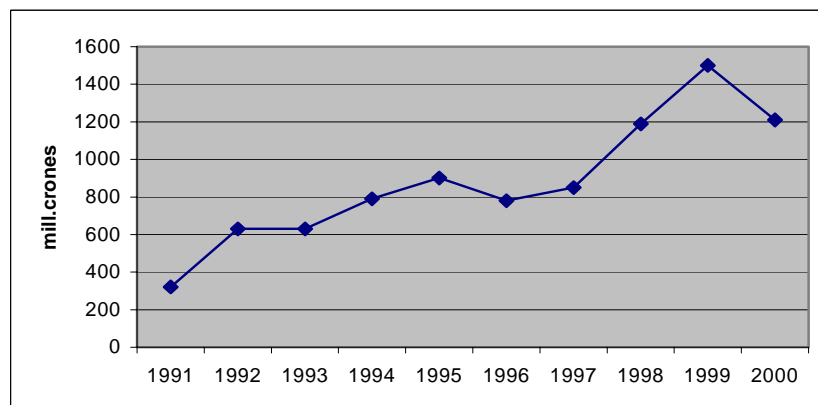


Fig.4. Value of Russian cod landed in Norway (NOK million). (Norwegian Fisheries Directorate)



In 2001 foreign vessels landed 176,000 tonnes of raw materials, of which 131,000 tonnes were cod, 9,000 tonnes shrimp and 19,000 tonnes of haddock. More than 90% of the volume was provided by the Russians.

2.1.5. Russian banking system

Russian present day banking system features two levels of banking institutions, the Central Bank of Russia (upper level) being the regulating and

governing body, and commercial banks and credit institutions (lower level) being banking services providers for economic subjects. Status, responsibilities and jurisdiction of the Central bank of Russia are outlined in the Federal Law on the Central bank and are as follows: The Central bank is a legal entity, which is not subject to claims for liabilities incurred by the State and vice versa, the state is not subject to claims incurred by the Central bank, unless directly specified in law or special agreement. Charter capital and other property of the Central bank belong to the state.

The principal purposes of activities of the Central bank are: protection of the national currency (Russian rouble), development and enhancement of national banking system, provision for efficient payment system functioning. Profit derivation is not considered a purpose of the Central bank's activity. Some of its functions are:

- currency issue (monopolised by the Central bank);
- payment regulations issue;
- issue and withdraw banking licenses;
- regulation of operations in foreign currency;

The majority of rouble payments in Russia are effected via the Central bank clearing system. The Central bank reports to the Parliament (State Duma).

Commercial banks and credit institutions are founded and operated in compliance with the Federal Law on Banks and Banking Activities other applicable law and regulations issued by the Central bank. Commercial bank is considered founded and regarded as legal entity after registration of its charter at the Central bank of Russia. The license, issued in its name by the Central bank confirms its entitlement to effect banking operations. Both legal entities and persons, both residents and non-residents may act as co-founders of the bank. The number of co-founders cannot be less than three. Charter capital of a bank can be formed only with the internal funds of its founders. Borrowed finances are not allowed to be used as founders' share in the charter capital of a bank. A founder's share in the charter capital should not exceed 35%. The newly founded banks should have their charter capital not less than the equivalent of 6 billion roubles (1 million ECUs), and for banks with limited scope of operations - not less than 1.5 billion roubles. Charter can be formed both with rouble and foreign currency funds, and with material assets. Material assets used to form the charter capital should be directly used in banking activities, and their value should not exceed 20% of the

initial charter capital; the only exception from this limitation is the building of the bank. For banks controlled by non-residents (more than 50% of its shares belong to non-residents) the minimum charter capital is set at 5 million ECUs (or the equivalent in other currencies, including Russian rouble), minimum share of a foreign participant is set at 2 million dollars (or the equivalent in other currencies including Russian rouble).

Commercial banks should have reserve funds, kept on their accounts with the central bank of Russia, amounting to: 10% of its charter capital, 20% of finances on clients' current accounts, 15% of finances on deposit accounts.*

Total amount of finances, borrowed by on client, including 50% of guarantees and similar liabilities, undertaken for this client by the bank, exceeding 20% of the bank's own capital, is regarded as "big" credit. All big credits should be immediately reported to the Central bank. The total monetary amount of "big" credits, lent by the bank should not exceed bank's own capital: fifteenfold - for banks, formed on the basis of former state-owned banks, tenfold - for other commercial banks except banks, whose legal status is open-type stock company, for which the total of "big" credits should not be greater than 8 times their own capital. Each month the Central bank checks commercial banks' balance sheets to find out whether the standards are observed. Should the bank fail to meet any of them, even after receipt of the Central bank's instructions, or submit defective data to the Central bank, the latter has the authorisation to use economic and administrative incentives, such as fines, limitation of scope of banking services, provided by the defective bank, up to withdrawal of its license. (www.cbr.ru)

The Russian banking sector is still considered weak. With USD 78.3 billion in total assets (45 % of the country's GDP) and USD 10.1 billion of total capital (5.6 % of GDP) at the end of 1999, the banking sector is considered relatively small in comparison with the size of the national economy.

Despite the "existence" of more than 1,300 Russian banking institutions, the industry remains highly concentrated, with the top five banks collectively having USD 29.6 billion in assets (38% of the total), and USD 4.8 billion in capital (48% of capital.) The industry is dominated by state-owned banks that continue to receive massive government support and a few of the highest rated privately owned banks.

*Zhukov E., Banks and bank operations, Moscow: UNITI, 1997.

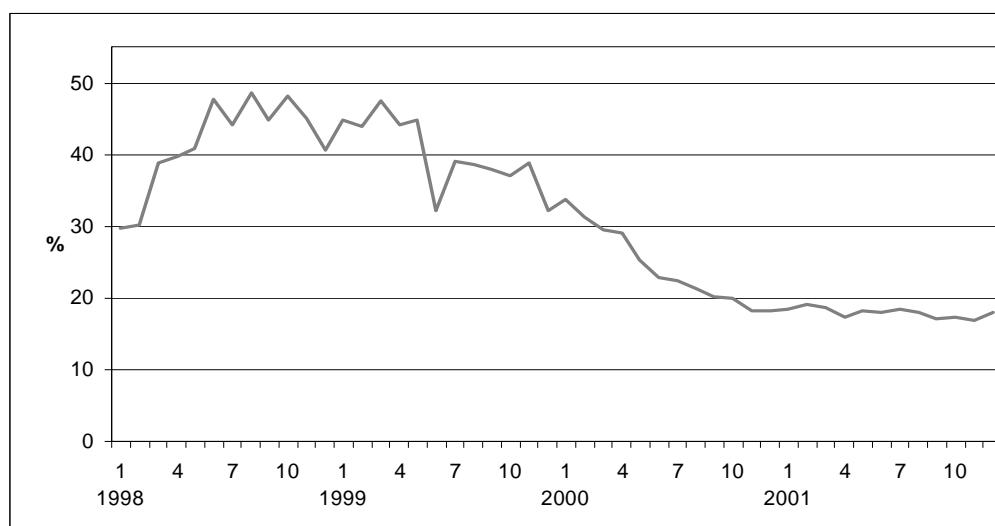
Among the general public, trust in the banking sector is very slow to return. Many Russians, even when they are prepared to take their money from under the mattress, are more likely to prefer dealing with the subsidiary of a foreign bank than with a local bank.

The range of banking products offered by domestic institutions, while growing, is generally still limited to only the most basic banking products and services. Only a few banks, particularly the leading privately owned banks, are developing new products, services and expertise to meet their clients' growing needs and to compete with the subsidiaries of foreign banks.

As a result of improved financial disclosure and performance, professional management, industry consolidation and a shift from exploitation of natural resources to the value added production, a number of Russian companies have gained the confidence of international financial institutions. In certain cases they received financial facilities directly from foreign banks without the intermediation of a local Russian bank.

The crediting rate (long-term credits) has significantly gone down from the end of 1998 to the year 2001. The highest rate was found in August 1998 - 48,5%. The lowest one, that is 16,9%, was offered in November 2001. (Information and research department of the Central Bank of the Russian Federation).

Fig.5. Credit Rate - an average-weighted rate on legal entities' ruble credits in credit institutions for a term of up to one year.



Still the Russian banking system is not yet quite ready to credit small and medium-size business. The chief reason according to some Russian experts is the lack of a material basis, which would be a pledge against credits given to small and medium-size business and the lack of legislative acts that would regulate property and mortgage crediting of businessmen. The conditions are such that without initial capital it is actually impossible to start a small enterprise.

2.2. OFFSHORE REGISTRATION

2.2.1. POPULARITY BASIS

Offshore registration of vessels is common practice now for many Russian fishing companies. It is necessary to get better insight in this issue so that one could encompass functioning of the fishing industry system in Russia in general.

Offshore industry has become a global business, encompassing in one-way or another a high percentage of world financial operations.

The political and economic catalysts that influenced the growth of the offshore industry in the eighties and nineties will continue to influence growth in the next two decades.

These catalysts are:

- Political and economic instability
- Market globalization and deregulation
- The internationalization of business
- The lifting of trade barriers
- Trends towards steady global economic growth
- A global relaxation of foreign exchange controls*

In addition to political and economic catalysts, there are also global tax related catalysts that continue to influence the growth of the offshore industry.

These include:

- High tax regimes
- More effective tax recovery
- The opportunities of utilising double tax treaties

Since the beginning of the 20th century a number of offshore jurisdictions became a place for registration of shipping companies. Today many well-known offshore

*Korneeva, E., "The offshore world", Moscow, Economics, 2001

jurisdictions offer modern organisations for registration of vessels, which provide inexpensive registration and relieve from taxes on income, received from shipping and charter operations. Among such jurisdictions there are Man, Madeira, Cyprus, Bahamas etc.

There are now more than 50 jurisdictions world-wide providing offshore company legislation. Some jurisdictions have introduced new and modern suites of corporate legislation, specifically designed for international business whilst others have amended existing domestic legislation to cater for offshore requirements.

The most essential criteria are that the legislation is modern, flexible and well proven. Furthermore, the legislation should preferably provide confidentiality and complete privacy regarding a client's business dealings.

2.2.2. DESIRABLE CORPORATE CHARACTERISTICS

Many offshore and "tax planning" jurisdictions have made efforts to ensure that their company law provides the following features:

- Limited liability
- Minimisation of directors liability - directors are generally responsible for the acts of a company however in certain jurisdictions directors may seek indemnities from both the company and its beneficial owners
- Minimal or optional statutory filing obligations
- Nominee shareholders allowed
- The availability of bearer shares
- Disclosure of beneficial ownership either not required or limited to special bodies, such as offshore authorities or central banks
- Minimal or optional statutory filing obligations
- Broad range of permitted company names and suffixes to denote limited liability
- Low capital requirements
- The ability to hold directors and/or shareholders meetings anywhere in the world
- The absence of or the optional requirement for the audit of accounting records*

*Korneeva, E., "The offshore world", Moscow, Economics, 2001

2.2.3. COMPANY LAW

Company law generally follows four different models:

- English Common Law
- European Law
- US Law
- Hybrid

Company law based on English Common Law is the most frequent model for the classic offshore jurisdictions, such as the BVI, the Bahamas, Hong Kong and Belize. Company law in this type of jurisdiction is typically modelled on the UK Companies Act 1948.

The Companies Act 1948 draws from 1844, 1855, 1862, 1897, 1900 and 1929 Acts and many concepts, such as the acceptance of nominee shareholders, are based on 19th Century Acts. The Joint Stock Companies Act 1856 introduced the Memorandum and Articles of Association and provided for incorporation by registration.

European corporate law is often based on French Law of 1864 and usually differentiates between the "share" company and the public company. The former is usually characterised by a lower initial capital and a smaller number of subscribers whilst the latter is allowed to issue securities that are publicly negotiable.

