TAX FOUNDATION

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Tax Aspects of Improving the Investment Climate in Russia

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Invited by Russia's State Committee on Taxation and the Ministry of the Economy to assemble a delegation of tax experts which could guide the new Russian government in the most efficient, reasonable way to tax foreign investment, the Tax Foundation agreed and submitted this statement on July 7, 1992, in Moscow to Vice President Aleksandr V. Rutskoi and I.A. Lazarev, chairman of the Russian State Tax Committee.

Preface

The Tax Foundation delegation wishes to see the Russian transition to a free market succeed. This is important for many reasons, most notably because it will improve the living standard of the Russian people and enhance the prospects for world peace.

The delegation wants American companies, by investing in Russia, to be partners in the successful transition. For this to be achieved, the Russian tax system must satisfy the objectives of taxpayers and the government. Prosperity in Russia requires that the tax system strive not to discourage the saving and investment that are necessary for economic progress.

In the delegation's meetings with representatives of the government, the Parliament, and the State Tax Service, it has shared its views in three areas: 1) the long-term goals for a tax system that is appropriate for a market economy, especially one that does not discourage investment; 2) aspects of the existing tax system that are of immediate concern to foreign investors; and 3) policies that would facilitate foreign investment during the interim period when the Russian tax system is in flux, while a system suitable to the long term is being developed. In all cases, these views are consistent with the Tax Foundation's long-established "Principles of Taxation." These principles include stability, reliability, simplicity, clarity, economic neutrality, the need for open discussions of policy, fair taxation of international transactions, moderate tax rates, and the importance of applying these principles to the taxes of subnational as well as national governments. For over 50 years, they have guided the Tax Foundation in its similar consultations with the government of the United States.

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Long-Term Policy Goals

Stability

Stability is a critical feature of a tax system that will encourage investment. An unstable system creates uncertainty that discourages investment.

Reliability

Investors should be able to rely on continued application of the tax laws in existence at the time they make their investments. New and heavier burdens should not be imposed after an investment is made. Taxpayers must be able to rely on published laws, decrees, regulations, and rulings. Laws must be administered fairly and consistently, with only limited administrative discretion. Procedures for resolving tax disputes should include administrative hearings and court proceedings, and taxpayers should be protected from unreasonable and capricious interpretations of the law. Changes in laws should only be applied prospectively, never retroactively. Subnational governments must not be allowed to deviate from (or unilaterally modify) legislation adopted by the federal government.

Certainty

Laws and regulations interpreting them must state precisely the tax consequences of various actions. This contributes to economic transparency (see below). Adoption of Western accounting conventions and their incorporation into the tax system will increase clarity. Legally binding advance rulings interpreting new provisions of the tax system that might otherwise be unclear must be readily available.

Simplicity

Russia should avoid the complexity found in the tax systems of many Western countries. Such complexity is extremely troublesome even in advanced Western countries with substantial experience in tax administration and compliance. It would be far worse in Russia, which does not yet have the tax administration and experience in taxpayer compliance required to cope with a complex system.

Economic Transparency

Under current Russian law, the economic consequences of certain actions are not immediately clear either to taxpayers or the government. Because the tax base differs from economic income as measured by Western accounting principles, the effective rate of taxation can depart radically from the statutory rate. Current practices that increase the effective rate substantially (discussed further below) include the unrealistically long useful lives of depreciable assets, the use of historical cost when calculating depreciation allowances, and the disallowance of deductions for some ordinary and reasonable business expenses, such as interest expense and labor payments in excess of four times minimum wages.

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Satisfactory Definition of Taxable Profits/ Income

The measurement of profits (income) for tax purposes should be based on standard Western accounting principles. All reasonable and necessary expenses should be deductible. This is necessary to facilitate economic transparency, to avoid disincentives for investment, and to assure foreign tax credits in the United States and perhaps elsewhere.

Moderate Tax Rates

Tax rates, both statutory and effective rates, should be moderate so as not to discourage investment. The top individual income tax rate of 60 percent* and the VAT rate of 28 percent‡ are high by international standards.

