Awara Russian Tax Guide
2014

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Awara Russian Tax Guide is the first comprehensive book offering a full overview of all Russian taxation laws and rules. Awara Russian Tax Guide describes the general framework of the Russian tax laws, the Tax Code and its principles. It describes the general rules of the Tax Code Part I and each type of tax and tax regime of Tax Code Part II, among them: Profit Tax, VAT, Personal Income Tax, Property Tax, Employer's Social Contributions. The book also covers the now so important case law and taxation principles set by court precedents.

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Hellevig started his carrier in Russia as lawyer and CFO for an American-Russian joint venture and subsequently worked as lawyer and CFO for Armstrong World Industries (Central and East Europe). He is a member of the Board of AEB (Association of European Businesses).

Hellevig has written Avenir Guide to Russian Taxes (2002, 2003, 2007 English and Russian editions); Avenir Guide to Labor Laws (2002, 2003, 2006 English and Russian editions). This work is now being continued in the form of this present book: Awara Russian Tax Guide, Expressions and Interpretations, a book on the philosophy of law and the development of Russian legal practices; All is Art. On Social Practices and On Democratic Competition (2007 English, 2009 Russian Vse Tvorchestvo); The Case Against Chomsky — A Biological Philosophy Volume 1 (2010); and Mental Processing — A Biological Philosophy Volume 2 (2010); Employee Engagement in Russia, which can be downloaded from this link[1].

[1] http://awaragroup.com/upload/pdf/Employee_Engagement_in_Russia_09_2012_Preview.pdf.

Jon Hellevig has a University degree in Law from the University of Helsinki, Finland (1985). In 1998 he acquired an MBA with the Ecole Nationale des Ponts et des Chaussees and University of Bristol Graduate School of International Business with KPMG European Training Center, 1998.

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Artem Usov joined the predecessor of Hellevig, Klein & Usov in 2002 and is presently a general corporate lawyer with specialties in: Taxation, Corporate Governance, Labor, Immigration, Company Structures & Incorporations. One of Usov's areas of expertise is helping Fortune 500 companies find the best practice approach to establishing the right corporate structure in the applicable situation. In order to serve clients better, Usov keeps abreast of all aspects of the Russian Tax Code and follows closely all amendments and proposed amendments in order to keep clients up to date.

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Kabakov advises Russian and foreign clients on a wide range of issues of tax, corporate, commercial and contract law, and also assists clients at all stages of transactions (legal analysis, structuring, and completion). Kabakov has extensive experience advising on taxation, tax calculation and payment, as well as refund of overpaid taxes and VAT. His legal acumen also touches upon issues of labor law, including the structuring of complex relationships with employees at Russian subdivisions and the representation of interests in legal disputes with employees and in collective negotiations.

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1. INTRODUCTION

Foreword — Russia's Good Fortune — the Tax Reform

By Jon Hellevig

This *Awara Russian Tax Guide* follows upon three editions of the Avenir Guide to Russian Taxes (2002, 2003, 2007), which two of the three authors of the present book co-authored, namely Jon Hellevig and Artem Usov. The first book came out in 2002 just after the great tax reform under president Putin had begun. By the time of the third edition in 2007, the authors could in the foreword write that the tax reform had brought about the Russian economic miracle, with GDP growing some five times or 500 % in as many years. The success has continued and now we can talk of more than a tenfold or 1000 % GDP growth in about a decade. Most would argue that the success of the tax reforms has been pivotal in ushering in the economic upsurge, an upsurge that we could well by now term an economic miracle.

I will dedicate this foreword to presenting the astonishing tax revenue and GDP figures of the Russian economic miracle of the last 13 years. I will present and discuss the GDP figures expressed in the three alternative ways of calculating GDP: (i) nominal GDP (GDP in current prices), (ii) GDP PPP (GDP at purchasing power parity), and (iii) GDP in constant prices or the so-called "real GDP" theory. It will be of special interest to show how misleading is the theory of expressing GDP in constant prices, or the so-called "real GDP" theory. But first a few words about the history of the tax reform.

History of the Russian Tax Reform

The taxation system, or rather the lack of a transparent, predictable and stable taxation system, has widely been considered as one of the main reasons for the economic woes that Russia experienced during the 1990s, after the country entered the shaky path of democracy and market economy. But after the tax reform was ushered in beginning from 2000 the taxation system went from being the big hindrance for investments and economic growth to being the locomotive of Russian economic success.

In the Soviet Union, the predecessor state to Russia, there existed in practice no real taxation system. This was quite natural against the background that the USSR, with its planned economy, was meant to be the first ever state without taxes. Practically, all property and assets were state-owned and the central planning organization collected and allocated resources at its will. In the planned economy companies were not actually taxed, they rather transferred certain residual amounts of financing back to the center.

With the downfall of the USSR and the economic reforms in Russia, a tax system started to emerge at the beginning of the 1990s. During these early years of reform the tax laws did not take shape within a unified system, but rather through a chaotic ad hoc adoption of laws and regulations. Moreover, during these early years the laws regulating taxation kept changing frequently. There was a lack of clear provisions of norm hierarchy (knowing which laws would take precedence over others) and a lack of statutory rules defining the authority of various governmental bodies. This led to serious flaws in the legal protection of the taxpayer, who was often left to the arbitrary whim of various authorities. Corruption and arbitrary practices were widespread among the officials of the tax authority.

It was only after Vladimir Putin became president in 2000 that order was brought into taxation in Russia, with the great tax reform and the gradual adoption of the Russian Tax Code Part II with lower tax rates and clearer rules concerning each of the different types of taxes. Tax Code Part I, containing the legal and administrative principles regulating taxation, was enacted in 1998. Gradually over the years, much aided by court practice and the precedents developed by the Constitutional Court and Supreme Commercial Court ("Supreme Arbitration Court"), the principles of Russian taxation and tax administration have developed to represent the best area of Russian state administration. Today the tax reform stands out as the prime example of Russia's success during the 12 years of reforms. At the heart of the reforms lies the classical liberal tax theory, according to which lower taxes translates into increased tax revenues. Therefore, it is an interesting historic irony that Russia, a country where the socialist creed reigned strong until very recently, has now been converted into the international showcase of economic liberalism. In America Ronald Reagan and like-minded politicians were known for campaigning for such tax policies, but it is only in Putin's Russia that they were implemented. Hardly could Reagan have even dreamt of such measures as Putin's 13 % flat income tax rate. Fair to say that never before has there been such a dramatic and speedy shift from socialist tax policies to classical liberalism, and hardly could the results have been any more impressive.

The tax reform as a model for far-sighted and well-thought out legislation also had the side-effect of helping to improve the overall lawmaking process and bring stability to state administration. This is also the area of the judiciary that is showing the most encouraging signs of development towards a system where court precedents are awarded a significant role, sometimes even resembling more the Anglo-American system than the stiffer European practices. As we predicted in the introductory chapter to the 2007 edition, courts and court practice with their precedents have had a decisive and positive role in shaping the tax laws in Russia.

The big remaining problem with the Russian tax system, notwithstanding the significant improvements during the last few years, is the heavy administrative burden, red tape and bureaucracy that the taxpayers are subjected to. But it seems that the Russian Government has finally acknowledged the problem, and therefore there are hopes that these excesses will be tackled in the future and the system streamlined.

The tax reform spearheaded by Putin has given Russia Europe's most liberal system of taxation. Today in Russia there are in place transparent tax laws and internationally low tax rates, which provide good incentives for hard work. The corporate profit tax rate is 20 % and in taxation of personal income residents of Russia enjoy a record low 13 % flat tax rate for all income brackets.

The total real tax on labor costs in Russia is among the lowest in the world. To determine what is the real tax rate on labor (payroll taxes), one must consider not only the personal income tax but also all the other statutory charges on medicine, pension and other social security benefits that are charged both from the employee and the employer (social security contributions). In Russia no social security charges are levied on the employee (the employer bearing the entire burden) whereas in most countries globally the employee is also liable for social security charges. The employer's social contributions are charged on a regressive scale at a rate of 30 % for the first 624 thousand rubles of annual salary, after which the rest is charged at a rate of 10 %. (The limit was 568,000 in year 2013). In addition there is only the mandatory workplace accident insurance with rates that vary according to the activities of the firm. The rate would be 0.2 % concerning the typical office worker.

Considering the low level of personal income tax, the absence of social contributions charged from the employee, and the regressive scale of the employer's social contributions, the total payroll taxes in Russia are among the lowest in the world. This has been confirmed by a survey undertaken by Awara in connection with publishing this book: Awara Global Survey of Total Payroll Taxes. The survey shows that in a global comparison the real tax in Russia on labor costs is exceptionally low. The survey measured what in various countries is the relation between the net take-home pay (net salary after taxes) and the total cost that the employer must carry considering the gross salary and all payroll taxes. Thus the survey tells how much the employer has to pay in order for the employee to receive a certain net salary after all statutory deductions. This can be expressed as the Gross Labor Cost Multiplicator, the factor by which net pay is multiplied to yield the total employer costs. (Figure 1). Conversely the same is expressed as the Net Take-Home Percentage, the percentage of the gross labor cost that the employee enjoys after tax. (Figure 2). This shows what in various countries is the actual tax burden on labor. (This is sometimes referred to as the *tax wedge*). It is seldom that all these three main tax elements (personal income taxes, employee's social contributions, and employer's social contributions) are combined in one transparent measure like the Awara survey does. Often a comparison is made only on the personal income tax rates, or the employer's total cost without considering the employee taxes and social contributions charged from the employee.

The Awara Survey on Total Global Statutory Payroll Cost can be accessed www.awarablogs.com/tax-survey.

Figure 1 — Gross Labor Cost Multiplicator

24.000 Euro Salary		60.000 Euro Salary	
Country	**Gross Labor Cost Multiplicator**	**Country**	**Gross Labor Cost Multiplicator**
Cyprus	1,24	Mauritius	1,29
Mozambique	1,26	Chile	1,31
Mauritius	1,29	Russia	1,32
Luxembourg	1,33	Mozambique	1,40
Malta	1,36	Malta	1,42
Chile	1,37	Luxembourg	1,47
USA	1,38	Sudan	1,52
Russia	1,39	USA	1,52
Ireland	1,45	Cyprus	1,54
Sudan	1,52	Mexico	1,57
Indonesia	1,52	Indonesia	1,63
Mexico	1,54	Canada	1,64
UK	1,55	China	1,64
Greece	1,55	Ireland	1,71

24.000 Euro Salary		60.000 Euro Salary	
Country	**Gross Labor Cost Multiplicator**	**Country**	**Gross Labor Cost Multiplicator**
Finland	1,56	Lithuania	1,73
Norway	1,56	UK	1,75
Canada	1,64	Estonia	1,77
Netherlands	1,70	Norway	1,81
Lithuania	1,73	Slovakia	1,88
Denmark	1,73	Finland	1,91
Austria	1,73	Greece	1,94
Estonia	1,75	Denmark	1,94
Germany	1,82	Czech Republic	1,95
Poland	1,82	Spain	1,95
Czech Republic	1,84	Hungary	1,96
Spain	1,92	Switzerland	2,02
Belgium	1,93	Poland	2,06
Switzerland	1,96	Germany	2,15
Portugal	1,96	Austria	2,16
Hungary	1,96	Sweden	2,20
China	1,99	Netherlands	2,26
Slovakia	2,00	Portugal	2,30
Italy	2,03	Italy	2,33
France	2,04	France	2,44
Sweden	2,04	Belgium	2,51

Source: Awara Global Survey of Total Payroll Taxes www.awarablogs.com/tax-survey

Figure 2 — Net Take-Home Percentage

24.000 Euro Salary		60.000 Euro Salary	
Country	**Net Take-Home Percentage**	**Country**	**Net Take-Home Percentage**
Cyprus	81 %	Mauritius	77 %
Mozambique	79 %	Chile	77 %
Mauritius	77 %	Russia	76 %
Luxembourg	75 %	Mozambique	71 %
Malta	73 %	Malta	70 %
Chile	73 %	Luxembourg	68 %

24.000 Euro Salary		60.000 Euro Salary	
Country	**Net Take-Home Percentage**	**Country**	**Net Take-Home Percentage**
USA	73 %	Sudan	66 %
Russia	72 %	USA	66 %
Ireland	69 %	Cyprus	65 %
Sudan	66 %	Mexico	64 %
Indonesia	66 %	Indonesia	61 %
Mexico	65 %	Canada	61 %
UK	65 %	China	61 %
Greece	64 %	Ireland	58 %
Finland	64 %	Lithuania	58 %
Norway	64 %	UK	57 %
Canada	61 %	Estonia	56 %
Netherlands	59 %	Norway	55 %
Lithuania	58 %	Slovakia	53 %
Denmark	58 %	Finland	52 %
Austria	58 %	Greece	52 %
Estonia	57 %	Denmark	51 %
Germany	55 %	Czech Republic	51 %
Poland	55 %	Spain	51 %
Czech Republic	54 %	Hungary	51 %
Spain	52 %	Switzerland	49 %
Belgium	52 %	Poland	49 %
Switzerland	51 %	Germany	47 %
Portugal	51 %	Austria	46 %
Hungary	51 %	Sweden	46 %
China	50 %	Netherlands	44 %
Slovakia	50 %	Portugal	43 %
Italy	49 %	Italy	43 %
France	49 %	France	41 %
Sweden	49 %	Belgium	40 %

Source: Awara Global Survey of Total Payroll Taxes www.awarablogs.com/tax-survey

The survey shows that the total statutory payroll cost in Russia is among the lowest in the world. On an annual salary of 24,000 euros, the Gross Labor Cost Multiplicator in Russia is 1.39. This means that at this salary level, the employer's total payroll cost is 1.39 times the net take-home income of the employee, or expressed from another point of view, the employee receives in hand 72 % of all the money that the employer must pay for the employment. On an annual salary of 60,000 euros the Gross Labor Cost Multiplicator in Russia is 1.32, whereas the employee receives in hand 76 % of that money.

Of the bigger developed nations only USA (Illinois) placed before Russia in the survey in the salary level of 24,000 euro per year with a multiplicator of 1.38. At the same time most European Union countries showed multiplicators from 1.5 to 2. On the salary level of 60,000 euro per year the picture was even more favorable for Russia. Due to an increasing tax burden with higher salary levels, so-called tax progression, the multiplicator of USA had at the salary level of 60,000 euro deteriorated to 1.52, while the European Union countries (excluding some of the smaller ones with specific economic conditions) now ranged from UK's 1.75 to Belgium's 2.51. This means that in Russia an employee would from a gross salary of 5,000 euro per month receive a net salary of 4,350 euro and the total monthly cost for an employer would be 5,720 euro, whereas an employee in Belgium would be left with 2,670 euro from a salary of 5,000 euro whereas the total payroll cost for the employer would be 6,700 euro.

Many analysts may be fooled by the division of labor taxes into the various components and then only consider the employer's social contributions in a comparison of labor costs. But in a real world what counts is what the employee gets as a take-home pay because the salary levels will adjust to reflect the economic necessity to receive a certain net salary as a take-home income so as to meet the individual consumption needs. In an economic sense, one may consider that when social contributions on salary are charged from the employee instead of the employer that the employee merely acts as an agent for the employer in carrying that tax burden. And the same is true for the personal income tax. The more so, in both cases, that the actual taxes are usually all over the world withheld by the employer from salaries due. It therefore follows that at the end of the analysis it is merely an accounting convention how to name the various components of payroll taxes, they are all equally taxes on labor.

The failure to understand the above discussed principles of total labor taxes is particularly evident in respect to the global comparison of tax systems called Paying Taxes 2014 by the World Bank, IFC and PWC[2]. (For reasons which remain unexplained this study which refers to data from year 2012 and was published in November 2013 is called Paying Taxes 2014).

2 http://www.doingbusiness.org/reports/thematic-reports/paying-taxes/

The study forms part of the bigger project known as World Bank's Ease of Doing Business Index. This bigger survey measures regulations affecting 11 areas of business activity, among them the regulations concerning taxation which is done in the context of the Paying Taxes survey. The tax survey attempts to measure both the compliance burden on tax administration (number of tax filings and the time it takes to perform them) and the cost of all taxes borne (the total tax rate). Unfortunately the methodology of the survey in respect to the total tax rate, and in particular concerning the total payroll taxes, is grossly inadequate as it only considers the taxes directly borne by the employer company (employer's social security contributions) and totally ignores the payroll taxes that are relegated to be charged from the employee (personal income tax and employee's social contributions). As a result the survey portrays a much skewed picture of the total tax burden. A case in point is Russia, which in reality as we have seen has among the lowest payroll taxes in the world, has been awarded a dismal ranking in the indicator of total tax rate. Russia is in the methodology of World Bank placed 178th out of 189 countries on this parameter. According to these misguided criteria taxes in Russia is supposed to take 50.7 of the profit placing Russia 56th in the rating.

To show how misguided an effort it is, as the World Bank does, to rank the tax burden solely by the criteria of what is the direct employer's social contributions we may look at the global comparison tables that show what are the personal income tax rates and what is the share of the employee's social contributions of the total labor taxes.

Figure 3 shows the rate for personal income tax in various countries according to the Awara survey. We see that Russia has the 9 lowest rate at the salary level of 24 thousand euros and 3rd lowest rate at the level of 60 thousand.

Figure 3. Personal Income Tax Rates for 24K and 60K Income Levels

24.000 Euro Salary		**60.000 Euro Salary**	
Country	**Personal Income Tax**	**Country**	**Personal Income Tax**
Luxembourg	1 %	Luxembourg	9.14 %
Cyprus	3.75 %	Chile	12 %
Chile	3.9 %	Russia	13 %
China	8.23 %	Lithuania	15 %
France	8.35 %	Sudan	15 %

24.000 Euro Salary		60.000 Euro Salary	
Country	**Personal Income Tax**	**Country**	**Personal Income Tax**
USA	9.30 %	Mauritius	15 %
Germany	11.27 %	Hungary	16 %
Austria	11.45 %	USA	16.7 %
Russia	13 %	Switzerland	20 %
Mozambique	14.7 %	Estonia	20.4 %
Malta	14.96 %	China	20.73 %
Lithuania	15 %	Slovakia	21 %
Sudan	15 %	Czech Republic	21.3 %
Mauritius	15 %	France	21.35 %
Finland	15.5 %	Cyprus	21.6 %
Czech Republic%	16 %	Mozambique	22.8 %
Hungary	16 %	Germany	23.76 %
Belgium	17.6 %	Mexico	24.33 %
Norway	18 %	Canada	24.9 %
Switzerland	18 %	Malta	25.18 %
Mexico	18.72 %	UK	26 %
Greece	19 %	Austria	26.08 %
Slovakia	19 %	Poland	27.04 %
Poland	19.35 %	Norway	28 %
Estonia	19.49 %	Ireland	29.52 %
Ireland	20 %	Finland	30 %
UK	20 %	Indonesia	30 %
Canada	20.05 %	Belgium	33.46 %
Netherlands	22.30 %	Greece	33.5 %
Indonesia	25 %	Italy	33.9 %
Portugal	25.83 %	Spain	34 %
Spain	26 %	Sweden	34.3 %
Sweden	28.54 %	Portugal	35.2 %
Italy	28.86 %	Netherlands	36.5 %
Denmark	35.50 %	Denmark	42.6 %

Source: Awara Global Survey of Total Payroll Taxes www.awarablogs.com/tax-survey

Figure 4 shows that the share of employee's social contributions of total social contributions is the lowest in the world as Russia does not levy such charges on employees whereas most countries in the world does it.

Figure 4. Employee's Social Contributions, Share of Total Social Contributions

24.000 Euro Salary		60.000 Euro Salary	
Country	Employee's Social Contributions, Share of Total Social Contributions	Country	Employee's Social Contributions, Share of Total Social Contributions
Mauritius	0%	Mauritius	0%
Russia	0%	Russia	0%
Denmark	0%	Denmark	0%
Estonia	11%	Estonia	11%
Mexico	12%	Mexico	12%
Indonesia	15%	Indonesia	15%
Spain	17%	Spain	18%
Sweden	18%	Sweden	16%
Netherlands	19%	Netherlands	15%
Finland	20%	Finland	20%
Lithuania	22%	Lithuania	22%
Czech Republic	24%	Czech Republic	23%
Canada	26%	Canada	18%
Slovakia	28%	Slovakia	27%
Belgium	28%	Belgium	28%
Portugal	32%	Portugal	32%
Sudan	32%	Sudan	32%
Norway	33%	Norway	33%
Italy	33%	Italy	33%
Greece	33%	Greece	33%
China	34%	China	33%
France	34%	France	37%
Poland	38%	Poland	38%
Cyprus	39%	Cyprus	39%
Hungary	39%	Hungary	39%
Mozambique	43%	Mozambique	43%
UK	45%	UK	44%
Austria	45%	Austria	45%
Luxembourg	46%	Luxembourg	46%
Malta	50%	Malta	50%
USA	50%	USA	50%
Switzerland	50%	Switzerland	50%
Germany	52%	Germany	53%
Ireland	55%	Ireland	45%
Chile	77%	Chile	78%

Source: Awara Global Survey of Total Payroll Taxes www.awarablogs.com/tax-survey

The World Bank survey contains several other flaws, not only is its theoretical framework wrong but wrong are also the actual methodology and the assumptions that the survey is based on. The point is that the World Bank with PWC has not in fact studied any real data and instead bases its survey on what would in a fictive world be the fictitious taxation of a hypothetical company. They determine certain parameters for this fictive company and then ask representatives of various countries to opine what would be the tax burden if such a company under such and such assumptions would operate in the given country. The business of this hypothetical company is defined as the production of ceramic flowerpots which it sells at retail. At the same time it is set that the company operates in the economy's largest business city, which in the case of Russia would be Moscow, or in case of UK — London, in Sweden — Stockholm. Thus to start with the premises of the survey are totally flawed. It is a very unreasonable assumption that such kind of business would be conducted in these kinds of European metropolises. There is also an assumption that the model company would employee the same amount of management and staff in each country, namely: 4 managers, 8 assistants, and 48 workers. There then is the question of how to define the salaries of the employees. This has in the fictitious survey been resolved by determining that the managers receive an annual salary defined as '2.25*income per capita', the assistants '1,25* income per capita,' and workers '1*income per capita.' By 'income per capita' the World Bank apparently refers to GDP per capita. But it is a strange assumption to determine salaries in such a way. GDP has very little, if anything, to do with salaries. It is even more strange that for this survey which refers to data of year 2012 (and is called the 2014 survey) uses the GDP data of year 2005 to determine the fictive salaries for year 2012. The GDP per capita for Russia in year 2012 was 14,037 according to the proper World Bank, but in the survey they used the 2005 figure of 5,337 USD, thus completely distorting any possibility to a real comparison.

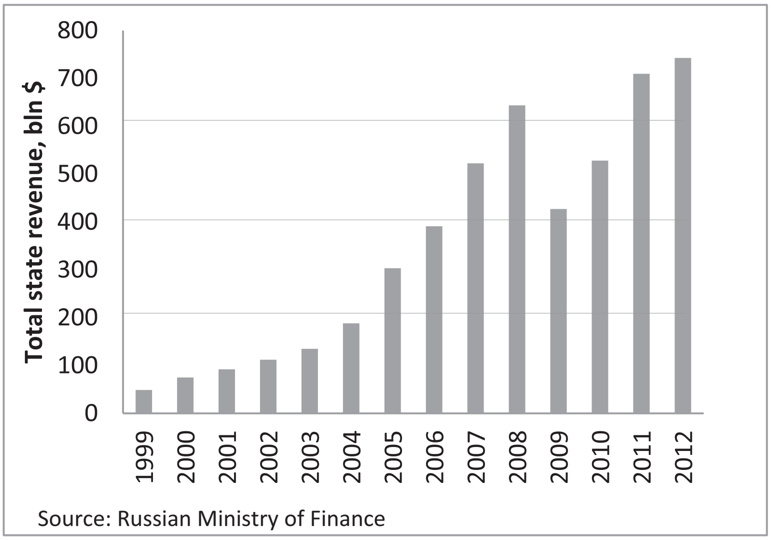
The problem with these totally unrealistic assumptions are that in various countries the rates of taxes and total tax burden are different for different levels of income. Thus when the survey defines the salaries at a completely unrealistically low level then the tax burden is not properly expressed. It was already mentioned above that the theoretical framework of the World Bank study was wrong to start with as it, while purporting to give the "total labor tax rates," solely included the employer's social contribution in the calculations and excluded the employee's social contributions and personal income tax which make up the majority of labor taxes. As Russia has low personal income taxes and no employee's social contributions this already places Russia at a disadvantage. But then the survey introduced another flaw by the series of blatantly wrong assumptions about the salary levels. As Russia applies a regressive scale on employer's social contributions, this resulted in the labor tax on that parameter seeming much higher than it in reality is. Using realistic salary assumptions (provided by Awara Direct Search recruitment agency), the total salary costs for the given positions would be 665 thousand US dollars, that is, more than double the salaries given for the survey, which was 304 thousand USD. This more realistic salary level in turn would yield 18.6 % as the total level of labor taxes (by the flawed method of only considering the employer's social contributions), whereas the wrong assumptions yielded 32.5 %, again almost the double of what more fair calculations would have yielded.

We have not attempted to analyze how the figures of the other taxes of the survey were actually arrived at, but given these apparent flaws in the labor taxes we may assume distortions in regards to them, too. It therefore seems to me that instead of attempting such a quasi-scientific survey, the World Bank should measure the tax burden not in relation to such a model company fraught with such numbers of defects in underlying assumptions and instead calculate the tax burden as we have done it in the Awara Global Survey of Total Payroll Taxes, that is, by directly analyzing the applicable tax laws to a given level of salary.

Flat Tax Leads to Surges in Tax Revenue

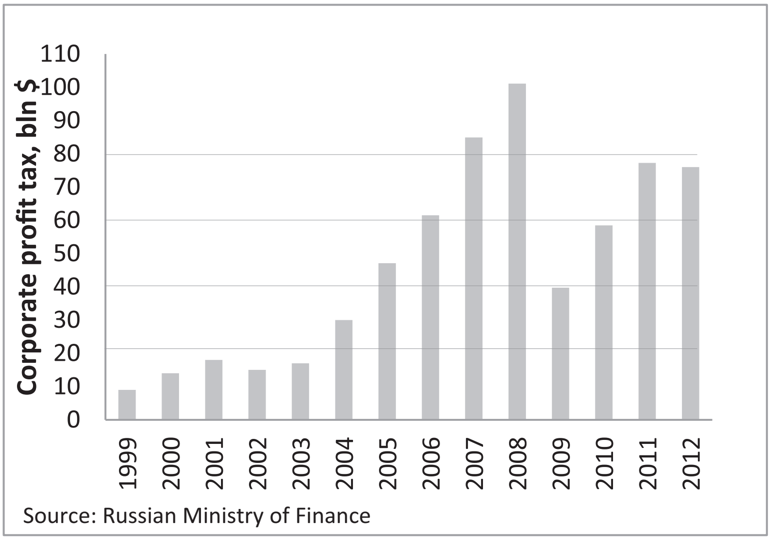
Russia's liberal tax reforms have yielded precisely the results a liberal theory would predict: with lower tax rates and simplified procedures, tax intake has surged — this when at the same time the economy has grown in leaps and bounds. We will show below, with reference to several figures, how tax revenue has skyrocketed from the onset of the tax reforms in the first year of Putin's presidency in 2000. In order to make all figures comparative and to remove distortions caused by inflation and devaluation, we present all figures in US dollars. Figure 5 shows the overall increase in state revenue from 1999 to 2012. The figures include tax revenue and all other state revenue, such as customs duties and employer's social contributions. In 1999, the year before Putin became president and prior to the onset of the tax reform, Russia's total state revenue was equal to 49 billion USD. In year 2012 this figure had snowballed into 743 billion. This represents an increase of more than 15 times in 13 years.

Figure 5: Total State Revenue 1999–2012



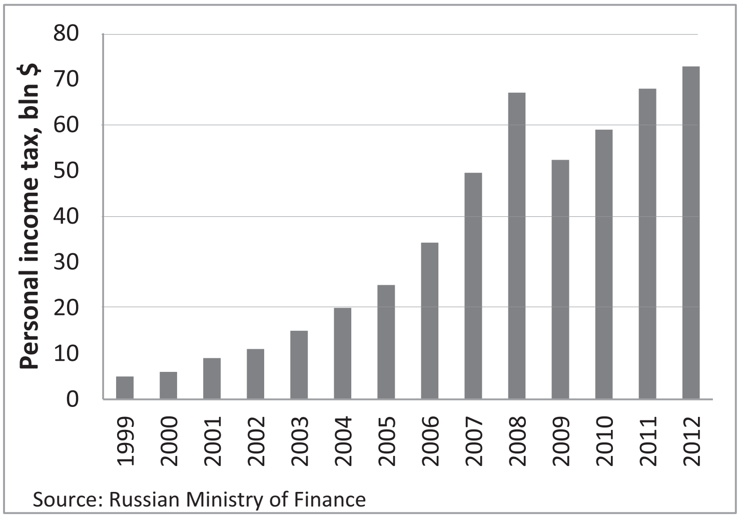
In 1999 the Russian state collected a mere 9 billion USD in corporate profit tax, but in 2012 the country raked in as much as 76 billion USD. (Figure 6).This represents an increase of more than 8 times compared to the year prior to the onset of reforms.

Figure 6: Corporate Profit Tax 1999–2012



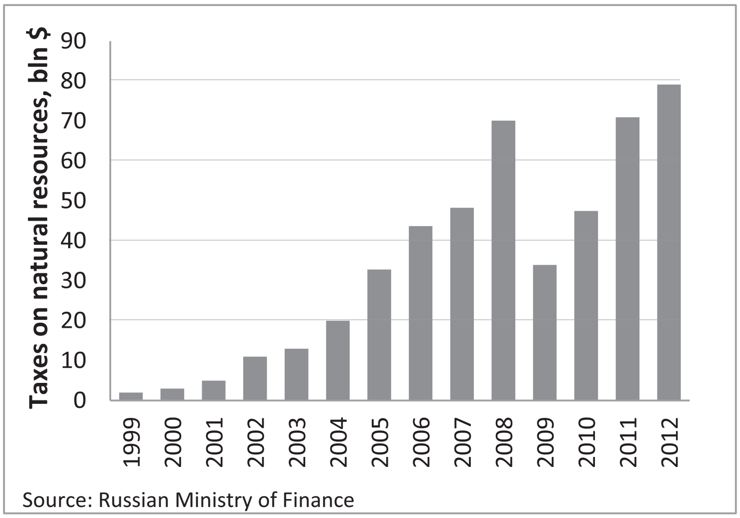
The introduction of the 13 % flat tax on personal income resulted in 2012 in a 15-times increase of revenue on this tax to 76 billion from the 5 billion of year 1999. (Figure 7).

Figure 7: Personal Income Tax 1999–2012



Revenue on various sorts of taxes on natural resources filled state coffers with 79 billion USD in 2012, whereas the corresponding figure for 1999 was a mere 2 billion. (Figure 8). This is also a case in point to refute the criticism that supposedly Russia's economic miracle was a windfall, exploiting its natural resource base and not attributable to the achievements of the political leadership. Yet these critiques forget that those minerals and natural resources have been in the Russian subsoil forever and it is only under Vladimir Putin's leadership that they have been taxed for the benefit of the economy and the Russian people. The tax reform has been pivotal in this respect.

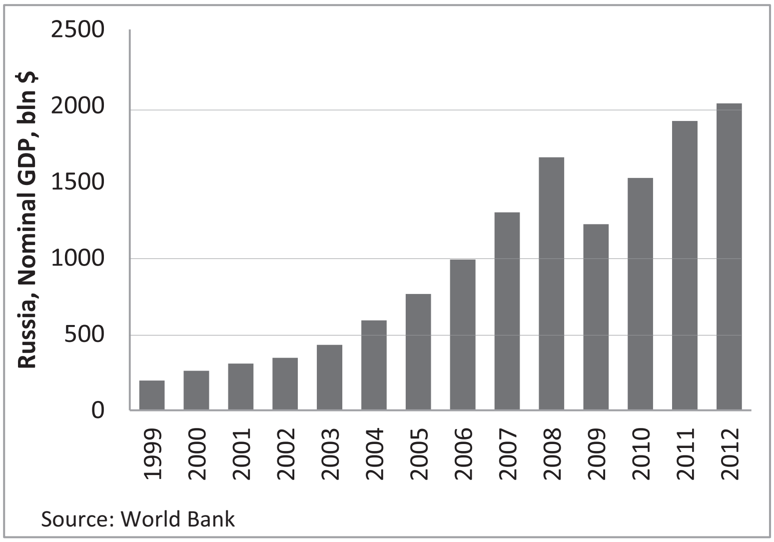
Figure 8: Taxes on Natural Resources, 1999–2012



The Russian Economic Miracle

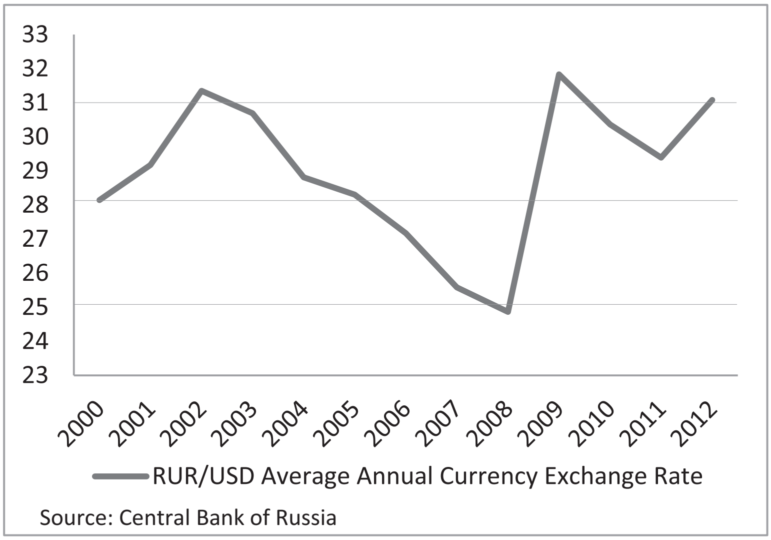
The Russian gross domestic product (GDP) in dollar terms has increased tenfold since Vladimir Putin first took office in year 2000. (All data are taken from World Bank if otherwise not stated). At end of 1999 the Russian *nominal* GDP was in US dollar terms 196 billion. By the end of 2012 the nominal GDP had risen to two trillions and 15 billion (2,015 billion; Figure 9). This represents a growth of more than 1000 % in 12 years.

Figure 9: Russia, Nominal GDP 1999–2012



Considering the economic indicators in this article, it is important to keep in mind that the exchange rate between the Russian ruble and US dollar has been relatively stable over the years under analysis (Figure 10). The average exchange rate for the starting year 2000 was 28.14, while it was 31.08 in 2012.

Figure 10: RUR/USD Average Annual Currency Exchange Rate 2000–2012



When attempting a comparison of GDP between countries, the nominal GDP figures may be misleading as they do not account for the different price levels in the countries. For this purpose economists calculate GDP estimations at PPP or purchasing power parity. If we report the figures in USD then the PPP calculations indicate what would be the size of the economy (the sum value of all goods and services produced in that country) valued at prices prevailing in the United States. This is the comparison how much one dollar buys in various countries. Expressing the GDP in PPP, the Russian economy has grown from 870 billion USD in 1999 to 3,373 in 2012. (Figure 11). By this measure Russia became in 2012 Europe's largest economy and the 5th largest economy in the world after USA, China, India and Japan. I refer in this article to the nominal GDP as the real-real GDP (in contrast to the wrong figure that the economists term "real GDP") but admittedly the GDP measured in PPP would probably deserve that denomination even better. The dynamics of the PPP and nominal measure are given in Figure 12.

Figure 11: Russia, GDP PPP 1999–2012

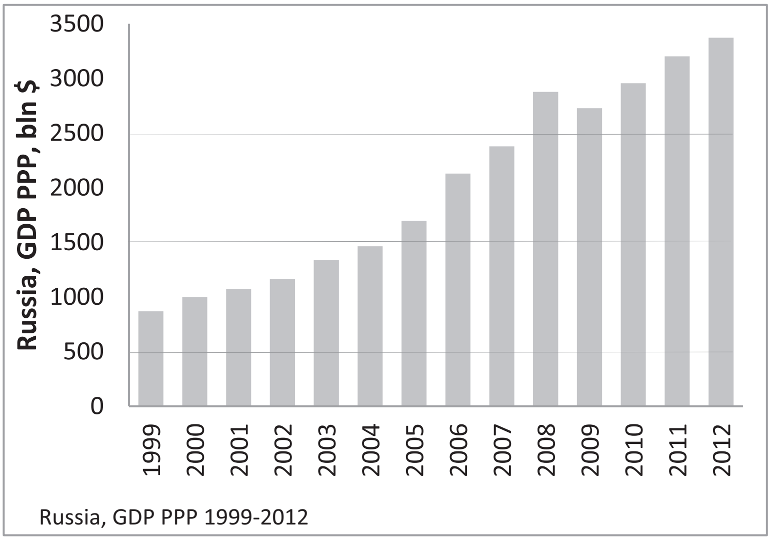
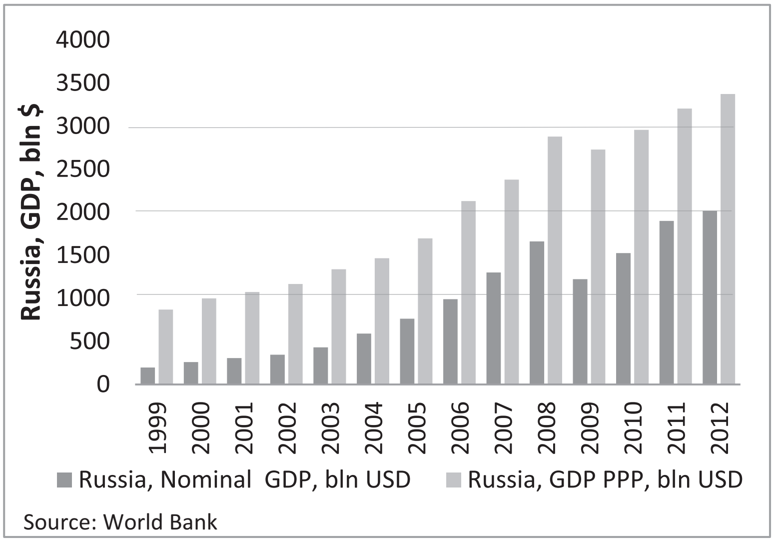


Figure 12: GDP PPP Compared with GDP Nominal 1999–2012



There is a third way to measure GDP which is to measure it in so-called "constant prices."

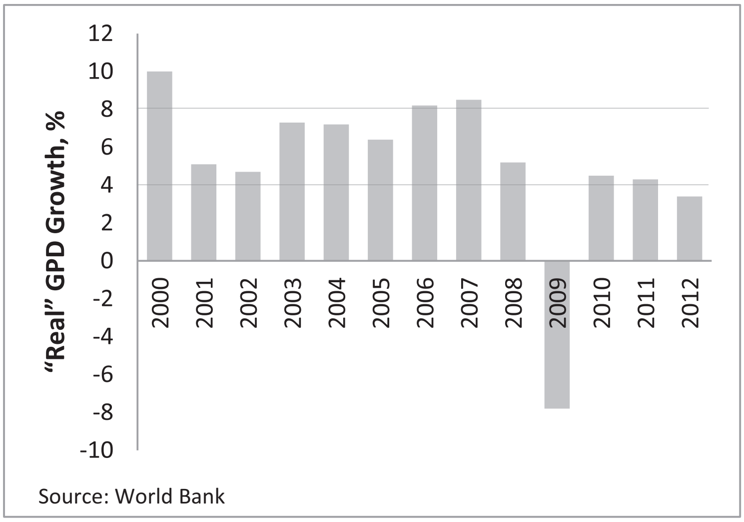
This is a quite misconceived method as it attempts to remove the effects of price inflation from the *nominal* GDP by venturing a restatement of the GDP expressed in current year's market prices by recalculating them in the prices of a preceding year, the base year. The idea is that by the use of a so-called GDP deflator, which matches the prices to the base year prices, one would arrive at a measure of *real* change in economic output free from inflation. By doing so this recalculation would yield something the economists want to call a “real GDP” which would reflect only differences in output volume from year to year. But this is quite a remarkable undertaking to start with, because the GDP, gross domestic product, is by definition the **market value** of all (final) goods and services produced within a country. If you remove market values from the equation, then the result is not any more GDP but something else. Therefore it is quite absurd, to put it mildly, that when the real-real GDP(which the economists want to call ‘nominal GDP’) is artificially adjusted to some supposed prices of a previous base year, the economists declare this product of fancy the “real GDP.” To start with a GDP measure is not a matter of fact of any kind, but a result of surveys, of a multitude of surveys, carried out mainly by governmental bodies for statistics continuously during the year and frequently adjusted when new input to the surveys arrive. Various assumptions, conventions and ad hoc concessions lay at the roots of the figures, which from time to time are pronounced to be the GDP. With these “constant prices” of a previous base year which are used for calculating the “real GDP” all the assumptions grow exponentially so as to finally border with the nonsensical. If there is an urge to calculate this “GDP in constant prices” then it seems to me that at least they should have the decency to refer to such a figure as the ‘adjusted GDP’ or better yet ‘virtual GDP’ and leave the good name of ‘real GDP’ to the one they presently call ‘nominal GDP’ — which is as real as they come. It is especially interesting that the economists seem to have a need to refer to this adjusted so-called real GDP when the question is about Russia’s economic performance. But we never hear that the real GDP of, for example, USA would be so and so much if expressed in constant prices of 1991 as it is done in the case of Russia.

What lies behind this is the attempt to depreciate the economic success of Russia by attempting to prove that the economy in fact has not developed as much as it has. But doing so the economists lose sight of the fact that GDP is nothing else than the measure of the *market value* of goods and services produced in the national economy. And in the case of Russia this market value has increased tenfold in the period we are analyzing. This cannot be denied. What then is the significance of such an increase of the market value measured as GDP is another question, but in no way particular to Russia. Depreciating the Russian GDP, one should depreciate the whole notion of GDP in reference to all countries. If the “real GDP” of Russia is something else than what our lying eyes tell us, then the GDP measures of other countries are not either what they would seem to be.

The actual GDP measure (the real-real GDP) multiplies the amount of goods (or services) produced by their market values (prices) in the present period. But the so-called “real GDP” transfers the measure into an index for quantity of output. This can be illustrated by the following example. If in a hypothetical economy there would, in year 1, be only 10 items of something produced for the price of 1 dollar each, then the GDP of that country would be 10 USD. Then let's consider a situation that in year 2 two of the items would change by way of quality improvement and enhanced features and the price of these two items would increase to 2 USD each. In this case the real-real GDP (nominal GDP) would be 12 USD (8*1+2*2), but in the fancy-real GDP the reality would be adjusted so as to disregard the change in value and we would then arrive at the conclusion that the GDP was still only 10 USD as the volume of output remained 10. However, if in that year the output of the old items had increased by one to 11, then it would be recognized that the fancy-real GDP had increased to 11.

This little excursion into theory was needed so as to understand why most economists disregard the notion that Russia's GDP has increased tenfold or 1000 % during the years Putin has been at the helm, insisting that the "real GDP" has increased only 92 % (the compounded growth by the so-called "real GDP" measure) over this period, although we saw from above that it has increased more than 1000 %. The economists arrive at this flawed figure by summing up the annual GDP growth figures that are given as the "real GDP", that is, the figure which largely ignores merely and quite inadequately change in quality and only considers the volume of output. (In theory the aim is to consider change in quality but it is done with gross inadequacy, which is the real object of criticism here.) Figure 13 gives the value for these annual growth figures for "real GDP." These yield an average annual growth rate per year of 5.2 % for the period from 1999 to 2012 and a compounded growth rate of 92 %.

Figure 13: Annual so-called "Real" GPD Growth 2000–2012



The nominal GDP divided by the "real GDP" yields a so-called GDP deflator. The GDP deflator is an attempt to measure inflation across the whole economy, as opposed to the consumer price index (CPI) which measures change of price of a typical consumer's basket of goods and services. Figure 14 compares the CPI inflation with inflation according to the GDP deflator.

Figure 14: Inflation (CPI) and GDP Deflator 2000–2012

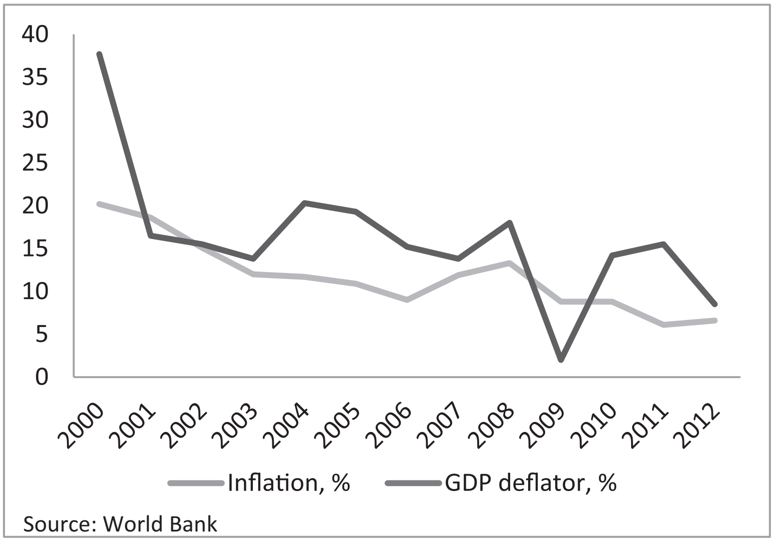
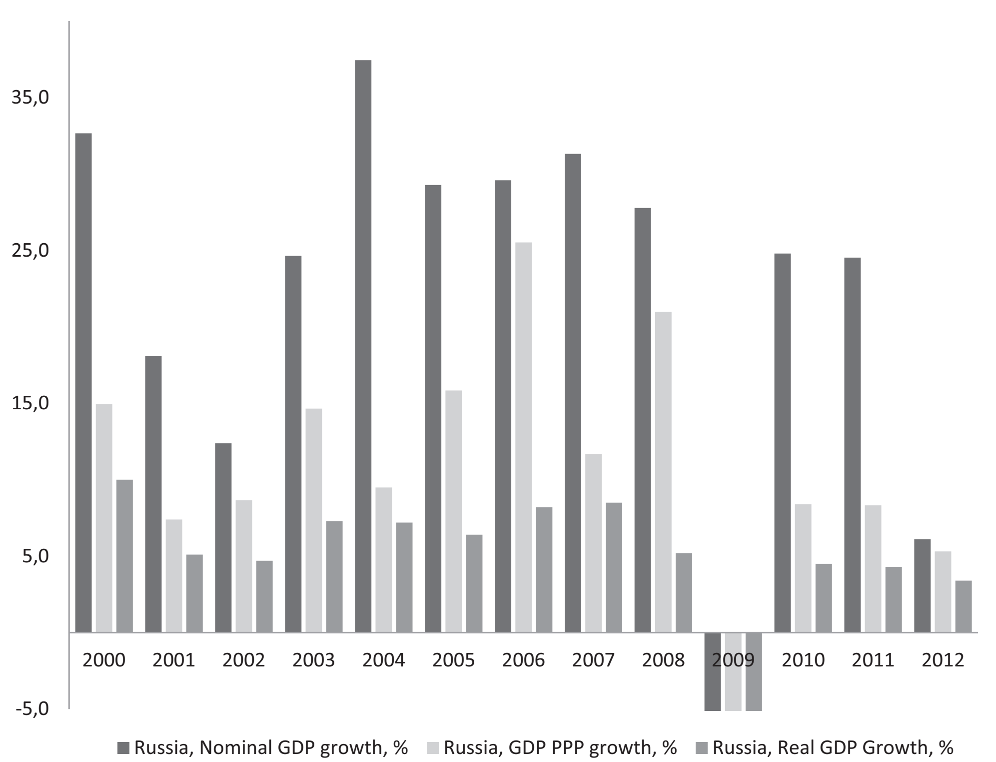


Figure 15 gives an interesting comparison of the annual GDP figures by reference to the various methods of expressing GDP: the so-called "real GDP" (which I have referred to as the 'fancy-real GDP'); the nominal GDP (which is the actual real GDP and which I will refer to as 'real-real GDP'); and the GDP PPP (purchasing power parity). This serves to prove how wrong the "real GDP" measure is.

Figure 15: Russia, GDP Growth: Nominal, PPP, "Real" 2000–2012



Source: World Bank

It is easy to understand how wrong you can get it if ,in a country like Russia for 12 years, you only consider the change in output and disregard change in quality (wrongly assuming it is only monetary inflation). Russia has from 2000 up till now changed its economic structure dramatically from a post-Soviet command economy to a modern market and consumer economy. During this period the choice of products (goods) on sale have changed in quality and features so that nearly all analogues from the end of 1990's have been eliminated from the market and investments in fixed assets have changed the production methods, whereas a whole new service culture has emerged. But according to the "real GDP" method all these changes are to be disregarded. It is as if these statistics would not recognize the value of an Armani suit over an old Soviet Bolshevichka suit, with the method of adjusting for price change they are worth equal, they are both just suits. In reality the quality and features of goods and services are in a constant change in a way that is not perceivable, and, in an emerging market like Russia, the changes are even faster and unfathomable. The method of constant prices cannot possibly account for that.

Considering these ideas, it is good to bear in mind that Russia's inflation has been quite high for these years as evidenced by Figure 14 (above). It is therefore understandable that one would attempt to clean the effect of inflation in the traditional sense it is understood as "bubbling of prices", or the inflation thought of as solely occurring as a result of excessive printing of money (growth of money supply) or devaluation of the currency (for example due to economic hardship). But, while trying to eliminate that effect from the statistics, the economists have really committed the error of throwing out the baby with the bathwater because these types of causes are clearly not the sole causes for inflation. Inflation (a rise in the general level of prices) is also attributable to a change in value of goods due to improved quality or new features. The German Central Bank has published a research paper that clearly analyzes the factors that affect inflation and the difficulties in properly recording it (Discussion paper 1/98 Economic Research Group of the Deutsche Bundesbank[3]).

The report identified four major sources of bias in the GDP deflator:

- bias resulting from the use of a «wrong» index formula (product substitution bias)
- bias due to inappropriate quality adjustment of prices (quality change bias)
- bias resulting from delayed consideration of new products (new product bias)
- bias due to insufficient consideration of changes in the retail structure (outlet substitution bias).

The authors of that report conclude that the "potential errors of measurement taken together, the evidence for Germany is that the true rate of inflation is overstated by the officially recorded increase in the Consumer Price Index. In this respect, the outcome is identical to that of studies for other countries." According to the authors, a large number of US studies have shown in detail that traditional methods of measuring inflation can lead to a considerable overstatement of the upward trend in prices. The report cautions that "only qualified use can be made of the rates of inflation published by the statistical offices for drawing economic policy conc1usions." We learn that even in such a mature market as Germany "prices are not correctly adjusted for quality improvements."

Naturally there is also some attempt to account for these calculation biases concerning the Russian "real GDP" figures, but they remain largely failed. Interestingly, we may compare this failed "real GDP" indicator with the figure for industrial growth. The "real GDP" growth figures for the years 2000 to 2012 compound to 92 %, considering the ef-

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3 http://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Discussion_Paper_1/1998/1998_02_01_dkp_01.pdf?__blob=publicationFile

fect of yield on yield. For the same period the compounded figures for annual industrial output accumulate to 72 % (source: Rosstat). Thus, these figures closely monitor each other, which goes to show that the "real GDP" is actually only a measure of industrial output.

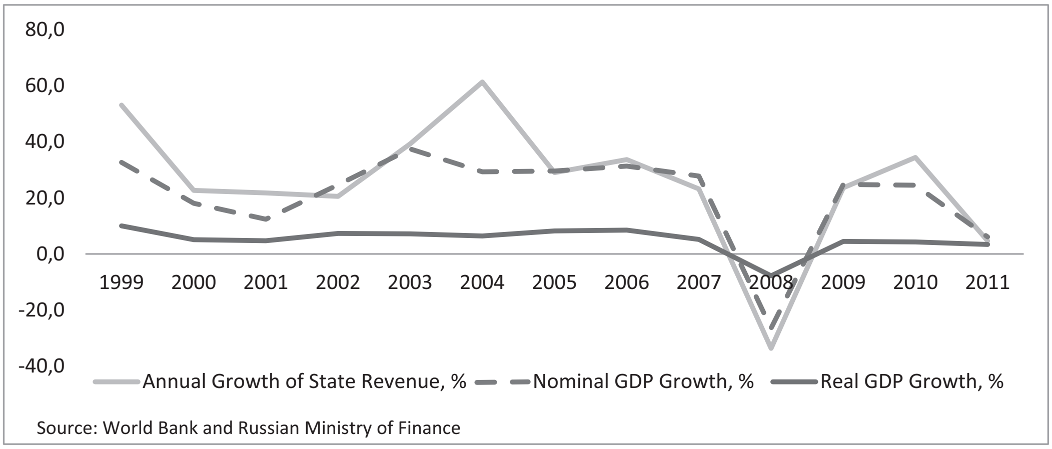
As a conclusion of this discussion, I would want to point out that I think that the attempt to adjust the GDP measure for inflation is a worthwhile endeavor for trying to identify the value added growth from one year to another (although in this case the adjustments certainly must be done more accurately). But it is certainly not acceptable to compound the thus adjusted annual growth figures to yield the growth over a period of years. The inflation rate and other inferences that go into it are too often based on vague assumptions. We need to bear in mind that the nominal GDP in itself is not a matter of fact but a figure arrived at through a series of surveys. Not to mention the problems with drawing the GDP figure, based on purchasing power parity (PPP), which is based on yet more assumptions and conventions. The only real way to calculate the GDP growth over a number of years is to compare the opening figure (the GDP of the first year of the comparison period) with the closing figure (the GDP of the last year of the comparison). Especially if we compare those figures in the equivalent of a freely convertible currency like the USD, then this is the closest we can come to something that can be called a fact in these matters. Then one might want to attempt to adjust this GDP expressed in USD to the USA price inflation in an endeavor to identify the "real GDP" growth. One would then use the GDP deflator for calculating USA GDP to adjust the Russian GDP. For a comparison the compounded inflation (CPI) in USA has been 37.9 % for years 2000 through 2012 (GDP deflator in line with that for 2000 is 82.60). This US inflation rate compares with the more than 1000 % growth of Russian GDP in USD terms showing that the Russia GDP growth is real and not inflated. Nothing can be more real than comparing the dollar denominated GDP of Russia of 1999 with its dollar denominated GDP for 2012. And that self-evident truth shows that the GDP in Russia has over these twelve years of Putin grown tenfold.

In addition to the difficulties to properly account for inflation, I would think that in the case of Russia another major difficulty has been the proper assessment of the shadow economy and especially the movement from the shadow economy into the transparent economy.

The economists' confusion with the GDP measures become the more absurd when you consider that at least most of them do not actually reject the fact that the nominal GDP in 1999 was 196 billion USD and that it was 2,015 billion USD in 2012. They just dispute the fact that what was 196 billion and became 2,015 billion has not grown more than

10 times; they merely claim, in reference to their alchemical formulae for calculating "real GDP", that the growth is chimeric. But if the GDP in reality has not grown to what it is — if the present real-real GDP is but a chimera — then from whence comes all the tax revenue reported above? If Russia's tenfold GDP growth is not real, then where do we get the 10 to 15 times increase in tax and other state revenue? (Reference is made to Figures 5 to 8, above). After all the tax revenue is for real, they are real rubles collected, with the real convertible exchange rate that yield a 15 times increase in revenue. If the "real GDP" had grown only 92 %, then naturally the growth in state revenue should have been on the same level and then Russia would not have had 743 billion USD in revenue in 2012, but only some 100 billion as would correspond to the "real GDP" growth. (Reference is made to Figure 16).

Figure 16: Comparison of GDP Figures with State Revenues for years 2000–2012



Interestingly, the chart shows that this fancy-real GDP growth is significantly lower than the growth of state revenue for this same period.

We may conclude that it is time to admit the fact that the Russian economy has since 1999 in fact grown tenfold in real terms measured by GDP. If you cannot explain that in terms of real GDP, then you might as well call it a miracle.

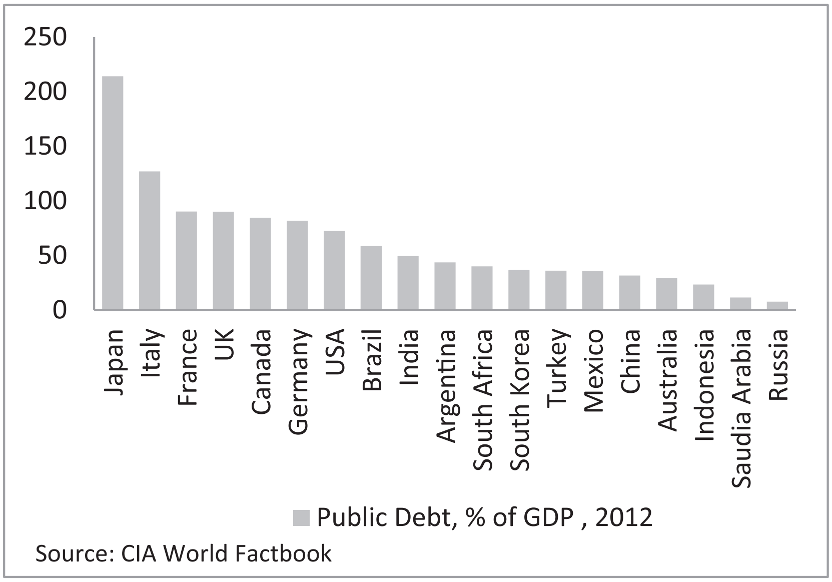
From Rags to Riches

When Vladimir Putin ascended to the presidency of Russia in 2000, the country was on the brink of ruin — for many it seemed that the fall was inevitable and final. GDP per capita was at the level of traditional low-income third world nations, a mere 1/25th of the level of that of the United States. The external debt was 178 billion USD, almost equal to 100 % of the country's GDP. (External debt defined as: the total public *and private* debt owed to nonresidents repayable in internationally accepted currencies; source CIA World Factbook). By contrast, by the end of 2012 the external debt had dropped to a level equaling 31 % of the GDP, being 632 billion USD of a now 10 times greater national economy. Note that this figure includes also the debt of business entities, private and public. For comparison, the external debt of USA at the same date was 15.93 trillion (and over 17 trillion dollars at the present date, October 2013) or 25 times higher than that of Russia, while, for example, that of France is 5.17 trillion, or 8 times higher than that of Russia's.

Before Putin assumed the presidency, Russia had only recently gone through a devastating devaluation and received an emergency aid loan of 10 billion from the International Monetary Fund to replenish its depleted gold and foreign currency reserves. But today Russia holds the world's fourth largest foreign-exchange and gold reserves worth 509 bln USD (August 2013, source: IMF).

At that time Russia's government was heavily mired in its public debt; in 1999 this equaled a staggering 99 % of the GDP. (*Public debt* records the cumulative total of all government borrowings less repayments that are denominated in a country's home currency; source: CIA World Factbook). Today the Russian state may by international comparison be regarded as virtually debtless; the debt level has sunk to less than 10 % of the GDP, while most of the developed Western nations, following a decade long debt binge, saw their public debt skyrocket to perilous levels, Japan leading the debt revelers with an astronomical 214 % of debt to GDP, USA standing at 72.5 %, Germany, France, the UK and Italy ranging from 80 — 127 %. (Figure 17).

Figure 17: Public Debt of G20 Countries, % of GDP, 2012



The officially calculated average monthly salary in Russia was 81 USD when Putin was placed at the helm of a country plagued by anarchy, but today it equals 30 thousand rubles or approximately 1,000 USD (Rosstat, May 30, 2013). Still this average salary, in nominal terms, should not serve as a comparison with levels of affluence with Western countries in view of the much more favorable purchasing power parity in Russia and low levels of income taxation.

In 1999 12.6 % of the workforce in Russia was unemployed, today the unemployment level has dwindled to 5.2 % (Rosstat, August 2013), which many economists term as virtual full employment.

The World Bank estimated that in 2001 27.3 % of Russians or 40 million people lived below the poverty line; by the end of 2012 this figure had dropped to 11.2 %.

Russia seemed also to have overcome the worst of the demographic crisis as the birth rate had risen from 8.27 (births per 1000 people) in 2000 to 13.3 % in 2012 (Rosstat), which together with brisk immigration and significantly reduced emigration has stemmed the feared plummeting of the population. The population has against predictions been reduced by less than four million from 147 million in 1999 to today's 143.5 million (August 2013). At the same time life expectancy has normalized from the lows of 66 years in 1999 to today's 70 years.

The overall normalization of Russia is perhaps best evidenced by the dramatically improved conditions of security of its residents, as seen against the murder statistics. In 2002, still in the aftermath of the anarchy of the 90's, there were 44,252 murders, or 30.2 murders per 100 thousand residents. By 2011, the number of murders had dramatically fallen to 16.4 thousand murders, or 11.5 per 100 thousand. In 2012 there was a further decline to 15,408 or 10.4 per 100 thousand (source Rosstat). The figures are now at the level of the global average and far below the levels seen in the most problematic countries. Here are the statistics for some other countries: Colombia 61.1 per 100 thousand; South Africa 39.5; Brazil 30.8; Mexico 11; USA 5.6; UK 2.6; global average 9.61 (figures for 2004-2006)[4]. Here it needs to be kept in mind that in Russia there are big differences between its European territories, where the murder statistics are already well below the global average (and comparable to the US), and the more problematic Caucasian regions.

