A REVIEW OF TAXATION REGULATORY DOCUMENTS ADOPTED IN DECEMBER 2014 – JANUARY 2015

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The following developments marked the period under review: the Gaidar Forum 2015 was held in Moscow on January 14–16, the World Economic Forum's Annual Meeting was held in Davos (Switzerland) on January 21–23, 2015, as well as a draft document of anti-crisis measures aimed at tackling the impact of economic sanctions on the Russian economy was prepared by Russia's government and submitted on January 21 to the President of Russia, having regard to a more than two-fold fall of crude oil prices (to $46 a barrel early in 2015 from $110 early in 2014) and the ruble's depreciation against world currencies. The anti-crisis measures haven't yet been embodied in a consistent manner in the fiscal legislation (although a few fiscal laws were adopted on a fast-track basis to cope with the adverse developments in the foreign exchange market), they are scheduled for consideration at the State Duma in February 2015.

The Russian government encountered a serious challenge late in 2014, which was triggered by the national currency drastic weakening against global currencies and crude oil prices seeing a more than two-fold fall. The previously comfortable policy of distributing extra revenues stemmed from long rising prices of hydrocarbons between , on the one hand, state-controlled corporations, state-controlled banks, public officials, security and law enforcement agencies and, on the other hand, individuals (retirement benefits recipients, students) gave way to the need for a mechanism designed to cut budget spending on economic agents. In spite of the fact that nominal budget spending in rubles may remain intact, the real user-values have to be redistributed anyway. As long as the global market remains open for Russia, it is the global market that determines prices of goods, not the Russian government and State Duma members, whatever are their preferences and views of justice. Russia should either close its market and set prices by way of a "hand steering" mode while Russia's government has to prepare to rationing of goods (works, services), i.e. go back to the late Soviet era economy whereby entailing quite obvious and already time-tested consequences, or undertake drastic changes in the economy management scheme. There is no longer way to make any efforts to redistribute the shrinking (in response to reduced inflows of foreign currency) real market and shrinking foreign exchange revenues for the benefit of state-controlled corporations, state-controlled banks, public officials, security and law enforcement agencies so that other groups of state-funded persons (first of all individuals) cannot see their real consumption shrinking. Pumping ruble liquidity in any form into the economy: forcing the central bank to drop the key interest rate and banks to provide low interest loans to manufacturers, taking measures aimed at compensating for individuals' consuming capacity (to which the recommendations of old-Soviet-school economists[1] are basically reduced), will have an adverse effect on prices (with a certain lag of 2–3 months as is evidenced by the past practice of indexation of wages and retirement benefits). The inflation-related bearing on prices may be seen in retail trade, above-trend growth in public utility services, tariffs of the services provided by natural monopolies, etc. If there is no mature internal commodity market, any form of ruble liquidity injection (like payments under government contracts, lifting the central bank key interest rate, etc.) will first of all stem reallocation of resources to the foreign exchange market, which may destabilize public finance at all levels and will increase the pressure on the ruble exchange rate. The central bank will be able to maintain the ruble's exchange rate at a relatively stable level for as long as the golden and foreign-exchange reserves are there (as a reminder, the reserves already shrank annually to $388bn early in 2015 from $510bn late in 2013). Russian government's wavering in undertaking prompt, structural economic reforms and delay in lifting all (fiscal, administrative, etc.) restrains on small and medium-sized businesses may, in our opinion, trigger extremely threatening trends under the circumstances.

This opinion needs to be explained. We assume that low crude oil prices and economic sanctions will long be a problem. Under the circumstances, a choice of economic policy priorities plays a special role. The key objective at this stage is to steadily ease the pressure on the ruble, achieve the macroeconomic stability of economy. Russia's market was made open for global capital after the demise of the Soviet Union. A new outlet for goods (works, services) of foreign origin

1 See debates in Russia's State Duma Committees and Commissions in view of the results of Gaidar Forum 2015.

emerged. At the same time, Russian organizations' assets were found to be undervalued compared to prices in the global market. Russia's market appeared to appealing to foreign investors, and capital flooded into the revaluation of Russian assets, rising their price up to the global market prices, first of all the assets relating to the extraction of minerals and hydrocarbons. The value of Russian's labor force was updated amid growing market, initially in the mineral extraction industries, then in other industries and the public (state-sponsored) sector. The above-trend growth in the value of hydrocarbons and linking budget revenue growth rates via the tax system with the rise in the turnover of exporters and importers helped accumulate budget resources in the amount sufficient to increase the income of certain groups of Russia's population. This triggered an instant growth in consumer demand inside the country. Relatively cheap mass production of goods of foreign origin were determined by the fact that large lots of fast-moving consumer goods were purchased in foreign markets and then sold via the retail system on the territory of Russia. Basically, the state of the manufacturing of fast-moving consumer goods was very poor in Russia after the 70-year ruling of the Communist Party committed to fighting ideologically with the imperialism. This is a reason why Russia's market absorbed almost everything, including second hand cars and equipment, unmarketable and slow-moving goods accumulated in external markets, thereby creating the opportunity for other countries to develop their economy. Mounting trade turnovers made Russia's financial system grow, namely banks, security market players, etc.

