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## **DEVELOPMENT AND DISTINGUISHING FEATURES OF INVESTMENT TAX DEDUCTION IN THE RUSSIAN FEDERATION**

**ABSTRACT.** The paper addresses a new tax deduction (*videlicet*, investment tax deduction), that is effective from 2015. The objective is to study the implementation details of the deduction in the Russian Federation and reveal development prospects. Investment tax deductions are classified into investment tax deductions as tax allowance for long-term holding of securities and investment tax deductions linked to opening individual investment accounts (types A and B). The authors present three schemes of investment tax deductions implementation. Besides, types of investors are identified and financial instruments for each type of investment tax deduction are recommended. It is determined that using tax allowance for long-term holding of securities and individual investment account (type A) implies conservative investment, whereas using individual investment account (type B) is associated with speculative investors. Foreign practice in implementing analogous deductions is summarized. The authors identify bonds as a dominant instrument in the framework of investing in individual investment accounts and present reasons for such considerations. Statistical data regarding opening individual investment accounts is presented from year 2015 and for the period January – May of 2016. The authors conclude that investment companies dominate in this market segment and make optimistic forecasts regarding development of this financial instrument. However, controversial issues related to investment tax deduction legislation are revealed. Lack of information on individual investment accounts, poor awareness of Russian citizens as well as a need for financial advisors are also named as a hindrance to the development of individual investment accounts system.

**KEYWORDS.** Investment tax deduction; individual investment account; individual retirement account; individual savings account; individual investor; Moscow Exchange; bonds; shares; fund units; individual income tax.

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## **ФОРМИРОВАНИЕ И ОСОБЕННОСТИ СИСТЕМЫ ИНВЕСТИЦИОННЫХ НАЛОГОВЫХ ВЫЧЕТОВ В РОССИЙСКОЙ ФЕДЕРАЦИИ**

**АННОТАЦИЯ.** Статья посвящена анализу особенностей предоставления гражданам нового вида налогового вычета по НДФЛ – инвестиционного налогового вычета, действующего с 2015 г. Целью настоящей статьи является анализ особенностей применения инвестиционных налоговых вычетов в РФ, а также выявление перспектив их развития. Авторами представлена классификация инвестиционных налоговых вычетов как инвестиционных налоговых вычетов в виде льготы для долгосрочного владения ценными бумагами и инвестицион-

ных налоговых вычетов, связанных с открытием индивидуальных инвестиционных счетов (типы А и Б). Рассмотрены три схемы получения инвестиционных налоговых вычетов. Для каждого вида инвестиционного налогового вычета авторами определены типы инвесторов и рекомендованы виды финансовых инструментов. Использование льготы для долгосрочного владения ценными бумагами и индивидуального инвестиционного счета типа А подразумевают консервативное инвестирование. Применение индивидуального инвестиционного счета типа Б возможно спекулятивными инвесторами. Авторами также обобщен зарубежный опыт использования аналогичных вычетов. Облигации названы доминирующим инструментом в рамках инвестирования средств на индивидуальных инвестиционных счетах в силу высокой текущей доходности, большого числа надежных эмитентов и значительного числа эмиссий на внутреннем рынке. Приведены статистические данные относительно открытия индивидуальных инвестиционных счетов по итогам 2015 г. и пяти месяцев 2016 г. Сделан вывод о доминировании в данном сегменте рынка инвестиционных компаний. Авторами дан оптимистичный прогноз относительно дальнейшего развития инвестиционных налоговых вычетов. Выявлены спорные вопросы законодательства об инвестиционных налоговых вычетах, преимущественно связанные с ведением индивидуальных инвестиционных счетов. Отмечена слабая информированность населения относительно индивидуальных инвестиционных счетов и необходимость привлечения финансовых консультантов.

**КЛЮЧЕВЫЕ СЛОВА.** Инвестиционный налоговый вычет; индивидуальный инвестиционный счет; индивидуальный пенсионный счет; индивидуальный сберегательный счет; индивидуальный инвестор; Московская биржа; облигации; акции; инвестиционные паи; НДФЛ.

### **Introduction**

In 2015, the Tax Code of the Russian Federation was amended to introduce a new type of tax deduction for individual income tax, that is to say, the investment tax deduction. It entitles to claim a reduction of the tax base in securities transactions. This mechanism is well-established worldwide; however, it remains a completely new and uninvestigated phenomenon for Russian investors, analysts, and tax advisors. This paper seeks to provide a detailed understanding of investment tax deduction schemes available in the framework of Russian legislation, as well as to outline its development. The investment tax deduction is intended to promote long-term investments in Russian securities traded on the established securities market, build an investment culture among Russians, and create a long-term investors segment within the society. In this context, it is obvious that the investment tax deduction is targeted at the middle class individuals with some experience in investing.