As this article summarizes, the economic achievements since 2000 when Putin first became president of Russia, it is appropriate to make reference to a remarkable document that set the course for Russia's economic transformation, and indeed the tax reform. This is a prophetic article titled "Russia at the turn of the millennium" originally published on the government web and republished in print. It was a program article by the then Prime Minister Vladimir Putin, published on December 30, 1999, a day before Boris Yeltsin resigned, and thus transferred the presidency to Vladimir Putin who under the Constitution as the then prime minister became acting president. This was in essence Putin's manifesto on how to tackle Russia's dire woes prevailing at the time and a vision of how to lead Russia into a better future. This is a stunning document about a vision come true. The article was written in another world and in a completely different reality but yet it remains fresh, as if it had been written only recently. Based on my observations, I think that the author would not have written it much differently, even having access to all the experience gained twelve years later — he has been able to address and remedy the problems identified back then, and he has converted Russia into a country that has metamorphosed into a modern country that is now in the vanguard of the new millennium, just as he would have wished it.

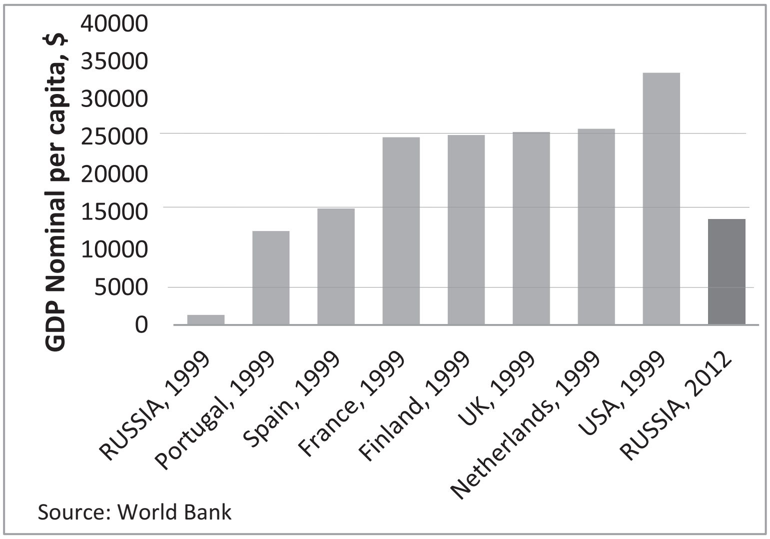
The article touched all aspects of life and society, identified the problems and outlined the remedies. In essence it spelled out the strategy for Russia, the strategy that this man as the CEO of Russia meticulously implemented. For those that are interested in how one brings vision into action at the highest level of organization, at the level of an entire country, which in this case is the largest country in the world by territory and ninth largest by population, I recommend reading this article. The article can be accessed in English and Russian at the links indicated in this footnote[5].

4 Jon Hellevig, Putin's New Russia, 2012
5 An English translation cited per the Appendix of Richard Sakwa's "Putin: Russia's choice"; in electronic form a translation can be accessed from this link http://pages.uoregon.edu/kimball/Putin.htm

In this connection, being the introduction to a book on Russian taxation, I will only refer to Putin's now prophetically sounding pronouncement of how many years of zealous work of a consolidated society it would take for Russia to catch up in economic terms with the Western nations. In reference to expert calculations (presumably from the Center of Strategic Research), Putin predicted that it would take 15 years to catch up with the *then* per capita GDP income of Portugal and Spain. This, he said, would be achieved if the Russian economy grew on average 8 % annually. But he added that if the growth was at the level of 10 % p.a. then Russia would reach the level of the per capita GDP prevailing in the UK or France in 1999.

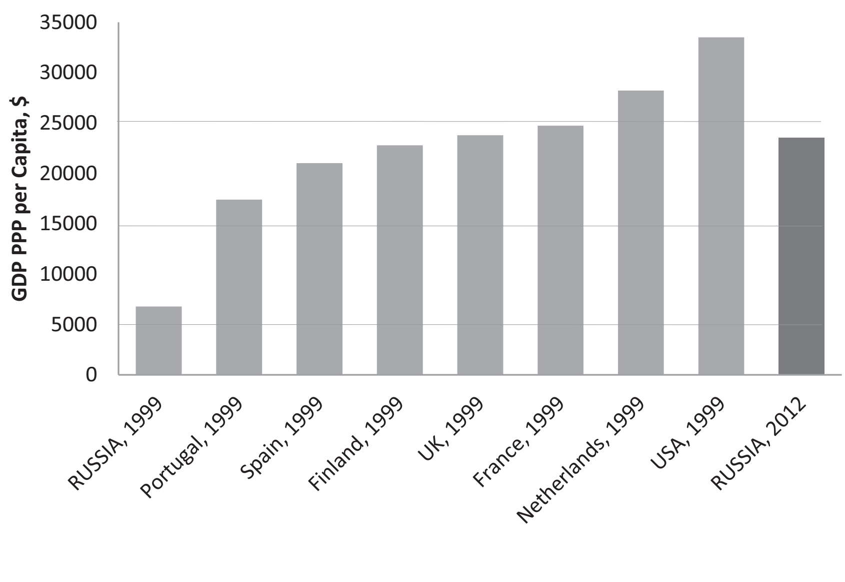
These were quite ambitious goals considering that Russia's nominal per capita GDP for 1999 was in dollar terms 1,334. (Figure 18). The corresponding figures for the countries in comparison were: Portugal 12,473, Spain 15,473, UK 25,630, France 24,930. We can see that by this measure Russia was 9 times behind Portugal and almost 20 times behind the UK. Thirteen years later, at the end of 2012, Russia's GDP was 14,037. Thus, in thirteen years, two years ahead of the 15 years period allowed for in the prognosis, Russia had reached the level of Portugal and Spain and made significant headway on reaching the then prevailing levels of the UK and France.

Figure 18: Putin's Millennium challenge — GDP Nominal per Capita of Russia 1999 and 2012 Compared with Reference Countries' GDP 1999



By a more accurate measure, the GDP PPP, the picture looks even rosier. In 1999 the GDP PPP per capita for Russia was 6,787 USD, while those in the comparison were: Portugal — 17,393, Spain — 21,009, UK — 23,784, France — 24,731. (Figure 19). By 2012 Russia had reached 23,501 per capita GDP measured in PPP. Thus Putin had complied with even the most ambitious goal to catch up with the GDP levels that prevailed in 1999 in the leading Western nations.

Figure 19: Putin's Millennium challenge — GDP PPP per Capita of Russia 1999 and 2012 compared with reference countries' GDP 1999



Source: IMF for 1999, World Bank for 2012

Mind the Gap!

Obviously the compared countries have also grown over the years and therefore it is also interesting to study the contemporary indicators. At the end of 2012, the nominal GDP per capita for Portugal was 20,182, Spain — 29,195, UK — 38,514, France — 39,722; this when the figure for Russia was 14,037. (Figure 20). This means that the GDP gap which used to be 9 times in favor of Portugal over Russia had been reduced to only one half, while the GDP gap with the UK had narrowed so that Russia's GDP now was one-third of UK's, having been 1/20th. (Figure 21)

Figure 20: Putin's Millennium challenge — GDP Nominal per Capita 2012, Russia Compared with Reference Countries

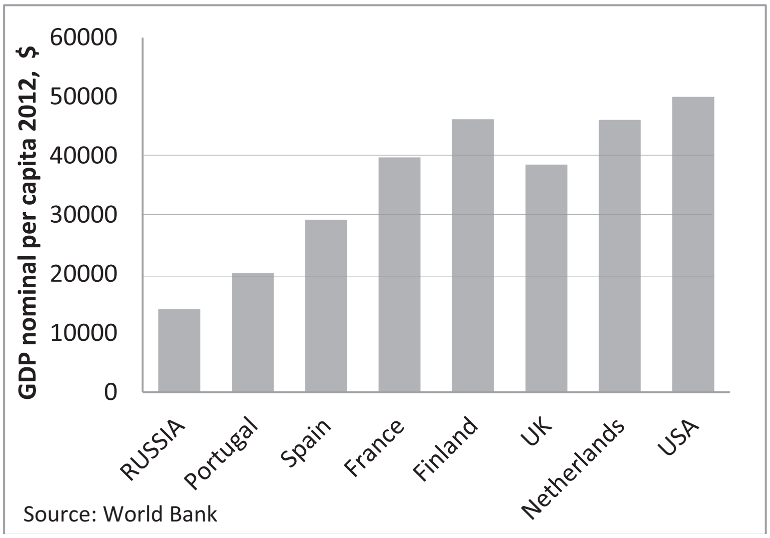
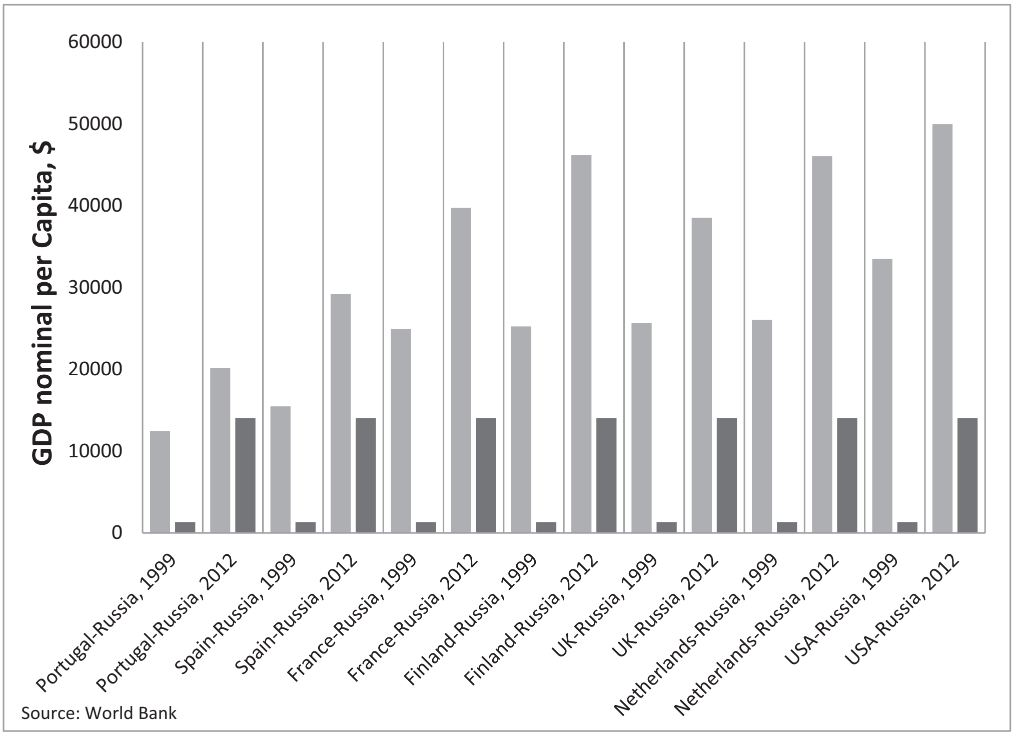


Figure 21: Putin's Millennium Challenge — Reduction of Russia's GDP Gap, Nominal, with Reference Countries, 2012



The corresponding figures of GDP per capita in PPP for 2012 are: Russia — 23,501, Portugal — 25,411, Spain — 32,682, UK — 36, 901, France — 35, 295. (Figure 22). Here we see that not only had Russia caught up with the level of Portugal of 1999, but virtually put itself on par with the present day level. The GDP gap with the other countries had also been significantly cut, Russia's per capita income now standing at less than half of the level of the UK, while the gap in 1999 had measured 3.5 times (Figure 23); this after 13 years, with two more years still to go of the 15-year forecast period.

Figure 22: Putin's Millennium Challenge — GDP PPP per Capita 2012, Russia Compared with Reference Countries

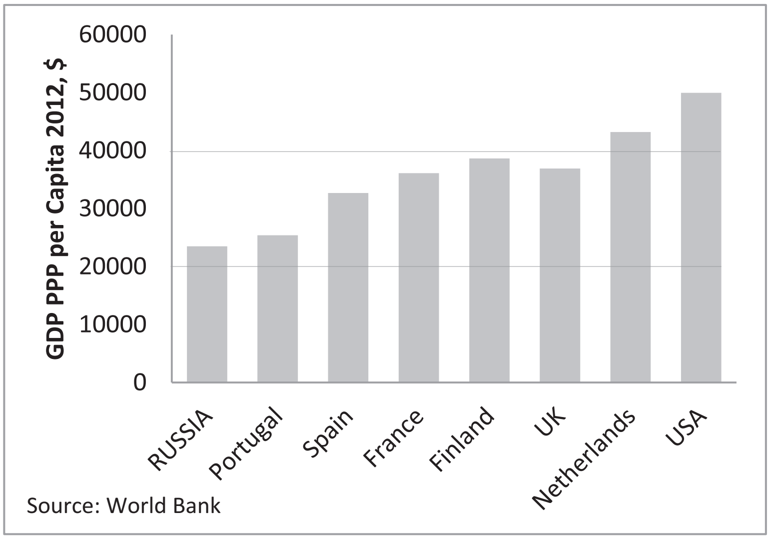
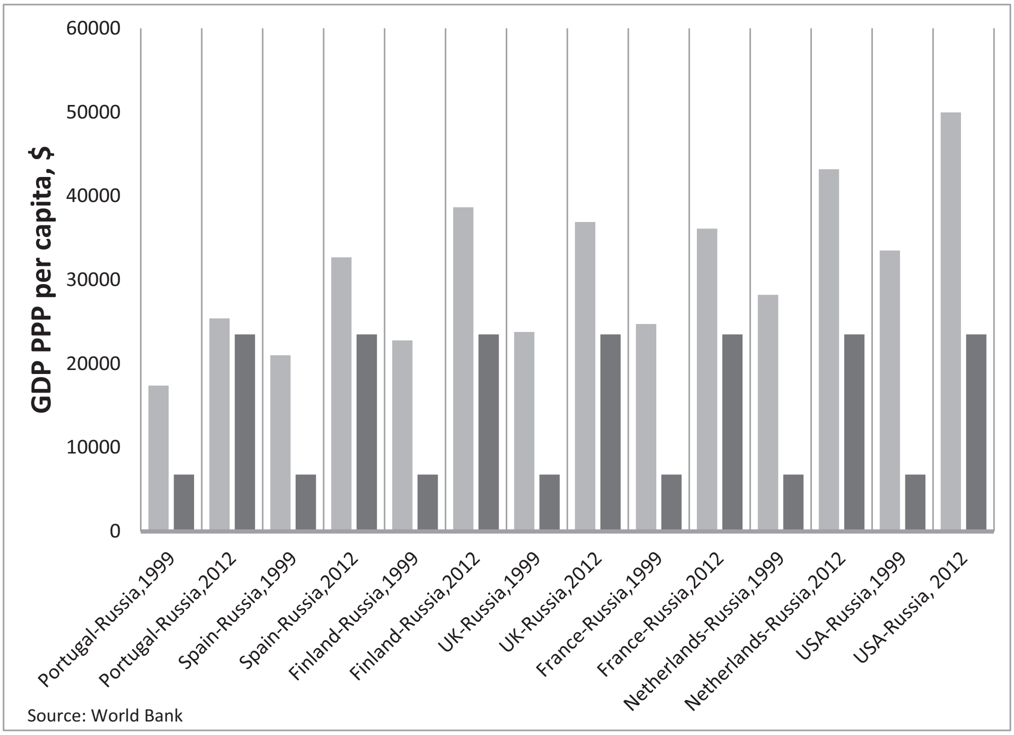


Figure 23: Putin's Millennium Challenge — Decrease of Russia's GDP Gap, PPP



It is also interesting to note how the GDP gap between the USA and Russia has been bridged during these years. The Russian GDP per capita, which still in 1999 was a mere one-twenty-fifth of the US level at end of 2012 had been reduced to between a third to a quarter. According to the purchasing power parity figure, a fifth of the US level, while at end of 2012, it had been reduced to half.

At the same time Russia has from lowly levels gone on to become the fifth largest economy in the world in just thirteen years (PPP measure, source: World Bank).

Making these comparisons, one also needs to keep in mind that Russia has reached these levels without the effect of debt doping, while the countries of the comparison have been excessively leveraged by debt during the same period. Essentially, all the growth there has been in the countries of comparison has come exclusively from debt which has been used for consumption in an attempt by the politicians in power to buy the favors of the electorates of their respective countries.

Finally, I want to address the comparison of the size of Russia's economy with that of the Netherlands. It used to be popular, in an attempt to belittle Russia, to compare the size of its economy to that of the Dutch economy (and some critics are still singing the same tune). Back in the early years of the new millennium there was some merit to the comparison, as the size of the GDP of the two countries were comparable. In 1999, by the measure of nominal GDP, Russia's economy at 196 billion was roughly half of that of the economy of the Netherlands which stood at 411 billion. For the same year the PPP measured GDP depicted Russia's economy with 879 billion, twice as big as the Dutch economy at 426. But by year 2012 Russia had, by the nominal GDP, turned the tables on the Dutch economy, being measured respectively at 2,015 and 772 billion (Figure 24). The same year, according to the GDP PPP measure the Russian economy was valued at 3,370, or some 4 times bigger than the Dutch GDP at 725 (Figure 25).

Figure 24: GDP Nominal, Russia and Netherlands 1999 and 2012

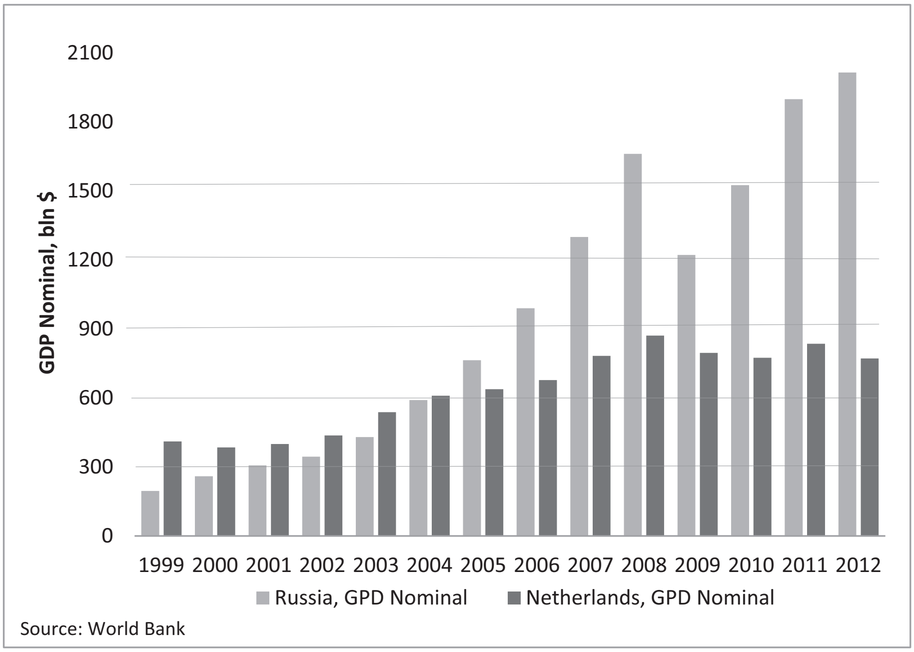
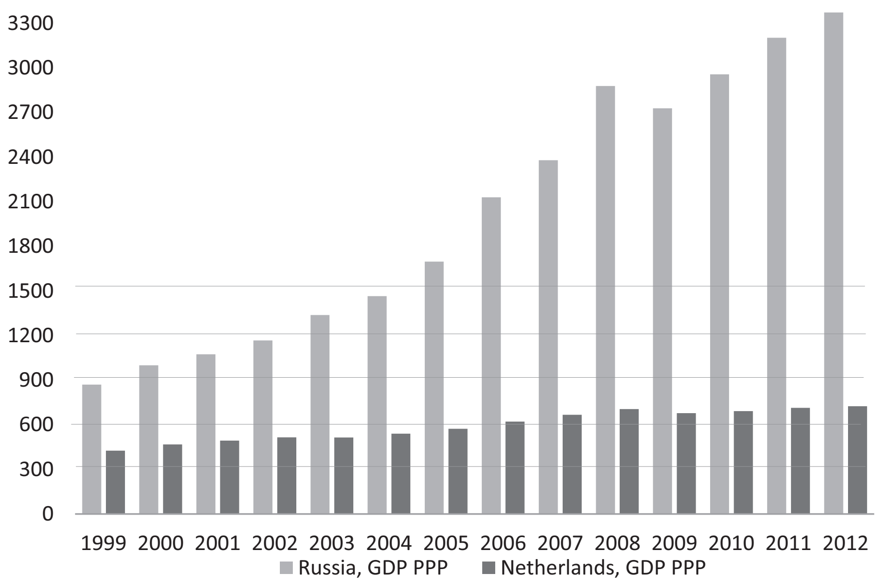


Figure 25: GDP PPP, Russia and Netherlands 1991 and 2012



Source: World Bank

2. GENERAL ABOUT RUSSIAN TAX LAW

The highest norm of Russia tax law is in the Russian Constitution (article 57), which states, that "all are obliged to pay legally established taxes and duties" and the principle that new taxes and adverse changes to taxes cannot be applied retrospectively. There are direct references to taxation in five other articles of the constitution: articles 57, 71, 75, 104, 106 and 132[6]. Article 57 contains the main general reference to taxation proclaiming: "Everyone is obliged to pay legally established taxes and levies. Laws introducing new taxes impairing the situation of the taxpayer do not carry retroactive effect." Article 71 states that taxation laws are the prerogative of the Russian Federation (as opposed to being in regional competence). According to article 75, item 3 of the Constitution the general principles of taxation are determined by federal law, which federal law in this case is the laws incorporated in the Tax Code[7]

Since 1998 the main laws governing taxation have been codified in the Tax Code, which consists of two parts[8]. Tax Code Part I was adopted in 1998 and entered into force on 1 January 1999. Tax Code Part I regulates general taxation matters, setting out the most important provisions of the Russian taxation system. Tax Code Part I specifies the procedures on how taxes are introduced and repealed and defines all aspects of interactions between state, taxpayers and tax agents. The first part of the Tax Code also provides the general principles of taxation and the rules for tax administration including the rights and obligations of taxpayers and tax authorities. The below table gives an overview of the provisions of Tax Code Part I.

In particular the Tax Code Part I regulates:

1. Types of taxes and fees that can be levied (articles 12, 13, 14, 15)
2. Circumstances giving rise to tax liability and its discharge (Chapter 8)

6 The Constitution of the Russian Federation (approved by referendum 12.12.1993) No. 1-FKZ // Code of Russian Laws. 2009. No. 4. Art. 445.
7 Art 75 (3) of the Constitution of the Russian Federation (approved by referendum 12.12.1993) // Code of Russian Laws. 2009. No. 4. Art. 445.
8 The Russian Federation Tax Code: Part 1 // Code of Russian Laws. 1998. No. 31. Art. 3824 and the Russian Federation Tax Code: Part 2 // Code of Russian Laws. 2000. No. 32. Art. 3340.

3. Principles of the introduction, enforcement and cancellation of taxes and dues, federal and local (article 12)
4. The general conditions for setting taxes and levies (article 17)
5. Rights and obligations of the taxpayers and the tax authorities (articles 21, 23, 31, 32)
6. Detailed description of administrative compliance rules and Tax Audits (Chapter 14)
7. Liability for Tax Offences (Section VI of the Tax Code)
8. The appeal procedures and dispute regulation (Section VII of the Tax Code)

Tax Code Part II is devoted to the different types of taxes (tax regimes) and is divided in chapters containing such rules for each tax separately. This Awara Tax Guide will explore the most important of these rules throughout the book.

It is intended that the legal provisions of all federal taxes and levies would be fully detailed in the Tax Code (see e.g. article 3).

The Tax Code should determine (article 17) who is taxpayers of a given tax; objects of taxation; tax base; tax period; tax rates; provisions for recording, reporting and settlement of the tax (tax administration); and exemptions (if any). For regional and local taxes the Tax Code sets out common principles with an aim to unify taxation through the whole of Russia. Regional and local governments are left with some discretion to set tax rates, extend some exemptions and decide on other taxation matters within the framework of the Tax Code (art. 12).

The aim has been that the Tax Code *in principle* sets a closed list of taxes and levies (articles 13, 14 and 15). This principle has, however, not been fully adhered to. Some important provisions of tax law are still contained in other laws[9].

Some of the provisions of the Law on Tax Authorities of the Russian Federation (originally of March 1991) are still in force[10]. Similarly some of the provisions of the Law on Corporate Profit Tax of December 1991[11] are still in force (although the bulk of the law has been abolished).

9 During the transition period until 2005 the old law "On the Fundaments of the System of Taxation in Russia" (No. 2118-1 of 27 December 1991; as gradually amended) was concurrently in force.

10 Law of the Russian Federation "On Tax Authorities of the Russian Federation" 21.03.1991 No. 943-1 // The Bulletin of Normative Acts. 1992. No. 1.

11 Law of the Russian Federation "Law on Corporate Profit Tax" 27.12.1991 No. 2116-1 // Russian Newspaper. 1992. No. 53.

Taxation of property of individuals are regulated in a law that is not contained in the Tax Code (Law on Individual Property Tax[12]).

There are also a number of obligatory official charges (duties, dues) which are not recognized as taxes (quasi-taxes) but which de facto are of tax nature in the sense of being mandatory contributions imposed by the lawmaker and collected for the purpose of financing state functions and expenditure).

Such mandatory charges are:

- Customs duty[13]
- Customs fees (dues; fees for the completion of customs formalities, customs escort and customs storage)[14]
- Employer's social contributions[15]
- Dues for use of water resources[16]
- Environmental protection fees and charges[17].

It is also worth noticing that some other important laws also contain important taxation specific provisions, such laws are:

- Code of Administrative Offences[18]
- Criminal Code[19] (contains the corpus delicti of tax crimes and the sanctions thereof).

12 Law of the Russian Federation "Law on Individual Property Tax" 09.12.1991 No. 2003-1 // The Russian Newspaper. 1992. No. 36.

13 Chapter 25.3 of the Russian Federation Tax Code: Part 2 // Code of Russian Laws. 2000. No. 32. Art. 3340

14 Federal Law of the Russian Federation "On Custom regulation in the Russian Federation" 27.11.2010 No. 311-FZ // Code of Russian Laws.2010. No. 48. Art. 6252 and Custom Code of the Russian Federation // Code of Russian Laws.2010. No. 50. Art. 6615.

15 Federal Law of the Russian Federation "On insurance fees in Pension Fund of the Russian Federation, Fund of Social Insurance of the Russian Federation, Fund of Medical Insurance of the Russian Federation" // Code of Russian Laws.2009. No. 30. Art. 3728.

16 Water Code of the Russian Federation // Code of Russian Laws. 2006, No. 23. Art. 2381.

17 Federal Law of the Russian Federation "On the Protection of the Environment" 10.01.2002 No. 7-FZ // Code of Russian Laws. 2002. No. 2. Art. 133, Federal Law of the Russian Federation "On subsoil use" 21.02.1992 No. 2395-1 // Code of Russian Laws. 1995. No. 10. Art. 823, Water Code of the Russian Federation // Code of Russian Laws. 2006, No. 23. Art. 2381, Federal Law of the Russian Federation "On Production and Consuming Wastes" 24.06.1998 No. 89-FZ // Code of Russian Laws. 1998, No. 26. Art. 3009 and others.

18 Code of Administrative Offences of the Russian Federation // // Code of Russian Laws. 2002, No. 1 (part 1). Art. 1.

19 The Criminal Code of the Russian Federation // Code of Russian Laws. 1996. No. 25 (part 1). Art. 2954.

– Civil Procedure Code[20]

– The Commercial Procedure Code [21].

Determining which laws concern taxation we also need to consider what as such is a *tax*. We would suggest to define a tax as a mandatory charge imposed by the lawmaker and collected for the purpose of financing state functions and expenditure[22].

By an explicit provision of the Tax Code (article 3) all compulsory payments and charges that are of the nature of a tax and levy as defined in the Tax Code fall under the general regulations of the code. Thus taxes, levies, other dues and charges would also be regulated by the same set of principles and rules. The regulations concerning employer's social contributions are a case in point. Presently an employer pays such contributions to the Pension Fund, Social Fund and Medical Fundя[23]. These funds are considered to be off the balance of the Russian State budget. Some experts would like to draw from this the conclusion that employer's social contributions were therefore not to be considered to be under the general tax laws[24].

Prior to a change of law (with effect of January 2010[25] the employer's contributions were paid in form of a so-called unified social tax which was regulated by the Tax Codes and especially its chapter 24. And yet before the Unified Social Tax was introduced in 2001[26] the contributions were paid similarly to four different funds.

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20 Civil Procedure Code // Code of Russian Laws. 2002. No. 46. Art. 4532.

21 The Commercial Procedure Code of the Russian Federation // Code of Russian Laws. 2002. No. 30. Art. 3012.

22 The Russian Constitutional Court has in its resolution 11.11.1997 (Resolution of the Constitutional Court of the Russian Federation 11.11.1997 No. 16-P // Code of Russian Laws. 1997. No.46. Art. 5339) given a definition of the nature of a tax. See also Constitutional Court Resolution 17.12.1996 (Resolution of the Constitutional Court of the Russian Federation 17.12.1996 No. 20-P // Code of Russian Laws. 1997. No.1. Art. 197). Pepelyaev S.G., has defined tax as 'the sole legally sanctioned form of alienating the assets of individuals and legal entities based on compulsion, individual direct recompense, and irretrievability, backed up by state coercion while not constituting a punishment or contribution, with the purpose of ensuring the solvency of the public authorities' (Foundations of Tax Law: Textbook / Guidebook, ed. by S.G. Pepelyaev, Moscow .1995. P. 24).

23 Resolution of Council of Ministers of the Russian Federation 29.07.1998 No. 857 "On Charter of the Federal Fund of Obligatory Medical Insurance" // Code of Russian Laws. 1998. No.32. Art. 3902, Resolution of Council of Ministers of the Russian Federation 12.02.1994 No. 101 "On Fund of Social Insurance of the Russian Federation" // Russian Newspaper. 1994. No. 35, Resolution of Supreme Council of the Russian Federation 27.12.1991 No. 2122-1 "Questions of Pension Fund of the Russian Federation"// The Bulletin of SPD and SC of RSFSR. 1992, No. 5. Art. 180.

24 The most unprincipled legislation // [Electronic resource]. — http://www.rbcdaily.ru — Title of screen.

25 Federal Law of the Russian Federation 24.07.2009 No. 213-FZ // Code of Russian Laws. 2009. No. 30. Art. 3739.

26 Federal Law of the Russian Federation 05.08.2000 No. 118-FZ // Code of Russian Laws. 2000. No. 32. Art. 3341.

The Different Taxes and Special Tax Regimes

Below we will list the different types of taxes and tax regimes by grouping them in categories based on the hierarchical status of the taxes and dues: Federal, Regional or Local (Municipal). After the list of types of taxes follows a list of the special tax regimes.

Federal Taxes and Levies

1. Profit Tax (Tax Code chapter 25)
2. Value Added Tax (Tax Code chapter 21)
3. Excises (Tax Code chapter 22)
4. Personal Income Tax (Tax Code chapter 23)
5. Mineral Extraction Tax (Tax Code chapter 25.1)
6. State Duty (Tax Code chapter 25.3)
7. Water Tax (Tax Code chapter 25.2)
8. Charges for Use of Natural Resources (Fauna Dues) (Tax Code chapter 25.1)

Regional Taxes and Fees

1. Property Tax (Corporate) (Tax Code chapter 30)
2. Tax on Gambling Business (Tax Code chapter 29).
3. Transport Tax (Tax Code chapter 28).

Local Taxes and Fees

1. Land Tax(Tax Code chapter 31)
2. Individual Property Tax (Law on Individual Property Tax of 09.12.1991, No. 2003-1)

Special Taxation Regimes

The Russian law may provide for some special taxation regimes (systems of taxation) for the calculation and payment of taxes for certain types of activities or taxpayers.

Currently, the following special tax regimes are in force:

1. A special tax regime for producers of agricultural goods (Tax Code chapter 26.1; chapter 20 Taxation of Small and Medium Enterprises (SME) and Certain Activities of Individual Entrepreneurs in Russia of the present book);

2. The simplified system of taxation (Tax Code chapter 26.2, chapter 20 Taxation of Small and Medium Enterprises (SME) and Certain Activities of Individual Entrepreneurs in Russia of the present book);
3. The unified tax on imputed income for certain types of activities (Tax Code chapter 26.3, chapter 20 Taxation of Small and Medium Enterprises (SME) and Certain Activities of Individual Entrepreneurs in Russia of the present book);
4. A special tax regime for the performance of production sharing agreements (Tax Code chapter 26.4, chapter 20 Taxation of Small and Medium Enterprises (SME) and Certain Activities of Individual Entrepreneurs in Russia of the present book);
5. Taxation by license (taxation based on a patent; from January 2013, Tax Code chapter 26.5, chapter 20 Taxation of Small and Medium Enterprises (SME) and Certain Activities of Individual Entrepreneurs in Russia of the present book);
6. Regimes in special economic zones (Agreement on the free (special) economic zones in the customs territory of the Customs Union and the customs procedure of free customs zone[27]; Law of 22.07.2005 No. 116-FZ "On Special Economic Zones in the Russian Federation Law of 31.05.1999 No. 104-FZ; Law of 10.01.2006 No. 16-FZ, Law of 30.09.2013 No. 267-FZ, chapter 9 Tax Concessions and Subsidies of the present book).

Quasi-Tax Payments

By quasi-tax payments we mean those legally imposed obligatory payments which in essence are like taxes albeit not regulated by the Tax Code. These are:

1) Customs duties
2) Customs dues (or fees)
3) Employer's social and pension contributions
4) Environmental protection charges
5) Mineral extraction tax
6) Excise tax
7) Gambling tax
8) State duty
9) Fishing, Hunting and Trapping Dues

[27] Agreement on the free (special) economic zones in the customs territory of the Customs Union and the customs procedure of free customs zone // The Bulletin of International Treaties. 2012. No.7.

Tax Reform and Court Precedents

The great Russian tax reform was undertaken during President Putin's first term in office in 2001-2002 which saw the emergence of chapter 25 on Profit Tax; chapter 26 on Mineral Extractions Tax; chapter 27 on Sales Tax (later abolished 01.01.2004), chapter 26.2 on the simplified system of taxation for small and medium sized companies; chapter 26.3 on unified imputed Tax; chapter 28 on transport tax; and chapter 29 on taxation of gambling business.

Further reform in years 2003-2005 brought a special system of taxation for production sharing agreements (Chapter 26.4) fishing, hunting and trapping dues (Chapter 25.1); unified agricultural tax (Chapter 26.1.); corporate property tax (Chapter 29); on state duty (Chapter 25.3); and land tax (Chapter 30).

The previously feared tax police was abolished as of 1.07.2003 and its powers were transferred to Economic Security Department of the Ministry of Interior. There has been further liberalization of the laws concerning taxation, among this the rule that the initiation of criminal investigations in taxation matters may be undertake only after receiving a corresponding case from the tax authority[28].

Earlier, by effect of January 2010, the law was amended so as to exempt from criminal liability first time offences if the subjected first paid the corresponding tax[29].

By effect from 01.01.2010 the Social tax was abolished and replaced by the system of employer's social contributions (Employer's Social Contributions and Employee Social, Medical and Pension Benefit in Russia chapter of the Tax Guide).

In 2011 significant amendments were made to the laws on transfer pricing which aim at approaching the Russian laws closer to international practice. The amendments foresee a gradual tightening of the rules between years 2012 and 2017[30]

One of the striking anomalies of Russian tax laws was addressed by a law withdrawing movable assets from the base of tax on corporate property came into force 01.01.2013[31] (concerning assets acquired after the date).

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28 Art. 32 (3) of the Russian Federation Tax Code: Part 1 // Code of Russian Laws. 1998. No. 31. Art. 3824 and Federal Law of the Russian Federation 06.12.2011 No. 407-FZ // Code of Russian Laws. 2011. No. 50. Art. 7349.

29 Federal Law of the Russian Federation 29.12.2009 No. 383-FZ // Code of Russian Laws. 2010. No. 1. Art. 4.

30 Section v.1 of the Federal Law of the Russian Federation 18.07.2011 No. 227-FZ // Code of Russian Laws. 2011. No. 30 (part 1). Art. 4575.

31 Federal Law of the Russian Federation 29.11.2012 No. 202-FZ // Code of Russian Laws. 2012. No. 49. Art. 6747.

As of 30th June, 2013 the Russian law introduced the concept *beneficial owner*[32]. A beneficial owner is an individual, who ultimately, directly or indirectly (through third parties), owns (or holds a participation of more than 25 %) a client (legal entity), or is able to affect a client's actions. From now on, companies must in their business transactions take measures to identify their clients' beneficial owners and update such information at least once a year.

Over the past two decades, Russia has achieved some success in developing the Customs Union (consisting of Russia, Belarus, and Kazakhstan) and finally becoming a member of the World Trade Organization (WTO).

The history of the formation of the Customs Union dates back to the CIS countries' Treaty of 24.09.1993 entitled "On funding of Economic Union"[33], which expresses the participating countries' intention to create the Customs Union. This treaty implied that a large number of CIS countries would be included in the new economic space. The next stage was the signing of the Agreement on the Customs Union on 06.01.1995 between the RF and the Republic of Belarus[34]; later, the Republic of Kazakhstan, the Kyrgyz Republic, and Tajikistan acceded to this.

In 1999, the participants in the Agreement on the Customs Union of 1995 entered into the Treaty on the Customs Union and the Unified Economic Space[35]. The most significant changes in the organization's activity, its goals, and the bodies' competence, were made via protocols to the above-mentioned treaty in 2006 and 2007. As a result of lengthy negotiations, during the preparation of the draft Customs Union, Kyrgyzstan, Tajikistan, and Uzbekistan withdrew from it for various reasons. The Treaty on Funding of the Unified Custom Territory and Forming of the Custom Union[36] was concluded by and among the RF, the Republic of Belarus, and the Republic of Kazakhstan.

As a result, the currently active Customs Union comprises three participating countries: the RF, the Republic of Belarus, and the Republic of Kazakhstan. One of the most sig-

32 Federal Law of the Russian Federation 28.06.2013 No. 134-FZ // Code of Russian Laws. 2013. No. 26. Art. 3207.

33 Treaty of CIS Countries "On Funding of Economic Union" 24.09.1993 // The Bulletin of International Treaties. 1995. No. 1.

34 Agreement between Council of Ministers of Russian Federation and Council of Ministers of Republic of Belarus "On Custom Union" 06.01.1995 // The Bulletin of International Treaties. 1995. No. 10.

35 Treaty on the Custom Union and the Unified Economic Space (signed in Moscow 26.02.1999) // The Bulletin of International Treaties. 2001. No. 12.

36 Treaty on Funding of the Unified Custom Territory and Forming of the Custom Union (signed in Dushanbe 06.10.2007) // The Bulletin of International Treaties. 2011. No. 7.

nificant results of the Customs Union's work is putting the unified Customs Code of the Customs Union[37] into effect as from 06.07.2010. Another step on the road to integration, this time with European countries, is the subsequent accession of Russia to the WTO. On 22.08.2012 Russia entered the World Trade Organization (WTO)[38]. As a result of lengthy negotiations, a transitional period was set for the WTO rules to take effect inside Russia, depending on the type of goods for which the rules are valid.

A new special regime of simplified system of taxation is in force from 2013 for certain individual entrepreneurs engaged in certain types of small business activities (Tax Code chapter 26.5). This tax regime is referred to as the system of taxation by license (actually in Russian "taxation by patent").

Perhaps the most important and significant changes in tax law have happened in the courts. The Russian Constitutional Court and the Supreme Commercial Court have actively through case law in a system that reminds of the precedents of Anglo-Saxon law.

According to the Constitution[39], the general principles of taxation are determined by federal law, which federal law in this case is the laws incorporated in the Tax Code. Notwithstanding this provision, the Constitutional Court and the Supreme Commercial Court has a wide practice of actively developing principles which cannot be directly identified in statutory laws. Considering the activities of these courts, the Russian law could even be considered to be to a significant level determined and developed through a system of precedents.

The constitutional provisions directly concerning taxation are scarce but the Court frequently refers to more broad categories of constitutional principles. The principles can be divided according to the subjects they are addressed to: lawmaker, courts, (tax) authorities, and taxpayers. Broadly, the principles could be subsumed under two broad categories, one being the principle of a state of justice (or shortly principle of justice), and the other the principle of a bona fide taxpayer. Here the first is chiefly addressed as a guideline for due behavior of lawmaker, courts and authorities and the second as a measure of due behavior of taxpayer.

37 The Decision of Interstate Council of EAEC 05.07.2010 No. 48 // Code of Russian Laws. 2011. No. 38. Art. 5323.

38 The Protocol 16.12.2011 "On Accedence of the Russian Federation to the Marrakesh Agreement on Funding of WTO 15.04.1994" which is ratified by the Federal Law "On Ratification of the Protocol on Accedence of the Russian Federation to the Marrakesh Agreement on Funding of WTO 15.04.1994" 21.07.2012 No. 126-FZ // Code of Russian Laws. 2012. No. 30. Art. 4177.

39 Art. 75.3 of the Constitution of the Russian Federation (approved by referendum 12.12.1993) No. 1-FKZ // Code of Russian Laws. 2009. No. 4. Art. 445.

The Constitutional Court and Supreme Commercial Court practices have developed principles combatting abuse of rights in taxation by means of malicious or antisocial exercise of otherwise legitimate rights.

Typically the expression of these principles distinguish between taxpayers in good faith ("dobrosovestny") and taxpayers in bad faith ("nedobrosovestny").

The Constitutional Court introduced the principle of bona fides taxpayer in a resolution of 12.12.1998[40]. In this decision the Court proclaimed that the obligation to pay taxes is to be considered fulfilled from the moment when the bank has executed the transfer of funds from the taxpayer's bank account. Enforcing payment of the tax a second time would mean an unconstitutional infringement on private property. The background of the case was a situation where the taxpayer had given a relevant payment order to the bank but due to the insolvency of the bank the funds had not finally been remitted to the state budget.

In a later resolution of 25.07.2001 the Constitutional Court confirmed that in tax law the presumption of bona fides taxpayer is valid[41]. At the same time the Court pointed out that the principle according to which the tax liability was considered to be extinguished from moment when bank had accessed the funds in taxpayer's accounts was valid only in relation to bona fides taxpayers and did not concern mala fides taxpayers[42]. The Constitutional Court later distributed this principle to cover payment of all taxes and levies[43].

In a much published case of 14.07.2005[44], the Constitutional Court used the principle of mala fide taxpayer to extend the statute of limitation for tax offences (normally being three years). The taxpayer is denied the protection offered by the statute of limitation if it has resisted or otherwise countered the efforts of tax control by, for example, refusing to submit necessary documents and data or delayed the submission[45].

40 Resolution of the Constitutional Court of the Russian Federation 12.10.1998 No. 24-P// Code of Russian Laws. 1998. No.42. Art. 5211.

41 Resolution of the Constitutional Court of the Russian Federation 25.07.2001 No. 138-O // Code of Russian Laws. 2001. No. 32. Art. 3410.

42 Taribo E.V. Doctrines of the Constitutional Court of the Russian Federation in Taxation (Theoretical and Practical Acpects): diss… of cand. of legal sciences. / E.V. Taribo; Russian Academy of Justice. — M., 2005. P. 158-159.

43 Ruling of the Constitutional Court of the Russian Federation 01.07.1999 No. 97-O // Code of Russian Laws. 1999. No.31. Art. 4038 and Popova S.S. Constitutional and Legal Principles of Tax System in Decisions of Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / S.S. Popova; MSU. — M., 2005. P. 86.

44 Resolution of the Constitutional Court of the Russian Federation 14.07.2005 No. 9-P // Code of Russian Laws. 2005. No. 30 (part 2). Art. 3200.

45 Kuznezov A.A. Tax Legislation Use in Courts' Bodies Practice (Financial and Legal Aspects): diss… of cand. of legal sciences. / A.A. Kuznezov; Russian Academy of Governmental Service. — M., 2005. P. 128.

The Supreme Commercial Court has chosen to introduce the principle unjustified tax benefit *("neobosnovannaya nalogovaya vygoda")* instead of the principle of mala fide taxpayer[46].

The anti-abuse principles are also connected with considerations that have to with establishing the business purpose ("delovaya tsel") and identification of the substance under the form a transaction or a series of transactions are given (often referred to as "form-over-substance" but should more correctly be referred to as "substance-over-form"). According to the business purpose principle, SCC has determined that the aim to reach a tax benefit cannot be regarded as a valid business purpose[47]. According to the *substance-over-form* principle the courts must not restrict themselves to regarding the form transactions are given but identify the real underlying circumstances and intentions[48].

The Court has given detailed criteria of what constitutes an attempt to gain an unjustified tax benefit in a resolution of 12.10.2006[49].

According to the Court, under a tax benefit is meant a reduction of the tax liability as a result of, inter alia, decreasing the tax base, applying a tax deduction, a tax exemption, application of a lower tax rate, as well as obtaining the right to a refund from the budget.

A tax benefit may be considered unjustified particularly in cases where the transactions have not been recorded in accordance with their real economic essence or when transactions have been recorded without regard to any reasonable economic or other good business considerations. A tax benefit cannot be considered justified, if it has been obtained beyond any connection with real entrepreneurial or economic activities.

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46 Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P. 178-179.

47 Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P.179.

48 Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P.154, 164-165, Kuznezov A.A. Tax Legislation Use in Courts' Bodies Practice (Financial and Legal Aspects): diss… of cand. of legal sciences. / A.A. Kuznezov; Russian Academy of Governmental Service. — M., 2005. P. 72, Decision of Moscow Commercial Court 05.08.2011 No. 40-1164/1199-7 // [Electronic resource]. — 2011; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen, Resolution of Presidium of the Supreme Commercial Court 15.11.2011 No. 8654/11 on case No. A27-7455/2010 // [Electronic resource]. — 2011; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen.

49 Resolution of Plenum of the Supreme Commercial Court of the Russian Federation 12.10.2006 г. No. 53 // The Bulletin of the Russian Federation Supreme Commercial Court. 2006. No. 12 and Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P. 139.

However, the Court stresses that that the ability to achieve the same economic result with a lower tax burden by other legal means shall not serve to recognize an unjustified tax benefit.

In particular the below listed circumstances may according to the Court serve as evidence of unjustified tax benefits:

- The apparent impossibility of actually having performed the alleged activities considering the time allowed for them, location of assets or volume of material resources that would have been required for actually carrying out the operations
- The lack of the necessary conditions for achieving the alleged results of the business activities considering of the lack of management and technical staff, necessary fixed assets, operating assets, warehouses, vehicles
- The peculiarity that accounting has been done only regarding the transactions that would seem immediately necessary for obtaining the tax benefit, if it normally would be necessary to accomplish and record also other types of operations for the given type of activities
- Undertaking operations with goods which are not produced or could not have been produced in the volumes as recorded by the taxpayer
- The existence of peculiar patterns of calculation of costs and prices as well as peculiar payment terms that point to collusion between parties

At the same time the Court points out that certain types of circumstances cannot be held as such to constitute evidence of an unjustified tax benefit, such are the following:

- setting up a company only shortly before the contested business transactions commenced
- affiliation of parties of the contested transactions
- spasmodic nature of the business transactions
- past tax law violations
- one-time nature of the operations
- carrying out business transactions outside the home location
- settling the transactions between parties within the same bank
- making use of payments of a transit character between related parties
- the use of intermediaries in the implementation of business operations.

However, the Court points out, that the above listed circumstances in combination or together with other circumstances, in particular those that were referred to above as serving as evidence of unjustified tax benefits, may accumulate to evidence of unjustified tax benefits.

The Court also rules that the justification of the tax benefit cannot be dependent on the type of capital uses, equity or debt, new issues of shares and bonds etc.

Abolished Taxes

As a result of reforms in the system of taxation, a whole array of taxes was abolished during the years 2003-2013 namely:

1. Securities Issuance Tax (2005)
2. Sales Tax (2004)
3. Tax on Gifts and Inheritance (2006)
4. Tax on Advertisement (2005)
5. Tax on resale of cars and computers (2004)
6. Tax on construction of production plants in resort areas (2004)
7. Registration fee of Individual Entrepreneurs (2004)
8. Resort duty (2004)
9. Duties on maintenance of the militia, for amelioration works on territory, for education and other aims (2004)
10. License fee for right to trade with alcoholic drinks (2004)
11. License fee for right to carry out local auctions and lotteries (2004)
12. Fee for keeping a dog (2004)
13. Fee for right to trade (2004)
14. Fee for housing billet (2004)
15. Parking fee (2004)
16. Fee for right to use local symbols (2004)
17. Fee for participation in horse races (2004)
18. Fee for gains at races (2004)
19. Fees collected from participants at horse races (2004)
20. Fee for right to film for television and cinema (2004)
21. Fee for cleaning of urban areas (2004)
22. Fee for opening of gambling outlet (2004)

23. Tax on the purchase of foreign bank bills and payment documents denominated in foreign currency (2003)
24. Road Tax (2005)
25. Tax on owners of motor vehicles (2003)
26. (Unified) Social Tax (2010)

Tax Authorities

Tax administration and administration of quasi-tax payments (such as employer's social contributions) are handled by the following authorities:

- The Ministry of Finance;
- The tax authorities: the Federal Taxation Service of Russia (former Ministry for Taxes and Levies) and its territorial subdivisions, which are also referred to as the tax inspectorates;
- The Ministry of Economic Development ;
- Ministry of Labor and Social Development
- The Customs Authorities: the Federal Customs Service and its territorial subdivisions (customs bodies);
- Economic Crime Unit of the Ministry of Interior (until 2011 functioning as Economic Security Department of the Ministry of Interior , which received the competence of the former tax police;
- State non-budgetary funds;
- The Investigative Committee
- Public Prosecutor's Office ;

The Economic Crime Unit has the right to carry out tax inspections if there are sufficient grounds to suspect a crime. The Economic Crime Unit's special rights include the right to launch criminal investigations of the financial operations of the taxpayer, the right to tap telephones, intercept correspondence and exercise control over electronic mail (when sanctioned by a court). In investigative activities the Economic Crime Unit is guided by general rules of criminal procedure[50], which are in equal degree in force for workers of Investigation Committee in the process of investigation of other crimes.

50 The Criminal Procedure Code // Code of Russian Laws. 2001. No. 52 (part 1). Art.4921.

Powers and Obligations of the Tax Authorities

The Tax Code enumerates the powers of the tax authorities in article 31; article 32 contains a corresponding list of obligations of the tax authorities; and article 33 sets the obligations of the officials of the tax authorities. These latter would provide the fundaments for developing principles of due tax administration practices but have not yet received due attention in court practice and therefore remain underdeveloped. In addition to the Tax Code there is still in force the law on Tax Authorities which also contains some provisions concerning the rights of the tax authorities (art. 7). Below table enumerates the main obligations as per these laws.

The Powers of the Tax Authority

1. To carry out tax audits
2. To request from the taxpayers supporting documents in compliance with the legal form
3. To seize documents from taxpayers to serve as proof in investigating a tax offence
4. To summon a taxpayer for questioning for in connection with probing a taxa matter
5. To inspect or examine any production, storage, trading or other premises connected with taxpayer's activities
6. To carry out a stock-take of the taxpayers inventory
7. To determine when permissible the tax due by application of the deemed method
8. To require the taxpayer to make corrections in tax returns and supporting documents
9. To request banks to provide documents confirming payment of taxes by taxpayers and tax agents
10. To submit a petition to the relevant authorities to cancel or suspend business licenses
11. To recover tax arrears, penalty interest, and fines (from individuals only subject to court ruling)
12. To freeze operations on bank accounts (art. 76, Tax Code)

13. To seize taxpayer's assets for securing payment of taxes, penalty interest, and fines (art. 77, Tax Code)
14. To levy distress on taxpayer's assets for settlement of tax debt (from individuals only upon a court ruling; art. 46-48, Tax Code)
15. Upon discovering violations the tax authority has the right to apply to a court in matters that go beyond the taxation discipline (art. 31(14) of the Tax Code in the version effective of 2012; art. 7(11) of the Law on Tax Authorities of the Russian Federation of 21.03.1991 (as amended)). For example, tax authority may apply to court for:
    – claiming tax arrears, penalty interests, fines
    – a claim to bank for compensation of damages to the state or municipality in case of bank wrongfully omitting to withdraw funds o suspension of taxpayer's operations
    – early termination of agreement
    – and other cases

Rights and Obligations of the Taxpayers

The Tax Code provides and explicit list of the rights of the taxpayers. These provisions are mainly in article 21 and 81 and are presented in below table.

Taxpayer's Rights

1. To receive from tax authorities, free of charge, information on laws and rules; duties of the taxpayers and powers of the tax authority and its officials; tax reporting forms with advice on how to complete them (art. 21(1(1))
2. To receive from the Ministry of Finance and other bodies of the tax authority written explanations or instructions on implementation of taxation laws and rules (art. 21(1(2))
3. To receive temporary credit (offsetting) or refund of taxes, penalty interests and fines paid or collected in excess. The tax authorities, hereby, have an obligation to initiate refunds or offsetting ex officio without waiting a request from the taxpayer (arts. 21(1(4) and 21(1(5))

4. To take part in hearings, provide explanations and receive copies of tax audit protocols and decisions of the tax authority (arts. 21(1(7) and 21(1(9))
5. To appeal against actions (or omission) of tax and other relevant authorities (art. 21(1(12))
6. To refuse compliance with any unlawful acts or demands from the authorities (art. 21(1(11))
7. To receive compensation for losses caused by unlawful acts, actions and omissions (art. 21(1(14))
8. The right to amend a tax return before the deadline for its filing (art. 81(1))
9. Exemption from liability provided that the debt is paid together with the Penalty Interest after the expiration of the due time, and the correction is made before the tax authorities have noticed the error or announced a Tax Audit (art. 81(4)).
10. The right to take part in consideration of the tax audit reports and other similar decisions of tax authorities (art. 21(1(15)).
11. The right to conduct together with the tax authority reconciliations of tax calculations

An open list of a taxpayer's obligations are found in art. 23 of the Tax Code. Among these we note the obligations to:

- store accounting records for a minimum of 4 years
- report about opening or closing of bank accounts within 7 days
- report about receipt of electronic bank signature rights or the ceasing of them within 7 days

  report about acquisition of or cessation of ownership in Russian or foreign organizations (except for Russian limited liability companies and economic partnerships) within one month from receiving title To report about founding or closing of subdivisions within one month from the event;
- To report about founding or closing of subdivisions within one month from the event and, within 3 days from change of status of such a subdivision about reorganization or liquidation, and within 3 days from decision of liquidation of subdivision

Tax Secrets

The Tax Code (art. 102) qualifies as a tax secret practically any information that has come to the attention of tax and other relevant authorities regarding the taxpayer. In fact, the law separately lists only the data or information that cannot be considered as a aax secret. Some type of data are expressly excluded from the scope of tax secrecy, namely:

- Data in the public domain
- Taxpayer's identification number (INN)
- Confirmed facts of tax offences and sanctions imposed
- Information exchanged between law enforcement bodies in concordance with international treaties
- Data about taxation provided by a candidate for elections to State Duma.
- Data about payment of state and municipal payments.

In a curious twist of logic the tax secrecy laws have by the tax authority been converted to means of protecting the tax authority against the legitimate interest of the taxpayer to take part of the material in his case. Unfortunately the Supreme Commercial Court has validated this approach in its rulings 21.09.2010[51] and 28.05.2010[52], both in the same case.

[51] Ruling of the Supreme Commercial Court of the Russian Federation 21.09.2010 No. 12980/10 // [Electronic resource]. — 2010; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen.

[52] Decision of the Supreme Commercial Court of the Russian Federation 28.05.2010 No. VAS-4281/10// [Electronic resource]. — 2010; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen.

3. THE RUSSIAN JUDICIARY

As this book goes to print, we have just received the news that the president has submitted a bill proposing significant amendments to the judiciary[53]. Most importantly it is suggested to merge the Supreme Commercial Court with the Supreme Court, the latter remaining as the unified court. The new merged Supreme Court would preside over all courts in civil, criminal and administrative matters. It is too early at this stage to say which all other changes this would entail but it is clear from the explanatory notes to the bill that there would be an overhaul of a number of central laws concerning the judiciary[54].

With this in mind we think that this chapter can be read as a description of what will soon become history of the Russian judiciary from the onset of the democratic reforms till this date.

The Russian judiciary (system of courts) is divided into three main branches with the Constitutional Court, Supreme Court, and Supreme Commercial Court respectively at the apex.

The Russian judiciary is regulated on the level of the Constitution by Chapter 7, Articles 118 to 129[55]. Based on the constitutional norms there are three laws on the judiciary that have been adapted in the form of constitutional laws (that is, which have been adopted in conformity to the qualified procedures and votes required for passing constitutional amendments[56]. The most important constitutional laws in this connection are: Law on

53 The Bill of Law of the Russian Federation on amendment to the constitution of the Russian Federation 07.10.13 Pr-2355 // [Electronic resource]. — 2013; the Russian Federation State Duma. — Mode of access: — http://www.duma.gov.ru — Title of screen,

54 Explanatory note to the Bill of Law of the Russian Federation on amendment to the constitution of the Russian Federation 07.10.13 Pr-2355 // [Electronic resource]. — 2013; the Russian Federation State Duma. — Mode of access: — http://www.duma.gov.ru — Title of screen,

55 Chapter 7 of the Constitution of the Russian Federation (approved by referendum 12.12.1993) // Code of Russian Laws. 2009. No. 4. Art. 445.

56 Art. 118 (3) of the Constitution of the Russian Federation (approved by referendum 12.12.1993) // Code of Russian Laws. 2009. No. 4. Art. 445.

the Judicial System[57], Law on Constitutional Court[58]; Law on Courts of General Jurisdiction[59]; Law on Commercial Courts [60].

More detailed provision for the organization of the courts, the limits of their competence and how they should function are given in a number of laws, the most important of which are: Law on the Status of Judges[61]; Law on Access to Information of Court Activities[62]; Law on the Self-Regulatory Organs of the Judiciary[63]; Law on Assessors in Commercial Courts[64], Law on Judicial Disciplinary Court[65].

In addition to these laws, of special importance are the laws which lay down court procedures (process law). In Russia these laws are codified in form of: the Civil Procedure Code[66]; the Criminal Procedure Code[67]; the Code of Commercial Court Procedure (the Code of Arbitration Procedure[68]; and the Code of Administrative Infractions [69].

In order to properly understand how the Russian judiciary works, we need to briefly overview the basics of the system of appeals. In the Russian judicial system appeals are divided into four categories: (i) appeal ("apellyatsionnaya zhaloba"); (ii) cassation ("kassatzionnaya zhaloba"); (iii) supervisory appeal; and (iv) an appeal founded on new or newly discovered facts.

57 Federal Constitutional Law on Judicial System of the Russian Federation 31.12.1996 No. 1-FKZ // Code of Russian Laws. 1997. No. 1. Art. 1.
58 Federal Constitutional Law on the Constitutional Court of the Russian Federation 21.07.1994 No. 1-FKZ // Code of Russian Laws. 1994. No. 13. Art. 1447.
59 Federal Constitutional Law on Courts of General Jurisdiction 07.02.2011 No. 1-FKZ // Code of Russian Laws. 2011. No. 7. Art. 898.
60 Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.
61 Law on the Status of Judges in the Russian Federation 26.06.1992 3132-I // Russian Newspaper. 1992. No. 170.
62 Federal Law on Access to Information of Court Activities in the Russian Federation 22.12.2008 No. 262-FZ // Code of Russian Laws. 2008. No. 52 (p. 1). Art. 6217.
63 Federal Law on the Self-Regulatory Organs of the Judiciary 14.03.2002 No. 30 — FZ // Code of Russian Laws. 2002. No. 11. Art. 1022.
64 Federal Law on Assessors in Commercial Courts 30.05.2001 No. 70 — FZ // Code of Russian Laws. 2001. No. 23. Art. 2288.
65 Federal Constitutional Law on Judicial Disciplinary Court 09.11.2009 No. 4-FKZ // Code of Russian Laws. 2009. No. 45. Art. 5261.
66 The Civil Procedure Code // Code of Russian Laws. 2002. No. 46. Art. 4532.
67 The Criminal Procedure Code // Code of Russian Laws. 2001. No. 52 (part 1). Art.4921.
68 The Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
69 The Code on Administrative Infractions // Code of Russian Laws. 2002. No. 1 (part 1). Art.1, there are process law rules also in Part I of the Tax Code (The Russian Federation Tax Code: Part 1 // Code of Russian Laws. 1998. No. 31. Art. 3824) and the Law on Insolvency (Federal Law on Insolvency 26.10.2002 No. 127-FZ // Code of Russian Laws. 2002. No. 43. Art. 4190).

The first type of appeal can be characterized as a *de novo appeal* where the higher court re-hears the case with full authority to review all the circumstances in the case[70]. The second (cassation) is an *appeal on the record* where the court of appeals does not review the circumstances of the case and (usually) does not admit new evidence, rather the court will only consider the correct application of material and procedural law and the legal reasoning behind the application. The cassation court is however required to base the factual deliberations on the facts as established by the lower court. When deemed necessary, the cassation court may remit a case to the lower court for retrial. A supervisory appeal may also result in remitting a case for retrial.

Courts of General Jurisdiction

The Supreme Court ("Verkhovny Sud") is the highest court in the branch of courts of general jurisdiction. The courts of general jurisdiction handle cases of civil, labor, property (etc.) and criminal law as well as administrative matters and administrative offences. Broadly speaking, it would be true to say that all cases not referred to the commercial courts (in Russian referred to as "arbitration courts") are handled by the courts of general jurisdiction, whereas the commercial courts handle cases between corporations and entrepreneurs and their claims against the state in relation to commercial activities.

