

A REVIEW OF TAXATION REGULATORY DOCUMENTS ADOPTED IN THE PERIOD AUGUST–SEPTEMBER 2014

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A widespread controversy raised in the period under review regarding measures of tackling the effects of economic sanctions on Russia. In our opinion, decision-making should be based on a comprehensive analysis of potential effects of measures proposed by the Russian Government and/or experts.

In the period of August to September 2014, the draft budget for 2015 and the planning period of 2016–2017 was drafted on the basis of long-lasting disputes in the Russian Government on the possibility of introducing a sales tax at up to 3% and the delegation of the authority to introduce the tax to the regions, increase in the VAT rate, introduction of a progressive income tax scale¹. Considering a possible recession, it was decided not to increase the tax burden of these taxes, which can lead to involuntary weakening of the effective demand.

The projections to the draft budget included lifting of limits on the assessment base of contributions to the Federal Compulsory Medical Insurance Fund (FCMIF) (federal budget expenditures on transfers to public social funds were slightly reduced by increasing the burden on manufacturers' costs on contributions to the FCMIF, thereby making it less scarce as part of the draft for 2015 and 2016–2017 submitted to the State Duma).

Let's review some of the proposed measures of tackling the effects of economic sanctions and recovering from a stagnation.

Russian Government's intention to substitute direct budget expenditures with state guarantees is controversial at the current stage of economic development. The problem here is that the budget provides for no reserves for state guarantees. Should the guarantor (it will be the state) receive applications for payment under commercial contracts, substantial volumes of unsecured current expenses may accumulate in the budget. Should volumes of issued guarantees be substantial, it may absolutely unexpectedly and instantly collapse public finances and lead to a sovereign default. Economic sustainability of the state is based on maintaining a balance between the income base of the state which is generated from taxes and assumed obligations within the limit of these revenues. At the same time, the Executive Order of the Russian Government of August 14, 2012, No. 825 (as amended by the Executive Order of the Russian Government of 1.09.2014, No. 880) still provides for the possibility to grant guarantees "if legal entities have delinquent accounts payable to the Russian Federation, mandatory payments to the budgets of the budgetary system the Russian Federation"².

The ongoing practice of depositing the resources of public funds in ailing state-run banks and banks es-

tablished by the Central Bank of Russia is exposed to a high risk. Securing the irrevocable status of such deposits suggests that financial problems of state-run banks and state corporations are expected to be addressed by using the resources of sovereign funds (The National Wealth Fund – the NWF). Additionally, for the first time in recent years the government has spoken about using the resources of the Reserve Fund to finance planned expenditures. The problem here is that by recovering financial sustainability of large financial entities in bankruptcy using the resources of the budget and sovereign funds, the state simply covers the inefficient, non-profit costs which cause the insolvency, i.e. the state spends the economically needed resources by investing them in dead, absolutely useless assets, whilst today these resources should be appropriated to efficient projects in order to accelerate economic development. State-run banks and state corporations should be financially rehabilitated before increasing their capital. Reciprocal liabilities of state-run banks may be cancelled during their financial rehabilitation. This may shrink the balance sheet of such banks. It may appear to be reasonable for some state-run banks to undergo restructuring by merging with other financial institutions. Should every state-run bank be propped individually, they would simply exchange the resources under reciprocal liabilities, in which case the state budget will have to pay the same amounts twice. Furthermore, it should be remembered that the sanctions were imposed, above all, on government officials at state corporations and state-run banks. The development of free-market schemes and institutions is a way of tackling the effects of the sanctions on the Russian economy. Adequate financial rehabilitation of state corporations and state-run banks can create an

1 Е. Аликина, «Налоги из будущего. Как изменится фискальная политика в отношении граждан», сайт kommersant.ru/doc/2548164 от 3.09.2014 г. [E. Alikina, Taxes from the future. How fiscal policy will change for individuals. The text (in Russian) is available on kommersant.ru/doc/2548164 dd. 3.09.2014.]

2 Clause 4, the Government Executive Order of 14.08.2012, No. 825 (as amended on 1.09.2014).

opportunity of revaluating at market price the assets accumulated in banks. This would make investment cheaper, more attractive, available for new investors and eventually facilitate modernization. Furthermore, it, or course, is necessary to think on the terms of transfer of the assets to new owners to ensure that the assets are not transferred to persons seeking to just get rid of competitors and monopolize the market of respective goods (works, services). Such deals must be deemed illegal at the early signs.

