THE REVIEW OF REGULATORY DOCUMENTS ON TAXATION ISSUES IN JANUARY–FEBRUARY 2016

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In the financial sector, the documents published in the Russian Federation in January–February 2016 point to the fact that despite a crisis situation financial experts keep working consistently on development and introduction of documents regulating relations in market conditions. Unfortunately, legislative and executive authorities do not consistently and comprehensively implement the required legislative novelties and under the influence of emotions take populist and/or administrative decisions. It is believed that for further successful development of the internal market a "fine tuning" of the Russian legislation in the field of economy and finance is required and it should be brought in strict compliance with international practices.

In the period under review in 2016, the following developments took place:

1. By Order No.217 of 28 December 2015 of the Ministry of Finance of the Russian Federation, 40 standards and 26 interpretations of IFRS[1] were introduced. In particular, IAS: 1, 2, 7–8, 10–12, 16–21, 23–24, 26–29, 32–34, 36-41; IFRS: 1–8, 10–13; IFRIC interpretations: 1–2, 4–7, 9–10, 12–21 and SIC interpretations: 7, 10, 15, 25, 27, 29, 31, 32 were introduced. In accordance with Cl.7 "Accounting Policy of a Legal Entity" of the Accounting Regulations 1/2008, in formation of the accounting policy of a legal entity selection of one of the few methods is permitted by the legislation of the Russian Federation on accounting. If in regulatory legal acts methods of accounting are not established, in formation of an accounting policy development by a legal entity of a relevant accounting method, including that on the basis of the international financial reporting standards (IFRS) is permitted.

IFRS testing in Russia showed that introduction of international accounting standards should be accompanied by system adjustment of the effective Russian legislation.

What is meant here is as following: IFRS emerged as a result of aggregation of practices and unification of accounting and reporting principles in market conditions. The above principles and practices became the result of development of key unification decisions in application of the legislation – regulating the rules of entering in, execution and fulfillment of deals in different countries with developed market economies – formed during a long period and adapted to international free market conditions. In application of IFRS in the Russian Federation, it is important to take into account the fact that many economic relations embodied in IFRS are not yet formed in Russia and are still at the stage of formation. For Russian economic and financial agencies, IFRS creates good conditions to carry out large-scale system work on identification of gaps in the Russian legislation regulating market relations in order to

1 IFRS (International Financial Reporting Standards); IAS (International Accounting Standards); IFRIC (International Financial Reporting Interpretation Committee); SIC (Standard Interpretations Committee).

fill them, identify and eliminate excessive regulation measures and bring the Russian legislation in harmony with generally accepted regulatory systems as regards important criteria and approaches. Application of IFRS will permit to ensure preparation of comprehensive amendments to the entire system of legal acts on regulation of economic relations and it is not only the Civil Code of the Russian Federation, but also the Customs Code of the Russian Federation (CC RF), the Budget Code of the Russian Federation (BC RF), the Tax Code of the Russian Federation (TC RF), special legislation and other.

Here is an example. The problem of vital issues which are not regulated by the internal Russian legislation consists in the fact that there is no strict division between the notions of dividends and capital (as regards retained profits and reserves), nor is it clear which sources dividends can be paid out from; the situation is not regulated either as regards replacement of payment of labor remuneration (partially) by bonuses in the form of equities or interests in the capital of an entity in which the worker is employed, including the right to deferred sale of them (equities and interests) on the market (with use, for example, of financial forward instruments, such as equity options and other). Lack of experience and insufficiency of regulatory relations may result in serious financial losses for the Russian Federation.

The main issue of the analysis of updated IFRS (IAS) 32 – "Earning per Share" – which is being introduced in the Russian Federation is calculation of the denominator of the earning per share formula.

It was already stated in one of the previous reports that the Russian legislation does not exclude the feasibility of using the attracted funds (for example, loans) for payment of current dividends. For example, IFRS (IAS) 33 deals with a whole range of situations and includes instructions how dividend amounts should be accounted for depending, for example, on the type of equities (common equities or preferred ones), method of payment of dividends (proportional allocation or with a growing norm) and other. All those technicalities are determined by direct relation between yields on shares and other equity securities and capital (as regards the retained profit and reserves) of a company.

