

*Lyudmila Anisimova*

## **An Overview of Normative Documents on Taxation Issues for October-November 2012**

The law on the federal budget for 2013 and the planning period 2014–2015 was approved by the RF State Duma in the third reading on 23 November 2012<sup>1</sup>. The domestic debt ceiling is set at the level of 10% GDP, the foreign debt ceiling – at about Rb 2.1 trillion. These figures are above the budget liquidity ceiling recommended by international organizations (10%). We believe this index to be very important, because it describes the ratio between the size of expenditure on debt servicing and redemption and the size of federal budget revenue. An accelerated growth of the value of this index reflects the budget's shrinking capacity to provide adequate funding for other types of current expenditures in the future. On the whole, the budget for 2013 has been drawn up with a slight deficit (0.8% of GDP) which, in a situation of a reinstated budget rule, is indicative of the government's intention to exercise real control over the economy's financial sustainability also at the macro-level.

In our opinion, at present the priority issues in the financial sphere are as follows: to ensure compliance with the principles of fiscal federalism in the tax and budget spheres; gradual discontinuation of the use of the tariffs set by natural monopolies in the capacity of pseudo-taxes that generate the government's revenue base outside of the domain regulated by the RF Tax Code; discontinuation of the practice of treating the tariffs for services rendered by natural monopolies as targeted mandatory payments and setting the housing and utilities tariffs without due regard for the recommendations of international organizations as to the share of these payments in the incomes of households.

Over October-November 2011, no significant alterations were introduced in existing legislation with regard to mandatory payment regulation. The RF Ministry of Finance's standpoint concerning the transfer of part of personal income tax (PIT) to the local budgets at the place of residence of employees has remained the same. RF Minister of Finance has confirmed the previous statements, explaining that the Ministry does not believe it to be feasible that the procedure for the payment of PIT should be altered. The motivation behind that standpoint is not that it would be difficult for technical reasons, but that the amount of subsidies transferred from the federal budget to some of the regions will become lower<sup>2</sup>. It is evident that the possibility of reestablishing of the previously existing regions' own tax base and PIT redistribution will be repeatedly discussed at different points as more and more newly elected governors appear on the scene, because the issue of a new period in office for an incumbent governor will no longer depend solely on the RF President's decision – the citizens residing in a given region's territory will now also have their say.

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<sup>1</sup> See [kp.md/online/news/1303671](http://kp.md/online/news/1303671)

<sup>2</sup> 'Siluanov postavil krest na predlozhenii Shoigu po NDFL. Uplata etogo naloga po mestu zhetelstva povredit investitsionnomu potentsialu regionov, schitaet glava Minfina' ['Siluanov has brought to naught Shoigu's proposal concerning PIT. The payment of that tax at the place of residence will be detrimental to regions' investment potential, believes the head of the RF Ministry of Finance']. See [izvestia.ru](http://izvestia.ru) of 3 October 2012.

The reason behind the exacerbating debate around the issue of tax revenues received by the regions is the lack of proper regulation of the federal center's and regions' financial powers to dispose of the revenue base and spending obligations of regional budgets. Thus, at the federal level it was decided to implement a one-time increase of the salary tariffs for the employees of budget-funded institutions across the entire territory of Russia, without taking into consideration the actual potential of regional budgets to ensure the implementation of that measure in each given region. The result was increased debts of the regional budgets<sup>3</sup> (in 20 regions, the size of government debt by more than half exceeds that of budget revenue).

The RF Ministry of Finance is prepared, at best, to restructure regional debts<sup>4</sup>, but by no means – to write off these debts against the resources of the federal budget. The increasing tension experienced by regional finances as they are no longer able to sustain the same rate of growth of their financial resources at the expense of subsidies flowing to regional budgets from the federal budget, coupled with the tough attitude of the RF Ministry of Finance with regard to writing off the debts that the regions owe to the federal budget, may trigger the process of uncontrolled 'sovereignization' of Russia's territories. The Council of the Federation and the RF Audit Chamber, in view of the complexity of the situation faced by the regions, submitted a proposal to the RF Ministry of Finance that part of regional debt should be written off at the expense of the federal budget.

