

## REVIEW OF TAXATION REGULATORY DOCUMENTS ISSUED IN THE PERIOD OF MAY–JUNE 2014

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*The period under review saw events that will have a significant effect on Russia's economic policies in the near term: Russia imposed a prepayment regime on natural gas supplies to Ukraine and signed an agreement on the establishment of Eurasian Economic Union (EAEU) embracing Russia, Belarus and Kazakhstan. The discussion on dividend taxation initiated by the Ministry of Finance of Russia continued, as well as the discussion on restoration of the right of the Investigative Committee of the Russian Federation (IC of Russia) to initiate at its own discretion criminal cases related to violations of the tax legislation was resumed.*

Russia's imposition of the prepayment regime on gas supplies to Ukraine and the establishment of the EAEU are politically driven decisions, but their economic impacts seem to be controversial in the short run and unpredictable in the long run. On the one hand, Russia expands the market which is however not quite a free market (we are seeing a few countries with the participation of Russia constructing a stand-alone "market" inside the common market of the World Trade Organization (WTO)). Russia will enjoy basically political bonuses from such an agreement, while the other parties thereto may enjoy the opportunity to buy Russian hydrocarbons at Russia's domestic market prices and impose a tax on export of hydrocarbons outside the Union. This restricts the financial base of the Russia's budget.

On the contrary, the fact that Ukraine will have to pay for Russian natural gas on the basis of world market prices (irrespective of whether or not it is going to be done under the existing agreement or a new agreement which will settle the issue of debts accrued under the existing agreement) is a positive step, notwithstanding the motives behind. Russia deserves overall support in situations when it settles conflicts in accordance with the WTO rules and regulations.

The Russian Government still remains to be focused on increasing supplies of hydrocarbons to Asian and European countries, not least because crude oil prices went up 10% during the last month (according to experts, mineral products accounted for about 43% of Russia's exports 20 years ago and more than 70% in 2011)<sup>1</sup>. On the contrary, fixed asset investment in other countries have long been tending to decrease. Investment declined 3.8% since the beginning of the current year compared to that in the period of January to May 2013. This is indicative of investors getting in-

creasingly skeptical as to the prospects of the Russian economy<sup>2</sup>.

As investment activity declines, the business environment in Russia gets tougher thereby accelerating capital fleeing the country, which, in turn, entails even more administrative restrictions in the internal market.

The recent policies aimed at raising liability for violations of the tax legislation seem to be quite controversial. The trade-off between the stance of the IC of Russia and the Federal Tax Service (FTS) of Russia on interaction of these departments in detecting violations of the tax legislation which is set forth in a draft amendments to the applicable legislation, has been criticized by experts and the business community<sup>3</sup>. The problem is that pursuant to the proposed procedure, managers of an organization will be held criminally liable (as defined by the Criminal Code of the Russian Federation (CC of Russia)) even when the violations committed by the organization as taxpayer itself (as defined by the Tax Code of the Russian Federation (TC of Russia)) have been totally settled (the outstanding amount, penalties, and fines have been paid). In other words, there is no formal matter of violation under the TC of Russia, but the manager may be held criminally liable according to the the CC of Russia. And what about the situation when the money from the buyer wasn't received in time which was the reason for the failure to pay tax in the due time? What is the reason for the director (general manager) of an organization being subject to criminal prosecution? The problem, in our opinion, is that the tax and criminal laws and

1 Исчезающий несырьевой экспорт России, сайт [ng.ru/editorial/2014-06-18](http://ng.ru/editorial/2014-06-18) от 18.06.2014 г. [Vanishing non-mineral export in Russia. The full text is available in Russian at: [ng.ru/editorial/2014-06-18](http://ng.ru/editorial/2014-06-18) dd. 18.06.2014.]

2 Павел Сморщиков, «Инвестиционная фикция», Газета.Ru, сайт [news.ru.msn.com/economy/](http://news.ru.msn.com/economy/) от 23.06.2014 г. [Pavel Smorschikov. "Investment Fiction", Gazeta.ru. The full text is available in Russian at: [news.ru.msn.com/economy/](http://news.ru.msn.com/economy/) dd. 23.06.2014.]