Incorporation procedures in Civil Law jurisdictions are different from those in Common Law countries, e.g.:

- An amount of paid-up capital must be subscribed before incorporation
- A company's statutes are essentially a contract between the subscribers
- Procedures are more onerous than in Common Law countries
- Incorporation is facilitated by a notary
- Corporate law in Civil Law countries often splits the responsibility of boards of directors between an executive and a supervisory board
- Powers of directors may be curtailed
- Liquidation procedures are time consuming and complex
- A legal reserve may be required (<http://www.cn-c.com/cncyprus.htm>)

US Corporate Law has been influenced by both English and Civil Law. Apart from differences in language, terminology and interpretation US Company Law differs from English Law in significant ways, including:

- US Corporations have officers in addition to directors

- By-laws are often adopted after incorporation
- Directors are often empowered to change by-laws

2.2.4. DOUBLE TAXATION AVOIDANCE TREATIES

The jurisdictions around the world can be categorized as follows:

- Treaty jurisdictions
- Non-Treaty jurisdictions

Clients seeking to take advantage of double tax treaty relief need to establish a company situated in a treaty jurisdiction. This is essential for the minimization of withholding taxes on the payment of dividends and royalties from contracting states. Treaty jurisdictions also portray a non-offshore image and thus provide cosmetic appeal.

Non-treaty jurisdictions are mainly used because of the absence of corporate taxes on the profits of the company and usually only require companies to pay a fixed annual license fee.

It is; therefore, important to assess the taxation implications of the business that is to be conducted, and decide whether or not a treaty jurisdiction is required. Under normal circumstances, a treaty jurisdiction would not be required for the international movement of goods and most services. Inward investment in to certain countries, however, may require a treaty jurisdiction to minimize the impact of taxation.

Speaking about the vessels functioning under financial leasing contracts one should say the Republic of Cyprus is the offshore registration place for Russia. It is explained by the fact that it is the only offshore jurisdiction that has a double taxation avoidance treaty with Russia. But is not the only explanation. So, for example, if the company is registered on Cyprus but the owner plans to establish a subsidiary company in Russia, Cyprus becomes the best place for the offshore registration, as the Russian Registration Department has a new demand now that obliges to give the tax payers identification number of the mother company. A classical offshore company does not have such a number, as the offshore zone is the tax free zone. As for the company, registered on Cyprus, it has the advantage of acquiring such number at the registration time.

2.2.5. CYPRUS: PROFILE

Geography

Cyprus is at the north-eastern end of the Mediterranean Sea at the cross-roads of Europe and Africa. It covers an area of 9,251 sq. km (3,572 sq. mi.) and lies 65 km south of Turkey, 96 km west of Syria, 385 km North of Egypt and some 980 km south-east of Athens.

Language

Greek, English and Turkish are the official languages of Cyprus English is widely spoken and understood, particularly in commercial and government sectors.

Currency

Cypriot pounds.

Exchange control

It exists but does not apply to offshore companies.

Type of law

Civil code with many English Common Law influences.

2.2.6. CYPRUS: ECONOMY

Cyprus has an open, free-market, serviced-based economy with some light manufacturing. The Cypriots are among the most prosperous people in the Mediterranean region. Internationally, Cyprus promotes its geographical location as a "bridge" between West and East, along with its educated English-speaking population, moderate local costs, good airline connections, and telecommunications.

In the past 20 years, the economy has shifted from agriculture to light manufacturing and services. The service sector, including tourism, contributes 70% to the GDP and employs 62% of the labor force. Industry and construction contribute 24% and employ 25% of labor. Manufactured goods account for approximately 69%

of domestic exports. Agriculture is responsible for 6% of GDP and 12% of the labor force. Potatoes and citrus are the principal export crops.

Trade is vital to the Cypriot economy as the island is not self - sufficient in food and has few natural resources that causes the growth of the trade deficit. Exports rose by 1.3% in 1997, while imports rose by 2.2%, resulting in a trade deficit of \$2.1 billion (2.7% higher than the previous year). Cyprus must import fuels, most raw materials, heavy machinery, and transportation equipment. More than 50% of its trade is with the European Union (especially the U.K.); the Middle East receives 20% of exports. Cyprus signed an Association Agreement with the European Union (EU) in 1972, which resulted in the establishment of a Customs Union between the two sides. Cyprus applied for full EU membership in 1990 and has since linked the Cyprus pound to the European Monetary Unit (ECU). EU accession negotiations started on March 31, 1998. In 1991, Cyprus introduced a Value Added Tax (VAT), which is currently 8%. Cyprus ratified the new world trade agreement (GATT) in 1995 and began implementing it fully on January 1, 1996.*

Cyprus has the fourth-largest ship registry in the world, with 2,758 ships and 25.5 million gross registered tons (GRTs). It is an open registry and includes ships from more than 43 countries, including Greece, Germany, and Russia.

2.2.7. CYPRUS: INVESTMENT CLIMATE

In February 1997, the government revised its policy on foreign direct investment, permitting 100% foreign ownership in certain cases. Regulations on foreign portfolio investment in the Cyprus Stock Exchange also have been liberalized. Additionally, Cyprus passed a modern banking law in July 1997, incorporating all the provisions and directives of the EU for the prudential supervision of credit institutions.

Cyprus has concluded treaties on double taxation with 26 countries and has removed exchange restrictions on current international transactions. Non-residents and foreign investors may freely repatriate proceeds from investments in Cyprus.

*(<http://kypros.org/Government/>)

2.2.8. CYPRUS: OFFSHORE SECTOR

The 1,049 full-fledged offshore companies--which are located in Cyprus but conduct business abroad only, qualify for various tax- and duty-free concessions. Foreign exchange earnings from offshore companies rose to \$346 million in 1997. There are about 40 U.S.-owned firms in Cyprus; about half operate exclusively on an offshore basis.

Cyprus has great business facilities and thousands of offshore companies; many firms are incorporated each year. Only 4,25% is tax on corporate profit in Cyprus.

- Dividends to shareholders are tax-free.
- Double tax treaties are in place between Cyprus and 27 countries including Russia and the Ukraine
- Offshore companies situated in Cyprus may purchase duty free cars etc.
- Cypriot offshore company owners may remain anonymous using nominee services.*

2.2.9. CYPRUS: RELATIONS WITH EASTERN EUROPE

Cyprus has been developing an extensive network of tax treaties with the Eastern European countries since 1980 and by 1986, it had concluded tax treaties with all of them, with the exception of Poland.

The recent political developments in Eastern Europe and the tremendous investment potential, which have resulted, have brought the network of Cyprus tax treaties with Eastern Europe back into focus in the international tax-planning scene.

What makes Cyprus a particularly attractive bridge for doing business in Eastern Europe is the combined effect of its double tax treaties and the preferential fiscal treatment of Cyprus offshore entities.

Furthermore, the provisions of the treaties are themselves advantageous in one important respect: the reduced withholding tax rates are not in principle made subject to the requirement that the recipient of the income should also be the beneficial owner thereof and in the case of royalties, none of the treaties signed contains such a restriction.

Before examining the advantages that may be reaped from the Cyprus - Eastern European tax treaty network, one should also briefly describe the tax regime governing Cyprus based offshore entities.

*Korneeva, E., "The offshore world", Moscow, Economics.

2.2.10. TAX TREATMENT OF CYPRUS OFFSHORE ENTITIES

Companies incorporated in Cyprus, whose shares belong directly or indirectly, exclusively to non-residents, and trade or carry out business outside Cyprus, are taxed at the rate of 4.25% on net profits. Income tax is thus imposed on net profits after crediting any tax on profits which is levied outside Cyprus, and no further withholding tax is levied on the dividends paid to the shareholders of such Cyprus companies /no double taxation/.

Branches of non-resident companies, which are registered in Cyprus and have their management and control in Cyprus are taxed in the same manner as offshore companies, whilst offshore branches having their management and control outside Cyprus are fully exempt from income tax in Cyprus.

Double tax treaties

Cyprus offshore entities have increasingly been attracting the attention of foreign investors that do business or invest in Eastern Europe because they are particularly advantageous vehicles in minimising the tax burden on the income derived from such operations.

Indicatively, Cyprus offshore entities have been used in the following schemes:

1. For extracting dividends at withholding tax rates ranging from zero to 15%.

If the dividends reaped from investments in Eastern European countries were to be routed directly to the investor's Western home country which has not concluded any Tax Treaty with the Eastern European source country, the tax consequences would be as follows: any dividends received from investments in Eastern European countries by a shareholder (individual or company) would first suffer the withholding tax levied at source and will subsequently be added to the investor's overall income and be also subject to the individual or corporate taxes levied in the Western home country at the normal rates. Such combined rates (i.e. withholding tax in an Eastern European country plus the normal home tax rate) are invariably higher than the combined withholding tax and the 4.25% income tax that

would be levied on the income (including dividends from Eastern Europe operations) of a Cyprus offshore entity.

Furthermore, any subsequent distribution of dividends of the Cyprus company to the foreign shareholders in the western country could not be subject to further withholding or any other tax in Cyprus.

The advantage of using an "intermediate" Cyprus offshore company for channelling dividends from Eastern European countries to the West is therefore apparent. Any final additional taxation in the recipient's own country after distribution of dividends by the Cyprus Company is, of course, a different matter and should be taken into account in each individual case.

2. For extracting interest at either nil or a maximum 10% withholding tax rate.

As in the case of dividends, interest derived from Eastern European countries is normally included in the recipient's taxable income in his country of residence and is taxed at the normal rates, subject to a credit for the withholding tax levied in the source country.

In the case where Cyprus is the recipient country, the effective tax burden on the interest received by say an offshore company will be the higher of either the tax on the income of the offshore company levied in Cyprus (4.25%) or of the withholding tax in the source country.

Invariably, the tax burden on interest received from an Eastern European country by a resident of a Western country is higher than that levied in Cyprus taking into account also the withholding tax at source. This is the case not only where there is no tax treaty between the Eastern European and Western countries concerned, but also in cases where there is a tax treaty between them which provides for a reduced rate of tax in the source country and for a credit for foreign taxes in the recipient's country of residence.

3. For extracting royalties free of tax (with the exception of Yugoslavia which levies 10% in all cases and Czechoslovakia and Romania which levy 5% withholding tax on patent royalties).*

As already mentioned, in the treaties between Cyprus and the Eastern European countries, there is no requirement for the recipient of the royalties to be the beneficial owner thereof.

*Korneeva, E., "The offshore world", Moscow, Economics

The maximum tax payable on royalties flowing from Eastern European countries to an offshore company in Cyprus is 4.25% (if the relevant treaty provision provides for nil withholding tax) or 5% (if the relevant treaty provision reduces the withholding tax to 5%, as for example in case of patents). Only in the case of Yugoslavia is the effective tax rate 10%.

The parent company of a Cyprus offshore company based in a Western country with anti-avoidance measures may consider selling the patent or granting a license to its Cyprus subsidiary. The gains from such sale or license may be subject to taxation in the Western country involved, but this may be dearly outweighed by the combined advantages of the foreign tax credit, the 4.25% Cyprus income tax and the reduced or non-existent withholding tax in the East European country. Consequently, such a scheme would in most cases be preferable rather than having the royalties paid directly from an Eastern European to a Western country.

4. For extracting tax-free profits from construction and assembly sites for a period not exceeding the time limit beyond which they would be considered a permanent establishment.

If a Cyprus offshore company is used as a sub-contractor in the cases of construction or assembly projects, the parent company based in a Western country may be able to avoid the high rates of tax generally imposed on income from construction projects under the national laws of the East European countries. This is subject to the restriction that the duration of such projects must not exceed 12 months, or in the case of Czechoslovakia, 6 months. Normally, full tax rates are imposed on such projects and for such duration, which may reach up to 60%.

5. For extracting free from any tax in all the Eastern European countries profits from international traffic including shipping and air traffic as well as road transport .

Profits from international traffic as above described are only taxable in the place of the effective management and control of an enterprise, irrespective of the existence of a permanent establishment.

When profits from international traffic are received by a Cyprus offshore entity, managed and controlled in Cyprus, such profits will be taxed at 4.25% as with any other offshore company. Furthermore, in the case of shipping companies, shipping profits will be fully exempt in Cyprus in addition to all other advantages enjoyed by Cyprus shipping companies.

Any profits distributed from the Cyprus intermediary company to its parent company will then receive the same treatment as described under 1 above.

It is important to note that none of the treaties concluded with Eastern European countries contain any special anti-avoidance provisions.

The variety and the tax planning potential of the schemes which may be set up to take advantage of both the Cyprus offshore entities regime and the wide range of tax treaties which Cyprus has concluded, not only with Eastern Europe but also with Western countries, is very wide and may cater to a number of the individual investor's need. (<http://www.c-n-constantinou.com/DoubleTaxRussia.htm>).

