

## A REVIEW OF TAXATION REGULATORY DOCUMENTS ISSUED IN MAY 2013 L. Anisimova

*In the period of 2013 under review, President Putin presented a Budget Message in which he outlined the guidelines for the state monetary policy in years to come, and the Taxation Policy Guidelines for 2014–2016 adopted by the Russian Government were published. Both documents showed higher quality of the economic decision-making procedure at the top levels of power and a visible refusal to present a standard set of populist measures as economic policy and apply the recent practice of promoting economic development though nothing by tax allowances and exemptions for certain categories of manufacturers amid further acceleration of state socio-economic obligations without providing any reference to sources of financing thereof.*

An international economic forum was held in St. Petersburg on June 20 thru 22, 2013. The forum was dedicated to challenges faced in the development of global economy and the role of the middle class. The forum was attended by approximately 5,000 domestic and foreign participants, namely entrepreneurs and businessmen, top-level civil servants of Russia, international experts.

President Putin's Budget Message outlined a new trend in the economic policy – financial functionalism. More specific rules for balancing government revenues and expenditures focused on providing support to businesses and creating comfortable business conditions were proposed:

1) stop increasing tax burden on manufacturers, while it was explicitly stated that social expenditures may rise with economic growth only;

2) fix a premium rate of 30%<sup>1</sup> or less to state extrabudgetary funds for a few years to come, recover premium exemption for individual entrepreneurs;

3) complete the pension reform until the end of 2013<sup>2</sup>, covering the deficit of the Pension Fund of Russia (PFR) partially at the expense of National Wealth Fund (NWF)<sup>3</sup>;

4) a provision was made to use the NWF to finance self-supporting infrastructural projects<sup>4</sup> apart from covering PFR deficit;

5) a proposal was made to defer national defense expenditures until a later time and incur them subject to specific programs<sup>5</sup>;

6) combating tax evasion was proclaimed as a priority task (optimization of the tax burden on private businesses by transferring capital to offshore)<sup>6</sup>;

7) a proposal was made to simplify fiscal accounting, narrow the gap between fiscal accounting and accounting;

8) governors and mayors were given an order to publish their budget so that citizen can see how efficiently they spend public resources<sup>7</sup>. Financial federalism is planned to be strengthened: "Expenditures of the constituent territories of the Russian Federation must be secured as far as possible by their own sources of income. For this purpose, all decisions made must be worked out in advance and financially secured. Supplementary financial aid to the constituent territories of the Russian Federation must be combined with the development of their economy at their own account"<sup>8</sup>. The foregoing measures are economically viable and deserve support.

It should be noted that Russia has not avoided many blunders which are normally faced by other countries amid a financial crisis<sup>9</sup>. Apart from low level of public debt Russia has managed to create a relatively sustainable system of internal protection of the banking sector from financial shocks. The following is intended.

Under the applicable legislation banks must have provisions with the Bank of Russia, which are calculated according to established standards, funded through the accounts of the Bank of Russia Cash Settlement Center (BR CSC) and then used for commercial banks'

7 "The President will set key economic objectives in his annual message to the Federal Assembly", *izvestia.ru* dated 13.06.2013.

8 C. 8 of the Presidential Budget Message dated 13.06.2013.

9 O. Plotonova, "G20 leaders are about to refuse to provide banks with systemic state support. G20 countries will no longer save their banks, even the largest ones, – this is what they are going warn about after the September meeting in St. Petersburg", *vedomosti.ru* dated 11.06.2013.

According to Deputy Minister of Finance S. Storchak, G20 leaders will make a special statement in St. Petersburg: "Nobody is going to use national budgets to save private financial institutions who issue subsidiary loans to insecure borrowers and accumulate bad assets and afterwards, through their influence in national economies, apply to the government for incredible amounts of financial support".

1 N. Raibman. "Putin orders to retain a premium rate of 30%", *vedomosti.ru* dated 13.06.2013.

2 C. 4 of the Presidential Budget Message dated 13.06.2013.

3 It is not clear, however, how the deficit is planned to be covered amid low oil prices, in which case the NWF might rapidly run out of money due to the current deficit.

