

# Administrative and managerial issues of tax reforms

## Административно-управленческие проблемы налоговых реформ

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### Tax incentives for bond-oriented individual investors: evidence from the Russian Federation

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#### ABSTRACT

The paper addresses the specificities of tax incentives in the form of tax reliefs designated for individual investors, who invest in bonds in the Russian Federation. The need for the use of tax incentives to encourage individual investors to purchase bonds is regarded as an integral aspect of the bondization, announced by the Bank of Russia. The objective of this paper is to analyze the specific features of the investment tax relief implementation in the Russian Federation and to reveal issues that remain controversial and require particularization. It was found that stimulation of investment through tax is widely studied by foreign scientists; however, it is almost completely disregarded in Russia. The following tax innovations related to investments of individual Russian investors were analyzed: tax relief for coupon income, derived from corporate bonds; investment tax deductions (individual investment account and long-term capital gains exemption); long-term capital gains exemption for securities of the high-tech (innovation) sector of economy. Reconciliation schemes for the above-mentioned reliefs were identified. Insufficiency of quantitative data for the effectiveness evaluation of tax relief for individual investors was revealed, which was explained by the short validity period of this relief. The authors proved the absence of a uniform system tax relief instruments for individual investors and found that bond holders have more tax relief options, compared to share holders of other investment instruments. In this context, it was proposed to make amendments to the Tax Code of the Russian Federation in order to ensure tax equalization with relation to derivative instruments, designed on the basis of bonds, mutual fund units). In addition, it was recommended to adjust a number of technical aspects, connected with tax relief application and to evaluate the effectiveness of the reliefs under study.

#### KEYWORDS

Bond, coupon, individual income tax, tax relief, investment tax deduction, individual investment account, long-term securities holding, financial marketplace

JEL H24, D14, G11

**HIGHLIGHTS**

1. A tendency towards emergence of a tax relief system for individual investors is revealed in the context of the active development of the bond market in the Russian Federation
2. In the Russian Federation, there are a number of tax reliefs for bond holders, including coupon income exemption from tax and investment tax deductions, which are not bound into a uniform system
3. Reconciliation of tax reliefs for individual investors is possible; however, there are issues that remain controversial and require particularization
4. The current tax reliefs for individual investors require improvement. It is important to make certain amendments to the Tax Code of the Russian Federation and evaluate the effectiveness of tax reliefs

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**Налоговое стимулирование инвестиций частных инвесторов в облигации в Российской Федерации**

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**АННОТАЦИЯ**

Статья посвящена анализу особенностей налогового стимулирования инвестиций частных инвесторов в облигации в РФ. Необходимость налогового стимулирования приобретения облигаций частными инвесторами отмечена как составная часть стратегии бондизации, заявленной Банком России. Целью настоящей статьи является анализ специфики применения инвестиционных налоговых льгот в РФ, выявление спорных и требующих конкретизации вопросов. Отмечены широкое освещение темы налогового стимулирования инвестиций в иностранной периодической литературе и практически полное игнорирование данной тематики отечественными авторами. В статье проанализированы налоговые новации в области инвестиций российских частных инвесторов: льгота по купонному доходу корпоративных облигаций, инвестиционные налоговые вычеты (индивидуальные инвестиционные счета и льгота по долгосрочному владению ценными бумагами), льгота по долгосрочному владению ценными бумагами высокотехнологичного (инновационного) сектора экономики. Определены возможности совмещения вышеназванных льгот. Отмечен недостаток количественных данных для оценки эффективности налоговых льгот для частных инвесторов вследствие короткого периода их действия. Авторы пришли к

выводу относительно отсутствия единой системы предоставления льгот частным инвесторам и более широком льготировании облигаций в сравнении с прочими инструментами. Конкретным результатом работы можно считать констатацию необходимости внесения изменений в НК РФ с целью выравнивания налогообложения по производным инструментам, созданным на основе облигаций, паем паевых инвестиционных фондов и корректировки ряда технических моментов применения льгот, а также оценку эффективности описанных льгот.

#### **КЛЮЧЕВЫЕ СЛОВА**

Облигация, купон, НДС, налоговая льгота, инвестиционный налоговый вычет, индивидуальный инвестиционный счет, долгосрочное владение ценными бумагами, финансовый маркетплейс

#### **ОСНОВНЫЕ ПОЛОЖЕНИЯ**

1. Формирование системы налоговых льгот для частных инвесторов в РФ имеет место в рамках активного развития рынка облигаций
2. В РФ существует ряд налоговых льгот для владельцев облигаций, включая льготу по купонному доходу и инвестиционные налоговые вычеты, не связанных между собой единой системой
3. Совмещение налоговых льгот для частных инвесторов возможно, однако существуют спорные и требующие конкретизации вопросы
4. Логично реформирование системы налоговых льгот для частных инвесторов в РФ, включая необходимость внесения изменений в НК РФ и оценку эффективности льгот

#### **Introduction**

In 2016–2018, the new term “bondization”<sup>1</sup> (from English bond), which means activation and development of the bond market within the Russian financial market, was popularized. By “development”, the following phenomena are meant: an increase in the number and volume of bond issuances, liberalization of taxation, elimination of some organizational barriers, advancement of the infrastructure, and improvement of the individuals’ investment culture.

In the course of bondization and even before its official announcement (in 2015), new types of bonds appeared in the Russian Federation. Those bonds included both government and corporate ones, viz. inflation-linked federal loan bonds, federal bonds for individual investors, bonds issued under exchange-traded bonds programs, one-day bonds, infrastructure bonds, retail bond tranches

of banks. Simultaneously, an increase in trading activity within the segment of perpetual and subordinated bonds was registered; bonds of the Bank of Russia re-entered the securities market.

