"THIN" CAPITALISATION (UNDER-CAPITALISATION): NEW RULES

For the attention of heads of finance, tax, accounting and legal divisions

Pepeliaev Group advises that on 29 January 2016 the State Duma adopted a federal law[1], which significantly changes the rules for taxing interest on debt obligations to related parties and/or on debt obligations raised with such parties involved (the so-called "thin" capitalisation, or "under-capitalisation" rules). The law also clarifies many issues which may arise in connection with law enforcement practice where these rules are applied.

As compared with the initial version of the draft law[2],the new law has been tailored to the advantage of taxpayers.

Main changes

1. The threshold for a related foreign party to participate in a taxpayer's issued capital so that debt to such party is recognised as controlled has been increased from 20% to 25%. The law refers to the general criteria of relatedness which are based on a 25% membership interest rather than on the fact that the parties are affiliated (unlike before).
2. Debt to an individual may also be recognised as controlled if the same conditions are met.
3. The legislative level has incorporated the approaches worked out during judicial practice that the following types of debt incurred on debt obligations may be recognised as controlled:
   - debt to a foreign 'sister' company; and
   - in other cases (through the court), if it is established that the ultimate goal of the payments under such debt obligations is to pay a foreign party which is treated as related on the grounds specified in legislation.
4. At the same time, the requirements are eased for the mutual financing of Russian entities within groups with foreign ownership: a taxpayer's debt to a Russian 'sister' company is recognised as controlled only if such Russian creditor company has had an unsettled debt in relation to comparable debt obligations to a foreign related party during the reporting (tax) period. In other cases, debt to a Russian 'sister' company will not be considered to be controlled.

The main criteria for treating liabilities as comparable are set out in law, which allows taxpayers to assess independently the risks that debt to a Russian sister company will be recognised as controlled.

5. If a taxpayer's debt in relation to a debt obligation to a bank is secured by collateral (under a guarantee or otherwise) by a foreign related party, such debt is not treated as controlled provided that the following conditions are met:

[1] Federal Law "On amending article 269 of Part II of the Tax Code of the Russian Federation in terms of defining the concept of controlled debt".
[2] Draft law No. 724609-6.

- the bank is not a related to the taxpayer and the parties providing the collateral, guarantee or other security for the taxpayer's obligation;
- since the debt obligation to the bank arose, such obligation had not been discharged (settled) by the foreign related party which granted the security (i.e. the foreign related party had not paid under the guarantee, there had been no execution levied on a pledge granted by that party, etc.).

6. Debt under a debt obligation due to foreign entities is not recognised as controlled if the relevant debt arose in connection with foreign entities placing marketable bonds and if such entities submit to the taxpayer any information supporting that, as at the date when the interest income was paid, their permanent place of residence was within states with which Russia has international tax treaties.
7. The concept of a leasing organisation has been defined: a leasing organisation is an entity in which the income received during a reporting (tax) period from leasing activities and taken into account when the tax base is calculated, constitutes no less than 90% of the aggregate income for the relevant reporting (tax) period.

Previously, leasing companies were prone to the risk that they would not be able to apply the 12.5 coefficient when calculating the ratio between assets and liabilities with regard to controlled debt for the tax periods in which the leasing companies completed insignificant transactions to sell/lease out property.

However, the legislation does not give a definition of 'income from leasing activities'. In practice, the tax authorities do not treat as leasing-related income from selling or leasing property which has been seized from the lessee. This approach, at least, to the extent of the seized property being sold, is rather controversial since such sale is aimed at settling the debt incurred under the lease agreement and is treated as such in civil law disputes[3].

To promote positive practice, we could recommend treating the revenue from the sale of the seized item under lease as income from the lessee's debt being settled in the leasing agreements and the accounting policy, which would be a correct classification of such income.

Similar recommendations could be given with regard to other types of income connected with leasing activities (positive exchange rate differences, an insurance indemnity for the leased item being lost, etc.).

Coming into force

The law will come into force on 1 January 2017.

The law features transitional provisions which extend over 2016 the new provisions with regard to debt obligations to banks if such obligations were secured (under a guarantee or otherwise) by a foreign controlling entity and/or its affiliate.

What to think about and what to do

The new legal regulation will require the taxpayers at least to assess whether existing debt obligations fall within the amended “thin” capitalisation rules.

In addition, judicial practice is evolving: further to a taxpayer's claim, on 1 February 2016, the Judicial Panel for Economic Disputes of the Russian Supreme Court has received a case file regarding interest being reclassified as dividends when financing takes place among Russian entities, in accordance with the current version of 269(4) of the Russian Tax Code[4]. The outcome of this case may affect the judicial practice for settling similar disputes.

Help from your adviser

Based on our extensive experience of advising on how expenses on debt obligations should be booked if such debt obligations are treated as controlled debt, and our litigation work relating to this category of disputes, Pepeliaev Group's lawyers will readily provide the necessary assistance when the new taxation

[3] See Resolution No. 17 of the Plenum of the Supreme Commercial ('Arbitration') Court dated 14 March 2014.
[4] Case No. A40-87775/2014.

rules are implemented. This includes advising on structuring intra-group financing transactions and assisting with reducing the risks for business.

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