In this guide we provide an overview of the employee-related issues which should be taken into consideration upon entering the Russian market.

The focus on employee matters in Russia is two-fold. On the one hand, the Russian authorities pay careful attention to immigration issues, organization of labor and structure of employee compensation packages, and impose penalties for non-compliance established by legislation.

On the other hand, the problem of getting the best out of personnel is now being increasingly recognized as a key success factor for business development and growth.

In this guide we cover both points mentioned above, which are key to successful business operation in Russia.

We believe that an understanding of the key issues around Russian immigration, labor and tax legislation will help you make your operations in Russia prosperous and successful.
1. Employment

In the years leading up to the onset of the global economic crisis in 2008, the Russian labor market had become to a large extent an employee’s market. The lack of qualified employees in some industries had become critical and sharpened competition for the most experienced and qualified human resources among employers. Larger compensation packages and more elaborate benefits were offered to key employees. This situation had its roots in various factors. The decrease in the Russian population, coupled with a certain loss of quality in education programs, as well as the steady economic growth supporting the growth of small and medium businesses, resulted in a further decrease in qualified labor in Moscow and other regions.

However, since 2008 the world economic crisis has changed this trend significantly. Many businesses in these challenging times began focusing on cost cutting and optimization of cash flows, which has been fostering careful planning of personnel costs. Many companies faced a necessity to reduce headcount or introduce part-time working hours, as well as pare back benefits and training. It is worth mentioning that any cost-cutting measures which affect the human resources of the company should be carefully planned in advance and properly documented, as violation of certain procedures established by Russian law may result in a negative outcome for the company.

1.1. Russian labor legislation

The Russian Labor Code forms the basis of labor relations in Russia, establishing procedures for hiring and dismissal of employees, as well as regulations concerning working time, vacations, business trips, salary payment, and so on. The Labor Code continues to be very protective of employees. If a conflict arises, an employee would be able to demand the application of any relevant protective provisions of the Labor Code, which will prevail over any conflicting provision of the individual’s labor contract. Moreover, the Labor Code establishes certain guarantees for some categories of employees which should be fulfilled by employers even if they are not specifically mentioned in the employment agreements.

Russian labor law applies to all employees working on the territory of Russia regardless of their nationality or country of incorporation of their employer. In other words, Russian labor law covers not only Russian citizens, but also expatriates working in Russia, regardless of where employment contracts were concluded. It is worth mentioning that Russian immigration rules and their practical administration, which have become increasingly complex, oblige employers to conclude local employment agreements with expatriates in order to obtain work permits.

Standard daily working hours are determined by the employer. The generally accepted standard is a five-day working week with an eight-hour working day. Thus, the standard week is 40 working hours. Overtime work should not exceed four hours within two consecutive days and 120 hours within a year. Under Russian labor law, overtime work may only be required in exceptional cases with the written agreement of the employee. Certain employees may also work under an irregular working regime, in which case they must be compensated for this by at least three calendar days of additional paid vacation per year.

Employees must be granted at least 28 calendar (as opposed to working) days of paid vacation a year. According to Russian labor law, the monthly salary paid to an individual cannot be less than the minimum salary established by the regional agreement at the level of a constituent entity of Russia or, in the absence of such an agreement, by federal legislation.

As of 1 June 2011 the minimum monthly salary established by the federal legislation amounted to RUB 4,611 (approx. USD 160). The minimum monthly salary in Moscow is set at RUB 11,300 (approx. USD 355) as of 1 January 2012. This amount is periodically adjusted for inflation. The minimum salary is far below salaries offered in the market, as it is actually more a factor for the calculation of state social compensatory payments, rather than a real minimum subsistence level.

In addition to the conclusion of a written labor contract with an employee (which should be in Russian or bilingual), the recruitment must be documented internally by the employer through the issuance of a formal appointment order stating the name, position, and date of appointment of the new employee. Legislatively introduced guarantees for the employees and rights of the employees may not be contractually limited. Under the labor law, it is normal for an employment contract to be for an
indeterminate term, since fixed-term employment contracts can only be used in limited cases.