The emergence of the new types of domestic bonds in 2015 is explained by the fact that external capital markets were closed to Russian borrowers in that time; therefore, the borrowers aimed to raise the maximum amount of capital from the domestic market. In 2016–2017, the situation slightly improved, and Russian issuers could access more world markets. However, the new sanctions of 2018 made the domestic market more foreground and favorable. The effect of sanctions on the Russian bond market is also emphasized by other authors, e.g. T. Vandersteel [1, p. 14].

It should be noted that the trend towards bondization is typical of not only Russian market, but also of emerging markets in general, regardless of whether these markets are under sanctions or not. This trend is described in the works of J. D. Burger and F. E. Warnock [2]; J. D. Burger, F. E. Warnock, and V. C. Warnock [3]; D. Kidd [4]; and it is of significant interest to investors from developed markets. These authors focus on

<sup>1</sup> The term “bondization” was officially introduced by the Bank of Russia in an analytical note, titled “Bondization is the development of the bond market”, in July 2017; however, this term had been used by the market participants before (in 2014–2016) to indicate the active development of the bond market.

the importance of developing local currency bond markets in order to avoid the financial fragility associated with a currency mismatch.

One of the factors for the successful development of the Russian bond market consists in ensuring that Russian individual investors' investments in corporate bonds will be subject to the conditions that are similar to the conditions for investment in deposits and government bonds (e.g. income, derived from deposits and government bonds, is not subject to individual income tax). Some changes related to this issue have already occurred and will be considered in later chapters of this paper.

It should also be noted that the role of bonds in investment portfolios formation is gradually changing in the framework of the classical theory of investment. Previously, it was presumed that an investment portfolio was required to be dominated by shares as investment horizons increased in length. However, now bond-dominated portfolios or 50/50 portfolios in the long run are already considered by certain studies. P. Shen [5, p. 44] states that shares are safer compared to bonds, but this refers to long-term (over 25 years) investment in government bonds. Obviously, most investors regard such a long investment period as unrealistic. A. E. Abramov, A. D. Radygin, and M. I. Chernova substantiate the advantage of bond portfolios over share portfolios in the context of long-term investment and the need to ensure that bonds, issued by qualitative issuers, will represent a larger portion of asset allocation [6, p. 44].

Therefore, the objective of the paper is to investigate the implementation of investment tax reliefs in relation to individuals' bond investments in the Russian Federation and to determine areas for improvement.

### **Literature review**

The impact of tax on investments has received much research attention in foreign studies. General studies address the relationship between tax and decision-making, investment volume, and a firm's value. In

particular, E. F. Fama and R. F. French [7] studied how a firm's value is related to dividends and debt, using cross-sectional regressions. R. Dammon and R. Green [8] designed a basic model under conditions of tax arbitrage and the existence of equilibrium prices for financial assets. R. E. Hall and D. W. Jorgenson [9] estimated the effects of change in tax policy on investment behavior for three major tax revisions in the post-war period in the USA. C. D. Romer and D. H. Romer [10] investigated the impact of tax change on economic activity, identifying the size, the timing, and the principal motivation for all the major post-war tax policy actions.

Taxes are also taken into account for the purpose of financial asset valuation models to ensure a more realist approach. For example, R. H. Litzenberger and K. Ramaswamy derived an after tax version of the Capital Asset Pricing Model [11]; O. Belomyttseva, L. Grinkevich, and A. Grinkevich [12] proposed a modification of the Gordon Growth Model with taxes.

Among studies on bond taxation, special emphasis should be placed publications of Professor R. C. Green from Carnegie Mellon University, who analyzed various aspects of bond taxation in different years. In particular, R. C. Green [13] performed an analysis of the anomalous behavior of the taxable and tax-exempt yield curves of municipal bonds in 1993. In 1997, together with B. A. Odegaard [14], he investigated the impact of the Tax Reform Act of 1986 on the relative pricing of U.S. Treasury bonds and supported the hypothesis that this event largely eliminated tax effects from the term structure. In 2007, R. C. Green, B. Hollifield, and N. Schurhoff [15], using a mixed-distribution model, quantified the losses that uninformed traders or issuers give up to broker-dealers on the municipal bond market. Sh. Liu, J. Shi, J. Wang, and Ch. Wu examined the effects of investors' taxes on the pricing of corporate bonds [16]. A. Ang, V. Bhansali, and Y. Xing [17] studied taxes on tax-exempt municipal bonds. A. Kalotay [18] analyzed the formation of optimal municipal bond portfolios for dynamic tax management, A. Kalotay and C. D. How-

ard [19] quantified the value of the tax option embedded in municipal bonds.

In the course of our study, publications on tax reliefs, linked to accounts that are similar to individual investment accounts, as well as the effectiveness of these reliefs were of significant interest. For example, we referred to M. Donnelly and A. Young [20], who had studied similar accounts in Canada and the UK; and O.P. Attanasio and T. DeLeire [21], who had debated the effect of individual retirement accounts on household consumption and national saving.

Among Russian publications, studies related to the above-mentioned issues are next to none. There are only some general studies. I.V. Karzanova [22] proposed a theoretical framework that can be used to evaluate the potential impact of the taxation system on the accumulation of physical capital in Russia. S.S. Lazaryan and M. A. Chernotalova [23] presented a good overview of foreign empirical studies that consider the impact of the tax system on investments.

