Introduction to Session 2:
Local Perceptions: Challenges in Banking and Trading

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My name is Mark Rachovides, and I am a principal banker with the natural resources team of the European Bank for Reconstruction and Development (EBRD). I am very pleased to be invited to chair the next session, which is entitled ‘Local Perceptions’ and deals with challenges in banking and trading.

I will keep my opening comments very brief, as we have a distinguished panel, who I will announce one by one. I will summarise the gist of the session at the end of it, and invite your questions in the same format as in the first session.

By way of some introductory remarks, I am very pleased to be here for many reasons, both personal and institutional. EBRD is the largest foreign investor in Russia. We have been probably the longest-term participant in natural resource investment in this country. We have seen both bad and good times, and that theme brings to mind two separate quotations from press cuttings.

In 1999, I remember very poignantly the cover of Euromoney that depicted the retreat from Moscow of the EBRD. Well, sorry – we never left, and we are still here. I am very pleased to see many faces in this audience that have been through the bad times. I’ve known quite a few of you for years, which says a lot for your credibility, and I applaud you for your persistence, your efforts and for the great progress you’ve made.

A more recent press quotation this year in the Financial Times was given by the chief executive of Rio Tinto, Leigh Clifford, who commented that when we have bullish commodity markets, and where political risk doesn’t seem to be that important any more, it’s remarkable how many experts seem to ‘come out of the woodwork’. On this occasion, it serves to illustrate a broader point: the question of credibility. This session, I hope, will go some way to address what I think are extremely important themes and pointed issues for the development of banking and trading in this country. The local banking system went through some difficult times in 1998 and 1999, and I am very happy to see how much it has recovered. Indeed, taxation and the legal environment as a whole are absolutely essential to the understanding of foreign investors.
The Official View

Konstantin Mikhaltchuk
Deputy Chief of Administration, GOKhRAN of Russia

We are happy to welcome representatives from the LBMA and have them here with us on Russian soil. By discussing the matters which have brought us all together here at this Forum, as players in the precious metals market, we will be better able to understand and resolve the challenges facing all of us.

Over the last ten years GOKhRAN of Russia has been working actively with the London Bullion Market and the London Platinum and Palladium Market. GOKhRAN supports the policy being implemented by these associations on the international precious metals market. We are working to realise the main objectives of the LBMA and LPPM to ensure that only high-quality bullion is traded on precious metals markets.

Over the course of many years, GOKhRAN has done much to ensure that precious metals produced by Russian refineries meet national standards, LBMA requirements and international standards. It is in all of our interests that Russian enterprises, which have been producing precious metals for many years, be able to work consistently, that personnel within such enterprises are permanently employed and highly qualified, and that all manufacturing processes are equipped with the latest technology. All of this will ensure the high quality of precious metal bullion.

After the collapse of the USSR, a complicated situation arose on the international precious metals market, to do with the fact that Soviet gold represented both Russian-Uzbek and Kazakh gold. In connection with this, the Russian government was approached by Rothschild, the chairman of the London Gold Fixing, who made a request that work start on awarding Good Delivery status to Russian enterprises.

Commencing in 1995 under the instruction of the Government, ROSKOMRAGMET (the Committee of the Russian Federation for precious metals and stones) and subsequently GOKhRAN, started working with analytical laboratories at refineries, organising retraining of analysts and preparing proposals to change the marking of bullion, to replace “USSR” and the hammer and sickle with a Russian mark, and to introduce changes to national standards. They also drew up plans and subsequently presidential decrees and governmental resolutions governing the issue of precious metals from the State fund held by enterprises hoping to be awarded Good Delivery status, and likewise prepared relevant decrees for controlling the import of precious metal samples, pursuant to LBMA regulations.

All these works were carried out by GOKhRAN of Russia together with Vneshtorgbank and the Russian Central Bank. There was a mass of correspondence with the LBMA and LPPM and hundreds of letters were written and received. As a result of this, the LBMA and LPPM gained a comprehensive understanding of the situation with Russian precious metal producers.

All this work was completed in compliance with the requirements of Good Delivery status, as current at that time. Co-operation with enterprises hoping to gain international recognition resulted in Good Delivery status being awarded in 1999 to gold and silver bullion produced by the Ekaterinburg, Novosibirsk, Shyolkovsky, Prioksky and Krasnoyarsk plants.
From 1999 to 2001, Good Delivery status was awarded to platinum and palladium bullion from the Krasnoyarsk, Prioksky, Ekaterinburg and Novosibirsk plants.

I must note that the tradition of awarding LBMA certificates to enterprises whose products have attained Good Delivery status, started with a recommendation made by GOKhRAN of Russia, which was supported by the LBMA and LPPM. We hope that this tradition will continue.

Good Delivery status, which ensures the sound liquidity of bullion in the international precious metal markets, is the basis for the creation of a gold reserve in the State Repository for Precious Metals and the Central Bank of the Russian Federation. It is no accident that bullion of Russian origin is in constant demand on the international market.

Currently, GOKhRAN of Russia, acting on applications received from the Kolymsk refinery and Uralentermed, is working for the admission of these enterprises to the group of recognised precious metal producers.

In this regard, we see just how stringent LBMA requirements have become for those wanting to join the Good Delivery Lists. Not only have the requirements become more stringent, but costs to refiners have increased due to the introduction of proactive monitoring – there is now an annual maintenance fee, although this is waived if the company joins the LBMA as an Associate. We support LBMA policy, but we are concerned that the high cost of proactive monitoring will affect the attitude of precious metal producers to LBMA requirements.

The precious metals market is distanced from the influence of official agencies, which are unable to change current opinion on the LBMA position, to aim to reduce the number of Associate members of the LBMA by sharply increasing the cost of procedures. This is at a time when the tightening of general requirements for those wanting to join in relation to the state of their manufacturing process, financial condition, the quality of precious metals and the capacity of analytical laboratories, has been vindicated.