CHAPTER 3.
SUBJECT AND OBJECT IN THE FINANCIAL LEASING
AGREEMENT

3.1 Legal basis.

Till the end of 1996 in accordance with the Russian Civil Law, leasing was considered to be an arrangement, which “was not considered by the law, and did not confront it”.*

Leasing is actively developing now, but there are a number of points, which prevent the process, the main point there is imperfect law base. That is especially double taxation of leasing arrangements.

For example, the analysis of the current civil codex of the Russian Federation, in connection with leasing reveals a number of drawbacks. Civil code does not set any limits on the leasing period. Duration of the agreement is discussed and set up by mutual agreement of the parties concerned. That can cause a problem of identification and distinguishing of a leasing agreement from contracts arranged like “leasing agreement”, which have a purpose of getting tax privileges.

In accordance with paragraph 666 in the Civil Code of the Russian Federation, “any non-consumable articles, used for enterprise / business activities, can be a subject for the financial leasing agreement...” This limitation actually excludes noncommercial organizations, using leased articles for realization of their goals.

It is obvious from the definition of the leasing agreement that the Civil Code recognizes only financial leasing, as it provides for the presence of three parties in the arrangement, those are lesser, lessee and seller. Besides, paragraph 665 of the Civil Code of the RF assigns non-recurrent nature of operation, meaning that lessor must buy the article for each new operation. This excludes a number of types of leasing, worked out and practiced for many years, such as operational, returnable etc. All relations which are not encompassed by paragraph 6, chapter 34, can not be officially recognized as leasing arrangement. These problems can be solved and regulated in concrete agreements with the usage of general norms of chapter 34 of the Civil Code of the RF. Nevertheless such agreements will be deprived of tax privileges, initially provided for leasing.

In connection with the abovementioned drawbacks a separate law about leasing operations was considered necessary to be adopted in 1996. The content of the project of the law gives the main definitions, connected with the leasing operations,

*paragraph 4 in the Civil Law of the Russian Federation, dated 1964, paragraph 8 in the Civil Law of the Russian Federation, dated 1994.

and determines the participants in the leasing operation; it gives definition of the main leasing types; formulates the rights and obligations of the parties; gives the general terms of a leasing contract; explains insurance procedure for articles, involved in leasing; gives the order of consideration of disputes between the parties, including leasing operation involving a foreign partner; fastens the structure and the content of leasing payments; explains the demands for licensing of leasing activities. This project provides for state guarantees for realization of leasing projects, the right for the participants in the operation to determine the period for the depreciation of equipment, immunity from taxation during 1 year from the date of company establishment, a number of tax privileges for leasing companies, functioning in definite brunches of industry, for example, agriculture and aircraft industry). This Federation Law was adopted on the 29th of October 1998, with number 164 FZ.

Unfortunately, the Tax Code of the Russian Federation, adopted by the Government of the RF on 16.08.1998, does not give the term “leasing”. There is a term “arenda” used in the text. The term has a close but not identical sense. The project of the Tax Code does not eliminate the incorrect practice of imposing VAT (value added tax), in accordance with the existing regulations VAT is levied on the equipment purchased by the lesser. Its amount, as well as payment of the interest charged on the credit taken by the lesser, is placed on the leasing payments. In accordance with the common practice, VAT is additionally charged on leasing payments. This means that value added tax is charged twice on the same article.

The project stipulates that the date of expire of the leasing agreement is the date of income obtaining, if the method of invoices is used. If the period of the leasing agreement encompasses several accounting periods, the income becomes proportionally divided among such accounting periods. With such regulations it becomes impossible to apply quite logical schemes of irregular leasing payments.

Leasing as a relatively new business arrangement for Russia should be constantly observed and corrected to reveal stipulations preventing the leasing arrangement from development.

*The Tax Code of the Russian Federation, adopted by the Government of the RF on 16.08.1998.

3.2 FINANCIAL LEASING AGREEMENT

3.2.1. Definition of the financial leasing

The noun “leasing” expresses a combination of property relations formed in connection with transfer of property from one to another participant in the leasing operation. Thus leasing, as economical and legal notion, is a special type of business arrangement, which has for the purpose the investment of temporary free or involved finances, where in accordance with a financial leasing agreement, the lessor is obliged to buy the property specified in the agreement from a concrete seller and to deliver such property to the lessee against payment for temporary use for the sake of putting into practice a business project.

The definition of leasing is given in part 1 paragraph 665 of the Civil Code of the Russian Federation: “In accordance with the financial leasing agreement the lessor is obliged to buy the article, specified by the lessee, from a concrete seller and to deliver this article to the lessee to be possessed and temporary used by him against payment with business / industrial purpose. The lessor, in this case, is not responsible for choice of the subject for leasing and seller”. In accordance with part 2 paragraph 665 of the Civil Code of the Russian Federation the financial leasing agreement can stipulate, that the choice of the seller and the article to be bought is done the lessor”.*

“Leasing activity is a type of investment activity having a purpose of buying an article with its further delivery to leasing”.

Definition of leasing, given by the European Federation of national leasing associations /Leaseurope/: Leasing is defined as an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time. (<http://www.leaseurope.org>)

The law of the Russian Federation stipulates several other features characteristic of leasing operations:

1) The amount of leasing payments for the whole period of leasing must include the complete /or close to the complete/ price on the leased article, where the prices used are the prices at the moment of arrangement of the deal/ operation. The whole amount of leasing payments also includes:

- amount paid to the lessor for the credit resources, used by him to purchase the article under the leasing agreement;
- commission to the lessor;

*The Civil Code of the Russian Federation: part I, dated 30.11.1994 (reduction, 12.08.1996), part II dated 26.01.96 (reduction, 24.10.1997).

- amount paid for insurance of the leased article, in case it was insured by the lessor;
- sundry expenses, covered by the lessor and stipulated in the leasing agreement.

2) Leasing can be internal, when all the participants of the leasing operation are the residents of the Russian Federation; leasing can be international, when one or more of the participants are not residents in accordance with the legislation of the Russian Federation.

3) The leased article is the property of the lessor during the whole period of leasing, except for property acquired by a leasing company for account of budget money. Conditions for putting the leased article on the balance of the lessor or lessee are separately discussed by the parties concerned, and become fixed in the leasing agreement.*

In accordance with paragraph 666 in the Civil Code of the Russian Federation “any inconsumable things, used for industrial / business activities, except for land and other nature objects, can be the subject for the financial leasing”.** The subject for the financial leasing, as well as the subject for the leasing agreement, can be represented by any thing, which does not lose its natural qualities in the process of their exploitation.

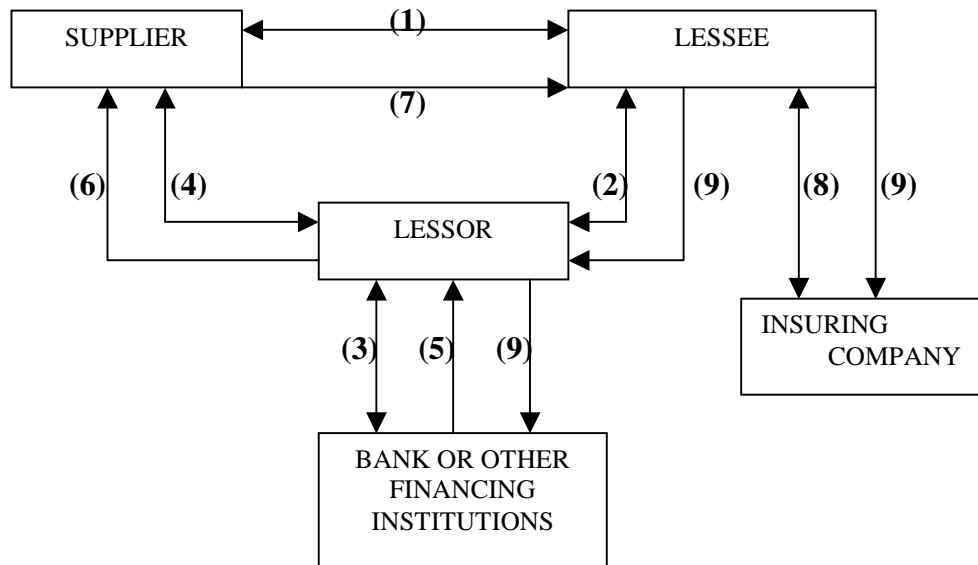
3.2.2. Parties in the financial leasing agreement.

A classical leasing agreement binds three persons: a seller of the property (producer), its buyer (lessor) and lessee. But the participants of the leasing agreement are usually interconnected by more than one agreement. The Lessor signs a Sales contract with the Seller of the property and a Leasing contract with the Lessee. Both agreements are interconnected as a rule, as it is usually the Lessee who chooses the Seller and participates in discussion of the conditions of the Sales contract. The Lessee negotiates about the subject of the Sales contract, its price, place and terms of delivery to lease.

* The Federal Law of the Russian Federation about leasing, 29.10.98, nr.164-F3.

**The Civil Code of the Russian Federation: part I, dated 30.11.1994 (reduction, 12.08.1996), part II dated 26.01.96 (reduction, 24.10.1997).

Fig.(6) THE SCHEME OF THE LEASING ARRANGEMENT



- (1) - the Lessee chooses the property and the supplier;
- (2) - conclusion of the leasing contract between the Lessee and the Lessor;
- (3) - agreement between the Lessor and a financing institution about monetary provision for property purchase;
- (4) - conclusion of the Sales contract between the Lessor and the Supplier;
- (5) - provision of financial resources by the financing institution to the Lessor;
- (6) - the Lessor pays for the property;
- (7) - delivery of the property by the supplier to the Lessee;
- (8) - conclusion of the insurance contract between the Lessee and the insurance company;
- (9) - the Lessee pays insurance premiums to the insurance company and the leasing instalments are paid to the Lessor;

The scheme of the relations of the parties in the financial leasing agreement is built as follows: the potential Lessee, who is interested in getting a particular article (equipment, machine, vessel etc.), finds a supplier possessing such article, using the information he has, his previous experience and recommendations. Having certain problems with the access to the financial resources or in case of absence of the necessity to buy such an article, the Lessee takes contact with the potential Lessor, which possesses sufficient resources, and suggests his participation in the deal. Participation of the Lessor can be described as follows:

- Lessor (that can be a juridical or a physical person) checks if the price negotiated by the Lessee is up to the level of market prices;
- The Lessor buys the article the Lessee is interested in, having concluded a Sales contract with the supplier / producer, thus becoming the owner of the article;
- The Lessor delivers the purchased article to lease to the Lessee on the basis of the concluded leasing contract.

In accordance with the Federal Law about leasing, the direct participants in the leasing arrangement are:

a) Lessor (the owner of the boat)

Lessor is a juridical or a physical person, which invests own or / and attracted money to purchase a certain article with the purpose to deliver it to lease to the Lessee against certain payment under the Leasing contract, on concrete terms and for a certain period, to be temporary owned and used with or without transfer of the ownership.

b) Lessee (the user of the boat)

Lessee is a juridical or a physical person, who is obliged to overtake the article against a certain payment and in accordance with a financial leasing contract, for a certain period and on certain terms, to be temporary owned and used in accordance with the leasing contract.

c) Seller

Seller is a juridical or a physical person, who sells the article to the Lessor under the Sales contract. The article is to be later delivered to lease to the Lessee. The Seller is obliged to deliver the subject for the leasing to the Lessor or to the Lessee in accordance with the conditions of the Sales contract. The Seller may at the same time represent the Lessee in the frame of the same leasing legal relations.

The indirect participants in the leasing arrangement are commercial and investment banks, giving credit to the Lessor and providing guarantee for the deal, insurance companies, dealers, and brokers.

Leasing has common features with crediting, when a credit is given to purchase an article. Leasing can be considered as property relations on the basis of that a Lessor gives a credit to the Lessee with condition of urgency and ability to pay back. But it is only one of the characteristics of the lease. The other major specific feature is the bases on the property relations. The ownership right on the leased property is kept by the Lessor and the Lessee has the right only to temporary use, that is the right to use the article is separated from the ownership right. To possess this right, the Lessee pays to the Lessor certain payments (leasing payments), where the amount, the type and the schedule of their transfer is determined by the conditions of the leasing contract.

