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Reform of the Tax System

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The foundations of the present tax system were laid at the turn of the 1990s. Around a dozen and a half tax laws were adopted by the RSFSR Supreme Soviet at the very end of 1991. They became effective as of the start of 1992, and remain effective today, even though a large number of amendments and supplements were introduced into them over the past years.

The laws adopted in 1991 were prepared over the course of just several months, as a consequence of which they were not distinguished by any depth of analysis, and their legal completion was essentially carried out after the laws were adopted but before their official release. The time shortage, the indeterminate nature of the future structural transformations in the economy, the quickly changing legal space, and the absence of experience and of the knowledge of international experience in setting up tax systems adapted for operation in the conditions of the market economy were the main reasons why the Russian tax system possessed inborn shortcomings right from the start. They included, in particular, a hypertrophically large role for profit tax, persistence of earmarked transfers to extrabudgetary funds (mainly road and social funds), an unjustifiably diminished role for taxes collected from individuals and those received on property, inadequate development of issues concerned with taxing natural resources, and some others. Serious damage was done by the clearly pronounced punitive orientation of the tax system held over from the Soviet era, expressed in particular as the obvious defenselessness of the taxpayer before controlling bodies and the unjustifiably high penalties for tax violations.

Value-added tax, which was introduced in place of earlier turnover tax, was the sole truly revolutionary element of the new tax system. However, even this tax was typified by distortions (some of which have persisted to this date) brought about by the state's desire to strengthen its fiscal role and concurrently adapt it to the complex situation in the economy, characterized by widespread defaults, barter, and so on.

Even so, in the first years of its existence the Russian tax system performed its role not too badly in general, keeping the necessary financial resources flowing into budgets at all levels despite high inflation and the profound changes in the economy. However, as market transformations deepened and as the corresponding laws laying a legal foundation beneath these processes were developed and enacted, shortcomings inherent to the tax system became increasingly more noticeable, and its inconsistency with changes occurring in the society became ever clearer. The tax system became a clear impediment to the state's economic development. As a consequence there was mass dissatisfaction with and justified reproaches against the existing system of taxation on the part of domestic enterprises, entrepreneurs, and foreign investors. Numerous amendments introduced each year into legislation on taxes and

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levies in 1992-1999 solved only some particular problems without affecting the system's foundations.

The unsystematic way the amendments were introduced, their number, and the frequency with which they were introduced had the consequence that up to recent times the tax system could only be characterized as unstable and unpredictable. Given such a situation, it was impossible to plan business even for the short term, and as a consequence the risks associated with changes in taxation were assessed to be exceptionally high. The same causes made the tax system excessively complex, contradictory, and confused, and moreover, there was an excessive number of taxes and levies.

In this case many changes were made for the purposes of realizing the popular thesis that taxes play a "stimulatory role," and to support certain sectors of the economy, forms of business, and particular categories of taxpayers. Such stimulation additionally deformed the tax system and transformed it into an unfair one in relation to the ordinary law-abiding taxpayer who does not enjoy special tax concessions. The state is currently imposing an excessively high tax burden on such ordinary taxpayers. At the same time, the federal budget's annual losses due to the presence of concessions are estimated by experts at something on the order of \$12-15 billion.

Evaluating the role and significance of tax concessions, we should take account of international experience, and in particular, the analysis of the experience of their use in different states carried out by the Organization for Economic Cooperation and Development. Such analysis shows that:

- tax concessions hardly ever reach the goal for the sake of which they are introduced, and their effectiveness is significantly below the results that might be anticipated from direct (transparent and readily controllable) earmarked budget funding of particular expenses or programs;
- tax concessions violate the principle of equal competition and free flow of capital between different sectors of the economy;
- companies receiving tax concessions lose the stimuli for development, and focus on preserving their privileged status, and when the concessions are abolished, such companies lose their viability;
- companies not receiving concessions fight to obtain them or try to "associate" with those that have them;
- tax concessions inhibit technical progress and promote corruption;
- tax concessions once granted are practically impossible to abolish.

These findings permit the conclusion that not only does granting tax concessions not

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promote fast economic growth, but it also does nothing to strengthen confidence in the state or to make people any more ready to pay unfair taxes voluntarily. Understanding these circumstances, as a general line of improving their tax systems many states have been choosing to cut tax concessions and create equal competitive conditions despite resistance from opponents to such transformations.

In Russia, the situation is aggravated by the fact that the state is objectively incapable of maintaining total control over payment of taxes by all subjects of economic activity. Despite the fact that tax control and tax administration are improving with every year, many potential taxpayers drawn into the "shadow economy" either do not pay taxes at all, or pay them in significantly smaller amounts than prescribed by law. Such a situation, which is a violation of one of the fundamental principles of a market economy--that of creating equal conditions for all subjects of entrepreneurial activity--compels law-abiding taxpayers to also seek ways to minimize taxes and avoid taxation. This is facilitated by the presence of obvious loopholes in legislation on taxes and levies, and by the absence of clear mechanisms in the law making it possible to prevent tax evasion (for example by using "transfer" prices).

While a number of rules were introduced into tax law to compensate for losses of tax receipts, they are devoid of reasonable economic grounds and serve in turn as yet another major factor increasing the hostility of most taxpayers toward the existing tax system.

In turn, the state's inability to resolve, over the course of many years, urgent issues concerned with creating a fair tax system and realistically lightening the tax burden on law-abiding taxpayers has become one of the main causes of development of the shadow economy, massive capital flight abroad, and absence of major foreign investments into the Russian economy, and it is ultimately impeding economic growth and reinforcement of statehood.

