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Russia Changes Interest Deductibility Rules in Light of New Economic Reality

This briefing discusses the

1. Federal Law No. 32-FZ of 8 March 2015 (the "**Amendment Law**"), which applies retroactively from 1 January 2015 and modifies the interest deductibility rules in the aftermath of the significant depreciation of the Russian Rouble in 2014 followed by the dramatic increase of the prime rate by the Central Bank of Russia ("**CBR**"); and

2. further amendments to the thin capitalization rules which are currently being considered by the Russian Parliament.

The Amendment Law

The Amendment Law (i) establishes new interest deductibility caps in light of the current high interest rates and (ii) changes the thin capitalization rules applicable to loans denominated in foreign currency in order to address the significant depreciation of the Rouble in late 2014.

New interest deductibility caps

As discussed in our briefing of February 2014 *Global Tax Warming, or New Year Presents from the State Duma*, starting from 2015 no deductibility limits are in place for debt obligations that are not subject to Russian transfer pricing rules ("non-controlled loans"). As for loans that are subject to transfer pricing control ("controlled loans", which broadly includes loans from related parties and loans from residents of offshore jurisdictions blacklisted by the Russian Ministry of Finance), the interest on such loans is deductible insofar as it does not exceed arm's-length interest. Prior to enactment of the Amendment Law, if a party to a controlled loan was a bank, the parties had the *right* to apply the statutory intervals set out in the Russian Tax Code for determining expenses (and income) instead of applying the transfer pricing rules. For Rouble loans the value of the interval was linked to the CBR refinancing rate[1], and for loans in foreign currency it is linked to LIBOR, EURIBOR or SHIBOR, depending on the particular currency.

The Amendment Law extends the option to use statutory intervals for any controlled loans (i.e. not only for controlled loans where one of the parties is a bank), and in respect of Rouble denominated loans only it (i) modifies the statutory intervals, and (ii) allows taxpayers to use the statutory intervals also for non-controlled loans (although the drafting of the Amendment Law in this regard is rather poor). These changes are summarized in the table below:

[1] The CBR refinancing rate is the CBR's historic RUB lending rate, which has lost its meaning since September 2013, when it was effectively replaced by the so-called "prime rate". However it is officially still quoted by the CBR and is currently set at 8.25%.

Year	Old Intervals for RUB Loans	New Intervals for RUB Loans
2015	*For controlled loans*: from 0.75 to 1.8 times the CBR refinancing rate; *For non-controlled loans*: no interval	*For controlled loans*: from 0 to 1.8 times the CBR prime rate[2] *For non-controlled loans*: from 0.75 times the CBR refinancing rate[3] to1.8 times the CBR prime rate
2016	*For controlled loans*: from 0.75 to 1.25 times the CBR refinancing rate; *For non-controlled loans*: no interval	*For controlled loans*: from 0.75 to 1.25 times the CBR prime rate; *For non-controlled loans*: from 0.75 to1.8 times the CBR prime rate

In addition, a special deductibility cap has been introduced for interest that accrued on Rouble denominated loans in December 2014. Such interest is deductible up to a multiple of 3.5 times the CBR refinancing rate, i.e., 28.875%.

New thin cap rules for loans in foreign currencies

The deductibility of interest on loans captured by the thin capitalization rules (so-called "controlled indebtedness") is also limited to a 3:1 debt-to-equity ratio. While equity is always an amount fixed in Roubles, in case of a foreign currency denominated loan Russian borrowers must periodically revalue their debt based on the current CBR exchange rate. USD/EUR denominated debt has been quite popular in Russia – largely due to the lower interest rates compared to RUB denominated loans. However, as a result of the Rouble losing almost half of its value against the USD and EUR in 2014, suddenly loans that had previously been compliant with the 3:1 debt-to-equity ratio breached that threshold, with significant amounts of interest on such loans suddenly becoming non-deductible.

To address this situation the Amendment Law introduces temporary rules specifically for foreign currency debt that arose before 1 October 2014: for the purposes of calculating the debt-to-equity ratio in respect of interest that accrued from 1 July 2014 to 31 December 2015 the revaluation of such liabilities is to be based on the CBR exchange rate, provided that it does not exceed the CBR exchange rate as on 1 July 2014, and currency fluctuations are not to be taken into account for the purposes of calculating equity.

Further Changes to the Thin Cap Rules Are Being Discussed in Parliament

As currently drafted, the Russian thin capitalization rules are fairly controversial and have certain loopholes (which have partly been addressed in the jurisprudence – please see our briefing *Re-thinking Thin Cap*), yet at the same time technically they also capture genuine third party financing. The State Duma is currently considering draft legislation that purports to address some of the loopholes and also introduces certain 'safer-harbour' provisions for third party financing. While it is yet to be seen whether this draft law will be adopted or not, below we describe the key principles of the proposed thin cap reform:

1. In terms of closing the loopholes, it is proposed to expressly extend the thin cap rules to loans from foreign affiliates of Russian borrowers (under the current thin cap rules loans from foreign affiliates are technically not captured, although the courts increasingly tend to find such structures abusive);
2. In terms of creating a 'safe harbour' for third party financing, it is proposed that the thin cap rules should not apply to loans from non-affiliated banks (Russian or foreign), provided that the bank in question is not being used to 'front' what is effectively related party financing. In particular, the current proposal is that if a borrower's affiliates have accounts in, or claims against, the lender or its affiliates, then the 'safe harbour' would be available provided that:

[2] The CBR prime rate is currently set at 15% (in December 2014 it was raised several times and reached 17%).
[3] It is unclear whether the reference to the CBR refinancing rate at the lower end of the interval is intended or erroneous.

(a) the funds in the accounts (deposits) or claims cannot be used as security with respect to the principal and interest of the Russian borrower;

(b) the placement of funds in accounts (deposits) or issuance of other obligations is not a prerequisite to the funding of the Russian borrower;

(c) the amounts, conditions and terms of the accounts (deposits) or claims should not be comparable to the amount, terms and conditions of the Russian borrower's debt.

3. Finally, it is proposed to expressly exclude interest payable under Eurobond transactions from the scope of the thin cap restrictions.

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