3.2.3. The rights and obligations of the parties in the financial leasing agreement.

The Lessee has no contract relations with the Seller, but he still has a number of rights and obligations in this connection. In accordance with paragraph 668 in the Civil Code of the Russian Federation "...if nothing different is stipulated in the financial leasing agreement, the article, which is the subject for such leasing contract, is to be delivered to the Lessee at the place of his presence. In case, when the article, which is the subject for such leasing contract, is not delivered to the Lessee on the terms stipulated in this contract, the Lessee has the right to demand cancellation of the contract and reimbursement, if the delay is due to conditions, for which the Lessor is responsible". The size of the loss is calculated in accordance with the general rules, stipulated in paragraph 15 in the Civil Code of the Russian Federation. "...the loss is the expenses incurred by the person, whose rights were violated, or expenses this person will have to incur to restore the violated right. That is also loss or damage of his property and also income, which could have been received by this person in case his right was not violated (lost opportunity/ profit)".* Here the Lessor is responsible for the mistakes of the Seller.

One the peculiarities of the financial leasing contract is the possibility for the Lessee to claim the quality and completeness of property under leasing contract, terms

* The Civil Code of the Russian Federation: part I, dated 30.11.1994 (reduction, 12.08.1996), part II dated 26.01.96 (reduction, 24.10.1997).

of its delivery and other demands stipulated in the Sales contract, concluded between the Seller and the Lessor, directly to the Seller (paragraph 670 in the Civil Code of the Russian Federation). Here, in case of misfulfillment of the conditions of the Sales contract, the Lessee gets the rights and bears the obligations, as if he were a buyer in the Sales contract. That is to refuse to take over the delivered property; to demand change of the property, which does not conform to the conditions of the Sales contract, with the property conforming this contract; to demand additional delivery of the missing equipment etc., except for the obligation to pay for the property.

Nevertheless, the Lessee has no right to cancel the Sales contract with the Seller without having received a permission from the Lessor. The question about cancellation of the contract can be solved only between the parties in the Sales contract, that is the Seller and the Lessor.

As far as the responsibility for choosing the Seller is on the Lessee, if nothing different is stipulated in the leasing contract, the Lessor is not responsible for Sellers misfulfillment of obligations under the Sales contract, except for when the Seller is chosen by the Lessor in accordance with the conditions of the contract. In case the Seller is chosen by the Lessor, the Lessor and the Seller are jointly responsible to the Lessee for non-performance of the conditions of the Sales contract.*

The peculiarity of the financial leasing contract is also manifested in the obligation of the Lessor to deliver the purchase property to a particular Lessee (paragraph 667 in the Civil Code of the Russian Federation). This specification, together with the other conditions in the Sales contract and Financial Leasing contract, clarifies the relations in the financial leasing, what is important for the correct use of the norms in the Civil Code. Absence of stipulation of a concrete purpose for purchasing such article does not actually influence the validity of the contract, but may become a reason for reimbursement claim.

In accordance with the general rule, the risk of accidental loss or accidental damage of the property is carried by the owner of the property, unless other is stipulated in the contract. In case of financial leasing the Lessor is the owner of the leased property. But, the risk of accidental loss or accidental damage of the property is carried by the Lessee from the moment of delivery of the property to lease unless other is stipulated in the contract (paragraph 669 in the Civil Code of the Russian Federation).

Under the leasing arrangement the Lessee takes the following obligations:

*Part two, paragraph 670 in the Civil Code of the Russian Federation.

- to take over the subject for the deal right at the delivery point and to provide for all necessary technical and legal conditions;
- to mount and to put the article into operation, if the obligations of the supplier do not encompass it;
- to confirm the completeness of the delivered article, the quality of the functioning of the equipment and the achieving of the projected capacity;
- if any faults are discovered, the Lessee is obliged to set up a list over such faults, to include it in the Delivery report and to inform the Lessor about them.

The Lessee is also obliged to give necessary guarantees to the Lessor, such guarantees are listed in the Financial Leasing contract.

The Lessee can get a number of services from the Lessor, they are: technical services in connection with transportation of the article to lease to the place of its usage by the Lessee, mounting and adjustment of the leased equipment, technical maintenance and repairs of the equipment, consultations about taxation, registration of the deal etc.

3.3. FORMS OF PAYMENT

3.3.1. General forms

The following forms of payment can be applied in accordance with the common practice:

- documentary credit (L/C);
- collection of payments;
- bank transfer;
- open account;
- advance payment.

Besides, there can be used payments with application of cheques and bills.

Documentary credit is an agreement, on the basis of which the bank is obliged to make payment of the documents to a third person on the request of the client.

Collection of payments is a bank operation, through which the bank gets a payment from a third person for the delivered services on the request of the client, transferring the payment to clients bank account.

Bank transfer is an order (on request of the client) of one bank to another one to transfer a certain amount to remittee.

Advance payment is payment for goods and services before their actual delivery.

Payments to the open account. The essence of this operation is in periodical payments between the partners. The amount of current due is registered and controlled in their account books. *

3.3.2. Payment forms for the leasing arrangement

Payments to the open accounts are not used, because the payment periods are determined in the Leasing contract.

Advance payment is possible as first down payment in case of international leasing , when the Lessee is a Russian company. This is done as a rule when the foreign partners try to be careful with the Russian companies and businessmen.

The main forms of payment for leasing are the Letter of credit and Bank transfers.

The letter of credit is usually used for the first down payment.

Leasing payments under the contract are made with the appliance of bank transfer.

If it is an international leasing, then the following points can be particularly important:

- the choice of the currency for the contract,
- evaluation of the risk of the currency change,
- customs regime of the Lessee,
- the firm tax in relation to the Lessor,
- the existence of the treaty about non-appliance of double taxation between the countries,

*Dzhukha V.M. "Leasing", Rostov-na-Donu: Feniks, 1999.

- protection of the proprietary right of the foreign Lessor in the country of the Lessee.

When calculating the total amount of the leasing payments under the leasing contract, the Lessor includes in it the amount of his actual expenses and the planned profit.

The main methods for the calculation of the leasing payments are described in “The methodical recommendations on the calculation of the leasing payments”, worked out by the Ministry of economics of the Russian Federation and adopted on the 16th of April 1996.

The first given method* stipulates that the total amount of the leasing payments is charged in equal parts during the whole period of the validity of the contract in the periods mutually agreed by the partners.

$$P = (C \times p) / (1 - (1 / (1+p)^t))$$

Where: *P* – the amount of the leasing payment
C – the value of the lease property
p – interest rate
t – the number of payments

The second given method* stipulates that the Lessee pays an advance payment to the Lessor at the moment of conclusion of the leasing contract. The amount of the advance payment is determined in the leasing contract. The rest of the leasing payments minus the advance payment is charged and paid during the validity period of contract in the way described in the first method.

The total amount of the leasing payments, when using **the third method***, includes:

- The amount of depreciation charges for the whole validity period of the leasing contract;
- Commission fee;
- Payment for additional services delivered by the by the Lessor and stipulated in the contract.

If it is a leasing contract with the right to purchase the leased property, the amount of the leasing payments includes the repurchase value of the property.

The total amount of the leasing payments should be calculated as follows:

*The methodical recommendations on the calculation of the leasing payments, Ministry of economics of the Russian Federation ,the 16th of April 1996.

$$P = A + K + B + D + H$$

Where: *P* – total amount of the leasing payments
A – the amount of the depreciation charges on the leased property
K – Payment for the credit resources used by the Lessor
B – commission fee to the Lessor for delivery of the property under the leasing contract
D – the cost of the additional services delivered to the Lessee by the Lessor on the basis of the contract;
H – value added tax

It is necessary to take into consideration that in accordance with the Law of the Russian Federation the turnover in connection with the delivery of the property to lease, a small enterprise* is not charged with the value-added tax.

Payment for the credit resources, used by the Lessor, is calculated from the interest on the credit, which is actually to be paid.

In connection with the fact that the amount of the used credit resources reduces with each following accounting year, payment for the used credit resources has to be correlated with the average year cost of the leasing property.

* A small enterprise is the commercial organization, where the share percentage in its authorized capital of the Russian Federation, subjects of the Russian Federation, social and religious organizations, charity and other funds, does not exceed 25%. The share belonging to one or several juridical persons, who are not small enterprise, should not exceed 25%. The average number of employees for one reporting period does not exceed the following figures:

- industry – 100 pers.
- building – 100 pers.
- transport – 100 pers.
- agriculture – 60 pers.
- scientific and technological sphere – 60 pers.
- wholesale trade – 50 pers.
- retail trade and the sphere of everyday service for the population – 30 pers.
- other branches and activities – 50 pers.

A small enterprise is also a physical person, having his own business without establishing a juridical person.
(The Federal Law dated 14.06.1995, no.88-F3. The information system "Consultant-plus).

The following formula can be applied in this case:

$$P = ((C_H + C_k) \times n) / 2$$

Where: *P* – credit resources, used for purchase of the equipment; payment for the resources is made in the current year;
C_H – accounting rest value of the property (or the amount of the outstanding payment on the credit) per the beginning of the year
C_k – accounting rest value of the property (or the amount of the outstanding payment on the credit) per the end of the year
n – coefficient, considering the share of the reciprocal resources in the total value of the purchased equipment

This formula can be applied when the payments on the credit are made by the Lessor on the regular basis during the year and in accordance with the amounts of the incoming leasing payments (in the sphere of payments, compensating the payment of the Lessor for the used credit resources). The commission fee to the Lessor can be calculated in two ways.

The first way is the calculation of the balance value of the leased property:

$$B = P \times C$$

Where: *B* – commission fee to the Lessor for the accounting year;
P – commission fee rate;
C – balance value of the property;

The amount of the commission fee for each year will be the same if the calculation will be made in accordance with the given formula.

The second way is to calculate the average year rest value of the leased property:

$$B = ((C_H + C_k) \times P) / (2 \times 100)$$

Where: *B* – commission fee to the Lessor for the accounting year;
C_H – accounting rest value of the property per the beginning of the year;
C_k – accounting rest value of the property per the end of the year;
P – commission fee rate, set in the terms of interest from the average year rest value of the leased property, %.

The amount of the commission fee will gradually go down because of the reduction of the rest value of the leased property, when this formula is applied.

Commission fee is the income of the Lessor from the leasing deal. The expenses of the Lessor in connection with the delivery of the services under the contract are covered from this income. The amount of this income influences directly the amount of the potential income of the Lessor, as income will be equal: commission fee minus actual cost of the leasing services.

The amount of the commission fee is determined by mutual agreement of the parties and can be set as a fixed amount, which is different in months, quarters, years, or as a certain percent from a concrete parameter.

Payment for the services delivered by the Lessor is calculated with consideration to costs on one or another service.

It can be calculated with the formula:

$$D = ((Z1 + Z2 + \dots + Zn)) / T$$

Where: *D* – payment for the additional services delivered by the Lessor in the accounting year;
Z1 + Z2 + ... + Zn – expenses of the Lessor in connection with each service;
T – the validity period of the contract, years.*

*The methods recommended for calculation of leasing payments. Adopted by the Ministry of economy of the Russian Federation, dated 16 April 1996.

The Regulation of the State Customs Committee of the Russian Federation of the 20th July 1995 nr.01-13/10268 “ Customs registration of the goods, temporary exported in the frame of leasing contracts” declares, that the customs registration of the goods, being a subject for leasing, is done in accordance with the order from the State Customs Committee of the Russian Federation of the 25th of April 1994 nr.01-12/328 “About some questions related to the appliance of the temporary export / import customs regime”. That gives partial exemption from the payment of the customs fees and taxes.

In accordance with the paragraph 3 In the Regulation of the State Customs Committee of the Russian Federation nr.01-12/328, for each complete and non-complete calendar month of the goods being under the temporary export / import customs regime, it is paid 3% of the actual sum of the customs fees and taxes, which could be paid if the goods were produced for free circulation.

When calculating the above mentioned sum of the periodical payments, it is used the rate of the customs duties and taxes, which are valid on the date of receiving the customs declaration with the declared temporary import / export regime.

The above mentioned Declaration determines that the customs unit has no right to demand payment of the periodical customs payment for more than three months at the same time. The amounts of the periodical payments are paid with relation to the order, set for the payment of the customs duties.

Example (Table 1,2)

The value of the leased article is **400 thousand dollars**.

Leasing period – **4 years**.

