

A REVIEW OF RUSSIA'S TAXATION REGULATORY DOCUMENTS ADOPTED IN THE PERIOD OF SEPTEMBER–OCTOBER 2014

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It's worth noting that administrative bodies in the period under review made active efforts in rule-making regarding the issues within the scope of their competence. Considering the challenging situation faced by Russia due to western sanctions, there are two reasons that might cause such an activity. On the one hand, the quality of regulatory documents and administration schemes should be enhanced, because the role of public funding becomes critical, competition for resources gains momentum amid projected growth in investment capital outflows in 2014¹ and falling crude oil prices during 2014. On the other hand, active rule-making efforts amid crisis may reflect exacerbation of the struggle for survival between different government agencies.

Western economic sanctions against Russia can hardly be lifted in the short run. The economy cannot advance at outstripping growth rate, the Russian President spoke of, unless the country is appealing for investors. From the economic standpoint, investors consider the imposed sanctions, high taxes and heavy administrative pressure mechanism (with heavy penalties) as a type of financial risks they have to assume while operating on a certain territory. The risk is compensated by higher returns – this is the general rule in a market-driven economy. If Russia today has no extra returns for investors, the same should be created by forcing down tax and administrative burdens. Otherwise capital would flight, specialists with competitive competences seek to leave this country and sell their competence in other countries where it can be appraised at a market value (drain of brains and young hopefuls), and Russia would face less development prospects.

The attempts to replace western with eastern money should be supported indeed, because Russia needs investment for the development, but the difference between the money should be understood. The interests of market manufacturers and free market shouldn't be identified with the interests of government-owned corporations (both Russian and foreign ones). Chinese investment in Russia mostly refer to government-owned corporations (entities with strong state support). In our previous reviews we already provided examples of shattering impact of government-owned corporations on free markets: making use of state financial support, government-owned corporations can, for as long as they wish, keep prices (including interest on loans) lower than the prices at which independent manufacturers (independent credit institutions) sell their products (render services), driving

the latter out of business. This results in a global turn of cash (financial) flows towards government-owned corporations controlled by foreign states – the funds would be transferred from the country or used to expand into and gradually capture the “alien” market, i.e. squeeze domestic manufacturers out of the market and make them bankrupt). Even with a small gap in prices of goods (works, services), the shattering impact of the government-owned corporation presence in the market manifests itself quickly and irrevocably: the banking business would be weakened, domestic manufacturers would fail to stand the competition in the internal market (they wouldn't receive the same support as their Chinese counterparts have). No wonder that market-driven economies allow foreign government-owned corporations to enter their internal market on the conditions that the latter take no advantage of unlimited opportunities to cover their losses with state budget resources. Turning towards eastern countries, Russia should draw on the European countries' experience of dealing with “alien” government-owned corporations. It can be assumed that facing no competition from private foreign investment in Russia, Chinese investors would offer any kind of extra encumbrances on loans, e.g. loans may include labor costs of specialists whom government-owned corporations send to work under contracts in Russia, costs of machinery operation training and provided technologies. Furthermore, one should remember proposals to allocate unpaid or late-paid interest on loans to the capital of joint productions, and other forms of state capital in-growth into the economy of other country. In our opinion, relationships with major eastern investors concerning the development of hydrocarbon deposits should adhere to the legal schemes developed as part of the decisions made by the Eurasian Economic Commission (EEC). The principle of making tariffs on hydrocarbons pumping will presumably be provided for explicitly in the text of pipeline construction con-

¹ The socio-economic development forecast of the Russian Federation in 2015 and the planning period of 2016–2017 (developed by the Ministry of Economic Development of Russia (MED)).

tracts with Chinese counterparties. This is why such contracts should stipulate that state support through the Russian budget of investment in a pipeline construction project may not be deemed to be subsidy of subsequent product pumping services, lowering the tariffs¹ (otherwise the project pay-back period for the Russian counterparty may extend indefinitely, whereas the Chinese counterparty would benefit from a cheap pumping cost).

In our opinion, it is critically beneficial for Russia to become more appealing in terms of investment for independent, private entrepreneurs, which should be done by easing tax and administrative burden on businesses. This is why we consider that the adoption of regulatory documents without in-depth consideration of their potential impact on the behavior of business entities will not be able to address the issues faced by the modern economy of Russia and by contrast might eventually provoke further crisis developments resulting from inefficient use of the available resources and escalation of social tensions.