We know how the LBMA feels about compromise. In 1998, during negotiations on international requirements for marking bars, the LBMA proposed stating the weight of Russian bars in ounces, but it agreed with our position, that to state the weight in ounces in a country operating on the SI system would not be defendable.

For its part, GOKhRAN of Russia conducts incoming quality control of precious metal bullion and issues this both on the external and internal market and then tracks its further movement, including in high-technology industry. Every time questions arise concerning the quality of precious metals, these become the subject of very serious consideration and remedial action is quickly taken, wherein lies the guarantee of the competitiveness of Russian precious metals.

Thank you for your attention.
Good day. To be honest, I have been working in the field of precious metal trading for quite a long time now – since the time when the market as we know it didn’t yet exist and we still had the Soviet system of precious metal distribution. You could say that I have been through all the stages of the market’s development in Russia. I will take you on a brief historical journey and show you how we inherited the business we have today.

As we know, in the Soviet Union operations involving precious metals were within the scope of guarded State secrets. Even when compared to other industry sectors, this sector stood out because of the tight central control it was subjected to. Of course, there was certainly no talk of a market.

Mining was carried out by large State enterprises under the control of Glavalmazzoloto. However, paradoxically, these enterprises incorporated what were, in effect, market structures; so-called prospectors’ co-operatives.

These enterprises supplied metal to GOSKOM at fixed rates. Money, in the form of funding, was provided in the same way from public funds via the finance ministry. Users obtained metal from Gosfond, likewise at fixed rates, and exports were made through Vneshtorgbank of the USSR, which was renamed Vneshekonombank and latterly known as Vneshtorgbank. Similarly, on the basis of a decision made by the Government of the Soviet Union, this bank would acquire gold from GOKhRAN for sale on the external market in exchange for freely convertible currency.

Roughly speaking, that was the sort of system we had: very simple. Yet the system that existed in the Soviet Union far outlived the Soviet Union itself, which had created it. It continued to exist largely unchanged right into the mid-90s.

In the period leading up to this time, the mining industry faced a growing number of serious problems, the most significant of which was a severe lack of funds available both for advance payments and final settlements for metal supplied to Gosfond.

As it was, by the way, withheld payments became a common occurrence throughout the entire public sector, because such payments were coming from public money. In addition to this, naturally the entire industrial decentralisation and privatisation process engulfed the precious metal mining industry.

Numerous small independent enterprises sprang up in the place of large associations and this, of course, caused the then-operating distribution system to become inactive. As a result, a real threat existed that the sector would crumble, which meant that a self-regulating market mechanism was needed to replace the old distribution system.

As a result, the first governmental documents were issued to sketch out the shape of the future precious metals market. However, from a theoretical point of view the market is a system enabling the movement of goods from supplier to consumer and ensuring equivalency in the turnover of goods. In order for it to function normally it must be liquid, meaning that it must be possible to make a transaction at any moment. This is made possible by attracting the maximum number of players, who, at a specific point in time, will create a critical mass so that the price setting process becomes self-perpetuating.

The market structure is formed by its participants, who are the producers – the primary producers; subsoil users, and secondary producers and those reprocessing scrap metal and other waste-containing precious metals.
Then there are the consumers, industrial and investment intermediaries, and it is they who create the fabric of the market and bind all the other players together. In addition, there are the traders who add to the market’s critical mass, generating large volumes of transactions and creating a collective middleman – the exchange (in theory).

In practice, the banks took on the role of middlemen in the development of the world precious metals market. This was by virtue of the fact that they held the financial resources, which are essential in relation to the capital-output ratio both of the mining sector and the market itself. And on the other hand, historically, precious metals – primarily gold – have acquired the image of a banking commodity, a financial instrument, and, naturally, the role of the banks here is quite logical. It was in the very same way that the banks were put forward as intermediaries in the creation of the newly formed Russian market structure.

From an official perspective, the history of the market can be recounted from December 1993 when Russian Presidential Decree number 2148 was adopted. This formulated the concept of authorised banks and determined that these banks would carry out operations involving precious metals on the basis of licenses issued by the Central Bank of the Russian Federation, with the approval of the Finance Ministry.

In conjunction with this, the decree, which was simply a declaration of intent, set specific objectives for other State institutions.

A few more years were needed before all the critical rulings stipulated by this decree would be adopted. In particular, Governmental Resolution 756 followed in mid-1994, which for a long time right up to March 1998 was all but accepted as the law on precious metals. This Decree was the principle document regulating the market.

The final regulatory principles for working in the commercial banking market were set out towards the end of 1996, when the Central Bank adopted a statute governing the execution of operations with precious metals by credit organisations.

It’s worth noting that by the mid-90s a developed banking system was already established in Russia, which incorporated very large banks, even by worldwide standards, such as Sberbank and Vneshtorgbank, which were State-owned banks, and also large private banks; Oneksibank, Stolichniy, Inkombank, Inotep and others. It was the representatives of these banks that participated in the development of general principles for the functioning of the market in the early stages of its development. Quite frankly, they were the founders of the so-called “Gold Club of Russia”, an association which, in the early stages, considered all the principle project documents that then went on to form the basis for the market.

Subsequently, and unsurprisingly, a multitude of all kinds of proposals were made in the course of the work of the association, of which even the most daring were properly discussed. There was an idea to create a Russian analogy of the LBMA, a kind of association to unite not only the banks carrying out precious metal transactions, but also the producers and buyers.

Incidentally, the matter of the creation of a precious metal exchange was considered on a number of occasions back in the mid-90s. Unfortunately, much of what was then proposed was never realised, and it would seem that in all likelihood it could never have come about in view of the inertness of the powers that be.