Understanding the urgent need for implementing tax reform, the RF government took steps in this direction on several occasions in recent years. Thus, twice the government submitted drafts of the Russian Tax Code to the State Duma (most recently in spring 1998) as a systematized legislative act having the purpose of integrally solving the main problems of tax reform. However, because the government's proposals affected the interests of extremely powerful lobbies, under various excuses the Duma dragged its feet in considering this document and achieving its final adoption. Given the Duma's blatant reluctance to adopt the Tax Code of the Russian Federation (henceforth--Code), the government took steps to resolve the most acute issues of taxation by drafting individual bills addressing specific problems, or its own resolutions. However, there was nothing like a program of transformations or even consistent actions to be seen in this case. One time the government made preparations to repeal VAT in phases, another time it felt that it needed to do away with depreciation deductions, at another time it suggested abolishing standard VAT regulations for exporters, and it vacillated between abolishing and preserving taxes paid on proceeds.

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It would be wrong to assert that there was no forward progress at all in recent years in the area of tax reform. Adoption of the first (general) part of the Code in 1998 and its enactment as of January 1, 1999 was an important step, making it possible to resolve a large number of acute issues associated with interrelationships between taxpayers and controlling authorities, and with administration of tax collection. The adopted document was stripped of many important rules and innovative proposals as it passed through the Duma, and it injected not altogether faultless regulations and mechanisms into tax legal relations, which generated new problems associated with their interpretation. But all of its shortcomings notwithstanding, the Code clearly stipulated the rights and obligations of participants of tax legal relations, regulated performance of tax payment obligations, sorted out tax control regulations, and established liability for tax violations. It also established exclusive lists of federal, regional, and local taxes, and introduced important definitions and new instruments needed for operation of the qualitatively new tax system. Unfortunately far from all of the adopted decisions satisfy the needs of the times. Standing in the wings is a large series of amendments to correct these shortcomings, inasmuch as the revenue base of budgets may suffer the most negative consequences from the action of rules according to which fines can be collected only through court proceedings, from the fact that tax instructions of the Ministry of Taxes and Levies lost their status of normative documents binding on taxpayers, from practical application of the policy of presumption of innocence of the taxpayer and the principle of interpreting dubious and unclear provisions of legislation on taxes and levies exclusively in favor of taxpayers, and from obvious conflicts and inconsistencies between the first part of the Code and the laws and instructions on specific taxes and levies still in force.

However, truly serious steps never have been taken in relation to the conditions governing application of specific taxes and levies. For practical purposes the principal changes in this direction boil down to lowering the rates on enterprise profit tax and income tax in 1999 and introducing amendments into VAT in 2000 rectifying certain imbalances (in relation to regulations on VAT paid by trading organizations and compensation of VAT in capital construction).

The experience of the past years shows how useless it is to try to correct the principal shortcomings in the current tax system by introducing only separate pinpoint--albeit needed--changes into tax legislation. Obviously the problem can be solved solely by adopting a single internally cohesive and comprehensive document in which a balance is achieved between the interests of the state and those of taxpayers. Tax reform must provide, on one hand, for a decrease in the tax burden and for resolution of issues most important to business (elimination of barriers impeding development of business), and on the other, for greater "transparency" of taxpayers to the state, improvement of tax administration, and reduction of the possibilities for tax evasion.

Tax reform will have a chance at success only if we manage to reach a compromise between the government, the regional elite, the Parliament, and business in respect to the direction of the transformations, how fast they occur, and how radical they are. To reach such a compromise, it is important for all sides to demonstrate a readiness to make significant concessions for the sake of the common goal of Russia's economic rebirth. The government

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must initiate a far-reaching propaganda campaign to explain the essence of the reform and show how the unavoidable minuses (from the standpoint of some or even many taxpayers) of the proposed transformations in certain taxes would be compensated by pluses in the same or other taxes. Only by discussing a package solution can we force a departure from customary assessment of individual parts of the picture in favor of its integral perception, and encourage participants of the debate, who have objectively conflicting interests, to make certain sacrifices in particular issues for the sake of reaching the common goal.

Obviously the fastest possible completion of the first phase of tax reform in the form of adoption of the entire Code can become an important prerequisite for generally improving the economic situation and supporting the economic growth that has started in the country.

Obviously, tax reform must not pursue the goal of fundamentally changing the current tax system: its evolutionary transformation facilitating correction of the shortcomings and imbalances inherent to it and aimed at creating a rational, fair, stable, and predictable tax system would be more realistic. Inasmuch as Russia's economy cannot be isolated from the world economy, it is important for such evolution to be directed at convergence with European tax systems. Creation of its own tax system dissimilar from others would inevitably generate problems for foreign investors and foreign companies doing business in Russia, and for Russian companies striving to gain entry into world markets. In particular, a unique tax system would automatically make arrangements for avoidance of double taxation impossible, since these arrangements are applicable only to similar taxes in effect at the same time in the agreeing states.

In addition, we need to consider that the principal taxes listed in articles 13-15 of the first part of the Code provide the principal revenues to the expanded budget even today. Correspondingly, we need to approach serious experiments with these taxes with utmost caution. As for the "traditional" taxes themselves, they have been tested out successfully in most states and under the most varied economic conditions. Both taxpayers and tax authorities in Russia have already managed to adapt themselves to them as well.

However, none of this means that tax reform has to be purely cosmetic. On the contrary the following global goals must be reached through its implementation:

1. Creating a fair tax system.

This goal presupposes:

- equalizing taxation conditions for all taxpayers (chiefly by repealing existing unjustified concessions and exceptions);
- repealing ineffective taxes and levies (mainly the so-called "turnover" taxes) having the most negative influence on the economic activity of economic agents;

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- correcting deformations in regulations on determining the tax basis for particular taxes that distort the economic content of these taxes;

2. Reducing the overall tax burden on law-abiding taxpayers.

This presupposes:

- seeking a more equal distribution of the tax burden among taxpayers;
- lowering the tax burden on the labor compensation fund (ancillary to measures foreseen in item 1).