The new deduction has not demonstrated any direct evidence of its effectiveness in terms of stimulating the secu-

rities market development (after a year and a half in effect) since its introduction. However, it is apparent that the system of investment tax deductions appeals to investors and requires some modifications, which substantiate this study.

According to the Article 219.1 of the Tax Code of the Russian Federation investment tax deductions are classified into three types. However, from a practical perspective, it is advisory to distinguish the following two groups of investment tax deductions:

- investment tax deductions by way of tax allowance for long-term holding of securities;
- investment tax deductions related to opening individual investment accounts (IIA).

### **Tax allowance for long-term holding of securities**

According to subsection 1, clause 1 of the Article 219.1 of the Tax Code of the Russian Federation, a taxpayer is entitled to claim an investment tax deduction in the amount of the positive financial result obtained by the taxpayer in the tax year from the sale (or redemption) of securities

tradable on the established securities market, provided that the taxpayer has owned the securities for more than three years.

By «securities tradable on the established securities market», we mean securities that are listed on the Russian stock exchanges, as well as open-end mutual funds units under the management of Russian asset management companies. The investigated tax allowance has been effective since 2015; however, it applies to securities purchased after January 1, 2014.

An investment tax deduction is granted in the form of allowance for long-term holding of securities in the event that the following requirements are observed:

1. The maximum amount of the tax income deduction for the tax year is calculated as the product of coefficient  $C_s$  and an amount equal to 3 million rubles.

With this in mind, coefficient  $C_s$  shall be calculated as follows:

$$C_s = \frac{\sum_{i=3}^n I_i \cdot i}{\sum_{i=3}^n I_i}, \quad (1)$$

where  $I_i$  stands for an income from sale (redemption) of all the securities, held for  $i$  number of full years, in the tax year;  $n$  represents a number of holding periods measured in full years, for the securities that have been sold (redeemed) in the tax year, following which a taxpayer is granted the right to receive a tax deduction.

Formula (1) considers taxation in case a taxpayer realizes multiple securities with different holding periods within the same tax period.

2. The holding period of a security for a taxpayer shall be calculated based on the FIFO method.

3. A tax deduction shall be granted to a taxpayer when tax is being calculated and withheld by a tax agent or upon the submission of a tax return.

4. In case tax deduction is granted by multiple tax agents, the aggregate amount thereof exceeds the limit (i.e., 3 million rubles), the taxpayer shall be obliged to submit a tax return and pay the appropriate amount of the tax shortfall.

5. A tax deduction shall not apply in case of sale (redemption) of securities recorded in an IIA<sup>1</sup>.

The investment tax deduction scheme in the form of allowance for long-term holding of securities is presented in Fig. 1.



**Fig. 1. Investment tax deduction scheme in the form of allowance for long-term holding of securities, implemented by an investor**

According to Russian legislation it is necessary to note that tax allowances related to long-term holding of securities were also granted before 2007. Previously, tax deduction applied to the entire amount obtained from sale of securities held for more than three years, however, the new version of the law makes deductible only the positive financial result. The new allowance for long-term holding of securities applies to securities obtained as a result of donation and inheritance.

#### **Investment tax deductions related to individual investment accounts**

A Russian taxpayer is entitled to have two investment tax deductions related to the IIA, and therefore, it is necessary to clarify the concept of IIA and its features.

<sup>1</sup> Tax Code of the Russian Federation (Part II) of August 5, 2000, no. 117-FZ. Available at: [http://www.consultant.ru/document/cons\\_doc\\_LAW\\_28165/](http://www.consultant.ru/document/cons_doc_LAW_28165/).

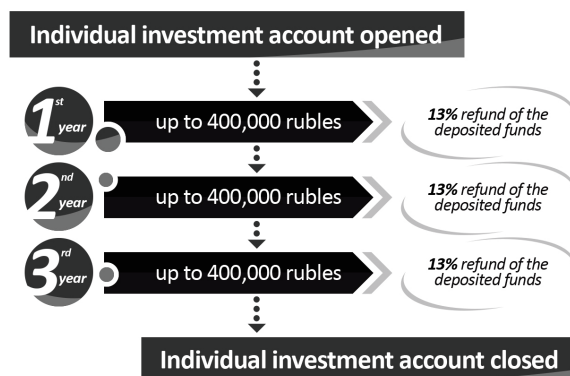


Fig. 2. The investment tax deduction scheme implemented by an investor (Type A)

According to the Article 10.2-1 of the Federal Law «On the Securities Market», individual investment account is an account of internal accounting, intended to keep separate records of monetary funds, securities of the client (the individual), and liabilities under the contracts involving the funds of this client<sup>2</sup>. The IIA can be opened by a broker or an asset administrator under a particular brokerage services agreement or asset management agreement and shall be managed by them.