1. The Ministry of Economic Development (MED) suggests that a moratorium on tax burden growth should be introduced. The MED and the Federal Anti-Monopoly Service of Russia (FAMS) published a joint information letter on the possibility to allow small-sized business entities and socially-focused non-profit organizations (NPOs) to lease state-owned property at preferential interest rates less than a market value appraised by an appraiser, and also renew lease contracts. At the same time, the Ministry of Finance of Russia suggested that small-sized businesses should be limited in accessing tax allowances². As one can

1 See the text of the Recommendation of 7.10.2014, No.10 of the Panel of Eurasian Economic Commission includes "On the Unified Methodology of the Tariff Policy of Natural Monopolies": "...Funds allocated to the implementation of special-purpose investment projects shall be considered in constructing the investment program of a natural monopoly entity, but shall not be considered in calculating tariffs (RGP)". For information purposes: RGP stands for required gross proceeds.

Furthermore, there are other noteworthy reservations with regard to the calculation of tariffs of natural monopolies. In particular, according to the Recommendations, "...Natural monopoly's costs saving ... shall not be considered in tariff calculation (costs (expenses) are calculated without regard to saving) within a period of the commencement of the formation of costs saving until the expiration of three years from termination of the payback period of the costs on optimization measures" etc.

2 «Минфин предложил ограничить доступ малого бизнеса к налоговым льготам», сайт lenta.ru/news/2014/10/09/fin-business/ от 9.10.2014 ["Minfin suggests limited access to tax allowances for small-sized businesses, available (in Russian) on lenta.ru/news/2014/10/09/fin-business/ от 9.10.2014]; «Глава Минэкономразвития предложил запретить рост налогов», сайт lenta.ru/news/2014/10/08/ulykaev/ dd. 9.10.2014. ["The Head of the Ministry of Economic Development suggests a ban on

see, the former measure is exactly the opposite of the latter. The reasoning of the Ministry of Finance needs to be further explained: if the objective is to eliminate channels of tax avoidance as downsizing of businesses to meet the established criteria entitling them to preferential tax treatment, another simple lowering of the criteria cannot, in our opinion, address the issue of tax avoidance.

2. The role of the state budget as source of funds for investment becomes increasingly important amid limited access to external resources. The Executive Order of the Russian Government of 11.10.2014 No. 1044 approved the Program for Support of Investment Projects Implemented on the Territory of the Russian Federation (project financing program focused on the engagement of business entities and banks).

The Program established criteria for eligible projects; criteria and procedure for qualifying Russian credit institutions and international financial organizations eligible for the Program; procedure for granting public guarantees on loans issued for the implementation of investment projects.

A special feature of the Program is that the Ministry of Finance is assigned to appropriate federal budget funds, 25% of the value of loans issued under investment projects, to discharge the obligations on the state guarantees granted for investment projects. VEB is assigned as the agent of the Russian Government for the implementation of the Program (analytical accounting of granted guarantees, as well as debt recovery under the loans of authorized banks).

The Program establishes the following terms and conditions for obtaining loans from participating banks. Loans may be issued against the guarantee of the Ministry of Finance by the authorized Russian banks and international financial institutions in Russian rubles at an interest rate equal to the Central Bank's key interest rate increased by 1%.

An authorized bank may be a Russian bank with at least Rb 100bn of equity working capital as of the last accounting date, not banned for accepting retail deposits, with at least 10-year experience in investment projects with a value of at least Rb 3bn each within the past three years. An authorized international financial institution may be an international financial institution in which Russia has an interest of at least 30%, with PIO experience on the territory of the Russian Federation, with at least 20% capital adequacy as of the last accounting date, with its credit portfolio including at least 25% of loans to Russian entities or

tax growth", available (in Russian) on lenta.ru/news/2014/10/08/ulykaev/ dd. 9.10.2014.]

invested in securities of Russian issuers, with at least 3-year experience in investment projects.

Investment projects are qualified based on the following criteria: a project is located on the territory of the Russian Federation, covers a priority line for the economy of the Russian Federation, the project value ranges within Rb 1bn and Rb 20bn. Borrowed funds account for 80% or less of the project value.

Upon closer examination, the funding scheme of investment projects appears to be disputable. Having selected VEB as the agent, the Russian Government basically allows the bank to generate risk-free extra profit from fees. At the same time, the qualified authorized banks must issue loans for low-margin projects (Central Bank's interest rate plus 1%) against ruble-denominated guarantees by the Ministry of Finance (amid the weakening ruble, and the guarantees will be covered only 25% with budget resources, which presumably make it difficult for banks to be reimbursed in case of project failures). VEB will keep account guarantees, as well as recover debts, presumably charging a fee for both. On an even closer examination, the scheme appears to be beneficial for all but individuals who eventually might pay for all. Banks will participate in investment project financing despite small returns, because the Central Bank is assigned to make sure their loans for projects are refinanced (i.e. banks will eventually be paid back and have the guaranteed profit equal to a central bank's interest rate increased by 1%). The Bank of Russia can use only two sources of resources, namely reserves and ruble devaluation, to refinance the participating banks' loans. In other words, one cannot rule out the possibility of financing investment projects with inflation tax on individuals.

