

COMPARATIVE ANALYSIS OF FEDERAL INCOME TAX  
IMPOSED ON U.S. C CORPORATIONS AND RUSSIAN JOINT STOCK COMPANIES

by

ALINA YURIEVNA MITSKEVICH

(Under the Direction of Professor Hellerstein)

ABSTRACT

This thesis compares federal income tax imposed on corporations in two different tax systems: U.S. and Russian. Russian joint stock companies and U.S. C corporations are viewed as subjects of the federal income tax. The thesis analyzes and compares such elements of corporate federal income tax as taxpayers, tax base, rates. The focus of the paper is to find in the U.S. tax system advantages which may be successfully adopted by Russia.

INDEX WORDS: Federal Income Tax, C Corporation, Russian Joint Stock Company, The Tax Code of the Russian Federation

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## DEDICATION

This thesis is dedicated to the memory Larry E Blount, Associate Professor of Law,  
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## CHAPTER 1

### INTRODUCTION

Every year, the State Duma of the Federal Assembly of the Russian Federation has long discussions and serious battles over the annual budget. The problem is always the same: expected expenditures outweigh expected income. Secondly, expected budget income is almost never fully collected. To resolve this problem, the State Duma passes tax laws, for the effective collection of income, which sometimes impose additional burdens on taxpayers.

Despite the fact that the Ministry of Taxes and Fees reported a tax surplus in 2003, the federal budget of the Russian Federation still has a significant deficit.<sup>1</sup> At the same time,

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<sup>1</sup> Department of Analysis and Planning of Tax Collection. Collection of Taxes and Fees (Jan. 15, 2004) (Official Chronic. News) *available at* <http://www.nalog.ru/document.php?id=88178topic=budget>.

However, this data can be argued. Thus, according to Sklyarova Irina, Ministry of Taxes and Fees of the Russian Federation decided to use administrative punishment for its representatives as a tool of effective tax collection. Thus, in case if tax officials do not find any violations of law under tax checks of companies they will suffer administrative sanctions.

I. Sklyarova, *Nalogoviki Nakazut Sebya Sami* [Tax Officials Will Punish Themselves], GAZETA, Apr. 30, 2004, & 76, at 8.

Consequently, presented data may reflect efforts of tax officials to avoid criticism of the Government.

Also, according to Anna Aleksandrova, Commission of Accounting Chamber of the Russian Federation reviewed problems of tax, custom and budget legislation. In the process of discussion it was noticed that tax law consists serious loop holes. Business can avoid taxation significantly and it brings to low effective tax collection. Thus, according to expert estimation, because of tax avoidance, budgets all levels lose from 30 to 40 percent of taxes annually.

A. Aleksandrova, *40 Procentov Nalogov – Mimo Budzeta* [40 Percents Taxes Avoid Budget]. PARLAMENTSKAYA GAZETA Apr. 27, 2004, & 77, at 1.

business suffers from a high tax burden and uses every possible method to avoid taxation. Thus, according to OECD data, the Russian underground economy was 39.2% from the total market in 1995 versus only 8.8% in the United States in 1996.<sup>2</sup> Of course, a high tax burden is not the only problem which pushes Russian companies to avoid taxes. Compared with the United States, Russia is a country with a high level of corruption.<sup>3</sup>

In general, Russia is not always able to fulfill minimum Constitutional guarantees, like protecting citizens from illegal actions taken against them. One of the reasons companies are not willing to pay taxes is the need to provide their own protection, establish their own security departments, or sign contracts with private security agencies. Since the Russian Ministry of Internal Affairs cannot provide adequate protection,<sup>4</sup> companies have to spend significant amount of their income on necessities which should be covered by taxes. Other significant and nondeductible expenses are bribes which companies are pushed to pay officials.<sup>5</sup> As such, neither the Government nor private business are pleased with the present situation.

Conversely, the U.S. tax system demonstrates more progressive tax policy. Even, a cursory view shows that companies may fully pay taxes while simultaneously turning a profit.

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<sup>2</sup> Friedrich Schneider, *Dimensions of The Shadow Economy* (Grafic Detail) V THE INDEP. REV. 1, 81 (Summer 2000) available at [http://www.independent.org/tii/media/pdf/tir51\\_schneider.pdf](http://www.independent.org/tii/media/pdf/tir51_schneider.pdf).

<sup>3</sup> Corruption Perceptions Index 2003. Transparency International. available at [http://www.transparency.org.ru/CENTER/cpi\\_oz.asp](http://www.transparency.org.ru/CENTER/cpi_oz.asp).

<sup>4</sup> D. Krylova, *Za Svoe Pravo Parazitirovat' na Biznese Chinovnikyi Budut Bitsyi do Konza* (Vistuplenie Upravlauscheyi Fondom "Delovaya Perspektiva" D. Krylovoyi na Konferenzyi "Souz Protiv Korrupzyi: SMI, Gragdanskyi Sektor u Biznes Ob'edinayaut Usilia v Borbe s Korrupzieyi) (Moscow. Nov. 23-24, 2000) (June 15, 2001) available at <http://www.ofdp.ru/hotline/mns/dina150601.shtml>.

<sup>5</sup> Yu. Ermakov, *Korrupzionnie Bar'eryi Protiv Businessa – Iz Vyistuplenia na Sekzyi Protivodeistvia Administrativnym Bar'eram* [Corruption Barriers Against Business- From the Presentation made on Section Fight with Administrative Barriers] available at [http://www.nisse.ru/analitics.html?id=ural2003\\_1#21](http://www.nisse.ru/analitics.html?id=ural2003_1#21).

Thus, corporate profits before taxes per National Income and Product Accounts (NIPA), net income (less deficit) per SOI and Income subject to tax (per SOI) increased from 51.5; 43.5 and 47.2 in 1960 to 782.3; 927.5 and 760.4 in 2000 accordingly.<sup>6</sup> Despite the fact that the U.S. economy is not at full strength, companies are still able to grow their business.<sup>7</sup>

Of course, most corporations in the United States also seek to minimize their tax burden by spending significant amounts of money on sophisticated tax planning. Corporations also use so-called tax sheltering, which is one of the most serious obstacles to collection. Corporate tax shelters cost the federal government approximately ten billion dollars per year.<sup>8</sup> Nevertheless, the level of economic development in the United States is much higher than in Russia. As mentioned above, the reason lies in the large Russian shadow economy, corruption, and weak institutions in the Russian Federation.

According to Maurizio Bovi of the ISAE:

If a country is relatively corrupt, its hidden economy is large even if its regulations and tax burdens are not particularly heavy. On the contrary, if institutions were perfectly efficient and completely uncorrupt, high tax rates and onerous regulations would be uncorrelated to the shadow economy, because underground agents can not share the benefits stemming from efficient governments, and because the probability to be detected would approach one. A similar cost-benefit analysis of the firm's decision to operate in the shadow sector helps to understand why black economy and social contributions seem to be orthogonal. On the employee's side, if social contributions are actually fair, there is an incentive to pay for them. On the employers' side, it is possible that social contributions contribute to higher productivity, and are an appreciated source of credit. Furthermore, to the extent the long run

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<sup>6</sup> IRS Statistics of Income Bulletin, 1136 Rev. 09, 2003 available at <http://www.irs.gov/pub/irs-soi/01co15pa.xls>.

U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the United States, 1929-1997, V. 2 (September 2001). Survey of Current Business, various issues, for more recent years. Data on "net income (less deficit)(per SOI)" are from Statistics of Income Tax Returns, various years.

<sup>7</sup> Kathy A. Gambrell, *CBO Predicts Higher Federal Budget Deficits*. UPI White House Reporter. (Aug. 26, 2003) available at [http://www.upi.com/print.cfm?Story\\_ID=20030826-012341-6944r](http://www.upi.com/print.cfm?Story_ID=20030826-012341-6944r).

<sup>8</sup> Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax "GAAP"*. 3 COLUM. BUS. L. REV. 539, 540 (2001).

elasticity between the wage dynamic and the social tax rate tends to  $-1$ , the gross wage, and the firms' behavior, should be relatively independent from the level of the social contributions. Vice versa, the income tax rate shows the highest elasticity, because it creates incentives to go underground that are stronger and one-way: without exemptions hiding income tax base allows to pay less taxes, but also to receive more means-tested social transfers... One is characterized by good institutions, light regulations, little black economy, wide tax base and large tax revenue, the other is characterized by bad institutions, intrusive regulations, large black economy, narrow tax base and reduced tax revenue.<sup>9</sup>

The purpose of this paper is to review present tax laws of the Russian Federation, looking at the federal income tax imposed on legal entities and examining why the federal budget of the Russian Federation has a permanent deficit and reasons taxpayers cannot or do not derive their income legally. U.S. federal income taxation will also be reviewed. As one of the most economically developed countries in the world, the United States has a balanced tax policy which is able to generate enough revenue while not restricting the ability to earn profit legally.

The main purpose for the establishment of a business enterprise is to earn income.<sup>10</sup> Thus, when legal entities cannot earn profit legally, their efforts are frustrated. In such circumstances companies have two choices: to terminate their business altogether or to establish their own rules by going to the shadow market and using shadow transactions to generate "black income". Both options are unproductive for both country and company because the economy is weakened and opportunities for development are lessened; legal entities cannot earn a profit or successfully develop their business; the risk of organized crime expropriating a company's assets and income is increased; and business owners face the imposition of penalties and/or imprisonment.<sup>11</sup> In Russia, a significant number of large, medium and small businesses wish to conduct their business with transparency. They do not

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<sup>9</sup> Maurizion Bovi, *The Nature of the Underground Economy. Some Evidence from OECD Countries*. Institute for Studies and Economic Analyses (ISAE) available at <http://www.brunochiarini.it/research/bovi.pdf>.

<sup>10</sup> GRAZHDANSKII KODEKS RF [GK RF] art. 50 available at <http://nalogi.consultant.ru/cgi/online.cgi?req=home>.

<sup>11</sup> NALGOVYI KODEKS RF [NK RF] available at <http://mns.garant.ru/public/default.asp?no=10800200>.

want to feel pressure from either organized crime or tax services. They are even willing to be involved in some social and charitable programs.<sup>12</sup> Also, many foreign companies, which originally came into the Russian market paying taxes, later avoided taxation. Companies which have the principled position of paying all taxes, including the earnings tax for their employees, hardly survive.<sup>13</sup>

The dilemma is how to pay taxes and stay profitable at the same time. Currently, it is difficult to derive income without violating the law. Therefore, the primary goal of this thesis is to examine weaknesses in the Russian tax system and to identify the primary benefits of the U.S. system which may be successfully adopted in Russia.

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<sup>12</sup> This perception was received in the process of conversation with representatives of companies in the frame of workshops, seminars, conferences, training sessions in the field of fighting corruption and business ethics.

<sup>13</sup> This statement have two sources:

personal experience and experience of other commercial Russian and foreign companies, operating in Russia;

experience of study special course of taxation and calculation net income, left after payment all taxes.

## CHAPTER 2

### CORPORATE TAX AND ITS PAYERS

#### A. Federal Income Tax Imposed on U.S. Corporations and Russian Joint Stock Companies

Before reviewing the U.S. and Russian federal income tax, it is necessary to establish the definition of tax under both U.S. and Russian tax laws.

According to Article 7 of the Tax Code of the Russian Federation (hereinafter –Tax Code), tax is a required, personalized, gratuitous payment levied from organizations and individuals in the form of disposition of assets vested them on the basis of ownership, economic authority or efficient management of funds with the purpose of financially providing for the state’s or municipal’s activity.<sup>14</sup>

In accordance with the Article 17 of the Tax Code a tax is considered stated only when the following elements are determined: taxpayers; object of taxation; tax base; tax rate; tax period; order to calculation of this tax; and order and terms its payment.”

If one of the enumerated elements is missing, the tax is considered unstated and must be repealed.<sup>15</sup>

In the United States, “tax is a charge by the government on the income of an individual, corporation, or trust, as well as the value of an estate or gift. The objective in assessing the tax is to generate revenue to be used for the needs of the public.”<sup>16</sup> Further,

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<sup>14</sup> NK RF art. 7.

<sup>15</sup> NK RF art. 17.

<sup>16</sup> BLAKE’S LAW DICTIONARY 1457 (6<sup>TH</sup> ed. 1990).

extracts from court rulings demonstrate the involuntary nature of taxes and distinguish them from other payments.

*“Commission v. Patt* stated: “Essential characteristics of a tax are that it is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority”... And its essential characteristics is not a debt.”<sup>17</sup> U.S. and Russian law are similar in their definition of tax. In both countries corporate income tax is imposed by the federal government to generate and redistribute income for certain budget items. Both countries define tax as an involuntary and required payment. Unlike Russia, the United States does not identify particular elements of a tax. This thesis will analyze the corporate income tax according to the structure offered by the Tax Code. This chapter will offer a comparative analysis of a group of taxpayers. The second chapter will examine tax objects, or those assets, including funds, which are imposed by corporate income tax. Also, the second chapter will review tax base, one of the most significant components of taxation. Tax base is of significance because taxable base defines the nature of the tax and its influence on the taxpayer’s after-tax profit. A general overview of U.S. and Russian tax policy will conclude the second chapter.

Before reviewing particular taxes, it is necessary to analyze the understanding of income tax in Russia and the United States. Black’s Law Dictionary offers the following definition: “Income tax is a tax on the annual profits arising from property, business pursuits, professions, trades, or offices. A tax on a person’s income, wages, salary, commissions, emoluments, profits, and the like, or the excess thereof over a certain amount. Tax levied by the U.S. Government, and by some state governments, on an individual, corporation, or other taxable unit’s income.”<sup>18</sup>

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<sup>17</sup> Id.

<sup>18</sup> BLAKE’S LAW DICTIONARY 764-765 (6<sup>TH</sup> ed. 1990).

Thus, income taxes paid by individuals and corporations are not distinguished.

Individuals and corporations are treated differently, however, under the Internal Revenue Code. There is no separate definition of income tax in the Russian Federation either. According to Article 12 and 13 of the Tax Code, though, income tax imposed on a legal entity is a federal tax, which requires payment in all regions of the Russian Federation.<sup>19</sup>

## B. Taxpayers

### a. Classification of Russian Legal Entities

According to Article 19 of the Tax Code (Part I), organizations and individuals who are required to pay taxes under the Tax Code are considered taxpayers.<sup>20</sup> The term “organizations” includes legal entities established under Russian law.<sup>21</sup> The legal source that provides the definition of a legal entity is the Civil Code of the Russian Federation (hereinafter Civil Code). Article 48 of the Civil Code offers the following definition: “Legal entity is organization, which has ownership, economic management or efficient management under detached property and assets and is responsible for its obligations by these assets, can *sui juris* acquire and realize rights of property or personal non-property rights and bear responsibilities, to be plaintiff and defendant in court. Legal entities shall have self-dependent balance sheet or account evaluation.”<sup>22</sup>

A comparison of the Russian joint-stock company with the U.S. corporation is relevant because of their similar structure.<sup>23</sup>

Article 66 of the Civil Code provides a general definition for commercial partnerships and companies. “Commercial partnerships and companies are considered commercial entities

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<sup>19</sup> NK RF art 12, 13.