For the most part there were objective reasons: first of all, there was the initial imbalance of the market structure. Above all this manifested itself in the extremely low demand for metal within the country.

Big industries were in decline, particularly defence industry enterprises, which were the most important metal consumers in Soviet times. Market requirements for jewellery were limited by the public’s inability to drive demand due to the lack of spending power. The problem was accentuated further by the fact that liberalisation of the precious metals market was long overdue.

The currency market was opened up much earlier and the US dollar firmly took on the role of the store of value. Even when (a good while later) kilo bars were launched and natural persons were given access to the market, the potential of public demand turned out to be significantly less than expected.

During the preliminary stage the market structure proved to be somewhat curtailed. What happened as a result of this first phase? The banks virtually became the source of financing and the intermediary between mining enterprises and the Bank of Russia, which was, during the first phase, just about the only final buyer of the metal from banks.
Further development of the market and transformation of the mechanism that had come about in the existing market during this initial stage could only happen if other sources of liquidity were created. Since there were no sufficiently large buyers in Russia, only the international market could become such a source.

The next step towards a feasible market was taken by decree of the President in July 1997, when it was decided to regenerate exports of gold and silver. In 1998 credible exports of precious metals were started by the commercial banks under licence from what is now called the Ministry of Economic Development (at that time it was the Ministry of External Economic Relations), which created a fundamentally new level of market liquidity based on its permanent multi-channelled relationship with the international market (i.e. not only via the Bank of Russia, but by means of a number of banks).

Moreover, the banks received additional instruments to expand services offered to subsoil users, including opening and maintaining metal accounts in London and commission sale on the external markets of metal belonging to subsoil users. Thus, the market expanded. That’s a general idea of what happened as a result.

The market did not develop without any hitches; it’s worth recalling the introduction of customs export duty. This was when, for a period of time, the Bank of Russia once again became the exclusive buyer of metal, and then, when its pricing policy changed and sales were no longer profitable, export operations underwent pretty serious distortions. All told, there were many sorts of schemes.

Now, however, these difficulties are thankfully in the past, at least in relation to gold and silver. It can be said that the market as a whole is now established – that is, at last we’ve constructed something viable that works.

Just about the same time as the liberalisation of exports, the decision was made to open up the retail market. To some degree this, logically, expanded market liquidity as a whole and fostered diversification of banking operations. Truthfully speaking, more was expected of the retail market – demand is weak nevertheless. There are good reasons for this, tax in particular. We will discuss this later today.

On the whole, the inclusion of the banks in precious metal circulation has had a beneficial affect on the development and state of the gold mining industry. If 1997 saw a significant drop in gold production, then after the creation of the market we can see its sustained growth. Moreover, it is clear that the banks’ share of the total gold mined in Russia is constantly increasing, and currently, practically all gold is being bought by the banks.

A few words should be said regarding platinum and platinum group metals. The banks’ role in this market is still limited because of the lack of liquidity in the internal market and the inability of banks to export these metals directly. The Almazyuvelirexport Association remains the sole exporter of platinum group metals. Moreover, this association acts as the export agent for the largest producers, in effect squeezing the banks out of the field.

This means that for the most part the state of the Russian precious metals market is defined by the following features. Firstly, the majority of operations with subsoil users are concentrated in the hands of the largest banks. According to data from GOKhRAN of Russia, of 53 banks carrying out transactions with precious metals, more than 60% of metal extracted last year was handled by the five largest operators (these being Sberbank, Vneshtorgbank, Nomosbank, Rosbank and Alfabank). And if we take the top ten, they bought 80% of Russian gold.

Secondly, the market is characterised by the creation of financial-industrial groups, i.e. to all intents and purposes a union of industrial and banking capital. These groups and the banks alike also include mining enterprises. In particular, it’s worth citing the Enteroc Group and a range of other similar groups, which effectively unite the largest extractors with the banks.

Thirdly, a serious factor is the expansion of co-operation between Russian banks and foreign credit institutions, the latter of which provide credit to our subsoil users via Russian banks financed by the international market.

It’s worth noting that an inter-bank gold and silver market has now developed. Along with this, the market is limited by physical metal – market listings are largely one-sided and represent a discount to London market prices. Complete quotations in roubles, without even mentioning forward quotations, are all but absent. Moreover, the need for such quotations is ever more evident, in particular on the part of subsoil users wanting to hedge their future output.
Until the present time, the international market only allows hedging of the market currency, whereas the rouble remains unhedged. In addition to this, the further accumulation of a critical mass, which would enable metals to be quoted in roubles on a permanent basis, requires a large number of participants and preferably the inclusion of investors and traders.

In this regard, the creation of a market trading floor for precious metals becomes relevant. The matter of such an exchange, as I have already mentioned, was included on the agenda a number of times in the days of the gold club, and then during meetings of the association of Russian gold sector banks. There were even a few attempts at setting up such an exchange, in particular the Russian raw material commodities market endeavoured to start trading, but the idea was not supported by the market.

There were good reasons for this. Among other things there was the fact that at that time the rouble was steadily, and sometimes catastrophically, falling. Naturally, hedging the rouble price component under such conditions was pointless. The situation has now changed, the rouble has stabilised and the matter of hedging the rouble price component is becoming very relevant.

But the problem with creating an exchange at this time continues to be in the difficulty of establishing a financial settlements centre based at one of the commercial banks, which would be mutually acceptable to all banks. The question of the banks’ trust of each other is still quite a thorny subject. Possibly, the Bank of Russia could assist in resolving the problem, since it enjoys an unreserved position of trust for Russian commercial banks.