There are several restrictions concerned with the IIA in the Russian Federation:

- an individual is allowed to sign only one IIA management agreement;
- under the IIA management agreement an individual is permitted to transfer only monetary funds to brokerage firms or asset management companies;
- the amount of money transferred is limited to 400 000 rubles per year;
- the IIA has to be owned by a taxpayer for at least three years.

Thus, the IIA is a regular brokerage account, but with restrictions on replenishment and withdrawal of funds. There are no restrictions related to the nomenclature of securities and other financial investment instruments within the IIA. According to subsections 2 and 3, clause 1 of the Article 219.1 of the Tax Code, a taxpayer is entitled to have two mutually

exclusive investment tax deductions involving the IIA:

- in the amount of monetary funds deposited by a taxpayer during the tax year in the IIA (type A)<sup>3</sup>;
- in the amount equal to income obtained from transactions recoded in the IIA (type B)<sup>4</sup>.

Thus, investors are entitled to choose the type of investment tax deduction (A or B).

The investment tax deduction as per type A is provided under the following conditions:

1. A tax deduction shall be granted to a taxpayer upon submission of a tax return based on the documents that confirm the depositing of monetary funds in the IIA.
2. In the event that the IIA management agreement terminates before the expiry of the 3-year period, the amount of tax not paid by the taxpayer to the budget must be restored and paid to the budget including penalties.

The investment tax deduction scheme as per type A is shown in Fig. 2.

The investment tax deduction as per type B is granted to an individual by the tax authority upon submission of a tax return or when tax is calculated and withheld by a tax agent subject to the presenta-

<sup>3</sup> The terms «Type A» and «Type B» are introduced by the author.

<sup>4</sup> Tax Code of the Russian Federation (Part II) of August 5, 2000, no. 117-FZ. Available at: [http://www.consultant.ru/document/cons\\_doc\\_LAW\\_28165/](http://www.consultant.ru/document/cons_doc_LAW_28165/).

<sup>2</sup> RF Federal Law «On the Securities Market» of April 22, 1996, no. 39-FZ. Available at: [http://www.consultant.ru/document/cons\\_doc\\_LAW\\_10148/](http://www.consultant.ru/document/cons_doc_LAW_10148/).

tion of a statement from a tax authority to the effect that:

- taxpayer has not exercised the right to claim a tax deduction as per type A;
- taxpayer has no other IIA management agreements during the term of the IIA management agreement.

The investment tax deduction scheme as per type B is shown in Fig. 3.

The essential differences between the tax allowance for long-term holding of securities and investment tax deductions involving individual investment accounts are as follows:

1. In order to obtain tax allowance for long-term holding of securities, investor has to acquire securities and hold them for at least three years without selling. Thus,

investor’s monetary funds are «frozen» in certain securities.

2. The management of IIA implies «monetary funds’ freezing» not within specific instruments, but in a separate account (within the actual IIA). The restrictions regarding the investment period for the IIA are not regulated. Investment within the IIA is not limited to securities; investors can allocate funds in bank deposits, purchase currency and derivative financial instruments.

**Special aspects of investing using investment tax deduction**

Implementation of a particular type of investment tax deduction has a significant impact on investment strategy (Table 1).

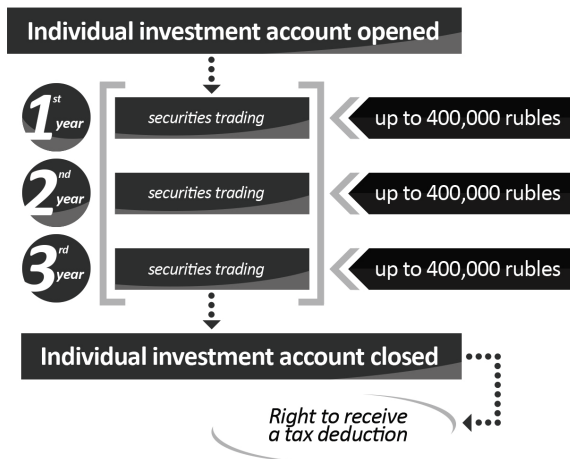


Fig. 3. The investment tax deduction scheme (Type B)