<sup>20</sup> NK RF art 19(2).

<sup>21</sup> NK RF. art 11.

<sup>22</sup> GK RF art 48.

<sup>23</sup> See following analysis of United States corporations.

with divided shares (contributions) from their founders (shareholders) charter fund. Assets established from the contributions of founders (shareholders) and assets, manufactured or acquired in the process of commercial activity considered company property.”<sup>24</sup> Further, commercial partnerships and companies are divided into several subgroups. Among commercial partnerships, the Civil Code specifies complete partnerships and complete partnerships on trust. Commercial companies can exist in the form of joint stock companies, limited liability companies, and companies with additional liability.<sup>25</sup>

One of the most significant differences between commercial partnerships and companies is that members of commercial partnerships cannot be individuals, except if that person is registered as an individual entrepreneur. In addition, only joint stock companies (open or closed) have the right to issue stock.<sup>26</sup> Article 96 of the Civil Code provides:

A Joint Stock Company is a company, which is chartered with capital divided into a certain number of shares. Shareholders are not responsible for its obligations and carry the risk of loss connected with the company’s activity to the extent of owned shares. Shareholders who do not completely own their shares carry joint responsibility for the obligations of the Joint Stock Company only to the extent which shares are not owned.<sup>27</sup>

An almost identical definition is provided for Russian limited liability companies. Article 49 Section 1 of the Civil Code states the legal capacity of a joint stock company: Legal entities<sup>28</sup> shall have civil rights corresponding to the goals of its activity provided in its charter documents<sup>29</sup> and bear obligations connected with its activity. The legal capacity of legal

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<sup>24</sup> GK RF art. 66.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> GK RF art. 96.

<sup>28</sup> Including joint-stock companies.

<sup>29</sup> Such as bylaw.

entities arises from the moment of its founding and ends at the moment of complete liquidation.<sup>30</sup>

#### b. Classification of U. S. Corporations

A U.S. corporation is defined as:

An artificial person or legal entity created by or under the authority of the laws of a state. An association of persons created by statute as a legal entity. The law treats the corporation itself as a person, which can sue and be sued. The corporation is distinct from the individuals who comprise its shareholders. The corporation survives the death of its investors, as the shares can usually be transferred. Such entity subsists as a body politic under a special denomination, which is regarded in law as having a personality and existence distinct from that of its several members, and which is, by the same authority, vested with the capacity of continuous succession, irrespectively of changes in its membership, either in perpetuity or for a limited term of years, and of acting as a unit or single individual in matters relating to the common purpose of the association, within the scope of the powers and authorities conferred upon such bodies by law.<sup>31</sup>

This definition of a corporation as a legal entity is consonant with the general definition of a legal entity under Russian law and particularly with the definition of a Russian joint stock company.

A person who invests in the “equity” instruments of a corporation (a “shareholder”) acquires a legal claim on the corporation’s assets. So does a person who invests in the “debt” instruments of a corporation (a “creditor”). In the paradigm cases, the creditor obtains a right to the return of her investment on a fixed schedule with a fixed rate of return, and with a superior claim to that of any shareholder. The shareholder obtains a right of share in the (potentially unlimited) net profits from the venture once all those holding superior claims have gotten theirs.<sup>32</sup>

For tax purposes, however, not all U.S. corporations are treated as legal entities. Thus, so-called Service corporations<sup>33</sup> may elect to be taxed differently than C corporations. Many corporations though, are not eligible for this election because of the number and kind of shareholders. An eligible corporation can elect Subchapter S of the Internal Revenue Code for

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<sup>30</sup> GK RF art. 49.

<sup>31</sup> BLACK’S LAW DICTIONARY 340 (6<sup>th</sup> ed. 1990).

<sup>32</sup> DOUGLAS A. KAHN. & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION. (4<sup>th</sup> ed. 1994).

<sup>33</sup> These corporations are taxed under Subchapter S of the Internal Revenue Code.

purposes of taxation, or it may operate as a C corporation and later convert to an S corporation.<sup>34</sup> Likewise, an S corporation may change its tax status under Subchapter S to C corporation. “For nontax purposes S and C corporations are treated in the same manner and are subject to the same state laws.”<sup>35</sup> Consequently, an S corporation represents a hybrid of corporate and partnership-type characteristics, and remains subject to the rules of Subchapter C except to the extent preempted by the rules of Subchapter S.<sup>36</sup> According to the Internal Revenue Code, only C corporations are taxed on the legal entity level.<sup>37</sup> Thus, a regular or so-called C corporation is an entity taxable under Subchapter C of the Internal Revenue Code.<sup>38</sup>

A significant nontax aspect of a corporation is that its owners ordinarily are not personally liable for corporate debt.<sup>39</sup> One of the most important aspects of C corporation taxation is double taxation on its profit. First, taxes are assessed on the corporate level. Taxes are then assessed at the shareholder level if the corporation distributes earnings to its shareholders.<sup>40</sup>

Certain business entities are automatically classified as corporations (“per se” corporations), including entities incorporated under state law, certain enumerated foreign

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<sup>34</sup> Jerold A. Friedland, *Tax considerations in selecting a Business Entity: The New Entity classification rules*.

9 DE PAUL BUS. L.J., 111, 109-125, (1996-1997).

<sup>35</sup> *Id.*

<sup>36</sup> KAREN C. BURKE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS*. 13-14 (5<sup>th</sup> ed. 2003).

<sup>37</sup> However, major opinion United States tax experts is that Subchapter C is premised on double taxation of distributed corporate earnings, and, consequently, not only corporation is subject of tax, but also shareholders are taxed on distributions of the corporation’s after-tax earnings.

<sup>38</sup> I.R.C. Subchapter C.

<sup>39</sup> Jerold A. Friedland, *Tax considerations in selecting a Business Entity: The New Entity classification rules*.

9 DE PAUL BUS. L.J., 110, 109-125, (1996-1997).

<sup>40</sup> PHILIP D. OLIVER, BEN J. ALTHEIMER, WILLIAM H. BOWEN *TAX POLICY*. 866 (2<sup>nd</sup> ed. 2004).

entities, and entities classified as corporations under other Code provisions.<sup>41</sup> Other business entities have a right to elect their tax status under the Internal Revenue Code. The legal source for such election is Section 7701 of the Internal Revenue Code.<sup>42</sup> This regulation permits most domestic business organizations, except corporations and joint-stock companies, to be taxed as pass-through entities, which provides for taxation on the shareholder (partner) level.<sup>43</sup>

New regulations provide a “check-the-box” classification by allowing most unincorporated business organizations to elect their corporate or partnership tax treatment under the Internal Revenue Code.<sup>44</sup> “Check-the-box” classification was created for the purpose of reorganizing the existing system and eliminating the burdensome four-factor test.<sup>45</sup> “The former regulations classified an unincorporated organization as a corporation for tax purposes only if it exhibited more than two of these four characteristics: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability of interests.”<sup>46</sup> In contrast, the new “check-the-box” classification system simplifies the election process and provides a more flexible test. For example, corporations or partnerships do not need to restructure their operating agreements to obtain new pass-through tax status.

According to Jerold A. Friedland:

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<sup>41</sup> Reg. & 301. 7701-2(b).

<sup>42</sup> Jerold A. Friedland, *Tax considerations in selecting a Business Entity: The New Entity classification rules*.

9 DE PAUL BUS. L.J., 110, 109-125, (1996-1997).

Victor E. Fleischer, *It looks like a Duck. Corporate Resemblance and Check-the-box Elective Tax Classification*. 96 COLUM. L. REV., 518, 518-557, (1996).

<sup>43</sup> *Id.*

<sup>44</sup> Victor E. Fleischer, *It looks like a Duck. Corporate Resemblance and Check-the-box Elective Tax Classification*. 96 COLUM. L. REV., 518, 518-557, (1996).

<sup>45</sup> *Id.* at 519.

<sup>46</sup> Jerold A. Friedland, *Tax considerations in selecting a Business Entity: The New Entity classification rules*.

9 DE PAUL BUS. L.J., 118, 109-125, (1996-1997).

Under the final Regulations, certain business entities automatically are classified as corporations for tax purposes. Domestic business entities subject to this automatic classification rule include:

- 1) An entity formed under a federal, state or Indian Tribe statute that refers to the entity as “incorporated”, a “corporation”, “body corporate”, or “body politic”.
- 2) An entity organized under a state statute that refers to the entity as a joint-stock company or joint stock association.
- 3) A state chartered entity conducting banking activities, if any of its deposits are FDIC insured.
- 4) A business entity wholly owned by a state or any political subdivision thereof.
- 5) An insurance company.
- 6) Any business entity wholly owned by a state or any political subdivision thereof.
- 7) Any entity that the Code specifically classifies as a corporation for tax purposes outside of section 7701(a)(3), such as publicly traded partnerships under section 7704. The Final Regulations also describe 82 kinds of foreign entities that are classified as corporations for tax purposes... If no member of a foreign entity has unlimited liability, the default classification is taxation as a corporation.<sup>47</sup>

In fact, yet “in 1987, congress added the publicly traded partnerships rules Section 7704, which treat most publicly traded partnerships as corporations for federal tax purposes.”<sup>48</sup> The publicly traded partnership rules proved to be an important addition to entity classification. Thus, Section 7704 states that a partnership (including an LLC or other flow-through under Section 7701) is taxable as a C corporation, if its interests are traded on an established securities market, secondary market, or substantial equivalent.<sup>49</sup>

Every other business entity has the right to elect their tax status. Such business entities are classified as an “eligible entity.”<sup>50</sup> An eligible entity may be both domestic (organized under the laws of the United States) and foreign (organized under the laws of any other

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<sup>47</sup> *Id* at 119-120.

<sup>48</sup> KAREN C. BURKE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS*, 23-24 (5<sup>th</sup> ed. 2003).

<sup>49</sup> I.R.C. & 7704 (2000). An exception is provided where the income of the partnership is “passive type” i.e. if 90% or more of the gross income of the partnership consists of income from passive sources like interest, dividends etc. & 7704 (d) (1).

I.R.C. & 7704 (b) (2000). New publicly traded partnership regulations define “substantial equivalent” rather broadly.

<sup>50</sup> Treas. Reg. & 301.7701-3(a) (1996).

foreign country). For example, a domestic eligible entity with at least two members can elect corporate or partnership status; in the absence of an election, such an eligible entity is classified as a partnership by default.<sup>51</sup> A domestic eligible entity with a single owner can elect corporate status; if no election is made such an eligible single-owner entity is classified as a sole proprietorship, branch, or division.<sup>52</sup> Once chosen, corporate or partnership status may be changed by an eligible entity. Thus, elective conversion from corporate to partnership status is treated as a taxable liquidation of the corporation, followed by a contribution of its assets and liabilities to a newly formed partnership.<sup>53</sup> Elective conversion from partnership to corporate status is treated as a contribution of the partnership's assets and liabilities to a newly formed corporation in exchange for stock. This is followed by a distribution of stock to liquidate the partnership.<sup>54</sup>

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<sup>51</sup> Treas. Reg. & 301.7701-3 (b)(1) (1996).

<sup>52</sup> Treas. Reg. & 301.7701-2(c)(2) (1996).

<sup>53</sup> Treas. Reg & 301.7701 -3 (g)(1) (1996).

<sup>54</sup> *Id.*

## CHAPTER 3

### TAX OBJECTS AND TAXABLE INCOME

#### A. Definition of Taxable Income

The Tax Code consists of two parts: the first part offers tax definitions and the main tax institutions. The second part reviews each tax imposed on companies and/or individuals in detail.

The object of taxation for federal income tax purposes is taxable income of organizations derived by taxpayer. Taxable income, for purposes of the Tax Code and this chapter is:

- 1) For Russian organizations –income less expenses, provided by the present chapter;
- 2) For foreign organizations operating in Russia through permanent establishment – income less expenses derived from such permanent establishments, reduced by the amount of expenses of such permanent establishment;
- 3) For foreign organizations –income derived from sources in the territory of the Russian Federation.<sup>55</sup>

The same definition is found in the United States. The gross income of a corporation is defined under Section 61, and corporate taxable income is determined under Section 63(a) of the Internal Revenue Code by subtracting allowable deductions from gross income.<sup>56</sup> Allowances for deductions can make the tax base narrower or broader, which shall be addressed in Subchapter 3.

#### B. Classification of Taxable Income

Article 248 of the Tax Code provides that income of legal entities consists of:

- a. Income derived from the realization of goods (works, services, and rights of property);
- and

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<sup>55</sup> NK RF art. 247.

<sup>56</sup> I.R.C. §§ 61, 63(a) (2000).

b. Non-realization, but taxable income, which is derived from the activity of a corporation not directly related to its primary activity.<sup>57</sup>

The Tax Code also provides that property (goods or services) or rights to property are received gratuitously if there is no obligation by the receiver to transfer property or services in response.<sup>58</sup> The same is true in the United States.

One group of income is derived from the first realization of goods, works, or services. Each may be produced, manufactured, or purchased by the taxpayer. Also income from the realization of property is included. In short, this income consists of income from primary corporate activity.<sup>59</sup>

Article 39 of the Tax Code gives the following definition of realization of goods, works, and services:

Realization of goods, works, and services by the corporation or individual is transferring in exchange for compensation (including exchange goods, works, and services), rights of ownership for goods, results of works, fulfilled by one entity (individual) for another, paid services, provided for one entity (individual) by another, and in cases, provided by the present Code, transfer of rights for the ownership of goods, results of fulfilled works by one entity (individual) for another, providing services by one entity (individual) for another on gratuitous basis.<sup>60</sup>

Gross income derived from the realization of goods, works and services may be received and booked according to two methods: accrual and cash. In Russia, companies may elect either method. In the United States, by contrast, the corporation must usually elect the accrual method.

Article 314 (tax accounting) of the Tax Code requires taxpayers to calculate their tax basis on accounting data.<sup>61</sup> Russian legal entities are required to keep their records in business

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<sup>57</sup> NK RF art. 248.

<sup>58</sup> *Id.*

<sup>59</sup> NK RF art. 249.

<sup>60</sup> NK RF art. 39.

<sup>61</sup> NK RF art. 313.

accounting as well. The business accounting can be performed under cash method. In practice, the legal entity separates business and tax accounting, because each has significant differences. Recording capital assets and intangible assets in business accounting, for example, is significantly different from their recording in tax accounting. Period amortization of assets is also calculated differently and order of assessment of residue of noncompleted construction records in business and tax accounting.