A combination of financial sanctions closing Russian organizations from international capital markets and falling crude oil prices has weakened dramatically the Russian economy's ability to convert raw materials into purchases of foreign goods and repay the current liabilities owed by Russia's financial sector. Under newly created circumstances, retailers have found themselves unable to meet the costs on mass purchases in external markets of fast-moving consumer goods for selling them in Russia's internal market, contracting reciprocal trade turnovers and, consequently, making foreign manufacturers overstock [1]. The driving of Russian public-related manufacturers and financial institutions from foreign markets has worsened the issue of repaying liabilities to foreign creditors. While the issue of overproduction and overstock is still waiting for foreign manufacturers (having a free access to financial resources) due to the sanctions imposed on Russia and Russia's tit-for-tat embargo, the Russian market, in contrast, have been purged (although it is running short of domestically manufactured goods and financial resources). Major players cannot operate on the scale they did before in this market, because of the weakened solvent consumer demand and high exposure to possible losses, however, the developed consumption pattern appears to run short of the required goods, thereby driving prices up and hence creating opportunities for small and medium-sized manufacturers to occupy a newly emerged niche. The question is whether or not a modern market will start to develop in the Russian Federation? Whether is it possible for the market to function without liquidity? The answer is probably "no" for financial players and large retailers, and it is probably "yes" for small and medium-sized manufacturers, because the latter are more adaptive financially and can partially compensate for liquidity shortage through barter transactions, and also they are faster in terms of pricing.

Regretfully, those who make the economic policy in the Russian Federation have not jelled yet as to which strategy to follow, as is evident from the vagueness of the proposals made by the Russian government for the report to the President[2]. Ministries' proposals are mostly focused on making the Russian government more independent and giving it a full swing in prompt responding to changes in the current situation and disposing of funds. The final version of proposals on coping with crisis developments includes a proposal on the abolishment of the value added tax (VAT) on imported materials and components (thereby protecting the interests of foreign manufacturers instead of domestic ones and the Russian budget). At the same time, ministries made a proposal to develop measures aimed at stimulating lending to the public sector and establish a "bank of bad loans" for corporate loans (the appropriation of Rb 300bn from the National Welfare Fund (NWF) to the Vnesheconombank (VEB) is envisaged for the purpose of financial rehabilitation of too-big-to-fail enterprises); a proposal is being under consideration on the provision of an extra transfer worth Rb 147,5bn to the Pension Fund of Russia (PFR) with a view to rising retirement benefits if the consumer price index goes "beyond 6%"; a proposal to freeze the wages of employees at state-controlled corporations was rejected; allocations to the regions for the purpose of coping with unemployment were increased in volume; a provision was made for extra

1 The European Central Bank (ECB) announced a quantitative easing policy for, among other things, the purpose of mitigating the problem of overstock caused by having no access to certain external markets.

2 D. Butrin, D. Skorobog'tko, A. Mainuilova, "At all costs. Government's anti-crisis plan is ready for submission to the President] available in Russian on: kommersant.ru/doc/2650535 of 01.21.2015.

reserves in support of agricultural enterprises (for the purpose of "coping with climatic and natural risks", the Russian government is probably sure that agricultural enterprises are not going to insure the crop in 2015). Of the measures aimed at cutting government spending, a provision was made for authorizing Russia's government to change budget transfers through direct update of the wording of state programs, as well as limit advance payments under public contracts to 80% of the value thereof. No sources of extra funds are specified. In other words, we can see that the proposals are more likely aimed at providing financial aid to too-big-to-fail economic agents, whereas adaptive management of government spending is supposed to face totally uncertain sources of financing. In our opinion, it is strict anti-inflationary policies that should be given priority under the circumstances[1].

