



Russian Tax Brief

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Ministry Instructs Tax Authorities to Limit the Application of Treaty Benefits in Eurobond Structures

A new front has opened in the tax authorities' campaign to limit the application of treaty benefits to financing structures. The immediate target is Eurobond structures but the concepts applied have adverse implications for the tax treatment of other forms of back-to-back structure.

A typical Eurobond or loan participation notes structure financing activities in Russia consists of a Luxembourg or Irish vehicle (SPV), which is the issuer of loan participation notes and uses the proceeds from the issue to finance a loan to the Russian entity which is the borrower. Interest income on loans granted to Russian borrowers by foreign SPV companies issuing Eurobonds has generally been accepted as exempt from Russian withholding tax under the double taxation treaty concluded between Russia and the country of incorporation of the SPV. In practice the tax authorities did not challenge this approach on the basis of the beneficial ownership of the income until recently.

Since spring 2006 the Ministry of Finance in private responses as the Russian competent authority for treaty purposes to taxpayers' queries more and more often has referred to the OECD Model Tax Convention on Income and Capital and commentaries thereon. This was the first indication of an attempt to differentiate between the actual and the beneficial recipient of income by the ministry. There followed the President's message on budget policy for 2010-2012 in which the enactment of anti-avoidance mechanisms with respect to treaty benefits was proposed in cases where the ultimate beneficiaries of income do not reside in the relevant treaty jurisdiction. The Ministry of Finance proposed amendments to the Tax Code in line with this message. The business lobby joined forces to prevent the draft from becoming a law, inter alia because of Eurobond structures. Attempts by the Ministry of Finance and the Federal Tax Service in letters issued in 2008 and 2010 to target Eurobond structures with a view to denying treaty benefits to issuing vehicles prompted similar lobbying. Again, these attempts did not withstand the business lobby and failed.

In 2011 the Federal Tax Service (FTS) evidently decided to try again but pursued a different route. It looks as if they have decided to create a few precedents. To strengthen their position, in December they sent a letter to the Ministry of Finance asking it to confirm as the competent

authority the correctness of the FTS's understanding as to who should be entitled to treaty benefits. On 30 December 2011 the Ministry of Finance issued its response (the Letter). By now this response must have been distributed to all local tax inspectorates. It is mandatory for them to follow it.

The Ministry of Finance has clarified that Russian tax agents paying interest income to foreign SPV companies should apply the provisions of the tax treaty concluded between Russia and the country of residency of each holder of the notes. The ministry opines that foreign SPV companies which are "nominal" issuers of Eurobonds may not be considered the beneficial owners of interest income. In its Letter the ministry refers to the interpretation of the beneficial ownership concept suggested by the OECD Model Tax Convention on Income and Capital and existing international practice of the application of tax treaties.

We expect that the FTS's request and the ministry's Letter will be used in disputes with taxpayers which are the borrowers in Eurobond structures. We are aware of at least three cases when as a result of on-site tax audits carried out in respect of such taxpayers the Russian tax authorities have raised the issue of the non-availability of treaty benefits to the SPV companies which are the recipients of interest income.

It is noteworthy that the FTS's letter and the ministry's response relate to a specific case involving a deposit placed by the SPV with the borrower which is a bank. For this reason the Letter refers to the non-availability of treaty benefits to Russian banks which have accepted deposits from foreign SPV companies where the performance on the notes mirrors the performance on the relevant deposit. One might conclude that the Letter addresses a precise case and should not apply to other, albeit similar, Eurobond structures. However, we believe that the reasoning set out in the Letter is expressed such that the Letter might not be applied as narrowly as the background in the case in question might suggest.

We believe that this is not the end of the story. Lobbying efforts by the business community will undoubtedly continue as large amounts of tax are at risk. Furthermore, the FTS and the Ministry of Finance will likely pursue other opportunities to limit treaty benefits with respect to other structures and arrangements, if and as soon they become successful in their denial of treaty benefits in Eurobond structures. We believe that the Letter is a strong indication of a new trend and that it is time to start revisiting and reconsidering existing

back-to-back financing, royalty and other arrangements which historically have not been challenged by the tax authorities using the beneficial ownership concept.

There are a few approaches taxpayers may take in respect of Eurobond structures which are already in place. They may wait and see, and prepare to defend themselves, if and when needed, with the argument that the beneficial owner concept is not envisaged in Russian law and certain other arguments. Alternatively, or in addition to this, they may try and identify the noteholders and their tax residency in the preceding three years and take steps to minimize possible amounts of claims by the tax authorities.

Future Eurobond structures will probably require a fresh approach, unless the business community is ultimately successful in its lobbying efforts.

Guidance Published Concerning Advance Pricing Agreements

The Federal Tax Service has published a letter¹ on its official website² which provides guidance concerning the conclusion of pricing agreements for taxation purposes (Advanced Pricing Agreements or APAs) in Russia. Such agreements are possible in limited cases under the transfer pricing regime which entered into force this year. Where a taxpayer has complied with the conditions of an APA, the Federal Tax Service does not have the right to adopt a decision to charge additional taxes, penalties and fines in relation to controlled transactions for which prices (or price determination methods) were agreed upon in the APA based on the transfer pricing rules (Chapter 14.6 of the Tax Code).

Some of the most noteworthy points addressed in the letter are summarized below.

The intention of the tax authorities is to adhere to the generally accepted principles for the conclusion of such agreements applied in international practice and provided in the OECD Transfer Pricing Guidelines. The guidance includes details of the OECD website at which materials relating to APAs may be found.

