Preparation #2

1 PARTIALLY DEDUCTIBLE EXPENSES

1.1 General

- Certain expenses may be *partially* deductible or totally *disallowed* for corporate profits tax (CPT) purposes.

1.2 Interest (art. 269, art. 328)

1.2.1 General

- Treatment of interest does not depend on the loan purpose and the type of the loan provider. Interest may be deductible even if the debt is overdue.
- Debt obligations of a taxpayer in particular include commercial credits, bank loans, loans received from enterprises and individuals, and debt securities issued by a taxpayer (i.e. notes and bonds).
- For taxation purposes interest will be calculated for the period of actual usage of the borrowed funds (even if the obligation is overdue).
- Interest calculation is based on the number of days of the loan (i.e. rounding up is not possible).
- Interest starts accruing on the *date following* the loan receipt date and stops accruing on the *loan payment date* (including this date).

Illustration 1

If a loan is taken out on 1 January and paid back on 3 February (both principal and interest), the interest will be calculated for 33 days (30 days in January and 3 in February).

- For accruals basis taxpayers, accrued interest should be recognised on the *earliest* of:
  - the last day of each month of the reporting period (if the loan term exceeds the reporting period); or
  - the date of agreement termination (or cancellation of liability).
- If a loan is taken in foreign currency by an accruals basis taxpayer the interest is also calculated at the end of each month of the reporting (tax) period using the exchange rate on this date.

1.2.2 Interest deductibility limits

- The Tax Code provides two methods of calculating interest deductibility limits. The first method should be applied first, however if there is insufficient data for its application, a taxpayer may apply the second method.

Method 1

- This requires comparison of actual interest rate on each loan with the average interest rate on loans of similar types received on similar conditions in the same reporting (tax) period.

  Loans are regarded as similar if ALL of the following conditions are met:

  - same currency;
  - same loan term;
  - close amounts;
  - same quality of guarantees.

- If the actual rate exceeds the average rate by more than 20% the deductible interest amount will be limited by the average rate + 20%; otherwise actual interest will be fully deductible.

Method 2

- This method is simpler. The limit for loans is based on:
  - 1.1 times Central Bank refinancing rate for rouble loans; and
  - 15% for loans in foreign currency.

- The statutory rate is *fixed* on the loan receipt date unless the loan agreement contains a provision that the interest rate per agreement can be changed.
- If, by agreement, the interest rate is changed, the Central Bank rate *effective on the date of the recognition of interest expense* is taken into consideration.
- Interest on debt obligations is included in non-operational expenses of a taxpayer.

Topic Summary

Classification of interest expense	Non-operational expenses of the current month
Types of loans on which interest may be deductible	Debt obligations of any type, arising from business activities
Interest deductibility period	The term of actual usage of the borrowed funds (in days)
Limitations on the interest amount	The rules are uniform for all types of debt obligations; statutory limits are different for loans in roubles (CB rate × 1.1) and loans in foreign currency (15%).

Illustration 2(a) – Rouble loan

ZAO ABC took out a 1 million RR loan on 2 February 2013 to finance the construction of a new warehouse. The loan was paid back on 26 July 2013. The loan interest rate is 16%. 2013 Central Bank rates (notional): 1 January – 30 April – 15%; 1 May – 30 September – 8%. ABC pays corporate profits tax on a monthly basis.

Option 1: Loan does not contain a provision for a possible change in the interest rate.

Number of days: 26 + 31 + 30 + 31 + 30 + 26 = 174 days
Deductible %: $1{,}000{,}000 \times {}^{174}/_{365} \times 16\% \times 1.1 = 76{,}274$ RR

Option 2: Loan contains a provision for a possible change in the interest rate.

Number of days:

3 February – 30 April: 26 + 31 + 30 = 87 days
1 May – 26 July: 31 + 30 + 26 = 87 days

Deductible %:	RR
$(1{,}000{,}000 \times {}^{87}/_{365} \times 16)$	38,137
$(1{,}000{,}000 \times {}^{87}/_{365} \times 8\% \times 1.1)$	20,975
	59,112

Illustration 2(b) – Currency loan

ZAO ABC took a currency loan of USD 100,000 on 10 March 2013. The loan is paid back on 10 May 2013. Interest rate on the loan is 18%. ABC pays corporate profits tax on a monthly basis.

