INTERNATIONAL BAR ASSOCIATION

NATIONAL REPORT 2009

RECENT DEVELOPMENTS IN DIRECT TAXATION

RUSSIA

Anna Lessova, LL.M.

Dewey & LeBoeuf
5 Nikitsky Pereulok
Moscow 125009 Russia

Direct: +7 495 737 5114
General: +7 495 737 5000
Fax: +7 495 737 5050
www.dl.com

July 2009

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY 1

2. RECENT LEGISLATIVE DEVELOPMENTS OF INTEREST 2

2.1. Reducing the Corporate Profits Tax Rate 2

2.2. Increasing the Limits for Interest Deductibility 2

2.3. Increasing the Capital Investment Allowance on Fixed Assets 2

2.4. Changes to the Tax Depreciation Rules 2

2.5. In-kind Contributions to a Russian Subsidiary 3

2.6. Changes to Mineral Extraction Tax 3

2.7. Amendments to the double taxation treaty with Cyprus 4

2.8. Tax Administration and Dispute Resolution 4

3. RECENT COURT DECISIONS OF INTEREST 5

3.1. General Remarks 5

3.2. Repeat Tax Audits 5

3.3. Costs of Litigation 5

3.4. Allocation of Head Office Costs to Russian Branches 6

4. FUTURE DEVELOPMENTS OF INTEREST 6

4.1. Proposed Changes to the Transfer Pricing Rules 6

4.2. Consolidated Corporate Group Regime 7

4.3. New Legislation on Contributions to the State Social System 7

1. EXECUTIVE SUMMARY

A considerable number of amendments have been made to the Russian tax regime over the last year. The changes affect most taxes levied in Russia, including corporate profits tax, VAT, payroll and other taxes. Some of these measures have been in force since 2008; the others are part of the Government's "anti-crisis" package of reforms and are intended to provide immediate tax relief for companies in 2009, particularly in the natural resources and industrial sectors.

In 2009 Russia adopted an obligatory pre-trial procedure for the resolution of tax disputes which is intended to improve the tax administration system as well as reduce the workload of the courts.

After several years of relative stability, in 2010 the Russian tax system will enter into another reforming stage:

In April 2009 the Russian Government approved frameworks for the new transfer pricing rules (which are expected to be more in line with internationally accepted principles) as well as for a consolidated corporate group regime.

Further, the Government has initiated a replacement of the current scheme for financing of the state social and pension system. The existing combination of the unified social tax and compulsory social contributions is to be eliminated and the new system of contributions to various state social funds will come into force in 2010.

On 25 May 2009 President Medvedev issued the annual Budget Address, for 2010-2012, that, inter alia, proposed various legislative measures in order to counteract tax abuses, including the use of double taxation treaties for minimization of taxes. The Russian Government, in fact, has been considering these issues for some time now. Thus, the Ministry of Finance succeeded in negotiating significant changes to the Russian/Cyprus Double Taxation Treaty. The new protocol reserves to Russia the right to tax profits from Russian real estate where investments are made through sophisticated corporate structures.

Some analysts expect now renegotiating of the Treaties with other jurisdictions actively used in international tax planning, e.g. The Netherlands; however, there is no information on such negotiations available so far.

2. RECENT LEGISLATIVE DEVELOPMENTS OF INTEREST

2.1. Reducing the Corporate Profits Tax Rate

Starting from January 1, 2009, the general rate of corporate profits tax in Russia has been reduced to 20% (from 24%). This combined rate consists of two parts: federal and regional taxes. The federal portion is 2% (as opposed to 6.5% before 2009) and the regional portion is 18% (as opposed to 17.5% before 2009). In addition, regional authorities have the right to decrease their portion of the tax for some categories of taxpayers. Thus, the minimum rate of corporate profits tax payable to regional budgets is 13.5%; the minimum combined federal and regional rate is 15.5%. It is expected that some regions will take advantage of the change to lower their taxes for certain categories of taxpayer and compete for investments.