3. Simplifying the tax system by

- establishing an exclusive list of taxes and levies;
- reducing the number of taxes and levies;
- maximally unifying tax bases and regulations on their calculation in relation to particular taxes, and the procedure of their payment.

4. Making the tax system stable and predictable.

Tax reform must proceed in several phases over a period of 4-5 years. The times successive phases begin should be determined in this case. The entire timetable and sequence of actions must be reflected in the law enacting the second part of the Code. After that, this timetable must be adhered to unconditionally, which will be highly important to the authority of the state and all branches of power in the eyes of the society.

5. Improving tax administration and increasing tax collectability.

To reach this goal, we need to incorporate additional mechanisms and instruments into tax legislation able to support:

- genuine tax control;
- reduction of controlling bodies (through state extrabudgetary funds);
- the possibility to appeal actions (inaction) of tax authorities;
- greater possibilities for out-of-court dispute resolution;
- reduction of opportunities for tax evasion and tax avoidance.

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In order to realize these general goals of tax reform, we must make adjustments in tax and budget legislation that would change the role of the surviving taxes in forming budgets at different levels and extrabudgetary funds.

In particular, while a major decrease in receipts from tax on income of organizations (tax on the profit of enterprises) and tax on income of individuals (individual income tax) is unavoidable, it can become an additional stimulus for developing entrepreneurial activity and expanding the population's solvent demand. In this case we would need to raise the fiscal importance of taxes associated with use of natural resources, and of property taxes, which must become the basis for forming regional and local budgets. A high share of indirect taxes, and mainly VAT, must be preserved within the overall volume of tax receipts at least for the next few years.

As was noted earlier, real easing of the tax burden on the economy must become one of the priority directions of tax reform (according to tentative estimates the nominal tax load reckoned on the basis of 100 percent collection of all taxes and levies is approximately 41 percent of the GDP). Despite serious budget constraints, the Tax Code must provide for a decrease in the nominal tax burden by not less than 8-10 percent as early as in the first year, by not less than 13-15 percent in the next year, and by not less than 20 percent in the third. This decrease must be accompanied by measures increasing actual collection of taxes. These measures must be oriented on broadening the tax base, and they should include decreasing the number and volume of tax concessions and plugging tax loopholes in the legislation.

Overall liberalization of the tax system and noticeable enhancement of protections to taxpayers should facilitate the return, to legitimate use, of capital that disappeared into tax shelters and was taken abroad in recent years. However, we could hardly expect a noticeable positive impact within the first one or two years, although there are examples of a faster response to a tax decrease. Thus, after the share of excise tax in the selling price of hard liquor was decreased in 1999, there was a noticeable increase in legal alcohol production and an abrupt increase in excise receipts associated with it.

The proposed improvements in taxation must include repeal of market-unfriendly taxes and levies (including phased reduction and subsequent repeal of the larger part of taxes paid from proceeds), as well as "minor" taxes and fees producing negligible receipts but relatively expensive to administer, unification of taxes having a similar tax base, and minimization of narrowly targeted taxes and levies. In particular, it would be suitable to repeal taxes on sales of fuel and lubricants, on acquisition of motor transportation resources, and on operations with securities, levies for the needs of educational institutions, levies for use of the names "Russia," "Russian Federation," and words and word combinations based thereon, and taxes for the needs of educational institutions. A single transport tax must combine the currently existing tax on individual kinds of transportation resources with the tax on owners of motor transportation resources.

As was emphasized earlier, equal and fair distribution of the tax burden among all taxpayers is a fundamentally important issue. Such a thing can be achieved mainly by

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reducing the numerous unsystematic tax concessions violating the principle of fairness in relation to those participants of economic activity who do not enjoy tax privileges, inasmuch as concessions for some taxpayers inevitably mean an added tax burden for others. At the same time, in conditions where the state is not as yet able to provide budget support to those who really need it, repeal of tax concessions for some categories of taxpayers must proceed gradually. Consequently some concessions (for example those supporting the disabled, or victims of Chernobyl) will obviously have to be retained, but with tighter conditions on their application that would preclude their use by persons for whom such concessions are not intended. This pertains in full measure to concessions on charitable activities. Certain rules interpreted today as concessions can be transferred to the category of general regulations: in particular, the possibilities for deducting outlays associated with R&D, nature protection measures, and development of mineral deposits may even be expanded.

Despite the fact that the capability of the proposed tax system for providing revenues to federal, regional, and local budgets from guaranteed tax sources is the most important issue to be considered in choosing the areas of tax reform, and that this issue will inevitably arise every time the draft is brought up for discussion, the second part of the Code must be based on the strict understanding that distribution of tax receipts from federal and regional taxes and levies among the different levels of the budget system must remain the exclusive prerogative of budget legislation. This approach follows logically from the provisions of the current Budget Code and the first part of the Tax Code.

Although crediting all federal taxes to the federal budget and subsequently redistributing them would be the better solution, this would hardly be possible in the foreseeable future. Even so, the Code does make room for all kinds solutions to budget problems, even the most flexible, inasmuch as it is based on the fact that even if some tax or levy is classified as a federal tax, this doesn't at all mean that receipts from this tax will go exclusively to the federal budget, since other criteria are used as the basis for classifying taxes going to different levels: the level of legislative (representative) government possessing the right to establish the tax, and the territory on which this tax is applied uniformly. To maintain uniformity of application of federal taxes over all Russian territory (and in contrast to the policy currently effective in relation to certain taxes), tax rates or the share of particular taxes credited to budgets at different levels must not be set directly by the second part of the Code.