Depreciation rate charges - **15 %**

Interest on credit – **3% per year**

*The letter of the State Customs Committee of the Russian Federation of the 20th July 1995 nr.01-13/10268 “ Customs registration of the goods, temporary exported in the frame of leasing contracts”.

The commission fee rate in accordance with the contract – **1%** per year from the balance value of the equipment.

The Lessor delivers services to the Lessee in connection with the transportation and mounting of the equipment, and training of the personal for the amount of 20 thousand dollars.

VAT – 20% to the income received from the sale of the equipment.

Here:

1. Year amount of the depreciation charges:

$$15 \times 400 = 60\,000 \text{ USD}$$

2. Calculation of the payment for the credit resources used by the Lessor:

Table 1

(thousand dollars)

<i>year</i>	<i>Cost of the equipment per the beginning of the year (C_H)</i>	<i>The amount of the depreciated on charges (A)</i>	<i>Cost of the equipment per the end of the year ($C_k = C_H - A$)</i>	<i>Credit resources ($(C_H + C_k) / 2$)</i>	<i>Interest on credit</i>	<i>Payment for the used credit resources (K)</i>
1	400	60	340	370	3	11,1
2	340	60	280	310	3	9,3
3	280	60	220	250	3	7,5
4	220	60	260	190	3	5,7

3. The annual amount of the commission fee:

$$B = 1 \times 400 / 100 = 4\,000 \text{ USD}$$

4. The annual payment for the additional services:

$$D = 20 / 4 = 5\,000 \text{ USD}$$

5. Calculation of VAT:

(thous.USD)

<i>year</i>	<i>Commission fee (B)</i>	<i>Payment for the use of credit resources (K)</i>	<i>Payment for the additional services (D)</i>	<i>Income for the year (K+B+D)</i>	<i>VAT rate %</i>	<i>Amount VAT</i>
1	4	11,1	5	20,1	20	4,02
2	4	9,3	5	18,3	20	3,66
2	4	7,5	5	16,5	20	3,30
4	4	5,7	5	14,7	20	2,94

6. The amount of the leasing payments will be:

1st year: $60 + 20,1 + 4,02 = 84,12$ thousand dollars

2nd year: $60 + 18,3 + 3,66 = 81,96$ thousand dollars

3^d year: $60 + 16,5 + 3,30 = 79,8$ thousand dollars

4th year: $60 + 14,7 + 2,94 = 77,64$ thousand dollars

In accordance with the above mentioned Regulation, in case of declaration of the temporary imported goods to the customs regime of release for free circulation, and temporary exported goods declared to the customs export regime (that is for buying out of the leased property by the Lessor), the amounts paid as periodical customs duties are included in amounts of customs duties and taxes, which are to be paid in connection with the inclusion of the goods in the mentioned customs regimes.

Besides, in case of the delayed payment of the customs duties for the period of the good's being under the customs temporary export / import regime, rents have to be paid in accordance with the rates set for credits by the Central Bank of the Russian Federation.

In case of international leasing, the parties can use tax concessions of the countries, participating in the leasing arrangement.

3.4. CLASSIFICATION

3.4.1. General

The market of leasing services is characterized by the variety of leasing forms, models of leasing contracts and juridical norms, regulating leasing operations.

Classification can be based on the following characteristics of the leasing arrangement:

- relation to the leased property;
- type of financing of the leasing deal;
- type of leasing property;
- composition of the participants in the leasing deal;
- type of the property delivered to lease;
- recoupment of the leased property;
- market sector where the leasing operation takes place;
- relation to the customs, tax and depreciation exemptions;
- order of the leasing payments.*

Classification in relation to the leased property:

- *Net leasing*, when the Lessee carries all the expenses in connection with the property servicing. Here, the Lessee transfers net payments to the Lessor.
- *Wet leasing*, when the Lessor carries all the expenses in connection with the property servicing. It is used, as a rule, by the producers of the equipment themselves. Wet leasing is one the most expensive types, because of increase of the Lessor's expenses on the technical maintenance, supply of the qualified personal, repairs, delivery of essential materials etc.
- *Partial*, when the Lessor carries only a number of functions in connection with the property servicing.

3.4.2. Classification in accordance with the type of financing

- *Urgent*, that is for one-time leasing.
- *Renewable*, when the leasing contract can be renewed for another period after the first period is over. Here the objects of the leasing arrangement can be changed with the more modern ones after the requirement of the Lessee. The Lessee carries

*Chekmareva E., "Leasing", Moscow, "Economics", 1993.

all the expenses connected to the change of the equipment. The number of the leased objects and the period of their usage under the renewed leasing contract are not discussed by the parties in advance.

- One of the types of the renewable leasing is the *general* leasing, which gives an opportunity to the Lessee to enlarge the list over the leased equipment without the necessity to conclude a new separate contract. It is very important for enterprises having a production cycle, which should not be stopped. General leasing is used when an urgent delivery or change of already delivered to lease equipment is required but there is no time to make and to sign a new contract. In accordance with the conditions for the general leasing, the Lessee can just send a specification over the required equipment to the Lessor with a reference to the accepted list or catalogue. At the end of the period under the contract, the additional calculation of the leasing payments takes place, with regard to additional Lessor's expenses, after that a new contract can be concluded.

3.4.3. Composition of the participants in the deal

Depending on the **composition of the participants in the deal**, the following types of leasing can be differentiated:

- *Direct leasing*, where the owner of the property (supplier) delivers the property to leasing without any third part, thus there are only two parties in the leasing arrangement.
- *Non-direct leasing*, when delivery of the property to lease goes through an intermediary agent. This is a classical model, when a supplier, a lessor and a lessee participate.
- *Leveraged leasing*, this type of leasing is used as a form of financing of complicated, large objects, such as planes, vessels, trains etc. Such leasing is also called group leasing, where several supplying companies participate, as well as several Lessors participate and the credit resources are borrowed from a number of banks. This type of leasing is considered to be the most complicated one, as it is characterized by complex financing. A specific feature of this type of leasing is that the Lessors provide only a part of the amount, which is required for purchase of the property to be leased. These resources are attracted and accumulated through disposing of shares among the Lessors, participating on financing the deal. The rest amount of the property value is financed by the creditors (banks, other investors). Here, as a rule, the creditors have no right to demand repayment

on the credit directly from the Lessors. Because of a great number of the participants in the deal, it is customary to involve a creditor's agent to coordinate the actions of the lenders, and a Lessors' agent to coordinate the general actions of the subagents. The Lessors' agent acts as a nominal lessor and is named as an owner of the equipment. He also distributes the income among the shareholders.

- *Sale and leaseback arrangement* is one of the forms of the direct leasing. It is a system of interconnected agreements, where an enterprise, which is an owner of land, buildings or equipment, sells this property to a financial institute (a bank, an insurance company, an investing fond, a company specially oriented on the leasing operations) and at the same time concludes a leasing contract on its former property.

Sale and leaseback arrangement in this case is an alternative to a mortgage operation, where the seller of the property becomes a lessee of the property in the result of the deal. He gets it to lease from the buyer getting at the same time the money from the sale of his property. The buyer continues to participate in the deal, but now as a lessor of the property. This type of leasing is essential first of all for those enterprises, which are in great and urgent need for current assets.

An important advantage of the sale and leaseback arrangement is the use of the already exploited equipment as the source of financing for building of new objects, from here comes an opportunity to make advantage of tax exemptions, given for the participants of the leasing operations. This type of leasing gives an opportunity to refinance the capital investments with lower expenses, than for example the resources are attracted from a bank, especially if a crediting institution does not consider the repayment abilities of the enterprise to be worth giving a credit.*

The amount of the leasing payment in this case is determined in the following way: the amount of payments should be sufficient for the complete reimbursement of the whole amount paid by the investor to purchase the equipment and it should provide for the average income norm for the investment capital.

*Balabanov A., Balabanov I., "International relations", Moscow "Statistics and finance" 1998.

3.4.4. Type of property

Depending on the type of property, there can be distinguished:

- *Leasing of movables* (equipment, cars, vessels, planes etc.), brand new and already used.
- *Leasing of immovables (buildings, constructions etc.)*, except for land and other natural objects.

3.4.5. Recoupment grade of the leased property

- *Completely recoupable leasing* (or close to complete), when during the validity period of the leasing contract the complete or close to complete amortization of the equipment takes place, and as a result, payment of the property value to the Lessor.
- *Partially recoupable leasing*, when during the validity period of the leasing contract only partial amortization of the equipment takes place.

In accordance with the **recoupment features (property amortization conditions)** there are *financial* and *operating leasing*.

- *Financial leasing (capital leases)* is the relations among partners which provide for payment of leasing installments under the validity period of the contract, which cover the complete cost of the amortization of the equipment or its greater part, plus additional expenditures and Lessor's income. This type of leasing is characterized by the following main features:
 - participation of three parties, they are the Lessor, the Lessee and the Supplier (producer) of the article which is to be delivered to lease;
 - impossibility of terminating the contract during its general validity period, that is the period essential for reimbursement of the Lessor's expenses;
 - long-term period of the leasing contract (sometimes close to the life time of the equipment).

After the termination of the period under the leasing contract, the Lessee has an option to buy the leased equipment having paid its rest value; he can also renew the contract for a shorter period or deliver the equipment back to the Lessor.

The Lessee is supposed to inform the Lessor about his decision. If the contract contains an option of purchase of the leased equipment, the parties determine the rest property value in advance.

- *Operating (service) leasing* – is the leasing relations, where the expenses of the Lessor connected to the purchase and maintenance of the equipment to be delivered to lease, are not covered by leasing installments during the validity period of one leasing contract. Such contract is concluded as a rule for 2 – 5 years. Risk of damage or loss of the property is carried by Lessor in this case. The rate of leasing installments is usually higher, in comparison with the financial leasing, because of the absence of guarantee that the expenses will be recouped. After the termination of the operating leasing contract, the Lessee has the right to prolong the contract under more profitable conditions; to return the equipment to the lessor; to buy the equipment out from the lessor, if the contract contains a purchase option, having paid for the equipment in accordance with the market value of such equipment.*

3.4.6. Market sector of the leasing operation

Depending on the market sector where the leasing operation takes place, there are:

- *Internal leasing*, when all the participants are the representatives of the same country.
- *External (international) leasing*, when at least one of the parties represent a foreign country. If at least one of the parties works and has a common capital with a foreign enterprise, then the deal is also classified as an external (international) leasing.

External (international) leasing can also be divided into *import* leasing, when the Lessor represent a foreign country; and *export* leasing, when the Lessee represents a foreign country.

3.4.7. Relation to the customs, tax and depreciation exemptions

In accordance with this feature there can be differentiated the following types:

*Gazmanov V.D., "Leasing: theory, practice, comments", Moscow, 1997

- *Leasing with the usage of tax exemptions on the property, income, VAT, different dues, accelerated depreciation etc.* The deals under this type of leasing base on getting tax exemptions by the Lessor. Exemptions concern investments in equipment, which is delivered to lease abroad. Such type of deals can be organized in such a way that the Lessees in their countries make depreciation deductions, using tax exemptions, and paid to the Lessor applying artificially reduced leasing rates. It was possible because of the use of tax exemptions on investments in equipment, delivered to lease. In a number of cases the opportunity to get tax exemptions for the leasing operations is applied to make fictitious leasing operations.
- *Leasing without exemption appliance.*

Depending on the character of leasing payments leasing can be divided in accordance with:

- **the type of leasing** (financial, operating);
- **types of payments between the Lessor and the Lessee:**
 - a) monetary, when all the payments are made in the monetary form;
 - b) form of compensation, when the payments are done through the delivery of products, produced with the equipment, delivered to lease, or through the services delivered by the Lessor and the Lessee to each other.
 - c) mixed, when both types are applied.
- **composition of the payments** (depreciation, additional services, insurance etc.);
- **the applied calculation method:**
 - a) with the fixed total amount;
 - b) with an advanced payment;
 - c) with consideration to purchase of the equipment at the rest value;
 - d) payment intervals (every year / half a year / quarter / month);
 - e) payment urgency (at the beginning / in the middle / at the end of the payment period);
 - f) way of payment: in equal parts; in increasing / decreasing amounts (depending upon the financial state of the Lessor and contract conditions).*

*Abdullina S.N., Yakupova N.M., Chikurina N.V., Leasing, Kazan, KFEI, 1996.

