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TAXATION OF COMPANIES

Newsletter

Relevant Tax Issues
for Companies Involved in Shelf Projects in Russia

Professional Guidance & Partnership

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CONTROVERSIAL TAX ISSUES

1 A foreign company operates in Russia through a number of representative offices, one of which is used to engage in the core business, with the other offices responsible for support functions: specifics of profit tax treatment

Many foreign companies create two or more representative offices in Russia to implement one project. In most cases this is due to the difficulties that can arise if one office is used to perform all functions. For example, if a foreign company engages in its core business through one office (hereinafter – main office), which is a fair distance from a residential settlement (discharge of construction, drilling and other work performed on a rotational basis in forests, on the shelf, etc.), it is clear that the company may need at least one auxiliary office (hereinafter – auxiliary office) to recruit personnel, procure materials, advertise the activities of the main office, keep financial and tax accounting, etc. The main and auxiliary offices may be located in different residential areas and even in different constituent entities of the Russian Federation.

The tax authorities often require a foreign company to calculate and pay profit tax separately for each of these offices.

This leads to the following question: are these requirements of the tax authorities legitimate?

The definition and criteria for determining a permanent establishment for profit tax purposes are stipulated by article 306 of the Russian Tax Code. According to the provisions of this article, the place of business of a foreign company used to engage in business in Russia on a regular basis may be recognised as the permanent establishment of this company.

An office used by a foreign company to engage in business (core line of business) in Russia will constitute such a place of business. In the case under review this is the main office.

An auxiliary office is not used by a foreign company for regular business activities and only serves as the base for preparatory and support work.

In accordance with clause 4, article 306 of the Russian Tax Code, the support activities of a foreign company that are performed through an auxiliary office do not lead to the formation of a permanent establishment for tax purposes. A double tax treaty may stipulate other cases where the operations of a detached subdivision are recognised as preparatory or support activities.

If an organisation generates income and incurs expenses in connection with the operations of the main office, how should its expenses on the auxiliary office be accounted for?

As mentioned above, the operations of a company through an auxiliary office do not lead to the formation of a permanent establishment. An auxiliary office may, therefore, not be recognised as a taxpayer for the profit tax. In other words, it does not incur any obligation to calculate profit tax and submit tax returns. Consequently, there is no need to consider expenses in the profit tax base of this office.

The main office, however, is recognised as the taxpayer for profit tax purposes and the operations of the auxiliary office are performed to support its activities. According to clause 2, article 247; clause 1, article 307 and clause 4, article 306 of the Russian Tax Code, the expenses of the auxiliary office may be considered in the profit tax base of the main office.

These conclusions are confirmed by judicial practice regarding similar disputes[1].

[1] See for example the Resolution of the Federal Arbitration Court for the Volga Region Circuit dated 12 April 2006 on case No. A55-19098/05-34 and dated 1 June 2006 on case No. A55-23268/05-51; the Resolution of the court of appeal of the Arbitration Court for the Sakhalin Region dated 18 February 2008 on case No. A59-1053/07-S15.

2 Transfer of the expenses incurred by a foreign company to its representative office: how should the documents be drawn up properly (in compliance with the Russian Tax Code)?

A foreign company operating in Russia through a permanent establishment tends to find it difficult to confirm expenses relating to the permanent establishment.

In accordance with the provisions of international treaties between Russia and other countries, when determining the profits of the permanent establishment, expenses incurred for the purposes of the permanent establishment, including management and general administrative expenses, may be deducted[2].

However, neither international treaties, nor the Russian Tax Code stipulate the list of documents required to deduct similar expenses or the requirements on their execution. In general, such documents are drawn up by the parent company in its country of residence in compliance with foreign legislation. For this reason, the content of the documents may not comply with Russian tax legislation[3].

In practice, this leads to a situation where the tax authorities often file claims over the documents that confirm such expenses. Accordingly, the tax authorities remove such expenses from the tax base for profit tax purposes and subsequently assess additional tax and default interest and hold the taxpayer liable for a tax offence.

Such a position of the tax authorities, however, is not based in many cases on the Russian Tax Code, since, as we noted above, the Russian Tax Code does not stipulate any requirements on the execution of source documents in this situation.

Any documents on the transfer of expenses (acceptance certificates on expenses, transmittal letters, etc.) constitute source documents that confirm expenses. Source documents, however, should reflect the data specified in clause 2, article 9 of Federal Law "On Accounting": title of the document; date of execution; name of the company on whose behalf the document was executed; description of the business transaction; indicators of the business transaction in kind and in monetary terms; positions of the company's officials responsible for the business transaction and the correctness of the documentation; and signatures of said officials[4].

The tax authorities also pay attention to the level of detail in said source documents. If these documents lack sufficient detail (for example, regarding specific types of transferred expenses broken down by the amounts of corresponding expenses), the filing of claims by the tax authorities is unavoidable. The Russian Tax Code and clause 2, article 9 of the Federal Law "On Accounting" do not set requirements on the level of detail of the source documents, while the format of said documents is not prescribed by legislation. At the same time, however, to mitigate such risks, we recommend taking into consideration the opinion of the tax authorities. In addition, a judge, when resolving a specific dispute, may state that a breakdown of corresponding expenses is required and that additional documents should be submitted to the court[5].

If the list of such expenses is fairly cumbersome, it may be executed as a separate appendix to the acceptance certificate of expenses (other similar document) that should be referred to in the acceptance certificate[6].

The expenses in question may relate to the expenses of several business units located both in Russia and abroad. The proportion of expenses of the Russian representative office should be determined on the basis of a documented methodology for allocating expenses, which is developed by the parent company and must be properly documented.

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[2] Such expenses include, in particular, business trips by the employees of the head office of the foreign company to Russia if they are directly involved in the execution of agreements concluded by the representative office (Letter No. 03-08-05 of the Russian Ministry of Finance dated 23 October 2006, Resolution of the Federal Arbitration Court for the North-Western Circuit dated 19 January 2007 on case No. A13-634/2006-14).