An employer hiring an employee may wish to establish a probation period, which can be of a maximum duration of three months for all employees except for a general director and chief accountant, for whom the probation period may be up to six months.

According to Russian labor law requirements each employer is obliged to maintain a large number of HR documents aimed at documenting various HR events (hiring, vacation, business trips, termination, etc.). These documents are subject to authorities’ audits. Russian labor legislation also prescribes maintenance of a number of obligatory internal HR policies. Our HR consultants will assist you with preparation of any individual HR documents and development of company-wide documents.

Our HR consultants will also assist you with adjustment of international HR policies to the Russian market practice and legal requirements. We will help you identify and mitigate the risks of breaching applicable labor regulations which may arise when implementing international policies.

Upon conclusion of employment agreements with Russian employees, it is necessary to request their insurance certificate for State Pension Insurance. The personal number indicated in the certificate plays an important role for state pension accruals, as the Pension Fund allocates pension contributions to this account. If an employee does not have such a certificate, it is the employer’s obligation to submit an application to the Pension Fund and obtain the certificate. Foreign citizens staying in Russia based on work visas are not covered by the Russian pension system and do not need insurance certificates.

Termination

An employee may terminate the employment relationship at any time with two weeks prior written notice to the employer.

Termination by the employer is restricted to an exhaustive list of reasons. Termination without a specific, expressly stated and valid reason is null and void. A termination may also be considered invalid because the employer has not complied with the procedure for termination set out by the labor law. A competent court may reinstate an employee illegally dismissed in his/her former position with payment of salary with interest for the period of exclusion from the workplace, and possibly levy further amounts for moral damages as well.

Certain limited reasons entitle the employer to dismiss the employee without a notice period or any severance pay. In other cases, the employee is entitled to a notice period and severance pay, depending upon the circumstances of the employment and the termination.

Various post-employment restrictive covenants (confidentiality, non-competition, non-dealing with customers/suppliers, non-solicitation of remaining employees, etc.) are hard or impossible to enforce.

Sanctions for non-compliance

Currently the fine for non-compliance with labor legislation imposed on responsible executives (i.e. General Director, Chief Accountant, HR Director) amounts to RUB 1,000–5,000 (approx. USD 30–160). With regards to legal entities the fine amounts to RUB 30,000–50,000 (approx. USD 1,000–1,700). If a violation leads to salary underpayment, an employer is likely to be obliged to repay the underpaid amount plus potentially the interest for each day of delay.

An alternative sanction may be applied, which is the suspension of the activity of the organization for up to 90 days (though in practice this happens extremely rarely). Violation of labor laws and labor protection laws by a person who has been administratively penalized for a similar administrative offense in the past may entail disqualification for a period from one to three years. Cases of suspension of a company’s activity and disqualification of company executives may be enforced only through a court decision.

Labor law in Russia is complicated and contains a lot of rules and conditions which are obligatory for all the employers and companies operating in Russia. Ernst & Young provides the full range of consulting services with respect to the proper establishment of labor relations in Russia.

Remuneration

Under Russian labor law, an employer has significant discretion regarding the level of compensation and the methods through which this is delivered.

The development of the Russian labor market has brought it closer to the labor markets of Western European countries, and human resources management practices are approaching global best practices. More companies benchmark their pay levels against the market using the results of compensation and benefits surveys, and take into consideration market practice when developing benefits packages. Competition for qualified personnel also forces employers to provide better opportunities for professional and career growth.

On an annual basis, Ernst & Young conducts numerous compensation and benefits surveys which are focused on various industries and job categories of employees, allowing us to present our clients with accurate and comprehensive data on salary levels, benefits, social programs and HR policies in various segments of the labor market in Moscow, other regions of Russia and throughout the CIS.

It should specifically be noted that care should be taken before implementing any global stock option plans or other equity-based compensation plans for Russian employees, as the legislative framework for such programs is limited and the accounting, tax, labor law, and currency control implications are complex.
1.2. Immigration

If a company intends to use foreign personnel in Russia, it should brace itself to face the complication of the Russian immigration regime.