In other words, to make the foregoing scheme up and running properly, projects should offer extremely high returns. Otherwise projects will receive loans but it is individuals who will have to pay.

3. Another financing scheme which raises questions about its efficient implementation is a model designed by the Ministry of Industry and Trade for prequalification and competitive selection of Russian organizations to be entitled to subsidies covering a share of R&D costs in priority areas of the civil industry based on the Order of September 26, 2014 No. 1931 issued for the purpose of *The Industrial Development and Competitive Growth* state program of the Russian Federation approved by the Executive Order of the Russian Government of 15.04.2014 No. 328 and the Rules for Granting Subsidies from the State Budget approved by the Executive Order of the Russian Government of December 30, 2013 No. 1312.

The developed Procedure establishes that legal entities with at least 50 qualified employees on a full-time basis may be entitled to the said subsidy on a competitive basis; whose technical and test equipment is worth at least Rb 150m; with premises as buildings, structures measuring at least 500 square meters.

Without going into the competition's subject matter which is planned to cost billions of rubles¹, let's focus on the scheme of granting subsidies. Formally, the competition deals with the reimbursement of R&D costs incurred by customers, rather than R&D financing. Under the law on science, scientific research can produce either an intangible asset recognizable in the balance sheet or no results. In the former case, the Ministry of Industry and Trade of Russia presumably must transfer funds to reimburse the customer's costs incurred on the purchase of the R&D item from the contractor. In the latter case, the customer's costs incurred as payment for R&D which has produced no results in the form of intangible asset are to be written off to the customer's current expenses and recognized as customer's overhead costs reducing the taxable profit. In the latter case, the Ministry of Industry and Trade must from time to time grant a subsidy to the customer to cover his unsuccessful costs so that he can recover his working capital loss. As one can see, there is no economic basis whatsoever behind any kind of competitions on subsidies to reimburse costs incurred on R&D².

4. There is another subsidy distribution scheme that raises as many questions as the previous one. The Executive Order of the Government of Russia of October 2, 2014 No. 1006 for the purposes of the provisions of the Budget Code of the Russian Federation approved a method designed to calculate standards of maintenance costs on the government bodies of a constituent territory of the Russian Federation. The size of a standard sets the ultimate share of maintenance costs on government bodies of a constituent territory

1 The order of the Ministry of Industry and Trade of August 26, 2014 No. 1919 established the subject matters, предельные объемы of subsidies and maximum number of organizations entitled to the subsidy per each subject matter of the Competition.

2 The Executive Order of the Government of Russia of 15.04.2014 No. 328 approved *The Industrial Development and Competitive Growth* state program.

The Executive Order of the Government of Russia of 30.12.2013 No. 1312 approved the Rules for granting subsidies from the federal budget to Russian organizations to reimburse a share of the R&D costs in priority areas of the civil industry as part of the implementation of *The Industrial Development and Competitive Growth* state program. Under clause 20 of the Rules, the subsidy may not exceed 100% of the research costs as part of the implemented investment project specified in the contract.

of the Russian Federation in the total value of tax and non-tax revenues of the consolidated budget of a constituent territory of the Russian Federation and grants to equalize fiscal capacity of a constituent territory of the Russian Federation.

The foregoing method supersedes the previous standards established by the Executive Order of the Russian Government of December 29, 2007 No. 990.

It should be noted that the Ministry of Finance has long been refining the method designed to define the ratio of budget revenues of a constituent territory of the Russian Federation and grants to equalize fiscal capacity of a region. This work is important, because it will allow subjective factors to be excluded in the evaluation of grants from the federal budget. However, according to the constituent territories of the Russian Federation, the applicable criteria and calculation techniques are excessively complex, itemized on many indicators, which in practice only strengthens the status quo, offering no opportunities for the development of the regions.

In our opinion, the regions' point of view appears to be reasonable. The method sets a standard limit – under no circumstances the subsidy may exceed 10% y-o-y for a constituent entity¹. However, the idea of these extremely sophisticated multifactor estimates remains unclear if the subsidy eventually may not increase more than 10%, and inflation (which must be considered in the distribution of budget subsidies) will be 8.5% in 2014.

