

## A REVIEW OF TAXATION REGULATORY DOCUMENTS ADOPTED IN THE PERIOD OF OCTOBER–NOVEMBER 2014

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*The period of October–November 2014 was very unstable economically. The rapid slide of crude oil prices, below \$80 per barrel, was followed by a nearly 40% depreciation of the ruble against world currencies. Having lifted limits on the ruble exchange rate fluctuations and imposed limits on access to the ruble liquidity, the Bank of Russia has stopped in the short run the fall of ruble exchange rate, however, according to experts, this shouldn't be regarded as stabilization of the ruble. A package of legal acts and technical documents on taxation was adopted. Some of the decisions made are questionable and not economically seamless. In our opinion, some of the decisions are timeserving and should be reconsidered.*

The Central Bank's decisions in November 2014 to limit the ruble liquidity is not a silver bullet to achieve a sustainable financial stability in this country. Such limits will result in a higher domestic price of money, i.e. they will be followed by growth in loan interest rates, thereby recoiling upon retail prices in the consumer market, which will unavoidably start to grow. To stabilize retail prices, the Central Bank will have to, as experts note, periodically replenish the ruble liquidity<sup>1</sup>. As a result, the ruble exchange rate will depreciate.

Another phenomenon which is very specific to the tough economic situation in Russia is attempts to pump as much money as possible into the budget and make the same as soon as possible. While it is the inflation tax driven by the depreciation of the ruble exchange rate that has become an additional source of federal budget revenues, the regions initiated the submission by the State Duma Committee on Budget and Taxes of a draft law on the introduction of additional levies on 22 types of business activity of legal entities and individual entrepreneurs (self-employed persons)<sup>2</sup>. It is Prime Minister Dmitry Medvedev who suggested to introduce local levies at the Sochi Investment Forum in September. President Putin made some comments on the reason for this initiative at a meeting of All-Russia

People's Front: commercial centers located in Moscow paid only a few million of rubles of taxes to the municipal budget of Moscow in 2013. We already noted in our previous reviews about the need to introduce imputed taxes as per square meter of commercial surface. Commercial centers may generate a small profit even from a large turnover in such, where products are sold, like in the banking business, for a margin as percent of turnover, in which case sales costs are deducted from the margin. The most likely way to conceal income is based on schemes under which commercial premises are leased to third parties. A potential leaseholder is offered a large surface for leasehold and then he should himself look for sub-leaseholders. Since small businesses prefer not to enter into long-term leasehold contracts and assume risks of looking for sub-leaseholders, they are ready to pay directly to the landlord for the opportunity to use commercial surfaces. The lack of imputed taxes on commercial surfaces may encourage the emergence of shadow markets.

However, having accepted the need to introduce imputed taxes as per square meter of commercial surface, we, in the meantime, cannot support the proposal of the foregoing State Duma Committee unless detailed clarifications are provided. The initiators of the law argue that such levies will have no adverse impact on the financial status of entrepreneurs, because the amount of the levy is based on the value of a patent as per square meter, while paid taxes will be allocated to commercial centers' costs. The argument is wrong from the economic standpoint: the patent is to be obtained prior to the commencement of a business activity, while the profit tax is to be paid on the business performance basis. To pay in advance the levies to be introduced, entrepreneurs will have to obtain loans, therefore to ensure "force equation" the value of square meter under a patent should be discounted by at least a market rate on bank loans. Economic

1 В. Гайдаев. Рубль освоился в свободном плавании. Коммерсант, 21.11.2014. [msn.com/ru-ru/money/news/](http://msn.com/ru-ru/money/news/) [V. Gaidayev, The ruble learns a free floating], available (in Russian) on [msn.com/ru-ru/money/news/](http://msn.com/ru-ru/money/news/), Kommersant, 21.11.2014.

А. Михайлов. Тяжкое бремя свободы: что делать Центробанку с плавающим рублем [A. Mikhailov. Heavy burden of freedom: what does the Central Bank have to do with the floating ruble]. Available (in Russian) on [slon.ru/economics/1180494.xhtml](http://slon.ru/economics/1180494.xhtml).

