Korpus Prava

#1 / Winter, 2018

Analytics

Tax & Law Journal for Top Executives

Amendments in Legislation Enforced in 2018

Co-publisher

МГЮА

Korpus Prava

#1 / Winter, 2018

Analytics

Tax & Law Journal for Top Executives

Amendments in Legislation Enforced in 2018

Co-publisher

Московская государственная юридическая академия

МГЮА

Dear readers,

We are glad to welcome you in the pages of the winter edition of “Korpus Prava.Analytics”, which is traditionally dedicated to topical issues of the new year.

This new year has brought up a number of new issues, particularly in the sphere of taxation. Our auditor Svetlana Sviridenkova covers in her article those amendments, which apply to the majority of legal entities and individuals of the Russian Federation.

In recent years, the issue of foreign exchange legislation has always been the focal point of discussions. Thus, by the end of 2017, the State Duma received the draft law On Amendments to the Federal

Law on Foreign Exchange Regulation, which became effective from January 1, 2018. This event became a long-awaited present to thousands of Russian citizens residing abroad. The lawyer of Korpus Prava Private Wealth Tatiana Frolova gives in her article a detailed review of all new introductions to the foreign exchange regulation.

We traditionally follow not only the legislation of the Russian Federation, but also the one of other countries. This issue covers the latest news on the U. S. tax legislation.

2017 is often called the last year of tax schemes. Having reviewed all the latest changes, our specialists have agreed with this statement. Given the tendency of tax control strengthening, tax schemes

should be avoided. However, it does not prohibit taxpayers from applying special tax treatments and tax benefits. This issue covers all significant changes, which will influence business activities in 2018, and provides recommendations on business practices.

We hope these materials will be really beneficial to your business. We always welcome your feedback and comments. Happy and prosperous New Year!

Artem Paleev
Managing Partner
Korpus Prava


a hot stove

Itzik Amiel
Attorney-at-Law

Evgeniy Dridze
Department of Foreign Economic and International Relations, the city of Moscow, Head of Foreign Economic Activity

Konstantin Rizhkov
The Russian Direct Investment Fund, Director

Maxim Bunyakin
Branan Legal, Managing Director, Partner

Dmitriy Tizengolt
Bank Avangard, Head of Legal Department

Marketing and Advertisment

Julia Lubimova
Marketing Director, Korpus Prava

Phone: +7 495 644-31-23 (Russia)
E-mail: lubimova@korpusprava.com

Editorial's address:
Korobeynikov per., bld. 22, str. 3,
119034, Moscow, Russia

historical information. This information necessarily is provided for your reference only. We have no obligation to confirm and update any information in this magazine. You agree that it is your responsibility to monitor changes to the legislation ever mentioned in this magazine.

“Korpus Prava. Analytics” magazine 5 issues are published per year. The circulation depends on subscription.

The material, texts and analytics in this magazine is provided for general information only and should not be relied upon or used as the sole basis for making decisions without consulting primary, more accurate, more complete or more timely sources of information. Any reliance on the material in this magazine is at your own risk. This magazine may contain certain legal and historical information. This information necessarily is provided for your reference only. We have no obligation to confirm and update any information in this magazine. You agree that it is your responsibility to monitor changes to the legislation ever mentioned in this magazine.

“Korpus Prava. Analytics” magazine 5 issues are published per year. The circulation depends on subscription.

Korpus Prava
LAW & TAX

Each business requires reasonable and professional legal support:

- When signing agreements with the contractors
- When creating and maintaining the due document flow within the company
- When representing the company in relationships with third parties

Korpus Prava has been providing a wide range of services for more than 12 years, and tax and legal advice in regards with subscriber-based consulting service is taking up a considerable part of it.

We offer four most popular service packages:

Package "Basic"

Emergency service for your business

- Unlimited number of verbal consultations
- One written monthly opinion of any level of complexity

Package "Comprehensive"

Complete replacement of an in-house lawyer

- Unlimited number of verbal and written consultations
- Drafting and legal opinion on agreements and contracts

Package "Comprehensive+"

Complete replacement of an in-house lawyer+

- Unlimited number of verbal and written consultations
- Drafting and legal opinion on agreements and contracts
- Additional services (16 hours per month)

"Exclusive"

Legal department outsourcing

- Unlimited number of verbal and written consultations
- Drafting and legal opinion on agreements and contracts
- Additional services

Personal sense of responsibility for every decision made, and being ready to help the client in any situation are the key principles of our team of professionals.

+7 495 644 31 23 www.korpusprava.com russia@korpusprava.com

THE YELLOW HOUND BROUGHT SOMETHING ROUND!

Svetlana Sviridenkova

Auditor

Audit Practice

Korpus Prava (Russia)

The New Year brought numerous changes, particularly in taxation. Changes were introduced to various chapters of the Tax Code of the Russian Federation, i. e. Corporate Profit Tax, Personal Income Tax, Simplified Tax System, Insurance Premium, Property Tax and many others.

This article will cover those amendments that apply to the majority of legal entities and individuals in the Russian Federation.

Reintroduction of the personal property tax

According to Article 381.1 which was added to Chapter 30 of the Tax Code of the Russian Federation, the corporate property tax privilege applying to immovable property acquired after January 1, 2013

shall remain valid in 2018 provided such resolution is made on the regional level.

Clause 3.3 was added to Chapter 380 of the Tax Code of the Russian Federation, which states that tax rates determined by constituent entities of the Russian Federation regarding non tax-free immovable property shall not exceed 1.1% in 2018.

Regions shall determine for 2018 the availability of tax privileges as well as the tax rate in case of their absence.

The tax rate of 0% has been determined for Moscow and Moscow Region for the period from 2018 to 2020 regarding immovable property recorded as fixed assets since January 1, 2013, with known exceptions.

Given the estimation of the top rate in the Tax Code of the Russian Federation

solely for 2018, it is likely to be revised for 2019 and further years.

Children first!

Since 2018, the legislation has introduced new birth (adoption) allowances for the first and the second child for families with an average income not exceeding 1.5-multiple of the minimum living wage set out for the constituent entity of the Russian Federation. Families are subject to monthly allowances upon the birth (adoption) of a child after January 1, 2018.

Monthly allowances for the birth (adoption) of the first or the second child are estimated at the level of the living

wage for children set out for the constituent entity of the Russian Federation under Federal Law 134-ФЗ On the Lining Wage of the Russian Federation dated October 24, 1997 for the second quarter of the year preceding the year of application for the said allowances.

The living wage for children in Russia equals about 10 thousand roubles.

Moreover, in February 2018, birth allowances shall be adjusted according to 1.032 index.

In 2018, the allowances shall be as shown below.

Since 2018, the readjustment of child-related allowances shall take place on annual basis as of February 1.

Tax exemption for individuals and sole proprietors

On December 28, 2017, President of the Russian Federation signed the draft law which provides for tax authorities to charge off individuals' arrears in transportation tax, personal property tax, land tax, arising as of January 1, 2015, and fine debts imposed for the said arrears.

Moreover, debts of sole proprietors in pro se insurance premiums accrued before January 1, 2017 shall be charged off.

The tax authority shall make a resolution on the debt charge-off based on the debt data of individuals and sole proprietors.

The Federal Tax Service has always been the administrator for personal tax

debts, but it's been only last year that non-budgetary funds transferred data on insurance premiums to the Federal Tax Service. Meanwhile, the data transfer on incurred and paid insurance premiums (particularly on legal entities) was performed incorrectly. Numerous long paid debts were disclosed, and data on payments and on 2016 returns were lost in the process.

Type of allowance	**Amount, RUB**
One-time birth allowance	16,873.54
Minimum monthly child care allowance for the first child	3,163.79
Minimum monthly child care allowance for the second child and further children	6,327.57
One-time allowance for early pregnancy registration	632.76

Given last year precedents of incorrect data registration on insurance payments, sole proprietors with debts shall check with their tax authorities in advance in order to fully charge off their debt.

No interest? Here you go!

Since June 1, 2018, unless a loan agreement directly states that a loan is interest-free, interest is charged at the current key rate of the Bank of Russia as of the interest period.

The said provisions were added to Article 809 of the Civil Code of the Russian Federation. Now the absence of interest mentioning in the agreement does not qualify it as a reason for not charging it.

A special warning has also been introduced regarding interest overestimation for legal entity lenders that do not provide consumer loans on a professional basis. The amount of loan interest under a loan agreement between individuals or a legal entity and an individual, which twice or more times exceeds the standard interest charged in similar cases, and therefore, is too burdensome for a debtor, may be cut by the court order down to the interest amount chargeable in comparable circumstances.

Additional insurance premium deferrals for sole proprietors

Additional insurance premiums on compulsory pension insurance shall be paid

by sole proprietors in case their annual income exceeds 300,000 roubles at the rate 1% of the excess amount.

Earlier, the due date for additional premium payments was set until April 1 of the year following the reporting period. From additional premium payments for 2017 the due date is set until July 1, 2018.

The said changes do not provide more time to calculate the amount, as the due date for tax filing under the simplified tax system (the most common tax system among sole proprietors) is still April 30. The said provision shall solely provide deferrals for insurance premium payments based on the actual income received.

Be careful when filing in ‘Calculation of insurance premium’

The Federal Tax Service continues to stiffen the filling procedure for the calculation of insurance premium and sanctions for its violation. Once again, payers of insurance premium will have to file a new form for 2017.

The due filing date of the calculation of insurance premium shall remain unchanged, i.e. until January 30, 2018.

Tax authorities shall not accept the calculation of insurance premium, if they reveal discrepancies between section 1 (consolidated data on accruals) and section 3 (personalized data).

Last year tax authorities accepted calculations of insurance premium with

the said discrepancies and demanded to file a revised calculation. In 2018, such discrepancies will serve as a reason for refusal and penalty charging, unless a payer of insurance premium files the correct calculation in due time.

In addition to that, the maximum amount of personal income chargeable at the standard rate in 2018 shall amount to:

- 815,000 roubles for insurance premium on social security;
- 1,021,000 roubles for insurance premium on compulsory pension insurance.

Maximum limits for insurance premium on compulsory medical insurance have not been determined yet.

Personal financial benefit: income or not?

The Tax Code was amended regarding tax burdens on personal income in the form of financial benefits from interest savings.

Since January 1, 2018, taxes on financial benefits from interest savings shall be charged only in cases:

- the income is received from an affiliated company (sole proprietor) or an employer;
- the income is in the form of a financial aid or reciprocal performance of obligations to an individual;

Moreover, since January 1, 2018, if the company remits the individual of the debt, he/she acquires the income (financial benefit) in the form of the

remitted debt, provided the company is affiliated with the individual.

If there is no evidence of affiliation, there is no income chargeable with the personal income tax.

VAT: separate without limits

Up until the new year, the obligation of separate accounting was imposed on those taxpayers which operating VAT-free expenses exceed 5% of the total expenses.

Since 2018, separate accounting is obligatory for all taxpayers performing either VAT activities or VAT-free activities. The rule of 5% shall be eliminated.

However, the right to accept VAT deductions on tax-free activities within 5% shall remain.

Thus, the said amendments complicate accounting, but do not aggravate tax burdens.