As regards the bond market, Russian studies mainly address the bond market development issues with respect to issuance aspects, the market analytics, and development prospects. Surprisingly, we found no Russian studies directly related to bond taxation, viz. individual income tax on coupon income (coupon rate), analysis of the long-term capital gains exemption for securities of the high-tech (innovation) sector of economy, etc. This can be explained by the fact that tax re-

lief for coupon income is absolutely new, and long-term capital gains exemption is relatively new. Furthermore, no statistical data has been accumulated so far, which makes it impossible to evaluate their effectiveness. Nevertheless, from 2016 to 2018, in Russian periodicals, there appeared a large number of publications on individual investment accounts (hereinafter IIA) and bonds as a promising and effective instrument for investment with IIA (e.g. studies by U.V. Lakhno [24; 25], O.A. Grazhdankina and S.V. Shaposhnikova [26], M.A. Khloev [27], O.S. Belomyttseva [28]).

### The current tax reliefs for bond-oriented investors: a brief overview

Today, Russian bond investors are entitled to a number of tax reliefs. A classification of tax reliefs in effect is presented in Figure 1. All the reliefs, except for the exemption of coupon income on government bonds, are comparably new to the Russian market. Consequently, they are not fully known and exploited by investors.

The current tax reliefs are classified by the authors into tax exemptions of coupon income on various types of bonds; investment tax deductions; and other tax reliefs, e.g. long-term capital gains exemption, which is applied to income earned from securities of the high-tech (innovation) sector of economy (hereinafter LTCGE-IIM).

The coupon income tax exemption for corporate bonds was introduced in 2018 and applies only to corporate bond issuances that conform to certain requirements.

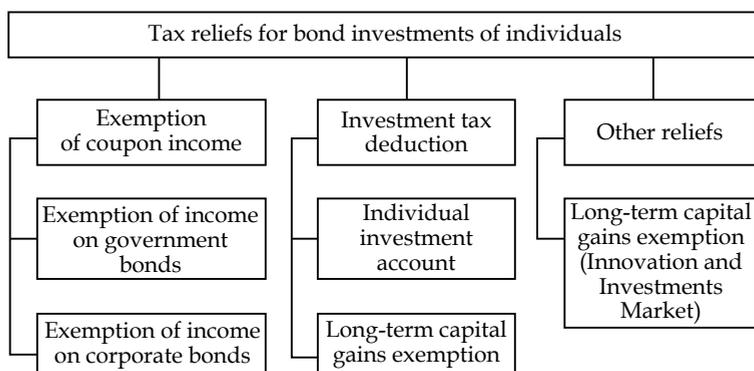


Figure 1. The current Russian tax reliefs for bond-oriented individual investors

At the end of 2013, the Tax Code of the Russian Federation was amended with the new concept “investment tax deduction”, directly related to bonds. This term has been in effect since 2015 and is interpreted as the taxpayer’s right for reduction of the tax base on the individual income tax in case of transactions with securities and under certain conditions. Article 219.1 of the Tax Code states 2 types of investment tax deductions:

- investment tax deduction related to the opening of individual investment accounts (hereinafter IIA);

- investment tax relief in the form of long-term capital gains exemption (LTCGE).

As regards LTCGE-IIM, this relief is presented by the Tax Code as a separate type of relief, without being related to LTCGE. All these reliefs are analyzed below.

#### **Changes in the taxation of the individual income derived from corporate bond coupons**

On 1 January 2018, the procedure of taxation of individual income gained in the form of interest on exchange-traded bonds of Russian organizations underwent changes. Article 214.2 of the Tax Code of the Russian Federation determines the following criteria for the exemption of corporate coupon income from individual income tax:

- bonds are issued by a Russian organization;

- bonds are nominated in Russian rubles;

- bonds are issued as from 1 January 2017.

- bonds are considered to be “exchange-traded” as described in article 214.1 of the Tax Code of the Russian Federation.

The most “ambiguous” of the outlined criteria is, undoubtedly, the date of issuance. According to the interpretation of the Ministry of Finance of the Russian Federation of 3 November 2017 No. 03-03-10/72515, the term “bonds issued from 1 January 2017 onwards” refers to bonds that were placed on the

securities market on a date within the specified period; the date is disclosed as stated in article 30 of the Federal Law “On the Securities Market” as well as clauses 5.3–5.6, 26.10 and 26.11 of the Regulations of the Central Bank of Russia of 30 December 2014 No. 454-R.

Regarding the admission of exchange-traded bonds (refers to bonds on the organized securities market), it should be noted that according to clauses 3 and 4 of article 241.1 of the Tax Code of the Russian Federation, exchange-traded bonds traded on the organized securities market include securities that conform to the following criteria:

- bonds must be admitted to trading on the Russian stock exchange;

- market quotation must be provided with respect to these bonds.

“Market quotation”, as stated by clause 4 of article 241.1 of the Tax Code of the Russian Federation, is the weighted average price of the bond settled as a result of transactions that were executed within one trading day on a stock exchange. In the absence of information on the weighted average price of the bond on the stock exchange, the market quotation is considered to be the weighted average price (the closing price) established on the date of the proximate trading, which took place prior to the date of the execution of a particular transaction, and if trading of these bonds had been held minimum once over the past three months.

Since corporate bonds are often purchased for the purpose of formation of a long term and high-yield portfolio, bond transactions can presumably occur sporadically. Therefore, in order to fulfill the requirement for the recognition of particular bonds as “exchange-traded”, it is sufficient to have minimum one weighted average price, calculated by the exchange over a period of three consecutive months preceding the date, on which the list was compiled (including the date of the list compilation). A similar view is presented by the Moscow Exchange in provided comments. The main issue that remains unclear is whether primary of-

fering transactions should be considered for the purpose of the calculation of the weighted average price of a bond. Since the Ministry of Finance of the Russian Federation has provided no comments on this issue, it seems to be impossible to include primary offering transactions in the calculation of the weighted average price of bonds.