The delegation appreciates the need to control deficits and the difficulty of reducing public expenditures (including subsidies to state enterprises) under current circumstances. It is equally important, however, to remember that in the long run only a growing private sector can provide productive employment, a rising standard of living, and the tax revenue needed to finance essential government services. An overburdened private sector will not experience the investment needed for dynamic growth.

Areas of Immediate Concern

High Tax Rates

The Tax Foundation delegation believes the 60 percent* top statutory tax rate applied to individual income to be much too high. The combined effective rate paid by enterprises and their employees, including the effect of the disallowance of deductions for labor payments in excess of 4 times minimum wages, is even higher, approximately 73 percent. Attention should also be paid to the marginal effective tax rates on income from capital invested in Russia resulting from the low rates of depreciation allowed under Russian law and the failure to take account of inflation in calculating taxable profits (income).

Foreign Tax Credits

Ratification of the double taxation treaty with the United States will alleviate some concerns about the creditability of the current Russian profits tax, but does not assure creditability under all circumstances. Moreover, some foreign investors wish to use organizational structures for which issues of creditability will remain. The only satisfactory way to deal with the issue of creditability is to allow deductions for all reasonable and necessary expenses of earning income.

Labor Payments

Wages and salaries are generally deductible, without limit, in advanced Western countries. Placing limits on the deductibility of labor payments is not a satisfactory means of dealing with the tendency for the management of state enterprises to grant unjustified and

* Changed to 40% 7/15/92. ‡ Changed to 14% on most products 7/16/92.

inflationary wage increases. At best such a policy is only appropriate for state enterprises—and then only if reforms of managerial compensation policy are not adequate to provide incentives for cost control. This policy

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distorts the tax base, raises enterprises' cost of managers and skilled workers, discourages foreign economic activity in Russia and thereby the process of technological transfer, and raises questions of creditability. In the case of service industries the disallowance of deductions for labor payments is particularly problematical, since it can produce a definition of the tax base that approaches gross income.

Capital Recovery

It is appropriate to allow tax-free recovery of the cost of capital investments. The generally accepted method of doing this throughout the world is the deduction of depreciation allowances (in the case of investment in tangible assets) and amortization (for intangible assets). The useful lives assumed in calculating depreciation allowances under Russian tax law

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are much too long (and the implied depreciation rates much too low) to allow timely recovery of capital, especially since inflation reduces the real value of such allowances. It is necessary to have more rapid depreciation and to prevent the loss of the real value of allowances caused by inflation. The conceptually correct way of achieving the second of these objectives, indexation of the cost basis of assets, is extremely complicated. An alternative approach that deals with both problems simultaneously in a relatively simple manner is to allow immediate write-off (expensing) of investment.

Discrimination Against "Middlemen"

Many foreign multinational corporations may operate in Russia through organizations that would be defined as middlemen, subjecting them to the 45-percent profits tax rate. This will place them at a competitive disadvantage relative to organizations that can avoid such characterization. This discriminatory provision, which reflects a continuation of the socialist view that commerce is unproductive, should be eliminated.

Loss Carryforward

In order to avoid disincentives for investment, losses incurred in one year should be available to offset income earned in subsequent years. It is especially important that it be possible to carry losses incurred during the typically unprofitable start-up period forward to offset taxable profit/income once the enterprise becomes profitable. Most other countries allow net operating losses to be carried forward for extended periods. It would also be desirable to prevent inflation-induced declines in the real value of deductions for past losses, perhaps by indexing such losses (or paying market interest rates on them) or by denominating them in hard currency.

Uniform Treatment

The tax law should treat all forms of enterprise in the same way.

Export Taxes

Russia must export in order to earn the foreign exchange needed to import capital and technology. Export taxes discourage exports and should be eliminated. Since the world market price of most goods and services is beyond the control of one country, export taxes cause an involuntary reduction in net selling prices and thus the profits of exporters. They can discourage potential investors from investing in Russia. Russia can design other mechanisms to prevent windfalls from the export of subsidized raw materials.