3 Бизнесмены попросили Путина сохранить порядок возбуждения налоговых дел [lenta.ru/news/2014/06/24/putin-tax/](http://lenta.ru/news/2014/06/24/putin-tax/) [Businessmen asked Putin to keep intact the procedure for initiating criminal cases. The full text is available in Russian at: [lenta.ru/news/2014/06/24/putintax/](http://lenta.ru/news/2014/06/24/putintax/)]

regulations seem to exist collaterally to each other. A conflict of interests and competences arises between respective ministries and departments. The conflict still remains to be settled. In our opinion, the Constitutional Court of the Russian Federation (CC of Russia) should thrash out the stance of the IC of Russia. A possibility of constitutional implementation of the legal framework being designed by the IC of Russia, which provides for the application of criminal punishment against the general manager of an organization for violations of the tax legislation in cases when basic violations committed by the organization as taxpayer have been rectified according to the rules of the criminal law, should be studied.

There is another issue that needs follow-up study. Gradual closure of external markets for Russian manufacturers in response to the economic sanctions imposed against Russia in 2014 by a few developed countries has forced Russia to look for new partners and new relationship schemes in the global market. There have been more and more proposals (even among a few Russian economists) on the advisability of replacing the US dollar with the currency of the countries with whom Russia has commercial and economic settlements. In our opinion, economic feasibility shouldn't be sacrificed for patriotic feelings. The US dollar has a unquestionable advantage over many other currencies – the United States cannot influence the amount of the national currency to be issued, money issue centers are business enterprises which don't report to the state. This is what allows the US Federal Reserve System (FRS) to conduct a formally independent currency policy and provide sustained control over the exchange rate of the national currency.

Regretfully, the Central Bank in Russia has increasingly been tuning into a ministry of monetary policy. This is evident from, for example, the contents of the Executive Order of the Russian Government of 21.05.2014 No. 476 'On the Consent of the Assignment of Receivables', under which the Central Bank of Russia issues bank loans guaranteed by the Government of Russia (these are basically loans issued to defense enterprises)<sup>1</sup>. Furthermore, suggestions to use the Central Bank's international reserves for funding investment programs and projects were repeatedly made by Duma members and even the President of Russia (in particular, when JOSC Gazprom follow-on capitalization was discussed). It is unlikely that the Russian Government will agree to receive as payment for supplied goods with the absolute value in use (hydrocarbons) national currencies which are likely to be issued by order of a lead political party or foreign government especially for settlements under a specific agreement (agreements). To avoid country risks, the

current exchange rate of such currencies against the ruble will be evaluated through the cross rate of these currencies and the ruble against the standard reserve currencies (the US dollar and the Euro).

Another very controversial proposal, being discussed among economists, is a Ministry of Finance's proposal to pay dividends from the profit before taxation rather than net profit<sup>2</sup>. The Ministry of Finance of Russia explains this by saying that taxable profit can be easily reduced through "paper" losses. However, the term "paper" losses has no economic sense. Let's provide an example. The introduction of a consolidated group of taxpayers, formal legal entities, made it possible for loss-making entities to "trade" their losses. This is a privilege. Should this privilege have resulted in loss of regional budget revenues, it should be cancelled. But then the Ministry of Finance of Russia didn't participated in making the decision on tax base consolidation. If the tax base is calculated according to the rules set forth in the TC of Russia (at market prices) or in accordance with the International Accounting Standards (IAS) (at market prices), then tax base erosion has nothing to do with "paper" losses and should be accepted as objective reality. The market is subject to fluctuations. Exchange rates are subject to fluctuations, the value of assets is subject to fluctuations, thereby leading to a natural erosion or reduction of the tax base. Budget revenues can be unreasonably lost in a free-market environment only due to the provision of privileges or because of violations of the tax legislation. Failure of the Ministry of Finance of Russia to oppose those who lobby tax allowances and exemptions shouldn't be a reason for giving up the basic concept of profit and dividends. The profit tax must be paid to the federal budget. This tax is paid by an organization as taxpayer, because it owns the profit, and it is only the organization that may decide how to further distribute these resources. Dividends are distributed in favor of third parties, appropriated by their recipients and, not until then, become the assets owned by these third parties and are subject to taxation. Recipients of dividends also pay the property tax. If a decision has been made to credit the amount of paid dividends for the reduction of the profit tax base, it is a methodologists' mistake which might have re-