2 Е. Крючкова. Нагрузка на местах. Депутаты внесли законопроект о введении сборов на 22 вида деятельности [E. Kryuchkova. Local burden. State Duma submits a draft law imposing levies on 22 types of business activity]. Available (in Russian) on [kommersant.ru/doc/2604035](http://kommersant.ru/doc/2604035) от 6.11.2014. It is the levy on commercial activities that was left in the draft law following its discussion. The levy is planned to be introduced as an experiment in Moscow.

downturn isn't the best time for fiscal novels, because of drastic increase in financial risks for all producers of commodities and market entities (including retail networks) in response to unavoidable changes in the consumer demand pattern, money saving tends to prevail, the money market tends to face hard times (people tend to postpone their purchases, delay repayments on loans, etc.). We noted in our previous reviews that the economy might face such trends, and any increase in the financial burden on commodity producers shouldn't be an option in times of downturn.

A package of legal acts on taxation were adopted in the period under review. These acts are worth considering, given the fact that they were adopted in times of stagnation and Western financial sanctions against Russia.

1. The Federal Law of 24.11.2014 No. 366-FZ introduced material and controversial amendments to the Tax Code of Russia (the RF Tax Code), some of which are mentioned below.

1) A provision is made of a mechanism of reinstatement in the tax base of the amounts of input value added tax (VAT) accepted for deduction in respect of acquired or constructed fixed assets and intangible assets. The introduction of a common 10-year period of amortization of fixed assets and intangible assets allows a ceiling amount of paid VAT on acquired fixed assets and intangible assets to be defined, this amount is annually included into the taxable income.

A tax amount subject to reinstatement and payment to the budget is calculated on the basis of 1/10 of the tax amount previously accepted for deduction, in a proportion defined as the value of shipped goods (works, services), transferred tax free title, in total value of goods (works, services), title, shipped (transferred) during a respective calendar year. The VAT amount subject to reinstatement is to be allocated to other costs under Article 264 the RF Tax Code, rather than included into the value of shipped goods (title), works, services.

If within a 10-year period the fixed asset under upgrade (reconstruction) is excluded from amortizable assets and not used by the taxpayer during one or more full calendar years, the tax amounts accepted for deduction may not be reinstated for these years. The assessment of the suspended 10-year period is to be resumed beginning with the year when the fixed asset (intangible asset) is back in service.

2) The RF Tax Code contains separate articles with detailed description of payment of excise duties on petrochemical products (benzene, paraxylene or ortoxylene). It's not quite clear, why excise taxation on operations with these compounds are not included into the

common procedure and set forth in separate articles in the RF Tax Code. Perhaps, since there is no special industry-specific legislation covering these compounds, the authors of the law tried to include into the RF Tax Code all what they know about the chemical makeup of these compounds, workflow management of petrochemical industry products, etc. As a result, the logic of the RF Tax Code was disturbed. For example, specific chemical elements or compounds can hardly be legally described as part of the RF Tax Code: "...for the purposes of this chapter, benzene shall be recognized as a liquid containing (by weight) 99 percent of the respective primary aromatic hydrocarbon;...paraxylene or ortoxylene shall be recognized as a liquid containing (by weight) 95 percent of the respective xylene isomer (dymethylbenzene) ..." etc. The descriptions of certain actions included into the RF Tax Code aren't quite logical<sup>1</sup> from the taxation standpoint, for example: "For the purposes of this chapter, *purchase of the title to* benzene, paraxylene, ortoxylene shall be recognized as *acquisition of* benzene, paraxylene, ortoxylene ..." <sup>2</sup>, and then "booking" is considered as the operation regulated by the RF Tax Code<sup>3</sup>, etc. Following the common logic, it is sales, not purchases, of goods (works, services) that are subject to excise duties and VAT.

Perhaps, the need to make changes in the excisable item of benzene, paraxylene, ortoxylene vs. the standard procedure was to exempt from excise taxation a part of income generated from excisable goods. For instance, under the amendments to Articles 199 and 200 of the RF Tax Code, excise duties assessed on the "booked" raw materials in question are not included into their cost, instead they are subject to a deduction using multiplying coefficients which are to reach, effective from 1.01.2017, 1.94 times the amount of the previously accrued tax. In using the received (booked) benzene, paraxylene, ortoxylene for the production of petrochemicals, the foregoing coefficient is to increase to 3.4 times effective from 1.01.2017. As a reminder, the paid VAT and excise duties are subject to offset or

1 Далее Points at issue in Articles 181 and 182 are hereinafter italicized and underlined.

2 The fact of purchase (acquisition) of raw materials and supplies and holding a title to them has nothing to do with excise taxation. It is the seller, not the buyer (owner), who pays excises.

3 "Booking" means recognition in the balance sheet. Recognition in the balance sheet is not an excisable item.

