

Special Update on Tax Legislation

January 2010



In this Special Tax Update we discuss what is new in Russian tax laws effective as of 1 January 2010.

VAT

VAT exemptions

Exemption from VAT is available for housing and utilities services, and maintenance and repair services performed by specialized organizations in block apartment buildings.

Please also refer to Section Tax regime for transactions with securities and derivatives below.

VAT exemption for export sales

With respect to goods sold which are brought under the customs regimes of exports, international transit or free customs zone, the period for proving entitlement to the 0% VAT rate applicable under such regimes is extended from 180 days to 270 days. The extension applies until 1 January 2011 to goods brought under the relevant customs regimes in the period from 1 July 2008 to 31 March 2010. The extension favors exporters in instances where collection of export revenues is delayed for more than 180 days.

Factura-invoices

Input VAT offset can no longer be denied due to mistakes in invoices where such mistakes do not prevent the tax authorities from identifying (i) the seller and the buyer, (ii) the type and the value of the goods (work, services and property rights); and (iii) the rate and the amount of VAT.

VAT reimbursement procedure

It remains unchanged that, where a VAT return indicates that the taxpayer is entitled to reimbursement of an input VAT excess, the tax authority will conduct a desk tax audit of such VAT return in order to confirm the grounds for the input VAT offset and to grant or to deny the reimbursement (whether by way of set-off against other tax payments or cash payment).

In parallel with this general procedure, a special procedure has now been established to speed up the process for reimbursement by way of a cash refund.

Under this special procedure taxpayers who meet the formal requirements described below are permitted to file an application for a cash refund of reimbursable input VAT simultaneously with (or within 5 days after) filing their VAT return.

The tax authority has 5 business days to check compliance of the taxpayer's application with the formal requirements (described below) and to decide on a cash refund or set-off against outstanding tax liabilities, if any. The decision on a cash refund is then be forwarded, on the following day to the local division of the Federal Treasury, and the refund is to be made within 5 business days.

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If, as a result of a desk tax audit, the input VAT offset is denied in full or in part, the taxpayer is obliged to repay the refunded amount to the state treasury together with interest at double the Russian Central Bank's refinancing rate.

In order to qualify for the special procedure, the taxpayer must comply with either of the two following requirements:

- It has been in existence for at least 3 years, and has paid over the 3 previous years at least RUB 10 billion in taxes, including VAT, excise tax, profit tax and natural resources production tax; or
- It provides a bank guarantee (from a qualifying bank appearing on a list published on the website of the Ministry of Finance) with respect to the obligation to repay any excessive amount to the State treasury as a result of the tax audit.

Excise Tax

Tax rates

The tax rates for most excisable goods have been increased (for example, the rates for wine and alcohol-containing products with a low ethyl content, strong beer and cigarettes, have been increased by 30-40%, and the rates for engine oil and straight-run petrol have been increased by 10%). Further increases have been announced for 2011 and 2012.

The tax rates for gasoline and diesel have been increased by 10% for 2010. As of 2011, tax rates will be differentiated depending on types of fuel (with the lower rates applying for higher grades of fuel).

Individual Income Tax

Tax exemptions and allowances

For capital gains from sales of property (other than residential houses and land plots) that has been in the taxpayer's ownership for less than three years, the property allowance has been increased from RUB 125,000 to RUB 250,000. For capital gains from sales of residential houses and land plots owned for less than three years, the allowance remains at RUB 1,000,000.

Social allowances with respect to paid contributions to voluntary pension plans may now be granted upon calculation of tax by employers, provided that such contributions are paid through the employer.

A number of new incentives have been introduced for individuals purchasing land plots with residential houses and land plots for the construction of housing.

Tax reporting

The law now requires that, if a tax agent, such as an employer, cannot withhold individual income tax, it has to report each such case not only to the tax authority, but also to the taxpayer, and such report must be made within one month after the year end (as opposed to one month of the occurrence of the failure to withholding event, as previously).

Please also refer to Section [Tax regime for transactions with securities and derivatives](#) below.

Mandatory Social Contributions

Social contributions instead of unified social tax

The unified social tax (under which mandatory social contributions have been consolidated since 2001) has now been abolished. Mandatory social contributions continue to exist, but their rates and the assessment base have changed significantly.