Only Russian legal entities classified as major taxpayers have the right to apply to conclude an APA. No foreign legal entities, even those operating

through a branch in Russia, are eligible to enter into an APA.

Unless the APA provides otherwise, the period of validity will be from 1 January of the calendar year following submission. However, an APA may have retrospective effect from 1 January of the year of application. It is therefore possible for an APA submitted in 2012 to apply from the entry into effect of the new transfer pricing regime.

The tax authorities recognise that a preliminary discussion between the applicant and the tax authorities (prior to submitting a formal APA application) is a useful first step in the APA process widely used in international practice.

The recommended form of an application for the conclusion of an APA is provided in an appendix to the letter.

The process has four potential outcomes: a decision to conclude an APA, a substantiated decision to refuse to conclude an APA, a decision requiring modification of the draft APA or the taxpayer withdrawing the application voluntarily.

The APA may specify the mechanism for monitoring compliance with the terms of the APA including the range, format and content of documents required to confirm compliance and the intervals at which those documents are to be provided.

The conditions of a pre-existing APA will remain unchanged in the event that amendments are introduced to tax legislation with respect to the regulation of relations arising in connection with the conclusion, amendment or termination of APAs. Should any other amendments be introduced to Russian tax legislation which affect a taxpayer's activities, the parties to the agreement will have the right to amend the text of the APA accordingly.

The letter implies that a single APA may cover only one specific controlled transaction or a group of similar transactions. Consequently some taxpayers may require multiple APAs.

A model structure for an APA is recommended in appendix 3 to the letter and a flowchart illustrating the process for seeking an APA is provided in appendix 5.

The tax authorities may request additional documents besides those prescribed by the law, as part of an APA process. The list of documents which may be relevant is very extensive, including, among others, documents supporting the results of services provided, tax registers with financial analysis of transactions covered by an APA (e.g. profitability by transaction), job descriptions of

¹ Letter No. OA-4-13/85@ of 12 January 2012.

² <http://www.nalog.ru/mnstrus/transfer/3883192/>

staff involved in the transactions, customs and transportation documentation, currency control documents, and bank registers.

Publication of the Presidium of the SAC's Reasoning on the Interaction of Treaty Benefits with Domestic Thin Capitalization Rules

The week following the New Year holidays saw the long-awaited publication of Ruling No.8654/11 of the Presidium of the Supreme Arbitration Court (SAC) of 15 November 2011. The Ruling concerns the deductibility of interest on loans to Russian organizations from foreign shareholders and their Russian affiliates. It is significant because the Presidium confirmed the tax authorities' view that treaty relief does not override domestic thin capitalization rules in the case in question and this is likely to reduce the chances of positive court decisions for taxpayers in other cases.

Nothing has changed in relation to loans from foreign sister companies or loans to foreign legal entities. The case did not involve any attempt to reinterpret the thin capitalization rules, only the extent to which an applicable treaty might override those rules.

The case concerned the deductibility of interest accrued by the company Severny Kuzbass Coal Company ("the Company") on loans from ZAO Severstal-Resurs, Mittal Steel Holding AG (Switzerland), and OAO Karelsky Okatysh. The Swiss company owned more than 20% of the Company's share capital in the period in question as did a Cypriot company, Frontdil Limited. ZAO Severstal-Resurs and OAO Karelsky Okatysh are Russian affiliates of Frontdil Limited. That the relevant loans were all controlled indebtedness for the purposes of Article 269 of the Tax Code was not disputed.

The subject of the dispute was whether restrictions on interest deductibility applied under clause 2 of Article 269 of the Tax Code. The Company deducted the interest in full. The tax authorities disallowed interest expenses totalling 1,131,638,884 roubles. The Company claimed the right to deduct the interest based on the non-discrimination provisions of Russia's treaties with Cyprus and Switzerland. Such treaties override any provisions of domestic law in the event of a conflict. The issue was whether a conflict arose in this case. The tax authorities asserted that the thin capitalization rules did not involve any discrimination prohibited by the treaties.

We have known since November that the ruling was in favour of the tax authority and likely to set an adverse precedent for future court practice on thin capitalization. Unusually, the oral arguments put to the presidium during the hearing were filmed and can be viewed on YouTube. However, until the text of the ruling was published we did not know which of these arguments the Presidium accepted, the grounds for rejecting others or whether the Presidium had formulated any significant new interpretations of applicable law in reaching its decision to reject the claim filed by the taxpayer in relation to interest deductions.

The crucial point is whether the Presidium denied treaty relief on grounds equally applicable to all thinly capitalized companies or left scope for further disputes to be considered on a case-by-case basis and treaty relief granted to taxpayers in certain circumstances.

The reasoning set out in the Ruling is likely to lead to fewer positive court decisions for taxpayers in future. The Ruling rejects as erroneous the view of the lower courts that Article 24 of Russia's double tax treaties with Switzerland and Cyprus supports the deduction of interest by the taxpayer, asserting that these courts' broader interpretation of that article effectively makes it impossible to restrict deductions for interest on controlled debt under clause 2 of Article 269. The Ruling states that the restriction on interest deductibility is imposed in cases:

"where a Russian company's business is organized so that there is a high level of debt, the borrower is affiliated with the creditor, which may be either a foreign company or a Russian company affiliated with a foreign company, and the debt obligation is not actually paid"

In fact there is no criterion relating to payment in clause 2 of Article 269. The implication that no restriction might apply if the debt obligation is paid is very surprising and probably unintended. The drafter of the Ruling may have had in mind that deductions can be denied based on general principles if an interest expense was not genuinely incurred because it is clear settlement is never intended to occur.