As a prerequisite to starting many work permit application processes, companies should be registered with the local employment service, and in any event should be observing the employment law requirements to submit monthly information on all current vacancies (including positions intended for both Russian and foreign citizens).

If the employer is not in compliance with the above, there is a high risk that further applications for work permits for expatriate employees will be rejected by the authorities.

Highly Qualified Specialists (HQS)

Starting from 1 July 2010 “Highly Qualified Specialist” was introduced as a new term in Russian immigration legislation. An HQS is a foreign citizen earning not less than 2,000,000 rubles per annum from an employer in Russia.

A simplified quota-free one-step application procedure for work permits and visas is established for HQS intending to work in Russia for Russian legal entities or branches of foreign legal entities (but not representative offices). Such HQS may apply for work permits and work visas valid for three years with the opportunity to extend their validity for subsequent three-year periods, in comparison with one-year work permits and visas received by other foreigners.

Companies have to register HQS with the tax authorities and provide these individuals with private medical insurance. The immigration legislation also establishes a requirement for employers engaging HQS to submit quarterly reports to the immigration authorities on salaries/remuneration paid to HQS, on cases of termination of employment agreements with HQS and on cases of provision of unpaid leaves exceeding one month.

Submission of foreign labor needs forecasts (quota applications)

Companies must report annually, before May 1, the number of foreign employees (including both actual employees and civil/legal contractors, but excluding HQS) they anticipate needing to engage in the following calendar year (including CIS citizens), including the precise positions and citizenships of those anticipated foreign employees. This effectively constitutes an application for quota, whereby quota must first be obtained before it is possible to launch a work permit application for any foreigner who is not a HQS or to occupy a limited list of specific quota-free job positions. It is in theory possible to apply for quota at other times of the year, although approval may be harder to obtain for such “off-cycle” quota applications.

Work permits

In accordance with the Russian immigration legislation, all expatriates working in Russia (except for some specific categories) must hold valid work permits. A company planning to engage expatriates to work in Russia should assume the responsibility for the work permit application process and take into consideration that, with the possible exception of HQS (see above), it will be time and resource consuming, often confusing and contrary, and not without risk, but should note that most organizations do, in due course, manage to achieve something workable.

Note that most CIS citizens apply for their own work permits under a simplified procedure. The further discussion below focuses on the longer procedure applicable for citizens who are from other countries and who are not HQS.

The application process (possible only after any necessary quota has been obtained by the employer) consists of three key steps, whereby an employer first submits to the Employment Center the latest information on job vacancies foreseen for expatriate employees. At the second stage the employer applies to the Migration Service for a permit to engage foreign labor (corporate permit). And finally, once a corporate permit is issued, an individual work permit should be applied for.

Work visa

Once the individual’s work permit is issued, the employer should arrange for a work visa invitation. A single-entry work visa is initially issued by the Russian Consulate abroad and is valid for up to three months. Once the foreign individual arrives in Russia under this single-entry work visa, it should be replaced by a multiple-entry visa valid for the term of an individual’s work permit, but not more than one year.

In the case of accredited representative offices, it may be possible to apply for work visas on a schedule independent of the work permit process.

Notifications

Companies are required to notify various state authorities regarding the engagement of foreign employees. The tax authorities additionally monitor compliance with the notification procedures and often request copies of such notifications when accepting corporate reporting documents, including payroll-related tax reporting.

Enrollment/De-enrollment

The enrollment procedure involves the responsible hosting party notifying the respective territorial office of the Federal Migration Service within three business days of a foreign citizen’s arrival at the place of his/her stay in the Russian Federation, or arrival at a new location in Russia.
Russia where this individual will stay for three days or more.

A de-enrollment must be completed by the responsible hosting party within two calendar days of a foreign individual’s departure from Russia.

The responsible hosting party will generally be the hotel if the foreign citizen is staying at a hotel, or otherwise the employer.