As a result of this reform, Russia has one of the lowest corporate income tax rates among developed market economies. This should encourage domestic companies and international investors to retain profits in Russia, rather than transferring them to other jurisdictions via interest or royalty payments. On the other hand, such a substantial tax reduction for Russian subsidiaries may result in the application of CFC rules (or failure to qualify for participation exemptions) in the jurisdictions of foreign parent companies. In consequence, the group as a whole may face higher overall taxes.

2.2. Increasing the Limits for Interest Deductibility

Russian tax law imposes certain limitations on the amount of interest which may be deducted, including “thin capitalization” rules. However, a company is entitled to choose one of several methods for the calculation of the rate of deductible interest. Most companies prefer to deduct interest within the express thresholds set forth in the Tax Code. Under the new rules (which are retroactive to September 1, 2008), for debt obligations in a foreign currency, the maximum deductible interest rate is 22% per annum; for debts in rubles, it is equal to 1.5 times the "refinancing rate" of the Central Bank of Russia (which is currently 11.5%).

2.3. Increasing the Capital Investment Allowance on Fixed Assets

Russian tax law allows companies to claim a lump sum of up to 30% (as opposed to 10% before 2009) of their investment in the acquisition or upgrading of fixed assets, as a one-time deduction from their taxable income. This rule applies to fixed assets with a useful life from three to twenty years and an amount equal to the allowance is deducted from the costs qualifying for tax depreciation. However, the tax relief will be forfeited if the assets are sold within five years after being brought into use.

2.4. Changes to the Tax Depreciation Rules

Apart from the existing straight-line depreciation method (which has been used by most taxpayers) the reducing balance depreciation method has been introduced for all

fixed assets except buildings, installations, transmitters and intangible assets. The new method is advantageous for companies with a long-term program of re-investment in fixed assets as it allows the cost of assets to be written off for tax purposes faster than under the straight-line method.

2.5. In-kind Contributions to a Russian Subsidiary

Russia has introduced changes in the types of equipment that are exempt from import VAT when a foreign investor contributes equipment to the charter capital of a Russian subsidiary.

Previously, the Tax Code provided exemption from import VAT for "technological equipment" contributed by a foreign investor. However, this exemption was often subject to disputes and challenges from the tax and customs authorities, and was not viewed as favorable from a public policy standpoint (since it did not provide any incentive for domestic manufacturing of such equipment).

Under the latest amendments, only equipment of a type not produced in Russia, and expressly included in a list adopted by the Russian Government, may be exempted from import VAT.

2.6. Changes to Mineral Extraction Tax

The following changes in the "mineral extraction tax" applicable to oil, gas and mining producers came into effect on January 1, 2009:

The tax base for the mineral extraction tax is the volume of the oil recovered. Before 2009 disputes often arose as to whether the volume of crude or processed oil (i.e. dewatered, desalted and stabilized oil) constituted the base for the tax.

A zero rate may now apply, irrespective of the accounting method (i.e. direct or indirect method) used by the taxpayer. Previously, only companies using the direct method were entitled to the zero rate, which applies to oil fields with a level of depletion greater than 80 percent. The direct method envisages that the producer will measure the oil extracted from each particular subsurface site, which is technically impossible for most oil producers.

Certain new oil fields will be fully exempt from the tax (including fields located north of the Arctic Circle, in the Sea of Azov, in the Caspian Sea, in the territory of the Nenets Autonomous district and on the Yamal peninsula), provided that certain specific requirements (as to production volume and life) are met.

Expenses associated with the acquisition of subsoil licenses may now be deducted over a two-year period. Previously, such expenses were only deductible (over a longer period) via depreciation.

The underlying aim is to encourage exploration and production in more challenging/marginal fields.

2.7. Amendments to the double taxation treaty with Cyprus

The core changes in the treaty remove a prior exemption for taxation of capital gains from the indirect sale of Russian real property.

Currently, capital gains from the sale of shares in a Russian subsidiary by its Cypriot parent company are tax exempt in both jurisdictions, even if the subsidiary owns real property in Russia. The amended treaty will remove this benefit for sales of shares in Russian subsidiaries where more than 50 percent of the subsidiary's total assets consist of Russian real property.