Russian companies have the right to calculate income tax according to accrual or cash methods.<sup>62</sup> Since business accounting must be performed under the accrual method, legal entities must use two different accounting methods if they are to use the cash method. Thus, in practice, legal entities prefer to use the accrual method for both tax and business accounting to avoid using both methods.

In the United States, the Internal Revenue Code Section 448 requires most C corporations to use the accrual method of accounting. The exception is certain farming corporations 'qualified personal service corporations' (as defined in Section 448 (d) (2)), and entities with average annual gross receipts of \$5 million or less for the 3-year period preceding the taxable year. Qualified personal service corporations are defined as corporations with substantially all of their activities involving the performance of services in certain specified fields (including health, law and accounting), provided that substantially all of the stock in such corporations is owned by employees, retired employees, or their estates.<sup>63</sup>

Non-realization income includes passive income, such as income from stock in other companies, penalties paid by a debtor for violation of contractual obligations, rent income, royalties, interest, misuse of targeted funds, and discharge of indebtedness.<sup>64</sup> Other kinds of non-realization income are provided in Article 250 of the Tax Code.<sup>65</sup>

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<sup>62</sup> NK RF art. 271-273.

<sup>63</sup> I.R.C. & 448 (2000).

KAREN C. BURKE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS. 30-31 (5<sup>th</sup> ed. 2003).

<sup>64</sup> NK RF art. 250.

<sup>65</sup> *Id.*

The same items of passive income are seen in the Internal Revenue Code. Section 61 does not provide a complete list of realization or non-realization income, but it does include income such as gains derived from dealings in property, interest, rents, royalties, dividends, and income from discharge of indebtedness.<sup>66</sup>

Some specific items of non-realization income relevant in the Russian economy may be also relevant in the United States. However, the legislation treatment of these items are significantly different.

Because of instability in the Russian currency, most companies calculate contract amounts in U.S. dollars. Though payments must be made in rubles, Russian law allows contract prices to be in the chosen foreign currency because of the ruble's fluctuation.<sup>67</sup> Suppose two companies signed a contract with all amounts calculated in U.S. dollars. At the time, the exchange rate was 30 rubles per dollar. One party fulfilled its obligation by providing services, but the other party did not pay. Consequently, the first party has accounts receivable. The purchasing party does not pay its debt and during this time the dollar became stronger. If the exchange rate changes to 31 rubles per dollar, receivables increase to 31,000 rubles. According to The Tax Code, this means that the creditor has an income of 1,000 rubles which must be recognized.<sup>68</sup> Further, case if the debtor did not fulfill his obligation to pay, the creditor can consider such failed obligations as a bad debt and report losses within three years.<sup>69</sup> If the obligation to pay is impossible to fulfill and, is terminated by an Act of official

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<sup>66</sup> I.R.C. § 61 (2000).

<sup>67</sup> GK RF art. 317(2).

<sup>68</sup> NK RF art. 250.

According to the Article 250, Section 11 of the Tax Code in case of changes in exchange rate versus official exchange rate and reevaluation of assets of the company, which is subject to claims and liabilities, company has to recognize gain on such changed exchange rate.

<sup>69</sup> When general term of legal claims shall expire GK RF art. 195.

representatives or due to liquidation of the company,<sup>70</sup> the creditor may similarly consider it a bad debt.

Though the creditor did not receive any actual payment, the corporation-creditor must pay taxes on 1,000 rubles of income in the current reporting period. If the chosen foreign currency becomes weaker, the losses may be deducted under Article 265, section (5) of the Tax Code.<sup>71</sup>

The same currency problems are faced in the United States. Thus, it is possible that a U.S. taxpayer who sells an asset purchased abroad or settles a liability arising from a foreign source may realize a gain or loss attributable solely to a change in the value of the U.S. dollar.<sup>72</sup> Thus, foreign currency transactions are treated separately from related transactions.

Section 988 of the Internal Revenue Code provides that with certain exceptions, any foreign currency gain or loss is treated as ordinary income or loss.<sup>73</sup> Such gains or losses are treated as interest income or expenses.<sup>74</sup> However, recognition of ordinary gains or losses under foreign currency transactions may appear under certain circumstances. Thus, the U.S. tax law separates two terms: functional and nonfunctional currency. Section 985 (b) of the Internal Revenue Code provides that in most cases required functional currency for U.S. corporations is the U.S. dollar. However, in certain cases C corporations are allowed to use foreign currency as their functional currency.<sup>75</sup> Thus, corporations are qualified to use foreign currency under the following circumstances:

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<sup>70</sup> NK RF art. 266(2).

<sup>71</sup> NK RF art. 265(5).

<sup>72</sup> Edward A. Weinstein. *The U.S. Tax Treatment of Gains and Losses Realized on Foreign Currency Exchange Rate Hedging*. 18 CASE W. RES. J. INTER'L L. 501 (1986).

<sup>73</sup> I.R.C. § 988(1)(A) (2000).

<sup>74</sup> I.R.C. § 988(a)(2) (2000).

<sup>75</sup> I.R.C. § 985(b) (2000).

- If a U.S. corporation has a self-contained, unincorporated foreign branch and this branch conducts all transactions in local currency; and
- If parent corporation has separate and clearly identified unit of a trade or business of the taxpayer, which maintains separate books and records. Such units are defined as Qualified Business Units.<sup>76</sup>

The functional currency of a Qualified Business Unit, which does not conduct actual business and fulfills only representative functions, shall be the U.S. dollar. Also, corporations are required to use the U.S. dollar as their functional currency for any Qualified Business Unit in a foreign country, which has “hyperinflationary currency”.<sup>77</sup> The Internal Revenue Code precludes any gain recognition due to hyperinflation under Section 985(b) (3).<sup>78</sup> In every other case, foreign currency for business purposes is qualified as the nonfunctional currency and requires recognition of gains. As far as nonfunctional currency is treated as property, its disposition triggers recognition of a gain or loss.

Section 988 (c) of the Internal Revenue Code provides that definition of Section 988 transactions includes following characteristics: transactions where amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. This section includes following transactions: the acquisition of a debt instrument or becoming the obligor under a debt instrument; accruing (or otherwise taking into account) for purposes of this subtitle any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into

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<sup>76</sup> I.R.C. & 989(a) (2000).

<sup>77</sup> Treas. Reg. & 1.985-2(d). A hyperinflationary currency is defined as the currency of a country in which there is cumulative inflation of at least 100 percent during 36 calendar months immediately preceding the last day of such taxable year.

<sup>78</sup> I.R.C. & 985(b)(3) (2000).

account; entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.<sup>79</sup>

Thus, if an accrual basis U.S. corporation sells goods or provides services in exchange for an amount of money denominated in a nonfunctional currency, these receivables are taxed first as U.S. source income, and second as ordinary income, but only when the receivables will be paid.<sup>80</sup> This is a significant difference between Russian and U.S. tax law.

One more difference lies in the timing of recognition of losses. According to Section 166 of the Internal Revenue Code, a corporation may deduct debt which became worthless wholly or partially in the current taxable year. There is no specific criteria to identify when debt is worthless. In contrast, in Russia, the worthless debt generally may be deducted only in three years, or under certain specific circumstances.<sup>81</sup>

### C. Recognition and Nonrecognition Transactions.

#### U.S. Earnings and Profits v. Russian Net Assets

In both countries, income derived from sale or other disposition of stock may initiate a taxable event. Some stock transactions trigger to the realization and recognition of income. Under the Internal Revenue Code, shareholders realize gains from the sale or exchange of property<sup>82</sup> under distribution of property other than dividends made by the corporation, if the distributed property exceeds the adjusted basis of the shareholder's stock.<sup>83</sup> If the distributed property does not exceed the adjusted basis of the shareholder's stock, the adjusted basis is

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<sup>79</sup> I.R.C. & 988(c)(B) (2000).

<sup>80</sup> I.R.C. & 988(c)(1)(B)(ii) (2000).

<sup>81</sup> NK RF art. 266(2).

<sup>82</sup> Term of property is defined by & 317(a) and includes money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

<sup>83</sup> I.R.C. & 301(c)(3) (2000).

reduced by the distributed amount.<sup>84</sup> A shareholder who receives property distributed by a corporation has to treat the fair market value of the property as its basis.<sup>85</sup> These distributions have an effect on the distribution of corporate earnings and profits. According to Section 312 of the Internal Revenue Code, the distributing corporation must make adjustments to its earnings and profits depending on the type of distributed property.<sup>86</sup> Thus, if a corporation distributed appreciated property, corporate earnings and profits must be increased by the amount of the excess.<sup>87</sup> If the corporation distributed depreciated property, it must reduce its earnings and profits by the difference between the fair market value of the distributed property and its adjusted basis.<sup>88</sup> Also, the distributing corporation must adjust the amount of liability to which the distributed property is subject.<sup>89</sup>

There is no definition of earnings and profits under the Internal Revenue Code. However, it refers to the earnings and profits of a corporation after operational expenses and taxes, not to the liquid funds in a corporation.

Current earning and profits are the earning and profits of the current tax year of the corporation. Accumulated earning and profits are the undistributed earnings and profits of prior tax years. The mechanism of calculation of earnings and profits is following. Received gross income is reduced by operating expenses and comes to taxable income. Then taxable income less taxes comes to tentative earnings and profits. In case if corporation has tax exempt interest, it exempts from the tentative earnings and profits as well and comes to the current earning and profits.<sup>90</sup>

Current and accumulated earnings and profits are crucial element in a corporate taxation. Thus, calculation of corporate and shareholder tax liability depends entirely on the

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<sup>84</sup> I.R.C. & 301 (c)(2) (2000).

<sup>85</sup> I.R.C. & 301(d) (2000).

<sup>86</sup> I.R.C. & 312(a) (2000).

<sup>87</sup> I.R.C. & 312 (b) (2000).

<sup>88</sup> *Id.*

<sup>89</sup> I.R.C. & 312(c)

<sup>90</sup> SAMUEL C. THOMPSON, JR., BASIC FEDERAL INCOME TAXATION OF C CORPORATIONS, 148 (1995).

amount current and/or accumulated earnings and profits. Thus, distribution of property<sup>91</sup> to noncorporate or corporate shareholders is regulated by Section 301 of the Internal Revenue Code. The general mechanism of tax treatment distributed property is following: distributed property in extend of current and accumulated earnings and profits are treated as dividend<sup>92</sup> and is taxed consequently. The distribution in excess of earnings and profits is treated as returns of capital in extend of adjusted basis of contributed property. The amount in excess of adjusted basis of invested property is treated as capital gain and is taxed consequently. All distributions in extend of adjusted basis of contributed property reduces adjusted basis of the shareholder. Distributing property is treated according to its fair market value.<sup>93</sup> If the property is subject to a liability or in connection with the shareholder assumes a liability of the corporation, then the amount of the distribution is reduced by the amount of liability.<sup>94</sup> This approach is applied to preclude tax free distributions as redemption and some other shade transactions. Thus, Section 302(a) of the Internal Revenue Code treats redemption as a distribution in part or full payment in exchange for stock.<sup>95</sup> However, there are some limitations imposed by subsection (b). The general rule for the treatment of redemption applies if redemption does not trigger a transaction equivalent to the dividend distribution, provided that immediately after the redemption the shareholder owns less than fifty percent of

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<sup>91</sup> The term property is defined in &317(a) as “money, securities and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)”.

<sup>92</sup> & 316 defines dividend as any distribution of property (1) out of the earnings and profits of a corporation accumulated after February 28, 1913 (accumulated earnings and profits), or (2) out of the earnings and profits of the corporation for the current taxable year (current earnings an profits).

<sup>93</sup> I.R.C. &301(b)(3) (2000).

<sup>94</sup> Treas. Reg. &1.301-1(g) (2000).

<sup>95</sup> I.R.C. &302(a) (2000).

the total combined voting power of stock of all classes entitled to vote or the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.<sup>96</sup>

A series of redemptions resulting in a distribution which (in the aggregate) are not substantially disproportionate with respect to the shareholder cannot be treated as a distribution in part or full payment in exchange for the stock.<sup>97</sup> The same redemption treatment is applicable to related corporations, but not subsidiary corporations. Thus, under Section 304, if one or more persons are in control<sup>98</sup> of each of two corporations and in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, such property is treated as a distribution in redemption of the stock of the corporation acquiring such stock.<sup>99</sup>

Under the Tax Code, transactions involving the sale, exchange, or other disposition of stock may trigger recognition of gains. The gain is based on the amount of realization, which has to be equivalent to fair market value.<sup>100</sup> If stock is not publicly traded, however, the fair market value is the actual price of the disposition, provided that one condition is satisfied: 1) The actual price of such transaction is in the same price bracket on the same date as identical stock registered and traded on a security market; 2) The deviation from the actual price on the date of the trading nearest the first transaction of the average price of identical stock publicly traded on the security market.<sup>101</sup>

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<sup>96</sup> I.R.C. & 302 (b) (2000).

<sup>97</sup> I.R.C. & 302 (d) (2000).

<sup>98</sup> Under I.R.C. & 304(c) a person is treated being in control of a corporation, if this corporation owns at least fifty percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least fifty percent of the total value of the shares of all classes of stock of another corporation.

<sup>99</sup> I.R.C. & 304 (a) (2000).

<sup>100</sup> NK RF art. 280(2).

<sup>101</sup> NK RF art. 280(6).

Shareholder selling his stock gotten upon increasing charter fund of a joint stock company defines the income as a difference between initial price of stock and price of sale.<sup>102</sup>

Tax base from the sale is defined as income received from sale of stock, reduced by expenses and/or losses from its sale.<sup>103</sup> However, expenses and/or losses from the disposition of publicly traded stock can be deducted only against profits, received from disposition the same class of stock. The same rule is true for not publicly traded stock.<sup>104</sup>

In Russia equivalent of earnings and profits is net assets of a company.

Thus, net assets play crucial role under following circumstances: 1) when the charter fund must/can be reduced or can be increased,<sup>105</sup> 2) when Board of Directors makes decision regarding redemption of stock by a company,<sup>106</sup> 3) when a company makes decision to distribute dividends to shareholders.<sup>107</sup> Under Article 35 Section 3 of the Federal Law “About

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<sup>102</sup> Price must be corrected with respect to changes amount of stock in result of increasing charter fund.

NK RF art. 280(7).

<sup>103</sup> NK RF art. 280(8).

<sup>104</sup> NK RF art. 280(10).