There you have the history of the creation of the market and an idea of its current state. We could say that we’ve been down a complicated, tough and most contradictory path, but on the whole it’s been a successful one. And although there is much more to be done, what has been achieved is most impressive. At the very least, those present in this room today have got something to work with. Thank you.
The Taxation of Bullion Business: Viewpoint of a Commercial Bank

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In modern economics, precious metals are considered to be a substance having dual functions, being both a commodity and a financial asset. That is why the taxation of precious metals business is usually organised in different ways depending on the nature of transactions. When precious metals are used for the purpose of investment, various tax exemptions and preferences may be established in order to provide special economic conditions for their circulation.

In this presentation the taxation of precious metals is considered from the point of view of a commercial bank, the counterpart of which under bullion business can be an industrial company, financial institution or individual investor. Thus, the bank is involved in both the financial and commodity circulation of precious metals.

Value Added Tax

As far as value added tax (VAT) is concerned, Russian legislation follows common practice. Different tax regimes are applied when precious metals are traded as a commodity and as an investment asset. Similar to the taxation of any other goods, in general the domestic sale of precious metals is taxed at the standard 18% rate and export sales at 0% rate; the exporter is able to reclaim the VAT paid before to third parties or to offset its amount against other tax obligations.

The special tax regime for the circulation of precious metals as a kind of financial asset was established by means of the following tax preferences1:

1) 0% tax rate is applied when a mining or recycling company sells precious metals to the State Fund or to the bank. Thus, when selling its product to the bank, the producer enjoys the same right to reclaim VAT as in the case of an export sale.

2) the following transactions are exempt from tax:

- when a bank obtains precious metals as a deposit or, vice versa, lends precious metals under a loan or deposit agreement;
- when the sale of monetary bullion coins takes place (with the exception of collection examples minted with proof quality);
- when a taxpayer (any entity other than a producer) sells precious metals to a bank;
- when a bank sells precious metals in bullion form (to any other party), provided that bullions sold is left in one of the “certificated vaults”.

It should be noted that sales that are taxed at zero rate and sales that are tax-exempt bear different economic results for the seller. In the latter case, the seller is unable to reclaim VAT paid previously to third parties and has to charge it to expenses.

In fact, it is the last of above-mentioned tax exemptions that should provide different tax conditions for the sale of precious metals as a commodity and as an investment asset. It is presumed that the investor does not need to have physical control over the bullion bought; it is enough for him to enjoy certain rights which are linked to precious metals and could be

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1 In this presentation only transactions in which the bank can participate are considered.
transferred to other parties at the current bullion market price (e.g. ownership for specific bullion placed in some vault, or a certain quantity of metal deposited at investor’s unallocated bullion account with a bank).

This approach is basically the same as one adopted in international practice, but the wording in which it is described in the Tax Code of the Russian Federation, combined with other items of civil and tax legislation, results in various problems and risks for those banks and investors who wish to take advantage of special tax regime.

1. The concept of “certificated vault” is not clear enough. In fact, it is a novelty that was introduced specially in order to formulate the VAT exemption mentioned above. It is explained by the Tax Code as a “vault of State Fund (i.e. Gokhran), vault of the Central Bank of the Russian Federation or vault of a bank”. But most of the Russian banks, similar to their foreign colleagues, apply to special transportation companies for safe carriage delivery, safekeeping and storage of precious metals. Such non-banking companies provide technical support for the safe and prompt circulation of valuable assets, and thus form a necessary infrastructure for a bullion market. It is usually more efficient for a bank to transfer these functions to an outsourced basis than to handle all physical flow on its own. Unfortunately, while the literal meaning of the Tax Code is taken, it is unlikely that tax exemption will cover the case of sold bullion left for safekeeping in the vault of a non-banking carrier.

2. Disregarding the problem of non-banking vaults, it turns out that it is very difficult to use the above tax exemption in practice, because it is not clear how long the bullion sold should stay in a vault (maybe forever?), whether it must stay in only one particular vault (without any possibility of transfer to other certificated vaults) and so on. Thus, when trying to apply this tax exemption, a number of special cases may occur:

Example 1: Bullion is sold by a bank to its customer with transfer of ownership to the buyer, but under the condition that the metal shall be left in the bank’s vault for safekeeping (no VAT is charged). Sometime later the customer (who now bears all rights of a depositor under a safe custody contract) comes back to the bank and needs to remove the bullion. According to the Civil Code, it is the bank’s liability to release the bullion at the customer’s first claim. But it may be very difficult for the bank to charge VAT from the customer at this point, because the object of taxation can only be a sale transaction (particularly, the transfer of ownership to the buyer), which was previously effected at a price that did not include VAT, and release of a bullion under a safe custody contract is not taxable.

Example 2: Metal is sold by a bank to its customer and credited to the customer’s unallocated bullion account with the same bank (no VAT is charged). After that, the customer orders the transfer of the quantity of metal bought to its unallocated bullion account with another bank, and then requires physical delivery of the bullion. It is not clear which bank and under what legal basis VAT should be charged in this case.

Currently there is no judicial precedent that clarifies how Russian courts should treat the wording of the Tax Code for such cases, so the risks are obvious.

Example 3: The case when one bank sells precious metals to another bank should be considered separately. It is clear that the purchase is made for further sale or lending of the metal, so the buyer is not interested in assuming any obligations that could limit its physical control over the metal.

Taking the above-mentioned into account, the exemption from tax under the condition of leaving the bullion in a certificated vault can only be applied to the case when a bank sells precious metals with their credit to the buyer’s unallocated bullion account, provided that physical withdrawal from such an account is not allowed. When a bank-to-bank transaction takes place, it should rather be considered as a case when the taxpayer (i.e. the selling bank) sells precious metals to the bank, so the other reason for VAT exemption seems more appropriate.