The bulk of the revenues of federal and regional budgets is currently formed out of receipts from **federal taxes** (chiefly VAT, profit tax, income tax on individuals, excises) and tax on the property of organizations. Around 89 percent of the entire amount of tax receipts in the expanded budget for 2000 are represented by federal taxes and levies (including transfers to social and road funds). Federal taxes must continue to be the main sources for formation of the revenue side of budgets at all levels; however, changes making these taxes and levies consistent with their economic intent and precluding existing distortions and imbalances have to be made in each of them.

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Value-added tax (VAT) has to undergo some minimal changes (if we're not going to rework it fundamentally). This tax is presently the basis and the most stable source of tax receipts for the federal budget (moreover, it would be entirely possible to consider and resolve the issue of assigning it exclusively to the federal budget). Any drastic changes in VAT would hardly be justified, such that major innovations should be limited solely to including individual entrepreneurs among the taxpayers on the condition that the volume of proceeds obtained by them would not fall below a certain level (the decision to offset VAT in capital construction has already been adopted, and shouldn't be subjected to revision).

VAT rates should not be lowered in the foreseeable future. This tax is rather painless compared to turnover taxes, and does not have a decisive influence on the results of the activities of organizations, inasmuch as it is paid into the budget not out of their profits (income) but out of resources obtained from the purchasers of their goods (work, services). When material resources, including those carried into Russian territory, are acquired for manufacturing purposes, the amounts of VAT paid to suppliers and (or) customs authorities are not charged to product manufacturing and sales costs, but are offset instead against the amount of VAT obtained from the purchasers (customers, clients) of the sold goods (work, services). On the other hand, being an inseparable part of the price of goods (work, services), VAT does not have the dominant influence on the level of prices, inasmuch as the principles of free price formation (the influence of supply and demand, the level of inflation, the ruble's exchange rate relative to foreign currencies, and so on) operate in the conditions of market relations. In this connection, as seven years of experience in applying VAT in Russia shows, a decrease in the tax rate will not lead to a corresponding decrease in the level of the prices of goods (work, services). Consequently VAT is a maximally neutral tax in relation to the dimensions of the working capital of the taxpayers, while being of priority importance to the revenue side of the budget in the face of an unstable financial situation in the economy.

It should also be taken into consideration that the VAT rate currently in effect in Russia is not too high by international standards. In some countries (Finland, Sweden, Poland, and Hungary, for example) VAT rates are higher, being 22-25 percent.

However, transition to payment of the tax at the soonest of three dates--at the moment of shipment, at the moment the invoice is made out, or at the moment payment is received--should have fundamental importance in relation to VAT. In precisely the same way, payment of tax on the income of organizations should be reoriented on the accrual method.

With VAT organized in this way, taxpayers acquiring goods (work, services) will be given the right to offset amounts of "included" VAT at the time of their delivery by suppliers (vendors) irrespective of whether or not the taxpayer has paid for the corresponding goods (work, services). On the other hand when the accrual method is used in application to the tax on income of organizations, a taxpayer determining the amount of his tax obligation will report his income or expenses not in relation to the tax (reporting) periods in which the monetary resources actually passed through the bank accounts or the settlements were completed in some other form, but in relation to those tax (reporting) periods in which

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respectively his right to the income or his obligation to make expenditures arises in accordance with contracts.

Only by making a transition to such a procedure can we get invoices to really begin working as an instrument of tax control, reduce the volume of nonpayments between enterprises (which they often bring about deliberately today), and accelerate receipt of taxes by the budget. At the same time, understanding that the transition to the new procedure can worsen the financial position of enterprises temporarily, and not wishing this proposal to become a serious obstacle to the Code's adoption, we could introduce this procedure with a deferred starting date (for example, by making it effective one or two years hence). Other modifications of the procedure for placing the new regulations into effect are possible as well. In order to make the transition to the new procedure, as a result of which "new" tax obligations will be superimposed over "old" ones, smoother for taxpayers, we need to develop interim statutes providing relief through deferments or installment payments. Even more-radical solutions are possible as well: as an example, when it made a transition of this sort in 1944, the USA opted to forgive "old" taxes in their entirety (while not making such a decision public in advance).

Among other major changes pertaining to VAT, we can single out transition to a new procedure for reckoning and paying this tax on exports to CIS states, under which a transition would be made from payment under the country of origin principle to payment under the country of destination principle. This matter has been under discussion for years already. Other CIS states (chiefly Ukraine and Belarus) are exerting constant pressure with the goal of compelling the Russian Federation to go over to this procedure. Because such a transition will mean obvious losses to the Russian budget due to the positive trade balance with these states and due to the absence of an organized Russian customs border (which opens up extensive possibilities for sham exports [direct translation of *lzheeksporty*]), the Ministry of Finance, the Ministry of Taxes and Levies, and the State Tax Committee have been delaying such a transition. Obviously, however, sooner or later the transition to this procedure will have to be made anyway, all the more so because sham imports are a no less urgent problem under the existing conditions.

The circumstances being what they are, apparently the optimum thing to do would be to foresee, in the Code, implementation of such a transition on the basis of bilateral agreements executed by the RF government with each of the CIS states. In this case rather than granting a tax exemption it would be suitable to follow the international practice of introducing a zero tax rate on exports.