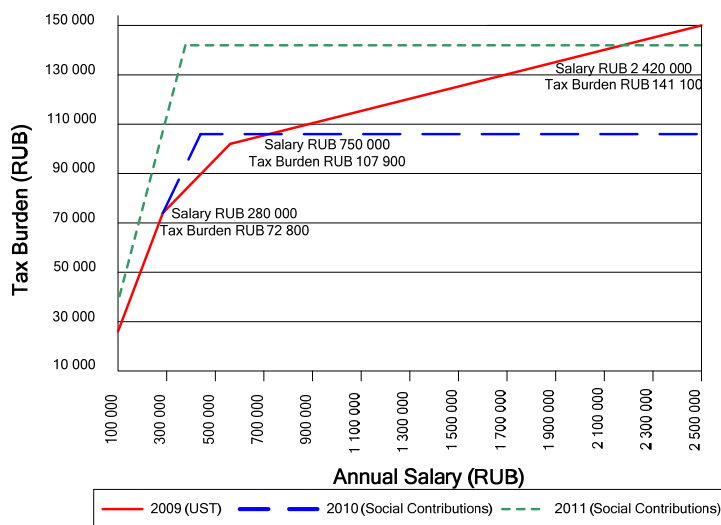
Rates and assessment base

The most important change is that the assessment base – which is, as before, the annual remuneration of each individual working under an employment or work/services contract – is capped at the amount of RUB 415,000 (which is subject to annual adjustment, but for the year 2010 remains unchanged). Furthermore, the assessment base now includes remuneration regardless of whether it is deductible or not for profit tax purposes.

Mandatory social contributions are payable at the following – now flat – rates:

Governmental off-budget funds	2010	as of 2011
mandatory pension insurance - to the Pension Fund	20% max. RUB 83,000	20% max. RUB 107,900 ¹
mandatory social insurance for temporary disability and maternity - to the Social Insurance Fund	2.9% max. 12,035	2.9% max. 12,035
mandatory medical insurance		
- to the Federal Fund for Mandatory Medical Insurance	1.1% max. RUB 4,565	2.1% max. RUB 8,715
- to the Territorial Fund for Mandatory Medical Insurance	2% max. RUB 8,300	3% max. RUB 12,450
Total social contributions	26% max. RUB 107,900	34% max. RUB 141,100

The following chart gives an indication of the financial impact of these changes in comparison with the regressive unified social tax.



¹ Subject to annual indexing of the capped assessment base of RUB 415,000.

The graph shows that the new regime reduces the burden with respect to employees earning more than RUB 750,000 in 2010 (and more than RUB 2,420,000 in 2011). At the same time, with respect to those who earn less, it increases the burden slightly in 2010 (in some cases, with a significant increase in 2011).

Social contributions for foreign citizens

A remarkable positive change is that mandatory social contributions are no longer payable for employees who are foreign citizens, stay in Russia temporarily and work on the basis of visas and work permits. Foreign citizens who reside in Russia permanently (on the basis of residence permit) or temporarily (on the basis of a permission to reside in Russia temporarily) continue to be treated in the same way as Russian citizens.

Administration and control

The functions of administering and controlling mandatory social contributions have been returned from the tax authorities to the off-budget funds, and employers are now obliged to make payments and report to the funds directly.

Profit Tax

Exchange profits and losses

Where advance payments are made in foreign currency, any profits or losses arising from exchange rate fluctuations occurring on the subsequent re-evaluation of such advance payments as receivables and payables are not deemed to be taxable income and deductible expenses.

Employment costs

Deduction is no longer permitted for payments to employees in cases of temporary disability in addition to statutory payments from the Social Security Fund (for example where such payments make up the difference between the statutory payments and the employee's regular salary).

Deduction is now permitted with respect to costs incurred with medical organizations for medical services rendered to employees under their contracts of employment. Together with the costs of voluntary medical insurance, a deduction may be claimed for up to 6% of total employment costs.

Interest expense

From 1 January 2010 to 30 June 2010, the deductible interest threshold for ruble loans disbursed before 1 November 2009 is double the refinancing rate of the Russian Central Bank (currently, 8.75%).

For new ruble loans disbursed after 1 November 2009 and, as of 1 July 2010, for all ruble loans, the deductible interest threshold is 1.1 of the refinancing rate of the Russian Central Bank.

For foreign currency loans, the deductible interest threshold in 2010 is 15%.

