Russia

Recent Court Rulings Support Taxpayers in VAT Set-Off Dispute

In the latest in a series of disputes between taxpayers and the Russian tax authorities with respect to set-offs of value-added tax ("VAT"), taxpayers appear to have won another victory – this time in respect to setting off VAT paid to suppliers using borrowed funds.

As a general rule, under Article 168 of the Russian Federation ("RF") Tax Code (the "Tax Code"), VAT is included in the price of goods sold to a buyer. A taxpayer can reduce its total VAT obligation to the government by taking certain deductions as set forth in Article 171 of the Tax Code. One such deduction allows taxpayers to set off incoming and outgoing VAT payments, such that, for example, a taxpayer acquiring goods for subsequent resale may subtract the amount of VAT paid to the original supplier from the VAT amount received from the subsequent buyer. However, a court ruling last Spring suggested that the right to such deductions was not absolute.

On April 8, 2004, the RF Constitutional Court adopted Ruling 169-O ("Ruling 169-O"), which stated that only taxpayers who have paid suppliers with their own (non-borrowed) funds may set off VAT paid to other taxpayers against incoming VAT payments (see the October 11,2004 issue of the *CIS* & *Central Europe Legal Newswire* for a discussion of Ruling 169-O). Shortly thereafter, the tax authorities began conducting numerous audits of taxpayers' indebtedness, and took the position that deductions for VAT amounts paid to suppliers with borrowed funds were unlawful.

On November 4, 2004 the RF Constitutional Court adopted Ruling 324-O ("Ruling 324-O"), aimed at clarifying Ruling 169-O. According to Ruling 324-O, the right of taxpayers to set off incoming and outgoing VAT payments can be denied if the taxpayer failed to bear real expenses to pay the outgoing VAT amount *(e.g.,* if the taxpayer had no intention of paying the creditor back for the funds borrowed to pay its supplier). Ruling 324-O thus provided a mixed message, since, on the one hand, it generally denies the apparent position reflected in Ruling 169-O that taxpayers cannot set off VAT amounts paid on assets acquired with borrowed funds, yet, on the other hand, sets forth a basis upon which tax authorities may deny the deduction by arguing that the taxpayer had no intention of repaying the borrowed funds. The implications of Ruling in 324-O may therefore vary widely in court practice.

A recent court case, however, seems to suggest an interpretation of Ruling 324-O that is more favorable to taxpayers. On December 14, 2004, the RF Supreme Arbitration Court (the "SAC") issued a decision in connection with a dispute between the Chkalovsky Regional Tax Inspectorate of Yekaterinburg under the RF Ministry for Taxes and Duties (the "Inspectorate") and Limited Liability Company "Euromebel Factory" ("Euromebel"). In March of 2002, Euromebel apparently paid its supplier 4.6 million Rubles for the purchase of equipment, using funds from a payment received under certain bank promissory notes. Euromebel, apparently, had purchased the promissory notes from an individual under an agreement requiring the purchase price to be repaid in installments within one year from the date of their purchase. As of the date of the equipment purchase, Euromebel reportedly had an outstanding balance due for the promissory notes. Thus, the Inspectorate considered that Euromebel did not have the right, under Article 171 of the Tax Code, to deduct the VAT amounts paid to the supplier until Euromebel had repaid this balance. On the basis of Ruling 169-O, arbitration courts of the first, appellate and cassation instances supported the tax authorities. However, the SAC, guided by Ruling 324-O, decided to invalidate the tax inspectorate's decision and all court decisions taken in support thereof. The SAC concluded that the Inspectorate had failed to prove that Euromebel employed unfair practices *(i.e.,* to prove that Euromebel did not intend to pay for the promissory notes), and therefore Euromebel was entitled to set off the VAT amount paid to the supplier even if the payment was made with borrowed funds.

Although this most recent court decision and Ruling 324-O certainly give taxpayers cause for optimism, the Federal Taxation Service will undoubtedly continue to aggressively challenge set-offs of VAT in this long-running dispute between taxpayers and the tax authorities.

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Land Re-Classification Law Finally Comes into Effect

The new RF Law No. 172-FZ "On the Re-classification of Land or Land Plots" (the "Land Re-classification Law") was signed by President Putin on December 21, 2004, and took effect on January 5, 2005. The Land Re-classification Law outlines the procedures, criteria, and special requirements applicable to the approval of an application for the re-classification of land.

In the past, local authorities often inconsistently applied their authority to allow re-classification of land since no specific criteria or specific procedures with respect to approval of such re-classification were set forth by law. Further, the RF Government, although vested with the authority to re-classify land at the federal level, was often reluctant to do so until federal law clarified the criteria and procedures for such re-classification. The adoption of the Land Re-classification Law should help to make the process much more transparent.