3. Another problem is that all of the above-mentioned tax preferences are subject to Clause 7 of Item 149 of the Tax Code, which means that exemption from tax cannot be applied when the deal is done in the interests of a third party on the basis of an agency or commission agreement.

According to the Civil Code, when buying
goods under a commission agreement, the agent bears all rights and obligations under the deal done, but the title of ownership comes directly from the seller to the principal. That is why in terms of the Tax Code, the sale of bullion to the agent is considered as a direct sale to its principal.

The risk appears when a bank sells bullion to another bank, and the buying bank unfairly keeps secret that it is acting as an agent in the interests and at the expense of a non-banking entity. In this case the selling bank that is not aware of the agency functions of its counterpart cannot charge VAT from the buyer. Worst of all is that in this case, the tax claims could theoretically be addressed both to unfair buyers of metal and to innocent sellers.

That is why, in order to ensure rightful use of tax exemptions, banks have to include a special clause in their contracts that provides a guarantee from the buying bank that it is acting at its own expense and presumes an appropriate liability for any breach of this guarantee.

**Charging VAT at 0% rate** when a mining or recycling company sells precious metals to the bank can also bear some problems:

- The common problem for both producers of precious metals and exporters of any other goods is **regular delays in reimbursement of VAT** that they pay to the third parties and then try to reclaim from the federal budget.

- The other specific problem is that, contrary to an exporter, who has 180 days to present documentary evidence of export to the tax authorities, **a producer selling precious metals to a bank is obliged to present evidence of delivery on a monthly basis** (not later than the 20th day of the month which is next to the reporting one). Such a short-term limit in reporting restricts the use of prepayment that a bank can make in favour of a producer under the purchase and sale contract. Thus if, according to its accounting policy, the seller calculates VAT at the time of receiving payment for the metal, then it has to deliver metal to the bank within the same calendar month as a prepayment was made, otherwise the seller will not be able to present satisfactory documentation and the amount of prepayment will be subject to VAT. Of course, the seller will be able to reclaim the VAT when delivery is confirmed, but reimbursement takes a long time. For this reason, most producers prefer to use financing in the form of prepayments no longer than within one calendar month.

To finalise a review of VAT-related problems, let us consider the tax impact on individual investors. It is quite right that when buying a bullion bar from a bank (with its release from the bank’s vault), the individual pays a price increased by VAT and when selling the bar back to the bank, he will not be able to charge VAT because of tax exemption. Nevertheless, this approach seems rather reasonable and corresponds to the main idea of providing different economic conditions for commodity and financial circulation of precious metals. Moreover, to a certain extent, such practice is to the bank’s benefit, since individuals are stimulated to buy precious metals through their unallocated accounts with banks (such purchases are tax-exempt). Those individuals who wish to avoid the risk of the bank’s bankruptcy and would like to retain physical control over their investments can choose tax-free purchase of bullion coins issued by the Central Bank (e.g. golden “Sower” or silver “Sabel”).

Obviously in the very near future, certain aspects of an individual’s income taxation will have a more serious impact upon their market activity than VAT-related problems.

**Individual Income Tax**

Contrary to VAT regulations, the taxation of individual income does not provide any specific conditions for income received from precious metals transactions. Thus, taking into account that interest received on deposit from a domestic bank is exempt from tax, it would be reasonable to extend this tax preference also to deposits in precious metals. Unfortunately, exemption is currently applied only to monetary deposits (both in roubles and foreign currency). Thus when a bank pays interest on an individual’s bullion deposit in monetary form, it is obliged to charge 13% as a tax agent; when interest is paid in precious metals, the individual himself should calculate and declare its amount as income received in natural form and to pay the relevant tax.

Further, when an individual sells bullion previously purchased, the proceeds resulting from the sale are taxed in the same way as income from sale of any other property. So the seller is obliged to present an annual tax declaration.
When calculating the tax base, the individual seller has the option:

- to make a deduction of the full value of the metal sold irrespective of its amount, if this metal was in seller’s possession for three or more years, or
- to make a deduction of the full value of the metal sold, but no more than RUR125,000 (which is about US$4,300), if the metal was in the seller’s possession less than three years, or
- to reduce the taxable income for the amount of documented confirmed expenses for purchasing the bullion sold.

It is clear that the first and the second options are not appropriate for those individuals who wish to invest a substantial amount, but for limited tenors (less than three years). That is why the most popular option is the third one; but it also bears some problems for individual taxpayers. For example, it is not clear how the investor should calculate his expenses in the instance of having purchased metal in several lots, each time at a different price, and then sold a part of his metal. When a corporate profit is taxed, a company is allowed to choose in its accounting policy the method according to which the outgoing material is appraised: “last in-first out” (LIFO), “first in-first out” (FIFO), average purchase price and so on. For individual income tax, this question is not clarified.

To summarise, it should be noted that, according to the internationally adopted approach, the Russian tax legislation is trying to provide different economic conditions for the “commodity” and “financial” circulation of precious metals.

Nevertheless, such separation appears to be a rather complex problem: an attempt to solve it in a simple way has resulted in serious problems for those banks and investors who wish to benefit from the special tax regime.

In this view it would be very helpful to study more carefully the experience of the taxation of bullion business in other national and global markets. For example, in the United Kingdom the special VAT regime (the so-called “black box”) is regulated by the Market Agreement between the Commissioners of Customs & Excise and the London Bullion Market Association. This document of about six pages (compared with one paragraph in the Russian Tax Code) includes both general principles of taxation at preferential 0% rate and a detailed description of various cases: e.g. when custody storage or safe carriage delivery between a member and non-member of the LBMA takes place, refining, providing a loan in physical metal and so on. It should be specially noted that LBMA members who can use tax exemptions are not restricted to financial institutions and bullion traders, but also carriers such as Brinks and VIA Mat International, refiners and the other entities that form the bullion market infrastructure.

