

LT In Focus

Review of changes to controlled debt and thin capitalization rules

On 10 February 2016, the Federation Council, the upper house of Russia's parliament, approved the draft law No 724609-6, which amends clause 2 of article 269 of the Russian Tax Code – the section of the code related to the concept of controlled debt. The changes provided by this draft law clarify several issues that have been subject to numerous disputes between taxpayers and tax authorities.

The draft law introduces significant changes to controlled debt and the range of transactions controlled for the purposes of applying thin capitalization rules. The draft law also specifies the procedure for calculating the debt-to-equity ratio required to acknowledge debt as controlled, the capitalization coefficient and interest limitation rules for profit tax purposes.

Importantly, the draft law extends the list of debt obligations that can be acknowledged as controlled. Under the new policies, loans from foreign sister companies actively used by taxpayers to avoid the application of thin capitalization rules will be acknowledged as controlled by a direct provision of the Tax Code. On the other hand, a number of bona-fide loans from banks and Russian affiliated parties will be excluded from the range of controlled debts.

The draft law eases the current requirements on leasing companies that are entitled to apply an increased debt-to-equity ratio, and introduces a number of clarifications into the procedure for calculating this ratio.

If approved, the amendments will enter into force on 1 January 2017, with the exception of the amendments related to loans from banks described above, which will apply retroactively, starting from 1 January 2016.

In this issue, we will review the following aspects of the suggested changes:

Changes to the concept of controlled debt

Exclusion of a number of loans from controlled debt

Clarification of the procedure for calculating debt-to-equity ratio, the capitalization coefficient and interest limitation

Expansion of the range of leasing companies that can apply an increased debt-to-equity ratio

Enactment of the new thin capitalization rules

Issues that remain unclear

Changes to the concept of controlled debt

The draft law identifies the following types of debt obligations as controlled:

- To a foreign entity that is a related party to the taxpayer under subclause 1, 2 or 9 of clause 2 art.105.1 of the Russian Tax Code (individuals and businesses acknowledged as controlled for transfer pricing purposes), if this foreign entity directly or indirectly holds shares in the taxpayer's charter capital;
- To an entity that is acknowledged as a related party of the above foreign entity according to subclause 1, 2, 3 or 9 of clause 2 art.105.1 of the Russian Tax Code;
- A debt obligation secured by any of the above mentioned individuals or businesses.

If the draft law is approved, debt obligations to foreign sister companies will be included into the scope of controlled debt by a direct provision of the Russian Tax Code.

Although the current wording of clause 2 of the article 269 of the Russian Tax Code does not acknowledge loans (credits) obtained from foreign sister companies as controlled ones, arbitral courts have tended to rule in favor of tax authorities, which claim that such loans should be regarded as controlled (see the cases of [Nestle Russia LLC](#), [Achimgas LLC](#), [Vozdushniye Vorota Severnoj Stolitsy LLC](#), [Kasihirsky Dvor Severyanin OJSC](#), [Kama-Plastic LLC](#), [UNITED BACKERS Pskov LLC](#), and many others).

Arbitral courts have noted the need to apply Russia-wide thin capitalization rules along with the provisions of Double Tax Treaties on associated enterprises, which would result in the application of thin capitalization rules to both directly and indirectly affiliated Russian taxpayers and foreign lenders – including two subsidiaries of the same foreign parent company.

The draft law significantly extends the list of debt obligations that can be acknowledged as controlled by a direct provision of the Tax Code.

Additionally, the draft law provides for the possibility to acknowledge obligations that are not directly mentioned in clause 2 of article 269 of the Russian Tax Code as controlled ones via a court

ruling if it has been proven that the aim of the financial structure in question was to transfer profits to a foreign shareholder or entities related to a foreign shareholder.

