Planning for Tax Rules Changes in 2006*

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The end of 2005 is nearing and it's time to look at which new tax rules will come into force in 2006 and how they will impact businesses – and which preparations businesses can make to meet new legislative requirements. This article will focus on changes in the Russian profits tax and VAT rules, which will come into effect in 2006.

Corporate Profits Tax

After several years of waiting, certain technical amendments were finally incorporated into the Tax Code. Most of these changes become effective in 2006 and, by and large, will have positive – or at least neutral – effects on taxpayers:

! Taxpayers now have the right to deduct immediately 10 percent of the initial value of a fixed asset upon purchase or construction of that asset. Inseparable leasehold improvements made by a tenant (e.g., fitout costs) into its landlord's property can now be amortized by the tenant.

! A list of direct expenses is now available and can be determined by a taxpayer; service companies no longer need to account for work in progress and are allowed to deduct immediately from taxes their expenses.

! A list of supporting documents has been broadened, allowing businesses to use documents made in accordance with legislation or business practices of foreign countries to support tax deductions in Russia.

! R&D expenses (both successful and unsuccessful) now may be fully deductible within two years (instead of three and 70 percent limitation for unsuccessful R&D).

! A list of tax deductible expenses has been expanded to include bonuses paid to customers and lessor's costs on acquisition of leased assets accounted for on the balance sheet of the lessee.

! Starting in 2006, the limit for utilizing tax loss carry forward is increased from 30 percent to 50 percent, and starting in 2007 the limit is entirely removed.

Unfortunately, there are disadvantageous changes as well:

! The changes make it more difficult for companies to pass the thin capitalization test starting in 2006. These changes need to be taken into account now to decide how to structure debt financing for 2006 projects.

! Rules for charter capital contribution completely phase out the possibility of tax-free step up in the basis of contributed property.

! Only debts related to the sale of goods, works, or services may be included for tax purposes (before, any debts could be included).

! The income tax on dividends to Russian companies and individuals is now 9 percent (was 6 percent).

VAT

Most of the changes in VAT rules take effect at the beginning of 2006. Similar to the profits tax changes, most of these changes are either neutral or positive. However, there are clearly adverse changes, too. Neutral or positive changes include:

! A cash basis may no longer be applied for VAT purposes, a practice now in line with European norms. All taxpayers will be required to account for output VAT on the day when a supply (delivery) is made or when payment from customers is received, whichever is earlier

! Symmetrically, input VAT can be offset on an accrual basis. The new accrual rules should be neutral for most industries. At the same time, the new accrual rules are not detailed and clearly require further fine tuning. For example, treatment of bad debts

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is not addressed in the new accrual rules, leaving room for potential disputes. In view of the forthcoming switch to the accrual regime, taxpayers need to consider how to manage the transition period and discuss the impact of the accrual regime with suppliers and customers.

! VAT incurred on capital construction can now be claimed as input credit immediately after work has been performed and billed by the contractor.

! The place of supply rule is expanded to the supply of services, which are considered as being provided at the place of economic activity of the buyer, including: services related to creating software and databases and their installment and modification, marketing services and provision of nonexclusive rights on trademarks, licenses, patents and other similar rights.

Among the adverse changes, are the following:

! Input VAT previously offset shall be reversed in the cases of charter capital contributions of an asset, use of an asset in a non-VAT applicable activity and some other cases. The amount of reversed input VAT is expensed for profits tax purposes. New rules on VAT reversal rules may limit significantly the amount of reclaimable VAT for many businesses. Furthermore, the new rules should significantly increase compliance costs.

! From Jan. 1, 2007, under barter transactions as well as on mutual settlements and payments by securities, the buyer should pay the amount of VAT to the seller separately in cash.

Combined, these changes are the most sizeable one-time changes in tax rules seen since the introduction of VAT and profits tax chapters of the Tax Code. ☐

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