



CROSS-SECTORAL COMMITTEES



# FINANCE & INVESTMENTS COMMITTEE



**CHAIRMAN:**

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2021 has shown the resilience of the Russian economy in the face of the pressures from the COVID-19 epidemic. The conservative fiscal policies have created a stable foundation and the economy has benefited from stronger energy prices, but challenges remain. The forecast GDP growth of 4.5% reflects the base effect from the negative impact on the economy of COVID-19 last year, an economy skewed to the public sector has fared better than many western markets and the impact of firmer energy prices. Additionally, the year has seen a very significant increase in capital raising in 2021 with activity in London and Moscow including 5 market debuts with further issues expected before year end.

The foreign investment climate however remains at its lowest level in the past two decades (around USD 1.4bn in 2020),

much of it reflecting reinvestment from Russian offshore entities. Foreign investors closely followed the Michael Calvey case and were disappointed when he was found guilty with a 5-and-a-half-year sentence for what was seen as a commercially driven criminal case. Whilst impacting investors looking to enter the market for the first time, existing investors remain satisfied with the operating environment and the AEB-GFK 14th survey showed an improvement in the index which grew 20% based on market medium term potential combined with existing returns on investment.

The government has spent 3% GDP on anti-crisis measures which has in part fueled an increase in retail demand of 8.7% this year. Inflation has become a major issue with an increase of 8% in CPI forecast by year end. In response, the Central Bank of Russia has increased its reference rate

to 7.5 % and is expected to maintain a tight fiscal policy until at least the middle of 2022.

The political climate remains extremely strained with major issues between Russia and the EU and USA. Recently sanctions have not been as central a topic as in previous years, the threat remains that actions by Russia might trigger a tough response and this uncertainty hangs over the market. Additionally, the SME segment remains very undeveloped and has suffered from the COVID-19 crisis whilst the public sector continues to expand. Combined with a weak performance in venture capital and continuing concerns on judicial reform, there is the danger that Russia will not be able to attain its potential as a diversified economy.

## LOCALIZATION

The import substitution (localization) policy, launched in Russia as early as in 2014, is now entering a new stage of development. New factors are arising that influence the adoption of strategic localization solutions, both by the state and businesses. The main such factor is the COVID-19 pandemic. Among other challenges are the power crisis and the resulting partial suspension of production in China, a global-scale manufacturer of parts for an overwhelming majority of industries. These circumstances have caused the appreciation of export products from China, first and foremost, raw materials and parts, but has also caused material delays for supplies, etc.

Importantly, it is these factors that impact the state's priorities regarding localization in Russia, too: these days, the task of overcoming import dependence has risen to the fore as an imperative in ensuring national security, particularly in socially important and strategic industries. To complete this task, the state has proposed a number of initiatives, among them the introduction of the "two-is-a-crowd" rule that allows only those producers who have localized their full-cycle production in Russia and other EAEU countries to participate in state-sponsored tenders.

The "two is a crowd" rule has been applied since late summer 2021 to manufacturers of a number of medical devices (tomographic scanners, ultrasound machines, etc.); its implementation is also being considered for some strategic medicines (for the treatment of HIV, cancer, etc.). The trend is obvious, and it can be both expanded as a part of these socially important industries and cover others.

On the one hand, the state approach, intended to localize stock, raw materials and parts as well as the goods produced using them, is understandable. On the other hand, the restrictive approach (inability to participate in state-sponsored tenders) will not promote attractiveness for foreign investment or the implementation of localization programs by European companies, it would narrow the sales markets and, highly likely, put the existing localization plans of manufacturers on hold. Moreover, there is

a risk that the introduction of the two-is-a-crowd rule will have a reverse effect: companies will simply leave the Russian market, seeing no prospects for themselves.

## RECOMMENDATIONS

- › In order to complete new, large-scale tasks in pursuit of localization, the importance of regular, systemic, open dialog between the state and market players comes to the fore. Moreover, it would be advisable to perform a joint analysis of extant mechanisms (e.g., the odd-man-out mechanism, current pricing preferences in state-sponsored procurement, etc.) and build a localization strategy for the production of parts and raw materials with a sober account of what results are achievable.
- › What's more, in order to attract investors, it is important to take into account the industry's characteristic features and develop new sales markets (inter alia, while maintaining a dialogue with EAEU member states and other countries) and incentives at the federal and local levels, and also to ensure the stability of the regulatory environment and a high degree of intellectual property protection.

## INVESTMENT TAX DEDUCTION

An investment tax deduction (ITD) implies a material saving on taxes; however, businesses treat this incentive carefully. The lack of demand for ITDs is caused by a number of defects that we intend to eliminate.

### LIMITS ON THE DISCRETIONARY POWER OF THE RUSSIAN FEDERATION'S CONSTITUENT ENTITIES IN ITD REGULATION

When implementing ITDs, the constituent entities of the Russian Federation are given a wide range of powers, including that to determine the supported category of taxpayers through the restriction of types of incentivized fixed assets, activities, etc. Such width of discretionary power allows the introduction of ITD conditions that do not coincide with the goals of an ITD. Restrictions on ITD application based on the capital origin criterion are most significant for international groups of companies.

In particular, the requirements for state registration of an investor as a legal entity in the region and for the status of a participant of the national project "Labor Productivity and Population Employment Support", in which investors with a foreign interest share in excess of 25% cannot participate, are popular. They are used as conditions of ITD application by 18 constituent entities of the Russian Federation, in fact prohibiting the use of ITD for businesses with foreign interest.

## RECOMMENDATIONS

- › The extensive discretionary power of a constituent entity of the Russian Federation does not seem expedient



without a material burden on the regional budget (for example, constituent entities of the Russian Federation are compensated 2/3 of the tax income received from the use of the benefit). In this regard, it is necessary to restrict the regions' use of ITD regulation. It would be expedient to include in the Tax Code of the Russian Federation reasonable additional conditions, regarding which regional authorities are given the discretionary powers. Also, we propose a direct prohibition on the requirement for state registration of an investor in the region and of establishing similar conditions for ITD use that actually introduce a restriction based on the factor of capital origin.

### **GROUNDINGS AND PROCEDURE FOR RESTORATION OF THE ITD AMOUNT**

According to the Tax Code of the Russian Federation, in the event of a sale or other disposal of a fixed asset (with the exception of liquidation) before the end of its useful life, the amount of tax left unpaid in connection with ITD application to such property is to be restored and paid to the budget, along with relevant penalty amounts.

Despite how onerous the consequences introduced by the law are, the regulations of Clause 12 of Article 286.1 of the Tax code produce a number of practical problems:

- › the uncertainty of the "other disposal" concept (in particular, it is unclear how the benefit is to be handled when the property is transferred in the course of reorganization);
- › lack of a procedure for declaration of the restored tax.

### **RECOMMENDATIONS**

- › The Tax Code of the Russian Federation needs to establish an exhaustive list of grounds for tax restoration that would not admit any ambiguous interpretation, and also to determine a period in which the tax restoration would be declared; to specify the forms of income tax declaration (at present, the form does not provide lines for ITD restoration).

### **THE PROCEDURE FOR ITD APPLICATION BY FOREIGN ENTITIES**

In the literal sense of Article 286.1 of the Tax Code of the Russian Federation, foreign entities are not forbidden to use ITDs. However, the deduction cannot be declared by permanent representative offices in the Russian Federation, since declarations for the income tax of foreign entities do not have the requisite lines.

### **RECOMMENDATIONS**

- › It is advisable to supplement the declaration form for the income tax of foreign entities with an attachment, on which an investor would declare the amounts of capital investments and declare any ITDs.



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