Recognition of interest income and interest expense

Interest income and interest expense under any loans (whether in cash or in the form of securities) are to be recognized for profit tax purposes at the end of each month (even if the taxpayer has opted for a quarterly tax period).

Taxation of dividends

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As of 2011, the participation exemption rules will be changed with respect to dividends paid for 2010 and subsequent years, so that the minimum investment requirement (currently, RUB 500 million) will no longer apply in order for dividends to qualify for the 0% profit tax rate.

Motor Vehicle Tax

Tax rates

Russia's regions are now permitted to increase or reduce the rates of motor vehicle tax, as established under the Tax Code, by up to 10 times (instead of 5 times, as was previously the case). They may also introduce differentiated rates depending on the age of motor vehicles and their ecological class.

In Moscow and St.Petersburg, the rates for 2010 remain unchanged as compared to 2009. In Moscow Oblast, the 2010 rates for most vehicles have been increased by 10%.

Corporate Property Tax and Land Tax

Filing

Companies not possessing taxable property or taxable land plots are not deemed to be taxpayers of property tax and land tax, and are no longer obliged to file the corresponding tax returns.

Tax Regime for Transactions with Securities and Derivatives

The tax regime for individual and corporate investors in securities and derivatives has been improved in an effort to create an international financial center in Russia.

Profit tax (corporate investors)

Transactions with securities

Securities are deemed to be listed for tax purposes only if their price quotes have been calculated for the 3 preceding months (Previously, mere inclusion in quotation lists was sufficient).

With respect to listed securities, the rules on the determination of price quotes and of the fair market price have been slightly amended, but, as before, the contractual price is deemed to comply with the fair market price if it is within the maximum and minimum price quotes range as determined by the stock exchange. Where the contractual price falls beyond this range, the adjustment is required for profit tax purposes not only by the seller, but also by the buyer.

With respect to non-listed securities, the contractual price is accepted for tax purposes if (i) if it is not below the estimated (fair market) price, reduced by 20% for sold securities and (ii) if it is not above the estimated (fair market) price, plus 20% for purchased securities. In other cases, an adjustment is required for tax purposes. As of 2011, the determination of the estimated price will be regulated by the Federal Service for Financial Markets in coordination with the Ministry of Finance. Until then, as before, the estimated price may be determined by the taxpayer itself, applying the appraisal methods established under Russian law.

With respect to shares in open-end and closed mutual funds, the contractual price is accepted for tax purposes if it complies with the estimated value as determined

in accordance with securities regulations.

The LIFO method no longer applies for deduction of acquisition cost upon disposal of securities; instead only the FIFO and unit value methods are available.

REPO

It is now expressly permitted to discharge obligations under REPO via offset of counterclaims with no reclassification of REPO into sale and purchase transaction.

Transactions with derivatives

Where derivatives do not enjoy court protection under Russian laws, the profit tax base of such derivatives is to be calculated separately and the loss resulting from the separate calculation is not deductible. Court protection is granted to a limited number of derivative transactions, where such transactions meet each of the following eligibility criteria:

- the derivative transaction is executed with respect to "eligible basis assets", including *change in prices on commodities* and securities, exchange rates, interest rates, the level of inflation (or estimates calculated on the basis of these measurers or combinations of them) or other "events governed under law the probability of occurrence of which is unknown" (the basis assets eligibility criteria);
- under a non-deliverable derivative transaction, (a) at least one party is a holder of a banking license or a professional securities market participant license, or (b) such transaction is made on an exchange with a legal entity holding license permitting trading on an exchange (*the parties eligibility criteria*).

Professional securities market participants and banks engaged in dealing activity are now allowed to include in their general profit tax base the loss resulting from transactions with non-listed derivatives (similarly with losses from transactions with listed derivatives).

With respect to hedge transactions (losses from which can be included into the general profit tax base), it is now the case that the basis asset can differ from hedged objects, so long as the connection between these two can be proven.

Securities lending

The newly established rules provide that, for tax purposes, the term of securities lending is limited to 1 year, and that interest (payable in cash) is charged on the fair market value of securities (or the estimated value, if securities are non-listed).

Under these conditions, the transfer of securities from the lender to the borrower and their return are not recognized as disposal, and only interest income/expense are recognized for profit tax purposes. Interest deduction is available under general rules (including interest rate thresholds and thin capitalization rules).

Clearing houses

The new special rules expressly provide that clearing houses are subject to profit tax only on clearing fees they charge.

