

DRAFT

Deducting costs on construction-in-progress

FAO CEOs, tax experts and employees of companies' legal departments

Pepeliaev Group advises that, on 21 August, the Russian Supreme Court's Judicial Board for Economic Disputes considered a tax dispute over how costs should be booked relating to the creation of depreciable assets.¹

The Supreme Court concluded that, if a taxpayer refuses, for practical reasons, to continue developing a fixed asset, it may deduct all the costs it has incurred on constructing the asset under article 265(1)(8) of the Russian Tax Code (the 'Tax Code'). Nonetheless, the deduction of some of such costs can be disallowed if those costs continued to accrue despite it no longer being economically feasible to develop the fixed asset.

Which problem has been solved

On the one hand, the state aims at promoting investments by different means. On the other, the administrative and judicial authorities sometimes nullify all efforts.

During the construction of fixed assets, there is a possibility that the economic environment may change and the project will become unfeasible. The events of recent years demonstrate especially well that the possibility might at times be rather high.

Investors who have made a tough call to terminate an uncompleted project have subsequently faced tax claims. In the opinion of tax authorities and state commercial courts, costs that have been amassed cannot be deducted for taxation purposes because the depreciable asset has never been created.

Article 270(5) of the Tax Code prohibits capitalised costs from being deducted other than by depreciating an asset after it has been put into operation. Article 265(1)(8) of the Tax Code only allows for costs to be deducted that have been incurred in relation to the liquidation of a construction-in-progress

¹ Ruling No. 305-ES24-1023 of the Russian Supreme Court's Judicial Board for Economic Disputes dated 28 August 2024 in case No. A40-288396/2021 of PJSC OIL COMPANY LUKOIL.

or other assets whose assembly has not been completed. These include costs on the disassembly, dismantling and removal of knocked-down property.

The literal interpretation of the above provisions led to a situation when an investor that has found itself in a financial position that is not the best has been deprived of the possibility to deduct its losses as costs for taxation purposes. Such losses, in particular, may include expenses on developing design documentation, preparing the land plot and similar.

The Russian Supreme Court has taken notice of this problem. In the case at hand, such costs, among others, were examined: costs on reconstruction, obtaining an extract from the land plot development plan, developing specifications and design documentation, carrying out engineering and surveying work, construction and assembly operations, as well as the value of equipment.

The conclusion has finally been reached that a refusal to complete the construction of a facility cannot, in itself, serve as the ground for disallowing costs that have already been incurred.

What to think about and what to do

If a company in a similar situation decided not to deduct its costs for taxation purposes owing to the high tax risks, it now has good chances to revisit the matter. The main thing is that the limitation period has not passed for an adjusted tax return to be filed to declare such investment costs.

It is important to assess the circumstances that the Economic Board has pointed out as being significant:

- it is presumed that a taxpayer has acted reasonably when it refused to continue the project (meaning that the tax authority may dispute this);
- the reasons that served as the ground for terminating the project are not subjective;
- if the costs were incurred before the circumstances arose which indicate that there is no obvious economic feasibility in creating the fixed asset, such costs are not economically justified.

We see that a number of evaluative factors remain which constitute the subject matter for a dispute between a tax authority and a taxpayer. For this reason, special attention should be paid to drafting relevant documents and clarifications relating to the above circumstances.

Help from your adviser

Pepeliaev Group's specialists are ready to conduct a full analysis of the available documents and assist with preparing necessary evidence to prove that the company has reasonably incurred the costs on creating a construction-in-progress.

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