Special report
Tax and Russia

This feature on the tax landscape in Russia is final report in our series on the BRIC countries. This report covers:

- current developments in Russia's tax regime;
- a tax adviser's view on doing business in and with Russia; and
- the tax and compliance landscape.

Current developments in tax

- **The Russian government is pursuing a 'de-offshorisation' initiative and making numerous changes to legislation to raise revenue for the government, including the introduction of 'luxury taxes' on the wealthy.**
- **There are recent changes to the Russian court system.**
- **For multinationals doing business in Russia, securing deductions for expenses is a 'perennial concern', especially in relation to charges from foreign affiliates.**

While all eyes are on Russia at present with the 2014 Winter Olympics in Sochi, less well reported is the number of ongoing Russian tax trends and changes affecting businesses that the government has pushed through in recent years. As **Artem Toropov**, a senior associate in international tax at **Goltsblat BLP** (the Russian practice of Berwin Leighton Paisner) says businesses operating in Russia 'should keep track of rapid developments better than ever, as they happen both in legislation and court practice at a very fast pace – don't rely on advice from a few years ago.'

To understand the driving factor behind these changes, it is important to note Russia's deficit fears: according to Russian news agency RIA Novosti, preliminary data released by the Finance Ministry reported the country ran a budget deficit of 310bn rubles (roughly £5.4bn) for 2013 – about 0.5% of Russia's GDP. To western economies, this may seem like nothing to worry about, especially with the country's total income for 2013 being around 13 trillion rubles (or £227.8bn) – until one notes that, according to the budget president Vladimir Putin signed into law last year, Russia is expected to record a budget deficit of 391bn rubles (£6.9bn) for 2014, and 817bn rubles (£14.3bn) in 2015. Coupled with a weakened economy and a need for long-term fiscal planning that is not reliant only on the non-renewable resources of oil and gas, it seems policymakers will either have to curtail public spending – and with the government's spending plans already set out, this seems unlikely for the foreseeable future – or raise revenue.

The government admits it has limited room for raising tax rates and introducing new taxes in the current economic environment. Instead, it is focusing on increasing the collection of existing taxes from corporations and individuals, eliminating many tax incentives, changing the tax base calculation mechanisms, and fighting tax base erosion with new anti-avoidance mechanisms. It is the latter that is driving the tax changes in the country.

Anti-avoidance and international tax issues

'The hottest topic at present is the government's so-called 'de-offshorisation' initiative,' says **Maureen O'Donoghue**, executive director of tax in **EY** Russia. 'This encompasses a number of elements intended to reduce losses to the Russian budget including the introduction of a controlled foreign companies regime, setting limits to the application of treaty benefits, introducing a basis for taxation of foreign companies based on a residence test, and improved sharing of information with foreign tax authorities. The required legislation is being drafted.'

'Anti-avoidance practices have been changing especially rapidly,' Artem Toropov agrees. 'The Russian government loses significant revenue every year with offshore structures being so widely used, so the ongoing de-offshorisation reform aims to increase tax collection and fight abusive tax avoidance. In 2014, we can expect to see further anti-avoidance rules being introduced, as well as the introduction of CFC rules for businesses and individuals – the CFC rules are especially expected to affect large state-owned and privately-owned corporations that typically have extensive networks of subsidiaries in low tax jurisdictions and offshore, as well as high net worth individuals in Russia who structure their affairs through personal offshore holding companies and trusts. The introduction of a 'beneficial ownership' concept will make it harder to repatriate income away from Russia, and foreign businesses investing in Russia through SPVs in the Netherlands, Luxembourg, Switzerland and Cyprus could also be affected.'

Russia's current transfer pricing regime came into effect on 1 January 2012. Maureen O'Donoghue explains: 'The switch from a system with a 20% safe-harbour rule, and the burden of proof being placed firmly on the tax authorities, to one more in line with the with the OECD model has forced companies doing business in Russia to devote considerably more attention and resources to documenting pricing methods and decisions. Audits of transfer pricing compliance in 2012 have only become possible in the last two months, and it may be some time until sufficient audit decisions will have been issued for any noteworthy patterns in audit practice to be identified.'

Court challenges

One noteworthy feature of the tax system experienced by businesses in Russia is that no binding tax ruling practice exists in the country. Tax authorities very often follow fiscal-oriented interpretation of law, while tax litigation and court disputes with the Russian tax authorities is 'quite common and widespread', according to Artem Toropov. 'Many European businesses in Russia typically start off being very cautious, but then they realise that, even if they are super-compliant, they might still find the tax authorities make a claim against them'.

'However, it is possible to successfully defend one's position in court, and once foreign investors obtain positive experience of successful disputing of tax charges in court they become braver and more willing to stand for their rights and fight ungrounded and frivolous claims of tax authorities', Artem Toropov says.

'The recent trend, however, has been for fewer court disputes (due to the successfully developing mandatory pre-trial administrative dispute resolution procedure with higher tax authorities), but the disputes themselves are getting more complex as the tax authorities have become more experienced and more knowledgeable about business structures, as well as more powerful with new anti-avoidance regulations available for them to use. With Russia's growing budgetary deficit, the tax authorities have become more aggressive about tax collection, and the courts have found in their favour more often.'

Court practice in relation to deductions for interest on loans from foreign sister companies also 'continues to cause concern', Maureen O'Donoghue says: 'While the wording of the Tax Code excludes such loans from limits on interest deductions under the thin capitalisation rules, there have been a number of cases in which courts including the Supreme Arbitration Court have ruled that the limits apply. However, recent changes to legislation in relation to interest are another hot topic, with significant amendments to the profits tax treatment of interest income and expenses being enacted in Federal Law No. 420-FZ of 28 December 2013. The general limits on the deductibility of interest in article 269 of the Tax Code are to be replaced with provisions relevant to controlled transactions only.