Comparatively negligible changes need to be introduced into the existing procedure of applying excises. In particular, excises on diesel fuel and motor oils should be introduced additionally, in connection with the proposed repeal of the tax on fuel and lubricant sales. The amounts of excises on these goods, plus an increase of some amount in the excise on automotive gasoline, should correspond to that part of the tax on fuel and lubricant sales which is paid today by the gasoline and diesel fuel manufacturers. As a result of such measures, the tax burden on gasoline and diesel fuel manufacturers will not increase.

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In order to lower somewhat the tax burden on manufacturers of alcoholic products and stimulate their legitimate production, we could expand the range of payers of excises on alcoholic products containing more than 25 percent ethyl spirits by volume by transferring the responsibility for paying a part of the excise from the manufacturers to accredited wholesaling organizations that sell such products.

According to requirements of the first part of the Code, the rates of excise on gas, which is one of the main tax sources of the federal budget, must be set directly by the Code. In this case an excise rate of 15 percent is proposed for natural gas, for which state-regulated wholesale prices have been set for deliveries of natural gas to the Republic of Belarus as well, and keeping the rate at 30 percent is proposed for all other natural gas (chiefly that supplied for export). Thus the state will be able to collect a part of the rent from recovery and use of natural gas.

Excises are one of the few taxes for which settlements are already being made (with a certain grace period) not upon payment for the excisable goods but upon the product's shipment. However, this does not extend to natural gas. The Code proposes extending settlement for the excise "upon shipment" to natural gas as well, starting in the second year after this law's enactment.

The most serious changes are to be made in the tax on income of organizations (formerly the tax on profit of enterprises and organizations). It is in relation to this tax that the largest number of problems requiring immediate solution have accumulated. In particular, the inconsistency between the way these expenses are handled for internal accounting purposes and for tax purposes raises serious problems. This is the only currently effective federal tax that is regulated, besides by federal law, by a number of government resolutions addressing the particulars of charging certain expenses of organizations to the cost of goods (work, services).

The approach to forming the tax basis for this tax must be fundamentally changed so that it would correspond to the greatest degree to the income actually received in the tax period. In this case all necessary, justified, and documented expenses of production, movement to the market, and sale of goods (work, services) must be taken as deductions. As we proceed with the transition to the new accounting standards, an increasingly larger gap will form between regulations on recording certain operations and essential circumstances in the financial reports of organizations on one hand, and the need for accounting for these operations and circumstances for tax purposes on the other. This compels us to develop new regulations essentially setting up an independent system of tax accounting. In this case we must avoid a conflict between record keeping for tax purposes and for internal accounting purposes so as not to require taxpayers to conduct two independent forms of accounting. Tax accounting must be based on internal accounting data, and the discrepancies between these two forms of accounting need to be rather easily reconcilable.

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The first and foremost measure that needs to be implemented as early as in 2001 is to lift existing restrictions on the possibility for charging "business expenses" associated with deriving profit to cost (for taking deductions from the tax basis), particularly the expenses on:

- advertising;
- property insurance and insurance of commercial risks;
- interest on borrowed resources obtained both from banks and from other institutions;
- personnel training.

The procedure for depreciating fixed assets and intangibles for tax purposes needs to be changed. Instead of the differentiated system of depreciation rates currently in effect, we need to use consolidated depreciation groups. Maintaining records on just seven such groups is proposed. In this case a mechanism of accelerated depreciation (under which depreciation rates would increase an average of 35 percent over existing ones) and nonlinear depreciation is suggested, allowing enterprises to expense a sizable fraction of the cost of depreciable property in the first months and years of its use.

The taxpayer should certainly have the possibility for obtaining compensation within reasonable time for his expenses on expansion of production, on introduction of the accomplishments of scientific-technical progress, on nature protection measures, and on some other purposes. To realize this principle, a mechanism for capitalizing such expenses followed by their subsequent depreciation is proposed. Such a mechanism is foreseen, in particular, in respect to expenses that cannot be charged all at once to an enterprise's costs in the corresponding tax period (R&D, experimental design, expenses on exploring, preparing, and developing natural deposits, and so on). There are plans to introduce rather flexible and differentiated regulations, for example on "dry" and productive wells, which will make it possible to lower the risks and losses associated with developing new deposits.

More-liberal regulations will be established on carrying over losses to future periods by increasing from 5 to 10 years the period during which such carryover is possible, and lifting current restrictions (carryover only in equal installments, the impossibility for carrying over nonsales losses to future periods).

In addition, regulations currently absent from legislation on taxation of organizations and shareholders upon reorganization and liquidation, upon sale (acquisition) of a business, upon transfer of property to fiduciary management, and in other cases characteristic of today's realities and new legal relations must be prescribed.

In particular, special attention must be devoted to taxation of operations with securities, and of income from such operations or from possession of securities. The tax

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basis for such income must be determined separately from the "main" tax basis, and losses under such operations should be carried over to future income from such operations.

Doing away with "cascade" taxation of dividends is also proposed, so that shareholders could offset tax on dividends withheld at the source when paying income tax.

Of course, introduction of an essentially new tax will also require introduction of a new set of tools, which is why the second part of the Code contains special regulations aimed at curbing possible abuses. It is for this reason that there have appeared tests of insufficient capitalization, and the ensuing peculiarities of applying general regulations, regulations on controlled companies, and some others. Part of the problems associated with transactions between interdependent companies need to be solved within the framework of the first part of the Code, and the corresponding amendments have been proposed to the government.

The tax rate for the income of organizations would best be kept at the level to which it has already been lowered as of the start of 1999--that is, 30 percent (it could even be increased theoretically, so as to avoid the tax system's influence on the choice of forms of a business's organization resulting from the difference in the tax rates applied to the income of organizations and citizens). In this case the tax rate must be the same for all areas of activity (higher tax rates are paid today by banks, insurers, intermediaries, and audio and video product renting institutions).