Some experts' proposals to drastically change the national economic policy seem to be very risky¹: the transition to a deficit budget with a simultaneously drastic ease of the tax burden. This, in our opinion, may instantly destabilize the exchange rate and shortly push the economy into a runaway inflation. No efficient monetary easing system has been created in the country to date, the banking system lacks a smoothly running prompt loan repayment control scheme, the mopping up of entities mixed up in shady transactions is underway in the private banking sector. Upon the Olympic Games in Sochi and the introduction of economic sanctions state participation banks and state corporations found themselves both running out of funds and having no access to international sources of long-term financing. Furthermore, soon they will have to make repayments due on their previous loans from abroad. If they fail to meet the payment schedule, the defaulted amount will have to be reimbursed using the gold and foreign currency reserves of the Central Bank of Russia and Russia's overseas property (state participation banks and state corporations' liabilities are recognized as state's rather than private sector's liabilities). It would be unreasonable in this situation to spend all public resources and business stimulus reserves, as Sergey Glaziev suggests, while devaluating the national currency (i.e. basically providing more reasons for flight from the ruble to foreign currencies).

Additionally, there should be a warning against attempts to address financial issues through the introduction of earmarked levies of any types and the establishment of state off-budget funds with stand-alone sources assigned to them². It is only the state that must have the right to collect mandatory payments,

1 А. Башкатова, «Правящая партия меняет экономический курс. Сергей Глазьев предлагает ввести налог на валютные операции». Сайт ng.ru/economics/2014-09-23/1_course.html от 23.09.2014 [A. Bashkatova, The ruling party changes its course. Sergey Glaziev suggests that a tax should be imposed on FX operations. The text (in Russian) is available on ng.ru/economics/2014-09-23/1_course.html dd. 23.09.2014.]

2 «Путин поддержал идею введения целевого сбора с продаж программного обеспечения». Сайт ng.ru/news/480020.html от 24.09.2014 [Putin supports the introduction of a target tax on software sales. The text (in Russian) is available on ng.ru/news/480020.html dd. 24.09.2014.]

and the federal budget must be the fund. The budget is drafted using the so-called "simple cost accounting" method and spent under the adopted law. This type of budgeting and budget spending ensures transparency of items and volumes of government spending, allows tax burden limits to be optimized, makes it possible for the state to easily maneuver all the available resources, appropriating them in a timely manner to address the most important issues. Setting up stand-alone public off-budget funds with mandatory contributions can split cash flows, deteriorate the effectiveness and responsiveness of public administration (every public entity seeks to set up its personal, stand-alone fund and make sure it has the exclusive right to administer its revenues and expenditures), restrict the agility and scope of the state's financial maneuver, increase the burden on manufacturers.

Despite the wide-spread controversy in the press, public entities are still pursuing quite a restraint, calibrated financial policy. A timely fundraising was made in the internal market through bonds placed by the Ministry of Finance of Russia. The placement of long-term 10-year bonds at 9–10% p.a. made the national currency sustainable amid western economic sanctions, demonstrated that the state is capable of mobilizing long-term resources using market methods in the domestic market. State borrowings in the national currency have not yet created higher risks for macroeconomic stability of this country, and the use of the raised funds for investment purposes can promote the development of efficient types of production. To ensure sustainability of the ruble exchange rate in external markets and mitigate the risks of economic sanctions, it would be safer for the time being to keep the available foreign currency assets in the generally accepted reserve currencies and government securities of the world leading economies.

To prevent a recession in the current situation, it is extremely important that taxes should be cut down, but it is government spending that should be curtailed first, otherwise taxes will be replaced with other sources (liabilities) or repaid by selling state-owned property. Loans from abroad shouldn't be obtained before economic recovery, because in times of downturn interest-ridden loans would only worsen the depth and complexity of economic problems amid weakening ruble exchange rate.

Inflation's redistribution of resources, by lowering the fair value of individuals' ruble savings or devaluating their current wages, are most painful measures of mobilizing internal resources for financing the economy, because this strategy is based on shrinking the traditional effective demand of the overwhelming majority of the population and may lead to a social fallout, a

flight from the national currency and macroeconomic destabilization in the society. This is why the Central Bank of Russia should combine the inflation targeting objectives with the provision of ensuring smooth changes in the exchange rate of the national currency.

In the period under review the following regulatory documents are worth of focusing on.

1. The Executive Order of the Russian Government of September 6, 2014, No. 914 approved the Provision on the exercising of the license-holder powers by the state customer on behalf of the Russian Federation in case of using for state needs intellectual activity deliverables created during the implementation of research-and-technology programs and projects sponsored by the Russian Science Foundation.

It is not quite clear how the Executive Order will be implemented in practice. Under the general legal rules and procedures, the state customer may not assign, on a non-repayable basis and without the approval of the Federal Agency for State Property Management (FASPM), to any person the rights to goods (works, services) paid with the budget resources received as a result of exercising its public contract. The deliverables of the public contract must first be approved by the true customer – the state whose interests are represented by the FASPM. The deliverables of the public contract may, by order of the FASPM, be transferred to the possession of the contractor (it also depends on the FASPM whether this should be at a charge or free of charge). When the state officially transfers the deliverables of the public contract to the possession of a third party (at a charge or free of charge), this must be documented in a separate instrument¹. Additionally, the amount of tax payments is to be determined in accordance with the decision made.