Table 1

**Special aspects of investing using investment tax deductions**

Type of investment tax deduction	Type of investor	Types of financial instruments	Mandatory taxable income in hand
Tax allowance for long-term holding of securities	Long-term Unqualified Passive Non-speculative	Shares (first- or second-tier) Government or corporate bonds Units of open-end mutual stock and bond funds	No
Investment tax deductions with IIA involved (Type A)	Long-term Unqualified Passive Non-speculative	Government or corporate bonds Units of open-end mutual bond funds Deposits in commercial banks Structured products, bond-based	Yes
Investment tax deductions with IIA involved (Type B)	Short-term Qualified Active Speculative	Shares (first- or second-tier) Structured products, stock-based Futures Options ETF units	No

Tax allowance for long-term holding of securities implies a conservative approach to investment, i.e., acquisition of shares, bonds, fund units, which is due to the fact that securities are to be held by a taxpayer for a period of more than three years. The choice of a particular type of securities, as well as of their varieties (first- or second-tier shares, government or corporate bonds) depends on the risk tolerance of a particular investor.

Investors who choose the investment tax deduction with IIA involved (Type A) tend to obtain a guaranteed financial result and maintain a conservative approach. They are likely to focus on fixed-income instruments – primarily, bonds. In this case, an individual tax deduction is granted each year, and the maximum annual tax deduction shall amount to 52 000 rubles (13 % of 400 000 rubles). An investor can expect to return funds that do not exceed the amount of tax already paid and, as relevant, he must have taxable income from another source of payment. Upon closing an account, an investor will have to pay individual income tax on income derived from transactions in the IIA.

In 2015, effective application of the investment tax deduction with IIA involved (Type A) was possible without using securities market instruments. Thus, an investor was able to conclude an IIA management agreement with an asset management company and invest all the funds in a bank deposit, while receiving an investment tax deduction. Since January 1, 2016, this investment option has no longer been available due to the changes to the Federal Law «On the Securities Market». Currently, an asset management company has the right to allocate funds in deposits in credit institutions, but their amount shall not exceed 15 % of the managed funds.

The investment tax deduction with IIA involved (Type B) is of profit to investors who pursue acquisition of shares, derivatives based on shares (structured products), and active speculative trade.

Short selling with IIA is impossible since the margin lending is not available. However, in this case, an investor may demonstrate a similar stance by purchas-

ing futures or put options in the context of using the investment tax deduction with IIA involved (Type B).

What concerns classification of IIA investors, the authors are in line with the classification proposed by M. Shabanov, who divides potential holders of IIA into 3 groups: current customers; investors managing their own assets, but not operating in the stock market; people unfamiliar with investment activities [1, p. 43]. M. Shabanov also presents recommendations for each group of IIA holders.

### **Foreign analogues of individual investment accounts**

Analogues of the IIA are quite common in other countries so its application in Russia is logical, reasonable and expected. Similar accounts have been used in developed countries since the 1970s. For example, there is IRA (Individual Retirement Accounts) in the US; in Australia, Superannuation; in the UK, ISA (Individual Saving Accounts); in Canada, TFSA (Tax-free Savings Accounts); and in Japan, NISA (Nippon Individual Saving Accounts). These accounts have similar preferential tax treatment for individuals. However, they were designed to address different objectives and to have different investment features. In addition, some of them are associated with pension savings, whereas others are not.

The US IRA was introduced in 1974; it was an individual retirement plan designed for people who do not participate in the corporate pension plans. The IRA gives to the US citizens tax advantages for pension savings investment. This type of investment account makes it possible to invest in a wide range of financial instruments, including fund units. There are six types of IRAs in the US: Traditional IRA, Roth IRA, SEP IRA, SIMPLE IRA, Roll-over IRA, Conduit IRA. They differ in the context of investment/taxation terms and conditions. IRA schemes cover about 50 million of the US households [2, p. 39].

The IRA legislation was designed to encourage new saving. Households can replenish IRA using three sources: transferring funds from a previous non-IRA

financial asset balance, transferring funds from a non-IRA savings account, which is implemented even in the absence of IRAs, and through decreased consumption. According to O. P. Attanasio, T. DeLeire (2002) «participation in the IRA program is simply an indicator of a high propensity to save and that participants would have saved the same amount without the tax incentives. If so, these tax incentives merely represent a transfer from taxpayers to savers» [3, p. 505].