<sup>105</sup> According to Article 35, sections 3 and 4 of the Federal Law “About joint stock companies” in case if net assets of a company became less than its charter fund according to accounting data, a company is required to reduce its charter fund to face the same net assets amount. In case if in the result of reduction of the charter fund, it will become less than required minimal charter fund, a company must be liquidated. Further, According to Article 28, section 5 of the Federal Law “About joint stock companies”, in case of issuance additional stock for account of companies’ property, the amount on which the charter fund is planned to be increased can not exceed the difference between the net assets and amount of the charter and reserve fund.

<sup>106</sup> Article 75, Section 2 of the Federal Law “About joint stock companies” stipulates that a company can not acquire stock from shareholders in case if at the date of purchase net assets of a company is less than its charter and reserve fund.

<sup>107</sup> Article 43 of the Federal Law “About Joint Stock Companies” imposes number of limitations for distributing dividends. Thus, company can not distribute dividends to its shareholders if net assets of a company is less than its charter and reserve fund.

Joint Stock Companies” and joint Order of Ministry of Finance of the Russian Federation and Federal Commission of Security Market #03-6/PZ, net assets is difference between company’s assets and payables.<sup>108</sup>

Significant difference between the U.S. and Russian tax treatment of distributing transactions lies in the different approach to the conception of legal entity and its shareholders. According to Russian corporate law, shareholders have right for corporate distributions in certain limited cases. Thus, shareholders can receive corporate property in the form of dividends, return their investment upon complete liquidation<sup>109</sup> and under redemption of stock.<sup>110</sup> In case if property is distributed in the form of dividends tax rates is 6 percent for dividends received from the Russian corporation and 15 percent, if dividends received from the foreign company through permanent establishment or without.<sup>111</sup> In case of liquidation or redemption shareholders are taxed on the difference between adjusted basis of stock and its present fair market value. Article 77 of the Federal Law “About Joint Stock Companies” defines methods of calculation of fair market value redeemed stock. Thus, only not interested

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<sup>108</sup> FZ Ob Akzionernyih Obschestvah [FZ Ob AO] art. 35(3) (Russ.)

available at <http://nalogi.consultant.ru/cgi/online.cgi?req=home>. Prikaz of Ministry of Finance of the Russian Federation and Federal Commission of Security Market, “O poryadke ozenky stoimisty chistyyih aktivov akzionernogo obschestva” ? ? 10n, 03-6/pz [Order of Estimation Amount of net assets of joint stock companies] (Jan. 29, 2003) available at [http://www.valuer-cis.ru/files/ds/4252\\_290103.txt](http://www.valuer-cis.ru/files/ds/4252_290103.txt).

<sup>109</sup> FZ Ob AO art. 31-32.

<sup>110</sup> According to Articles 75 and 76 of FZ Ob Akzionernyih Obschestvah shareholders can claim for redemption their stock by a company under certain circumstances and in certain proportion. For example, shareholders can require a company to acquire their stock in case of reorganization company or in case if company decided to conduct significant transaction, or add changes to the corporate charter, if these shareholders do not take part in the general meeting or voted against. According Article 76 even if shareholders meet Article 75 test, a company cannot spend for acquiring stock from its shareholder more than 10% from the amount of its net assets on the date of the decision, which was the basis for the shareholders’ requirements.

members of Board of Directors,<sup>112</sup> independent directors<sup>113</sup> or independent expert can evaluate the fair market value of stock. Consequently, the Russian tax law does not consist detailed rules for tax treatment distributions to shareholders.

The Russian conception of legal entity strongly separates legal entities from shareholders. From one side, this approach shows short history of corporate law in Russia and not very developed investment policy. From the other side, it protects corporations from using them as a tool for tax sheltering and does not require imposition complicated regulations. In contrast, U.S. corporate law treats corporation as a tool for redistribution profits. The price for this investment favorable policy, however, is highly detailed and sometimes complicated rules for tax treatment corporate distributions.

Both systems exempt some income from taxation. Income in the form of a security deposit, for example, does not constitute taxable income since the company cannot claim ownership. Also, charitable contributions do not constitute taxable income. Furthermore, the Russian and U.S. tax systems provide nonrecognition treatment for contributions to corporate assets (such as money and property) in exchange for stock. At the same time, shareholders cannot realize income and corporations cannot deduct expenses when the corporation distributes the initial cost of the stock to shareholders.

A comprehensive list of non-recognition income is provided in Article 251 of the Tax Code.<sup>114</sup> Non-recognition income includes property, rights to property, work or services received from others in the form of advanced payments and payments or property received in

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<sup>111</sup> II NK RF art. 284(3).

<sup>112</sup> In case if number of shareholders does not exceed 1000.

<sup>113</sup> In case if number of shareholders exceed 1000.

<sup>114</sup> NK RF art. 250.

the form of gratuitous support.<sup>115</sup> Also included are capital and intangible assets gratuitously received in accordance with international agreements of the Russian Federation, property received by budget organizations<sup>116</sup> under the decision of the executive branch officials, money or property received by an agent with the purpose of fulfilling his obligations under an agent contract, money or property received under a mortgage or loan contract, property received gratuitously from a Russian company, property received under targeted financing, and grants, and additional stock received by company-shareholder.<sup>117</sup>

Russian tax law provides that companies do not recognize gains or losses under contribution-distribution transactions at the time of their establishment, reorganization, or liquidation.<sup>118</sup> If a corporation is a shareholder in another company, the corporation may realize gains if transferred assets are appreciated. In this situation, corporations must recognize gains as the difference between the adjusted basis and present fair market value of the asset.<sup>119</sup> The situation is similar in the United States. Section 1001 (c) of the Internal Revenue Code provides that corporations shall recognize the entire amount of the gain or loss on the sale or exchange of property, except as otherwise provided.<sup>120</sup> “Congress has chosen to

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<sup>115</sup> Classified under the Federal Law “About gratuitous support of the Russian Federation and including changes and additions in some legal acts of the Russian Federation about taxes and about establishment of benefits under payments in state non budget funds in connection with implementation of gratuitous support of the Russian Federation”

<sup>116</sup> Under the Russian legislation term budget organization means organization financed from federal or local budgets.

<sup>117</sup> NK RF art. 251.

<sup>118</sup> NK RF art. 251(4).

<sup>119</sup> NK RF.

<sup>120</sup> I.R.C. & 1001(c).

grant many transactions nonrecognition treatment in situations where it is concerned that tax laws might otherwise impede the efficient restructuring of enterprises.”<sup>121</sup>

Thus, according to Section 1001(c) and 1032 (a) no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).<sup>122</sup> However, the same Section provides that individuals, who contributed depreciated or appreciated property to a corporation in exchange for stock or other property ordinarily recognize a loss or gain to the extent the fair market value of the stock and other property received differed from the basis in the transferred property.<sup>123</sup>

Under the Tax Code, neither corporations nor shareholders require to recognize any gain or loss on the difference between the nominal value of stock and the value of property contributed to a corporation in exchange for the stock. The value of acquiring stock is deemed equal to the value of contributed property.<sup>124</sup>

Interestingly, according to the Internal Revenue Code, in the case of complete liquidation, shareholders do not recognize income on property distributed to them in redemption of their stock.<sup>125</sup> In Russia, shareholders do not recognize income only on the value of contributed property on the date of its contribution. If stock has appreciated since the time of contribution, shareholders are taxed on this difference.<sup>126</sup> One exception under Sections 267(a)(1) and (b)(2) of the Internal Revenue Code disallows a deduction for losses

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<sup>121</sup> DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 16 (4<sup>th</sup> ed. 1994).

<sup>122</sup> I.R.C. && 1001 (c), 1032 (a) (2000).

<sup>123</sup> DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 589 (4<sup>th</sup> ed. 1994).

<sup>124</sup> NK RF art. 277(1).

<sup>125</sup> I.R.C. & 331 (2000).

<sup>126</sup> NK RF art. 277(1).

on the sale or exchange of stock when more than fifty percent of the value of the outstanding stock is owned, directly or indirectly, by or for the individual selling the stock.<sup>127</sup> At the same time, if an individual or corporation contributes property to another corporation without any tangible or intangible compensation, the transaction is treated as a contribution of capital and does not produce a taxable event for the acquiring corporation<sup>128</sup> or shareholder.<sup>129</sup> Moreover, section 362(a)(2) provides that “if property was acquired by a corporation...as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer”.<sup>130</sup> Also, a capital contribution does not allow the contributing shareholder to deduct losses from the contribution since the shareholder benefits from an increase in the value of his stock.<sup>131</sup>

Non-recognition treatment is available under Section 351 of the Internal Revenue Code for transfers of property to a controlled corporation in exchange for stock in that corporation.<sup>132</sup> However, non-recognition treatment for such transfers is available only if: (1) one or more persons transfer property to a corporation in exchange for stock in the corporation, and (2) the transferors as a group are in “control”<sup>133</sup> of the corporation “immediately after” the transaction.<sup>134</sup> “Property” includes cash,<sup>135</sup> tangible property, accounts

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<sup>127</sup> I.R.C. & 267(a)(1),(b)(2) (2000).

<sup>128</sup> I.R.C. & 118 (2000).

<sup>129</sup> I.R.C. & 263 (a)(1) (2000).

<sup>130</sup> I.R.C. & 362 (a)(2) (2000).

<sup>131</sup> I.R.C. & 263 (a)(1) (2000).

<sup>132</sup> I.R.C. & 351 (2000).

<sup>133</sup> “Control” means direct ownership of stock possessing at least eighty percent of the total combined voting power of all classes of voting stock and at least eighty percent of the total number of shares of each class of nonvoting stock I.R.C. & 368(c) (2000).

<sup>134</sup> I.R.C. & 351 (2000).

<sup>135</sup> Rev. Rul. 69-357, 1969-1. Cum. Bull. 101.

receivable,<sup>136</sup> a partnership interest,<sup>137</sup> stock in the transferor corporation,<sup>138</sup> stock and securities of the transferee corporation or any other corporation,<sup>139</sup> nonexclusive licenses and industrial know-how, corporate name and good will,<sup>140</sup> and if the local law so recognizes, an enforceable property right in such items. The inclusion of cash does not specifically affect a person who transfers only cash, since he would recognize no gain or loss anyways.<sup>141</sup>

Nonrecognition treatment is also available under the Internal Revenue Code for a corporation issuing its own stock. Section 1032(a) provides that a corporation is not taxed on the issuance of stock nor on the receipts from the sale of its own stock.<sup>142</sup> Neither is a corporation taxed on the profit derived from the sale of its own debt securities.<sup>143</sup> Also, under Section 355 of the Internal Revenue Code, both shareholders and the distributing corporation may receive non-recognition treatment in connection with a corporate division that conducts its business under the auspices of the same corporation.<sup>144</sup> According to this section, no gain or loss shall be recognized and no amount shall be includible in the income of the recipient of the stock or security holder if the following conditions are satisfied:

- 1) A distributing corporation distributes to a shareholder, with respect to its stock, or distributes to a security holder, in exchange for its securities, solely stock or securities of a controlled corporation which it controls immediately before the distribution;
- 2) The transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are

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<sup>136</sup> Rev. Rul. 77-81, 1977 1 Cum. Bull. 97.

<sup>137</sup> Rev. Rul. 84-111, 1984-2. Cum. Bull. 88; Rev. Rul. 81-38, 1981-1. Cum. Bull. 386.

<sup>138</sup> Rev. Rul. 74-503, 774-2 Cum. Bull.

<sup>139</sup> Rev. Rul. 74-503, 1974-2 Cum. Bull. 117.

<sup>140</sup> Rev. Rul. 79-288, 1979-2. Cum. Bull. 139.

<sup>141</sup> *Id.*

<sup>142</sup> I.R.C. & 1032 (a) (2000).

<sup>143</sup> DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 649 (4<sup>th</sup> ed. 1994).

<sup>144</sup> I.R.C. & 355 (2000).

sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device);

3) The requirements of subsection (b) (relating to active businesses) are satisfied, and

4) As part of the distribution, the distributing corporation distributes -

- all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

- an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.<sup>145</sup>

This approach applies to corporations without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation, whether or not the shareholders surrender stock in the distributing corporation, and whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a)(1)(D)).<sup>146</sup> Furthermore, Section 355 contains some limitations and additional conditions, which allow corporations nonrecognition treatment for transactions.

Immediately after the distribution each subsidiary whose stock is distributed must be engaged in the active conduct of a trade or business that is deemed to have been conducted throughout the five-year period leading up to the distribution. Also, if the parent corporation had any assets other than stock or securities in the subsidiaries immediately before the distribution, then the parent corporation as well as subsidiary must be engaged in the active conduct of such a trade or business immediately after the distribution.<sup>147</sup>

This rule designed to preclude shadow transactions with sole purpose to avoid taxation.

For mergers, acquisitions, and structural adjustments, sections 354, 356, 357, 361, 368 of the Internal Revenue Code govern the tax aspects of distribution of property for corporate reorganization. In accordance with Section 361(a), “no gain or loss shall be recognized to a corporation is a party to a reorganization and exchanges property, in pursuance of the plan of

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<sup>145</sup> I.R.C. & 355 (2000).

<sup>146</sup> I.R.C. & 355(a)(2) (2000).

<sup>147</sup> DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 653 (4<sup>th</sup> ed. 1994).

reorganization, solely for stock or securities in another corporation a party to the reorganization.”<sup>148</sup>

Almost the same principle can be seen in the Section 354(a) of the Internal Revenue Code, but with some limitations. Thus, according to Section 354(a)(1) “no gain or loss shall be recognized, if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization”.<sup>149</sup> Such treatment of stock and securities distributions made under the reorganization has a logical explanation: Congress “has decided that taxpayer’s investment remains unliquidated, and that a mere change in the form of investment is not the proper time to tax any gain (or deduct any loss).”<sup>150</sup>

In addition,

Section 361(b)(1)(A) and (B) of the Internal Revenue Code provides nonrecognition treatment not only for exchange of stock or securities, but also for other property and money received together with stock or securities in reorganization plan. However, if such other property or money were not distributed under the plan of reorganization, the gain, if any, to the corporation shall be recognized.<sup>151</sup>

For distribution of appreciated property other than qualified property<sup>152</sup> where the fair market value exceeds its adjusted basis (in the hands of the distributing corporation), the

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<sup>148</sup> I.R.C. & 361(a) (2000).

<sup>149</sup> I.R.C. & 354 (a)(1) (2000).

<sup>150</sup> Christine M. Adams, *Corporate Reorganizations get a New Look: Tightening the Reigns on the Runaway Continuity of Interest Doctrine*, 29 MCGEORGE L. REV., 261, 264 (1998).

<sup>151</sup> I.R.C. & 361 (b)(1)(A), (B) (2000).