Sanctions for non-compliance with the immigration legislation

Russian legislation envisages severe sanctions for companies, their executives and foreign citizens for non-compliance with the immigration legislation. The upper end of financial sanctions applied to a company can reach RUB 800,000 (per foreign individual per violation); the worst case scenario can include deportation of the individual from the country and/or suspension of the employer’s business activities for up to 2 years. Financial sanctions and even deportations have been increasingly applied.

Ernst & Young offers a full package of immigration services for proper start and ongoing development of companies using foreign personnel in various regions of Russia and throughout the CIS.

2. Personal income tax

Russia currently has a flat 13% personal income tax rate (for tax residents), one of the lowest personal tax rates of any non-tax-haven country in the world. The low rate is, however, somewhat offset by continuing difficulties faced by taxpayers in dealing with the tax administration system: even paying tax can be logistically challenging in Russia.

2.1. Tax rules

Who is liable?

Payers of Russian individual income tax are defined as tax residents of Russia and non-resident individuals who receive income from Russian sources. The personal income tax rules are the same for Russian and foreign nationals.

Definition of resident

For tax purposes, individuals are considered resident if they spend not less than 183 days in Russia in a period of 12 consecutive months. At the moment of writing, the Ministry of Finance and the Federal Tax Service were continuing to promulgate a view that an individual must also spend at least 183 days in Russia in a calendar year to be considered tax resident, and this is followed in practice.

As regards counting of arrival/departure days for tax residency determination purposes, the current approach of the Ministry of Finance appears to be that any part day in Russia is viewed as present. At the same time, the methodology for days count is not defined in the law and previously the Ministry of Finance considered that days of arrival are not to be counted as days in Russia, whereas days of departure are counted as full days in Russia. We recommend seeking additional advice in case of any disputable situation with respect to the determination of Russian tax residency status of an individual.

Accordingly, non-residents are those individuals who do not meet the aforementioned test.

Object of taxation

Russian tax residents are taxed in Russia on their worldwide income.

Individuals who are not tax residents in Russia are taxed on their Russian source income, which includes but is not limited to the following:

- Remuneration for the performance of employment duties, services, and actions in Russia (regardless of where paid)
- Dividends and interest paid by a Russian organization
- Insurance payments made by a Russian organization
- Income from the sale of property in Russia (e.g., immovable property, participation interests in the charter capital of organizations, etc.) which has been owned by the taxpayer for less than three years and income from the sale of securities regardless of ownership period.
There are currently five flat rates of 9%, 13%, 15%, 30%, and 35%, applicable to different types of income.

- Dividend income and certain other less common forms of investment income (both Russian and non-Russian source) received by residents: 9%
- All income received by tax-resident individuals for which another rate is not specified, for example, salary and other earned income; also earnings received by a Highly Qualified Specialist as defined by immigration rules, regardless of tax residency status: 13%
- Dividends received by non-residents: 15%
- All taxable income (other than dividends) received by individuals who are not tax residents in Russia and who are not foreign citizens qualifying as Highly Qualified Specialists under immigration rules: 30%
- Interest income on bank deposits in excess of the refinancing rate of the Central Bank of the Russian Federation plus 5% on ruble deposits (or exceeding 9% on non-ruble deposits), certain prizes, and deemed income from certain loans extended at a rate of the lesser of 2/3 of the refinancing rate for ruble loans or 9% for loans denominated in foreign currency: 35%

Although the law stipulates self-assessment, many tax authorities continue to issue formal notifications of a taxpayer’s liability.

Under the Tax Code, a penalty of 5% per each full or partial month of delay is imposed for the late submission of a tax declaration after the established deadline. The penalty is capped at 30% and cannot be less than RUB 1,000. Criminal sanctions could also be applied in rare cases. The late payment of tax is subject to interest at a rate of 1/300 of the annual refinancing rate of the Central Bank of the Russian Federation for each day of late payment.