5. Another controversial example of rationed distribution of federal budget funds are the rules approved by the Executive Order of the Russian Government of September 30, 2014 No. 999 for the formation, granting and distribution of subsidies from the federal budget to the budgets of the constituent territories of the Russian Federation to co-finance capital investment in state-owned property of the constituent territories of the Russian Federation (municipal property, execution of measures regarding design and/or construction (reconstruction with some restoration, technical upgrade) capital construction projects and/or purchase of items of immovable property).

The Rules contain a formula for calculating a reduction of the subsidy's volume for the ensuing fiscal year, if the obligations under the subsidy agreement were violated in the preceding period of granting the subsidy, and the violations haven't been dealt with in time, before the first date of reporting on the compliance with the performance measure of using the subsidy in accordance with the agreement in the year following the year of granting the subsidy.

Simplifying the statement of the problem, the following should be noted. The method introduces an estimate of incompliance with the *i* performance measure of using the subsidy. In case of incompliance with the subsidy performance measure in the reporting year, the subsidy is to be reduced for the year to come.

The Ministry of Finance monitors the granting of subsidies, compliance with the performance measures of using the subsidies by the constituent territories of the Russian Federation, keeps the register of subsidies which also includes subsidies for co-financing of capital investment in state-owned assets of the constituent territories of the Russian Federation (municipal property), as well as the register of agreement.

Regretfully, the performance measures seem to be artificial to a certain extent. Subsidies for capital investment and specific works are earmarked funds, i.e. they originally must be provided for in the required volumes and appropriated on the dates set for the financing of a project or performance of a work. The use of the estimate for reducing the subsidy allocated for the ensuing fiscal year creates an illusion of control instead of addressing the foregoing issue. The issue can be addressed by freezing the financing of a project (works) until goal-achievement conditions are clarified.

Therefore, as one can see, the programs designed to stimulate investment are disputable. There is, in our opinion, no reason to believe that such programs can replace the development of a free market.

The following taxation regulatory documents are worth noting.

6. The Federal Law of 4.10.2014 No. 284-FZ made amendments to the Tax Code of the Russian Federation. The rights granted in C.4, Art.12 thereof to the representative government bodies of Moscow and St. Petersburg to define specifics for assessing the tax base for local taxes, tax allowances, the grounds and procedure for their application are extended to the representative government bodies of the city of Sevastopol.

Clarified was the procedure for adjusting the cadastral value in assessing the corporate property tax with regard to the immovable property of administrative and business and trade centers, nonresidential premises, items of immovable property owned by foreign organizations which are not operating through permanent establishments. Clarified was the accounting procedure for the adjusted cadastral value of land plots for the purpose of land tax.

Personal property tax was introduced. Resident buildings (premises: apartment, room); garage (car

¹ Paragraph 25 thereof.

parking space); construction project in progress, other buildings, structures, premises were recognized as taxable items. The tax base is assessed on the basis of cadastral value. The tax was introduced across the entire constituent territory of the Russian Federation until 01.01.2020. Allowance was made for deductions from cadastral values: for a stand-alone house – 50 square meters, apartment – 20 square meters, room – 10 square meters. The tax base assessed on the basis of cadastral value is subject to tax rates of 0.1% or less (for residential premises, garages, business structures with a floor space of up to 50 square meters), 2% (for premises in administrative and business and trade centers, items of immovable property owned by foreign organizations not operating through permanent establishments), 0.5% for other taxable items. Tax allowances are allowed for certain categories of taxpayers.

Adjusting (decreasing) coefficients to the tax base are applicable within the first four years (0.2 to the first fiscal period, 0.4 to the second one, 0.6 to the third one, 0.8 to the fourth one).

7. The Federal Law of 4.10.2014 No. 285-FZ established that employment income of refugees and persons granted temporary asylum in the territory of

the Russian Federation, who are not tax residents of the Russian Federation, shall be subject to taxation at a general rate of 13% (not 30%). This tax allowance was introduced in response to flows of refugees from Ukraine.

8. The Federal Law of 04.10.2014 No. 287-FZ a share of the profit to be transferred by the Bank of Russia to the federal budget was lifted to 75% from 50%.

9. The Executive Order of the Russian Government of 20.09.2014 No. 963 approved a mechanism of bank supply of very large contracts on supply of goods (works, services) for public needs. This refers to transactions of more than Rb 10bn (under construction, reconstruction contracts, with a single supplier). It is assumed that banks will open special accounts for settlements, as well as monitor contract execution monitoring, provide services allowing accepted goods, works (results thereof), services to comply with the contract terms and conditions. It was recommended to enter into similar bank support agreements for transactions of at least Rb 1bn for a constituent territory of the Russian Federation, at least Rb 200m for a municipality. The bank support is subject to a fee of 1–1.1% of the contract value. ●