In the above IFRS (IAS) 33, the notion of "market" dividends is used. It means that dividends should normally be paid out of the after-tax current profit calculated with use of market prices. But within the frameworks of the current policy, in placing or repurchasing of equities of a company payment of dividends out of the after-tax profit of the previous years, that is, at the expense of accumulated reserves (reserves are formed out of the retained profit of the previous years and included in the entities' supplementary capital) is sometimes admissible. Dividend amounts paid "above" or "below" the market level should strictly correspond to the reserves, that is, they should be reflected simultaneously in the change in the company's capital. As soon as dividends are paid out not from the company's reserves, it can be stated that the financial standing of the company has become worse and it lacks sources of paying dividends.

So, a question arises how the dividend tax base should be calculated as in the Russian Federation a reduced profit tax rate is set. The issue of sources of dividend payments is not settled legislatively. In a complicated situation, shareholders (participants) may be willing a great deal to withdraw their earlier invested capital under the guise of dividends, thus depriving the company established in the territory of the Russian Federation of liquidity and making

it bankrupt. It is not meant here that the capital should be blocked, but the legislation should provide for a scheme which is accepted in the international practice how to deal with such situations; normally that issue is solved by way of selling equities (interests) on the market at a market price. Investors voluntarily take risks on their investments. So, dividends paid out above the "market" level should probably be regarded in the fiscal period as a transfer of property without compensation and taxed at a general rate. The above example illustrates the situation when the term "dividends" used in the Russian legislation may reflect incompletely the content of a similar term used in free market conditions. It is to be noted that such inconsistencies may arise on many issues. Each market term customary used within the frameworks of the Russian legislation should, probably, be dealt with meticulously because discrepancies in interpretations may result either in economic conflicts or revenue base losses for the state.

Let's consider IFRS (IAS) 33 as applied to dividends on preferred shares (Cl. 15 and Cl. 16 of IFRS (IAS) 33): "15. Preferred shares at which low dividends are originally paid in order to compensate the entity the sale of preferred shares with a discount or at which at later periods dividends are paid above the market ones in order to compensate investors the purchase of such shares with a premium are sometimes called preferred shares with a growing norm of dividends. Depreciation of the entire sum of the original issuing discount or premium on preferred shares with a growing norm of dividends is reflected in the retained profit on the basis of the method of effective interest rate and considered dividends on preferred shares for the purpose of calculation of earnings per share". As it can be seen, "payment of dividends short of the market level of dividends on preferred shares is subject to accounting in the reserves, that is, the capital of the company and, probably, can be utilized as a supplementary (free of charge) financial source for carrying out current operations and speeding up the buildup of production (speeding up growth in revenues from sales). Subsequent additional payment of dividends is attributed to reduction of reserves, but is regarded as payment of dividends on preferred shares. It seems that the source of dividends paid to holders of common shares in the period under review is the current profit (profit in the period under review) less dividends on preferred shares paid in the same period (including additional payments of dividends on preferred shares which were not paid before). So, the total sum of dividends should not exceed the current profit and accumulated reserves on dividends on preferred shares which were not paid out earlier. Such a wording may influence the volumes of payments recognized (or not recognized) as dividend payments within the frameworks of the double taxation treaty. Amounts called, but not recognized as dividends (paid above the current profit and additional payments at the expense of reserves on preferred shares) should not be taxed as dividends and be regarded as income received in the territory of the Russian Federation. "16. An entity may repurchase its preferred shares on the basis of a tender proposal. The excess of the reasonable compensation value paid out to holders of preferred shares over the balance-sheet value of preferred shares represents income of holders of preferred shares and is accounted for in the entity's retained profit. The above sum is deducted in calculating of profits and losses which the share of holders of the parent company's common shares is accounted for". So, the amount paid out to holders of preferred shares (out of the current profit) in excess of the balance-sheet value of such shares should probably be attributed to reduc-

tion of reserves (capital), while consumption of reserves in its turn is compensated out of the current profit or (in case of absence of it) attributed to the company's current losses. It can be supposed that dividends paid in excess of the ultimate limits of sources of such dividends on common shares should also be regarded as a transfer of property without compensation and taxed at the general (rather than privileged) rate.