2.2. Tax collection procedure

Tax, for most taxpayers, is payable through withholding at source. Any individual who has received income subject to tax in Russia where the tax was not already withheld at source is obliged to file a tax return. In particular, individual filing obligations typically arise due to non-withholding in one of the following situations:

- A Russian tax resident has received income from payers outside Russia
- An individual has received Russian source income that should not be subject to withholding at source
- An individual has received Russian source income from another individual under a civil-legal contract (e.g., rental or sales agreements).

An individual may also file a tax return on a voluntary basis, even where there is no technical requirement to do so. In particular, this may be needed in order for excess withholding to be refunded in connection with certain tax deductions which cannot be granted through the payroll.

Annual tax returns are due no later than by April 30 of the year following the reporting calendar year; the corresponding tax self-assessed in the declaration must be paid no later than July 15 of said following year. Foreign nationals permanently leaving Russia are required to file a tax return one month prior to their permanent departure and pay the corresponding tax within 15 days of filing the return.

Ernst & Young has great experience in personal income tax compliance and consulting services, helping Russian and foreign individuals with personal income tax matters at each stage of the tax process.
3. Payroll

Starting from 1 January 2010 certain changes were introduced into the social security system.

Under the Russian legislation, as a general principle, Russian legal entities or branches and representative offices of foreign legal entities must pay Russian social contributions to the Pension Fund, the Social Insurance Fund and the Federal and Territorial Compulsory Medical Insurance Funds on remuneration paid to Russian citizens and foreign citizens holding residency permits, as well as social insurance contributions against accidents at work on remuneration paid to Russian and foreign citizens.

3.1. Payroll operations

Generally, under the provisions of Russian tax legislation, employers must pay the following contributions on gross payroll:

- social contributions to the Pension Fund, the Social Insurance Fund and the Federal Compulsory Medical Insurance Funds
- social insurance contributions against accidents at work and work-related diseases.

In order to fulfill its obligation as a personal income tax withholding agent and a payer of social contributions, the employer must register with the following state bodies: Tax Inspectorate, Pension Fund, Medical Insurance Fund, Social Insurance Fund and State Statistics Committee. Organizations which have branches/subdivisions in other locations within Russia (irrespective of whether such branches/subdivisions have separate balance sheets or bank accounts) must also register with the tax authorities at the location of these branches/subdivisions.

3.2. Social contributions

Starting from 1 January 2010 the unified social tax was replaced by a system of social contributions to the Pension Fund, the Social Insurance Fund and the Medical Insurance Fund (hereinafter referred to as “social contributions”).

Social contributions are paid entirely by employers (without similar charge on employees) and should be calculated and paid to each of the above-mentioned non-budgetary funds separately no later than 15th day of the following month.

Social contributions are to be accrued on the majority of payments to individuals within employment relationship and under civil-legal contracts of a service nature. Generally the base for accrual of contributions includes salary and most benefits provided to employees as well as remuneration for performance of works and (or) provision of services under civil-legal contracts. The legislation also provides a close list of payroll items which are exempt from social contributions. This list includes the majority of social allowances, several types of payments to employees of a compensatory nature, several types of material aid to employees, etc.

Social contributions should be calculated on an individual basis (i.e. separately for each individual) and the applicable rates of social contributions are dependent on the amount of cumulative annual income of each individual subject to accrual of social contributions.

In 2012 and 2013, the following rates of social contributions are established for all categories of payers (except those which are entitled to beneficial social security regime):

<table>
<thead>
<tr>
<th>Individual cumulative year-to-date income subject to social contributions</th>
<th>Up to RUR 512,000*</th>
<th>Over RUR 512,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension Fund</td>
<td>22.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Social Insurance Fund</td>
<td>2.9%</td>
<td>0</td>
</tr>
<tr>
<td>Medical Insurance Fund</td>
<td>5.1%</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>30.0%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

* This threshold limit value will be increased to the level of RUR 563,000 in the year of 2013.
The legislation also stipulates certain categories of organizations which are entitled to apply lower rates of social contributions which include, but not limited to the following:

- Small companies conducting certain specific types of economic activity
- Certain types of IT companies
- Certain types of mass media companies
- Participants of Skolkovo project
- Companies rendering engineering services
- Some others.