[3] Letter No. 03-08-05 of the Russian Ministry of Finance dated 18 April 2008.

[4] This fact is also established by courts when considering tax disputes (for example, the Resolution of the Federal Arbitration Court for the Moscow Circuit dated 16 July 2007 (20 July 2007) on case No. KA-A40/6743-07; Resolution of the Federal Arbitration Court for the Moscow Circuit dated 6 March 2006 on case No. KA-A40/875-06; Resolution of the Federal Arbitration Court for the North-Western Circuit dated 28 July 2003 on case No. A 56-37837/02).

[5] Resolution of the Federal Arbitration Court for the Moscow Circuit dated 6 September 2005 (30 August 2005) on case No. KA-A40/7275–05–1, 2.

[6] Resolution of the court of appeal of the Arbitration Court for the Sakhalin Region dated 18 February 2008 on case No. A59-1053/07-S15.

The accounting policy of the foreign company that regulates the distribution of expenses may serve as such documented evidence. An excerpt from this policy may be submitted to the tax authority during an audit or to the court. This conclusion is supported by the clarifications issued by the tax and financial authorities that stipulate this need[7]:

- the availability of the methodology, signed by the head of the parent company, for distributing the transferred expenses and calculating specific indicators serving as the basis for the distribution of expenses;
- submission of the calculation of the proportion of expenses transferred to the Russian branch of the foreign company, with the calculation performed on the basis of approved indicators and supporting documents[8].

In addition, we recommend that a company establish the procedure for transferring expenses and booking them in tax accounting in the accounting policy of the company's representative office (branch)[9].

As we can see from the above analysis of the recommendations of the tax (financial) authorities and court practice, the issues arising from supporting documentation confirming the transfer of expenses by the parent company to its representative office remain disputable and often provoke disagreements with tax authorities.

3 Taxation of the profit of contractors and subcontractors operating under the Sakhalin II Production-Sharing Agreement (Sakhalin II PSA)

At this moment in time profit tax is arguably the most debatable issue for companies involved in the Sakhalin II PSA project. This is attributable to the fact that the local tax authorities have distributed en masse notices to all the contractors and subcontractors of the operator involved in this project, in which they requested that these companies recalculate profit tax from a tax base assessed in accordance with profit tax legislation[10] that is now invalid. In addition, the tax authorities requested that these companies recalculate the profit tax at the rate of 32%.

The tax authorities launched this wide-ranging campaign after the Russian Ministry of Finance issued a corresponding interpretation of the relevant provisions of the Sakhalin II PSA in Letter No. 03-06-06-06/4 dated 31 January 2008.

The situation has been exacerbated by the rulings of the state arbitration courts at all levels, in which they upheld the position of the tax authorities and the Russian Ministry of Finance. The Federal Arbitration Court for the Far Eastern Circuit was the first to review similar cases at the beginning of 2009 and to uphold the judicial acts that were being appealed. In July 2009 the Supreme Arbitration Court of Russia dismissed the claims of two contractors, in which they requested that their cases be referred to the Presidium of the Supreme Arbitration Court. The Supreme Arbitration Court did not establish corresponding grounds for upholding such claims.

The opinion of the judges was based on an interpretation of the provisions of the Sakhalin II PSA. By virtue of article 346.35 of the Russian Tax Code, the provisions of the

[7] Paragraphs 3, 4 clause 5.3 and clause 4.1.1 of the Methodological Recommendations on How to Apply Certain Provisions of Chapter 25 of the Russian Tax Code Regarding the Specifics of the Taxation of the Profits (Income) of Foreign Companies approved by Order No. BG-3-23/150 of the Russian Ministry for Taxes and Levies dated 28 March 2003; Letter No. 03-08-05 of the Russian Ministry of Finance dated 18 April 2008. In judicial practice, the courts also establish such circumstances: for instance, Resolution of the Federal Arbitration Court for the Moscow Circuit dated 16 July 2007 (20 July 2007) on case No. KA-A40/6743-07, Resolution of the Federal Arbitration Court for the North-Western Circuit dated 28 November 2008 on case No. A56-3517/2008.

[8] The courts also accept the opinions of external auditors as such evidence (see for example, Resolution of the Federal Arbitration Court for the North-Western Circuit dated 28 November 2008 on case No. A56–3517/2008 and Resolution of the Federal Arbitration Court for the West-Siberian Circuit dated 17 March 2008 No. F 04-1466/2008 (1627-A75-15).

[9] The availability of the accounting policy of the branch of a foreign company was also taken into consideration by the Federal Arbitration Court for the West Siberian Circuit in Resolution dated 17 March 2008 No. F04-1466/2008 (1627-A75-15).

[10] See Law No. 2116-1 of the Russian Federation dated 27 December 1991 "On Profit Tax of Companies and Organisations"; Resolution No. 552 of the Russian Government dated 5 August 1992 "On Approval of the Regulations on the Composition of Production and Sales Costs of a Product (Work, Service) and on the Procedure for Forming the Financial Results that are Considered for Profit Tax Purposes".

Sakhalin II PSA take precedence over effective legislation. In connection with this fact, the judges refer to clause 1, Addendum 1, Schedule E of the Sakhalin II PSA, which stipulates that the contractors and subcontractors of Sakhalin Energy Investment Company Ltd. should pay the profit tax established by the Law of the Russian Federation "On the Profit Tax of Companies and Organisations" (hereinafter – the "Profit Tax Law") effective on 1 January 1994. The terms and conditions, rate and procedure for collecting profit tax should remain unchanged throughout the term of the Agreement, including the term of its extension.

