

RUSSIA: REDUCED INTEREST DEDUCTIONS ON FOREIGN CURRENCY LOANS IN 2011 AND 2012

26 August 2010

To Our Clients and Friends:

On the 27 July, the President of the Russian Federation signed into law Federal Law No. 229-FZ (the “Law”), which introduced certain changes into Russian tax legislation, including a change in the threshold of deductible interest on loans denominated in foreign currency. The Law generally enters into force on 2 September 2010, but the lower thresholds discussed below will become effective only in 2011–2012.

Presently, accrued interest is fully deductible so long as the interest rate does not deviate more than 20% above or below the average rate charged for similar loans granted in the same quarter (or month, for certain taxpayers) under comparable conditions. However, if no comparable loans are available in such period for reference, or at the discretion of the taxpayer, the amount of deductible interest is limited to a maximum of (i) 110% of the refinancing rate of the Bank of Russia (with respect to a ruble-denominated loan) or (ii) 15% (with respect to a foreign currency-denominated loan). This regime applies to shareholder loans as well as loans made by third parties.

Pursuant to the Law, from the beginning of 2011 until the end of 2012, the maximum safe harbor amount of deductible interest with respect to loans in foreign currency (*i.e.*, the rate applicable either in the absence of comparable loans or at the taxpayer’s discretion, as detailed above) will be limited to 80% of the refinancing rate of the Central Bank of Russia (or the lesser agreed interest rate). At present the refinancing rate is 7.75%; accordingly, if the new limits were applicable today, the effective threshold would be 6.2%, which is a significant decrease as compared to the current 15%. As for ruble-denominated loans, when the Law comes into effect, the deductibility threshold for interest on such loans will be increased to 180% of the refinancing rate of the Central Bank of Russia and will remain stable during the same period. After 2012 and absent an extension of the Law, the old rules would go back into effect.

Due to the vague language of the Tax Code and the corresponding ambiguity of the relevant provision regarding “deviation by more than 20% above or below the average interest rate charged on loans granted in the same quarter under comparable conditions,” which caused a significant number of court disputes initiated by the Russian tax authorities, many taxpayers currently prefer to rely on the maximum safe harbor deductibility rate (15% with respect to foreign currency loans). However, this approach may change in the future with respect to loans denominated in foreign currency due to the clearly disadvantageous deductibility threshold of

6.2% (using today's refinancing rate for illustrative purposes) applicable for the period from the beginning of 2011 until the end of 2012.

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

Dmitri V. Nikiforov
+7 495 956 3858
dvnikiforo@debevoise.com

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

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