'For multinationals doing business in Russia, a perennial concern is securing deductions for expenses,' Maureen O'Donoghue continues. 'Significant tax risks may arise in relation to headquarter charges and charges from shared service centres for costs such as management services, shared IP, IT support and other services. Tax inspectors often challenge charges from foreign affiliates based on a perceived lack of substance, an apparent absence of benefits to the Russian taxpayer or inadequate supporting documentation. There have been a number of court cases in which Russian subsidiaries of multinationals have failed to convince the courts to allow deductions for such charges.'

But changes are afoot in the court system too. Artem Toropov explains: 'One of the ongoing court reforms is the merger of the Supreme Arbitration (Commercial) Court and the Supreme Court. The Supreme Arbitration Court, which was the highest court in Russia for deciding corporate tax disputes, has been quite progressive and has contributed a lot to good court practice. It is effectively being liquidated, and decisions will now be made in the Supreme Court, which is widely seen by many as being pro-government. There is a fear among many tax professionals that, once the courts are merged, the Supreme Court can influence tax disputes in Russia for more pro-government (or pro-tax authority) outcomes.'

Reported by Santhie Goundar, freelance news reporter (santhie.goundar@lexisnexis.co.uk)

Luxury taxes on the wealthy

The ongoing debate in Russia about a 'luxury tax' has also resulted in more changes to come, as **Ruslan Vasutin**, tax partner at **DLA Piper** Russia, reports. 'In its approved Main Directions of the Tax Policy for 2015 and 2016, the government of the Russian Federation has announced that it is planning to introduce a series of new laws aimed at the taxation of luxury items,' he says. 'There is no such definition as 'luxury', so in practice these laws extend to real estate properties and high value transport vehicles owned by individuals.

'The Ministry of Finance has been tasked to devise amendments to the Tax Code introducing a new tax on real estate that should replace the property tax. The discussed plan specifies that for real properties including land plots, buildings, constructions, residential and non-residential properties owned by individuals, the taxation regime will be introduced based on the "cadastral value" of these assets. The draft law anticipates that real estate assets will be taxed at a rate of 0.1% to 1% of the cadastral value. The new cadastral value will be essentially a new tax base that should be far closer to the real market value of an asset compared to the existing book (or state inventory) value. For luxury properties, it would effectively mean that the maximum rate of 0.5% to 1% will apply to properties located in Moscow or St Petersburg exceeding the 300m rubles threshold (approximately £5.3m) in their cadastral value, regardless of how many taxpayers keep the asset in freehold or which tax concessions they may have as eligible taxpayers.

'Further, for the purpose of realising its tax policy, the Russian government has prepared a federal law amending article 362 of the Tax Code. Among various law changes, a new tax regime applicable to luxury transport vehicles has been introduced, covering vehicles with an average value greater than 3m rubles (about £52,600). The new taxation operates by establishing several increasing co-efficients pertinent to the tax.

'The transport tax is a regional tax that is determined on a progressive tax basis. Its calculation involves a procedure whereby the engine horsepowers are multiplied by an X amount of rubles, then adjusted by the relevant co-efficient. According to the new law, an average value is the one that should be established by the federal state body regulating the functions of state policy for trade (supposedly the Ministry of Industry and Trade) and may differ from the fair market value. In this regard, a list of cars subject to taxation by this "luxury tax" should be determined and published by this authorised state body on its official website not later than by 1 March of the relevant year. Obviously, the motivating driver behind these changes is some political interest to show "fairness" and "objectivity" in the tax system, rather than boosting any budget collections.'

Doing business in and with Russia: a tax adviser's view

Andrew Terry
Partner and joint head of CIS group, Withers
Email: andrew.terry@withersworldwide.com
Tel: 020 7597 6020

Why invest in Russia? Despite its justified reputation as a challenging market in which to do business, the Russian market is one which is difficult to ignore.

The Russian Federation comprises the largest land mass of any country on earth and contains vast natural resources. Russia contains 32% of the world's explored reserves of natural gas, 18% of world oil reserves, 23% of world coal reserves as well as 23% of world forest resources. Russia is also a major producer of gold, diamonds, silver, copper and lead as well as holding 10% of the world's uranium resources. Russia has a population of around 140 million people with a growing middle class and a generally well educated workforce. The domestic consumer market is still not fully mature. A PWC study showed that in 2010 sales of foreign brands produced in Russia grew by 73% in unit terms and by 100% in terms of monetary value.

I was first asked to go to Russia in early 1995 by one of my then law firm partners, who had recently taken on some Russian clients engaged in the vodka business. (Strangely, this was a period of vodka shortage in the mid-range market which followed the reduction of capacity resulting from the Gorbachev anti-alcohol campaign in the final days of the Soviet Union.) Whilst I certainly jumped at the opportunity, I had no idea what to expect having had few previous dealings with the country and never having visited before. After a whistle-stop tour of Red Square and a visit to a recently opened McDonalds I found myself on a train to the city of Nizhny Novgorod in a compartment bolted from the inside with a wire coat hanger having been told that this was 'a necessary precaution against bandits'. Having survived this initial visit, I quickly became fascinated by the country and have now travelled to Russia regularly for the past 18 years in connection with both inbound and outbound investment projects for corporates and advising ultra-high net worth individuals and families on international wealth planning issues.

During my early visits to Russia, the most challenging problem for a Western tax adviser was the difficulty of establishing what the correct Russian tax position was based on a certain set of facts. Different and competing legal interpretations were issued by different government ministries and obtaining complete certainty was often not possible. The situation today is vastly different. The tax system (as described in detail below) is now well developed and in many aspects competitive. The general corporate income tax rate of 20% is low by G20 standards and is the same rate as the UK will have from April 2015. There are provisions for loss carry forward for a ten-year period, as well as a participation exemption for dividends from 50% Russian subsidiaries and dividends from non-residents provided that the paying company is not located in a listed low-tax jurisdiction and/or does not exchange information with Russia. Various incentives are available such as accelerated depreciation for companies operating in special economic zones and investment tax credits for companies engaged in research and development. Additionally, Russia now has a growing network of double taxation agreements with its main trading partner countries. All the old agreements to which the former Soviet Union was a party and to which Russia succeeded in 1991 have been superseded by new comprehensive agreements based on the OECD model.