2 «Минэкономразвития против выплаты дивидендов до налогообложения. Минэкономразвития раскритиковало законопроект Минфина об отмене ограничения на выплату дивидендов только за счет чистой прибыли», сайт [izvestia.ru/news/572264](http://izvestia.ru/news/572264), июнь 2014 г. [“The Ministry of Economic Development against payment of dividends before taxation. The Ministry of Economic Development of Russia has criticized Minifin's draft law on the removal of limit on payment of dividends exclusively through net profit”. The full text is available in Russian at [izvestia.ru/news/572264](http://izvestia.ru/news/572264), June 2014. ]

1 See further as the text goes.

sulted in the problems which the Ministry of Finance of Russia is trying to resolve<sup>1</sup>. Indeed, a situation in which the mount of profit was less than the amount of dividends seems to be unreal. Ministry of Finance's proposal to tax dividends only and give up profit taxation is extremely risky, as we noted in our previous reviews, because under all international agreements dividends are subject to taxation at recipient's place of residence. The Ministry of Finance of Russia actually suggests to implement a colonial taxation scheme in the Russian Federation, under which returns on capital investment are sourced tax-free at capitalist's place of tax residence, and earning of labor are taxable at employee's place of tax residence.

The following documents issued in May-June 2014 are especially noteworthy:

1. The Eurasian Economic Union (EAEU) Agreement between the Republic of Belarus, the Republic of Kazakhstan and the Russian Federation was signed on May 29, 2014. The Agreement specifies that it recognizes the WTO regulations, rules and principles. The EAEU provides for free movement of goods, services, capital and labor force, conducting a coordinated, mutually agreed or single policy with regard to the industries specified therein and in international agreements as part of the Union. The Union is an international organization endowed with international personality. The functioning of the Unit will rely upon the key principles such as market-driven economy and bona fide competition, functional customs union without exceptions and restrictions upon the expiration of transition periods (EAEU unified customs tariff has been introduced, movement of commodities inside the EAEU is free of customs clearance, except certain types of goods (works, services)).

The Agreement provides for anti-dumping measures, countervailing measures aimed at protecting the EAEU internal market. All disputes will be settled in the Union Court, a permanent judicial body.

An adverse factor for the Russian economy is a high threshold of national debt (50% of GDP)<sup>2</sup> agreed within the EAEU, which can be considered a hidden stepwise increase in the national debt threshold in the member countries, including the Russian Federation<sup>3</sup>. Annual consolidated budget deficit of the EAEU state administration sector must not exceed 3%, as stipulated by the Agreement.

<sup>1</sup> This is only case when the taxable profit may turn out to be less than the amount of dividends.

<sup>2</sup> See Article 63 thereof.

<sup>3</sup> Which is currently established under the Russian legislation within a range of 10–12% of GDP, as the IMF recommended to Russia.

There are noteworthy positive effects such as the VAT payment treatment established by the Russian legislation for import and export of goods (works, services)<sup>4</sup> is applied while goods move within the EAEU territory. Approximation of the member countries' systems of taxation is scheduled in the near future, namely harmonization of rates of excise duty "on the basis of most sensitive excised commodities", more extensive application of information technologies in paying taxes, etc.

2. The Ruling of the CC of Russia of June 3, 2014 No. 17-P gives explanations on the payment of value added tax (VAT) by entities which are subject to the unified tax on imputed income (UTOII) and apply the general system of taxation, assessing the tax by the rules of this general VAT framework and declare operations subject to VAT and amounts of the assessed tax. Detecting violations by such taxpayers under the two systems of taxation, tax authorities often tend to hold violators liable for violation of the tax legislation, charging the outstanding amount of tax payable both under the UTOII and VAT. The situation gets worse, because VAT taxpayers must issue invoices and retailers covered by the UTOII issue sales slips to their customers in which no VAT is outlined. In the latter case, retailers calculate VAT by themselves and report it in their tax return.

