

# RUSSIA TAX OUTLOOK

# 7, October 2009

## How to calculate default interest

### Russian Supreme Arbitration Court formulates its position

Today many companies are confronted with difficulties in the recovery of their debt receivables. Practice clearly demonstrates that the number of cases involving defaults on contractual obligations have increased significantly in the present times of financial crisis. Consequently, companies' creditors are willing to compensate their losses and try not only to recover debt, but also to get fines and penalties for delays in execution. Russian civil legislation offers various methods of creditor protection and, more particularly, article 395 of the Russian Civil code (Part I No. 51-FZ of 30 November 1994) provides for one of the most commonly used methods, "default interest", which is applicable to monetary obligations.

At a first glance the provisions of the aforementioned art. 395 of the Civil Code appear to be explicit: it is stipulated that where a debtor delays or avoids his payments to the creditor, the latter is entitled to demand not only the principal debt but also default interest at an amount calculated using the Bank of Russia refinancing rate<sup>1</sup> per year. However, the method of calculation of the basis upon which default interest will be charged can lead to practical problems, particularly in the tax sphere.

As a general rule, the default interest amount is calculated on the basis of the principal debt sum. The latter can be calculated in two different ways: adjusted for VAT taxation or net of VAT. Provided that the general VAT rate is 18%, the difference in the result may be quite important for both debtor and creditor, as illustrated in the table below:

	Debt principal	VAT amount (inclusive)	Basis for default interest calculation	Sum of default interest <sup>2</sup>
Default interest on the debt principal, VAT inclusive	1 180 000 RUB	180 000 RUB	1 180 000 RUB	<b>118 000 RUB</b>
Default interest on the debt principal, net of VAT	1 180 000 RUB	180 000 RUB	1 000 000 RUB	<b>100 000 RUB</b>

Formerly, Russian judicial authorities have considered that the default interest should be calculated on the base of the debt sum net of VAT. This position was based on the Information Letter of the Presidium of the Russian Supreme Arbitration Court No. 9 of 10 December 1996. This Information Letter relied on the provisions of the legislation in force at that time when the obligation to pay VAT had been deemed to appear, i.e. at the moment of payment receipt by the creditor. Consequently, companies did not have to book a relevant legal operation for accounting purposes and did not have to pay VAT to the budget at their own expense before the debtor's payment.

The legislation was changed with the adoption of the Part II of the Tax code No. 117-FZ of 5 August 2000. According to the legal provisions in this act, the creditor's obligation to pay VAT to the budget appears at the moment of booking the debtor's obligation, before the receipt of payment from

<sup>1</sup> For your information, please note that since 30 September 2009 the refinancing rate is equal to 10%.

<sup>2</sup> Calculated on the basis of the refinancing rate in the amount of 10% (assuming that the debt payment was delayed for a one-year period).

the debtor. It means that there are no more legal grounds to apply the position expressed in the Information Letter discussed above.

Most of the courts, however, have continued to support the position of calculating the default interests on the base of the sum of the principal debt net of VAT (see, for instance, the Resolutions of Federal Arbitration Court of the Povolzhskiy region No. A12-11220/2007 of 26 February 2008, of Federal Arbitration Court of the Uralskiy region No. F09-2958/08-04 of 30 April 2008). At the same time the Supreme Arbitration Court has started to change its position in various Resolutions (No. 5706/08 of 13 May 2008, No. 15771/08 of 18 December 2008, No. 2775/09 of 18 March 2009 etc.). These discrepancies caused serious problems for both tax authorities (which also had not formulated a unique position) and companies.

This situation has recently attracted the attention of the Presidium of the Russian Supreme Arbitration Court, which expressed its opinion on the problem in the Decree No. VAS-5451/09 of 22 September 2009. It was explained in the Decree that VAT must be taken into account for the purposes of the default interests' calculation. The conclusion is based on the art. 168 of the Tax code stipulating that the sum of VAT represents a part of the sum payable under the contract. Consequently, in delaying the execution of the monetary obligation the debtor is deemed to use, without due right, the funds of the creditor and not a sum payable to the budget (in particular for the corresponding VAT).

According to Russian legislation, the interpretations of Russian laws by the Presidium of the Supreme Arbitration Court are not considered as legal rules, though they are obligatory for all courts of the Russian Federation. This fact leads us to believe that both tax and judicial authorities will now commonly use this creditor-friendly position regarding the calculation of default interest.

In addition, the other question closely related to the recovery of default interest - the question of VAT taxation of default interests received by the creditor – has not been decided unambiguously yet. The Russian Ministry of Finance has recently issued a Letter No. 03-07-11/222 of 11 September 2009 stipulating that VAT is applicable to default interest. The Ministry refers to the art. 162.1.2. of the Tax code, according to which all sums associated with payments for goods (works, services) increase the VAT base. The courts do not support this position and have delivered more than 30 resolutions (including the Decree of the Presidium of the Russian Supreme Arbitration Court No. 11144/07 of 5 February 2008) supporting creditors and stipulating that the default interest represents a method of protecting from defaults and is not associated with payments for goods and, thus, should not be subject to VAT. Based on the aforesaid, we believe that creditors willing to save VAT on received default interest have a good chance of defending their position in the court.

The numerous court resolutions and clarifications of the Ministry of Finance on the problem of default interest prove that this issue continues to gain increasing importance. We consider that the legal acts discussed have a special significance for companies trying to recover their debts and we recommend taking these new positions into consideration when negotiating contracts and estimating the potential associated risks.

**CMS can offer you the following assistance:**

- Audit of your current contractual strategy and advice on choosing the most suitable and efficient contractual instruments
- Draft and/or review of your existing agreements and assistance in negotiations to achieve more favorable terms
- Audit of existing or planned expenses in view of tax planning
- Representation of your company in disputes with tax authorities and/or contracting parties

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) 786 4000 or [Dominique.Tissot@cmslegal.ru](mailto:Dominique.Tissot@cmslegal.ru) or your regular contact at CMS, Russia.

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