Under its domestic law, Russia imposes withholding taxes on dividends (15%), interest (20%) and royalties (20%). These rates are generally reduced to 10% or 5% in the case of dividends, or reduced or entirely eliminated in the case of interest and royalties by provisions in the double taxation agreements to which Russia is a party.

From the perspective of a UK corporate investing into a Russian entity, the existing UK/Russia double taxation agreement of 15 February 1994 ('the UK agreement') is not especially helpful. First, it only reduces Russian withholding tax on dividends paid to a UK parent to 10% (article 10(2)) and, second, even this reduction to 10% is subject to a requirement that the dividend should be subject to tax in the UK. Of course, since 1 July 2009, broadly, most foreign dividends received by UK resident companies have been exempt from corporation tax, so the subject to tax requirement in article 10(2) cannot be satisfied unless the UK recipient has made an election for the dividend to be taxable. However, withholding tax on interest and royalties paid to a UK parent is reduced to zero by articles 11 and 12 of the UK agreement respectively. Capital gains arising to a UK parent from the disposal of non-listed shares in a Russian company which derive the greater part of their value from 'immoveable property' may be taxed in Russia (article 13). Most other capital gains should be taxable only in the UK where the substantial shareholding exemption may provide relief from any UK corporation tax charge.

Russia has several double taxation agreements that contain a dividend article that reduces dividend withholding tax to 5% and do not contain a 'subject to tax requirement'. This has resulted in a number of UK/Russia inward investors using a double tier structure with a sub-holding company in one of these '5% jurisdictions' to hold an interest in a Russian operating company. Typically the Netherlands has been used as a sub-holding company location as provided the Netherlands company owns at least 25% of the shares in the Russian company paying the dividend withholding tax is reduced to 5%. No withholding tax is applied to payments of interest and royalties to a Dutch parent. Capital gains are also treated favourably under article 13 of the Russia/Netherlands double taxation agreement of 16 December 1996. Even in the case of gains arising from the disposal of shares which take their value from immoveable property gains are only taxable in the Netherlands and not in Russia (c.f. the UK agreement). In practice, such gains should escape tax altogether as they will be exempted under the Netherlands participation exemption. Profits can then be repatriated to the UK by way of dividend, although this often requires some planning around the Netherlands' own 15% dividend withholding tax despite the existence of the EU Parent/Subsidiary Directive which in principle reduces this to zero. Another advantage of the Netherlands in the area of Russian/UK structuring is that it does not impose any outbound withholding tax on interest or royalties under its domestic law.

Other examples of sub-holding company locations that are used for Russian investment by UK corporates are Luxembourg, Sweden, Cyprus and Latvia. Austria and Switzerland have also been used although my experience is that there may be difficulties in avoiding dividend withholding taxes unless a substantial degree of substance is present in the UK.

For some years, it has been very common for Russian owned operating groups to be controlled through Cyprus-based structures. A Russian operating company would be owned by a Cypriot parent holding company which, in turn, would be owned by an offshore company (typically a BVI vehicle). The shares in the BVI company would be owned by the individual Russian owners directly or often through a discretionary trust or foundation structure. This very common structure which is comparatively simple and inexpensive to establish and run is attractive in terms of dividend flow because there is only a 5% Russian dividend withholding tax under article 10.2(a) of the Russia /Cyprus double taxation agreement of 5 December 1998. No tax is payable in Cyprus on the inbound dividend due to the Cypriot participation exemption in domestic law, whilst dividends can be paid gross to any location including the offshore as Cyprus does not have dividend withholding taxes.

However, the attractiveness of Cyprus has been severely diminished by the recent crisis in its banking system. Several structures have already been relocated whilst much new business appears to be looking closely at the other 5% dividend withholding taxes jurisdictions referred to above. The main beneficiaries of the move from Cyprus seem to be Netherlands and Luxembourg despite the increased costs that these jurisdictions involve and the need to plan around the 15% outbound dividend withholding taxes that they both impose.

The Cyprus crisis has also highlighted another major non-tax issue in international structuring namely the availability of potential protection against nationalisation and expropriation of assets and other actions by a state under a bilateral investment treaty. Whilst obtaining relief under such a treaty is in practice not easy the actual existence of a treaty does provide a strong disincentive to Russia against expropriation. Although Cyprus does have a bilateral investment treaty with Russia this has never been ratified by Russia so investments into Russia made through Cyprus are unprotected. Ironically, if Russia had ratified this treaty, many of its own citizens could have benefited as they would have had some possibility of recovering funds lost in the bank 'haircut' by bringing an action under the treaty. In contrast to Cyprus, both Luxembourg and the Netherlands do have subsisting bilateral investment treaties with Russia.

The tax and compliance landscape

Andrey G. Duyunov
Senior associate, Pepeliaev Group
Email: a.duyunov@pgplaw.ru

Petr A. Popov,
Senior associate, Pepeliaev Group
Email: p.popov@pgplaw.ru

Overview of the tax regime

The general Russian tax regime includes:

- profit tax (at a basic rate of 20%);
- VAT (at a basic rate of 18%);
- property tax (the value of real estate is taxed at a basic rate of 2.2%);
- social contributions payable by employers and levied on employees' salaries; these payments are formally named 'insurance contributions' but are in essence taxes (until 2015, the rate is 30% for payments up to an annual upper limit of about $20,000 for one person, and 10% for payments exceeding this upper limit; from 2016, the rate is 34% up to upper limit, with no contributions charged for payments in excess of the upper limit;
- personal income tax withheld from employees' remuneration (at a rate of 13%).

The employer will also pay contributions in relation to the risk of industrial accidents and occupational illnesses. These contributions are currently similar to the social taxes mentioned above, as they are formally called 'insurance contributions' but in essence constitute a tax payable by employers and levied on employees' salaries. The rate depends on the level of occupational risk.

Profit tax is paid on a monthly basis, while VAT is paid on a quarterly basis.