Regulating Authority

According to the Land Re-classification Law, applications seeking the re-classification of agricultural and reserved lands (except for those lands which are the property of the RF) are to be submitted to local authorities at the RF subject level. Applications with respect to all other lands are to be submitted to the RF Government.

Necessary Supporting Documents

The Land Re-classification Law lists the documents which must be supplied along with a land re-classification application, including the conclusion of an ecological review (in cases prescribed by law) and a calculation of agricultural or forestry losses (where applicable). The Land Re-classification Law clarifies that both of these documents must be included with the application upon filing.

Classification and Registration of Land Re-classification

According to Article 285 of the RF Civil Code, use of a land plot in violation of its permitted use, as determined by the land's classification, may serve as grounds for terminating the property rights to the land plot.

The Land Re-classification Law provides that the re-classification of a land plot enters into legal force from the moment of the reflection of the re-classification in the State Unified Register of the Rights to Immovable Property and Transactions Therewith.

Grounds for Refusing a Re-classification Application

Under the Land Re-classification Law, a re-classification application may be rejected on three grounds: (i) where a legislative restriction exists on re-classifying lands of a particular land category; (ii) in the event of a negative ecological review; and (iii) when the re-classification sought does not comply with governmental plans for the development of that territory.

Thus, although the grounds for rejecting an application for re-classification appear to be relatively narrow, they could in practice continue to give local and federal authorities broad authority to reject an application for re-classification of land for several reasons.

First, despite the new law, numerous legislative restrictions continue to exist with respect to each particular category of land. For example, agricultural land may be re-classified only in very limited circumstances, *e.g.,* agricultural land may be re-classified as industrial land only if the land is unsuitable for agricultural use.

Second, it would appear that the government may always use the grounds that such re-classification does not comply with governmental plans for a particular area, even if such plans are not formally adopted at the time an application is submitted, since no further detail is provided with respect to this issue under the law.

At the same time, it should be noted that the law expressly permits decisions on land re-classification to be challenged in court, and thus applicants will now have recourse to the courts if an application is rejected.

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Requirement to Notarize Mortgage Agreements Abolished

On December 30, 2004, President Putin signed RF Law No. 216-FZ "On the Introduction of Amendments to the Federal Law on Mortgages (Pledges of Immovable Property)" (the "Mortgage Law Amendments"), abolishing the requirement for notarizing mortgage agreements and introducing certain other changes to RF Law No. 102-FZ "On Mortgages (Pledges of Immovable Property),"

dated January 16, 1998, as amended (the "Mortgage Law"). The Mortgage Law Amendments, which entered into force on January 10, 2005, generally simplify the process of concluding mortgage agreements and establishing mortgages over land plots or related property. The key changes introduced by the Mortgage Law Amendments are summarized below.

Form of a Mortgage Agreement

Until recently, excessively high state duties on the notarization of mortgage agreements complicated the process of concluding such agreements. This burden was significantly reduced by RF Law No. 104-FZ "On the Introduction of Amendments to Article 4 of the RF Law 'On State Duties'", which entered into force on September 25, 2004 (the "State Duties' Amendments"), dramatically lowering notaries' mortgage fees (see the October 11,2004 issue of the *CIS and Central Europe Legal News wire* for a discussion of the State Duties' Amendments). The Mortgage Law Amendments go one step further by changing the procedure for concluding mortgage agreements to eliminate the notarization requirement entirely.

The Mortgage Law Amendments leave intact other requirements for the form of mortgage agreements, namely that they must be made in writing and must be registered with the State.

Mortgage of Property, Inseparable Improvements on Mortgaged Land Plots

The Mortgage Law Amendments also introduce a rule that any buildings or objects under construction which are located on a mortgaged land plot are automatically subject to the mortgage as well, unless the mortgage agreement or a federal law states otherwise. Previously, the opposite principle applied: buildings or objects under construction were not considered to be subject to the mortgage of the underlying land plot unless specified as such in the mortgage agreement or a federal law.

Similarly, the Mortgage Law Amendments provide that inseparable improvements to mortgaged property are also deemed mortgaged automatically, unless the mortgage agreement or federal legislation provides otherwise. Mortgages of inseparable improvements to mortgaged property were previously not regulated by the Mortgage Law.

Creation of a Mortgage

The Mortgage Law Amendments also provide for new rules regarding the creation of a mortgage without a mortgage agreement. Under Articles 64.1 and 64.2 of the Mortgage Law, as amended, a land plot (or lease rights thereto) is deemed mortgaged in favor of a creditor of the owner (or lessor) of such land plot if: (i) the land plot (or lease rights thereto) was acquired using a loan from such creditor; or (ii) a building located on the land plot was constructed using such loan. Conclusion of a separate mortgage agreement is not required, and the mortgage is effective from the time of registration of the mortgagor's title to the land plot (or the land lease rights), or the mortgagor's title to the building, as appropriate. These rules apply unless the mortgage agreement or federal legislation provides otherwise.