On firmer ground, the Ruling notes that the restrictions on interest deductibility apply only in cases involving parties with characteristics consistent with "associated enterprises" as defined in Article 9 of each of the treaties. The official commentary to the OECD model tax treaty is cited in support of the fact that the provisions of Article

9 allow consideration both of whether a loan is at a market rate, and whether it is genuine or to be treated as some form of equity contribution. This is undoubtedly true. As such comments have not been made in any previous Russian court rulings to our knowledge, such statements in a ruling of the Presidium represent a significant development in Russian tax practice.

It is surprising and disappointing that the Ruling does not address whether the loans in this case were at a market rate and any reasons why they should not be recognised as genuine from a tax perspective. This would seem to follow naturally as the next step in the analysis. Russia is clearly free to disallow interest in excess of the market rate based on Article 9 and there are precedents in international tax practice for interest being disallowed entirely in circumstances in which no third party would provide loan finance (meaning that no expense should be treated as interest on a loan for tax purposes). Instead, the ruling asserts that the Articles 9 of the two applicable treaties:

"not only permit but even require the application of provisions of domestic law concerning controlled indebtedness ..."

This implies that all controlled indebtedness can be treated as on non-arm's-length terms, no analysis of the particular facts and circumstances being required to determine whether interest accrued exceeded amounts which would have arisen in a transaction between independent enterprises.

In fact there are circumstances in which a loan characterised as controlled indebtedness under clause 2 of Article 269 may satisfy an arm's-length test, in which case Article 9 would not provide a basis for restricting interest deductions. This might be the case, for example, if a shareholder loan can be proved to have been granted on arm's-length terms based on documented loan proposals from potential third-party lenders. Furthermore, where a debt falls within the definition of controlled indebtedness solely because of a parent-company guarantee, it should be possible to obtain a full deduction if it can be proved that a third-party loan could have been secured without such a guarantee and the guarantee was provided to the lender solely in order to secure a reduced interest rate or other improvements in the terms of the loan.

If, as asserted in the Ruling, Article 9 requires the application of the domestic thin capitalization rules, then it should override the provisions of Article 24 (non-discrimination) in all circumstances. We believe that Article 9 allows Russia to deny deductions for any interest expenses in excess of

those which would have arisen had the loan been on arm's-length terms. It is unfortunate that the Presidium did not note this limitation of the extent to which Article 9 allows discrimination in the tax treatment of companies resident in one contracting state with shareholders resident in the other contracting state relative to other companies resident in the first state.

The conclusion which follows inevitably from the positions expressed in the Ruling is that the tax inspectorate was correct in denying interest deductions based on clause 2 of Article 269.

It is noteworthy that unlike some other rulings of the Presidium this Ruling does not include any statement to the effect that the interpretation of legal provisions which is set out in the Ruling are universally binding and must be applied by arbitration courts when examining similar cases. This does not mean that other courts will ignore it. In practice it has been cited in subsequent court decisions on thin capitalization.

Any thinly capitalized Russian organizations which have assumed that treaty relief will allow full deductions for interest accrued on their controlled indebtedness should revisit their tax-risk analysis in the light of this ruling. Companies which have not exceeded the relevant debt-to-equity ratio in Article 269.2 of the Tax Code should have no cause for concern. Others may wish to reconsider their financing structure or their tax policies with respect to interest.

The SAC Refuses to Consider the Case for an Override of the Thin Capitalization Rules Based on the Netherlands-Russia Tax Treaty

Court practice on thin capitalization has changed drastically in the last few months. As we reported in our November 2011 edition, the first court case lost in a cassation court³ by a Russian company attempting to defend its right to deduct interest expenses with no thin capitalization adjustment based on the "Non-discrimination" clause of a bilateral tax treaty seems to have been in October 2011. The taxpayer, CJSC "Bryansk Engineering Works" Management Company subsequently petitioned the SAC to refer the cassation court's decision to the Presidium of the SAC for a supervisory review. The SAC rejected this petition

³ Ruling of the FAC of the Central District of 7 October 2011 in Case No. A09-6854/2010.

on 13 January, stating that no review was needed as the cassation court's conclusions were consistent with the Presidium's ruling in the Severny Kuzbass case.

It is noteworthy that this case involved the following two types of controlled indebtedness:

- ▶ Loans from Russian affiliates of a Dutch company holding an indirect interest in the taxpayer well in excess of 20%; and
- ▶ Bank loans for which a Russian affiliate of that Dutch company had provided security (a surety, bond or pledge).

In both cases the loan interest is income of another Russian taxpayer, meaning that the transactions may not have involved any loss of tax to the budget.

In this case the cassation court did not cite Article 9 to the treaty in its ruling, basing its decision on a very narrow interpretation of what constitutes discrimination for the purposes of Article 25 of the Netherlands/Russia tax treaty. Also, the Netherlands-Russia treaty, unlike the treaties relevant to the Severny Kuzbass decision, includes additional wording in a protocol concerning the deductibility of interest which means that it is not necessary to prove discrimination under Article 25 in order to deduct interest in full. Nonetheless, the SAC refused to consider whether grounds might exist for allowing a treaty override in this case.