Following this scheme, OOO Torgovy Dom Kamsnab filed a lawsuit on ruling as unconstitutional Clauses 6 and 7, Article 168 of the TC of Russia and Clause n. Article 173 of the TC of Russia, because the arisen dispute was settled in different ways in commercial courts at various instances.

Having considered the case on its merits, the CC of Russia made it clear that the foregoing clauses of the TC of Russia don't contradict the Constitution of the Russian Federation, because within the existing legal and regulatory framework they neither constitutionally nor legally make a person engaged in retail trade, without issuing invoices to customers, be obliged to pay VAT to the budget, if the person falls under the UTOII category of taxpayers according to the type of his entrepreneurial activity. As a conclusion, the CC of Russia suggested that judicial and tax authorities should revise the law enforcement practice.

The Ruling of the CC of Russia under review is worthy of special attention, because it contains explanations of the stance of the CC of Russia on many issues related to taxation principles.

3. Due to reorganization of the system of commercial courts and their integration in the system of

<sup>4</sup> See Article 72 thereof.

judicial bodies of the Supreme Court of the Russian Federation, Federal Constitutional Law No. 8-FKZ of 04.06.2014 established that the explanations on court practice provided by the Plenum of the Supreme Commercial Court of the Russian Federation (SCC of Russia) will remain in force until the Plenum of the Supreme Court of the Russian Federation makes respective decisions. This is an important decision preventing the law enforcement practice of commercial courts from collapsing.

4. Federal Law of 04.06.2014 No. 143-FZ withdraws the entire category of litigation from the jurisdiction of commercial courts (e.g. cases on challenging the results of cadastral valuation; on challenging laws and regulations concerning appraisal activity; on the principles of regulation of tariffs of public utility entities; on the protection of competition; on the consideration of laws and regulations concerning customs regulation, etc.). Enabling the Supreme Court of the Russian Federation to revise commercial courts' rulings that have come into legal force with regard to cases on administrative offences, without making reservation that such a review may be possible as long as it doesn't worsen the taxpayer's situation, is a very controversial and ambiguous decision which makes business functioning less sustainable.

5. The Executive Order of the Government of Russia of 21.05.2014 No. 476 can be qualified as sort of a decision on "quantitative easing" (actual acceptance of money issue) conducted by the Bank of Russia. The latter is entitled to redeem Russian banks' loans issued against the guarantee of the Government of Russia (these are basically loans issued to defense enterprises). In fact, the money has long been in circulation and spent by the borrowers (including payment of wages, the amount of which the managers of state corpora-

tions refused to publish this year), however lending banks seem to be unable to write off the outstanding loans at the cost of the profit-based reserves. The state stops short of declaring bankrupt such banks and state corporations (for example, Vnesheconombank State Corporation). This is why the Central Bank of Russia will compensate the lending banks for the outstanding loans (apparently, this includes the accrued interest and interest receivable on overdue loans, covering the entire outstanding period), thereby legalizing a money issue. The question is whether the budget provided for provisions for state guarantees? Should the answer be negative, a direct money issue would be the source of payment. A second noteworthy aspect is that the Executive Order allows the Bank of Russia to resale the redeemed loans to new creditors. However, the document prescribes no procedure for determining a resale price of a given asset.

6. The Letter of the Ministry of Finance of Russia of June 2, 2014 No. 03-05-05-01/26195 explained that the former privilege – under which entities applying the UTOII were exempted from the corporate property tax with regard to the property used for conducting an entrepreneurial activity subject to the UTOII – ceased to be in force after the effective date of Federal Law of 02.04.2014 No. 52-FZ 'On Amendments to Part 1 and 2 of the Tax Code of the Russian Federation and Certain Legal Acts of the Russian Federation'. Now Clause 4, Article 346.26 of the TC of Russia establishes such an obligation with regard to real estate property items whose tax base is determined as their cadastral value. Entities may determine specifics of tax base assessment (in fact, they may grant privileges) only if a constituent entity of the Russian Federation has duly approved the results of cadastral valuation of real estate property items located on the territory of its region. ●