

Dilemma over directors' tax

Russian companies paying fees to board members face a quandry: to save on profit tax or on unified social tax? Ilya Rybalkin, partner, and Ivan Meleshenko, associate, at Hogan & Hartson in Moscow examine a division in opinion.

The finance ministry and the Supreme Arbitration Court are divided on the issue of board directors' tax. The court suggests saving on profit tax, which is economically expedient for the company. It is no surprise then that the opinion of the finance ministry is just the opposite. Relying on the court's point of view could lead to a controversy with tax inspectors. Litigation of such a dispute in favour of the company seems to be rather promising. Irrespective of the outcome of this dispute the fees of the board members are subject to personal income tax.

In the near future many Russian companies will have to hold general shareholders meetings where, among other things, the decisions will be made on paying fees to the members of the board.

Under certain conditions the payments of fees to members of the board of directors allows companies to save on profit tax and unified social tax. However in many cases it leads to disputes with tax authorities. The cause for dispute is a provision of the Tax Code under which payments to individuals are not subject to unified social tax provided they do not reduce the company's taxable profit.

Court opposed

The finance ministry's opinion says that the fees of board members, which are decided by a general shareholders meeting, do not reduce the company's taxable profit and should not be subject to unified social tax. The court's opinion is contrary to this: the fees of the members of the board of directors should be subject to unified social tax. Accordingly, a company may reduce its taxable profit by the amount of such fees. If the fees of the board members are paid from the undistributed profits from previous years, there is no obligation to pay unified social tax.

Meanwhile, the actual availability of undistributed profits from previous years

must be confirmed by documents. The court also says that the company has no right to choose which tax (unified social tax or profit tax) is used to reduce the taxable base by the amount of fees payable to members of the board of directors. As a matter of practice, regional courts, in general, adhere to the point of view of the Supreme Arbitration Court.

If the fees of the members of the board of directors are substantial, the Supreme Arbitration Court's point of view, which allows for the reduction of taxable profit by the amount of fees given, is economically expedient for the company (the profit tax rate being 24%). So far as unified social tax is concerned, considering the descending tax rate scale (26% through 2%), the effective tax burden will be minimal.

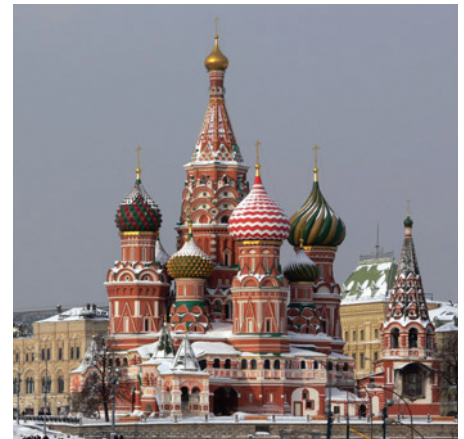
Practical use

The practical use of this option, most likely, would lead to a conflict with a tax authority, which would, in the first place, follow the official point of view of the finance ministry. However, the chances of litigation of such a dispute in favour of the company, with an allowance for the above-said position of the Supreme Arbitration Court, are not bad, according to our reckoning.

The safest option seems to pay the fees to members of the board of directors with previous years' undistributed profits, because here the points of view of the ministry and the court essentially coincide.

Such payments do not reduce the taxable profit and, so, are not subject to unified social tax. However, this option is not optimal from an economic point of view, because, on the one hand, it does not allow to reduce the profit tax; and on the other hand, the savings on unified social tax are minimal, because of the descending tax rate scale.

As regards personal income tax, according to double tax treaties concluded by Russia with the world's most countries



(including the UK and the US), the fees received by members of the board of directors of Russian companies may be taxed only in Russia. The tax rates vary and depend on whether a board member is a tax resident of Russia or not.

According to the Tax Code, if a member of the board of directors is actually present in Russia for an aggregate period of at least 183 days over a period of 12 consecutive months (excluding days of arrival in Russia, but including days of departure from Russia), s/he is recognised as a tax resident of Russia and shall pay the Russian income tax on its worldwide income (including fees for the service as board member) at a flat rate of 13%.

If a member of the board is actually present in Russia for an aggregate period of less than 183 days over a period of 12 consecutive months (excluding days of arrival in Russia, but including days of departure from Russia), s/he is not recognised as a tax resident of Russia and shall pay the Russian income tax only on incomes derived from sources in Russia (including fees for the service as board member) at a flat rate of 30%.

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