Courts of general jurisdiction include magistrate courts, district courts and regional courts. At the first level of the system of courts of general jurisdiction there are the magistrates' courts ("mirovoi sud", terminologically comparable with Justices of Peace Courts). These courts handle in the first instance criminal cases in which the maximum penalty is imprisonment for no more than three years (see exceptions to this rule below in connection with discussion of the jurisdiction of regional courts), civil cases such as most family law matters and divorces, most property disputes where the underlying value at stake does not exceed 50 thousand rubles (except inheritance cases and cases concerning intellectual property rights), disputes concerning use of jointly owned property and property with third party interests, court order

70 In theory we may speak about full or partial appeal. Hereby by full appeal is meant a trial de novo, when the court rehears anew both on points of fact and points of law. In partial appeal, the court is restricted in the scope of its authority and may usually only consider matters of law and procedure. An appeal in a Russian court may be characterized as a mixed system but closer to full appeal (compare with article 166 of Code of Commercial Court Procedure).

on certain documented facts[71], and some of the administrative offences[72], and other cases.

On the second level there are the district courts. District courts can be formed on the level of an administrative area of a federal region referred to as a *rayon* or on the level of a borough of a city. When covering under its jurisdiction a whole town the relevant court may be called a city court. (In Russian "rayonny sud" or "gorodskoi sud"; these used to be called, until 1996, "narodny sud" or people's court). In Moscow and St. Petersburg the district courts are on the level of the boroughs and the regional courts are referred to as city courts (such as Moscow City Court). The former serve as courts of first instance in cases of general jurisdiction in civil and criminal law, except for those cases which in the first instance are heard in a magistrates' court. In the latter case the district court functions as a court of appeal. However, some matters are heard in first instance in a regional court and some even in the Supreme Court. (Note that a magistrate court has not yet been formed in all districts, in which case the district court hears the corresponding cases in first instance).

Regional courts operate at the level of Russian regions, the 83 federal subjects of Russia which may have different constitutional statuses and denominations, namely one of the following: republic, kray, oblast, federal city (Moscow and St. Petersburg), autonomous okrug, autonomous oblast. We refer to the all these federal subjects as *regions*.

A regional court functions depending on the case as either an appellate court or a cassation court in cases previously handled by a district court. In some cases it may serve as the court of first instance. Cases are referred to regional courts at first instance when they qualify as more complex civil cases or if they are criminal cases in which there is the possibility of imprisonment for more than three years. Other cases in which a regional court can act at first instance are those concerning state secrets, and criminal cases in which the accused has some special status, such as being a member of the Duma or the Federation Council, or is a judges (when requested by the judge)[73].

The work of a regional court is organized in three sections: the collegium (chamber) on civil law matters; the collegium (chamber) on criminal law matters; and the presidium. The presidium hears cassation cases and appeals de novo but it has also an important function in the review, compilation and analysis of court practice.

71 Court order on determination of documented facts concerning applications regarding collection of money or return of movable property (Art. 121 of the Civil Procedure Code // Code of Russian Laws. 2002. No. 46. Art. 4532.

72 Federal Law on Magistrate Courts in the Russian Federation 17.12.1998 No. 188-FZ // Code of Russian Laws. No. 51. 6270.

73 Art. 31 of the Criminal Procedure Code // Code of Russian Laws. 2001. No. 52 (part 1). Art.4921.

The Supreme Court

The Supreme Court conducts judicial supervision of the activities of all courts of general jurisdiction and military courts, and supervises court practice by issuing guidelines on the proper application of the relevant rules. The full scope of the competence of the Supreme Court is given in Article 9 of the Law on Courts of General Jurisdiction. The work of the Supreme Court is organized under different structures which are (Law on Courts of General Jurisdiction, Article 10): plenary sessions; presidium; appeals chamber; judicial chamber on civil cases; judicial chamber on penal cases; judicial chamber on administrative cases; and military chamber.

Depending on the case, the Supreme Court may handle both appeals on the record and cassation cases, as well as review matters based on new or newly discovered facts. In some cases the court can hear either criminal or civil matters at first instance. Which civil and administrative law matters are heard at first instance in the Supreme Court are determined by the Civil Procedure Code (Article 27) and concern mainly disputes about regulations ("normativny akt", also referred to as "abstract review of regulations") and decisions concerning particular persons in specific cases ("nenormativny akt") taken by the President, the Government (Cabinet of Ministers), the Duma, the Federation Council or other government agencies. Other cases which can be heard at first instance are disputes concerning the suspension or termination of the office of a judge, disputes on electoral rights, and the organization of political parties and non-governmental organizations. Issues concerning Russia's international treaties are can also be reviewed by the Supreme Court acting as a court of first instance (Law on Courts of General Jurisdiction, Article 9).

The Supreme Court also hears at first instances administrative cases [74] which involve:

- challenges to laws and regulations ("normativnie akty"): by the President of Russia, the Cabinet of Ministers, Ministries and other government departments;
- challenges to decisions concerning individual subjects and recommendations, procedures etc. ("non-normative act", "nenormativny akt"[75]) by the President of Russia, the Duma and Federation Council and the Cabinet of Ministers
- appeals against a decision to suspend or terminate a judge's mandate.

[74] Art. 27 of the Civil Procedure Code // Code of Russian Laws. 2002. No. 46. Art. 4532.

[75] In Russian jurisprudence a non-normative act refers to such legal decisions of authorities which do not serve to proclaim generally binding rules.

The effect of all this is that the Supreme Court performs judicial review of laws and regulations issued by the legislative and executive branches of government[76]. But in this connection we need to note that judicial review at the highest level, or constitutional review, is performed by the Constitutional Court (see below).

The Supreme Court may turn to the Constitutional Court requesting its resolution on the conformity with the Constitution of federal and regional laws and regulations (including regional constitutions); treaties between the federal powers and regional powers and those between two or more regional powers; as well as Russia's international treaties[77] (before they have entered into force).

In addition to the effect on harmonization of court practice which occurs by supervising the decisions and activities of the courts in particular cases, the Supreme Court, in its plenary session, is explicitly *de jure* tasked with the function of (Law on Courts of General Jurisdiction, Article 9) ensuring harmonization of court practice in Russia by issuing clarifications as to the proper interpretation and application of provisions of law. This is done by compiling, reviewing and analyzing court practice and issuing clarification about what is considered due practice The Scientific Council of the Supreme Court ("Nauchno-konsultativny sovet") is responsible for aiding the court in performing its role in supervising court practice in civil, administrative and penal laws with the aim of ensuring a unified court practice (Law on Courts of General Jurisdiction article12). This is done by reviewing the practice of all courts of general jurisdiction and preparing guidance notes on proper application of the relevant law. It also summarizes court practice, prepares judicial statistics, introduces legislative initiatives, issues interpretations of the law and instructions to courts, etc.[78] The recommendations and drafts are reviewed by the court's plenary sessions which have the authority to adapt them and then issue them in the name of the court.

Commercial Courts

In Russia disputes in commercial matters are assigned to a special branch of the judiciary, the so-called arbitration courts. Due to the risk of confusion with what are interna-

76 Hereby to be noted that the Supreme Court is not considered to be authorized to perform judicial review of laws and regulations beyond the context of an actual case (Resolution of the Constitutional Court of the Russian Federation 27.01.2004 No. 1 // Code of Russian Laws. 2004. No. 5. Art. 403).

77 Art. 125(2) of the Constitution of the Russian Federation (approved by referendum 12.12.1993) // Code of Russian Laws. 2009. No. 4. Art. 445.

78 Resolution of Plenum the Supreme Court of the Russian Federation 11.12.1968 No. 45 // Code of Resolutions of the Supreme Court of the Russian Federation 1961 — 1993 M. Legal Literature, 1994.

tionally known as arbitral tribunals and to emphasize the actual nature of these courts, we follow international practice and refer to them as *commercial courts*. Thus we write about the Supreme Commercial Court not the Supreme Court of Arbitration.

Commercial courts deal with disputes concerning business activities between legal entities and individual entrepreneurs, and their disputes with the state, for example in matters of taxation.

The commercial courts are organized in a four-tier hierarchy, with the Supreme Commercial Court at the top. On the first level there are the *regional commercial courts* which function as trial courts ("arbitrazhniye sudy subyektov federatsii"). There is one such court in each of Russia's 83 regions. These are followed on the second level by 20 *appellate commercial courts* ("arbitrazhniye appellyazionniye sudy"). On the third level there are 10 *territorial commercial courts* ("arbitrazhniye sudy okrugov") which serve as courts of cassation for a number of appellate courts. In addition, a specialized court dealing with intellectual property disputes was introduced in 2011[79]. This sits as a trial court and also as court of cassation for cases it dealt with in first instance.

The process in commercial courts is governed by the Commercial Procedure Code.

The rulings of an appellate court may be appealed in a cassation court within 2 months of becoming effective, with possible extensions of up to 6 months[80]. The judgments of a trial court that were not subject to appeal proceedings may be appealed in a cassation court only when the appeal was left unheard for failure to comply with the submission deadline and the deadline was not restored[81].

The work of the Supreme Commercial Court is organized under different structures which are: plenary sessions; presidium; judicial collegium for civil law matters (and similar); judicial collegium for administrative matters; and six judicial panels.

An important function of the Supreme Commercial Court is to perform judicial supervision of the activities of all commercial courts. To this we will return below after listing the other main functions of the court.

The Supreme Commercial Court decides matters concerning international treaties within the scope of its competence. The Court also possesses a right to legislative initiative.

79 Federal Constitutional Law 06.12.2011 No. 4-FKZ // Code of Russian Laws. 2011. No. 50. Art. 7334.
80 Art. 276 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
81 Art. 276 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

The Supreme Commercial Court hears[82]some types of cases in the first instance, these encompass cases on challenging regulations ("normativny akt") and decisions concerning particular persons in specific cases ("nenormativny akt") taken (issued) by the President, the Cabinet of Ministers, the Duma, the Federation Council, or other government agencies (Code of Commercial Court Procedures, Article 34). The Court also hears at first instance disputes between the federal state and its regions as well as those between regions.

The Supreme Commercial Court performs judicial supervision of the activities of all commercial courts and all the cases handled in them[83]. We may divide this activity into four categories: (i) handling supervisory appeals of cases heard in lower cause; (ii) submitting petitions to the Constitutional Court in respect of constitutional control of laws; (iii) performing judicial review of official regulations and decisions; and (iv) delivering guidance on court practice.

The powers of the Court to perform constitutional review are restricted to submitting petitions to the Constitutional Court to review the constitutionality of laws and regulations both in general (abstract control of norms) and in connection with the possible application of a particular law or regulation to a given case in any of the commercial courts[84]. An important function of the Supreme Commercial Court is to ensure uniformity of court practice by analyzing, summarizing and digesting the practice of the commercial courts and clarifying what is meant by due practice[85]. This work is carried out by the plenary sessions[86] and the Presidium[87] as well as the court chambers[88] which

82 The cassation process can be either written or oral depending on the case and stage.

83 Art. 9 — 10 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

84 Art. 10 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

85 Art. 10 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

86 Art. 13 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

87 Art. 16 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

88 Art. 18 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589.

As an example of this kind of work, Kuznetsov tells about an information letter, a practice review (Kuznezov A.A. Tax Legislation Use in Courts' Bodies Practice (Financial and Legal Aspects): diss… of cand. of legal sciences. / A.A. Kuznezov; Russian Academy of Governmental Service. — P.37-38), issued by the Presidium of the Supreme Commercial Court (Information Letter of the Supreme Commercial Court of the Russian Federation 17.03.2003. No. 71 // The Bulletin of the Supreme Commercial Court of the Russian Federation. 2003. No.5) where it clarified the application of Tax Code article 40 (provision about principles of acceptable pricing) (the article is still in force).

are supported by the Scientific Council ("Nauchno-konsultativny sovjet") of the Supreme Commercial Court[89].

The Constitutional Court

The Constitutional Court of the Russian Federation is the first judicial body of constitutional review in the history of Russia. The Court was created on 30.10.1991.

The Constitutional Court of the Russian Federation is the first judicial body of constitutional review in the history of Russia. The Court was created on 30 October 1991 and specializes mainly in judicial review and adjudication on the constitutionality of laws. This is also referred to as constitutional control or constitutional supervision.

The objects of constitutional control are parliamentary laws, presidential and governmental decrees and regulations as well as laws and regulations of the Russian regions (federal subjects). The court also rules on disputes concerning the competence of various state authorities and certain relations between the federal state and the regions as well as those between regions. It also rules on the constitutionality of Russia's international treaties before they take effect. The court also reviews other types of case, among which are issues connected with impeachment of the federal president. Other courts may ask the Constitutional Court to pronounce on the constitutionality of a law that is applicable to a particular case.

It is the first and only instance in its judicial branch. Each of the 83 Russian Regions has the right to establish regional constitutional courts or chartered courts ("ustavnoi sud"). These regional constitutional courts are called constitutional courts in the regions that have the status of republic, while they are called chartered courts in the other regions. Presently there are 25 such courts. But these courts are not in a hierarchical dependence to the federal Constitutional Court.

The functioning and competence of the Constitutional Court are regulated by the law on Law on the Constitutional Court of the Russian Federation which provides for a court with 19 judges appointed by the Federation Council (upper chamber of the Russian par-

89 Art. 18 of Federal Constitutional Law on Commercial Courts of the Russian Federation 28.04.1995 No. 1-FKZ // Code of Russian Laws. 1995. No. 18. Art. 1589, Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P. 67.

liament). A plenary session rules on constitutional control, disputes concerning competence of governmental agencies, impeachment of the president of Russia and legislative initiatives, and any other issues competently referred to it.

The Constitutional Court is not entitled to pick on its own initiative cases for review rather an application (request) is required by any one of the following authorities: the Russian president, the federal government, the State Duma (or one fifth of the deputies), the Federation Council (or one fifth of the deputies), the Supreme Court, the Supreme Commercial Court, the Federal Government, or a regional legislative or executive body.

In its constitutional control the Constitutional Court reviews laws or regulations in respect to both formal requirements and material norms. The court strives to uphold the principles of the separation of powers between the legislative, executive and judicial branches of government, and adherence to the constitutional principles of distribution of competence between state organs. The scope of the Constitutional Court is limited to consideration of matters of law and it refrains from an examination of the actual facts and circumstances of a case whenever such activity falls within the competence of another court or another authority.

Any federal court (without regard to level of court or position in the court hierarchy) may request the Constitutional Court to rule on the constitutionality of a law when the law is relevant to a case in front of that court and the court has reached the conclusion that it might not be in conformity with the Constitution. An interruption in the case, or a stay of execution of the judgment, happens when a reference is made to the Constitutional Court.

An individual may also file with the Constitutional Court a complaint about violation of one's constitutional rights and freedoms by way of a court which has applied an allegedly unconstitutional law in a particular case concerning that individual.[90] Class actions by groups of citizen is also permissible. In such cases the Court rules on the constitutional-

[90] Constitutional Court has acknowledged that a foreign national also has the right to file suits at the Constitutional Court (Ruling of the Constitutional Court of the Russian Federation 18.12.2007 No. 961-O-O // [Electronic resource]. — 2007; the Russian Federation Constitutional Court. — Mode of access: — http://www.ksrf.ru — Title of screen, Ruling of the Constitutional Court of the Russian Federation 24.06.2008 No. 429-O-O // [Electronic resource]. — 2008; the Russian Federation Constitutional Court. — Mode of access: — http://www.ksrf.ru — Title of screen, Resolution of the Constitutional Court of the Russian Federation 26.12.2003 No. 20-P // [Electronic resource]. — 2003; the Russian Federation Constitutional Court. — Mode of access: — http://www.ksrf.ru — Title of screen.

ity of a particular law or regulation which is identified in the complaint. Legal persons are not considered to be entitled to file suits with the Constitutional Court but individuals (natural persons) whose interests are represented by a legal entity may do so in matters concerning that legal entity[91].

The court also reviews other types of case, including impeachment of the federal president. Another power of the Constitutional Court is to resolve disputes concerning competence of governmental agencies. The court also has the right to introduce legislation.

Laws and regulations, or their separately identified provisions, deemed unconstitutional by the Court become null and void. Decisions take immediate effect and do not require confirmation by any executive or legislative body. Laws or regulations struck down by the Court cannot be revived by reissuing them. The relevant legislative or executive body is obliged to adapt the laws or regulations (decisions) to confirm with the ruling of the Constitutional Court as well as any other laws and regulations which are based on the unconstitutional law or regulation.

When a court judgment has been declared unconstitutional it cannot be executed, and must be reviewed. In addition to adjudicating on disputes, the Constitutional Court may also issue authoritative and binding interpretations of the Constitution. Such constitutional interpretations may only be undertaken in response to a petition by the President of the Russian Federation, the Duma, the Federation Council, the Federal Government or a regional legislative body.

In normal cases the Court makes decisions by a simple majority vote, but statements of interpretation of the law require a two-thirds majority to take effect.

The law on the Constitutional Court acknowledges that the literal meaning of a provision of law may differ from the interpretation it has been given in an official or legal context.. The Constitutional Court must consider these interpretations and legal practice in its resolutions[92].

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91 Resolution of the Constitutional Court of the Russian Federation 24.10.1996 No. 17-P // Code of Russian Laws. 1996. No.45. Art. 5202.

92 Art. 74 of Federal Constitutional Law on the Constitutional Court of the Russian Federation 21.07.1994 No. 1-FKZ // Code of Russian Laws. 1994. No. 13. Art. 1447.

The European Court of Human Rights

Through its adherence to international treaties, Russia is subject to the jurisdiction of international courts or tribunals. Russia has signed the Vienna Convention on the Law of Treaties according to which the interpretations of a treaty by a relevant international court is binding on its signatories[93].

In taxation matters there are three international courts of relevance. These are the European Court of Human Rights (ECHR); the Economic Court of CIS[94]; and the newly formed Court of the Eurasian Economic Community, which started operating on 1 January, 2012[95] The Economic Court of CIS has jurisdiction only in disputes between countries[96]. The European Court of Human Rights (ECHR) is an international court established by the European Convention on Human Rights which Russia signed on 30 March 1998, and ratified in May 1998[97].

The ECHR is not to be considered as a supreme court over the national judicial system of a signatory country[98]. It can thus not overrule decisions of national courts or state organs. It merely hears cases alleging that an applicant's human rights under the Convention or its protocols have been violated by a contracting state[99]. A case is admissible to the Court only after exhaustion of all domestic remedies and so long as six months has not elapsed since the last domestic decision. In the event that the Court finds a contracting state has violated a human right under the Convention it may order that state to pay

93 Art. 32.3 (b) of the Vienna Convention on the Law of Treaties, 1969 // The Code of International Treaties of USSR Issue XLII,.1988. and also Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 38.

94 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 38.

95 Kamenkova L.E., Babkina E.V. Economic Court of CIS and Court of Eurasian Economic Community // Russian Justice. 2012 No.8. P. 24-28.

96 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 42.

97 The European Convention on Human Rights, 1950 // The Bulletin of International Treaties. No. 3.2001 and also

Federal Law on ratification of the European Convention on Human Rights and Protocols to it 30.03.1998 No. 54-FZ // Code of Russian Laws. 1998. No. 14. Art. 1514 and also Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 39-40.

98 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 40.

99 Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P. 35-36.

damages and to recompense the applicant for the legal expenses incurred in both the domestic courts and the ECHR.

The Court has no jurisdiction to annul domestic laws or administrative practices which violate the Convention. But the Committee of Ministers of the Council of Europe is charged with supervising the execution of the Court's judgments and ensuring that contracting states make the required amendments to national law.

The Constitutional Court has consequently in its practice shown that it acknowledges the effect of ECHR decisions over Russian law[100], as has similar positions can be identified in judgments of the Supreme Commercial Court[101]. Vlasenko reports that by the time of publishing her dissertation in year 2011, the Constitutional Court had referred in more than 90 decisions to the Convention and decisions of ECHR[102].

The chairman of the Constitutional Court Valery Zorkin has publicly acknowledged the mandatory role of ECHR precedents for the Russian judiciary[103]. However, the chairman

100 Resolution of the Constitutional Court of the Russian Federation 14.07.2005 No. 9-P // Code of Russian Laws. 2005. No. 30 (part 2). Art. 3200.and also Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P. 42, Resolution of the Constitutional Court of the Russian Federation 14.07.2005 No. 9-P // Code of Russian Laws. 2005. No. 30 (part 2). Art. 3200, Ruling of the Constitutional Court of the Russian Federation 13.06.2006 No. 272-O // Code of Russian Laws. 2006. No. 45. Art. 4738, Ruling of the Constitutional Court of the Russian Federation 23.06.2005 No. 274-O // [Electronic resource]. — 2005; the Russian Federation Constitutional Court. — Mode of access: — http://www.ksrf.ru — Title of screen.

101 Ruling of the Supreme Commercial Court of the Russian Federation 06.12.2006 No. 11484/06 // [Electronic resource]. — 2006; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen, Ruling of the Supreme Commercial Court of the Russian Federation 06.12.2006 No. 11484/06 // [Electronic resource]. — 2006; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen, Ruling of the Supreme Commercial Court of the Russian Federation 19.12.2006 No. A56-1789/2005 // [Electronic resource]. — 2006; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen, Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P. 36-37, Dvornikova O.A. Administrative Precedent in the System of Sources of Law: theoretical legal Research: diss… of cand. of legal sciences. / O.A. Dvornikova; Inst. of Legislation and Comparative Law. — M., 2009. P. 36-37, Resolution of the Constitutional Court of the Russian Federation 14.07.2005 No. 9-P // Code of Russian Laws. 2005. No. 30 (part 2). Art. 3200, Resolution of the Constitutional Court of the Russian Federation 05.02.2007 No. 2-P // Code of Russian Laws. 2007. No. 7. Art. 932.

102 Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P. 107-108.

103 Zorkin V.D. Appearance on official opening of new court year in ECHR 'For legal dialogue between the Court and the European Constitutional Courts'. Strasbourg, 21.05.2005 and also Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P.107-108.

has later modified that position by pointing out that there is a limit to the acceptance of the decisions of the ECHR. This is when the decisions would seem to go against the provisions of the very Convention and when they directly affect the national sovereignty of Russia and its fundamental constitutional principles. According to him, Russia has the right to develop protective measures against such decisions[104].

The Supreme Commercial Court of Russia has also in its information letter of December 1999, stressed to all its subordinate courts that they must consider the precedents of ECHR in their practice[105]. A similar position has been taken by the Supreme Court[106]. Chekmishev in his dissertation confirms that these are not mere declarations of intent and that the Russian courts, especially commercial courts, in practice actively refer to provisions of international treaties, principles of international law and precedents of international courts[107].

Justice in Russia — a Work in Progress

After this description of the Russian judicial system, it is perhaps appropriate to mention some of the structural problems inherent in it. The present author believes the main problems are: (i) the excessively formal approach of judges with respect to evidence and motivation of the claims; (ii) an inadequate knowledge of market economy mechanisms,

104 Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P. 108 and also Zorkin V.D. Limit of flexibility // Russian Newspaper. 29.10.2010 and also Vlasenko L.V. Legal Opinions of Courts in Tax Law: diss… of cand. of legal sciences. / L.V. Vlasenko; Russian Academy of Justice. — M., 2011. P.108.

105 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P.40 and also Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P. 38-39, Informative Letter of the Supreme Commercial Court of the Russian Federation 20.12.1999 No. C1-7/СМП-1341 // The Bulletin of the Supreme Commercial Court of the Russian Federation. 2000. No.2.

106 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P.41, Resolution of Plenum Supreme Court of the Russian Federation 10.10.2003 г. No. 5 // The Bulletin of the Russian Federation Supreme Court. 2003. No. 12.

107 Chekmushev C.N. Courts' Acts in the System of Tax Law regulation: diss… of cand. of legal sciences. / C.N. Chekmushev; All-Russian State Tax Academy — M., 2009. P.41, and also Borisova O.V. Legal Opinions of the Constitutional Court of the Russian Federation: diss… of cand. of legal sciences. / O.V. Borisova; Stavropol State University, 2007. P. 39, Dvornikova O.A. Administrative Precedent in the System of Sources of Law: theoretical legal Research: diss… of cand. of legal sciences. / O.A. Dvornikova; Inst. of Legislation and Comparative Law. — M., 2009. P. 36.

which hamper judges' ability to apply the laws; and (iii) corruption. With regard to the second point, it should be remembered that Russia started, at the beginning of the 1990s, to make the transition to a democratic market economy by dismantling the Soviet system with its communist-inspired laws and practices. This has meant a need to undertake an almost total revamp of the laws and naturally judges and all other participants of the legal system have been subjected to a steep learning curve[108]. Corruption, though not universal in the Russian courts, remains a major barrier to the impartial administration of justice[109].

These problems are partially off-set by the speed with which the Russian court system works compared with what is customary in Europe. A commercial trial court must normally hear cases within three months of an application (claim) being filed, while the judge may request an extension for up to six months[110]. In practice a case may last longer, but regularly cases are concluded within these time-limits [111]. The deadline for filing an appeal is one month from the date of the judgment, and the appeal must be heard within two months of being filed [112].

The decision of the court of appeals comes into force immediately after it has been proclaimed. Even when the decision thus becomes enforceable it does not mean that it cannot be further appealed in the system of commercial courts. A cassation appeal can be filed within two months from the decision[113]. The cassation court must hear a case within two months of the filing of the claim[114].

After the cassation process, a supervisory appeal to the Supreme Commercial Court may potentially be filed[115] within three months. The supervisory appeals process may consist of three stages as follows. In the first stage it is decided whether to allow the claim

108 Hellevig J. Expressions and Interpretations // [Electronic resource]. — 2010; Hellevig Jon. — Mode of access: — http://www.hellevig.net — Title of screen

109 Putin V. We need new economics // [Electronic resource]. — 2012; Vedomosti. — Mode of access: — http://www.vedomosti.ru — Title of screen). Decree of the President of Russian Federation 13.03.2012 No. 297 On National anticorruption plan on 2012-2013 and amendments in several acts of the President of Russian Federation on anticorruption questions // Code of Russian Laws. 2012. No. 12. Art. 1391.

110 Art. 152 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

111 Abozonova O.V. Accessibility of Justice and Order of Application to Federal Commercial Courts for Judicial Protection // Russian Justice. 2012. No. 12. P. 24 — 28.

112 Art. 267 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

113 Art. 267 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

114 Art. 285 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

115 Chapter 36 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.

to go forward to the supervisory process. Supreme Commercial Court judges may also request a case from the trial court. In the second stage of the process the case is handled by a panel of judges without the presence of the parties or their representatives. According to the law this has to be completed within one month. At this stage, the panel must decide whether there is reason to review the case. There are three categories of grounds for reviewing a decision:

(i) when it is deemed that the disputed decision breaches the uniformity of commercial court practice of interpretation and application of legal rules[116]
(ii) if the disputed decision violates the rights and freedoms of a person according to general accepted principles and rules of international law[117]
(iii) if the disputed decision violates the rights of violates the rights and legitimate interests of unspecified persons or other public interests[118].

In the third state the Presidium of the Supreme Commercial Court hears the case[119], a process which must be completed within three months from the completion of the second stage. At this stage the process is open to the parties. The final decision is taken by the Presidium, voting by a simple majority, in the form of a resolution ("postanovlenie").

The Court may alternatively remit a case to cassation before handing it over to the Presidium[120]. It should be kept in mind that in each instance of the commercial process, except for appeals, a case may be remitted to the lower court for a rehearing[121].

Practice has shown that in Russia it is common for a case to progress from first filing to a hearing in the Supreme Court within eighteen months[122].

116 Art. 304.1(1) of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
117 Art. 304.1(2) of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
118 Art. 304.1(3) of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
119 Art. 303 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
120 Art. 299.6 of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
121 Art. 287, 305, of the Code of Commercial Court Procedure // Code of Russian Laws. 2002. No. 30. Art. 3012.
122 Dmitrieva A., Titaev K., Chetverikova I. Research of Russian Commercial Courts Work by methods of Statistical Analysis. News of International Legal Cooperation // [Electronic resource]. — 2012; the Supreme Commercial Court of the Russian Federation. — Mode of access: — http://www.arbitr.ru — Title of screen and Makarov I. Commercial Procedure Reform // Domestic Notes. Justice in Russia. No.2. 2003. P. 271-279.

Another positive aspect of the Russian judicial system is that it does not confer a monopoly of representation on lawyers, or lawyers with a special status such as barristers in the English system or advocates in many Continental European jurisdictions. In civil and administrative cases there are no legal rules that would restrict representation to a privileged category of lawyers. A legal entity may be represented by its general manager (CEO) or a person duly authorized by the general manager; neither of whom need be a lawyer. In criminal cases the rule is that the accused is defended by an advocate[123]. The court may also allow a relative or another person to carry the defense alongside an advocate In a magistrate's court it is permissable for a laymen to act instead of an advocate[124].

123 Russian advocate is a person who, in accordance with the Federal Law "On Advocateship and Advocacy in the Russian Federation" has acquired the status of the advocate. The legislation provides for specific requirements for the person claiming the status of a lawyer, such as a law degree, experience of legal work, passing the exam on the status of the advocate. Advocates are required to be members of chambers of the Bar formed in each region of the Russian Federation. Advocates can only work in legal practice and may not work under an employment contract in other organizations.

124 Art. 49 of the Criminal Procedure Code // Code of Russian Laws. 2001. No. 52 (part 1). Art.4921.

4. TAX REGISTRATION (INCORPORATION) AND REGIONAL REGISTRATION OF SUBDIVISIONS

All legal entities and individual entrepreneurs that intend to engage in business activities must register with the tax authority. In Russia the tax authority keeps the trade register and is thus the primary registration organ also for incorporation of legal entities. The filing for incorporation and tax registration is done simultaneously. (Representative Offices and Branches of foreign legal entities are registered with the State Registration Chamber with subsequent tax registration). Also foreign legal entities may have to register in Russia providing their activities in Russia meet certain threshold criteria (more about this "simple tax registration" below).

In Russia business entities do not undergo separate registrations for the purpose of various types of taxes, such as profit tax or VAT, rather an entity is immediately recorded in the system of all taxes with the single registration. But in addition to the tax registration companies also need to register with the social, medical and pension funds, and the state statistics agency.

The Tax Code sets the general rules for tax registration (articles 83, 84) and the provisions of incorporation are in the Law "On State Registration of Legal Entities and Individual Entrepreneurs" (Law No. 129-FZ of 08.08.2001). There are also special rules for tax registration certain activities even when the activities do not constitute a separate entity or just consist of a virtual subdivision as defined by the law. This kind of registration will be dealt with more in detail below under the heading *Simple Tax Registration and Regional Tax Registration of Subdivisions*.

A foreign legal entity ("FLE") may choose to do business in Russia in one of several forms depending on the level of engagement of the company in Russia. The first option is to function only as an exporter which does not under normal circumstances lead to any kind of taxable presence in Russia nor any obligation to register with the Russian authorities. The involvement on the Russian market may be increased without setting up a legal structure by the following steps:

- Keeping stock on the territory of the Customs Union under a procedure of customs warehouse. (There will be no Russian presence for the FLE if a Russian customer is the actual importer).

- Using an Agent. If the Agent is an independent party and has the tax status of an independent agent, then this creates no Russian presence for the FLE. If the Agent is related (or non-independent), then the FLE runs the risks of creating itself a taxable presence in Russia in the form of a permanent establishment (see below).

Next in line for organizing Russian presence is undertaking a so-called 'simple tax registration' which have to be made if the operations of the foreign legal entity meet certain qualifying criteria. These are the rules when a foreign legal entity has to register with the Russian tax authority without de facto setting up any kind of entity or even not a representative office or branch. We will discuss the rules for simple tax registration below together with the rules determining the obligation of a Russian legal entity to register its presence in a location other than its home location.

A more established presence in Russia can be achieved by setting up a representative office (RO — Russian "Predstavitelstvo") or a branch office (Branch — Russian "Filial"). An RO and Branch are not considered as Russian legal entities, rather they are determined as subdivisions of foreign firms for representing their interests in Russia. (Therefore references to FLEs also concern ROs and Branches). As long as they carry out merely representative, preparatory and auxiliary functions, they are not liable for profit taxation in Russia. But as soon as the activities qualify more directly as actual business activities then they may be liable for profit tax as so-called permanent establishments, a de facto business operation. (For further details on this see chapter Permanent Establishment Hereby to note that strictly in accordance with the Russian Civil Code it would not be permissible for an RO to transcend the limit of representative functions, whereas a Branch may do it and engage in actual business operations. In practice this means that a Branch has the right to invoice for business transactions in its own name and accept payment to its own bank accounts. The tax authority, which plays a key role here, has so far waived this provision and accepted ROs as commercial entities. A part from this, and slight differences in the registration and accreditation procedures, there are no differences between the RO and Branch, for example, what comes to the accounting and tax regulations.

A Representative Office or a Branch of a foreign company needs to be accredited with the State Registration Chamber. Alternatively the accreditation may be done with the Russian main chamber of commerce (Chamber of Commerce and Industry) or another authorized body depending on the industry, for example, banks are accredited with the Central Bank. But when accreditation is not done with the State Registration Chamber, then an additional registration has to be done with it, as it keeps the consolidated register over all ROs and Branches

ROs and Branches shall also separately be registered with the tax authorities, the social funds, and statistics agency.

In addition to what was said above a FLE may be taxed on its Russian income also without operating in Russia. This is the case when the Russian rules on withholding tax, or source tax, becomes applicable (see chapter Profit Tax for details).

A way to limit the Russian presence while being actively engaged in Russian business is to enter into a joint activity agreement (JAA) with a Russian entity (sometimes referred to as simple partnership). The Russian Civil Code (art. 1041-1054) provides for this form of co-operation, and provisions regarding a JAA are also in the Tax Code (art. 174.1, 180, 278). A JAA is basically a profit sharing arrangement where the foreign party contributes funds, property and know-how, and the Russian party usually manages the business according to the agreement between the parties. Based on the circumstances at hand, a JAA may or may not be deemed to form a Permanent Establishment. The JAA is taxed at the level of its participants with the exception of the Value Added Tax (art. 174.1) and Excise Tax (art. 180, Tax Code). The Russian partner, who is the managing partner, has the obligation of accounting by keeping separate books for the JAA and filing the Tax Returns. Income from the JAA is subject to Russian withholding tax. Hereby, an applicable Tax Treaty may provide relief.

A special form of joint activity is the investment partnership based on a new law of 01.01.2012 (Law No. 335-FZ "On Investment Partnerships" of 28.11.2011). The investment partnership is mainly intended for attracting private equity and venture capital to innovative businesses. The investment partnership does not constitute a legal entity.

Russian Subsidiary Company

Finally the foreign investor may take the full step into Russian business by investing in a wholly or partially owned subsidiary. (When the shareholding of the local entity is divided between one or more Russian, or foreign, companies, then people often refer to the local entity as a 'joint venture.' But there is in fact no special legal form of 'joint venture' — the actual legal form of such a firm is any of the permissible legal forms by Russian law).

The two most popular forms of corporate legal entities in Russia are the limited liability company (LLC, Russian "OOO") and the joint stock companies ("JSC"). According to present law a joint stock company can be registered either in the form of a Closed Stock Company (Russian "ZAO") or an open stock company (Russian "OAO"). Publicly traded companies are registered as OAO. However, according to a published project of amendment of the Civil Code, the OAO and ZAO distinction would be abolished and both forms would be qualified just as stock companies, but there would be a new distinction between public and non-public corporations. Corporations, the shares of which are publicly issued or traded would qualify as public corporations. And it is by this factual criterion that such companies would be subject to more severe governance and disclosure provisions. Other stock companies and OOO companies would qualify as non-public corporations.

There are no differences in the tax treatment of the various forms of legal entities, but other issues might affect the choice of legal form.

Other possible types of legal entities are:

- – Full partnership
- – Limited partnership
- – Production cooperative

A full partnership ("polnoe tovarischestvo") is a commercial organization, the members of which (partners) according to the concluded agreement carry out business activities on behalf of the partnership and have personal responsibility for its liabilities. General partnerships operate under constitutive agreements, which are signed by all members of the partnership.

A limited partnership ("tovarischestvo na vere") is a commercial organization in which there are partners and limited partners. Limited partners are investors who bear risk of losses up to the amount of their investments and do not participate in the business activities of the partnership.

Partnerships are generally not very popular in Russia and are usually used only for conducting limited set of activities such as legal services, audit assurance, etc.

Simple Tax Registration and Regional Tax Registration of Subdivisions

Russian legal entities and foreign firms which operate in various locations in Russia must under certain conditions undertake separate tax registration at the other locations. Under Russian law such regional presence may qualify as a so-called subdivision even in the case when the firm itself would not consider that the remote operations would amount to a "subdivision." Different rules apply in relation to subdivisions of foreign legal entities. FLE's that set up Russian presence without registering a Russian legal entity e.g. OOO or ZAO may register a representative office or branch or alternatively merely make a tax registration without forming any kind of entity. We refer to this kind of tax registration as simple tax registration.

There is a duty to undertake the simple tax registration when the legal criteria are met, and it is thus not left to the discretion of the company to decide whether to register or not. The obligation to register does not *per se* entail the obligation to pay taxes. Not all companies that register must pay taxes, but all companies present are subject to registration. Registration itself will not create a taxable status of a permanent establishment. If the foreign firm intends to be active at multiple locations in Russia, then it is preferable that it establishes its main Russian presence through a legal entity for it is much easier to comply with the regional registration requirements through a Russian legal entity as opposed to doing it as a FLE. A FLE would have to go through the same procedures for making tax registration at each location, requiring among other things to ensure all the corporate decisions and receive all the original documents from the foreign head office each time separately.

This form of registration is also referred to as Simple Tax Registration. The Tax Code (article 11) defines subdivisions as follows: "For tax registration purposes, a subdivision is any territorially separate subdivision of an organization with permanent workplaces. A workplace is deemed permanent if set up for more than one month." In other words, as far as subdivisions are concerned, the decisive criterion is not whether a company intended to establish a separate organizational structure, but their existence is determined by factual circumstances. It is therefore sufficient for a company subdivision to be established to have at least one person working permanently in a separate Russian location.

The obligation to comply with Simple Tax Registration fulfills a control function. The process is therefore more like filing information than applying for the establishment of an entity, while the activities (or presence) may occur before filing for registration.

Tax registration is performed in accordance with article 83 of the Tax Code. By this article the Ministry of Finance is delegated powers to set further details for registration of regional presence of Russian entities (Order No. 114n of 05.11.2009) and the presence of foreign entities of 30.09.2010 No. 117n).

Russian legal entities are required to undertake regional tax registration under the following circumstances:

1. When remote work of employees qualifies as a "subdivision"

   The Tax Code (article 11) defines a subdivision as any territorially separate subdivision of an organization with permanent workplaces. A workplace is deemed permanent if set up for more than one month. In other words, as far as a subdivision is concerned, the decisive criterion is not whether a company intended to establish a separate organizational structure, rather the existence of such is determined by factual circumstances.

   It is a sufficient condition for meeting the criteria triggering the registration obligation that one person is hired under the given circumstances to work remotely for the company. Following a recent amendment of Russian labour law, distance workers are as of April 2013 exempted from this general rule. It is considered that the work of distance workers do not constitute such a permanent workplace that leads to the need to perform tax registration.

   The registration application has to be filed within one month from meeting the criteria of registering the presence as a subdivision.

2. Registration of real estate, other immovable property, and means of transportation

   A taxpayer (corporation and individual) holding title to real estate must register for this purpose with the local tax office. Under Russian law sea and river vessels as well as aircraft is considered immovable property and is also subject to this kind of registration.

   Other means of transport, such as cars, also need to be registered at the location of their home base. Although the law refers this obligation to the party holding title to the car, the tax office has issued instructions requiring that a leased car also be registered at the local tax office.

The registration requirements for foreign legal entities are as follows:

1. Remote work of employees qualify as a "subdivision"

   The main conditions for this registration requirement are similar to those for Russian legal entities as per above.

2. Registration of real estate, other immovable property, and means of transportation

   The main conditions for this registration requirement are similar to those for Russian legal entities as per above.

3. Registration in the capacity of taxpayer for mineral's extraction tax

4. Opening of a bank account

   Foreign legal entities must register with the local tax office of the bank in connection with opening of a ruble or foreign currency denominated bank account.

5. Operating a taxable permanent establishment through a dependent agent

   If the activity of the organization or individual in accordance with Russian laws and double taxation treaties forms a permanent establishment of a foreign organization, then the foreign legal entity must register with the local tax office.

6. When a foreign company exports products that have been produced in Russia under tolling arrangements (and other forms of processing)

Accounting and Taxation of Subdivisions

Branches and representative offices (or other subdivisions) of foreign companies may waive the requirement to keep statutory financial accounting (bookkeeping) books as long as they follow the tax accounting rules prescribed by the Russian Tax Code (keeping of all the necessary tax ledgers for each type of tax applicable to the entity's business). Regional ROs and branches of Russian legal entities, as well as other subdivisions (those under "simple tax registration"), both of Russian and foreign legal entities) do not have to do separate accounting (they do not need to run a separate accounting balance). However if the business operations amount to a taxable permanent establishment, then full accounting is required.

We will briefly outline the special issues that concern taxation of subdivisions.

1. Profit tax

   A subdivision files profit tax returns and pays the tax at the local tax office. The amount of tax due to be paid locally is calculated in proportion of the arithmetical mean of the payroll cost of the subdivision to the total payroll cost of the company and the value of fixed assets of the subdivision to the total value of the fixed assets of the company (art. 288).

2. Property tax

   In case that the subdivision does not run a separate accounting balance, the property tax is paid only at the location of the head office (art. 384).

3. Employer's social contributions

   A company does not have to separately pay social contributions at the location of its subdivision if the following conditions are met in regards to the subdivision: (i) it does not run its separate accounting balance; (ii) it does not have its separate bank account, and; (iii) the salaries of the employees are paid at the head office (art. 15.11 Law No. 212-FZ of 24.07.2009 "On insurance contributions").

   A foreign organization does not need to pay employer's social contributions when it does not pay salaries in Russia and does not have a bank account and separate balance in Russia.

4. Personal income tax

   Personal income tax has to be submitted to the tax office at the location of the subdivision. The tax is declared to the tax offices both of the head office and subdivision (art. 226.7, 230.2).

   A subdivision of a foreign legal has to perform the withholding of tax in case it has a subdivision in Russia and an employee is remunerated for work in relation to such a subdivision. also has this obligation (art. 226.1).

Taxpayer's Identification Number

At initial registration the with the tax office, taxpayers, both legal entities and individuals, receive a taxpayer's identification number (INN). The INN is a universal identification number for all types of taxes and duties. The INN should be indicated in all correspondence with the tax authority such as tax returns, statements, applications and other submissions to the tax authority.

Obligation to Keep the Tax Inspectorate Informed

The taxpayer has an obligation to keep the tax office informed about legally determined matters that may affect compliance with tax law (art. 23). Some of these are presented in below table.

Changes to be Reported	Time Limits
Opening and closure of bank accounts	Within seven days
Acquisitions of shares or other ownership in another business entity	Within one month
Setting up, reorganization or liquidation of a regional subdivision	Within one month
Reorganization or liquidation of a legal entity	Within three days

5. ACCOUNTING AND AUDIT IN RUSSIA

The Russian system of accounting rules has significantly changed since 2013 with the enactment of Federal Law No. 402-FZ "On Accounting" dated 06.12.2011. The new law establishes five levels of accounting regulation (Article 21 of Federal Law No.402):

1) the accounting law;
2) federal standards;
3) industrial standards;
4) accounting recommendations;
5) standards of an economic agent

Moreover, federal standards are mandatory, unless otherwise stated in the standards, and regardless of the business activity cover such issues as accounting items, permitted ways of determining the cash value of accounting items, the procedure for converting accounting items denominated in a foreign currency into the currency of the Russian Federation, requirements to the accounting policy, the chart of accounts and other issues stipulated by the law. Industrial standards describe how federal standards are applied in individual business sectors. Accounting recommendations are used to ensure the right application of federal and industrial standards, to decrease costs for the accounting system, as well as to share the best practices and results of research and development in the field of accounting. Accounting recommendations may be applied on a voluntary basis. Standards of an economic agent have been developed to coordinate the way an economic agent organizes and keeps accounting records. The agent may define the necessity of and the procedure for developing, approving, amending and annulling its standards at its own discretion.

At the same time, as the new accounting control system has become effective since 2013, public bodies have not yet elaborated regulations corresponding to it, consequently, everyone has to continue using the system stipulated by Federal Law No. 129-FZ "On Accounting" dated 21.11.1996 which is now void.

The Federal Law No. 129-FZ also stated the priority of the accounting law. However at the second level there were the accounting standards ("PBU" in Russian, short for Polozheniya po Bukhgalterskomu Uchetu) issued by the Russian Ministry of Finance.

The ministry derives its powers in this connection from the Accounting Law (article 23 of the new accounting law).

A new accounting law has been enacted in 2011 and replaces the previous law from the beginning of 2013. The discussion in this chapter is in reference to the new law if otherwise not indicated. We list below the most important changes brought by the new law:

Recognition of possibility to outsource accounting. The new law now explicitly recognizes that outsourcing of accounting is an option alongside of employing an in-house chief accountant. As opposed to the previous version of the law the new law does not require such a company to have a special status (specialization). This status had been previously provided for in the law, but never put into practice. Accounting outsourcing is, however, not available for banks.

The role and qualifications of chief accountant. The role and qualifications of the chief accountant have been clarified. For most companies, all limited liability partnerships (so-called "OOO companies") and all joint stock companies of the closed type ("ZAO companies"), there are no special competence criteria set for the chief accountant. Statutory competence criteria have been set in respect to chief accountants of open stock companies ("OAO companies"), insurance companies, and various forms of investment companies. These are not, however, very demanding: higher education, 3 of the last 5 years experience shall be connected with accounting or audit, or 5 of the last 7 years experience shall be connected with accounting or audit if higher degree in accounting and audit is absent, and no conviction for economic crimes. A company providing accounting services must employ at least one such specialist. Hereby the law does not require that the person responsible for the accounting is particularly a chief accountant, recognizing the possibility that "another officer of the firm" can be entrusted this function. Thus the function could be given, for example, to a chief financial officer, or outsourced as it was said above.

The competence criteria for chief accountants of banks and credit institutions are set by the Central Bank.

Flexibility with source (primary) documents. An important change in the law has to do with source (primary) documents which must be in place to support the accounting transactions. The law scraps the earlier requirements to standardized document forms that are a hangover from the Soviet system. Now the template for source documents has to be adopted by the company itself with approval by the chief executive officer. In other words, every company is free to use its own forms and documents. In addition, the law now allows for the primary accounting documents to be drafted in digital form and hence be approved by a digital signature. — See below for more details.

Entities exempt from keeping full statutory accounting records**.** After the new law individual entrepreneurs and private professionals are exempt from the duty to maintain accounts in conformity with the accounting laws and standards if they maintain their tax accounting records in conformity with the tax laws regulating their specific tax regimes.

Branches and representative offices (or other subdivisions) of foreign companies may waive the requirement to keep statutory financial accounting (bookkeeping) books as long as they follow the tax accounting rules prescribed by the Russian Tax Code (keeping of all the necessary tax ledgers for each type of tax applicable to the entity's business). However if the activities of the foreign company in Russia lead to the creation of a permanent establishment, the company's permanent establishment must keep accounting records of the fixed assets for the property tax purposes pursuant to the Russian rules.

The new law now removes the requirement that documents relating to monetary operations be approved jointly by the director and chief accountant, allowing for companies to adopt their own internal policy for such approvals.

The PBUs issued by the Ministry of Finance are largely based on International Financial Reporting Standards (IFRS), with each new amendment aimed at bringing RAS closer in principle to IFRS.

In addition to the PBUs the Ministry of Finance regularly issues detailed instructions as to the application of the PBUs in specific situations. Examples of such instructions are the compulsory unified chart of accounts that all Russian firms must use and Recommended practices of accounting for fixed assets and inventory. The standard chart of accounts is prescribed for all Russian companies by the Ministry of Finance (Order No. 94n). According to the chart each balance sheet and income statement account is given a two digit number. This two digit coding must be adopted by each company and cannot be changed through adoption of internal accounting procedures, but naturally they may be adapted to specific requirements by introducing a needed amount of subaccounts.

We may consider as the fourth level of regulations the rules that the company (or entrepreneur) establishes within the framework permissible by the government regulations. These concern areas which are not completely covered by the law, or where the company is left with a choice. The regulations individual to the company are set in its 'accounting policy.'

One of the most important changes introduced by new law No. 402 is the obligation to ensure internal control over accounting records and preparation of financial statements in companies subject to mandatory audit (except those whose heads are responsible for the accounting records) (Article 19 of Federal Law No. 402).

Russian Tax Accounting

The Russian Tax Code requires taxpayers as well as permanent establishments (PEs) to keep separate accounting records for tax purposes. As with many other countries, tax accounting rules differ from statutory financial accounting principles. This can create major differences in calculations, specifically for example in regards to the treatment of depreciation, reserves, interest expenses (capitalization or deductions of interests) and losses. For many companies the existence of separate Tax Accounting rules means a third set of books must be kept alongside the Russian Statutory Accounts in addition to the books kept in accordance with some international accounting principles such as IFRS and US GAAP.

Examples of the Russian Tax Code providing for the application of individual company accounting policies are the requirements to adapt rules for 'keeping of tax records' and 'determination of the tax base.' In this regard, the Russian Tax Code (art.313, 167) allows an option for a company to choose amongst tax accounting principles, however the Russian Tax Code also details a fall back set of principles should the company choose not to adopt its own set of custom principles. Companies must also consistently maintain their adopted tax accounting policies from one year to the next, unless legislation prescribes otherwise or the company develops a superior method of maintaining accounting policies and sees fit to change them. It is necessary that in both of these situations that the newly adopted policies take effect from the beginning of the financial year.

It should be noted that a company must issue separate regulations on financial accounting policy and tax accounting policy, respectively.

Russian Accounting Standards vs. International Standards such as IFRS and USGAAP

During the time of the Soviet Union, accounting in Russia was traditionally used for statistical purposes. All enterprises reported only to the state and accounting was largely put in place for the benefit of the state only.

Since the break-up of the Soviet Union in 1992, Russia has undergone radical changes to shift from a centrally planned economy to a market economy. In doing this, the shift in accounting policy had to reflect a shift in process for accounting, from a system of state economic administration to a process of the private business community. This posed problems for the traditional accounting system, as a shift also had to occur in regards the end use of accounting records. With the new market economy, financial reporting had to be put in place that satisfied the requirements of investors, creditors and other interest holders. This contrasted to the previous state system.

In more recent years, this initial transition has been accelerated even further through by the Russian Government identifying the necessity to align Russia's accounting principles with those of IFRS. Although this alignment has taken place to some degree, the previous state-centered traditions have still negatively affected the contemporary development of accounting policy. While there are now some principles resembling those of IFRS, the implementation of these principles in practice still have some flaws.

The problems are often caused by the restrictions that prescribe that a source document has to be in place before specific accounting entries can be made. As a consequence, accounting statements prepared according to RAS do not necessarily show the true account of accruals and do not convey a true and fair value of the assets or liabilities of the entity. Therefore, in order to understand the financials of a Russian company in a true and fair view, the statements need to be restated in international accounting standards such as IFRS (International Financial Reporting Standards), US GAAP (US Generally Accepted Accounting Principles) or any other standard used by the parent company. In doing so, there are a number of difficulties to overcome.

- The main shortfall in the development of RAS in comparison with IFRS arises from the fact that the accounting principles still favor the tax authorities as the main recipient of the information. This is in direct contrast to IFRS basic root principles, in that financial and accounting information should be produced specifically in the interests of accuracy and fairness towards shareholders and relevant stakeholders.

- Form over substance — Russian administrative practice in all fields of activities and life is quite formalistic. As a consequence of this obsession with form, Russian accounting practice has been quite slow to adapt to IAS rules where subjective judgment is often needed. In addition to this, RAS is in theory 'substance over form;, whereas in reality it is 'form over substance'.
- RAS does not provide guidance on the procedure for consolidations, business combinations, purchase price allocation, impairment of property, plant & equipment, share-based payments or employee benefits.

Moreover if companies have to prepare consolidated financial statements pursuant to the law (credit, insurance companies, and institutions whose securities are permitted to circulate in organized securities markets) or foundation documents, these consolidated financial statements must be prepared on the basis of the IFRS. For these reasons in 2011 the Russian Ministry of Finance put into effect the international financial reporting standards and their interpretations in the territory of the Russian Federation. This means that in fact a professionally managed Russian subsidiary company has the needed to make financial reports on four different levels:

1. Russian statutory financial reports (statutory bookkeeping)
2. Russian tax accounting reports
3. Group financial accounting reports
4. Management accounting reports

Primary Source Documents

Each operation has to be supported by an appropriate source document or a set of documents. The Russian Tax Code mandates that for tax compliance purposes the transactions will have to be supported by source documents compiled in accordance with the Accounting Law. According to the profit tax laws the deductibility of expenses is subject to proof that they are economically justifiable and properly documented.

Following amendments to the Law on Accounting[125] (effective from 2013) considerable flexibility was introduced in regards to the requirements on the form of accounting primary source. It is now up to the company to establish its own templates for source documents by decision of the chief executive officer (general director). There also emerged

125 Federal Law of 06.12.2011 No. 402-FZ "On accounting"

the possibility to compile accounting source documents in electronic form (Law on Accounting, art. 9.5).

According to the new accounting law, the source documents must contain at least these mandatory requirements:

a) Title of the document:
b) Date on which the document is drawn up;
c) Name of the entity;
d) Nature of the business operation;
e) Volume and monetary indicators of business transactions;
f) Name and title of signatories

Concerning expenses that have been incurred in another country the source documents have to be drawn up in accordance with ordinary business practices applicable in the relevant foreign jurisdiction.

Notwithstanding the fact that the new law no longer requires the use of the official state-sponsored template documents, taxpayers are well advised to use discretion in considering to what extent they can skip their application. Some of the old template documents will remain in force by virtue of other regulations (e.g. documents for cash records). The tax authority may also insist that some of the old forms be still used: this is the case, for example, when the Ministry of Finance claims that the old template for a waybill confirming deduction of transport costs must still be used. The Ministry of Labor in turn insists, clearly without legal backing, that the old template for confirmation of business trips must still be used. It is thus clear that businesses will for a transitional period still be harassed with formal requests stemming from bureaucrats that do not want to honor the new law. According to statements by high-ranking officials, decisions are expected in year 2014 to remove the remaining vestiges of this bureaucracy.

Recent court practice (referring to the time of the old accounting law) has supported a tendency of judging the accuracy of source documents not strictly in reference to the official template source documents and instead considering the extent of documentary support on more substantial criteria. The Supreme Commercial Court has determined that the taxpayer may refer to any documentary evidence in support of confirmation of the conditions of deductibility, and that all the evidence must be considered as a whole (Supreme Commercial Court Determination No. VAS-5445/09 of 17.06.2009; see also, for example, Resolution of the Federal Commercial Court of the Central District dated

February 18, 2010 in Case No. A35-5033/08-C21). According to the profit tax laws, the deductibility of expenses is subject to proof that they are economically justifiable and properly documented.

Although the new accounting law contains the welcomed reform of abolishing the mandatory templates for source documents, there is now a risk that the tax authority will try to fulfill the vacuum by imposing on the taxpayers the forms developed by itself. Such a practice is, however, understandable in respect to the common source documents that require digital exchange and digital processing, which would not be possible without standardization. The Federal Tax Service has already issued two orders establishing the electronic formats for the common and necessary primary documents[126] namely, the electronic form of a waybill (TORG — 12) and Act of Acceptance (for works and services; in Russian referred to as "akt").

The Federal Tax Service have issued directives which enabled the issuance and exchange of electronic VAT invoices effective of May 2012[127]. These directives have been complemented with instructions from the Ministry of Finance[128].

The Federal Tax Service has announced the issuance of a template for a combined VAT invoice, act of acceptance and waybill[129]. It is expected that the combined electronic format would be available in 2014.

In its letters, the Ministry of Finance has confirmed that to submit at the request of the tax authorities documents not compiled according to the established formats, one must submit them in printed form on which a note is inscribed, stating that the document was signed using an electronic signature.[130]

Taxpayers presently have the right to choose whether to file tax returns electronically or on paper. However, organizations whose average number of employees for the preceding calendar year exceeds 100 people and the largest taxpayers regardless of the number of employees must file tax returns only in soft copy (Tax Code art. 80(3)).

126 Orders of Federal Tax Service No. MMB-7-6/138@ of 5 March 2012 and No. MMB-7-6/172@ of 21 March 2012

127 Order of Federal Tax Service No. MMB-7-6/138@ of 5 March 2012

128 Order of Ministry of Finance No. 50n dated 25 April 2011

129 Letter of Federal Tax Service of 21.10.2013 N MMB-20-3/96@ «On the absence of tax risks when taxpayers apply the initial document drafted on the basis of the tax invoice»

130 Letter of the Ministry of Finance dated 26 August 2011 No. 03-03-06/521, Letter of the Ministry of Finance dated 15 September 2011 No. 03-02-09/96, Letter of the Ministry of Finance of the Russian Federation dated 11 January 2012 No. 03-02-07/1-1

As for reports to the social security funds, this obligation is set for organizations whose average number of employees exceeds 50 people. From 2014 all taxpayers will be obliged to file returns for the value added tax (VAT) solely in electronic form.

Storage of Accounting and Tax Records

No time periods have been established separately for the storage of electronic documents, therefore electronic documents should be kept as long as paper documents. According to the Tax Code accounting records as well as taxation documents including tax receipts must be stored for 4 years (art. 23(1)8). However, the storage period specified in the Accounting Law (art. 29) is 5 years unless the laws on national archive set a longer period. When claiming deductions for losses relating to prior periods, the corresponding accounting records will have to be available for all those periods to which the loss carried forward refers.

Despite the storage period stipulated by the law, in order to avoid any potential risks, taxpayers are advised to store documents until all issues and processes related to these documents have been resolved and completed, even if this period exceeds that determined by the law (Decree of the Federal Commercial Court of the East Siberian District dated 4 July 2012 in case No. A33-5433/2011).

Audit in Russia

The Russian Law requires that the following entities have their accounting records fully audited by a licensed auditor (article 5 of the Russian Audit Law):

1. Open stock companies ("OAO companies")
2. Banks, credit or insurance companies, mutual insurance associations, clearing agencies, commodity and stock exchanges, incorporated investment funds, non-budgetary state funds, holding/management companies of investment funds, unit investment funds or non-state pension funds (excluding non-budgetary state funds).
3. Enterprises that have annual revenue in the preceding financial year exceeding 400 million RUB (approximately 12,4 million US dollars as at September 2013)

4. Enterprises that have total assets at the end of preceding financial year exceeding 60 million RUB. (approximately 1,8 million US dollars as at September 2013)
5. If securities of a company are admitted to trading on stock exchange.
6. If an entity provides or publishes its consolidated accounting report to the public (excluding state companies and state non-budget funds).
7. In other cases as stipulated by the law.

A Russian audit requires not only a systematic verification of the accounts, but also a meticulous examination of the procedures and accounting procedures of the enterprise to ensure that the books have been kept in the manner prescribed by the law as per the accounting and tax laws.

6. TAX AUDIT (TAX INSPECTIONS) AND TAX DISPUTES

The tax authority can subject legal entities to the following two types of inspections: a cameral inspection and a field inspection. A cameral tax inspection is performed by way of requesting documents for review at the tax office (art. 88) or by hearing witnesses (art. 90). A field tax inspection is carried out in the premises of the taxpayer (art. 89). During these inspections not only documents of a taxpayer under inspection are scrutinized but the tax inspector may also request from other persons documents relating to the activities of the taxpayer under inspection.

The Tax Code sets detailed rules regarding tax inspections and rights of the taxpayer in connection of such. There are special provisions for protecting the rights of the taxpayer during the tax inspections (art. 21). In particular, the taxpayer has the right to:

- Be heard and explain the issues under inspection
- Be present at a field tax inspection
- Receive copies of the relevant documents relating to the inspection and the resolutions of the tax office Appeal against decisions of the tax authority
- Get full compensation of the damages incurred as a result of unlawful actions of the tax authority.

Cameral Tax Inspection

As a general rule a cameral tax inspection is carried out as a routine procedure within a period of three months from the date of filing a tax return. After expiration of the three months period, the tax authorities lose a right to require further actions by way of cameral inspection (Decision of Presidium of Supreme Commercial Court 17.11.2009 No. 10349/09). However, the same transactions may further become the object of a field tax inspection.

The tax inspectorate is restricted by special rules as to its powers to request documents and clarifications during a cameral tax audit. The inspectorate has only a limited right to request additional information in connection with cameral inspection. It is explicitly said that the tax inspectorate may request documents confirming the rights to enjoy a particular tax benefit (art. 88). A cameral tax inspection must be terminated if a revised tax return has been filed.

A cameral tax inspection may be conducted after submission of a revised tax return. From January 1, 2014 onwards, the tax authority will be entitled to request clarifications to motivate the changes in the tax return in connection with an inspection initiated after a revised tax return. Such clarifications must be submitted within five days from the date of the request. In practice it means that the proceedings in relation to the earlier filed tax return are terminated but are initiated anew in relation to the new tax return.

In case it is found that there are mistakes, deficiencies or inconsistences in the tax returns or other data provided, the tax inspectorate may request clarifications from the taxpayer and allow 5 days for submission (art. 88.3). (According to a draft law presently reviewed in the Duma, this rule may change so as to allow for much wider powers to request additional documents and data).

The question whether a tax return for a certain period may be subjected to repeated cameral inspection is not quite clear. From one side the Ministry of Finance considers that this is not permissible except for in the case of filing a revised tax return (Letter 03-02-07/1-267 of 31.05.2007). But in an authoritative ruling of a territorial commercial court (Territorial Commercial Court of Urals No. F09-1533/07-C3 of 11.04.2007) the court ruled that such repeated cameral tax audit is permissible. Noteworthily the territorial court was supported by the Supreme Commercial Court which rejected an appeals hearing in the case (Ruling No. 9663/07 of 09.08.2007).