Happy New Year and happy new report!

Until March 1, 2018 all employers have to file a new SZV-STAZH (СЗВ-СТАЖ) report to the Pension Fund of the Russian Federation on the pensionable service of its employees.

Insurers fill in and file SZV-STAZH on all insured persons that are engaged in labour relations with the insurer or have entered into civil law contracts with it regarding work performance.

The report shall contain the data on all its employees, period of employment in the reporting period, grounds for preferential service and other data.

Moreover, since January 1, 2018, new tax return forms on transportation and land taxes are introduced. The tax return on the land tax has undergone no significant changes.

The new tax return on the transportation tax shall contain the following additional data:

- registration date of the vehicle;
- deregistration date of the vehicle;
- vehicle manufacture year;
- tax deduction code;
- tax deduction amount (RUB).

The due filing date of tax returns on transportation and land taxes has remained unchanged, i. e. until February 1, 2018. A

ALL QUIET ON THE WESTERN FRONT?!?

Tatyana Frolova
Leading Lawyer
Korpus Prava Private Wealth

The foreign exchange legislation of the Russian Federation has always been strict and imperative, but up until 2014 no one really cared about compliance with it. After amendments to the administrative code of the Russian Federation were introduced specifying that any fine for an illegal foreign exchange transaction equals to the amount of this transaction, many fellow citizens, particularly the ones living abroad, were put under threat of losing all their bank assets.

The issue of reforming the foreign exchange legislation was discussed not only in the Russian Federation. Upon signing bilateral agreements as part of automatic tax data exchange, certain countries noted that Russian foreign exchange legislation was too strict in terms of sanctions for its violation.

In autumn, potential changes began to shape up, and by the end of the year the State Duma received the draft law On Amendments to the Federal Law on Foreign Exchange Regulation.

The key interest of these amendments was the status of the foreign exchange resident and the expanded list of authorized foreign exchange transactions.

The legislator has lived up to expectations. Prior to amendments, foreign exchange residents of the Russian Federation were all citizens of the Russian Federation and foreign citizens permanently residing in the Russian Federation with the residence permit (one year and more). The exceptions were citizens of the Russian Federation who continuously resided abroad for at least 1 year. The condition of continuity was breached as

soon as the resident entered the territory of Russia even for one day.

Pursuant to the introduced amendments, foreign exchange residents shall be all citizens of the Russian Federation, however, certain exceptions were made for citizens residing outside Russia for more than 183 days in a calendar year.

Thus, citizens of the Russian Federation residing outside Russia for more than 183 days in a calendar year shall be exempted from the obligation to file notices on opening an account at the bank outside the Russian Federation, and they shall not report on the activity of such accounts.

Therefore, foreign exchange residence in its simplified form is defined by the rules of tax residence. Citizens of the Russian Federation will be able to determine their category of foreign exchange

residence only in the second half of the year, provided they resided abroad during the first half of the year.

In order to avoid any unpleasant surprises the legislator introduced the following exception: if a resident individual fails to file a notice on opening an account and fails to file a report on the activity of the account at the bank outside the Russian Federation, and his/her period of stay outside Russia for the past calendar year amounts to 183 days and less, he/she shall:

- notify tax authorities where he/she is registered on opening (closing, detail changing) of his/her foreign currency accounts (deposits) and/or Russian currency accounts (deposits) at the banks outside the Russian Federation until June 1 of the calendar year following such past calendar year;

- file reports on the activity of accounts (deposits) at the banks outside the Russian Federation to tax authorities where he/she is registered.

An additional bonus for foreign exchange residents residing outside the Russian Federation for more than 183 days is elimination of foreign exchange transactions made between such residents outside the Russian Federation from the list of banned transactions.

Therefore, the foreign exchange legislation now includes two categories of residents:

- ordinary foreign exchange residents, i. e. citizens of the Russian Federation residing in Russia for most part of the year,

- ‘light’ foreign exchange residents, i. e. citizens of the Russian Federation, who will not qualify as tax residents by the end of the calendar year.

However, one should remember that the list of income foreign exchange residents are allowed to get on their accounts at the banks outside the Russian Federation are identical for ordinary and ‘light’ residents.

The list of authorized transactions now includes two types of income allowable for foreign accounts. Thus, no violation of the foreign exchange legislation shall ensue from depositing:

- monetary funds received by a resident individual from a non-resident after selling a vehicle owned by a resident individual outside the Russian Federation by a resident indi-

vidual to a non-resident under a sale and purchase agreement;

- monetary funds received by a resident individual from a non-resident after selling real estate owned by a resident individual outside the Russian Federation by a resident individual to a non-resident under a real estate sale and purchase agreement, provided such real estate is registered (located) on the territory of a foreign OECD or FATF member country, and such country has joined the multilateral Agreement of Competent Authorities on the Automatic Exchange of Financial Information dated 29.10.2014, or has entered into a different international agreement with the Russian Federation, which provides for the automatic exchange of financial information, and the ac-

count (deposit) of a resident individual is opened at the bank located in the territory of this foreign country.

THE NEW REVISED LAW SPECIFIES THAT RESIDENTS SHALL BE ENTITLED TO CREDIT THEIR FOREIGN ACCOUNTS (DEPOSITS) WITH THE FUNDS FROM THEIR ACCOUNTS (DEPOSITS) AT AUTHORIZED BANKS OR OTHER FOREIGN ACCOUNTS (DEPOSITS)

Besides, foreign exchange residents are entitled to get the amounts of taxes compensated by the competent authorities of such resident's countries of stay to their foreign accounts.

Now foreign exchange residents are entitled to conduct foreign exchange transactions using funds credited to foreign accounts (deposits) without limitations pursuant to the foreign exchange legislation. Prior to amendments, it was applicable only to funds non-related to the property transfer or service provision in the territory of the Russian Federation.

The new revised law specifies that residents shall be entitled to credit their foreign accounts (deposits) with the funds from their accounts (deposits) at authorized banks or other foreign accounts (deposits).

The new revised law determines tax authorities for filing notices and other foreign exchange regulation documents.

Thus, for individuals it shall be the tax authority at the place of residence (place of stay in the absence of the place of residence in the territory of the Russian Federation), and in case a resident individual has no place of residence (place of stay) in the territory of the Russian Federation - the tax authority at the location of the real estate owned by him/her (in case of several real estate facilities — the tax authority at the location of one of real estate facilities owned by him/her at the resident's choice).

In case a resident individual has no place of residence (place of stay), real estate in the territory of the Russian Federation, notices on opening (closing) accounts (deposits) and changing details

of accounts (deposits) at the banks outside the Russian Federation shall be filed to the tax authority determined by the federal executive authority responsible for tax and levy control and supervision.

The obligation to file a notice to the tax authority on opening an account (deposit) upon the first transfer of monetary funds to an account at the bank outside the Russian Federation with the mark of notice acceptance has been canceled for foreign exchange resident individuals.

For the purposes of foreign exchange regulation, banks acting as foreign exchange agents instead of documents confirming permanent residence of individual citizens of the Russian Federation in the foreign country under its jurisdiction shall request documents confirming facts of stay outside the Russian Federa-

tion, and documents confirming entering and/or leaving the Russian Federation.

The law shall come into force on January 1, 2018. The simplified foreign exchange regulation regime shall apply to 'light' foreign exchange residents following the results of 2017.

The law was adopted at the end of December and became a long-awaited present to thousands of Russian citizens residing abroad. However, it is time and law application practice by regulatory authorities that will show whether the new revised foreign exchange law facilitates compliance with requirements and restrictions of the foreign exchange legislation. A

IT'S BETTER TO AVOID BIG TROUBLES THAN ENJOY SMALL BENEFITS

Anna Senchenko

Leading Lawyer

Tax and Legal Practice

Korpus Prava (Russia)

The definition of the term tax advantage was given by Resolution of the Supreme Arbitration Court Plenum of the Russian Federation No. 53 On the validity estimation of tax advantages granted to taxpayers by arbitration courts (hereinafter — Plenum Resolution No. 53) dated 12.10.2006. The tax advantage is defined as the reduction of the tax burden due to tax base reductions, granted tax deductions, tax benefits, application of lower tax rates, and the granted right for tax refund (credit) or tax reimbursement from the budget.

Meanwhile, tax legislation provisions do not limit the taxpayers' right to conduct their business transactions so that tax effects turn out to be minimal. However, in letter No. ЕД-4-9/22123@ dated 31.10.2017, the Ministry of Finance of the Russian Federation specified that

the chosen deal (transaction) type should not demonstrate signs of meaningless artificiality. Besides, tax authorities shall not enforce taxpayers to choose this or that type of business transactions. Therefore, the presumption principle of taxpayer's good faith shall remain as the crucial element of the constitutional legal regulative regime of tax relations and public order.

Therefore, it is important to delineate between tax planning, which allows taxpayers to get legal tax advantages, and 'aggressive' tools of tax optimization.

In letter No. ЕД-4-9/22123@ dated 31.10.2017, the Ministry of Finance of the Russian Federation states that article 54.1 of the Tax Code of the Russian Federation introduced by Law No. 163-ФЗ is aimed at the prohibition of 'aggressive' tools of tax optimization. By letter No. CA-4-

7/16152@ dated 16.08.2017 the Federal Tax Service of Russia made tax authorities avoid formalistic approach towards the estimation of tax advantages.

Article 54.1 of the Tax Code of the Russian Federation is not a codification of regulations set out in Plenum Resolution No. 53, but a new problem-solving approach to the abuse of rights by taxpayers, which considers major aspects of the formed legal practice.

The said norm defines actual conditions, which prevent tax schemes aimed at illegal reductions of tax liabilities, including the failure to account taxable items, unlawfully claimed benefits, etc.

The main aspect of changes is as follows: the legislator specifies taxpayer's actions qualified as the abuse of rights, and obligatory conditions for taxpayers to get an opportunity to account their

expenses and claim tax deductions for conducted deals (transactions).

Thus, clause 1 article 54.1 of the Tax Code of the Russian Federation bans the reduction of the tax base and/or the payable tax by taxpayers following the misrepresentation of business activities (combination of such activities), taxable items subject to recognition in tax and/or accounting records or taxpayer's tax returns. Typical examples of such 'misrepresentation' are:

- development of a split-up business scheme aimed at the illegal application of special taxation treatments;
- actions aimed at the artificial development of conditions for the application of lowered tax rates, tax benefits, tax exemption;

- development of a scheme aimed at the illegal application of international double taxation agreements;
- unrealistic terms of deal (transaction) performance by the parties (absence of its performance).

Misrepresentation of taxable items subject to qualification under clause 1 article 54.1 of the Tax Code of the Russian Federation includes:

- failure to record income (revenue) from goods (works, services, titles) sales, including through engagement of controlled entities into business activities;
- registration of deliberately inadequate information on taxable items in registers of tax and accounting records by a taxpayer.