The given Executive Order of the Russian Government raises the question of limiting the rightholder's rights, i.e. draws on the legality of the recognition of the contractor as rightholder of the deliverables of the public contract. At the same time it is absolutely not clear how the contractor has become the rightholder – the beneficiary under the public contract agreement. The Executive Order provides for the rightholder's obligation to grant to the state customer, at request of the latter, the right to use the intellectual activity deliverables for state needs pursuant to a free ordinary (nonexclusive) license (hereinafter "license") for a tokenistic annual payment equal to the amount of the royalty paid to the author (authors)². Should the

rightholder refuse to enter into a license agreement with the state customer on such terms, the Executive Order allows the state customer to file a legal claim. However, by transferring the right to the contractor under the legal procedures the state customer should have lost the right to claim an ordinary (nonexclusive) license and also may not prescribe the terms of such licensing.

One can only guess that the transfer of rights as part of the execution of public contract has to-date been performed with violation of the legal procedures. It can be assumed from the text of the Executive Order that public entities as customers fail to enter in their books the deliverables of the public contract, i.e. instead of registering the deliveries as state-owned property, they transfer the rights to the deliverables of the public contract to the contractor and acknowledge the same as rightholder explicitly as part of signed agreements. At the same time, the state customer fails to perform its duties as fiscal agent and inform tax authorities of the appearance of income in kind for the contractor.

If the foregoing assumption is correct, in order to prevent the Russian Federation from losing its rights and facing leakage outside Russia of intellectual activity deliverables paid by the state as part of public contracts, the FASPM should challenge, through legal actions against state customers and contractors-beneficiaries, the unlawfulness of the transition as part of public contract agreements of the rights to the deliverables obtained during the execution of such agreements, if the contractor has been recognized as beneficiary without applying for FASPM approval.

The reviewed Executive Order of the Russian Government may need clarifying for the foregoing reasons.

2. A special emphasis should be paid to the Letter of the Ministry of Finance of Russia and the Federal Tax Service of Russia (FTS of Russia) of August 22, 2014, No. CA-4-7/16692. This Letter provides explanations as regards the application in practice of the Ruling of the Plenum of the Supreme Commercial Court of the Russian Federation (SCC of Russia) of 30.07.2014, No. 57 *Concerning Certain Issues Arising During the Application of Part 1 of the Tax Code The Russian Federation at Commercial Courts*.

The Ruling provides a detailed explanation as regards the actions to be taken by the fiscal agent in cases when the personal income tax cannot be levied (e.g., if no payments have been made after income in kind and etc in the current fiscal period).

payment determined on the basis of the data provided by the Federal State Statistics Service.

¹ When the transfer is free the beneficiary must pay the taxes due on the deal.

² Which must at least be equal to the average wage rate across the Russian Federation during the calendar year preceding the

The Ruling clarifies the issues concerning types of powers of attorney to be equal to notarized ones for the purpose of a third party dealing on behalf of the taxpayer with tax authorities.

The Ruling clarifies the procedure for settlement of disputes on granting a deferral (or installment) in case when the taxpayer has changed the place of tax registration. According to the SCC of Russia, since tax authorities constitute an integral centralized system of control over compliance with the taxes and levies act, the change in the taxpayer's place of tax registration must not have an effect on legal relations between the taxpayer and tax authorities.

The Ruling clarifies the sequence of actions to be taken by tax authorities in cases when the taxpayer fails to provide access for tax authority's officers so that they can inspect production, warehouse, sale and other premises and areas which the taxpayer uses for income generation, fails within more than two months to provide the tax authority with the documents required for tax assessment, if the taxpayer keeps no records of income and expenditure, taxable activities and assets, or such records are kept with violation of the duly prescribed procedure, thereby making it impossible for the tax authority to determine by means of a calculation an amount of taxes. At the same time, such a provision cannot be applied if the tax authority has found no actual business activity as part of the execution of disputable transactions.

The Ruling clarifies the rules of calculating a period of limitation actions on tax obligations for the purpose of the Tax Code of the Russian Federation (Tax Code of Russia).

The Ruling clarifies the procedures for holding liable and imposing penalties in the application of various articles of the Tax Code of Russia.

Of most interest is the explanations concerning cumulative sanctions and fines in case of violation of the tax law on multiple grounds at a time.

The SCC of Russia clarifies the cases in which taxpayer's illegal actions (omission) are to be recognized as having no elements of tax abuse. For example, if a filed tax return contains a correct tax assessment while the taxpayer's omission is exclusively the failure to pay to the budget the amount of tax specified in the tax return or tax notice. Such an omission, according to the SCC of Russia, shall have no elements of the violation established by C. 1, Art. 122 of the Tax Code of Russia¹. Since the tax has been correctly assessed and recognized in the tax return, the taxpayer shall be subject to a fine for late transfer of the tax.