In our opinion, the courts applied incorrectly the provisions of the Sakhalin II PSA and contractors and subcontractors are eligible for the reduced profit tax rate in accordance with applicable tax legislation[11] and may also apply other norms of effective tax legislation, if it improves their position compared to provisions that existed (or could have existed) on 1 January 1994.

To be able to understand correctly the parties' intentions expressed in these provisions of the PSA, we need to analyse, apart from this clause, all the other provisions of the PSA, on which the clause is based. Analysis of other clauses of the PSA (including the main text of the Agreement and Addendum 1 to Schedule E) makes it possible to conclude that the PSA clause under review is a so-called "grandfather clause" or stabilisation clause, aimed at preventing the application of amendments to profit tax legislation (starting from 1 January 1994) that have an adverse impact on the taxpayer.

This interpretation of the provisions of the PSA is consistent with analysis of the Sakhalin II PSA and also complies with analysis of Russian investment legislation, the Russian Constitution and international law. Moreover, the Constitutional Court of Russia and the Presidium of the Supreme Arbitration Court of Russia have repeatedly pronounced on similar issues.

As far as we know, this argument was not used in the considered court cases. Consequently, it can be applied in new court proceedings.

Moreover, even in such a negative situation the taxpayer has an opportunity to avoid or at least reduce the adverse impact of the accrual of tax arrears and default interest as well as tax liability.

Firstly, contractors and subcontractors are eligible for benefits and preferences stipulated by the Sakhalin II PSA and may assert their right to these benefits and concessions in their objections to an audit report, appeal before a higher-instance tax authority or court. In particular, they may assert their right to an exemption from a number of taxes, such as property tax and transport tax.

Secondly, the previous version of profit tax legislation stipulated certain benefits and preferences, which should remain valid for the whole period of application of the Sakhalin II PSA.

For example, taxable profit may be decreased by the amount of expenses on the financing of capital investments (acquisition (creation) of fixed assets), not only by writing off the value of the fixed assets through depreciation and amortisation, but also by deducting the amounts of capital investments of a production and non-production nature, as well as expenses on the repayment of bank loans[12] obtained for this purpose. To be eligible for the above tax benefit, the taxpayer should meet all the requirements set out in sub-clause (a), clause 1 and clause 7, article 7 of the Profit Tax Law. The main requirements include the following:

- the company should develop its own production and non-production capacities;
- the taxpayer should retain sufficient after-tax profit (if no loan was received for these purposes) in the reporting period;
- the costs on the financing of capital investments should have actually been incurred (paid) in the reporting period;
- the amounts of accrued depreciation (amortisation) should have been fully used by the most recent reporting date;
- application of the benefit should not decrease the

[11] Please note that the profit tax rate stands at 20% effective 1 January 2009.

[12] As at 1 January 1994 the profit Tax Law did not contain any limitations in respect of the sources of financing. However, Federal Law No. 54-FZ dated 3 December 1994 introduced certain amendments in respect of the booking of loan repayment expenses. Moreover, such an adjustment was made according to Decree No. 2270 of the President of the Russian Federation dated 22 December 1993.

actual tax amount, calculated net of the benefit, by more than 50%.

In addition to the aforementioned benefit on capital investments performed for production and non-production purposes, which is stipulated by the Profit Tax Law, an additional benefit was effective in the period under review. This benefit was stipulated by article 5 of Law No. 4520-1 dated 19 February 1993 "On Government Guarantees and Compensations for People Working and Living in the Far North and Areas Equated to the Far North". Please note that the whole of the Sakhalin Region constitutes such an area.

The essential feature of this benefit is that the profit (income) spent on capital investments for production and non-production purposes is not taxable.

When applying this benefit, the taxpayer is entitled to reduce taxable profit by the full amount of capital investments made for production and non-production purposes (without prejudice to the depreciation accrued by the last reporting date). Moreover, the taxpayer is entitled to reduce the tax by 100% instead of just 50%, irrespective of the size of other benefits stipulated by article 7 of the Profit Tax Law. At the same time, the sources of finance are not limited to net profit (or after-tax profit).

The main requirements for applying this benefit:

- the company should generate sufficient profit and actually use this profit to finance capital investments. The profit may include not only the net profit (or after-tax profit as required under the Profit Tax Law), but also gross profit (in other words, the proceeds from the sales minus the primary cost) or profit before taxes.
- the costs on the financing of capital investments should have actually been incurred (paid) in the reporting period;

Therefore, the benefits stipulated by the PSA Sakhalin II and legislation effective at the time under review may materially reduce the tax burden or grant an exemption on the profit tax, even if the old rules are applied.

It follows from the content of this article that the taxation of contractors and subcontractors of the PSA Sakhalin II project operator (Sakhalin Energy Investment Company Ltd.) remains disputable and that corresponding tax issues may be raised on a number of occasions in the near future.

4 VAT deductibility criteria applicable to a foreign company operating in Russia through a permanent establishment

What is the correct way to file for a VAT deduction if a foreign company operates in Russia through a permanent establishment?

Articles 171 and 172 of the Russian Tax Code stipulate general VAT deductibility criteria, in particular:

- acquisition of goods (work, services) to perform transactions in Russia that are recognised as VATable or to resell them;
- booking of the acquired goods (work, services);
- properly issued VAT invoice and the existence of corresponding source documents.

It follows from these rules that a foreign company may deduct VAT at the location of a permanent establishment if appropriately documented goods (work, services) were acquired by this establishment to perform transactions recognised as VATable or to resell the goods (work, services). In this case the foreign company should have documents confirming the acquisition of the goods (work, services) for the operations of the permanent establishment at the location of which the company has declared its entitlement to a tax deduction.

The goods (work, services) should be booked by the permanent establishment for which they have been purchased. In addition, VAT invoices should be registered in the purchase and sales ledgers of this permanent establishment.

This application of the above legal rules is supported by judicial practice[13].

5 13% or 30%: which rate of personal income tax should apply to foreign employees?