If a foreign company has two or more places of business in Russia that give rise to permanent establishments, then:

- each office pays profit tax as if it were an independent enterprise; if the operations of these offices are closely linked to each other the offices may file unified reports, but they must obtain the relevant approval from the Federal Tax Service; separate reports must be filed and separate payments must be made with regard to property tax, as well as social contributions and personal income tax withheld from the employees' salaries;
- with respect to VAT, unified reports may be filed through one of the offices, as the full amount of VAT is paid to the federal budget; in such a case tax authorities at the location of each of the offices involved should be notified to this effect.

If a Russian company has subdivisions in municipalities outside its principal corporate seat, corporate profits tax is divided between municipalities and regions in proportion to the value of capital assets and the payroll (or number of employees) in the head office and the relevant units. VAT is not divided and is paid to federal budget by the head office. Property tax is paid and reported by units, as well as social contributions and personal income tax withheld from the employees' salaries.

Russia has a well-developed network of tax treaties, based mainly on the OECD model, but some are based on the UN model.

Tax incentives

There are several tax incentives for taxpayers who qualify as 'agricultural commodity producers', for some types of R&D activities and for certain other business activities.

There is a possibility of a regional corporate profits tax rebate, i.e. a tax rate discounted by up to 4.5%. Also, the regions can grant exemptions and rebates for corporate property tax. Theoretically any grounds for these tax incentives can be introduced by regional laws, subject to discussions with regional authorities. However, in Russia tax incentives can only be granted to categories of taxpayers and cannot be granted to individual taxpayers. If the criteria for obtaining a benefit are drafted in such a way that only one taxpayer may qualify, such criteria may be challenged in court by public prosecutor (in Russian, 'prokuror') or by any person whose rights are or may be infringed.

Transfer pricing

The specifics of Russian tax rules relating to transfer pricing consist of obligations being imposed on taxpayers that apply not only to foreign trade but to transactions performed inside the country (because there are independent regional and municipal budgets to which specific types of taxes are remitted). The rules also establish limits for the amounts of such transactions that may be checked.

When transactions are between related persons, prices must be justified when transaction amounts in the relevant year exceed certain limits:

- for transactions between Russian companies: under the general rule, around €50m for 2013 and €25m from 2014 onwards; for transactions with a Russian person enjoying tax preferences the limits are lower and are from €1.5m to €2.5m;
- for transactions with foreign entities: around €2m for 2013 and, from 2014 onwards, around €1.5m (under a preliminary assessment).

The obligation to justify prices is not imposed for so-called 'simple pairs', such as transactions between related companies located in the same region that do not have standalone offices in other regions, pay the whole of their profit tax to the same regional budget and do not enjoy preferential tax treatment, if neither company makes a tax loss.

The transfer pricing rules of taxation may apply to:

- the purchase of goods abroad from related persons (as well as the possible export of goods to related persons);
- payments for the use of intellectual property (it should be borne in mind that excessive part of payments is subject to withholding tax in Russia at the rate of 20%, which is directly permitted by Russia's tax treaties with most countries);
- payments for international support services and secondment of personnel, if applicable;
- intra-group transactions in Russia.

Transfer pricing 'safe havens', i.e. advance pricing agreements as well as the 'consolidated group of taxpayers' regime, are currently available only to major Russian companies, which are mostly state-owned.

Russian transfer pricing methods are based on an arm's length range, not on clear rules of what the arm's lengths margin is presumed to be (e.g. gross margin of 20% etc). However, since the rules are newly introduced and no tax audits can take place at the time of writing (meaning that these new rules have not been litigated), there is no meaningful information on how these rules will be applied in practice.

Allocation of general group expenses

Cost contribution arrangements, despite being mentioned in several tax treaties, between legal entities are not at present recognised in Russian tax law.

The tax authorities consider cost-sharing arrangements unacceptable since they do not provide a detailed breakdown of the exact activities performed for the benefit of the Russian enterprise; therefore, expenses under cost-sharing arrangements are disallowed.

There is at least one precedent in recent case law upholding cost sharing agreements between legal entities. However, the more recent case law is negative.

A Russian legal entity will not be able to state that it contributes to group costs and these are allocated in proportion to revenues. To deduct payments to foreign group entities, a Russian legal entity will have to confirm the actual volumes of goods and services received and these must correspond to the price of the goods or services.

Nevertheless, Russian double tax treaties with some countries do recognise that the general management and administrative costs of a Russian permanent establishment may be allocated.

In view of the above, it is advisable to structure the cost-sharing through Russian representative offices of entities incorporated in such countries to an extent that corresponds to the functions of these representative offices.

Taxation of repatriation of capital and on exit

Equity financing and distribution of profits: Contributions to share capital, as well as any voluntary increase of net assets by a member of the Russian business entity (e.g. in the form of a debt forgiven) are not subject to tax.

A distribution of profit is taxed at source, the rate depends on the tax residency of a shareholder and, accordingly, on the relevant treaty provision.

Debt financing and interest: Loans extended to a taxpayer are not regarded as income.

A payment of interest is exempted from tax withheld at source in accordance with Russia's tax treaties with particular countries, or is taxed at a lower rate depending on a treaty.

There are restrictions on the amount of interest on loans that the borrower may deduct as expenses, including:

- restrictions connected with the terms of the loan agreement; and
- restrictions connected with the 'thin capitalisation rules' applied to a borrower that receives loans from or together with related persons.

The interest rate must be at the market level determined on the basis of comparable terms of loans (currency; amount; period; security; the type of rate – fixed or floating; credit history). This rule is stipulated by both Russian legislation and international tax treaties. Russian legislation allows for a 20% deviation from the average level of interest charged under comparable conditions. If there is no information about the market level of interest or if the taxpayer so chooses, the maximum amount of interest deductible as expenses shall be deemed equal to:

- the refinancing rate of the Bank of Russia multiplied by a coefficient of 1.1 if the loan is extended in rubles;
- the refinancing rate of the bank of Russia multiplied by a coefficient of 0.8 if the loan is extended in foreign currency (the reduction coefficient applies until 2014, after which a marginal rate of 15% will come into force, though future amendments to tax legislation may reduce this).