<sup>152</sup> “Qualified property” is “any stock in (or right to acquire stock in) the distributing corporation or obligation of the distributing corporation, or any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange.” I.R.C. & 361(c)(B) (2000).

distributing corporation must recognize a gain.<sup>153</sup> Also, included in the fair market value of distributed property subject to liability is the amount of such liability.<sup>154</sup>

If property acquired is a subject to a liability, the transaction passes through Sections 351 or 361 of the Internal Revenue Code.<sup>155</sup> Some exceptions are contained in Subsections (b) and (c) of Section 357. They touch issues of tax avoidance,<sup>156</sup> recognition of gains in excess of adjusted basis<sup>157</sup> where no former shareholder of the transferor corporation receives any consideration for his stock,<sup>158</sup> and exclusion of certain liabilities which would give rise to a deduction.<sup>159</sup>

Under Russian law, reorganization of a joint-stock company does not produce taxable income for shareholders or the company. According to Article 277 Section 3 of the Tax Code, any reorganization of a company does not create income (loss) for tax purposes.<sup>160</sup>

Another transaction identical in Russia and the United States is nonrecognition of appreciation until a sale or other disposition by the shareholder.<sup>161</sup> As for corporate level nonrecognition treatment, the U.S. Tax Reform Act of 1986 established provisions by which a corporation that makes a nonliquidating distribution of appreciated property (other than its

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<sup>153</sup> I.R.C. & 361(c)(2)(A) (2000).

<sup>154</sup> I.R.C. & 361(c)(C) (2000).

<sup>155</sup> I. R. C. & 357(a)(1)(2) (2000).

<sup>156</sup> I.R.C. & 357(b) (2000).

<sup>157</sup> I.R.C. & 357 (c)(1)(B) (2000).

<sup>158</sup> I.R.C.& 357(c)(B) (2000).

<sup>159</sup> I.R.C. & 357 (c) (3)(A) (2000).

All definitions, describing core terms of reorganization, a transfer of assets or stock to subsidiaries, party to a reorganization et c provided in section 368 of the Internal Revenue Code.

<sup>160</sup> NK RF art. 277(3).

<sup>161</sup> I.R.C. (US). NK RF.

own stock or obligations) shall recognize gains.<sup>162</sup> At the same time, if a corporation makes a nonliquidation distribution of depreciated property, the corporation cannot recognize losses on the distribution.<sup>163</sup>

To conclude, the United States and Russia have similar approaches to nonrecognition transactions, with some minor differences, that do not have a great effect. Each approach may be summarized as follows:

- 1) Nonrecognition policy rests on the assumption that a contribution of property or transfer contributed property under plan of reorganization to a corporation represents a continuation of the investment in modified form, rather than a realization of the shareholder's investment;
- 2) As a logical consequence, the nonrecognition policy supports accumulation of investments within a corporation. One purpose of such accumulations is to have sufficient authorized funds to cover creditor's claims, and protect basic capital investments from taxation.
- 3) Shareholders are taxed only on the amount exceeding their contribution in exchange for stock. According to Section 351(b) gains will be recognized at the shareholder level to the extent that the taxpayer receives "boot"<sup>164</sup> and stock.<sup>165</sup>
- 4) The taxation of some dispositions of stock is connected with the prevention of sham transactions, which is the misuse of nonrecognition transactions to avoid taxation or reduce taxable basis.

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<sup>162</sup> I.R.C. & 311(b)(1) (2000).

<sup>163</sup> I.R.C. & 311(a) (2000).

<sup>164</sup> Boot is cash or other property received in addition to stock.

<sup>165</sup> I.R.C. & 351(b) (2000).

#### D. Double Taxation of Corporations in the United States and the Russian Federation

Double taxation is a major issue for U.S. corporations. In contrast to most European countries, the U.S. corporate tax system has a two-level tax structure. First income is taxed at the corporate level. Then, earnings and profits<sup>166</sup> are taxed, a second time when distributed to shareholders.<sup>167</sup> The Internal Revenue Code treats a corporation as an independent taxpaying entity distinct from its shareholders.<sup>168</sup> Thus, a corporation pays income tax on its profits despite the fact that it may distribute profits to shareholders in the form of dividends.<sup>169</sup> According to Catherine Brown, Christine Manolakas:

In the United States, corporate dividends include actual and constructive dividends. Constructive dividends result when, to avoid the double tax, corporations attempt to distribute corporate earnings to shareholders in a form that is deductible at the corporate level. Such distributions are merely recharacterized by the Internal Revenue Service as dividends, and taxed accordingly. Distributions, which result in constructive dividend treatment, include excessive compensation and rents, questionable business expenses, and interest payments on shareholder debt that in reality represents equity. Other examples of constructive dividends include purchases of shareholder property above fair market value, bargain rents or purchases of corporate property, interest-free loans from the corporation, and loans to shareholders without shareholder intent to repay.<sup>170</sup>

The Russian system of taxation has the same classical two-tier approach. According to Article 248 of the Tax Code,<sup>171</sup> realization income<sup>172</sup> and non –realization income<sup>173</sup> are subject to the federal income tax imposed on legal entities.<sup>174</sup>

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<sup>166</sup> The basic role of earnings and profits is to determinate whether a corporation has sufficient amount of a after tax profits be able to make distributions in the form of dividends without impairing its capital, which was formed by shareholders' contributions. 1975 -1. Cum.Bull. 677.

<sup>167</sup> I.R.C. & 61(a)(7), & 301 (2000).

<sup>168</sup> I.R.C. & 11(a) (2000).

<sup>169</sup> I.R.C. & 11(b) (2000).

<sup>170</sup> Catherine Brown, Christine Manolakas, *The United States and Canada: A Comparison of Corporate Nonrecognition Provision*, 30 CASE W. RES. J. INT'L L. 1, 8 (1998).

<sup>171</sup> NK RF art. 248.

<sup>172</sup> NK RF art. 250.

On March 9, 2004, the State Duma passed changes to Article 42 of the federal law entitled “About Joint Stock Companies”<sup>175</sup> to clarify the definition of after tax income from accounts which dividends can be distributed to shareholders. Article 42 of “About Joint Stock Companies” provides that dividends must be paid from net assets.<sup>176</sup> Further, Article 270(1) of the Tax Code, as is the case in the United States, disallows deductions for accrued and distributed dividends and other sums distributed as shareholder income.<sup>177</sup> For both types of shareholders, corporate and individual dividends produce taxable income. According to Article 208, Section 1 of the Tax Code, “An individual has taxable income from dividends or interests when received from Russian legal entities and/or foreign legal entities operating in the Russian Federation through permanent establishment.”<sup>178</sup> Also, Article 250, Section 1 of the Tax Code provides that income from participation of one legal entity in another legal entity is taxed to the first mentioned legal entity.<sup>179</sup>

In contrast, Section 243(a)(1) of the Internal Revenue Code holds that a dividend paid by a domestic corporation (corporation organized or created in the United States or under the law of the United States or of any State)<sup>180</sup> to corporate shareholders shall be allowed as a deduction in an amount dependent on the type of dividend.<sup>181</sup> In fact, corporate shareholders

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<sup>173</sup> NK RF art. 251.

<sup>174</sup> NK RF art. 248.

<sup>175</sup> Pravo. Gosduma RF Prinyala Popravkyi o Dividendah v Zakon “Ob Akzionernih Obschestvah” (News) (Mar. 10, 2004) available at <http://rcc.ru/Rus/LegalServices/?ID=46573>.

<sup>176</sup> FZ About AO art. 42 (RF).

<sup>177</sup> NK RF art. 270(1).

<sup>178</sup> NK RF art. 208(1).

<sup>179</sup> NK RF art. 250(1).

<sup>180</sup> I.R.C. & 7701(a)(4) (2000).

<sup>181</sup> I.R.C. & 243(a)(1) (2000).

have a right to a one hundred percent deduction for dividends only if the corporation, which distributed the dividends and the corporate shareholders, are members of an affiliated group. Otherwise, the corporation qualifies for a partial deduction of seventy to eighty percent.<sup>182</sup>

In contrast to the U.S. corporate tax system, Russian corporations have limitations on distributing dividends to shareholders. According to Article 42, Section 1 of the Tax Code, dividends must be paid in money, or in special cases provided in the corporate charter, in the form of property.<sup>183</sup> Dividends for certain kinds of preferential stock can be paid through an account of special funds established by a company.<sup>184</sup> In contrast to the United States, the Russian Federal Law “About Joint Stock Companies” restricts dividend payments in certain cases. According to Section 1, Article 43 of the Tax Code, a company cannot pay dividends if the charter capital was not completed by contributions of shareholders; if the stock must be redeemed in accordance with Article 76; if the company has indications of bankruptcy<sup>185</sup> or if dividend distribution triggered these indications; if net income is less than charter capital and reserve fund and; in other cases according to Russian federal laws.<sup>186</sup>

In general, the Russian and U.S. systems have similar approaches to the taxation of dividend distributions. However, they have different approaches to the double taxation of corporations. In the United States, theorists and practitioners debate the existing approach to corporate taxation and its possible elimination. To understand the problem of so-called double taxation in the United States it is necessary to apply to the definition of this term. Black’s Law dictionary offers following definition:

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<sup>182</sup> *Id.*

<sup>183</sup> FZ About AO art. 42(1) (RF).

<sup>184</sup> *Id.*

<sup>185</sup> Federalnyi Zakon O Bankrotstve [FZ OB].

<sup>186</sup> FZ About AO art. 43(1) (RF).

The taxing of the same item or piece of property twice to the same person, or taxing it as the property of one person and again as the property of another, but this does not include the imposition of different taxes concurrently on the same property or income (*e.g.* federal and state income taxes), nor the taxation of the same piece of property to different persons when they hold different interests in it or when both the mortgagor and mortgagee of property are taxed in respect to their interests in it, or when a tax is laid upon the profits of a corporation and also upon the dividends paid to its shareholders. “Double taxation” means taxing twice for the same purpose in the same year some of the property in the territory in which the tax is laid without taxing all of it...To constitute “double taxation” two taxes must be imposed on the same property by the same governing body during the same taxing period and for the same taxing purpose...Term also refers to the structure of taxation under the Internal Revenue Code which subjects income earned by a corporation to an income tax at the corporate level and a second tax at the shareholder level if the same income is distributed to shareholders in the form of dividends.<sup>187</sup>

From this definition is seen that even official legal edition, such as Black’s Law Dictionary does not make clear situation with taxation of dividends. From one side, it excludes taxation of dividends from definition of “double taxation”. From the other side, term double taxation includes distribution of corporate after tax earnings and profits to shareholders. Opinions about definition of corporate taxation system as a double taxation system are shared. Part of experts does not agree with the definition of double taxation. First of all, under the Internal Revenue Code C Corporation is treated as independent legal body distinguished from its shareholders. Second, corporations impose real tax burdens on consumers and employees.<sup>188</sup> Third, corporations use advantages of non-taxable deferral of income and other nonrecognition transactions, which minimize their tax burden. The additional leverage to minimize taxable income is passing personal income through corporation, since individual tax rates are higher than corporate.<sup>189</sup>

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<sup>187</sup> BLACK’S LAW DICTIONARY 491 (6<sup>th</sup> ed. 1990).

<sup>188</sup> Consumers bear tax burden paying higher prices for corporate goods, works and services. Employees suffer from lower salaries, than would be without corporate tax.

<sup>189</sup> I.R.C. && 1, 11(b) (2000).

Thus, according to John William Lee:<sup>190</sup> The overwhelmingly high income individual owners of such small income private C Corporations are mostly taxed from thirty-six to forty-five percent on any marginal income, such as the income they have split with their small or moderate income C Corporations (which are taxed from fifteen to thirty-five percent)...A second, outside tax on that corporate income is largely avoided by (1) holding the private C Corporation stock (or merging with a public firm and holding that stock) until death, ideally without paying formal dividends; or by (2) selling it at a long-deferred capital gain, taxed at eighteen to twenty percent. This gives rise to at least a \$3 billion a year or more tax subsidy...Thus, the true tax policy issue for private C corporations is not double taxation, but whether the Treasury will get one tax, one time.<sup>191</sup>

One more advantage to invest in C Corporations is possibility to avoid thirty percent at the source tax on income derived from U.S. corporations by nonresident aliens.<sup>192</sup> “In contrast, a nonresident alien member of an U.S. LLC is subject to a United States income tax on her distributive share of such income.”<sup>193</sup> Consequently, this group of experts suggests that there is no double taxation of corporate dividends.

Most specialists support the idea that the corporate structure of taxation involves double taxation. This camp may be divided into two sub-camps: proponents and opponents of the existing corporate taxation system. Opponents of the so-called integration system have a number of arguments. Some of them have a theoretical character and some of them are practical. Opponents of integration argue that:

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<sup>190</sup> John William Lee, III, Professor of Law, College of William & Mary.B.A.1965, University of North Carolina; LL.B. 1968, University of Virginia; LL.M. (Taxation) 1970, Georgetown University.

<sup>191</sup> John W. Lee, *Populist Political Perspective of the Business Tax Entities Universe: Hey the Stars Might Lie But the Numbers Never Do*, 78 TEX.L.REV., 983, 885-993, (1999-2000).

<sup>192</sup> I.R.C. & 871(a)(1) (2000).

<sup>193</sup> *Id.*

The modern corporation should not be viewed as a mere conduit, because contemporary capital structures allow (i) ownership and management control, (ii) potential economic profits, and (iii) potential economic losses to be divided among many different people, who may or may not be shareholders. Others, have suggested that two-tier taxation helps to solve what is sometimes described as a difficult “agency” problem- without a corporate tax, shareholders might disagree about whether the corporation should dispose of corporate assets; with a corporate tax, such disagreement are minimized.<sup>194</sup>

Opponents of integration have practical arguments as well. Some suppose that double taxation of corporate profits produces more income and presents an effective tool to raise revenue. One of the strongest arguments is that if the integration policy is adopted, existing shareholders will receive a windfall.

Proponents of the integration policy<sup>195</sup> express the following concerns about the existing corporate tax structure:

The double taxation of corporate profits creates significant economic distortions:

- 1) It creates a bias in favor of debt as compared to equity, because payments of interest by the corporation are deductible while returns on equity in the form of dividends and retained earnings are not. It creates the risks of bankruptcy during economic downturns.
- 2) It creates a bias in favor of unincorporated entities.
- 3) Double taxation of corporate profits encourages a corporation to retain its earnings rather than distribute them in the form of dividends.
- 4) Double taxation encourages corporations to engage in transactions such as share repurchases rather than to pay dividends because share repurchases permit the corporation to distribute earnings at reduced capital gains tax rates.
- 5) Double taxation increases incentives for corporations to engage in transactions for the sole purpose of minimizing their tax liability.<sup>196</sup>

At the present day, under the Jobs and Growth Tax Relief Reconciliation Act of 2003, shareholders got partial relief from double taxation.<sup>197</sup> Dividends received by shareholders are taxed at the same rate as capital gains, or at a maximum rate of fifteen percent.