4 C. 5 of the Presidential Budget Message dated 13.06.2013.

5 C. 2 of the Presidential Budget Message dated 13.06.2013.

6 C. 7 of the Presidential Budget Message dated 13.06.2013.

current operations<sup>1</sup>. For this purpose, Russia's taxation system allows banks not only to book provisions for impairment of loan receivables and their equivalent to tax base reduction, but also compensate for losses from outstanding interest on such loans by easing tax obligations. If a bank finds itself in a severe financial hardship, in addition to payments for insured retail deposits through the compulsory deposit insurance fund in case of bankruptcy or financial rehabilitation of the bank, the Bank of Russia would compensate the trustee or temporary manager (represented by the State Corporation Deposit Insurance Agency (DIA) in both cases) for the previously built up reserves in order to repay bank's obligations to other creditors, as well as impose (in case of financial rehabilitation) a special monitoring regime which provides for preferences in observation of compulsory bank standards during financial rehabilitation so that the bank can gather momentum. Therefore, the banking system itself provides for a recovery mechanism designed for banks facing temporary hardships or bankruptcy of non-viable banks with the use of protective schemes for making reserves on accounts with the Central Bank and insurance of retail deposits in order to minimize the effect of bank insolvency on sustainability of the banking system and reduce losses for bank's customers. DIA's effectiveness is monitored by the Accounts Chamber of the Russian Federation. We believe that these measures are sufficient, provided that efficient banking supervision is in place.

Therefore, it is the recently initiated State Duma's proposals to exempt bank capitalized profit from taxation<sup>2</sup> that are alarming. The fact is that profit is not an absolute indicator of the effectiveness of an organization, especially when it comes to finances. Market value of financial assets depends on current market conditions, foreign currency exchange rates, inflation factors. Tax-exempted capitalization of profits generated from fluctuations of currency exchange or inflation rates would lead to economically unreasonable imbalance between budget revenues (a decrease) and expenditures (which would be paid at market prices, i.e. subject to inflation rate and current exchange rate). Like in the 1990s (when the difference in exchange rate was not subject to profit tax), banks will earn basically from the difference in exchange rate. One should expect more active application of "under-the-table"

payroll schemes to minimize officially reported salaries (cost reduction) and make payments as different types of bonus from after-tax profit, revival of note-based payroll schemes, non-deliverable swaps, etc. Any profit tax relief means that such profit is automatically granted the "after-tax profit" status, i.e. becomes a part of its equity capital. In a free market, any organization is entitled to dispose of their equity capital at it thinks fit, because it totally owns this capital which may not be subject to any restrictions when it comes to transfers to a tax haven. In addition, tax exemption for capitalized profit will create unreasonable advantages for banks over other manufacturers, thereby breaching the fair market competition principle.

Russia's Government approved the *Guidelines of Fiscal Policy in the Russian Federation for 2014 and the Planning Period of 2015 and 2016* on May 30, 2013. The Government highlighted the need to retain competitive power of the Russian fiscal system vs. fiscal systems in other countries involved in the battle for investments in the global market and provide taxpayers in good faith with as comfortable as possible tax administration procedures. No significant changes are planned in the existing fiscal system in years to come, except for revision of real estate excises and taxes.

In our opinion, however, some of the measures proposed in the Guidelines need further refining which is likely to take place at State Duma commissions and committees as part of the consideration of the draft federal budget for 2014–2016.

**1. Personal income tax.** Personal income tax allows for measures of support concerning socially important personal income tax relieves. No progressive personal income tax is planned to be introduced. A proposal was made to allow tax exemptions to parents who adopt a parentless child, including a disabled child; streamline the list of incomes and payments to be exempted from personal income tax, in particular grants, compensation payments; a proposal was made to exempt from taxation cash aid and gifts to veterans and disabled persons, as well as widows of servicemen participated in the WWII, the Soviet-Japanese War, former prisoners of Nazi concentration camps, prisons and ghettos, as well as former under-age prisoners of concentration camps, ghettos and other detention facilities established by Nazis and their allies during the WWII.

