

# RUSSIA TAX OUTLOOK

#5, July/August 2009

## Anticipated reform of unified social tax: impact on businesses?

The official statistics demonstrate that in the current times of worldwide recession, tax proceeds to the Russian budget and state non-budgetary funds have narrowed by more than 20.1%<sup>1</sup> which can seriously affect the Russian economy. At the same time, Russia is experiencing drawbacks in its pension system (undeveloped pension legislation, low and unfair pension amounts, etc.) which also constitutes a challenge for the national economy and social stability. Thus, Russian authorities have decided to launch a unified social tax (UST) reform to address both these challenges.

In the context of this reform, **draft Federal Law No. 195768-5 “On Insurance Contributions to the Pension Fund, Social Security Fund, Mandatory Medical Insurance Fund and Territorial Mandatory Medical Insurance Funds”** (hereinafter the “Draft”) has been developed. The Draft was passed by the State Duma on its third reading on June 17, 2009 and will be sent to the Federation Council within 5 days of this date. In other words, the Draft should be signed into law in the very near future and be enacted by January 1, 2010 provided no objections are formulated by the Federation Council. This being said, most probably the Draft will be signed into law in the current version as its adoption is provided for by the Basic Guidelines of the Russian Tax Policy for 2010-2012 (approved by the government in April 2009).

An explanatory note to the Draft states that the main objective of the reform is to increase the pension amount. On the other hand, the Draft may appear to increase the fiscal burden which runs counter to the main trend of the Russian tax policy (*i.e.*, diminishing the tax burden) and looks quite unreasonable amid the existing financial crisis. Nevertheless, an analysis of the Draft shows that the effects of the reform on diverse companies may vary significantly, depending on a company's profile.

UST generally regulated by the Russian Tax Code is one of the most burdensome corporate taxes which, according to the official statistics as at May 31, 2009, accounts for over 18% of the aggregate federal tax proceeds<sup>2</sup>. UST is charged on an employee's annual pay and is paid by the employer at own expense (this means that the total UST amount paid by the company depends on the number of employees it hires, the pay disbursed to each employee and the UST rate applied). Originally (in 2001), the base UST rate was fixed at 35.6%, but with effect from 2002 to date a regressive scale has applied with a base rate of 26%.

The Draft aims, *inter alia*, to replace UST with **insurance contributions** to be paid to four separate non-budgetary funds: the Pension Fund, the Federal Social Security Fund, the Federal Mandatory Medical Insurance Fund and the Territorial Mandatory Medical Insurance Fund. Moreover, it is proposed in the Draft that **the general tax rate be increased to 34%** and that the regressive scale be cancelled as follows:

<sup>1</sup> January-May 2009 compared with the same period of 2008, according to the Ministry of Finance.

<sup>2</sup> For reference, VAT accounts for over 40% of federal tax revenue; mineral tax accounts for 26%, corporation tax – for 10% and excise duties – for 2.6%.

Current UST rates	
Employee's annual remuneration	Rate
Below RUR 280,000 (around EUR 6,360)	26%
RUR 280,001 – RUR 600,000 (around EUR 13,630)	RUR 72,800 (around EUR 1,650) + 10% of sum exceeding RUR 280,000
Above RUR 600,000	RUR 104,800 (around EUR 2,380) + 2% of the excess over RUR 600,000

Rates of insurance contributions proposed by the Draft	
Employee's annual remuneration	Rate
Below RUR 415,000 (around EUR 9,430) <sup>3</sup>	34%
Above RUR 415,000	0%