Individual income tax (individual investors)

Transactions with securities

Income and losses from transactions with listed securities and securities-based derivatives are consolidated and netted. Losses from these transactions can be carried forward over 10 years.

Any loss from transactions with listed non-securities-based derivatives firstly reduces income from transactions with listed derivatives and then reduces income from transactions with listed securities. Such loss can also be carried forward over 10 years.

No loss carry-forward is permitted for losses from transactions with non-listed securities and non-listed derivatives.

Upon the sale of securities purchased with borrowed funds, interest deduction is available within a threshold equaling the Central Bank refinancing rate multiplied by 1.1 (for ruble loans) or 9% (for foreign currency loans).

Securities lending

As for companies (see Profit tax – Securities lending, above), transfer of loaned/borrowed securities is not recognized as disposal as long as certain conditions are complied with. Instead, only interest income constitutes taxable income.

Interest expense incurred as a result of securities lending (within the threshold of the Central Bank refinancing rate multiplied by 1.1 (for interest expressed in rubles) or 9% (for interest expressed in foreign currency)) can reduce income from other securities lending transactions and income from transactions with borrowed securities.

REPO transactions (as of 2011)

As of 2011 special tax regime for REPO transactions performed by individuals will be introduced. This regime is similar to the current tax regime for companies.

Material benefit upon purchase of securities below fair market value

It is now expressly provided that “material benefit” income is deemed to arise not only upon purchase of listed securities, but also upon purchase of non-listed securities and derivatives.

As of 2011, the determination of the fair market price of listed securities and the estimated (fair market) price of non-listed securities as well as the “safe harbor” price fluctuation will be regulated by the Federal Service for Financial Markets in coordination with the Ministry of Finance.

In 2010 the following interim rules apply: with respect to listed securities, the fair market price is determined on the basis of average price calculated by the securities exchange; with respect to non-listed securities, the estimated price can be determined by using the appraisal methods established by Russian legislation. The “safe harbor” price fluctuation is 20%.

VAT (corporate investors)

Transactions with derivatives

Transactions with derivatives are exempt from VAT unless they provide for sale/delivery of basis assets and such sale/delivery is not exempt from VAT.

Upon sale/delivery of basic assets, the VAT base is determined as follows:

- for non-listed basis assets – as the contract value, but not less than the

fair market price on the earliest of the settlement date or delivery date;

- for listed basis assets (such as wheat, rye, etc.) – as the contract value determined in accordance with specification of the derivative instrument as established by the stock exchange;
- for listed basis assets sold in accordance with option contracts – as the contract value determined in accordance with specification of derivative instrument as established by the stock exchange, but not less than the fair market value on the earliest of the settlement date or delivery date.

REPO, securities lending

It is now expressly stated that REPO and securities lending are exempt from VAT (as are credits and loans in monetary form).

Assignment of loans

It is now expressly stated that VAT exemption applies not only to the assignment of loans, but also to their re-assignment.

Tax Incentives Encouraging Energy Effectiveness

Investment tax credit

The following new categories of taxpayers are permitted to apply for investment tax credit:

- taxpayers who increase energy effectiveness of their production activity; and
- taxpayers who invest in creation of facilities in the highest class for energy efficiency and/or facilities, pertain to sources of renewable energy and/or heat or electric energy generation facilities that have more than 57% performance ratio, or other facilities and technologies with high energy efficiency, as per the list to be established by the Government.

The credit is limited to 30% of the qualifying investment. The credit is given in the form of a deferral of profit tax and regional and local taxes (e.g., property tax, motor vehicle tax) for the term of 5 years. The interest rate is to be within the range of $\frac{1}{2}$ and $\frac{3}{4}$ of the Russian Central Bank refinancing rate.

Depreciation for profit tax purposes

Accelerated depreciation with multiplier of 2 (by reducing the useful life by half) is extended to apply to fixed assets that pertain to:

- high energy efficiency facilities, as per the list to be established by the Government; or
- facilities in the highest class for energy efficiency, once Russian legislation defines the energy effectiveness classes.

