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Tax Alert

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Draft Federal Law "Concerning Amendments to Parts One and Two of the Tax Code of the Russian Federation and Individual Legislative Acts of the Russian Federation"

On 6 November 2009 the State Duma of the Russian Federation considered the Draft Federal Law "Concerning Amendments to Parts One and Two of the Tax Code of the Russian Federation and Individual Legislative Acts of the Russian Federation" (the "Draft Law") in the second reading.

The Draft Law was significantly revised after it passed the first reading in May 2009. In addition to amendments relating to the treatment of derivatives for purposes of corporate income tax ("profits tax") and value added tax ("VAT"), the Draft Law introduces a number of other amendments to these parts of the Tax Code as well as to the Chapter on personal income tax ("PIT") and Article 40 "Principles for Determining the Price of Goods, Works or Services for Tax Purposes" of the Tax Code. It should also be noted that the Draft Law makes amendments to the Law "On the Securities Market", "On Banks and Banking Activity", "On the Central Bank of the Russian Federation (Bank of Russia)", "On Commodity Exchanges and Exchange Trade", "On Non-State Pension Funds", "On Investment Funds", etc.

The Draft Law is expected to enter into force on 1 January 2010, except for certain provisions for which a different implementation procedure is envisaged.

The third reading of the Draft Law is to be held this week.

Below is a summary of key amendments proposed by the Draft Law. We have primarily focused on amendments to tax legislation. These changes are key for financial institutions and non-financial entities as well as individuals involved in securities transactions including REPO deals, securities lending and derivatives.

Profits tax (Chapter 25 of the Tax Code)

The key amendments proposed by the Draft Law regarding profits tax include (but are not limited to) the following:

- ▶ Provisions regulating the taxation of securities transactions. These changes in particular concern the tax treatment of units in mutual investment funds and transfer pricing rules for securities transactions, including the need for a downward adjustment of the purchase price of securities when it exceeds the maximum market price;
- ▶ Provisions relating to the tax treatment of REPO deals, including short positions, unclosed REPO deals, the substitution of collateral and netting in REPO deals;
- ▶ There are changes regarding the taxation of derivatives, including derivatives used for hedging purposes. In particular, foreign currency and mark-to-market revaluation of derivatives (except for actually paid/received amounts) are excluded from taxation. Amendments introduce new methodology for the determination of the tax base by dealers, including banks, for operations with non-traded derivatives. Losses on operations with derivatives that are unenforceable under Russian civil law will not be recognized for tax purposes. A procedure for determining the tax base for SWAP deals is envisaged;

Ernst & Young is organizing a seminar for companies in the financial sector on November 17, 2009 from 14:30 until 17:00¹. The seminar will cover the proposed changes in tax law relating to the taxation of derivatives and other financial instruments.

- ▶ Article 282.1 is introduced, establishing special rules for the taxation of securities lending operations. The amendments propose that securities lending operations be taxed similarly to REPO deals;
- ▶ The procedure for creating a securities devaluation reserve is refined, including with respect to securities transferred and/or received under REPO agreements and in securities lending operations, as well as with respect to securities denominated in foreign currency;
- ▶ Dividends are to be taxed at the level of the economic owner of shares or depository receipts when REPOs and securities lending operations are concluded between a foreign entity and a Russian organization (i.e. where a foreign entity is a seller of securities in the first leg of a REPO or the lender in securities lending operations). The tax agent function is assigned to a Russian entity that is a buyer of securities in the first leg of a REPO or a securities borrower. Similarly, the tax agent function is assigned to a Russian asset manager where the settlor of a trust management is a foreign entity;
- ▶ Articles 299.1 and 299.2, establishing special provisions for determining the income and expenses of clearing companies, are added to the Tax Code;
- ▶ Revaluation of received/issued advance payments in foreign currency is not required;

¹ Invitations to this Seminar will be centrally distributed and may also be obtained by contacting Zhanna Kim (not later than November 16, 2009) by phone: 7(495) 755-9700 or by e-mail: zhanna.kim@ru.ey.com.

- ▶ The methodology for the depreciation of inseparable improvements to leased fixed assets is specified;
- ▶ The date of recognition of interest income and expenses is specified.

Transitional provisions

The Draft Law envisages transitional provisions with respect to: (a) the taxation of REPO deals and securities lending transactions where the first part falls prior to 1 January 2010; (b) the taxation of losses on derivatives that are unenforceable under the Russian civil law; and (c) the taxation of losses on derivatives concluded prior to 1 January 2010 but with an execution date after 1 January 2010.

VAT (Chapter 21 of the Tax Code)

No significant changes were made to the Draft Law as regards the VAT treatment of derivatives. However a few points have been clarified:

- ▶ It is clarified that derivatives are not VATable, except for the sale of the underlying asset, which is VATable;
- ▶ A methodology is established for determining the value of derivatives for purposes of calculating the ratio for the allocation of input VAT by taxpayers performing both VATable and non-VATable operations.

It is worth mentioning the introduction of direct VAT exemption for the following transactions:

- ▶ Securities lending operations, including interest accrued thereon;
- ▶ REPO deals, including amounts payable for the provision of securities in REPO deals;
- ▶ The assignment of liabilities arising from the provision of loans in monetary form and/or credit agreements as well as the execution of liabilities by a debtor to a lender who is not the original lender ("each new lender").

Personal income tax (Chapter 23 of the Tax Code)

The Draft Law proposes a new version of Article 214.1 of the Tax Code which refines the methodology for determining the tax base for securities and derivatives transactions and establishes rules for the tax treatment and carrying forward of losses from such transactions. In contrast to the current version of the Tax Code, which regulates only the tax treatment of derivatives whose underlying asset is securities or stock indices calculated by exchanges, the proposed version regulates the taxation of derivatives irrespective of the underlying asset.

The Draft Law introduces several new articles:

- ▶ Article 220.1 on the procedure for obtaining tax deductions when losses from securities and derivative transactions are carried forward.
- ▶ Article 214.3 "Special considerations relating to the determination of the tax base for REPO deals with securities" (effective from 1 January 2011).
- ▶ Article 214.4 "Special considerations relating to the determination of the tax base for securities lending operations".

Amendments to Article 212 recognize material benefit received from the purchase of derivatives as taxable income, establishes rules for determining the material-benefit tax base in the light of this amendment and stipulates a procedure for determining the market value of securities, shares of mutual investment funds and derivatives.

Federal Law "On the Securities Markets"

The Draft Law introduces a definition of financial instruments and derivative financial instruments and also establishes the terms of agreements recognized as derivative financial instruments.

In accordance with the new definition, the Draft Law makes respective amendments and additions to a number of other articles, in particular regarding brokerage activity and the securities asset management activities.

A definition, conceptual framework and principal requirements for REPO agreements are introduced. Procedures for executing liabilities under such an agreement as well as the terms that may be envisaged by a REPO agreement are established.

Federal Law “On Banks and Banking Activity”

Banks are specifically entitled to enter into commodity derivatives, provided that delivery liabilities cease without delivery of underlying commodities.

Other Amendments

Amendments to other legislative acts generally relate to the amendments to the Law “On the Securities Markets” as regards the definition and procedure for entering into derivative contracts and REPO transactions.

Please note that we have highlighted only the key amendments being introduced by the Draft Law to the TC and other legislative acts of the Russian Federation. It should be mentioned that the Draft Law contains a number of other amendments that may require thorough study and analysis to determine their implications for a specific taxpayer.

We would be happy to discuss the Draft Law with you - in particular, its influence on your business.

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