Amendments to the Russian Tax Code that modified the notion of tax resident for personal income tax purposes came into force on 1 January 2007. The notion is crucial for the establishment of the tax rate (13% or 30%) with respect to the income of foreign employees. To date, there is no well-established judicial practice on the application of this article. The Russian Ministry of Finance has only recently started to develop its position on this issue and has been very cautious. In practice, this gives rise to numerous questions relating to the essence of such amendments and differences compared to the previous procedure.

For example,

- at what rate should personal income tax be assessed for a foreign employee who leaves Russia in early 2010, if he/she had the status of tax resident in Russia in 2009?
- at what rate should personal income tax be assessed for a foreign employee (for example, a German citizen) in cases where he/she starts working in Russia in November 2009 and is a non-resident subject to the 30% tax rate by end of the year?

RATE OF PERSONAL INCOME TAX ON THE 2010 INCOME OF A FOREIGN EMPLOYEE WHO LEAVES RUSSIA IN EARLY 2010, IF HE/SHE HAD THE STATUS OF TAX RESIDENT IN RUSSIA IN 2009.

Pursuant to clause 2, article 207 of the Russian Tax Code, tax residents are individuals that de facto stay in Russia for at least 183 calendar days for 12 consecutive months.

It follows from a literal interpretation of the rule of law that 12 consecutive months and, accordingly the aforementioned 183 days, are not pegged to a calendar year and may start in the previous calendar year and finish in the current year.

If at the end of 2009, an employee stayed in Russia for more than 183 calendar days and resigns in early 2010, then the employee had still been in Russia for more than 183 days for 12 consecutive months on the resignation date and, therefore, remains a resident.

Therefore, the 13% rate would apply to the income of such employee for 2010, with no reassessment of tax obligations at the 30% rate for 2010.

A similar conclusion was drawn by the Thirteenth Arbitration Court of Appeal in a Resolution dated 28 July 2008 on case No. A56-5933/2008.

The correctness of this interpretation is also substantiated by analysis of the procedure for adopting amendments to legislation concerning determination of a tax resident.

The aforementioned rule of law in article 207 of the Russian Tax Code (clause 2) was introduced by Federal Law No. 137-FZ dated 27 July 2006. Until then the concept of an individual, who is a tax resident, was contained in article 11 of the Russian Tax Code and was defined as follows: "individuals who are tax residents of the Russian Federation are individuals, who de facto stay in Russia for at least 183 days in a calendar year…"

The Explanatory Note to draft law No. 181057-4 (which abolished aforementioned clause of article 11 of the Russian Tax Code and introduced clause 2, article 207 of the Russian Tax Code and was adopted in its final version as Federal Law No. 137-FZ dated 27 July 2006) stated that such amendments had been introduced to the Russian Tax Code for the following reason: according to article 11 of the Russian Tax Code, when determining the status of a tax resident "...the periods of the de facto presence of individuals in Russia that precede a specific tax period are not taken into account. The status of a tax resident of the Russian Federation is acquired by an individual with

[13] See the Resolutions of the Federal Arbitration Court for the West-Siberian Circuit dated 14 August 2006 on Case No. F04-5000/2006 (25222-A75-34) and dated 11 May 2006 on Case No. F04-2753/2006 (22294-A75-34).

respect to each calendar year. …To guarantee the rights and legitimate interests of individuals, it is proposed that the Code be supplemented by provisions that clarify the notion of tax resident of the Russian Federation with due account of the continuous nature of the actual presence of individuals in Russia for at least 183 calendar days during 12 months, which started in a period that immediately preceded the current tax period and expire in the current tax period…"

This conclusion is also confirmed by the Russian Ministry of Finance, for example, in letters No. 03-04-06-01/32 and No. 03-04-06-01/331 dated 13 February 2009 and 7 November 2008, respectively.

RATE OF PERSONAL INCOME TAX LEVIED ON THE 2009 INCOME OF A FOREIGN EMPLOYEE (FOR EXAMPLE, A GERMAN CITIZEN) WHO STARTS WORKING IN RUSSIA IN NOVEMBER 2009 AND IS A NON-RESIDENT AT THE END OF THE YEAR

As noted above, pursuant to clause 2, article 207 of the Russian Tax Code, individuals that actually stay in Russia for at least 183 calendar days for twelve consecutive months are deemed to be tax residents of the Russian Federation.

Consequently, if a foreigner is employed in November 2009, he/she will not be a tax resident and may only become a tax resident on the expiry of the specified period.

The Russian Ministry of Finance believes that the 30% rate of tax is only reassessed at the 13% tax rate (refund of excessively personal income tax to the employee) once the employee acquires the status of tax resident and only for the period in which the employee acquired such a status. In other words, in the case in question, the reassessments will be performed for 2010, provided that the employee stayed in Russia for at least 183 days from November 2009. No reassessment will be carried out for 2009.

These conclusions were formulated by the Russian Ministry of Finance in Letters No. 03-04-06-01/331 and No. 03-04-05-01/399 dated 7 November 2008 and 24 October 2008, respectively.

Consequently, the least risky option that might be accepted by the tax authorities would involve the withholding of personal income tax from the employee's salary at the rate of 30% until the expiry of the 183-day period of his/her stay in Russia in 2010 (starting in November 2009, unless the employee stayed in Russia before that date) and a reassessment of the tax at 13% and refund of excessive tax payments for 2010 to the employee. Personal income tax would not be reassessed and refunded for 2009.

However, in our opinion, the company may conduct reassessments and return excessively paid taxes to the employee for both 2010 and 2009 (starting from November).

In the above letters, the Russian Ministry of Finance does not cite the provisions of the Russian Tax Code that expressly stipulate the impossibility of reassessing taxes for the tax period that preceded the one when the individual acquired the status of tax resident. On the contrary, as stated above, both the current and preceding tax periods should be taken into account when determining this status.

