Global Tax Alert

Russian draft law on extension of the thin capitalization rules submitted to State Duma

On 16 December 2014, Russia's Draft Law No. 675906-6 “Concerning the Introduction of Amendments to Article 269 of Part Two of the Tax Code of the Russian Federation in Regard to the Definition of the Concept of Controlled Indebtedness” (the December draft) was submitted to the State Duma. It was scheduled for a first reading on 21 January but consideration of the bill has been postponed until another plenary session.

No revised text has been published since December. Representatives of the Ministry of Finance have suggested that amendments will be made to the formula for the thin capitalization ratio for foreign currency debts to exclude the impact of any devaluation of the ruble after 1 July 2014 (which could otherwise be extremely significant). This “exemption” is expected to be a short-term measure and effective until the end of 2015. The required changes are expected to be introduced in time for the second reading.

The December draft broadens the range of debt covered by the thin capitalization rules by replacing the current criteria relating to Russian organizations with foreign shareholders with new criteria relevant to Russian organizations (and foreign companies treated as Russian organizations for profits tax purposes) with foreign interdependent persons. The draft also provides for the exclusion of loans from third-party banks from the scope of thin capitalization rules, provided that certain conditions are met.

Proposed change in the definition of “controlled debt”

The Draft Law introduces changes to clause 2 of Article 269 of the Tax Code. Currently debt may be recognized as controlled only if a Russian borrower has a foreign direct or indirect shareholder. The proposed amendments would replace the current criteria with criteria concerning interdependent persons (as defined in Article 105.1 of the Tax Code). The rules in question apply to interest payable by Russian organizations. Notably, under amendments enacted in Federal Law
No. 376-FZ of 24 November 2014, a foreign company which is tax resident in Russia in accordance with the procedure established by Article 246.2 of the Tax Code is treated as a Russian organization for profits tax purposes with effect from 1 January 2015 and, therefore, becomes subject to the thin capitalization rules.

Controlled debt will include the indebtedness of a Russian organization under the following:

- Debts to a foreign person which is recognized as an interdependent person of that Russian organization
- Debts to a Russian person which is recognized as an interdependent person of the above foreign person
- Indebtedness to a person in relation to which the foreign person or its Russian interdependent person acts as a surety or guarantor or otherwise undertakes to guarantee the fulfilment of the debt obligation

Under these proposals debt may be recognized as controlled if the borrower and a foreign company are interdependent based on specified criteria (25% direct or indirect participation, a chain of ownership in which each party owns at least a 50% participation in the next member, a single person acting as the sole executive body for two organizations, etc.) and also if relations between the companies may influence the terms or the results of their transactions or the economic results of their operations.

The changes are broadly in line with current court practice. In recent years the courts have increasingly been willing to recognize debt owed by Russian organizations to foreign related companies which are not shareholders as controlled.

The December draft does not amend the ratio of controlled debt to a borrower’s equity at which restrictions on interest deductions may arise under the thin capitalization rules. This is to remain 3:1 (12.5:1 for banks and leasing companies). A 90% threshold for income from leasing activities is introduced for leasing companies below which the 12.5:1 ratio cannot apply. This will remove the current uncertainty regarding the level of non-leasing income at which thin capitalization is deemed to arise at a 3:1 debt-to-equity ratio.

The December draft still uses the “participating interest of an affiliated foreign person” in the borrower’s capital in the calculation of the capitalization coefficient. It is expected that in future versions of the Draft Law this will be corrected to take account of the fact that the foreign interdependent party in relation to which a debt is deemed to be a controlled debt may not have such a participating interest. A revised formula will be needed to calculate the limit on interest deductions in such cases.

Per the draft, the above changes are intended to enter into force on 1 January 2016.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young (CIS) B.V., Moscow**
- Vladimir Zheltonogov  +7 495 705 9737  vladimir.zheltonogov@ru.ey.com
- Alexei Ryabov  +7 495 641 2913  alexei.ryabov@ru.ey.com
- Marina Belyakova  +7 495 755 9948  marina.belyakova@ru.ey.com

**Ernst & Young LLP, Russian Tax Desk, New York**
- Julia Samoletova  +1 212 773 8088  julia.samoletova@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CMS171

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com