We believe it to be a priority in the present situation that the federal government's participation in the handling of the regions' own sources of budget revenue should be brought to a minimum, and that the revenue base of regional budgets should be restored. These are the fundamental principles of building the financial base of a federal state with a market economy.

The importance and complexity of that task is vividly illustrated by the issues that the European Union is currently trying to deal with – namely to elaborate the rules and principles for drawing up and executing a consolidated budget that would be acceptable to all. Russia has accumulated vast experience in that sphere – positive as well as negative. Thus, financial troubles became one of the main factors that triggered the 'sovereignization' of the former USSR republics, while on the other hand, in the 1990s the Council of the Federation (whose members were elected governors, each burdened with their specific region's problems) took upon itself the very important function of balancing the interests of businesses and the budgetary system at all its levels. By now Russia – in contrast to Europe – has already developed a single tax system for a market economy; there also exists the RF Budget Code. It seems that in the current phase of development it is necessary to define more precisely the relative powers of federal and regional authorities in drawing up and implementing the budgets of Russia's territories. So far, there has been excessive command-type guidance on the part of the RF Ministry of Finance. In market conditions such an approach has no economic substantiation. Commodity producers act as independent economic entities; regional budgets cannot collect more taxes than is allowed by the law.

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<sup>3</sup> E. Karpenko. 'Ot vrachei po regionam poidut "dyry"'. Defitsit regional'nykh biudzhetov vyrastet s 50 mlrd rublei v 2013 g. do 1,8 trillion rublei v 2018 godu. [Because of physicians, financial black holes will be spreading across regions. The regional budget deficit will increase from Rb 50bn in 2013 to 1.8 trillion in 2018]. See Gazeta.ru of 20 November 2012.

<sup>4</sup> D. Ushakova. *Minfin otkazyvaetsia proshchat' regionam dolgi*. [The RF Ministry of Finance refuses to forgive the regions' debts]. See izvestia.ru of 17 October 2012.

This country's integrity can be maintained by ensuring approximately similar living standards throughout her entire territory. In order to equalize the population's living standards, large amount of money must be allocated to the transfers from the federal budget to regions. The actual cost of living standards equalization becomes even higher due to the substantial debts owed by the regions to the federal budget. As the cost of debt servicing, as noted earlier in our overview, exceeds 10% of federal budget revenue, there remains only 50% of revenue for the funding of the rest of the federal government's expenditure. So, the opportunities for the RF Government to undertake any financial maneuver in the framework of the federal budget are very narrow. That is why it is essential to abolish, wherever possible, most of the exemptions from those taxes that generate regional budget revenues, thus restoring the regions' own revenue base.

Another evidence of the fact that even the heads of biggest metropolitan areas are experiencing shortage of cash has been the recent proposal of Mayor of Moscow Sergei Sobianin that the principle of taxation of losses, abolished by the 2000 tax reform, should be reestablished in Russia's current fiscal system.<sup>5</sup> The essence of his proposal is that taxpayers must pay a certain kind of levy in advance. If the company then gains profit, the levy will be recorded as the payment of tax; if it incurs a loss, the levy will then simply be retained in the budget. According to the authors of that proposal, this will make the companies that submit 'zero' reports reveal their true amount of income.

In our opinion, this proposal must be rejected because it will replace the system based on taxation of incomes received over a reporting period by the one aiming at seizure of property irrespective of the actual results of a taxpayer's economic activity. The business community has already expressed its negative reaction to this initiative of the Mayor of Moscow. Regretfully, the RF Ministry of Finance chose to abstain from comment. We believe that this country's leading financial department must respond more actively to any proposals aimed at altering the basic principles that form the foundation of the taxation system in market conditions, because the absence of any distinctly expressed viewpoint with regard to that issue can be detrimental to the investment climate in the Russian Federation.