Historically, foreign nationals who did not hold permanent or temporary residency permit in Russia (this category covers the majority of expatriates coming to Russia for work) were exempt from social contributions. However, starting from 1 January 2012 new legislation is in force and foresees that salary payable to the above-mentioned category of expatriates should be subject to contributions to the Pension Fund (at standard rates outlined above) provided that they hold employment agreements in Russia for a period of at least six months. The only exception is made for expatriates who have a status of highly-qualified specialist in Russia (i.e. hold HQS work permit).

Information on accrued and paid social contributions should be reported by companies to the Pension Fund and the Social Insurance Fund on a quarterly basis (the reporting periods are the first quarter, six months, nine months and full calendar year). According to the current requirements, the respective types of reporting should be submitted to the authorities electronically if the number of individuals in respect of whom social contributions were paid (i.e. insured persons) exceeds 50 individuals.

Social insurance against accidents at workplace and professional diseases

The current legislation establishes another type of contributions payable to the Social Insurance Fund (in addition to those described above), which is contributions for obligatory insurance against accidents at the workplace and professional diseases (hereinafter “IAD contributions”). The IAD contributions are also payable by employers only (with no similar charge on employees) and should be accrued on the most types of payroll items. Remuneration payable to individuals performing works/rendering services under civil-legal contracts is exempt from accrual of IAD contributions.

Current rates of IAD contributions are flat, without cap and vary from 0.2% to 8.5% of gross payroll (including foreign employees’ pay), depending on the degree of “professional risk”. Each industry belongs to one of 32 classes of professional risk, and the rate is annually determined by the Social Insurance Fund for each particular company based on its activity.

The IAD contributions are due to the Social Insurance Fund no later than the day established for salary payments to the employees and should be reported to the Social Insurance Fund on a quarterly basis.
4. Does your company have any US citizens or green card holders working in senior management positions?

US citizens and residents remain taxable in the US on their worldwide income even though they may live, work and pay taxes in a foreign country.

**US Tax Implications**

The US Tax Code has several pieces of legislation aimed at mitigating the double taxation of its citizens and residents, including the foreign earned income and housing exclusions and foreign tax credits. Providing US taxpayers meet certain tests, they can elect to exclude up to $92,900 of foreign earned income and housing expenses over a base amount up to $108,000 (Moscow limit) in 2011. Taxpayers may also claim foreign tax credits for foreign taxes paid in respect of their foreign source income.

However, the implications of electing the foreign earned income and housing exclusions should be carefully considered in light of the interaction between the exclusions and foreign tax credit rules.

**Punitive US Taxes on Deferred Compensation Plans**

The US introduced significant changes to the taxation of deferred compensation for tax years beginning after 31 December 2004. Under IRC Section 409A, if a non qualified deferred compensation plan fails to satisfy specific requirements related to the timing of elections, the timing of distributions and funding, then amounts deferred under the plan for the current year and all preceding years could be included in the gross income of the US taxpayers. This income is also subject to a 20% penalty tax and interest charges.

The term nonqualified deferred compensation plan means any plan, arrangement or agreement that provides for the deferral of compensation other than a qualified employer plan (i.e., US qualified plan) and may also include certain share award plans.

**US Payroll Obligations**

US citizens and resident aliens who are working abroad for a foreign corporation are generally not subject to US social security taxes.

However, if your company qualifies as an “American employer” or is a foreign affiliate of an “American employer” and makes certain elections, then US social security taxes may be due for your US citizen and resident alien employees.

**US Tax Assistance**

Many employers offer US tax assistance to their senior executives.

Ernst & Young may assist your US citizen and resident alien executives with their US tax matters, including tax advice, tax planning and preparation of US tax returns.

Ernst & Young may also advise on the US tax implications of your company’s deferred compensation or share award plans.
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For more information on Russian labor and immigration legislation, payroll and income tax issues, please contact your local Ernst & Young Human Capital professional, or in Russia:

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