In accordance with article 214.2 of the Tax Code of the Russian Federation, taxation of the coupon income (coupon rate) earned on corporate bonds, which were issued on 1 January 2017 and conform to the above-stated criteria, is performed as follows:

1. Coupon income on bonds at the rate of the key rate<sup>2</sup> of the Bank of Russia increased by 5% and valid through the coupon pay period is not subject to individual income tax.

2. In case the bond coupon rate exceeds the key rate of the Bank of Russia increased by 5% and valid through the coupon pay period; the tax base, subject to the tax rate of 35%, is considered to be an excess sum between coupon payments on bonds and the bond coupon interest rate, which is computed on the basis of the par value of bonds and the key rate of the Bank of Russia increased by 5% and valid through the coupon pay period.

In practical terms, introduction of the provision stated under clause 2 make sense only in limited number of cases due to the fact that there are not many recently issued 12.25%-yield bonds on the stock market.

The procedure for taxation of coupon income earned on bonds, which do not meet the above-stated criteria, remains unchanged. This relates to income on foreign-currency bonds or bonds issued before 1 January 2017 as well as to income earned by taxpayers from any mutual funds.

Therefore, it can be stated that individual income tax is imposed on coupon income earned from the corporate bonds of new issuances similarly to the way it is imposed on income received on bank de-

posits. Since the proportion of individual investors on the corporate bond market is small, these changes are expected to enhance the investment attractiveness of the exchange-traded bonds of Russian joint-stock companies and encourage the inflow of private investment into the economy of the Russian Federation.

The new provisions on the taxation of coupon income earned on corporate bonds are logical, expected and correspond to the general trend towards the liberalization of taxation of transactions in securities, which is considered in detail by O.S. Belomytseva [28; 29], and the activation of the stimulating function of taxation.

Foreign studies on the taxation of coupon income predominantly address the effect of the tax relief on the prices and the yields of bonds. According to M.H. Miller [30], there is an individual tax discount in the pricing of corporate interest payments that can eliminate the corporate tax benefit of debt. E.F. Fama and R.F. Kenneth [7] state that corporate bond yields are higher than nontaxable bond yields. Sh. Liu, J. Shi, J. Wang, and Ch. Wu [16] believe that taxes have a strong positive effect on corporate bond yields, which has been largely ignored in traditional term structure models of corporate bonds. R.C. Green and B.A. Odegaard [14] hypothesize that all bonds are priced so that they can be optimally held by a marginal investor with a zero tax rate. E. J. Elton and T. C. Green [31] hold the view that the lack of substantial tax and liquidity effects in the relative prices of bonds has important implications for investors deciding when to select bonds. Our stance corresponds to that of E. F. Fama and R. F. Kenneth [7], who suppose that investors in high tax brackets can rationally hold tax-free bonds at lower yields than taxable bonds, whatever the tax bracket implicit in the pricing of taxable interest.

In Russia, the taxation of coupon income has not been investigated so far. Studying the impact of tax reliefs on corporate bonds will be possible when a few years have passed since the introduction of the tax relief.

<sup>2</sup> At the date this manuscript was written, the key rate of the Bank of Russia was 7.25%.

### Corporate bonds with a zero-percent individual income tax

The Moscow Exchange daily updates lists of bonds with coupon rate, on which individual income tax is imposed within the limits established by article 214.2 of the Tax Code of the Russian Federation. As of 18 May 2018, this list was composed of 319 bonds. Among the issuers of these bonds, there are such well-known joint-stock companies as MTS, Sberbank of Russia, Gazprombank, etc.; and less known issuers, who pay a higher yield, such as Russian Helicopters, Softline Trade, Verkhnebakansky Cement Plant, etc. (Table 1).

Table 1  
The yield of some<sup>3</sup> corporate bond issues, traded on the Moscow Exchange as of 18 May 2018

Name of issuer	Security code	Yield, %
MTS	RU000A0ZYJ83	6.95
Sberbank of Russia	RU000A0ZYUJ0	7.02
Gazprombank	RU000A0ZYRY5	7.39
Russian Railways	RU000A0ZYU05	7.44
Alfa-Bank	RU000A0ZYGB6	7.46
Russian Helicopters	RU000A0ZYMM1	8.59
Softline Trade	RU000A0ZYLD2	11.28
Verkhnebakansky Cement Plant	RU000A0ZYLK7	12.37
GruzovichkoF-Center	RU000A0ZZ0R3	15.53
Microfinance company "MoneyMan"	RU000A0ZYJX4	16.55

Source: Compiled by the using the Moscow Exchange data: List of exchange-traded ruble bonds, issued by Russian organizations, with the coupon income that is not subject to individual income tax within the established limits as of 18 May 2018. Available at: <http://www.moex.com/ru/markets/stock/privilegeindividuals.aspx> (accessed 18 May 2018).

Thus, there are numerous corporate bonds with different risk and yield rates, the coupon on which will not be subject to individual income tax. It should be noted that the list of exchange-traded ruble bonds, issued by Russian companies and generating coupon income (coupon rate),

<sup>3</sup> Here we present data on the yields of randomly selected corporate bond issues. In fact, this list may contain several issues of bonds of one and the same company and have different yield rates.

which is not subject to individual income tax, is composed of predominantly exchange-traded bonds.

The yield of the MICEX corporate bond index (MICEXCBICP) as of 18 May 2018 amounted to 7.64%<sup>4</sup>. According to the data of the Bank of Russia, the base level of yield on deposits with a more than one-year<sup>5</sup> amounted to 7.841%<sup>6</sup> in May, 2018. This imbalance in yield is explained by the fact that the corporate bond market is entered mostly by known and well-reputed issuers of bonds, demonstrating good indicators of quality and period-to-maturity. Consequently, the yield on these bonds is relatively low. As regards the yield on deposits, it is computed for every single commercial bank.