Exchange rates USD/RR (notional):

31 March – 30.7;
30 April – 30.6,
10 May – 30.3

Deductible interest:

	RR
11 March – 31 March: $100{,}000 \times {}^{21}/_{365} \times 15\% \times 30.7$	26,495
1 April – 30 April: $100{,}000 \times {}^{30}/_{365} \times 15\% \times 30.6$	37,726
1 May – 10 May: $100{,}000 \times {}^{10}/_{365} \times 15\% \times 30.3$	12,452
Total deductible interest	76,673

1.3 Business travel (art.264)

1.3.1 Types of expenses

- Business travel expenses include:

  - travel expenses (including transfer);
  - accommodation expenses including additional services provided by the hotel (except meals, laundry, sports and recreational facilities);
  - per diem allowance;
  - costs incurred on visas and passports preparation;
  - consulate, transit and airport fees;

- Accommodation expenses are deducted in full provided that they are confirmed by supporting documents. In the absence of such documents accommodation expenses are non-deductible.

- *Per diem* allowance is fully deductible in any amounts as it is **not** limited for **corporate** profits tax purposes. However to meet the requirement of documentary proof the specific amount (internal norm) should be stipulated by the taxpayers themselves in the internal documents of the organisation (e.g. order of the general director).

- Note, however, that for **personal** income tax purposes *per diem* allowance **is** limited (see *Session 6*).

- Travel expenses (cost of bus/air/train tickets) are deductible in full where they are incurred to get to the place of business trip from the working place and back. Transfers by taxi from/to airports (railway station) to the hotel are also deductible for **CPT**. (Clarifications by the Ministry of Finance in this area are conflicting, but they should be considered to be deductible for examination purposes.)

- Business phone expenses, incurred by an employee in the hotel are deductible. Cost of personal services (e.g. laundry) is non-deductible.

- Business travel expenses are classified as "other expenses" ("prochie rashodi") on production and sales. Consequently, such expenses are considered to be "indirect" under the accruals method.

- The table below provides a short summary of the topic:

Type of expense	*Deductibility limits*
Accommodation expenses	Deductible in full with supporting documents. No deduction without supporting documents.
Per diem allowance on business trips.	Deductible in full.

Example 1

An employee of a Moscow-based company went on a business trip to St. Petersburg for 3 days. The train ticket cost was 950 RR (net of VAT). Per diem allowance is fixed in the amount of 2,000 RR per day in the company's rules for business trips in Russia.

The hotel bill included the following (net of VAT):

	RR
Accommodation	1,500
Restaurant	6,500
Laundry services	100
Cable TV in hotel room	1,500
Taxi transfer from and to the train station	500
Taxi for sightseeing	3,000
Business phone charges	180

Required:

Calculate the deductible amount for profits tax purposes.

Solution

	RR
Total deductible amount	

1.4 Advertising (art. 264 item 4)

- The deductibility of advertising expenses depends on the type of advertising.
- The following types of advertising expenses are deductible in full:
  - mass-media advertising (TV, radio, press, telecommunication networks);
  - out-door advertising (street posters and lights);
  - participation in exhibitions/fairs, maintenance of demonstration halls, printing of advertising catalogues and brochures.
- Expenses on prizes used during mass advertising campaigns are deductible up to 1% of the sales revenue (net of VAT).

- VAT on advertising expenses, which are partially deductible, is recoverable only in the part relating to deductible expense portion.

Illustration 3

In 2013 ZAO Alfa spent 8.64 million RR (including VAT of 1.44 million RR) on the acquisition of prizes awarded to winners of prize draws during a mass advertising campaign. 2013 sales revenue of Alfa was 210 million RR (including VAT of 35 million RR).

Calculation of deductible expense:

Topic summary

Deductible limit on advertising expense	For general advertising expenses (art. 264) **no limit** is established. For expenses on prizes used during mass advertising campaigns – 1% of sales revenue (net of VAT).
Base for taxable limit calculation	Sales revenue – for all types of entities including trading companies (net of VAT).

- Advertising expenses are classified as "other expenses" ("prochie rashodi") on production and sales. Consequently, such expenses are considered to be "indirect" under the accruals method.

Insurance

Premiums paid on mandatory property insurance contracts are tax deductible within insurance tariffs set by the legislation.