3.5. STATE REGULATION OF LEASING RELATIONS

3.5.1. Licensing of leasing activities

In accordance with the Licensing Provision, dated the 26th of February 1996, adopted by the government of the Russian Federation, license is the main official document, giving a permission to a leasing company (any company / enterprise engaged in the leasing activity as a lessor) to practice leasing activity. Permission allows such activity during a determined time clause and with respect to the licensing conditions and valid law.

It is the Ministry of economics of the Russian Federation that is responsible for the licensing of the leasing activities.

In accordance with the above mentioned Provision, one of the major conditions for getting a license is that the leasing activity should be prioritized compared to other types of activities, in which the company is engaged, that is not less than 40% of income from marketing of the leasing services in the total amount of income per year. For Russian lessors following this condition can be difficult if not impossible:

1. A number of operators of the Russian leasing business, even those the most famous, have a difficult economic situation, that is why they have to get involved in other types of activities.
2. If it is a Russian bank who is a Lessor, then such a norm is unacceptable for him, because in this case the appliance of financial leasing becomes complicated for them.

This 40% norm complicates activities of both resident and non-resident investors, because the norm deprives the producers themselves and the selling companies the opportunity of leasing their articles, as they have major specialization different from leasing, so the income from leasing can not be that significant.

3.5.2. Insurance of leasing activities.

The general leasing practice shows that the Lessee usually get responsibility of insuring the transportation of the equipment received by him to lease, as well as its mounting, works connected with regulations and start and property risks.

The necessity of insuring the property, delivered to lease is stipulated by the Convention “About the international Financial Leasing”, concluded in Ottawa on 28.05.1988.

In accordance with the paragraph 18, part 2 of the Leasing Provision, the Lessee covers all the expenses connected with the maintenance of the leased property, its insurance.

In accordance with paragraph 929 in the Civil Code of the Russian Federation, one party (insurer) is obliged to reimburse to another party (insurable or a third person – profit benefitor) the occurred loss or damage of the leased equipment, or loss in connection with the property interests of the insurable, that is to pay the insurance indemnity in amount determined in the contract. The insurance contract stipulates the necessity of payment of insurance premium.

The contract of property insurance can contain the following insurance types:

- 1) risk of loss, shortage or damage of certain property;
- 2) risk of liability on obligations in the result of injure or damage caused to life, health or property of other persons, and in cases provided for by the law, also liability under the contracts – risk of civil liability (P & I);
- 3) risk of loss from the business activities, caused by the sub-suppliers’ break of obligations or change of conditions of this activity due to reasons which do not depend upon the insurable; inclusive risk of non-getting the expected income – business risk.

The property can be insured under an insurance contract in favor of a person (insurable or profit benefitor), which has a legal interest, confirmed by a certain document, in keeping this equipment. Besides, if an insurance contract is concluded with a person (insurable or profit benefitor), who does not have such confirmed interest, the contract is considered to be invalid.

An insurance contract in favor of a profit benefitor can be concluded without giving the name of the benefitor. When such type of contract is concluded, the insurable gets insurance police to bearer. In this case the police should be delivered by the insurable when executing rights.

P & I insurance is considered to be made in favor of third persons, which are not clearly noted in the contract, even if the contract is concluded in favor of the insurable or profit benefitor, responsible for causing damage.

In case the liability for causing damage is insured as necessary due to the type of equipment / article insured or due to reasons separately stipulated in the insurance

contract, the person, in favor of which the contract is considered to be concluded, has the right to claim the reimbursement of the damage in the amount of the insurance sum.

These types of insurance are traditional for the Russian insurance market. The only point that may complicate insuring of the leasing activities, is too high value of the equipment / article delivered to lease. Then, double insurance comes to the scene.

This mechanism is provided for in paragraph 967 in the Civil Code of the Russian Federation. Here the risk of payment of the insurance sum, carried by the insurer, can be reinsured completely or partially via another insurer / insurers, having concluded a new insurance contract.

For such reinsurance contract the rules of business risk insurance are usually applied unless other is stipulated in the contract. Here the insurer (under the main insurance contract) is considered to be the insured (under the reinsurance contract).

In case using this double insurance mechanism, a Russian insurance company carries, for example, 10-15% from the total insurance amount, and the rest, greater part is transferred to a larger insurer or a number of the insuring companies.

This mechanism is usually used when foreign equipment is delivered to lease, having value of several million dollars, and there is a demand from a foreign partner to have a solid foreign insurance company as a participant.

Under the contract of business risk insurance, which includes as well risk of failure to pay leasing installment, it is also possible to insure the risk of the insurer himself and only in his favor.

3.5.3. Leasing benefits

A number of expenses are charged on prime cost of the products that means they are not charged with the profit tax. The following expenses are charged on the prime cost: leasing payments, interest on the received credits inclusive bank credits and credits from other organizations.

The Central Bank of the Russian Federation has simplified the former order of foreign currency operations connected to the international leasing. For example, now it is not necessary to get a special bank permission for the following types of operations with the foreign currency:

- foreign currency transfers by the residents from the Russian Federation as payment of insurance installments (insurance premiums) to non-resident insurers. Type of the insured interest is not

significant. Also placing of amounts in foreign currency as payment of insurance sums (insurance reimbursement) to a foreign currency account of residents in the authorized banks of the Russian Federation and with regard to the Insurance Law of the Russian Federation;

- foreign currency transfers to the Russian Federation as payment for lease of air, sea and river transport. The article is delivered to lease by a Russian resident to a foreign resident. The condition is that the payment is transferred to the foreign currency account of the resident in the authorized bank of the Russian Federation periodically once within 180 days from the moment of delivery of the article to lease. The period of leasing is not significant;
- foreign currency transfers from the Russian Federation as payment for lease of air, sea and river transport. The article is delivered to lease by a foreign resident to a Russian resident. The condition is that the payment is transferred periodically once within 180 days from the moment of delivery of the article to lease. The period of leasing is not significant;
- obtaining (repayment) a foreign currency credit by juridical / physical persons (residents and non-residents) for a period of more than 180 days from / to the authorized banks, having the authority to give credits in foreign currency. Obtaining / repayment of interest on the used credit in foreign currency and the amount of penal sanctions, which are due to be paid in foreign currency in accordance with the contract, in case of misfulfillment or improper fulfillment of obligations on the repayment (giving) such credits;
- transfer of foreign currency by the resident from the Russian Federation and also to a foreign currency account opened in the name of non-resident in an authorized bank, as payment for imported goods (customs clearance). The time gap between the payment day and the day of customs clearance is not significant.
- transfer of foreign currency by the resident from the Russian Federation and also to a foreign currency account opened in the name of non-resident in an authorized bank, as payment for delivered

imported services and works. The time gap between the payment day and the day of customs clearance is not significant.

All the rest of the foreign currency operations in connection with capital movements and not prohibited by the Bank of Russia, are made on the basis of permissions issued by the Bank of Russia for each particular case. (www.cbr.ru)

Profit tax.

In the leasing arrangement when it is *the leasing company*, who is *the resident of the Russian Federation*, the profit tax is paid in accordance with the general internal rules. In this case the amount of the profit tax, paid in accordance with the foreign law, should be recalculated within the terms of the tax and in accordance with the Russian law.

In the leasing arrangement when it is *the lessee*, who is *the resident of the Russian Federation*, and the lessor is the foreigner, the following rules will be applied:

- the profit tax is charged in the same way as for Russian enterprises, in case the foreign juridical person has a permanent representative company in Russia;
- if the foreign juridical person has no permanent representative company in Russia, the tax is charged with the reduced taxation rate 10% (in stead of 36%) from the value of leasing payments (from the 1st of January 2002) minus value of the equipment delivered to lease, interest on the credits, attracted for the purchase of this equipment and property tax paid for this equipment. The Lessee must pay taxes from the income of the foreign leasing company.

Value added tax.

Tax release.

Property tax.

The foreign leasing company has to pay property tax in case the property is kept on the balance of the lessor. The value of the leased equipment is the rest value of the equipment with respect to depreciation.

Turnover Tax.

The most undoubtedly positive change to the tax structure has been the reduction in the turnover tax (tax on revenue), and the planned removal of this tax entirely. Until 2001, the total turnover tax was 4%, a level that significantly increased the cost of leasing deals - particularly since leasing companies, as credit-granting operations, generally have narrow gross margins and depend on high turnover to cover overhead costs. Leasing companies paid turnover tax on the total sum of leasing payments, even if they were operating at a loss. In January 2001, the two turnover taxes, social fund payments of 1.5% and the 'road tax' of 2.5%, were reduced. The social fund tax was eliminated entirely, and the road tax was reduced to 1%; the road tax will be eliminated on January 1, 2003.

3.6. Financing of purchase of major production means

The main financing source of equipment purchase in Russia is the unallocated profit and equity capital. But this is still too problematic for small and middle companies, having low year profit to purchase major production means.

Bank crediting is hardly achievable for many companies, because of the shortage of long-term credits that is credits over one year. Leasing arrangement provides for a fixed interest rate on the credit. But very few or no banks in Russia possess financial resources to be offered as credit on fixed interest rate for a period over one year. The bank sector suffers the shortage of capital, and the funds from depositors are not large in amount and in terms of periods. Many banks manage to survive only due to transfer payments and cash operations. Getting credits from banks can be also complicated by the psychological factor, when the banks prefer to give credits to enterprises they work together with for several years. Besides, the conditions of leasing companies on credits, payments and guarantees are softer and less aggressive in comparison with bank demands. As, for example, a personal guarantee of the director of the enterprise is as a rule insufficient for the bank but can be acceptable for a leasing company.*

There is a specific factor to the Russian market that may in the short to medium term increase the attractiveness of leasing. The Russian banking sector as a whole has a fairly bad reputation, with the possible exception of Sberbank. The Russian financial crisis of 1998, with the associated collapse of many banks, did not

*Shtelmah, V., Economic effectiveness of leasing compared to bank credit with regard to purchase of major production means, "Leasing express", January-February, 1999 no.1.

endear the sector to most Russians.

While this image may be unfair to many of the banks, the fact remains that a large number of Russian businesses are wary of working closely with a powerful banking institution particularly if getting credit means revealing substantially all of one's business details. For smaller businesses, a significant amount of payments may take place in cash or by bank transfer without an account. A leasing deal may represent the first use of the banking system ever, or the first use of the banking system aside from personal savings accounts. With the first access to real external financing, firms for the first time may have sufficient incentive to bring their businesses out of the grey market, where firms operate quasi-legally: not breaking any laws, perhaps, but not fully declaring their income, sales or purchases.

Thus financial leasing seems to be a feasible solution. It is the most acceptable one compared with the bank credit and own capital investment (Enclosure 1). For example, crediting and own capital investment do not give tax exemptions, the last demands immediate investment of large capital, that results in lower competitiveness of the investor. Leasing gives a possibility of building a soft payment schedule with regard to costs and profit, unlike the other investment types, plus the possibility of acquiring finances without presenting any guarantees in the form of property pledge or guarantee from a third person.

CHAPTER 4.
DESCRIPTION OF THE CONTRACT RELATIONS
IN THE NORWEGIAN-RUSSIAN PROJECT
PELAGIC PURSE SEINER

4.1. GENERAL

Commencement of the Financial Leasing Agreement between the two partners, that is a Russian company, registered in St. Petersburg, having a subsidiary company, registered in Murmansk, and a Norwegian partner, having registration in Ålesund and Tromsø, took place in January, year 2001.

Condition for the co-operation and signing the contract was that the Norwegian partner becomes an investor, providing financing for the whole project, when the Russian partner performs the duty to provide the pelagic purse seiner with sufficient Russian pelagic quota. Duration of the Financial Leasing Agreement is eight years.

General description of the vessel under the leasing contract:

The pelagic purse seiner / freezer trawler.

Built in Norway in 1978.

Rebuilt in Norway in 1986 and 1990.

LOA 69,23m

Main Engine: 3000 BHP

GT: 1946 tons

NT: 992 tons

The Vessel was bought by a Norwegian company (Lessor) from another Norwegian one (Seller), with the purpose to lease it later to a Russian company (Lessee) under the contract of financial leasing. So, initially there were the Seller, the Buyer / the Lessor and the Lessee.

