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**NOVEMBER 2017**

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# Special Economic Zones Offer Tax Privileges in Russia



**Anton Nikiforov**  
Pepeliaev Group

Special economic zones have been operating in Russia for many years, providing many tax privileges. The Russian government is proposing to maintain a 2 percent corporate income tax rate for companies operating within its special economic zones reducing the level of uncertainty for business and boosting foreign investment.

On October 3, 2017 the Russian Ministry of Finance published the draft “Main directions of the budgetary, tax and customs tariff policies for 2018 and for the planning period of 2019 and 2020” (see <http://src.bna.com/tUK>). The draft states that it is necessary for Russia to reduce its dependency on the export of oil. Over the next several years this will have to be accomplished in difficult economic and international conditions. New investments in the country’s economy will need to be attracted.

## Investment Tax Deduction

One of the directions for the development of investment activity is to continue the implementation of the federal policy of granting tax benefits. In particular, it has been proposed that investing taxpayers be granted

a right to reduce profit tax by the amount of costs connected with purchasing (creating) or modifying (reconstructing) PP&E (the so-called “investment tax deduction”).

At present, special taxation conditions exist for regional investment projects, advanced development areas, the Free Port of Vladivostok, special investment contracts, greenfield projects and companies that make capital investments in manufacturing facilities. These mechanisms provide for an opportunity to receive a tax benefit equal to the amount of the investment.

## Special Economic Zones

Special economic zones have been operating in Russia for several years, and these zones also provide

**Anton Nikiforov is a Partner at Pepeliaev Group, Russia**

tax benefits. Currently, companies that are residents of special economic zones, the rate of corporate income tax to be paid to the Russian federal budget is reduced, sometimes at 0 percent.

However, on January 1, 2017 the tax burden for residents of special economic zones worsened. The rate of the corporate income tax to be paid to the federal budget increased from 2 to 3 percent.

Article 38 of Federal Law No. 116-FZ “On special economic zones in the Russian Federation” dated July 22, 2005 states directly that to worsen the condition of an investor is prohibited. However, a disagreement has arisen which in all likelihood will need to be resolved in court.

In 2015, certain foreign investors had already encountered courts giving an unfavorable interpretation to the law which grants regional tax benefits. Those disputes did not touch on the changes in tax legislation. They had to do with the period when the tax benefit should be in effect and stirred up a heated discussion between tax experts.

Many pointed out that the courts’ approach was unfair (Resolution No. Å56-26419/2014 of the State Commercial Court for the North-Western Circuit dated May 27, 2015 regarding PSMA RUS (Peugeot-Citroen), Resolution No. Å56-37722/2014 of the State Commercial Court for the North-Western Circuit dated June 29, 2015 regarding Volkswagen group RUS).

On the other hand, issues connected with the application of the so-called “grandfather clause”, in other words, the legitimacy of a tax law being changed to worsen an investor’s situation, have already been raised in the case law on tax disputes. There have also been precedents that were favorable for taxpayers (Resolution No. 14632/06 of the Presidium of the Supreme State Commercial Court dated May 15, 2007 in case No. Å56-25237/2005 regarding OJSC Baltika Breweries).

## Case Law

On July 12, 2017, the Russian Supreme Court approved an “Overview of courts’ practice of resolving disputes relating to the protection of foreign investors.” In clause 8 of this overview the court has once again emphasized that the tax burden for investors may not be worsened: amendments in the legislation which establishes a legal regime for foreign investments with respect to tax benefits may not have retroactive effect if such changes worsen the position of a foreign investor in a continuing relationship connected with an investment project being implemented.

However, regardless of the favorable case law on this matter, the state authorities are trying to demonstrate that they control how the previously promised preferential tax regime for investors is being provided. For example, on October 13, 2017 the State Duma passed in the first reading the Russian government’s draft law which provides that for residents of a special

economic zone the rate of the corporate income tax transferred to the federal budget should remain at 2 percent.

Also, it is proposed that this rule be extended to the previous period starting from January 1, 2017. This will eliminate the period in which investor’s conditions worsened before the law comes into force.

Obviously, resolving the conflict in this way is much better than through litigation. Removing contradictions by amending legislation reduces the level of uncertainty for business and improves the investment climate.

At present, we are observing a general trend that the number of tax disputes won by tax authorities is growing. Despite this, the Russian Supreme Court is trying to demonstrate that in certain cases it uses approaches to interpreting legislation in favor of investors.

For example, the Russian Supreme Court is planning to revise a case in which tax authorities denied a taxpayer which was a resident of a special economic zone the right to apply the reduced rate of income tax paid to the budget of the relevant constituent entity of Russia. The reason for this refusal was the fact that the company received non-operating income in a form of an exchange rate difference for its bank deposit in foreign currency.

The inspectorate decided that this income is not connected with production activity within the economic zone and should therefore be taxed at the general tax rate. This was despite the fact that the taxpayer had purchased the foreign currency in order to perform a cross-border contract within the framework of its primary activity (on October 24, 2017, at the time of writing, the case had not been considered; see Ruling No. 306-KG17-9355 of the Russian Supreme Court dated September 26, 2017 regarding Ozon Pharm).

## Tax Benefits

Going back to the Russian Ministry of Finance’s draft “Main directions of the budgetary, tax and customs tariff policies for 2018 and for the planning period of 2019 and 2020”, it is obvious that, as a rule, stimulating investment activities through tax benefits creates risks for regional budgets of constituent entities of Russia.

If the tax benefits being provided are ineffective and do not result, in the mid-term, in the growth of investors’ financial results, then local budgets will receive less taxes and will have insufficient funds to finance social programs.

In view of this, the Ministry of Finance is proposing that a cautious and well thought out policy be implemented for granting tax privileges. For this purpose, according to the draft, a moratorium should be established for new benefits with respect to taxes that are paid to regional and local budgets, and the existing benefits should be revised so that ineffective tax incentives are done away with.

*Anton Nikiforov is a Partner at Pepeliaev Group, Russia.*