

FEDERAL ARBITRAZH COURT OF MOSCOW DISTRICT REVERSES UNFAVORABLE LOWER COURTS' RULINGS DISALLOWING THE DEDUCTION OF INTEREST DUE TO THIN CAPITALIZATION RULE

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To Our Clients and Friends:

On 13 July 2010, the Federal Arbitrazh Court of Moscow District (the "Court") issued a ruling that reversed the decisions of two lower courts concerning the deduction of loan interest owed to a foreign sister lender for the purpose of corporate income tax. The lower courts, to the disfavor of a taxpayer, had disallowed the full deduction of interest paid by a Russian borrower to a foreign sister company, by applying the thin capitalization rule. The lower court decisions were contrary to the literal interpretation of existing tax legislation and court practice, created a risk of forming a negative judicial trend and thus raised considerable concern among investors and practitioners. As discussed below, however, the Court reversed the lower courts' decision and reinstated the common practical interpretation of the issue.¹

SUBSTANCE OF THE CASE

The case at issue stemmed from an unfavorable decision by the tax authorities following their audit of the tax returns of a Russian limited liability company, Hydromashservis (the "Company"), a wholly-owned subsidiary of a Cypriot legal entity (the "Parent Company"). The Company received a loan from a sister Hungarian company, also 100% owned by the Parent Company. The Company fully deducted the amount of the paid interest on the loan for Russian corporate income tax purposes. The Russian tax authorities, supported by the lower courts, disallowed the deduction.

According to Russian Tax Code, the thin capitalization rule can only be applied in limited circumstances. It is only applicable to Russian corporate borrowers:

- with outstanding debt owed to a foreign corporation that directly or indirectly holds more than 20% of the Russian borrower's charter capital,

¹ The ruling of the court enters into force immediately after its adoption and in most cases represents the final and binding decision. However, within three months after the ruling is issued, a party to the dispute may appeal to Superior Arbitrazh Court ("SAC") to have the decision held unlawful. The SAC then has discretion to decide whether the case should be admitted for consideration. Since the three month term for such appeal has not expired, and there has been no ruling to reject the consideration by the SAC, it is possible that the Hydromashservis case may be subject to further review.

- if the debt is granted by a Russian corporation which is an affiliate of such foreign corporation, or
- if the foreign corporation or its Russian affiliate issues a guarantee or otherwise secures the debt (the “controlled debt”),

provided that the amount of the Russian corporation’s controlled debt exceeds its own capital (*i.e.* net assets) by more than three times (or 12.5 for banks and leasing companies). As a consequence, a Russian corporate borrower must calculate the maximum amount of deductible interest by dividing accrued interest by a “coefficient of capitalization.”² Any excess of accrued interest payable during a reporting period over the maximum amount of deductible interest is treated as a dividend subject to withholding tax at a basic rate of 15% (potentially subject to reduction under applicable bilateral tax treaties).

Under a literal interpretation of the above Russian Tax Code provisions, the loans granted to Russian borrowers by foreign sister companies should not qualify as a controlled debt and therefore, the thin capitalization rule should not apply. This interpretation is widely held and supported by court practice.³ However, recently the Russian Ministry of Finance issued a private clarification⁴ that contradicted this interpretation. In line with this new trend, the lower courts’ decisions in the Hydromashservis case was in contrast with what has been the common position on the issue.

REVERSED RULINGS

The decisions of the lower courts were based on the view that the involved legal entities in fact belonged to the same group and that both the Russian and Hungarian subsidiaries and its financial decisions were fully controlled by the Parent Company. The lower courts also took the position that the Parent Company could be the only source of funds transferred as a loan, at the expense of funds previously raised by an IPO. Based on these facts, the courts concluded that the loan was in effect granted by the Parent Company (while the involvement of a Hungarian sister corporation was merely technical). Under this interpretation, the deduction of interest was subject to compliance with the thin capitalization rule. As a

² *The coefficient is calculated by dividing the amount of controlled debt by the value of net assets of the debtor and then by dividing the result by three (or 12.5 for banks and leasing companies).*

³ *For example, Rulings of the Federal Arbitrazh Court of Moscow District No. KA-A40/5532-10 of 1 June 2010, No. KA-A40/4269-10, and of Far Eastern District No. Ф03-A51/06-2/4898.*

⁴ *Letter No. 03-08-05, dated 27 November 2009.*

consequence, the courts ruled that Company should have deducted the interest at the maximum amount allowed under the thin capitalization rules (rather than deducted in full), and thus held the actual deduction unlawful. In addition, the courts alluded to a range of other debatable arguments on various aspects of the problem, including the applicability of non-discrimination provisions of a double tax treaty, calculation of non-qualified interest, moment of interest deduction in the absence of actual payment and re-qualification of excess interest into taxable dividends.

By contrast, the Court, considering the case, found no reason to apply the thin capitalization rule in this situation. Instead, it rejected the conclusion that the loan represented controlled debt, as the lender did not hold any interest in the charter capital of the Company, either directly or through intermediaries. The Court noted that the conditions for applying the thin capitalization rule are limited by the provisions of the Tax Code, and any extension thereof is not acceptable. All other related arguments of the lower courts were rejected as well. As a result, although there remains a chance that the case can still be subject to further revision, the Court's decision signals a move against the position of the lower courts and the Ministry of Finance, thus making a significant contribution to the formation of favorable court practice and upholding the generally limited applicability of the Russian thin capitalization rules.

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

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