Field Tax Inspection

The law aims to protect the rights of taxpayer during a field tax inspection by a number of provisions. A tax audit may cover only a period of previous three calendar years. The tax inspector may not conduct more than two field inspections in relation to one type of tax per year (art. 89). Moreover, the tax authority does not have a right to initiate a new inspection in the current year or any coming years in relation to a type of tax that has already been the subject of a tax audit in that year. It should, however, be remembered, that this provision does not prevent tax authorities from conducting an inspection in relation to other types of taxes (types of taxes are, for instance, value added tax, profit tax, social tax).

A field tax audit is always preceded by an official decision by the relevant tax inspectorate which must specify which type of tax will be reviewed and what is the period for which the tax is reviewed.

Irrespective of when the previous inspection was carried out, a repeat field inspection in respect to the same tax period can be conducted only in three cases:

- (i) in connection with the reorganization or liquidation of the taxpayer organization (art. 89.11)
- (ii) in connection with a subordinate taxation body being audited by a superior body of the taxation authority (art. 89.10)
- (iii) by the same tax authority in case when a taxpayer submitted a revised tax return (art. 89.10).

The power of the higher taxation body to audit a subordinate taxation body by instigating a repeat inspection was limited by a ruling of the Constitutional Court (N 5-P of 17.03 2009). In its ruling the Court prohibited the practice of instigating a tax audit by a higher tax body from conducting a repeat tax inspection in the case when the matter had already been previously subject to a judicial review.

It is noteworthy that when a violation has been detected anew during a repeat field inspection, a taxpayer is exempt from liability unless the previous non-detection was the result of the taxpayer having conspired with the tax inspectors during the first field inspection (art. 89.10).

The taxpayer is also protected by way of the restrictions as to the authority to initiate a tax audit. It can be authorized only by a decision of the head or the deputy of the relevant tax office. Another important safeguard is the limitation of the duration of such inspections. As a general rule, the term is limited to two months (article 89, Tax Code). However, it may, according to the Tax Code, be prolonged for up to four months and in exceptional cases for up to six months. But sadly, in practice the effectiveness of these provisions is limited due to administrative and court practices which have extended the statutory limits. In this connection we may refer to a remarkable court cases. According to a ruling of the Constitutional Court the two-month period was considered to be the time of actual presence of tax inspectors at the territory of the taxpayer (Decree of Constitutional Court No. 14 of 16.07.2004). Moreover, the court ruled that this term could be interrupted for up to six months and in some cases for up to nine months. From its part the Federal Tax Service has established a list of reasons allowing for a prolongation of the field inspection (Order of Federal Tax Service No. CAE-3-06/892@ of 25.12.2006).

The tax authority announced, for example, that it will consider as reason for prolongation the fact that the taxpayer operated through several subdivisions, or that it had detected violations on the side of the taxpayer. In fact, this means that the tax inspectorates possess quite arbitrary powers to prolong the audit terms.

Requesting Evidence

In the process of a tax inspection, the tax authority has the right to require the taxpayer to provide documentary evidence and give testimony in regards to the transactions under inspection. Typically the tax inspector would require seeing, for instance, agreements, invoices, payment receipts, accounting policy, pricing policy, and other documents. A taxpayer must produce the necessary documents within 10 days. The tax authorities may also demand to review documents that are stored remotely, for example, at foreign headquarters. The inspector may also request documents and information concerning a particular taxpayer (or tax agent) from the taxpayer's business partners (art. 93.1).

As a general rule, documents should be submitted as copies (notarization is not necessary). The documents, once requested and received, cannot be repeatedly requested at any time later (art. 93.5). The tax inspectorate has the right to seize documents in case it is deemed that there is a risk that the relevant documents would be tampered with or destroyed (art. 94.8).

Audit Protocol and Resolution

Upon concluding the field inspection the tax authorities draw up an audit protocol. The statement is signed by the tax inspectors and is presented to the company management who are requested to sign it. The company managers may refuse to sign the statement in case they disagree with the findings. The taxpayer may submit within 15 days its objections against the audit statement (art. 100.6).

The audit protocol together with the objections are reviewed by the head (or the deputy head) of the tax authority within 10 days. This term may possibly be prolonged up to one month. During a hearing the head (or deputy head) of the tax authority reviews the documents and establishes whether the identified transactions have been done in violation of the tax law, who is to be held liable and whether there are mitigating or aggravating circumstances. . In case the head of the tax office decides that there is sufficient ground to hold the taxpayer liable for a tax offence, the grounds, details and circumstances of the tax offence will have to be spelled out in a relevant resolution on the tax audit. The ruling shall clearly specify the alleged tax offence that the taxpayer is charged with by identifying the relevant articles of the Tax Code and the applicable sanctions. Only after the ruling has been adopted in the due course can the tax authority demand payment of the tax arrears (art. 101).

The ruling comes into force in 10 days after having been duly communicated to the taxpayer.

After the ruling has come into force, a payment advice is sent to the taxpayer. As a general rule this claim has to be executed within 8 days.

Tax Disputes

The procedures of appeal against tax authorities were considerably changed as of 3rd August, 2013[131]. Actions or omissions of tax authorities or tax officials may be appealed to a higher tax authority or in court (Chapter 19 Tax Code). Under the new rules, non-normative actions of tax authorities, actions or omissions of tax officials (with some exceptions) may be challenged in court only after they have been appealed at a higher tax authority (Article 138(2) Tax Code).

Taxpayers have the choice to appeal both against general purpose regulatory acts issued by the tax authorities (the Ministry of Finance and the Federal Tax Service) and against resolutions in particular cases which are based on the general regulatory acts. This choice has been confirmed in a ruling by the Supreme Commercial Court (Ruling No. 7445/of 04.10.2005).

The proper jurisdiction for filing of an appeal is the local commercial court when the plaintiff is a legal entity or an individual entrepreneur, whereas private individuals will file with courts of general jurisdiction.

The procedures for tax appeal vary depending on whether a taxpayer appeals against (i) a decision adopted by the tax authority as a result of a tax audit, or (ii) against an action or omission under other circumstances.

131 Federal Law of the Russian Federation 02.07.2013 No. 153-FZ // Code of Russian Laws. 2013. No. 27. Art. 3445.

Separate procedures need to be followed depending on whether a resolution following a tax audit has come into force or is still pending. An appeal against a resolution which has not come into force must be filed with a higher body of the tax authority within 10 working days from the date of proper issuance of the resolution. An appeal against a decision that has not come into force, an appeal petition, must be filed with the authority that adopted the contested decision prior to the entry into force of the decision (Tax Code, article 101). A higher tax authority must consider such appeal within one month (in some cases, this term can be brought down to 15 days). This time period may also be extended to up to a month. A decision that has already entered into force may be challenged at a higher tax authority only if the taxpayer did not appeal against it prior to its coming into force. The Tax Code refers to such appeals as "complaints". Such complaints must be filed within one year from the date on which the challenged decision was rendered. The tax authority must then consider such appeal within one month. An appeal will not suspend enforcement.

Actions or omissions of tax authorities or tax officials may be appealed against within 3 months from the date on which the taxpayer became aware or should have become aware of the violation in question (Civil Procedure Code Article 256; Arbitration Procedure Code Article 198(4)). In this case the taxpayer may file an appeal either with a higher body of the tax authority or with a court. At the request of taxpayers, a court may issue an injunction suspending the enforcement of the appealed decision. Such injunctions are frequently awarded when the amount of the tax claimed by tax authorities is substantial.

General regulatory acts may be appealed against at any time without consideration of the time of their issuance.

Special procedural rules apply for court appeals in taxation matters as established in the Civil Procedure Code (chapters 23-25) and the Arbitration Procedure Code chapters 22-24. Rulings of a court of first instance may be further appealed in a superior court. Provisions of federal laws, including the Tax Code, regional laws and regulations, decrees of the Russian Government, and presidential decrees may be challenged in the Constitutional Court.

The Code of Administrative Offences confers to courts the right to examine some cases of administrative offenses. The administrative sanctions for tax offenses are set in the Code of Administrative Offenses (articles 15.3-15.12). If an administrative investigation is conducted, a district court will further examine the case, but when no administrative investigation needs to be conducted, cases are considered by a Justice of the Peace (Code of Administrative Offenses Article 23.1.3). Cases of administrative offences may be appealed in higher courts.

7. TAX OFFENCES AND ENFORCEMENT MEASURES

The Russian law enforcement measures and sanctions for breach of tax law may be classified in three categories as follows:

(i) Securing measures;
(ii) Enforced tax collection, and
(iii) Sanctions for tax offences

Securing Measures

Among securing measures we may list the following:

- Penalty interest
- Pledge of assets
- Guarantee
- Bank guarantee
- Freezing of bank accounts
- Seizure of assets
- Establishing the tax due using the deemed method

In our view the 'penalty interest' and 'recalculation of tax using the deemed method' should be considered as 'sanctions' instead of 'securing measures,' but we have here chosen to follow the classification principles of Russian law as expressed in the Tax Code, which lists them under securing measures. The idea in the law is that sanctions follow from offences, whereas penalty interest and recalculation of tax do not require that a tax offense be first identified.

Securing Measures

Penalty Interest

The taxpayer must calculate and settle penalty interest on its own initiative without any prompting from the side of the tax office in respect to all overdue taxes (art. 75). The penalty interest accrues for each calendar day at a rate equal to 1/300 of the refinancing rate of the Central Bank of Russia. The obligation to pay penalty interest is independent from any other possible sanctions.

Unpaid penalty interest may be collected from legal entities and individual entrepreneurs according to the means of enforced tax collection without court sanction. But enforced collection of penalties from an individual requires a court order.

In order to restrain the tax officials from excess and abusive practices, the law contains a provision prohibiting levying of penalty interest on amounts that remain unpaid as a consequence of the actions of the tax officials, for example, following a freezing of a bank account, seizure of assets, or seizure of monetary funds.

Penalty interest is also applicable on tax debt which has been officially permitted in the form of a tax credit granted (art. 67).

Pledge of Assets and Guarantee

Pledge of assets as collateral for unpaid taxes and dues is established by an agreement between the taxpayer or a third person (pledger) and the tax authority (art. 73). The law also provides that a guarantee (personal or corporate) may be issued to secure tax debts (art. 74).

Bank Guarantee

Bank guarantees were included in the list of ways to secure the fulfillment of obligations on 01.10.2013 (Law N 248-FZ dated 23.07.2013). A bank guarantee must be issued by one of the banks included in a list by the Ministry of Finance of banks meeting the requirements for acceptance of bank guarantees for tax purposes (art. 74.1 of Tax Code).

Freezing of Bank Accounts

The tax authority has the right to suspend debit transactions on a taxpayer's bank accounts by freezing accounts so as to collect taxes due from the funds available (art. 76) in accordance with the rules of enforced tax collection (see below). Freezing of accounts may be ordered in case the taxpayer owes overdue tax debt.

From January 1, 2015 it will be possible to freeze bank accounts (Law No. 134-FZ dated 28.06.2013):

1) If a taxpayer (organization) fails to file its tax return with tax authorities within 10 days of the set deadline for filing the tax return. In this case, bank accounts may be frozen for a period of three years from the stated deadline.
2) If a taxpayer (organization) fails to submit to the tax authority an acknowledgment of receipt of documents. In this case, a bank account may be frozen for 10 days from the date of expiration of the time period set for the submission of an acknowledgment of receipt of documents sent by tax authorities.

It should be noted that there is no such corresponding right to freeze bank accounts due to matters concerning an employer's social contributions, but such contributions can be the object of enforced collection (unilaterally withdrawn from bank accounts; Law on Social Contributions, No. 212-FZ of 24.07.09).

Seizure of Assets

Seizure of assets may be undertaken for securing payment of taxes, penalties, and fines. There are two possible forms of seizure of assets, both of which can be undertaken in relation to an organization (art. 77). These are

(i) Total seizure. In this case the taxpayer retains the possession and right to use the asset with special permission and under supervision of the tax (customs) authority, whereas the right to dispose of the asset is withheld.
(ii) Partial seizure. In this case the taxpayer retains the possession and right to use the asset and also dispose of it with special permission and under supervision of the tax (customs) authority.

The measure of seizure of assets may be undertaken only with the consent of a public prosecutor and only to the extent necessary for the fulfillment of the overdue liability. In order to initiate a seizure of assets, the tax authorities must show sufficient reason to believe that the taxpayer intended to hide the assets or to abscond with them.

Establishing the Tax Due Using the Deemed Method

In certain cases the tax authority has a right to determine tax liability according to the deemed method (art. 31.1.7). According to this method, the tax authority may determine the revised tax liability based on other available information regarding the particular taxpayer or taxpayers within the same industry. This can be done in the following cases:

- non-submission (or refusal) for more than two months to submit necessary tax filings;
- sufficient accounting records or supporting documents are lacking;
- the quality of the accounting records does not allow for proper calculation of taxes due;
- refusal to allow the tax inspectors to perform an examination at the relevant premises;
- when a foreign entity performs auxiliary and preparatory services for no consideration for the benefit of third parties;

With respect to VAT payable at customs (and customs duties), the securing measures follow different regulations foreseen by the customs laws (art. 86, Customs Code of the Customs Union; chapter 16 of the Federal Law on Customs regulation in the Russian Federation of 27.11.2010 No. 311-FZ). These obligations can be secured by: a deposit; bank guarantees; (third party) guarantee; pledge of assets.

Enforced Tax Collection

The tax authority has the right to enforced collection (or involuntary execution) from a taxpayer (and tax agent) of taxes due (as well as fines and penalty interests) by unilaterally withdrawing money from bank accounts or realizing the value of other seized assets by way of involuntary execution.

Enforced collection may be undertaken in relation to assets of legal entities and individual entrepreneurs without a court order; but in relation to private individuals such an order will be needed. The procedures respective to these two categories of taxpayers also vary in other aspects.

Tax Code article 46 sets the rules in regards to enforced collection of tax debt by withdrawing funds from bank accounts, whereas article 47 determines the rules for collecting the debt by realization of other assets. The corresponding rules concerning enforced collection of tax debt from private individuals are in article 48.

If an organization or an individual entrepreneur fails to pay taxes or dues, the appropriate amounts can be charged to the entity's bank accounts (art. 46) without a court order. The tax authority must make the decision on such enforced collection by withdrawal of funds from bank accounts within 2 months from the end of the time for voluntary execution. However, after this time frame has elapsed the tax authority may still, within 6 months from the due date of voluntary execution, solicit a court order for authorization of enforced execution. But the law explicitly states that this time frame may be further extended if the deadline was missed for honorable reasons.

In the event that competing claims are presented to the bank and there are not sufficient funds to satisfy them all, then the competing claims should be awarded the order of priority set by art. 855 of the Civil Code.

In regards to involuntary execution of other assets (other than funds in a bank), the tax authority is allowed one year within which the relevant decision of execution must be taken. Failing the deadline, the tax authority may, within 2 years from the due date for voluntary execution, solicit the permission for involuntary collection through a court. The court may further extend this period.

The law on Enforced Execution (No. 229-FZ of 02.10.2007, art. 69) establishes the order of priority for categories of assets of legal entities and individual entrepreneurs that can be the object of enforced collection as follows:

(i) Cash and bank

(ii) Assets which are not utilized in the production and sales of goods and services (such as securities, premises not utilized directly for work, objects of design and art, personal cars).

(iii) Finished goods, raw materials and other production materials, machinery and equipment, buildings, other fixed assets

(iv) Assets given for lease or possession to other parties, after cancellation of relevant contracts

(v) Other assets, except for those of everyday private use of an individual entrepreneur or his family

Such enforced collection may also be undertaken by the customs authority for debt on taxes payable at customs (concerning other assets than funds in a bank the reference is to article 47 of Tax Code; concerning funds in a bank the reference is to article 91 of the Customs Code of the Customs Union, and chapter 18 of the Customs Law of Russia).

The law on Enforced Execution (art. 69) establishes the order of priority for categories of assets of private individuals that can be the object of enforced collection.

Individuals are thereby protected so that some classes of assets are totally excluded from the scope of enforced collection; such assets are (Civil Procedure Code, art. 79):

(i) housing (and the underlying land) that serves as the sole possible living quarters for the taxpayer and his family, except in the case that the housing has been mortgaged; ordinary furniture, appliance and décor items of a home, and items for personal use (clothes, shoes, etc.), except for jewelry and other kinds of objects of luxury;

(ii) items necessary for professional activity (within limits);

(iii) food supplies;

(iv) other cases, among these certain assets connected with auxiliary husbandry for private needs.

Sanctions for Tax Offences (Tax Violations)

Sanctions for tax offences are stipulated in three laws: Tax Code (tax sanctions or fines); Code of Administrative Offences (administrative sanctions); and Criminal Code (criminal sanctions). The liability for committing tax offences can be imposed both on legal entities and individuals. A tax offence can either be committed intentionally or by negligence (art. 110).

Holding a legal entity liable for a Tax Code or administrative tax offence is subject to proving the guilt of the officials who acted on behalf of the entity. Punishment of the legal entity will not release its officials from further liability.

An individual is presumed innocent of committing a tax offence (under all the laws) until his or her guilt is determined by a court. The burden of proof lies with the tax authority. When in doubt, there is a presumption of innocence (Tax Code art. 108(6); Criminal Code art. 14; Code of Administrative Offences 1.5.)

A taxpayer cannot be held responsible for a (Tax Code-related) tax offence where the taxpayer has relied on written directives provided by the tax authorities at the request of the taxpayer (art. 111).

Based on the circumstances, liability for a (Tax Code-related) tax offence may be mitigated or, on the contrary, aggravated. Past tax offences will serve as aggravating circumstances for a one–year period upon their commitment. The possible fines will be reduced at least by half if at least one mitigating factor is present. Correspondingly, in the presence of an aggravating factor the amount of the fine will be doubled (art. 112, 114).

The statute of limitations for liability for a Tax Code-specified tax offence is three years from, depending on the type of offence, expiration of the day when the offence was committed or from the first day after the end of the tax period during which the offence was committed, depending on the type of offence (art. 113). However, in a decree of 14 July 2005, the Constitutional Court has permitted the tax authorities and courts to call taxpayers to account even upon the expiry of this 3-year term. The limitation is deemed waivable if the taxpayer strongly resisted the field tax audit, and the resistance led to the impossibility of conducting the tax audit and revealing the outstanding tax obligations. Nevertheless, the tax authority is limited in bringing a suit for tax offences to a period of 6 months from learning about the offence and issuing a corresponding resolution (art. 115). Hereby it is to be noted that a field tax inspection may only cover three years prior to the year of inspection (art. 89).

Tax Offences as per the Tax Code

The Tax Code establishes a number of different tax offences along with examples of fines applicable to the offences (Tax Code Chapter 16). Below we give a list of some of these offences and the sanctions they carry:

- Violation of registration obligations, fine RUB 10,000, in case of failing to perform due registration; if activity is carried out without due registration, fine of 10 percent of the income derived (minimum fine RUB 40,000); failure to timely report on opening and closure of bank accounts;
- Failure to submit a tax return in due time, fine 5 percent of the amount due for each calendar month during which the breach occurs (maximum 30 percent of tax due, minimum RUB 1,000);
- Improper submission of tax returns;
- Gross violation of tax accounting rules, fine RUB 10,000; if the same offence occurs during several tax periods, then the fine is RUB 30,000. If the offence resulted

in understatement of the tax base, then a fine equal to 20 percent of amount of tax due (minimum RUB 40,000);

- -Non-payment or partial payment of taxes (dues), fine 20 percent of the tax due, 40 percent of the tax in case the understatement of the tax was deliberate;
- Violation connected with reporting within a consolidated group of taxpayers;
- Failure to comply with responsibilities of a tax agent, fine 20 percent of tax due;
- Failure to comply with regulations of registration of objects of gambling;
- Failure to submit necessary data requested by the tax authority required for tax compliance control;
- Violations connected with transfer pricing rules;
- Breach of rules imposed on holding, use and disposal of seized assets or pledged assets;
- Failure to appear or evasion of appearance without good reason by a person called in as a witness in a case of tax offence;
- Unlawful refusal to testify, or giving false testimony;
- Refusal of expert, interpreter or specialist to participate in a tax audit, or submission of knowingly false opinion or knowingly translating wrongly; failure to properly report to the tax office

In a case when a taxpayer rectifies the error on its own initiative, no fines are due.

In addition to fine,s a penalty interest is charged in the amount of 1/300 of the refinancing rate of the Russian Central Bank (8.25 percent as of 22 November 2012) for each day of delay.

Chapter 18 of the Tax Code lists a number of offences which concern the liability of banks in matters of taxation (art. 132-135.2).

Tax Offences per Code of Administrative Offences

Some of the provisions of the Code of Administrative Offences relating to taxation (articles 15.3-15.9, 15.11) resemble the tax offences envisaged by the Tax Code. The principal difference is that for administrative tax offences only an official of a legal entity can be held liable and not the legal entity itself.

Below we list some of the administrative tax offences and the sanctions they entail:

- Violation of registration obligations, fine RUB 500 to 1,000 in case of failing to perform due registration; RUB 2,000 to 3,000, if activity carried out without due registration, fine
- Failure to submit a tax return in due time, fine RUB 300 to 500
- Improper submission of essential information for tax control purposes: for individuals, RUB 100 — 300; for company officials, RUB 300 — 500

Criminal Tax Offences

The Criminal Code foresees criminal liability for tax offences for individuals and representatives of legal entities (art. 198, 199 and 199.2). Representatives of a legal entity may assume criminal liability for the tax offences committed by the entity they act for. Criminal liability for tax evasion arises if the taxpayer (i.e. its representative) is found guilty of tax evasion by not duly filing tax returns or filing deliberately false data. Thus criminal liability cannot arise if the taxpayer filed tax returns but merely failed to pay taxes due to economic woes.

The possible punishments are: prison for up to 3 years for crimes committed by an individual; prison for a period of up to six years for officials of legal entities; prohibition on being engaged in certain activities for three years; fines in the amount of RUB 200,000 to 500,000, or an amount equal to the salary or similar income of the offender for one to three years.

Criminal liability for tax evasion may arise for a private individual or individual entrepreneur if during 3 consecutive financial years the amount of unpaid taxes exceeds RUB 600,000, provided that this amounts to not less than 10 % of the whole amount of taxes due, or exceeds RUB 1,800,000. But if the amount of unpaid taxes for the same period exceeds RUB 9,000,000, criminal liability would arise regardless of the total amount of taxes due (art. 198, Criminal Code). It should be noted that here and in all cases of application of criminal and administrative sanctions, it is naturally a condition for punishment that the accused offender is found to be guilty of the offence.

With regard to officials of a legal entity, the thresholds for criminal liability are higher; specifically, they exceed RUB 10,000,000 in case this represents no less than 20 % of the total amount of taxes due, or exceed RUB 30,000,000.

Criminal liability for an owner or representative of legal entity or individual entrepreneur may also arise for the concealment of money or other assets subject to enforced collection of tax arrears if the value of the concealed assets is more than RUB 1,500,000 (art. 169 and 199.2, Criminal Code).

In the year 2004, the sanction of confiscation of property was abolished as one of the possible sanctions for criminal offences. But in 2006 confiscation was reintroduced into the Russian Criminal Code (chapter 15.1).

There is a separate provision for criminal liability of tax agents (art. 199.1, Criminal Code). The threshold of severity is the same as the one provided for officials of legal entities as per the above. No criminal punishment ensues when the tax evasion was committed for the first time and all taxes due (incl. penalty interests and fines) were paid in full.

8. DOUBLE TAXATION TREATIES IN RUSSIA

Double Taxation Treaties, abbreviated DTTs, are agreements concluded by and between two states aimed at eliminating taxation-related obstacles to the movement of capital, goods or income, at preventing tax evasion and discrimination, and also at establishing procedures for interaction between the states when collecting taxes.

DTTs concluded between Russia and other states are based on the Model Agreements on Avoidance of Double Taxation of Income and Property, approved by resolutions of the Russian Government in 1992 (now inoperative) and in 2010 (currently in effect). In turn, these model agreements reproduce to a significant degree the Model Tax Convention on Income and on Capital by the OECD (hereinafter the "Model Convention"). Despite the fact that Russia does not participate in the OECD, the Convention and the Commentary on it are used by Russian courts when making decisions in disputes involving the application of DTTs.

In particular, the Commentary on the Model Convention was applied in some of the most recent court decisions (see the Severny Kuzbass case, Resolution of the Supreme Commercial Court dated 15.11.2011).

By January 2012 Russia had signed 80 DTTs, and all of them are currently in effect. The majority of the DTTs are applied in relation to such Russian taxes as corporate profit tax (including income from business activities, income from real estate, interest, dividends, and royalties), as well as personal income tax (including income from independent activities, from work for hire, fees of directors, artists, and athletes, and from real estate). The DTTs include taxes on the property of enterprises and of individuals among the taxes excluded from double taxation. The DTTs do not extend to indirect taxes like value-added tax.

In most cases, the essence of the mechanism for preventing double taxation consists in the fact that taxes on income or capital to be paid in one country may be partially or completely deducted from the amounts of tax (or counted towards payment thereof) which are subject to payment in another country in regard to that income or capital. Income received under certain conditions may also be exempt from taxation or taxed at rates lower than the rates applied to taxpayers not falling under the operation of the DTTs.

Below, we look at some matters related to application of DTTs concluded by Russia in regard to types of income most characteristic for business, for instance, profit from business activity, dividends, interest, royalties, and income from real estate (capital gains).

Residents

DTTs extend to parties that are residents of Russia or of a state that is a party to a relevant agreement. Normally, DTTs do not apply when a party is not a resident of any of the participating states. For DTT purposes, resident is any individual or legal entity that, under the legislation of that state, is subject to taxation there based on dwelling place, permanent residence, place of registration, place of management, or place of foundation of a company or any other similar criterion. If the taxpayer is a resident of both states, additional criteria for determining residency status for DTT purposes are applied.

Permanent Establishment

Under the majority of DTTs concluded by Russia, profit tax is not levied on the profit of foreign companies obtained from business activity in Russia, except in cases when a company is engaged in business activity via a permanent establishment set up in Russia. The DTTs set certain thresholds above which foreign organizations are recognized as having a permanent establishment.

Generally, the term "permanent establishment" means a fixed place of business through which an enterprise from a Contracting State regularly (partially or completely) engages in business activity in another Contracting State.

The term "permanent establishment" includes specifically:

a) place of management;
b) branch;
c) office;
d) factory;
e) workshop;
f) mine, oil or gas well, quarry, or any other place for extracting natural resources.

In case the national legislation sets higher thresholds for recognizing the existence of a permanent establishment (that is, ones less favorable for the taxpayer), the provisions of the appropriate DTT are applied (more favorable ones). For instance, in Russia, a construction site is regarded as a permanent establishment, irrespective of how long it has actually existed; whereas according to DTTs, a construction site leads to a permanent establishment if the length of its existence as a rule exceeds a certain period of time (generally speaking, 6, 12 or 18 months).

The profit received through a permanent establishment is taxed only for that portion which the permanent establishment could have received if it had existed as an independent entity under similar conditions.

Dividends

Dividends paid out by a Russian company to a foreign company may be taxed both in Russia and in the country of which the foreign company is a resident. Dividends to which DTTs might apply may be taxed at rates lower than those set by national legislation. That said, DTTs may set certain requirements for the amount of interest from shares and the size of the investments of the recipient of the dividends.

Loan Interest

Interest payable to a foreign resident is taxed at the source of the payment in Russia. Moreover, DTTs might stipulate an exemption from tax in Russia or a reduced tax rate at the source. Exemption and a reduced tax rate do not apply to interest related to the permanent establishment of a foreign resident in Russia.

In a situation where companies are interdependent, interest is exempt from taxation only to the extent which would be agreed to between independent entities; for the remaining excess portion, the accrued interest is taxed as profit tax in accordance with Russian law.

Royalties

Income from royalties paid by a resident of Russia to a foreign resident is subject to Russian taxation at the source of payment. That said, DTTs may envisage tax exemption in Russia or a reduced tax rate at the source. Exemption and a reduced tax rate do not apply to royalties related to the permanent establishment of a foreign resident in Russia.

In the event that the payer of royalties and the recipient have special (dependent) relations, then the amount of income paid in the form of royalties is not taxed only on the portion that would have corresponded to the amount of royalties paid under similar conditions between independent entities.

Beneficial Owner

As a rule, DTTs grant exemption or a reduced tax rate for dividends, interest and royalties provided that the recipient of the income acts as a *beneficial owner*. A beneficial owner is recognized to be any individual or legal entity enjoying benefits of receipt of income. The concept of beneficial owner is intended to limit the application of DTTs in cases when an agent or nominee acts as the recipient of the income, as well as to prevent tax evasion with the help of conduit companies.

The protocol to the DTT signed by Russia and Switzerland on 24.09.2011 specifically contains an amendment prohibiting the use of conduit arrangements, whereby income paid to a resident of a state that is a party to the DTT and which is taxed on preferential terms subsequently is transferred entirely (or almost entirely) to another party which would not be able to take advantage of similar tax benefits if that income were paid to it directly. However, Russian law does not require mandatory disclosure of the end recipients of the income.

Non-Discrimination

DTTs contain provisions aimed at ruling out discrimination. Taxation on foreign citizens or companies from a foreign country in Russia should not be more onerous (discriminatory) in comparison with taxation of Russian citizens or companies in the same circumstances. This rule also extends to the activity of foreign entities which creates a permanent establishment in Russia. The prohibition on discrimination also means that

Russian companies whose capital directly or indirectly belongs to (or is controlled by) residents of a foreign country should not be subjected in Russia to more onerous taxation in comparison with the taxation of other similar Russian companies.

It should be noted that the Russian tax authorities, applying rules on non-discrimination, believe that taxation of Russian companies owned by residents of one foreign country are subject to comparison (non-discrimination) with taxation of companies owned by residents of other foreign countries. Russian court practice follows the path of not applying the provisions on non-discrimination in cases of tax abuse practice (for example, when applying thin-capitalization rules).

Capital Gains

Russian profit tax is levied on income received by a foreign resident from alienation of real property (capital gain) located in Russia. This rule extends likewise to income arising from the sale of shares or other corporate rights in Russian companies whose assets principally consist of real estate located in Russia. Moreover, some DTTs allow one to avoid paying profit tax in Russia in connection with a foreign resident's sale of shares or other corporate rights in Russian companies whose assets principally consist of real estate located in Russia.

Exchange of Information

Most DTTs stipulate that the competent authorities of the contracting states exchange information necessary to implement the provisions of the DTTs or of national legislation of the contracting states concerning taxes to which the DTTs extend, to the degree to which the specified taxation does not contradict the DTTs. Exchange of information is not limited to information on the parties mentioned in the DTTs. Such information may be disclosed in the course of open court hearings or in court decisions. In practice, in some cases, the Russian tax authorities may use the information obtained from the tax authorities of other states against the taxpayers.

Furthermore, Russia is a party to Convention on Cooperation and Mutual Assistance in Tax Matters (Minsk, 1999). In 2011, Russia signed Convention on Mutual Administrative Assistance in Tax Matters (Strasbourg, 1988), which has not yet been enacted by the Russian Parliament.

The List of the Countries which Signed the Double Taxation Treaties with the Russian Federation

Albania
Algeria
Argentina
Armenia
Australia
Austria
Azerbaijan
Belarus
Belgium
Botswana
Brazil
Bulgaria
Canada
Chile
China
Croatia
Cuba
Cyprus
Czech Republic
Denmark
Egypt
Finland
France
Germany
Greece
Hungary
Iceland
India
Indonesia
Iran
Ireland
Israel
Italy
Japan
Kazakhstan
North Korea
South Korea
Kuwait
Kyrgyzstan
Latvia
Lebanon
Lithuania
Luxembourg
Macedonia
Malaysia
Mali
Mexico
Moldova
Mongolia
Morocco
Namibia
Netherlands
New Zealand
Norway
Philippines
Poland
Portugal
Qatar
Romania
Saudi Arabia
Serbia and Montenegro (former Yugoslavia)
Singapore
Slovakia
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Syria
Tajikistan
Thailand
Turkey
Turkmenistan
Ukraine
United Kingdom of Great Britain and Northern Ireland (UK)
United States of America (USA)
Uzbekistan
Venezuela
Vietnam

9. TAX CONCESSIONS AND SUBSIDIES

The Russian law foresees a range of special tax regimes and a variety of tax concessions and subsidies that enterprises, entrepreneurs and investors may become eligible for. The present chapter will not deal in detail with all the special tax regimes (for a general overview we refer to chapter 2 General about Russian Tax Law of the present book), rather this chapter takes aim at presenting the tax concessions available by discretion of the regional governments as well as the special economic zones and innovation centers. Usually tax concessions are granted by a combination of federal and regional laws and hereby the regions are restricted by federal law in the range and type of tax concessions and subventions they may make available. The Russian Tax Code grants Regions the possibility to extend tax concessions in respect to profit tax, corporate property tax, land tax, and transport tax.

The Tax Code especially prohibits regional authorities (as well as any other authorities) granting individual tax concessions that would benefit a particular firm (art. 56(1)). Tax concessions may only be granted in a general form, such that spells out the conditions under which firms qualify for the concession. (Naturally, there might be a temptation to abuse these rules by framing a concession intended to a particular firm in general terms). In addition to those specified types of tax concessions, regions may stimulate investments by way of subventions. The possibility to grant subventions is foreseen in the Budget Code (see below).

Another possibility of stimulating investments is the granting of a so-called tax credit for investment (Tax Code art. 66 and 67) which represents a possibility to defer tax payments over a certain time by way of agreement with the tax office. However, such tax credits have not been granted to any significant extent.

Regional Tax Concessions

By virtue of the Tax Code the regional governments are vested with certain rights to reduce the tax rates on the regional taxes or the part of a tax that goes to the regional budget as follows.

The total tax rate for the Profit Tax is 20 % and it is currently divided between the various levels of government in Russia as follows (art. 284):

Federal government 2 %

Regional governments 18 %

The regional governments are left with the right to reduce the part of the Profit Tax payable to the regional government by 4.5 % down to 13.5 %. This allows for a maximum reduction of the overall tax rate down to 15.5 %.

Regions may reduce the corporate property tax from the maximum rate of 2.2 % down to 0 % (art. 380). We refer to chapter corporate property tax for further details.

Regarding the details about the possible tax concessions on Transport and Land tax we refer to the relevant chapters.

Governmental Subsidies (State Financial Aid)

Governmental financial aid or subsidies can be granted on various levels of the state hierarchy by Russian Federal Government, the regional government, and a municipal council. The extension of subventions is foreseen by the federal Budget Code, other federal budgetary laws and respective regional as well as municipal laws. Some regions have also enacted special laws on stimulating investment, for example, Moscow Region (No. 96/2010-OZ of 23.07.2012) and Leningrad Region (No. 24-OZ of 14.05.2012).

The beneficiaries of the subsidies are categories of organizations (or individual entrepreneurs) defined in the laws (decisions) or named legal entities (especially so in cases of provision of government investing in the capital of firms, "budgetary investments") A relevant investment agreement is concluded between the authority extending the subsidy and the beneficiary company (or individual entrepreneur). Among other things the law (decision) and the agreements must spell out the amount of subsidies, the purpose for which the subsidies are granted and the conditions for enjoying them. As a rule the granting of a subsidy is preceded by the adoption of a relevant program for economic development or similar policy document.

State financial aid or subsidies can come in the following forms: cash injections, investment in capital, credits from the budget, and state or municipal guarantees.

Various federal laws on state supplies foresee a range of possible benefits for suppliers, these include: subsidies, and subsidized credits etc. Such laws are, for example, Law on State Defense Supplies, Law on State Material Reserve, Law on Purchase and Supply of Agricultural Products, Raw Material and Food Staples for State Needs.

Innovation Centers and Other Special Economic Zones

The possibility for establishing a special economic zone is provided by the law on "On Special Economic Zones in the Russian Federation" (Law of 22.07.2005 No. 116-FZ) and other laws (Law No. 104-FZ of 31.05.1999; Law No. 16-FZ of 10.01.2006; Law on Skolkovo Innovation Center, No. 244-FZ; and other laws). The Tax Code also contains special provisions regarding the taxation of the special economic zones.

Presently there are 20 special economic zones as detailed below.

Innovation (technology development) special economic areas:

"Dubna" (Moscow Region)
"Tomsk" (Tomsk Region)
"Zelenograd" (Zelenograd administrative district of Moscow)
"St. Petersburg" (St. Petersburg)
"Innopolis" (Republic of Tatarstan)

Industrial special economic areas:

"Alabuga" (Republic of Tatarstan)
"Lipetsk" (Lipetsk region)
"Togliatti" (Samara region)
"Titanium Valley" (Sverdlovsk region)
"Ludinovo" (Kaluga region)
"Pskov" (Pskov region)

Travel special economic areas:

"Turquoise Katun" (Altai Territory)
"Baikal Harbour" (Buryatia)
"Gate of Baikal" (Irkutsk region)

"Altai Valley" (Altai Republic)

"Tourism Cluster NCFD" (Karachay-Cherkessia, Krasnodar Territory, the Republic of Adygea, Kabardino-Balkaria, North Ossetia — Alania, Dagestan, Ingushetia, Stavropol Territory)

"Russky Island" (Primorsky Krai)

Port special economic areas:

"Ulyanovsk" (Ulyanovsk region)

"Sovetskaya Harbour" (Khabarovsk Territory)

"Murmansk" (Murmansk region)

New tax exemptions will enter into force from January 1, 2014 in order to promote investments in the Far Eastern Federal District and other regions in Russia[132]. This new law differs from the earlier laws regarding special economic zones in that they cover the entire territories of the given regions and not only a specific place as is the case with the earlier laws granting tax exemptions. Moreover, the new law does not make the application of tax exemptions dependent on a specific type of business or industry cluster as is the case with the earlier special economic zone. The criteria for eligibility for the tax exemptions are specified in the law.

Residents of innovation centers and special economic zones enjoy a range of tax exemptions. Typically a resident of a special economic zone would be taxed as follows on the example of Zelenograd:

- Profit tax, 13.5 % until year 2016 and 18 % until 2018; accelerated depreciations; more beneficial treatment of R&D costs
- Land tax, total exemption for 5 years (shipbuilding, 10 years)
- Corporate property tax, total exemption for 10 years (from accounting initiation)
- Transport tax, 0 % 5 years (from registration of vehicle)
- VAT 0 % (for assets used at Zelenograd; otherwise normal VAT regime)

As a rule the special economic zones for innovation and tourism enjoy benefits for employer's social contribution as follows: 2011-2017 14 %, 2018 — 21 %, 2019 — 28 % — for up to 563 thousand rubles (in year 2013). (Percentages indicated as total amounts for all three components of the employer's social contribution).

132 Federal Law of the Russian Federation 30.09.2013 No. 267-FZ // Code of Russian Laws. 2013. No. 40. Art. 5037

The tax regimes for Magadan and Kaliningrad special economic zones may differ in many aspects from what is typical for the other zones. And for Skolkovo innovation center an altogether different (even more beneficial) tax regime is in place.

Participants of Skolkovo Innovation Center (upon being granted the official status as such) enjoy tax concessions for 10 years in respect to:

- Profit Tax, 0 %
- Corporate property tax;
- VAT, 0 % (see below details)
- Land tax, 0 %
- Employer's social contributions 14 % for 10 years (payable only to the pension fund, 0 % for the social and medical fund; a company loses the right for applying this beneficial regime from the month when annual profit exceeds 300 million rubles)

The exemption on VAT means that such companies do not charge their clients VAT for their services and goods, but they are not exempt of paying the VAT that other vendors charge. These companies also need to pay the VAT at customs in connection with imports. They are, however, given the possibility to reclaim the customs VAT which has been incurred in connection with construction works at the Skolkovo innovation center and equipment used there insofar as they are required for the chartered innovation activity at site. Customs duties can be reclaimed in the same manner.

10. CORPORATE PROFIT TAX IN RUSSIA

The Russian laws on taxation of corporate profits are set out in Chapter 25 of the Tax Code. Russian legal entities, as well as foreign legal entities acting through permanent establishments, are subject to profit tax on their taxable income, which is generally determined as gross income less allowable expenses. To be deducted, all expenses have to be economically justifiable and substantiated by corresponding documents. The law stresses a connection between the expense and earned income: expense has to be incurred in connection with generating income. If the deductibility is contested, the burden of proof rests with the tax authority.

Some issues relating to profit tax have been dealt with in other parts of this Awara Guide to Russian Taxes. Reference is especially made to chapters: Accounting and Audit in Russia; Double Taxation Treaties; Permanent Establishment; Tax Registration (Incorporations) and Regional Registration of Subdivisions; Tax Concessions and Subsidies; and Transfer Pricing in Russia.

Taxpayers

All Russian legal entities which are engaged in commercial activities are taxpayers of profit tax for their worldwide income. Foreign legal entities that act in Russia through a *permanent establishment* are also subject to profit tax (see chapter Permanent Establishment). Foreign legal entities that act in Russia without creating a permanent establishment and receive income from sources in Russia are subject to withholding tax (source tax) for the income from Russian sources (see below about Russian source income).

The following kinds of businesses are exempt from profit taxation:

- Foreign legal entities which are recognized as accredited firms participating in the organization of Sochi 2014 Olympic and Para-Olympic Games (for the income gained in connection with the Games). The exemption is valid until 01.01.2017.
- Accredited broadcasting companies of the Sochi 2014 Olympic and Para-Olympic Games (for the income from media activities connected with the Games). The exemption is valid till 01.01.2017.

- Participants of Skolkovo Innovation Center (for 10 years from the date of receipt of such status)
- Entities providing education and medical services (confirming with a list of eligible activities issued by the Government).
- Organizations that are subject to a special profit tax regime (unified agricultural tax; simplified system of taxation; imputed tax).

The Tax Code provides for a number of tax concessions and preferential taxation regimes. These are presented in the chapters General about Russia Tax Law and Tax Concessions and Subsidies of the present book. The chapter General About Russia Tax Law provides a list of all the special taxation regimes intended to stimulate entrepreneurs, small business, certain fields of the economy (such as IT), or certain regions of the country. These tax regimes may be applied for taxation of profit providing the relevant conditions are met.

Individual entrepreneurs are taxed with the personal income tax for their business profits and not the profit tax presented in this chapter. The deductibility of expenses for individual entrepreneurs is however determined in accordance with the rules for corporate profit tax (art. 221). In addition to the default method of taxation by the personal income tax, individual entrepreneurs may also choose a special tax regime such as: simplified system of taxation; taxation by license, unified tax on imputed income; unified agricultural tax; and special tax regimes available for residents of special economic zones.

Tax Rates

The profit tax rates for various situations are as follows:

1.	General rate for corporate profit tax	20 %
2.	Withholding tax (source tax) for non-residents	20 %
3.	Dividends from Russian entities received by non-residents	15 %
4.	Income in relation to international transport (freight) income (operating, maintaining, rent, leasing of vessels, airplanes, other means of transport and containers)	10 %

5.	Dividends from Russian and foreign legal entities received by Russian legal entities (unless participation exemption 0 % is applied)	9 %
6.	Participation exemption: dividends received by Russian tax residents, provided that they have been participating in the company paying dividends: • for not less than 365 consecutive calendar days; • for not less than 50 % of the share capital; • amount of participation gives the right to receive not less than 50 % of all dividends	0 %
7.	Yields from state and municipal securities and mortgage bonds (art. 284(4))	15 %, 9 % or 0 % (the actual rate depends on the date of issue)
8.	Income from securities held on nominee accounts in case when the identity of beneficiary is not disclosed (in force from 01.01.2014)	30 %
9.	Income from the sale or other redemption of certain categories of interests (shares) in the charter (share) capital of Russian companies after such interests (shares) were held for over five years, if such interests (shares) were acquired on or after January 1, 2011	0 %

In reference to what was said above, we remind that taxpayers are eligible for tax concessions and that there are a number of special tax regimes providing for preferential tax treatment and rates subject to meeting the special conditions.

The total tax rate of 20 % is divided between various levels of budget in Russia as follows (art. 284): 2 % is due to the federal government; and 18 % is due to a regional government. The regional governments are left with the right to reduce the part of the profit tax payable to them by maximum 4.5 %. This allows for a maximum reduction of the tax rate down to a total of 13.5 % (see chapter 9 Tax Concessions and Subsidies of the present book).

Profit and Income

The taxpayer's income falls into two major groups: sales income and non-sales income. Sales income is receipts from sales of goods, works, services or property rights (art. 249). Other receipts are deemed to be non-sale income. An open list of receipts subsumed under the latter category can be found in article 250 of the Tax Code. The distinction between sales and non-sales income turns on the different dates of their recognition (art. 271).

At the same time, the law provides a closed list of non-taxable income with the aim to expressly exclude financing items and other receipts from taxable income (art. 251).

The list of excluded (non-taxable) items contains over 40 positions, the most important of which are the following:

- Advances received (when accruals method is used)
- Collateral received
- Equity contributions to charter capital
- Liquidation receipts
- Distributions by a simple partnership to its partner (no more than the amount of the partner's initial contribution to the capital of the simple partnership)
- Withdrawal of equity
- Loan receipts
- Loan repayments
- Gratuitous aid
- Funds received by an agent for the benefit of the principal
- Revaluation gains of securities
- Inter-company asset transfers (subject to certain restrictions)
- Special-purpose financing and other special-purpose receipts
- Property and rights transferred from a reorganized legal person to its successors

Inter-company transfers are transfers that occur between a controlling parent company and a subsidiary. A controlling parent-subsidiary relation is in place when the parent holds an ownership share of not less than 50 %. The transfer can be made in both directions: from the parent to the subsidiary and from the subsidiary to the parent. A condition for using this provision is that such assets are not further transferred to third parties within 1 year (this rule does not concern money received). The transferring party (but not receiving party) can also be an individual.

Special-purpose financing may consist of, for example:

1. Investments received from foreign investors for financing of capital investments for production purposes, when the received assets are utilized within one year from receipt.
2. Investments as the result of investment tenders according to the laws of Russia
3. Funds received from state and regional budgets
4. Grants

Assets under special-purpose financing have to be used according to the designated purpose, as instructed by the donor entity. These assets have to be separately accounted for and failure to do so would lead to taxation of the assets as income from the date of their receipt. The taxpayer receiving special-purpose financing must after the end of the tax year present to the relevant tax office a report on the utilization of this financing (in the form mandated by the Ministry of Finance). It has been determined in court that the special-purpose financing must be utilized in the calendar year when the financing (assets) were received. According to a court such special-purpose financing would have to be utilized by the end of the calendar year even when received at the end of the year (FSUE "State ATM Corporation", Decree of Federal Commercial Court of Moscow district of 09.07.2007, 16.07.2007 No.KA-A40/6343-07-1,2 and ruling of Supreme Commercial Court of 23.10.2007 No. 13535/07). In another case the Supreme Commercial Court has ruled that a temporary deposition of money in bank would not qualify as proper utilization of special-purpose financing (Russian Public Organization "Russian Red Cross", ruling of Supreme Commercial Court of 02.04.2008 No. 4246/08). Assets that have been acquired or created by means of special-purpose financing do not qualify for expense deductions or depreciation (art. 256).

Another form of special-purpose financing is what is referred to as special-purpose receipts ("zelevie postupleniya").These include receipts allocated from the budget to recipients of budgetary funds, and receipts for the maintenance and carrying out of the chartered activities of non-commercial entities. The rule concerning separate accounting also applies. Special-purpose receipts include, among other things:

1. Admission fees and membership fees paid to charities and other non-commercial organizations
2. Contributions to mutual funds
3. Donations that are recognized as such in accordance with the Russian Civil Code
4. Funds received for charitable activity

Expenses

The Tax Code divides expenses into two major groups: sales expenses (connected with production and sale) and non-sales expenses (art. 252). Sales expenses are further divided into direct and indirect expenses (art. 318(1)).

These classifications are merely accounting conventions and do not by themselves result into any restrictions as to the deductibility, but they may affect the timing of the deductibility of expenses. Thus, direct sales expenses are deductible in the reporting (or tax) period in which the income to which the expenses relate is recognized. Indirect sales expenses and non-sales expenses are deductible in the reporting (or tax) period in which they are incurred (art. 318).

In order for expenses to be deductible they have to meet certain conditions, namely, the expenses have to be:

- Be economically justifiable
- Serve the function of generating income
- Be substantiated by relevant supporting documents

Article 252 of the Tax Code establishes that the supporting documents have to be produced in the form as prescribed by the Russian law or by normal business practice of foreign states on which territory the expenses incurred. With recent changes in the law there will be more flexibility for companies to adopt their own templates for the supporting documents. For more details on the requirements to substantiate tax deductions with source documents, please, refer to chapter 5 Accounting and Audit in Russia of the present book.

It should be noted that Russian tax law does not require the proof of direct linkage between income and expenses for the latter to be deducted from the former. In other words, the difference of sources of income and expenses does not preclude the deduction.

Losses

The law recognizes not only expenses intentionally committed by the company as deductible, but also various kinds of losses brought about by unfortunate circumstances.

Such losses are, for example (art. 254(7); art. 265(2))

1. Losses in prior tax periods revealed in the current period
2. Bad debt
3. Losses due to downtime (or stoppages) caused by intrafirm reasons
4. Losses due to externally caused stoppages for which no compensation has been received
5. Expenses in the form of shortages of stock (if there is no guilty person)
6. Losses due to natural disasters, fires, accidents and other emergencies
7. Foreign exchange losses
8. Technological losses
9. Losses within the established norms of natural decrease at transportation or storage
10. Losses resulting from assignments of claim

Recognition of Income and Expenses

Recognition of income and expenses is made in the period in which they arose with the accrual method irrespective of cash settlement. The cash method can be used by small-scale business (art. 273). Companies may use this exemption for small-scale business if on an average during the four prior quarters sales revenue did not exceed the amount of one million rubles (net of Value Added Tax).

The date of receipt of sales income under the accrual method is considered to be the day when goods are dispatched, or services and works are transferred (art. 271(3)).

The Tax Code gives quite precise rules for the recognition of various types of income and expenses (arts. 271-273). According to these rules, the date of recognition may depend on various actions or factors, such as:

1. Date of signing an act of acceptance of delivery of goods, works or services
2. Date of receipt of money in bank or cash account
3. Date of settlement or issuance of settlement documents
4. Terms of financial agreements (e.g. date of interest payment)
5. Last date of tax period
6. Date when income was revealed (for income of prior years)

Stock Evaluation Methods

A taxpayer may choose one of the following methods of stock valuation (art. 254(8)):

- The cost of production of a unit of stock
- The average cost
- FIFO (the cost of first acquisitions)
- LIFO (the cost of last acquisitions)

Depreciable Assets

The law recognizes as depreciable assets those fixed assets and intangibles that have a minimum useful life exceeding 12 months and initial value not less than RUB 40,000 (art. 256). The tax accounting and financial accounting rules provide for similar, but not identical recognition rules.

Depreciable property includes fixed assets and intangible assets. Fixed assets are defined as property used in the management and production and sale of goods and services (art. 257(1)). Intangible assets are defined as assets which are the results of intellectual activity and other intellectual property rights (or the exclusive rights thereto) and which are used in the processes of management, production and sale of goods and services for no less than 12 months (art. 257(3)).

To be recognized as a depreciable asset, the *fixed asset* will have to be used for management, production or sales activities of the company. However, in reference to intangible assets there is in the Tax Code no reference to use in sales activities, although the provision of services as a purpose of their use is included (art. 257(1 and 3)).

The following types of intellectual property qualify as intangible assets:

1. Exclusive rights of a patent-holder to an invention, industrial sample or working model
2. Exclusive rights of an author or other possessor of rights to use computer programs and databases
3. Exclusive rights of an author or other right holder to use an integrated microcircuit topology;

4. Exclusive rights to a trademark, service mark, appellation of origin of goods and company name;
5. Exclusive rights of a patentee to selection achievements;
6. Possession of know-how, a secret formula or process, information on industrial, commercial or scientific experience
7. Exclusive rights to audiovisual works.

It should be noted that the law stresses the words *exclusive rights* as a criterion for recognizing intangible assets, meaning that the relevant intellectual property right belongs to a named person and he has the right to freely dispose of it.

It is improbable that a taxpayer would achieve the conditions for being able to deduct goodwill from the corporate profit tax base. In principle the Tax Code allows (art. 268.1), that goodwill is capitalized in the tax accounts and amortized as an expense over a 5 year period, but this provision is made conditional to the assets having been officially registered as an 'entity of assets' ("imuschestvenny complex"). Such a registration is a cumbersome process of unknown duration, and is rarely done, which means that the provision of deducting goodwill as an expense is a dead letter of the law.

The law especially excludes from the scope of intangible assets certain types of expenditures, namely:

1. Research and Development (R&D), which have not yielded a positive result
2. Individual qualities of employees (intellectual and business qualities, qualifications and capacity for work)

Recognition of intangible assets presupposes that there is proper documentation in place. The documentation will have to confirm the existence of the intangible asset and the exclusive rights to the results of intellectual activity in accordance with Russian law or laws of a foreign country, as applicable. Such documentation may include patents, certificates, trademarks, other protective documents and relevant agreements.

Certain Types of Assets are not Subject to Depreciation:

- Land, water and other natural resources
- Inventory (stock) and goods (i.e. property which is sold or designated for sale)
- Securities and derivatives
- Assets of budgetary and non-commercial organizations used for entrepreneurial purposes

- Assets acquired with special purpose financing
- Assets received for use without consideration_
- Assets temporarily taken out of production process (for more than 3 months)
- Assets undergoing reconstruction or modernization for more than 12 months

Assets are recorded at their historical cost, which is defined as the expenditure for acquiring, erecting, supply and manufacturing of the assets as well as rendering them fit for use, in general excluding VAT and excises (art. 257(1)).

Depreciation

For the purpose of determining the depreciation rates the Tax Code (art. 258) divides all types of fixed assets into 10 depreciation groups, according to their useful lives. By virtue of the Tax Code the Russian Government has issue a depreciated assets classification list(Decree of 01.01.2002 No. 1).

Depreciation Groups	Useful Life	Asset Examples (The items indicated are examples only. The law contains much more asset types for each depreciation group.)
Group 1	1 to 2 years	Hand instruments and tools for construction industry
Group 2	2 to 3 years	Pumps for mining industry, medicine instruments
Group 3	3 to 5 years	Elevators, loading and unloading machines, office equipment (copiers, computers, phones), cars
Group 4	5 to 7 years	Mobile constructions (kiosks), separators, equipment for medicine industry, trucks
Group 5	7 to 10 years	Tanks, gas pipes, industry ovens and furnaces, combiners, harvesters, optic wires systems, limousines
Group 6	10 to 15 years	Steel furnaces, gang saws, forestry industry machines, barges
Group 7	15 to 20 years	Open-heat furnaces, railroad bridges, highways

Group 8	20 to 25 years	Blast furnaces, wharfs, electric locomotives
Group 9	25 to 30 years	Nuclear reactors, passenger ships
Group 10	Over 30 years	Buildings, subway cars, forest shelter belts

The taxpayer is reminded about the need to verify the applicable depreciation group by referring to the relevant decree of the Government. To note, for example, 'buildings' can be found in different depreciations groups depending on the type of the building and materials used.

In case of most fixed assets, a taxpayer chooses a useful life for the fixed asset that falls within the useful life range for the depreciation group to which the fixed asset has been classified by the Russian Government. If an item is not classified to any depreciation group, the taxpayer determines the useful life of such an asset based on the asset's technical characteristics or recommendations from the producer of the asset (art. 258(6)).

For determining the useful life of an intangible asset, relevance will be given to the terms (indication of duration etc.) provided for in patents and certificates as well as to the provisions in Russian law or the law of a foreign state (if applicable) and the relevant agreements between the parties concerning the term of use of the assets in question. If it is not possible to determine the useful life of an intangible asset, then its useful life is deemed to be 10 years.

The applicable depreciation methods are the straight-line method and the reducing balance method. According to the straight-line method the asset value is depreciated in equal yearly increments over a number of years. The straight-line method is mandatory for depreciation of buildings, constructions and transfer mechanisms in depreciation groups 8-10.

The reducing balance method enables accelerated depreciation, because it recognizes a higher depreciation cost early on in an asset's lifetime. Since many assets are most useful when they are new, this method may be a more realistic reflection of an asset's actual value, as well as the expected benefit from the use of the asset. Generally, this method commends itself for those who wish to recognize more expenses (and, respectively, to keep the tax base lower) during the first years of the asset's useful life.

The chosen depreciation method can be changed from the beginning of the new tax period, but a taxpayer can move from the reducing balance method to the straight-line method not more than once within the period of 5 years.

For the straight-line method the depreciation rate has to be determined separately for each item. For the reducing balance method the depreciation is determined separately for each depreciation group (sub-group).

Accelerated depreciation rates are applicable to assets used in a so-called aggressive environment or for assets that are subject to exceptionally high replacement frequency. In these cases the rates may be increased twofold. This increasing ratio of depreciation does not apply, if a taxpayer uses the reducing balance method and his fixed assets are assigned to the first, second or third depreciation groups.

Accelerated depreciation is also available for assets under a financial leasing arrangement, where the depreciation rate can be increased threefold. These provisions apply unless the assets in question are assigned to the first, second or third depreciation group and are depreciated under the reducing balance method (art. 259.3(2)1)). Also, the threefold ratio of depreciation can be applied with respect to fixed assets used exclusively for scientific and technical activities.

A twofold rate can be used by agricultural organizations and residents of special economic zones.

Reduced rates may be used upon management decision (art. 259(4)).

The expenditures for capital improvement and for reconstruction or modernization of fixed assets amounting to not more than 10 % (30 % for depreciation groups from 3rd to 7th) of their original cost can be immediately deducted from the tax base (art. 258(9), Tax Code). However, if such fixed assets are sold within 5 years from the moment of their accounting (entry into exploitation), the amounts of expenditures included in the expenses in the relevant accounting (tax) period shall be re-included in the Profit Tax base.

In the case when the obtaining of title to a fixed asset requires state registration, the asset shall be included in a respective depreciation group from the month following the month in which the item was commissioned, irrespective of the date of its state registration (art. 259(4)).

For an asset acquired on the secondary market, the historical cost can be set taking into account the useful life reduced by the months (years) of operation of the asset at the previous owner (art. 258(7)).This option is available only for assets depreciated by the straight-line method.

Deduction of Capital Losses

Losses from the sale of fixed assets (including transaction costs) are deductible over the remaining period of the originally determined useful life in the seller's balance (art. 268(3)), whereas losses from sales of other assets are deductible in the period when they are sold.

Expenses in the connection of repair of fixed assets are fully deductible in the period they were incurred (art. 260). But in order to spread the expenses more evenly over the years, the taxpayer may create a reserve for upcoming repairs in accordance with article 324 of the Tax Code.

Reserves

The Tax Code allows to make certain reserves for future or doubtful expenses. According to the law the following kinds of reserves are available: reserve for warranty period repairs and warranty service; bad debt reserve; vacation salary reserve; reserve for future expenses on research & development; reserves for future expenses on commercial activities (available for non-commercial organizations).

Bad Debt Reserve

The terminology in the Tax Code calls the debt for which reserves are made as doubtful debt, and debt, which has finally turned out to be impossible to collect, is named Bad Debt (due to bankruptcy or expiration of statute of limitations and for other reasons).

The reserve for doubtful debt can be made for any indebtedness, including trade credits, that has not been settled within the agreed times, and that is not secured by any collateral, pledge, security or bank guarantee.

Debt in the form of unpaid interest income cannot be included in the reserve, except for in the case of banks.

The deductible reserve increases progressively depending on the maturity of the debt as follows:

- Debt outstanding 90 calendar days or more — full amount of debt may be reserved
- Debt outstanding 45-90 calendar days — 50 % of the amount of the debt may be reserved
- Debt outstanding less than 45 calendar days — no reserve allowed

The maximum allowance for the reserve is limited to an amount equal to 10 % of the sales revenue in the relevant period.

The amount of reserve may be carried forward to the next tax period. Any reduction in the amount (as a result of corrections, etc.) will have to be included in the income for the period, whereas any increase should be included into expenses.

Warranty Repair and Warranty Servicing

Companies extending repair guarantees (repair warranties) may create a reserve for future expenses connected with warranty repair and warranty servicing (art. 267, Tax Code). In order to create a reserve, the company has to determine the rules for the applicability of the reserve and its maximum amount in the tax accounting policy.

It is a condition of the reserve that the actual sales contracts contain provisions of such warranties (guarantees).

The limit of the amount of the reserve is a product of the share of expenditures for warranty-related repairs in the company's income from warranted goods (or works) for the previous three years and gains from the sales of goods and works in question during the accounting period (art. 267(3)).

In the case that the company has engaged for less than three years in sales of warrantable goods then the limit is determined based on the sales in the actual period, In this case, the company has to draw a plan of fulfillment of guarantee obligations, and the expected expenses have to correlate with this plan. After the end of each tax year the reserve will be adjusted in accordance with the expenses actually incurred for warranty works and the volume of sales. As the warranty period expires, the amount of the reserve which has not been used will be credited into the non-sale income for the period.

Vacation Salary Reserve

From 2002 on taxpayers were able to make a reserve for vacation salaries (art. 324.1). In practice the possibility to make such a reserve is limited. This because the law mandates that at the end of the year the reserve has to be terminated and any unused balance of the reserve has to be credited into income. From the new tax period the reserve can be built up again with monthly transfers. As vacations are usually taken in the middle of the year the provision of the reserve would be more valuable if the time cycle of the reserve would match the time of actual vacations.

Carry-Forward of Losses

Losses from previous tax periods may be carried forward and deducted from future profits (art. 283). The loss carry-forward is available for 10 years following the year in which the loss occurred. Hereby supporting accounting documents will have to be kept going back to all the periods to which the loss refers to. However, losses from sales of securities and fixed-term financial instruments are accounted separately and are carried forward separately in accordance with the loss carry-forward rules applicable to other tax losses.