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<sup>194</sup> DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 39 (4<sup>th</sup> ed. 1994).

<sup>195</sup> Integration means unification the corporate and shareholder taxes using different methods.

<sup>196</sup> U.S. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS, at 11-17, 19-22 (2003).

<sup>197</sup> JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003.

This treatment lasts until 2008.<sup>198</sup>

The proposals about Integration, as a panacea from double taxation, have been raised by politicians and tax experts during whole history of corporate taxation. However, it has never been completely and successfully implemented in reality. If presume that the question of double taxation exists for corporation and represent serious problem for their future, either method of elimination two tier system can be applied. Thus, “The Treasury 1992 Integration Study “presents three prototypes representing a range of integration systems”:

- 1) The dividend exclusion prototype;
- 2) The shareholder allocation prototype; and
- 3) The comprehensive business income tax prototype (CBIT).”<sup>199</sup>

According to first approach, a corporation’s taxable income is subject to a 34-percent tax. The after-tax income is added to an excludable distributions account.<sup>200</sup>

Second approach based on allocation corporate income to the shareholders. Under this approach shareholders became taxpayer of corporate income.

All businesses, including corporations, partnerships, and sole proprietorships, would be subject to a single level of tax. An exception would apply, however, for small businesses with gross receipts of less than \$100,000. In computing taxable income, no deduction is allowed for interest on funded indebtedness, like bonds. Comprehensive Business Income Tax Entities (CBIT) would be subject to tax on taxable income at a 31-percent rate. Dividends and interest would be excluded from income of shareholders and debtholders, and under certain circumstances, investors would not be taxed on capital gains on the equity and debt of CBIT entities.<sup>201</sup>

Two first approaches are the most popular today and effective for implementation. Thus, elimination shareholder level tax will allow tax a C corporation independent of

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<sup>198</sup> *Id.*

<sup>199</sup> U.S. TREASURY DEPARTMENT REP., INTEGRATION OF INDIVIDUAL AND CORPORATE TAX SYSTEMS, CHAPTER 1 (JANUARY 9, 1992).

<sup>200</sup> EDA, and distributed dividends of the EDA are not subject to shareholder level tax.

<sup>201</sup> *Id.*

distribution its earnings and profits in the form of dividend. From the other side, imposition corporate tax obligations only on the shareholder level make them closer to the partnerships and S corporations and also may be attractive. This method represents pure integration. Like S corporation and partnerships, shareholders, not C corporations are subject corporate income tax. Under this approach, shareholders are taxed on corporate earned income under any circumstances (whether this income distributed or not). However, the implementation of this approach may produce some technical difficulties for large publicly trade corporations and corporations, which stock held by foreign shareholders.

In Russia, virtually no debate is to be found. The common conception is that a legal entity is separate and independent from shareholders.<sup>202</sup> Thus, shareholders are treated as separate taxpayers and, consequently, corporations are not viewed as subject to double taxation. However, recently, Head of Committee of Property of the State Duma of the Russian Federation, Mr. V. Pleskachevsky proposed to make changes in the Federal Law “About Joint Stock Companies” and reduce tax on dividends, distributing to shareholders by joint stock companies. According to proposal, federal income tax should be reduced from 24 percent to 15 percent on that portion of corporate income, which deemed to be distributed to the shareholders in the form of dividends. At the same time, Mr. Pleskachevsky proposed joint stock companies to distribute no less than 10 percent of their income to shareholders, owners of ordinary stock.<sup>203</sup>

#### E. Classification of Expenditures

The core question for identification of taxable income is whether certain expenses may be deducted or not. The corporate tax burden depends on the total amount of taxable income,

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<sup>202</sup> GK RF.

<sup>203</sup> E. Mazin, Deputaty Pozabotiatsy o Prostih Akzionerah, IZVESTIYA, APR. 26, 2004, at 14.

Deputaty Hotiat Izmenit Nalogooblogenie Dividendov, KOMMERSANT, APR. 26, 2004, at 15.

or tax base. At least in Russia, public opinion disfavors a high tax rate and support reducing individual and corporate taxes to make more after-tax income available. Thus, a lot of politicians build their careers on the basis of cutting taxes. However, it is quite a superficial view. During the last 10 years, the income tax in Russia has been reduced from thirty nine to twenty four percent, but the tax burden is still significant for most companies operating in Russia. And the problem with tax collection lies not only in an insufficient tax rate, but many other factors where expenditures play a role.

In the United States, tax expenditures are tax benefits used as incentives or rewards in lieu of outright payments by the government.<sup>204</sup> In the United States, tax expenditures include credits, exclusions and exemptions, deductions not used in computing net profit, lower tax rates on specified types of income, and increasingly, timing benefits such as accelerated deductions and deferrals.

An ideal definition of tax expenditures is: “Not being outlays from the Treasury, tax expenditures are not reflected in government expenditures and are not subject to the annual Congressional appropriation process. They are not items listed in the budget and affect the budget only through tax receipts being lower than they otherwise would be”.<sup>205</sup>

The Russian legal definition of expenditures is that they are reasonable expenses<sup>206</sup> confirmed by written documents<sup>207</sup>, or are losses sustained by the taxpayer.<sup>208</sup> Expenses are any expenses used for maintenance activity aimed at deriving income.<sup>209</sup>

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<sup>204</sup> PHILIP D. OLIVER, BEN J. ALTHEIMER, WILLIAM H. BOWEN, TAX POLICY. 677 (2<sup>nd</sup> ed. 2004).

<sup>205</sup> *Id* at 678.

<sup>206</sup> “Reasonable expenses” are economically justified expenses expressed in a money equivalent.

NK RF art. 252(1).

<sup>207</sup> Confirmed expenses are expenses, confirmed by documents, executed in accordance with Russian law. *Id*.

<sup>208</sup> NK RF art. 252(1).

<sup>209</sup> *Id*.

As with income, expenditures may be divided into realization and non-realization expenditures. If the same expenditure fits into both groups, the taxpayer may select the group in which to classify the expenditure.<sup>210</sup> The same expenditure cannot be deducted twice.<sup>211</sup> Realization expenditures are expenses connected with manufacturing, storage and delivery, performed work, provided services, acquisition and realization of goods (works, services, rights of property), expenses for maintenance and exploitation, repair and technical maintenance of fixed assets, expenses for developing natural resources, and scientific research.<sup>212</sup>

Realization expenditures are material expenses, expenses on remuneration of labor, amortization deductions, other expenses.<sup>213</sup>

The category of other expenses includes the following expenditures: taxes and fees, accrued according to applicable Russian law (excluding taxes which have already been deducted), expenditures for certification of goods, fees paid to other companies for providing work and/or service, expenditures for providing fire protection to the company, expenditures for providing appropriate work conditions, business trip expenditures, representative expenditures, expenditures for mail and telephone, expenditures for advertisement, expenditures for legal and information services, consulting and audit services, expenditures for acquisition of office supplies, and expenditures for the social protection of invalids (available for organizations, employing invalids<sup>214</sup>).<sup>215</sup>

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<sup>210</sup> NK RF art. 252(4).

<sup>211</sup> NK RF art. 252(5).

<sup>212</sup> NK RF art. 253(1).

<sup>213</sup> NK RF art. 253(2).

<sup>214</sup> Number of invalids consist no less than fifty percent from total number of employees and share of expenses for salary of such people consists no less than twenty five percent.

<sup>215</sup> NK RF art. 264.

Non-realization expenditures do not have a direct connection with manufacturing or realization of goods, works or services and include reasonable expenses connected to the company's activity, and not related to manufacturing and/or realization. Such expenditures include expenses connected with maintaining property transferred under a lease contract (including depreciation), interest from debt obligations, expenditures from issuing stock, unfavorable exchange rate, expenditures of taxpayers using the accrual to form reserves for bad debts,<sup>216</sup> court and arbitrage fees, expenses for bank services, expenses for annual meetings of shareholders, and other necessary expenses.<sup>217</sup>

Non-realization services also include losses to the taxpayer. Thus, included are losses from past tax periods discovered in the present tax period, bad debts (if the taxpayer established a reserve fund to cover dubious debts, amounts not covered by the reserve fund are also included in losses), and losses from a delay in manufacturing (organizational) due to internal or external causes, expenses in the form of lack of stocks of materials and capital equipment in the manufacturing or storages, losses from a force of nature, acts of God, accidents, or other extraordinary situations. These expenses also include expenditures connected with prevention or recovery from such situations and losses under transaction of assignments.<sup>218</sup> Some legal entities, such as banks and insurance companies, have specific rules about expenditures.<sup>219</sup>

The U.S. tax expenditures system includes deductions, credits, deductions for charitable activity, and other preferential treatment for business, especially small business

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<sup>216</sup> NK RF art. 266.

<sup>217</sup> NK RF art. 265(1).

<sup>218</sup> *Id.* &2.

<sup>219</sup> NK RF art. 253(3).

amortization. The U.S. definition of deductible expenditures is found in Section 162 of the Internal Revenue Code:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.<sup>220</sup>

Also deductible is interest, state, local and foreign real property taxes, state and local personal property taxes, the environmental tax imposed by Section 59A, and the GST tax imposed on income distributions. Additionally, a deduction is allowed for state, local, and foreign taxes not described in the preceding sentence, which are paid or accrued within the taxable year in carrying on a trade or business or activity described in Section 212 (relating to expenses for production of income).<sup>221</sup> Double deduction, however, is disallowed.<sup>222</sup>

According to the Tax Code, corporations may deduct expenses which the company incurred for producing goods, paying salaries and other material bonuses for employees, developing natural resources, researching, engineering, and traveling. The same expenditures are found in the Internal Revenue Code, but not described in detail. In Russia, most of these expenditures can be deducted in a very limited amount, which greatly affects taxable income and tax base.

In contrast, under U.S. law, for example, corporations may deduct all ordinary and necessary business expenses (confirmed by receipts or other applicable documents).<sup>223</sup> For purposes of corporate activity, the corporation may deduct all reasonable expenses such as

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<sup>220</sup> I.R.C. & 162, 1 (2000).

<sup>221</sup> I.R.C. & 212

<sup>222</sup> I.R.C. & 642(g) (2000).

<sup>223</sup> I.R.C. & 162 (2000).

travel expenses, meals, lodging, advertising, and hospitality.<sup>224</sup> These expenses do not have limitations and may be deducted if all business, ordinary and necessary criteria are met. In some cases, Congress imposes certain limitations on expenses, which applies to prevent corruption. According to the Foreign Corrupt Practice Act, a \$25 limitation is placed on presents where employees represent their corporation before officials, partners, or clients.<sup>225</sup>

In Russia, strict limitations exist which very often do not allow a significant deduction from gross income. For example, Russian limitations on travel expenses hardly cover 1/3 of real expenses.<sup>226</sup> Thus, companies must include travel expenses in taxable income. This increases companies' taxable income and increases the taxes paid.<sup>227</sup> This is economically inefficient and hampers tax collection because it forces companies to hide income to recover their expenses.<sup>228</sup>

According to Article 264, Section 2 and 4 of the Tax Code, representative expenses of no more than four percent of total salary for the reporting period may be deducted.<sup>229</sup> Expenses for advertising cannot exceed one percent of gross income for the reporting

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<sup>224</sup> I.R.C. § 162(a)(2) (2000).

<sup>225</sup> JEFFREY P. BIALOS, GREGORY HUSISIAN, THE FOREIGN CORRUPT PRACTICES ACT: COPING WITH CORRUPTION IN TRANSITIONAL ECONOMIES 46-48 (1997).

<sup>226</sup> Postanovlenie Pravitelstva Rossiskoy Federatsii O Razmerah Vozmeschenia Rashodov, Svyazannykh so Sluzhebnykh Komandirovkami na Territorii Rossiskoy Federatsii Rabotnikam Organizatsiy, Finansiruemih za No. 729 (Feb. 2, 2002). ROSS. GAZETA.

Rostanovlenie Pravitelstva Rossiiskoy Federatsii Ob Ustanovlenii Norm Rashodov Organizatsii na Viplaty Sutochnykh ulu Polevogo Dovolstvia, v Predelakh Kotorykh pri Opredelenii Nalogovoy Basi po Nalogu na Pribil Organizatsiyi Normah Rashodov Organizatsiyi Takie Rashodyi Otnosyatsya k Prochim Rashodam, Svyazanym s Proizvodstvom i Realizatsiyey. No. 93 (Feb. 8, 2002). ROSS. GAZETA.

<sup>227</sup> In Russia it calls cover expenses for account of net income.

<sup>228</sup> Practical experience of work with different companies.

<sup>229</sup> In Russia the standard reporting period is quarter. NK RF art. 264(2).

period.<sup>230</sup> This is probably inconsequential for large corporations, but significant for newly formed corporations. Usually, when starting, a company has a small staff that consists of essential personnel only. At the same time, the newly established company needs advertising of its goods and services, and must also represent the company to new partners, new clients, and suppliers. Consequently, the company has minor salary expenses, but spends a significant amount of money to promote the business. Thus, the company has a lot of representative and advertising expenses, but can deduct only four percent from salary expenses for representative expenses and one percent from gross income for advertising. The remaining amount must be paid for out of net income.<sup>231</sup>

This approach does not encourage investors to establish a new business if they do not have serious investment capital or the will to conduct sham transactions to generate more untaxed income. Therefore, the Russian economy is not supported, the black market is encouraged, and small businesses are not developed.

Further, according to Article 270, Section 16 of the Tax Code, gratuitous transfers of property, services, work, and all related expenses are nondeductible expenses.<sup>232</sup> If a company wishes to transfer property to a nonprofit fund or organization, it may do that, but without reducing net income. As such, the government completely discourages companies from making donations or participating in charitable activity. In contrast, contribution is encouraged in the United States.<sup>233</sup> A corporation cannot deduct charitable contributions that exceed ten percent of its taxable income.<sup>234</sup> Charitable contributions that exceed the ten

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<sup>230</sup> *Id.*

<sup>231</sup> NK RF art. 270 (42),(44).

<sup>232</sup> NK RF art. 270(16).

<sup>233</sup> I.R.C. & 170 (2000).

