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LT in Focus

Thin capitalisation rules: going easy on foreign investors

On 3 July 2018, Bill No. 325651-7 that exempts controlled loans raised to finance investment projects in Russia from the thin capitalisation rules passed the Russian State Duma's second reading.

The bill was initiated by the Russian Government and is highly likely to be adopted by the end of the legislators' spring session.

If adopted, the bill will exempt the foreign investors that finance the long-term investment projects of their subsidiaries from the thin capitalisation rules.

Read on for more details on the exemption conditions.

The amendments that exclude investment financing from the thin cap scope were originally intended for the added income tax bill's second reading.

According to the amendments, a Russian entity's outstanding debt **will not** be considered controlled, provided **all** of the conditions below are met:

1. The funds are used **solely** to finance the taxpayer's investment project in Russia
2. Payments on the loan start five years or more after the loan origination
3. The total direct and indirect interest of the foreign related shareholder in the meaning of Sub-Item 1, Item 2, Article 269 of the Russian Tax Code (the entity that controls the loan) in the Russian borrower does not exceed 35 percent
4. The lender is incorporated (has tax residency) in a state that Russia has a tax treaty with.

For the purposes of thin cap rules exemption, an investment project will mean the development in Russia of a **new manufacturing complex for production of goods and/or delivery of services**.

The complex will qualify as new if commissioned on or after 1 January 2019.

Unless all of the above-mentioned criteria are met, a loan will be deemed controlled starting from its origination date, i.e. **retrospectively**.

Summary

A number of important points will need to be taken into account if the bill is adopted:

- To prove that the loan is used solely to finance an investment project, the expenditure of loan proceeds will need to be accounted for separately (possibly, via separate bank accounts)
- Disputes are likely to arise with the tax authorities over what is to be considered 'designated investment project financing', e.g. if a loan is used to finance the general expenses or refinance other loans
- Since the exemption applies to the new production facilities only, modernisation projects are likely to be out of scope
- It is not clear from the current wording of the bill whether the residential and commercial property developers will qualify for the exemption.

Also, please note the five-year loan repayment grace period.

The tax authorities often cite the non-repayment of a loan for a considerable period to reclassify it into an investment and disallow the related interest expenses and the expenses for foreign exchange differences.

The bill indirectly support the treatment of such loans as debt and not as investment, which the taxpayers may cite as an additional argument.

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We hope that you will find this newsletter interesting and informative. Please feel welcome to contact us for more information on the topics covered.

Kind regards,

Deloitte CIS Partners

Contacts

Tax Dispute Resolution

Anton Zykov
Partner
azykov@deloitte.ru

Alexei Sergeev
Senior Manager
alsergeev@deloitte.ru

TaxSmart App

deloitte.ru

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