The preferential tax treatment (i.e. corporate tax relief) of corporate income arising out of the purchase of Russian corporate bonds by legal entities has not received much consideration in scientific literature. Nevertheless, it should be noted that in accordance with clause 4 of article 284 of the Tax Code of the Russian Federation, a 15% corporate income tax is placed on interest income derived from a number of Russian bonds issued after 01 January 2017. The criteria that determine whether particular bonds are subject to this tax relief are generally similar to the criteria that are applied to corporate bonds purchased by individuals; however, these criteria have some distinctive features. Lists of bonds, issued by Russian organizations and generating interest income, which is subject to corporate income tax at the rate of 15%, are also compiled and updated by the Moscow Exchange on a daily basis.

<sup>4</sup> Moscow Exchange. The MICEX corporate bond index (MICEXCBICP), 2011–2018. Available at: <https://www.moex.com/ru/index/MICEX-CBICP> (accessed 18 May 2018).

<sup>5</sup> Since bonds normally have a minimum three-to-five year term to maturity; for the purpose of comparison, we can refer only to interest rates on long-term deposits. According to the statistical data of the Bank of Russia, the longest deposit duration is over one year.

<sup>6</sup> Bank of Russia. The base level of yield on deposits (in May 2018). Available at: [http://www.cbr.ru/analytics/basic\\_level/files/budv\\_2018-05.pdf](http://www.cbr.ru/analytics/basic_level/files/budv_2018-05.pdf) (accessed 18 May 2018).

### Specificity of investment in bonds via individual investment accounts

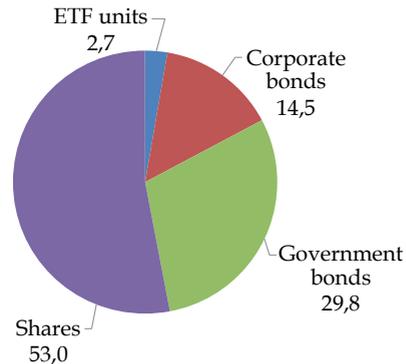
Over the last few years, IIA, which were introduced in 2015, have gained much popularity, compared to other individual investor's forms of tax relief. This popularity of IIA, in our view, is associated with their "multipurposeness" (i.e. compatibility with a large number of instruments and suitability for various investors), wide availability, simplicity for understanding, promotion facilitated by a large number of the financial market participants, and a decrease in bank deposit rates. The specificity of opening and operating IIA is studied in detail by O.S. Belomytseva [28].

Bonds are an essential tool for investment with IIA of A-type because they enable working individuals to obtain higher yield, compared to the yield on deposits; and bondization in its turn offers a wide range of tools. According to the authors' observation, about 40% of investors using IIA are conservative and bond-oriented. As regards purchasing bonds via IIA, it should be mentioned that there some restrictions in effect. For instance, it is impossible for an individual to purchase securities of a foreign issuer, which are not admitted to trading on the Russian exchange, as well as federal loan bonds ("people's" OFZ).

On 31 December 2017 the first three-year moratorium on early closure of IIA expired. The main statistically significant results<sup>7</sup> of the three-year use of IIA for the purposes of the bond segment of securities market as of 31 December 2017 were as follows:

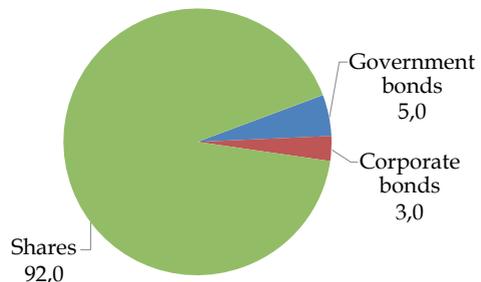
1. The share of government bonds in IIA portfolios was 29.8%; the share of corporate bonds, 14.5% (Figure 2). Since the total assets on IIA reached 43.4 billion rubles at the end of 2017, the share of bonds amounted to 19.2 billion rubles, respectively.

<sup>7</sup> Source of data: Moscow Exchange. NAUFOR. Report on IIA. Results of 2015–2017. Available at: <https://fs.moex.com/f/9254/iis-2015-2017.pdf> (accessed 20 April 2018).



**Figure 2. The structure of individual investment account portfolios as of 31 December, 2017, %**

2. In the context of the bond investors' trading activity, transactions in government bonds constituted 5% of the trading volume; corporate bonds, 3% (Figure 3). The low share of bond trading in this case is explained by the fact that bond holders primarily purchase them and hold till redemption, which minimizing their trading activity.



**Figure 3. The trading activity of individual investment account holders at year-end 2017, %**

3. According to data of the Federal Tax Service, the amount of tax deductions, granted to more than 21,000 IIA holders at year-end 2016, amounted to more than 6.6 billion rubles<sup>8</sup>. The share of bond deductions in this amount cannot be calculated without detailing.

We drew the following conclusions regarding the development of investment tax deduction, linked to the opening of IIA:

<sup>8</sup> Data for 2015 and 2017 are not freely available.

1. During the first three-year period (period of the account closure-moratorium), IIA were successfully employed by numerous investors. Currently, IIA with B-type deduction prevails; however, in the future the active development of the domestic bond market will presumably shift investors' focus onto IIA with A-type deduction.

2. Introduction of protection (insurance) mechanisms for individuals' investments with IIA is expected to occur in the nearest future.

3. In the course of further development and use of IIA, a number of technical parameters are likely to be adjusted, which involves a possible increase in the amount of annual contribution, more flexible requirements for annual contribution, options for the withdrawal of funds under certain conditions.