Thus, in order to apply clause 1 article 54.1 of the Tax Code of the Russian Federation, tax authorities shall prove the combination of the following circumstances:

- essence of misrepresentation (i. e. actual facts of misrepresentation);
- causal connection between taxpayer's actions and misrepresentation;
- deliberate nature of taxpayer's actions (its officials) resulting in deliberate misrepresentation of business activities (combination of such activities), taxable items subject to registration in tax and/or accounting records or taxpayer's tax returns aiming to reduce the tax base and/or the payable tax by a taxpayer;

- budget losses.

Deliberate nature of taxpayer's actions may be confirmed by established facts of legal, economic and other submission to control, including mutual dependence of disputing counterparties, to a taxpayer under examination, established facts of transactions between interdependent or affiliated participants of interrelated business transactions, including via agents, using special payment methods and payment terms, and evidences of action coordination between business participants, etc.

By letter No. ЕД-4-2/13650@ dated 13.07.2017, the Ministry of Finance introduced guidance notes on substantiating evidences of willful intent in actions of taxpayer's officials aimed at tax (levy) evasion during tax and procedural inspections.

The practice reveals the following tax evasion schemes:

1. The classic tax evasion scheme is conducting fictitious deals in order to increase the cost of goods (services), increase expenditures or decrease income, i. e. selling goods at lowered cost (economically unreasonable deals). Dishonest taxpayers may conduct fictitious deals either with a short-lived company or an affiliated company.
2. Splitting-up business in order to apply special taxation treatments.

In order to minimize tax burdens, numerous taxpayers split their activities subject to certain limitations, which hinder their transfer to a simplified tax system, into several smaller ones, which are covered by a simplified tax system

or a tax system introducing the single tax on imputed income for certain types of activities. For example, one large shop is divided into separate departments of less than 150 m^2. Department heads are registered as entrepreneurs, and they process their sales through the single tax on imputed income, sale goods by getting their trading space in rent and entering into a surety agreement, for instance.

3. Unjustifiable application of tax benefits, lowered tax rates.
4. Thus, a taxpayer and other companies forming group A developed a relationship scheme on production asset leasing according thereto buildings, constructions, land plots, machinery and equipment required for car production are owned by a resident of the special economic zone, which pays 0% profit tax. LLC B

was created as a single controlled asset centre in order to accumulate significant funds in the form of rentals on the accounts of this company for their further abroad withdrawal in the form of dividends. Such structure of financial and operational activities provided lessees with an opportunity to recognize oversized rental charges as part of profit tax expenses and minimize tax revenues.

5. Substitution of civil law relations in order to gain tax advantages.

In order to reduce the tax base, many taxpayers substitute certain legal relations with others in their documents, therefore, during inspections, tax authorities are recommended to analyze agreement terms applying two integrated and interdependent procedures: analysis pursuant to civil and tax legal provisions

by disclosing a real deal based on actual facts.

The practice provides other tax evasion schemes by inaction, for example, deliberate failure to specify adjustment invoices when getting discounts from a supplier for reaching premium purchase limits, which are proved by comparing taxpayer's and supplier's tax returns, checking incoming correspondence, and questioning of accounting department employees.

Having regard to the above, one may say that tax authorities' work will be less formal and much more oriented on the essence (subject) and feasibility of the taxpayer's business. On the one hand, it has certain advantages, as one may expect the number of formal claims to drop; however, it is difficult to predict tax inspectors' line of reasoning, as the

Tax Code has no interpretation of the term unreasonable tax advantage. General guidelines for tax authorities in more details may be found in letter of the Ministry of Finance No. ЕД-4-2/13650@ dated 13.07.2017.

PRACTICAL APPLICATION OF SECTION V.I OF THE TAX CODE OF THE RUSSIAN FEDERATION: 2017 IN REVIEW

Olga Kuramshina
Leading Lawyer
Tax and Legal Practice
Korpus Prava (Russia)

Russian courts have finally formed their official opinion on the key issues regarding the application of section V.I of the Tax Code of the Russian Federation. Let us recall that pricing regulation norms for deals between interdependent persons came into force in 2012. In 2015 and 2016, several cases based on pricing regulation norms were already heard by arbitration courts, however, they mainly covered either rights of local tax authorities to apply provisions of transfer legislation when proving unjustified tax advantages, or conditions of qualifying parties as interdependent. But only now, when all transitional provisions and preferential amount limits become invalid, when tax inspections detected wrongdoers which had not filed notices on controlled transactions, and when taxpayers were

additionally charged with the profit tax on such transactions, when arbitration court procedures complied enough cases appealing against such judgments, there appeared an opportunity to systemize the legal practice for the most significant law provisions.

The year of 2017 began from a high-profile judgment in the case of a small refining company — Neftyanaya kompaniya Dulisma, CJSC. The Arbitration Court of Moscow passed the actual judgment in case No. A40-123426/2016 back in 2016, but the statement of reasons (consequently, all conclusions of the court hearing) dates January 27, 2017. The case hearing itself was of particular interest, as this case was the first to cover the application of transfer pricing methods. The judge did not even risk of hearing this case sitting alone. The unprecedent-

ed decision was to form the collegial body of three judges for the hearing. Besides, it was the tax inspection that initiated the revision of judgment legality, despite the fact that the taxpayer had withdrawn the claim and paid arrears. As a result, this case hearing was actually aimed at forming the legal precedent, and it is likely to be the first time when both tax authorities and the taxpayer were seeking the truth, rather than the case victory. You must agree that this case is truly unique.

Although the judgment in the case of Neftyanaya kompaniya Dulisma, CJSC was not appealed against in supreme bodies, it contains a number of conclusions which should be considered by taxpayers that conduct controlled transactions:

1. The Arbitration court confirmed the importance of the detailed execution of the notice on controlled transactions and preparation of transfer documents. In the said case, the taxpayer filed the notice, but did not specify the pricing method which it considered reasonable, and did not submit documents upon the request of the tax authority, therefore, the tax authority was entitled to choose the method and calculation criteria at its own discretion. Should the taxpayer have used the opportunity to specify the method in the notice or documents, the tax authority would have to prove the invalidity ofsuch method, and there are no guarantees that such dispute would have even arisen.

2. If taxpayers know that the transaction price corresponds to the market price, they shall ensure obtaining data on such comparable market prices on their own, and in case of failure, they shall choose a different pricing method. The court declined the taxpayer's arguments that the Federal Tax Service of Russia has to hold data on prices of comparable transactions conducted by small oil companies in the region, and accepted the price quotation according to the specialized analytical agency as the comparable price. By the way, the tax authority actually held and submitted data on prices of comparable transactions, which turned out to be significantly higher than those applied by the taxpayer.

While experts were reviewing every detail of the remarkable judgment, the Supreme Court was getting ready to take matters under control. Thus, in February, it prepared the Review of court hearings of cases regarding the application of particular provisions of section V.1 and article 269 of the Tax Code of the Russian Federation[1], which almost set the record straight. Here are some major conclusions made by the supreme judicial authority, which are to be complied with in the near future.

1. The Review is ratified by the Resolution of the Supreme Court Presidium of the Russian Federation dated 16.02.2017.

On the right of local tax authorities to control compliance with the regulation on transfer pricing

Pursuant to the general rule, local Federal Tax Service authorities are not entitled to control pricing of any transactions, whether they are controlled or not. The courts' case implying that tax inspections are entitled to check the accuracy of price application for non-controlled transactions during in-office and on-site tax audit has been deemed illegal.

There is one case when local tax authorities are legally entitled to control the compliance of pricing methods with market pricing guidelines, i.e. when income, profit, revenue shall be estimated

based on market prices pursuant to part two of the Tax Code. For that purpose, tax authorities shall apply provisions of section VI.

Although the incompliance of the price set by the taxpayer with the market level bears no evidence of gaining unreasonable tax advantages, the Presidium emphasized that repeated deviation of transaction prices from the market level may be regarded as one of the signs of gaining unreasonable tax advantages combined and interlinked with other circumstances, which revealed discrepancies between the transaction execution and the subject of the business transaction. In other words, such deviation of prices from the market 'corridor' is added to the list of reasons which may initiate on-site tax audit and raise doubts

about the economic viability of any given transaction.

On the effects interdependent persons have on economic results of controlled transactions

The Presidium also covered the following issue — the effect of interdependency of transaction parties on its results. The judges pointed out that although interdependency of parties leads to strengthening of control over transaction pricing, non-market prices do not always result from interdependency. Thus, a taxpayer that conducted a transaction with an interdependent person under non-market conditions is entitled to prove that it was conducted under other economic circumstances.

Besides, a taxpayer is entitled to justify the non-market price of one transaction by compensating terms of another controlled transaction. Therefore, although the system of compensating adjustments does not work, excess profit under another transaction among interdependent persons may become the reason for its inefficiency under a disputable transaction.

On the independent evaluation as the method of transfer pricing

Judges' rhetoric shows that the appraiser's report as the evidence of market value has long lost its importance. The Presidium recalled two cases where expert evaluation is allowed as the major data source on comparable market prices:

1. As the major data source used when comparing transaction terms, in case data on comparable transactions conducted by a taxpayer with non-interdependent persons and other data sources specified in clause 1 article 105.6 of the Tax Code are missing or deemed insufficient[2].
2. Instead of methods of income (profit, revenue) determination set out by chapter 14.3 of the Tax Code, in case a taxpayer conducted a one-off transaction, and the said methods do not allow to determine the price correspondence to the market level[3].

It is worth mentioning that upon determining a price of a controlled

2. Sub-clause 3, clause 2, article 105.6 of the Tax Code of the Russian Federation.
3. Clause 9, article 105.7 of the Tax Code of the Russian Federation.

transaction, taxpayers may not only use an actual method set out by the law, but also the combination of methods or the method at their own discretion, in order to make their case. Therefore, it is reasonable to apply the method of comparable profitability by completing its conclusions with an expert opinion when determining real estate prices upon making controlled purchase and sale or lease transactions.

In June, the legal community livened up again, as the Arbitration Court of Moscow passed the first favorable judgment in the case challenging the controlled transaction price under the provisions of section V.I of the Tax Code. This time round, dispute parties were much more authoritative, thus the case drew more attention. The claimant was Uralkali, PJSC, a large participant in the

Russian market and one of the largest taxpayers. By the judgment in case No. A40-29025/17 a different judge of the Moscow Arbitration Court, having no fear of hearing such a significant case sitting alone, fully recalled the decision of the Federal Tax Service on additional charges of lost profit due to the execution of the controlled transaction. This time round, the taxpayer performed all risk-minimizing actions, i.e. filed a notice on controlled transactions, prepared transfer documents and submitted them upon the request of the tax authority. The taxpayer proved that the applied pricing method was the method of comparable profitability, and the transaction party under analysis was a foreign company. Its profitability was compared to the profitability of companies carrying out identical activities abroad.

The pricing method suggested by the taxpayer was deemed compliant with the law, and the judgment was passed in its favor. However, the judgment did not stand in court of appeal, and the Ninth Arbitration Court of Appeal passed a new court order. The superior court decided that the priority pricing method could have been applied to the controlled transaction, i.e. the method of comparable market prices, because required data was available in price quotations of the price information agency Argus Media. It seems that taxpayer's representatives will find ways to prove their case in the court of cassation. The case is to be heard at the beginning of February, and its result is definitely worth waiting. A

STRENGTHENING OF TAX CONTROL

Igor Chaika

Managing Director

Audit Practice

Korpus Prava

2017 was abundant with conceptual approaches to tax control developed by tax authorities both for applicable approaches (methods) and for the introduction of execution limits to taxpayers' rights to apply methods of tax saving.

