



That closed open list



RUSSIA HAS ONE OF THE LOWEST TAXATION LEVELS IN THE WORLD. With corporate income tax at 20%, personal income tax (for residents) at 13% and a number of generous double tax treaties, it is a perfect place to set up a business.

Yet, there is a glitch. Some types of expenditure that, to an untrained eye, appear cost-related and, therefore, deductible will not be seen as such by the taxmen.

It is ironic that in law – that is art. 252 of the Russian Tax Code – all reasonable and documented expenses can be deducted from taxable income.

Life would be too simple if what is written in a legal act would be an undisputed truth. In practice the tax authorities fight for every penny in your pocket. What is not specifically mentioned as a deductible expenditure in the Tax Code is, they say, not deductible.

What was supposed to be an 'open' list (everything is deductible unless it is unreasonable or undocumented) becomes a 'closed' list (everything that is not in the list is a part of your taxable profit).

The Yaroslavl Metal Frames factory applied to the court to collect debt owed from a company with the somewhat provocative name 'Thirteen Plus'. The parties reached a settlement agreement in court: the debtor had to pay a large portion of the debt and the remainder was cancelled.

The amount of the bad debt that was written off was included in the non-operating expenses of the creditor. This did not please the taxmen. They charged the company with additional tax, interest and penalties.

The factory lost the case in all lower instances and reached the Supreme Arbitrazhniy Court where it finally won. The judges ruled – surprise, surprise! - that the law does not limit the deductible expenses to some list. (What is not prohibited is allowed.)

In the whimsical twist of events, the company that wanted to save time and money – and to that end wrote off a comparatively small debt (about \$3,000) – had to climb through the whole system and present its case to the panel of judges of the Supreme Court.

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TAX CONSEQUENCES OF WRITING OFF A DEBT

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In principle business is not charity, its aim is profit. Yet it is often beneficial to cancel a debt either in part or completely rather than trying to get back the whole amount owed.

This can happen for various reasons: the need for an early repayment without spending time and resources on litigation, for example, or in exchange for a discount on any products of the debtor, or for many other reasons.

Very often the decision to write off a debt is made in the course of litigation as a condition of a settlement agreement. The point of the agreement is to resolve mutual claims and save time.

However, one should always think about tax implications. The decision to cancel a debt is not an exception. Is it possible to credit the amount of debt that has been written off against the income tax liability? Let's find out.

The Tax Code permits reduction of income tax base for expenditures that are reasonable and documented (Article 252 of the Tax Code). Expenses incurred by the taxpayer according to art. 252(2) of the Tax Code are divided into the costs associated with production or sales and so-called non-operating expenses. Losses that arise from writing off a debt are not production expenses, of course, and therefore may only be assigned to non-operating expenses.

Tax authorities try to close the 'open' list and exclude costs and losses not expressly mentioned in art. 270 of the Tax Code

The legislator has identified a list of non-operating expenses to be taken into account for income tax purposes. The list is set out in Art. 265 of the Tax Code, and it is open, because it includes 'other reasonable expenses'.

This means that not only those costs that are expressly provided in this list but other expenses not specified in the list can be deducted from taxable income. Only unfounded and / or undocumented costs, as well as those listed in Art. 270 of the Tax Code, cannot be deducted. (This article contains a list of expenses that under no circumstances can be taken into account.)

Tax authorities quite often try to close the 'open' list and exclude costs and losses not expressly mentioned in art. 270 of the Tax Code. They do this (or at least should do it) in the public interest, thereby increasing the tax base and, accordingly, the amount of tax revenue. Losses arising from writing off a debt are not an exception. Tax authorities think that you cannot deduct those expenses from taxable profit.

Taxmen claim that writing off a debt constitutes a gratuitous transfer of property whose value can not be considered for income tax purposes. In other words, tax authorities believe that writing off a debt is always a gift.

However, tax authorities do not take into account the fact that writing off a debt is not always free of charge and is not a gift, otherwise the implementation of the rules of art. 415 of the Civil Code for discharge of debt between commercial organizations would be impossible because of art. 575(1) of the Civil Code as a void transaction.

The Supreme Arbitrazhny Court has already expressed its point of view on this subject which cannot be ignored by the tax authorities, especially given that the Russian judicial system, according to the chairman of the Supreme Arbitrazhny Court has long been moving towards a system of precedent.

Thus, in Section 3 of the Information Letter of December 25, 2005 № 104 of the Presidium of the Supreme Arbitrazhny Court, it is explained that *'the relationship of a creditor and a debtor in writing off a debt can be described as gift only if a court finds that the creditor's intention to release the debtor from the obligation to pay the debt was in fact to make a gift.'*

It appears that the absence of the creditor's intention to benefit the debtor may indicate the presence of some commercial interest in writing off a debt.

Thus, if writing off a debt as part of a settlement agreement (as, indeed, in other cases) is economically justified (eg the debt is cancelled in order to speed up the return of the remaining part), as well as documented, such writing off cannot be seen as a gift. Therefore, the losses may be taken into consideration when calculating income tax liability.

This approach was supported by the Presidium of the Supreme Arbitrazhny Court in 15 July 2010 in the case of the Yaroslavl Plant of Metal Frames which should significantly strengthen the position of taxpayers in

their opposition to the tax authorities who persistently ignore the rules of the Tax Code and try to "close" the "open" lists of costs and losses that are considered as deductible expenses.



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