The Russian Tax Code does not regulate the procedure for the reassessment of personal income tax, nor does it restrict such right to the period preceding the one when the individual acquired the status of tax resident, provided that it is within the period of 12 consecutive months.

In this case, a reassessment for the current period that does not take into account the previous period would attest to a lack of consistency in the application of this rule of law by the Russian Ministry of Finance. Such an approach of the competent authority would also violate the principle of taxation equality (clause 1, article 3 of the Russian Tax Code) in a situation where, for example, one foreigner comes to work to Russia in December, while the other comes in August. In both scenarios, these individuals would not be tax residents of the Russian Federation at the end of the year and would only become tax residents once they have been resident in Russia for 183 days. However, proceeding from the position adopted by the Russian Ministry of Finance, the first foreigner would be entitled (on the expiry of 183 days in the next tax period) to a reassessment and refund of personal income tax for all the months (from January to May), other than December of the previous year, whereas the second foreigner would "lose" five months (from August to December) and would only be entitled to a reassessment of personal income tax for January of the

following year (on the expiry of 183 days).

Moreover, article 207 of the Russian Tax Code does not link the status of resident to the individual's citizenship. At the same time, however, the fact that an individual does not have Russian citizenship serves as grounds for applying the presumption that this individual does not have the status of tax resident in Russia, until it has been confirmed by supporting documentation that he/she actually stayed in Russia for at least 183 days.

Neither article of the Russian Tax Code contains legal grounds for the application of the aforementioned presumption. Otherwise, personal income tax should have been assessed at the 30% rate from the salary received by Russian citizens, until the latter proved that they actually stayed in Russia for at least 183 days. As we know, however, this does not happen.

In our opinion, such a difference in the taxation of Russian citizens and foreigners, which is not explicitly stipulated by the Russian Tax Code, violates the principles of universality and equality of taxation (clause 1, article 3 of the Russian Tax Code) and the principle of non-discrimination (clause 2, article 3 of the Russian Tax Code).

Furthermore, application of the last principle mentioned above is even more important given that the foreigners in case in question are citizens of Germany with which Russia concluded on 29 May 1996 a Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital.

Pursuant to clause 1, article 24 of this Convention, the citizens of one Contracting State may not be subject to taxation or assume a relevant obligation in the other Contracting State that would be different or more onerous than the taxation or relevant obligations that are or may be imposed on the citizens of such a state in the same circumstances.

The Convention takes precedence over Russian tax legislation (article 7 of the Russian Tax Code).

At the same time, however, the incomes of Russian citizens working in Russia are subject to 13% tax from the first day of the tax period.

Accordingly, the German citizens appear to be in a worse position than Russian citizens, which results in more onerous taxation of the former (with due account of the above explanations of the Russian Ministry of Finance).

We would like to note here that this conclusion is substantiated by the fact that, according to a similar provision in the Double Tax Treaty with Belarus (when article 11 of the Russian Tax Code was effective until the entry into force of the Protocol to the Treaty as at 31 May 2007 that regulated this procedure), the Russian Ministry of Finance in Letter No. 03-05-01-03/82 dated 15 August 2005 and the Russian Federal Tax Service in Letter No. VE-6-26/786@ dated 21 September 2005 indicated to discrimination in this case and the need to apply the non-discrimination article of the international treaty.

This conclusion is also confirmed by previous judicial practice, which upheld the above position of the Russian Ministry of Finance, for example, Resolution of the Federal Arbitration Court for the Moscow Circuit dated 2 September 2008 on case No. A40-53140/07-4-317.

However, the above explanations of the Russian Ministry of Finance make it possible to assert that if the company reassesses and refunds personal income tax for 2009 to the employee, there is a material risk that the company could face claims from the tax authorities and that the dispute would have to be settled in court. Moreover, there is no case law on such matters at present. This is attributable to the comparatively recent entry into force of clause 2, article 207 of the Russian Tax Code.

LEGAL POSITIONS OF THE PRESIDIUM OF THE RUSSIAN SUPREME ARBITRATION COURT

1 The provision of hot meals to employees working on a rotational basis is subject to general taxes, rather than the unified tax on imputed income (Resolution of the Presidium of the Russian Supreme Arbitration Court No. 2799/09 dated 21 July 2009)

CASE SUMMARY

The taxpayer, an oil producer, provided its employees and the employees of its contractors with hot meals during work on a rotational basis. No other persons were provided with meals. To this end, the taxpayer equipped special facilities (canteens and canteen wagons) on the production sites, purchased and cooked food, which was subsequently sold under the menu at the production cost of the foodstuffs (without a mark-up). The expenses were reimbursed by deducting the cost of the products from the salaries of the employees, and as for contractors – under the terms and conditions of contracts in the amount of the consumed products. This was a loss-making activity.

The tax office, based on the results of the field tax audit, claimed that this type of taxpayer's activity was subject to the unified tax on imputed income (provision of catering services). As the taxpayer failed to calculate and pay the unified tax on imputed income on this type of activity during the audited period when paying taxes under the common taxation system and failed to file a tax return for the unified tax on imputed income, the taxpayer was held liable for a tax offence under clause 1, article 122 of the Russian Tax Code.

The taxpayer contested the decision in court, but its claims in this respect were not granted. Consequently, it filed an appeal with the Russian Supreme Arbitration Court.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The Presidium ruled in favour of the taxpayer.

According to article 346.28 of the Russian Tax Code, companies and entrepreneurs engaged in entrepreneurial activities subject to the unified tax on imputed income are recognised as taxpayers for the purposes of the unified tax on imputed income.

In accordance with clause 6.1 of the Main Provisions on the Work on a Rotational Basis (approved by Resolution No. 794/33–82 of the USSR State Labour Committee, Secretariat of the All-Union Central Council of Trade-Unions and the USSR Health Ministry dated 31 December 1987), three meals must be provided on a daily basis for the employees of companies that work "on a rotational basis". The taxpayer issued a corresponding order to comply with this requirement and provide normal working conditions.