Superannuation in Australia, introduced in 1992, is another type of investment retirement account. The superannuation model includes government-funded pensions, compulsory contributory superannuation savings, and voluntary superannuation savings. This superannuation model is designed to partly shift the burden of the senior population away from government and onto individuals, which implies self-funded retirement rather than public pension arrangements. Australian government also benefits from the taxation revenue that is collected from superannuation savings [4].

ISA (earlier – Personal Equity Plan) was introduced in Great Britain much later, in 1999. The ISA, unlike the IRA, is not associated with pension savings and ensures a wide range of investment types, including investment of funds in bank deposits. The ISA is not tax-deductible, and the revenue derived from contributions is not taxable when it is withdrawn. Two types of ISAs are currently available; those are cash, and shares. The cash type has more restrictions than the equity type. The typical ISA holder is male, belongs to the highest-income cohort, and is approaching retirement [5, p. 372].

ISA accounts are protected in the UK by the Deposit Guarantee System, but only partially – to the amount that is less than £85 000. The ISA program is available for young British citizens. Thus, the ISA is intended for individuals who have reached the age of 16. According to I. Krivosheyeva, the UK ISAs have accumulated around £400 billion [2, p. 39].

Canadian TFSA, which was introduced in 2009 as an analogue to the ISA,

is also a non-pension product. It provides a wide range of securities for investment and intended for citizens aged 18 or older. Capital gains and other investment income earned in a TFSA is not taxed, withdrawals are tax-free.

NISA accounts in Japan were designed by analogy with the English ISA and were introduced only recently – in 2014. These accounts are intended to promote the culture of public investment and encourage investment in stock market instruments. Particular emphasis is placed on the Junior NISAs for young people (of 20 years old); they were designed to be similar to the British Junior ISAs. Since the introduction of NISA (i.e. a year and a half period), Japanese citizens have opened more than 9 million accounts and have invested about \$43 billion via these accounts [6]. Japanese government is working on a scope of measures to reform NISA, including the simplification of the account opening procedure and the increase of maximum amount of annual investment up to \$10 000.

Thus, foreign IIA analogues are always concerned with tax allowances and imply either classic investment or pension-related investment. The Russian version of the IIA has comprised some features of the British ISA, including possibility of investing funds in bank deposits, which is due to be introduced in 2016, and some of the features of the Japanese NISA (in terms of the investment culture development). In our view, the UK practices may appear more useful because their ISA accounts have existed for a longer period of time.

### **Bonds as a dominant instrument for investing in individual investment accounts**

The current pressing economic conditions contribute to the increase in the yield of debt instruments and bring bonds to the foreground of investing that involves investment tax deductions. In a context of uncertainty, government bonds, as well as highly-rated corporate bonds, ensure that investors will obtain high and guaranteed returns. The other positive features of bonds include their being a simple and

transparent investment instrument. Consequently, plans for domestic issuance of both the government and corporate bonds in 2016 are extensive.

Government and municipal bonds currently have an advantage over corporate bonds because coupon payments on them are not subject to individual income tax. This advantage will soon (supposedly, from January 1, 2017) be eliminated (the relevant bill is currently being prepared), which is likely to cause a surge of interest in corporate bonds.

The yield of the government bonds index on the Moscow exchange (RGBI) as of January 15, 2016 amounted to 10,59 %, whereas the yield of the corporate bonds index (MICEXBICP) was 11,68 %. The deposit reference rate amounted to 11,2 %<sup>5</sup> in January 2016. Respectively, on July 1, 2016, the rates of similar indices decreased to 8,7 % and 10,35 %, while the deposit reference rate amounted to 10,7 % in July 2016. Thus, the rate of return on bonds is already comparable to returns on deposits. Obviously, it has to be taken into account that the rates of the indices are average values, and investors can purchase certain bonds with return much higher than the index.

The issuance of federal loan bonds with index-based par value (OFZ-IN) and the launch of exchange-traded bond programs that facilitate reissuance are the two major innovations of 2015 on the bond market that are contributing to the bond market development and increasing investors' interest.

If in the short-term investors are more interested in bonds, the expected fall of Russian companies' stock prices can lead to a significant inflow of investors' funds in the «cheap» stock market. The favorable changes such as transparency and predictability in the stock market will only promote this trend. Predominantly, this refers to the assignment of separate record dates to participation in the general meeting of shareholders and dividend payment, as well as the reduction of dividend payment

period, which was described in detail in the author's paper [7, pp. 117–119]. A possible decrease in Russian issuers' stock prices can stimulate the use of tax allowances for long-term holding of securities. Furthermore, it can contribute to increased dividend yield, which is currently low and on average amounted to 3,8 % and 5,3 % at year-end of 2013 and 2014, respectively, as regards Russian «blue chips» [8, p. 41].