- The following table provides a summary of deductibility rules on insurance premiums made under voluntary insurance contracts:

<table>
<tr><th>Type of insurance</th><th>Required conditions of insurance agreement for deductibility</th><th>Deductibility limit †</th></tr>
<tr><td>Voluntary life insurance</td><td>(1) No payments during five-year term (except payments in case of incident or death)
(2) Term of the agreement – not less than five years; the agreement should be concluded with Russian insurance companies with relevant licence.</td><td rowspan="4">The limit is set for total amount of both life and pension insurance premiums as 12% of deductible labour costs*</td></tr>
<tr><td>Voluntary pension insurance (“dobrovolnoje pensionnoje strahovanije”)</td><td>(1) Non-state pension fund has a license
(2) Pensions are paid up to death of employee
(3) Payments start from the pension age established by the Law.</td></tr>
<tr><td>Non-state pension security (“negosudarstvennogo pensionnogo obespechanija”)</td><td>(1) Fund has a license
(2) Pensions are accumulated on personal pension accounts of insured employees
(3) Pensions are paid from personal account for not less than five years.</td></tr>
<tr><td>Additional contributions by the employer to labour pension</td><td>(1) Documented by the internal order in the taxpayer’s organisation or in collective or personal labour contracts
(2) Employer should inform pension Fund of RF within 3 days after the request of the employee
(3) Employer can start payments not early than next month after the request is received.</td></tr>
</table>

Voluntary medical insurance	Term of the agreement – not less than one year.	6% of deductible labour costs*
Voluntary insurance against incidents	Insurance covers incidents which caused injury or death (not only at work place).	15,000 RR per year per employee (calculated as total payments divided by total employees with insurance).

† The 6%, 12% and 15,000 RR limits are provide in the tax rates and allowances in the examination.
* For the purpose of calculation of this limit labour costs are taken net of any employees' related voluntary insurance expenses.

- Expenses on other types of employee insurance are *non-deductible*.
- If the terms of insurance agreements initially satisfy deductibility conditions but then are changed and those conditions are not met anymore, tax should be recovered.

Illustration 4

ZAO Addis has signed a one-year voluntary medical insurance contract for one of its employees in January. The contract provided for monthly payments of 10,000 RR. Addis made 7 payments and took a tax deduction of 70,000 RR (it is assumed that 70,000 RR is less than 6% of labour costs).

However, in August the employee left the company and the insurance contract was terminated.

Therefore, in August Addis will have to include 70,000 RR in its taxable income.

- Expenses on mandatory and voluntary insurance of employees are classified as labour costs. However, such expenses should not be considered direct even if they relate to main production workers and thus, should not be pro-rated. This is an **exam approach**.

Illustration 5

In 2013 ZAO Bella, a production company, signed a one-year voluntary medical insurance contract for its employees. The contract provided for an insurance premium of 900,000 RR.

In 2013 Bella accrued 9 million RR of wages and salaries of personnel involved in production process and 4.5 million RR of wages and salaries of administrative staff.

Only 80% of direct expenses for 2013 were deducted for CPT purposes.

Deductible insurance is limited by 6% of deductible wages and salaries, i.e.
$(9 \times 0.8 + 4.5) \times 6\% = 0.702$ million RR

Thus, only 702,000 RR qualifies for deduction, while 198,000 is paid out of after tax profits.

- Mandatory and voluntary insurance expenses recognition date is the date of payment. For payments which cover more than one reporting period, expense is allocated in equal portions over the agreement term according to the number of days. This means that there is an additional condition (i.e. they must be paid for) for such expenses to be recognised for CPT on accruals basis.

1.8 Compensation of interest expenses

- A limited deduction is allowed for certain benefits provided by employers, including compensation of interest on loans used for the purchase or construction of residential premises.
- The labour cost for CPT purposes includes such compensation of interest expense to employees (art. 255).

- Compensation to employees for their interest expenses is deductible if the loan is obtained to finance the purchase of apartments or construction of houses. The deductible expense is limited to 3% of labour costs. (Again, this limit is provided in the examination.)

1.9 “Thin capitalisation” rules (art. 269)

- “Thin capitalisation” rules relate to taxation of interest on loans provided to a taxpayer by a foreign legal entity (FLE) or by a Russian legal entity (RLE), which constitutes an affiliated company with regard to FLE.

- Thin capitalisation rules apply in the following cases:

  - if a FLE-lender has more than 20% (directly or indirectly) in the share capital of RLE-borrower; **or**

  - if a loan is given by an affiliated company (RLE) of a FLE; **or**

  - if FLE or its affiliated company (RLE) pledges a guarantee on loan repayment; **and**

  - the loan amount (including any unpaid interest) exceeds net assets* of a RLE by 3 times on the last day of the reporting period*.