In contrast to the draft submitted to the RF government previously, according to which tax rates were to be broken down into federal and regional directly within the Code, the new draft does not contain such a rule, thus delegating breakdown of the amount of tax to budget legislation.

Inasmuch as the proposed procedure for depreciation accrual makes it possible for organizations to charge a significant part of the cost of fixed assets to expenses in the first years of their use, we need to do away with the concessions currently effective in relation to profit allocated to funding capital investments.

Serious changes are also needed in the existing conditions of taxing the income of individuals, which have been around since the Soviet era with minor changes. The proposed tax on income of individuals (formerly individual income tax) permits a major step in the direction of strengthening the social orientation of the tax system and implementing the principle of fairness and equal distribution of the tax burden.

In contrast to the current income tax, which foresees numerous tax concessions, the proposal is to have a system of clear and universal standard, social, property, and professional tax deductions. In particular, all taxpayers could be granted a monthly standard deduction of Rub 300, while a Rub 1,000 deduction could be given to disabled persons, victims of Chernobyl, victims of the blockade, and some other poorly protected categories of citizens. Moreover a tax deduction for each spouse amounting to Rub 200 could be foreseen

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in relation to each child up to 18 years of age (the sizes of the deductions are based on today's prices and can be changed with regard for the macroeconomic indicators proposed for 2001).

In the area of social deductions, there are plans to reduce taxable income by exempting socially important expense items such as medical treatment, health care services, and the cost of drugs, as well as tuition charged by secondary and higher educational institutions attended both by the taxpayer himself and by his children. In addition there could be an exemption for specific expenses of organizations on treating employees and (or) their families, on drugs acquired by them, and on all or part of the cost of passes to sanatoriums and health resorts. There are plans to keep in place (with some updates) property deductions related to expenses on acquiring or erecting housing, and those related to income from the sale of real and other property (within certain limits).

The current rates of the tax on income of individuals (12 percent, 20 percent, and 30 percent) would best be kept the same with two-time indexing of the brackets of their application.

Residency.

Inseparability from taxes on the labor compensation fund.

Pursuant to the list of federal taxes set forth in Article 13 of the first part of the Code, and with consideration for the interests of taxpayers, the second part of the Code must include a chapter on contributions to state extrabudgetary social funds, which should provide a uniform procedure for reckoning the tax basis for these payments. However, this doesn't mean doing away with the financial independence of state social extrabudgetary funds. Also of fundamental importance is the fact that in order to legitimize the real expenses of organizations on labor compensation, we need to foresee a regressive scale of contributions to extrabudgetary funds pegged to the proposed scale of taxes on income of individuals, having in mind that the total amount of taxes reckoned for the labor compensation fund must not exceed 50 percent in the first year of the Code's enactment, 45 percent in the second year, and 38-40 percent in the third. Implementation of these proposals will become a major stimulus for legitimizing the real expenses of organizations on labor compensation for employees, and will ultimately expand the basis of taxable contributions and increase the receipts of state extrabudgetary funds.

In the second phase (after 2-3 years) transfers to state extrabudgetary funds will have to be replaced by a uniform social tax, receipts from which should fund the state's expenses on paying minimum pensions, free health care to certain socially unprotected categories of citizens, and expenses on unemployment assistance. Personal pension insurance and health insurance funded by voluntary contributions from citizens will develop in parallel.

The policy of collection of state duties should basically be kept intact in the proposed tax system. Changes should be associated for the most part with repealing certain levies and payments upon enactment of the first part of the Code. In particular, there are plans to

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introduce state duty for state registration of commercial and noncommercial organizations, for changes to founding documents, and for legally important services rendered by the State Motor Vehicle Inspectorate, including issuing state license plates and certificates of technical fitness. A state duty on registering bills of exchange and promissory notes and, in connection with repeal of the tax on operations with securities, state duty for registering a prospectus on issuance of securities could be introduced.

Customs duty and customs levies--a special kind of taxes serving as an instrument of trade policy and state regulation of the domestic Russian commodity market and its interaction with the world market--must be included as a separate chapter in the second part of the Code. Customs duty has the purpose of facilitating effective regulation of taxation of the movement of goods across the customs border of the Russian Federation. Consequently in contrast to other taxes and levies, the right to establish the amounts of customs duties on specific goods moving across the customs border of the Russian Federation must be retained by the government of the Russian Federation both in the immediate future and over the long term.

In contrast to the draft submitted previously by the government, it seems suitable to retain within the combination of federal taxes, at least for the next year or two, the tax on purchase of foreign bank notes and payment documents denominated in foreign currency, which has proven itself well as a stable source of tax receipts for the federal and regional budgets. The regulations governing application of this tax must generally be consistent with those governing that tax today. After a certain while, this tax could be repealed concurrently with stabilization of the money market and consolidation of the banking system and as citizens begin conducting fewer operations of exchanging Russian rubles for foreign currency.

In contrast to the draft submitted previously by the government, it seems suitable to move inheritance and gift tax out of the realm of local taxes and into the composition of federal taxes and levies. Only a definitive list of property should be subject to this tax, as is the case today, and the rates for this tax should be differentiated depending on the degree of kinship with the decedent or benefactor. Things need to be set up such that this tax would be collected not from the first ruble but after deduction of a tax-free minimum, which must be increased significantly. Such a tax exists in many countries, and it has to be a part of the tax system of Russia of the future.

