

Legal Alert

Special investment contracts (SICs) - an import replacement and localization instrument - new advantages of SICs

EY's Russian Tax & Law practice was named **a leading Tax firm in Russia** in "World Tax 2015," an annual guide published by the *International Tax Review*.

Background

As part of the campaign to support Russian industry, certain types of light industry and machinery output of foreign origin were banned from 1 January 2015 from being purchased via state and municipal procurement (Government Decrees 656 and 791)¹. Depending on the case, in order to be allowed to participate in a public tender, one of the following documents has to be submitted:

- ▶ Confirmation that the industrial products were manufactured in Russia (an expert opinion issued by the Ministry of Industry and Trade (Minpromtorg))²,
- ▶ Confirmation that the products are classified as having no analogues produced in Russia / confirmation that such products are not produced in Russia, issued by Minpromtorg,

¹ Bans on the procurement of certain light industry products and similar bans (in relation to foreign software), as well as restrictions on procurement (for medical goods), together with bans and restrictions on participating in public defense industry tenders, each have their own particular features and are not discussed in detail below.

² The criteria for classifying industrial products as produced in Russia or as having no analogues in Russia, as well as the list of operations that have to be completed in full under the SIC, are outlined in Government Decree No. 719 of 17 July 2015.

- ▶ Confirmation that the products originate from one of the member states of the Eurasian Economic Union (a certificate of origin).

What is a SIC?

The special investment contract as an instrument to support Russian industry is envisaged in Federal Law On Industrial Policy No. 488-FZ of 31 December 2014. The rules for concluding SICs are set in Government Decree No. 708 of 16 July 2015.

A special investment contract is an agreement between an investor and the Russian Federation (or one of its regions), which sets forth:

- ▶ the investor's obligations to establish or upgrade the production of industrial products / to implement the best available technologies within a fixed term, and
- ▶ obligations of the RF or the given region to guarantee a stable tax and regulatory environment, and to provide incentives and support.

The duration of a SIC shall equal the time required for the project to turn profitable, plus five years, but in any event no longer than 10 years.

The minimum financing threshold to establish a federal SIC (i.e. concluded with the RF) is RUB 759m. In order to obtain certain incentives and benefits a higher investment may be required.

What has changed?

The new rules have been in place for one year, during which over 10 applications for SICs have been filed. However, no contracts had been concluded prior to the start of SPIEF 2016. June-July 2016 saw the signing of the first SICs (e.g. CLAAS and Mazda-Sollers). At the same time new rules were adopted, aimed at making SICs more attractive to investors, in particular:

- ▶ starting from 1 July 2016 it is sufficient to attach a copy of a signed SIC in order for machinery products of a foreign manufacturer to qualify for procurement,

- ▶ starting from 1 September 2016 a state customer will be able to procure products manufactured based on a SIC without holding a competitive tender, provided that the product supplier is included in the register of sole suppliers,
- ▶ the Tax Code has been amended to provide tax benefits for tax paying signatories of SICs (Federal Law No. 144-FZ of 23 May 2016).

Advantages of a SIC

In the current situation of ongoing sanctions and the policy favoring import substitution and localization, signing a SIC may in a number of cases be the most effective and profitable way for an investor to retain a share of the Russian market while complying with Russian localization requirements. The key advantages of concluding a SIC include:

- ▶ it is sufficient to attach a *copy* of a SIC contract verified by the CEO of the investing company in order to be admitted to a procurement tender for machinery products (i.e. the actual investing of funds and compliance with the SIC conditions etc. are not checked). In other cases, providing a SIC speeds up the process of obtaining confirmation from Minpromtorg that the goods were produced in Russia,
- ▶ starting from 1 September 2016 a customer under Federal Law 44-FZ will be able to procure products manufactured under a SIC without holding a competitive tender procedure provided that the supplier has been included in the register of sole suppliers,
- ▶ the possibility to include the full range of available state benefits and incentives in the SIC (subsidies to finance the establishment of production infrastructure, grants and loans from the industry development fund, regional benefits),
- ▶ potential corporate tax incentives (a reduction in the federal tax rate to 0% and others),

- ▶ signing the contract makes it possible to obtain a state guarantee of a stable regulatory environment (a similar guarantee is available through PPP, which is a more complex process) for the duration of the contract,
- ▶ a SIC's duration is longer than the validity period of the Minpromtorg confirmation (10 years vs. 3 years),
- ▶ admission to state procurement under Federal Law 44-FZ and priority ahead of foreign products in procurement procedures under Federal Law 223-FZ.

Who is the target?

Foreign importers / assemblers / partial cycle-producers with foreign ownership, if most of their client portfolio consists of state contracts or private Russian companies fulfilling state orders, and if they provide goods or services prohibited from state procurement.

Prohibited products and services include:

Machinery products (for the full list see Government Decree 656)

- ▶ Tractors
- ▶ Bulldozers
- ▶ Excavators
- ▶ Dump trucks
- ▶ Mobile cranes
- ▶ Loaders
- ▶ Emergency vehicles (ambulances, fire engines, rescue vehicles)
- ▶ Special transport vehicles (for transporting oil products, liquid foods, cash, food, etc.)
- ▶ Containers
- ▶ Buses
- ▶ Trolleybuses
- ▶ Tram carriages
- ▶ Trailers.

Exceptions are made for ambulances and new diesel and spark-plug ignition vehicles, provided they were produced by either

companies operating under the "industrial assembly" regime in 2010 or importers of automotive components based on agreements with the Ministry of Economic Development or in special economic zones.

Light industrial products (for the full list see Government Decree 791)

- ▶ Textiles
- ▶ Textile goods (clothes, underwear, overalls)
- ▶ Carpets and textile covers
- ▶ Footwear
- ▶ Leather goods
- ▶ Suitcases and bags
- ▶ Rubber goods (22.19.73 OK (all-Russian classifier) 034-2014 (KPES (Classification of Product by Economic Activities) 2008))
- ▶ Other plastic goods (22.29.29)
- ▶ Hiring of textile / shoes / clothes.

How EY can help

EY offers integrated support including

- ▶ Advising on the optimal option for production localization in Russia, taking into account the client's background
- ▶ Preparing and explaining the concept of the chosen option (e.g. conclusion of a SIC or obtaining confirmation from Minpromtorg), as well as accompanying the client when they discuss the project's concept with the state authorities
- ▶ Preparing the SIC application (in full or partially), including:
 - ▶ Analyzing and selecting state support measures and incentives to be included in the SIC, assistance with securing them
 - ▶ Preparing a business plan and financial model for the project
 - ▶ Calculating tax receipts from the project
 - ▶ Drafting non-standard clauses of the SIC

- ▶ Assembling and submitting the set of documents for the SIC application
- ▶ Supporting negotiations with the cross-ministry commission on SIC approval and negotiating required changes to the SIC clauses
- ▶ Providing support until the closing of the SIC
- ▶ Providing other legal, tax and financial advice on SIC-related issues.

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