

New rules for deducting R&D expenses; Duma passes bill in first reading

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What's new?

On 15 January 2011, the Russian State Duma passed Bill No. 448864-5 in the first of three readings (here's a link to text of the Bill on the Duma website: <http://www.duma.gov.ru/faces/lawsearch/gointra.jsp?c=448864-5>). The Bill clarifies the rules for deducting R&D expenses for profits tax purposes.

The most significant changes include:

- ❖ the Bill establishes a list of specific R&D expense items;
- ❖ it introduces administrative control over expenses that are deducted using the 1.5 multiplier;
- ❖ it provides for the right to set up a tax accounting provision for future R&D expenses and sets the rules for calculating such provisions;
- ❖ it clarifies rules related to intangible assets resulting from R&D.

These changes are discussed in more detail below.

List of R&D expense items

The Bill establishes the following exhaustive list of R&D expenses:

- Depreciation of fixed and intangible assets (except for buildings and facilities) used in R&D, charged during a period defined as the number of full calendar months during which the relevant fixed and intangible assets were used exclusively for R&D purposes;
- Salaries of employees involved in R&D;
- Provided for material expenses directly associated with R&D;
- Other expenses directly associated with R&D that in total do not exceed 75% of the aforementioned salary expenses;
- Cost of work done under work performance contracts for taxpayers that are customers for R&D work;
- Contributions to the Russian Technology Development Fund and other industry and cross-industry funds for R&D financing created under the Federal Law "On Science and Governmental Research-and-Technology Policy" that in total do not exceed 1.5% of the income from sales determined under Russian Tax Code (RTC) Article 249.

Administrative control over expenses that are deducted using the 1.5 multiplier

Taxpayers that incur R&D expenses included on the Russian government list (see Russian Government Resolution No. 988 of 24 December 2008) are entitled to gradually include the actual amount of expenses multiplied by 1.5 under other expenses within one year starting from the first day of the month following the month in which R&D activity (or its separate stages) was completed. If the taxpayer exercises this right, it will need to file a special report with the tax authorities, along with the tax return for the tax period when the R&D was completed.

Such reports should be filed for each research and/or development project (or its separate stage) and must comply with the general requirements established by

the national standard format for scientific and technical reports. The tax authorities are entitled to obtain expert opinions on such reports. If the taxpayer fails to file a report, the actual expenses for research (development, or its separate stage) multiplied by 1.5 and included in other expenses shall be reinstated and included in the tax base under non-sale income in tax accounting.

The Explanatory Note to the Bill points out that the introduction of an exhaustive list of expenses and introduction of special R&D reporting (for R&D deducted with 1.5 multiplier) should help minimise tax avoidance.

Provision for future R&D expenses

The Bill entitles taxpayers to set up a provision for future R&D expenses. A provision for implementing each approved R&D programme may be set up for a period of no more than two years. The size of the established provision shall not exceed the size of planned expenses (budget estimate) for implementing an R&D programme that has been approved by the relevant taxpayer. The Bill provides a formula for calculating the maximum size of provision contributions. Expenses incurred will be written off using the established provision.

If the amount of the established provision is less than the amount of actual expenses, the difference shall be additionally deducted as an expense. The amount of a provision that is not completely used by the taxpayer within two years from the date when it was included in the provision shall be included in the non-sale income of the taxpayer of the current reporting (tax) period. The income shall be increased by interest calculated for the period of the provision based on an interest rate equal to double the Bank of Russia refinancing rate in effect on the date when the provision was set up.

Exclusive rights to intellectual property generated as a result of R&D

The proposed version of RTC Article 262 provides a detailed description of the tax treatment for those cases when a taxpayer is granted exclusive rights to intellectual property.

It is pointed out that R&D expenses that were previously included under other expenses shall not be reinstated and included in the initial value of the intangible asset (IA).

The R&D expenses deducted with the 1.5 multiplier shall be included in the initial value of the IA with the same 1.5 multiplier. That said, if the given IA is sold within five years after it was recognised, one third of the R&D expenses included in the IA's initial value with the 1.5 multiplier shall be reinstated and included in the tax base within the non-sale income in tax accounting.

Other changes

The Bill provides for a range of other changes. Among these, it proposes adding a new article to the RTC – Article 332-1 (Tax Accounting of R&D Expenses).

What you need to know at this stage

Before becoming law, the Bill must first pass the second and third readings in the State Duma, after which it goes to President Medvedev for his signature. The Duma may alter the current text of the Bill. If the Bill becomes law, it is likely that the new rules will take effect in 2012.

At this stage, we recommend that taxpayers actively engaged in R&D carefully assess the potential economic impact of the proposed new rules, such as the right to set up R&D provisions, and also look closely at the potential increase in administrative burdens (in case of deduction of R&D expenses with the 1.5 multiplier).

Contacts in Russia

David John

Partner, Russia Tax & Legal
Leader
david.c.john@ru.pwc.com

Ekaterina Lazorina

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

Denis Gorin

Partner, Energy, Utilities
and Mining
denis.gorin@ru.pwc.com

Irina Martakova

Partner, Consumer Industrial
Products
irina.martakova@ru.pwc.com

Natalia Milchakova

Partner, Technology InfoCom
Entertainment
natalia.milchakova@ru.pwc.com

Karina Khudenko

Partner, International
Assignments and HR Services
karina.khudenko@ru.pwc.com

Natalia Kuznetsova

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

Evgenia Veter

Director, Transfer Pricing
evgenia.veter@ru.pwc.com

Galina Naumenko

Partner, Mergers and
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

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