Double taxation treaties

Protocol to the double taxation treaty with the Czech Republic

Applicable as of 1 January 2010, the Protocol amends the double taxation treaty with the Czech Republic such to provide that:

- capital gains may be taxed in Russia upon sales of shares and LLC

shares if the underlying assets consist by more than 50% of immovable property situated in Russia;

- no permanent establishment arises in Russia if services, including consulting and management services, are rendered by a Czech company in Russia for a period or periods not exceeding in aggregate 6 months during any 12-month period; and
- interest that is treated as dividends pursuant to Russian tax legislation (due to thin capitalization rules) is deemed to be dividends for the purpose of the treaty.

Protocol to the double taxation treaty with Germany

Applicable as of 1 January 2010, the Protocol amends the double taxation treaty with Germany such to confirm that 5% tax rate is applicable to dividends if the investment of at least 10% of shares is no less than EUR 80,000 (previously, DM 160,000, which equalled EUR 81,806).

Criminal Liability for Tax Crimes

Thresholds for criminal liability

The threshold amounts of evaded taxes that trigger criminal liability have been increased significantly. These thresholds are now as follows:

		As of 2010	Before 2010
Individuals	Major tax evasion	<ul style="list-style-type: none"> • RUB <u>600,000</u> of unpaid taxes for three consecutive years (when the unpaid amount exceeds 10% of the total amount of taxes due); and • RUB <u>1,800,000</u> in other cases 	RUB <u>100,000</u> and RUB <u>300,000</u> respectively
	Large-scale tax evasion	<ul style="list-style-type: none"> • RUB <u>3,000,000</u> of unpaid taxes for three consecutive years (when the unpaid amount exceeds 20% of the total amount of taxes due); and • RUB <u>9,000,000</u> in other cases 	RUB <u>500,000</u> and RUB <u>1,500,000</u> respectively
Companies	Major tax evasion	<ul style="list-style-type: none"> • RUB <u>2,000,000</u> of unpaid taxes for three consecutive years (when the unpaid amount exceeds 10% of the total amount of taxes due); and • RUB <u>6,000,000</u> in other cases 	RUB <u>500,000</u> and RUB <u>1,500,000</u> respectively
	Large-scale tax evasion	<ul style="list-style-type: none"> • RUB <u>10,000,000</u> of unpaid taxes for three consecutive years (when the unpaid amount exceeds 20% of the total amount of taxes due); and • RUB <u>13,000,000</u> in other cases 	RUB <u>2,500,000</u> and RUB <u>7,500,000</u> respectively

Exemption from criminal liability

The Criminal Code now provides for an exemption from liability, (i) if the person is

charged with tax evasion for the first time, and if (ii) relevant taxes, late-payment interest and fines have been fully paid. If the relevant taxes, late-payment interest and fines are paid during the preliminary investigation, criminal proceedings should be stopped.

Recognition of decisions of commercial courts

The courts of general jurisdiction, prosecutors and officers of internal affairs authorities are now required to recognize without additional examination decisions of the commercial courts on tax disputes.

Changes Announced, but not Effected

We would like also to briefly mention a few tax law changes that were announced last year and raised broad discussions, but not yet been effected.

Transfer pricing

Over recent years, the Ministry of Finance has made several attempts to revise and tighten the transfer pricing rules. None of these attempts have materialized so far.

The most recent draft law was submitted to the State Duma by the Government on 25 December 2009. Its first reading is scheduled for February 2010.

Limitation of treaty benefits

In December 2009, reportedly the Ministry of Finance proposed a draft law to amend Article 7 of the Tax Code by limiting the treaty benefits only to "actual recipients of income". Neither the draft law nor the Tax Code define the term "actual recipient of income".

The official website of the State Duma does not list this draft law as one currently scheduled for reading.

Protocol to the Russia-Cyprus double tax treaty

In April 2009, the Russian and the Cypriot Governments initiated a draft Protocol to the Russia-Cyprus double tax treaty.

The draft Protocol aims to bring the treaty more closely in line with the latest version of the OECD Model Tax Convention and to tighten certain rules (including those regarding exemption of capital gains and permanent establishment status). The enactment of the Protocol is expected to be followed by the removal of Cyprus from the "black-list" of countries from which dividends sources are disqualified from the Russian participation exemption. Please refer to our April 2009 Special Update on Amendments to the Russia - Cyprus Double Taxation Treaty.

The Protocol was expected to be signed and ratified before the year-end. No such signing took place, however. Cyprus remains on the "black-list" for the participation exemption.

This update is a general summary of recent legislative developments and should not be treated as legal advice. Readers should seek the advice of legal counsel on any specific question. All translations of terminology in this update are unofficial.

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