Exclusion of a number of loans from controlled debt

The draft law introduces a number of significant exceptions from the range debt recognized as controlled. It does not acknowledge as controlled the following types of debt:

- To a Russian tax resident, related to a foreign shareholder, if such Russian subsidiary has no comparable outstanding debt to the above foreign shareholder (comparability criteria are also stipulated by the draft law); the exemption applies only upon the filing of written proof showing compliance with the above criteria;
- To a Russian or a foreign bank secured by a foreign shareholder, or a related party to the the foreign shareholder, provided that the bank is not an affiliated party and, since the day of the loan was transferred the foreign shareholder and its related parties have not paid off the loan or interest to the Russian or foreign bank. This exemption applies only upon filing written proof showing compliance with the above criteria. This exemption will change the current approach of tax authorities, since currently arbitral courts tend to acknowledge such debts as controlled regardless of whether or not the loan or interest is paid off by a securer;
- In case no income tax is withheld on the interest income paid to foreign entities under subclause 8 of clause 2 of article 310 of the Russian Tax Code (debt to foreign entities that emerges due to the placement of traded bonds under specific conditions).

The draft law excludes any bona fide debt to credit organizations and Russian affiliated entities from the concept of controlled debt.

The introduction of these amendments should reduce the number of disputes related to the necessity of application of withholding mechanism while repaying interest reclassified into dividends to Russian affiliated lenders that have no comparable debt to a foreign parent or independent bank.

The current court practice is quite ambiguous on this matter. We are aware of both negative rulings (see cases [Novaya Tabachnaya Kompania LLC](#) and [Arcticgas OJSC](#)), and positive rulings (see cases [Samaraagroprompererabotka LLC](#) and [ROLF Estate St Petersburg LLC](#)).

Clarification of the procedure for calculating the debt-to-equity ratio, capitalization coefficient and interest limitation

The draft law provides for a comparison of the aggregate amount of all controlled debts of a particular taxpayer to its equity for the purposes of applying thin capitalization rules.

This issue has also been a matter of some controversy. We are aware of certain clarifications of the Ministry of Finance and arbitral court rulings stating that taxpayers could calculate the debt-to-equity ratio per each lender (e.g. the case of [YII Sibir LLC](#)). In meantime, there have also been rulings against this practice (cases [MC Bryansky mashinostroitelny zavod CJSC](#) and [Kolvinskoye OJSC](#)). If the draft law is

approved, we believe the tax authorities may interpret these amendments as a clarification of the thin capitalization rules in force prior to the enactment of this draft law and could try to apply these rules retroactively.

The draft law suggests using a discrete method for calculating deductible interest at the end of each reporting period. This approach is supported both by the current clarifications of tax authorities and litigation pattern (see cases [R-Telecom Holding CJSC](#), [International Airport Domodedovo CJSC](#), [Severlstal-Resource CJSC](#) and [GTI Elets LLC](#)).

Expansion of the range of leasing companies that can apply an increased controlled debt-to-capital ratio

The draft law eases requirements on leasing companies for the purposes of applying the increased debt-to-equity ratio. The increased ratio of 12.5 may be applied by those businesses that have derived at least 90% of their taxable income from leasing activities. The current law allows application of the increased ratio only to those taxpayers that carry out leasing activities exclusively.

It is likely that, after the enactment of the new procedure, taxpayers who wish to apply the increased ratio will be obliged to confirm the ratio of leasing income to other income using a

method similar to one applied by medical or educational institutions that use profit tax incentives or IT companies that use social insurance incentives. If there is a chance to apply the beneficial debt-to-equity ratio, we recommend reviewing the accounting policy and, where possible, mitigate the risk of losing the right to apply it due to carrying out transactions with securities, significant assets disposal, deriving large income in the form of positive FOREX differences and others during a tax (reporting) period that would impact the ratio of qualified income to other types of taxable income.

Enactment of the new thin capitalization rules

If approved, the amendments will enter into force on 1 January 2017. Positive amendments related to the exclusion of debt obligations to banks

(subject to certain conditions) from the concept of controlled debt will apply retroactively as of 1 January 2016.

Issues that remain unclear

Although the draft law clarifies many controversial provisions of clause 2 of article 269 of the Russian Tax Code, a number of questions still remain unclear, including:

- The provision on withholding tax on interest reclassified into dividends in those cases when the taxpayer retains the dividends or does not

pay off the debt by any other means (e.g.: capitalization of interests into the principal, novation or mutual offset of obligations);

- Withholding tax on interest reclassified into dividends paid to banks and Russian companies.

We hope that you will find the information in this edition interesting and informative. Should you have any questions, please do not hesitate to contact us.

Best regards,

Partners of Deloitte CIS

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