The rate of the Bank of Russia is determined:

- as at the date when the loan is extended, if the agreement provides for a fixed rate;
- on the date when expenses in the form of interest are deducted, in all other cases.

Moreover, Russian tax legislation provides for tax audits to be performed with respect to loans that have been received from or secured by related foreign entities. Tax audits aim to check compliance with the 'thin capitalisation' rules, i.e. the tax authorities check whether or not the debt-to-equity ratio exceeds the marginal level at which it may be assumed that the borrower could not obtain the loan on the market, as it is unable to service its debt. Such marginal debt-to-equity ratio is deemed to be 3 to 1.

In earlier case law, no underpayment of tax was recognized by courts if there was an international treaty with the country in which the recipient of income was resident and if such treaty did not stipulate the audit. However, case law has recently taken quite the opposite turn (*Resolution No. 8654/11* of the Supreme Commercial Court, dated 15 November 2011). The new approach is that international tax treaties do not preclude national rules from being applied if those rules aim to prevent bad faith understatement of tax obligations by booking transactions that are objectively impossible or economically unjustified. It is considered that where debt exceeds net assets by more than three times, the borrower could not obtain a loan on the market, as it would be unable to service the debt, and consequently payments booked as interest camouflage the distribution of profit or (if losses are booked) the siphoning of assets.

'Thin' capitalisation creates a presumption that interest is excessive if it exceeds the interest that would be payable had the company's debt-to-equity ratio been no more than 3 to 1. Under the tax treaty the taxpayer may prove that the 'thin' capitalization does not prevent it from obtaining loans on the market, if other indicators are taken into account. For instance, it may prove that its net debt/EBITDA indicator, as used in the sphere of international finance, is at an acceptable level.

At the same time, if the borrower does not have an objective need for a loan based on the conditions of its activity and can finance expenses using the income it generates (EBIAT), this may mean that its expenses on paying interest under the loan are unjustified and the borrowed funds are excessive.

The excessive part of the interest is subject to Russian withholding tax as a distribution of profit. Bearing in mind the negative case law that has evolved to date, it is believed that international tax treaties do not rule out such tax implications.

We assume that any Russian entity may incur losses instead of profits in the first stages of its business activity in Russia. As a consequence, a Russian entity may have negative net assets. Here, given that 'thin capitalisation' debt-to-equity ratio is calculated on a basis of net assets, it will be impossible to determine the ratio and therefore the interest becomes non-deductible. In view of the above, at the stage of expanding the business before steady profits are generated, equity financing, rather than debt, may be the preferable option.

Taxation on exit: Capital gains in form of profits from selling a participation interest in a Russian company are treated as regular income and under national rules are taxed at a general rate of 20% instead of at the lower rates applicable to dividends. This income is exempt under Russian double tax treaties with most countries, but if the assets of a Russian entity primarily comprise real estate, Russian treaties with some countries make provision for withholding tax at a rate of 20% in these circumstances; at the same time, the acquisition cost is deductible.

In the case of an entity which is being liquidated, its remaining property receivable by the shareholders is exempt from profit tax in the hands of such members only to the extent of their actual investments, and, moreover, the property so distributed is valued at a fair value.

A capital gain in form of the excess of the market price of the balance received over the amount of actual investments is currently treated as a dividend and therefore taxed at the reduced rates applicable to dividends under the double tax treaties.

Changes to the tax administration and litigation process

In 2013, amendments were made to the Tax Code concerning the tax administration procedures and the general rules for calculating any taxes.

Resolution No. 57 of the Plenum of the Supreme Commercial Court (the SCC) dated 30 July 2013 on how part one of the Tax Code should apply (the 'resolution') is considered to be important for tax administration and the resolution of tax disputes. The reader should bear in mind that in Russia, the highest courts are entitled to issue clarifications of an abstract nature, which are either mandatory for other courts by operation of the law or, while being recommendations in formal terms, are in fact used as instructions by the courts. In recent years, the SCC's rulings have been the main channel for the development of law in Russia, including tax law. It was the SCC, not the legislature, that formulated the main principle on which the taxpayers' and tax authorities' existing practice is based, according to which the economic substance of relationships prevail over their legal form.

However, in 2013, the Russian president proposed that the SCC be abolished and submitted to the State Duma the relevant draft amendments to the Russian Constitution. The SCC is continuing to work until it is abolished and subsequently the newly formed Russian Supreme Court will ensure that state commercial courts' rulings are consistent. It is probable, however, that the importance of at least some of the SCC's legal positions will decrease even if they are not amended or cancelled officially, and this also applies to the substance over form doctrine. It cannot be ruled out that state commercial courts, when hearing disputes, will place greater emphasis on the formal aspects of legal relationships in dispute. The forthcoming changes may significantly affect business activity and liaison with the tax authorities, right up to a number of standard business issues being transferred from the ordinary judicial sphere to the criminal law sphere. At present, since there is not enough basic data, it is impossible to provide a reliable and meaningful forecast of the relevant changes. We have relied on the information available at the time of writing.

Procedures for liaising with the tax authorities will become stricter

Whether addresses of legal entities are reliable is a specific Russian problem relevant for relationships between legal entities and other legal entities, individuals or state authorities, in particular, tax authorities.

Historically, there was an acute shortage of office premises in Russia. For this reason the owners of office premises, when leasing them out, usually dictated the terms and conditions of lease agreements. In particular, they did not allow the lessees to specify the address of the leased premises as the lessees' official address, being afraid that if the lessee moved out, its counterparties and state authorities would start to inundate the owner of the premises with various letters of claim addressed to the lessee. The problem was aggravated by the fact that until 2002 there was no unified state register of legal entities in place that would contain, among other things, information about companies' addresses, which could be checked and which would be publicly available. Registration issues were resolved on the regional level. Companies needed to prove that the owner of the premises agreed to the address of the premises being used. However, there was no requirement to check whether the company was located at the address that was specified. Information from this registration database was neither free nor publicly available. In other words, the owner's consent to the address of the premises being used for registration was to a large extent meaningless in terms of protecting the interests of creditors and the public interest. These circumstances gave rise to a specific Russian service in the form of 'providing a legal address': basically, this means that the service provider permitted a particular address to be used as a location specified for registration purposes. In fact the company could be located in another place, and sometimes it did not even ensure that its mail was sent to the registered address. Such a company would provide to its counterparties and state authorities its 'actual address' where it was located or, at least, where it received mail. However, nothing prevented the companies from changing their 'actual address' without letting anyone know and thus from avoiding being compelled to perform their legal obligations: in some situations the companies stated that they had failed to receive a particular communication, argued that they had informed third parties about their 'actual address' and, therefore, managed to significantly delay performing their obligations if not to avoid them altogether.