Other Changes

The Mortgage Law Amendments also provide for certain other changes of a more technical nature. In particular, the Mortgage Law Amendments:

- simplify the rules for changing the terms of a mortgage deed (zakladnaya), by establishing, inter alia, a one day period for registering an agreement on the amendment of a mortgage deed;
- allow a borrower mortgaging a residential house or an apartment to insure against liability for non-performance of its obligations under the underlying loan agreement. The insurance coverage under such an insurance arrangement cannot exceed twenty percent of the cost of the mortgaged property; and establish certain rules for the state registration of a mortgage in connection with the issuance of "mortgage certificates", securities introduced by RF Law No. 152-FZ "On Mortgage Securities", dated November 11,2003, as amended.

The Mortgage Law Amendments were introduced as part of the State's recent initiative to facilitate lending in Russia, and, in general, it is anticipated that their entry into force will increase mortgage lending in Russia.

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Legislative Alert: Amendments to Joint Stock Company Law Proposed

On November 22, 2004, a draft law "On the Introduction of Amendments to the RF Law "On Joint Stock Companies" (as amended) (the "JSC Law")" (the "Draft Amendments"), was introduced to the RF State Duma for initial consideration. The Draft

Amendments address, among other things, provisions on the establishment and reorganization of joint stock companies ("JSC(s)") (Chapter 2 of the JSC Law), the competence of general shareholders' meetings (Chapter 7), the procedures for shareholders to exercise their rights to demand the repurchase of their shares (Article 76), and approval of interested party transactions (Chapter 11). The most substantive changes proposed by the Draft Amendments are summarized below.

Establishment of a JSC

The Draft Amendments would extend the list of issues to be approved by the founders of a JSC at the foundation meeting, stipulating that the founders elect the audit committee (or auditor) and the external auditor, if required. In cases where founders have not yet paid for shares or made in-kind contributions to the initial charter capital of a JSC, the Draft Amendments would allow the board of directors to change the procedure and form for paying for such shares or making such in-kind contributions within one year of the JSC's establishment. Such decisions would need to be approved by the board of directors unanimously.

Reorganization

The Draft Amendments attempt to simplify the process for reorganizing a JSC. In particular, according to the Draft Amendments, when a reorganization results in the establishment of a new company, issues related to (1) the approval of the charter of the newly established company, and (2) the formation of its governing bodies would be adopted by a general shareholders' meeting of the reorganized company. Under the current JSC Law, these issues fall under the competence of the general shareholders' meeting of the newly established company.

Competence of the General Shareholders' Meeting

According to the Draft Amendments, the issue of a JSC's participation in holding companies, financial-industrial groups, associations and other units of commercial organizations would be within the competence of the board of directors of the JSC, rather than the general shareholders' meeting, as currently provided by the current JSC Law. The issue of a JSC's participation in any other organization would also be transferred from the competence of the general shareholders meeting to the board of directors, if the company's charter does not provide otherwise.

Share Repurchases

The Draft Amendments would revise Article 76 of the JSC Law, regarding the right of shareholders to demand that a JSC repurchase their shares in the company, by requiring a shareholder's signature on its repurchase claim to be notarized. The Draft Amendments also provide that such claim would be the legal basis for making changes on the repurchase of shares in the shareholders' register.

Interested Party Transactions

The Draft Amendments would alter Chapter 11 of the JSC Law to introduce a new approval procedure for interested party transactions, allowing such transactions to be approved within 90 days of their conclusion. Currently, the board of directors or general shareholders' meeting (as the case may be) must approve an interested party transaction prior to its execution. As information on issues to be considered by the board of directors or general shareholders' meeting of a JSC is in many cases publicly available, this statutory requirement weakens a company's position in competitive tenders, because the company must reveal the proposed purchase price when seeking approval for the transaction.

At this time, it is not clear when deputies of the RF State Duma will consider the Draft Law. We will continue to monitor the status of the Draft Amendments and will report on any developments.

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Chapter 31 of the RF Tax Code "Land Tax"

Chapter 31 of the RF Tax Code "Land Tax" entered into force from 1 January 2005.[1] However, RF Law No.1738-1 of 11 October 1991 On the Fee for Land will only lose legal force (except for article 25 "Standard price for land") from 1 January 2006, except in those municipalities in which land tax was introduced by the relevant local regulatory acts from 1 January 2005. There the old law will lose effect from the beginning of this year.[2]

The **land tax** introduced by chapter 31 is one of two local taxes remaining after 1 January of this year to be used by the municipal authorities to supply local budgets. As a local tax, it must be introduced by a regulatory legal

[1] Federal Law No.141-FZ of 29 November 2004.