4.2. FINANCING OF THE PURCHASE

Purchase of the vessel was financed with the help of a bank loan, taken by a Norwegian partner in one of the Norwegian banks. The amount of the loan: **38 million** Norwegian crowns. The second part that made the financing of the vessel was the equity contribution in the amount of **22 million** Norwegian crowns, where the Norwegian investor came with 17 million Norwegian crowns, that is responsible loan capital, and the Russian partner contributed with 5 million Norwegian crowns, as downpayment on the loan.

Responsible loan capital was deposited on the bank account in the name of the Norwegian partner, when the downpayment was deposited on the bank account in the name of the Russian partner.

Specification of the investment in the vessel

The price paid to the Seller for the vessel made **52.500.000,-** Norwegian crowns totally.

To deliver the Vessel to the Lessee in condition proper and ready to use for operation, the Lessor purchased the following fishing gear:

- one purse seine net for herring and mackerel
- one purse seine net for capelin
- hard ware
- wire etc.

at an estimated market price of **5,5 million** Norwegian crowns.

Plus one pelagic trawl at the price of approximately 1 million Norwegian crowns.

Thus, **total investment** in the Vessel makes **60.000.000,** - Norwegian crowns.

4.3. REGISTRATION AND OWNERSHIP OF THE VESSEL

The vessel is classified by the Norwegian classification society Det Norske Veritas. The conventional part of the vessel is controlled by the Russian State Ship's Registry. Thus the Vessel is registered in the Russian State Ship's Registry for leased vessels under the contract of financial leasing, port of registry – Murmansk. The underlying Ship's registry for the Vessel is Cyprus. The Vessel flies the Russian flag.

The buyer/ Lessor holds full (100%) ownership of the Vessel during the leasing period (eight years), until the first and the second priority mortgage loans in the Vessel are fully paid off. When this condition is fulfilled the ownership is transferred to the Lessee.

4.4. AGENCY AGREEMENTS BETWEEN THE PARTNERS

There was concluded an exclusive Agency contract between the Russian Partner. One of the companies, representing the Norwegian partner, registered in Tromsø, serves as an exclusive management company for the Vessel (Managing company- MC). The other company, representing the Norwegian partner, registered in Ålesund, has an exclusive right to sell all fish and fish products from the Vessel, though the Russian partner keeps the right to introduce new fish buyers, in case they manage to find a better price offer. In this case the sales commission becomes twice reduced.

MC pays costs with respect to the vessel, that may include, for example,

- provision of necessary materials and technical supplies, such as fuel, lubricating oils, food, stores, spare parts, fish gears etc.,
- arrangement of technical inspections,
- arrangement and supervision of any technical maintenance between trips, and repair, including periodical surveys by the Classification Society and other controlling authorities,
- port arrangements, such as mooring and unmooring, quay facilities, pilot, tugs, custom control etc.,

- arrangement of air flights to crew members,
- all payments in foreign currency to crew members,
- medical surveys to crew etc.

MC appoints during the first three months the following crew members: fish master, mate, chief engineer, plus one additional engineer, two production managers and two purse seine experts. These Norwegian crewmembers are in charge of the fishing operation as long as they are on board the vessel. They have for the goal to provide proper instruction for the Russian crewmembers in the operation of the Vessel as per Norwegian fishing and processing methods. The number of Norwegian crewmembers becomes gradually reduced during the following three months to fish master, chief engineer, and production manager and purse seine expert. Norwegian crewmembers stay on board the vessel until it is mutually agreed between the partners that they are no longer required.

MC gets MANAGEMENT FEE, which makes 4% of the Vessels gross income. The company, selling fish and fish products from the vessel gets SALES COMMISSION, that makes 5% of the income from sale of fish and fish products. Both, management fee and sales commission are paid on monthly basis.

4.5. BROKER AND EXPERT ADVISER

1% (one per cent) fee of the Vessel's gross revenue is paid to the Broker and Adviser. This is included in 4% management fee, paid to the managing company.

4.6. LEASING PAYMENTS

TOTAL AMOUNT payable under the Financial Leasing Contract is 86.983.085,- Norwegian crowns, inclusive:

- cost of the Vessel
- first priority mortgage holder's interest

- second priority mortgage holder's interest
- insurance costs related to the Vessel, crew, fishing gear and cargo
- Lessor's fees.

There may be variations in the amounts paid due to changes in the interest of the first priority mortgage loan and alteration in the insurance premiums.

Payment condition: paid in monthly instalments.

The advance payment in the amount of 5.000.000,- Norwegian crowns is considered to be the first leasing payment, downpayment.

Lease payments include only interest and not instalments on the first priority mortgage during the first 12 months and only interest and not instalments on the second priority mortgage during the first 18 months from the date of delivery of the Vessel to the Lease.

Payment of leasing fee is effected by bank transfers.

4.7. INSURANCE

The Lessee enters into Insurance agreements with Russian insurance companies as directed by the Bank, holding the first priority mortgage in the Vessel. In accordance with the contract the Vessel must be insured against marine, war, protection and indemnity risks in such a form as the Lessor and mortgage holders shall in writing approve. There can be taken additional assurances, if directed by the Bank holding the first priority mortgage in the Vessel, for example, such as: port risk insurance, crew and crew belongings in accordance with the Norwegian practice, fish products on board for the full value, political risk insurance, mortgage interest insurance. Value of the vessel for the insurance is 60.000.000,- Norwegian crowns.

4.8. PRACTICAL SIDE OF THE PROJECT

After delivery of the Vessel to lease to the Russian partner, the Vessel turned out to have serious hidden defects. The Vessel was delivered by the Norwegian partner with the hull and machinery classified until December 2005, that actually should

guarantee that the Vessel does not have such defects. Such defects still manifested themselves. It caused the necessity to make significant and expensive repairs. The second complication was a problem with acquiring the Russian pelagic fish quota. Thus the very beginning of the project was spoiled by force-majeure conditions.

Today, the project is in **minus for 3 million** Norwegian crowns (balance sheet of the company).

The vessel is being repaired in Poland now. Approximate price of repair and fish fabric renovation is **8.000.000,-** Norwegian crowns.

Amount to be paid for insurance is **1.000.000,-** Norwegian crowns.

Thus, totally per today, before the Vessel starts fishing again, the project is in **minus for 12.000.000,-** Norwegian crowns.

Only **4,5 million** is downpaid on the loan in the bank. Practically all the income from operation of the Vessel was used to cover this part of the loan plus necessary repairs and maintenance, wages to the crew and fishing gears, agency fee and sales commission.

The Vessel started fishing from the 15th of March.

Income from March, 15 till December, 31, 2001: **30.564.815,-** Norwegian crowns (instead of 50 million expected). **Insurance:** 500.000,- Norwegian crowns. 4% - agency fee, 5% - sales commission, 7% - paid to the Russian crew, 15% - paid to the Norwegian crew. Expenses connected with the purchase and maintenance of the *fishing gear*: 7 518.721,- Norwegian crowns. **Total operation expenses** for the whole period: **36.480.201,-** Norwegian crowns.

The project may come into balance after taking three trips, that is by the end of July:

Each trip per approximately 500 t, total income makes 15 million Norwegian crowns, minus operation expenses (specified later).

4.9. SPECIFICATION OF OPERATION EXPENSES

4.9.1. VARIABLE EXPENSES

1) Fuel oil: approx. 6000 ltr. per day, that is 180.000,- ltr. per month

$$180.000,00 \times \text{average price } 2,624 = 472.320,00$$

2) Lubrication oil and hydraulic oil make approximately 2% of the fuel oil use.

$$3600 \text{ ltr. per month} \times \text{average price } 12,3 = 44.280,00$$

3) Fishing gear costs (maintenance) – 1.400.000,00 per year, that is 3330,00 per day (balance sheet of the company).

4) Maintenance of the vessel - 3.240.000,00 per year, 9000,00 per day (balance sheet of the company), including maintenance of the fish fabric – 1.080.000,00 per year

5) Gas, washing middles – 250.000,00 per year, 1250,00 per day (balance sheet of the company).

6) Discharging costs make approximately 0,30 Norwegian crowns per 1 kilogram.

7) Food supplies: approximately 150 Norwegian crowns per person per day.

$$27 \text{ (the number of crewmembers)} \times 150 = 4.050,00 \text{ per day}$$

$$4.050,00 \times 360 = 1.458.000,- \text{ per year.}$$

8) Packing materials, labels – approximately 0,30 Norwegian crowns per kilogram.

9) Wages to the crew: 5 Norwegians = 14% from gross yield

$$22 \text{ Russians} = 7\% \text{ from gross yield}$$

10) Sundry expenses, such as communication, port charges, make approximately 1 000,00 Norwegian crowns per day (balance sheet of the company).

11) 4% - agency fee.

12) 5% - sales commission.

4.9.2. CONSTANT EXPENSES

1) The first priority mortgage loan – 38.000.000,00 Norwegian crowns —
downpayment and interest.

2) The second priority mortgage loan – downpayment and interest.

3) Insurance:

Vessel (hull) - 570.000,00

Fishing gears - 45.000,00

Catch - 63.200,00

Fuel oil and oil - 12.500,00

Fire on board - 3.150,00

Net - 95.000,00

War risk - 15.800,00

804.650,00

Crew - 400,00 USD per person x 27 = 10.800,00

98.000,00 NOK

902.650,00

4.9.3. ESTIMATION

Such type of project seems to be cost efficient for the Russian partner. The following assumptions are done to make the estimation of the 8-years financial leasing project:

	specification	1	2	3	4	5	6	7	8	9	total	
	Initial value of vessel	52000000										
	advanced payment	5 000 000	0	0	0	0	0	0	0	0	0	
	1 pr.mortgage loan interest+installm.	2 804 400	7 677 077	8 522 304	7 988 134	7 453 964	6 919 793	6 385 623	5 851 453	1 397 478	55 000 227	
	2 pr.mortgage loan interest+installm.	2 034 900	3 358 354	5 032 929	4 615 511	4 198 093	3 780 676	3 363 258	2 945 840	671 138	30 000 699	
	tot.1+2 pr.mortgage	9 839 300	11 035 431	13 555 233	12 603 645	11 652 057	10 700 469	9 748 881	8 797 293	2 068 617	85 000 925	
inn.	revenue (gross) approx. ¹	30 000 000	47 000 000	57 000 000	60 000 000	67 000 000	72 000 000	75 000 000	63 000 000	21 275 000	492 275 000	
deprec.	depreciation rate 10%	5 200 000	5 200 000	5 200 000	5 200 000	5 200 000	5 200 000	5 200 000	5 200 000	5 200 000	46 800 000	
labour	wages Russ.crew 7%	2 100 000	3 290 000	3 990 000	4 200 000	4 690 000	5 040 000	5 250 000	4 410 000	1 489 250	34 459 250	
	wages Norw.crew 14%	4 200 000	6 580 000	7 980 000	8 400 000	9 380 000	10 080 000	10 500 000	8 820 000	2 978 500	68 918 500	
other costs	4% agency fee	1 200 000	1 880 000	2 280 000	2 400 000	2 680 000	2 880 000	3 000 000	2 520 000	851 000	19 691 000	
	5% sales commission	1 500 000	2 350 000	2 850 000	3 000 000	3 350 000	3 600 000	3 750 000	3 150 000	1 063 750	24 613 750	
	sundry expenses	400 000	360 000	500 000	1 150 000	450 000	360 000	600 000	360 000	90 000	4 270 000	
	insurance	900 000	900 000	900 000	900 000	900 000	900 000	900 000	900 000	900 000	225 000	7 425 000
material	material costs/ total	17 500 000	22 830 600	14 830 600	16 030 600	14 845 600	14 830 600	14 830 600	14 830 600	3 707 650	134 236 850	
	exp.per year	33 000 000	43 390 600	38 530 600	41 280 600	41 495 600	42 890 600	44 030 600	40 190 600	15 605 150		
exp.	total										340 414 350	
	profit per år	-3 000 000	3 609 400	18 469 400	18 719 400	25 504 400	29 109 400	30 969 400	22 809 400	5 669 850		
profit	total										151 860 650	
	profit tax 24%	0	0	1 179 400	1 467 781	3 324 562	4 418 143	5 092 925	3 362 906	864 296	19 710 013	
	net.profit										132 150 637	
Result		-3 000 000	3 609 400	17 290 000	17 251 619	22 179 838	24 691 257	25 876 475	19 446 494	4 805 554	47 149 711	
		52000000	-9 839 300	-11 035 431	-13 555 233	-12 603 645	-11 652 057	-10 700 469	-9 748 881	-8 797 293	-2 068 617	14.16 %

The ideal revenue level can be calculated in accordance with the following assumptions:

- 1) Capelin season from January till April; and from November till December.
- 2) Herring season: from May till September.
- 3) Approximate number of trips per month for herring season - 2
- 4) Approximate number of trips per month for capelin season - 3 (delivery of frozen products and to oil fabric)
- 5) Average price for herring (filet) - 10 Norwegian crowns
- 6) Average price for capelin 1Norwegian crown - delivery to oil fabric, 2,50 Norwegian crown - frozen

- no extraordinary expenses are carried by the company;
- the companies or vessel come into no force-majeure conditions;
- the Russian partner manages to get sufficient amount of quota resources;
- the Norwegian partner delivers sufficient financing for the project;
- there are enough fish resources;

The reference should be made that the operation expenses included, also contain essential expenses on classification of the vessel and its propeller, and also expenses connected with the regular dock-setting of the vessel.