The SAC Determines the Beginning of the Limitation Period for Liability

Ruling No. 4134/11 of the SAC of 27 November 2011 (hereinafter, "Ruling No. 4134/11") addresses the timing of the beginning of the limitation period for tax offences. Previously the SAC had not directly expressed its position on that issue with respect to tax offences. In 2006, however, a Plenary Meeting of the SAC expressed the view⁴ that the period should be calculated from the last date of the end of the tax period which is the date of the origin of the obligation to pay tax, and not from the time of submission of a tax declaration or the date of the end of the tax payment period. The arbitration courts have applied this interpretation⁵.

Since there was no uniformity in the arbitration courts' interpretation and application of the relevant norms of tax legislation, the SAC's judicial board found grounds for handing the case to the Presidium to conduct a supervisory review of the judicial decisions concerning the case in question.

With regard to the case covered by Ruling No. 4134/11, the following was disclosed: according to the results of the on-site tax audit, the taxpayer was charged additional VAT for June 2006. The statement of the audit results was drawn up on 29 May 2009 and a decision adopted on 30 July 2009. This means that the tax authorities charged the taxpayer additional VAT three years and one month after the expiry of the period to which the unpaid tax related.

Before the case was considered by the SAC, the courts of the previous three levels had determined the limitation period to start from 1 July 2006. The courts of all levels decided that the tax authorities acted within the limitation period on the grounds that the date on which the tax audit statement was drawn up was within the three-year limitation period for the tax offence identified.

In its Ruling, the SAC declared that the general provisions of tax legislation⁶ which were effective in the period under review did not link the end of the limitation period to the date of discovery of a legal offence and the drawing up of the audit statement. In addition, the SAC asserted that the limitation period should be calculated from the end of the tax period in which tax was to be paid, i.e., from 1 August 2006.

However, the limitation period starts from the day following the end of the tax period in which a legal offence was committed⁷. Before amendments were made to Article 113 of the Tax Code, an issue which was long contested was whether the limitation period started prior to the date of the audit statement or prior to the date of the decision made. In mid-2006, however, amendments to the Tax Code came into force⁸, whereby that Article was amended to the effect that the limitation period starts prior to the date of the decision made.

Hence, the additional VAT for June 2006 charged by the tax authority with regard to the decision of

⁴SAC Resolution No. 25 of 22 June 2006.

⁵Decision No. A40-32073/07-33-190 of the Moscow Arbitration Court of 16 October 2007, Resolution No. A09-7320/2007-21 of the FAC of the Central District of 9 September 2008,

Resolution No. F04-3438/2009(8540-A27-19) of the FAC of the West Siberian District of 11 July 2009, among others.

⁶Article 113 of the Tax Code as amended by Federal Law No. 137-FZ of 27 July 2006.

⁷Articles 120 and 122 of the Tax Code.

⁸Federal Law No. 137-FZ of 27 July 2006.

30 July 2009 was legitimate for the purpose of holding the taxpayer liable in the form of a fine for the failure to pay VAT for June 2006.

Cases already resolved in favour of the taxpayer cannot be revised in the light of this Ruling. However, we believe that the Ruling will influence the outcome of similar disputes which have yet to be settled.

New Legislation and Other Measures Targeting "One-Day" Companies

In the last twenty years one of the most popular grounds for additional tax charges as a result of tax audits has been relationships with so-called "bad faith suppliers" ("fly-by-night companies", "one-day companies", "odnodnevky").

It should be understood that Russian legislation does not contain any definition of a "one-day company"/"bad faith supplier". Such companies usually exist only on paper, do not pay taxes and are used in various illegal arrangements as SPVs. The use of "one-day" companies is one of the most widely used mechanisms for illegally extracting money from Russian businesses without paying any tax.

In 2001 a federal law concerning anti-money laundering was issued. It made banks the main agents in the prevention of the setting-up of "one-day" companies. In the past ten years the Central Bank has issued a number of regulations and instructions, which provide methods of control and in several cases oblige banks to use these when opening a company's bank, including:

- ▶ comparing the legal and actual addresses of a company;
- ▶ interviewing the company's General Director;
- ▶ analyzing the economic expediency of the company's operations.

If anything suspicious or unusual is identified in company's business activity, banks should report this to the authorities.

Ruling No. 53 of the Plenum of the Supreme Arbitration Court of 12 October 2006 "Concerning the Evaluation by Arbitration Courts of the Legitimacy of the Receipt by a Taxpayer of a Tax Benefit" provides a list of circumstances that could indicate a bad faith supplier for tax purposes. This list is not exhaustive. In practice tax authorities often cite additional grounds based on their perception of a taxpayer's business practice. The tax authorities usually seek to identify as many

relevant attributes as possible to build a more solid case in the course of a tax audit.

During a tax audit putative bad faith suppliers are selected from the list of the taxpayer's contractors. If satisfied that there are grounds for suspecting a degree of collusion in tax evasion or negligence in establishing the bona fides of trading partners, the tax authority then rejects tax deductions and denies the offset of input VAT on amounts paid to the putative bad faith supplier.

The authorities have issued many documents (federal laws, recommendations, regulations, letters) aimed at facilitating the identification of and prevention of activity of bad faith taxpayers. In 2007, for example, the FTS published a list of 109 features attributable to non bona-fide taxpayers, including registration at a place of mass registration and having a CEO who is the CEO of a number of companies. While evidence of certain features is insufficient to prove a taxpayer is non bona-fide, the tax authorities often take it into account when deciding those companies on which they should concentrate.

These measures have proved insufficient to eliminate the setting-up and use of "one-day" companies. Risks remain that taxpayers dealing with a large number of suppliers may unknowingly enter into transactions with "bad faith" companies, triggering tax exposures for the innocent party.