Such a significant change in taxation will definitely have an impact on existing structures. The positive news, however, is that the new treatment will not come into effect until 2014 at the earliest, so that during the transitional period investors may develop new exit and restructuring strategies. For example, a typical strategy may involve creating, and selling at, a higher tier in the corporate holding structure.

Other important changes relate to mutual equity funds investing in real property situated in Russia. The intention seems to be to reserve to Russia the right to tax distributions by such funds out of their rental income and disposal gains, and to counter the argument that such distributions are exempt from tax in the hands of Cypriot members of such funds (in reliance on the "Other Income" Article). However, the Russian tax treatment of such structures remains unclear, since Russian domestic law does not specifically address the situation.

The amendments introduce an expanded Article on Exchange of Information between the competent authorities of the contracting states. It complies with international standards set by the Organization for Economic Cooperation and Development (OECD). As an immediate, positive consequence of the revised Article, Cyprus will be removed from the so-called "black list" of non-compliant countries issued by the Russian Ministry of Finance two years ago. The black list was part of the new Russian holding company regime, introduced in 2008, which provides a tax exemption for dividends from foreign subsidiaries of Russian companies under certain circumstances. The exemption does not apply to dividends paid from subsidiaries in countries on the black list.

Other changes in the Treaty worth noting relate to the limitation of benefits provisions.

2.8. Tax Administration and Dispute Resolution

In 2008 the Federal Tax Authority adopted a strategy for the planning of tax audits and introduced criteria for selecting taxpayer companies to be audited. Both documents are public and intended to provide the business community with more transparency with respect to the assessment of tax risks.

Although some tax experts note a general improvement in the professional education and skills of tax officials, dispute resolution in court remains the sole mechanism for the protection of taxpayer's rights.

As part of the approved tax policy initiatives for 2009-2011, an obligatory pre-trial procedure for certain types of tax dispute has been introduced. Prior to 2009 taxpayers had a choice of making an appeal to a higher tax authority, filing suit with a court, or doing both simultaneously. Under the new regulation, pre-trial dispute resolution is obligatory for decisions of the tax authorities issued as a result of tax audits. Other decisions (for example, decisions on suspension of transactions on bank accounts) will still be appealed in accordance with current procedures. The new regulation is intended to improve the tax administration system as well as reduce the workload of the courts.

3. RECENT COURT DECISIONS OF INTEREST

3.1. General Remarks

Although Russia is not a common law jurisdiction, the role of case law in tax dispute resolution has increased significantly. In addition, in tax disputes the courts actively use general legal doctrines developed by the highest courts of the Russian Federation, such as the concepts of “bona fides”, “unjustified tax benefit”, or “business purpose” and the “substance over form” principle. It is likely that in the future, the Russian tax authorities and Russian courts will use these concepts more actively in dispute resolutions concerning reliefs provided by the Double Taxation Treaties, for example, in considering "beneficial ownership" issues.

3.2. Repeat Tax Audits

Under Russian law a repeat tax audit may be performed by a higher tax authority in the course of inspecting a lower tax authority that has performed an (initial) tax audit. In practice such a repeat tax audit can result in new tax claims against the company, even if the company successfully litigated the results of the initial tax audit in the courts.

On 17 March 2009 the Russian Constitutional Court ruled that where a higher tax authority alters the rights of the company, which have already been confirmed by valid court judgment, the higher tax authority contradicts the court's decision and, thus, the rights guaranteed by the Russian Constitution.

3.3. Costs of Litigation

Where the tax authorities succeed in tax litigation, they normally then file suit against the company claiming reimbursement of their litigation costs. The court practice is still inconsistent but there are few decisions issued in favour of taxpayers. Unfortunately, in this context, the Russian Arbitration Supreme Court supports the tax

authorities. In its recent Decree of 17 March 2009 the Presidium of the Court ruled that litigation costs may be collected from the defeated party (taxpayer, in this case) and there is no valid reason not to apply general principles derived from civil law litigation to the relationship between a taxpayer and the tax authorities. The argument that the expenses of the tax authorities were financed by the state budget, i.e. from fiscal sources, has been dismissed by the Presidium.