¹ This article establishes a penalty of 20% for the failure to pay the tax due to its incorrect assessment.

3. The Letters issued on 1.09.2014 No. 03-11-09/43709 by the Ministry of Finance of Russia and September 12, 2014, No. GD-4-3/18435 by the FTS of Russia provide a detailed explanation as regards the record-keeping of mandatory insurance contributions paid under the Federal Law of 24.07.2009 No. 212-FZ by individual entrepreneurs to state off-budget funds in the taxation of the income of such individual entrepreneurs under the Tax Code of Russia.

Individual entrepreneurs who make no payments and other remunerations to natural persons shall pay fixed amounts of insurance contributions to the Pension Fund of Russia (PF of Russia) and Federal Compulsory Medical Insurance Fund (FCMIF) pursuant to the procedure as follows:

- for income less than Rb 300,000 insurance contributions shall be determined as the minimum wage rate (MWR)² multiplied by 12 months and multiplied by the tariff rate of insurance contributions to state off-budget funds;
- for income more than Rb 300,000 insurance contributions, as calculated using the foregoing method, shall be increased by an amount equal to 1% of the generated income beyond Rb 300,000.

Tax obligations for such taxpayers shall be determined pursuant to the procedure as follows: with the taxable item as income under the simplified taxation system, and under the uniform tax on imputed income (UTII) the taxable base is to be reduced by the entire amount of paid fixed insurance contributions.

The things are different for individual entrepreneurs who make payments and other remunerations to natural persons. Such taxpayers have no possibility of reducing the tax base by a fixed amount of insurance contributions, including 1% insurance contributions.

4. In order to reduce the quantity of tax disputes and litigations, enhance conditions for doing business on the territory of the Russian Federation, financial agencies give reasonable explanations of their views in responding to taxpayers' requests, which only can be welcomed, because this mitigates manufacturers' and individuals' tax exposure and has a positive impact on the investment climate on the territory of the Russian Federation.

4.1. For instance, the Letters issued on 3.09.2014, No. 03-03-10/44000 by the Ministry of Finance of Russia and September 18, 2014, No. GD-4-3/18838 by the FTS of Russia provide explanations as regards

² MWR was Rb 5554 as of the beginning of 2014 (Federal Law of 2.12.2013, No. 336-FZ On Amendments to Article 1 of the Federal Law On the Minimum Rate of Labor Payment).

federal financial agencies' views about accounting for the taxation of representation expenses of non-profit organizations.

Pursuant to the Tax Code of Russia, representation expenses during the accounting (fiscal) period shall be included into other expenses in an amount equal to or less than 4% of taxpayer's labor costs during the same accounting (fiscal) period. If a non-profit organization has covered its representation expenses with the resources of earmarked financing (receipts), they must not be considered in the formation of the profit tax base, because earmarked receipts shall not be considered a part of the taxable income.

4.2. In its Letter of 20.08.2014, No. SA-4-3/16606@ the FTS of Russia explained that sums of remuneration paid to the general manager of a state unitary enterprise (SUE) from the after-tax profit must not reduce the profit tax base. If such remuneration is stipulated in the labor contract and the amount of remuneration is determined as a percentage of the after-tax profit, the remuneration may be allocated to labor costs and reduce the profit tax base.

4.3. The Letters issued on 16.06.2014 No. 03-07-15/27306 by the Ministry of Finance of Russia and August 26, 2014, No. CA-4-3/16879 by the FTS of Russia provide explanations about the deduction of the value added tax (VAT) by the taxpayer acting simultaneously as investor, customer and developer as regards such

taxpayer's maintenance costs on the unit which provides construction progress control and technical supervision services.

Since a construction project is performed by the contractor, while the technical supervision group only exercises control over the given construction project and the taxpayer-developer performs by itself no installation and construction works, it may claim the deduction of the VAT amount on the goods (works, services) purchased for the maintenance of its unit which provides construction progress control and technical supervision services.

4.4. The Letters issued on 21.08.2014 No. 03-04-07/41923 by the Ministry of Finance of Russia and August 28, 2014, No. BS-4-11/17195 by the FTS of Russia provide explanations as regards the procedure for personal income taxation of amounts overdue under a credit agreement. Financial agencies explain that writing off the debts from the bank's books creates economic benefit for the debtor as skimming on the cost of the repayment of the principal and/or interest accrued, i.e. income subject to personal income tax at a rate of 13%.

The date of such income is deemed to be the date when the debt was written off from the bank's books (subject to the enforcement officer's ruling on the termination of enforcement proceedings) or the date when the bad debt was written off from the books of a credit institution to off-balance accounts. ●