Investment in the development of modern export-focused production facilities will not solve the problem, because stand-alone "exhibits" cannot revive the economy in whole, not to mention the support to too-big-to-fail enterprises, because conditions have changed. Being overloaded with debts, state-controlled corporations and state-controlled banks are basically focused on servicing their own liabilities amid the financial and economic crisis, as in, they will service the reversal of foreign exchange resources towards the western economies, and hence the maintenance costs of such entities will entail extra losses, which must be minimized, for the Russian economy. Should the current format of state-controlled corporations, state-controlled banks remain intact, then with long-lasting sanctions and low prices of mineral resources these entities would begin by themselves to generate sweeping losses which the country is unable to afford. The aforementioned entities were designed to operate under a different pattern of relations and circumstances, as in, amid a steady growth of capital inflows to the country in exchange for raw materials.

The development of small and medium-sized manufacturers may be focused on today. In our opinion, the (administrative, fiscal, etc.) burden on small and medium-sized businesses should be eased in order to release by developing internal demand the pressure on the current foreign exchange rate and forestall mounting inflationary trends. To avoid the risk of hyperinflation spiral, it would be reasonable to stop indexation of retirement benefits and wages in order to release as soon as possible the pressure on retail prices, which in turn will strengthen the ruble exchange rate without having to spend the foreign-exchange and gold reserves for this purpose. The latter is critically important to preventing devaluation of household savings, which will help avoid a new turmoil in the foreign exchange market and national currency aversion[2]. It's time to begin to cut the supply expenditure on the public sector and public-related entities. Mandatory contributions to public social extra-budgetary funds should be charged on employees' wages (keeping intact their current wages) instead of enterprises' costs.

To develop the market, a system of grants to individuals (final consumers) can be designed so that they can buy certain types of domestically produced goods (works, services), i.e. such grants should be allocated to cover final consumers' purchases of products in demand, not to too-big-to-fail enterprises (manufacturers). However, Russia's government is likely to take efforts in preventing large enterprises from going bust. In particular, Russia's Prime Minister Dmitry Medvedev said to reporters about a plan to provide grants as part of the anti-crisis program[3] to compensate some of industrial enterprises for their costs on working capital loans, as well as appropriate funds to mitigate seasonal risks and keep up growth rates of lending to the agricultural sector.

The recent abrupt, drastic depreciation of the ruble's exchange rate has created the same fiscal problem that had to be resolved during the crises of 1998 and 2008: the emerged foreign exchange gain (expressed in rubles) on the liabilities (expressed in foreign currency) to foreign counterparties entails extra losses for Russian organizations as debtors.

1 The adopted federal budget 2015 haven't yet been updated to meet the real situation, the budget rule haven't been revised (see kommersant.ru/doc/2645746 of 15.01.2015. A. Mainulova, "There are no problems that cannot be resolved. Prime Minister Dmitry Medvedev promises to cope with the crisis within a year"), economic growth gave way to economic contraction. Under the circumstances, while executing the federal budget, government spending will probably grow as much as the exchange rate grows, and budget revenues will grow as much as the ruble cash flows increase, which will deepen the budget deficit. Regretfully, there is still high hopes in the Russian society that crude oil prices will rebound soon, so there's no readiness to the introduction of a strict anti-inflationary regulation. Initiatives have so far been reduced to financial aid, support, compensation for price variance losses, stricter capital movement monitoring, etc, meaning that the problems at the initial stage are likely to be remedied with cash injections.

2 A point to emphasize is that even small entrepreneurs fear the state may run out of its foreign-exchange and gold reserves, and hence they recommend anti-crisis measures aimed at postponing for a later date the introduction of a sales tax scheduled for July 1,2015; easing the profit tax burden through the federal component; reducing by 20% the staff at regulatory and supervisory government agencies; reducing to 12% from 17% the central bank key interest rate, etc., including mandatory sale of foreign exchange revenue by exporters (See A. Bashkatova, "Vladimir Putin puts the blame for the crisis on the rest of the world", available in Russian on: Ng.ru, 01.22.2015).

3 msn.com/ru-ru/money/business от 01.22.2015.

For example, a Russian organization is to pay a interest of $20 US under a loan. The interest amount has increased 60% because of the exchange difference resulting from the ruble's weakening against other currencies. Under double taxation conventions, while paying $20 US, the fiscal agent (the Russian organization) must be charged 5% to 10% of the profit tax to the Russia's budget, i.e. an amount equal to $1–2 US. Having purchased $1–2 US at a new exchange rate in the market and transferred thereof to the recipient as interest payment, the Russian agent must simultaneously transfer to the Russia's budget an amount equal to 5–10% of the counterparty' phantom gain as exchange difference. Similar tax burden discrepancies arise when the plowback rate is calculated (if the Russian counterparty makes loans in foreign currency, the percentage of interest in terms of rubles may be far above the established interest/payout marginal ratio which allows interest to be allocated to costs for profit tax purposes, which will involuntary classify large sums as dividends paid, increasing the profit tax burden)[1], including some other cases. According to experts, the federal budget may face problems, because in the market the return on investment at the Central Bank key interest rate lifted to 17% may exceed the amount of penalty charged over a comparable period for late payment of taxes to the budget, which may result in mass late payments of taxes.