3.4. Allocation of Head Office Costs to Russian Branches

Most foreign and domestic groups operating in Russia face difficulties with the tax efficient implementation of cost sharing agreements within the group and the allocation of costs incurred by the foreign head office to the Russian branch. There are some positive early-stage developments regarding the latter issue. In November 2008 one of the Federal Arbitration Courts supported the taxpayer's position that the general and administrative expenses incurred by the foreign head office can be deducted from the taxable income of the Russian branch of the company. The court decision is interesting because it summarize the legal requirements for such deduction, including a reference to the relevant double tax treaty, as well as setting out a list of documents required to evidence the proper allocation of costs, including indirect costs.

4. FUTURE DEVELOPMENTS OF INTEREST

In April 2009, the Russian Government approved frameworks for the new transfer pricing rules and the consolidated corporate taxpayer regime. The new regimes are expected to become effective in 2010.

4.1. Proposed Changes to the Transfer Pricing Rules

The key changes proposed by the new transfer pricing rules are the introduction of:

- an extended list of controlled transactions, to include transactions with IP rights and financial transactions like loan and credit agreements or transactions with promissory notes; it is unclear, however, if financial transactions will be subject to transfer pricing control to the full extent;
- the "arm's length concept" as opposed to the existing "20% price deviation concept";
- amendments to the existing pricing methods to bring them in line with internationally accepted transfer pricing principles;
- new sources of information which can be used to determine the market price range;
- transfer pricing documentation requirements and reporting obligations;
- advance pricing agreements with the tax authorities (the respective provisions

will come into force in 2011).

The list of controlled transactions is expected to be limited to related-party transactions, in particular if one party to the transaction enjoys certain tax preferences, and to certain types of third-party cross-border transactions.

4.2. Consolidated Corporate Group Regime

Although no draft law has been brought before the State Duma so far, the key provisions of the proposed regime can be considered based on the outline published in April this year. The primary motive for a new consolidated corporate taxpayer regime is to allow major Russian groups to consolidate profits and losses, and minimize the burden of profit tax within the group.

A consolidated group may be formed on the basis of an agreement between its participants and is created for the purposes of profits tax only. The regime allows the offsetting of losses of one member of the group against the profits of another and provides for transactions between the group members to be excluded from the consolidated tax calculation. It is expected that transactions in assets and financial transactions between the members of the group will be excluded from transfer pricing control; however, the draft law does not clearly address these questions.

A group may only be created between companies which belong to the same industry sectors. For instance, banks may form a consolidated group only with banks, etc.

The draft law provides for certain restrictions counteracting potential abusive behavior. Thus, companies enjoying specific tax exemptions are excluded from tax consolidation.

Under current law, the common structure of a foreign parent company holding a Russian company which, in its turn, holds the local operating subsidiaries is tax-inefficient due to an additional 9% tax charge on the dividend stream from the subsidiaries to the Russian company. This tax cannot be offset against the tax on dividends payable to the foreign parent company. It seems that the proposed draft law does not address this issue and profit distributions within a Russian holding will remain subject to Russian tax on dividends (unless the "substantial shareholding exemption" applies under Article 284.3 (1) of the Tax Code).

4.3. New Legislation on Contributions to the State Social System

Beginning in 2010, the unified social tax will be replaced by contributions to the state pension, medical insurance and social insurance funds. The rates will be flat, as opposed to the current regressive scale, and will remain at their current maximum of 26 percent (34 percent from 2011). On the other hand, the ceiling for calculating contributions will be set at RUB 415,000 (approximately US$ 13,300) per annum. This is expected to mean that from 2011 the (social) tax burden on remuneration will increase with respect to employees with relatively low incomes and might even be

reduced for companies that employ highly paid personnel. Remuneration paid to foreign nationals temporarily residing in Russia will be exempt from insurance contributions.