As far as the taxation of individual income is concerned, it would be reasonable to extend the tax preference to interest paid by Russian banks on metal deposits, and also to clarify the procedure for calculating an investor’s expenses for purchase of metal sold.
Ladies, gentlemen and colleagues; hello. I am happy to welcome you today and I would like to thank the organisers of today’s forum for the opportunity of talking before such a representative audience. Similarly to my two colleagues who have already spoken today, I am also a seasoned worker in the precious metals market and have observed the history of its development, quite literally, since the beginning of its liberalisation. I am well acquainted with the problems and difficulties of the market, and I can say with a degree of humility that I was personally involved in developing special features of the tax system which are now incorporated in the Tax Code.

In fact, under the circumstances of current tax reform, it’s quite rare for an industry sector to have any sort of special tax treatment. I do not know of any other industry sectors, other than those of social significance, which enjoy similar preferences in the tax system. Tax reform in the Russian Federation is now in its final stages. A whole array of laws regulating taxation of transactions in the Russian Federation have been replaced by the Tax code, a single regulatory act, which is a directly applicable law not requiring sub-legislative regulatory acts and containing both a procedural and a material section, so that both the monetary relations of tax recovery methodology and the processes of tax administration are fully regulated.

My colleague has explained tax assessment methodology to you in sufficient detail. I agree with the array of problems he has voiced today, but I would separate them into matters of a technical nature and matters of principle, which are unlikely to be resolved in the current situation with policy as it stands in our country.

In my opinion, a number of the problems seem to me to have been sufficiently resolved and do not require any more detailed formulation in the Tax Code. Therefore, I won’t concentrate in any detail on tax assessment methodology; all I will say is that, in my opinion, the system is now sufficiently preferential to members of the industry sector, and the most recent changes have improved yet further the tax climate and tax regime in this area.

It is enough to examine an example – the repeal of 5% duty on jewellery items, which was welcomed very positively by members of the jewellery industry in Russia. The range of concessions already available has been expanded; so operations in the sale of precious metals to the funds of Russian Federation subjects are now exempt, which the subjects had been long fighting for. This not only applies to sales made to the State Fund of Russia, but also those made to the State Funds of the subjects of the Russian Federation.

Chapter 25, “Income Tax”, establishes a more concessionary regime for accepting losses incurred on the precious metals markets by commercial banks for tax assessment purposes. Formerly, such losses did not reduce the tax base subject to income tax. These are some of the things that readily come to mind.

When we say that tax reform is in its final stages, we must concentrate on the fact that, having resolved matters of tax legislation governing tax assessment and tax recovery methodology, the tax agencies are now turning their attention to tax administration, i.e. monitoring payment discipline and tax payments by taxpayers.
In this regard we have developed an ideology of combining converging streams of information, obtained from various sources, on the financial transactions of taxpayers.

For example, if a commercial bank completes a transaction with precious metals and we receive a declaration from it, along with supporting documents within the commercial control framework, we then compare all of this with information received from customs agencies and information obtained from the currency control system, which is now taking shape quite actively within tax agencies. Comparison of information flows and identification of inconsistencies in this information provides the tax agencies with a signal to conduct field tax inspections.

That’s the ideology currently taking shape. Naturally, this requires the construction of a substantial database for comparison, and that is just what the tax agencies are currently working on.

Since I have already mentioned the law on currency regulation and the new currency control system we are now working with, we should recognise just what change has been made, namely, the exclusion of precious metals and stones from the list of foreign exchange assets. It is true, however, that these operations are subject to taxation depending upon whether the transaction involved a commodity or financial investment instrument.

As long as gold, precious metals and precious stones were considered foreign exchange assets, they were subject to the same tax regime as freely-convertible world currencies. We do not yet know just how this situation will change, what steps the Central Bank will take in this area and how it will resolve the issue of commercial banks carrying out what are, in effect, trading transactions rather than operations involving foreign exchange assets. But we will address the issue of the tax assessment regime for precious metals in line with what is decided.

If we talk of the prospects for tax assessment in the area of precious metals, then we can say that they correlate strongly with the general orientation of tax policy in the area of tax assessment of transactions with raw material resources in the Russian Federation.

Of course, reforms in the area of subsoil use are bound to affect the taxation system for transactions with precious metals. As soon as the State Duma prepares and adopts the new Subsoil Code, and resolves the issues of annuity tax assessment and exclusion of additional income from subsoil use, this will in some way affect taxation of precious metal mining.

I think that in the near future the tax assessment regime, which has undergone quite effective development in taxation of oil extraction, will be applied to precious metals. You are probably aware of the fact that oil is not taxed in line with a percentage rate, but according to an *ad valorem* rate, i.e. the base rate is determined according to the quantity of extracted oil, and a coefficient based on world oil prices is applied.

This allows for a very flexible attachment of taxation to excess earnings connected with high oil prices. This also helps tax agencies to avoid transfer pricing used by companies to reduce tax liability. Therefore, I believe that in the near future virtually all tax on mining of mineral resources will be transferred to a charge system dependent on the quantity of mined precious metals.

Policy in the area of value added tax is being incorporated into the general taxation policy of reducing rates, which is also planned for value added tax. This will take place in the same manner as current rate reductions, which are in line with tax reduction and linked to the repeal of concessions.

All of this is included in the objectives set out in a letter from the President on equalisation of the tax regime for all taxpayers. This means that differentiation or tax stimulation will gradually be phased out, and, as far as I understand world practice in the area of tax policy, such tax functions as stimulation are recognised as not always being economically viable, since any concession will be open to abuse and being used to avoid payment of taxes. Therefore, if VAT rates are to be lowered, this will most likely be accompanied by the repeal of some concessions.