Issues concerned with paid use of natural resources are presently addressed neither by legislation on taxes and levies nor by legislation on exploitation of natural resources. In this case the statutes on paid exploitation of natural resources are general in nature, and they do not provide a clear definition of the principal elements of taxation to be considered when reckoning taxes collected on the use of natural resources. At the same time, according to Article 17 of the first part of the Code the tax is considered to be applicable only to the case when the taxpayers and all elements of taxation are identified. Consequently taxes associated with use of natural resources must be included in the second part of the Code as independent tax payments. This pertains to the mineral resource use tax, tax on reproduction of the

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mineral and raw material base (the rates for which are to be gradually lowered with an eye on their total repeal after five years), the levy for the right to exploit objects of the animal world and aquatic biological resources, water tax, and forest tax. An environmental tax that is essentially a counterpart to existing payments for dumping and discharging pollutants, for burying wastes, and for harmfully impacting the environment in other ways is also proposed.

Taxes associated with use of natural resources do not take all that much of a bite out of taxpayers and are not of major fiscal importance to the state today. Without question, however, their importance should grow in the future. They need to help us solve two problems in this case. First, the impact of these taxes must be sufficient to compel exploiters of mineral resources to use natural resources carefully and economically. Second, receipts from these taxes must become the main source from which to fund statewide measures for the reproduction and maintenance of the natural environment.

To create a favorable and stable investment climate in oil recovery, there is a proposal to introduce a tax on additional income from hydrocarbon recovery, which must be paid by mineral resource users developing new deposits instead of the existing excise on oil. This will make it possible to create a more flexible and fairer tax regime for oil recovery organizations, one which accounts for the higher costs of the first years of exploitation of oil deposits. While excises are collected at a constant rate throughout the entire time of a deposit's development, this tax is to kick in upon attainment of a certain level of recoupment of the costs of oil recovery, and it is to increase progressively as recovery rises and decrease as recovery falls.

Establishment of special tax treatments for product sharing agreements within the framework of the general tax system should become another element of the tax system having the purpose of accounting for the special conditions of recovering minerals. This is brought about by the need for clearly defining the particulars of taxation associated with fulfillment of product sharing agreements with the purposes of creating stable work conditions for investors throughout the entire time of exploitation of mineral deposits, and to ensure observance of the state's interests in the implementation of these agreements.

Also proposed for inclusion on the list of special treatments is a system of taxes on development of unused and low-yield oil wells, to be applied by oil enterprises recovering oil from low-yield wells, as well as from reactivated inactive and test wells and mothballed wells. Such a special treatment will make it possible to put unused and low-yield wells in turnover, inasmuch as their use is economically ineffective under the general tax regime. Possible losses to the budget will be compensated in this case by tax receipts from inactive, test, and mothballed wells placed back in service.

Instead of the current deductions for maintenance of motor roads, which are a vestige of the Soviet era, and which are having a most negative impact on the economic activity of enterprises, there is a proposal for introducing, into the composition of **regional taxes** temporarily for a period of two years, a road tax with a maximum rate of 1.5 percent in the first year of its introduction, and in the second year 0.75 percent of the tax basis taking the

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form of income from the sale of products (work, services) (as opposed to the currently effective maximum rate of 2.5 percent of the volume of proceeds from goods (work, services), which may even be increased by up to 50 percent of the rate insofar as concerns the amount to be credited to territorial road funds). Retention of this tax is seen by us as a forced compromise, necessary for adoption of the second part of the Code, considering the appeals from most subjects of the Russian Federation and the insistent demands from many deputies of the State Duma. However, this tax should be excluded from the tax system after as little as two years.

Among the sources for forming territorial road funds, there is a proposal for introducing, as a regional tax, a transport tax which will essentially make it possible to combine the currently effective tax on owners of transportation resources with the tax on certain kinds of transportation resources. In this case the rate of this tax must be noticeably increased and made dependent upon vehicle engine power.

There is a proposal for introducing a tax on sale of combustible materials for motor fuel in connection with the proposed repeal of the tax on sale of fuel and lubricants in order to provide partial compensation for the lost revenues of road funds. This tax should be paid by wholesale and retail vendors of gasoline, diesel fuel, and liquefied gas. The rates for this tax, which will be set at fixed amounts per unit of sold product, will be computed in such a way as to compensate for that part of the currently effective tax on the sale of fuel and lubricants that is being paid in wholesale and retail motor fuel trade. Together with excises on gasoline, diesel fuel, and passenger cars, such a scheme will make it possible to preserve a guaranteed source of funds with which to replenish territorial and federal road funds without increasing the tax burden on producers of gasoline, diesel fuel, and liquefied gas. Allocation of collected taxes on sale of combustible materials for motor fuel to territorial road funds will create additional stimuli making government authorities of subjects of the Russian Federation interested in maintaining control over full payment of this tax.

The tax on property of organizations, which is collected by a procedure that basically corresponds to that of the tax of the same name presently in effect, must be retained within the composition of regional taxes for the time being. In particular, there are plans to leave in place the tax rate (2 percent) within which legislative bodies of subjects of the Russian Federation are entitled to set specific rates for this tax. Considering the right of territories to introduce additional tax concessions in relation to this tax, and in relation to other regional and local taxes as well, noticeable reduction of such concessions established at the federal level must be foreseen. It seems that the tax on property of organizations should be phased out gradually over the course of 3-5 years. Later on, it should be superceded by a tax on real property, which should also be included on the list of regional taxes foreseen by the Code. This tax could be introduced by decision of legislative (representative) bodies of subjects of the Russian Federation in coordination with bodies of local self-management in place of the tax on property of organizations, the tax on property of individuals, and land tax. Land parcels with buildings, structures, and so on situated thereon belonging to legal entities and individuals would become the object of this tax, which will have as its basis an appraisal of the market value of this property. A maximum tax rate of 2 percent is proposed. It must be

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stipulated in this case that the tax basis for residential real estate must be not less than 10-15 percent of the appraised market value. Some real property shouldn't be recognized as objects of taxation (property belonging to bodies of state government and administration, bodies of local self-management, and budget-supported organizations, property belonging to foreign states or international organizations, property intended for mobilization purposes, and other property). An experiment is currently being conducted with this tax in the cities of Velikiy Novgorod and Tver with the goal of perfecting the mechanism of its application.