<sup>234</sup> I.R.C. & 170(b)(2) (2000).

percent limit, however, can be carried over in the next five years.<sup>235</sup> “If a corporation has a carryover of excess contributions paid in 2002 and it does not use all the excess contributions in the carryover year until after the corporation deducts contributions made in that year (subject to the ten percent limit). The corporation cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.”<sup>236</sup> According to official data, charitable deductions are projected to be one of the top tax deductions from 2004 to 2008.<sup>237</sup>

In Russia, “material support”<sup>238</sup> for employees is distinguished from salary, bonuses and other compensation. If a company subsidizes an apartment purchase, for example, the expenditure is nondeductible.<sup>239</sup> In the United States, this compensation is presumed a bonus and is deductible since the Internal Revenue Code imposes no restrictions on such expenses. Such compensation stimulates employees and makes them more loyal to the company. This is especially true in Russia since the joint social tax is so high <sup>240</sup> and companies pay their employees a lower salary or pay part of it under the table. Though material support would significantly increase employees’ motivation, the current tax structure renders it unprofitable.

According to the Tax Code, all expenses must be sufficiently recorded. Companies must prove sustained expenditures that were necessary and related to the activity of the company. However, in practice, it is not always possible to record and consequently prove all expenses. For example, a company that conducts business in different regions of Russia and

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<sup>235</sup> Publication 542 (2003). Corporations, available at <http://www.missouribusiness.net/irs/publications/p542-2.html>.

<sup>236</sup> *Id.*

<sup>237</sup> PHILIP D. OLIVER, BEN J. ALTHEIMER, WILLIAM H. BOWEN, TAX POLICY, 691 (2<sup>nd</sup> ed. 2004).

<sup>238</sup> NK RF art. 270(23).

<sup>239</sup> *Id.*

<sup>240</sup> NK RF art. 241.

the world market would incur large telephone bills. Theoretically, the company may deduct these expenses, but they must be justified as a necessary expense. Tax regulations require the taxpayer to present a contract or other written document to prove that the phone number dialed belongs to a potential partner with whom the company would like to develop business or conduct negotiations. If a company cannot prove an expense, it includes it in taxable income. Tax services thus try to preclude companies from deducting personal phone calls. Despite this fact, some trust should exist. In the United States, for example, a company may deduct its phone bills, but if the Internal Revenue Service later finds dishonesty, the company faces serious penalties, including criminal prosecution. Thus, while it is important to install rules, it should be done in a balanced way which does not impose an additional burden on corporations.

Russian tax policy is focused on results. Thus, under the Tax Code, if a company signs a contract with a partner or with a client, it can deduct its expenses. If a company conducts scientific research centered on improvement of its products, the company deducts expenses in the full amount when success is achieved.<sup>241</sup> If a company does not achieve success, however, it can deduct only seventy percent from expenses.<sup>242</sup> U.S. tax policy is more oriented on effort. A company may deduct if it tried to develop its business. According to Section 174 of the Internal Revenue Code, “a taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to a capital account. The expenditures so treated shall be allowed as a deduction”.<sup>243</sup> Moreover, research or experimental expenditures, which are paid by a corporation in connection with its trade or business and which are not

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<sup>241</sup> NK RF art. 262(2).

<sup>242</sup> *Id.*

<sup>243</sup> I.R.C. & 174 (a)(1) (2000).

qualified as expenditures mentioned above, may be treated as deferred expenses. “In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realized benefits from such expenditures).”<sup>244</sup>

The U.S. approach is more reasonable. A company can only find success if it takes risks. As such, U.S. tax policy encourages companies to take risk.

The United States also allows business start-up expenses to be deducted in certain circumstances. According to Section 192(b) “start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins)”.<sup>245</sup> Thus, when a U.S. corporation starts its business, a number of costs connected with establishing the business may be deducted. For example, the corporation may deduct an analysis or survey of potential markets, products, labor supply, and transportation facilities even before the corporation officially registers.<sup>246</sup>

Office utilities may also be deducted, subject to significant limitations, according to Russian tax law. For example, a company cannot deduct office utilities unless it has a direct contract with the provider of the services. In reality, it is not always possible to have a direct contract with the provider. In many cases a landlord maintains a contract with providers and renders services under the lease contract. Terminating the contract with the landlord and signing a new one with each lessee is insufficient for service providers, so they are unwilling

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<sup>244</sup> I.R.C. & 174 (b)(1) (2000).

<sup>245</sup> I.R.C. & 192(b) (2000).

<sup>246</sup> *Id.*

to change their contractual relationships with landlords. Consequently, in many situations, companies which lease offices cannot deduct their expenditures for utility services.

In addition to the nondeductible items mentioned above, Article 270 generally makes items transferred to the company for temporary use nondeductible. The same is true when title to property is not yet transferred, for penalties for violation of laws, and for bonuses to employees or nonprofit organizations which are presumed to be unnecessary.<sup>247</sup>

Deductions disallowed under U.S. law include:

1. Expenses connected with issuing or selling stock and expenditures connected with transfer of assets to the corporation. Under Russian law these expenses are deductible;
2. Expenses connected with the reacquisition of stock;
3. Payments in excess of \$1 million to a “covered employee”, which is the CEO or one of the four most highly compensated executive officers.<sup>248</sup> This rule does not apply if shareholders approve the transaction, if the corporation meets requirements accountability or if CEO supervision leads to significant results;
4. Section 267(a)(1) disallows deductions for losses on sales or exchanges of property between certain related parties.<sup>249</sup> Under Section 267(b),<sup>250</sup> an individual and a corporation are treated as related parties if the individual owns directly or indirectly more than fifty percent of the value of the corporation’s outstanding stock;
5. The “matching” rules of Section 267(a)(2) also defer deduction when an item of expense or interest owned by accrual-method taxpayer is transferred to a related party that uses the cash method until the item is included in the payee’s gross income (generally when paid).<sup>251</sup> This

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<sup>247</sup> NK RF art. 270.

<sup>248</sup> I.R.C. & 162(m)(2000).

<sup>249</sup> I.R.C. & 267(a)(1)(2000).

<sup>250</sup> I.R.C. & 267(b) (2000).

<sup>251</sup> I.R.C. & 267(a)(2) (2000).

provision is intended to prevent a corporation from deducting accrued but unpaid salary owed to a controlling shareholder employee;

6. “Golden parachute” payments, which are payments to a “disqualified individual.”<sup>252</sup>

The U.S. tax system uses tax credits. U.S. tax law has historically been used to encourage certain activities that the government deems desirable, but that people or companies might not otherwise undertake on their own business.<sup>253</sup>

A significant difference from deductions is that allowable amounts on tax credits always remain the same regardless of the income level and tax bracket of a corporation. With deductions, however, the amount of money, which a corporation is actually saving by claiming a deduction depends largely on the income level and tax bracket of a corporation. Tax credits are a good example of that type of policy.<sup>254</sup>

The work opportunity tax credit was designed to provide an incentive to hire people from certain disadvantaged groups with a high unemployment rate. It was created in 1996 to replace the expired targeted jobs credit.<sup>255</sup> Disabled access is another tax credit that was established under the American with Disabilities Act of 1990 (ADA). Law provides that businesses open to the public must accommodate persons with disabilities who seek to use their services. The tax credit is available only to small businesses – that is, those having: (1) gross receipts of \$1 million or less, or (2) having no more than 30 full-time employees.<sup>256</sup> According to the Tax Code, companies operating in Russia also may enjoy deductions if they hire disabled individuals. Article 264, Section 38 of the Tax Code provides that expenditures incurred by a company to provide social benefits for disabled employees can be deducted if

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<sup>252</sup> I.R.C. §280G (2000).

<sup>253</sup> CCH. Financial Planning Toolkit. Credits Benefiting Disadvantaged Groups.

*available at* <http://www.finance.cch.com/text/c60s15d775.asp>.

<sup>254</sup> Intro to Corporate Taxes: Corporate taxes – Your Tax Credits.

*available at* <http://www.taxgaga.com/pages/c-business/corptaxcredit.html>.

<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

the number of disabled employees is not less than fifty percent of all staff and the share of their salary is not less than twenty five percent of total payroll.<sup>257</sup>

The Indian employment credit is for those corporations whose businesses are located on an Indian reservation. If the corporation has employees who live on or near the reservation, it can receive a special tax credit.<sup>258</sup> The low-income housing credit is a part of the general business credit that is available to corporations that subsidize the construction of low-income housing. Likewise, the welfare-to-work tax credit is a general business credit available to corporations that hire qualified long-term family assistance recipients. This tax credit may be applied to employees hired between January 1, 1998 and December 31, 2004.<sup>259</sup> The empowerment zone employment credit is available to corporations located in a federal empowerment zone and that hire employees living in this zone. This credit is calculated as a percent of wages paid to each employee. However, this tax credit has certain limitations. A company cannot count wages paid to employees who work for less than 90 days.<sup>260</sup> Employees who are closely related to a corporation or who own five percent or more of the business; have their wages excluded, as do employees at golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetrack or gambling facilities and liquor stores.<sup>261</sup>

A tax credit is also given for contributions to community development corporations, which are special organizations that provide employment and business opportunities to low-income individuals. Five percent of contributions made by a corporation can be claimed as a tax credit.

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<sup>257</sup> NK RF art. 264(38).

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> The exception is for employees who become disabled or are fired for misconduct.

<sup>261</sup> I.R.C. § 1396 (2000).

The new market credit is for qualified entity investments made after December 31, 2000 to acquire stock in a community development entity (CDE). A CDE is any domestic corporation or partnership whose primary mission is serving or providing investment capital for low-income communities or low-income persons that maintains accountability to residents of low-income communities through representation or governing or advisory boards of the CDE, and is certified by the Treasury Department as an eligible CDE. The credit is worth over 30 percent of the amount invested.<sup>262</sup>

Tax credits are usually based on a percent of the taxpayer's expenditure for the rewarded behavior. A business credit for the current year may be increased by the carry back or carry forward basis from other years. Such benefits motivate corporations to support civil society and help government implement its social programs. According to Carol Steinbach, "The Low Income Housing Tax Credit has become the nation's primary engine for affordable rental housing. Both Congressional leaders and the Administration support its expansion. The housing credit has generated 80,000-100,000 units each year – plus an estimated 70,000 jobs, \$1.8 billion in wages, and \$700 million in tax revenues annually."<sup>263</sup>

Amortization is apportioning the initial cost of an intangible asset, such as a patent, over the asset's useful life.<sup>264</sup> The initial cost of inventory may also be apportioned. Depreciation is a decline in an asset's value because of use, wear, or obsolescence.<sup>265</sup> Under both U.S. and Russian laws, certain property can be amortized. According to Article 256 of the Tax Code, the results of intellectual activity and objects of intellectual property which the taxpayer uses for deriving income can be amortized. Amortized property must have a useful

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<sup>262</sup> Intro to Corporate Taxes: Corporate taxes – Your Tax Credits.

available at <http://www.taxgaga.com/pages/c-business/corptaxcredit.html>.

<sup>263</sup> Carol Steinbach. The CDC Tax Credit: An Effective Tool For Attracting Private Resources To Community Economic Development. August 1998, available at <http://www.knowledgeplex.org/showdoc.html?kpid=2540>.

<sup>264</sup> BLACK'S LAW DICTIONARY 83 (7<sup>th</sup> ed. 1999).

<sup>265</sup> *Id* at 452.

life of no less than twelve months and have an initial cost of more than 10,000 rubles, or \$350.<sup>266</sup>

Some property cannot be amortized, like land and other objects of nature (water, mineral wealth, and other natural resources), stock, objects of uncompleted capital construction, and manufacturing supplies.<sup>267</sup> Also, unable to be amortized is property of budget organizations, targeted property of nonprofit organizations, property acquired (or created) that is used for nonprofit activity, property acquired for targeted financing and livestock such as bullock, deer, and other wild animals adopted for commercial activity (excluding working livestock).<sup>268</sup> Some capital assets such as property received gratuitously and property that is under construction or modernization is also excluded.<sup>269</sup> Under Article 258 Section 3, of the Tax Code, all amortized property is divided into ten groups with a useful life from one to than thirty years.<sup>270</sup>

The U.S. amortization and depreciation system is similar to the Russian system. The Internal Revenue Code grants a reasonable allowance for the exhaustion, wear, and tears as a depreciation deduction for property used in the business or for property used in the production of income.<sup>271</sup> Exhaustion, wear and tear, and obsolescence are adjusted as provided in section 1011.<sup>272</sup> As prescribed by the Tax Code, the Internal Revenue Code imposes certain limitations on property subject to depreciation. No depreciation is allowed on any interest in property, when the remainder interest in such property is held (directly or indirectly) by a

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<sup>266</sup> NK RF art. 256(1).

<sup>267</sup> *Id.*

<sup>268</sup> *Id.* at (2).

<sup>269</sup> *Id.* at (3).

<sup>270</sup> NK RF art. 258(3).

<sup>271</sup> I.R.C. & 16(a) (2000).

<sup>272</sup> I.R.C. & 167(c) (2000).

related person.<sup>273</sup> In addition, certain property which is excluded from Section 197,<sup>274</sup> is subject to special exclusions for depreciation purposes. For example, computer software may be deducted using the straight-line method with a useful life of thirty six months, and mortgage servicing rights may be depreciated using the straight line method with a useful life of one hundred eighty months.<sup>275</sup>

In general, under Section 197 of the Internal Revenue Code, a corporation is entitled to an amortization deduction with respect to any section 197 intangible item. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible items ratably over the 15-year period beginning with the month in which the intangible was acquired.<sup>276</sup> Section 197 includes intangible property which was acquired by a corporation after the date of enactment and is held in connection with of a trade or business or an activity described in Section 212.<sup>277</sup> This includes goodwill, going concern value, any patent copyright, formula, process, design, pattern, know how, format, other similar items, any license, permit, or other right granted by a government unit or an agency and any franchise, trademark, or trade name.<sup>278</sup> This definition does not include such intangible property as financial interests, interests in a corporation, partnership, trust, or estate, or any interest in land, computer software, interests under leases, or debt instruments.<sup>279</sup> Deduction or amortization is also available to a lessee for exhaustion, wear and tear, and obsolescence.<sup>280</sup>

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<sup>273</sup> I.R.C. & 167(e)(1) (2000).

<sup>274</sup> Amortization of goodwill and certain other intangibles.

<sup>275</sup> I.R.C. & 167(f)(1),(3) (2000).

<sup>276</sup> I.R.C. & 197(a) (2000).

<sup>277</sup> Expenses for production of income by individual.

<sup>278</sup> I.R.C. & 197(c)(d) (2000).

<sup>279</sup> I.R.C. & 197(e) (2000).

<sup>280</sup> I.R.C. & 178(a) (2000) .