Comparing the conclusions that are outlined above with the foreign practice, we should emphasize as follows:

1. In developed foreign countries, bonds are not the dominant instrument in the case of investing through accounts similar to IIA<sup>9</sup> (Table 2); shares and equity funds prevail. The share of the latter varies from 51 to 54%, which corresponds to the current structure of IIA portfolios in the Russian Federation (Figure 2). The described situation, however, does not invalidate the authors' conclusions about the active role of bonds in investment using IIA. The small percentage of bonds in foreign portfolios can be explained by the fact that this type of investment accounts currently exists only in developed countries, where bond yield is rather low; so bonds are less attractive to investors.

2. IIA analogues are actively developing in other countries and are often modified in search of the optimum result. Issues related to these accounts are studied by O.P. Attanasio and T. DeLeire [21]; C. Cortese and J. Glynn [32]; M. Donnelly and A. Young [20]; etc.

<sup>9</sup> Accounts that analogous to Russian IIA are as follows: IRA (USA), ISA (Great Britain), Superannuation (Australia), TFSA (Canada), NISA (Japan).

Table 2  
The percentages of shares<sup>10</sup> and bonds<sup>11</sup> in foreign investment portfolios, formed through accounts analogous to IIA

Country	Name of account	Percentage of shares, %	Percentage of bonds, %
USA	IRA	54	16
Great Britain	ISA	54	–
Australia	Superannuation	51	21

Source: Compiled by the using of data: Investment Company Institute. Ten Important Facts about IRAs, 2017. Available at: [https://www.ici.org/pdf/ten\\_facts\\_iras.pdf](https://www.ici.org/pdf/ten_facts_iras.pdf) (accessed 10 May 2018); HM Revenue and Customs. Individual Savings Account (ISA) Statistics, 2018. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/703782/Full\\_Statistic](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/703782/Full_Statistic).

3. The effectiveness of the introduction of IIA analogues and contribution of these accounts to national saving are of significant interest to foreign economists, despite the fact that these issues are rather controversial. For example, J.G. Gravelle [33] found that "IRAs were not effective savings incentives". Likewise, E.M. Engen, W.G. Gale, and J.K. Scholz [34] arrived at the conclusion that the effect of these incentives on saving was next to zero. M. Feldstein, an adherent of the opposing viewpoint, believes that "some of the increase in personal saving raises the corporate capital stock, and this additional capital raises corporate tax payments" [35]. His position on the issue is supported by R.G. Hubbard and J.S. Skinner, who state that "saving incentives generate substantial net capital accumulation over time per dollar of forgone revenue" [36]. Some researchers, e.g. G. Ruggeri and M. Fougere [37], hold the intermediate opinion. Referring to the practice of the Russian Federation, the effectiveness using IIA remains undetermined due to the insufficiency of data on tax deductions linked to IIA.

<sup>10</sup> "Shares" also means "equity funds".

<sup>11</sup> "Bonds" also means "bond funds".

### Distinctive features of the long-term capital gains exemption

As of 1 January 2015, in accordance with article 219.1, Russian investors can be granted the so called LTCGE, which applies to securities that have been purchased since 2014. The right to receive this tax relief extends to the positive financial result, obtained (in a tax period) from the sale (redemption) of securities traded on the organized securities market and held by the taxpayer for more than three years. LTCGE also applies to securities transferred as a gift or inheritance, excluding the securities held for a period of less than three years due to their redemption or repurchasing.

According to clauses 1, 2, and 3 of article 214.1. of the Tax Code of the Russian Federation; for purposes of the computation of LTCGE and others, the term “exchange-traded securities” comprises:

- securities admitted to trading by the Russian organizer of trade on the securities market;
- units of open-ended mutual funds, managed by Russian asset management companies.

In the case of the sale of securities with the same holding period ( $N$  full years,  $N$  above or equal 3) the maximum amount of tax exemption will be equal to  $N \times 3$  million rub. (Table 3). In the case of the sale of securities with different holding periods, the exemption is calculated with a special formula [28, p. 100].

Table 3

#### The limit on the long-term capital gains exemption

Year of purchase of a security	Maximum income by the year of sale of the security		
	2017	2018	2019
2014	9 million rub.	12 million rub.	15 million rub.
2015	-	9 million rub.	12 million rub.
2016	-	-	9 million rub.

Source: The amount of income was calculated by the authors with reference to article 219.1 of the Tax Code of the Russian Federation by multiplying the amount of years of holding by 3 million rub.

It should be noted that a similar relief was in effect until 2007. However, previously, the full amount gained from the sale of securities, held for more than three years, was tax-free. As regards LTCGE, it ensures a tax exemption only in the amount of the positive financial result, obtained from the sale of securities held for more than three years and purchased after 1 January 2014.

Hence, we can draw a number of inferences with regard to the application of LTCGE in Russia:

1. The tax relief is formulated in a logical, clear, and comprehensible way.

2. LTCGE is primarily aimed at shares as a more volatile, risk-related and profitable instrument; and, in the second place, it is designated for medium-term corporate bonds, so it obviously stimulates medium-term investments of individual investors.

3. Investors are encouraged to purchase bonds with a more than three years term to maturity, which are in ample supply on Russian securities market.

As regards the analysis of LTCGE in the context of comparison with the foreign practice and studies of foreign economists, we found as follows:

1. The terms and conditions of LTCGE are formulated similarly to those of analogous tax reliefs of developed countries, e.g. Great Britain, where such parameters as the holding period (3 years), prohibition of sales, and the requirement of exchange-traded instruments coincide with the parameters of the Russian LTCGE<sup>12</sup>.

2. In foreign countries, studies of tax reliefs analogous to LTCGE are nearly absent; there are mostly studies of reliefs linked to shares, the effect of tax reliefs on the trading volume, investors' inclination towards investment, etc.

3. Some authors (e.g. D. Feenberg and L. Summers L. [38]) perform a financial and sociological analysis of capital gains tax reductions analogous to LTCGE, which calls into question the effectiveness of these tax reliefs.