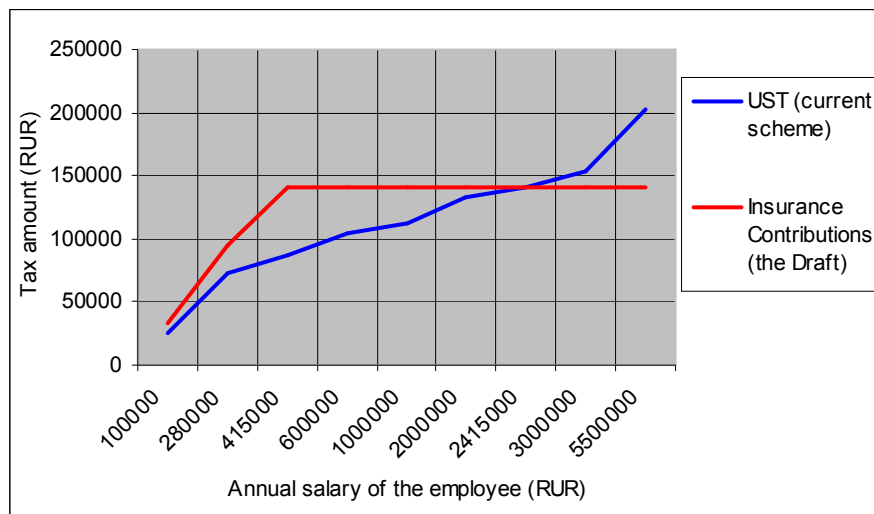
The Draft establishes a transitional period (January, 1 2010 to December, 31 2010) for insurance payments to replace UST and for all general principles introduced by the Draft to apply, save for the general rate which will remain unchanged (i.e., a 26% rate will apply to any pay below RUR 415,000). Moreover, some tax privileges under the Tax Code will be preserved during this period (e.g., companies operating the simplified taxation system will pay insurance contributions at a general rate of 14%).

The attitude towards the Draft in the business environment and Russian mass media is rather negative for several reasons:

- according to the official statistics, the tax burden will increase by up to 150% for most companies and by 300% for small-scale businesses which may prove disastrous for certain taxpayers;
- the Draft tends to cancel privileges for small-scale businesses eligible to use the simplified taxation system: if the existing system exempts such taxpayers from UST, the Draft does not;
- as per the Draft, the rights of the tax authorities to administrate insurance contributions are transferred to the Pension Fund and the Social Security Fund (i.e., these Funds will be entitled to apply enforcement procedures against taxpayers, adopt regulations, etc.). This provision is believed to conflict with the Russian Constitution which does not treat the aforementioned Funds as governmental authorities;
- the Draft does not address side-lining practices, such as underreporting the actual pay.

The most sensitive point of the Draft is a **0% rate for an annual pay above RUR 415,000** (i.e., RUR 34,500 or around EUR 785 per month). Since the average annual pay in Russia is RUR 214,200 or around EUR 4,870 (RUR 374,000 or around EUR 8,500 in Moscow), the difficulties caused by the new UST regime will be experienced by most companies (in particular, large factories, retailers, etc.). However, this provision of the Draft may prove to be rather advantageous for a small number of companies with a high pay: the excess of a monthly pay over EUR 785 will be *de facto* **tax-exempt**. Nevertheless, in comparison with the existing UST system, the new regime will offer tax advantages only for employees with an annual pay above RUR 2,415,000 (or around EUR 54,900, i.e., RUR 201,250 or EUR 4570 per month), as demonstrated below in the comparative chart of the existing and proposed social taxation models:

<sup>3</sup> This sum will be indexed yearly under the corresponding government resolutions.



If the Draft is adopted, the tax paid by the employer will be affected as follows:

- for employees with an annual pay below RUR 280,000: **+30%**;
- for employees with an annual pay of between RUR 280,000 and 415,000: **+53%** (on average);
- for employees with an annual pay between RUR 2,415,000 and RUR 5,500,000: **-15%** (on average).<sup>4</sup>

Although the Draft was adopted only by the State Duma and despite rather negative attitude towards<sup>4</sup> it, the Russian government and the Ministry of Health Care, who elaborated it, believe that the concept and core provisions of the Draft (as discussed in this Tax Outlook) should remain unchanged when further examined in the Federation Council and by the President.

If the Draft is adopted in its current state, your Russia-based company may consider the opportunity to revise its remuneration/HR policies in the context of the new rates of insurance contributions with a view to reduce costs. Once the Draft is adopted, **CMS, Russia** will be happy to assist you in so doing by implementing new and/or revising your existing remuneration/HR structures.

If you have questions on the matters referred to in this **RUSSIA TAX OUTLOOK**, please do not hesitate to contact Dominique Tissot, Partner at +7 (495) 7864000 or [Dominique.Tissot@cmslegal.ru](mailto:Dominique.Tissot@cmslegal.ru) or your regular contact person at CMS, Russia.

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<sup>4</sup> Tax savings may be bigger for a higher pay (for example, an average of - 41% for an annual pay of up to RUR 20,000,000 (or around EUR 454,550)).