New measures to address this problem have been enacted⁹. The law in question establishes criminal liability for the illegal or fraudulent setting-up of a company. Misleading a person in order to use their documents to set up of a company in his name may result in a prison sentence of up to 5 years. Illegal usage of documents to set up a company may result in a prison sentence of up to 3 years.

In January 2012 a new governmental working group has been created on the President's instructions. The group's activity will be directed towards the prevention of money-laundering and tax evasion, especially involving the setting-up and use of "one-day" companies. It is likely that representatives of the Central Bank, the FTS and law-enforcement authorities will participate in the group.

These measures are aimed primarily at stopping money-laundering and the use of tax evasion schemes, and decreasing illegal capital flight from Russia. An added benefit is that they may decrease

⁹ Federal Law No. 419-FZ of 7 December 2011.

or largely eliminate tax risks for honest taxpayers or inadvertently doing business with putative bad faith suppliers.

Initial Clarifications Issued Concerning Tax Consolidation

Since 1 January 2012 taxpayers which satisfy certain criteria listed in Article 25.2 of the Tax Code have been able to establish a consolidated group of taxpayers (hereinafter - 'a Group'). Recently the Ministry of Finance issued the first letters clarifying issues arising from the Law¹⁰.

A letter of 16 December confirms that to establish whether the criterion that the net assets of a company-participant exceed its charter capital is satisfied, the charter capital should be determined as at 31 December 2011. The aggregate revenue and value of assets also should be determined based on the accounting data for 2011. The aggregate taxes (VAT, excise duty, profits tax and MET) should be determined based on the payment orders of every proposed participant in the group dated 2011¹¹.

Another important criterion is that a Group may be established by companies if one company directly or indirectly holds at least a 90% share in the others. This fact can be confirmed by the following documents: a statement from the Uniform State Register of Enterprises and Organizations, copies of charter documents, statements from a joint stock company's register of shareholders, and lists of participants of limited liability companies containing the necessary information about the participants of a legal entity and calculations of the participants' shares. Statements from the Uniform State Register of Enterprises and Organizations can also confirm that none of the participants in the Group is under the process of reorganization or liquidation. The new law also provides that a participant should not be subject to bankruptcy proceedings, which should be confirmed by a written statement signed by the participant in charge. All documents should be dated no earlier than one month before the date of their presentation to the tax authorities, except documents for which other requirements are stated.¹²

On New Year's Eve the Ministry of Finance issued a further letter¹³ clarifying the calculation of advance payments, the application of tax exemptions and some requirements relating to the Group's accounting policy. The letter states that the participant in charge can switch to making monthly advance payments based on the actual revenue of all participants of the Group if it has informed the tax authorities about this change before 31 December of the year prior to the year the taxpayer started to exercise this right. The payment due for the first quarter of the existence of the Group is equal to the sum of all monthly advance payments of all participants of the Group for the third quarter of the previous year¹⁴. The method of calculating advances should be stipulated in the Group's tax accounting policy.

The Group's tax accounting policy should be approved by the participant in charge before its presentation to the tax authorities. The consolidated accounting policy should contain only those provisions which are necessary for calculation of the consolidated tax base.

One more very useful point was covered in this letter. If one of the participants applied a reduced regional profits tax rate before joining the Group, the participant in charge when calculating the profits tax base (or advance payments) should take this tax benefit into account in respect to the tax base of that participant.

Despite these letters there are still many questions left unanswered in relation to the application of the law and it is expected that further clarifications will be issued soon.

Annual Reporting Requirements for 2011 for Foreign Legal Entities in Moscow

Moscow Tax Inspectorate No. 47 has issued its traditional letter concerning the requirements for the preparation and submission of the annual tax reporting package by foreign legal entities carrying out activities in Moscow, Russia in 2011.¹⁵

The annual profits tax reporting package must consist of the Profits Tax Declaration, the Annual Statement of Activity in the official form and the

¹⁰ Federal Law No. 321-FZ of 16 November 2011.

¹¹ Letter of the Ministry of Finance No. 03-03-10/118 of 16 December 2011.

¹² Letter of the Ministry of Finance No. 03-03-10/120 of 21 December 2011.

¹³ Letter of the Ministry of Finance No. 03-03-10/126 of 28 December 2011.

¹⁴ Article 286 point 8.

¹⁵ Letter No. No. 07-12/34144 of Moscow Interdistrict Inspectorate No. 47 of 29 December 2011.

Explanatory Note to the Annual Statement of Activity ("Explanatory Note"), as requested by Moscow Tax Inspectorate No. 47, and be filed with the Moscow tax authorities by 28 March 2012. Generally the points and requirements reflected in the letter are the same as in the previous years' letters.

The tax authorities provide a reminder that foreign companies registered for the purposes of carrying out activity in Russia (the 5th and 6th digits of their code of registration are "51") must submit the Profits Tax Declaration and Statement of Activities, even if they had no financial and economic activities in 2011. Foreign organizations which are registered solely because they own immovable property in Russia are obliged to submit only the Assets Tax Declaration.

Taxpayers allowed to submit the Unified (Simplified) Tax Declaration instead of the Profits Tax Declaration are not exempt from submission of the Annual Statement of Activity and the Explanatory Note.

Taxpayers with an average number of employees as of 1 January 2012 exceeding 100 persons must submit tax declarations (computations) to the tax authorities in electronic form via telecommunication channels¹⁶. The Statement of Activities and Explanatory Note are still to be submitted in hard copy.