Mandatory Conversion of Hard Currency Earnings

The requirement for mandatory conversion of hard currency earnings is a troublesome policy that resembles a discriminatory tax on the exports and other hard currency earnings of foreign investors. All investors considering projects in Russia must be concerned with risks of exchange rate fluctuations. Mandatory conversion aggravates such risks for those contemplating investments in export industries in Russia. Mandatory currency conversion is essentially an

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involuntary loan made in a currency other than that in which the foreign investor calculates and reports his profits. As such, it subjects the investor to additional unwanted risk of fluctuations in the exchange rate. The delegation hopes that the exchange rate can be stabilized, that such risk will be reduced, and that foreigners will find investing in rubles will become attractive. This is currently not the case; moreover, ruble investments cannot be hedged. It is important that this onerous requirement for mandatory conversion be eliminated, thereby removing a troublesome source of inconsistency with the law on foreign investment.

Import Duties

It is important that any import duties be levied at a single rate and that the rate of import duty be kept low, in order to avoid uneconomic and unfair protection of selected industries resulting from high rates of effective protection. Russia has not followed this policy in the recent past.

Value Added Tax

Most countries that levy value added taxes (VATs) employ consumption-based VATs. As a result, the aggregate base of the VAT is limited essentially to the value of final products sold to consumers. This is achieved by allowing businesses to offset (credit) all taxes paid on purchases—including taxes on capital goods (such as machinery and equipment) — against tax due on sales. Russia should follow standard international practice in this regard.

VAT on Financial Services

The application of VAT to financial services and credit card services involves extremely complex issues. This problem should be discussed with the representatives of these industries, especially those actively considering doing business in Russia.

Actions of Subnational Governments

Subnational governments have been engaging in actions that are extremely troublesome to potential investors; it appears that some of these may be inconsistent with current federal law. For example, they have been imposing taxes not allowed under federal law, they have required that potential investors engage in joint ventures with them or with state enterprises under their jurisdiction, and they have refused to allow local banks to remit tax revenues to the central government. This type of behavior is extremely inimical to investment.

Risk of Confiscatory Taxation

Almost all companies doing business in Russia are subject to several forms of taxation (or tax-like provisions), including not only the profits tax and the value added tax, but also excises, export taxes, and mandatory conversion of hard currency. In some cases, the combination of taxes is confiscatory, or nearly so. It is important to analyze the consequences of policy to be sure that in total, taxes and similar measures do not absorb all of the profits—or even almost all of them—and do not impinge so heavily on the markets for the products of some industries as to destroy them.

Interim Suggestions

Based on the delegation's meetings, it understands that establishment of the type of system suggested above will be politically difficult. Thus, it offers several suggestions for an interim policy that will facilitate the process of foreign investment while the permanent system is being developed.

Review of Proposed Legislation

Views of foreign investors should be sought as new legislative proposals are being developed. Written drafts of proposals should be readily available for analysis, discussion, and comment. It is especially important that such drafts be widely distributed to interested foreign investors (actual or potential). Adequate time should be allowed for translation, analysis, and the submission of comments. Ideally, one Russian agency would be responsible for this activity, in order to simplify communication and increase efficiency and consistency. The Tax Foundation would be pleased to facilitate this process in the case of American investors.

Advanced Interpretive Rulings

It should be possible for investors to obtain legally binding rulings interpreting existing laws. It is especially important to reduce uncertainty during the next few years when investment is badly needed and there is a high risk that legislation will be unclear.

Guarantees Against Adverse Fiscal Changes

A procedure should be instituted that would provide investors with guarantees that tax rules (including maximum rates) will apply for specified periods of time.

Uniformity and Consistency

Ruling letters and guarantees (see above) should treat similarly situated taxpayers in a similar manner. All ruling letters and the terms of all guarantees should be published promptly and have general applicability.

The Tax Foundation, a nonprofit, non-partisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.

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