One more issue that has given rise to some acute problems in the current economic situation in Russia is that of the tariffs on services rendered by natural monopolies.

We have repeatedly drawn attention to the distinct trend towards replacing the taxes established by the RF Tax Code by the rising tariffs on natural monopolies' services. There are several reasons behind this policy. One of them is the need to do away with the traditional practice to set a very low price on utilities (the heritage of the Soviet era).

The complexity of the task of reforming the housing and utilities sector is evident from the content of the draft government program 'Provision of Quality Housing and Utilities to the

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<sup>5</sup> S. Guneev. *Sobianin pridumal nalog na ubytki*. [Sobianin invented a tax on losses]. See lenta.ru or 29 October 2012.

'Vedomosti': *Mer Moskvyy predlagaet vvesti sbor s malogo biznesa*. ['Vedomosti': The Mayor of Moscow suggests that a levy on small-sized businesses should be introduced]. See news.rambler.ru 29 October 2012.

Population of Russia' for 2013–2020<sup>6</sup>. In that program, the decision to deviate from the level of 7% recommended by international organizations for the share of housing and utilities costs in household incomes is explained by the poor condition of Russia's housing and utilities sector (the government program acknowledges that its fixed assets are deteriorating, breakage incidence is on the rise, a considerable percentage of resources is wasted, the volume of water loss is estimated to be 21%, heat loss – 11% of supplies, and the expenditures of the enterprises and networks in the housing and utilities sector are by 25—30%, and sometimes even by 50% higher than the European level). The Program states that the RF Government shifts the burden of investments in the housing and utilities sector directly onto the population and other consumers of these services through raising the relevant tariffs<sup>7</sup>. As a result, the practice of targeted consolidation of relevant mandatory payments to a specific program or fund is *de facto* reestablished, while mandatory payments are placed outside of the system of control over the levy ceiling for commodity producers and taxpayers, established by the RF Tax Code, while the resources thus generated are placed outside of the general sphere of budget-based distribution of resources. The cost-effectiveness and manageability of the economy become lower, and the government policy's potential for maneuver is reduced.

In our previous overview we already noted that the price of services rendered by natural monopolies must be determined on a commercial basis – say, by means of loans that must be repaid over a certain period of time at a certain interest. A bank is a subject in market relations, and so it is interested in timely repayment of its money; in other words, a loan is issued against services that will be consumed and paid for. If the price of the service against which a loan is taken is excessively high, the borrower (an organization rendering a monopoly service) will, most likely, be unable to repay the loan with an interest in due time, and then it will be the bank that will find itself on the verge of financial troubles; thus, banks can really influence the pricing process already in the phase of loan issuance. Any attempts to 'rid' the federal budget of the cost of the upkeep of natural monopolies, to shift the burden of investment onto the population and commodity producers by means of simply raising the tariffs over the level recommended by international organizations will be equal to the introduction of additional mandatory payments for the population, which is not envisaged in the RF Tax Code.

This can be illustrated by the following example. The RF Government issued Decree No 1075 of 22 October 2012 'On Pricing in the Field of Heating Supply'. The fundamental pricing principles for the heating supply sector approved by that decree establish the scheme for determining the necessary amount of gross proceeds to be covered by tariff.