The performance of entrepreneurial services such as the provision of catering services is not stipulated by the company's constituent documents.

In view of the above, the taxpayer's provision of hot meals for company employees cannot be treated as entrepreneurial activities in catering services, as this activity was not performed to derive a profit, but rather to establish normal working conditions for the taxpayer's employees.

2 The 18% VAT applies to work (services) relating to the import of foreign goods into Russia (Resolution of the Presidium of the Supreme Arbitration Court No. 8133/09 dated 8 December 2009)

CASE SUMMARY

Under the contract, the supplier provided the company with services relating to the storage of goods imported into Russia at bonded warehouses, as well as a set of services to arrange for (perform) the unloading of goods and their transportation to the bonded warehouses. VAT was indicated on the VAT invoices issued by the supplier for the services rendered at the 18% tax rate.

The Company filed for the offset of paid VAT, but was denied.

In the opinion of the tax office, these services are subject to 0% VAT pursuant to sub-clause 2, clause 1, article 164 of the Russian Tax Code. VAT invoices issued by the service provider (indicating the 18% tax rate) do not comply with the requirements established in article 169 of the Russian Tax Code and may not serve as grounds for tax deductions and the recovery of VAT from the budget.

The Company appealed to the court, holding that sub-clause 2, clause 1, article 164 of the Russian Tax Code is only applicable to work (services) that are directly related to the sale of goods specified in clause 1 of the article, in other words, goods exported under the export customs regime or placed under the free customs zone regime.

As the supplier provided services for the storage of imported goods unrelated to said customs regimes, there were no grounds for applying the 0% tax rate with respect to the sale of such services and the supplier of the services lawfully issued VAT invoices indicating the 18% rate.

The courts of first instance and cassation supported the taxpayer's claims. They also cited clause 5, article 164 of the Russian Tax Code, which stipulates that the tax rates indicated in clauses 2 and 3 of said article (either 10% or 18%) should be applied to the import of goods onto the customs territory of the Russian Federation, which implies the application of the same tax rate to the transactions indicated in paragraph 2, sub-clause 2, clause 1, article 164 of the Russian Tax Code.

The tax authority filed an appeal with the Russian Supreme Arbitration Court.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The Presidium ruled in favour of the taxpayer.

The reporting judge (A. I. Babkin) noted that the case had been referred to the Presidium, as there was no uniform approach on the interpretation and application of paragraph 2, sub-clause 2, clause 1, article 164 of the Russian Tax Code in arbitration practice.

When reviewing this dispute, the judges of the Presidium asked the representative of the tax authority why, in the opinion of the latter, the legislator had stipulated a zero percent rate of VAT on the import of goods. The representative proposed that this had been done to avoid double taxation.

As a result, the Presidium of the Russian Supreme Arbitration Court upheld the position maintained by the taxpayer and the lower courts on this case.

3 The 18% VAT applies to services involving the transport of goods for export, if the services were provided prior to the placement of the goods under a customs regime (Resolution No. 9476/09 of the Presidium of the Russian Supreme Arbitration Court dated 3 November 2009)

CASE SUMMARY

The tax authority held that a 0% tax rate (instead of the 18% rate applied by the taxpayer) should have been applied to some of the services provided to the taxpayer relating to the transportation of oil and petroleum products in rail tank cars. Accordingly, the tax authority claimed that the VAT deductions performed by the taxpayer were unsubstantiated. The goods were transported by rail across Russia to the port and then exported by sea from the port (the carrier was the agent).

In the opinion of the tax authority, prior to the actual shipment, the participants in the transaction knew that the transportation services were being provided solely with respect to goods exported from Russia and, accordingly, should have applied the 0% tax rate.

The courts at all three levels (Moscow Region) upheld the position of the tax authority. The taxpayer filed an appeal with the Russian Supreme Arbitration Court.

The panel of three judges of the Russian Supreme Arbitration Court that referred the case to the Presidium upheld the Court's position on previously reviewed cases, namely: the 0% tax rate is applied to services relating to the export of goods only from the date when the goods are placed under export customs regime.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The Presidium ruled in favour of the taxpayer.

During the hearing, the representative of the tax authority cited the court practice of the Federal Arbitration Courts for the West-Siberian, Volga and North-Western Circuits, which assessed the nature of services in their entirety. In the case under review, it clearly transpires from the taxpayer's documents (contract, acceptance certificates and VAT invoices) that the goods are being exported.

The judges of the Presidium of the Russian Supreme Arbitration Court asked the representative of the tax authority, whether the transport operator could have issued a VAT invoice reflecting a 0% tax rate before the goods were placed under the customs regime. The representative answered in the affirmative, noting that it was obvious that the goods were designated for export.

The Presidium of the Russian Supreme Arbitration Court, however, ruled in favour of the taxpayer. The transactions mentioned in sub-clause 2, clause 1, article 164 of the Russian Tax Code are subject to tax at the 0% rate provided that corresponding goods are placed under the export customs regime when such transactions are performed. In accordance with clause 3, article 157 of the Russian Customs Code, the day when the goods are placed under the customs regime constitutes the date when the goods should be released by the customs authority.

Moreover, in the addendum to its statement of claim filed with the Supreme Arbitration Court the taxpayer suggested that goods be recognised as exported goods since the date put in the accompanying documents (export permit mark). However, the reporting judge (M. G. Zorina) pointed out that this argument was new and had not been discussed in lower-instance courts. The taxpayer's representative explained that such an argument was made to form the unified practice of reacting to the new arguments of the tax authorities that were stated in their new audit reports and decisions issued after the filing of this case with the Presidium of the Russian Supreme Arbitration Court (the taxpayer's representative did not specify what exact arguments were stated by tax authorities).