Limits to the execution of taxpayers' rights

Article 54.1 named Limits to the execution of rights to the calculation of the tax base and/or tax, duty, insurance contributions was added to Part 1 of the Tax Code of the Russian Federation.

The first paragraph of this article prohibits taxpayers to reduce the tax base and/or the payable tax due to misrepresentation of business activities, taxable

items subject to recognition in tax and/or accounting records or taxpayer's tax returns.

The legislator further states that taxpayers shall be entitled to reduce the tax base and/or the payable tax pursuant to the regulations of the relevant chapter of Part Two of this Code provided the following conditions are met simultaneously:

1. The main purpose of a deal (transaction) is not gaining tax non-payment (partial payment) and/or tax credit (refund);
2. A deal (transaction) obligation was performed by a person acting as the party of an agreement executed with a taxpayer and/or a person thereto a deal (transaction) obligation was transferred under an agreement or the law.

Signing of primary accounting records by an unidentified or unauthorized person, violation of the law on taxes and duties by a taxpayer's counterparty, possibilities of taxpayer's gaining the same economic results upon the execution of legal deals (transactions) may not be regarded as the sole reason for recognizing reduction of the tax base and/or the payable tax by a taxpayer as an illegal act.

Therefore, from August 19, 2017 on, tax authorities are not entitled to deny the right to reduce the tax base by detecting technical discrepancies in the execution of documents. Tax authorities have to prove that the major goal of a deal is tax non-payment (partial payment) and/or tax credit (refund).

Prior to article 54.1 of the Tax Code of the Russian Federation came to force, the joint collegium meeting of the

Federal Tax Service of Russia and the Investigative Committee of the Russian Federation on the issue of raising cooperation efficiency of tax and investigative authorities on tax crime detection and investigation took place and developed 'Guidelines on substantiating evidences of willful intent in actions of taxpayer's officials aimed at tax (duty) evasion during tax and procedural inspections' (Letter of the Federal Tax Service of Russia No. ЕД-4-2/13650@ dated 13.07.2017).

The tone of guidelines is quite aggressive. Particularly, they recommend the following: "evidence presented in a tax audit report should clearly show that a taxpayer's wrongdoing did not result from any discrepancies in accounting or tax records, but from deliberate and intentional actions by a taxpayer and its representatives.

Tax authorities are advised to follow the style adopted for indictments in criminal proceedings.

Common practice shows that generally tax authorities fully reconstruct tax crimes in details in their tax audit reports, clearly and explicitly describe methods and facts of tax evasion, but pay very little attention to memorable and express interpretation and verbal comments on a taxpayer's wrongdoing being a deliberate act. Tax authorities are advised to focus on such cases."

Guidelines give examples of illegal reductions of tax amounts and describe tax evasion schemes, which are worth revising. If you use one of the described examples, it is time to change something.

Final pages of guidelines have lists of questions, which have to be answered by the director and employees (by coun-

terparty's choice) on the procedure of agreement execution, inventory records. Try to answer them.

Therefore, we strongly suggest reading these guidelines and ensuing letter of the Federal Tax Service of Russia No. CA-4-7/16152@ dated 16.08.2017.

Identification of taxpayers' actual location at the registered address

At the end of 2017, tax authorities began to detect companies, which did not locate at their registered addresses. Should a company fail to locate where it is registered, a relevant entry on misrepresentation of the registered address is made to the Unified State Register of Legal Entities. As a result, a bank may freeze company's accounts, and it will

be unable to carry out its business until its reincorporation at the actual location address. Besides, the fact of entry on misrepresentation of the registered address itself may become a warning sign for counterparties and may cause partners' unwillingness to keep business relations with such a company. Thus, in case the actual location address of your company does not correspond with the registered address in incorporation documents and, consequently, in the Unified State Register of Legal Entities, we strongly suggest changing the registered address for the actual location address of your company. Tax authorities are likely to visit you after that in order to check whether your company is actually located at its reincorporation address.

Deviation of prices from the market level

Taxpayers sometimes lower selling prices and raise acquisition prices in order to minimize tax liabilities.

When may the deviation of transaction prices from the market level serve as the reason for additional tax charges?

Specialists from the Federal Tax Service of Russia answered this question in letter No. ЕД-4-13/23938@ dated 27.11.2017. Tax inspectors state that provisions of Section V.1 of the Tax Code regulate pricing procedures for transactions subject to tax control due to entering into transactions with interdependent persons. Unless specified in this section, tax authorities are not entitled to doubt the price of goods (works, services) set by transaction parties and recognized

upon tax charging during in-office and on-site tax audit inspections. However, repeated deviation of transaction prices from the market level may be regarded during in-office and on-site tax audit inspections as one of the signs of gaining unreasonable tax advantages combined and interlinked with other circumstances, which revealed discrepancies between the transaction execution and the subject of the business transaction. Specialists from the Federal Tax Service of Russia note that the said viewpoint is presented in clause 3 of the Review of court hearings of cases regarding the application of particular provisions of section V.1 and article 269 of the Tax Code of the Russian Federation ratified by the Supreme Court Presidium of the Russian Federation on 16.02.2017. It clarifies that repeated deviation of transaction prices from the

market level may be regarded as one of the signs of gaining unreasonable tax advantages combined and interlinked with other circumstances, which reveal discrepancies between the transaction execution and the subject of the business transaction

However, even less than twofold price deviations, but for 255 million roubles, are deemed as the sign of tax schemes (see Definition of the Supreme Court of the Russian Federation No. 301-КГ17-5808 dated 05.06.2017 in case No. А43-27884/2015).

Splitting-up business

Letter of the Federal Tax Service of Russia No. CA-4-7/15895@ dated 11.08.2017 On issuing the review of legal precedents on taxpayers appealing against non-

regulatory acts issued by tax authorities following the results of tax control procedures, which substantiated facts of gaining unreasonable tax advantages by formalistic business separation (split-up) and artificial operating revenue distribution among controlled interdependent persons is a guideline to follow, as is the abovementioned letter of the Federal Tax Service of Russia No. ЕД-4-2/13650@ dated 13.07.2017. It analyzes signs of action coordination between participants of business split-up schemes for the purposes of tax evasion. Such signs are as follows:

- business (industrial process) split-up takes place among several persons that apply special tax systems (the tax system introducing the single tax on imputed income for certain types of activities or the simplified

tax system) instead of computation and payment of VAT, corporate profit tax and corporate property tax by the principal participant which carries out actual activities;

- adoption of the business split-up scheme influenced business conditions and economic results of all participants of this scheme, including their tax liabilities, which decreased or hardly changed with the general expansion of all business activities;
- the taxpayer, its members, officials or persons with actual control over the scheme are beneficiaries of the business split-up scheme;
- scheme participants carry out similar economic activities;

- participants developed the scheme during a short period of time shortly before the expansion of production facilities and/or increase in the number of personnel;
- scheme participants bear expenses for each other;
- direct or indirect interdependency (affiliation) between the participants of the business split-up scheme (kinship relationship, membership in governing boards, subordination, etc.);
- formalistic rotation of personnel between scheme participants without changes in their official duties;
- controlled persons own no fixed or current assets, human assets;

- scheme participants use the same signs, identification, contacts, website, actual location addresses, premises (offices, storage and supply facilities, etc.), banks for opening and keeping settlement accounts, cash register equipment, access points, etc.;
- the sole supplier or buyer for one of the scheme participants is either the other scheme participant, or all scheme participants have the same suppliers and buyers;
- actual management over scheme participants is performed by the same persons;
- common for scheme participants services on bookkeeping, HR record management, recruitment, search for

suppliers and buyers and work with them, legal support, logistics, etc.;

- representation of arrangements with state authorities and other counter-parties (not involved in the business split-up scheme) is performed by the same persons;
- performance results, e.g. the number of personnel, occupied space and income amount, are close to limits restricting the right to apply special tax systems;
- taxpayer's accounting records, including newly established companies, may indicate decreasing production profitability and profit;
- distribution of suppliers and buyers between scheme participants on the basis of applied tax systems.

The letter gives examples from arbitration precedents, which were passed either in favour of tax authorities or otherwise on the admission of business split-up facts aiming at the reduction of payable taxes.

The abovementioned list of signs is not complete. It was composed by the Federal Tax Service based on the analysis of arbitration precedents. However, it would not hurt to check your business for the abovementioned business split-up signs, as they may be used to prove the reduction of payable taxes, according to the Federal Tax Service and judging from legal precedents.

Bank control

For a number of years, companies as well as individuals since 2017, have acknowl-

edged the significance of bank control, which includes thorough analysis of transactions conducted by bank clients and the amount of tax payments.

Letter of the Central bank of the Russian Federation No. 236-T dated 31.12.2014 instructed banks to control transit operation of their clients in order to prevent money laundering, financing of terrorism and other illegal intentions.

Transit operations may feature (simultaneously have) the following characteristics:

- crediting clients' accounts with money from numerous other residents coming from accounts opened at the banks of the Russian Federation with their further debiting;
- debiting accounts within two days from the day of money crediting;

- regularly conducted (generally, on a daily basis);
- conducted for a long period of time (generally, for at least three months);
- client's activities in terms thereof crediting and debiting are carried out entail no obligations for the account holder to pay taxes, or the tax burden is minimal;
- the account for the abovementioned transactions is either not used for tax payments or other obligatory payments to the budget of the Russian Federation, or those payments are insignificant compared to the scope of account holder's activities.

Letter of the Central bank of the Russian Federation No. 18-MP dated 21.07.2017 explains in details that if

a company pays less than 0.9% of the turnover on account, banks should check whether payments transferred through this company are transit or not. The Bank of Russia recommends considering the following additional characteristics of the clients that conduct the said operations:

- the account is not used for the payment of salaries to client's employees and associated payments of personal income tax and insurance contributions, or such payments do not correspond with the average number of client's employees and/or indicate the understatement of actual salary sizes (taxable base);
- payroll budget of client's employees is lower than the official living wage;

- the account is used to pay personal income tax, but is not used for insurance contributions;
- account balance is either null or insignificant compared to the scope of account transactions normally conducted by the client;
- reasons for payments made from the client's account do not correspond with the expenses typical for business entities that carry out activities specified by the client upon opening/keeping the account;
- there is no connection between the reasons for prevailing crediting of the client's account and reasons for its further debiting;
- there is an abrupt increase of turnover on the client's account, exceed-

ing maximum turnover to the one specified by the client upon opening (keeping) the account;

- the account is not used for payments in the current conduct of client's activities (e.g. rentals, utility payments, office expenses, etc.);
- the client's account is credited by counterparty buyers under contracts for goods and services with VAT deductions and almost fully debited by the client to counterparties for VAT-free items (transactions of goods sales, service provision, securing obligations, granting of loans, scrap sales). That notwithstanding, with similar business activities of other clients upon the specified structure of income and outcome payments, VAT amount payable should come

close to VAT amount recognized in credits for VAT transactions.