An analysis of the content of Items 33, 46 and 48 of that document has revealed that, in addition to ordinary costs (which include the cost of raw materials and supplies, fuel, personnel

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<sup>6</sup> E. Karpenko. Tarif 'Putinskii' ugrozhaet realizatsii pravitel'svennoi programmy razvitiia ZhKKh. ['Putin's Tariff' threatens the implementation of the government program for the housing and utilities sector's development]. See [gazeta.ru](http://gazeta.ru) of 22 November 2012

<sup>7</sup> It is becoming a widespread practice to include an 'investment' component in the tariffs for services rendered by natural monopolies. Thus, for example, Vice Prime Minister Arkady Dvorkovich in his interview given to the *Kommersant* newspaper, when commenting on the decision to apply, in 2013, an upward index of 7% to the railway cargo shipment tariffs, confirmed this principle as follows: 'The government approved the principle of the possibility of adding an investment component in railway tariffs, the corresponding report was submitted both to the Prime Minister and the President, and there are no objections' (See [Kommersant.ru](http://Kommersant.ru) of 22 November 2012, *Kommersant Online*, *Liubye pravila igry mogut izmenit'sia*. [Any rules of the game may be altered.]

salaries, the amount of depreciation of fixed assets to be taken into account when calculating the profit tax, and other production costs), the expenditures to be covered by the tariff include overheads consisting of interest to be paid on borrowed funds, deductions to reserves against dubious debts, environment pollution fees (within established standards), taxes, etc. Besides, the tariff – funded by profit after taxes – covers the cost of capital investment in amounts no more than 7% of the expenditures included in the necessary amount of gross proceeds and associated with the production and sale of products (or services) and with the overheads. From this scheme it is by no means clear why the investment component of the tariff is charged not only to the costs of production and sale, but also to the overheads; in other words, the higher the amount of the overheads reported by an organization and unrelated to its core activity, the higher the amount of investment to be taken into account when setting the size of the tariff. The source of fines and sanctions to be paid for violations of contractual terms, as well as penalties and fines imposed for failures to effectuate mandatory payments is also unclear; probably these expenditures will be covered by profit after taxes, at the expense of the investment component.

We believe that this scheme for calculating the size of the tariff has no sound economic substantiation, and that it is detrimental to the interests of the consumers of services, because it only accumulates producer costs and envisages no mechanism for adjusting the tariff size (or the price of service) by the current price level on the market. Besides, the amount of net profit after taxes received by the federal state unitary enterprises, which are subordinated to the RF Ministry of Energy as the main executor of budget funds, is at present transferred to the budget<sup>8</sup>. Thereby an additional mandatory payment to the state budget has been effectively levied on the consumers of utilities in the form of tariff's investment component. The base for calculating the size of that mandatory payment has no economic substantiation for its payer, because it is composed of the expenditures incurred by a third party, including that third party's overheads (the costs that are not directly associated with the rendering of services consumed by the payer of the tariff).

In our opinion, consumers must pay for the services rendered by natural monopolies with due regard for the market level of prices (in particular, the tariff for the services in the housing and utilities sector must be calculated on the basis of the norm of consumption per individual consumer (determined as a relative value)<sup>9</sup>, the average number of such consumers, and the price of a service unit (P) determined by the following formula:  $P = 7\%$  of aggregate household income divided by aggregate standard consumption, weighted by type of service). The producers of services can get bank loans against the market level of their tariffs. All the incomes received in excess of the market level can be covered by allocations from relevant budgets only after the producers' expenditures have been verified by the RF Audit Chamber and on the basis of its resolution concerning the size of the sums that can be included in each budget's expenditure for the next financial year.

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<sup>8</sup> Item 9 of the List of Federal Budget Revenue Sources administered by the RF Ministry of Energy in its capacity of administrator of federal budget revenue (Annex 2 to the RF Ministry of Energy's Order of 26 October 2012, No 513)

<sup>9</sup> Article 28.2 of Federal Law 'On Social Protection of Disabled Persons in the RF', No 181-FZ of 24 November 1995 (wording as of 20 July 2012, No 124-FZ) the housing allotment standard per disabled person was established in the amount of 18 square meters; in accordance with this standard, the relevant consumption norms for natural gas, electric energy, water, and heating can be established.