A failure to use generally accepted financial methods of differentiation of the capital (as regards the retained property and reserves) and dividends and lack of relevant norms in the Russian legislation protecting effectively the property (capital) of entities and defining the scope of shareholders' (participants') titles to revenues from the company's operations may result in a situation where the company loses its capital through unlimited payment of dividends; it is to be noted that for an inexperienced owner that may happen inconspicuously. As regards trans-border deals, it may result in revenue base losses for the Russian budget. Specification of the economic essence of the term "dividend" and strict determination of sources of dividend payments in the Russian legislation is crucially needed.

Let's pay attention to the fact that until recently sources of dividend payments with state-owned corporations were not controlled by the Russian state as the owner. As a result, those corporations happened to be unable to operate independently in market conditions.

Here is another example.

In the territory of the Russian Federation, IFRS 2 "Payment on the Basis of Shares"[1] setting the procedure for preparing financial reporting for legal entities carrying out payments on the basis of shares has been introduced. In the preamble, it is explained that IFRS 2 determines (among other things) the procedure for accounting of operations in which the legal entity receives or buys goods or services under the agreement concluded on the basis of conditions which suggest that a legal entity or provider of those goods may select the method of settlement, that is, either by cash (or other assets) or by way of issuing equity instruments for some exceptions.

IFRS 2 includes an interpretation that: "4 For the purpose of IFRS in question, operations with a worker (or another party) in which he/she acts as a holder of equity instruments of a legal entity is not regarded as an operation on payment on the basis of shares. ….However, equity instruments provided to workers of the acquired legal entity in cases where they act as workers (for example, in exchange for continuation of their services) are related to the field of application of this IFRS…). What is meant here is that workers receive shares (equity instruments) within the frameworks of their labor activities "in exchange for continuation of their services" (probably, labor services). IFRS 2 explains the issue of determining the income for each party to the deal. So, financial agencies should take into account the procedure for determination and recognition of income for the purpose of application of the individual income tax and profit tax in such situations.

In addition to explanation of tax issues, in our opinion it is important to make amendments to the Tax Code of the Russian Federation to avoid labor conflicts.

1 One should differ IFRS (IAS) 19 "Workers' Labor Remuneration" which aim is to set the rules of accounting and disclosure of information on all other remunerations to workers paid by the employer (except for IFRS (IAS) 26 "Accounting and Reporting on Pension Schemes").

The scheme utilized in the international practice is as follows: labor remuneration is not paid out, but partially replaced by shares or equity instruments with a deferred period of sale of shares or conversion of equity instruments into shares. It is believed that with granting shares to the personnel, workers become more interested in the outputs of their company's activities (workers receive dividends and share prices go up). However, the scheme is effective only at the stage of the company's growth accompanied by growth in revenues and protects the interests of shareholders for whom the terms of sale of their shares (equity instruments) are not important.