The principle of a marginal fixed property-related tax relief of Rb 2m per person is envisaged for personal income tax in case of purchase of personal residence irrespective of the number of property items (units in purchased property items). In other words, a citizen may use his/her unrealized deduction entitlement when he/she buys property items in the future.

1 See the Provision on the procedure for building up provisions for losses approved by the Central Bank of Russia dated 20.03.2006, No. 283-P (concerning loan receivables and their equivalent for taxation purposes) and the Provision on the procedure for building up provisions for losses at credit institutions (concerning devaluation of other assets).

2 A. Aleksandrovskikh, T. Shirmanova, "Banks will receive Rb 177bn as presentation", *izvestia.ru* dated 30.05.2013.

The Russia's Government believes that personal investments in real estate (in the context of property exemption) should not allow for more benefits than financial investments and investments in listed securities, because real estate sale exemptions can unreasonably discount cash from stock market. Regrettably, Government's explanations on the reasons for the proposed exemption from personal income tax on income generated from securities, placement of funds on bank accounts, and other financial operations are quite controversial.

It should be recalled that income subject to personal income tax comprises two radically different groups, namely personal income from business activities and other personal income. The introduction of articles concerning taxation of income from securities operations and interest into the personal income tax chapter was intended to equal the terms of taxation of certain types of business transactions irrespective of organizational form of such business activity carried by an individual – he/she (individual) may open and close stock market deals on his/her own account without having to register as entrepreneur, or separate a part of his/her property – make a contribution to legal entity's capital in order to play as professional in the market and restrict to the amount of such contribution his/her property liability under transactions.

When the Government speaks about inadequate tax burden upon trade in immovable property and stock market instruments, it confuses business income and other personal income. Trade in real property is to be regarded as type of business activity: in this case, an individual must register as self-employed entrepreneur or set up a company (legal entity), because investments are intended to generate income. Such investments in real estate for the purpose of further reselling have nothing to do with property exemption relating to sale of personal residence, country house, etc. Any person needs personal property as much as food products, water, some need books, others pay for gas, etc, but such expenses are not personal expenses and can't reduce the personal income tax base. Various types of such expenses include personal residence, personal property which are not to be confused with investments. Therefore, an allowance as property-related personal income tax deduction is granted for these large property items which are required for normal human life.

By placing his/her idle funds in the stock market or bank, an individual conducts business activity aimed at profit generation, and such an activity is to be taxable under the rules which apply to self-employed entrepreneur or legal entity. Stock market instruments have nothing to do with individual's personal property. It is,

therefore, economically wrong to link tax burden level on stock exchange operations with property-related tax deduction on sale of personal property (residence).

2. *Profit tax.* The Guidelines retain the proposal to introduce a preferential tax regime for interest on corporate Eurobonds (qualified as "crucial decision in the field of taxation", see the text of the Guidelines) against which we spoke in our previous review. Russia's Government brought forward the following argument as rationale: "Account should be taken on the need to create incentives for the development of Russian financial center, an element of which is an opportunity for direct purchase of Russian corporate bonds by foreign organizations subject to mandatory holding on nominal holder's accounts opened by largest international depository and clearing systems with the Russian central depository". It should be noted that this fails to comply with the decisions made by G20 leaders at their meeting in Lough Erne (Northern Ireland) in June 2013: "The OECD suggested that financial regulators and automatic data exchange should cover not only personal dividends and interest income (e.g., as they do in the European Union), but also chains of fly-by-night companies, trusts and other entities which can "conceal" both assets and related revenues. 'Income concealing' bearer shares as well as nominal shareholders and nominal directors must cease to exist in financing in the long-term perspective<sup>1</sup>." President Putin attended the meeting.