The additional burden on the population resulting from rising tariffs is increasing at a very alarming rate; thus, over the past two years it increased by 36% (in the draft government program discussed earlier it is envisaged that the share of housing and utilities expenditures in the budgets of households will grow from 7% in 2011 to 9.5% in 2013. By 2015, their share will further increase by one-third – to 12%, and the RF Government is convinced that their accelerated growth rate against that of household incomes is inevitable<sup>10</sup>. All the issues relating to the introduction (or adoption), alteration or abolition of taxes (and consequently – the levy ceiling for commodity producers and taxpayers established within the framework of the RF Tax Code) are directly delegated to the Federal Assembly; and the regulation of legislation relating to the setting of natural monopolies' tariffs is the prerogative of the RF Government. We believe that the government's functions with regard to the tariffs set by natural monopolies must be determined more precisely.

Natural monopolies are an indispensable environmental component of contemporary civilized lifestyle. The goal of the State in this connection is to create for each member of society appropriate conditions for gaining free access to a guaranteed set of services provided by one or other natural monopoly. In other words, the granting of access to a service provided by a natural monopoly and maintaining the necessary volume and quality of such services may be qualified as a commercial service provided to an individual by the State. If any individuals cannot pay in full for the service provided by a natural monopoly, they must be granted a subsidy from welfare funds in an amount sufficient for covering the standard level of services rendered by natural monopolies.

Any other approach to determining the value of a 'utilities unit', as we have demonstrated, will transform it into a source of additional revenues derived by the providers of such services (or by the State – if the payments are transferred into the budget) through making the consumers pay for them in an enforced procedure.

The issue of government policy with regard to the tariffs for services rendered by natural monopolies has recently become very acute. The ongoing large-scale transformation of budget-funded institutions into non-profit organizations, and federal state unitary enterprises – into joint-stock companies, will inevitably result for some of their former employees in a forced 'transfer' to other sectors of the national economy – or in being dumped on the labor market. Under these conditions, social tension may increase manifold. The accelerated growth in the 'housing and utilities' tariffs against the background of a slower growth rate of the population's incomes may exacerbate the situation even further.

Among the technical issues of running the RF taxation system that emerged over the period under consideration, the following ones may be pointed out as the most noteworthy.

1. The RF Federal Tax Service's Letter of 17 October 2012, No ED-4-3/17589, concerning VAT. Essentially, the Letter explains that the work (or services) that can be regarded as subject to the exceptions to the general VAT rules stipulated in Article 148, Items 1, Paragraphs 1–4 with regard to the place of performance of work (or services), including the work

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<sup>10</sup> E. Karpenko. *Tarif 'Putinskii' ugrozhaet realizatsii pravitel'stvennoi programmy razvitiia ZhKKh*. ['Putin's Tariff' threatens the implementation of the government program for the housing and utilities sector's development]. See gazeta.ru of 22 November 2012

(or services) that apply directly to movable property (in particular, installation, assembling, processing, treatment, repair and technical servicing), are to be considered to be realized at the place where that movable property is situated (including beyond the borders of the Russian Federation), even when both parties in a given transaction are Russian organizations.

In contrast to the taxation of income, Russia has no agreements concerning the elimination of double taxation with regard to indirect taxes. Under Russian legislation, a payer of VAT is designated not as a stationary representative office, but as a person (an organization or individual entrepreneur). In other words, tax agencies must on their own identify those non-residents that render to other non-residents services related to movable property in RF territory, while the services relocated by Russian residents beyond the borders of the Russian Federation are not levied with that tax, although under the general rule the place of rendering a service is determined as the place where its recipient is engaged in economic activities. To identify that place, it is sufficient to know a person's place of registration or the place where a given organization is situated in accordance with a relevant entry in its charter or founding documents, or the place where an organization is administered, or the place where its stationary executive body is situated, or the place where its stationary representative office is situated (if the work (or services) are realized through that stationary representative office), or the place of residence of a physical person.

