

Top Changes in Tax Legislation

2011 Results

1. Transfer Pricing Law adopted

Federal Law № 227-FZ of July 18, 2011

The tenets and principles of the new Law, which took around 11 years to draft, are based on the recommendations of the Organization for Economic Cooperation and Development (OECD). The law contains a number of appraisal criteria, which increase the scope for professional discussion by both taxpayers and tax officials.

The Law establishes rules for pricing in transactions between related parties, in particular:

- criteria of relatedness and the term “controlled transaction”;
- a list of transactions deemed to be transactions between related parties;
- price calculation methods for tax purposes;
- particulars of informing the tax authorities of controlled transactions;
- particulars of tax controls with respect to transactions between related parties;
- procedure for concluding an Advance Pricing Agreement.



Articles 20 and 40 of the Tax Code of the Russian Federation (“TC RF” or “RF Tax Code”) will apply solely to transactions in which the income and expenses are recognized before January 1, 2012.

A new form of tax audit is introduced for controlling pricing in transactions between related parties – auditing the correct calculation and payment of taxes in transactions between related parties. At the same time, a prohibition is established on performing such audits during documentary and field tax audits.

2. Adjustment VAT invoices introduced

Federal Law № 245-FZ of July 19, 2011

Amendments to the RF Tax Code establish a procedure for VAT accounting in the event of a change in the value of consigned goods (works, Services) or transferred property rights, including changes in price/tariff and/or quantity/scope of goods/services, or transferred property rights.

Art. 168 TC RF provides that the seller submits an adjustment VAT invoice to the purchaser no later than within five calendar days of the date of the document confirming the purchaser’s consent to (or notification of) the change.

The VAT invoice is the basis for accepting the difference between the VAT based on the original delivery price and the VAT based on the adjusted price for deduction by the seller (if the price is reduced) or the purchaser (if it is increased). Correspondingly, the other party to the transaction must calculate the difference for payment: the purchaser must reinstate VAT payable for the period in which the adjustment VAT invoice and/or the initial document on the price change were received (for a reduction in price), and the seller must calculate the difference payable in the shipping period (for an increase in price).

The RF Tax Code provides a general limit on the application of deductions – three years from time the adjustment VAT invoice is generated.

3. Higher insurance contributions for the “rich”

Federal Law № 379-FZ of 03.12.2011

The new rules provide for a reduction in the total rate of insurance contributions from 34% to 30% over the period of 2012-2013.

In the same period of 2012-2013, the Law establishes an additional RF Pension Fund insurance contribution rate for incomes greater than the maximum base for accruing insurance contributions. In 2012, that base is 512,000 rubles for each individual. Income above this level will be subject to a Pension Fund insurance contribution of 10%.

The Law also expanded the list of insured persons for the purpose of mandatory pension insurance in the RF to include foreign citizens (other than highly-paid specialists) temporarily staying in the RF, who have concluded an employment contract for an indefinite period or a fixed-term employment contract for less than six months.

4. Severny Kuzbass Coal Company case

HAC RF Presidium Ruling № 8654/11 of November 15, 2011

In the course of this case, the court considered whether double taxation agreements/conventions/treaties (in particular, non-discrimination provisions) allow the application of art. 269.2 TC RF to be avoided. In other words, the judges considered whether restrictions on the deduction of interest on loans taken by a Russian borrower from a direct or indirect foreign participant, or from a Russian affiliate of such foreign participant, should be viewed as contrary to the prohibition on discrimination established in most Russian international tax agreements.

The court took a negative position on this question, effectively taking art. 269.2 TC RF out of the scope of international tax agreements.

This judgment will make it impossible for taxpayers to cite the non-discrimination provisions of double taxation agreements/conventions/treaties as the basis for deducting interest in excess of the limit calculated in accordance with art. 269.2 TC RF.

Nevertheless, we believe the Presidium Ruling in the Severny Kuzbass Coal Company case will not affect the applicable rate of tax on the income of foreign organizations. In this case, the court practice showing that interest in excess of the limit in art. 269.2 TC RF is not reclassified as dividends and is subject to the provisions of double taxation agreements/conventions/treaties governing the taxation of interest will continue to apply. This often means that the said rate will be zero.

Furthermore, the Ruling does not touch on the application of art. 269.2 TC RF to foreign companies affiliated with the foreign shareholders of a Russian borrower, but which are not directly or indirectly participants in the Russian borrower (for example, foreign sister companies of a Russian borrower).

At the same time, it is not clear what should be done in cases where double taxation agreements/conventions/treaties contain special rules granting the right to unlimited interest deductions (for example, the agreements with Germany and Holland). Can these rules be considered the next line of defense against art. 269.2 TC RF?

5. The income of the head office of a foreign organization cannot be included in the expenses of a permanent establishment

MD FAC Ruling №A40-138835/10-118-799 of September 9, 2011

The case of CMS Cameron McKenna is highly important as it was the first time a court spoke in such detail on the procedures for determining the tax base in commercial operations in which both the permanent establishment of a foreign organization and its head office are parties.

In this case there are two options for determining income and expenses. The first option assumes that the income and expenses of the permanent establishment and the head office are formed separately, that is, income from activities not carried out through the permanent establishment is not included in its income. Correspondingly, the expenses incurred by the head office in

activities not related to the permanent establishment are likewise not included in the expenses of the permanent establishment.