Upon detection of the said operations, the Central bank of the Russian Federation recommends to treat the client as a high-risk one and take further measures, e.g. exercise the right under the relevant online banking service agreement to decline the client's order for account (deposit) transactions signed by the analogue signature.

Furthermore, the letter gives a full list of the most typical dubious transactions, which is worth reading. It may help to avoid ending up among clients that conduct dubious transactions, as well as suspension of account transactions and a close attention from the Central bank of the Russian Federation.

Conclusion

2017 is often called the end year of tax schemes. Having reviewed the abovementioned, it seems fair. Unfortunately, the size of this article does not allow to provide a comprehensive description of tax control strengthening, but only point out the most significant indicators of this inevitable process. Given the tendency of tax control strengthening, tax schemes should be avoided. However, it does not prohibit taxpayers from applying special tax treatments and tax benefits. The point is for the major purpose of a transaction (number of transactions) not to be gaining tax advantages.

CRIMINAL LIABILITY FOR CRIMES IN THE SPHERE OF BUSINESS AND OTHER ECONOMIC ACTIVITIES

Diana Voroshilova

Lawyer Assistant

Tax and Legal Practice

Korpus Prava (Russia)

Under the current legislation, any crime is punished with the criminal liability. However, crimes pose different levels of danger to the community, e. g. some crimes endanger lives and well-being, and their consequences are often impossible to compensate, while others endanger state economic interests and assets, and damages imposed thereby may be compensated.

Due to the different nature of crimes, the Russian criminal legislation introduces article 76.1 of the Criminal Code of the Russian Federation on the exemption from criminal liability in cases of economic crimes.

It is deemed as a compromise norm, because it allows a wrongdoer to avoid criminal liability and get mitigation of punishment by performing post-criminal

actions aimed at the reparation of the damage done.

The said norm of the Criminal Code was introduced as part of the general concept of humanizing the criminal policy by Federal Law No. 420-ФЗ On amendments to the Criminal Code of the Russian Federation and certain legal acts of the Russian Federation dated 07.12.2011. Article 76.1 of the Criminal Code of the Russian Federation provides for the exemption of persons who committed an economic crime for the first time, provided the damage done by unlawful actions is reimbursed in full.

The demand for this norm existed long before its introduction, however, current events demonstrate its insufficiency. Thus, on December 13, 2017, the Federation Council discussed humanization of the criminal legislation and sug-

gested mitigation of sanctions for crimes of low-to-medium severity by compensation of pecuniary damage incurred by the offended. One also suggested decriminalization of business and economic crimes. For example, these are crimes committed through faults in carrying out economic activities, which pose no danger to the society.

Experts who made their reports on December 13 at the Federation Council analysed sentences under article 22 of the Criminal Code of the Russian Federation (economic crimes), article 159 of the Criminal Code of the Russian Federation (fraud), article 160 of the Criminal Code of the Russian Federation (embezzlement or squandering committed using official position) and discovered that in the majority of sentences entrepreneurs made mistakes which posed no danger to the

public, and consequently, there was no need in criminal punitive measures.

It should be noted that the step towards decriminalization of economic crimes was successfully taken in 2016, when the State Duma of the Russian Federation adopted the draft law on the partial decriminalization of economic crimes.

Such changes as the increase of the minimum damage for criminal case initiation on economic crimes were introduced, as these minimum levels have not changed since early 2000s and do not comply with current circumstances. Moreover, the minimum amount of unpaid taxes and levies for criminal case initiation on tax-related crimes was doubled, i. e. from 1.8 million to 2.7 million roubles. Certain amendments were introduced to the Criminal Procedure Code of the Russian Federation, which,

from the moment of arrest or house arrest, grant the suspect or the accused the right to unlimited in time and number meetings with their notaries for the execution of the power-of-attorney for the right of interest representation in the business sphere.

Due to the draft law, sanctions under part 4, article 180 of the Criminal Code of the Russian Federation for the illegal use of means of individualization for goods, works or services committed by a group of persons in collusion were mitigated.

The urgent demand for decriminalization of economic crimes is determined by the fact that these crimes are deemed as the daily bread for law enforcement authorities. At the moment, when a person chooses between the registration of an enterprise and illegal economic activities, he chooses the latter, as it is much more

difficult to be brought to justice for shady business activities, than in the situation when an entrepreneur is constantly monitored by law enforcement authorities. Consequently, decriminalization of economic crimes will allow inter alia cutting down corrupt practices of law enforcement authorities.

However, there is a different opinion on this issue. The analysis of legal precedents shows that accusing law enforcement authorities of undue pressure is not justified. For example, statistics show that for the last decade the number of business and other economic crimes decreased by 60%.

The number of registered economic crimes for 2005–2015

Year	2005	2008	2010	2012	2013	2014	2015
Number of crimes	73,251	80,743	57,162	34,405	27,388	26,737	29,789

The number of economic crime perpetrators whose criminal cases came to court also decreased by 61%.

The analysis of legal precedents allows to make a conclusion that the number of persons convicted for economic crimes decreased by 58.8%.

The analysis of legal precedents for identifying sentences in such cases makes it clear that judges pass sentences on quite a liberal basis. Thus, in 2015, only

The number of identified economic crime perpetrators whose criminal cases are taken to court for 2005–2015

Year	2005	2008	2010	2012	2013	2014	2015
Number of identified perpetrators	8,174	7,937	4,639	2,050	1,976	2,111	3,163

The number of persons convicted for economic crimes for 2005–2015

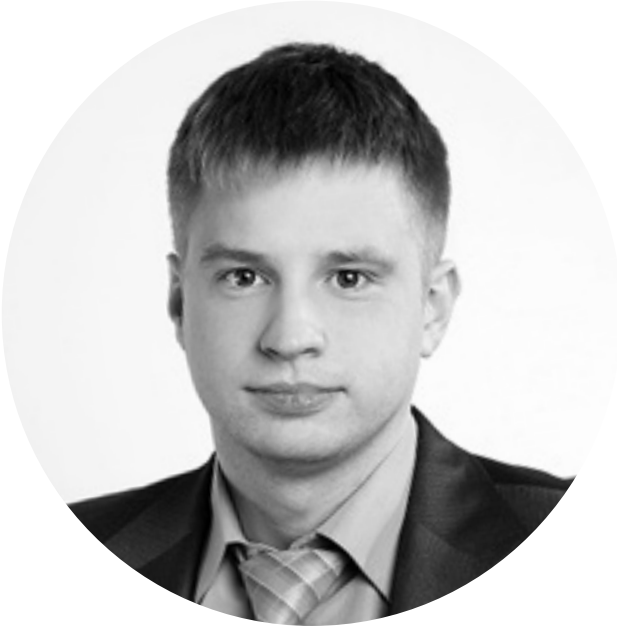
Year	2005	2008	2010	2012	2013	2014	2015
Number of the convicted	10,250	11,402	8,175	4,276	3,729	3,842	4,225

17% of the convicted for economic crimes were sentenced to imprisonment.

However, as noted above, the criminal legislation requires certain revision. It appears that there is a need for decriminalization of business and economic crimes.

At the moment, the Federation Council develops a new concept of the Russian criminal policy, so there is hope for humanization of the criminal legislation. A

ONE FOR ALL AND ALL FOR ONE: EXPLANATORY STATEMENTS OF THE SUPREME COURT ON THE MATTERS OF SUBSIDIARY LIABILITY OF PEOPLE WITH SIGNIFICANT CONTROL



Aleksey Oskin

Deputy Managing Director

Tax and Legal Practice

Korpus Prava (Russia)

At the end of the passing 2017 year, the Supreme Court of the Russian Federation held a plenary session and adopted Resolution of the Supreme Court of the Russian Federation Plenum No. 53 dated December 21, 2017 on the matters of subsidiary liability for people with significant control over the debtor upon bankruptcy.

In fact, it is the first and only Resolution of the Supreme Court of the Russian Federation Plenum on the matters of subsidiary liability for people with significant control over the debtor.

Given the development of an ambiguous legal practice and recent changes in the legislation on bankruptcy (regarding subsidiary liability for people with significant control), this resolution is particularly significant and long-awaited.

This article will cover key aspects and conclusions made by the Supreme Court in this resolution.

People with significant control over the debtor

Who shall be qualified as a person with significant control?

Pursuant to the general rule, a person shall be qualified as a person with significant control over the debtor provided they have an actual possibility to give binding instructions to the debtor or otherwise determine its actions.

The actual control is assumed (presumed until proven otherwise) in cases when a person is a director or a founder (member) holding more than 50% of the registered capital stock (shares).

However, one may have an actual control over the debtor regardless of technical signs of affiliation or their absence (through kinship or affinity with members of debtor's governing boards, direct or indirect participation in capital or management, etc.).

Technicalities (membership in governing boards, participation in the registered capital or kinship/affinity with the said persons) are not enough to be qualified as a person with significant control. The court shall determine the level of involvement in the control process over the debtor of the person subject to subsidiary liability by checking the significance of its influence on the adoption of material business decisions regarding debtor's activities.

Particularly, a person shall be qualified as a person with significant control

over the debtor, if deals which changed the economic and/or legal status of the debtor had been made under the influence of this person.

Besides, a person which profited from illegal behavior, including misbehavior, of the debtor's director may be declared a person with significant control. According to explanatory statements of the Supreme Court, such benefit involves the increase (saving) of assets. For instance, this may be the third party which acquired debtor's material asset (including via a chain of consecutive deals) which got out of the debtor's possession under the deal made by the debtor's director to the detriment of the company under its direction and its creditors (for example, on intentionally unbeneficial conditions or with a person unable to perform its obligations ("short-lived company", etc.) or using documents

that do not reflect actual business activities, etc.). Pursuant to the general rule, such beneficiary bears subsidiary liability with the debtor's director. Counter to the said presumption, a person subject to this liability shall be entitled to prove its good faith by confirming fee-based acquisition of the debtor's asset under the conditions typical for similar deals.

It's also assumed that a beneficiary shall be considered a person with significant control when it gained significant benefits from the business administration that is aimed at the reallocation (including via invalid documents) of the total income from the performance of these activities by persons with common interest (for example, united production and/or distribution cycle) for the benefit of these persons with a simultaneous accumulation of the main debt load on the debtor's

side. However, the beneficiary may prove its good faith (particularly, the fact that its profit-gaining transactions are recorded in accordance with their actual economic rationale, and that received benefits are justified by economic reasons).

Moreover, the list above is not complete.

Which period is taken into account when determining a person with significant control?

For the application purposes of special legal provisions on subsidiary liability, pursuant to the general rule, one shall consider the control that took place during the period preceding the actual appearance of bankruptcy signs, whether the actual financial situation of the debtor was disclosed or not, i. e. one shall consider a 3-year period preceding the

moment when the debtor was unable to fully satisfy creditors' demands.

Meanwhile, the said legal provisions do not exclude the possibility of holding a person with significant control liable for actions performed during the said 3-year period, for example, liabilities set out by the legislation on legal entities.