On 17 November 2010 the Federal Tax Service approved Order № MMV-7-6/610@ regarding the introduction of the software required for electronic filing. The order brought into force from 24 November 2010 methodical recommendations for organizing electronic documentation turnover in relation to the submission of the tax reports in electronic form via telecommunication channels¹⁷.

The above-mentioned documents apply to all participants in the electronic filing processes, including taxpayers, specialized operators and tax authorities. From the taxpayer's point of view the main issue is that where tax reports are filed through a representative (for example through a specialized organization) it is first necessary to present to the tax authorities a Power of Attorney ("PoA") confirming the representative's authority. The details of the PoA are to be sent to the tax authorities as a separate notice with each report through electronic communications channels. It is

also necessary to present to the tax authorities the original of the PoA and an electronic copy via telecommunication channels (as an attachment).

The letter specifies 17 items about activity of a foreign entity in Russia (Moscow), which should be disclosed in the Explanatory Note for 2011. Many of these items match the requirements per the analogous letters issued in prior years. The taxpayer has to disclose its name and information about its type of activity, contracts, personnel, income and expenses (in particular any allocated by the Head office), immovable property and means of transport, and any rent of residential premises. There are some amendments to the list of the information to be disclosed relative to prior years. For example, item 5 is a request to disclose information about all foreign trade contracts realized by a firm in Russia in its own name, including those realized with the participation of the Moscow branch. Furthermore, it is explicitly mentioned in the letter that documentation supporting expenses incurred abroad and transferred to the branch by its Head office should be kept in the Moscow branch ready to be provided upon request of tax authority within the time limits prescribed by law (item 9). Also, under item 12 there is now a requirement to disclose information about any rented immovable property.

In addition, the taxpayer should submit certain documents, such as a copy of its accounting policy for 2011-2012 (for permanent establishments), copies of licences, the order of appointment of the Chief Accountant (accountant), the certificate of a tax agent on withholding of tax at source, certificates from the bank on the absence of cash movements or salary payments for dormant entities, copies of forms 2-NDFL in case of any payments to individuals related to the rent of living premises, and documents supporting tax benefits, if applicable.

There is also new guidance concerning foreign organizations which do not carry out activity in Russia through a permanent establishment but are payers of assets tax as owners of immovable property.

There is a reminder that taxpayers with several branches in Russia which file a consolidated VAT declaration and pay the full amount of VAT to the regional tax inspectorate appropriate to the place of registration of one of its branches (other than Moscow), after each tax (reporting) period have to present to Moscow tax inspectorate No 47 a copy of that VAT declaration (stamped by the regional tax inspectorate where the consolidated VAT declaration was filed).

¹⁶ Article 80.3 of the Tax Code.

¹⁷ Order No. MM-7-6/534@ of 2 November 2009.

A new section related to “high tax risk” activity is included in the Letter. Order № MM-3-06/333@ of the Federal Tax Service of 30 May 2007 stipulates the conceptual framework for planning on-site tax audits. It describes the principles of selection of taxpayers to be audited based on certain criteria. The conceptual framework specifies 12 criteria allowing companies to assess for themselves the likelihood that they will be subject to an audit by the tax authorities as carrying “high tax risk activities”. Moscow Tax inspectorate No. 47 recommends in its letter that taxpayers analyze their activities from the perspective of potential “high tax risks” in order to exclude tax risky and doubtful operations from the tax computations and, if needed, re-submit the respective tax declarations for prior periods notifying the tax authorities about the tax risk reduction measures.

Treatment of Foreign VAT for Russian Profits Tax Purposes

Operations of a Russian taxpayer can be subject to VAT under the regulations of a foreign state. Depending on the circumstances such VAT could be withheld by the counterparty from gross revenue, or collected from a foreign customer and paid to the foreign state by the Russian taxpayer. Tax law does not specify how such “foreign” VAT should be treated for Russian profits tax purposes.

The position of the Ministry of Finance has undergone changes over years, ultimately recognizing that amounts of foreign VAT invoiced to customers should not be subject to Russian profits tax. Earlier clarifications stated that foreign VAT should not be excluded from taxable income (according to Article 248 of the Tax Code, only Russian VAT invoiced to customers should not be included in taxable income). At the same time, the authorities recognized the right to deduct foreign VAT as an “other business expense”.¹⁸ More recent letters clarified that foreign VAT should not be included in taxable income and should not be deductible as an expense. The authorities stated that the specific norm in law concerning taxes should be applied with respect to the deduction. Taxes and levies accrued based on Russian law are deductible, consequently, foreign VAT should not be.¹⁹

¹⁸ Article 264.1.49 of the Tax Code, Letter No. MM-6-03/171@ of the Federal Tax Service of 16 February 2006, and Letter No 03-03-01-04/1/250 of the Ministry of Finance of 12 May 2005.

¹⁹ E.g., Letters of the Ministry of Finance No. 03-03-06/1/708 of 12 November 2011, No. 03-03-06/1/226 of 8 April 2011, No.

At the same time a less favourable approach has been applied by local tax inspectorates during field audits, according to which foreign VAT should not be excluded from taxable income and is not deductible as an expense.