To compare, see Paragraph 2, Article 187: "The tax base arising from the sale (or transfer if such transfer is deemed to be taxable in accordance with this Chapter) of excisable goods produced by the taxpayer shall be determined according to the tax rates which are established for those goods ..." (further as the text goes).

In case of barter (exchange of commodities) transactions, the RF Tax Code employs the following standard legal expression "... and the use thereof as payment in kind shall be regarded as the sale of excisable goods".

reimbursement. It appears that owners of benzene, paraxylene, ortoxylyene would be reimbursed from the budget using coefficients being many times the amount they paid<sup>1</sup>. The fact that our assumption is not groundless can be evidenced from the amendments to Article 250 of the RF Tax Code, under which the given amounts are recognized as non-operating gains subject to the profit tax<sup>2</sup>

3) The adopted law establishes in the RF Tax Code a 30% excise duty rate on natural gas (with a provision that natural gas is recognized as excisable if excise taxation is provided for by the international treaties of the Russian Federation (Article 205.1 thereof), as well as amendments were made to excise duty rates on other excisable goods (alcohol-containing products, motor vehicles, etc.).

4) Total tax rate for the profit tax and income tax on dividends was lifted to 13% from 9% (reduced rate of 9% is retained for organizations which beneficially and continuously hold within 365 calendar days at least a 50% interest (share) in the charter (pooled) capital (fund) paying dividends to the organization or depositary receipts giving the right to receive dividends, provided that such organization is located in an offshore zone).

5) Amendments were made to the water tax payment procedure (multiplying coefficients to tax rates were introduced).

6) Fuel gas pricing for the purpose of the mineral extraction tax was updated. The oil pricing formula<sup>3</sup> was updated. Therefore, a "fiscal maneuvering" was undertaken, under which export customs duties on crude oil and petroleum products are subject to gradual reduction, whereas the mineral extraction tax rate on crude oil and natural gas liquids is to increase.

7) The agreements on the establishment of consolidated groups of taxpayers registered during 2014 is suspended until January 1, 2016.

1 Under Paragraph 1, Article 203.1: "If, as of the end of fiscal period the amount of tax deductions exceeds the total tax amount computed by persons holding a straight-run gasoline refining certificate and/or a certificate for operations with benzene, paraxylene or ortoxylyene and/or entered on the Russian Federation Civil Aviation Operators Registry and holding an air operator certificate, the resulting difference shall be subject to reimbursement (setoff, refund) to the taxpayer..."

2 See the wording of the Law: "30) amend Part 2, Article 250 by adding Paragraph 24 as follows: 24) as difference between the amount of tax deductions from excise amounts assessed during the operations specified in subparagraphs 21, 23 – 28, Paragraph 1, Article 182 of the RF Tax Code, and the specified excise amounts".

3 For the purposes of Article 342.4 of the RF Tax Code, the Federal Tariffs Service of Russia (FTS) commented on the calculation procedure for the average estimated gas sales price within the Unified Gas Supply System, providing equal revenues from gas supplies to consumers in the Russian Federation and consumers in countries other than the CIS member states.

2. The so-called offshore counteracting Federal Law of 24.11.2014, No. 376 *On Amendments to Part 1 and 2 of the Tax Code of the Russian Federation (With Regard to Profit Tax on Controlled Foreign Companies and Income Tax on Foreign Organizations)* needs a few comments.

The legally provided mechanism of fiscal control over the taxation on income generated on the territory of the Russian Federation by foreign companies and non-legal entities which are recognized as taxpayers under the Russian legislation, has some technologic deficiencies. Foreign organizations and unincorporated foreign entities owning assets recognizes as taxable item, are obliged under Article 374 the RF Tax Code to inform tax authorities at the place of residence of the real property owned by the participants of this foreign organization (an unincorporated foreign entity must provide information about its incorporators, beneficiaries and managers). Formal beneficiaries of such income generated on the territory of the Russian Federation are covered by Double taxation conventions, unless the ultimate beneficiary is proved to be a Russian resident. Therefore, the ultimate beneficiary identification scheme is efficient, provided that foreign organizations and unincorporated foreign entities generate income from the real property located on the territory of the Russian Federation.

Should they have no real property, it is much more difficult to identify the true beneficiary of foreign company's operating income or income generated from sources in Russia. The law in question provides for the procedure of notification by a Russian tax resident – foreign company's incorporator (beneficiary) – to Russian tax authorities of the controlled foreign company (the interest held in the equity thereof) and the amount of retained profit.

