

# *The review of letters of the Ministry of Finance*

Issues № 20-21, December 2011

*Can taxes paid abroad be deducted in Russia?*

*Is property held for resale subject to property tax?*

*Liquidating construction in progress*

*What to expense - the cost of the construction project as a whole, or just the expenses for dismantling it?*

*Does offsetting shareholder's counter-claims against a capital contribution generate income?*

## Can taxes paid abroad be deducted in Russia?

Letter of the Ministry of Finance of the Russian Federation No. 03-03-06/1/715 of 3 November 2011

[1] In Resolution No 09АП-13190/2006-AK of 20 October 2010, the Ninth Arbitrazh Appellate Court explained that the Company's expenses representing mandatory payments (taxes and fees) and penalties paid by representative offices of the Company abroad meet the criteria listed in Article 252.1 of the Tax Code since they are related to the taxpayer's business. The inspectorate's argument that according to Article 264.1.1 of the Tax Code the income tax base should be reduced only by amounts of taxes and levies stipulated in Russian law is unfounded, since according to Article 264.1.49 of the Tax Code, the list of expenses related to production and sales is not exhaustive and may include other expenses related to manufacturing and/or sales.

## Is property held for resale subject to property tax?

Letter of the Ministry of Finance of the Russian Federation No 03-05-05-01/87 of 15 November 2011

[2] Clause 4 of Accounting Regulation "Fixed asset accounting" RAS 6/01, approved by Order of the Russian Ministry of Finance No. 26H on 30 March 2001, clause 2 of Regulation "Inventory accounting" RAS 5/01, approved by Order of the Russian Ministry of Finance No. 44H on 9 June 2001, and the Guidelines for applying the Chart of accounts to account for financial and economic activities of companies, approved by Order of the Russian Ministry of Finance No. 94H of 31 October 2000

## The Russian Finance Ministry's position

The Ministry of Finance (MinFin) considered the following situation: An LLC opened a representative office in Ukraine. The office performed a solely representative function, was financed entirely by the LLC and made payments to Ukrainian social funds from the salaries of its employees.

Referencing Article 264.1.1 of the Tax Code, the MinFin decided that mandatory deposits made by a Russian company to the social funds of a foreign government are not deductible for profits tax purposes in Russia.

### Comments

According to Article 311 "Elimination of double taxation" of the Russian Tax Code, income received by a Russian company from sources outside of Russia is taken into account when calculating the company's tax base. This income is taxed in full after deduction of expenses incurred both in Russia and abroad. When calculating the tax base, costs incurred by a Russian company due to income received from sources outside of Russia are deducted in amount established by Chapter 25 of the Russian Tax Code.

Under Article 264.1.1 of the Russian Tax Code, the taxpayer's other production and sales-related expenses include the following: 1) taxes and levies, customs duties and fees, insurance contributions to the Pension Fund of Russia for compulsory pension insurance, to the Russian Social

Insurance Fund for mandatory social insurance in case of temporary disability or motherhood, to the Mandatory Federal and Local Medical Insurance Funds for mandatory medical insurance, all duly accrued according to the laws of Russia, with exceptions listed in Article 270 of the Tax Code.

Furthermore, the list of deductible expenses is not exhaustive (Article 264.1.49 of the Tax Code). Also, taxes and insurance contributions that are paid in accordance with the laws of foreign states are not included in the list of non-deductible expenses (Article 270 of the Tax Code). So the law can be interpreted as allowing a reduction in taxable income by the amount of such expenses.

There are some examples in court practice where court confirmed the taxpayer's right to deduct tax expenses paid by a representative office located abroad from taxable income. However, in the absence of uniform enforcement and court practice on the issue, taxpayers will have to develop approaches for filing corresponding expenses on their own.

## The Russian Finance Ministry's position

The MinFin considered a situation where an LLC had purchased real estate for subsequent resale.

Having reviewed the relevant accounting standards, the MinFin concluded that the property is listed as a commodity on account 41 "Commodities", and so is not taxable property.

### Comments

According to Article 374.1 of the Tax Code, movable and immovable property of Russian companies recorded on the books as fixed assets in line with accounting procedures are considered taxable. Since under accounting regulations property held for resale is not considered a fixed asset, it is not subject to property tax.

To avoid any disputes with tax authorities we advise companies have documents confirming the intended sale of their property to support their tax position.

## Liquidating construction in progress

### What to expense - the cost of the construction project as a whole, or just the expenses for dismantling it?

Letter of the Ministry of Finance of the Russian Federation No 03-03-06/1/772 of 23 November 2011

## The Russian Finance Ministry's position

The Ministry of Finance (MinFin) points out that according to Article 265.1.8 of the Tax Code, expenses for liquidating construction in progress and other property which was never completely assembled (dismantling, disassembly expenses and costs of removing the dismantled property), for subsoil conservation and other similar work are deducted for tax purposes as non-operating expenses.

Further, the company's profits tax base is not reduced by the value of the liquidated construction in progress.

### Comments

The MinFin took a conservative stance on the issue. Article 265.1.8 of the Tax Code can be interpreted to allow expensing only the cost of liquidating the construction, and not of the value of the construction itself. Section 25 doesn't contain any other mention of liquidating construction in progress. There is only one other provision that permits expensing the value of a liquidated fixed asset (Article 265.1.8 of the Tax Code). What should you do in this situation?