More than ten years after the unified state register was introduced, the authorities have decided that it is time to demand that legal entities provide reliable information about their addresses for registration purposes. Legal entities must actually, not declaratively, be liable for their debts, so that effective legal protection may be safeguarded and it may be ensured that legal obligations are properly performed; to make this happen there should at least be an opportunity to contact those entities. Legal entities bear the risk of the consequences if they are absent at the address specified in the register: in particular, any communications sent to such address will from now on be deemed delivered, even if the company has moved away, but, whether through design or carelessness, failed to inform the register of this fact.

In view of stricter requirements as to the reliability of the addresses of legal entities, it is stipulated that the tax authorities should send correspondence to companies to their location specified in the register. Only individuals (including individual entrepreneurs) will be able to specify another address. Therefore, a communication from the tax inspectorate, such as a request to provide a document, will be deemed to have been received, so a company will bear the risk of the consequences that arise if it is absent at its official location: taxes will be collected from the company, but it will actually lose the right to raise a claim against such collection.

Many companies engaged in everyday operations have adapted to the new requirements and entered new reliable information to the register by specifying the address where they are located or to which they at least receive their mail. Risks arise for companies which have performed or are performing special functions (SPV) and do not carry out everyday operations, but which have been engaged in key transactions or performed other economically important transactions: carelessness could result in such 'dormant' or 'auxiliary' companies forgetting to specify their real address in the register. Such a lapse in memory may, in particular, trigger the negative tax consequences described above: the tax inspectorate may easily treat such a company as a 'fly-by-night' company (companies of this type most often 'forget' to provide reliable information about themselves, and therefore, any 'forgetful' company may be easily treated as a ‘fly-by-night’ company). Consequently, we recommend that a careful check be made of whether the addresses of all companies of the group specified in the register are reliable.

Powers of the tax authorities to check information

Requesting documents outside the scope of the formal checking procedure: Until this year, the only way for Russian tax authorities to request the documents regarding transactions performed by taxpayers was within the scope of desk or field tax audits. Desk tax audits are carried out within three months after a tax return is submitted and the law limits the list of documents the tax inspectorate may request. Field tax audits are also limited in terms of time and procedures. Outside a tax audit, the tax inspectorate may only request information about a specific transaction (operation), but not the documents relating to such a transaction (operation).

From the end of July 2013, the tax authorities obtained a right to request parties to transactions and third parties to provide not only information, but also documents relating to specific transactions. Moreover, staring from 1 July 2014, the tax inspectorates will obtain a right to request that a bank provide information not only about a taxpayer which is being audited, but also about an entity from which the documents and information were requested according to the procedure specified above (outside the scope of the tax audit).

These new powers will potentially be able to help the tax authorities to better select which taxpayers to designate for field tax audits and to prepare for tax audits beforehand.

However, to request the documents, it is sufficient for the tax inspectorate to know, for example, the number and date of a contract. If it is a major long-term contract concluded for many years, the tax inspectorate will be able to request thousands of documents (way bills, invoices, etc.) There is a risk that such a procedure for requesting documents will turn into an eternal tax audit not limited by any deadlines or procedural limits of the law.

Using the results of investigative activities: The SCC’s Plenum believes that the tax authorities may use materials from investigative activities. The draft resolution offered another clarification: such materials may only be used as a ground for tax control procedures, in other words as a reference point in the search for evidence. This position was previously expressed by the Russian Constitutional Court. However, a representative of the public prosecutor’s office argued against this restriction. The final version of the resolution does not include any requirements established in the code with regard to evidence of the relevant type: a warning about criminal liability for perjury or about the participation of the audited party and witnesses.

However, if these requirements are observed, this will in any case make the evidence more reliable; the fact that certain materials may be used does not in itself mean that these are adequate evidence.

It is possible to put forward some rather obvious examples of situations where the procedure established for obtaining evidence has not been complied with, but where the data collected may be treated as evidence.

If police officers, whom the tax authorities are entitled to engage in the field tax audit, discover that the taxpayer maintains ‘parallel accounts’ with a list of transactions that are not reflected in its accounting records and seized such documents without witnesses, but if an expert examination confirmed that it was the taxpayer that kept ‘parallel accounting’, then the documents seized without witnesses and the expert opinion will together be the evidence of potential offences. Alternatively, if police officers engaged in the field tax audit interrogated the taxpayer’s employees without a transcript and without cautioning them about their liability, then the audio record of interrogation with an expert opinion that confirms the identity of interrogated employees and confirms that the tape has not been cut or edited, will also together be treated as evidence.

Liability for insufficient payment of one tax while another tax is overpaid

When summing up the audit results and establishing the grounds for imposing fines, tax authorities still need to consider excess payments, but they will only be required to take into account the excess payment for one particular tax and may disregard the fact that other taxes have been overpaid to the same state budget. One of the earlier drafts of the resolution suggested that excess payments should not be taken into account at all. This position found its way into the Resolution of the Presidium of the SCC which appeared shortly before the resolution of the Plenum of the SCC (resolutions of the Plenum of the SCC rank above resolutions of the Presidium of the SCC in terms of their legal force). The discussion resulted in more restrictions being imposed on the practice, even though they are not as stiff as those which had been planned. Now the old approach could only be restored on the legislative level if, for example, the debt to the state budget arising as a consequence of the action is added to the article which sets out the criteria for establishing that the tax is underpaid.