Taxpayers have successfully challenged the inspectorates' position in court. The Federal Arbitration Court (FAC) for the North-West District in its Decision of 23 November 2009 supported the approach of the taxpayer and, referring to the general principles of determination of the tax base stated in Chapter 25 of the Tax Code, recognized the inclusion of foreign VAT in deductible expenses (with its simultaneous inclusion in taxable income) as economically justified.²⁰

A recent Decision of the Arbitration Court of the City of Moscow issued on October 10, 2011 broadened the court practice in favour of taxpayers.²¹ The taxpayer (a German legal entity with a tax-registered permanent establishment in Russia) had not included foreign VAT collected from customers and paid to the German state either in income or expenses, an approach which was challenged by the tax inspectorate during a field tax audit. The main arguments which helped to win the case were as follows. First of all, the decision of the tax authorities contradicted the clarifications of the Ministry of Finance and Federal Tax Service given earlier to various taxpayers on a similar issue. Another argument in favour of the taxpayer was based on the non-discrimination clause of the Russia-Germany double tax treaty. In the opinion of the taxpayer, the position of the tax authority to include foreign VAT in taxable income of the permanent establishment discriminates against the taxpayer by comparison with the Russian legal entities providing similar services. Finally, if one accepts the position of the tax authorities not to exclude foreign VAT from taxable income, then such VAT is deductible as a genuine business expense under Article 252 and Clause 1.49 of Article 264 of the Tax Code.

03-03-06/1/112 of 28 February 2011, No. 03-03-06/1/407 of 11 June 2010, No. 03-03-06/1/813 of 16 December 2009, and No. 03-08-13 of 28 April 2008; and Letter of the Federal Tax Service No. 16-12/027370 of 17 March 2010.

²⁰ Decision of the FAC for the North-West District No A56-4991/2009 of 23 November 2009.

²¹ Decision of the Arbitration Court for the city of Moscow No. A40-65914/11 99-293 of 10 October 2011.

The Procedure for Maintaining a Register of Authorized Economic Operators is now in Force

The concept of authorized economic operator (hereinafter, "AEO") appeared in the Customs Code of the Customs Union in 2010, but the relevant persons could not use the concessions granted to those with AEO status until now because there was no prescribed procedure for entering such persons in the relevant register.

At the end of 2011, the Federal Customs Service adopted the Administrative Procedure for providing a state service of maintaining the register of authorized economic operators (hereinafter, the "Procedure")²², which along with Federal Law No. 311-FZ of 27 November 2010 "Concerning Customs Regulation in the Russian Federation" (Chapter 6) determines the procedure for entry in the Register, and also the use of simplifications envisaged for AEOs.

An AEO can temporarily store goods in its warehouses without being entered in the register of owners of temporary storage warehouses, and perform certain customs operations involving the release of goods directly at its warehouses using a special procedure to complete the customs transit procedure (Article 87 of Federal Law No. 311-FZ of 27 November 2010). Such concessions do not apply to certain categories of goods. Currently, limitations are imposed only on excisable goods which require labelling.

An AEO may be a legal entity which is registered in accordance with Russian law and which imports goods into Russia for use in production and other entrepreneurial activity and/or exports goods from Russia, and which is entered in the register of AEOs and:

- ▶ has engaged in foreign trade activity for at least one year;
- ▶ has no outstanding obligations to pay customs duties and taxes;
- ▶ has not been held liable twice or more within one year for customs offences, whereupon the amount of imposed fines totaled 500,000 roubles or more; and
- ▶ uses a specified system for recording goods and logistics operations.

Another requirement is the presentation of collateral for the payment of customs duties and taxes in an amount of no less than one million euros or, for companies producing and/or exporting duty-free goods, 150,000 euros. The criteria for choosing the amount of collateral were established a decision of the Customs Union Commission²³. For instance, collateral amounting to 150,000 euros may be paid by a legal entity which is engaged in the following in Russia:

- ▶ the production of goods, the possession under ownership and operational management or lease (sublease) of premises as well as outside areas and other sites where production operations are performed, as confirmed by the relevant documents;
- ▶ the export of duty-free goods, provided they are fully produced or substantially processed in Russia and are worth no less than 500,000 euros annually, and also their export at least twelve times within one year before an application for entry in the AEO Register is filed with a customs authority.

The AEO Register is maintained by the Federal Customs Service, and no payment is to be made for examining an application and entering an operator in the Register. An operator is entered in the AEO Register on the basis of an application and additional documents confirming compliance with the relevant requirements.

The Federal Customs Service will begin to accept applications for entry in the AEO Register in January 2012. The application should be considered within 90 days, during which the Federal Customs Service is to verify the data submitted by the applicant (information is to be requested from other state bodies and an on-site customs audit conducted). Experts maintain that much time is likely to be needed for an applicant to prepare an application for entry in the Register (preparation for an audit, the bringing of the system for recording goods into line with the requirements, and the preparation of the necessary documents).

When all the above requirements are met and all the necessary data presented to the Federal Customs Service, the applicant is to be entered in the AEO Register and issued a Certificate of Entry in the Register. The Certificate becomes valid

²² Order No. 1877 of the Federal Customs Service of Russia of 14 November 2011.

²³ Decision No. 872 of the Customs Union Commission of 9 December 2011.

indefinitely 10 days after it is issued and cannot be assigned to another person.

Overview of Changes in Mineral Extraction Tax in 2012

On 1 January 2012 mineral extraction tax (MET) provisions introducing new holidays and tax rates for oil and gas extraction have come into effect. The amendments are designed to stimulate the development of new oil, gas and gas condensate fields in certain regions and fields with low initial recoverable reserves.

MET Holidays

A zero MET rate applies to oil extracted in the Black Sea and the Okhotsk Sea, and in areas located north of 65 degrees latitude within the borders of the Yamal-Nenets Autonomous District. This exemption also applies to the extraction of natural gas used for producing liquefied natural gas and gas condensate extracted in areas located on the Yamal peninsula in the Yamal-Nenets Autonomous District.

