

## Tax Alert

### RUSSIAN THIN CAPITALIZATION RULES

January 26, 2012

#### **Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation in the matter of OJSC Northern Kuzbass Coal Company**

In January the Presidium of the Supreme Arbitration Court of the Russian Federation (“SAC”) issued Ruling No. 8654/11 dated November 15, 2011 in the matter of OJSC Northern Kuzbass Coal Company (the “Ruling”), which is adverse to taxpayers. It vests in the tax authorities much broader discretion in applying the controlled debt rules set forth in Art. 269(2) of the Tax Code of the Russian Federation (the “Tax Code”).

We also note that the Ruling is a logical outcome of the court practice in relation to controlled debt which shaped during 2011 and which is generally adverse to taxpayers (cases involving LLC Naryanmarneftegaz, OJSC PO BMZ and CJSC Promleasing).

#### **Affected Parties**

The controlled debt rules (internationally known as thin capitalization rules) may affect Russian entities with direct or indirect foreign investments (in excess of 20%) which raise intragroup or outside debt financing (secured by affiliates).

If the amount of such financing outstanding is more than three times the borrower’s equity capital interest on such debt may not be deducted as expense for profit tax purposes (in full or in part, as applicable). In addition, interest non-deductible for tax purposes is treated as dividend and is subject to withholding tax at the rate established for dividends.<sup>1</sup>

#### **Past Practice**

Until recently a number of companies managed to avoid application of the rules by relying upon the non-discrimination provisions of the Double Taxation Conventions (the “Conventions”) between Russia and other states (such as Cyprus, the Netherlands, Switzerland, Germany) of which the shareholders of the companies are residents. The non-discrimination provisions of Conventions prohibit imposition of more onerous taxes on companies of one state whose capital is owned or controlled by residents of another state, as compared to taxes imposed on other similar companies of the first-mentioned state.

Since pursuant to Art. 269(2) of the Tax Code only debts of Russian companies with direct or indirect foreign participation in the capital may be treated as controlled debt, the courts used to rely on the Conventions and to hold that such provisions discriminate the companies vis-à-vis those without foreign investment. As a result, the courts did not

<sup>1</sup> In the matter of OJSC Northern Kuzbass Coal Company no interest was paid during the period under review, so the issue of its reclassification as dividend and assessment of the withholding tax was not addressed by the tax authorities and the SAC.



grant tax claims for enforcement of such provisions, despite the fact that the debt was formally a controlled one. However, the Ruling may trigger significant changes to such practices in the near term.

## Potential Changes

The matter of OJSC Northern Kuzbass Coal Company involved the issue of whether the non-discrimination provisions of Clause 24 of the Conventions with Cyprus and Switzerland preclude application of controlled debt rules. Unlike lower courts, the SAC found that the provisions of Art. 269(2) of the Tax Code may not be treated as discriminatory since they apply to any and all Russian companies with significant foreign investment which have a controlled debt to a foreign entity. Therefore, the provisions of the Conventions do not preclude application of the rules. Moreover, as stated in the Ruling, the Conventions (Clause 9) not only permit but require application of domestic thin capitalization rules to the so-called “associated enterprises” due to special business and financial relationship between them. Among the criteria specified by the SAC are high debt ratio, affiliation between the borrower and the lender, failure to discharge the debt.

It is noteworthy that in support of its position the SAC relied on the Commentary on the Model Tax Convention of the Organization of Economic Cooperation and Development (OECD) which underlies the Conventions with Cyprus and Switzerland. At the same time, OECD Commentary also provides that the Conventions do not preclude application of thin capitalization rules to the extent the same ensure compliance with the “arm’s length” principle between affiliates. This provision of the OECD Commentary is not reflected in the Ruling. Therefore, it is unclear what approach the SAC could take as to whether the provisions of Art. 269(2) should apply if the taxpayer proves that financing was on an arm’s length basis, despite the formal elements of controlled debt.

Though the SAC’s findings are questionable, we deem it appropriate to assume that lower courts will take note of such approach, and non-discrimination provisions of Conventions in the future will not be a defence against tax claims. Also the tax authorities may be expected to more actively file claims under Art. 269(2) of the Tax Code in reliance on the SAC’s position.

Finally, it should be noted that the SAC’s Ruling indirectly threatens the financing structure involving foreign “sister” companies which until recently were deemed exempt from controlled debt rules. However, as the matter of LLC Naryanmarneftegaz (Ruling of the Ninth Arbitration Court of Appeals dated October 28, 2011 in case No. A40-1164/11-99-7; cassation appeal pending review on the merits) demonstrates, the use of such structures in itself does not protect companies against tax claims relating to controlled debt or guarantee support from courts. In its turn, the SAC’s Ruling removed the additional bar (non-discrimination principle) which could help to keep the structures in place.

## First Priority Steps

We recommend that the companies that have or intend to raise significant borrowings review closely the relevant financing structures (paying special attention to foreign “sister” company loans) and do the following, as appropriate:

- increase the debt-to-equity ratio so that it does not exceed 3:1; or
- modify the existing financing structure to make sure there are no elements of controlled debt; and
- consider paying the profit tax and overdue interest relating to the controlled debt for past periods (if any), if the company failed to apply Art. 269(2) of the Tax Code in reliance upon any of the Conventions.

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