Sales tax has recently assumed a special place within the composition of regional taxes. It is presently effective in the overwhelming majority of subjects of the Russian Federation, and has become one of the stable sources for replenishing regional and local budgets with "cold hard cash." Consequently it would be unreasonable to do away with this tax. That certain adjustments must be made in the conditions of application of sales tax (exemption of labor compensation paid in kind and of acquisitions of goods under noncash settlements by individual entrepreneurs from the tax, expansion of the list of goods and services enjoying concessions at the federal level, and so on) with regard for the experience of its application accumulated in 1998-1999 in subjects of the Russian Federation is another matter. Sales tax should also be kept in place as the main regional indirect tax farther into the future, especially after the principle of crediting VAT to federal budget revenues in its full amount is realized.

Instead of the currently existing large number of **local taxes**, the proposal is to limit their list to just five. Tax on maintenance of the housing fund and social and cultural facilities, which is collected at a rate of up to 1.5 percent of proceeds from the sale of goods (work, services), is also among taxes proposed for abolition. This tax currently contributes up to 70 percent to total receipts from local taxes. However, to preserve the tax base for local budgets, it would seem necessary to foresee, within the composition of local taxes, a municipal tax collected from organizations doing business on the territory of a municipal entity in which a normative legal act concerning this tax has been adopted. As with road tax, the object of taxation could be revenues from sale of goods (work, services), and the maximum rate could be 1 percent. In the future, as the fiscal importance of property and land taxes grows, this tax should be repealed. However, as is true for repeal of the road tax, its repeal should proceed in phases through gradual reduction of the tax rate.

In regard to land tax, which is also a local tax, the Code should foresee only the general principles of taxation, which bodies of local self-management will use to determine the procedure for reckoning and paying land tax on the corresponding territory and the specific tax rates on land parcels (from 0.1 to 2 percent of the corresponding tax basis). The tax basis is defined as the cadastre value of the land parcel, and in the absence of the latter it would be the standard price of this parcel. The proposal is to have the government of the Russian Federation specify the procedure for determining cadastre value and the standard price.

The fiscal and social role of the tax on property of individuals must be enhanced in the next few years, particularly by establishing higher tax rates on prestigious and expensive

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real property, by using the market value of property to calculate the tax (under certain conditions), and by making the value of real property still under construction an object of taxation. At the same time, enhancement of the fiscal importance of this tax must be approached rather cautiously so that low-income citizens wouldn't suffer.

Advertising tax, for which the maximum tax rate could be set at 5 percent of the cost of advertising services, is to be kept in place among the large number of local taxes applied in the past. The importance of this tax as a source by which to replenish local budgets should grow after limits on the amount of advertising expenses by which the tax basis of the tax on income of organizations could be decreased are lifted pursuant to the Code.

The Code provides for retention of the currently effective uniform tax on imputed income from certain kinds of activity in somewhat modified form within the framework of a special tax treatment.

However, this tax also contains certain differences accounting for the experience accumulated in its application. Thus, there are plans for constricting the circle of payers of the uniform tax so that it would apply chiefly to the subjects of small entrepreneurial businesses that are in fact small, tax control over which is objectively difficult. A size restriction is proposed in this case for taxpayers going over to this system. Organizations and entrepreneurs conducting business from permanent retail fuel and lubricant outlets using machines to keep a check on cash receipts and meters controlling the receipt and dispensing of fuel and lubricants, both for the fueling station as a whole and for each pump, which makes the entire process completely controllable, should be excluded from payers of the uniform tax. Transition to this regime should be obligatory for taxpayers, in the same way that the present regime is obligatory.

The uniform tax on imputed income foreseen by the Code should "wither away" as controlling efforts by tax authorities improve and the motivations for engaging in tax-free turnover in the form of "unrecorded cash" [*chernaya nalichnost*] decrease. Consequently this regime should not remain in the tax system in the more-remote future.

The draft also foresees a special tax treatment in the form of uniform tax for agricultural commodity producers, which should take account of the peculiarities of agriculture as a sector tied to specific parcels of land. This treatment is an alternative to the currently effective procedure of taxing agricultural commodity producers. Consequently in contrast to the special treatment mentioned above, this procedure is voluntary for taxpayers. The appraised (cadastre) or standard value of agricultural land recognized as the object of taxation is to be adopted as the tax basis. The right to set the rate of the uniform tax, which is determined as a percent of the appraised (cadastre) or standard value of agricultural land, should be placed within the competency of legislative (representative) bodies of subjects of the Russian Federation. And as with the regime of imputed tax, this procedure must be repealed in the more-remote future as the fiscal position of agricultural commodity producers grows stronger.

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The changes to the tax system proposed above must be realized in the form of the second part of the Code, which could be made effective as of January 1, 2001. In the years after that, changes in the tax system will most likely have the nature of refinements, and will be aimed at making the rules foreseen in the Tax Code more specific. Decisions concerning final repeal of all "turnover taxes" and special treatments of the uniform tax type, introduction of a uniform social tax, and universal transition to tax on real property will obviously be exceptions. Other serious changes in the tax system would hardly be suitable in subsequent years.

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Notes on the topic "Reform of the Tax System" are hereby forwarded in connection with the existing agreement and Letter EN-44, February 23, 2000 of the "Center for Strategic Development" Fund.

Attachment: As referenced, on 25 pages.