Under Section 172 of the Internal Revenue Code, net operating losses may also be deducted. According to subsection (a) “there shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.”<sup>281</sup> The years to which loss may be carried shall be a net operating loss carryback to each of the two taxable years preceding the taxable year of such loss, and a net operating loss carryover to each of the twenty taxable years following the taxable year of the loss.<sup>282</sup> “Net operating losses” are the excess of the deductions allowed by Chapter 1 over the gross income.<sup>283</sup>

As with Russian law, the Internal Revenue Code divides all deductible property into classes.<sup>284</sup> Depending on useful life, nine classes cover a range of three to fifty years.<sup>285</sup> “In general the applicable depreciation method is the two hundred percent declining balance method, which is switching to the straight line method for the 1<sup>st</sup> taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance.”<sup>286</sup> In some cases, the one hundred fifty percent declining balance method is applied. Any fifteen - year or twenty - year property, and any property used in farming, can only deduct one hundred fifty percent annually.<sup>287</sup>

In the United States, the period of amortization for purposes of taxation is shorter than the items actual life. Amortization for taxation is calculated using the MACRS method, which looks like the double reducing balance. Accordingly, profit for new assets is higher under

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<sup>281</sup> I.R.C. & 172(a) (2000).

<sup>282</sup> I.R.C. & 172(b) (2000).

<sup>283</sup> I.R.C. & 172(c) (2000).

<sup>284</sup> I.R.C. & 168 (2000).

<sup>285</sup> *Id.*

<sup>286</sup> I.R.C. & 168(b)(1) (2000).

<sup>287</sup> I.R.C. & 168(b)(3) (2000).

financial accounting than tax accounting.<sup>288</sup> Such amortization is profitable for companies because they can deduct and recapture the asset's value quickly. The taxable basis is reduced as well. The same system was recently adopted in Russia. Thus, amortization cannot be calculated using either the line or non-line methods. The line method is used only for amortization of real estate which has a useful life of more than 20 years. In all other cases, the taxpayer decides which method to adopt.<sup>289</sup>

#### F. Tax Period and Tax Rate

A corporation must choose a taxable year and method of accounting for tax purposes.<sup>290</sup> Generally, corporations may adopt either a calendar or a fiscal year.<sup>291</sup> Under Section 441(i), a personal service corporation<sup>292</sup> may be required to use a calendar year unless it obtains the IRS's approval to use a fiscal year. Similarly, an S corporation is generally required to use a calendar year.<sup>293</sup> These rules are intended to eliminate the advantages of tax deferral arising from a difference between the taxable year of the corporation and that of its shareholders.

Article 285 of the Tax Code considers the tax period a calendar year. Reporting periods are quarterly, while the reporting period for taxpayers is monthly.<sup>294</sup> Article 284 of the

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<sup>288</sup> KAREN C. BURKE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS*, 31-32 (5<sup>th</sup> ed. 2003).

<sup>289</sup> NK RF art. 259.

<sup>290</sup> I.R.C. §§441, 446 (2000).

<sup>291</sup> I.R.C. §§441, 446 (2000).

<sup>292</sup> Defined in Section 269A as a corporation of which the principle activity is performance of personal services by its shareholders.

<sup>293</sup> I.R.C. § 1378 (2000).

<sup>294</sup> NK RF art. 285.

Tax Code prescribes twenty four percent as the general rate for Russian federal income tax.<sup>295</sup> Companies, which do not operate in the Russian Federation are taxed at a twenty percent rate. Some income is taxed at a different rate, such as dividends and income derived from the use, maintenance, or lease of aircrafts, ships, or other mobile transportation involved in international transportation.<sup>296</sup> Interest earned from state or municipal stock is taxed at fifteen percent of taxable basis, or zero percent if the state or municipal bonds were issued before January 20, 1997 and also from state currency bonds issued<sup>297</sup> in 1999.<sup>298</sup>

The United States has a progressive income tax. The highest tax bracket for corporations is thirty five percent of taxable income. The first \$50,000 of income is taxed at the rate of fifteen percent. The next \$25,000 is taxed at twenty five percent, and the next \$9,925,000 is taxed at thirty four percent. Any income above \$10,000,000 is taxed at thirty five percent. However, five percent surtax is levied on taxable income between \$100,000 and \$335,000. The maximum surtax liability is five percent of the amount of taxable income in the \$235,000 phase-out range (\$335,000 less \$100,000), or \$11,750 is exactly equal to the difference between a flat thirty four percent tax on \$75,000 (\$25,000) and the tax imposed at the fifteen percent and twenty five percent rates (\$13,750). Thus, a corporation with taxable income between \$335,000 and \$10,000,000 pays tax at an effective (as well as marginal) rate of thirty four percent. The benefit of the thirty four percent rate is phased out by three percent surtax on taxable income between \$15,000,000 and \$18,333,333, producing a maximum additional surtax of \$100,000 (three percent of \$3,333,333). As a result, corporate taxable income over \$18,333,333 is subject to an effective (as well as marginal) rate of thirty five

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<sup>295</sup> NK RF art. 284.

<sup>296</sup> NK RF art. 284(2).

<sup>297</sup> With purpose to provide balance of internal debt under former Soviet Union obligations and internal and external debt of the Russian Federation.

<sup>298</sup> NK RF art. 284(4).

percent.<sup>299</sup> In other words, companies with a taxable income of more than \$100,000 have an aggregate tax rate of thirty four percent when the three percent tax is accounted for. Thus, the real tax benefits only flow to companies with a taxable income that is less than \$100,000. Such small businesses are numerous in the United States.

Russia maintains a simplified system of taxation,<sup>300</sup> which applies to some small business enterprises. Under this system, taxpayers are eligible to pay joint taxes, use more deductions, not pay some required taxes,<sup>301</sup> and elect to be taxed on six percent of gross income or fifteen percent of gross income less deductions.<sup>302</sup> Because of special requirements applied to such small companies, the total number of taxpayers using the system is limited and a significant percent of small businesses are still taxed on the regular basis. Article 346.12 of the Tax Code has twelve limiting items which deter companies from using the simplified system of taxation.<sup>303</sup> The worst limitation excludes companies that have more than twenty five percent of their stock belonging to corporate shareholders.<sup>304</sup>

At the present time, the Government of the Russian Federation intends to restore unified social tax for small business. According to the Ministry of Finance of the Russian Federation, many large businesses try to use advantages of small business and restructuring their business in a way to meet conditions of small business.<sup>305</sup>

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<sup>299</sup> I.R.C. § 11(b) (2000).

<sup>300</sup> N.K. RF art. 346.11.

<sup>301</sup> Id.

<sup>302</sup> NK RF art. 246.20.

<sup>303</sup> NK RF art. 346.12.

<sup>304</sup> NK RF art. 346.12(14).

<sup>305</sup> Unified Social Tax put significant burdens for companies. Since companies, not employees are responsible to pay this tax, it takes thirty percent from fund of financial compensation.

The Russian Federation also maintains a special system of taxation for certain kinds of activities called the Unified Tax for estimated income. This tax is regulated by Chapter 26.3 of the Tax Code and represents a system where total profit is estimated by the Russian Federation. This tax replaces three main corporate taxes such as income tax, joint social tax and property tax.<sup>306</sup> The tax rate is lower than in the regular system and fifteen percent of estimated profit.<sup>307</sup>

Taxpayers from six categories representing small business are eligible. The first version of this law, issued in 1998, was not very popular among taxpayers. Initially, this tax was designed to minimize tax burdens imposed on small business, but in practice, when this tax was adopted in seventy seven Russian regions, business representatives in four of them blocked it.<sup>308</sup>

#### G. Capital Gain and Losses

Russian tax law does not distinguish between capital, ordinary gain, or loss treatment. All income is divided on items and is taxed under certain rates. In contrast, under the Internal Revenue Code, some property is taxed as a capital gain or loss. The significant difference between capital and ordinary gain is a more preferential rate for taxation capital gain than ordinary income and more favorable conditions for deducting ordinary losses than capital

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T. Zykova, *Malyi Bisnes Zapodozrili v Bolshom* [Small business is suspected in large], ROSS. GAZETA, APR. 23, 2004 at 5.

I. Sklyarova, *Igra po Melkomu* [A little game], VREMYA NOVOSTEYI, APR. 26, 2004.,#72, at 1.

<sup>306</sup> NK RF art. 346.26(4).

<sup>307</sup> NK RF art. 346.31.

<sup>308</sup> I.Hakamada, *Vpered k Novomu Feodalismu*. [Further toward to new feudalism] *available at* <http://www.hakamada.ru/1321/324>.

losses. Thus, the maximum capital gain rate cannot exceed twenty eight percent,<sup>309</sup> while the maximum tax rate for ordinary income is thirty five percent.<sup>310</sup>

In contrast to ordinary losses, which are generally deductible without limitations,<sup>311</sup> capital losses may be deducted only to the extent of gains from sales or exchanges, plus (if such losses exceed such gains) the lower of \$3,000 or in the excess of such losses over such gains.<sup>312</sup> In case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.<sup>313</sup>

However, not all assets can trigger capital gain treatment.

Under Section 1221 of the Internal Revenue Code, capital assets do not include stock in trade of the taxpayer or other property of a kind, which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in Section 167, or real property used in his trade or business; a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property, in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B); accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1) of Section 1221; a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer who so received such publication, or a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).<sup>314</sup>

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<sup>309</sup> I.R.C. & 1(h) (2000).

<sup>310</sup> I.R.C. & 11(b) (2000).

<sup>311</sup> I.R.C. & 165(a) (2000).

<sup>312</sup> I.R.C. & 1211(b) (2000).

<sup>313</sup> I.R.C. & 1211(a) (2000).

<sup>314</sup> I.R.C. & 1221 (2000).

## H. Some Aspects of Taxation Income of Foreign Corporations

Taxation of national corporations is similar in Russia and the United States. The absence of bilateral treaties with other foreign countries can trigger double taxation for domestic corporations operating abroad.

Corporations operating in Russia and the United States enjoy benefits provided by the “Income and Capital Tax Convention” (hereinafter, Convention). This treaty was signed on June 17, 1992, and came into force on December 16, 1993 (hereinafter – the Convention).

The Treaty applies to corporations residing in one of the mentioned countries. The criteria for residence is provided in Article 4 of the Convention: “Any person who, under the laws of the state is liable to tax therein by reason of ... place of incorporation (for companies) or any other criteria similar nature.”<sup>315</sup> According to the Convention, only companies which operate in the contracting state through “permanent establishment” may be taxed by the contracting state on their income in that state”.<sup>316</sup>

For the purposes of the Convention, the term ‘permanent establishment’ means a fixed place of business through which a resident of a Contracting State, whether or not a legal entity, carries on business activities in the other Contracting State (section 1). This term specifically includes a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop; and f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources (paragraph 2). A building site or construction, installation or assembly project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than 18 months.<sup>317</sup>

Operations of a subsidiary of the foreign company may trigger “permanent establishment” if the subsidiary a) has authority to conclude contracts in the name of the parent; b) he habitually exercises that authority; c) he is not an agent with independent

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<sup>315</sup> Income and Capital Tax Convention, June 17, 1992, U.S.-Russ. 92 LEXIS TNI 57-18.

<sup>316</sup> *Id.* art. 5, 6(1).

<sup>317</sup> *Id.* art. 5(3).

status,<sup>318</sup> and d) his activities are not limited to those mentioned in paragraph (4). However, any activity which has a preparatory or support character does not trigger “permanent establishment” status.<sup>319</sup>

Preparatory or support activity is

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to this person; b) the maintenance of a stock of goods or merchandise belonging to this person solely for the purpose of storage, display, or delivery; c) the maintenance of a stock of goods or merchandise belonging to this person solely for the purpose of processing by another person; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for this person; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for this person, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business by this person solely for the purpose of facilitating the conclusion of, or for the mere signing of, contracts in the name of this person concerning loans or the delivery of goods or merchandise or technical services; g) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (f).<sup>320</sup>

Income derived from real property located on the territory of one country by a resident of another country may be taxed in the foreign territory.<sup>321</sup> Ships, boats, and aircraft are not considered real property.<sup>322</sup> Income derived from the use of this equipment shall be taxed only in the home country.<sup>323</sup> Also, according to the Convention, “capital represented by movable property forming part of business property of a permanent establishment which resident of a Contracting State has in the other Contracting State... may be taxed in that other State.”<sup>324</sup>

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<sup>318</sup> Thus, according to the Article 5, paragraph 6 of the Convention agent of an independent status consists broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

<sup>319</sup> *Id.* art. 5(4).

<sup>320</sup> *Id.* art. 5(4).

<sup>321</sup> *Id.* art. 9(1).

<sup>322</sup> *Id.* art. 9(2).

<sup>323</sup> *Id.* art. 8(1), 21(3).

<sup>324</sup> *Id.* art. 21(2).

Convention provisions are related to national legislation differently in the United States and Russia. Thus, Convention provisions do not have priority under the Internal Revenue Code.<sup>325</sup>

In contrast, under the Constitution of the Russian Federation, “if an international treaty of the Russian Federation stipulates other rules than those stipulated by the law; the rules of the international treaty shall apply”.<sup>326</sup>

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<sup>325</sup> I.R.C. §§ 894(a)(1), 7852(d)(1) (2000).

<sup>326</sup> Konstitutsiia RF art. 15(4) (1993).

## CHAPTER 4

### CONCLUSION

The Russian and U.S. federal income tax systems are based on similar principles. The systems have significant differences, however, which are often crucial for determining final after-tax profit.

To derive as much income as possible, neither government should refuse tax advantages. Reducing the tax rate and denying tax advantages cannot achieve sufficient tax collection.

The United States has a higher tax rate than Russia. If all deductions are taken into account with amortization and depreciation rules, U.S. corporations are able to earn more after-tax income than companies operating in Russia. Thus, reducing the tax rate cannot singly eliminate heavy tax burdens. People's profit motive will remain and push them into the shadow market.

The Russian government is ignorant of an opportunity to encourage business to support civil society and provide financial support to social projects. U.S. corporations receive some benefit when contributing to charitable activities. They establish a positive reputation in the market (which is very important in the business society), and are able to exclude some assets from their taxable base.

Additionally a high level of corruption pushes corporations to carry extra expenses which cannot be deducted. Thus, taxation is avoided.

In Russia, a complicated procedure for justifying expenditures and policies unfavorable to newly established businesses is also troublesome for taxpayers. Double taxation of dividends is a part of both tax systems. These problems do not create a positive

business environment, do not increase national or foreign investments and do not facilitate economic growth.<sup>327</sup>

To achieve sufficient tax collection, Russia should establish a long - term plan touching all aspects of corporate economic activity. This includes a broad tax base, reasonable deductible items, tax advantages to encourage social responsibility, a simplification of the reporting process, and additional advantages for small and newly established businesses.

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<sup>327</sup> Tauno Tiusanen , Sirpa Vinni & Jary Jumpponen, The Investment Climate in Russia. Part II. Case Studies. The Lappeenranta University of Technology. Studies in Industrial Engineering and Management. Research Rep. No. 0 19.(2002), *available at* <http://www.compiler.fi/idankaupan/tutkimukset/LTKK13.html>.

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