Since the ruble crisis was triggered by falling crude oil prices and the Central Bank key interest rate was abruptly lifted late in 2014, no methods of anti-crisis regulation have yet been fully embodied in the fiscal laws adopted late in December 2014 – January 2015. Most of these laws can be regarded as update of the currently applicable taxation schemes, granting extra tax allowances to certain categories of taxpayers running specific types of business. At the same time, some laws were adopted on a fast-track basis to cope with the turmoil trends in money supply due to the ruble's devaluation and protective measures of the Central Bank of Russia.

1. The Federal Law of 29.12.2014 No. 462-FZ makes amendments to Articles 46 and 74.1, Part 1 and Article 217, Part 2, the Tax Code of the Russian Federation (TC of Russia).

According to the TC of Russia, the obligation to pay taxes may be secured by a bank guarantee if the due date/dates of such obligation is changed. The adopted amendments allow for the acceptance of guarantees of banks being under financial rehabilitation as approved by the Central Bank of Russia and the Deposit Insurance Agency (DIA). In addition, to avoid mass withdrawals of retail bank deposits, the Central Bank refinancing rate was lifted by 10%, allowing natural persons to draw interest on bank deposits, not being subject to the personal income tax (PIT) in the period between 12.15.2014 and 12.31.2015.

2. The Federal Law of 29.12.2014 No. 463-FZ removes from the list of taxable income the naked transfer of exclusive rights to intellectual deliverables by the governmental customer to the contractor under a public contract. Hence contractor's costs equal to the cost of granted exclusive rights don't reduce the profit tax base.

3. Federal Law of 29.12.2014 No. 464-FZ establishes tax allowances for organizations providing social services to individuals. Such services are excepted from VAT. Organizations must meet certain criteria to be entitled to a 0% profit tax rate: manpower must be at least 15 employees; revenues generated from the provision of social services to individuals must account for at least 90% of the aggregate income; the organization must be registered in the register of social service providers of a constituent territory of the Russian Federation; organizations may not enter into bill of exchange transactions and financial instrument future contracts during the fiscal period.

4. Federal Law of 29.12.2014 No. 465-FZ exempts from personal income tax (PIT) compensations paid employers to hired workers (internal migrants) based on a certificate[2] issued by a constituent territory of the Russian Federation which allows labor force to be hired from other regions of the Russian Federation (except payments for compensating such migrants for accommodation costs).

5. Federal Law of 29.12.2014 No. 477-FZ introduces so called "tax holidays" for a period of two years from the date of registration with tax authorities for self-employed persons (SIP) who apply the simplified taxation system (STS) or the license-based taxation system (LBTS), for the first time registered as taxpayers and being engaged in the production, social and science areas. A reduced tax rate of 0% for such SIPs shall be established as set forth in the laws of constituent territories of the Russian Federation which also may impose limits on the reduced tax rate as certain amount of tax-free income, average manpower, etc.

1 M. Pyapchenkova, "The drastic ruble's depreciation increases the tax burden on Russian companies", available on vedomosti.ru/finance/news/38412641/kursovaya-pereocenka-nalogov, 20.01.2015. The article includes extensive comments of Deputy Finance Minister Shatalov S. D on the issues concerning the tax burden on manufacturers, as well as experts' opinion.

2 The certificate must be issued as set forth in the Federal Law of April 19, 1991, No. 1032-1 On the Employment in the Russian Federation.

6. The executive order of the Federal Tax Service (FTS) Russia of 26.11.2014 No. MMV-7-3/599@ introduces a new form of the license for the entitlement to apply the LBTS (form No. 26.5-P), which contains fields to complete with information of the area in which the license is applicable (the name of a municipal district, city district, city of federal importance or constituent territory of the Russian Federation). The attachment to the license includes the business addresses or the type of business activity of a license-holder (information of vehicles, points of sale, catering facilities, etc.). This allows for better monitoring of the distribution of foreign labor force on the territory of the Russian Federation, as well as enhance the social protection of hired foreign workers, because the license confirms that the tax has been paid to the budget of a given region, and hence allows foreign worker and his/her family members to use the regional social infrastructure in accordance with the usual procedure.