The process of rate reduction taking place today along a unified social path will be directly linked with the withdrawal of concessions. In particular, this is because the volume of tax revenue should correspond to demands made on public funds by the social measures now being implemented by our government.

Of course, it is not possible to have a serious discussion on the fiscal function of taxes in the area of gold mining and banking, because the total volume of tax received from enterprises in the gold-mining and silver-processing industry comprises just 2% of total revenue. Likewise, approximately 2% of the total is received from
the banking system, this is at the same time as approximately 88% of revenue is received from the oil and gas industry.

Therefore, we feel that taxation as it stands today in the sector is sufficiently concessionary and quite within the sector’s means, and, taking into consideration world gold prices, which have been rising in recent years, and the financial condition of gold-mining enterprises, industrial enterprises and the banking system, it seems to us to be positive enough, at the very least it doesn’t require any sort of intervention on the part of the government.

I would like to draw your attention to some other problems associated with tax assessment, not so much to do with transactions of precious metals but more in relation to operations involving derivative financial instruments. Derivatives have already been mentioned a number of times today, and I know that a number of banks make use of them to hedge risk. These are not, of course, derivatives on the internal market of the Russian Federation, but on overseas markets. Taxation of these operations has always been a big issue for tax agencies, because this is such a complex field, and it is very difficult to levy tax properly so as, on the one hand, not to damage the interests of the market players whilst, on the other hand, to ensure budget revenue.

Nevertheless, within the framework of Chapter 25, which I personally helped to develop, we managed to set out Articles 301 to 305, laying down a procedure for tax assessment of derivative financial instruments. We certainly do find a number of problems here, which are difficult to resolve at the current time. We are reassured by the fact that not only the Russian Federation faces these problems, but the whole world community, in so much as it has always been difficult to differentiate hedging and speculative derivative operations – extremely complex criteria.

It is extremely difficult to evaluate the true value of derivatives in the absence of a liquid derivatives market. We are forced to fall back on the notorious Article 40 of the Tax Code, and compare this with some sort of market prices, and to be honest, it is not very clear just where to get them from. So we are, of course, grateful to agencies regulating the market, including the Central Bank, for the fact that we have some points of reference, some price pegs, to which we can make comparisons when determining the actual value of deals. We would like to see the same thing in the field of derivatives.

In conclusion I would like to say that the best footing for the market at the moment is stability in the area of taxation methodology, which we have now enjoyed for the past four years. However, in view of the changing legislative system of the Russian Federation and taking into consideration changes in the area of currency regulation and currency control, it is difficult to say how credible this is.

Thank you, ladies and gentlemen. If you have any questions I will be happy to answer them. If anyone is interested, I will be happy to discuss point-by-point the observations of the previous speaker, tell you what I agree with and what I don’t agree with, which will be easy to see.

I’ll just make one additional comment – I genuinely agree with the fact that taxation of income received by natural persons from deals with precious metals has been written quite badly. But the reason for this is that, all told, nobody has ever dealt with it.

You know the system for developing legislation in the Russian Federation, you know that it is not so much the government of the Russian Federation that holds the right to initiate legislation, but the deputies of the State Duma, who are, quite frankly, representing your interests. You say that this isn’t in the Code, or that isn’t in the Code; but did you not introduce these amendments through the deputies and the State Duma? If, sirs, you did not introduce them, then I only have one thing to say, and that is to rebuke you for your lack of civil interest in this matter.

Perhaps the tax agencies did not develop this sufficiently, but, as I have already stated, the function of the tax system is principally a fiscal one, and our objective is to make it impossible for taxpayers to avoid paying taxes. Therefore, sirs, I call on you to show initiative in this area.
Session 2: Challenges in Banking and Trading
Questions and Answers

Q – Sergei Kashuba, “Zapadnaya” Gold Mining Company: I have a question for Ms Safonova, “Comrade Colonel”. Yes, Tatiana, we have known each other for a long time. We’ve heard about the changes in taxation of the mining of mineral resources, for example, oil and gas. If possible, please tell us what will this coefficient mean? When will it happen? And what legislation will be passed in relation to solid mineral resources and gold?

A – Tatiana Safonova: Well, this hasn’t yet been drafted as a law, but the idea has been passed on by the tax agencies to a number of deputies and it is in line with the objective set out by the President to optimise revenue in the field of subsoil use.

As I have already stated, when levying tax on the extraction of oil we encounter the problem of transfer pricing, where oil is sold directly to intermediaries by extractors at cut prices. And prices are now even being fixed in offshore zones, i.e. by intermediaries working offshore. In this way the entire income of offshore zones was being fixed. Since tax on mining of mineral resources was at that time being set according to the sale price, we were receiving a very small amount of super income tax on what was, in effect, a reduced tax base. This issue was resolved when tax rates started to be applied to the volume of mined mineral resource rather than to the sale price. At this same time, an index-linked coefficient was introduced. In fact, this spring the coefficients were reviewed again. They are linked to oil prices on the world markets, which allows revenue volumes to be correlated with income levels from oil-producing holdings and avoid transfer pricing.

Of course, this will not affect precious metals to the exclusion of all else. More than likely it will be introduced as a package of tax measures applicable to solid mineral resources. But to tell you exactly when this is going to happen, well, that is difficult to say just now, because current administrative reform has caused a degree of confusion for a number of governments, and, whereas before the tax agencies were directly and closely involved in the legislative and regulatory creation process, now it seems that this will be the sole responsibility of the Finance Ministry. True, this doesn’t make much sense – just what will it lead to? Nothing good will come of it, I think.