The primary purpose of introducing that norm into the RF Tax Code was to make exempt from VAT the services relating to repairs of special and military equipment rendered by Russian organization to other Russian organizations outside of the borders of the Russian Federation. However, after the creation of the Customs Union, the loss of VAT resulting from the exemptions granted to that type of transactions may become substantial. So we believe that, within the RF Tax Code's framework, the list of movable properties to which exemptions VAT are applied must be reduced.

2. Another noteworthy document is the explanation, by First Deputy Chairman of the RF Government Igor Shuvalov, of the procedure for Russia's accession to the OECD<sup>11</sup>. It is planned that the relevant negotiations (the accession request was submitted 12 years ago) should be completed in 2013, and that Russia will become a full-fledged member of that organization from 2014 onwards. To avoid being treated as an offshore zone by the other OECD members, Russia must assume the obligation to comply with the OECD criteria. One of the most important criteria is the one concerning mandatory disclosure of foreign companies' beneficiaries. The RF Ministry of Finance has confirmed its intention to prevent the withdrawal of profit into offshore zones by introducing a tax on the undistributed profit of those foreign companies that are directly or indirectly controlled by Russian organizations; the tax will be paid by their parent companies situated in Russia. It should be reminded that this proposal is stipulated in the *Main Directions of Tax Policy for 2013–2015*. In our opinion, the introduction of tax on undistributed profit of those foreign businesses controlled by Russian organizations whose beneficiaries have not been disclosed to Russian tax agencies must be fully supported – regardless of Russia's accession to the OECD.

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<sup>11</sup> M. Liutova. *Rossii pridetsia zastavliat' inostrannye kompanii raskryvat' benefitsiarov*. [Russia will have to force foreign companies to disclose their beneficiaries]. *Vedomosti.ru* of 1 November 2012

3. By Decree of the RF Government of 25 October 2012, No 1097, some alterations to the *Model Agreement on Eliminating Double Taxation and Preventing Evasion of Income and Property Taxes* are introduced, which were approved by the RF Government's Decree of 24 February 2010, No 84 '*On the Conclusion of Intergovernmental Agreements Concerning the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Regard to Income and Property Taxes*'.

The newly introduced alterations define more precisely a Russian party's approach to determining the tax base of a Russian taxpayer in those transactions with non-residents where transfer prices are applied. The suggested scheme can be concisely described as follows: the profit derived by a Russian organization and the profit derived by its foreign contracting party as a result of one and the same transaction is to be consolidated,<sup>12</sup> and profit tax is levied on the sum of consolidated profit (profit received from a transaction with an independent contracting party). It is suggested that the financial structures of a foreign state are to determine on their own whether the amount of tax paid by the Russian contracting party to the Russian budget on a given transaction should be taken into account in their tax records, or not.

It is not quite clear how Russian tax agencies can actually know the actual amount of profit tax paid by a Russian organization's contracting party to the budget of a foreign state. Our general impression of the suggested scheme is that it is correct in theory, but can hardly be implemented in actual practice.

Besides, the *Model Agreement* contains a stipulation that an equal approach must be applied to Russian and foreign organizations when determining the size of debt of one contracting party to the other in order to identify 'taxable capital'. The term 'taxable capital' is questionable, because the subject of the *Model Agreement* is the prevention of double taxation and the fiscal evasion with regard to the income and property taxes. In accordance with Item 1 of Article 128 of the RF Civil Code, the notion of property includes, among other things, also a legal entity's property rights. In other words, 'property' is comparable to assets on a balance sheet. Capital is part of liabilities, it can belong to an entity (including its net profit) or be borrowed. If tax is levied on assets (or property), there can be no 'taxable capital'. As far as profit is concerned, tax is levied not on balance-sheet profit (assets in excess of liabilities), but on the operating profit constituted by the income from entrepreneurial activity in excess of the expenditures incurred over a reporting period. Therefore it is evident that the wording of Item 24 of the *Model Agreement* will, most likely, be further elaborated.

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<sup>12</sup> Profit on one and the same deal cannot be received simultaneously by both contracting parties (always one of them receives money, and the other pays money).