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Briefing note

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# Taxation of Eurobonds: Russian MinFin Proposes New Regime

Further to our client briefing ("*Beneficial Ownership in the Context of Eurobond Transaction: New Reality*?") this note discusses the proposals recently published by the Russian Ministry of Finance ("**MinFin**") in response to the market reaction to their intention to levy withholding tax on interest payments under Russian Eurobond structures.

## Key issues

- MinFin's proposals on Eurobond taxation published
- Offerings made prior to 2013 will be grandfathered
- Full exemption for direct offerings proposed, but is there a market for this product?
- Exemption for issuances via SPV is proposed, but the practical operation is yet to be clarified

## Background

As discussed in our earlier note, the issue at hand has arisen at the end of 2011, when MinFin issued a letter stating that in the context of eurobond offerings the SPVs issuing bonds would not qualify as beneficial owners of interest. This meant that Russian borrowers are supposed to withhold 20% income tax on any interest paid to the SPVs unless the borrowers would have evidence that ultimate bondholders are also residents of a jurisdiction that has a double tax treaty with Russia fully exempting interest from Russian withholding tax. The letter heralded a substantial change in the fiscal approach and caused significant uncertainty in the market with respect to the taxation, and, ultimately, the borrowing costs, of future issuances. If adopted, this approach could also result in massive tax assessments on Russian borrowers for issuances dating back to 2008.

This sudden change of policy, quite understandably, precipated a very strong push-back from the issuers and underwriters alike, and the first month and a half of 2012 have seen intensive consultations between MinFin and the market participants, investors and tax professionals on the issue. We also understand that MinFin has been in touch with the tax authorities of Ireland and Luxembourg, which are among the jurisdictions most commonly used by Russian borrowers for Eurobond issuances to discuss their views on the subject.

## MinFin's Proposals

As a result of these consultations, on 20 February 2012 MinFin published its proposal to resolve the situation (*press-release in Russian and English*) and a draft law implementing these proposals. Although the draft is somewhat unclear, it seems that MinFin's proposal may be summarised as follows:

1. Starting from 2012, an exemption from the Russian withholding tax will be granted for so-called "quoted bonds" (*obrashayushiesya obligatsii*), i.e. bonds quoted on one or more of recognised foreign exchange(s) or cleared through a recognised clearing system as per the list to be approved by the MinFin and the Russian securities regulator.
2. However, the way the exemption would work depends on whether a "quoted bond" is issued:

(a) directly by a Russian issuer, in which case interest would be fully exempt from Russian withholding tax; or

(b) through an SPV, in which case exemption would apply only if all of the following criteria are met:

– SPV residency test: SPV is a resident of a jurisdiction that has a double tax treaty with Russia fully exempting interest from Russian withholding tax; and

– Qualifying bondholder test: *"pursuant to the records of the clearing or depositary organisation recording rights to quoted bonds of SPVs, the bondholders are either Russian resident organisations or organisations resident in jurisdictions that have double tax treaties with Russia*".

The exact practical application of the "qualifying bondholder test" is unclear, but based on the wording of the MinFin press-release it would appear that the tax authorities will establish the residency of the bondholders by reference to those bondholders/custodians that maintain direct accounts with the clearing systems (so-called "first level bondholders") rather than the ultimate bondholders. If that is indeed the case, then for the exemption to be available in practice, it will be necessary for the clearing systems to agree to provide the relevant extracts and, more generally, to ensure that only qualifying bondholders are bondholders of record in the clearing systems. The bondholders' certification would need to be provided in respect of each coupon payment date by reference to the clearing systems records as of the date that is not more than 10 business days prior to the coupon payment date. The certification can be made in the form of both hard and soft certificates produced by clearing systems.

If no record in respect of a bondholder is provided by the clearing system, or if a bondholder fails to meet qualifying bondholder test, Russian borrower will have to withhold 20% tax from the portion of interest income payable to such bondholder.

3. The proposed legislation will apply to all Eurobond offerings made after 1 January 2007, but the pre-2013 offerings will be grandfathered from tax claims provided that the relevant bonds are "quoted bonds" (see item 1 above) and the SPV is located in a jurisdiction that has a double tax treaty with Russia exempting interest from the Russian withholding tax. In the press-release MinFin has also assured the borrowers that tax authorities will not assess WHT claims against Russian issuers while the draft law is going through the Parliament.

4. Finally, in the same draft law MinFin intends to provide full exemption from withholding tax for interest on sovereign bonds of the Russian Federation, its constituents and municipalities (which will legitimise the existing practice in respect of sovereign bonds).

# Conclusions

The MinFin's willingness to consider the market's sentiment and, especially, not to assess taxes for past periods can only be welcomed.

As for the exemptions MinFin is proposing for direct offerings of Russian borrowers, it is uncertain if it would be relevant for the market at least in the short term. Historically, the Eurobond offerings were structured via SPVs to overcome the hurdles and inefficiencies of Russian securities market regulations, and until these inefficiencies are removed the move to direct offerings may remain problematic.

As regards the exemption for the offerings structured through SPVs (both new and those outstanding as at 1 January 2013), the practical aspects of interaction between the Russian borrowers and clearing systems on confirmation of the residency of the bondholders are yet to be worked out. It may not be excluded that at the end of the day Russia will follow the clearance procedure for claiming exemptions on quoted Eurobond, that existed in Spain until 2011.

It is also worth noting that in resolving the issue the MinFin has left the shaky terrain of "beneficial ownership" and has instead come up with an exemption that to a certain extent mimics the "quoted bonds" exemption available in some other jurisdictions. Thus, while creating the exemption specifically for Eurobonds, the proposed solution does not address the broader issue of beneficial ownership in Russian tax law that has come into the spotlight in the wake of the MinFin's letter of 30 December 2011, and the MinFin's position expressed in that letter may still have repercussions for other products/transactions having back-to-back element in them.

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