The random factor perhaps would play a major role in the detection of tax evasion facts, because Russia normally has no information exchange agreements with offshore zones.

3. The Federal Law of 24.11.2014 No. 368-FZ establishes a common regime of personal income tax payment under a patent for foreigners as employees (not only natural persons, but also organizations and individual entrepreneurs and persons engaged in private practice). Fixed advance payments (applied against the patent value) established as Rb 1200 per month adjusted for the deflator coefficient set by the Ministry of Economic Development of Russia and regional coefficient annually set by a constituent territory of the Russian Federation.

Under the Federal Law of 24.11.2014 No. 374-FZ effective from January 1, 2015, revenues from the personal income tax paid as fixed advance payment by foreign nationals who run their business under a patent on the territory of the Russian Federation will be transferred to the budget of the constituent territories of the Russian Federation at a 100% standard. At present, such income is transferred in equal proportion of 50% to the federal budget and the budget of the constituent territories of the Russian Federation.

4. The Federal Laws of 14.11.2014 No. 347-FZ and No. 348-FZ improved considerably the tax administration: the status of taxpayer user account available at the tax service official website was legally established, and a fiscal control regime in the form of fiscal monitoring for large corporate taxpayers was introduced.

Tax monitoring is intended to assess the accuracy, completeness and timeliness of corporate taxpayer's (levypayer, fiscal agent) obligatory payment (remittance) of taxes and levies. Any organization which meets all of the following criteria may apply for fiscal monitoring: total amount of tax liabilities (VAT, profit tax, excise duties, mineral extraction tax) during the preceding year is no less than Rb 300m; total volume of the income generated during the preceding year is no less than Rb 3bn.; total value of assets as of December 31 of the preceding year is no less than Rb 3bn. Tax authorities may not conduct on-site tax audits in the periods fiscal monitoring. The tax authorities draws up a conclusion based on the documents provided by the taxpayer. Should the taxpayer disagree with the tax authorities' conclusion, a mutual agreement procedure is to be initiated.

Other regulatory documents adopted in the period under review reflect and/or technically establish a stronger government presence in the economy. The documents are classified as follows:

a) the documents designed to cope with economically ungrounded marginality of the income generated by certain types of business activity. The marginality has resulted from the substitution of objective market relations with ordinary financial speculations;

b) the documents designed to establish relations in the areas which still cannot provide conditions for a free market, but produce socially significant goods (works, services);

c) there is a large group of documents which are questionable in terms of economic necessity. These comprise all kinds of ministries' developments on distribution arrangements of budget resources based on abstract indices, proportions, etc. as part of state

programs. Such index-focused distribution creates an illusion of streamlining the budget spending. In fact, however, this resembles pumping of budget resources to support non-competitive enterprises. It should be kept in mind that resources for such a redistribution come from taxes on market entities.

A) An example of the documents pertaining to the group which we conventionally label as "A" is the Bank of Russia's explanations. Under the Federal Law of December 21, 2013 No. 353-FZ *On the Consumer Credit (Loan)*, the Bank of Russia published information on average market values of consumer credits (loans) (by category) during the period of September 1–30, 2014 and maximum full values of consumer credits (loans). The data will be used in entering into consumer credit (loan) agreements with natural persons in Q1 2015.

The Bank of Russia explained that it estimates existing average market values rather than sets interest rates. Under the Law, as of the date of a consumer credit (loan) agreement, total value of the consumer credit (loan) may not exceed more than 1/3 of an average market value of the consumer credit (loan) calculated by the Bank of Russia.

The Central Bank has plans to study the specifics of consumer lending business models in order to implement measures aimed at introducing additional mechanisms of borrower's risk evaluation and reduce costs of consumer loans in order to reduce interest rates. The Bank of Russia has plans to further develop standards for professional lenders. These standards are intended to disclose information on credit products, including loan risks for natural bodies, at interest rates beyond which they are unable to serve loans.

Despite that a legal act regulating microfinance organizations was adopted, in our opinion, the very fact of the existence of such organizations lending cash under enslaving terms to individuals cannot be tolerated in a socially mature society and is the evidence of lacking advanced mechanisms of social support to persons in financial distress, employment of the same in the public sector. It is the families of persons in financial distress, which borrow in the market at speculative, high interest rates that have to cover the costs of immaturity of the social system of public works as a source of income for such persons. The Central Bank promptly addressed the situation by defining the limits of the burden that could be placed on individuals in the market.