Tax losses incurred in separate tax periods are carried forward and used in the order in which they are incurred (art. 283(3)).

The benefit of carry-forward of losses will pass on to any successor company formed in the process of reorganization or mergers according to the more detailed provisions of the law.

From 01.01.2011 those taxpayers whose income is subject to 0 % rate cannot carry forward any losses incurred during the period when this rate is applicable (art. 283(1)).

Interest on Borrowed Funds as Expenses

The law recognizes as deductible the interest paid on any debt liabilities, regardless of their form, be it bank loans, trade and commercial credits, securities, other loans or borrowings (art. 269(1)).

The deductible interest is, however, restricted to the comparable average interest rates charged on the market (arm's-length principle). A deviation of more than 20 % from the market rate may lead to an adjustment for the taxation purposes.

When there is no information available on comparable market rates (or at the taxpayer's choice), then the cap on the interest allowed for deductions is limited by formal criteria. The limit for interest denominated in rubles is the prevailing refinancing rate of the Russian Central Bank multiplied by 1.1. For debt in foreign currency the 15 % rate is applied.

However, there have been enacted in the Tax Code several deviations of temporary character so that that the maximum deductions are set differently as per below:

<u>Loans in foreign currency</u>

- For period 01.01.2010-31.12.2010 maximum deductibility 15 %
- For period 01.01.2011-31.12.2014 maximum deductibility Russian Central Bank refinancing rate multiplied by 0.8

<u>Loans in Russian rubles</u>

- For period 01.01.2010-31.12.2014 maximum deductibility Russian Central Bank refinancing rate multiplied by 1.8

To note, transfer pricing rules also apply to interest deductibility, as well as the thin-capitalization rules discussed below.

All direct expenses connected with the arrangement of the loan are deductible expenses. Such are for example transaction fees, commitment fees and penalties.

Thin-Capitalization Rules

The Tax Code provides for so-called thin capitalization rules that aim to prevent foreign companies from evading payment of profit tax by repatriating profits from Russian subsidiaries in the form of excessive interest on debt instruments instead of taxable dividends (Items 2-4, Article 269). Indeed, since interest is deemed to be a deductible expense for a Russian borrower, it may reduce the tax base for profit tax, whereas dividends may not. Moreover, as a rule, dividends are subject to source tax in Russia, which means that the Russian subsidiary is required to withhold profit tax upon payment of dividends to its shareholders. Interest is therefore a more advantageous form of repatriating profit for taxpayers than dividends.

Controlled debt

The thin capitalization rules are applicable under the following conditions:

(a) debt financing is provided by a foreign company that directly or indirectly owns more than 20 % of the Russian company;
(b) debt financing is provided by a Russian affiliate of such a foreign company; or
(c) the repayment of the loan is guaranteed or secured in another way by such foreign company or its Russian affiliate notwithstanding who is the creditor.

In cases when the debt corresponds to the above-mentioned criteria, it is called "controlled debt."

Debt from foreign affiliated company

The debt financing provided by a foreign affiliate (as opposed to a Russian affiliate) of a foreign shareholder is not regarded as controlled debt. Lately, however, the Ministry of Finance has taken the position that upon taking loans from a foreign affiliate of a foreign shareholder, such loans would also have to be counted as controlled debt (Letter of the Ministry of Finance of 27.11.2009, No. 03-08-05).

The above-mentioned position of the Ministry has found support in as following court resolution. In a resolution of February 2012 the Federal Commercial Court of Moscow in the case involving Naryanmarneftegz LLC, declared that the amount of debt to a foreign affiliate should be counted as controlled debt (FCC MC Resolution № A40-1164/11-99-7 of 27.02.2012). The resolution was motivated by reference to the consideration that the ultimate source of the financing was a company for which the financing would have been considered controlled debt if this company had extended the loan directly to the end borrower. It was thereby claimed that the foreign affiliate was used as a conduit exclusively for the purpose of creating formal conditions to avoid falling under the applicability of the thin-capitalization rules. The scheme was thus considered as an attempt by the creditor to gain an unwarranted tax benefit, based on which the court held that the transactions would have to be taxed according to their real essence by applying the thin-capitalization rules.

It follows from the above discussion that this court resolution should not as such be interpreted as extending the rules of thin-capitalization to cover financing extended by foreign affiliated companies. Rather it should be seen as an instance of application of the taxation principle of rejection of an unwarranted tax benefit which basically is an anti-avoidance rule, and a manifestation of the principle that taxation of transactions should be made according to their real essence, that is, putting substance over form. The real test, then, should be if there has been a real commercial justifiability of financing being received from the foreign affiliated firm. Commercial justification can be confirmed, for example, by the following types of circumstances:

- that the affiliated firm functions as a real financing center of a group of companies;
- that the affiliated firm takes on real commercial risks in connection with extending the financing and has its own resources (staff and other assets);
- other considerations that point to independent activities on the part of the affiliated firm.

Application of thin-capitalization rules

The application of thin-capitalization rules requires measuring the ratio between the net assets of a Russian entity paying interest, on the one hand, and the debt provided or secured by the foreign owner and its Russian affiliates (controlled debt), on the other hand. A thinly capitalized entity is thus one whose assets are funded by a high level of debt and relatively little equity.

If the controlled debt exceeds the Russian borrower's net assets threefold or more, then the deductibility of interest paid on the controlled debt is limited. All interest exceeding this limit will not reduce the Russian debtor's profit tax base and will be subject to profit tax as dividends. An exception is made for banks and leasing companies for which the thin capitalization rule is applied if the controlled debt exceeds the amount of nets assets by more than 12.5 times. The law provides a formula to calculate this limit in two stages, as described below.

Step 1.

The calculation of the capitalization coefficient (CC):

$$CC = \left(\frac{CD}{EB \times S\%}\right) \times \frac{1}{3}, \text{ where}$$

CD is Controlled Debt
EB is Equity of Borrower
S% is percentage of shareholding

For banks and leasing companies the latter part of the formula is slightly different, reflecting the higher coefficient of permissible debt:

$$CC = \left(\frac{CD}{EB \times S\%} \right) \times \frac{2}{25}$$

<u>Step 2.</u>

The calculation of the admissible limit on the interest paid (AL):

AL = RI/CC, where:

RI is the amount of interest really paid
CC is the capitalization coefficient.

The positive difference between real interest (RI) and the allowed limit (AL) is treated as dividends and is subject to Profit Tax at the source of payment (art. 269(4), Tax Code). (It should be noted that if the equity are zero or less, then all the interest will be deemed non-deductible and will be taxed as dividend (Ministry of Finance Letter No. 03-03-06/1/319 of 30.05.2011).

The law states that a taxpayer should determine the maximum degree of interest for controlled debt for the final day of each reporting (tax) period (art. 269(2)). The law's provisions do not designate unambiguously whether the taxpayer is entitled to recalculate based on the results of the taxation period (year) the amount of deductible interest for the whole year if the controlled debt exceeded the borrower's net assets threefold or more at the ends of the reporting periods (quarter, 6 months, 9 months), and therefore deductible interests were limited, but stopped exceeding the indicated threshold for the end of the tax period. This situation can occur specifically if the taxpayer substantially increases its own capital in the final quarter of the year. In the recent case involving ZAO Er-Telecom Holding, the Supreme Court of Arbitration put this matter to rest (case No. A50-4254/2012).

The essence of the case boiled down to the following. Er-Telecom Holding had controlled debt to a foreign parent company; the amount of this debt over a year exceeded the amount of Er-Telecom Holding›s own capital by a factor of greater than 3. In this connection, the deductibility of interest paid on the controlled debt was limited. All interest exceeding this limit did not reduce Er-Telecom Holding›s profit tax base. Upon the annual results, Er-Telecom Holding improved the correlation between its own capital and the controlled debt, and stopped exceeding its own capital. Er-Telecom Holding contented that since the taxation period for profit tax lasts one year, it was entitled to recalculate the interest taken for profit tax purposes for the entire year, and treat it in full as expenses for profit tax purposes.

The tax inspectorate disagreed with that approach, and stated that calculation of the maximum value of the interest recognized as an expense is done for each quarter on a discrete basis, and a taxpayer is not entitled to recalculate the value of quarterly maximum interest based on the annual results. In that case, in the tax inspectorate›s view, Er-Telecom Holding was able to accept in full the interest on the controlled debt only on the results of the 4th quarter, but not at all for the entire year. The Supreme Commercial Court backed the tax authorities in this dispute, and stated that a taxpayer was not entitled to recalculate the amount of maximum interest counted for each quarter based on the annual results.

Contesting the applicability of thin-capitalization rules based on a relevant double taxation treaty

Many experts have brought up the possibility of contesting the applicability of thin-capitalization rules in reference to the nondiscrimination clauses that double taxation treaties (DTTs) usually contain. According to a non-discrimination clause, a company resident in one of the treaty countries cannot be subjected to any taxation requirement which is more burdensome than the taxation to which nationals are subjected in the same circumstances.

The OECD model DTT contains such a non-discrimination clause. Most of the DTTs concluded by Russia are based on this OECD model DTT and therefore include a similar non-discrimination clause. Such a clause is e.g. in the DTTs that Russia has concluded with Germany, Finland, and France. Based on the non-discrimination clauses, it indeed seems that the thin-capitalization rules should not be applied when the investor is a resident of a country with which Russia has concluded a DTT containing such a clause.

Before 2011, taxpayers quite frequently used a reference to the DTT non-discrimination standards as protection from applying the thin capitalization rules to debt but in 2011, the Supreme Commercial Court handed down a precedent-setting decision which restricted the possibility for taxpayers to evade application of thin-capitalization rules on the basis of a DTT (Resolution No. 8654/11 of the Presidium of the SCC in the case of Severny Kuzbass Coal Company v. the Tax Inspectorate of 15.11.2011). In the Severny Kuzbass case, the provisions of the DTTs with Cyprus and Switzerland were considered, including the provisions contained therein on the non-discrimination clause. The Supreme Commercial Court ruled that the provisions on the non-discrimination clause contained in the mentioned DTT do not rule out the application of national rules aimed at fighting tax evasion. The SCC classified the thin-capitalization provisions also among such national rules.

The court stated that the features of thin capitalization are as follows:

(i) a high share of the debt of the Russian borrower;
(ii) affiliation of the borrower and creditor;
(iii) the debt obligation remaining outstanding.

In the court's opinion, these features correspond to the concept of "associated enterprises," for which DTTs introduce a special profit tax procedure in view of the presence between them of special commercial and financial relations (Art. 9 of the DTT with Cyprus and the DTT with Germany). Such a special procedure subsists in the fact that any profit which might have been accrued to one of the enterprises, but which was not accrued due to the special relations, can be counted as profit of that enterprise and, correspondingly, taxed accordingly.

According to the OECD's commentary on the model convention, the above article on associated enterprises does not prevent the application of national rules on thin capitalization insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. Moreover, the article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital. Proceeding from this, the court concludes that the standards of the non-discrimination clause do not restrict the application of thin-capitalization rules.

We would like to point out that the standard of the non-discrimination clause contains a provision under which Russian enterprises with foreign capital should not be subjected in Russia to taxation that is different, or more onerous, than the taxation to which other *similar* enterprises in Russia might be subjected (art. 24.4 of the DTT with Cyprus). The court held that this provision did not restrict the application of thin-capitalization rules, as the latter are applied to all Russian organizations using foreign capital without exception. In other words, the court held that *similar* enterprises with which an enterprise using foreign capital should be compared, are other enterprises with foreign capital as opposed to companies with Russian capital. In other words, thin-capitalization rules, although they impose more onerous rules on companies with foreign capital than on companies with foreign capital, none the less this does not constitute discrimination, since they do not single out some companies using foreign capital among other companies using foreign capital.

Securities

Under the rules for taxation of securities fall all kinds of securities, both those that are publicly traded and those that are not (art. 280). Interest on securities is deductible under the general rules (art. 269). Expenses in connection with the issuance of securities, preparation of an emission prospectus, administration costs for the new issue and registration are all deductible expenses (art. 265).

Special rules exist for:

1. Taxation of transactions with state and municipal securities (art. 281)
2. Taxation of REPO transactions (arts. 282, 333)
3. Taxation of brokers and dealers (professional participants of the securities market) (arts.286, 299)
4. Creation of reserves for devaluation of securities by professional participants of the securities market (art. 300)
5. Taxation of derivatives, including futures, options and forward contracts (the general term for all these in the Tax Code is "term contracts") (arts.301-305, 326, 327)
6. Taxation of hedging operations (arts. 301, 304, 326)

The transfer pricing of securities and derivatives are subject to special rules. The Loss carry-forward rules are set separately for listed and non-listed securities and derivatives. For persons who are not professional participants of the securities market, losses and gains from listed and non-listed securities cannot be offset against each other.

Factoring

The law expressly recognizes the possibility of a sale (transfer) of receivables at a discount (factoring). The difference between the nominal value of the receivable and the transaction price is deductible depending on the maturity of the receivables within the limits set by the law (art. 279).

The deductibility of the loss on transfer of receivables that are not yet due is restricted to the amount of interest rate that would have been paid, if the creditor had received a corresponding amount of debt financing instead. For transfer of overdue debt, 50 % of the loss is deductible upfront and the remaining 50 % are deductible over a period of 45 calendar days after the transfer. The transaction price of receivables becomes fully deductible in a subsequent sale for the company that acquired the receivables.

The income at the receiving party (factor's income) is recognized only at the moment of resale of the receivables or settlement thereof by the debtor. The accrued interest is, however, recognized as income when accrued.

Management Services Agreements

A company may in principle deduct from the profit tax base the costs for management services and cost-sharing agreements. Russian tax authorities are, however, known to be prone to challenge the deductibility of such costs and therefore there is always a special risk involved with such arrangements, as evidenced by court practice.

According to the Tax Code deductibility requires that the costs are: (i) economically justifiable (i.e. necessary to generate income) and (ii) properly documented (Paragraph 1 Article 252, Paragraph 1 Article 264 of the Tax Code).

In practice, the tax authorities very frequently cast doubt upon the deductibility of management costs. The most widespread of their requirements are the existence of a formal report on the results of the rendering of services, as well as a statement on rendering of services, signed by the client and executor (see the section Uniform Source Documents). The absence of a report and a statement on rendering of services is commonly viewed by them as being equivalent to the absence of the rendering of the services themselves. From the standpoint of court practice, as a rule, a report is not required if such a report is not envisaged by an agreement (for example, the case of Open Joint Stock Company Silovye Mashiny — ZTL, LMZ, Elektrosila, Energomasheksport Ruling of the Federal Commercial Court of the Northwestern Circuit in case No. *A*56-2942/2008 dated 15.01.2009 and Ruling of the SAC RF dated 27.04.2009 No. SAC-4853/09).

In addition to this, very often the tax authorities reject the idea that it is advisable for a company to bear costs for management services, including in the event that such services are rendered by a foreign parent company. As often as not, the argument used in practice to reject recognition of costs for services as deductible is an indication that the taxpayer has employees on staff who perform functions similar to the services rendered. Furthermore, the tax authorities have declared themselves against recognizing as deductible expenses on auditing accounting records if the keeping of such is not mandatory for the company. The tax authorities are also known to have challenged the deductibility based on the argument that the expenses are not economically justifiable in case the services rendered duplicate the functions of the company's management or employees.

Expenses for remuneration under contracts with a so-called management company to which the functions of company general director have been transferred might be accepted as management costs. Concerning remuneration of the members of the boards of directors of Russian companies, the tax authorities believe that such remuneration cannot be considered deductible in the absence of a contract concluded between the company and the director.

More than once, courts have expressed the view that the tax authorities are not entitled to inspect the economic advisability of companies' bearing some expenses or other (for example, "Institute of Management", RF Constitutional Court ruling No. 366-O-P of 04.06.2007). Very often, during disputes with the tax authorities, taxpayers have to prove the following regarding acquired services:

1. Documentation of the rendering of services. That said, it is not sufficient to furnish merely an invoice for services rendered. It is important to have on hand, at a minimum, a contract and statement on rendering of services (bearing all the established requisites) which could confirm the nature, scope and cost of the services rendered.
2. The reality that the services were actually rendered. The first thing indicating this reality is the existence of documentary support. The reality can be confirmed by preserved correspondence, reports, presentations and so forth.
3. The acquisition of benefits obtained by the taxpayer through acquiring the services. As often as not, an increase in company profit during the periods succeeding the period in which the services were rendered appears to be a persuasive argument for a court. However, obviously not merely any services lead to an improvement in companies' financial indicators, nor does this always occur.

In a recent case, the tax authorities attempted to contest the deduction of various inter-company charges covering procurement, management, consulting, IT and software, marketing and other operational costs incurred by a foreign head office for the benefit of the Russian subsidiary of the Royal Bank of Scotland (RBS Bank JSC, Ruling of the Commercial Court of the Northwestern Circuit No. A56-94331/2009 dated 19.04.2011). The amount of charges was determined on the basis of the specific cost allocation methods set forth by the underlying services agreements. The total amount of contested charges was around US$41 million. The court upheld the taxpayer's position and allowed the deduction of costs due to a number of reasons, in particular:

The costs were supported by documentation, including acts of reconciliation with the attached list of projects and services provided; invoices for the services provided; acts of acceptance for the services provided; memoranda on the fulfillment of relevant service agreements signed by the parties; a list of accounts under the agreements, and an outline of the products delivered thereunder.

The supporting documentation provided by the taxpayer met the applicable requirements of Russian accounting legislation and allowed reliable determination of the volume and cost of the services provided.

The taxpayer lacks its own analyst group, service infrastructure and other units which would allow it to manage the business and personnel on its own (the taxpayer had a total headcount of 371 in Russia, whereas other Russian banks with a similar ranking had a headcount of about 6,000).

The assets and profits of the taxpayer increased during the period of the provision of the services.

The software products delivered and/or serviced under the agreements were actually used by the taxpayer in its activities and some of the products did not have Russian analogues.

The taxpayer is a member of an international banking group and has to meet its operating standards as stipulated by the parent bank and provide the services to the clients on a uniform level.

In a different case, the tax authorities challenged the deduction of inter-company consulting (management) fees paid by JSC Shell Oil, a Russian subsidiary of Shell, to a Shell service company located in the UK. The services provided included business support consulting, management consulting, and consulting on R&D and technical assistance. The tax authorities argued that the service fees were not economically justified and lacked proper documentation. The taxpayer won the case in the courts of first and second instance, but the court of third instance overturned the decisions of the lower-ranking courts and returned the case to the first instance for a new examination ("Shell Oil" JSC, Ruling of the Moscow District Commercial Court No. KA-A40/2152-11 dated 21.04.2011).

In brief, the court of third instance instructed the court of first instance to re-examine the documentation presented by Shell Oil to support the services provided. The court stated that the contents of the documents presented (invoices and acts of acceptance), which were made in accordance with UK rules and business practice, were not sufficient for Russian tax purposes, where they had to conform to the applicable Russian legislation and documentation requirements.

Furthermore, the court stated that the content of documents must allow it to ascertain:

(i) the specific matters upon which the UK service provider advised
(ii) the volume and nature of the services provided, and
(iii) the accuracy of the calculation of actual service fees (presumably, the pricing)

In regard to the taxation of management services, it should be noted that in addition to the question of deductibility of expenses from the profit tax base, other taxation issues may also arise. When the services are rendered by a foreign entity, the risk may arise that the activities could lead to a taxable permanent establishment in Russia for the foreign party. This would mean that the parent company itself would be taxed on the proceeds from the management services. This risk may come about if the services are rendered by staff physically present in Russia. There is also an issue of VAT in connection with such services (see the chapter 11 Value Added Tax in Russia of the present book).

Payroll Expenses (Labor Expenses)

The law provides, in principle, for the deductibility of all expenses connected with payment of labor (pay-roll expenses; art. 255).

The deductible expenses can be paid in cash or in-kind. These expenses may include any bonuses and incentive payments if a relevant provision is included in the employment contract (or an applicable collective bargaining agreement). Salaries, bonuses and other pay-roll expenses can also be regulated in a relevant company policy or instruction. Under Russian labor law companies shall have in force special policies or instructions regulating various issues in relation to the employment and human resources management.

The law provides for a list of expenses that are expressly deductible. There is also a list of expressly non-deductible pay-roll expenses. The division between deductible and non-deductible expenses is, however, not clearly distinguishable in view of the many exceptions to the rules, and in view of the general rule of the Tax Code which allows for the deductibility of all justifiable expenses.

There is quite a wide recognition that all pay-roll expenses are deductible, provided that they are mentioned in the employment agreements (collective agreements) or the relevant policies and instructions.

In below tables we list the expressly deductible and the expressly non-deductible pay-roll expenses, respectively.

Expressly deductible pay-roll expenses (art. 255):

1. Basic pay (salary, piece rates, pay as percentage of sales etc) in accordance with a documented system of compensation in force as envisaged by relevant policies and rules
2. Incentive payments, bonuses, based on objective and subjective indicators in accordance with a bonus and incentive policy
3. Supplementary pay relating to the working regime or special conditions of work (pay for night work, shift work, for combining of jobs, for work under harsh working conditions, overtime, work on holidays)
4. Payment of work performed by non-staff members, including so-called civil contractors or free-lancers
5. Compulsory insurance payments and voluntary insurance with restrictions (see below)
6. Compensation for unused leave
7. Severance pay and other compensations at redundancy
8. One-time remuneration for long service
9. Payments for periods of forced leave
10. Sick leave compensations (with restrictions)
11. Insurance
12. Benefits paid out for social reasons
13. Other expenses specified by the employment contract and (or) collective agreement

Free use or compensation of housing, utilities, meals, food and other items provided for free are deductible only when this provision is stipulated in other laws.

Goods handed out for free to employees or at subsidized prices, such as working clothes and uniforms for personal use of the employee are deductible only when specifically provided by special law.

<u>Expressly non-deductible pay-roll expenses (art. 270):</u>

- Any types of remuneration provided to management or employees in addition to the compensation stipulated in the employment agreements, collective agreements, or relevant policies
- Compensation for any kind of additional leave provided for by a collective bargaining agreement
- Additional pension in excess of stipulations in the law
- Compensation for increases in the cost of meals or the provision of such meals at reduced prices or free of charge (except for special cases in the law and except when stipulated in the employment agreement)
- Payment for travel to and from a place of work by public transport (except when stipulated in the employment agreement)
- Compensation of differences in price when goods are sold to employees at lower than market prices
- Expenses for personal services or goods for the use of employees, such as payment for vouchers to medical treatment or recreation, excursions or travel, attendance at sports clubs, study groups or arts clubs, visits to cultural and entertainment or sporting events, subscriptions to press (except technical and normative literature)
- Relocation allowance in excess of norms
- Representation expenses that do not qualify as deductible or exceed the limits set in article 264 of the Tax Code (limit 4 % of Pay-Roll costs)
- Compensation for the use of private cars in connection with work in excess of the norms (norms very insignificant)
- Compensations to members of Board of Directors
- Other types of expenses occurred for the benefit of an employee not provided for by an employment contract or a collective agreement

It is hard to find any logic behind this listing of expressly deductible and expressly non-deductible pay-roll expenses especially as the list of deductibles ends with the provision: "other types of expenses incurred for the benefit of an employee provided for by an employment contract or a collective agreement". At the same time there is the general rule of the profit tax in accordance with which all justifiable expenses are deductible if properly supported by documents in the form prescribed by the Russian law. We would conclude that the existence of such lists of deductible and non-deductible pay-roll expenses is just a vestige of the earlier Russian tax legislation and even the Soviet past and traditions. The decisive thing ought to be the economic justifiability of the expenses and proper documentation. It is therefore important to accurately specify all compensations and expenses in the employment agreement, or in relevant company policies or rules on expenses reimbursements, salaries incentives, etc. The employment agreement should in any case make reference to these policies or instructions.

It is also important to review the deductibility of pay-roll expenses from the point of view of profit tax against the provisions of personal income tax and employer's social contributions.

Business Trips and Daily Allowances

The employer has an obligation to carry all justifiable costs connected with business trips and also extend a daily allowance (per diem) for each day of business trip. When duly documented and economically justifiable, the costs will be fully deductible.

In terms of profit tax there exist no more, following a change of law in 2009, any limits as to the permissible amount of deductions. According to the law in force daily allowances are now fully deductible within the limits foreseen by an employment agreement or a relevant company policy.

Payroll Related Insurance

Compulsory insurance fees, i.e. the insurance that an employer is obliged to contract according to the Russian law, are fully deductible. The same is valid for all employer's mandatory social contributions (see chapter Employer's Social Contributions). Deductions on voluntary insurance are restricted by detailed provisions in the law as will be referred to below.

The first requirement for deductibility is that the insurer possesses a license in accordance with the laws of Russia. Therefore pay-roll related insurance payments paid abroad are non-deductible.

The following forms of voluntary insurance are deductible (art. 255):

1. Life insurance, under following conditions:
   - agreements concluded for no less than 5 years with Russian insurance companies having special licenses
   - during the first 5 years of the policy no reimbursements are allowed (payments to beneficiaries in case of death or bodily injury are allowed)
   - deductions in total are limited to 12 % of the employee's total pay-roll expenses. (The 12 % restriction will also include any payments as per item 2 below) premiums paid by an employer for the benefit of an employee for voluntary life insurance that are taken out exclusively in the event of the insured death or bodily injury are deductible up to RUB 15,000 per insured per year.

2. Pension savings plans, under following conditions:
   - deductible only when the reimbursements or pension payments start from the date when the person achieves the statutory pension age (or other statutory conditions) according to the Russian law deductions in total are limited to 12 % of the employee's total pay-roll expenses. (The 12 % restriction will also include any payments as per item 1 above

3. Medical insurance, under following conditions:
   - insurance contract concluded for a period of no less than 1 year
   - insurance provides for the payment of health-care and medicine for the insured
   - deduction restricted to 6 % of the employer's labor expenses

All other medical insurance premiums are non-deductible

4. Work-related accident insurance
   - insurance in case of death or permanent disability caused by accident relating to the job
   - deduction restricted to RUB 15,000 annually per one insured person

In case an insurance (items 1 and 2 above) that originally was set up as deductible is later amended so that the conditions for deductibility would no further be met, then the previous expense deductions would have to be reinstated in the income for the period (with the exception of cases of *force majeure).*

Property Insurance

All expenses on compulsory insurance of property are deductible within the types of insurances as foreseen by Russian laws and international conventions, which latter are interpreted by the tax authorities in a very restrictive manner. The wording of the law on voluntary insurance of property seems to favor an interpretation that it provides for a closed list of deductible insurance expenses (art. 263). This interpretation is reinforced by the fact that there is separately an open list of non-deductibles (arts. 270; 291 (20.1)). The main condition for deductibility of voluntary property insurance is that the underlying asset is used in production or sales of goods and services.

Deductible expenses on voluntary insurance of property must refer to any of the following (art. 263):

1. Means of transport (water, air or land transport, pipelines) owned and rented vehicles;
2. Fixed assets (including intangible assets and construction in progress);
3. Voluntary cargo insurance;
4. Risks in connection with carrying out construction and assembly works;
5. Inventory, crop harvests and animal husbandry;
6. Other assets that generate taxable income;
7. Insurance of liability for damages, in case such an insurance is a precondition for conducting business activities in accordance with Russian law or international obligations of the Russian Federation or generally accepted international requirements;
8. Insurance fees relative to the risk of death or disability of a borrower from a bank (art. 291(20.2));
9. Voluntary insurance of the risk of liability for non-performance or undue performance of obligations on the financing or construction of Olympic infrastructure (with respect to Sochi 2014 Olympic and Para-Olympic Games);
10. Voluntary insurance of certain property interests associated with the circulation of bank cards;

11. Voluntary insurance of export credits and investments against entrepreneurial or political risks;
12. Voluntary insurance with a view to finance measures laid down in a plan for the prevention and elimination of oil and oil products spills;
13. Other types of voluntary property damage insurance where, as stipulated by the applicable laws of the Russian Federation, such insurance is a precondition for the taxpayer to carry on its activities.

Research and Development

A new law containing tax measures to stimulate investment in commercial research and development increasing the deductibility of corresponding expenditure has come in force from 01.01.2012 (art. 262 and 267.2); some of the provisions of the new law apply from 08.06.2011, or retrospectively).

The major change is that there now is right to deduct R&D costs regardless of the success that the activity has yielded in the period when R&D was undertaken (under the old law such costs were to be deducted in equal installments over the year following completion of the relevant R&D).

Other significant provisions of the laws on taxation of R&D expenditure include:

(i) The right *in certain fields of activities* to deduct R&D expenses at a multiple of 1.5 (that is, deduct 50 % more than the actual expenses); such activities comprise among other things:
   - Bio-information technologies
   - Bio-catalytic, bio-synthetic and bio-sensor technologies
   - Cellular technologies
   - Nanotechnologies
   - Nuclear power, nuclear fuel cycle technologies, etc.

(ii) New rules for how to account in taxation for the costs incurred in acquiring exclusive rights to intellectual property (which are recognized as intangible assets) as a result of R&D

(iii) The right to set up reserves for future R&D costs

The right to use the stimulating coefficient of 1.5 in deduction of R&D expenditure is limited to the areas included in a special government-approved list. To benefit from this provision, the taxpayer will need to submit to the tax authorities a report describing the work performed.

The taxpayer may choose how to book costs incurred in acquiring the R&D derived exclusive rights to intellectual property: the costs may either be depreciated in the usual manner or deduct them as other costs over a period of two years.

The R&D reserve can be created for a specific R&D program for a maximum period of two years (after which the remaining value of the reserve must be reversed if not fully expended). The maximum amount of the reserve is to be calculated as the company's sales income multiplied by 3 percent less expenses incurred by the taxpayer in connection with the formation of the Russian Technological Development Fund. If a R&D reserve is set up, then the taxpayer books all current R&D costs against the given reserve. If the R&D expenses were deducted with the 1.5 ratio, then they are included in the initial value of the intangible asset with the same 1.5 ratio. In case this intangible asset is sold within 5 years after recognition, then the R&D expenses previously included in its initial value with the 1.5 ratio must be reinstated and included in the tax base (as non-sale income).

Deductible R&D expenses may include, for example:

- Depreciation of fixed and intangible assets used for R&D (except for buildings and construction structures)
- Pay-roll expenses relating to employees engaged in R&D activities (for each program separately);
- Material expenses directly connected with R&D activities
- Other expenses directly connected with R&D activities that in total do not exceed an amount equal to 75 % of the above mentioned pay-roll expenses (to note, that expenses above this limit can be expensed in the period of finalizing the project);
- Costs of R&D work performed by third parties (subcontracting, outsourcing)
- Contributions to the Russian Technology Development Fund and other industry and cross-industry funds for R&D financing created under the Federal Law «On science and governmental Research-and-Technology policy» that in total do not exceed 1.5 % of the income from sales determined under the article 249 of the Tax Code

Following the amendments to the law there are now more comprehensive tax accounting rules for R&D. Taxpayers must account for R&D expenses, including depreciation, material costs, and payroll costs, for each type of project and agreement separately.

Representation

Deductibility of expenses for representation and entertainment (representation expenses) remains restricted to their amount and to their nature (art. 264(2)). The general deductibility is limited to an amount not exceeding 4 % of the total annual pay-roll expenses.

It is a condition of deductibility that the representation expenses were incurred in connection with receiving representatives of other entities in connection with discussing mutual business. Deductible representation expenses include, for example, expenses in connection with reception of guests (luncheon, dinner or other similar functions); catering during meetings; costs for premises; costs for translators and interpreters; transport to take the guests to and from the place of the reception.

Representation Expenses occurred in connection with organizing board and shareholders' meetings are in principle deductible.

The law especially excludes from the scope of deductible expenses the provision of entertainment, recreation, preventive therapy or treatment of illnesses. Due to the specific exclusion of these expenses and in order to avoid misunderstandings we have chosen to call these expenses *representation expenses* and not *entertainment expenses* the deductibility of representation expenses is not restricted to the geographical location where such expenses are incurred.

Tax officials are known for attempts to challenge the deductibility of various types of representation expenses. For example, they have tried to deny deductibility of expenses connected with accommodating in hotels of travelling businessmen from foreign partner firms. In one case the regional commercial court rejected such claims of the tax office and supported the taxpayer's right to deductibility ("Geolbent" LLC, Decree of the Federal Commercial Court in West-North district of 01.03.2007 No. F04-9370/2006 (30552-A81-27 on case No. A81-1259/2005). Another court ruled similarly (JSC "Vologodavtodor", Decree of Federal Commercial Court North-West district of 19.06.2008 on case No. A13-7506/2006-28).

Training of Staff

Expenses for training of staff members are, in principle, deductible (art. 264(3)). There are no restrictions to the amount of the expense, but certain other restrictions apply as detailed below.

Training expenses are considered as deductible expenses under the following conditions:

1. Training services are provided by Russian schools (or educational institutions) which enjoy governmental accreditation (or possess an appropriate license), or by foreign schools which have a corresponding status
2. Training is provided for staff members, or apprentices
3. The training yields, in principle, a direct commercial benefit for the business of the employer

According to some experts, the restrictions in the deductibility of training costs (and other pay-roll related costs) could be overcome by specifying the costs in the employment agreement in accordance with the general rule.

Expenses connected with entertainment, recreation, medical treatment or other services rendered to the employee free of charge are explicitly excluded from the scope of training expenses.

In line with the provision that training directly benefits the employer, tuition fees for main education at higher and intermediate special schools (colleges and universities) are not deductible.

Marketing and Advertisement

Expenses on advertising are largely deductible, but some restrictions apply (art. 264(4)).

Most forms of marketing/advertisement expenses are fully deductible, for example:

- advertisement through mass media (press, radio and television, the Internet)
- outdoor advertising, for example, billboards, illuminated signs (including the manufacturing of stands and billboards)

- participation in exhibitions, fairs and expositions
- sample rooms and showrooms
- design, drafting and production of brochures and other marketing material
- design and other works on display windows
- production and registration of trade marks (etc.)
- price reductions for displayed goods (that have lost their original qualities when exhibited)

Expenses on other forms of marketing costs, than those listed above, are deductible only within a limit equal 1 % of sales revenue. It is expressly stated that this restriction applies to free gifts and prizes distributed in connection with marketing campaigns.

Non-Deductible Expenses

Certain other expenses remain expressly non-deductible (art. 270). Some of them are discussed above in connection with pay-roll expenses.

Such other non-deductible expenses are:

- Dividends (or other similar distribution of profit);
- Penalties, fees and other such officially imposed sanctions
- Voluntary membership fees or contributions (including admission fees) to unions, associations, legal entities simple partnerships and investment partnerships;
- Assets transferred without consideration (free of charge);
- Assets transferred under special-purpose-financing arrangements;
- Notary costs above established limits;
- Write-down of accounting losses on securities marked to market.
- Fees, contributions and other mandatory payments to non-commercial organizations and international organizations (with exceptions)

Profit Tax Filings (Tax Returns)

In Russia a tax year always equals a calendar year and no exceptions are possible to match a possibly different tax year applicable at the level of a foreign holding.

Tax filings are made quarterly (art. 289). The tax is calculated independently by the taxpayer and declared in the periodic tax filings (art. 286,). Profit tax is declared quarterly and paid in monthly advances (art. 287).

Special Rules

Special rules apply for a number of taxpayers and situations, including:

1. Banks (arts. 290-291, 331)
2. Insurance companies (arts. 293-294, 330)
3. Securities transactions (arts. 280-282, 329, 333)
4. Professional participants of the securities market (arts. 298-300, 329)
5. Non-governmental pension funds (arts. 295-296)
6. Taxpayers having permanent establishments (art. 288)
7. Deferred execution transactions, i.e. derivatives (arts. 301-305, 326-327)
8. Participants of the contract of trust management of property (arts. 276, 332).
9. Permanent establishments of foreign companies (see "Permanent Establishments" section of this Guide).
10. Withholding Tax (from sources in Russia) for foreign companies not having taxable presence in Russia (arts. 309-312)

Withholding Tax (Source Tax)

Income from Russian sources in favor of a foreigner that does not have a taxable presence in Russia (Russian registered entity or permanent establishment) is subject to withholding tax, or source tax, which in essence is a method for charging the profit tax at a standard rate (arts. 309-312).

The general withholding tax rate is 20 %. For certain types of income other rates are set:

1. Interest on a limited class of state and municipal securities — 0 %
2. Income relating to operating or rental of means of transportation for international freight — 10 %
3. Dividends from a Russian company; interest on all other State and municipal securities (other than those denominated in p. 1 above) — 15 %

The 15 % withholding rate on dividends also applies vice versa, that is for dividend income received by a Russian entity from a foreign source. In such a case the amount of tax can be reduced, if an applicable double taxation treaty provides for this (art. 275(1)).

The withholding tax is levied on the following types of income (art. 309):

1. Dividends
2. Other profit or assets distribution (including the property received as a result of liquidation of a legal entity)
3. Interest income (from any kind of debt instruments)
4. Income from intellectual property
5. Sale of immovable property
6. Sale of stock in a company (and its financial derivatives) holding immovable property (real estate), while the immovable property is more than 50 % of the assets. The sale of such stock and derivatives in a foreign Stock Exchange is excluded.
7. Lease revenue (equally financial lease) of assets in use in Russia, including lease of means of transportation
8. International transportation (including demurrage)
9. Fines and interest for breach of contractual obligations
10. Other similar income

The above mentioned income from intellectual property rights may include:

- Copyrights for literature, art, scientific work, films
- Patents
- Trade marks
- Layouts or models
- Secret formulas for production purposes
- Right to use information related to industrial, commercial or scientific experience

The taxpayer may claim deduction of expenses from the income before tax. With respect to a financial lease contract, the tax is paid on the lessor's gross margin of the leasing contract.

A Russian entity paying income to a foreign party has the obligation to withhold the tax (act as a tax agent) separately for each transaction. The tax has to be remitted to the tax office simultaneously with the payment to the foreign party. It should be noted that the tax agent, along with taxpayers, must regularly submit tax return (article 289).

A relevant double taxation treaty between Russia and a foreign country may stipulate that certain kind of source income is not taxable in Russia (and vice versa). According to domestic Russian law, the relief is, however, not automatic, for the tax agent must prior to payment receive a document issued by the relevant authority of the country of the beneficiary that the beneficiary is resident of the treaty country (art. 312).

When no advance relief has been extended and tax has actually been withheld, the taxpayer may claim reimbursement of the tax in accordance with a relevant treaty (art. 312(2)).

The reimbursement claim must be supported by the following documents:

- An application (in accordance with a set form);
- An acceptable document confirming (tax) residency in the treaty country;
- A copy of the relevant agreement or other documentation between the parties to the transaction
- Copy of the bank transfer documents confirming payment of the tax

The tax authority may ask for a translation of the above listed documents. It is noteworthy, though, that the law explicitly forbids the authorities to demand any notarization (or legalization) of the documents. Also, the law expressly forbids requesting of any other additional documents.

The reimbursement claim has to be submitted within 3 years from the end of the year when the tax was paid.

Permanent Establishments in Russia

A 'permanent establishment' (PE) is not an organizational form of business structure, but rather a taxable status of a foreign business operation in another country, in this case in Russia. The term is defined in the Russian Tax Code (art. 306) and in many double taxation treaties. A business may be considered as a permanent establishment when activities in Russia are carried out by a foreign firm through any fixed place of doing business: the office, branch, headquarters, business partner or agent of a foreign company.

The concept of a permanent establishment is often confused with the concept of representative office (RO), as the Russian terms for them are very similar. Representative office in Russian is 'predstavitelstvo' and permanent establishment is "postoyannoye predstavitelstvo'. However, the existence of a RO does not determine if the business is taxable or not.

RO itself can either form or not form a PE depending on the actual nature of the business. Even an agent or merely a Russian business partner based on the real circumstances can be deemed to form a de facto PE for the foreign entity with all the corresponding obligations to register as a separate taxpayer, file Tax Returns and pay taxes. A PE even without a specific organizational form in Russia is subject to all of the above.

The primary source of law for determining whether the presence of a foreign legal entity (FLE) creates a PE is in the Tax Code articles 306–308 (chapter on profit tax). However, double taxation treaties (DTT) concluded between Russia and other states take preference over the provisions of national law in determining the rules applicable for permanent establishments.(For details on DTTs see chapter Double Taxation Treaties). A detailed interpretation of this concept and related issues can be found in the recommendations of the tax authorities (Order of the Ministry of Taxes and Dues No. BG-3-23/150 of 28 March 2003.

Criteria for Permanent Establishment

According to the Tax Code, the activities of a foreign company create a PE in Russia if the following conditions are met:

1) The Foreign Legal Entity has a place of activity in Russia;
2) The place of activity is intended for carrying out a regular activity;
3) The activity is essentially of a commercial (business) nature;
4) The activity is not auxiliary or preparatory.

All four criteria have to be satisfied in determining that a PE is evident.

A place for activity in Russia can be a branch office, a representation office, an office (or bureau), an agent, a business partner or any other subdivision or a place of activity.

Dependent Agent

A foreign legal entity is also to be considered as having a PE, if it acts within the territory of Russia through a 'dependent agent' and the activity of the agent constitutes activities of a PE as outlined above. The relationship of dependent agency can be formed in the following ways:

(i) a foreign legal entity enters into a formal agreement with an agent

(ii) a Russian entity functions as a de facto agent based purely on the circumstances of the business relation or business dealings.

Such an agent may be deemed to have formed a PE for the foreign company if the agent is not acting as an independent agent (art. 306.9, Tax Code).

A dependent agent represents a foreign legal entity and acts in its interests within the territory of Russia; is authorized to conclude agreements or negotiate material provisions of contracts in the name of the FLE; and uses such authority to create legally binding obligations for the FLE in Russia. '

Independent agents (or representatives) are, for example:

- Brokers and other professional participants of the Russian securities market
- Any person acting in the ordinary (habitual) course of its business in the de facto capacity of an agent

The decisive factor is whether the activities of the agent are performed in the course of its normal business, i.e. if the agent usually performs the services in question.

Whether the agent is affiliated (or "related") to the foreign entity or not should not be decisive in considering if the agency forms a PE or not. Again, the general rules of determining if a PE is at hand should prevail and, specifically, the agency through an affiliated person would equally be considered against the rules regarding independent and dependent agents.

Activities Giving Rise to Permanent Establishment

To qualify for a PE, the activities must be carried out on a regular basis. Therefore, one-time transactions limited in time and extent should not fall under the criteria.

The law (art. 306.2, Tax Code) defines what is to be considered as conducting business from point of view of forming a PE, as outlined below.

PE criteria for Conducting Business:

1. Usage of natural resources
2. Construction, installation, maintenance services and the like
3. Sale of goods from warehouses in Russia
4. Other work, services or activities which are not specifically excluded from criteria of forming a PE

However, the last item in the list effectively encompasses all kinds of business activities, except for those specifically excluded.

The activities excluded from the definition are those of a preparatory and auxiliary character. The law gives an open list of what is meant by preparatory and auxiliary activities (art. 306.4, Tax Code).

Preparatory and auxiliary activities are:

- Using the place of activity solely for storage, display and delivery of goods
- Maintenance of stock solely for the purpose of storage, display and delivery
- A place kept solely for the purpose of purchasing goods
- A place solely for collecting and distribution of information, accounting, marketing, advertising or market research sold by the foreign entity, if the said activity is not the sole or regular activity of the foreign entity
- Keeping a place of activity for the sole purpose of signing contracts in accordance with detailed written instructions of the foreign organization

The lists of preparatory and auxiliary works, foreseen by the majority of Russia's Double Taxation Treaties are similar to the above list and to the OECD Model Tax Treaty, despite the fact that Russia is not an OECD member. However, it happens that Russian courts consider the activity meeting the criteria of "preparatory" or "auxiliary," as giving rise to a PE. For example, in 2010 Moscow Commercial Court ruled that the collection of information by Bloomberg LP's representative office in Moscow resulted in the creation of a PE under Russian law and the double taxation treaty between Russia and the United States., Bloomberg LP produces information products, including analytical databases. Between 2006 and 2007 it maintained a representative office in Moscow, where the employees gathered information to be incorporated into its databases. Under the Russian

Tax Code as well as under the US — Russia DTT, the collection of information is considered a preparatory and auxiliary activity. However the court held that collecting information and selling products based on such information in fact falls within the ambit of Bloomberg's core business, and by this criterion they were said to create a PE in Russia. The Court of Appeal in 2011 did not revoke the decision of the first instance.

Preparatory and auxiliary services performed for third parties may create a taxable activity. If this is the case and no payment (or consideration) is recorded or reported for the said services, the tax can be deemed as the equal amount of 20 % of the expenses of the PE connected with the activity in question (art. 307.3, Tax Code).

The ownership of assets in Russia does not as such give rise to a PE. Thus, for example, a subsidiary of a Russian entity is not considered to be a PE of the parent company by the fact of its mere existence. However, if the subsidiary in addition to the business that it carries on also performs above-mentioned functions in favor of the parent company, it may be deemed to form a PE for the parent.

A PE is deemed to exist from the moment of commencement of those activities that fall under the definition of a PE. The date of registration of the branch or representative office as such is not regarded as the start of the activities of the PE (special rules apply to PE involved in usage of natural resources). Correspondingly, a PE ceases to exist from the moment of discontinuing such activities (art. 306.3, Tax Code).

Conclusion of a joint activity agreement (or simple partnership agreement) does not in itself imply that the underlying business forms a PE (see art. 306.6, Tax Code). Therefore, in considering the taxable status of such an agreement, the business in question should be materially reviewed against the whole set of general rules on PE. If the business in reality would meet all the criteria of a PE, then the joint activity agreement would be deemed as forming a PE, not otherwise.

According to article 306.7 of the Tax Code, the provision of personnel (seconded) by a foreign entity to a Russian entity does not as such give rise to a PE. Nevertheless, in accordance with the general rules on PEs, the seconded person shall, hereby, act solely in the interests of the Russian entity to which he is seconded. In the case that the seconded person acts in the interest of the foreign entity that seconded him, then the general rules on PEs may become applicable.

To some extent the rules regarding PEs can be seen as anti-avoidance rules. Therefore, it is recommended that whenever a company actually wants to have a taxable presence, it is advisable to register some kind of Russian presence.

Tax Consequences for Permanent Establishment

The profits derived by a FLE through a PE are taxed in Russia at the usual profit tax rate (currently 20 %). Generally, the principles of taxation applicable to a PE are the same as those applicable to Russian legal entities. All of them are subject to profit tax, VAT, corporate property tax, and other applicable taxes. They are also all subject to Russian accounting and reporting rules.

The income and expenses are allocated between a foreign entity and its permanent establishment in Russia with account taken of the functions performed, the assets used, and the economic (commercial) risks assumed, by the permanent establishment (Article 307(9) of the Tax Code of the Russian Federation). These rules were adopted in 2011 concurrently with the introduction of the new transfer pricing rules in Russia. This may be regarded as an attempt to approve, at the level of the national legislation, the so-called authorized OECD approach to the determination of income and expenses of a permanent establishment.

The Ministry of Finance has also confirmed the deductibility by a permanent establishment of so-called notional charges of the head office. The term "notional charges" means, in relation to the so-called deemed transactions between the permanent establishment and its head office (the rest of the foreign entity), sales and other markups in the form of a profit margin that are usually charged in addition to the expenses incurred by the head office in the sale of goods or services. For example, in one of its recent letters, the Ministry of Finance approved the deductibility by a permanent establishment of a sales markup charged by the head office (a markup charged by the head office for the performance of a production function) in the sale of manufactured goods (Letter of the Ministry of Finance No. 03-08-05/33523 dated August 16, 2013). In this letter, the Ministry of Finance, referring to Article 7(2) of the Agreement between Russia and Italy, states that the profits of a permanent establishment located in Russia should be calculated as if this permanent establishment acted as a standalone and separate business, independent of the foreign entity, of which it is part. At the same time, the current practice of courts and tax authorities as to the deductibility by a permanent establishment of notional charges of the head office is rather contradictory.

In its recent decision, the Federal Commercial Court of the Moscow Circuit addressed how foreign companies operating in Russia through a PE should determine the taxable income and deductible expenses. A UK resident law firm, CMS Cameron McKenna, which provides legal services to clients worldwide, was determined to act in Russia through a branch which created a PE. Both Russian and British lawyers were involved in the production of services and the fees for the work of all lawyers were included in the invoices issued to clients by the Russian branch. As the branch included the British lawyers' fees in its taxable income, it accordingly deducted the corresponding expenses from the taxable base. The lower court upheld the position of the branch, because it deemed it in line with article 7.2 of the Russia-UK DTT, according to which the income of a PE shall cover all the income that it would have derived if it were a stand-alone entity independent from the parent company. The higher courts, however, ruled in favor of the tax authorities, claiming that the British lawyers were not acting independently when working on the projects of the Russian branch and both the head office and the Branch were acting as a single entity. The higher courts concluded that the deduction of the British lawyers' fees was therefore unjustified (Ruling of 9th Appellate Court of 09.06.11 No. 09АП-10460/2011-АК; Ruling of Territorial Commercial Court of Moscow Area of 09.09.11 on A40-138835/10-118-799; Resolution of Supreme Commercial Court of 10.01.12 No. ВАС-16887/11).

11. VALUE ADDED TAX (VAT) IN RUSSIA

In economic terms, VAT is an indirect tax which is included in the price of goods and is paid by the purchaser to the seller. The latter is to transfer the amount of tax to the government. But in legal terms it is the seller, not the purchaser, who is deemed to be the taxpayer of VAT (i.e. the one who carries the legal liability of its payment).

The taxpayers for VAT purposes are all Russian legal entities and individual entrepreneurs with certain exceptions which we will consider below. Foreign legal entities have the obligation to register as taxpayers in Russia when their presence in Russia meets certain criteria. There is no special requirement to register as a VAT taxpayer, rather the obligation to pay VAT follows by virtue of law for any registered taxpayer (notwithstanding what has been the original reason for tax registration). It should be noted, though, that a foreign legal entity may also be required to pay VAT even without having a Russian presence in cases when their operations are subject to VAT in Russia under the place of supply rules (see details of place of supply rules further down in this chapter). In this case, the Russian counterparty (buyer) acts as a tax agent under the reverse charge rules withholding VAT from payments to the foreign legal entity and transfers them to tax authorities (see details of reverse charge VAT further below).

If a foreign legal entity has several subdivisions in Russia in various towns or municipalities, then it may choose to conduct its VAT compliance reporting and tax payment for all the subdivisions through one of them. The local tax office at each of the locations must be notified in writing about the choice (art. 174).

Exempt Categories of Taxpayers

Certain categories of taxpayers are relieved from obligations of a VAT payer. These are:

- Small businesses meeting certain criteria (see below for details);
- Companies and individual entrepreneurs accredited as participants at Skolkovo innovation center (see below for details);
- Companies and individual entrepreneurs applying the simplified system of taxation (for details see chapter Simplified System of Taxation);

- Companies and individual entrepreneurs applying the tax regime of unified tax on imputed income (but only in regards to the activities subject to the tax on imputed income) (for details see chapter Tax on Imputed Income);
- Foreign organizers, marketing partners or broadcasting companies for Sochi 2014 Olympic Games and Paralympic Games with the relevant confirmation of such exempt status;
- FIFA and FIFA's subsidiaries, of which FIFA's stake in their charter capital amounts to at least 50 %, or where FIFA has at least half the votes in their upper management body;
- international football confederations, national football associations, international producers of media information for FIFA, and suppliers of goods, works, or services to FIFA (in regard to operations related to preparing for and holding the 2018 FIFA world football championship and the FIFA Confederation Cup of 2017).

By law small businesses may be relieved from the obligations to act as a VAT payer. This exemption is granted to small businesses with sales revenue of less than 2 million rubles over a period of three consecutive months (art. 145). The exemption is not available for VAT on imported goods payable at customs and for those taxpayers, which are liable for the excise tax (in regards to the excisable products). A taxpayer applying the exemption is not required to charge VAT or submit VAT returns, but such a taxpayer has to pay the VAT charged by its suppliers when the suppliers apply the normal VAT regime.

In order to exercise the right to this exemption, the taxpayer must notify the local tax office of the intention to make use of the exemption according to the established form and by submission of a number of supporting documents (accounting balance, sales ledger, etc.).

In practice, the tax authorities are reluctant to grant this VAT exemption to taxpayers and often are inventive in finding reasons to decline the right. For example, the tax authorities are of the opinion that it is not possible to exempt a company from the VAT obligations in the case when the company has had no revenue at all over the three-month period (letter of the Ministry of Finance No. 03-07-14/11 of 28.03.2007). We believe, however, that this is groundless insofar as the Tax Code does not set any requirements as to a minimal revenue threshold in order to qualify for the exemption. Our conclusion has found support in court practice (ruling of Federal Commercial Court in Ural Federal District, No. F09-3020/07-C2 on case No. A60-34201/06 of 02.05.2007).

The exemption is valid for a period of 12 successive months commencing from the month of submission of the application with possible extensions for further 12-months period. Once exempted, taxpayers may not withdraw from such exemption before the end of the 12-months period it is granted for, except in cases of loss of the right to the exemption as a result of exceeding the revenue thresholds or selling excisable goods.

But there are risks inherent to the application of this exemption. If the sales revenue exceeds the threshold limit, then from the first day of the month in which the threshold is exceeded, all revenue will be deemed VATable requiring to reverse the earlier VAT-free transactions. Naturally, it would in such a case be difficult to convince the customers to change the nature of the transaction and remit the required VAT.

In September 2010, the Tax Code was amended to introduce a range of tax incentives for participants in the Skolkovo innovation center project. Among other benefits the participants may be exempt from paying VAT. Overall, this exemption is similar to that granted to small businesses.

Tax Rates

Tax rates (Article 164):

<u>Standard rate 18 %</u>

<u>Reduced rate 10 %</u>

Applicable for:

- Sale of basic foodstuff;
- Sale of certain kinds of products for children;
- Sale of medical supplies and medicines;
- Sale of periodicals (excluding advertisement and erotic), scientific literature and text books.

<u>Zero-rate 0 %</u>

Applicable for (providing certain conditions are met):

- Exports of goods;
- Sales to diplomatic missions and their personnel, including family members;

- Sale of goods (works, services) in the field of aerospace;
- Sale of goods and services to FIFA, its subsidiaries, and certain other participants in the 2018 FIFA world football championship and the FIFA Confederation Cup of 2017 (under certain conditions);
- Transportation of passengers and baggage where either the point of departure or destination is outside Russia;
- Services for transportation of goods in connection with export and import;
- And other cases, which mainly are auxiliary to transportation services but also some other cases.

Subject of Taxation

VAT applies to the following kinds of transactions (art. 146 (1)):

- Sales (including barter) of goods, works and services and transfer of property rights in Russia;
- Alienation without consideration (free of charge) of goods, works and services;
- Imports into Russia (VAT payable at customs);
- Transfer of goods and services acquired or produced for company's own consumption, that is, which are not intended for business use (reselling or included in resalable goods and services). This category includes construction and assembly works;
- Transfer of goods and services for own consumption are subject to VAT only if the associated expenses are not deductible for profit tax purposes. However, construction and assembly works are VATable even though the corresponding expenses would be deductible for profit tax.

It is worth noting that according to the Tax Code, the transfer of goods and services is subject to VAT, not the purchase or production of goods and services for own consumption. The Tax Code does not define the notion of transfer. Tax authorities have filled this gap by stating that goods and services for own consumption are subject to VAT only if they are transferred to taxpayers' subdivisions. If goods and services for own consumption are not transferred to subdivisions, VAT is not levied (letter No. 03-1-08/204/26-B088 of the Russian Ministry of Taxes and Levies dated 21.01.2003; letter No. 03-04-11/132 of the Ministry of Finance dated 16.06.2005).

Imports

The rule is that all imports are taxed at customs at the general VAT rates. The Tax Code (art. 151) provides, however, for different treatment of imports of goods in accordance with the various customs regimes as set forth in the Customs Code of the Customs Union of Russia, Kazakhstan and Belorussia (Customs Union). A customs regime is a set of rules applicable to imports depending on the purpose or use of the goods in Russia.

VAT rules according to the various customs regimes may differ as follows:

1. Release for free circulation and for processing for internal consumption
   – VAT payable in full
2. Re-importation
   – The taxpayer pays the VAT amount, from which he was previously exempted or which has already been recovered
3. Transit, customs warehouse, re-exportation, duty-free shop, free customs zone, free warehouse, destruction, denouncing in favour of the Government, or carriage of stores
   – No VAT charged
4. Controlled processing on customs' territory
   – No VAT is charged provided that the finished goods are re-exported within certain periods
5. Temporary importation
   – Partial or full VAT exemptions available
6. Processing outside Russian customs territory
   – Partial or full VAT exemption available

Imports of the following types of goods are exempt from VAT at customs (art. 150):

- Medical supplies according to a list approved by the Russian government;
- Goods imported for the official or personal use of diplomats;
- Technological equipment for the purpose of manufacturing (including components and spare parts) where similar equipment is not produced in Russia as set forth in a list issued by the Russian government;
- Ships to be registered in the Russian International Ship Register;
- And other types.

Tax Base

VAT is paid from all revenue earned from sales of goods, works and services (and transfer of property rights). Such revenues constitute the VAT tax base (arts. 153, 154). The tax base is the value of the transactions as expressed by the parties to them. However, the tax office may challenge the expressed price and demand an adjustment to market prices according to the general rules for transfer pricing (see chapter 12 Transfer Pricing in Russia of the present book). The tax base for barter and in-kind transactions is their monetary market value.

Advance payments are also included in the tax base (art. 154). As the tax base for advance payments is determined as the amounts received including VAT, VAT is therefore calculated by subtracting the VAT amount from the received advance payments. To do so, advance payments are multiplied by 18/118 or 10/110 respectively depending on whether the sale is subject to VAT at a tax rate of 10 % or 18 %. However, no VAT is levied on advance payments for the following goods (art. 154(1)):

- goods taxable at zero rate;
- goods exempt from VAT;
- goods undergoing a long production cycle (more than six months) subject to certain conditions.

The tax base for services and goods transferred for own consumption is based on the price applied for the sale of identical or similar goods and services by the taxpayer. In the absence of relevant comparable data, market prices are used (art. 159). The tax base on construction works for own use is based on the actual expenses incurred.

An agent (commissioner or middle man) pays VAT only on the part which constitutes the agency fee and not on the part due to the principal.

The tax base for imported goods and services is determined as the sum of the customs value of the goods, customs duties and excise duties (when applicable, art. 160). The customs value of goods is the monetary value on the basis of which customs duties and taxes are calculated. In this sense, the customs value is a nominal value and may be different from the price of the goods set in contracts. The customs value of goods consists of the purchase price and additional costs (e.g., cost of transportation, cost of packaging, etc.).

There exist special rules for determining the tax base for certain types of transactions as listed below:

- Tolling arrangements (art. 154(5));
- Agricultural production bought from persons who are not VAT taxpayers (art. 154 (4));
- Purchase of cars from individuals (who are not individual entrepreneurs; art. 154(5.1));
- Sale of goods (work, services) under conditions of future (forward) transactions, i.e. transactions implying supply of goods upon expiration of the term established by the relevant contract (art. 154 (6)) Financial derivatives (options, futures) (art. 154.6);
- Transfer of property rights (art. 155);
- Commission, agency or commission agency contracts, and also the sale of pledged property by pledge-holder (art. 156) ;
- Transportation and international communication services (art. 157);
- Sale of an enterprise as a whole (art. 158);
- Withholding by tax agents (art. 161);
- Rules for calculating VAT in connection with certain settlements (art. 162);
- Legal entities undergoing reorganization (art.162.1);
- Sale of goods subsidized by the state (art. 154(2)).

Tax Base if Bonuses and Discounts are Given

The seller may establish a bonus for the buyer for fulfilling certain conditions of an agreement — for example, for reaching a certain procurement volume. Until 1 July 2013, the Tax Code did not regulate the consequences of granting bonuses and discounts for shipped goods or services. In this connection, practically speaking, disputes arise quite frequently as to whether such a bonus reduces the value of the services or goods shipped earlier, and correspondingly, whether the buyer and seller should adjust the tax base for the previous periods for which a discount was given (with the buyer lowering the VAT deductions, and the seller lowering the amount of outgoing VAT).

As from 1 July 2013, the Tax Code explicitly envisages that a bonus (including one for procurement volume) as a general rule does not reduce the value of services rendered or goods shipped earlier. That said, parties may specify another rule in their agreement, and reduce the value of services or goods shipped by the bonus amount (art. 154 (2.1)), with the exception of suppliers and retailers of food products. For these, that possibility is restricted by the Law "On the Foundations of State Regulation of Trading Activity in the Russian Federation."

Date for Determining Tax Base

Under article 167 of the Tax Code the tax base is determined at the earliest of the following two dates:

1) date on which the goods are dispatched (work done, services rendered, property rights transferred), or
2) date of receipt of payments or partial payments for the future supply of goods, services, or transfer of rights.

If goods are not shipped or transported, the date of transfer of title is deemed as the date of dispatch.

The law does not expressly define what should be considered as the date of dispatch of goods, but the tax authorities suggest considering the date on which the first primary document is issued to a buyer or carrier as the date of dispatch (letters of Ministry of Finance No. 03-07-09/23 of 28.07.2011, No. 03-07-08/44 dated 17.02.2011). Hereby certificates of transfer, consignment bills, etc. are considered as such primary documents. This conclusion is, however, disputed in regards to the situation when goods are shipped before title to goods is transferred, for example, when the relevant agreement provides for a later date of transfer of ownership. We would like to remind that VAT is in essence a tax imposed on sales (art. 146) which can be deemed completed only after the transfer of the title to the goods (art. 39). This means there can be no VATable transaction prior to the transfer of the ownership right to the goods. But the tax authorities have declined this argument as well (letter of Ministry of Finance No. 07-02-06/14 of 09.02.2011; No. 03-07-11/379 of 08.09.2010). There is no established court practice on this issue, but some courts support the position held by the tax authorities stating that the date of shipment is to be considered the date on which the documents confirming the transfer of goods are drawn up, even if this occurs before the transfer of ownership right to the goods.