Moreover, a great deal of questions can be addressed to the following principle set forth in the Guidelines: "Indeed, the taxation regime for the interest income that foreign organizations generate from Russian corporate bonds subject to mandatory centralized holding, shouldn't result, all other conditions being equal, in withholding by a Russian fiscal agent, who pays such income, of taxes in a volume higher than in payment of Eurobonds interest income". It should imply the following: since we plan to apply tax exemption to the interest on corporate Eurobonds (i.e. Russian corporate bonds issued by foreign mediators), the tax rate on interest on other corporate bonds should be reduced too. It should be recalled that Russia's fiscal agent will not withdraw "too much" on the interest paid, providing that the beneficiary provides in advance a certificate of registration with the tax authority at the tax residence, which is common practice in execution of international agreements on avoidance of double taxation. Therefore, the proposed tax exemption on the interest on Eurobonds in favor of "nominal" shareholders fails to comply with the G20 decisions and should therefore be adjusted.

1 T. Edovina, "G8 files a tax return", *Gazeta Kommersant*, 104 (5135) dated 19.06.2013.

We consider untimely the proposal to recognize revenues and costs from listed securities and forward/futures deal financial instruments in the aggregate with operating income and costs. Since it is sale of raw materials that generates principal revenues for Russia, the decision to book losses from securities operations to the results of sale of raw materials is aimed at tax-exempted reallocation of revenues from sale of raw materials in favor of stock market players rather than the development of a competitive market.

Other proposals to relieve excessive technical tax regulation for securities transactions are acceptable. By retaining separate taxation of operating income and financial market transactions, the acknowledgement of actual price of securities transaction and futures deal financial instruments (save for monitored transactions, i.e. between two interdependent parties) as market price, as provided for by the Guidelines, will have no adverse effect on the budget, in which case (as now) losses from stock-exchange transactions will not reduce taxable profit from real asset transactions.

Also acceptable in general are the proposals to requalify repo operations into securities realization transactions in case of non-execution of reverse transaction (failure to repurchase), and technical simplification of the currently applicable rule for assessing the maximum size of interest recognizable in costs for the purpose of reducing the profit tax base.

Lifting restrictions on booking to costs certain specific expenses such as advertizing costs, representation expenses for the purpose of reducing the tax base seems to be untimely. Capital under the guise of such expenses can be transferred from Russia to other tax jurisdictions. For example, booking a place for a shareholder meeting in other country at the prestige hotel controlled by shareholder's relative is an exact form of capital withdrawal – tax on rent revenues will be paid in other country, whereas representation expenses will be recognized in the Russian Federation. Indeed, tax accounting rules should be brought in line with the accounting rules, but Russian Federation has no court practice qualifying such expenses as necessary and sufficient for business activity, therefore, it would hardly be reasonable to abolish all restrictions on booking them to tax base reduction.

In addition, there is much truth in Ministry of Finance's remark that direct dependence of taxation parameters on accounting rules may create preconditions for the occurrence of tax consequences, including easing the tax burden on certain categories of taxpayers through changes in accounting rules, bypassing the legislation on taxes and levies.

The Guidelines contain a system of measures aimed at supporting participants in the investment projects

being in progress in certain regions of the Russian Federation.

With regard to investment project participants, a proposal was made to set a tax rate of 0% to the extent payable to the federal budget as tax incentive measure for profit of organizations for a 10-year term of investment project implementation. Furthermore, the respective term is to start from the period when the first proceeds are generated from sale of goods manufactured as part of the investment project, but not later than 5 (3) years from the date when a respective project is registered in a respective register. A proposal was made to allow by the decision of the government authorities of a constituent territory of Russia for a possibility to reduce profit tax rates down to zeroing for organizations during the first five years of investment project implementation and set at least 10% profit tax rates for organizations within subsequent 5 years of investment project implementation.

However, the following limits are to be imposed on participants in such projects: 1) an investment project may not be focused on the production of crude oil, natural gas production, and provision of services relating to oil and gas production; manufacturing ethyl alcohol, alcoholic products, manufacturing tobacco products and other excisable goods (save for motor cars and motorbikes); 2) non-profit organizations, banks, insurance companies, and other financial institutions may not be investment project participants; 3) capital investments under the project must total at least Rb 150m within a 3-year period, or at least Rb 500m within a 5-year period.