Changes in the procedure for settling tax disputes out of court

In summer 2013, a range of laws were adopted which substantially amended the regime for taxpayers to complain against decisions, acts and omissions of tax authorities.

The time period within which a taxpayer may file objections to a tax audit report has been increased from 15 business days to one month. There has been an increase in the timeframe (from ten business days to one month) for the entry into force of decisions handed down by tax authorities further to the results of their examining tax audit materials.

A decision further to the results of an audit must be handed over against signature, or by another way that evidences the date when the taxpayer received it. Only if it proves impossible to hand over the decision in this way, it should be sent by registered mail. Then it is deemed to have been received after six business days after being sent.

Clarity has been introduced in terms of a decision of the tax authority entering into force when, under an appeals procedure, only part of the claims are being challenged. Now both the part that is appealed but not revoked, and the part that is not appealed, should come into effect at the same time – on the day when the higher tax authority decides on the appeal.

Changes to the complaints procedure: An important change has been made in the form of a mandatory pre-trial regime for complaining against any non-regulatory decisions of tax authorities and the acts or omissions of their offices, rather than just decisions regarding the results of tax audits.

Also resolved is the issue, frequently encountered in practice, of whether it is possible to have recourse to the court when a higher tax authority does not hand down any decision in relation to a complaint. In most cases, the stance the courts have taken has been that when the tax authorities fail to comply with deadlines for considering complaints, this should not affect a taxpayer’s entitlement to judicial protection; thus the courts have accepted the relevant court cases for prosecution, believing that in such a case the mandatory pre-trial regime should be treated as having been complied with.

The legislature has followed the same line and opted to legislate directly to stipulate the consequences of a higher tax authority failing to rule on a complaint. In such a case, the mandatory pre-trial regime should be regarded as having been complied with and the taxpayer may have recourse to the court.

Changes to the procedure for filing an appeal: With the timeframe being extended for decisions of tax authorities further to tax audits to come into force, there has also been a corresponding increase in the deadline for filing an appeal. This has risen to one month.

Legislators also considered it necessary to enact more detailed requirements for the content of an appeal. An appeal should now state: the full name and address of the individual filing the appeal, or the name and address of the organisation filing the appeal; the tax authority's non-regulatory decision, or act or omission of its officers, that is being challenged; the name of the tax authority whose non-regulatory decision, or act or omission of its officers is being challenged; the grounds on which the appellant regards its rights as having been violated; and the claims of the appellant.

The appeal may state telephone and fax numbers, email addresses and other information necessary for the appeal to be examined on a timely basis (article 139.2(3) of the Tax Code).

Moreover, clause 4 of the above article stipulates that when a party appealing a non-regulatory decision of a tax authority, or act or omission of its officers, has an authorised representative file the appeal, documents confirming the representative's powers must be attached to the appeal.

Changes to the procedure for filing a complaint: In view of the mandatory pre-trial procedure for complaining against any non-regulatory decision of a tax authority, or act or omission of its officers, the procedure for filing any such complaints has also been amended. Instead of contacting the higher tax authority directly, such complaints now have to be filed through the tax office whose decision, act or omission is being complained against.

The legislature's approach in terms of increasing the deadlines for preparing communications to higher tax authorities has also been implemented here. Previously, the deadline of one year was set only for complaints against decisions handed down further to the results of tax audits, while a three-month deadline was in force for other complaints. The new rules set a single timeframe of one year for complaints.

Changes to the procedure for examining complaints/appeals: In practice, there has been a discussion over a long period over whether a taxpayer's representative may be involved when the higher tax authority examines a complaint. The legislature has made express provision for the complaint to be examined without the person who filed it participating. This prohibition is universal in nature; it does not allow involvement in such examination, whether at the taxpayer's own initiative or at the initiative of the higher tax authority.

Also of importance is the legislature's attempt to introduce a considerable degree of clarity to the issue of whether a complaint filed with the higher tax authority may be accompanied with documents which were not supplied to the lower tax office.

The previous version of the Tax Code skirted around this issue; in essence, the matter was left to the discretion of the relevant higher tax authorities. Now the law makes it clear that additional documents will be examined only if the taxpayer has filed an explanation of the reasons why these documents could not have been supplied on a timely basis to the tax office whose decision is being complained against.

The amendments have also touched on the consequences of a higher tax authority identifying that a lower tax office is guilty of material violations of the procedure for examining tax audit materials. While previously if these violations were identified, this was a ground for such decision to be revoked, the new version contemplates not only the decision being revoked but also that the higher tax authority is able to examine the audit materials according to the rules applying when the lower tax office examines them and hand down the appropriate decision.

Finally, the deadlines have also been adjusted in terms of a higher tax authority examining a complaint. The legislature has increased from 15 days to one month the period for extending an examination of complaints against decisions further to the results of audits, but in relation to other complaints has somewhat reduced the overall period for examining them (from one month to 15 days). However, it has in addition provided that a further extension by 15 days is possible.

Leaving a complaint unexamined: A new institution has been added to the procedure for examining disputes out of court – leaving a complaint unexamined. The grounds for leaving a complaint unexamined are:

- the party who filed the complaint or its representative has not signed it, or not supplied duly executed documents confirming that the representative has the power to sign it;
- it is filed after the deadline set for filing a complaint has expired, if it does not contain a petition for the deadline to be reinstated or if a petition to reinstate a missed deadline has been rejected;
- an application to revoke the complaint in full or in part is received before the complaint is accepted;
- a complaint relating to the same grounds has previously been filed.

Taking account of such grounds for a complaint not to be examined, it seems that in practice considerable attention should be paid to confirming the powers of the person who signed the complaint. And since in relation to this issue there is a place for the discretion of the specific person who assesses the documents filed to confirm such powers, it is prudent to file as complete a set as possible.

Tax authority amending or cancelling its resolution in favour of a taxpayer

The resolution recognises that tax authorities may amend or cancel their resolutions if this is to the taxpayer's benefit. This opportunity may be useful if, after the final resolution to assess additional tax has been adopted, the taxpayer obtains a 'legal alibi' because case law has been amended in a manner that is favourable for the taxpayer or because the Russian Ministry of Finance adopts a position favours the taxpayer. However, the higher tax authorities may fear losing control over lower authorities and demand to approve any such amendment or cancellation.