When powers of the sole executive body are transferred to a managing company

The Supreme Court explains that in case the debtor's director is a managing company, both the managing company and its director are supposed to be people with significant control over the debtor with joint subsidiary liability pursuant to the general rule, unless proven otherwise.

Will the issue of the power-of-attorney save from qualifying as a person with significant control?

A director that holds membership in legal entity boards, but performs no actual management (hereinafter, the nominal director) and, for example, fully delegated the management to another person under the power-of-attorney or made key decisions by order or upon express consent from a third party with no relevant powers (actual director), does not lose the status of a person with significant control, as such behavior does not mean losing its influence on the debtor and does not relieve the nominal director from performing obligations on choosing attorneys and controlling their actions (omission), as well as providing proper management of the legal entity.

In this case pursuant to the general rule, both nominal and actual directors shall bear joint subsidiary liability.

Possibility of mitigating the subsidiary liability

The burden of the nominal director's subsidiary liability may be mitigated, if he discloses information which was unavailable to independent economic agents, and therefore, helps to determine the actual director and/or the debtor's property or the actual director's property hidden by them, due to which creditors' demands may be satisfied.

Upon the matter consideration on the nominal director's subsidiary liability, the court has to take into account its assistance in information disclosure that ensured the restoration of violated credi-

tors' rights and reimbursement of their property losses.

In case of the mitigation of the nominal director's subsidiary liability, the actual director shall bear the full subsidiary liability. The nominal director shall be jointly and severally liable with the actual director to the non-mitigated extent.

Subsidiary liability for the failure to file (untimely filing) of the

debtor's application on its bankruptcy

Who is held liable for the failure to file a self-bankruptcy application to court in case of several directors?

If the debtor's incorporation documents state that several persons (directors) shall be given powers to act jointly or independently on behalf of the legal entity, pursuant to the general rule, the said persons shall jointly and severally bear the subsidiary liability.

The incorporation documents shall not give powers to appeal to court with the debtor's application on its bankruptcy only to one of its directors.

Upon which moment the director is obliged to appeal to court with

the debtor's application on self-bankruptcy?

The director's obligation to appeal to court with the debtor's application on its bankruptcy shall arise at the moment when a fair and reasonable director in similar circumstances pursuant to the basic management practice, considering the scope of debtor's activities, would objectively determine one of the conditions stipulated by the law (insolvency, property insufficiency, etc.).

If the director proves that the occurrence of the said circumstances itself bears no evidence of the objective bankruptcy, and that despite temporary financial difficulties, he expected in good faith to overcome them within a reasonable time and made best efforts to achieve this result by fulfilling an economically reasonable plan, such director may be

relieved from subsidiary liability for the period within which the fulfillment of his plan would be qualified as reasonable by an ordinary director in similar circumstances.

Is it required to prove a cause-and-effect link between the failure to file an application and the failure to satisfy creditors' demands?

It's presumed that there is a cause-and-effect link between the failure to file an application on bankruptcy by the debtor's director, liquidation committee, and the failure to satisfy creditors' demands, obligations to which arose during the expiration of the period for filing an application on bankruptcy.

Is it possible to hold the debtor's founder subsidiary liable for the

failure to file an application on self-bankruptcy by the debtor's director?

Upon the failure of the debtor's director to file the debtor's application on self-bankruptcy to court, the governing board responsible for settling the debtor's liquidation shall make the decision to appeal to court.

The person that does not qualify as the debtor's director, liquidator, and member of the liquidation committee may be held subsidiary liable (jointly with the director) for the failure to file (untimely filing) the debtor's application on its bankruptcy, given the following conditions:

- this person was a person with significant control, including through unproved presumptions on the control over the majority corporate

member (sub-clause 2, clause 4, article 61.10 of the Law on Bankruptcy), on the control of the beneficiary in the illegal deal (sub-clause 3, clause 4, article 61.10 of the Law on Bankruptcy), etc.;

- it could not know of the debtor's situation which resulted in its director, liquidation committee having an obligation to appeal to court with an application on bankruptcy, and on the failure to fulfill this obligation on their part;
- this person had powers to call the meeting of the debtor's collegial board responsible for the corporate decision on liquidation, or had powers to make the above decision on its own;

- it failed to properly perform actions aimed at calling the meeting of the debtor's collegial board to resolve on the matters of filing an application on bankruptcy to court or to make such a decision.

Who bears subsidiary liability upon the consequent change of directors that fail to perform their obligation on the appeal to court?

If several consequent directors fail their obligation to file an application on self-bankruptcy to court, the first of them shall bear subsidiary liability for the obligations arising during the time from the expiration of the monthly period set out for filing of such an application until the initiation of bankruptcy proceedings, and further directors — from the expiration of the month-extended reasonable period required to determine relevant cir-

cumstances being new directors as they are until the initiation of bankruptcy proceedings. Meanwhile, they are jointly and severally liable for any debtor's obligations arising during liability periods for several directors simultaneously.

Subsidiary liability for the failure to fully settle creditors' demands

Which actions of a person with significant control shall be considered as leading to the failure to settle creditors' demands?

The point at issue is such actions (omission) of a person with significant control which caused the debtor's bankruptcy, i. e. such actions, the absence of which would not lead to the objective bankruptcy (par-

ticularly, making key decisions violating good faith principles, including consent, making or approval of deals on intentionally unbeneficial conditions or with a person unable to perform its obligations ("short-lived company", etc.), giving instructions for making express profit-losing transactions, appointing managers that will clearly act against the interests of the managed company, creation and maintenance of the debtor's management system which is aimed at the systematic profiting of the third party to the damage of the debtor and its creditors, etc.)

The court shall estimate the effect of actions (omission) of a person with significant control on the debtor's situation by checking a cause-and-effect link between its actions (omission) and the occurrence of the actual objective bankruptcy.

However, as the legal entity activities are influenced by numerous deals and other transactions, pursuant to the general rule, the latest deal (transaction) initiated by a person with significant control, which critically changed the preexisting unfavorable financial state, i. e. appearance of objective bankruptcy signs, may not be considered the sole prerequisite for the bankruptcy.

Such actions also include those that took place after the objective bankruptcy and significantly aggravated the debtor's financial state.

When a person with significant control is not subject to subsidiary liability?

A person with significant control over the debtor is not subject to subsidiary liability in case its actions (omission) causing the adverse effect did not go beyond the

usual business risk and did not aim at the violation of rights and legal interests of the civil community of creditors (the so-called rule of business decision protection).

Besides, when proving absence of grounds for subsidiary liability, a person with significant control is entitled to refer to the fact that bankruptcy is caused by solely external factors (unfavorable market situation, financial crisis, significant changes of business conditions, emergencies, acts of God, other events, etc.).

In case the bankruptcy resulted from actions (omission) of a person with significant control, but besides the said actions (omission) some external factors (for example, illegal withdrawal of debtor's assets under the influence of a person with significant control and simultaneous damage of debtor's prod-

ucts by floods) also caused the increase of debt liabilities, the subsidiary liability may be mitigated pursuant to the second paragraph, clause 11, article 61.11 of the Law on Bankruptcy.

How do general procedures on indemnification (article 53.1 of the Civil Code of the Russian Federation) differentiate from special procedures on subsidiary liability?

According to the Supreme Court, in each particular case courts shall consider the significance of the adverse influence of a person with significant control on the debtor's activities by checking the change in the debtor's financial state under such influence, and tendencies of economic results typical for the debtor after such influence.

In case violations by a person with significant control were the direct cause of bankruptcy, provisions on subsidiary liability shall be applied, and pursuant to the general rule, its total amount shall be determined in accordance with the Law on Bankruptcy.

In case the damage caused by persons with significant control specified in article 53.1 of the Civil Code of the Russian Federation were reasonably expected not to cause the debtor's objective bankruptcy, such persons shall reimburse for any caused losses in the amount determined in accordance with article 15, 393 of the Civil Code of the Russian Federation.

How do several persons with significant control share their liability?

Pursuant to the general rule, if several persons with significant control acted jointly, they shall jointly bear subsidiary liability for causing the bankruptcy. When qualifying actions of persons with significant control over the debtor as joint, one may consider coherence, mutual coordination and orientation of these actions towards common goals, i. e. one may take into account engagement in any form, including joint participation, collusion, etc. Unless proven otherwise, it is presumed that actions of several affiliated persons with significant control are joint.

If several persons with significant control over the debtor acted independently and such independent actions were sufficient to cause the debtor's ob-

jective bankruptcy, the said persons shall also jointly bear subsidiary liability.

If several persons with significant control over the debtor acted independently and such independent actions were insufficient to cause the debtor's objective bankruptcy, but in total their actions caused such bankruptcy, such persons shall bear subsidiary liability on a pro rata basis. In this case the court shall divide the total subsidiary liability by determining the part of each person with significant control proportionate to the damage caused. Upon the failure to determine the damage caused due to particular transactions under the influence of any person, the part of each person with significant control may be determined proportionate to the period of their actual control over the debtor.

What are the conditions of holding the debtor's director subsidiary liable for the failure to submit documents to the official receiver?

When applying presumptions regarding the submission failure, concealment, loss or misrepresentation of documents for settlements of disputes on subsidiary liability, one shall consider the following.

The applicant shall provide explanatory statements to the court on the effect the document absence (absence of full information or misrepresentation) had on bankruptcy proceedings.

The person subject to liability shall be entitled to deny the said presumptions by proving that discrepancies in the documents submitted to the receiver caused no significant hindrance to bankruptcy proceedings, or by proving its absence of fault in the submission failure, improper

document keeping, particularly, by confirming that it took all reasonable efforts to fulfill its obligations on keeping, maintenance and submission of documents with all due care and diligence.

The significant hindrances to bankruptcy proceedings shall mean inter alia:

- the failure to determine the whole range of persons with significant control over the debtor, its major counterparties, and:
- the failure to determine debtor's core assets and to identify them;
- the failure to determine deals and their terms during the period of suspicion, which prevented from analyzing these deals and resolving on the necessity to impeach them in order to increase bankruptcy assets;

- the failure to estimate the content of resolutions adopted by the debtor's boards, which prevented from analyzing these resolutions for the purpose of discovering their damage to the debtor and creditors and revealing the potential possibility of loss recovery from the members of these boards.

In case of illegal actions by several consequent directors regarding keeping, maintenance and restoration of documents, it is presumed that their actions were sufficient to cause the debtor's objective bankruptcy.

Pursuant to the general rule, persons that are not qualified as persons with significant control, but are responsible for keeping and maintaining relevant documents (for example, chief accountant) shall jointly with the former

director bear subsidiary liability for causing the bankruptcy as joined parties, provided it is proved that they acted by order of the former director or performed joint actions therewith, which caused the destruction, concealment of documents or misrepresentation of data therein.

Conclusion

This article covers the most significant key explanatory statements of the Supreme Court on the matter under consideration. However, the Plenum Resolution contains other explanatory statements on interesting and urgent issues (the right-holder to file an application on subsidiary liability, application filing period, choice of cause of action/applications and other procedural aspects).

The adoption of the Plenum Resolution by the Supreme Court was logical, given the increased practice and recent changes in the legislation on bankruptcy, which specified procedures of subsidiary liability imposed on persons with significant control. Introduced changes to the legislation on bankruptcy supported by explanatory statements of the Supreme Court are supposed to encourage transparent business practices, decrease the number of short-lived companies and nominal service involved in business processes, and to ensure a more responsible approach to company management.

