

NEW LEGISLATION CLARIFIES TAXATION OF DERIVATIVES AND OTHER FINANCIAL TRANSACTIONS

November 30, 2009

To Our Clients and Friends:

Today, Federal Law No. 281-Φ3 on “Amendments to Part One and Two of Tax Code of the Russian Federation and Certain Legislative Acts of the Russian Federation,” dated November 25, 2009, regarding taxation of financial derivatives and REPO transactions involving securities for both corporations and individuals, securities loans, taxation of income of clearing systems and certain other financial matters (the “Law”) was officially published. The Law also contains related amendments to the Federal Laws on “Banks and Banking Activity,” “Commodity Exchanges and Commodity Trade,” “Securities Market” and certain other laws. Most of the changes will come into force as of January 1, 2010. However, certain amendments will have retroactive application, covering legal relations existing from January 1, 2008.

HIGHLIGHTS OF THE LAW

The amendments proposed in the Law are substantial and numerous, containing both technical and conceptual changes to the Profits Tax (the Russian corporate income tax), Personal Income Tax and VAT calculation rules. In this legislative update we briefly highlight only the most important changes, which are conceptual novelties in Russian tax law:

- dividend income from shares put into the Russian equivalent of a trust relationship (*doveritelnoe upravlenie*), where property is held for the economic benefit of another person, is treated as income of its settlors (beneficial owners) and not of the trustee. If the trustee is a Russian corporation and the settlors are foreign entities, the trustee is required to act as a tax agent and withhold tax on dividends, if such tax was not already fully withheld when the dividends were paid;
- the rules for calculating the Profits Tax base in respect of REPO transactions with securities are amended to establish in particular, that a REPO transaction is an agreement as defined in the Federal Law on “Securities Market” (that definition is also introduced in the Law). The law also clarifies that the performance (completion) of obligations under the first and/or second part of a REPO transaction by set-off does not change the tax regime of REPO deals. Further, an important change is that the REPO tax rules apply to REPO deals between Russian and foreign corporations. In particular, if a REPO

transaction is concluded between a foreign corporation (seller under the first part of REPO) and a Russian corporation (buyer under the first part of REPO) and dividends are paid on Russian shares after execution of the first, but prior to settlement of the second part of REPO, the Russian corporation will be treated as a tax agent, which is required to withhold tax on dividends, unless such tax was already fully withheld when the dividends were paid. It appears that the latter change may contradict specific rules set forth in the Russian Tax Code, pursuant to which a tax agent generally must withhold tax only from such funds that it actually pays (transfers) to a foreign recipient of income;

- the Law introduces new statutory provisions to the Russian Tax Code, which establish specific rules for the taxation of securities loans (generally similar to the taxation rules for a REPO) and also for the taxation of income and expenses of stock exchange clearing systems;
- the tax rules for financial derivatives are amended, in particular establishing that a financial derivative is an agreement on derivatives as defined in the Federal Law on “Securities Market.” Importantly, pursuant to the Law, financial derivatives based on agreements that are not afforded judicial protection under Russian law (such as gambling) are not treated as such for tax purposes, and the losses under such agreements are not deductible. An exception is available for financial derivatives concluded before July 1, 2009. Further, the Law clarifies that a taxpayer may choose between treating a transaction as a financial derivative or a supply transaction with delayed execution (*e.g.*, a forward contract) only with respect to those transactions that provide for physical settlement (therefore, forwards which are not physically settled are explicitly excluded). Another important change is made to the definition and qualification of hedging, which is substantially expanded and clarified;
- the Law introduces a number of important changes regarding taxation of income of individuals from various financial transactions. The most important amendments include in particular: detailed rules for determining the market and/or accounting price of securities, investment fund shares and financial derivatives and detailed rules for calculating the personal income tax base in respect of transactions with securities, financial derivatives, REPO transactions and securities loans. Also, the regime regarding the imputation of taxable income based on the difference between the fair market value and the actual price paid if securities are purchased at a discount is extended to encompass financial derivatives. Interestingly, individual taxpayers will, for the first time, be granted

the right of a ten-year carry-forward for losses recognized from transactions with listed securities and financial derivatives; and

- finally, there are a number of technical VAT changes, which clarify that factual supply of the asset underlying a financial derivative is subject to VAT (unless an exemption applies such as, for example, for the supply of securities) and that securities loans and REPO transactions are not subject to VAT.

We would be happy to answer any questions you may have on this or any other Russian tax issues.

Alan V. Kartashkin
+7 495 956 3858
avkartashkin@debevoise.com

Evgeny V. Smirnov
+7 495 956 3858
evsmirnov@debevoise.com

Anna S. Dulova
+7 495 956 3858
asdulova@debevoise.com