Let's review the scheme in detail. A consent to replace a portion of the labor remuneration by shares (equity instruments) means that the labor remuneration (from the revenues received by the company) replaced by shares is not excluded, that is, the revenues (after-tax) are attributed to the retained profit (reserves) and makes up the company's capital which can be utilized for promotion of the company's activities. Such a scheme can, probably, be used to speed up growth by means of attracting additional capital free-of-charge. The disadvantage of the above scheme consists in the fact that at the company's mature stage when the market has been saturated with that company's goods (services), the volumes of sales (revenues) stabilize and share prices may go down. It is to be noted that the term of sale of shares (equity instruments) may not necessarily become due. So, there is a risk that the sum of the revenues from one-time sale of shares and the value of dividends after the company has passed the peak of its growth may be short of the value of the replaced labor remuneration, that is, the worker happens to be in disadvantage. So, before applying this scheme in the Russian Federation, it is important to establish legislatively that a worker may receive the company's shares instead of labor remuneration only on a voluntary basis and nobody has the right to obligate a worker in a standard labor contract to receive a portion of his/her labor remuneration by shares with a deferred period of subsequent sale (for example, with utilization of financial instruments of forward deals). It is to be noted that Cl.41 of IFRS 2 recommends companies to determine if they have an obligation to pay cash funds or not. That is evidence of the fact that replacement of cash payments (including labor remuneration) by equity instruments and shares is not recognized as equal in the international practice: "41 For operations related to payments on the basis of shares where it is provided for by the terms of the agreement that the company may select a method of settlement, that is, payment by cash or by way of issuing equity instruments the company has to decide whether it has an obligation to make cash settlements and book accordingly the transaction related to payment on the basis of shares. A company has an obligation to make cash settlements if selection of the method of settlement by equity instruments is pointless in commercial terms (for example, if the company is legally banned to issue equities) or the company normally makes cash settlements, maintains the policy of making cash settlements or carries out cash settlements any time a counterparty asks for it".

2. In the period under review, in the Russian Federation amendments regulating the issues of accounting of revenues of controlled foreign companies (including those which do not have the status of a legal entity in accordance with the legislation at the place of registration thereof) were introduced for taxation purposes into the Tax Code of the Russian Federation.

2.1. By Federal Law No.32-FZ of 15 February 2016, amendments on taxation of profit of controlled foreign companies were introduced.

The notion of an income-receiving entity – now it is not only a legitimized structure (person), but also a non-legitimized structure recognized as a taxpayer in accordance with the legislation of a relevant state, that is, a foreign structure without a status of a legal entity – was specified.

Within the frameworks of Article 2, Russian taxpayers are obligated to inform tax authorities of establishment by them of foreign entities and foreign structures without the status of a legal entity. Foreign entities and foreign structures without the status of a legal entity – owners of real property situated in the territory of the Russian Federation – have to inform tax authorities at the place of situation of that real property of participants (as regards a foreign structure without the status of a legal entity the information on founders, beneficiaries and managers is to be provided). So, all the obligations provided for by the Tax Code of the Russian Federation and related to trust management and fulfillment of functions of a tax agent imposed on foreign entities are applied to foreign structures without the status of a legal entity, as well. In its turn, the rights and exemptions from profit taxation are applied to a foreign structure without the status of a legal entity, too.

The period of submission of notification on participation in a foreign entity (on establishment of foreign structures without the status of a legal entity) was extended from one month to three months from the day of origination of such participation. The requirement to submit notifications is not applied to taxpayers whose participation in foreign entities is carried out entirely through direct and (or) indirect participation in one or a few Russian public companies.

Notifications on controlled foreign companies (foreign structures without the status of a legal entity) are provided in a similar way.

It is noteworthy that amendments introduced into Article 217 of Tax Code of the Russian Federation are similar to those reviewed by us in IFRS (IAS) 33 (Article 217 was supplemented with Cl.66 and Cl.67), but do not reproduce completely IFRS. It is provided for by Cl.66 that "taxpayer-controlling person's income in terms of dividends received from the foreign company controlled by him/her as a result of distribution of that company's profit is exempted from taxation in the amount which does not exceed the sum of income in terms of the profit controlled by a foreign company …", while Cl.67 deals with the retained profit of the foreign structure without the status of a legal entity: "it is to be noted that in case of existence of the retained profit of the foreign structure without the status of a legal entity any payments from that structure within the limits of the retained profit are recognized for the purpose of the present Code as distribution of profit regardless of the specifics of legal execution thereof". It is not quite clear why in one case it is a controlled foreign company's dividends that are meant – they are exempted from payment of the profit tax within the limits of that company's profit – while in the other case it is only payments from the retained profit of a foreign structure without the status of a legal entity, that is, payments within the limits of the retained profit are recognized as distribution of the profit regardless of legal execution. It is believed that those norms should be specified. It seems they both should be applied to a foreign controlled entity and a foreign structure without the status of a legal entity.