4 Unified social tax does not apply to certain payments to employees in the areas where regional coefficient is paid (Resolution No. 2138/09 of the Presidium of the Russian Supreme Arbitration Court dated 9 July 2009)

CASE SUMMARY

Based on the results of the field tax audit, the unified social tax and relevant default interest were accrued on the amounts paid by the taxpayer:

- additional payments up to the amount of the actual salary in the event of temporary disability;
- payments in the form of the reimbursement of the actual travel expenses of employees and their dependents to the place of vacation in Russia and back;
- payments in the form of salary payable to employees during their additional annual paid vacation granted for working extra hours;
- inancial assistance payable to the employee's widow.

The tax authority recognised the above payments as expenses that reduce the profit tax base in accordance with clause 15, article 255 of the Russian Tax Code and are, accordingly, subject to the unified social tax.

The taxpayer contested the decision in court. The court at the first level granted the taxpayer's claims. However, the court of cassation quashed the decisions of lower courts and referred the case for a review. During the case review, the taxpayer was denied the claims, in which regard the latter filed an appeal with the Russian Supreme Arbitration Court.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The Presidium ruled in favour of the taxpayer.

The Presidium recognised as substantiated the taxpayer's claims on all the above payments. It follows from the ruling on the referral of the case to the Presidium and the position of the judge that delivered a report that the Presidium took the following into consideration.

By virtue of sub-clause 1, clause 1, article 238 of the Russian Tax Code, additional payments up to the amount of the actual salary in the event of temporary disability were not subject to the unified social tax in 2004, as they had been paid under Law No. 4520-1 of the Russian Federation dated 19 February 1993 "On Government Guarantees and Compensations for People Working and Living in the Far North and Areas Equated to the Far North". Resolution No. 1441/07 of the Presidium of the Russian Supreme Arbitration Court dated 3 July 2007 on a similar case was cited.

For similar reasons, it was held unlawful to charge unified social tax on payments in the form of reimbursements of the actual travel expenses of employees and their dependents to the place of vacation in Russia and back and payment of the salary due to employees during their additional annual paid vacation granted for working extra hours. In this respect, it was also held that the taxpayer had made the payments from after-tax profits obtained during previous years (clause 1, article 270 of the Russian Tax Code and Resolution No. 13342/06 of the Russian Supreme Arbitration Court dated 20 March 2007).

As the employee widow that was granted financial assistance was not in employment or civil law relations with the taxpayer, the funds paid to her were not subject to the unified social tax.

The taxpayer did not attend the session of the Presidium. The representative of the tax authority explained that the payments were subject to the unified social tax, as Kemerovo region had not been included in the areas covered by Law No. 4520-1 dated 19 February 1993. The coefficient effective in the area, which was considered by taxpayers (employers), was set as a temporary and individual (for the region) measure for another reason, namely for social tension (miner strikes) in the late 1980s – early 1990s.

With respect to the financial assistance granted to the widow, the representative of the tax authority ascertained that its claim was not related to the fact that the assistance had been subject to the unified social tax, but rather to the technical error in the taxpayer's accounts – the taxpayer had booked the relevant amount in the line where payments not subject to the unified social tax were booked, thereby decreasing the tax base for the unified social tax.

However, it follows from the Resolution issued by the Presidium that the above arguments of the tax authority had no effect.

5 When a higher-level tax authority considers a taxpayer's appeal against a decision of the subordinate tax authority, it may not change this decision in a way that places the taxpayer in a worse position (Resolution No. 5172/09 of the Presidium of the Russian Supreme Arbitration Court dated 28 July 2009)

CASE SUMMARY

In 2007 the taxpayer submitted amended profit tax returns to the tax authority for 2003 and 2004. The tax authority performed a repeat field tax audit for these periods. Based on the results of this audit it issued a decision not to hold the taxpayer liable for the tax offence and proposed that the taxpayer pay arrears on profit tax for 2004.

The decision of the tax authority contained the conclusion that profit tax had been underpaid in 2003. At the same time, the tax authority agreed with the taxpayer's objections, and no decision was issued on the collection of these arrears. The decision stated that it was unclear from the contents of sub-clause 2, clause 10, article 89 of the Russian Tax Code whether a repeat tax audit for 2003 could be conducted in 2007.

The taxpayer appealed against this decision. After considering this appeal, the higher-level tax authority changed the substantive and declarative provisions of the contested decision: it dismissed the appeal and also ordered the taxpayer to pay profit tax arrears for 2003.

The taxpayer challenged this decision in court. The court of first instance upheld the taxpayer's claim, stating that the tax authority had no right to rule in a way that aggravated the taxpayer's position when considering the taxpayer's appeal. The court of appeal upheld this court ruling.

However, the court of cassation quashed the rulings of the lower-instance courts and dismissed the lawsuit, citing the fact that a higher-level tax authority may, when considering a taxpayer's appeal, cancel or change the ruling of a lower-instance tax authority with respect to the part unrelated to the substance of the appeal.

The taxpayer filed an appeal with the Russian Supreme Arbitration Court.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The Presidium ruled in favour of the taxpayer.

According to the reporting judge, a higher-level tax authority issues a decision further to an appeal and not at its own initiative; therefore it has no right to issue a decision based on the results of the consideration of this appeal in a way that places the taxpayer in a worse position. The issue of a decision in a way that places the taxpayer in a worse position implies de facto the assumption of control functions over the activities of the lower-instance tax authority in breach of the procedure determined by legislation.

The reporting judge underlined that another approach would have established an impediment to the taxpayer's free expression of will when exercising its right to appeal against the decision issued in relation to the taxpayer. By way of substantiation of this conclusion, the judge referred to a similar position in legal literature. He also noted that under German legislation it was possible to aggravate a taxpayer's position in such a situation, but only if the taxpayer had been warned in advance by the tax authority about this adverse consequence and had been granted an opportunity to withdraw its appeal.