B) An example of the documents pertaining to the group which we conventionally label as "B" is, for example, the Russian Government Executive Order of 01.11.2014 No. 2222-p "On the Approval of

Indices of Changes in Individuals' Payment for Utility Services On Average by the Constituent Territory of the Russian Federation and Maximum Accepted Deviations from the Value of Specified Indices at Specific Municipalities".

This refers to the fact that the state will continue its policy aimed at restraining growth in prices of services furnished by public utilities as monopolies. Despite attempts to introduce concession-based relations in this area, the outstripping growth in tariffs shows that market entities are not interested in business investment in the utility sector. Fixed assets are worn-out, return on investment is negative. The federal government had to introduce a tariff growth regulation to prevent social conflicts. This issue cannot be addressed amid a stagnating market or recession followed by the depreciation of real personal income. It is extremely cost-intensive to keep in service worn-out utility systems, which may cause their collapse. Development of the utility sector is a key issue of economic performance amid a stagnation. The issue can hardly be addressed unless the state makes investment in the infrastructure.

The Order of the Federal Tariff Service of Russia of 11.10.2014 No. 227-e/3 established indices for maximum possible levels of tariffs of thermal energy (capacity) supplied by heating supply companies to consumers, on average by constituent territory of the Russian Federation for 2015 (8–14% on average).

The Order of the Federal Tariff Service of Russia of 11.10.2014 No. 228-e/4 established indices for maximum possible changes in the existing tariffs of water supply and sewage, on average by constituent territory of the Russian Federation for 2015 (100–110% on average).

C) Documents developed to provide financial aid and protection of interests of state-run corporations can be attributed to the documents which we conventionally label as "C", besides instructive explanations of the rules for holding tenders for subsidies for reimbursement of R&D costs.

For instance, the Russian Government Executive Order of November 14, 2014 No. 1204 made amendments to the Rules for insurance of export loans and investment against business and political risks approved by the Russian Government Executive Order of November 22, 2011 No. 964. The foregoing document contains decisions that need further clarification. The Federal Law On the Federal Budget in 2012 and for the Period of 2013–2014 previously introduced insurance of export loans or foreign investment by a special-purpose insurance company with the VEB's bank guarantee secured by the guarantee of the Russian Government. The approved amendments

which were introduced by the Russian Government Executive Order of 14.11.2014 No. 1204 have no reference to the regulations set forth in the budget law for the current year and subsequent periods. For that matter the budget sources of the current fiscal period the government guarantee issued to VEB, in our opinion, appears to be unregulated. This may result in unpredictable involvement of the national gold and foreign currency reserves in payments under the foregoing (unlimited) government guarantees. We proceed from the assumption that the Executive Order sets an acceptable limit of Rb 300bn for commitments at any time, but provides no maximum amount of VEB's commitments guaranteed by the Russian Government, just as the maximum amount of such time-specific guarantees.

The following technical documents on taxation adopted in the period under review should be noted.

5. A new double taxation convention with China of 13.10.2014 offers most favorable for the Chinese government a regime of taxation on income generated from a business run or investment made by Chinese legal entities and natural persons on the territory of the Russian Federation. Russia's taxation on Chinese investors' interest and dividends will be 5%, provided that investors hold in a Russian organization an interest of at least 25% and at least 80,000 euro in volume. In other cases, the dividend tax rate paid in Russia will be 10%.

6. The Instruction of the Central Bank of 7.10.2014 No. 3413-U, as agreed upon with the Ministry of Finance of Russia, for the purpose of Chapter 25 of the RF Tax Code *On the Profit Tax*, established the Procedure for defining the estimated value of term transaction financial instruments not listed on regulated trading floors. The Instruction contains a calculation formula for such instruments in cases when transactions are denominated in rubles and foreign exchange. A calculation formula for the value of a forward contract in which gold is the underlying asset was presented.

7. The Letter issued by the Federal Tax Service of Russia on 14.11.2014 No. GD-4-3/23640@ explains that for the purposes of double taxation intergovernmental conventions, no in cases when Russian banks pay income generated from operations with foreign banks, there is no need to confirm foreign bank's domicile in a state covered by an international convention (treaty) which regulates taxation, provided that such domicile can be verified in generally available information manuals. At the same time, the foregoing

standard may not be automatically applied to foreign banks' branches. When Russian banks pay income to foreign banks' branches, a document is to be issued by

a competent government body of the state in which a foreign bank branch is located to confirm or disconfirm the fiscal residence of the branch. ●