By the above Federal Law, other numerous amendments which need be reviewed in terms of their compliance with IFRS and the logic of the Tax Code of the Russian Federation were introduced into the text of the Tax Code of the Russian Federation. For example, within the frameworks of the profit tax the formula "foreign company (foreign structure without the status of a legal entity) introduced in Part I of the Tax Code of the Russian Federation and Chapter 23 (Individual Income Tax) suddenly ceases to be applied and a shorter formula – "foreign companies" – starts to be used. Later (for example, in Article 277), the expanded formula is used again.

There is a complicated structure of links based on utilization of the notion of "dividends". For example, "dividends received by a taxpayer-controlling person from the foreign company controlled by him/her" within the frameworks of the profit tax are used only in combination with a tax return of a Russian taxpayer and revenues in terms of profit of the controlled foreign company specified by a Russian taxpayer in that tax return (Article 251 (50) and (53)). It is to be noted that in Article 89 of the Tax Code of the Russian Federation field tax audits by Russian tax authorities of foreign taxpayers are provided for. However, it is not specified what visa is required for Russian tax officers: a business visa (it is unlikely to be issued without an invitation of foreign tax authorities) or a tourist one (then it is not clear why a field tax audit is included in the text of the official Russian law). It was inexpedient to set in the Russian law the deadlines for completion of liquidation procedures of foreign companies (structures without the status of a legal entity). Taking into account the fact that the newly introduced norms of the Tax Code of the Russian Federation will be applied only to the extent where applicable it is believed that the new provisions of the TC RF need be updated. It seems that the IFRS rules were applied as well in formulation of Article 309.1 (3) dealing with determination of profit (loss) of a controlled foreign company, but the wording of provisions of the TC RF requires, in our view, further examination. It is to be noted that other novelties require examination, too. It concerns Article 312 in which obligations of a tax agent are not specified quite clearly.

2.2. By Federal Law No.6-FZ of 31 January 2016, the Double Taxation Treaty and Agreement on Prevention of Evasion from Taxation as Regards Profit Tax between the Government of the Russian Federation and the Government of China, Protocols thereto, including that on amendment of the Agreement signed on 8 May 2015 were ratified.

Amendments introduced by the above Protocol set the right of the Contracting State to tax the full amount of interests received from provision by the taxpayer of that Contracting State of funds to a borrower who is a taxpayer of the other Contracting State. The above rule is not applied to interests received by that taxpayer's permanent representative office established in the territory of the other Contracting State – in that case the permanent representative office is a taxpayer at the place of its tax registration.

At the same time, the technique of drawing up the Protocol permitted to differentiate market interests from interests paid above the market level. The agreement provides for tax-free transfer of interests only to the extent which corresponds to the market size of dividends. The amount of interests above the market level is subject to taxation in accordance with the existing legislation of each contracting state, that is, in the Russian Federation it does not reduce the profit tax base, while in China it is subject to taxation.

3. By Federal Law No.25-FZ of 15 February 2016, amendments were introduced into Article 269 of the Tax Code of the Russian Federation as regards determination of the notion of a controlled debt.

Attributed to controlled debts is an outstanding debt of a taxpayer-Russian company on debt obligations to a foreign person which is a related party with the Russian company in accordance with Article 105.1 of the Tax Code of the Russian Federation (directly or indirectly participates in the taxpayer-Russian company and acts as a surety on its obligations).

The criteria of identification of an entity engaging in leasing operations were set for applying provisions of Article 269 (revenues from leasing operations should amount minimum to 90% of all the entity's revenues in the (fiscal) period under review.

In addition to the above, it is established that a taxpayer-Russian company's outstanding debt on debt obligations which are not specified in Article 269 can be recognized by a court of law as a controlled debt if it is established that the ultimate goal of payments on such debt obligations are payments to related foreign entities.

Among other regulatory acts on tax issues approved in the period under review, it is worth mentioning the following.