Tax base upon a further increase in the value of goods or services

As from 1 July 2013, the rules have been changed regarding determination of the tax base upon a subsequent increase in the value of services or goods shipped — for example, as a result of increasing their price after shipment. Until 1 July 2013, a taxpayer was supposed to take such an increase in value for determination of the tax base into consideration in the period in which the shipment of goods was made. From 1 July 2013, such an increase in the value of shipped goods or services is counted when determining the tax base for the period in which contracts, agreements or other initial documents were compiled which confirm the consent (notification) of the buyer to the change in the value of shipped goods.

Transactions onto which VAT is not Applied

For certain types of transaction VAT is not charged. These can be divided into five main categories of transaction as per below:

- Export and other zero-rate transactions (art. 164(1));
- When the place of supply rules exclude Russian VAT (arts. 147, 148);
- Operations not recognized as an object of taxation (art. 146 (2)).
- Goods and services exempt from VAT (art. 149);
- Exempt imports of certain types of goods (art. 150 see details below).

The main difference between zero-rate VAT and the goods (services) exempt from VAT is that in case of exempt goods (services) the corresponding input VAT is not recoverable but deducted as an expense from the profit tax base (art. 170 (2)).

VAT exempt goods and services are goods and services which according to the main rules would be taxable but have for various social and political reasons been exempt.

Export and Other Zero-Rated Transactions

The zero-rate VAT applies to the following types of transactions:

- Exported goods and goods placed under the customs regime of free customs zones;
- Services for export of goods as listed in article 164 of the Russian Tax Code (e.g. international transport);

- Goods, works and services to be used by diplomatic missions and diplomats;
- (see art. 164 for a full list).

Zero-rate on exports does not, however, apply automatically and is subject to the submission of a relevant VAT tax return and a number of supporting documents to tax authorities. Such supporting documents are (art. 165):

- a relevant export contract;
- a customs declaration stamped by the Russian customs authorities. Instead of customs declarations, taxpayers may submit to tax authorities a compilation list issued by customs officials enumerating all the relevant customs declarations;
- copies of transport, shipping and other documents stamped by customs authorities confirming the export of goods from Russia.

In order to retain the right to the zero-rate the taxpayer must submit the required documents to the tax office no later than 180 calendar days from the date on which the goods were placed under the customs regime of export (art. 165 (9)).

Failure to meet the deadline will result in the relevant transactions being taxed with the general rates of VAT instead of the zero-rate. However, there is a possibility to refund this VAT in case of subsequent compliance with the requirements (art. 165(9)).

The VAT returns must be submitted at the end of each quarter (art. 174), while the supporting documents may be collected during the tax period. Hereby it is disputed whether a taxpayer is entitled to apply zero-rate VAT if it provides the supporting documents together with the tax return which is filed at the end of quarter during which such a 180-day period has already elapsed in respect to certain transactions. The Ministry of Finance has stated that a taxpayer may claim zero-rate VAT in this case, provided a complete set of documents is actually collected before the expiration of the 180-day period and filed together with the tax return for the period which such a 180-day period has already elapsed (letter of the Ministry of Finance No. 03-07-08/136 of 03.06.2008). In support of this position, the Ministry of Finance refers to article 167(9) of the Tax Code under which the tax base for exported goods is determined on the last day of the quarter in which the complete set of documents has been collected to support the validity of application of zero-rate VAT. In a ruling the Federal Commercial Court in the West Siberian District (ruling No. Ф04-4348/2008 (8866-A27-14 of 16.07.2008) has, however, rejected this position and argued that the supporting documents will actually have to be filed within the 180-day period.

Exports Within the Customs Union

Kazakhstan, Belarus and Russia form members of a Customs Union, which adheres to a common Unified Customs Code. The Customs Code of the Union came into force on 01.07.2010. The Customs Code of the Union provides for simplified export and import procedures between the countries of the Union. There are no longer any procedures for customs clearance of goods exported from one of the member state to another.

When a Russian company exports goods to the countries of the Customs Union, the zero-rate VAT is applicable (Item 1 of Protocol dated 11.12.2009 "On the procedure for collection of indirect taxes and mechanism of control over their payment for export and import of goods in the Customs Union"). On the whole, the procedures for applying the zero-rate VAT regime on exports to Custom Union states is similar to the procedure for applying zero-rate VAT on exports to other countries as described above. However, when goods are exported to Belarus or Kazakhstan, there is no point of customs clearance. Thus no customs declarations are submitted and correspondingly no confirmation of the fact of export is received from the customs authorities. To cure this dilemma the governments of the Union's states have issued a special list of documents required to confirm the applicability of zero-rate VAT for exports to Belarus and Kazakhstan. On the whole, this list is similar to the list of documents to be provided to confirm zero-rate VAT upon exportation of goods outside the Customs Union. However, to confirm the validity of application of zero-rate VAT, instead of customs declarations, taxpayers provide an application for import of goods and payment of VAT by the buyer in a country of the Customs Union (one original copy). The buyer must complete this application on a special form, which must be stamped by the tax authorities in the country of export in which the buyer registers goods (the application form for import of goods and payment of indirect taxes was approved by Protocol dated 11.12.2009 "On exchange of information in electronic form between tax authorities of member states of the Customs Union about the paid amounts of indirect taxes").

In practice, tax authorities may impose additional requirements for the documents required to confirm the applicability of zero-rate VAT.

Place of Supply

Place of supply rules are intended for determining whether goods or services are considered to be supplied in Russia or abroad, with the idea that the goods (services) supplied in Russia are taxed with Russian VAT.

Place of Supply of Goods

The rules for determining place of supply of goods for VAT purposes are given in article 147 of the Tax Code. It is to be noted that these VAT rules applied are independent from the general rules of Russian Civil Law for defining the place of sale which allow for the parties of the transaction to contractually agree the place of supply (Civil Code art. 316).

Sale of goods is subject to VAT in Russia if they are sold on the domestic market or exported abroad from Russia. In cases when the goods are located abroad at the moment of sale, the sale is not subject to VAT in Russia, but such goods are still subject to VAT at customs when they are imported into Russia (see above for more details).

Place of Supply of Services

The rules for determining the place of supply of services for VAT purposes are given in article 148 of the Tax Code.

According to the place of supply rules, no Russian VAT is applied when services are considered to be performed abroad.

According to the general rule, Russia is considered to be the place of supply of services if the party giving the service (performing works) operates in Russia (the seller's place of economic activity is Russia). The law provides specific and formalistic criteria for determining when parties performing work are considered as being present in Russia.

Parties performing work (sellers) are deemed to be present in Russia when they meet any of the following criteria (art. 148 (2)):

- The seller is registered in Russia;
- The seller's foundation documents (charter) specify Russia as its place of economic activity;
- Russia is the official seat of management or place of actual management;
- The party performing work has a permanent establishment in Russia (if services are provided through this permanent establishment);
- An individual entrepreneur acting as a seller resides in Russia.

However, there are several exceptions to this rule. The place of supply of services is deemed to be Russia in the following cases regardless of whether the party performing work operates in Russia:

- Services directly related to immovable property in Russia (excluding aircraft, marine vessels and vessels for domestic navigation, space craft), e.g. construction, repair and maintenance, lease;
- Services related to movable assets located in Russia (including aircraft, marine vessels and vessels for domestic navigation), e.g. installation, assembly, processing, handling, repair and maintenance;
- Services performed in Russia in relation to culture, arts, education, fitness or tourism, leisure and sports;
- Transportation and related services in any of the cases below:
  (a) Services are provided by Russian companies, provided that the departure or destination points are located in Russia,
  (b) Services are provided by foreign companies, provided that both the departure and destination points are located in Russia.
- When the place of economic activities of the buyer of services is located in Russia (applies only to a restricted list of services as detailed below).

Buyer's Place of Economic Activity in Russia

Certain services as detailed below are considered to have been provided in Russia when the buyer is present in Russia (the buyer's place of economic activity is Russia). The law provides specific and formalistic criteria for determining when a buyer should be considered as being present in Russia. These criteria (as per below) are essentially the same as those used to determine the place of activity of a seller of services.

Buyers are deemed to be present in Russia when they meet any of the following criteria (art. 148 (4)1):

- The buyer is registered in Russia;
- The buyer's foundation documents specify Russia as its place of economic activity;
- Russia is an official seat of management or place of actual management;
- The buyer operates a permanent establishment in Russia (if services are provided through this permanent establishment);
- The buyer is an individual residing in Russia.

However, the rules on buyer's place of economic activity are only valid in relation to certain types of services as detailed in the law (art. 148 (4)1). These are:

- Transfer of immaterial rights (patent, license, trademark, copyright, etc.)
- Services in consulting, law, accounting, audit, engineering, advertising, market research, data processing, research and development work
- Development of software and databases
- Providing personnel (staffing) to a buyer of works at the buyer's location
- Leasing of movable assets (except for land automotive vehicles)
- Transfer of emission reduction units under the Kyoto Protocol

The above list does not seem to provide for a broad treatment. The narrow treatment of the list is emphasized by further specification of engineering services and data processing services that can be included in the definition. However, services that are auxiliary to the main service follow the place of supply rules of the main service.

Services and Goods Exempt from VAT

Certain types of services and goods are exempt from VAT, or are not recognized as an object of taxation (arts. 146 (2), 149,150). These are presented in below list:

Goods and Services Exempt from VAT

- Rent of premises and apartments to foreign accredited representative offices (and branches) and their accredited foreign nationals (this exemption is extended to foreign representative offices, branches and nationals from countries that extend the same treatment in their respective countries to Russian organizations)
- Transfer of property, if such transfer is in the nature of an investment (in particular, contributions to charter capital)
- Sale of land plots or participatory interests in them
- Public transport
- Rent of apartments
- Insurance
- Banking services
- Certain services on the securities market and on the commodities and foreign-currency markets (a list of these operations is given in art. 149(2)12.2)

- Services related to the organization and conduct of gambling activities
- Charity contributions
- Medical services, medicine and medical equipment (detailed list of exempted goods and services issued by the Russian Government),
- Education services (non-commercial)
- Securities trade (with certain exceptions)
- Loans and interest on loans
- Repairs during warranty period when no additional payment is charged
- Importation of certain technological equipment (detailed list issued by the Government; art. 150 (7))
- Sale of shares (art. 149(2)12)
- State duties and levies for licenses, registrations, etc., customs fees for storage
- Culture and arts services (in certain cases)
- Sales of residential real estate (including shares of joint ownership)
- Sale of certain types of intellectual property rights
- And others (arts. 146 (2), 149,150)

When an activity that is exempt from the tax requires a license then the exemption is valid only under the condition that the seller holds a valid license.

The tax exemptions are not valid in regards to the fees and commissions of agents or other commissioners.

Input and Output VAT, Tax Deductions

VAT is calculated and paid as the difference between output VAT (collected from clients) and input VAT (paid to suppliers). Input VAT is deducted from (or credited against) output VAT and the difference is remitted to the government. Special rules apply for the deduction of VAT depending on the nature of operations.

In order to deduct input VAT certain conditions must be met, (art.171(2)) as follows:

- goods (services) must have been acquired for transactions subject to VAT or for resale;
- relevant VAT invoices have been received from suppliers;

– transactions are duly recorded in the company accounts (bookkeeping). Transactions are recorded in a company's accounting on the basis of primary documents. Certificates of transfer, waybills, etc. are considered as such primary documents.

According to the general rule the payment of input VAT is not a prerequisite for VAT deduction against output VAT. However, there is an exception to this rule in regards to certain transactions where the actual payment of VAT has been set as a prerequisite for deduction. This concerns, for example, deducting VAT paid on imported goods and cases of reverse charge VAT.

It is worth noting that taxpayers are not required to provide tax authorities with documents supporting the validity of input VAT deductions, except when tax authorities request such documents (Constitutional Court ruling No. 266-O of 12.07.2006).

Liability to Ensure Trading Partner Acts in Good Faith

Court practice has developed a rule according to which a taxpayer must ensure that its contractor acts in good faith in terms of its tax compliance practices. In other words, the deduction of input VAT may be denied to a taxpayer if the taxpayer acted without due care and should have been aware of the tax violations committed by its counterparties. This rule is one of the special implications of the tax anti-avoidance doctrine known as unjustified tax benefit. Unjustified tax benefit has been established to prevent taxpayers from getting tax benefits (tax exemption, tax deductibility, etc.) when getting such benefits is the primary or sole purpose of the taxpayers' operations. This rule is aimed at avoiding tax evasion in the spheres of VAT and profit tax by making VAT and profit tax deductions at one party depending on the good faith of the other, in particular in regards to companies which have been set up only for the purpose of participating in a tax avoidance scheme ("fly-by-night companies", "one-day companies", "odnodnevky").

The Supreme Commercial Court has in a ruling provided a list of circumstances that could indicate a bad faith supplier for tax purposes (Ruling No. 53 of the Plenum of the Supreme Commercial Court of 12.10.2006 "Concerning the Evaluation by Commercial Courts of the Legitimacy of the Receipt by a Taxpayer of a Tax Benefit"). This list is not exhaustive.

The Ministry of Finance has issued guidelines for actions to be taken by the taxpayer in this respect (letters of the Ministry of Finance No. 03-02-07/1-430 dated 13.12.2011, No. 03-02-07/2-231 dated 31.12.2008.). Such measures may include:

- Verify the powers of the person acting on behalf of the counterparty and document the results of such a verification;
- Ensure that the representative of the contracting company has not been convicted of a tax or administrative violation;
- Request the foundation documents (charter, trade register certificate, from verified official sources);
- Request licenses (when applicable);
- Ensure that the counterparty is in fact in possession of relevant premises: office, production facilities, retail outlets (as appropriate).

In practice courts may judge on the good faith in choice of contractors considering any set of circumstances (see e.g. (decision of the Federal Commercial Court of the Moscow District on case No. A41-32101/10 of 07.12.2011).

It is important to note, though, that the contractors bad faith does not in itself entail that the taxpayer has received an unjustified tax benefit if the taxpayer can show due diligence in choice of contractors.

Deduction of Input VAT in Connection with Exports

VAT is not charged on export of goods, or to be more precise, export is taxed at zero-rate (art.164(1)). When manufacturing goods for export companies pay VAT to their suppliers, and thus acquire input VAT. But as the export transactions are taxed with a zero-rate, then no output VAT accumulates with which to offset the input VAT, therefore the taxpayer is left with the option to recover the input VAT from the government.

It is noteworthy that under current court practice the deduction of input VAT incurred in connection with producing VAT exempt goods for export is denied (ruling No.8870/04 of Supreme Commercial Court of 14.12.2004, letter of Ministry of Finance No. 03-07-08/32 of 02.02.2011). At the same time, there have been a court resolutions according to which taxpayers are entitled to deduct input VAT upon export of VAT exempt goods (Commercial Court in the North-West district on case No. A56-2177/2007 dated 03.10.2007).

VAT Deduction in Connection with Capital Construction

It is allowed to deduct input VAT in capital construction projects. However, there are some additional special requirements put forward by the tax authorities. As a rule, the tax authorities disallow deduction of input VAT indicated in VAT invoices issued by contractors based on signed interim statements of rendered construction services (in the prescribed form KS-2) before the transfer of results of construction project and risks to the client (investor).

We believe that this position is not legally founded as there is no requirement in the Russian Tax Code to wait until completion of the construction project and transfer of its risks to the client (investor) in order to able to deduct the relevant input VAT. Also, there is a court decision that dismisses the position held by tax authorities (Ruling N KA-A40/2227-11 of the Federal Arbitration Court in the Moscow Region dated 07.04.2011 on case N A40-60156/10-35-331).

At the same time, the Russian Ministry of Finance allows deductions of input VAT in such situations if input VAT is included into advance payments (letter No 03-07-10/12 dated 31.05.2012). Furthermore, in the letter 25.01.2011 N KE-4-3/860@ Federal Taxation Service states:

> *"Under Article 171 Item 12 of the Code, a taxpayer, who has made payment (partial payment) for future deliveries of goods (performance of work, provision of services, transfer of property rights), may deduct the tax amounts charged by the seller of such goods (work, services, property rights) upon receipt of such payment (partial payment). In addition, Article 172 Item 9 of the Code sets out that the deduction is made on the basis of the following documents:*
>
> - *VAT invoice issued by the seller upon receipt of prepayment;*
> - *Documents confirming the actual transfer of advance payment by the buyer;*
> - *Agreement providing for the transfer of prepayment.*
>
> *When the above conditions are met, the taxpayer transferring VAT (including when the taxpayer is at the same time investor and developer), who has made payment (partial payment) for the forthcoming performance of work, may deduct the tax amounts charged by suppliers and contractors."*

In other words, the tax authorities allow input VAT deduction provided that such input VAT is included into payments made to a contractor if such payments qualify for so-called advance payments. In order for a payment to qualify for an advance payment, it should be expressly provided for in the relevant agreement and named as such in invoices issued by the contractor and in bank payment documents submitted by the client (investor) to the bank. Advance payments are normally made before completion of the relevant construction project and before transfer of its results and risks to the client (investor).

Recovery of Excess Input VAT

VAT is calculated and paid as a difference between input and output VAT. Input VAT is deducted from output VAT and the difference is remitted to the government. But if input VAT exceeds output VAT, then the difference can be recovered by the taxpayer (art. 176). Offsetting and refunding are two possible forms of VAT recovery (art. 176(1)).

If the taxpayer is indebted on other form of federal taxes or penalty and fines on such, then the VAT recovery is effected by first offsetting the excess input VAT against such arrears (art. 176.4). But VAT may not be offset against any arrears on regional or local taxes.

If there are no VAT or other federal tax arrears, then the tax authorities must confirm that VAT may be recovered, that is, either refunded or offset. Taxpayers are entitled to choose how to effect the recovery, as follows:

(a) offset the recovered VAT against future VAT or other federal tax payments, or
(b) request a VAT refund in cash (art. 176.6).

The law does not differentiate between the procedures for offsetting VAT and for VAT refund. In practice, however, it has been quite difficult to receive actual cash refunds for excess VAT, while there have not been corresponding problems with the procedures for offsetting.

The Procedure on VAT Recovery Consists of the Following Steps:

1. Submission of a VAT return,

2. Desk tax audit.

   After receipt of the VAT return, the tax office will conduct a VAT desk tax audit (art. 176.1). Such a desk tax audit must be conducted within 3 months from submission of the tax return (art. 88.22).

   During a desk tax audit, the tax office may request additional data and supporting documents from the taxpayer to prove that the input VAT has been duly deducted (art. 88.8). In practice, the control is less rigid when the taxpayer claims an offset of tax as opposed to claiming a cash refund.

During such a desk tax audit the tax office may in practice also summon the taxpayer for questioning, which is frequently done especially when the taxpayer claims a refund (art. 31.1(4)).

Based on the results of the desk tax audit, the tax office will decide whether to allow the recovery (in full or partially) or decline it. This decision must be taken within 7 days from completion of the audit.

3. Request for actual refund (or offset against future tax liabilities)

   Tax authorities were known to require that a taxpayer additionally file a request to pay the recovered VAT to a certain account, and argued that without receipt of such a request no refund can be done.

   However, the courts have not always supported the tax authorities, and stated that if a taxpayer has submitted a tax declaration in which VAT has been calculated for reimbursement, the tax authorities must return the overpayment to any of the taxpayer's accounts known to them if the taxpayer has not requested in writing setting off the overpayment towards payments to be made in the future (see, for instance, Resolution of the Presidium of the SCC RF dated 21.02.2012 No. 12842/11).

On 1 October 2013, amendments were made to the Tax Code which confirmed the necessity of submitting a separate written application for return. Moreover, such an application must be submitted by the taxpayer to the tax authority before the tax authority hands down a decision to reimburse the VAT (art. 176 (11.1)). If the application is submitted later, then the procedure for reimbursement specified for reimbursement of other taxes is applied. It specifies longer terms for reimbursement. By virtue of law it is not quite clear whether offsetting of input VAT is subject to any time limit. Tax authorities attempt to impose a three-year limit by virtue of article 173.2 of the Tax Code although this article only restricts the period for filing a VAT return indicating the VAT to be recovered but not offset per se (letter No. 03-07-11/408 of the Russian Ministry of Finance dated 13.10.2010). This position held by tax authorities has found support in court practice (decision No. A13-9919/03-21 of Federal Commercial Court in the North-West district of 13.09.2004).

Until year 2002 offsetting of input VAT was conditional to the goods or services having been acquired for production activities (i.e. as input in the production of goods or services for sale). But even after the change of law the original provision lives on in the practice of tax authorities who often still insists on its applicability. It is also noteworthy that according to tax authorities, deductions of input VAT go hand-in-hand with the deductibility of expenses for profit tax purposes. Tax authorities indeed usually claim that taxpayers may not deduct input VAT if the expenses incurred upon purchase of goods on which the above input VAT is paid are not deductible for profit tax purposes. This position held by tax authorities is disputable since the law does not tie deductibility of input VAT to deductibility of expenses for profit tax purposes.

Tax authorities also attempt to deny VAT recovery in periods in which no taxable transactions have been undertaken (letter of Ministry of Finance of Russia No. 03-07-14/124 of 14.02.2011). In other words, if a company has no output VAT (does not charge its clients output VAT) in the relevant period, it may not recover in the same period input VAT paid to its suppliers and contractors, according to the Ministry of Finance. This position is not legally founded since there is no such prerequisite in the law. The latter position has found support in the Supreme Commercial Court (ruling of presidium of Supreme Commercial Court No. 14996/05 on case No. A06-2102y-4/04 of 03.05.2006). The Supreme Commercial Court ruled that lack of output VAT does not *per se* prevent a taxpayer from recovery of input VAT in the relevant period. Since then there have been other court decisions supporting the possibility to recover input VAT in periods with no output VAT (for example, Ruling N F03-2163/2009 of the Federal Commercial Court in the Far Eastern District dated 26.05.2009 on case N A59-2931/2008; Ruling of the Supreme Commercial Court of Russia dated 13.08.2009 N VAS-10133/09 on case N A59-2931/08-C19; Ruling N KA-A40/5815-09 of the Federal Commercial Court in the Moscow Region dated 25.06.2009 on case No. A40-86151/08-139-397). However, court practice on this issue is inconsistent.

Declarative Procedure for VAT Refund

The declarative procedure for VAT refund allows taxpayers to recover tax before completion of a tax desk audit as per above.

Only taxpayers, who meet specific criteria may apply this procedure (art. 176(2)). These criteria are as follows:

1) The total sum of VAT, profit tax, excise duties and Mineral Extraction Tax paid by the taxpayer over the 3 preceding years amounts to at least10 billion rubles, or
2) The taxpayer submits together with its tax return an irrevocable bank guarantee securing the recollection of funds possibly reimbursed in excess of the actual amount as a result of using this method.

The conditions of the bank guarantees are set forth in the Tax Code (arts. 176.1(6), 74.1). Ministry of Finance has issued a list of eligible banks. The law sets special requirements which banks must satisfy in order to be included in the list (art, 74.1).

Within 5 days from the receipt of an application from the taxpayer, the tax office must verify whether the taxpayer has any tax arrears, and then decide whether to offset or refund (in full or in part) the amounts claimed.

VAT Rules Concerning Foreign Suppliers

Payments in favor of foreign suppliers that are not registered in Russia as taxpayers are subject to a so-called reverse charge VAT, which is made by the Russian customer acting as a tax agent (arts. 161(1-2), 166 (1,3)). In this case, it is thus the client that must withhold the VAT from the payments due under the contract and remit it to the government simultaneously with effecting the payment to the foreign supplier (art.174(4)). In contrast to the general rule, under which VAT is added to the price of goods, in case of reverse charge VAT, it is presumed that the contract price does include VAT, if there are no provisions to the contrary in the contract.

The reverse charge VAT withheld from the foreign supplier represents input VAT for the tax agent (the client) and can therefore be deducted according to the normal rules (art. 171(3)).

When a foreign company acts as a buyer, it is entitled to deduct the input VAT paid to Russian suppliers, but to do so the following three conditions must be met:

(i) the foreign company has registered with Russian tax authorities,

(ii) the input VAT has accumulated in relation to the production of goods or services which have been further supplied to a Russian purchaser,

(iii) the Russian purchaser has withheld VAT.

Treatment of Input VAT in Connection with Exempt Sales

The treatment of input VAT follows special rules when the sale of goods or services does not constitute an object of taxation or is exempt from VATas per articles 146(2) and 149, or when no VAT is levied in accordance with the place of supply rules (arts. 147,148), and in some other cases. In these cases input VAT is not deducted from Output VAT and instead the corresponding VAT amount is to be attributed to deductible expenses for profit tax purposes (art. 170 (2)).

If a taxpayer has made sales of both the normal nature subject to VAT and VAT exempt sales, then the input VAT will be included in expenses in proportion of exempt sales to sales subject to VAT. In this case, taxpayers have to keep separate accounting records for both kinds of sales, or else risk losing the right to offsetting or refund.

When exempt sales represent less than 5 % of all sales, it is not required to include input VAT in expenses as per the aforementioned rule and in this case input VAT may be deducted according to the ordinary procedure (art. 171). Notably the tax authorities argued prior to 1 October, 2011 that this 5 % rule did not apply to commercial organizations reselling goods. But with amendments to the Tax Code of that date this issue was settled so as to extend by virtue of written law the 5 % rule also to cover the re-sale of goods (services).

Input VAT is included in expenses for profit tax purposes in the following cases:

- Input VAT is paid (e.g. at customs) by a company (or individual Entrepreneur), which is not a taxpayer of VAT or benefits from small business exemption (or Skolkovo exemption);
- Input VAT is incurred in connection with the purchase of goods or services, acquired for saleand/or production of goods and services, which are not subject to VAT or which are not supplied in Russia (art. 146-149);
- Input VAT is paid by banks and insurance companies in connection with purchase of goods (services) (if the banks or insurance companies decide to apply that procedure of recording incoming VAT).

VAT Restoration

One of the preconditions for deducting input VAT is that the purchased goods (services) are utilized in operations subject to VAT. If the purchased goods (services) are not intended to be used in VATable operations, then there will not be any grounds for the deduction.

If goods and services, for which input VAT has been deducted, are at some point in the future used for non-taxable purposes, then the tax must be restored (i.e. is returned to the government (art. 170 (3,4) and regarding capital construction art. 171(6)) . When the goods and services in question were partially used for both taxable and non-taxable activities, then the Input VAT previously deducted must be restored in proportion to the taxable and non-taxable operations. In most cases, such restored amounts of input VAT will for profit tax purposes be included in the value of goods (services) and deducted as expenses.

Offset (recovered) input VAT must also be restored in cases when goods (services) are used to manufacture goods, which are then sold in transactions onto which zero-rate VAT is applied. Such VAT is restored in the period before taxpayers confirm the validity of application of zero-rate VAT. As soon as zero-rate VAT is confirmed (or if it is not confirmed and taxpayers apply standard rate VAT), taxpayers may deduct the recovered input VAT.

Administrative Issues

VAT administration is quite cumbersome and places a heavy burden on a taxpayer's organization in Russia. In order to claim VAT deductions and VAT recovery the taxpayer has to ensure compliance with a number of technical rules concerning proper documentation of transactions. The collection of all supporting documents is time consuming and demanding on company resources. The supporting documents are subject to rigid rules as to their set form. And notwithstanding serious investments in VAT administration taxpayers anyway face the risk of arbitrary rejection of the supporting documentation based on mere technicalities or problems connected suppliers. Separate accounting records and tax returns are required for taxable and non-taxable operations. Taxpayers are required to file VAT returns quarterly and pay VAT in equal installments over three months following the tax period (i.e. quarter). For a transaction liable to VAT (a VATatable transaction) the seller is required to issue a VAT invoice (in Russian "Shchyet-faktura") following a rigidly prescribed form.

VAT Invoice

As a general rule, the VAT is added on to the price of goods, service, or property right. Sellers are required to issue and present to the buyer a relevant invoice containing the details prescribed by the law (arts. 168,169). Such invoices are referred to as VAT invoices (in Russian "Shchyet-faktura").

In business to business transactions the VAT amount is usually indicated on a separate line in the settlement documents. In retail sales, however, VAT is normally included in the displayed prices. Labels, price tags, cash receipts, as well as other documents given to customers do in these cased not indicate the VAT separately. Hereby cash receipts must be issued in compliance with a prescribed form.

The requirements on needed data fields in a VAT invoice are presented in below table.

Requirements to VAT Invoices

- Number and date of issuance
- Taxpayer's identification number ("INN") of buyer and seller
- Number, name and address of seller and buyer
- Name and addresses of the consignor and consignee
- Number of payment and settlement document (in case of advance payments)
- Details concerning the unit of measurement of the goods (services) sold
- Quantity (volume) of delivered (dispatched) goods (services)
- Unit price goods (services)
- Currency of transaction
- Total price, excluding VAT
- Excise tax (when applicable)
- VAT rate
- VAT amount
- Total price, including VAT
- Country of origin of goods (if goods are manufactured outside Russia)
- Number of customs declaration (if goods are manufactured outside Russia)

Some of these details are not required if a VAT invoice is issued for an advance payment.

VAT invoices must be signed by a company's general director and chief accountant or any officers duly authorized by the company.

VAT invoices for foreign trade transactions may indicate amounts in a foreign currency.

An important amendment to the Tax Code will take effect on 01.01.2014. Under this amendment, intermediaries and agents that are not taxpayers of VAT (for instance, those applying a simplified taxation system) will be obligated to keep journals recording tax invoices drawn up and received, in the event that they receive or draw up tax invoices when engaging in business activity in the interests of a principal. Previously, they had no such obligation. Also, starting on 01.01.2015 these agents, not being taxpayers, will also have to submit such journals to the tax authority. From 1 January 2015, agents and representatives that are taxpayers will likewise have to submit information to the tax authority on tax invoices drawn up and received by them when engaging in business activity in the interests of another party on the basis of agency agreements, commission agreements, or contracts of agency by including such information in the VAT declaration (art. 12 of Federal Law of 28.06.2013 No. 134-FZ).

Electronic VAT Invoices

VAT invoices may now be issued in electronic form. The relevant provisions were enacted in the Tax Code (art. 169), specifically allowing the issuance of electronic VAT invoices. Based on the law competent authorities had to approve a range of normative acts.

The Ministry of Finance issued an Order (No. 50n of 25.04.2011) that sets out: the procedures for transfer of e-VAT invoices from the seller to the buyer via an operator providing services of interchange of open and confidential information via telecommunication channels; the procedures for confirming approval and sending notifications between the operator, buyers and sellers.

A Governmental Decision (No. 1137 of 26.12.2011) established the forms and methodology of: the VAT invoice; journals of received and issued VAT invoices; sales and purchases books; Finally an Order of the Federal Tax Service (MMB-7-6/138@ of 05.03.2012) sets the technical requirements as to the electronic format of the necessary documents. On 11.04.2012 the Ministry of Justice of Russia registered the Order and it was officially published on 12.05.2012, coming into force on 23.05.2012.

On 11.04.2012 the Ministry of Justice of Russia registered the Order of the Federal Tax Service of the Russian Federation (hereinafter, “FTS”) dated 05.03.2012 No. MMB-7-6/138@ “On the approval of electronic formats of VAT invoices, journal of received and issued VAT invoices, purchases and sales books, additional sheets to the purchases and sales books”.

A precondition for the legislation to enable the issuance of electronic VAT invoices was the enactment of the possibility to use digital signature (federal law “on digital signature” No. 63 of 06.04.2011)). The electronic VAT invoice shall be signed with an electronic digital signature and transferred via a data channel operator.

Applying electronic VAT invoicing will not be compulsory and it is up to the parties of the transaction to decide upon using the system based on mutual consent and availability of compatible technical means.

It should be noted that ordinary invoices (apart from VAT invoices) do not have any official role in Russian accounting and tax law and can therefore be issued in any form that a company deems useful.

Corrective VAT Invoice (Credit Note)

Russian law and business practice was until recently ambivalent in regards to the possibility to issue credit notes (invoices cancelling earlier invoices). Neither the Tax Code nor the Accounting Law contained any clear provisions regulating the issue. But with an amendment of the Tax Code in 01.10.2011 provisions regarding a credit note in respect to VAT invoices was stipulated, referred to as a “corrective VAT invoice” (art.169).

It is important to point out that taxpayers may compile a consolidated tax invoice for a change in the value of shipped goods or services indicated in several tax invoices compiled earlier.

VAT Exemption for Diplomats

The VAT exemptions for diplomatic missions and diplomats can be divided in three categories as follows:

1. VAT exemption on rent of premises and apartments,
2. VAT exemption for goods imported for official or personal use,
3. VAT exemption (zero-rate VAT) for goods and services bought in Russia, applicable in consideration of the restrictions described below.

The Tax Code establishes the general rule for VAT exemption for diplomats (art. 164(7)). According to this provision, zero-rate VAT applies to the sale of goods and services for the official use of foreign diplomatic missions and other representations with a diplomatic status, or for the personal use of diplomatic, administrative and technical personnel and their family members.

In practice, applying zero-rate means that prices must be reduced by the amount of tax upon sale. But in many cases, particularly in retail transactions, it is impossible to buy goods or services without VAT. In such cases, the amount of tax must be reimbursed by the Treasury to the purchaser (letter of the Ministry of Taxes and Duties No.RD-6-23/670 of 17.06.2003). Government decrees No. 455 dated 22.07.2006 and No. 1033 dated 20.12.2000 establish the procedure for such reimbursement.

These VAT exemptions do not apply automatically to all diplomats and diplomatic and are only valid based on the principle of reciprocity (based on an international treaty or in the case that a corresponding tax regime applies in respect to Russia in another country). Thus the exemptions apply only to diplomats (diplomatic missions) from countries that have extended corresponding exemptions to Russian diplomats.

The Ministry of Foreign Affairs and Ministry of Finance have published a list of the countries that are parties to the respective treaties (Decree No. No. 6499/41N of 08.05.2007).

Administration Issues and Restrictions to Applicability

The Tax Code also delegates powers and authority to the Russian Government for establishing and describing in detail the procedures for the application of these VAT exemptions. Under these powers, the Russian Government has issued a decree (No. 1033 of 30.12.2000) with the relevant details.

According to joint decree of the Ministry of Foreign Affairs and Ministry of Finance (No. 6499/41N) the diplomatic missions eligible for the exemption can be grouped in three categories as follows:

Category I — countries whose diplomatic missions are fully exempt from VAT;

Category II — countries whose diplomatic missions are partially exempt from VAT;

Category III — countries whose diplomatic missions are not exempted from VAT.

The goods and services to which exemptions apply for category II countries apply are subject to a review from time to time and vary from country to country.

The extent of the exemption is separate for goods and services intended for personal use of diplomats and for goods and services intended for official use of the diplomatic mission, and is further depending on the status of the diplomat, family and other staff of the mission.

The diplomatic VAT exemptions may be illustrated by the rules applicable in relation to diplomats of the United Kingdom, which have been set following the principle of reciprocity. According to the rules the following kinds of goods and services acquired for official use are totally exempt from VAT: alcoholic products; tobacco products; fuel and lubricating substances; lease of premises; vehicles; building maintenance and reconstruction services.

Items of furniture and interior design items are exempt, provided that each separate receipt amounts to at least GBP 1,000.

The purchases for personal use by heads of diplomatic missions follow the same rules as those established for official use. And in addition to that the heads enjoy exemptions in regards to real estate. The head may acquire one car within the scope of the exemption whereas the diplomatic mission is not restricted in number of cars in this respect.

Other diplomats than heads of diplomatic missions are exempt from VAT on purchases for personal use of alcohol, tobacco, fuel and lubricates, one automobile, real estate, and the lease of premises.

Other staff of the missions and family members of diplomats do not enjoy any missions except for on purchase of one automobile.

Required Documents and Form

A diplomatic VAT exemption is valid only when certain documents have been produced and kept in support of the right to apply the exemption, as follows:

1. VAT invoice

   The Russian seller of goods (work, services) is required to issue an official VAT invoice in accordance with the legal requirements.

2. A written agreement

   The Russian seller and the diplomatic mission are required to sign an agreement outlining identifying the goods (services) purchased and the conditions.

3. A receipt confirming payment

4. An official letter from the diplomatic mission

   The Russian seller must be able to show an official letter addressed to the seller from the diplomatic mission, sealed and signed by the Head of Representation or a duly authorized deputy, which that the goods (services) are intended for official use of the diplomatic mission or personal use of the diplomats, staff and family (when applicable).

When the goods (services) are acquired for the personal use of the diplomats, family or other staff, certified copies of diplomatic cards have to be submitted.

12. TRANSFER PRICING IN RUSSIA

Russian rules on transfer pricing are set out in the Tax Code (arts. 20, 40, section V.1) as significantly amended in 2011. These amendments became effective on 01.01.2012 (some of the provisions were deferred to take effect in years 2013 and 2014).

The previous rules on transfer pricing had been in force since 1999, but were rarely applied in practice. It is likely that these new transfer pricing rules will now become one of the priorities of the tax authorities. The issue requires a lot of attention as the new transfer pricing rules do not enable to claim that one single price could be objectively ruled as being the only possible price among other prices depending on the details of the transfer pricing method used. Therefore the tax authorities will have ample room for mounting a challenge to the prices applied by taxpayers. A taxpayer must therefore be prepared to justify the prices applied regardless of his chosen transfer pricing policy hence the need for diligent documentation of the applied transfer prices.

Applicability of Transfer Pricing Rules

Controlled Transactions

By and large, the amendments to the Tax Code significantly narrow the sphere of transactions to which transfer pricing rules apply. With these new rules the focus has shifted from third-party transactions to related-party transactions. In case of domestic transactions in Russia, transfer pricing rules apply to related-party transactions if the transactions meet certain volume criteria and in certain exceptional cases (see Table 1 for details). But cross-border transactions between related parties remain subject to transfer pricing rules notwithstanding the volumes of the transactions. Cross-border transactions between independent (non-related) parties will be subject to transfer pricing rules only if the transactions involve certain goods traded on a foreign commodities exchange and in case when the counterparty is located in a tax haven (see Table 1 for details).

A novelty of the new law is that the rules may apply to a chain of similar transactions, and not only a single transaction, as under the previous transfer pricing rules. A chain of transactions between related parties entered into with the participation of non-related parties (or by agency of such) is considered a transaction between related parties, provided that these non-related parties:

- do not perform any additional functions other than the organization of sales (resale) of goods;
- do not take on any risks and use any assets in the process of organizing sales of goods.

Example: Company A (France) sells goods to Company B (Russia), a non-related company, which subsequently resells them to Company C (Russia). Company B does not do anything with the goods except reselling them. Company A owns a 60 % share in Company C's charter capital. This transaction may be considered as a transaction between related parties and therefore is subject to transfer pricing rules.

Table 1 — Criteria for applicability of transfer pricing rules

A. **Cross-border transactions**

1. Related-party transactions	No qualifying threshold for revenue is set for these types of transactions (but see 1.2. Transition Rules).
2. Third party transactions, involving certain goods traded on a foreign commodities exchange (oil and oil-product, ferrous and non-ferrous metals, mineral fertilizers, precious metals and stones)	If total annual revenue derived from these transactions exceeds **RUR 60 million**
3. Transactions between Russian tax residents and residents of jurisdictions deemed tax havens according to Russian law (blacklist[132])	

133 A list of countries, issued by the Ministry of Finance in accordance with Tax Code (art. 284(3)11 of the Tax Code), from which dividends received by Russian corporations do not qualify under the law of participation exemption. See Order of the Ministry of Finance No. 108n of 13.11.2007.

B. **Domestic transactions**

1. One of the parties applies either the tax regime of Unified Tax on Imputed Income or Unified Agricultural Tax	If the total annual revenue derived from these transactions exceeds **RUR 100 million**
2. Transactions involving operations with mineral resources subject to Mineral Extraction Tax at *ad valorem* rate, and one of the parties is a payer of this tax	If the total annual revenue derived from these transactions exceeds **RUR 60 million**
3. One of the parties is exempt from Corporate Profit Tax or applies a 0 % Corporate Profit Tax Rate (e.g. as a participant in Skolkovo)	
4. One of the parties is a resident of a Special Economic Zone (SEZ) (this provision will apply from 01.01.2014 onwards)	
5. Other related-party transactions (with certain exceptions)	If the total annual revenue derived from these transactions exceeds RUR 1 billion. (See 1.2. Transition Rules).

The law does not expressly limit the application of the new transfer pricing rules to any specific types of goods or services. On the contrary, the law expressly states that the new transfer pricing rules apply to any transaction resulting in taxable income or deductible expenses for at least one of the parties to the transaction (Item 13 Article 105.3 of the Russian Tax Code).

Inter-company transactions may include, for example, a transfer of tangible or intangible assets, an inter-company service, cost allocation arrangements, and financing agreements. All of the above transactions may be subject to transfer pricing rules mandating the parties to apply fair prices and provide proper documentation for the prices that they apply.

The law establishes a number of exceptions to this rule when transactions are not deemed controlled transactions for the purpose of transfer pricing rules (see below for more details).

Transition Rules

The new law contains transition rules according to which the applicability of the new rules will be imposed gradually until year 2014.Thus domestic related-party transactions will be deemed controllable if the total annual revenue derived from these transactions exceeds RUR 3 billion in 2012 and, RUR 2 billion in 2013. From 2014 the threshold will be RUR 1 billion.

According to other transition exemptions a taxpayer is not required to provide tax authorities with reports on controlled transactions or keep transfer pricing documentation, if their value in 2012 does not exceed RUR 100 million and RUR 80 million in 2013. From 01.01.2014 no exemption thresholds will apply.

The new transfer pricing rules do not apply to granted loans, credits (including trade and commercial credits), indemnity or bank guarantees. The said exception can, however, be used only if the conditions of the above transactions have not been changed after 01.01.2012.

Calculation of Annual Revenue

To determine whether a transaction is subject to transfer pricing rules, the total revenues derived from the transaction with one or several related parties in a calendar year must be compared to the above reported thresholds.

The law does not define whether the excess of the threshold amount shall be determined by comparing the latter (a) with the profit from transactions with each individual entity or (b) with the total profit from all controlled transactions of the taxpayer with all controlled entities. The latest letters of the Ministry of Finance of Russia confirm that to calculate whether the threshold amount has been exceeded or not it is necessary to sum up the profits for a calendar year from transactions with each individual entity, and not the profits from transactions with all affiliates (e.g. letter of the Russian Ministry of Finance No. 03-01-18/17224 dated 16.05.2013).

The law establishes that it is precisely the taxpayer's *revenues* which are considered to determine whether the set thresholds are exceeded. In this case such transaction is deemed as controlled transaction. But it is unclear as to whether a transaction is considered a controlled transaction when taxpayers are buyers/customers, i.e. when they incur only expenses (as opposite to making revenues).

We believe that transactions in which taxpayers are buyers/customers should still be subject to transfer pricing rules, provided that the revenue of the other party to the transaction exceeds the established thresholds. Indeed, it is not quite clear from the law whether the revenue to be considered for calculating the threshold values is solely limited to the revenue earned by one of the parties (Item 7 Article 4 of Federal Law N 227-FZ dated 18.07.2011), rather it seems that to determine whether the thresholds have been exceeded, the revenues derived by the other party (parties) should also be taken into account. The latter interpretation is supported by also by the provision according to which the transfer pricing rules should apply to transactions resulting in taxable revenue or deductible expenses for at least one of the parties to the transaction (article 105.3 paragraph 13). Inversely, it may be argued that if the transfer pricing rules would not apply to transactions in which taxpayers are buyers/customers, then the resale price method would not be applicable at all although it is expressly provided for as one of the methods for the cases when Russian taxpayers resell products purchased from a related party.

Another important question relating to VAT arises when determining whether a transaction exceeds the established thresholds: Should the VAT amounts included in the price of goods (work, services) be taken into account? The law does not allow drawing a clear conclusion. In some cases, the law uses the term "transaction price", which as a rule includes VAT. In other cases, the law refers to revenues of the party to the transaction to determine whether the thresholds are exceeded. But taking into consideration the general provision of the profit tax laws according to which revenue is to be calculated net of VAT (Article 248 of the Russian Tax Code) we may conclude that VAT should not be taken into account when determining threshold values.

Exceptions to Transfer Pricing Rules

Some types of transactions are exempt from transfer pricing controls by virtue of law; these are:

a. Transactions between parties to a Consolidated Group of taxpayers (except for transactions with minerals);
b. Transactions in which the following criteria are met simultaneously:
    - both parties are registered in the same region in Russia;
    - neither party has subdivisions in any other region in Russia;
    - neither party pays profit tax in other region in Russia;

- neither party has recorded any tax losses for profit tax purposes;
- neither party applies a special tax regime (Unified Tax on Imputed Income, Unified Agricultural Tax, Mineral Extraction Tax) or is exempt from corporate profit tax, applies a 0 % corporate profit tax rate, or is a resident of a special economic zone.

Related Parties

Compared to the previous rules, the new transfer pricing rules (effective as of 01.01.2012) expand the scope of related parties. According to the previous rules, related-party transactions arose in cases when one of the parties to a transaction owned at least 20 % of the charter capital of the other party, or in relation to individuals, when one party was organizationally subordinated to the other, or when the parties were relatives (spouses, other relatives, trustees, and legal guardians.)

The new rules define Related Parties more broadly as "such parties whose specific relationship may influence the transaction terms or their financial results." Such specific influence may be brought to bear by way of:

(a) shareholding (or other ownership);
(b) a contractual arrangement between the parties;
(c) professional or family relations;
(d) any other circumstance which allows one party to influence the other party's decision-making.

The law provides a list of circumstances under which a transaction is deemed transaction between related parties. Thus according to article 105.1 of the Russian Tax Code, the following transactions are considered as related-party transactions:

1) Transactions involving parties one of which owns directly or indirectly more than 25 % of the other;
2) Transactions between sister companies, if the mutual parent company owns directly or indirectly more than 25 % in both sister companies;
3) Transactions between a company and a party authorized to appoint general director or at least 50 % of the members of a supervisory or management board;
4) Transactions between companies of which the general director or at least 50 % of their supervisory or management board have been appointed by the same party;

5) Transactions between companies of which more than 50 % of the members of supervisory or management board consists of the same individuals or their close relatives;
6) Transactions between a company and its general director;
7) Transactions between companies that have the same general director;
8) Transactions within a chain of companies (or individuals) in which each company (individual) owns more than 50 % of the charter capital in the following company;
9) Transactions between individuals, if one of them is organizationally subordinated to the other;
10) Transactions between individuals in close family relations.

Further courts may on other grounds deem parties to a transaction as related parties, if the relationship between them is such that one party can influence the other party's decision-making.

The law grants to the parties to a transaction the right to be recognized themselves as related parties on grounds, which are not expressly specified in the law. A taxpayer may want to reach such recognition, for example, for the purpose of entering into an advanced pricing agreement (APA).

Arm's Length Principle

The new rules require that the prices applied in controlled transactions should be in line with the prices applied by non-related parties on the market for comparable transactions under similar economic conditions (arm's length principle). It is important to note that from the transfer pricing rules there does not follow any requirement to apply any determined price in a contract or a determined price for the settlement of transactions; transfer pricing rules only concern the taxation of the transaction requiring taxpayers to record the controlled transactions in the tax accounting records according to the rules (or in regards to the rules of transfer pricing at customs to declare the transactions accordingly). In other words, for the purpose of transfer pricing, taxpayers may set any prices for their transactions, provided that they pay taxes as if they had applied market (fair) prices.

Although the wording of the arm's length principle is quite simple, its application is complicated by the fact that taxpayers are required in order to comply with the rules to collect a considerable amount of information on comparable transactions. Such information is often hard to come by, for example, in regards to transactions involving non-related parties. Moreover, the information available may be incomplete or insufficient for the purpose of setting the fair price. We should also consider that there may be transactions that by their nature are such that only related parties would conclude such in the first place.

The application of the arm's length principle can be illustrated with the following steps:

Step 1 Analyzing controlled transactions

This analysis aims to determine the key conditions of controlled transactions, which affect or may affect the transaction price (compared conditions). These conditions of controlled transactions are compared to the conditions under which transactions between non-related parties are entered into in order to determine which transactions may be considered as comparable among the multitude of transactions on the market. Among comparable conditions are: comparable characteristics of goods and services, functions performed, risks assumed by each party (functional analysis), the terms of payment, etc.

Step 2 Identifying transactions which can be deemed comparable transactions, and their comparison to controlled transactions (comparability analysis). For more information about comparability analysis, please see section 3 below.)

Step 3 Establishing the price range in line with the arm's length principle and adjusting the prices of the controlled transactions according to the arm's length range (where necessary).

The results obtained by taxpayers at the end of each stage must be thoroughly documented.

Arm's Length Range

The new transfer pricing rules introduced procedures for calculating the price range within which the price of goods and services should fall for tax purposes (arm's length range). As a rule, one cannot establish the existence of a single market price for a particular commodity and all market participants. Transactions between non-related companies may be entered into at different prices, each of which will comply with the arm's length principle. Therefore, according to the general rule all transactions should be taken into account to determine the market price range. And as long as a controlled transaction price is within the market price range, it is considered to be at arm's length.

Prior to 01.01.2012 the law recognized as acceptable market prices such prices that did not deviate by more than 20 % from the prices applied by independent parties on the market. The new rules abolished this range and require that prices applied in controlled transactions correspond to prices applied by independent parties on the market for comparable transactions. This means that even a slight deviation from the market price range may be viewed as a violation of the arm's length principle.

The law establishes certain cases of exceptions to the rule of arm's length range, which are:

- Transactions with prices prescribed by antimonopoly authorities;
- Transactions with prices in line with a price regulated by Russian authorities (the law also provides additional requirements for these transactions);
- Price of transactions concluded on a recognized commodity exchange
- Prices determined in accordance with an advanced pricing agreement (APA see section 8 below);
- Other exceptions

The law prescribes certain methods that can be applied to determine the arm's length price range (transfer pricing methods.) You will find a more detailed description of these transfer pricing methods in section 5 below. It should be noted that regardless of which transfer pricing method is used, it must be used to determine the conditions and prices applied by third parties at arm's length, i.e. in comparable transactions. So, before considering transfer pricing methods, it is necessary to describe how comparable transactions are identified.

Comparability Analysis

The arm's length principle is generally applied by comparing the conditions in a controlled transaction to the conditions in transactions between non-related parties under similar economic circumstances. In other words, taxpayers should support the prices they apply in transactions with related companies by providing evidence that third parties would have applied the same prices under similar circumstances. To this end a comparability analysis represents a key aspect of applying the arms' length principle and, thus, compliance with the transfer pricing rules.

Comparability analyses are conducted with the aim to justify applied prices. In the course of such analyses, taxpayers collect and select information on comparable transactions (comparables), but this is only the first step of a comparability analysis, which also requires comparing particular transactions to comparable transactions. The second step of comparability analysis consists in interpreting and using the collected information on comparable transactions, including performing comparability adjustments. The information on comparables is further used to calculate the arm's length range to justify the prices applied by taxpayers. You will find below a more detailed description of comparability analysis.

'Comparables' mean transactions between non-related parties, which are executed under the same commercial and financial circumstances as the analyzed transaction (article 105.5 of the Russian Tax Code). There are two types of comparable transactions:

(a) Transactions between taxpayers and third parties (internal comparables);
(b) Transactions between third parties at arm's length (external comparables).

As a rule, it is recommended to thoroughly search for internal comparables since such transactions by definition comply with the particular taxpayer's business model and will therefore more likely be considered as comparables. Moreover, information on internal comparables is more readily available than information on external comparables.

Controlled and uncontrolled transactions are comparable if none of the differences between the transactions can materially affect the price or margin, or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences. The following factors should be revealed so as to determine the comparability of transactions (comparability parameters):

a. Characteristics of the goods (services) objects of transaction;
b. The functions performed by the parties and allocation of responsibilities between them, the resources used by the parties, and the risks assumed (functional analysis);
c. Terms and conditions of agreements (contracts) affecting the prices;
d. Characteristics of the parties' economic conditions, including characteristics of the relevant markets to the degree they affect the prices;
e. Business strategies applied by the parties in relation to the transactions.

Depending on the circumstances of a particular transaction, each of the above factors may have a greater or lesser weight. If the comparability parameters turn out to be different, the transaction can still be deemed "comparable", if these differences do not materially affect the results of such transactions. It is usually required to find at least 4 comparables for application of the Resale Minus, Cost Plus or the Comparable Profitability methods, while for the purposes of Comparable Uncontrolled Price Method, one comparable transaction is sufficient. If fewer than four comparables can be identified on the market, the law permits to broaden the criteria of comparables by, for instance, using data on transactions from other industries, provided that they do not differ functionally from the analyzed transactions.

Main Steps

Conducting a comparability analysis is a rather time-consuming and complicated process, which can be broken down into the following main steps:

1. Collecting and systemizing the necessary information about taxpayers and their controlled transactions;
2. Analyzing the collected information for the purposes of comparability analysis, conducting a functional analysis;
3. Determining the required comparability parameters;
4. Identifying sources of information on comparables that meet the established comparability parameters;
5. Searching for and identifying comparables required for the analysis;
6. Collecting information on and selecting the comparables;
7. Analyzing the collected information on the selected comparables;
8. Conducting a comparability analysis;
9. Making comparability adjustments, if necessary;
10. Establishing the arm's length range;
11. Preparing a report on comparability analysis.

Functional Analysis

To identify comparable transactions, a so-called functional analysis should be conducted and one of the legally defined transfer pricing methods applied. The functional analysis is part of the comparability analysis and allows determining which parameters should be met by a transaction to be considered as a comparable.

The functional analysis consists in identifying and reviewing the functions performed by the parties to a transaction, the resources used by these parties, the risks taken by the parties, and the allocation of responsibilities between the parties, as well as other similar conditions of controlled and comparable transactions.

The following functions of the parties to a transaction may be taken into account when conducting an analysis of comparability:

- Product design and technological development;
- Production of goods;
- Assembly of products or their components;
- Wholesale or retail sale of goods or organization of sale of products;
- Provision of repair, warranty services;
- Promoting goods (work, service) on new markets, marketing, advertising;
- Storage of goods;
- Transportation of goods;
- Insurance;
- Provision of advice, information services;
- Staff training and education;
- Others.

The functional analysis also takes into account the risks assumed by each party. The following risks are considered:

1) Operational risks, including risk of under-use of production capacities;
2) Risk of change in market prices for purchased materials and manufactured products due to changes in economic conditions, risk of change in other market conditions;
3) Inventory risks;
4) Risks associated with the loss of property, property rights;
5) Foreign currency risks, credit risks;
6) Risks associated with research and development expenses;
7) Investment risks;
8) Environmental risk;
9) Business (commercial risks) associated with the strategic marketing, including pricing policy and strategy of sales of goods (work, services);
10) Risk associated with the market demand for goods (stock risk, warehouse risk).

Official Sources of Information on Market Prices

A comparability analysis requires collecting and comparing information relating to third parties' activities. In practice, such information (price, activity volume, transaction terms and conditions, discounts, etc.) may not be available to taxpayers although the law requires considering a great number of factors affecting the prices applied. The question of possible sources of information is therefore of particular importance to taxpayers.

A comparability analysis should be based on publicly available information sources (article 105.6. paragraph 4 Tax Code). This also means that tax authorities may not use information, which is not available to taxpayers. Tax authorities may use the following sources of information for comparability analysis purposes:

1) Prices and quotations on Russian and foreign trade exchanges;
2) Customs statistics;
3) Official information on prices published by government bodies or foreign governments or international organizations as well as information on prices available in other similar public databases.
4) Information from agencies publishing information on prices;
5) Companies' internal information on comparable transactions;
6) Companies' financial and statistical reports;
7) Information from independent appraisals.

In addition to the above, companies are allowed to use any other information necessary for determining the market price as required by the applied transfer pricing method. Such information may be found in various professional databases.

There are not many databases of that kind in Russia. SPARK database (www.spark.interfax.ru) is the most developed professional database available in Russia. However, there are a number of foreign databases such as, for instance, Standard & Poor's database Compustat (www.compustat.com), Amadeus (www.bvdinfo.com/Products/Company-Information/International/Amadeus) and Osiris (www.bvdinfo.com/Products/Company-Information/International/Osiris) databases, which contain among others financial and other type of information on Russian companies. Particular attention should be paid to the fact that there are very few databases available, and those available offer a quite limited scope of relevant data on the conditions of actual transactions in a particular industry. This sparse information makes it difficult to search for reliable data comparables.

Transfer Pricing Methods

The new rules have increased the number of methods that can be applied to determine the arm's length range for prices. The earlier hierarchy of methods has been replaced with the "best method principle", which means that the most appropriate method must be applied to a specific situation, while the Comparable Uncontrolled Price Method generally remains the primary method.

Traditional Methods:

1. Comparable Uncontrolled Price
2. Resale Minus
3. Cost Plus

New Methods:

4. Comparable Profitability
5. Profit Split

Using a combination of several methods is also permitted. But it should be noted that according to the Tax Code the taxpayer is allowed to use other possible methods, the tax authorities are limited to applying one of the 5 methods referred to above (Article 105.7.12 of the Tax Code).

Comparable Uncontrolled Price Method

The new rules provide that the Comparable Uncontrolled Price method is the primary method for evaluating whether the applied prices are appropriate (except for in regards to trading companies which must apply the Resale Minus method on a priority basis). The Comparable Uncontrolled Price method consists in comparing the prices of controlled transactions to market prices. Applying the Comparable Uncontrolled Price method requires that comparable transactions between non-related parties can be identified on the market to which the transaction under review can be compared, as well as that sufficient information available on those transactions. If only one comparable transaction is found, this method may be applied provided the commercial and financial terms and conditions of the transactions are fully comparable and the seller is not a dominant company on the market.

Transactions between taxpayers and other non-related parties are also qualified as comparable transactions. So, transactions under which taxpayers buy goods from and sell goods to non-related parties, as well as transactions under which goods are bought and sold to affiliated companies may qualify as a comparable transactions and be used to establish market price.

Calculation of arm's length range

The range of market prices is calculated as follows:

Step 1 Sorting comparable transactions by ascending price. Each price value starting from the smallest is assigned a number (price No. 1, price No. 2, etc.)

Step 2 Determining the minimal range value. To do so, compared prices are divided by 4.

(a) If we obtain an integer, then the minimal range value for market prices is the average of the price with a sequence number equal to this integral number and the price with the following ascending number.

(b) If we obtain a non-integral number, then the minimal range value for market prices is the price with a sequence number equal to the integral value of this non-integral number + 1;

Step 3 Determining the maximal range value. To do so, compared prices are multiplied by 0.75.

(a) If we obtain an integral number, then the maximal range value is the average of the price with a sequence number equal to this integral number and the price of the following ascending sequence number.

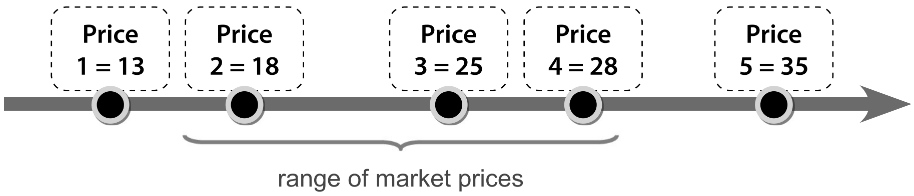
(b) If we obtain a non-integral number, then the maximal range value for market prices is the price with sequence number equal to the integral value of this non-integral number +1.

Step 5 Comparing a controlled transaction prices to a range of market prices for comparable transactions. If only one comparable transaction is available for comparison, then the price for this transaction can be regarded both as upper and lower limits of the range of market prices.

When the proposed method is applied to calculate market price ranges, marginal market prices are in actual fact excluded from the range of market prices. This is done to exclude from the calculation extremely low or extremely high prices, which are unusual on the market. We however believe this exclusion is disputable since these prices have been established between non-related companies under objective factors and should therefore be considered as meeting arm's length principle. If applying extremely high or low prices was dictated by taxpayers' particular economic situations or other factors, then such transactions should not be considered as comparable transactions and therefore should not be used for comparison.

Example of calculation:

The price of our transaction = 20 and we have information on 5 comparable transactions with the following prices:



Step 1 Determining market price range. To do so, compared prices are sorted in ascending order and each price is assigned a number.

Step 2 Determining the minimal value for market prices. To do so, the number of prices (5) is divided by 4. 5: 4 = 1.25.

1.25 is not an integral number. In this case, the minimal price will be the price with a sequence number equal to the integral number (1) + 1.

So, the minimal range value = Price No. 2 = **18**

Step 3 Determining the maximal range value. To do so, the number of prices (5) is multiplied by 0.75. 5 * 0.75 = 3.75

3.75 is not an integral number. In this case, the range value is the price with the sequence number equal to the integral number of this non-integral number (3) + 1. 3 + 1 = 4

So, the maximal range value = Price No. 4 = **28**

Step 4 Comparing our transaction price (20) with the range of market prices (from 18 to 28). In this case, our price is within the market price range and it is therefore deemed to be an appropriate price.

Resale Minus Method

The Resale Minus Method may be used when goods acquired from a related-party are resold by the purchaser to a third party. When this method is applied, it is assumed that the goods are re-sold to third parties at market prices. And it is precisely for this reason that the resale price is used as a base to calculate the market price for the initial sale of goods from the related company to the taxpayer. This method allows determining whether the purchase price of the acquired goods conforms to market prices by comparing the purchaser's gross margin (upon resale) to gross margins in comparable transactions under which resold goods have been acquired from a non-related party. The gross margin is calculated as a ratio of gross profit to sales proceeds.

This method is the primary method for trading companies. This method may not be used as primary method when:

(a) The buyer has substantially processed the good before selling them to a non-related party;
(b) The purchaser does not own any intangible assets which might materially affect the gross margin.