<sup>12</sup> London Stock Exchange Group. A Guide to AIM Tax Benefits. Available at: <https://www.londonstockexchange.com/companies-and-advisors/aim/publications/aimuktaxguide.pdf> (accessed 10 May 2018).

### The specificity of the long-term capital gains exemption (Innovation and Investment Market)

Since 2009, the Moscow Exchange has had Innovation and Investment Market (hereinafter IIM). There is even a special MICEX – Innovations Index (MICEX-INNOV), which is calculated as a market capitalization-weighted index of the shares of Russian companies, admitted to trading in the IIM sector.

At the end of 2015, the long-term capital gains exemption, which is applied to income earned from securities of the high-tech (innovation) sector of economy (hereinafter LTCGE-IIM), was introduced in the Russian Federation. The introduction LTCGE-IIM was intended to have a catalytic effect on the development of small and medium-sized enterprises of the innovation sector of Russian economy. This tax relief will be in effect up to 31 December 2022. According to article 284.2.1 of the Tax Code of the Russian Federation, a zero percent individual income tax rate applies to the tax base, generated by gains from the sale or any other disposal (including redemption) of shares, bonds of Russian companies and investment units of issuers of the high-tech (innovation) sector of economy. Here, it is important to note that LTCGE-IIM does not extend to bond coupons and dividends as well as does not imply restrictions on maximum income. The specific features of the implementation of LTCGE-IIM are presented in Table 4.

Table 4

#### Implementation of the long-term capital gains exemption (Innovation and Investment Market)

Type of transaction/ income, earned from securities	Applicability of the tax relief, based on the holding period	
	Up to 1 year	Above one year
Purchase/sale	Does not apply	Applies
Redemption	Does not apply	Applies
Depreciation	Does not apply	Applies
Coupons/divi- dends	Does not apply	Does not apply

An investor is eligible for granting LTCGE-IIM if the following two conditions are contemporaneously respected<sup>13</sup>:

1. Shares, bonds, and investment units on the organized market of securities must be admitted to trading on the IIM.

Requirements for assigning the securities to IIM are as follows<sup>14</sup>:

- shares must be issued by a Russian issuer, and the capitalization of a company over the first trading week must not exceed 10 billion rubles<sup>15</sup>;

- bonds must be issued by a Russian company, and the company's revenue, excluding VAT for the sold goods (work, services) must not exceed 10 billion rubles<sup>16</sup> per calendar year, preceding the year of inclusion in the IIM sector;

- the value of the net assets of the unit investment fund on the day of inclusion of investment units in the IIM sector must not exceed 10 billion rubles.

The exchange makes a decision regarding the inclusion of securities in the IIM sector upon the application of the issuer and in compliance with the Decree of the Government of the Russian Federation.

2. The investor must continuously hold securities for more than one year. In doing so, the securities must be included in the IIM sector at the time of sale (redemption).

As of 17 May 2018, 15 companies are listed among the issuers of the IIM sector of the Moscow Exchange. Three of companies are issuers of exchange-traded bonds;

<sup>13</sup> The conditions are stated in accordance with article 284.2.1 of the Tax Code of the Russian Federation.

<sup>14</sup> The requirements are formulated in accordance with the Decree of the Government of the Russian Federation of 22 February 2012 No. 156 "On Approval of Rules on Qualifying Shares and Bonds of Russian Organizations as well as Investment Units, Traded on the Organized Market of Securities, as Securities of the High-Technology (Innovation) Sector of Economy" (edn. 8 December 2016).

<sup>15</sup> As authorized by the Decree of the Government of the Russian Federation of 30 March 2018 No. 356, this amount will be increased to 25 billion rubles on 1 January 2019.

<sup>16</sup> As authorized by the Decree of the Government of the Russian Federation of 30 March 2018 No. 356, this amount will be increased to 25 billion rubles on 1 January 2019 as well.

two, issuers of units of unit investment funds; one, an issuer of units of ETF<sup>17</sup>. Nevertheless, the Moscow Exchange included shares of only 9 issuers<sup>18</sup> in the list of securities of the high-tech (innovation) sector of economy for the purpose of claiming tax relief, which reveals the non-conformance of the securities of the other issuers to the above-stated conditions and requirements.

Hence, we can draw the following inferences in relation to the application of LTCGE-IIM:

1. The implementation aspects of the tax relief are formulated in a clear and comprehensible way; however, the existence of two side-by-side reliefs (LTCGE and LTCGE-IIM) in different articles of the Tax Code of the Russian Federation, from our perspective, is irrational. With this in mind, it can be recommended to consider LTCGE-IIM as the type of LTCGE, described above and applied under the article “Investment Tax Deductions” of the Tax Code. In fact, LTCGE-IIM, judging by the essence and the economic rationale of this phenomenon, appears to a type of investment tax deduction. Introduction of special IIA for the purchase of securities of the high-tech (innovation) sector of economy can serve as another approach towards the development of the IIM sector. Similar accounts (innovative finance ISA) have been used in Great Britain since 2008.

2. Theoretically, investors can apply for LTCGE-IIM on transactions with

<sup>17</sup> Moscow Exchange. Issuers of the IIM sector, 2011–2018. Available at: <https://www.moex.com/s68> (accessed 17 May 2018).

<sup>18</sup> Moscow Exchange. List of securities of the high-tech (innovation) sector of economy, which are eligible for tax relief, 2011–2018. Available at: <https://www.moex.com/ru/markets/rii/rii.aspx> (accessed 17 May 2018).

bonds, but there are no de facto bonds in the IIM sector. In the light of the current bond boom and widespread interest of Russian investors in bonds [28, p. 40], this situation is extraordinary and demonstrates the insufficiency of work of the Moscow Exchange and the Bank of Russia with issuers.