On the other side, adopted changes nearly eliminate the distinction between company assets and member/founder assets, which undoubtedly, require diligence and caution when making significant business decisions.

LET'S SEE THE COLOUR OF YOUR MONEY!

Roman Moskovskikh

Lawyer

Tax and Legal Practice

Korpus Prava (Russia)

Fast development of the Armed Forces of the Russian Federation in recent years would have been impossible without the systematic renewal of the existing outdated equipment, which, in turn, required multi-million state budget injections as part of the Armaments 2020 priority procurement program. The major aim of the Armaments 2020 priority procurement program is to bring the percent of advanced arms and military equipment in the Russian armed forces up to 70% by 2020. To that end, 20.7 trillion rubles are to be allocated, with 19 trillion rubles aimed at arming forces, air forces and naval forces. About 70% thereof will be spent on arms procurement, and the remaining 30% will be equally divided between research and development, and arms refurbishment. Three more trillion rubles are allocated

for the technical upgrade of military-industrial complex enterprises.

Considering the amount of investments, these conditions justify the intention of the government to ensure maximum control over the spending procedure of budget funds. Taking into account the specific nature of arms and military equipment procurement, at the end of 2012, Federal Law No. 275-ФЗ dated 29.12.2012 On state defense order came into effect.

The cornerstone of the legal act under consideration is the prescribed procedure for account settlements among interacting participants of goods supplies under the state defense order in assisted transactions (cooperation). The cooperation includes the chief provider entering into the government contract with the government customer, providers enter-

ing into contracts with the chief provider, and providers entering into contracts with providers.

As envisioned by the legislator, participants of the abovementioned chain starting from the chief provider to the last provider should open a separate account, i.e. an account for the chief provider, provider at the authorized bank for account settlements regarding the state defense order under the terms of the government contract. In fact, a separate account is an ordinary settlement account at the bank; however, spending arrangements thereof have significant restrictions.

Thus, arrangements for using a separate account include:

1. Debiting money only upon the government contract identification in the order.

2. Debiting money only for a separate account, except for debiting money for other cbank accounts in the following cases:

    - payment of taxes and duties, customs duties, insurance contributions and other obligatory budget payments of the Russian Federation, stipulated by the legislation of the Russian Federation;
    - payment of expenses on goods supplies, works performance, service provision as per prices (tariff rates) subject to government regulation (the list of such goods, works, services is approved by the Government of the Russian Federation);
    - transfer of profit in the amount approved by the parties upon

the execution of the contract and stipulated by its terms after performing the contract and delivering the goods acceptance and delivery certificate (work completion certificate, service delivery certificate) to the authorized bank;

- transfer of money by the chief provider upon the partial performance of the government contract; the government customer shall notify the authorized bank on the approved amount of profit subject to transfer by the chief provider upon the partial performance of the government contract (the notification procedure shall be determined by the government customer);

- account settlements with foreign providers participating in goods supplies under the state defense order and making part of cooperation in the assisted transaction;
- transfer of money in the amount approved by the parties upon the execution of the contract and aimed at reimbursement of the chief provider for expenses incurred at its own cost on the stock development of goods, raw material, material supplies, components required for the execution of the state defense order, as long as the chief provider proves the reasonability of actual expenses on such stock development;
- payment of expenses not exceeding five million roubles per month

by the chief provider and payment of expenses not exceeding three million roubles per month by the provider;

Simultaneously, the legislator banned a number of transactions, the list thereof is also stipulated by the law.

Analysis of the abovementioned provisions and the common practice of their application brings to conclusion that participants of the government procurement system for the execution of the state defense order do not still fully comprehend principles of working with a separate account.

Thus, particular attention should be given to the issue of settling expenses not exceeding five million rubles (for chief providers) and three million rubles (for providers) from a separate account every month. Regulatory authorities

formed a negative practice of bringing participants of the government procurement system to administrative liability for spending money from a separate account, including financing projects which are not directly related to the performance of obligations under the state defense order.

Such viewpoint of regulatory authorities seems quite unusual, given that neither regulations of part one, article 8.3 of Law No. 275-ФЗ On state defense order, nor other provisions of current regulatory acts state that payments of other expenses not exceeding three million rubles per month may be made solely in relation to the expenses on the state defense order. The abovementioned viewpoint was confirmed by Resolution of the Arbitration Court of Moscow Region No. Ф05-11366/2017 dated 15.08.2017

in case No. A40-125631/2016. Provisions of sub-clause "з", clause 2, part 1, article 8.3 of Law No. 275-ФЗ provide no list of other expenses. Consequently, such transactions may include all expenses related to current activities of an enterprise which are not directly mentioned in the list of permitted transactions (article 8.3, sub-clauses "а" to "з"), list of exemptions from banned transactions (article 8.4, clauses 2, 3, 9, 10), while still not being mentioned among banned transactions (article 8.4 of Law No. 275-ФЗ).

One more issue which is worth discussing is debiting a separate account for the purpose of reimbursement for expenses incurred earlier at one's own cost on the procurement of components to perform the contract.

Law provisions on the state defense order specify that the chief provider,

provider prior to the execution of the contract are entitled to make provisional procurements of raw material, material supplies, semi-finished products, components required for the execution of the state defense order.

At the stage of contract execution, according to clause 3, article 7.1 of Law No. 275-ФЗ, the chief provider, provider are entitled upon approval of the government customer (chief provider, provider) to add to the government contract, contract the condition on reimbursement for expenses incurred at one's own cost on the stock development required for the execution of the state defense order, as long as the chief provider, provider prove the reasonability of actual expenses on such stock development

The law determines different conditions for reimbursement transaction:

- for chief providers — transaction may be performed prior to the performance of the government contract;
- for providers manufacturing products with a long technological production cycle — transaction may be performed prior to the performance of the contract;
- for other providers — transaction may be performed only after the performance of the contract.

Reimbursement for expenses incurred at one's own cost (except for funds on separate accounts) on the stock development of raw material, material supplies, semi-finished products, components required for the execution of the state defense order, pursuant to sub-clauses "e", "e.1" and "e.2", clause 2, part 1, article 8.3 of Law No. 275-ФЗ, may

be performed by money transfer from a separate account to a different account of the company only after fulfilling the following conditions:

- for chief providers:
    - upon providing reasonability evidence of actual expenses on such stock development (i. e. specifying expenses incurred at one's own cost (except for funds on separate accounts) on stock development and subject to reimbursement from a separate account in the terms of the government contract);
    - upon notice receipt from the government customer by the authorized bank on the amount of actual expenses incurred by the chief provider on the said

stock development following the procedure set by the government customer.

- for providers manufacturing products with a long technological production cycle:
    - upon providing reasonability evidence of actual expenses on such stock development (i.e. specifying expenses incurred at one's own cost (except for funds on separate accounts) on stock development and subject to reimbursement from a separate account in the terms of the contract);
- for other providers, upon submission to the authorized bank:

- documents confirming the full performance of obligations under the contract;
- goods acceptance and delivery certificate (work completion certificate, service delivery certificate);
- reasonability evidence of actual expenses on such stock development (i. e. specifying expenses incurred at one's own cost, except for funds on separate accounts, on stock development and subject to reimbursement from a separate account in the terms of the contract).

Meanwhile, the amount of payments from a separate account on these grounds shall not exceed the amount of expenses

on stock development specified in the government contract, contract.

The chief provider, provider may prove reasonability of actual expenses at the execution stage of the government contract, contract.

In the absence of conditions on reimbursement for expenses on the stock development incurred earlier at one's own cost in the executed contract, reasonability evidence of such expenses may be specified in the additional agreement to the contract, appendix to the contract or through letter exchange, provided they contain references to the contract and form an integral part thereof.

It is important to point out that in case debiting from a separate account for the purposes of reimbursement for expenses incurred at the provider's cost after the performance of the contract

takes place as part of the additional agreement to the contract (or by signing of other documents which form an integral part of the contract), the transaction should be suspended pursuant to Directive of the Bank of Russia No. 3729-У dated 15.07.2015.

Analysis of the current practice of interpretation and application of regulations covering the performance of the state defense order points out the urgent need for official explanatory notes from the relevant regulatory authorities. There are cases when even one authority is unable to reach an agreement on the application of this or that legal provision. Without any doubt, the abovementioned has an adverse effect on compliance with the terms for the execution of the state defense order. There is one more issue to be considered, i. e. commer-

cial supplying enterprises under the state defense order lose their interest in such procurements, because they do not understand 'rules of the game'. Hopefully, in 2018, competent authorities are going to take all required measures to introduce uniform approaches to the execution of the state defense order. A

RATE REDUCTION AND DEDUCTION CUTDOWN: THE MOST SIGNIFICANT CHANGES IN THE U.S. TAX LEGISLATION INTRODUCED AT THE END OF 2017

Yana Dmitrieva

Paralegal

AmLaw Group PLLC

On December 20, 2017, Congress passed the Tax Cuts and Jobs Act of 2017 (TCJA), and President Trump shortly thereafter signed it. This law, most of which will become effective as soon as January 1, 2018, dramatically changes the tax environment of the United States. New financial planning strategies will emerge in the coming months and years.

The tax law signed just before Christmas was intended to make U. S. businesses more globally competitive. Its signature feature was a lowering of the corporate tax rate from 35 to 21 percent. While that and other features of the new law may positively impact the desirability of doing business in the United States, President Trump has a particular fascination with the trade deficit. The law changes so many things at once — from

corporate rates to a repatriation tax to different depreciation rules to new individual rates — that it is exceedingly difficult to give a precise prediction on what exactly will change and how the economy will react in the longer perspective. The introduced tax changes will affect everything from how corporate assets are financed to how business is structured.

Certainly, the biggest beneficiaries of this legislation are corporations with high effective tax rates, because the corporate rate is dropping from 35% to 21%. Certain pass-through businesses will also see major reductions. Some LLCs, partnerships, S Corps, and sole proprietors will be able to deduct 20% of their qualified business income. Essentially, they will be paying taxes on only 80% of their revenue.

The personal exemptions are going away for taxpayers starting 2018 reporting year. That means for a family of three or more, the benefit of the standard deduction is completely offset by the $4050 deduction it used to be able to take for each person on the return. In other words, if a taxpayer has two or more kids, you may actually be hurt by the new deduction/exemption amounts. On the other hand, in the bigger picture this tax experiment will run up the already high national debt by another $1.5 trillion.

Let's try to review the main changes introduced by the Act for each type of tax to get the idea of how these changes will affect individuals and corporations.

1. Income Taxes

- The Act keeps the seven income tax brackets but lowers tax rates. The US employees will see changes reflected in their withholding in February 2018 paychecks. These rates will revert to the 2017 rates in 2026.
  The Act creates the following chart. The income levels will rise each year with inflation. But they will rise more slowly than it was before since the Act uses the chained consumer price index. Over time that will move more people into higher tax brackets.
- The Act doubles the standard deduction. A single filer's deduction increases from $ 6 350 to $ 12 000. The deduction for Married and Joint Filers increases from $ 12 700 to $ 24 000.