4. By Federal Law No.23-FZ of 15 February 2016, amendments were introduced to the Budget Code of the Russian Federation. In particular, for provision of a number of subsidies it is ordered to introduce as a mandatory condition a ban on purchasing at the expense of the received foreign currency funds, except for operations carried out in accordance with the foreign currency legislation of the Russian Federation in purchasing (delivering) of high-tech import equipment, primary materials, components and other.

The earlier existed order not to terminate the earlier concluded contracts in case of suspension of subsidies against the existing obligations was replaced by a more acceptable wording permitting amendment by mutual agreement of the parties of the amount and (or) time-limits of payment and (or) volumes of goods, jobs and services in case of reduction of allocated limits of budget obligations in accordance with the adopted procedure. At the same time, recipients of budget subsidies retain the right not to terminate the earlier concluded contracts.

A new norm (Article 241 (15 and (16)) prohibiting budget subsidies and budget investments to foreign legal entities whose place of registration is a state or territory included by the Ministry of Finance of the Russian Federation in the list of states and territories which provide a privileged tax regime and (or) do not require disclosure of the information in carrying out of financial operations (offshore zones) was included in the Budget Code of the Russian Federation. Russian legal entities in whose charter (pooled) capital the share of participation of offshore companies aggregately exceeds 50% do not have the right to receive subsidies, either. Similar amendments were introduced in respect of the right to issue state or municipal guarantees (except for state guarantees of the RF) for support of the export of Russian manufacturers' industrial products (goods, jobs and services). Russian legal entities in whose charter (pooled) capital the share of participation of offshore companies aggregately exceeds 50% cannot be principals under state or municipal guarantees.

5. By Letter No. 03-05-06-02/5874 of 5 February 2016 and Letter No. 03-05-06-02/5239 of 3 February 2016 of the Ministry of Finance of the Russian

Federation, the existing procedure for payment of the land tax and individual property tax, the range of taxpayers, composition of the tax base, procedure for enactment of regulatory acts of constituent entities of the Russian Federation on introduction of those taxes, the size of tax rates, tax deductions and procedure for granting tax privileges were explained in detail; the rules of determining the cadastral value of a land plot as the base of calculation of the land tax were explained, as well.

6. By Letter No. 168/03-16-3 of 26 January 2016 of the Federal Notary Chamber (FNC, the issue of calculation of state duties for notary certification of real property operations in accordance with Federal Law No.391-FZ of 29 December 2015 on Amendment of Individual Statutory Acts of the Russian Federation was explained. In respect of a number of transactions (in case of sale of interest in joint property to a third person, deals on disposal of real property on the basis of trust management or guardianship and operations related to sale of real property owned by a minor or a partially incapacitated person), a notary and officials carrying out notarial actions are entrusted with a responsibility (Article 333.25.1.(5) of the Tax Code of the Russian Federation) to determine the property value (a method of appraisal) for the purpose of calculation of state duties.

It is to be noted that according to explanations of the FNC notaries and officials carrying out notarial actions have no right to determine the property value (a method of appraisal) for the purpose of calculation of state duties and request the payer to provide a document certifying property value (method of appraisal). In case of provision by the payer of several documents with different property values, in calculating the size of the state duty the notary accepts the lowest property value.

The position of the FNC as regards acceptance of the lowest property value on the basis of documents provided by the payer proceeds from the fact that evaluation is carried out in accordance with the Federal Law on Evaluation (Federal Law No.135-FZ of 29 July 1998) and is not a special legislation for notaries.

The right of notaries to charge along with a notarial tariff in the amount of a state duty a fee for services of legal and technical nature was explained.

7. By Federal Law No.30-FZ of 15 February 2016, amendments were introduced to Article 15.25 of the Administrative Offences Code of the Russian Federation. The norm of responsibility for a failure to fulfill an obligation to return to the Russian Federation funds paid for goods which were not delivered and jobs and services which were not fulfilled was changed. For the purpose of speeding up a return of funds, a penalty in the amount of 1/150 of the rate of refinancing of the Central Bank of Russia of the default amount was introduced. It is to be noted that the sanction which was in effect before was left as the ultimate penalty amount which now (by virtue of use of a legal expression: and (or)) can either be paid along with penalties or not charged at discretion of the claimant.