### **Statistics related to opening individual investment accounts**

Today, it is impossible to give account of the statistical data regarding the utilization of the allowance for long-term holding of securities since the three-year investment period is still ongoing. However, the data on IIAs opened by brokers and asset management companies are available. It is provided by the Moscow Exchange and has been consolidated by the author in Table 2. Statistics related to opening and managing IIAs at year-end 2006 are presented in the paper [9, pp. 106–107].

The total number of accounts opened by citizens a year after the IIA introduction amounts to 88 907. This figure exceeds expectations of most of the experts and is 10% higher than the estimated figure presented by the author in 2015 [10, pp. 93]. As of June 1, 2016, the number of IIAs opened reaches 123 252. Thus, in 2016, the increase amounts to 38,6 %.

Sberbank, PJSC currently tops the list of trading participants with 24 525 IIAs opened by January 1, 2016 (27,6 % of the total number of IIAs), and 34 344 accounts opened by June 1, 2016 (27,9 % of the total number of IIAs). Sberbank, PJSC is followed closely by Finam, JSC, which leads the list of top investment companies in the IIA market (21 728 IIAs or 24,4 % of the total number of IIAs by January 1, 2016, 28 382 IIAs or 23 % of the total number of IIAs by June 1, 2016). Finam, JSC is followed by Otkrytiye Broker, JSC (13 752 IIAs or 15,5 % of the total number of IIAs, and 21 502 accounts or 17,4 % as of the corresponding dates) and Kompaniya BKS, LLC (14,315 IIAs or 16,1 % of the total number of IIAs; 18 077 accounts, 14,7 %). Six players in the market (includ-

<sup>5</sup> This refers to yield estimated in rubles for a period exceeding one year (according to the Bank of Russia).



ing the four above-mentioned companies with Aton, LLC and Alfa-Bank, JSC completing the list) «hold» 92,8 % of the entire IIA market. Thus, without regard to Sberbank, investment companies dominate the IIA market.

The second half of 2015 showed an increase in the IIS management agreements concluded. Thus, while in the first half of the year individuals opened 32 460 IIAs (36,5 % of the total number of IIAs opened in 2015), by the end of the second half of 2015, this figure had risen to 56 447. During the first five months of 2016 (January to May) a decline in individuals' investment activity (34 345 new accounts) was observed, which is obviously related to the economic crisis and decreased incomes.

It should be noted that a number of accounts is not active. Certain IIA holders had planned to replenish their accounts by the end of the first year but failed to do that due to the pressing economic conditions. According to the estimates of the Moscow Exchange, securities transactions

are recorded in 45 % of the IIAs and 75 % of the IIAs have monetary funds. G. Baranov provides similar data [11, p. 30]. A statistical of the IIA market at year-end 2015 was presented by the Bank of Russia. According to this review, the average account size (zero-balance accounts included) is approximately 57 000 rubles [12]. Thus, the current total assets of IIA market can be roughly estimated at 7,2 billion rubles. By the end of 2016, this indicator is expected to reach 12 billion rubles.

Further growth in the number and size of residual IIA balances can be assumed based on a vast amount of funds currently held in citizens' bank deposits (23 trillion rubles as of April 1, 2016).

#### Information support of individual investment accounts

IIAs are strongly supported by IIA market participants and the Moscow Exchange. There are several websites and information resources dedicated to IIAs, in particular:

Table 2

#### Moscow Exchange trading participants' ranking based on registered IIAs

Rank	Name of Trading Participant	Number of IIAs registered as of July 1, 2015	Number of IIAs registered as of January 1, 2016	Number of IIAs registered as of June 1, 2016
1	Sberbank, PAO	8 418	24 525	34 344
2	Finam, JSC	7 329	21 728	28 382
3	Otkrytiye Broker, JSC	7 699	13 752	21 502
4	Kompaniya BKS, LLC	3 072	14 315	18 077
5	Aton, LLC	2 103	4 963	6 236
6	Alfa-Bank, JSC	2 043	4 117	5 352
7	VTB 24, PAO	-	562	2 641
8	ALOR Plus Corporation, LLC	184	864	1 206
9	Promsvyazbank, PAO	231	823	1 171
10	IC ZERICH Capital Management, OJSC	273	610	825
11	KIT Finance Holding, LLC	225	526	763
12	Gazprombank, JSC	135	375	503
13	Surgutneftegazbank, CJSC	-	227	336
14	Investment Company IInvest, JSC	-	177	226
15	SOLID Asset Management Company, CJSC	103	144	153
	Other participants	645	1 199	1 535
	Total number of IIAs	32 460	88 907	123 252

This table is compiled by the author based on the data of the Moscow Exchange. Source: *Moscow Exchange. Ranking of trading participants according to the number of registered individual investment accounts*. Available at: <http://moex.com/ru/spot/members-rating.aspx?rid=125>.