- The Act eliminates personal exemptions. Before the Act, taxpayers subtracted $4150 from income for each person claimed. As a result, families with many children will pay higher taxes despite the Act's increased standard deductions.
- The Act eliminates most itemized deductions. That includes moving expenses, except for members of the military. Those paying alimony can no longer deduct it, while those receiving it can. This change begins in 2019 for divorces signed in 2018.
- It keeps deductions for charitable contributions, retirement savings, and student loan interest. It might be smart for the taxpayers to try to incur these expenses in 2017 if possible.

- It limits the deduction on mortgage interest to the first $ 750 000 of the loan. Interest on home equity lines of credit can no longer be deducted. Current mortgage-holders aren't affected.
- Taxpayers can deduct up to $ 10 000 in state and local taxes. They must choose between property taxes and income or sales taxes. This will harm taxpayers in high-tax states like New York and California. It is possible to prepay some of these taxes by the end of the year to deduct them in 2017.
- The Act expands the deduction for medical expenses for 2017 and 2018. It allows taxpayers to deduct medical expenses that are 7.5 percent or more of income. Before the bill, the cutoff was 10 percent for those born

after 1952. Seniors already had the 7.5 percent cutoff.

- The Act repeals the Obamacare tax on those without health insurance in 2019 (under current legislation the individuals who failed to buy health insurance plan were to pay a penalty). Without the mandate, the Congressional Budget Office estimates 13 million people would drop their health insurance plans. The government would save $ 338 billion by not having to pay their subsidies. But health care costs will rise because fewer people will get the preventive care needed to avoid expensive emergency room visits.
- The Act doubles the estate tax exemption to $ 11.2 million for singles and $ 22.4 million for couples. That

helps the top 1 percent of the population who pay it. These top 4 918 tax returns contribute $ 17 billion in taxes. The exemption reverts to pre-Act levels in 2026.

- It keeps the Alternative Minimum Tax. It increases the exemption from $ 54 300 to $ 70 300 for singles and from $ 84 500 to $ 109 400 for joint. The exemptions phase out at $ 500 000 for singles and $ 1 million for joint. The exemption reverts to pre-Act levels in 2026.

2. Child and Elder Care

- The Act increases the Child Tax Credit from $ 1 000 to $ 2 000. Even parents who don’t earn enough to pay taxes can claim the credit up to

$1400. It increases the income level from $110000 to $400000 for married tax filers.

- It allows parents to use 529 savings plans for tuition at private and religious K-12 schools. They can also use the funds for expenses for homeschooled students.
- It allows a $500 credit for each non-child dependent. The credit helps families caring for elderly parents.

3. Business Taxes

- The Act lowers the maximum corporate tax rate from 35 percent to 21 percent, the lowest since 1939. The United States has one of the highest rates in the world, but most corpora-

tions don't pay that much tax. On average, the effective rate is 18%.

- It raises the standard deduction to 20% for pass-through businesses. This deduction ends after 2025. Pass-through businesses include sole proprietorships, partnerships, limited liability companies, and S corporations. They also include real estate companies, hedge funds, and private equity funds. The deductions phase out for service professionals once their income reaches $ 157 500 for singles and $ 315 000 for joint filers.
- The Act limits corporations' ability to deduct interest expense to 30% of income. For the first four years, income is EBITDA, but reverts to earnings before interest and taxes thereafter. That makes it more expensive for

financial firms to borrow. Companies would be less likely to issue bonds and buy back their stock. Stock prices could fall. But the limit generates revenue to pay for other tax breaks.

- It allows businesses to deduct the cost of depreciable assets in one year instead of amortizing them over several years. It does not apply to real estate.
- The Act stiffens the requirements on carried interest profits. Carried interest is taxed at 23.8% instead of the top 39.6% income rate. Firms must hold assets for a year to qualify for the lower rate. The Act extends that requirement to three years. That might hurt hedge funds that tend to trade frequently. It would not affect private equity funds that hold

on to assets for around five years. The change would raise $ 1.2 billion in revenue.

- The Act eliminates the corporate AMT. The corporate AMT had a 20% tax rate that kicked in if tax credits pushed a firm's effective tax rate below that level. Under the AMT, companies could not deduct research and development spending or investments in low-income neighborhood. Elimination of the corporate AMT adds $ 40 billion to the deficit.
- It advocates a change from the current "worldwide" tax system to a "territorial" system. Under the worldwide system, multinationals are taxed on foreign income earned. They don't pay the tax until they bring the profits "home". As a result,

many corporations leave the profits overseas. Under the territorial system, they aren't taxed on that foreign profit. They would be more likely to reinvest it in the United States. This will benefit pharmaceutical and high-tech companies the most.

- The Act allows companies to repatriate the $2.6 trillion they hold in foreign cash stockpiles. They pay a one-time tax rate of 15.5% on cash and 8% on equipment.
- It allows oil drilling in the Arctic National Wildlife Refuge. That's estimated to add $1.1 billion in revenues over 10 years. But drilling in the refuge won't be profitable until oil prices are at least $70 a barrel.
- It retains tax credits for electric vehicles and wind farms.

- It cuts the deduction for orphan drug research from 50 percent to 25 percent. Orphan drugs target rare diseases.
- The Act cuts taxes on beer, wine, and liquor. The Brookings Institute estimates that will lead to 1 550 more alcohol-related deaths each year. The study found that lower alcohol prices are directly correlated to more purchases and a higher death toll.

As mentioned above, it is very difficult to predict the outcome of the new tax reform; however, it is possible at this point to estimate who will get the most affected by the introduced changes to the tax legislation. It's fair to say, that the new tax plan helps businesses more than individuals. Business tax cuts are permanent, while the individual cuts expire

Income Tax Rate		Income Levels for Those Filing As	
2017	**2018–2025**	**Single**	**Married-Joint**
10%	10%	$0–$9,525	$0–$19,050
15%	12%	$9 525–$38 700	$19 050–$77 400
25%	22%	$38 700–$82 500	$77 400–$165 000
28%	24%	$82 500–$157 500	$165 000–$315 000
33%	32%	$157 500–$200 000	$315 000–$400 000
33%–35%	35%	$200 000–$500 000	$400 000–$600 000
39.6%	37%	$500 000+	$600 000+

in 2025. Among individuals, it would help higher income families the most. The Act makes the U. S. progressive income tax more regressive. Tax rates are lowered for everyone, but they are lowered more for the highest-income taxpayers.

The Tax Foundation said those in the 20–80 percent income range would

receive a 1.7 percent increase in after-tax income. Those in the 95–99 percent range would receive a 2.2 percent increase. The Tax Policy Center broke it down a little more. Those in the lowest-earning fifth of the population would see their income increase by 0.4 percent. Those in the next highest fifth would receive a 1.2 percent boost. The next two quintiles would see their income increase 1.6 percent and 1.9 percent, respectively. But the biggest increase, 2.9 percent, would go to those in the top-earning fifth. The increase in the standard deduction would benefit 6 million taxpayers. That's 47.5 percent of all tax filers, according to Evercore ISI. But for many income brackets, that won't offset lost deductions. The Tax Foundation said the Act will add almost $448 billion to the deficit over the next 10 years. The tax

cuts themselves would cost $ 1.47 billion. But that's offset by $ 700 billion in growth and savings from eliminating the ACA mandate. The plan would boost GDP by 1.7 percent a year. It would create 339 000 jobs and add 1.5 percent to wages.

The impact on the $ 20 trillion national debt will eventually be higher than projected. A future Congress will probably extend the tax cuts that expire in 2025.

An increase in sovereign debt dampens economic growth in the long run. Investors see it as a tax increase on future generations. That's especially true if the ratio of debt to gross domestic product is near 77 percent. That's the tipping point, according to a study by the World Bank. It found that every percentage point of debt above this level costs the country 1.7 percent in growth.

Many large corporations confirmed they won't use the tax cuts to create jobs. Corporations are sitting on a record $2.3 trillion in cash reserves, double the level in 2001. The CEOs of Cisco, Pfizer, and Coca-Cola would instead use the extra cash to pay dividends to shareholders. In effect, the corporate tax cuts will boost stock prices, but won't create jobs.

Overall, the barrage of soundbites and testimonials from Congressional Republicans and the Trump administration that the tax reform is primarily about assistance to the middle class and job creation don't appear to correspond to reality. Wealthy individuals and corporations (in particular, multi-national ones) are almost certain to benefit first and foremost from the proposed changes. And given the restructuring of corporate tax rates, conventional corporations

(C corps) may in fact become the structure of choice, replacing the LLC as the preferred entity form. Given the complications and extensive changes in the new law, it will take an extended amount of time to determine its true effect on individuals, business structures, and the debt level of the U. S. government. However, given the experiences with past legislative efforts to amend the tax code (and ostensibly reduce the tax burden with the hope of spurring growth), there will likely be numerous unexpected consequences that no one can predict at this point in time.

Contacts

Korpus Prava (Russia)

Korobeynikov per., bld. 22, str. 3,
119034, Moscow, Russia
+7 (495) 644-31-23
russia@korpusprava.com

Korpus Prava (Cyprus)

Griva Digeni 84, office 102,
3101 Limassol, Cyprus
+357 25-58-28-48
cyprus@korpusprava.com

Korpus Prava (Hong Kong)

Level 09, 4 Hing Yip Street Kwun Tong,
Kowloon, Hong Kong
+852 3899-0993
hongkong@korpusprava.com

Korpus Prava (Latvia)

Jurkalnes Street 1,
LV-1046 Riga, Latvia
+371 672-82-100
latvia@korpusprava.com

Korpus Prava (Malta)

Pinto House, 95, 99, 103,
Xatt l-Ghassara ta' L-Gheneb
Marsa, MRS 1912, Malta
+356 27-78-10-35
malta@korpusprava.com

Tax & Legal Practice:
Irina Kocherginskaya —
kocherginskaya@korpusprava.com

Corporate Services:
Aleksandra Kaperska —
kaperska@korpusprava.com

Audit Practice:
Igor Chaika —
chaika@korpusprava.com

Business Development Division:
Natalia Lubimova —
nlubimova@korpusprava.com

Korpus Prava Private Wealth

Legal and Tax Support of Individual Clients

In 2014, as a result of longstanding cooperation with Private Banking subdivisions of leading private banks of Russia and Europe, we have created a team and launched a new activity on legal and tax support of individual clients.

Private Wealth team works in close cooperation with experts on other activities in all offices of the company.

Such service is provided both on the project basis (support of transactions on acquisition or sale of assets, structuring of investments in Russia and abroad and other), and on the subscription basis.

Private Wealth activity includes legal and tax services in Russia and abroad:

- Family and Inheritance
- Land and Real Estate
- Private Yachts and Planes
- Investments Structuring
- Bank Accounts and International Transactions
- Tax Planning
- Tax Returns
- Trusts and Funds
- Residence Permit and Citizenship in EU Countries
- Family Office Support
- Assets Protection

+7 (495) 644 31 23
www.korpusprava.com

Korpus Prava
PRIVATE WEALTH