Well, we know that the list of expenses that reduce taxable income is not exhaustive, i.e. any economically justified and documented expenses can be regarded as tax deductible, unless they are specifically listed as non-deductible. So taxpayers can argue as follows to support their exemption of these expenses:

The construction was intended for use in income-generating activities.

Circumstances changed and the construction needed to be liquidated for economic reasons.

The expenses in question are economically justifiable and so should be deducted for profits tax purposes.

Without a dedicated provision regulating this type of expense, a dispute with tax

authorities is a distinct possibility. Nevertheless, taxpayers can refer to court rulings in favour of taxpayers to support their argument. For example, Resolution of the Volga-Vyatka District Circuit FAC of 7 September 2010 in the matter of ZAO NP "Synthetic Leather Plant" addresses the issue of reporting the written-off value of liquidated construction in progress (the manufacturing facility) as non-operating expenses.

The cassation court agreed with the taxpayer pointing out that construction costs were incurred to obtain profit from the building's subsequent operation, and thus there are enough grounds for deducting its value. Tax authorities filed an application with the Russian Supreme Arbitrazh Court (SAC) to review the cassation court's ruling, but the SAC refused to pass the matter on to the Presidium.

In Ruling No. BAC-18063/10 of 20 January 2011, the SAC indicated that according to Articles 265.1.20 and 265.2 of the Tax Code, the list of non-operating expenses is not exhaustive. The deduction of the value of construction in progress corresponds to Article 265.1.8 of the Tax Code that permits reporting the net book value of a fixed asset as an expense in case of liquidation.

In Resolution of the Volga-Vyatka District Circuit FAC No. A28-11054/2006-320/2 of 3 September 2007 in favour of the taxpayers, the court noted that prohibiting the taxpayer from deducting the value of liquidated construction in progress as expense would put the taxpayer in an unequal position with respect to entities taking fixed assets out of operation and deducting them for tax purposes (Article 265.1.8 of the Tax Code). This contradicts the "equality of tax treatment" principle in Article 3 of the Tax Code.

In supporting their exemption of disputed expenses we recommend taxpayers refer to this pro-taxpayer court practice [1].

[1] The court practice on this issue is mixed. For other decisions in favour of the taxpayer: Resolution of the Urals Circuit of the Federal Arbitrazh Court No Ф09-3765/05-C7 of 31 August 2005, case No. A71-81/05, and in favour of the tax authorities: Resolution of the West-Siberian Circuit FAC No. Ф04-6485/2007(38369-A67-40) of 24 September 2007, case No. A67-7430/06, No. Ф04-883/2008(1734-A67-34), Ф04-883/2008(464-A67-34) of 12 March 2008, case No. A67-1857/07, and Resolution of the Urals Circuit FAC No. Ф09-866/07-C3 of 26 February 2007, case No. A76-7953/06.

**Does offsetting  
shareholder's counter-  
claims against a capital  
contribution generate  
income?**

*Letter of the Ministry of Finance of the  
Russian Federation 03-03-06/1/792  
of 1 December 2011*

***The Russian Finance Ministry's  
position***

The MinFin considered a situation when a new shareholder offsets his obligation to contribute to the charter capital with counter claims.

The MinFin cited civil law to confirm that the offset was allowed and then clarified: when monetary claims of members and/or third parties are offset against charter capital contributions, no taxable income is generated.

***Comments***

We agree with the MinFin's conclusion. We'd also like to add that Federal Law No. 409-FZ of 28 December 2010 added clause 3.4.1 into Article 251 of the Russian Tax Code, confirming that taxable income is not generated in this situation. According to this clause, the tax base will not include income in the form of property, property rights or non-property rights which were received from shareholders. This rule also applies to an increase of net assets that occurs simultaneously with a reduction or termination of obligations to the relevant shareholders. The new regulation applies to any relations that began after 1 January 2007.

# Contacts

**David John**

Partner  
Leader, Tax and Legal Services (TLS)  
david.c.john@ru.pwc.com

**Irina Martakova**

Partner, TLS CIP  
(Consumer and Industrial Products)  
irina.martakova@ru.pwc.com

**Denis Gorin**

Partner, TLS EU&M  
(Energy, Utilities and Mining)  
denis.gorin@ru.pwc.com

**Natalia Vozianova**

Partner, TLS TICE  
(Technology, Communication,  
Entertainment and Media)  
natalia.vozianova@ru.pwc.com

**Karina Khudenko**

Partner, Human Resource Consulting  
karina.khudenko@ru.pwc.com

**Natalia Kuznetsova**

Partner, International Tax Structuring  
natalia.kuznetsova@ru.pwc.com

**Ekaterina Lazorina**

Partner  
TLS Financial Services  
ekaterina.lazorina@ru.pwc.com

**Galina Naumenko**

Partner  
Mergers & Acquisitions Tax Services  
galina.naumenko@ru.pwc.com

**Vladimir Konstantinov**

Partner, Indirect  
Tax Services and Customs  
vladimir.konstantinov@ru.pwc.com

**Kirill Nikitin**

Partner, Tax Management  
and Accounting Services  
kirill.nikitin@ru.pwc.com

**Yana Zoloeva**

Partner  
Leader, Legal Practice  
yana.zoloeva@ru.pwc.com

**Svetlana Stroykova**

Director, Transfer Pricing  
svetlana.stroykova@ru.pwc.com