3. In case of the further development of the bond segment within the IIM, investors are encouraged to purchase bonds with a more than one year term to maturity.

4. In the IIM sector, there is an obvious lack of units of unit investment funds and ETF, which can be also based upon bonds.

5. The short LTCGE-IIM period as well as the underdevelopment of LTCGE-IIM impede the evaluation of the effect of its implementation or even contribute to the fact that this effect is considered unsatisfactory.

6. The validity period of the tax relief expires in 2022, which generates an illusion of the temporariness of this relief and may lead to the fact that investors will not perceive this tool as a long-term one.

#### **The possibility of reconciliation of the tax reliefs for individual investors**

Table 5 presents possible ways of tax relief reconciliation for individual investors.

Here, IIA and LTCGE are regarded as mutually exclusive, since they appear to be varieties of the same investment tax deduction in accordance with article 219.1. Moreover, law does not prohibit the reconciliation of the relief on bond coupons and LTCGE-IIM with IIA. However, this situation does not stimulate purchases of securities of the IIM sector, which is explained by the absence of mass offering of these investment instruments. Ultimately,

Table 5

#### **Reconciliation of the tax reliefs for individual investors on the basis of one investment instrument**

Investment instrument	IIA	LTCGE	LTCGE-IIM	Bond coupons
IIA	-	Prohibited	Allowed	Allowed
LTCGE	Prohibited	-	Allowed, does not make sense	Allowed
LTCGE-IIM	Allowed	Allowed, does not make sense	-	Allowed
Bond coupons	Allowed	Allowed	Allowed	-

the possibility of reconciliation of the coupon relief and IIA is a sign of the following tendencies:

- willful prioritization of the bond as an investment instrument over shares and other instruments;
- prospective domination of A-type deduction in relation to IIA.

### **A discussion on the status of exchange-traded securities with regard to the financial marketplace**

In the context of individual income tax payment, to an individual investor, the most important point is determining the current status of securities, i.e. whether the securities are exchange-traded or not. At first sight, the criteria for the identification of securities as exchange-traded are clearly stated in the Tax Code of the Russian Federation<sup>19</sup>. However, the latest idea of marketplace creation entails significant uncertainty about this issue.

The project “Marketplace” was announced by the Bank of Russia at the end of 2017. The aim of the project is to create a system of (1) remote retail distribution of financial products/services and (2) registration of financial transactions. In the terminology of the Bank of Russia, “marketplace” is a system, which combines platforms for financial transactions, data marts to accumulate and present information on financial products (or services), and bots (specialized algorithmized consultants) for selection of products (or services) for final consumers (i.e. individuals). Inherently, it will be a platform offering (to individuals) a wide range of financial products and services, provided by banks, investment, and insurance companies on a competitive basis, with consulting services and registration of transactions being available. The key objective in this case is to ensure that consumers of financial services will have equal access to financial market regardless of geographi-

cal location and other attributes as well as to stimulate competition. Some financial instruments that are interesting to a retail investor (e.g. mutual fund units, ETF units, and structured products), but not traded on exchanges can become more accessible on the marketplace, where the procedure of listing will supposedly not be used. From the authors’ perspective, deposits and bonds are likely to hold the leading positions within the marketplace.

In foreign literature, issues related to the marketplace development are barely presented, which is explained by the fact that this phenomenon is currently at the initial stage of development. Nevertheless, B. Vallee and Ya. Zeng [39] already state that investors themselves will conduct tasks traditionally performed by banks.

In the context of taxation, the marketplace has an unclear and controversial status, being neither an exchange nor a broker, but performing some functions of these bodies. It is obvious that securities, including bonds, purchased via the marketplace, should be granted status similar to that of securities traded on organized securities market. This situation requires introduction of changes to article 214.1 of the Tax Code of the Russian Federation. Without these changes and in case of the absence of these securities trading on exchange, investors will not be entitled to claim a range of reliefs, in particular individual income tax exemption for coupon income on corporate bonds and LTCGE.

### **Conclusion**

Thus, the bondization of Russian securities market corresponds to the overall tendency towards securitization of financial market, i.e. displacement of bank credit by securities. Liberalization of taxation of private investors’ transactions in bonds serves the purposes of the increasing securitization and savings stimulation.

There is no uniform system of tax reliefs for individuals (private investors) in the Russian Federation. For example, bond investors have more tax relief options, compared to individuals who invest in shares. In this context, the following issues, which are directly associated with

<sup>19</sup> These criteria in relation to bonds are presented under the chapter *Changes in the taxation of the individual income derived from corporate bond coupons*; in relation to securities in general, under the chapter *Distinctive features of the long-term capital gains exemption*.

the taxation of individuals' investment, still remain unaddressed:

- equalization of taxation of the investment instruments that are based on bonds (e.g. bond mutual funds and structured products) that are not subject to tax relief;

- a possibility for individuals to apply for exemption from individual income tax payment in relation to income derived from the exchange rate difference occurring in sovereign Eurobond transactions;

- exemption of individuals from investing in units of any mutual funds, not only from investing in bond mutual funds.

Referring to our analysis of particular tax reliefs, it was found that certain technical aspects of IIA require adjustment

and improvement; and that an amendment, identifying LTCGE-IIM as a modification of LTCGE, should be made to the Tax Code of the Russian Federation. An alternative course of the IIM sector development can be associated with the introduction of a special type of IIA, i.e. with innovative finance. The project "Financial Marketplace", announced by the Bank of Russia, is also likely to require that some change should be introduced to the Tax Code of the Russian Federation. This change will consist in improving the definition of exchange-traded securities.

The issues of the effectiveness evaluation of tax reliefs for private investors in the Russian Federation still remain unstudied.

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