Calculation of arm's length range

Gross margin is calculated as follows:

Step 1 Determining gross margin for a controlled transaction: sales profit is divided by sales proceeds. If the buyer subsequently sells the goods to non-related parties at different prices, when determining the gross margin, the price of the subsequent sale is used as the weighted average price of this commodity for all such transactions.

Step 2 Sorting gross margin for comparable transactions in ascending order. Each margin value is assigned a sequence number (price No.1, price No. 2, etc.)

Please note that margin values for comparable transactions must be calculated on the basis of the accounting records of the parties to comparable transactions, which makes applying this method quite difficult. At the same time, the law also permits using the data from information and pricing agencies to apply the Resale Minus Method.

Step 3 Determining the minimal gross margin value: the number of margin compared values is divided by 4.

(a) If we obtain an integral number, the minimal gross margin value is the average of the margin with a sequence number equal to the integral and the gross margin value with the following ascending number.
(b) If we obtain a non-integral number, the minimal gross margin value is the gross margin value with a sequence number equal to the integral + 1;

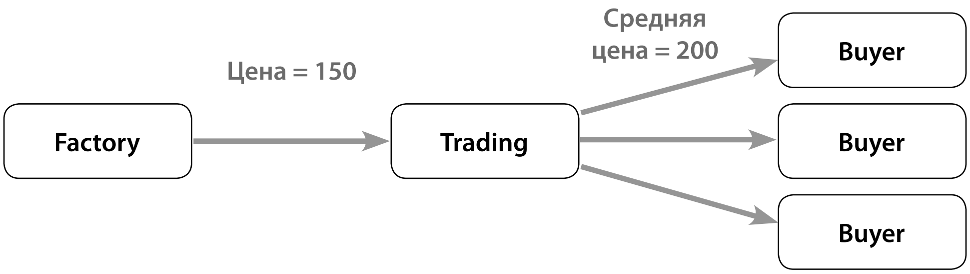
Step 4 Determining the maximal gross margin value: the number of compared gross margin values is multiplied by 0.75

(a) If we obtain an integral number, the maximal gross margin value is the average of the gross margin value with a sequence number equal to this integral and the gross margin value with the following ascending sequence number.

(b) If we obtain a non-integral number, the maximal gross margin value is the gross margin value with a sequence number equal to this integral number + 1.

Step 5 Comparing margin for a controlled transaction to gross margin for comparable transactions

Example of calculation:



Step 1 Determining the transaction gross margin.

Gross margin = gross profit / sales proceeds

Gross margin = (200 — 150) / 200 = 25 %

Step 2 Determining margin range: sorting compared gross margin values in ascending order and assigning a number to each value. In our case, the following 5: 15 %, 19 %, 27 %, 33 %, 36 %.

Step 3 Determining the minimal gross margin value by dividing the number of gross margin value (5) by 4.

5: 4 = 1.25

1.25 is not an integral number so the minimal gross margin value is the gross margin value with a sequence number equal to this integral number (1) +1.

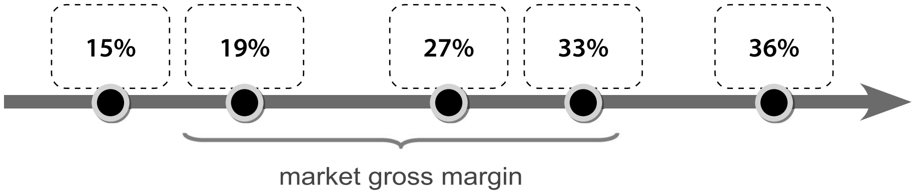
The minimal gross margin value is gross margin No. 2 = **19 %**

Step 4 Determining the maximal gross margin value: the number of the compared gross margin values (5) is multiplied by 0.75.

5 * 0.75 = 3.75

3.75 is not an integral number so the maximal gross margin value is the gross margin value with a sequence number equal to the integral number (3) +1= 4.

The maximal gross margin value is gross margin No. 4 = **33 %**



Step 5 Comparing the gross margin value of our transaction to the gross margin market range:

A gross margin of 25 % is within the market range [19 %- 33 %].

Cost Plus Method

As a rule, the prices of goods or services of non-related companies are formed on the basis of the goods and services' cost and a fair margin. This means that adding a fair margin to costs should result in the formation of arm's length prices.

The Cost Plus Method offers to determine a fair price by comparing the profitability of costs incurred by taxpayers to the profitability of costs on the market. The profitability of costs is defined as the ratio of gross profit to cost of goods sold. In other words, when applying this method, taxpayers compare how the return on their investments to the fair amount of such return on the market.

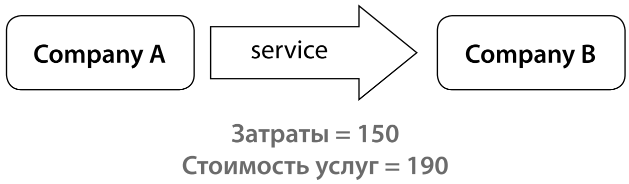
The Cost Plus Method mainly applies to the following cases specified by law:

– Works or services rendered by related parties;
– Provision of services for cash and financial management (treasure, securities market, foreign exchange);
– Management services;
– sale of raw materials or semi-finished products to related parties; or
– Long-term contracts for selling goods or providing services to related parties.

Calculation of arm's length range

The procedure for calculating cost profitability range is the same as the procedure for calculating gross margin range (Please see Section 5.2 above).

Example of calculation:



Step 1 Determining gross cost profitability

Gross cost profitability = gross profit / cost of services

Gross cost profitability = (190 — 150) / 150 = 26 %

Step 2 Determining the market cost profitability range for comparable transactions. To do so, we sort the compared profitability values in ascending order and assign a number to each value. In our case, we have 4 values: 14 %, 17 %, 29 %, 34 %,

Step 3 Determining the minimal value of the cost profitability range by dividing the number of profitability values (4) by 4.

4: 4 = 1

1 is an integral number. In this case, the minimal value of the cost profitability range is the average of the profitability value with a sequence number equal to this integral number (1) and the profitability value with the following ascending sequence number (2).

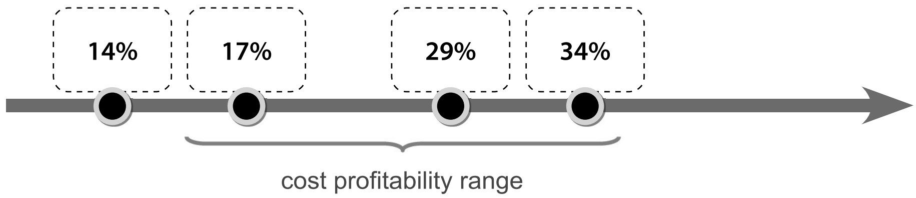
Minimal value of the cost profitability range = (14 %+17 %) / 2 = **15.5 %**

Step 4 Determining the maximal value of the cost profitability range by multiplying the number of compared profitability values (4) by 0.75.

4 * 0.75 = 3

3 is an integral number. In this case, the maximal value of the range is the average of the profitability value with a sequence number equal to this integral number (3) and the profitability value with the following ascending sequence number (4)

Maximal value of the cost profitability range = (29 % + 34 %) / 2 = **31.5 %**



Step 5 Comparing the gross cost profitability in our transaction to the market gross cost profitability range.

The gross cost profitability in our transaction amounts to 26 % and is within the market gross cost profitability range [15.5 % — 31.5 %].

Comparable Profit Method

The Comparable Profit Method weighs profit against particular bases (e.g. costs, sales, assets) derived by taxpayers from a controlled transaction. The ratio profit to a particular base is known as taxpayers' operational margin, which is further compared to third parties' operational margin at arm's length taking into account the company's functions, risks, and resources. This method should be used when there is not enough information available on comparable transactions to apply the Resale Minus or Cost Plus Methods. The Comparable Profit Method is similar to the Cost Plus and Resale Minus Methods.

Under this method, a company's operational margin is compared to the margin of companies in the same industry taking into consideration the company's functions, risks, and assets.

This method examines the financial indicators only of the party to a transaction, which meets the following criteria:

- The party performs functions the contribution of which to the profit derived from transactions is smaller than the other party's contribution;
- The party takes fewer economic (commercial) risks than the other party;
- The party does not own any intangible assets substantially affecting profitability.

The law provides for the following operational margin parameters:

a. Profitability of sales (sales profit to sales revenue ratio): this parameter is used to determine the market price for transactions related to the resale of goods.
b. Profitability of costs (ratio of sales profit to costs of sold goods, commercial and management costs related to sale): this parameter is used when services are provided or goods are manufactured.
c. Profitability of commercial and management costs (gross profit to commercial and management costs ratio): this parameter is used when the reselling party incurs negligible economic (commercial) risks when purchasing and subsequently reselling goods in a short period.
d. Return on assets (ratio of sales profit to asset market value): this parameter is generally used when goods are manufactured.

Calculation of arm's length range

The procedure for calculating operational margin range is the same as the procedure for calculating gross margin (Please see Sections 5.2 and 5.3 above).

Profit Split Method

The Profit Split Method is applied to eliminate the effect that the interdependence of parties may have on the applied prices. This method should therefore be used when parties' interdependence makes it difficult to find comparable transactions. This method is also applicable in particular to transactions involving intellectual property rights.

This method is based on the distribution of profits among parties to a transaction in the same manner as it would be expected from non-related parties. In this case, any reference to profit may be substituted to a reference to losses depending on the actual circumstances.

To apply this method, it is first necessary to determine the profit which is to be distributed among the parties. This may be done as follows:

(a) Consolidated profit is the sum of the operating profit of all parties to the reviewed transaction for the reviewed period. It is obtained by calculating and subsequently adding up the operating profit actually received by each of the parties; OR

(b) Residual profit is the difference between [1] consolidated profit and [2] estimated profit, i.e. the profit which the parties should have derived according to the pricing methods above described (CUP, Cost Plus, Resale Minus, and Comparable Profit Method). To calculate the profit due to a party, the estimated profit is added to the residual profit.

Using residual profit allows dividing profit in 2 parts: (a) arm's length of a party's remuneration determined by one of the above mentioned transfer pricing methods and (b) the remaining part that should be divided among the parties in accordance with their contribution to the transaction

The law provides several options for determining proportions according to which profit is distributed (both consolidated and residual):

1) *Function based allocation:* distribution in proportion to the contribution to consolidated profit (a) functions performed by the parties, (b) assets used by the parties and (c) economic (commercial) risks incurred;
2) *Asset-based allocation:* distribution in proportion to the return on invested capital;

3) Profit distribution in proportion to profit distribution among parties to comparable transactions (when information about sales profit distribution is available for similar transactions concluded between parties, which are not related.)

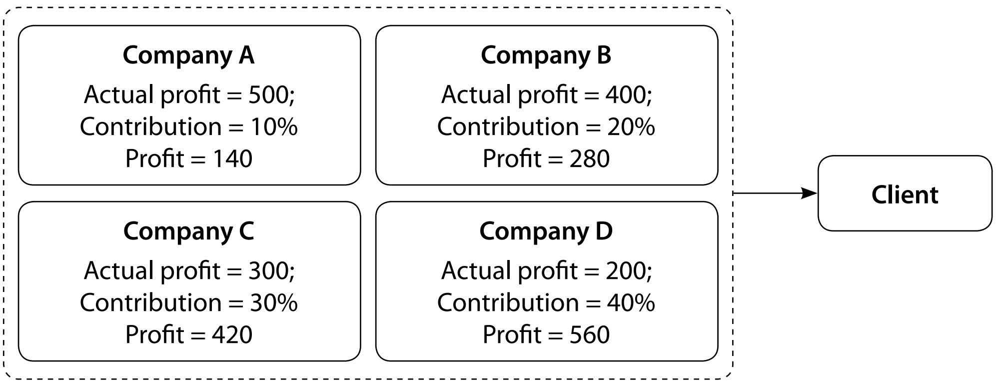
Although selecting the principles for profit distribution depends upon the actual circumstances at hand, they should ultimately result in the same profit distribution as the profit distribution among third parties at arm's length in the similar circumstances. To distribute profits fairly among parties and determine the parties' contribution to consolidated profit, the following factors may be taken into account:

1) The parties' expenditure in intangible assets the use of which affects the amount of profit;
2) The characteristics of the personnel employed by the parties (including their number, qualifications, hours worked, labor costs) affecting the amount of profit;
3) The market value of the respective party's assets the use of which affects the amount of profit;
4) Other factors reflecting the relationship between the functions performed, the assets used and the economic (commercial) risks incurred and the sales profit actually derived from the transaction.

If the profit actually derived is less than the profit calculated according to the method for profit distribution, the profit calculated according to the method for profit distribution is taken into account for tax purposes. If the profit actually derived equals to or is greater than the profit calculated using this method, the profit actually derived is taken into account for tax purposes.

Example of calculation

Total consolidated profit derived from the transaction = 1400



Step 1 Determining and distributing profit in proportion to the contributions

Total consolidated profit derived from the transaction = 1400.

Company A: 1400 * 10 % = 140

Company B: 1400 * 20 % = 280

Company C: 1400 * 30 % = 420

Company D: 1400 * 40 % = 560

Step 2 If the profit derived from the transaction is less than the profit calculated according to the method for profit distribution, **the profit calculated according to the method for profit distribution** is taken into account for tax purposes.

In our example, the profit actually derived by Companies C and D is smaller than the profit calculated according to the method for profit distribution. So, the profit calculated according to the method for profit distribution is taken into account for tax purposes.

If the profit actually derived equals to or is greater than the profit calculated according to the method for profit distribution, the **profit actually derived** is taken into account for tax purposes.

In our case, the profit actually derived by Companies A and B is greater than the profit calculated according to the method for profit distribution. So, the profit actually derived is taken into account for tax purposes.

Requirements for Documentation and Reporting

The new transfer pricing rules require taxpayers to provide documentation justifying the prices applied in all controlled transactions. The law does not set out a specific form for the documentation, but regulates its content. Transfer pricing documentation should include, among other relevant information:

1) The activities of the parties to such transactions;
2) A list of the parties with which such transactions are entered into;
3) A description of the transaction, including the terms of the transaction, the method applied for determining the price, terms of payment, and other relevant information;
4) A functional analysis clarifying the functions performed and risks assumed by the parties;
5) The reason why a certain transfer pricing method is used;
6) Sources of information;
7) Information about received income and expenses incurred in a controlled transaction;

8) Calculation of the arm's length range (comparability analysis); and
9) Information on any relevant tax adjustments made by the taxpayer, if any.

Transfer pricing documentation should also provide other information that affected the pricing of transactions. As a rule, taxpayers collect this information in the course of the comparability analysis.

The Federal Tax Service has developed recommendations on how to prepare documents on transfer pricing (Letter of the Federal Tax Service No. OA-4-13/14433@ dated 30.08.2012). The said recommendations also cover the documents' contents:

(i) the front page with the name, identification number and address of the taxpayer and the contractor;
(ii) the description of the basic features of the taxpayer's activities which is required to understand the particularities of the pricing process;
(iii) the analysis of affiliates or the description of the basic features of the group of companies that includes the taxpayer;
(iv) the data on the controlled transaction and the functional analysis;
(v) the selection of the pricing method for tax purposes and information sources;
(vi) the determination of the range of market prices and profitability.

Reporting

Taxpayers are required to provide tax authorities with reports on controlled transactions, if their value exceeds RUR 100 million (RUR 80 million in 2013; from 01.01.2014 onwards no threshold will apply) by May 20 of the following year. The law provides for an exception to this rule for transactions concluded in 2012. The reports on these transactions must be provided to tax authorities by November 20, 2013. To determine whether taxpayers should file a report on controlled transactions, it is necessary to establish whether:

(a) Taxpayers have entered into controlled transactions;
(b) The revenue derived from controlled transactions exceeds the abovementioned thresholds.

Example: A Russian company entered into a cross-border related-party transaction in 2012. The annual revenue derived from this transaction amounts to RUR 50 million. This operation is a controlled transaction, but its revenue amounts to fewer than RUR 100 million. The taxpayer is therefore not required to provide tax authorities with a report on controlled transactions.

These reports should indicate the calendar year, to which they refer, the subject of transaction, information on the parties to the transactions, and revenues derived or losses incurred from such transactions.

The Federal Tax Service has developed the form of notice. The report details the information on controlled transactions, which is to be disclosed by the taxpayer. Among this information, the Federal Tax Service recommends taxpayers to disclose

- information on controlled transaction methods and
- the information used to estimate market value (customs statistics, information from pricing agencies, companies' accounting information, etc.).

According to the Federal Tax Service, it is not mandatory to fill in information on controlled transaction methods and information used to estimate market price.

The fiscal authorities treat transaction as each separate operation, e.g. each delivery of goods, rather than each contract. Thus, filling out a notification could prove to involve significant administrative costs. But filling in the notice you are allowed to sum up the quantities of goods of different deliveries, if the transaction provides for a continuous and long-term supply to the address of one and the same client with the delivery terms and other indices specified in the notice remaining unchanged (Letter of the Federal Tax Service of Russia No. OA-4-13/611@ dated 22.01.2013).

Tax authorities may request taxpayers to present the relevant transfer pricing documentation. Taxpayers are required to provide documentation within 30 days from the date of such request, but tax authorities may not request this documentation before June 1 of the following year. There is an exception for transactions concluded in 2012. The tax authorities may not request TP documentation in respect to these transactions before 01.12.2013.

Transfer Pricing Audits

Transfer pricing audits are conducted separately by a special department of the Federal Tax Service. Such audits may review up to 3 calendar years, but the law provides exceptions for 2012 and 2013:

- Tax audits for 2012 may be initiated no later than 30.06.2014;
- Tax audits for 2013 may be initiated no later than 31.12.2015.

These audits do not generally take more than six months, but in some cases, tax authorities may extend them up to 12 months. Tax authorities may further extend tax audit periods up to 21 months, for example, in case of long-winded exchange of information with foreign authorities or additional time required for translation of documents.

Cost Contribution Arrangements

Cost contribution (or cost sharing) arrangements (CCA) are widely applied in international application of transfer pricing. For example, an entire chapter of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the OECD describes this concept (Chapter VIII). CCA apply to companies belonging to one group to distribute costs and risks associated with developing, producing or obtaining assets, services, as well as to determine the nature and extent of the participants' interests in those assets, services, or rights. In practice, very often when one company of a group produces assets or provides services, while the other companies of the group use them and compensate for the expenses incurred in proportion to their share.

The concept of CCA has not yet been introduced in Russian law and Russian tax authorities thereby encounter serious practical difficulties when CCA are applied. In particular, Russian tax authorities may challenge the validity of application of chosen allocation keys based on, inter alia, sales, units used, produced, or sold, gross or operating profits, the number of employees, capital invested. Representatives of the Ministry of Finance of Russia have promised to propose amendments to the Russian Tax Code to simplify the application of cost contribution arrangements in Russia.

Advance Pricing Agreements

The new transfer pricing rules also introduce the mechanism of Advance Pricing Agreements (APA) between taxpayers and tax authorities. The subject-matter of an Advance Pricing Agreement is the particular method used to determine the prices of controlled transactions. Only major taxpayers may enter into such agreements.

An APA is entered into upon taxpayers' application. These applications to enter into an APA are considered, provided taxpayers pay a state duty of RUR 1.5 million. An APA may be entered into for a period not exceeding 3 years, after which it may be extended by agreement of the parties for a maximum of 2 years.

Adjustments and Penalties

If the prices applied in controlled transactions do not conform to market prices, then tax authorities may adjust these prices by adding to the tax base the revenue that taxpayers would have earned, if correct pricing would have been applied.

At the same time, taxpayers can voluntarily adjust their tax base in accordance with the applied transfer pricing methods, provided such adjustment does not reduce their tax liability.

If additional taxes are imposed on a party to a transaction because the party had not applied market prices, the other party to the transaction may adjust its taxes accordingly, i.e. in practice decrease its taxes. Such *symmetrical adjustments* may be made by Russian taxpayers and for domestic transactions only. But it is important to note that such symmetrical adjustments are available only in case when the tax authority has through its decisions imposed additional taxes to one of the parties to a transaction. In other words, taxpayers may not make symmetrical adjustments if a party voluntarily increases its tax base by applying the principle of arm's length.

It should also be noted that Permanent Establishments of foreign companies may not apply symmetrical adjustments despite the fact that they pay taxes in Russia. This provision thus results in discrimination of permanent establishments compared to Russian companies.

From 2014 onwards, in addition to tax adjustments a special penalty of 20 % will be imposed on taxpayers, who do not apply market prices. From 2017 onwards, this penalty will be increased to 40 %, unless the considered breach relates to 2014-2016, in which case the 20 % penalty will apply.

The taxpayer is exempt from fines, if the taxpayer submits to the Federal Tax Service documents on transfer pricing.

Taxpayers are thus potentially liable for the following sanctions:

- Pay taxes as recalculated by tax authorities;
- Pay a penalty for late payment of tax;
- From 2014 onwards, pay an additional penalty for not applying prices within market range.

Transfer Pricing at Customs

Transfer pricing for customs purposes is entirely different from the above transfer pricing rules, which are set out for tax purposes. The issue of transfer pricing upon determination of customs value is regulated by the Customs Union of Russia, Belarus and Kazakhstan in an *Agreement for Determination of Customs Value for Goods Crossing the Customs Border of the Customs Union* dated 25.01.2008. The Federal Law *"On customs regulations"* and Government Decree *"On approval of the rules for determining the customs value of goods exported from Russia"* regulate this issue in more detail at national level.

As a general rule, customs payments are levied as a percentage of the value of imported goods. So, when taxpayers import into Russia goods purchased from related parties, they are required to confirm that the value of the goods is not understated. Taxpayers are also entitled to deduct the price of purchased goods for profit tax purposes. For that purpose, they are therefore required to confirm that the price of goods and consequently the amount of tax deductions are not overstated. In other words, high prices at customs result in greater customs duties thus simultaneously decreasing the importer's taxable profit as they increase costs. Taxpayers are therefore required to carefully plan pricing upon importation of goods purchased from related parties so that prices are not overstated for tax purposes and understated for customs purposes. At the same time, if the prices applied by a company in intra-group transactions are in line with market prices, it is possible to state with certainty that such prices should meet the requirements set out by tax and customs authorities.

Customs duties and taxes are calculated on the basis of the so-called customs value of goods. Customs value is a nominal value and may be different from the prices of goods set in contracts. The customs value of goods consists of the purchase price and additional costs (e.g., cost of transportation, cost of packaging, etc.). The customs value of goods may be determined using the following 6 methods:

Method 1 — Transaction value

Method 2 — Transaction value of identical goods

Method 3 — Transaction value of similar goods

Method 4 — Deductive method

Method 5 — Computed method

Method 6 — Fall-back method

You will find below a more detailed description of each method. These methods are applied in successive order, so when one method applies, this excludes the application of subsequent methods. Method 6, the Fall-Back Method, is a backup method in the sense that its application is limited to cases when it is not possible to apply the other 5 methods.

Although the above methods differ from the methods of transfer pricing, their main purpose is the same, i.e. confirm that the prices applied by related parties are in line with market prices.

Method 1 Transaction value

The customs value of goods is defined as the value of transaction with imported goods (i.e. the price actually paid or payable for goods when they are sold to be exported to Russia) plus additional costs, in particular, costs of packaging, transportation, loading-unloading, insurance associated with transportation, and other expenses. Method 1 applies when the following conditions are met simultaneously:

(i) The buyer's rights to use and dispose of the goods are not restricted, except for restrictions, which limit the geographical area in which the goods may be resold, or do not significantly affect the value of goods.

(ii) The price must not be subject to conditions or considerations for which a value cannot be determined with respect to the goods being valued.

(iii) No part of the proceeds from any subsequent resale, disposal or use of the goods by the buyer will be attributable directly or indirectly to the seller, unless adjustment can be made in accordance with the law.

(iv) The buyer and seller are not considered related parties or if they are:
- their relationship did not affect the price;
- the transaction price is close to the value of transaction upon sale of identical or similar goods to unrelated buyers and this price may be verified using other methods of control over pricing upon border crossing.

Method 2 Transaction value of identical goods

The value of transaction with identical goods sold for export or import into Russia is used to calculate customs value.

Method 3 Transaction value of similar goods

Method 3 is similar to Method 2, but here the value of transaction with similar (but not identical) goods is used. This method applies when data on transactions with identical goods are not available.

Method 4 Deduction method

Under this method, customs value is determined on the basis of the unit price at which imported goods or identical / similar goods are sold in the greatest aggregate quantity to an unrelated buyer in the country of importation at about the same time. Customs payments and taxes paid on the goods to be sold, cost of transportation within Russia, fees for brokers in Russia, and other similar costs payable before the sale of the goods are deducted from this value.

Method 5 Computed value method

Computed value method determines customs value on the basis of the cost of production of the goods being valued, plus an amount for profit and general expenses.

Method 6 Fall-back method

Method 6, the Fall-Back Method is a backup method in the sense that its application is limited to cases when it is not possible to apply the other 5 methods. Under this method, customs authorities may use any of the first 5 methods described above but with broad discretion.

13. PERSONAL INCOME TAX

The provisions on personal income tax for individuals are given in Chapter 23 of the Russian Tax Code.

Taxpayers

Taxpayers for personal income tax purposes are both Russian Residents and Non-Residents, who receive income from Russian sources (art. 207).

Individual entrepreneurs are taxed with the personal income tax also for their business profits. However, the rules for deductibility of expenses for individual entrepreneurs is however determined in accordance with the rules for profit tax (art. 221). An, individual entrepreneurs may also opt to be taxed under a special tax regime (for more details please refer to chapter 9 Tax Concessions and Subsidies of the present book).

Employers or other payers of income are considered tax agents which have the obligation to calculate, withhold and remit the tax to the Government (art. 226).

A tax resident is a person who has actually spent at least 183 calendar days in Russia over 12 consecutive months. Under certain exceptional circumstances, the tax residency status is not lost due to short-term visits abroad in particular when a tax resident spends a maximum of 6 months abroad for educational or medical treatment purposes. A non-resident is a person staying in Russia fewer than 183 calendar days over 12 consecutive months.

Tax residency is determined by the actual days spent in Russia during any continuous 12-month period counted back from the date of receipt of the income subject to taxation (Ministry of Finance No. 03-04-06/6-170 of 14.07.2011; No. 03-04-06/6-169 of 14.07.2011).

Tax rates and other tax obligations can vary significantly depending on whether an individual is conferred the status of tax resident or non-resident. It is therefore also important to consider the rules for calculating days of presence in Russia. According to the Ministry of Finance of Russia, an individual's tax status is determined by taking into account all the days actually spent by the individual in Russia, including the day of arrival and day of departure without regard to how many hours were spent in Russia during those days of travel. This position is confirmed by the Ministry of Finance (Ministry of Finance No. 03-04-06/6-324 of 29.12.2010; No. 03-04-06/6-283 of 01.12.2010). This has changed the earlier interpretations issued by the tax authorities (Federal Tax Service No. 04-1-04/929 of 28.12.2005). Despite the authoritative interpretation by the Ministry of Finance, there has been court practice upholding the earlier interpretation of not including the day of arrival to calculate the number of days spent by an individual in Russia to determine the individual's tax status (Federal Commercial Court of the Central Federal District on case No. A54-3126/2009C4 of 11.03.2010).

The Russian law on personal income tax may contradict the laws of other countries and may in extreme cases result in tax residency simultaneously in Russia under Russian laws and in another country under laws of that country. For such cases a relevant double taxation treaty concluded between Russia and another country contains rules for determining the residency status and avoiding double taxation of personal income in the two treaty countries. (Read more on double taxation treaties in chapter Double Taxation Treaties).

Tax residents are taxed in Russia for their worldwide income, while non-residents are taxed for Russian source income only. Russian source income is income received in connection with duties performed in Russia (not necessarily paid in Russia) and a number of other types of income, including interest or dividends and income from disposal of property in Russia (see below for more details on Russian source income).

It should be noted that residency according to the Tax Code (tax residency) and residency as envisaged by civil law or currency and administrative regulations are different matters. In accordance with the Russian Civil Code the place of residence of a Russian citizen is his place of permanent or habitual living (art. 20). However, the Supreme Court has held that the special procedure of "registration" of individuals (including foreigners) in their place of living is only indicative, not determinative of their residency status (ruling of the Supreme Court of 22.06.2005 No. 93-G05-7). It therefore appears that Russian civil law, currency and administrative regulations do not require that a person lives in Russia to keep their residency status. A foreign national may apply for a residence permit but it has in practice been very difficult to receive such. A tax residency, on the contrary, comes about automatically when a person spends 183 days or more in Russia during 12 consecutive months.

Foreign diplomats do not pay personal income tax in Russia, if their home country extends the same exemption to Russian diplomats (art. 215).

Tax Rates

The tax rates for various kinds of income are listed in below table (art. 224).

Income tax rate for tax residents	13 %
Dividends received by Russian tax residents	9 %
Income tax rate for non-residents, except for the following:	30 %
➢ Dividends	15 %
➢ Income from working for individuals under agreements for personal, domestic, and other similar purposes not related to business activities	13 %
➢ Income of a person who has acquired the migration status of highly-qualified specialist with relevant work permit (without regard to days actually spent in Russia, tax resident status or non-resident)	13 %
➢ Income of people with the immigration status of participants in state programs for voluntary resettlement to Russia of compatriots living abroad.	13 %
➢ Income of crew members of vessels sailing under the national flag of Russia	13 %
Interest on savings in bank and benefit on below-the-market interest rates on credits	35 %
Income from securities held on nominee accounts in case when the identity of beneficiary is not disclosed (in force from 01.01.2014)	30 %
Lottery winnings, etc. (under certain circumstances and when exceeding set limits)	35 %
Interest from mortgage bonds issued prior to 01.01.2007	35 %
And other cases	35 %

All income received by non-residents is subject to a tax rate of 30 % regardless of how it is earned (art. 224). The Tax Code provides for only a few exceptions to this rule. For instance, the income of foreign nationals working in Russia with the migration status of a so-called highly qualified-specialist is subject to a tax rate of 13 % regardless of the time of actual stay in Russia (tax residency or not). Foreign nationals are conferred the status of a highly qualified specialist in connection of successful application for the relevant work permit confirming this status.

From 01.07.2010 the procedures for employing foreigners as a highly qualified specialist were considerably simplified. Previously, all categories of foreign nationals could obtain a work permit only for one year. Now, highly qualified specialists may obtain a work permit and a work visa for up to 3 years.

The law efficiently provides for only one criterion defining foreign nationals as highly qualified specialists. In the normal case this criterion is that the annual salary paid by the Russian employer amounts to at least 2 million rubles per annum (approximately EUR 50 thousand euros).

For certain kinds of professions the annual salary thresholds are lower, as follows:

- RUB 1 million for scientists or teachers, invited for research or teaching at universities, colleges, research centers (higher educational institutions with relevant state accreditation).
- RUB 1 million for professionals invited to work at certain special economic zones.
- Without any minimal salary limit for foreign nationals working at the Skolkovo innovation center.

Russian Source Income

Russian source income is mainly income received for work performed in Russia, capital gains and rent from property in Russia, interest from deposits in Russia and dividends from Russian companies. The definition of Russian source income is relevant for determining the tax rates for income earned by Residents, and for determining the overall liability of non-residents to pay tax in Russia (art. 208).

Any compensation (or economic benefit) associated with a Russian operation is considered as income received for work performed in Russia and it is not of importance whether payment is actually executed in Russia or not. Any compensation charged back to a Russian company or a foreign company's separate subdivision in Russia is considered as Russian source income. Directors' remuneration and other similar compensation to directors received from a Russian company or a foreign company's separate subdivision are also considered as compensation of work from a Russian Source.

Any compensation from a company managed from Russia, regardless of the location in which managerial duties are actually performed or paid for, also falls under this category.

The below table provides a detailed list of what kind of income is considered as Russian source income.

<u>Russian source income</u>

- Salary and related compensations for work (including remuneration for work of crew members of vessels sailing under the national flag of Russia);
- Dividends and interest from a Russian entity (or a foreign organization's separate subdivision in Russia) and from Russian individual entrepreneurs;
- Dividends and interest from a Russian entity insurance compensations, including periodic insurance payments (rents, annuities) and payments associated with the insured party's participation in the insurer's investment income, as well as cash surrender values received from a Russian organization and/or a foreign organization in connection with the activities of its separate subdivision in Russia;
- Income associated with intellectual property rights;
- Lease income from property in Russia;
- Capital gains from sale of real estate in Russia;
- Sale of other assets in Russia, including shares and other securities;
- Sales of shares and other securities received through participation in an investment partnership;
- Sale of rights of claim against a Russian, or foreign organization in connection with the activities of its separate subdivision in Russia;
- Directors' remuneration and other similar compensation to directors of Russian entities
- Pensions and pension payments to a deceased pensioner's legal successors
- Scholarships (grants) Income from the vehicles, ships, aircraft, fiber and wireless telecommunications lines, communication facilities, computer networks located in Russia
- Other income earned by a taxpayer from activities in Russia

Non-Source Income

Some types of income are specifically excluded from the definition of Russian source income (art. 208(3)). Such non-source income is, for example, director's remuneration paid to Russian tax residents who are directors of a foreign entity, regardless of the place where the managerial duties were actually performed. Non-source income also includes pensions, benefits, scholarships and other similar payments payable under foreign laws. The Ministry of Finance is empowered to solve the uncertainties as to the origins of a particular income — whether it has been derived from Russian sources or from abroad, and the exact proportion of each kind of income (art. 208(4)).

Tax Base

Income is taxed regardless of the form in which it is received. This can be income in money, in-kind income or even a right of disposition. The inclusion of a right of disposition is an anti-avoidance measure, aiming at taxation of such income that the person could have earned, but has voluntarily deferred. If any deductions are made from the taxpayer's income on his instructions, or based on a court order, or imposed by other authorities, then such deductions do not reduce the tax base (art. 210).

As a rule, reimbursements of business expenses are not subject to taxation (sometimes within set limits). However, daily allowances (per diem) exceeding the limits set by the Government are considered taxable income (art. 217; for more details, see below regarding business travel and expense reimbursements). Reimbursements of business expenses are generally not taxed, although sometimes normative limits for deduction may be applicable. Daily allowances (per diem) within the limits set by the Government are not taxed as income (art. 217).

Losses and rights to deductions that have not materialized during the year are not carried forward to the following year. All possible tax deductions are only applicable to income that would otherwise be taxed at a rate of 13 % (which means that they are not available for non-residents).

Income earned or expenses incurred in a foreign currency are calculated in rubles at the exchange rate of the Central Bank of Russia on the date of actual receipt of income or payment of expense (art. 210).

Timing of Income

Monthly salary income is deemed received on the last day of the month to which it refers regardless of the actual date of payment. If employment is terminated before the end of a calendar month, then the income is deemed to have been received on the last day of work. Other income paid in cash is considered received when it is paid out. In-kind income is considered received upon transfer and material benefits are deemed received upon actual receipt of the contribution (or when interest is paid in case of material benefit in the form of credits, art. 223).

In-Kind Income

Income can be received in-kind in the form of goods or services, as well as rights to property (in-kind income). Such income is assessed at market value. The evaluated price also includes value added tax, possible excise tax, but excludes partial payment of the cost of goods received, work performed, or services rendered. Hereby the tax authority has the right to contest the prices applied by the parties and regulate them according to market prices (art. 211).

In-kind income includes, in particular:

- Payment of salary in-kind
- Goods and services, including public utilities, meals, recreation and training, provided for free of charge or at a discount by another party
- Goods received or services rendered as gifts, free of charge, or against partial payment

Material Benefits

The law makes a distinction between in-kind income and material benefit. In a broad sense, material benefits are also in-kind Income, but for taxation purposes they are defined separately. However, in-kind income and material benefits are generally taxed with the same tax rates. In this Awara Guide a reference to in-kind Income, if otherwise not indicated, will also generally include a reference to material benefit.

Material benefits include:

- Benefit in form of lower-than-market interest rates for loans (determined in accordance with art. 212(2)), except for:
  - ➢ interest free limits on banking cards (debit and credit cards)

    Benefit in form of lower-than-market interest rates on loans for the use of borrowed funds provided for new construction or purchase of housing (apartments) in Russia, land plots on which are located residential buildings for sale or provided for individual housing construction, as well as benefit derived from savings on interest upon re-financing (consolidation) of loans (credits) received for the above purposes (art. 229 (1)1);

- Benefit in form of above-the-market discounts on goods or services from related parties
- Benefit in form of below-the-market purchase of securities, financial instruments of future transactions.).

Benefit in form of lower-than-market interest rates for loans is taxable to the extent that the interest is less than 2/3 of the refinancing rate of the Central Bank (the refinancing rate set by the Central Bank of Russia amounted to 8 % on 01.06.2012). Lower-than-market interest rates on credits denominated in foreign currency are taxed as material benefits to the extent that the interest rate is less than 9 % (art. 212(2)).

When income is received as material benefit in form of lower-than-market discounts on goods or services from related individuals, organizations and individual entrepreneurs, the tax base is determined by comparing the prices to similar goods (services) sold at arm's-length by related parties to non-related parties (art. 212(3)).

When income is received as material benefit from the purchase of securities, financial derivatives (options, futures, etc), the tax base is determined by comparing the market value of securities, financial instruments of future transactions to the actual purchase cost paid by the recipient of material benefit (art. 212(4)).

Taxation of stock options

Personal income taxation of options involves the following considerations:

(i) Taxation of granting of option
(ii) Taxation of shares received when option is executed
(iii) Taxation of trade with options on an organized market

In this section we will especially emphasize the tax considerations concerning employee stock option plans.

Before the taxation rules may be understood, it will be necessary to determine what is meant by an option under Russian law. Broadly in common parlance 'option' means a contract conveying a right to buy (acquire) or sell in the future an asset at predetermined terms. The buyer of the option gains the right, but not the obligation, to engage in that transaction, while the seller incurs the corresponding obligation to fulfill the transaction. In finance, an option is a derivative financial instrument that specifies a contract between parties for a future transaction of an asset at pre-stipulated terms.

We have to keep in mind these general definitions of 'option' when we consider the Russian taxation rules of such. In particular it should be acknowledged that a particular definition of 'option' in one or another law does not yet cover all the possibilities of what the parties may mean by it. Following these premises we may recognize in Russian law three categories of 'options':

(i) An issued option ("opzion emitenta")
(ii) An option as a financial instrument as a future contract ("option as a futures contract", Russian "ФИСС")
(iii) Other and any contracts which stipulate terms that may be categorized as options

In Russian law there are specific taxation rules which concern the first two of above categories. An 'issued option' is defined in the law "On Securities Markets" (Law No.39 — FZ of 22.04.1996). According to this law an 'issued option" constitutes a security and may be issued by a joint stock company. The issuance of such "issued options" requires registration with the Central Bank of Russia. Before 01.09.2013 function of registration was related to newly abolished Russian securities commission ("FSFR").

An "option as a futures contract" is any kind of futures contract were the underlying instrument can be shares, other securities, currency or goods (commodities) but it does not itself constitute a security (Law on Securities Markets of 22.04.1996). Such futures contracts may be object of trade at an exchange.

A typical option under an employee stock options program would most likely constitute some other form of contract than "issued option" or "option as a futures contract", that is, a contract concluded under the principles of freedom of agreement and which does not represent any standardized form.

In principle any contract concluded between parties based on basis of their freedom to contract may constitute an option. In this connection (our subject being personal income taxation of options) it is important to recognize options often are concluded between a shareholder (shareholders) of a company and an employee with the aim to commit the employee to future work with the firm by promise to award shares conditional to certain activities in the future, for example, commitment to diligent work under certain KPIs during a certain period.

Of special concern here is how employee stock options are taxed, and in particular whether the mere granting of an option may be taxed as a material benefit before the option is exercised. With amendments enacted in 2009, the scope of taxable material benefits has been extended to cover "issued options" and "option as a futures contract" so that the material benefit in form of the difference between the granting price (value) and the market value is taxed (art. 212 (1)). Previously such options had a taxation consequence only when sold or exercised, that is, when the option was utilized to acquire the shares at the pre-stipulated terms or by requiring the cash equivalent between the exercise price and market value of the share. But other forms of option contracts (those made in free form) would not to our opinion be taxed under these rules.

The transaction of acquiring the shares upon exercise of an option is taxed as a material benefit when the striking price is less than the market value (art. 212). Hereby the taxpayer may deduct the cost of an option or the value of the corresponding material benefit if it was earlier duly taxed.

The tax rate for taxation of material benefits (and cash settlements) as per above is 13 % for residents and 30 % for non-residents.

Insurance and Voluntary Pension Plans

Employer's contributions to insurance programs or pension plans are not taxed as employee's income in case of: (i) compulsory (state) pension plans; or (ii) voluntary pension plans and voluntary personal insurance under the conditions detailed below:

- Insurance contributions to compulsory pension insurance paid by employers in accordance with Russian law;
- Savings component of compulsory retirement pension;
- Pension contributions under private pension agreements (including when contribution paid by employer or other individual)

According to the general rule pensions paid out under private pension saving plans constitute taxable income but the law establishes that certain forms of compensations (reimbursements) derived from insurance programs and pension plans are not taxable.

Compensation received from all compulsory insurance programs is not taxed as income.

Compensation stemming from voluntary insurance and pension plans is not subject to taxation (art. 213-213.1) in cases detailed below:

1. Compensation derived from voluntary life insurance in the event that (i) compensation is due under the condition that insured person attains a certain age or a specific period is reached, or (ii) a particular contractually determined event occurs. In such cases the payments are not taxable if (i) the taxpayer has contributed the corresponding insurance contributions, and (ii) the insurance compensation does not exceed the funds contributed by the taxpayer and yield on investment that stays within a limit calculated as the average annual refinancing rate of the Central Bank. In other cases, the difference between these amounts is taxed at source.
2. Under voluntary health, medical and life insurance

- Pension saving plans when compensation is paid upon reaching the statutory age of retirement.

In connection with premature termination of a voluntary pension savings plan, the repayment of contributed capital and the yield is taxed at source.

Other insurance compensations such as third-party liability and property insurance are not taxed when reimbursement is made within the limits of real damage. Compensation exceeding the real damage would be taxable.

Tax Deductions

Under Russian law, taxpayers may make certain deductions from their taxable income. Such deductions are, however, granted only to tax residents, and only from income taxed at the general tax rate of 13 %.

These deductions are grouped into standard tax deductions, social deductions, property-related deductions and occupational deductions.

Standard Tax Deductions

A taxpayer is entitled to certain tax deductions when determining the tax base in situations where he or she is deemed to possess a special status related to certain health conditions, recognition of participation in military operations and under other such circumstances.

The available standard tax deductions are presented in the below table.

Eligible Persons	Deductibility Limits
Chernobyl victims, and other victims of nuclear radiation catastrophes, war veterans, individuals with certain state awards, and others	RUR 500 and RUR 3,000 per month
Parents, spouse, adoptive parents, guardians, foster parents, spouse of an adoptive parent (until taxpayers' income for a calendar year exceeds RUR 280,000)	RUR 1,400 for the first and second child, RUR 3,000 for the third child and each subsequent child and RUR 3,000 for each child up to the age of 18 if the child is disabled or studies full-time as post-graduate, resident physician, inter, student under the age of 24, if he/she is not disabled group I or II

The standard deduction for child care can be applied for each child up to the age of 18, as well as for full-time students, post-graduate, resident physician, intern, and military student up to the age of 24.

Tax deductions are extended in an amount twice the usual for single parents. A couple that has the right to the deductions may also decide that both deduction rights will be concentrated to one of the parents in a double amount.

In case when the child does not reside in Russia, the right to deduction must be supported with documents certified by the appropriate authorities of the country in which the child resides (article 218(1)4).

Standard tax deductions are effectuated by one of the tax agents (such as an employer) as selected by taxpayers. The taxpayer must present to the selected tax agent a certain set of documents confirming the right to such tax deductions.

In case when the standard tax deductions have not been effectuated to the full amount in the course of the year, the tax authorities must in connection with the final tax return upon application recalculate the tax base considering the unused limit of these standard tax deductions (article 218(4).

Social Deductions

The main forms of social deductions are presented in below table.

Type of Eligible Transaction	Deduction Limits
Charitable contributions	Actual contributions, but not exceeding 25 % of gross income
Medical care costs Contributions to a voluntary pension saving plan	Actual expenses, with upper limit of RUB 120,000. For expensive treatments (according to a list approved by the Russian Government) — in the amount of the actual expenses.
Additional contributions to the savings component of mandatory retirement pension	Actual expenses actually incurred, with upper limit of RUB 120,000.
Education costs for personal benefit	Actual expenses actually incurred, with upper limit of RUB 120,000.
Education cost for benefit of child	Actual expenses actually incurred, with upper limit of RUB 50,000. This deduction is available for both parents per child each child.

Charitable contributions can be made as financial aid to science, culture, education, health and welfare organizations (approved and partially funded by the Government), sports organizations, as well as educational and preschool institutions.

Medical care costs of taxpayers and their immediate family, including children under the age of 18 may be deducted. Medical expense deductions are granted for prescription drugs and treatment in hospitals or clinics in Russia, and for prescription drugs and medical services specified by law.

Contributions to voluntary pension saving plans are deductible when they are made for one's proper benefit, and for benefit of spouse, parents, adoptive parents, disabled children, adoptive children or children under guardianship.

Additional contributions to the savings component of mandatory retirement pensions are deductible to the extent of actual costs but not more than 120 RUB per year.

Education costs for both personal benefit and the benefit of one's children up to the age of 24 may also be deducted. The right to tax deductions also applies to siblings up to the age of 24 when one sibling pays for the full-time education of another at a licensed school.

These so-called social deductions cannot be taken into consideration by the employers for the purpose of decreasing the withholding of tax during the year. The deductions are only available upon filing a tax return after the end of the year (art. 219(2)). However, employees that only receive income from tax agents (e.g., their employers) do not have an obligation to file a tax return, but may do so in order to claim a social deduction.

Property-Related Deductions

The forms of property-related deductions are presented in below table.

Type of Income	Deduction Limits
Capital income from sale of residential housing (houses, flats, rooms, cottages etc.) and land plots, as well as part ownership in the listed kinds of objects, when the objects have been held in ownership for more than three years.	amounts up to RUB 1,000,000
Income of sale of other property held for fewer than 3 years	amounts up to RUB 250,000
Expenses on construction or purchase of houses and residential land plots, as well as part ownership in the above. (excluding purchases from related individuals)	Up to RUB 2,000,000 (excluding interest on loans)

Property-related deductions are only available upon filing a tax return at the end of the year (art. 220). Thus employers (tax agents) may not apply the deductions in connection with withholding of tax. The only exception to this rule is in regard to deductions of expenses on construction or purchase of houses and residential land plots. This kind of deduction may be effectuated during the year by the employers (or other tax agent as the case may be). Providing that the taxpayer presents to the employer a relevant confirmation issued by the tax authorities of the right to this deduction.

Instead of having the expenses deducted from the annual income, the taxpayer may upon sale of the residential asset deduct the expenses from the capital gain at future sale (art. 220(1)1). Deductions that have not been fully utilized in the tax year may be carried over to the next year.

Sale of a Share in Property Held in Joint Ownership

The rules on property-related deductions for capital gain on sale *a share in residential property held in joint ownership* (without physically allotting the space to separate owners) are not quite clear in view of tax administration and court practice. The tax authorities have interpreted such property to relate to the category of 'residential property'

(Ministry of Finance Letter N 03-04-05/7-623). From this follows that according to the tax authorities the maximum permissible deduction of RUB 1 million would be allowed for such property when held for less than 3 years. However, according to a resolution of the Constitutional Court this kind of property in joint ownership should, however, be treated as 'other property' subject to a maximum deduction of RUB 250,000 (ruling N 5-П of 13.03.2008). The position of the Constitutional Court is thus such that only a share that is physically distinguished, such a house, a flat, or as a room in an apartment, can be regarded as 'residential property.'

Another point of contestation is whether the deduction is available in full (RUB 1 million) to each of the co-owners or if the maximum allowance is divided proportionally among the co-owners.

The applicability of the property-related deduction to capital gain on sales of shares in a Limited Liability Company (LLC, "OOO") is not quite clear in view of court practice.

The problem is connected with conceptual definitions of the Russian Civil Law according to which 'property' and 'property rights' should be considered as separate legal categories. Some judges want to apply this distinction to the question of deductibility arguing that as the capital of an LLC is not divided into stocks (shares that circulate as securities) then an ownership share in the LLC cannot be considered as 'property' and only a 'property right.' And this misguided method of conceptual interpretation would then supposedly lead to a rejection of the right to the deduction as the law in this connection only refers to 'other property' (review of legislation and court practice of Supreme Court for the 3rd quarter of 2007; rulings of Supreme Court No. 5-B10-5 of 29.01. 2010, No. 18-B10-53 of 04.08.2010, No. 5-B10-77of 20.10.2010). The Commercial Courts, which in general are less bound by the old misguided methods of conceptual jurisprudence, have on the contrary allowed the deductibility as evidenced by some cases (Federal Commercial Court of North-West Federal district No. A21-516/2007 of 29.10.2007 on case; Federal Commercial Court of Moscow Federal District No. KA-A40/15099-09 of 26.01.2010 and No. A40-83081/08-80-312).

When considering these rights to deductions it should be born in mind that according to the Tax Code the taxpayer may alternatively deduct the actual costs providing their sufficient documentation of them (art. 220.1; to note that this options seems not to be available for non-residents)

Property-related tax deductions do not apply to individual entrepreneur's capital gain from sale of property connected with business activities (article 220(1)1).

Tax Deductions of Carry-Forwards of Losses on Securities, Derivatives and Participation in an Investment Partnership

A taxpayer who has incurred a loss in the previous tax year on transactions on securities, derivatives (quoted on a recognized exchange), participation in an investment partnership, may deduct the entire loss (or a part of it) in the present period. The rules for these kinds of deductions are presented in below table.

Types of Income	Deduction Limits
Transactions with securities traded on a recognized securities exchange	Actual accumulated losses from profit of similar transactions (i.e. within the same tax base art. 220.1(2))
Transactions with derivatives on a recognized market	Actual accumulated losses from profit of similar transactions (i.e. within the same tax base article 220.1(1))
Participation in an investment partnership	Actual accumulated losses within a given tax bases (for various types of financial instruments separately; art. 220.2(2)).

The categories of tax bases for similar type of transactions are as follows:

- listed securities trade with derivatives on a recognized market securities trade of investment partnerships on recognized markets securities trade of investment partnerships beyond recognized markets derivatives trade of securities trade of investment partnerships on recognized markets beyond recognized markets
- purchase (investment) and sale of investment partnerships of unlisted shares
- other operations with financial instruments of investment partnerships

A loss-carry forward option is available from one year to another within the same tax bases for 10 years from the year of the loss.

Occupational Deductions

The available tax deductions which are connected with professional activities are presented in below table.

Type of Taxpayer	Deduction Limits
Individual entrepreneurs	Deductions are made according to the general rules for profit tax. When expenses actually incurred are not documented, 20 % of the income is deductible
Civil contractors (freelancers, individual consultants, etc.)	Actual expenses deductible when duly documented
Recipients of income from intellectual property rights	Actual expenses deductible when duly documented. When expenses not properly documented they are deductible in accordance with set norms (for a detailed list, refer to art. 221)

Business Travel and Expense Reimbursements

Expenses for business travel and reimbursements for other expenses incurred in connection with performance of one's work duties are, in principle, not taxed as income (art. 217(3)). However, certain restrictions apply, for example, in regards to daily allowances for business trips. Normally the deductibility also presupposes that the expenses have been properly documented.

For example, the following kinds of expenses are not subject to taxation when duly documented:

- Daily allowances (per diem) within the limits set by law
- Accommodation expenses
- Expenses for transfers to airport, railway stations, etc.
- Travel expenses (plane ticket, train ticket, etc.)
- Airport fees
- Commission charges

- Rent
- Communication costs
- Fees for issuing (obtaining) and registering foreign passports
- Fees for obtaining visas, currency exchange fees

The rules for compensation of business travel expenses also apply to directors' expenses (Board members and other executives) in connection with travel to attend official meetings. Such expenses must be supported by relevant minutes from the meetings, or other similar document.

Daily allowances (per diem) are not taxed as income within set legal limits (art. 217(3)). Presently the limit for domestic travel is RUB 700 per day and for foreign business travel RUB 2,500. There are also normative limits for the rent of accommodation during business trip or work at a remote location which apply in case when the rent expense is not properly documented. In case of proper documentation, the expenses are fully deductible.

In cases when an employee is sent to work abroad for a longer period a question arises concerning the taxation of his income for that period. The question is whether such income should be treated as Russian source income or not. According to the general rule remuneration for work performed outside the territory of Russia is not qualified as Russian source even in the case when the income is paid from Russia (art. 208(6)3)).

There are no precise limits in the Tax Code for determining what duration of the work outside Russia would qualify for the corresponding income to be considered as non-source income. The Ministry of Finance has tried to fill this gap by issuing its guidelines for determining under what conditions remuneration for work on a foreign business trip would be deemed as non-source income (Ministry of Finance, No. 03-04-06-01/178 of 08.06.2007; No. 03-04-05/6-430 of 20.06.2011; No. 03-04-06/6-73 of 05.04.2011; No. 03-04-06/6-48 of 24.03.2010). According to these guidelines there are two conditions (i) the business trip should be for an extended period (while again no amount of days or months is specified) and (ii) the employee performs specified work duties (according to a job description or similar) at a determined workplace abroad.

The Ministry of Finance has taken the stance that reimbursement of an employee's travel expenses and daily allowances during an extended stay abroad are to be treated as in-kind income from Russian sources

This interpretation is motivated by the claim that such reimbursements should be considered as Russian source income insofar as they may not be treated as compensation for work (which latter condition would motivate their treatment as non-source income). From this it would follow that these expense reimbursements would be taxed as income (Ministry of Finance, No. 03-04-06/6-136 of 10.06.2011).

Exempt Income

The law exempts certain kinds of income from taxation. The table below lists some of the items of such exempt income (art. 217).

Exempt income connected with employment

- Expense reimbursements (see above)
- Paid professional training
- Relocation expenses
- Expenses for professional training
- Compensations in connection with termination of employment (dismissal) other than compensation for unused vacation, severance payments within legal limits, compensation to CEO (and deputies) and chief accountants exceeding the statutory amount
- Assistance or gifts received from commercial entities for up to RUB 4,000 (art. 217(28))
- Compensation of prescription drugs for employees and family members for up to RUB 4,000 (art. 217(28))
- Funeral assistance to employees or their family in case of decease of employee or family member (art.217(8))
- Expenses for medical care paid to employees, their spouses, parents and children, and disabled persons by employers from retained earnings after tax (art. 217(10))
- Expenses for employees' and family members' visit to sanatoriums paid by employers from retained earnings after tax (art.217(9))
- Childbirth allowance of up to RUB 50,000 for each child (art.217(8))
- Additional contributions by employer to the savings part of mandatory pension plan, limited to RUB 12,000 per year (art. 217(39))
- Interest subsidized by employers on loans for purchase or construction of residential housing included in deductible expenses for profit tax purposes (art. 217(40)).

<u>Exempt income not connected with employment:</u>

- Compensation for injury
- Gifts and prizes from commercial sources up to RUB 4,000
- Social benefits extended by the state (except temporary disability allowances)
- State pensions
- Income of tax residents from sale of real estate (or share of joint ownership in such property) held for at least 3 years.
- Income of tax residents from the sale of 'other property' held for at least 3 years (except the sale of securities and property used by individual entrepreneurs in their business activities)
- Capital gain from sale of shares in a Russian company held for at least 5 years (in case the shares have been acquired 01.01.2011 or after that) Capital gain from sale of shares in Russian companies not traded on a stock exchange, as well as shares in companies recognized as high-tech and innovative companies and which are traded on a recognized stock exchange and have been held for at least 5 years and acquired after 01.01.2011
- Free accommodation, utilities, and fuel or corresponding cash compensation for such provided by law
- Alimony
- Welfare benefits
- Income from sales of livestock and crop grown in private farms and funds received to develop private farming
- Scholarships granted to students
- Awards and grants for support of science, education, culture and arts issued by foreign or international organizations, or Russian organizations approved by the Russian Government
- Interest on state treasury notes
- Interest on deposits in banks within set limits
- Income inherited from individuals
- Gifts received from individuals except for gifts of real property, vehicles, shares, participatory interest; (this restriction as to the nature of the gift does not apply to gifts from family members or close relatives, as defined by the Russian Family Code)

- Individual entrepreneurs' revenues taxed under the tax regime of single income tax or simplified system of taxation
- Employer's contributions to co-finance pension savings
- Pension savings paid out to the legal successors of a deceased person
- Borrower's income in the form of amounts owed under property insurance agreements securing the borrower's obligations (pledge), accrued interests, and penalties and fines awarded by a court; and others

Interest on bank deposits in rubles is exempt from taxation for the part of interest that does not exceed the refinancing rate of the Central Bank increased by 5 percentage points (art. 217(27)). Interest on amounts denominated in foreign currency is exempt from taxation when the interest rate does not exceed 9 % per annum.

To note, that income from the sale of property by non-residents and sale of securities and property used in business is subject to taxation regardless of such assets' duration of ownership (art. 217(17)1).

Individual Tax Declarations

Refund of overpaid tax due to change of tax status

Since different tax rates are set for the taxation of income from work performed by residents or non-residents, the Tax Code provides for the possibility of refunding overpaid tax due to the change of tax status from non-resident to resident.

When an employee becomes a tax resident during a calendar year, the employee's income received from his/her employer is taxable at a rate of 13 % from the beginning of the year. Since a non-resident's income from work in Russia is subject to an income tax of 30 %, the employer has actually withheld excessive income tax amounts for the period prior to the acquisition of the status of tax resident during the calendar year. According to the amendments to the Tax Code effective as of 01.01.2011, as soon as they become tax residents, employees may apply for a tax refund after recalculation of the amount of tax payable for the relevant fiscal period. Tax refund applications must be submitted to the tax office with which the employees were registered (art. 231(1)1).

Such applications are filed together with tax returns and the documents confirming the employees' status of tax residents. The law does not provide for any exceptions to this rule.

Tax agents calculate at the end of each month the amounts of payable tax on an accrual basis from the beginning of the year for all income taxed at a rate of 13 % deducting the tax withheld in the previous months of the current fiscal year (art. 226 (3)). However, if the employee continues to work with the same employer, the first option would be to offset the tax earlier charged with 30 % against future income charged at 13 %. No additional tax would be charged before the average effective rate for the annual income would be 13 %. The Ministry of Finance of Russia interprets this provision as the employers' right to offset the tax withheld at a rate of 30 % from the salaries received by employees before they acquired the status of tax resident, against the payable tax at a rate of 13 % on the salaries received from the beginning of the fiscal period (letter of the Ministry of Finance of Russia No. 03-04-06/6-263 of 11.06.2011).

In principle all taxpayers have to file tax returns for income tax no later than April 30 of the year following the year following the tax year (art. 229(1)). Declarations may be filed in person or by proxy. Tax Residents file declarations in respect of their world-wide income, while Non-Residents file declarations in respect of income received from Russian sources.

If a foreign individual finishes the activities from which income was derived and for which a tax return must be filed, when such individual leaves Russia, this person must at least one month before leaving Russia file a tax return for the income actually received during the current calendar year (art. 229(3)).

In case when a taxpayer receives income exclusively from parties that have the obligation to withhold tax as tax agents (such as employers), there will be no obligation to file a tax return. In certain cases such individuals may choose to submit a tax return in order to claim tax deductions, for example, for:

Individuals must file tax returns in any event in the below listed cases (arts. 227, 228):

- Individuals who received income from other individuals or organizations, which do not act as tax agents
- Tax residents who receive income from non-Russian sources
- Other individuals from whose income no tax is withheld by tax agents
- Individuals receiving taxable income as donations from other individuals

- Individuals receiving income in cash equivalent for real estate or securities transferred to top-up the special-purpose capital of non-commercial organizations
- Individual entrepreneurs
- Private notaries and other independent service providers
- Individuals who received income from other individuals and legal entities who are not tax agents (including labor contracts, rent agreements and sale of property and proprietary rights)
- Tax residents of Russia who receive income from non-Russian sources
- Other individuals from whose income no tax was withheld by tax agents
- Individuals receiving taxable gifts from other individuals Individual Entrepreneurs
- Private notaries and other independent service providers

Non-submission of tax returns due may lead to the following sort of penalties (art. 119):

- A penalty (surcharge) in the amount of 5 % of the tax subject to payment for each complete or incomplete month of delay, but not more than 30 % of the original tax due (and not less than 100 RUB)
- If the delay lasts for more than 180 days, then a fine is imposed in the amount of 30 % of the original tax due together with a 10 % fine for each complete or incomplete month from the 181st day of delay

Under the Criminal Code of Russia criminal sanctions may ensue from failure to duly file tax returns.

14. EMPLOYER'S SOCIAL CONTRIBUTIONS AND EMPLOYEE SOCIAL, MEDICAL AND PENSION BENEFIT IN RUSSIA

The system of payment for social, medical and pension insurance has undergone considerable changes, with new laws in force as of 01.01.2010. Prior to the changes a unified social tax was levied for all these purposes. Now the system has been amended so that the contributions to the social insurance fund, pension fund, and compulsory medical insurance funds are paid (hereinafter "employer contributions" or "insurance contributions") following separate rules for each of these purposes. In this connection the rules on social tax of chapter 24 of the Russian Tax Code have been abolished and replaced by the Law on Insurance Contributions (*"On insurance contributions to the pension fund of Russia, social insurance fund of Russia, compulsory medical insurance federal fund, and compulsory medical insurance local funds"*, Law No. 212-FZ of 24.07.2009).

These employer contributions go towards funding the following kinds of social welfare programs:

- Social insurance (compensation and paid leave in case of illness, pregnancy, childbirth, and childcare);
- Compulsory medical insurance (free public healthcare);
- Pension insurance (retirement pension).