The Guidelines attempt to resolve the issue of booking to costs goods lost in the course of commercial activity. A proposal was made to set standards for losses (shortfalls) booked to profit tax base reduction in the commerce sector at 0.75% or less of sales proceeds.

3. *Mineral tax.* The Guidelines has a big section dedicated to setting mineral tax rates on raw hydrocarbon extraction. Since there is no way to conduct a strict feasibility study of tax rate differentiation by deposit, the focus is placed on the development of a certain formula linking mineral tax rates to the value of total basket of raw hydrocarbon extracted (including natural gas and natural gas liquid). According to the developers, it should level the yield of gas supply to domestic and external markets.

Particularly worth noting is an attempt to introduce a sort of tax on extra income (taxation of revenues on the investment project at large) generated from the development of new subsea raw hydrocarbon deposits located within the boundaries of the internal sea waters, territorial sea, in the continental shelf of Russia and the Caspian Sea. A proposal was made to



set mineral tax ad valorem rates (5 to 30%) subject to the difficulty category of a new subsea raw hydrocarbon development project and keep the tax rates unchanged over a specific period of time (5 to 15 years), as well as lift limits on periods of deferral of tax losses and application of the accelerated amortization mechanism in evaluating the profit tax base for organizations for each of such investment projects. A proposal was made to allow exemptions on corporate property tax, VAT and import customs duties on property being used during implementation of new subsea raw hydrocarbon development projects.

Gradual decrease in the crude oil export customs duty rate along with compensation for income shortfalls through an increase in the crude oil mineral tax rate was formulated as a strategic objective in crude oil production. At current stage, however, each deposit will be subject to customized correction factors to the mineral tax.

The mineral tax which applies to extraction of solid commercial minerals is to be refined in terms of the tax assessment procedure for the production of precious metals and multi-component complex ores. Delegation to regional governments the authorities to set mineral tax rates on common commercial minerals is being under consideration.

The water tax collection procedure for the use of subterranean water bodies is planned to be rectified.

**4. Personal property tax.** Taxable item's cadastral value as of January 1 of a year as fiscal period is to be used as the tax base for immovable property tax assessment.

Draft amendment provides for a tax deduction equal to the cadastral value of 20 square meters in a residential building or any other respective taxable item in evaluating the tax base. Marginal tax rates were set for different types of property items. Tax rates of 0.1 to 0.5% are applied to taxable items whose cadastral value is up to and including Rb 300m.

Substandard tax rates within a maximum range of 0.5 to 1% are to be set for taxable items whose total cadastral value is more than Rb 300m.

A marginal tax rate of 1.5% is set for land plots.

Draft amendment provides for a transition period until January 1, 2018 during which an immovable property tax is to be gradually introduced when municipalities are ready for the introduction.

**5. Enhancing taxation of immovable property owned by organizations.** For the purpose of ensuring a unified approach towards taxation of the property owned by organizations and individuals, appraisal of the cadastral value of non-residential property items is proposed as the tax base for immovable property tax organizations. Therefore, the federal executive autho-

rities will have to develop a method for appraising the cadastral value of such property items (including industrial buildings, offices, facilities, linear facilities, etc.), as well as update the Unified State Immovable Property Cadastre with information about property items owned by legal entities.

**6. Excising.** Excise tax rates will be indexed subject to actual developments in the economy with regard to excising during the planning period. The current rates are expected to be retained, with some exceptions though, for the years of 2014 thru 2015. Later on, a proposal was made to index excise rates on alcohol-containing products as 10% of the 2015 value (on alcohol-containing products, on other types of alcoholic products – on the forecast inflation rate for 2016 (5.4% by 2015). Excise rates of the Customs Union member countries are expected to gradually become similar in size by 2020. Excise rates on diesel fuel oil, straight-run gasoline, lube products are subject to changes too.