[2] Article 3 of Federal Law No.141-FZ of 29 November 2004; Article 5.1 of the RF Tax Code.

act of the representative bodies of local government (laws of the cities of Moscow and St. Petersburg) in order to enter into force in a specific municipality. In establishing the tax the local authorities should determine the tax rate (which should not exceed the rates established in the Code), the procedure and terms of payment of the tax, and additional tax concessions and grounds for the exercise thereof. For example, in Moscow the tax was introduced from 1 January 2005 by the Law of the City of Moscow *On the Land Tax.*

The new chapter has sorted out the taxation of land to a considerable degree. The amendments concern not only entrepreneurs, but also everyone else who has a land plot (be it a home, dacha or simply an undeveloped plot).

The tax will be paid by organizations and individuals that have:

1) title to land plots;

2) the right to permanent (unlimited) use; or

3) the right to lifetime ownership with the right of inheritance.

The possession of land under rights to gratuitous *limited* use and leases of land are not taxable.

The tax base is determined as the cadastral value of the land as of 1 January of the year that is considered the tax period. If the cadastral value has not been determined, the standard value of land is used for tax purposes.[3] It should be noted that the figures on the cadastral value of land in the city of Moscow were approved as at 1 January 2005.[4]

The maximum tax **rates** have been set at the following levels:

0.3 percent for land plots:

1) set aside for agricultural purposes;

2) occupied by housing (or granted for construction of housing) or occupied by housing and utilities infrastructure (in Moscow – 0.1 percent); or

3) granted for private part-time farming;

1.5 percent for all other land plots.

It should be noted that in contrast to the 1991 Law, this chapter does not allow the differentiation of rates by category of taxpayer and does not contain conditions on a double tax rate if a land plot is unused or is used for purposes other than those designated.

The chapter stipulates a two-fold increase in the amount of tax accrued on land plots being used for housing construction for the first three years of construction, and a four-fold increase for any period over and above the first three years (pending the registration of rights to the object of real estate).

This chapter of the Code has established a substantially shorter list of **concessions** than the 1991 Law. For example, military persons and their family members and scholars have been excluded from the list. The Law of Moscow also does not establish any additional concessions.

The deadline for submitting the tax declaration is no later than 1 February of the year following the expiration of the tax period (calendar year).

The new chapter does not contain norms regulating payments for the **lease of land.** The relevant norms are contained in the Land Code.[5] The rates of lease payments for land are established depending on whether the land plots are owned by the Russian government, regional authorities or local government bodies.[6]

KPMG

New Schedule of Customs Clearance

For some years now, customs clearance fees have been unchanged at 0.15 percent of the customs value of goods, regardless of applicable customs regime.

This single rate has been consistently criticized by independent customs experts, foreign trade companies, WTO officials and others, who have argued that customs fees should be levied in proportion to the value of the imports concerned, and with due regard to the services delivered by customs officers.

It would appear their case has been recognized, since the Federal Customs Service has now issued a resolution effective from January 1, 2005, establishing differentiated rates for customs clearance in accordance with generally recognized international standards and requirements, as indicated below (in Russian Rubles, with an approximate equivalent in US Dollars):

[3] Article 3.13 of Federal Law No.137-FZ of 25 October 2001 *On the Entry into Force of the RF Land Code.*

[4] Moscow Government Resolution No.362-PP of 1 June 2004.

[5] Article 65 of the RF Land Code.

[6] The rates of lease payments for municipally owned land in the city of Moscow were approved by Order of the Mayor of Moscow No. 285-RM of 2 April 1999 *On Amendments to the Rates of Lease Payments for Land* from 1 January 1999.

Fee	Customs value of goods		
RUR	US$	(RUR)	(US$)
500	17.86	up to 200,000	up to 3,571.43
1000	35.72	200,000-450,000	7,142.86-16,071.43
2000	71.43	450,000-1,200,000	16,071.43-42,857.14
5500	196.43	1,200,000-2,500,000	42,857.14-89,285.71

Fee	Customs value of goods		
RUR	US$	(RUR)	(US$)
7500	267.86	2,500,000-5,000,000	89,285.71-178,571.40
20,000	714.29	5,000,000-10,000,000	178,571.40-357,142.90
50,000	1785.71	10,000,000-30,000,000	357,142.90-1,071,429.57
100,000	3571.43	10,000,000 or more	1,071,429.57 or more

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