

Fine tuning of Russian thin capitalization rules

June 11, 2015

In brief

The draft federal law introducing amendments to the thin capitalization rules in Russia has passed the first reading in the Russian Parliament's lower chamber. This document is in the early stages of the legislative process; it has two more readings to pass. Then it should be approved by Parliament's upper chamber and by Russia's President. The draft law likely will be enacted; legislators have tried to correct the thin capitalization rules several times. This time their attempt should be realized.

The draft law clarifies the provisions of Article 269 of the Tax Code which, in particular, regulates the deductibility of loan interest in accordance with thin capitalization rules. The draft law would:

- revise the list of loans which may be subject to control under the thin capitalization rules. In particular, it will include loans from foreign sister companies
- exclude loans from independent banks guaranteed by related parties from the scope of the thin capitalization rules under certain conditions
- clarify the method of calculation of non-deductible interest reclassified into dividends for tax purposes.

This draft law is expected to be effective on January 1, 2016.

In detail

Qualified loans

The draft law amends the list of qualified loans/indebtedness subject to the thin capitalization rules and will include debts from the following three categories of lenders:

1. foreign entities related to the Russian borrower as per subparagraphs 1, 2, and 9, paragraph 2 of Article 105.1. of the Tax Code, if such a foreign entity has a direct or

indirect equity interest in the borrower

2. an entity, both Russian or foreign, regarded as a related party to the foreign entity mentioned in item (1) above on any grounds specified by Russian transfer pricing (TP) rules in accordance with Article 105.1 of the Tax Code
3. any other entity, if entities mentioned in items (1) and (2) above acted as warrantor, guarantor or otherwise has

undertaken to ensure the discharge of this debt (with some exception for banks, see below).

Compared to the previous version of the thin capitalization rules, the participation criteria for qualifying lenders will change from 20% to 25% under the general rule, same as currently applied for the transfer pricing rules.

Also, the legislation will provide that loans from foreign sister

companies will fall within the scope of the thin capitalization rules. In the current version of the Tax Code such loans were not envisaged in Article 269, however, in some cases the tax authorities and courts applied the thin capitalization restrictions to these loans.

New exceptions for bank loans

In the draft law, bank loans guaranteed by related parties will no longer be subject to the thin capitalization rules if the following conditions are fulfilled:

- the debt has arisen with respect to an independent bank (including foreign banks), and
- related parties of the Russian borrower, as defined above for purposes of the thin capitalization rules, have no accounts, investments, or deposits opened with this bank. However, if such accounts, investments or deposits are opened, the corresponding funds and/or claims cannot be used as collateral on this debt, and the existence of such accounts, investments or deposits was not

considered a precondition for a loan, and loan amounts, terms and conditions are different.

Other changes proposed

For purposes of applying the thin capitalization rules, an entity that is engaged in *leasing activities* is deemed to have taxable income from such activities comprising at least 90% of all taxable income earned in the relevant reporting (tax) period.

The draft law now stipulates that companies must calculate the interest limitation on a *quarterly basis* and not recalculated in the following quarter (this approach corresponds to the latest relevant court practice in Russia).

The draft law also stipulates that indebtedness arising upon the placement of Eurobonds is not subject to the rules (this provision refers to Article 310 paragraphs 2, subparagraph 8 of the Tax Code).

The takeaway

US multinational companies (MNCs) should understand whether the amended Russian thin capitalization

rules apply with regard to any financing provided to their Russian subsidiaries. Note that foreign sister company loans now clearly fall within the scope of these rules.

MNCs with Russian subsidiaries that have financing provided by independent banks but guaranteed by related parties may benefit from the amendments. This is possible since these loans, under certain conditions, may no longer be subject to the thin capitalization restrictions.

Enacting the amendments may resolve some uncertainties about applying Article 269 of the Tax Code. However, some methodological questions will remain. For example, for the purposes of calculating the debt-to-equity ratio, the following questions may arise: (1) should loans from different lenders be summed up? (2) should net assets be multiplied by equity interest? (3) should the amount of outstanding accrued interest be included in the amount of debt, etc.?

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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