As long as these issues remain unresolved and not fully appreciated we will probably have a sort of legal vacuum, at least in the area of taxation. The last package of adjustments to tax legislation, including income tax - quite a revolutionary one (a large number of these affected the bond markets) – was prepared by the Ministry of Finance without our involvement and returned to the government by the Duma without being considered in the first reading. Now, the Duma is busy with other legislation – laws in the area of social policy and a law governing the powers of Federal agencies, including us and the customs agency.

This law is having a tough time going through parliament, you probably know that the State Duma has been extended for the whole of July. This sets a precedent, that they are working not only in June, but through to the end of July. My understanding is that they won’t be allowed to go ‘on holiday’ until they adopt these social laws governing the functions of the Federal agencies. So, at the moment I think that they simply don’t have the time to consider these other matters. Most likely, they will reconsider them – they’ll be able to return to them after reaching a decision on these more pressing government matters.

Q – Vladimir Butenko, IMPEXBANK: Good day. I have a question for Tatiana Safonova. Today we’ve discussed the centralised refunding of VAT and funds being tied to the federal, regional and district budget. I’m talking about the subsoil users, because there have been instances recently whereby they haven’t received anything for six months, so seasonal preparations are interrupted, and so on.

A – Tatiana Safonova: Well, you know that at the beginning of spring, the issue of the introduction of VAT accounts was widely discussed. On the one hand this would speed up refunding of VAT, but on the other hand, nevertheless, the market association decided that this was not in the best interests of companies because it would mean additional revenue being withdrawn from funds in circulation. It should
be said that the problem of VAT refunds is primarily linked to exports. The volume of false exports is so high in the Russian Federation, we refund so much tax that, at times, it exceeds receipts. This is a very serious problem, and it is for this reason that the periods stipulated for verifying the validity of VAT refunds are so long.

Of course, this will, to some extent, affect gold producers. But, I want to draw your attention to the new tax code, which contains regulations limiting tax agencies in the amount of time they can spend carrying out these checks. Decisions on VAT refunds should be reached within three months, and if the term exceeds three months and a decision has still not been made, then the refinancing interest rate will be applied to the refunded sum. So, there you have it, the refund terms are regulated sufficiently strictly. In fact, all of the procedural regulations in the tax code are perfectly clear.

However, if we are talking about further reducing the terms, there are certain “movements” in the area of exports. That is, at the level of control measures available to the tax agencies, there are registers of traditional exporters who are assessed and continually carry out these transactions – the criteria applicable to traditional exporters aren’t checked so thoroughly or meticulously.

Then there is the idea that there are other criteria for false export and export deals. If these are discovered then a more thorough examination begins, and if the criteria are met, then the appraisal will be carried out more quickly. There is also a range of mechanisms to speed up verification regimes when refunding value added tax. But, this is all in the field of exports. We encounter the same problem here as I have already discussed. If there are any desires or ideas on how to speed up the verification process, then please, feel free to say so. The Duma is open to hearing them, and since the tax code is a directly applicable law, we cannot issue any regulatory acts, so everything should be referred to the tax code.

Q – Larisa Selyutina, Central Bank of the Russian Federation: Tatiana, I have the following question: what do the tax agencies expect from the Central Bank in relation to changes in currency legislation, and what could the consequences be? I ask, because I was somewhat alarmed by your retort; “We are waiting on the Central Bank, whatever it says, we will follow”. In actual fact, we cannot see any negative consequences of precious metals no longer being classed as foreign exchange assets, since the most important issue for us is that the law on banking states that banks can carry out banking operations with precious metals in the same way as other deals with precious metals. Does that mean that there is a direct regulation intended to prevent any damage? I’d like to know what dangers we can expect. Thank you.

A – Tatiana Safonova: I absolutely agree with you in this area, but, unfortunately, everything we have been talking about so far falls within the scope of the way we understand things. At the moment, I am more concerned with the conflict of rules contained in the relevant regulatory acts, and I, on my part, have taken on the responsibility of reviewing these regulations for the object of such conflicts. In view of the fact that gold was not considered a commodity as long as it was classified as a foreign exchange asset,
then barter or trade operations were never applicable to gold. The issue is that now, when the legal framework for gold has changed to some extent, conflicts in applicable legislative acts could arise and we should try to iron these out now, somehow.

True, in relation to the world community, their experience is apparent and our desire to follow this experience is fully understandable, but the thing is that the legislative system of the Russian Federation is actually quite different from the legislative systems of a whole range of other countries with insular laws, which is primarily linked to the fact that nowhere, other than Russia, are the asset markets so distinctly separate. There are no distinctly separate laws. Our market is clearly differentiated according to the type of asset: securities, currency, commodities. Quite frankly, that’s the way it’s always been. To isolate some sort of fourth element from this criterion, (this is a question, of course, more for the theorists), is possible, and such a position is justifiable, but we must review our legislation from this perspective, and beyond this perspective, perhaps we need to review some of our regulations.

On the other hand, when the law on currency legislation and currency control was still under development, in which I directly participated, I always said that as soon as gold ceases to be considered a foreign exchange asset, either by the tax agencies or whoever stands up for concessionary dealing in this commodity, the question is bound to arise; “Why only for this commodity? Why just for precious metals?” Because, as you know, Russian statistics make no provision for the concept of “precious metals” – there is only the “non-ferrous metals” category. So why should just gold be treated this way? Why not aluminium? Why not nickel? Why not other metals? Why have this special arrangement? Whereas before it was quite easy to explain, now it will be a lot more difficult.

**Mark Rachovides:** Ladies and gentlemen, I think we’ve gone past our allotted time, and I must, therefore, curtail questions, sadly. Clearly, this has been, certainly in terms of the element of taxation, a very provocative session, and I’ve enjoyed the session very much.