* Net assets are defined as the difference between total assets and liabilities of a RLE (liabilities should be taken **excluding** tax liabilities).

Illustration 6

(1) FLE has 25% in RLE. FLE gives a RLE a loan.

(2) FLE has 50% in RLE-1. RLE-1 has 50% in RLE-2. FLE gives a loan to RLE-2.

(3) FLE has 40% in RLE-1 and 60% in RLE-2. RLE-1 provides a loan to RLE-2.

(4) FLE has more than 20% (directly or indirectly) in the capital of RLE. It pledges a guarantee for repayment of a loan taken by RLE from any source.

In all the above mentioned cases loans potentially can be considered as controlled if other conditions are met.

In (2) indirect ownership share is 25% (50% × 50%).

In (3) direct ownership of 60% is taken into consideration.

- If the above-mentioned conditions are met the loan from foreign legal entity (FLE) is considered as "controlled" and taxpayer must calculate "capitalisation coefficient" on the last day of reporting (tax) period.

$$\text{Capitalisation coefficient} = \frac{\text{Amount of controlled loan}}{(\text{Net assets } \times \%\text{ of FLE's ownership}) \times 3}$$

(Controlled loan includes accrued interest on loan not paid on the due date).

- On the last of each reporting (tax) period a taxpayer must calculate the maximum amount of interest on controlled loan, which is recognised as expense for CPT purposes:

$$\text{Maximum amount of interest} = \frac{\text{Actual interest accrued on controlled loan}}{\text{Capitalisation coefficient}}$$

- Actual interest rate cannot exceed:
  - 15% on foreign currency loans; or
  - $1.1 \times$ CB rate for rouble loans.
- The difference between the actual interest accrued on a controlled loan and the maximum amount of interest constitutes "deemed" dividends for CPT purposes, which are taxable at the foreign shareholder rate of 15%.

Thin capitalisation rules summary:

Step 1: If a loan is received from a foreign legal entity – define whether it is controlled.

Step 2: If the loan is not controlled – apply regular taxation rules. If the loan is controlled – calculate capitalisation coefficient.

Step 3: Using the coefficient determine maximum deductible amount of interest on controlled loan, which is recognised as expense for CPT purposes.

Step 4: Calculate tax at 15% rate on the "deemed dividends" (i.e. on the difference between actual accrued interest and maximum deductible amount calculated in Step 3).

Illustration 7

Russian company ZZZ owes 60% of shares in company AAA. A foreign company XYZ owes 50% of shares of ZZZ.

AAA's data at January 31:

	RR million
Assets	300
Liabilities	292 (including loan from ZZZ and tax liabilities of 2)

On 1 January 2013 ZZZ gave a 60 million RR loan to AAA at 20% per annum. Interest is paid on a quarterly basis. AAA pays CPT monthly. CB rate (notional) is 15%. CB rate $\times$ 1.1 = 16.5%.

Step 1: Define whether the loan is controlled.

First condition (i.e. FLE has more than 20%) is met. FLE (XYZ) indirectly owns 50% $\times$ 60% = 30% and the loan is given by the affiliated company of a FLE.

Second condition (i.e. the loan amount exceeds net assets of a RLE by 3 times) is also met.

Accrued interest for January is 0.99 ($60 \times 20\% \times {}^{30}/_{365}$) as first day is not counted. Loan plus interest is 60.99.

60.99/(300 – 290) = 6.1 is > 3 (tax liabilities are not taken into consideration). Thus, the loan is considered to be controlled.

Step 2: Calculate capitalisation coefficient

Capitalisation coefficient = Amount of controlled loan/(Net assets × % of FLE's ownership × 3) = 60.99/(10 × 30% × 3) = 60.99/9 = 6.1

Step 3: Calculate maximum deductible interest

First calculate interest under statutory rate $60 \times 15\% \times 1.1 \times {}^{30}/_{365} = 0.814$
Maximum deductible amount of interest = statutory deductible interest accrued on controlled loan/capitalisation coefficient = 0.814/6.1 = 0.133

Step 4: Calculate tax on "deemed dividends" i.e. on the difference between actual accrued interest and maximum deductible amount (0.99 – 0.133) × 15% = 0.13