A representative of the tax authority objected to the position of three judges, who referred the case to the Presidium. He noted that the declarative provisions of the decision of the territorial tax authority stated that the tax had been underpaid and specified the amount of the underpayment and on this basis the higher-level tax authority had considered the appeal within the limits of the decision contested by the taxpayer.

However, the arguments of the tax authority's representative did not affect the result of the dispute resolution by the Presidium.

It is interesting to note here that O. Naumov, judge of the Russian Supreme Arbitration Court, stated in an interview to the newspaper "Ezh-Yurist" (No. 37, 2009) that in the past a higher-level tax authority could have rectified through its decision the errors committed by the tax inspectors, for example, errors related to the calculation of the arrears, and could have indicated the need to pay a larger amount of tax. Taking into account the aforementioned Resolution of the Presidium of the Russian Supreme Arbitration Court, a higher-level tax authority may no longer act as it had in

the past in such situations. O. Naumov held that in such situations it would be more correct for the tax authority to perform the following actions:

- either to correct the arithmetical error in accordance with the procedure enshrined in article 101 of the Russian Tax Code: to invite the taxpayer to consider this issue, to take its objections into account and to issue a decision that can be challenged. However, this right of the tax authority and mechanism for its implementation are not regulated by law. Consequently O. Naumov held that this issue should be adjusted in laws and that the tax authorities should receive such a right;
- or to report the error to the higher-level tax authority that will issue a decision to perform a repeat audit during which the error will be eliminated.

6 A fine imposed for failure to file a tax return that exceeds many times the underpayment of taxes under such a tax return may qualify as an attenuating circumstance (Resolution No. 11019/09 of the Presidium of the Russian Supreme Arbitration Court dated 8 December 2009)

CASE SUMMARY

Based on the results of a field tax audit (in 2006), it was established that the Company had failed to calculate and pay tax to the local budget for December 2003 on the resale of cars, computers and personal computers written off from the balance sheet and sold for a consideration. The tax arrears came to RUB 5,070,872.

The tax authority held the Company liable pursuant to clause 1, article 122 of the Russian Tax Code for non-payment of the tax and pursuant to clause 2, article 119 of the Russian Tax Code for failure to file a tax return for over 180 days. The total fine accrued under clause 2, article 119 of the Russian Tax Code amounted to RUB 14,705,528.80.

The Company filed a court appeal against the decision adopted by the tax authority, while the tax authority filed a claim for the collection of the fines. The case on the collection of fines was suspended during the consideration of the main dispute (the dispute was examined twice). As a result, the decision of the tax authority contested by the Company was recognised as lawful (in May 2008).

Subsequently, the Company declared in the case on the collection of fines that there were attenuating circumstances: the amount of the damage done and unintentional form of guilt, complicated financial and economic situation (2008) and its good faith nature when discharging tax liabilities, as well as the technical nature of the offence stipulated by article 119 of the Russian Tax Code. The Company requested that the court reduce the fine at least ten times.

The courts of all three instances, however, did not take into account the circumstances declared by the Company and ruled that the fine accrued by the tax authority should be collected.

The Company filed an appeal with the Russian Supreme Arbitration Court.

CONSIDERATION OF THE CASE BY THE RUSSIAN SUPREME ARBITRATION COURT

The case was referred for a new hearing.

The Presidium referred the case for a new hearing.

In the opinion of the panel of judges who referred the case to the Presidium, the lower courts, when considering the case, failed to take into consideration the fact that the total fine to be collected under clause 2, article 119 of the Russian Tax Code exceeded total tax liabilities many times. To all intents and purposes, this resulted in excessive restrictions on the freedom of enterprise for the Company, which is inadmissible by virtue of law.

In its Resolution the Presidium of the Russian Supreme Arbitration Court pointed out that according to the Russian Constitution and article 3 of the Russian Tax Code, a tax sanction should comply with the requirements of fairness and proportionality and differentiation of liability, depending on the gravity of the actions committed, size and nature of the damage done

Therefore, according to the highest court instance, when imposing liability according to clause 2, article 119 of the Russian Tax Code, the penalty imposed on the taxpayer should be determined by courts on the basis of the aforementioned principles and with due account of specific case circumstances. However, this penalty should not exceed in any case the liability for the failure to file (or delay in the filing of) a tax return.

During the hearing the taxpayer's representative drew the court's attention to the fact that the Company had erred in good faith about its obligation to pay the tax and accordingly, the obligation to file a tax return, for which reason it had contested the decision of the tax authority in court. The Company compensated for budget losses through payment of the fine for non-payment of the tax (clause 1, article 122 of the Russian Tax Code) and default interest.

In turn the representative of the tax authority stated that if the tax authority had not conducted a field tax audit, the tax would not have been paid and the unpaid amount would have been material for the local government (RUB 5,070,872). Moreover, the violation was revealed three years after it was committed.

The Presidium asked the representative of the tax authority which violation was more dangerous: failure to pay the tax or failure to file a tax return. The representative answered that it depended on the specific situation. There is a difference between situations when the tax return is filed with a delay and when the tax return is not filed at all and the tax is not paid (as in the case under review) and the tax authority identifies these facts. He compared the case examined by the Presidium with the offence stipulated by the Russian Law "On the Foundations of the Tax System in the Russian Federation" (invalid since 1 January 2005) – concealment of a tax item.

Moreover, he pointed out that the attenuating circumstances cited by the taxpayer had not been confirmed by supporting documents, which contravened the provisions of the Russian Arbitration Procedure Code in respect of the submission of evidence on court cases.

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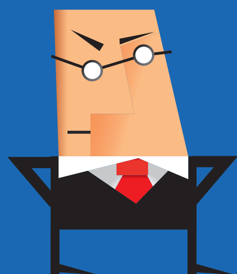

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