Preventing the abuse of the right to litigate with tax authorities

The resolution pushes taxpayers and tax authorities in the direction of mutually disclosing evidence before going to court; the penalty for withholding any evidence without a valid reason which prevents it from being disclosed is that court costs are awarded against the party in default irrespective of the outcome of the case. This restriction applies primarily to taxpayers because they have a greater interest in collecting court costs from the tax authority. In this matter, the case law has changed as compared with the clarifications which had previously been in effect.

In addition, if the evidence is withheld, this would most likely cause the court to doubt whether it is reliable or sufficient.

It should also be mentioned that the consequences of missing the deadline for challenging the primary resolution to assess additional tax have been tightened: after the deadline is missed, it will only be possible to challenge an additional assessment on the grounds that there is no liability to pay the tax or that there are inconsistencies in the procedure for summing up the audit results when a challenge is made to (an application is made to have treated as unenforceable) the writs of execution to collect the debt or to return amounts collected in excess. Among other things, such disputes involve the taxpayer having to pay state duty, and this is not a fixed sum but a percentage of the amount in dispute.

Collecting tax in arrears

Injunctive measures of the tax authority: One of the measures which could have severe consequences for taxpayers is a suspension of operations on accounts. There are two procedures for suspending operations; the more balanced of these allows accounts to be suspended only when other property is insufficient or within the limit of the sum being disputed. Unfortunately, the resolution has retained earlier case law which allows the more disproportionate procedure to be applied at the stage when additional arrears that have been assessed are collected; the time limit for this procedure runs from when the resolution to assess additional tax is passed until the tax payment notice is issued and collection begins. It is hoped that the legislators or the Constitutional Court will clarify this matter. According to the resolution and the position previously expressed by the SCC, when a dispute is considered in court, the tax authority may not impose injunctive measures by an administrative procedure. This restriction will, in all likelihood, encourage tax authorities to collect arrears that are in dispute or to suspend accounts before the court considers the case. For this reason, though the SCC's resolution seems so positive at first glance, it may in practice turn out to be rather unpropitious.

Procedure for collecting the arrears: The resolution provides that a tax authority may not collect the same amount of arrears more than once from different accounts: if orders for collection are submitted for several accounts, the aggregate value of the orders may not exceed the debt that is being collected. It is planned to enact this approach in legislation in the near future.

Collecting arrears and penalties from a tax agent: In certain cases, taxes are imposed on the business of one party (the taxpayer), but the liability to make the payment to the budget on behalf of this party is imposed on another party to the transaction; this is usually being a party which pays the taxpayer and becomes liable to withhold the tax from this payment (a tax agent withholding the tax at source). Tax agents include employers and those who buy goods or services from foreign persons or companies.

The resolution upholds the position from the case law of the Presidium of the SCC, according to which a penalty may be imposed on the tax agent if it delays paying the tax. The resolution clarifies that the penalty against the tax agent ceases to accrue on the date when the tax should be paid; subsequently, if the debt is not paid, the penalty should be collected from the taxpayer.

The same clause of the resolution includes a clarification that not only the penalty but also the arrears may be collected from the tax agent, if the taxpayer is a foreign person or company which is not registered with Russian tax authorities and administrative tax procedures may not be initiated against it.

Previously, it was recognised that tax arrears could be collected from a tax agent, but only when VAT was being calculated. Moreover, this was justified not by the indirect nature of the VAT as a tax that was transferred to the buyer (the tax agent is in fact the buyer and the bearer of the tax), but because it is impossible to collect the tax from the contractor. Now, there is no relevance whatsoever in the previous court practice, to the effect that arrears simply could not be collected from a tax agent.

Court applications for overpaid amounts to be returned or offset

It has been clarified that the time period for submitting an application to the court for overpaid amounts to be returned or offset should begin on the date when the taxpayer should have learned that its right to have the money returned or offset was breached, i.e. that the tax authority did not adopt in due time a proper resolution further to the application for it to do so.

In other words, within three years from when the excess payment arose (this date is usually when the tax was paid), the taxpayer should submit an application to the tax authority. The date when the tax authority should have adopted the proper resolution marks the start of the three-month time period for going to court to challenge the fact that the application has been dismissed and the three-year time period for submitting a property claim for the amounts to be returned or offset.

Forthcoming changes

We believe that in the legislators' focus will be on tackling the deliberate understatement of taxes. We expect the following changes to the law:

- rules to combat transactions which are booked primarily or solely for an artificial tax gain;
- rules on due care in selecting contractors (in connection with VAT carousel frauds and other similar unlawful schemes); and
- the long-promised measures aimed at boosting the economy by repatriating capital channelled to offshore jurisdictions.

However, in the light of the fact that the SCC is soon to be abolished, there are concerns that the authorities may need some time to develop clear rules on these matters and find a proper balance between general law methods and criminal law methods.

Some matters which are crucial for property to be in business circulation have not been addressed, either in the legislation or in case law. The problems of how the tax law should work over the course of time have not been solved, and these are important to create stable conditions for property to be in business circulation.

Some reforms are needed to the approaches to imposing injunctive measures in tax disputes. The position of law-abiding taxpayers would be improved by an approach according to which, if a tax authority imposes injunctive measures in line with the Tax Code (attachment of property, suspending operations on accounts), the taxpayer is not required to submit a counter security to the court for the injunction to be suspended, taking into account that there is already security of the collection of the arrears in the future.

For the taxpayers to be able to continue to operate, it would be useful in practical terms for the courts to be able to suspend injunctive measures imposed by the tax authority, even if the tax authority refuses to replace such measures with a bank guarantee or other similar security. The condition for this could be that the taxpayer submits to the court evidence of the counter security or pays the amount in dispute or a part of it which the court may consider sufficient to deposit with the court.

It is possible that legislators or case law will answer these and other questions in the coming years.