- *инвестicum.pф* is website that provides general information on the IIS;

- *Catalogue of individual investment account providers in Russia* is an information catalog published by the *Securities Market journal*;

- detailed information on the IIS is provided on the Moscow Exchange website, on websites of the majority of investment companies, on *FinGramota.org* and other resources.

### Legislative innovations

Improvement of the IIS is currently being addressed at the level of legislation. The following changes regarding investing within the IIA have come into effect since January 1, 2016:

- an asset management company has the right to place funds in deposits of credit institutions in the amount that is less than 15 % of the managed funds;

- foreign securities can be purchased by the broker or asset administrator, but only on the Russian established securities markets.

These restrictions shall not apply to agreements concluded before January 1, 2016.

Individuals are currently able to open IIS remotely and engage in simplified customer identification of non-credit institutions through registration in the ESIA (a universal system for identification and authentication in Russia) and via *Gosuslugi.ru*.

In addition to the already adopted innovations, there is a whole scope of planned measures awaiting approval. This includes the following:

1. An extension of the fund limit of the IIA from 400 000 to 1 000 000 rubles per year. The amount of 400 000 rubles is obviously insufficient to build the initial efficient portfolio both for brokerage IIAs and for the IIA fiduciary management.

2. Establishment of a compensation insurance fund for IIA holders. The Ministry of Finance, the Bank of Russia, and NAUFOR have reached certain interim agreements in this regard. It is planned that the compensation fund will be established by brokerage and asset management companies without government

support. Compensations will be paid only in two cases: in case of withdrawal of customer's assets from accounts of a broker or an asset administrator, or in case a professional participant is not able to return customer's funds.

3. Inclusion of funded insurance on the list of the instruments available for the IIA is also being discussed.

4. Asset management companies are expecting to get a permission to allocate IIA funds in their own mutual funds units.

### Controversies in legislation

There are evident flaws and controversial issues in the legislation related to the system of investment tax deduction. They primarily extend to the IIA:

1. Current legislation specifies different starting dates for the IIA agreement expiry both for asset management companies and for brokers. For brokers, a three-year period starts upon the agreement conclusion, while for asset management companies: upon the receipt of funds, which creates unequal conditions for brokers and asset management companies.

2. Investment tax deductions are defined in the Tax Code without regard to the taxation of certain forms of income derived from securities. In particular, this relates to dividends and bond coupons. According to clause 2 of the Article 210 of the Tax Code, tax base for income derived from equity participation is to be formed separately from other incomes, to which the rate of 13% is applied. However, tax deductions specified in Articles 218–221 of the Tax Code do not apply to income derived from equity participation.

In our opinion, the taxable income on dividend payments and coupon payments should be calculated with regard to the implementation of investment tax deductions.

3. Currently, dividends and coupon payments cannot be charged to the IIA. For investors, it is possible only when using a regular brokerage account, which is irrational. The Central Bank of the Russian Federation has not published any official commentaries on this issue yet.

In our view, the requirement to deposit funds that do not exceed 400 000 ru-

bles applies only to funds transferred by the customer to a brokerage firm or an asset management company under the IIA management agreement. Thus, funds received as a result of income distributions on securities accounted in the IIA should be posted to this account without restrictions. A prerequisite for this is that the IIS is not replenished through customer's account, but through the account of an issuer, a depository or an agent.

4. The expedience of investing of the IIA funds in bank deposits is also debatable. We believe that there is no need to stimulate citizens' investments in bank deposits, and this opportunity should be eliminated. However, the opportunity to invest in bank deposits should be maintained in case that future IIAs will be involved in pension coverage.

Some flaws related to granting individual tax deductions are expected, predictable, and avoidable, so they can be eliminated, eventually. Foreign practices show that the UK spent more than 10 years improving concessional taxation scheme under the ISA.

There is an evident contradiction in the legislation related to taxation of securities transactions. The system of investment tax deductions, the taxation procedure for coupons on government and corporate bonds, as well as plans to make corporate bond coupons exempt from individual income tax reveal an intention to encourage investing in domestic securities market. However, the individual tax rate on dividends has been raised from 9 % to 13 % since 2015, which is the cause of reduction of the actual dividend yield by 4,4 % [8, p. 43]. In other words, today we are witnessing certain contradictions and inconsistency in promotion of citizens' investing in securities.