The conditions for application of zero MET rate are presented in Table 1 on the following page.

The amendments are aimed at creating conditions for effective investment in the development of new oil and gas producing regions. Currently extraction is not profitable in those regions due to the lack of infrastructure.

Rate increase

From 2012 MET rates on oil and natural gas have been increased. The basic rate of MET on oil was indexed according to the expected level of inflation up to 446 roubles per tonne from 1 January 2012 and up to 470 roubles per tonne from 1 January 2013. The MET rate on natural gas has been increased to 509 roubles per 1,000 cubic meters of gas. Taxpayers which do not own property of the Unified Gas Supply System can apply the coefficient 0.493 to the basic rate in 2012. Since 1 January 2012 the MET on gas condensate is a fixed amount of 556 roubles per tonne instead of 17.5%.

Movements in MET rates from 2010 to 2013 are summarized in Table 2 on the following page.

New Rules for calculating MET on Oil

The MET rate on oil is calculated using special coefficients. In 2011 there were two coefficients - a coefficient reflecting the level of depletion of reserves of a particular subsurface site (Cd) and a coefficient reflecting movements in world oil prices (Cp). Since 1 January 2012 a new decreasing coefficient for MET on oil has been introduced (Cr).

This coefficient depends on the magnitude of reserves of a particular subsurface site and applies to small oil fields with initial recoverable oil reserves up to 5 million tonnes and a level of reserve depletion of no more than 5%.

Before this year the MET rate on oil did not envisage differentiation depending on the volume of oil reserves at a particular subsurface site. As a result development of small oil fields was often not economically viable due to the disproportionately high capital investment and operating costs involved. In Russia there are about 1,000 registered deposits with recoverable oil reserves of less than 5 million tonnes and a depletion level less than 5%, amounting to estimated total reserves of up to 1 billion tonnes.

The new decreasing coefficient Cr is intended to create better conditions for the development of new small deposits development of which under the general taxation system would be unprofitable. This should allow the development of additional oil reserves and increase the profitability of producers. According to the government's calculations, as a result of introducing the decreasing coefficient the volume of additional oil extracted from deposits with initial recoverable oil reserves of up to 5 million tonnes will be 10.2 million tonnes in the first year the benefit applies and 214 million tonnes over the following 10-year period.

According to the government's calculations, to make small fields profitable it would be necessary to introduce the following decreasing coefficients:

- ▶ 0.5 for fields with level of a reserves less than 1 million tonnes
- ▶ 0.75 for fields with a level of reserves from 1 million tonnes to 3 million tonnes.

To allow the conditions for the application of Cr to be the same for all small fields up to 5 million tonnes, a special formula for Cr was created:

$$Cr = 0.125 \times V_3 + 0.375$$

where V_3 is the initial recoverable oil reserves in millions of tonnes, determined as the sum of reserves of categories A, B, C1 and C2 according to the data of the state balance sheet of reserves of commercial minerals.

The coefficient applies to the oil fields with initial recoverable reserves (V_3) of up to 5 million tonnes and a level of depletion of up to 5%.

The level of reserve depletion should be determined as the proportion of the volume of accumulated oil production on a subsoil area (N) divided by the

volume of initial recoverable reserves in a given area (V3).

Benefits for Tatarstan and Bashkortostan

An MET deduction has been introduced for oil extracted in Tatarstan and Bashkortostan. The tax deduction for Tatarstan is 630.6 roubles per tonne. For Bashkortostan it is 193.5 roubles per tonne multiplied by a coefficient. The coefficient depends on the export duty rate and is either 0 or 1.

The deductions will apply in Tatarstan from 1 January 2012 to 31 December 2015, and in Bashkortostan from 1 January 2012 to 31 December 2016. Certain criteria in relation to the accumulated level of production and the duration of the licence apply.

Table 1

Mineral/Region where the fields are located	Period when the licence is obtained	Level of depletion – not more than (as of 1 January 2012)	Accumulated volume of oil extracted (million tonnes for oil and condensate; bln m ³ for gas)	Years for prospecting and extracting (years for geological study, exploration, prospecting and extracting)
Oil / The areas in the Black Sea	After 1 January 2012	n/a	20	10 (15)
	Before 1 January 2012	0.05	20	10 years from 1 January 2012 – until 1 January 2022
Oil / The areas in the Okhotsk Sea	After 1 January 2012	n/a	30	10 (15)
	Before 1 January 2012	0.05	30	10 years from 1 January 2012 – until 1 January 2022
Oil north of 65 degrees latitude within the borders of the Yamal-Nenets Autonomous District (excluding areas located in the Yamal peninsula)	After 1 January 2012	n/a	25	10 (15)
	Before 1 January 2012	0.05	25	10 years from 1 January 2012 – until 1 January 2022
Gas used for production of LNG / The areas in the Yamal peninsula in the Yamal-Nenets Autonomous District	n/a	n/a	250	12 (from the date of start of extraction)
Gas condensate / The areas on the Yamal peninsula in the Yamal-Nenets Autonomous District	n/a	n/a	20	12 (from the date of start of extraction)

Table 2

	Tax rate (RUR)			
	2010	2011	2012	2013
Oil	419	419	446	470
Gas - basic rate	147	237	509	582
Gas – coefficients ²⁴	-	-	0.493	0.455
Gas condensate	17.5 %	17.5 %	556	590

²⁴ Coefficients are for companies which do not own property of the Unified Gas Supply System (i.e., not Gazprom or its affiliates).

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