Russia's Government doesn't rule out that the growth rates in excise rates on tobacco products provided for by the Concept might slowdown until 2020, in spite of the of National Policy Concept for Tobacco Consumption Control (the executive order dated 23.09.2010, No. 1563-r) adopted by Russia's Government, which set a goal to bring excise rates on tobacco products from the current value of excise tax burden in the Russian Federation (about 30% of the price) in line with European countries (WHO) (about 47.5% of the price), subject to conclusion of respective accords with the Customs Union member countries.

**7. For the purpose of counteracting tax evasion** by using low-tax jurisdictions, proposals to introduce provisions on controllable foreign companies and income final recipients (beneficiaries) into the Russian legislation are planned to be submitted, as well as introduce a concept of fiscal residence of organizations, thereby counteracting violations in calculating income of foreign organizations which are subject to taxation in the Russian Federation. The procedure for taxation in the Russian Federation of the proceeds from sale of shares (interest in) of organizations whose immovable property in Russia account for more than 50% of their assets is expected to be refined.

**8. Tax administration.** The fiscal policy guidelines provide for a set of measures aimed at enhancing effectiveness of tax administration: exercising control over banks' compliance with the applicable tax legislation of Russia; taking measures to enforce taxpayer obligations against persons evading their obligations as taxpayers, e.g. through schemes involving fly-by-night companies or third parties; imposing taxpayer obligations on organizations and self-employed entrepreneurs to provide tax authorities with information

on the conclusion of simple partnership agreements and the parties thereto, or termination of simple partnership agreements, etc.

9. *Regrettably, the Guidelines don't address the e-commerce questions* brought up by the Customs Service (in particular goods delivered as postal items are not subject to VAT, and payments to suppliers are not subject to income tax, especially when the Russia's territory constitutes the source of such income<sup>1</sup>). Therefore, according to the Customs Service administration, foreign supply agencies acting on the territory of Russia unreasonably enjoy competitive advantages. One has to agree with this point of view. It is to be recalled that a priority objective of ensuring state budget revenues – income source was agreed upon by G20 leaders at the meeting in the Northern Ireland.

The following documents should be focused on among those adopted in the period of May thru June 2013:

The following amendments were made to Chapters 21 (VAT) and 25 (Profit Tax) of the Federal Law of June 7, 2013 No. 131-FZ. Application of VAT and preferences for the profit tax established for banks, insurance companies, non-governmental pension funds on organization constituting insurance of export loans and investments against business and/or political risks under the Federal Law of May 17, 2007, No. 82-FZ "On the Development Bank".

<sup>1</sup> A Kreknina, "Russians will pay for low price. The Federal Customs Service ready to regulate e-commerce. Russia's retail chain stores praise the initiative", *vedomosti.ru* dated 17.06.2013.

In its letter to the Ministry of Finance of Russia dated June 6, 2013, No. 07-02-05/20990, the Department for Regulation of State Financial Control, Auditing Activities, Accounting and Reporting prepared detailed recommendations for auditors on how to detect transactions covered by the requirements set forth in the Federal Law dated August 7, 2001, No. 115-FZ "On Combating the Legalization of Proceeds of Crime (Money Laundering) and Terrorist Financing", subject to the provisions set forth in the Manual for the application of the risk assessment approach for accountants adopted by the Financial Action Task Force on Money Laundering (FATF). A reason for regarding a transaction as controllable is counterparty's tax residence in a country (zone) offering a special taxation regime, i.e. offshore jurisdiction.

It should be recalled that the Law also applies to cash transactions of Rb 600,000; immovable property transactions, provided that the amount of transaction is Rb 3m or more; cash and/or other property transfer into the name of a non-profit organization from foreign countries, international and foreign organizations, foreign nationals and stateless persons, provided that the amount of such transfer is Rb 200,000 or more. Furthermore, the letter specifies other factors which may classify transactions as controllable under the Law.

The letter contains a list of FATF documents, a list and e-mails of other key sources of information concerning combating the legalization of proceeds of crime (money laundering).