#### **Discussion regarding the development and significance of individual investment accounts**

Development of the IIA in Russian market is associated with two questions:

1. Can the IIA change the current brokerage business model?

Currently brokers are focused on customer's sales volume, irrespective of the

market's growth or decline or customer's financial result. There is a point that rapid development of the IIA can cause reorientation of brokers to incomes that depend on the growth of customers' assets. In our view, such scenario is unlikely to occur in the near future, since the number of IIAs, even among the leading brokers, is insignificant (Table 1), and profit on transactions employing IIAs is significantly lower than that on regular brokerage transactions. However, following the market development, we might see such outcome in future.

2. Will the IIA be able to become a popular financial instrument and encourage individuals' investments in Russian securities?

Most authors are cautiously optimistic about the introduction of the IIA in Russia. For instance, Y.V. Lakhno considers that «a significant increase in new active individual investors should not be expected, since people who were waiting for the introduction of this innovation, tried to utilize it right after the law came into force» [13, p. 12]. P. K. Levin believes that «it is too early to expect a massive influx of IIA investors» [14, p. 385]. According to I. Krivosheyeva, «these accounts may act as a major channel for the inflow of private investments into the national economy» [2, p. 38]. M. Vasin states that «introduction of the IIA is definitely a step in the right direction, even though the practical measures were partly undermined by a number of constraints» [15, p. 37]. The Catalogue of individual investment accounts providers in Russia, 2015 calls the first six months of the IIA on the market «moderately optimistic» [16, p. 7].

The authors consider the IIA highly promising and effective from the standpoint of all market participants and deems important to define the mechanism of IIA application in the Russian Federation. If the IIA can ensure that investors increase their gains, this will enable the issuers to have more successful public offerings, as well as the support of the secondary market. Infrastructure entities and intermediaries can also benefit from the growing customers' sales volume.

The estimated amounts of funds in the IIA have reached 7 billion rubles. Given the daily turnover of the Moscow Exchange's stock market of about 1 trillion rubles, the amount of funds in the IIA may contribute to the turnover increase for Russian securities. This can also facilitate the organization of IPOs and new floats of corporate bonds.

### Conclusion

Thus, we can draw a number of conclusions:

1. Inherently, the investment tax deduction appears to be special tax treatment applied to a special (with a number of restrictions) brokerage account.

2. Binding IIAs to non-state pension coverage is unlikely to be accomplished due to uncertainties and controversies in the pension legislation of the Russian Federation.

3. Investment tax deductions are an effective mechanism to encourage citizens to invest in securities and provide investment opportunities for citizens looking for an alternative to deposits, while not having sufficient funds to invest in real estate.

4. Within the framework of the investment tax deductions system, the IIA is the most attractive opportunity, because it enables investors to apply both the conservative and speculative investment strategies.

5. Among all financial instruments, bonds are currently the most attractive instrument for conservative investors with regard to investment tax deductions due to their high yield and a wide range of instruments the bond segment has to offer.

6. The statistics regarding opening IIAs over a period of 2015 and five months of 2016 exceeds experts' expectations and

now gives grounds for optimistic forecast for development.

7. The legislation contains a number of controversies related to investment tax deductions. Elimination of these controversies will enhance the activity of investors and intermediaries.

8. Further development of the investment tax deduction system depends largely on the current geo-political situation and market conditions. Another important factor is the elaboration of government policy, designed to encourage the population to save money, as well as to stimulate involvement of savings in the economic turnover through an open market mechanism.

Lack of awareness among the Russian population regarding the IIA feasibility is another important factor. According to the National Agency for Financial Studies, 27 % of citizens are not aware of IIA's features, while 19 % are willing to give preference to IIA in case the terms become more favorable compared to the deposit<sup>6</sup>.

Investors who use investment tax deductions require qualified assistance, which could be provided by financial advisors. Therefore, the growth of this institution and investigations related to it are likely to follow.

Apparently, the subject of this study provides vast opportunities for further research that could involve the analysis of foreign practices and their effectiveness, assessment of the correlation between the number of opened IIAs and the revitalization of the Russian stock market, estimation of the stimulating effect of the investment tax deductions, and others.

<sup>6</sup> National Agency for Financial Studies. *The Individual investment account: knowledge and attitude*. Available at: <http://nacfin.ru/individualnyj-investicionnyj-schet-znanie-i-otnoshenie/>.

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