The other approach, which some experts consider more conservative, is that with respect to goods/works/services sold simultaneously via the head office and via the permanent establishment, all income is recognized as income of the permanent establishment, and the head office as treated as a “subcontractor” of the permanent establishment. Correspondingly, the expenses of the head office in providing the said services (including the cost of the time of the head office’s staff) are treated as expenses of the permanent establishment for the purposes of deriving income.

Both approaches may have the same financial results, however, in legal terms they are not equivalent. Apparently, the taxpayer decided to be sure and use the more conservative (in its view) approach to booking income and expenses, however, it was not supported by the court.

This case means, in our view, that in those instances where a foreign organization provides services through its permanent establishment and directly through its head office, the income from activities in the RF needs to be divided. One part of the income should be included in the income of the permanent establishment and duly taxed in the Russian Federation (less the expenses relating to the activities of the permanent establishment). The other part of the income (relating to the activities performed directly from the head office and with the activities of the permanent establishment), should not be included in the tax base of the permanent establishment and should be taxed (or not taxed) in accordance with art. 309 TC RF. Therefore, the expenses relating to this part of the activities (for example, salaries of head office employees) are not included in expenses for the purpose of calculating Russian profit tax.

6. Foreign taxes can be included in expenses for the purposes of Russian profit tax

FTS RF Letter № ED-20-3/1087 of September 1, 2011

Until recently, the tax authorities and the RF Finance Ministry formed a united front against accepting foreign taxes paid by Russian organizations in connection with their business activities abroad as expenses for the purpose of profit tax. Taxpayers were forced to defend their position in court, not without success.

However, last year, the issue moved forwards. The Federal Tax Service acknowledged that foreign taxes paid by a Russian organization abroad may be included as expenses for the purposes of profit tax on the basis of art. 264.1.49 TC RF. Hopefully, following this letter Russian organizations will find it easier to resolve this issue without disputes with the tax authorities.

7. RF HAC Presidium clarifies rules on calculating statute of limitations for tax liability

RF HAC Presidium Ruling № 4134/11 of September 27, 2011

In accordance with art. 113 TC RF, with respect to the violation described in art. 122 TC RF, a person cannot be held to liability for a tax offense if three years has elapsed from the day after the end of the tax period in which the violation took place and until the issuance of the decision to hold to tax liability (statute of limitations).

In Biryus the RF High Arbitration Court Presidium clarified this provision, indicating that the period in which the offense was committed means the period in which the tax should have been paid, and not the period for which the tax was payable. It should be noted that the latter approach has prevailed in enforcement practice since the adoption of Part I of the RF Tax Code.

8. Draft RF High Arbitration Court Resolution on the application of Part I of the RF Tax Code published

On September 13, 2010 the draft RF HAC Plenum Resolution on certain questions arising with respect to the application by arbitration courts of Part I of the RF Tax Code was published on the RF High Arbitration Court's website. This ruling is intended to replace the obsolete RF HAC Plenum Resolution No. 5 of February 28, 2001.

The draft is a substantial document, with 85 provisions, including absolutely new approaches to resolving tax disputes, which in a number of cases directly contradict current practice in applying the RF Tax Code rules under consideration.

The draft includes the following innovations:

- Recovery of taxes not withheld from the tax agent to compensate losses to the budget
- Liability is independent of overpayment
- The tax authority and taxpayer should gather and disclose evidence before court
- A higher tax authority that establishes a material breach of procedure in considering audit materials has the right to cancel a decision, consider the materials and issue a new decision
- A higher tax authority has the right to add and/or amend the grounds for additional assessments

The entire draft shows a clear intent to move the resolution of tax disputes into the pre-court area. In particular, this is dealt with in provisions concerning the rules on calculating terms for filing actions in court, compliance with mandatory pre-court procedures, determining the subject of proof with respect to a non-regulatory act of a tax authority, which may result in the denial of judicial protection if violated.

The resolution is to be adopted in early 2012 and will clearly require taxpayers to pay close attention to any procedural act they intend to take. Failure to do so may have fatal consequences.

9. New measures taken against fly-by-nights

Federal Law № 419-Φ3 of December 7, 2011

2011 saw a new outbreak of the battle against fly-by-night companies.

In 2011, the RF HAC Presidium considered six cases concerning the justification of tax benefits at the purchase of goods, works, or services from fly-by-night companies and resolved all of the cases in favor of the tax authorities. In doing so, the HAC RF Presidium emphasized that the taxpayers did not display due care in their choice of counterparty, and in a number of cases it was doubtful whether the transactions were genuine.

In late 2011, long-discussed offenses relating to fly-by-night companies were added to the RF Criminal Code:

1. Formation of a legal entity via a front person (art. 173.1). The maximum penalty provided is imprisonment for up to five years.
2. Providing or acquiring an identification document to form a legal entity for the purpose of financial fraud (art. 173.2). Maximum penalty – imprisonment for up to three years.

This situation does not only create risks with respect to tax aspects (additional tax assessments, late payment interest, fines), but also criminal risks with respect to the new offenses in the Criminal Code. At the same time, in 2009, the RF Criminal Procedure Code was amended with the effect that facts established by an arbitration court are accepted by courts, investigative and inquisitional authorities, and prosecutors without further verification.

It is now, therefore, vital to have a policy on counterparties to reduce (eliminate) the risk of being drawn into a tax fraud scheme. This policy should determine the procedure for selecting counterparties, concluding agreements, verifying counterparties, and other aspects enabling it to be used as evidence that a company has no “corrupt” links with fly-by-night companies.

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