Contributing Employers

Employers as well as self-employed entrepreneurs and professionals are liable to pay insurance contributions, the latter both for the people they employ and for themselves.

The pension system is funded by mandatory pension contributions made to the Pension Fund, which manages the state pension system (Law "On compulsory pension insurance" of 15.12.2001 No. 167).

The pension is divided into three parts: a basic part, an insurance part and an accumulative part. Unlike the first two parts, the latter applies only to persons born after 1967. It is inheritable and can be transferred to a licensed non-governmental pension fund.

The system of social security is managed by the Social Insurance Fund (Law of 29.12.2006 No. 255-FZ "On compulsory social insurance in case of temporary disability and maternity"). The details on the required employer's contributions to this system and the paid-out benefits will follow below.

The system of compulsory medical insurance is managed by the Medical Insurance Fund (Law No. 326-FZ «On compulsory medical insurance" of 29.11.2010). The system provides the (mainly) free healthcare and hospital services.

Contributions to the System of Mandatory Work-Related Accident and Health Insurance

The Social Fund also manages the system of compulsory work hazard insurance (insurance against work related accidents and occupational diseases; Law of 24.07.1998 No. 125-FZ "On compulsory social insurance against industrial accidents and occupational diseases").

The insurance rates or work-related accidents are differentiated in relation to the perceived occupational risk. But the system does not actually differentiate for individual risk, basing the risk factor on the statistics connected with the main activity as per official classification of the business of the employer. This assignment of risk factor is based on the amount of insurance premiums actually paid in the preceding year to workers of a certain industry.

The rates range from 0.2 % to 8.5 % of the salary (total remuneration). For example, a company employing mainly office workers would pay 0.2 % (1 class); a company producing steel would pay 1.9 % (class 16); and a coal mining company would pay the maximum 8.5 % (32 class). A company (legal entity) may, however, apply individual rates for each of its registered subdivisions.

The Base for Charging the Pension, Social and Medical Contributions

According to the law, the insurance contributions are levied from payments and other compensation made in favor of both salaried employees and freelancers (in Russia frequently referred to as civil law contractors, who may work e.g. on contracts for performance of works, provision of services, commissioning contracts, licensing agreements).

The question as to whether payments to members of a company's board of directors and audit committee should be subject to insurance contributions is still disputed. The Ministry of Finance previously held that since such payments are not made under employment or civil law contracts, they should not be subject to social tax (Letter No. 03-03-06/1/475 of the Ministry of Finance of Russia dated 10.07.2007). The Ministry of Health and Social Development has extended this interpretation (taken in relation to the former social tax) to apply to the insurance contributions under the new law (letters of Ministry of Health and Social Development No. 2519-19 item 6 of 05.08.2010, No. 1145-19 of 07.05.2010, and No. 421-193 of 01.03.2010). However, the Supreme Commercial Court of Russia in a ruling (under the old law) held that such payments should have been subject to social tax (information letter of the Supreme Commercial Court No. 106 of 14.03.2006).

The amount of insurance contributions due in relation to each employee (insured person) is calculated on an accrual basis from the beginning of the year. Each employer (or other payer of the insurance contributions) makes the calculations solely based on the income the employee earns from this same employer during the calendar year, without regard to income that the employee may have earned from another employer (strictly limited to one legal entity even within a group of companies).

The base for insurance contributions in respect of commissioning contracts and licensing agreements is the net amount after deducting the documented expenses, and in the absence of such documentation they are determined as a fixed percentage of income (Law *"On insurance contributions"* article 8(7)).

The tax base for compensation received in kind is the real cost of the received goods (services) (art. 8(6)) Federal law *"On insurance contributions"*).

Remuneration in favor of individuals under civil law contracts is not subject to insurance contributions for the part due to the social insurance fund (Law on Insurance Contributions art. 9(3)).

Individual entrepreneurs, lawyers, notaries and other persons with private practice are required to pay a fixed amount of insurance contributions to the Pension Fund of Russia and the Compulsory Medical Insurance Federal Fund based on a sum of required insurance contribution that the Russian Government sets for each year (art. 14 (1) Law No. 212-FZ). For people born after or in 1967 this value was set for 2013 year as RUR 35,664.66, of which RUR 32,479.20 is contributed to the Pension Fund and RUR 3,185.46 to the Compulsory Medical Insurance Fund.

The insurance contributions for self-employed people must be transferred to the Pension Fund of Russia and the Compulsory Medical Insurance Federal Fund no later than December 31 of the current calendar year (Article 16 (2) Law No. 212-FZ). Self-employed people do not pay disability and maternity leave to the Social Insurance Fund (Article 14(5) Law No. 212-FZ).

Compensations Exempt from Insurance Contributions

Some types of compensation (remuneration) are exempt from the calculation base for insurance contributions (art.9), such as:

- Reimbursed expenses associated with the performance of work duties (within the limits established by law);
- Daily allowances trip expenses (within limits set by law);
- Compensation of travel expenses;
- Compensation for physical harm;
- Compensation for accommodation, special clothing, and meals (within the limits established by law);
- One-off material aid to employees due to childbirth (adoption) or in connection with death of an employee or his/her family member;
- Training costs;
- Reimbursement of interest under loans for the purchase or construction of housing;
- Severance payments on dismissal;
- Compensation for unused vacation on dismissal;
- Aid to employees upon retirement (within the limits established by law);
- Federal, regional or local social aid set by appropriate law.

Accounting and Reporting Periods

The accounting period for insurance contributions is a calendar year (article 10.1).

Insurance contributions are accrued monthly when salaries (or other payments) are accrued, and paid monthly before the 15th of the month following the accounting month. For example, insurance contributions for December are paid up to January 15.

The contributing payer must report quarterly to the relevant authorities as follows:

- To the Social Insurance Fund no later than the 15th of the month following the end of the reporting quarter, and
- To the Pension Fund no later than the 15th of the second month following the end of the reporting quarter

Concerning subdivisions with a separate accounting balance and bank account, the company must separately pay the insurance contributions to the local fund authority and file necessary reports to it.

Rates

The insurance contributions are paid in full at a rate of 30 % for an annual income (from the same employer) of up to RUR 624,000, after which limit the income is subject to a charge rate of 10 % without any further regression. (In the year 2013 the limit was RUR 568,000, in the year 2012 — RUR 512,000). These limits are subject to annual indexation (Government Decree No. 1276 dated 10.12.2012).

Under the general rule the 30 % insurance contributions are divided as follows:

- 22 % is contributed to the Pension Fund;
- 2.9 % is contributed to the Social Insurance Fund;
- 5.1 % is contributed to the Compulsory Medical Insurance Federal Fund.

The 10 % tail on the amounts exceeding the limit goes to Pension Fund.

The table below presents the general rule calculation of insurance contributions under applicable rules as of 2013.

Salary (monthly, rubles)	Salary (annual, rubles)	Insurance contribution rate (%)	Insurance contributions (annual, rubles)
50,000	600,000	30 % on 568,000 + 10 % on 32,000 over the limit	173,600
140,000	1,680,000	30 % on 568,000 + 10 % on 1,112,000 over the limit	281,600
400,000	4,800,000	30 % on 568,000 + 10 % on 4,232,000 over the limit	593,600

There are several exemptions available for certain categories of employers in the form of preferential charge rates. Some of these are presented below.

Concessions and Reduced Rates

Certain categories of social contribution payers enjoy reduced rates of insurance contributions which will be phased out for all categories by 2027 as follows:

- Agricultural producers;
- Taxpayers who apply the tax regime of unified agricultural tax;
- Residents of high-tech and innovation special economic zone;
- Taxpayers working in the IT sector, under certain conditions;
- Taxpayers under the simplified tax system (but only for limited types of activities);
- Media organizations;
- Theaters, museums, and archives;
- Pharmacies;
- Charitable organizations;
- Taxpayers providing engineering services (under certain circumstances);
- Others (art. 58 Law “On insurance contributions to the Pension Fund” No. 212).

Preferential charge rates for insurance contributions are established for the above categories ranging from 0 % to 30 %, being subject to the same threshold limits as presented above. The additional contribution of 10 % to the Pension Fund does not apply to these kinds of employers (professionals).

The benefits are granted to employers (professionals), provided they meet a number of statutory conditions. Regulatory authorities verify whether the conditions are met at the end of each year. If a taxpayer does not meet any of the conditions, it is no longer entitled to benefit from preferential rates.

The law envisages that these benefits will gradually be effaced by a stepwise increase of rates every 2 years in order to finally catch up with the rates for ordinary categories of employers. But according to the present law, no gradually effacement is foreseen for employers that enjoy preferential treatment by being registered participants of the Skolkovo innovation project (these employers enjoy a special rate of 14 %).

Payments to Foreign Employees

In 2010 and 2011, payments to foreign employees were not subject to insurance contributions, except in regard to foreigners who had obtained a residence permit (temporary or permanent) in Russia. But with the change of law in November 2011, income paid to foreign employees (individual contractors) became subject to employer contributions. When the following conditions are met the income is subject to the contributions:

- The foreign employee is a temporary resident or is temporarily staying in Russia, and
- The foreign employee works under an employment agreement for an indefinite period or a fixed-term agreement for a period of 6 months or more.

However, these insurance contributions are due only for the part allocated to the Pension Fund at a rate of 22 % (of the total 30 %). But by an explicit provision of the law, although the remuneration of these foreigners is subject to these pension contributions, they will still not be entitled to any pension. (Only those foreign nationals who have received a temporary or permanent residence in Russia will be entitled to a Russian state pension.)

Foreigners with a certain kind of status are however still exempt from employer contributions, as follows (art. 7(4)):

- A foreign national living and working abroad (outside the territory of Russia), even in the case that the remuneration is paid from Russia;
- Foreign nationals that have received a work permit under the privileged status of a so-called highly qualified specialist (for more details, please refer to the chapter on Personal Income Tax).

Social Aid Paid by Employers and Their Possible Reimbursements

You will find below a list of cases when an employer is obliged to make various kinds of social aid payments to employees. These payments may be divided as follows:

a. Temporary disability benefit;
b. Maternity benefit;
c. One-off benefit to women registered with medical institutions in early pregnancy;
d. One-off child birth benefit;
e. Monthly child care allowance;
f. Funeral allowance.

Law No. 255-FZ *"On compulsory social insurance for temporary disability and maternity"* (hereinafter FZ No. 255) provides for the following types of social insurance (FZ No. 255 art. 1.4):

Temporary Disability Benefit

Employers pay temporary disability benefits using funds from the Social Insurance Fund and their own funds. The law provides for employers' obligation to pay for the first 3 days of temporary disability and from the 4th day onwards, such payment is made on account of the Social Insurance Fund (FZ No. 255 art. 3(2)1).

The law provides for these cases in which payment of temporary disability is made by the Social Insurance Fund from the first day of temporary disability (FZ No. 255 art. 3 (3)):

a. Care given to a sick family member;
b. Quarantine of an insured person, as well as quarantine of a child under 7 years of age attending a pre-school educational institution or another family member deemed incapacitated;
c. Having prosthetics done for medical reasons in a specialized institution;
d. Prescribed aftercare in sanatorium and spa resorts in Russia, immediately after hospitalization.

Temporary disability benefits are calculated on the basis of an a so-called average daily salary. This average daily salary is the actual average daily salary arrived at dividing the annual compensation for two preceding calendar years by 730. But this compensation is to a maximum amount which is calculated based the employer's contribution limits for two previous years. For example, the contribution limits were 463,000 rubles for 2011 and 512,000 rubles for 2012; the sum of these amounts is divided by 730, which yields in 2013 a maximum daily rate of 1,335. 62 rubles.

The amount of payable benefit depends on the period of time that the employee has been included in the insurance program. When that time is less than 5 years, then the benefits are paid out 60 % relative to the daily average compensation, 5 to 8 years membership yields — 80 % of average compensation, and from 8 years and over yields 100 % of average compensation. If the insured person has been working for fewer than 6 months, then the amount of compensation will not exceed the *minimum monthly wage* of a full calendar month. Temporary disability compensation is calculated according to a special formula (*FZ No-255,* art.7 (1)).

From the 4th day of disability onwards, employers are entitled to decrease or compensate the payments for disability contributions against insurance expenses incurred for their employees (*FZ No-255,* art.3 (2)).

You will find below a more detailed description of how to refund or offset amounts from the Social Insurance Fund.

Only the amounts for which insurance contributions are paid to the Social Insurance Fund are included in the calculation, including those paid while working at other insured parties.

Duration of payment of temporary disability benefit

The period of payment of this benefit depends on the grounds for the entitlement (FZ No. 255 art. 6) as indicated in below table.

Ground	**Duration of payment of benefit**
Illness or injury	• The entire period of temporary disability until the date of recovery (disability assessment); • Benefit is paid for a maximum of four consecutive months or five months in a calendar year; • Benefit is paid to an employee hired under a fixed-term employment agreement (fixed-term service contract) for up to six months.
Aftercare in sanatorium and spa resorts in Russia, immediately after hospitalization	During the period of stay in a sanatorium, but not more than 24 calendar days (except for tuberculosis).
Care given to a sick family member	• Caring for a sick child under the age of 7 — the entire period of care, but not more than 60 calendar days in a calendar year for all cases of care for that child. Benefit may be paid for up to 90 calendar days in exceptional cases; • Caring for a sick child aged from 7 to 15 — up to 15 calendar days for each case, but not more than 45 calendar days in a calendar year; • Caring for a sick disabled child under the age of 15 — the entire period of care, but not more than 120 calendar days in a calendar year for all cases of care for that child; • And other cases prescribed by law *(Article 6 FZ No. 255)*.

Quarantine of an employee or quarantine of a child aged 7 attending a pre-school educational institution or another family member deemed incapacitated	Benefit is paid to an employee who has contracted an infectious disease or who is found to be a bacteria carrier, during the entire period of suspension from work due to quarantine. If children under the age of 7 attending a pre-school educational institution or other family members are subject to quarantine, benefit is paid for the entire period of quarantine.

The law also provides for specific grounds under which temporary disability benefits are not paid out (art. 9(1) No 255 — FZ).

Maternity Leave Benefit

Compensation for maternity leave is granted to women at their request on the basis of a medical certificate. In this case, payable benefits amount to 100 % of average wages with some exceptions as listed below *(art. 255 Labor Code and No. 255–FZ, art. 13)*. Maternity benefit is paid in full by the Social Insurance Fund on the basis of a medical certificate confirming the fact. Employers initially execute the payment to the employee and may subsequently refund it from the Social Insurance Fund following the due process (FZ No. 255 art 13 (1)). This rule, however, does not apply to women with a pensionable service of less than six months. The maternity benefit payable to these women may not exceed the minimum monthly wage for one month.

Maternity leave is granted for a total of 140 calendar days (before and after childbirth) and in case of the birth of two or more children for 194 calendar days (total leave before and after childbirth).

The maximum amount of paid out compensation of maternity leave is the average daily salary (in the 730 preceding days) times the number of number of days of maternity leave.

If an employee happened to be on leave to care for a child under the age of 1.5 during the previous two years before going on maternity leave, then the employee may require that her compensation be calculated according to the income of those 2 years. The maximum average wage cannot exceed the threshold set for accrual of insurance contributions at RUR 568,000 *(the threshold set by the Russian government for 2013 is subject to annual indexation)*.

As of 01.01.2013, a new procedure has been introduced for calculating the child care benefit. It extends to insurance cases occurring starting from 01.01.2013. Moreover, in a range of cases, the application of a new procedure might lead to a reduction in the amount of the child care benefit. In connection with this, employees may opt for replacing maternity benefits with childcare allowances. But this will be possible only if the childcare allowances were greater than the maternity benefits *(FZ No. 255, art. 11.1(3))*.

You will find below a more detailed description of how to refund or offset amounts from the Social Insurance Fund.

Childbirth Allowance

This allowance is paid upon submission of a birth certificate confirming childbirth together with a statement from the workplace of the other parent to confirm that no allowance will be given to that parent. In 2013, this allowance was set at RUR 13,087.61, while in 2012 it was RUR 12,405.32.

Monthly Childcare Allowance for Children under the Age of 1.5

A mother (or other caretaker of a child) is eligible for a monthly childcare allowance for the time until the child reaches the age of 1.5 years. (It is to be noted that the person who takes care of the child may prolong the childcare leave yet further until when the child reaches 3 years but no compensation is due for the extended period).

This allowance is granted upon submission of a request to the employer's accounting department together with a birth certificate, a birth certificate for the previous child (if any), as well as a statement from the workplace of the other parent to confirm that no allowance will be given to that parent. The rights to childcare leave and allowance are not limited to the mother of the child. Other family members such as the father, grandparents and even other close relatives, who actually care for the child and contribute to compulsory social insurance, are also entitled to these rights. Childcare allowance is granted to one person only, so if another family member receives this allowance, then the mother will not be eligible for it *(Decree No. 1012n of the Ministry of Health and Social Development of 23.12.2009).*

This allowance is paid out to people subject to compulsory social insurance at a rate of 40 % of average wages without exceeding the threshold for accrual of these contributions established for the year *(RUR 568,000)*, but not under the minimum benefit amount:

- RUR 2,453.93 *(per month, in 2013)* for care for the first child;
- RUR 4,907.85 *(per month, in 2013)* for care for the second child and subsequent children.

You will find below a more detailed description on how the employer may refund or offset amounts from the Social Insurance Fund.

Temporary Disability Benefit for Caring for a Sick Child

Temporary disability benefit for caring for a sick child is paid as follows:

- In case of outpatient treatment — for the first 10 calendar days, in the amount determined by the length of pensionable service in accordance with the general procedure and for subsequent days, at a rate of 50 % of average wages;
- In case of inpatient treatment — in the amount determined by the length of pensionable service in accordance with the general procedure.

When such benefit is required to care for a sick child under the age of 15 under outpatient treatment, it is paid regardless of the length of the employee's pensionable service.

The law limits the number of days *(as mentioned in the above table)* for such sick leave in a calendar year. Companies must therefore keep a record of the number of days paid to their employees for caring for a sick child. If an employee has several children, records are kept for each child.

You will find below a more detailed description of how to refund or offset amounts from the Social Insurance Fund.

Recovery or Offsetting of Amounts from the Social Insurance Fund

From the 4th day of temporary disability, employers may set off the benefits paid to their employees against future payments to the Social Insurance Fund *(art. 3 (2)1 FZ No. 255)*. Employers may thus decrease their monthly payments to the Social Insurance Fund by the amount of benefits paid after the 3rd day of temporary disability.

If the amount of paid benefits exceeds the monthly payments to the Social Insurance Fund, employers may get this overpaid amount refunded by sending a written application and required documents to the local office of the Social Insurance Fund with which their company is registered *(please see section Refunds from the Social Insurance Fund)*.

<u>Benefit amounts exceed insurance contributions to the Social Insurance Fund</u>

The upper limit for payment of insurance contributions is set at RUR 568,000. When paid benefits exceed paid insurance contributions, employers may:

a. Offset against future payments to the Social Insurance Fund;

b. Get overpaid amounts compensated by the Social Insurance Fund.

a. Offset against future payments to the Social Insurance Fund

Employers may decrease their insurance contributions to the Social Insurance Fund by the amount of the following benefits paid out to their employees (FZ No. 212, art. 15 (2); art. 1.4(1) FZ No. 255)):

- Temporary disability benefits;
- Maternity leave benefit;
- One-off benefit to women registered with medical institutions in early pregnancy;
- One-off child birth benefit;
- Monthly child care allowance;
- Funeral allowance.

Employers are not required to pay contributions to the Social Insurance Fund until the overpaid amount is fully repaid. However, offsetting must be carried out within the reporting period, i.e. the calendar year (art. 15 (2.1) FZ No. 212).

b. Compensation from the Social Insurance Fund

To get the amounts paid over the limit set for insurance contributions compensated, employers must apply for compensation to their local office of the Social Insurance Fund. There is no limitation term for such application for compensation to the Social Insurance Fund, so the general term of 3 years is usually used *(art. 196 Civil Code)*.

Required documents

Employers must submit the following documents to the local office of the Social Insurance Fund with which their company is registered as prescribed by decree No. 951n of the Ministry of Health and Social Development dated 04.12.09:

- Application for compensation;
- Calculation of accrued and paid insurance contributions *(Form 4-Social Insurance Fund);*
- Copies of documents confirming the validity and correctness of expenditure;

If the Social Insurance Fund does not find any irregularities in the allocation, calculation and payment of benefits, as well as in the accrual and payment of contributions, it will transfer the required amount to the company's account. Such transfer is made within 10 calendar days from the date of submission of all required documents (FZ No. 255 Article 4.6).

The Social Insurance Fund may not compensate if benefits were paid in violation of the law, were not documented, or were paid on the basis of documents which were not duly drawn up (FZ — No. 255, art. 4.7 (4)).

The Social Insurance Fund may check the validity and correctness of insurance payments. In this case, the Social Insurance Fund may request additional information and documents confirming the validity of insurance payments and the correctness of their calculation (art. 4.7 and 4.6 FZ No. 255). For example, the following documents may be requested: copies of employment agreements, copies of employee passports, the sick leave registry and other documents directly related to the payment of benefits.

The benefits paid by employers for the first 3 days of temporary disability are not returned, but employers are entitled to deduct these amounts from their company's profit tax base (art. 264(1)48.1 Tax Code).

15. CORPORATE PROPERTY TAX IN RUSSIA

The Provisions on corporate property tax are in chapter 30 of the Tax Code. To note that the rules concerning taxation of property of individuals are in another law, namely the Law 'On taxation of property of individuals' (Law No. 2003-1 of 09.12.1991; see next chapter).

Corporate Property Tax is a regional tax. The regions of the Russian Federation are allowed to regulate some provisions of the tax, among them the tax rate, but within the general framework provided by the Tax Code.

Effective of 01.01.2013 there is a major change in the corporate property tax. Movable assets which have been recorded as fixed assets (in company's accounting balance) are now excluded from the tax base. This means that the movable fixed assets which have been acquired earlier (before 01.01.2013) still remain taxable.

Significant amendments to the rules concerning the calculation of property value (tax base) will enter into force from 1st January, 2014. Most importantly, the tax base will now be determined based on the cadastral value concerning property owned by foreign companies and certain other categories of real estate such as shopping malls and business centers. This replaces the method of determining the tax base according to the inventory value.

Exempt Assets and Taxpayers

Taxpayers of corporate property tax are Russian and foreign legal entities for the assets which fall within the scope of the law.

Certain categories of assets are exempt from corporate property tax (374.4), and certain types of assets held by certain categories of taxpayers are excluded from the scope of the tax (art. 381) such are, for example:

- Movable assets recorded as fixed assets (in company's accounting balance) not earlier than 01.01.2013
- Land and water resources
- Vessels registered into the Russian international ship register

- Spacecraft (space objects)
- Assets which have by virtue of law been recognized as historical or cultural assets
- Assets of residents of special economic zones (for a limited period of time)
- Assets of religious organizations, which are used in their statutory activities.
- Assets of Russian nationwide organization of disabled persons (when the membership consists of no less than 80 percent of disabled people).
- Production assets of pharmaceutical companies
- Certain new investments in high-energy efficiency facilities according to a list established by the Russian Government (Decree of the Russian Government No. 562 of 12.07.2011; benefit available 3 years from the registration date of the property).

Russian regions are granted some levy in granting concessions on the corporate property tax (article 372).

Objects of Taxation

According to the law the objects of taxation are different for Russian legal entities and for foreign legal entities. There is a further difference between taxation of assets of foreign firms acting through a permanent establishment and those that do not constitute a PE.

For Russian legal entities taxable assets are defined as (art. 374) movable or immovable assets that are recorded in statutory financial accounting books as fixed assets (including such fixed assets that have been transferred for temporary possession or use, joint activity etc.). But note that following the change in law reported above movable fixed assets recorded in company balance from new year 2013 are not included in the tax base.

For foreign legal entities that conduct business in Russia through a permanent establishment the taxable assets are defined as movable or immovable assets considered as fixed assets and assets received by way of concession agreements.

Those foreign legal entities that do not form permanent establishments in Russia are taxed only for immovable assets (including those received on concession agreements).

It should be noted that immovable assets include ships and aircraft in addition to real estate (whereas land is excluded from the tax base). Also to note that by law immovable assets have to be registered in state registers as detailed in relevant laws. The registration requirement should remove any doubt as to which assets are actually to be considered as immovable assets in case of a dispute with tax authorities.

According to the law land and other natural objects (such as water resources) are not the object of corporate property tax. However, there is a separate land tax and a tax on water resources.

Tax Rate, Periods and Tax Base

As the corporate property tax is a regional tax, the regions are authorized to set the tax rate within the maximum rate provided by the Tax Code, which is 2.2 %. And in accordance to the newly enacted amendments, the tax base may not exceed the following rates for real estate objects held by foreigner firms as well business centers and shopping malls (and other types of objects) :

1) For Moscow in 2014 — 1.5 %; in 2015 — 1.7 %; from 2016 and onwards — 2 %;
2) For other Russian regions in 2014 — 1 %; in 2015 — 1.5 %; from 2015 and onwards — 2 %.

Hereby most of the regions have chosen to set the rate at the highest permissible.

The tax rate for Moscow is set at 0.9 %[134] for 2014. The Government of Moscow has already approved a list with real estate objects for which it has set the cadastral values.

The tax period is a calendar year, but taxpayers are required to make advance payments as set out in the relevant regional law.

The tax base is calculated as the asset's average annual accounting value. In respect of foreign companies that perform business activity without forming a permanent establishment the tax base will be determined as the inventory value of their immovable assets as assessed by the agency charged to perform technical inventory.

134 Moscow City Law No. 63 of 20 November 2013 "On Amending Moscow City Law No. 64 of 5 November 2003 "On Corporate Property Tax".

16. INDIVIDUAL PROPERTY TAX IN RUSSIA

To differentiate from the corporate property tax we refer to the property tax levied on individuals as individual property tax. The rules on Individual Property Tax are unlike to most tax rules not found in the Tax Code but in a special law dating back to 09.12.1991, the very day the Soviet Union was dissolved (Law "On Tax on Property of Individuals", No. 2003-1 of 09.12.1991). In addition to the law, a number of instructions and letters have been issued by Ministry of Finance in order to clarify the details.

The Individual Property Tax is a local tax.

The objects of taxation are residential premises, (including apartments and separate rooms), cottages, garages, and other buildings, premises and facilities.

In case of coownership to the objects of taxation, each owner pays his appropriate share of tax.

If a taxable asset is held in joint ownership of two or more persons, then they have joint liability for the tax.

Tax Base and Rates

The tax base is calculated on the basis of the total inventory value of the asset, which normally is much less than the actual market value. This inventory value is determined by the state inventory agencies. Each year by March 1, the agency must submit the relevant data to the tax offices, which calculate the actual amount of tax due and issues to the taxpayer a corresponding payment order. The tax is due by November 1 of the year following the tax year.

Presently the effective tax rates are insignificant although charged with a progressively higher rate for higher inventory values. If the inventory value is less than RUR 300,000, the rate may not exceed 0.1 %. When property value is between RUR 300,000 and RUR 500,000, the property is taxed at a rate between 0.1 % and 0.3 %. More expensive properties are taxed at a rate between 0.3 % and 2.0 %. The local governing bodies may set the rates within the established limits.

17. LAND TAX IN RUSSIA

The land tax is a local tax regulated by Chapter 31 of the Tax Code.

Taxpayers

Taxpayers of the land tax are organizations and individuals, who own land or enjoy right of inheritable lifelong possession, or right of permanent (perpetual) use.

Exemptions in form of reduced tax rates are established in relation to some socially protected categories of people such as disabled persons (article 391(5). Some organizations are totally exempt from the land tax. (art.395) among them are residents of special economic zones (for a limited period) and religious organizations. Some additional exemptions to the tax may be set in local regulations (article 387 (2)).

Certain types of land are exempt from the tax, such are:

(i) land on which objects of cultural and historical heritage are located
(ii) land held by defense, security and customs authorities
(iii) land officially recognized as forest
(iv) land under state-owned water basins (with some exceptions)
(v) land which cannot be freely traded or inherited due to restrictions in the law. (In Russian jurisprudence this is referred to as “land withdrawn from civil law circulation”).

Tax Base

The tax base is the cadastral value of the land. This value is determined in accordance with the Russian Land Code (art. 66) and the Law “On state immovable property cadaster” of 24.07.2007.

The cadastral value is calculated as a result of either a state cadastral value or an independent land valuation (Land Code Article 66).

In a decision of 2011 the Constitutional Court (No. 281-O-O) ruled that for determining the market value of land, the cadastral value is set as a percentage of the market value.

The Supreme Commercial Court (No. 913/11 of 28.06.2011) stated that that if a taxpayer does not agree with the cadastral valuation of the land then the taxpayer may consider initiating an independent evaluation of the land. In that case the cadastral value will be equal to the value of the independent evaluation (an official independent valuation report of the land has to be issued). The court clarified that in the case when cadastral value would be significantly higher than the valuation arrived at by independent appraisal then the cadastral value may indeed be changed. However, the change has to be entered into the cadastral register. Other court practice supports this trend. (For example, Federal Commercial Court in the Volga-Vyatka Region No. A29-9636/2010 of 11.10.2011; Federal Commercial Court in the East-Siberian Region No. A74-300/2011 of 08.09.2011; Federal Commercial Court in the Volga Region No. A55-24797/2010 of 04.10.2011; Federal Commercial Court in the Ural Federal District No. F09-7091/11 of 03.11.2011).

In addition to the cadastral value and market value, there is also the concept of 'normative value of land.' This value is determined annual by the relevant regional government and includes considerations as to the quality and location of the land as well as economic payback. The method for determining the normative value has been set by Government decree (No. 319 "On the procedure for determining land normative price" of 15.03.1997).

As noted in ruling No. 54 of the Plenum of the Supreme Arbitration Court of Russia, if the cadastral value of a land is not established, then the normative price of a land is applied for tax purposes.

Organizations and individual entrepreneurs have the obligation to calculate the tax base, submit tax returns and pay the taxes on their own initiative, whereas in regards to individuals the tax office must issue a tax assessment note and demand payment.

The tax is paid annually, with quarterly advance payments (articles 393 and 396 of Tax Code).

Tax Rates

Maximum rates are established by the Tax Code (article 394). Local authorities may set any rates for different kinds of land within these limits.

A special tax rate of 0.3 % is established for the following types of land (art. 394):

a) Land reserved for agriculture and farming
b) Land granted for the purposes of private subsidiary farming, horticulture, gardening, or live-stock breeding
c) Land for housing and engineering infrastructure for municipal services.

Other land is taxed at the general rate 1.5 %.

Land Tax in Moscow and St Petersburg

The Moscow law "On Land Tax" of 24.11.2004 sets out some specific rules. For instance, individuals (except individual entrepreneurs) are not required to make advance payments. It provides a lower rate for lands used for housing (0.1 %). Some other exemptions are also provided for, including for land used by governmental and scientific institutions.

The St Petersburg law "On Land Tax" of 23.11.2012 does not require individuals to make any advance payments. The tax rate for agricultural land is 0.3 % of cadastral value, while the tax rate for land for housing and residential properties is set at 0,01 %; and 0.042 % for land for subsistence farming.

18. TRANSPORT TAX IN RUSSIA

The transport tax is a regional tax and will have to be implemented by separate laws of each Region of the Russian Federation. The regional laws will determine the applicable tax rate for the region within the limits specified by the Tax Code, the specific procedures, dates for tax payments, tax privileges, and also the forms for tax filings (art 356).

Taxpayers

The taxpayers for the tax are individuals and legal entities, in whose name the vehicles and vessels (means of transportation) are registered (art 357). Exempt are foreign legal entities which take part in organizing Olympic Games and Para-Olympic Games in Sochi 2014 (and are officially recognized as such) for the income gained in connection with their services in connection with the games. The exemption is effective till 1 January 2017.

Object of Taxation

The objects of taxation are automobiles, motorcycles, motor scooters, buses and some other self-propelled vehicles, caterpillars, aircrafts, helicopters, ships, yachts, sailing boats, cutters, snowmobiles, sledge-cars, motor boats and other water and air vessels registered in due order.

The following kinds of means of transportation are excluded from taxation:

1. Oar boats and motorboats with engine power not exceeding 5 horse powers;
2. Motor cars specially designed for the disabled;
3. Commercial fishing seagoing and river vessels;
4. Passenger and cargo sea, river and air vessels utilized in passenger and cargo transportation;

5. Tractors, combined harvesters, special motor vehicles of agricultural manufacturers used in manufacturing agricultural products;
6. Vehicles and vessels of federal military bodies;
7. Vehicles and vessels under search by the police authorities;
8. Aircrafts and helicopters medical services.
9. Vessels registered in the Russian International Register of Vessels

Computation and Payment of the Tax

The tax rates (art. 359) of the transport tax are determined as follows:

- engine power — for vehicles and vessels with engine (the tax rate differs, depending on the vehicle type, from 2 to 50 rubles per horsepower);
- total capacity measured as registered tonnage — for towed vessels (the tax rate is 20 rubles per a registered ton);
- vehicle unit — for other water and air vessels (the tax rate is 200 rubles per vehicle unit).
- static take-off thrust of the jet engine — for aircraft with jet thrust (20 rubles on each kilogram force of thrust)

Since the January 1, 2011 the base rent of transport tax was reduced by half due to the increase of excise on a fuel.

The tax rates given in the Tax Code can be increased or reduced by the laws of the subjects of the Russian Federation, but no more than ten times (art. 361 For passenger cars which engine less than 150 (110.33 kw) horsepower the tax rates may be even further reduced.

The tax period for the transport tax is a calendar year (art.360).

Companies calculate the amount of the tax on their own and file corresponding tax returns. The tax inspectorate compute the tax due by individuals and hand to the taxpayer the corresponding notifications with the sum of tax due.

The tax (including advance payments) is paid at the location where the vehicle or vessel is registered in accordance with the procedures and terms set in the laws of the relevant Region (art 363).

By an amendment to the law new tax rates were introduced now making the rates depending on the value of the vehicle and its year of registration. In the press these scaled rates are referred to as tax on luxury cars. (Rates in below table).

Multiplier	Value of car	Age of car
1.1	**RUB 3-5 million**	2-3 years
1.3	**RUB 3-5 million**	1-2 years
1.5	**RUB 3-5 million**	less than 1 year
2	**RUB 5-10 million**	less than 5 years
3	**RUB 10-15 million**	less than 10 years
3	**over RUB 15 million**	less than 20 years

Moscow Transport Tax

As an example of the regional application of the federal law, we refer to the Moscow law on transport tax on July 9, 2008 N33.

The Moscow law significantly increased the transport tax rates in comparison with the default rates of the Tax Code. The law also sets some exemptions in regard to persons owning motor vehicles with engine power not exceeding 70 horse-powers. There is also an exemption benefiting companies performing services for urban public transportation.

19. OTHER TAXES, DUES AND DUTIES

In this chapter we will briefly introduce the taxes that do not have such a big significance for most of the taxpayers (although some of them having an overwhelming impact on state revenue, such as the mineral extraction tax). Some of these are considered in the Russia system of financial law as taxes although not necessarily carrying the name tax. These types of tax are the:

- Mineral extraction tax
- Excise tax
- Gambling tax
- State duty
- Fishing, Hunting and Trapping Dues

There are also a number of obligatory official charges (duties, dues) which are not recognized as taxes but which de facto are of tax nature in the sense of being mandatory contributions imposed by the lawmaker and collected for the purpose of financing state functions and expenditure).

Such mandatory charges are:

10) Customs duty
11) Customs fees (dues; fees for the completion of customs formalities, customs escort and customs storage
12) Employer's social contributions. (These have been dealt in a separate chapter of this book)
13) Dues for use of water resources
14) Environmental protection fees and charges.

Minerals Extraction Tax

The provisions of the minerals extraction tax are in chapter 26 of the Tax Code.

The minerals extraction tax replaced the separate taxes previously levied on the oil, gas and mining industries. — With the adoption of the mineral extraction tax, the excise tax was no longer levied on crude oil and gas condensate as well as natural gas.

Taxpayers

All legal entities and individual entrepreneurs which according to the Law "On subsoil use" (of 21 February 1992, No. 2395-1), are defined as *subsoil users*, are liable for the minerals extraction tax (art. 334), pending relevant license when required.

The subsoil users have to register separately as payers of the minerals extraction tax with the tax inspectorate at the location of the subsoil plot granted for use within 30 days from state registration of the relevant license (permit) for the use of subsoil. When the extraction plot is in the continental shelf of Russia, an exclusive economic zone of Russia, land or water territory outside of Russia, registration will take place at the place of legal registration of a legal entity or the habitual residence of the individual entrepreneur (Tax Code art. 335).

Object of taxation and tax rates

The object of taxation includes certain types of extracted minerals, namely:

1) minerals extracted from the subsoil on the territory of Russia
2) minerals extracted from the mining industrial waste (if such extraction requires a separate license).
3) minerals which have been mined from the subsoil that locates outside the Russian territory but within the Russian jurisdiction (as well as territories that have been leased or that are used in foreign countries by virtue of an international agreement, art. 336)
4) Extraction from oil and gas fields and other located beyond the territory of Russia on plots within its jurisdiction or which are rented from other states are included in the taxable base.

Types of minerals included (among other things) in the scope of the law are:

- anthracite coal,
- coking coal,
- brown coal and coal;
- peat;
- hydrocarbon resources (crude oil and gas condensate extracted at gas condensate fields natural gas and associated gas),
- marketable ores,
- mining and chemical non-metallic raw materials,
- rare metals,
- non-metallic materials for the construction industry,
- precious stones,
- natural salt,
- underground waters containing mineral resources or mineral waters,
- raw materials of radioactive metals (art. 337).

The law provides for detailed provisions for the measurement and valuation of the extracted minerals (art. 339, 340).

Tax period, tax payments and tax rates

The tax period is defined as a month of a year. The tax is paid no later than the 25th of the month following the tax period.

The tax rates vary from 3.8 % to 8 % (0 % in certain cases) depending on the minerals in question. The tax rates in regards to some types of minerals (oil, gas) may be set as a fixed sum in rubles per volume indicators (tones or cubic meters) for the extracted mineral. The amounts may vary and may be set in different quantities (amounts) depending on the time of the year and tax period.

The tax rate may also be set as special coefficients, for example, the tax rate for oil extraction is set by a special coefficient reflecting the change of the price of oil on the world market art. 342(3).

Excise Tax

The provisions of the Excise Tax are in Chapter 22 of the Tax Code.

Taxpayers

All Russian legal entities and permanent establishments of foreign legal entities as well as individual entrepreneurs are recognised as payers of the tax.

The tax is also levied at customs when goods are imported into Russia and in certain cases when goods are exported from Russia (art. 179).

Excisable Goods and Raw Materials

The Excise Tax is applied to goods specified in the law. Among other things, with exclusions and specification in the law, excisable goods are, for example, the following (article 181):

- alcoholic products
- tobacco
- ethyl spirit
- gasoline, diesel fuel and motor oils
- spirit-containing products (except for medicinal products
- cars (regardless of engine power) and motorcycles (with engine power in excess of 112.5 kW, or 150 hp)

Crude oil, condensate and natural gas are no longer excisable goods and are instead subject to the mineral extraction tax.

The law contains an extensive and specific list of operations that are excisable and those that are exempt from the tax (article 182, 183). Exports are exempt when specified in the law (article 184).

Tax rates vary depending on the kind of goods and their qualities, and even time of the year. The rates are frequently changed as a result of economic policy and inflation (the rates are lump sums in roubles and are exacted from a certain amount of excisable good).

Amounts of Excise Tax paid at import of products which are resold or included in resalable products can, along with certain other items, under certain circumstances be deducted from the amount of the excise tax (art. 200).

Gambling Tax

The provisions of the gambling tax are in Tax Code chapter 29.

The taxpayers of the gambling tax are legal entities licensed to engage in gambling business. From the January 1, 2012 individual entrepreneurs have been excluded from the scope of the law as a result of the amendments to the laws governing the gambling business. The taxpayers of the gambling tax are exempt from VAT (art 149(3)).

The objects of taxation are game-playing machines, gaming tables, totalizer offices, and bookmaking offices (art. 366). Each object of taxation, when installed, must be registered at the appropriate tax office.

The maximum and minimum rates for each object of taxation are established by the Tax Code (art 369). Regional laws may establish the rate within these limits.

The gambling tax is paid monthly.

State Duty

A special chapter on state duty was added to the tax code in 2004 (chapter 25.3).

State duty is a levy which is collected in connection with an application to organs of the state or local government for the performance of certain legally determined acts or services as detailed in the Tax Code (art. 333.16).

The Constitutional Court ruled in 2007 that the state duty is the only and sufficient payment that a state body is authorized to charge for performing its statutory duties. Pursuant to this ruling a state authority cannot legally validly require any other payment for its services. For example, the Constitutional Court has ruled that it is unlawful to require a reimbursement other than state duty for expenses related to the issuance of a driver's license (ruling of the Constitutional Court of 01.03.2007 N 326-О-П).

Here are some examples of state duties and their amounts:

– for import of products of hazardous or toxic substances — 200,000 RUR;
– securities market license — 200,000 RUB
– accreditation of branches of foreign firms — 120,000 RUB

- emission of securities — 0.2 % but max. 200,000 RUB
- issuing an invitation to foreign citizens or stateless persons to enter the Russian Federation — 500 RUB per person
- issuing or renewal of residence permits to foreign citizens or stateless persons — 2000 RUB
- issuing of a permit to hire foreign employers — 6000 RUB per worker
- admission to the citizenship of the Russian Federation — 2000 RUB

Fishing, Hunting and Trapping Dues

The provisions on hunting, fishing and trapping dues are in Tax Code chapter 25.1.

The object of taxation is animals and aquatic organisms (fish, crustacean, squid, etc.). The code set the tax rates for each type of organism separately. The tax base is either the mass of the organisms (estimated in tons) or number of animals (art. 333.4).

No tax is levied when the animals (organisms) are used for the purposes of community health care, regulation of the animal population and the like (art. 333.3(6), then the tax rate is zero.

The dues for hunting are paid in full at the moment of receiving of a relevant permit. The dues for the use of aquatic organisms (fishing permit) are paid in installments: the first at the moment of getting the permit (one-time due amounting to 10 % of the total sum and subsequently as a regular payment in monthly installments as long as the permit is valid (art. 333.5). After the expiration of the fishing permit an additional lump sum shall be paid for the permit. .The fees paid for a permit to the extent it remained unused (or when the volume of catch that has been modified) can be reimbursed upon the expiry of the term of the permit (art. 333.7; see also ruling of the presidium of the Supreme Arbitration Court of 18.09.2007 N 3210/07 on case N A73-2213/2006-16).

Customs Duty and Customs Fees

This book will not concern itself in details with the customs duties and dues. We will only point out a few main characteristics of them.

Customs duties can appear both in form of import duty and export duty. After enacting the Customs Code of the Customs Union between Russia, Belarus and import duties are set by decision of the Commission of the Customs Union and issued in the "Unified Customs Duty Tariff." Imported goods are classified in accordance with a so-called Commodity Nomenclature for Foreign Economic Activity. Export duties are set by decision of the Russian Government according to internal laws (Russian Federation Law "On the Customs Tariff" of 21 May 1993 No. 5003-1).

Apart from revenue duties considered above the Customs Code provides for some other kinds of duties (special protective, anti-dumping and countervailing ones) which purport to protect Russian industries from detrimental competition of foreign manufacturers and importers (the classic example of such competition being dumping). They are regulated by a treaty between the Customs Union countries.

Customs dues are fees for the completion of customs formalities, customs escort and customs storage. They are levied on the basis of the Customs Code of the Customs Union (art. 72) and are further defined in the Russian internal law (Law No. "On Customs Regulations" of 27.11.2010).

Dues for Use of Water Resources

The Russian Water Code was adopted January 1, 2007 and it replaced the former provisions on water tax with the dues for the use of water resources. Nonetheless, for persons who have obtained rights on use of water resources prior to January 1, 2007, the water tax regime will be preserved until the expiration of the relevant agreements or licenses. We will below give an overview of both the old provisions on water tax and the new rules for dues on water resources.

Old Water Tax

Taxpayers of the Water Tax are legal entities and individuals who have obtained a license or concluded relevant agreements with the state for water use prior to the introduction of Water Code (art. 333.8).

The object of taxation includes water intake, the use of water basins, the use of water for timber rafting, and use of water for the purposes of hydro-electric engineering. Certain kind of usage of water is excluded from the tax base (for instance, water intake for fire safety, art. 333.9(2), for irrigation purposes, etc.).

Depending on the kind of water use, the tax base would be the volume water intake, or the square of the allotted water space, or the amount of power produced during the tax period (that is, 3 months); or (for timber rafting) a tax base determined as the produced volume of wood floated on rafts for the tax period for the distance of the wood floating divided by 100.

The tax rates vary depending on the object of taxation (mode of the use of water resources) and for different economic regions (art. 333.12).

The tax period is set as one quarter of a year. Foreign taxpayers must submit two tax reports: one is to be sent to the tax office at the location of the appropriate water resource and the second is due to the tax office which has issued the appropriate permit (art. 333.15).

New Law — Dues for the Use of Water Resources

According to the new law, the principle is that all use of water resources is payable. *Water dues are charged from the following types of water use:*

- intake of water resources;
- use of water facilities for the purposes of electricity production;
- use of water area for recreational purposes.

The amount of the water dues and other conditions are stipulated in a relevant agreement for the water use.

Since the January 1, 2007 calculations of water dues for water resources which constitute federal property will be made in accordance with the Russian Government decrees 'On rates of the payments of Federal water objects' (of 30.12.2006 N 876) and 'On adoption of rules on calculation and collection of payments for the use of federal water objects' (14.12.2006 N 764). These decrees have the same rates and terms of calculation as those given in the in Water Code.

Payments are charged for the following types of water use:

- intake of water resources;
- use of water facilities for purposes of electricity production;
- use of water area for recreational purposes.

The payment period is a quarter of a year.

The payment base depends on the type of water use:

- permissible amount of water intake per payment period;
- amount of produced electricity for the payment period;
- area of the water resource in use

Environmental Protection Fees and Charges

Under the Law on Environmental Protection (Article 4 No. 7-FZ of 10 January 2002) following are defined as environmental objects to be protected from pollution, depletion, degradation, spoilage, destruction, and other negative effects from business-related and other types of activity:

- lands, subsoil deposits, soils;
- surface and subterranean waters;
- forests and other plant life, animals and other organisms and their genetic stock;
- the atmosphere, ozone layer, and near-earth space environment.

The methods for economic regulation in the field of environmental protection comprise, inter alia, the following:

- establishing fines for affecting the environment negatively;
- establishing limits on emissions and discharges of pollutants and microorganisms, limits on disposal of industrial and consumer waste and other types of negative effects on the environment;
- due compensation for harm caused to the environment.

In Russia there are a number of laws which envisage the obligation to pay environmental protection fees or charges to compensate for the negative effect a certain (commercial) activity has on the environment. Such laws include the Federal Law of 10.01.2002 No. 7-FZ "On the Protection of the Environment", the Law of the Russian Federation of 21.02.1992 No. 2395-1 "On Subsoil", the Federal Law of 24.04.1995 No. 52-FZ "On Animal World" (art. 52), the Federal Law of 20.12.2004 No. 166-FZ "On Fishing and Conservation of Water Biological Resources", the Tax Code of Russia, the Water Code of Russia, the Forest Code of Russia, the Land Code of Russia, etc. There is significant number of subordinate acts regulating order of payment of such duties.

The federal laws and Decree of the Russian Government No. 632 of 28.08.1992 give an open list of such effects, which include:

1) atmospheric pollution;
2) venting contaminants and microorganisms into water;
3) pollution of soil and subsoil;
4) disposal of waste products;
5) such nuisances as noise, warmth, electromagnetic radiation and the like.

Under a Government Resolution two types of base normative payments are set for causing a negative effect (No. 632 of 28 March 1992):

a) for emissions and discharges of pollutants, disposal of wastes, and other kinds of harmful effects within acceptable norms;
b) for emissions and discharges of pollutants, disposal of wastes, and other kinds of harmful effects within set limits (temporarily approved norms).

The latter are paid in cases where the payer of fines exceeds the limits of admissible norms for emissions, and then only for the amount by which they are exceeded. The payer thereupon pays five times the amount of the norms. One must pay the same amount in the event that harm is caused without having obtained the appropriate permit.

Should the limits of the harmful effect be exceeded, the maximum amounts of the payment are set as a percentage of the profit remaining at the disposal of the user of natural resources, differentiated for different branches of the national economy with account taken of their economic peculiarities.

Base normative payments are set for each ingredient of a pollutant (waste), and the type of harm caused, taking into account the degree of danger they pose to the natural environment and to the population. At present, they are defined by Government Resolution No. 344 dated 12 June 2003.

For individual regions and river basins, multipliers have been set for the base normative payments. These take ecological factors into account: the climatic characteristics of an area, and the significance of objects of natural, social and cultural interest.

That said, making a payment for environmental pollution does not relieve the user of natural resources from the need to take measures for protection of the environment and for rational use of natural resources, nor from full compensation for harm caused to the natural environment, life and property of individuals by environmental pollution, in accordance with current legislation.

Despite the fact that these payments were described as not tax-related by the Constitutional Court Ruling of the Constitutional Court of the Russian Federation No. 284-O of 10 December 2002 they impose a serious financial burden on businesses.

In accordance with the Supreme Court Decision No. GKPI 03-49 of 12 February 2003, these fees cannot be recovered without acceptance.

20. TAXATION OF SMALL AND MEDIUM ENTERPRISES (SME) AND CERTAIN ACTIVITIES OF INDIVIDUAL ENTREPRENEURS IN RUSSIA

This chapter outlines the rules for the special tax regimes available for small and medium sized enterprises (SMEs) and certain activities of individual entrepreneurs. These tax regimes are: the simplified system of taxation; taxation by license; taxation of imputed income; and unified agricultural tax. The main rules on taxation of the income of individual entrepreneurs are in the chapter on personal income tax. Other special taxation regimes and rules may also apply, such as the rules of taxation of businesses in special economic zones, among which figure innovation centers.

Simplified System of Taxation

The simplified system of taxation (SST; chapter 26.2 of the Tax Code) is a special beneficial tax regime extended to small and medium size enterprises (as defined in Chapter 26.2.). Unlike the tax on imputed income (see below) it is a voluntary regime for which the taxpayer can opt for.

The simplified system of taxation replaces the normal rules of profit tax, exempts from the liability to charge VAT for services and goods sold, and provides (for certain types of businesses) benefits on employer's social contributions. Previously companies on SST where exempt from keeping accounting records in accordance with the general rules, but this exemption has been cancelled effective of 2013.

Companies under the SST regime are not payers of value added tax meaning that they do not charge VAT from their clients, however such taxpayers pay normally the VAT charged by their suppliers. They also must pay the VAT charged at customs on imported goods. These companies also follow the normal VAT regime in relation to joint activity agreements (simple partnerships), trust management and concession agreements.

Qualifying Taxpayers

The SST tax regime can only be used by those companies (and individual entrepreneurs), which meet the qualifying criteria set in the law. These criteria are:

1. Company (or individual entrepreneur) must be registered in Russia (owners can be foreign)

2. To qualify no less than 75 % of the company's shares have to belong private individuals (without regards to nationality) and only 25 % can be held by other legal entities.

3. The company applying SST is not allowed to have any branches or representative offices.

4. Following types of businesses are not eligible:
   – Financial companies (as specified in the Tax Code)
   – Taxpayers financed by public (state or municipal) funds
   – Notaries and advocates
   – Gambling
   – Manufacturers of excisable goods
   – Businesses extracting and trading in minerals
   – Businesses engaged in production sharing agreements

5. Companies under the SST regime may employ maximum 100 people (on an average during the year).

6. Book value of fixed assets (including intangible assets) may amount to a maximum of 100 million rubles (approx.3 million US dollars).

7. Sales volume restriction

   In addition to the other restricting criteria there are restrictions in regards to the maximum permissible sales volumes for businesses wanting to apply the SST tax regime. The restrictions are two-fold: (i) concerning the sales volumes of a business that wants to transfer to the SST tax regime, and (ii) concerning the right to continue applying the SST regime.

   A company may apply for SST if during nine months of a calendar year (preceding the year of entering into the system) its net sales revenue does not exceed 45 million rubles (presently approximately one and a half a million USD dollars).

A newly registered company has the right to apply the SST regime from registration (thus not being restricted by historical sales figures).

An application to transfer to the SST will have to be filed with the local taxation inspectorate between October 1 and November 30 of the year prior to the planned transfer. A newly registered entity has the right to register under SST anytime within 5 days from registration.

The maximum permissible sales volume for companies operating the SST system is 60 million rubles.

8. For further qualification criteria we refer to the law (Tax Code art. 346.12).

Once a company has started applying the SST it is not allowed to transfer back to general taxation regime before the end of the tax year unless its revenues surpass the thresholds or other qualification criteria are violated.

In case of surpassing the revenue limits the general rules for taxation will automatically apply from the beginning of the quarter in which a company's revenues have exceeded 60 million rubles.

Tax Base, Rates and Periods

The taxpayer has a choice between two alternative tax bases and rates for them, these are:

- Taxation of gross revenue at 6 % or;
- Taxation of profit 15 %.

The Regions of Russia are granted authority to lower the rates in the range of 5 to 15 % for various categories of businesses.

SST companies taxed for profit are required to pay a minimum tax in the amount of 1 % of revenue even if there is no profit. However, the company can book the thus paid minimum tax as an expense in the next year to the extent that it represents a surcharge compared with the calculated profit tax (this being available also as a loss carryforward provision).

Companies that have chosen gross revenue (as opposed to profit) as the object of taxation may reduce the tax normally due by a maximum of 50 % by deducting amounts corresponding to paid employer's social contributions.

The tax period is one calendar year. The reporting periods are the first quarter, half-year and three quarters of a year. The tax is paid in quarterly advance installments before the 25th of the first month following the end of the quarter. The advance payments are included into the final annual tax payment (art. 346.21 of the Tax Code).

Expenses

The taxpayers that have chosen profit as the subject of taxation can deduct expenses from profit according to a closed list of permissible types of expenses which in much correspond to the rules applicable for regular profit taxation.

In particular the following expenses are deductible:

1) Acquisition of Fixed Assets and intangible assets
2) Repair of Fixed Assets (including leased assets)
3) Rental (lease) payments
4) Material expenses (as defined for Profit Tax)
5) Pay-roll costs
6) Mandatory insurance of employees and property
7) VAT paid for supplies and other taxes and dues
8) Interest and banking fees paid
9) Fire, property protection
10) Maintenance of company vehicles and compensation for use of private cars for business trips within certain limits
11) Expenses for business trips
12) Notary fees (within limits)
13) Auditor's, accounting and legal services
14) Publication of business accounting reports
15) Office supplies
16) Post, telephone, telegraph, and communication services
17) Computer software databases under agreements concluded with the license holder
18) Advertisement
19) Research and Development
20) Unrecoverable customs payments

21) Remuneration paid under commission and agency contracts
22) Court expenses and arbitration fees
23) Royalties
24) Others

Taxation by License

A new special regime of simplified system of taxation is in force from 2013 for certain individual entrepreneurs engaged in certain types of small business activities (Tax Code chapter 26.5). This tax regime is referred to as the system of taxation by license (actually in Russian "taxation by patent"). This system replaces the now abolished tax regime called 'simplified system of taxation with a patent' (346.25.1). In this tax regime the entrepreneur acquires a license (patent) and pays a fixed license fee instead of taxes.

Taxation by licenses available for small businesses in certain fields of activities. For example these kind of business activities qualify: Production and repair of clothing; dry cleaners; hairdressers; repair shops; photo shops; transport; travel services; plumbers; electricians; training services; sports instruction; childcare and care for sick; leasing of buildings and land; cleaning and real estate management services; services for forestry, agriculture and food processing; small scale retail. — There is a closed list with 47 line items of various types of qualifying activities. The list of qualifying activities may slightly vary for different Regions of Russia.

This taxation regime is available only for small business when the annual sales revenue (for the given activity) is maximum 60 million rubles and when the entrepreneur employs no more than 15 people (including free-lancers and other such contract workers). An entrepreneur may simultaneously also be engaged in other activities for which the license (and its restrictions) do not apply. The entrepreneur does not file tax returns and does not have an obligation to make accounting in accordance with the general law and instead only keep a sales ledger.

Such a tax regime may only be enacted by regional laws for separate regions. The validity license is restricted to the issuing region.

A patent is issued only within one calendar year; the license always expiring at the end of the calendar year.

An entrepreneur using the patent system is exempt from the following taxes: personal income tax (regarding his/her own income but not concerning the obligation to withhold the tax from employees); individual property tax; value added tax. The system does, however, not exempt from employer's social contributions.

In this tax regime the profit tax is not paid according to actual revenue or profit but on formal criteria for the defined business activities. Each Region will determine a hypothetical revenue level for a given type of business under certain circumstances and calculate a 6 % tax on that, which constitutes the fee for the license. If the license is issued for a validity less than 12 months, then the fee is paid in proportion to actual months. A license valid for more than 6 months is paid for in two installments, 1/3 in 25 days after the commencement of the license period and 2/3 in 30 days before expiry of license. A license initially valid for less than 6 months is paid for in full in 25 days after commencement of license period.

Taxation of Imputed Income

The tax on imputed income is a special tax regime which applies to certain types of business activities (regulated by chapter 26.3 in force from year 2003). The imputed tax regime is foreseen by the Tax Code but requires that it is enacted by a local government (of a municipal area or urban district, or the in order to be in force in the municipality (town, city). At the time of writing, the imputed tax regime was implemented only on the new territories of Moscow, whereas in S.-Petersburg almost all the activities envisaged by Chapter 26.3 of the Tax Code are now covered by this tax regime.

When imputed tax is applicable, the taxpayer is exempt from the following taxes:

- profit tax
- personal income tax
- individual property tax
- VAT (these taxpayers do not charge from clients, but pay the VAT charged by suppliers and pay VAT at customs

The taxpayers are not exempt from paying employer's social contributions. However, by virtue of art. 346.32 such social contributions may be recovered by way of offsetting them against amounts of the imputed tax (reducing the tax otherwise due by a maximum of 50 %).

The tax rate is 15 % of the imputed income (art. 346.31). The tax period is equal to one quarter of a year.

Taxpayers

The taxpayers of imputed tax are companies and individual entrepreneurs engaged in the activities that fall under the provisions of this tax regime in the territory where it has been enacted. In contrast to the simplified system of taxation and the system of taxation by license, the imputed tax is a mandatory regime for all those businesses that fall under its scope.

The decisions (laws) of the municipalities (towns, cities) shall define which business activities fall under the tax regime. The Tax Code gives, for example, the below listed activities as possible areas of application:

1. Consumer services such as repair shops, laundries, hairdressers
2. Veterinary services;
3. Repair, maintenance and carwash services;
4. Retail sales through stores and pavilions with retail space not exceeding 150 square meters (also kiosks and similar retail points);
5. Restaurant services with serving area not exceeding 150 square meters;
6. Transportation services with a fleet not exceeding 20 vehicles.
7. Certain types of advertising services
8. Renting out of retails premises
9. Temporary accommodation services (hotels etc.).

The tax base is the imputed income calculated by multiplying a hypothetically established income level by the amount of physical indices characteristic for a certain type of activity (art. 346.29). The physical indices can be, for instance, the number of workers involved or the square meter size of a parking lot.

The taxpayers performing both activities that fall under the provisions of the imputed tax and other entrepreneurial activities are obliged to keep separate accounts on assets, liabilities and business transactions.

Individual entrepreneurs are not required to maintain their books in accordance with the accounting law.

Unified Agricultural Tax

The Unified Agricultural Tax (Chapter 26.1 of the Tax Code) ("UAT") is a special beneficial tax regime for organizations and individual entrepreneurs that engage in farming (including fish-breeding). It is a voluntary regime which may be chosen by the taxpayer, provided that the share of his income from farming is not less than 70 % of the total amount of profits.

Taxpayers who apply the UAT tax regime are exempt from the following taxes:

- Profit tax
- Personal income tax (for individual entrepreneurs who would otherwise be liable for profit under this tax regime)
- Value added tax (taxpayers do not charge from clients, but pay the VAT charged by suppliers, and VAT at customs)
- Property Tax (for companies and individuals)

Taxpayers of UAT are not exempt from paying employer's social contributions but enjoy beneficial rates for these liabilities.

The Object of Taxation is the amount of income reduced by the amount of expenses. The Tax Base is a monetary equivalent of the Object of Taxation (arts. 346.4, 346.6, Tax Code).

The tax rate is 6 % of the tax base.

The tax base is calculated according to the general rules for taxation of profit (chapter 25 of the Tax Code) but considering a closed list deductible expenses (art. 346.5) which parallels the one provided for simplified system of taxation. There is, however, a significant difference insofar as the taxpayers in the UAT regime will be able to deduct expenses for acquiring land plots for their entrepreneurial activities (art. 346.5.).

There is a provision for loss-carry forward allowing taxpayers to deduct losses of past periods for 10 years.

The tax period is one year, whereas the accounting period is six months. So tax declarations must be submitted and the amount of tax be paid every half year within the terms specified by art. 346.9-346.10 of the Tax Code.

As individual entrepreneurs the taxpayers under this regime are not required to keep their books in accordance with the accounting law.

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Awara Russian Tax Guide

Awara Russian Tax Guide is the first comprehensive book offering a full overview of all Russian taxation laws and rules. Awara Russian Tax Guide describes the general framework of the Russian tax laws, the Tax Code and its principles. It describes the general rules of the Tax Code Part I and each type of tax and tax regime of Tax Code Part II, among them: Profit Tax, VAT, Personal Income Tax, Property Tax, Employer's Social Contributions. The book also covers the now so important case law and taxation principles set by court precedents.

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