It is interesting to notice that the Norwegian vessel seem to show low expenses level compared to the Russian one. The Norwegian vessel is a pelagic purse seiner as well, but not equipped with the fabric. The highest difference goes to the fuel expenses. Food provision expenses are considerably higher on the Russian boat, given to the number of the crewmembers. One also should pay attention to the wages level of Norwegian and Russian seamen, the label of Russian seem to be much cheaper. Thus, in the common project, the level of expenses can be reduced by cutting down the number of the Norwegian crewmembers. Though it should be done carefully, only after the parties are sure that the Russian crew has been properly educated by the Norwegian instructors. (Enclosure 2)

So, the project can be profitable, given considerably favourable conditions.

5. SUMMARY

The following summary can be done in the result. In the introduction I described the background for the problem the Russian fishery industry faced, that is the necessity to acquire newer more efficient vessels. But the new economic and political situation in Russia with the loss of subsidies from the government, breakdown of the distribution system, absence of own shipbuilding yards and dismal banking system, left the participants of the Russian fisheries with the problem, which they had to solve on their own.

I further define the research objectives of my work, taking for the purpose to study the mechanism of the financial leasing on the international scene and consider the profitability issue of such arrangement for the Russian partner, taking into consideration the fact that such financial leasing contracts are gaining more and more popularity in Russia, especially its north-western part, and are actually the most practised way of getting more efficient and modern fishing vessels.

The next step is the definition of the research hypothesis, which is *Financial leasing is a cost efficient way of organising the fishing vessels purchase, given the dismal state of the present domestic banking system.* I give the sources for data obtaining and research methods used in the work.

I then start the theoretical part of my thesis with defining the state of fisheries in modern Russia, given the new economic situation, and particularly the situation in fisheries sector in Murmansk region, which practically is the major fishing port of the country, that is proved by the figures of quota distribution in Russia among the regions operating in terms of fisheries.

I then consider the new strategy of quota distribution, auction. I analyse the reasons for introduction of quota auctions and look upon the results some concrete auctions gave, also naming the problems, which follow auction practising. High prices at the auctions, and this year they went up to 700-750 USD dollars per one lot, make it impossible for smaller and poorer companies to survive, as allocated quotas are usually not enough for the company to work during the whole year. The second even more acute problem becomes the dependency of the Russian companies upon the

investments brought in by foreign companies. As most of the companies, which are in condition to buy quota at the auction are connected to foreign companies which actually subsidise the purchase.

I then discuss the intention of the Russian Federation to join the World Trade Organisation. The instability of the fishing sector, the way the Russian sanitary control system is organised and the state of the coastal processing make this intention quite doubtful.

Later I define the Russian modern banking system, describing its structure and functioning with respect to the core of the system, that is the Central Bank of the Russian Federation. In spite of positive signs in development of the system, it is not ready to give long term credits due to lack of material basis, which would be a guarantee against credits and lack of legislative acts that would regulate crediting of businessmen.

In the next part of the thesis I study registration of the companies in offshore jurisdictions. This issue is of considerable interest, as such registration has become a common practice for Russian fishing companies, and its understanding gives better insight into the system of Russian fisheries. I give reasons for popularity of offshore registration in general and the desirable characteristics for the jurisdiction the company plans to choose. I further enlighten the issue of double taxation treaties going directly to the study of the offshore zone the Russian Federation has such treaty with, Cyprus. I give general information on the island, that is geographical data, information on its economy, investment climate and its offshore sector. Particularly I look upon the relations with the Eastern Europe and the taxation system the island has in this relation.

In the second chapter I study the financial leasing agreement. Where first I define the legal basis for financial leasing, taking a look back at the development of the Law of the Russian Federation with regard to leasing and analysing its drawbacks.

I further give the definition of leasing presenting the characteristic features of financial leasing operations stipulated in the Law of the Russian Federation.

I further consider the parties in the financial leasing agreement, presenting a detailed scheme of the typical leasing arrangement, where the participants are

subdivided into direct and indirect, namely the Lessor, the Lessee, the Supplier (seller); and the insuring company, the bank or other crediting institution, also dealers and brokers, respectively.

Then I study the rights and obligations of the parties in the financial leasing agreement, putting accent on the peculiarities of such contract, and define the payment forms under the contract of financial leasing. I first look upon the general payment forms in accordance with the common practice and pick out the forms that can be applied with regard to the leasing arrangement.

I further define the methods of the calculation of leasing payments. The first method stipulates that the total amount of the leasing payments is charged in equal parts during the whole period of the validity of the contract. The second method stipulates that the Lessee contributes with the advanced payment at the moment of conclusion of the Leasing contract. The rest of the leasing payments minus the advance payment is charged and paid during the contract period. In accordance with the third method the total amount of leasing payments includes the amount of depreciation charges for the whole contract period, commission fee, payment for the additional services delivered by the Lessor.

I further give an example illustrating the way the calculations can be done with respect to a concrete leasing project, taking into consideration cost of the article delivered to lease, the amount of depreciation charges, credit resources and interest on them, commission fee, payment for the additional services, delivered by the Lessor and imposed VAT.

In the next part of my thesis I look upon the classification of leasing based on its different characteristics, such as relation to leased property, type of financing, type of the property itself, composition of participants in the arrangement, grade of recoupment of the leased property, market sector where the leasing operation takes place, with relation to customs, tax and depreciation exemptions, and finally with regard to the order in which leasing payments are done.

In the next part I study the state regulation of the leasing relations. First I define the licensing rules stipulated in the law for the all the companies desiring to

enter the leasing market. Then I define the rules for insuring the leasing activities, traditional for the Russian insurance market.

The next issue discussed is the benefits the leasing arrangement brings to the participating parties. Those are the simplified procedure and order of foreign currency operations, charging of a number of expenses on the prime costs and reduced taxation rates.

The last point I consider in this chapter is the financing of purchase of major production means, where I discuss the specificity of the Russian market with regard to such financing. I compare such financing ways, as bank crediting and leasing.

Chapter number four is the case study of a concrete Russian – Norwegian project under the contract of financial leasing. Where the vessel delivered to lease is a pelagic purse seiner. I give the main data on the vessel, financing of the vessel purchase. Further on I define the major significant items of the leasing contract and give description of the situation the project is now in with planning for the summer 2002. I further give specification of operation expenses carried annually by the vessel. And compare such expenses with the ones carried by a Norwegian purse seiner.

6. RESULTS AND RECOMMENDATIONS

FOR FUTURE RESEARCH

The intention of this research was to study the financial leasing arrangement in Russia with application to fishing vessels. The arrangement, which is extremely popular nowadays and the number of such financial international leasing contracts becomes more numerous. Leasing has become the main type of vessel purchase from abroad in Russia under the present economic situation. The most controversial issue here seems to be the profitability of such financial arrangement for the Russian partner. So the idea of examining the theory and application practice of leasing in Russia looked very interesting.

The conclusion to which I come is quite controversial in nature. It is quite obvious that such attraction of investments is very tempting. The Russian government is in no condition to subsidise the industry and the companies have to find their own sources of investments to acquire more efficient and better equipped vessels.

The financial leasing arrangement can be profitable for the Russian companies. It depends upon the amount of operation expenses, which can be reduced in one way or another, but mostly on the ability of a concrete company to get quota for their fishing vessels.

This type of financing the vessel purchase is really a solution for the problem the Russian fisheries have faced, especially taking into consideration the fact that hardly any other types have shown such success. But it should be said that such solution can be only a temporary one and can help the companies to survive.

Though bringing income, it is difficult to speak about high incomes as payment of leasing deprives the Lessee of the opportunity to accumulate the cash flow. As practice shows many Russian companies become involved into a debt circle. The recently introduced system of auction quota distribution makes them address themselves to the foreign investors who actually become the real buyers, thus increasing their debts. Moreover such mechanism is an indirect way of selling resources abroad. That is realised by parties on both sides of the boarder.

I did not take into consideration the possibility of force- majeure situation but such situation is very likely to happen when the country does not have sufficient economic and political stability. So in case default situation the company will have nothing left, no production mean and a considerable loss of money.

In spite of all the drawbacks this is a real successful, though temporary solution for the problem.

Stabilisation of the economic situation in Russia and consequently establishment of a stable and developed banking system can give an opportunity to chose to the Russian fishery sector to chose between a long term bank credit in a Russian bank and the financial leasing arrangement.

The work field on this topic is very large and leaves a lot unanswered questions. To my mind, it would be interesting to study the impact of the leasing arrangement on the internal market of fishery products, as it is claimed that fish caught by such leased vessels goes directly to foreign market, making poor the internal market.

Another issue I consider to be worth studying is actually the result itself or the goal of the financial lease, that is purchase of the vessel and the fait of the vessel after all the leasing payments are done and she becomes a property of the Russian company.

ENCLOSURE 1

**Comparison of leasing, crediting and
usage of own capital in terms of purchase of main production means by
an enterprise from the lessee's point of view.**

LEASING	CREDIT	OWN CAPITAL
1. The way of property purchase.	1. The way of property purchase.	1. The way of property purchase.
2. Purchase of the article is not required.	2. Obligatory purchase of article	2. Obligatory purchase of article
3. Investment of large capital is not required.	3. Investment of large capital is not required.	3. Immediate investment of large capital; as a result - low competitiveness.
4. Property and profit tax exemptions	4. No tax exemptions.	4. No tax exemptions.
5. The possibility of building a soft payment schedule under the contract, to regulate the cost value, and profit as a result.	5. The payment schedule is not primarily related to the cost value and profit (except for the interest)	5. The influence on the cost value and profit is only through property depreciation
6. The possibility of finance acquiring without presenting any guarantees in the form of property pledge or guarantee from a third person.	6. Obligatory property pledge or guarantee from a third person.	6. No guarantees required.
7. The possibility of getting more beneficial delivery conditions for account of the lessor's experience.	7. The necessity of direct negotiations with the supplier for getting more beneficial delivery conditions.	7. The necessity of direct negotiations with the supplier for getting more beneficial delivery conditions.

ENCLOSURE 2

**Comparison of operation expenses for pelagic purse seiners with
the average length 59.74 meter, Russian and Norwegian vessel**

Specification	Russian vessel	Norwegian vessel
<i>Operation revenue</i>	36363636.00	25176774.00
<i>Operation expenses</i>	Russian vessel	Norwegian vessel
Fuel	3652608.00	2288973.00
Fishing gear (maintenance)	1228500.00	1306608.00
Vessel maintenance	3240000.00	3224337.00
Packing materials	1300000.00	457722.00
Product fee	0.00	819789.00
Social expenses	0.00	213271.00
Insurance of the vessel	902650.00	787033.00
Sundry expenses	3430000.00	2074123.00
Food provision expenses	1458000.00	294974.00
Wages to the crew	7636363.56	7861151.00
Calulated depreciation	5200000.00	1826168.00
Sales fee	1818181.80	0.00
Agency fee	1454545.44	0.00
Expenses total	31320848.80	21154149.00
<i>Operation result</i>	<i>5042787.20</i>	<i>4022625.00</i>

The amount of days at sea:	232	232
The amount of operation days:	273	273
Crew quantity:	27	18

Lønnsomhetsundersøkelser for helårsdrevne fiskefartøy 8 meter største lengde og over, 2000,
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