CLIFFORD
CHANCE

Briefing note February 2016

# Russia Redesigns Thin Cap Rules

Russia has introduced amendments to its thin capitalisation rules to combat "sister company" financing schemes. The new rules also envisage exemptions for intra-group financing and most guaranteed bank loans.

## The existing rules

Generally speaking, Russian thin cap rules establish a 3:1 debt-to-equity ratio (a 12.5:1 debt-to-equity ratio applies to banks and leasing companies) in respect of the so-called "*controlled indebtedness*" of a Russian company if more than 20% of the Russian company's capital is owned (directly or indirectly) by a non-resident ("*foreign shareholder*").

A Russian company's "controlled indebtedness" includes indebtedness to:

i. its foreign shareholder(s);
ii. other Russian companies affiliated with a foreign shareholder of the debtor; and
iii. any third party debt for which security was provided by a foreign shareholder of the debtor or by a Russian affiliate of such a foreign shareholder.

Interest payable on such "controlled indebtedness" in excess of the 3:1 or 12.5:1 threshold will be treated as dividends, and consequently (i) double taxation treaty exemptions with respect to interest will be unavailable, and (ii) such interest will not be deductible for corporate profits tax purposes for the Russian borrower.

The detailed wording of the existing thin cap rules specifically captures foreign shareholders and Russian affiliates without making any mention of foreign affiliates of a Russian borrower, thus technically leaving them outside the scope of the thin cap rules. As a result, it has become quite common to structure financings (both intra-group and from third parties) by channelling the loans through foreign "sister companies" of Russian borrowers. Although Russian tax authorities started their attempts to combat "sister company" schemes around five years ago, until recently this loophole remained in the law.

Another issue triggered by the existing wording is that the thin cap rules technically capture financing from unrelated parties (e.g., banks) where such financing is secured by a foreign shareholder or its Russian affiliate, thus creating additional difficulties (although this was arguably not the intention).

The legislators have addressed these and other issues in Federal Law No. 25-FZ dated 15 February 2016 (the "**Amendments**"). The Amendments attempt to close the "sister company" loophole, change the approach to determining affiliation, and introduce a number of exemptions to the existing thin cap rules.

## Key issues

- "Sister company" financing is now captured by thin cap rules
- Exemptions for intra-group loans, bank loans and loans under Eurobond transactions
- New rules effective from 2017
- Secured bank loans are exempt from the thin cap rules from 2016

## The Amendments

**New affiliation rules and the end of the "sister financing" era?**

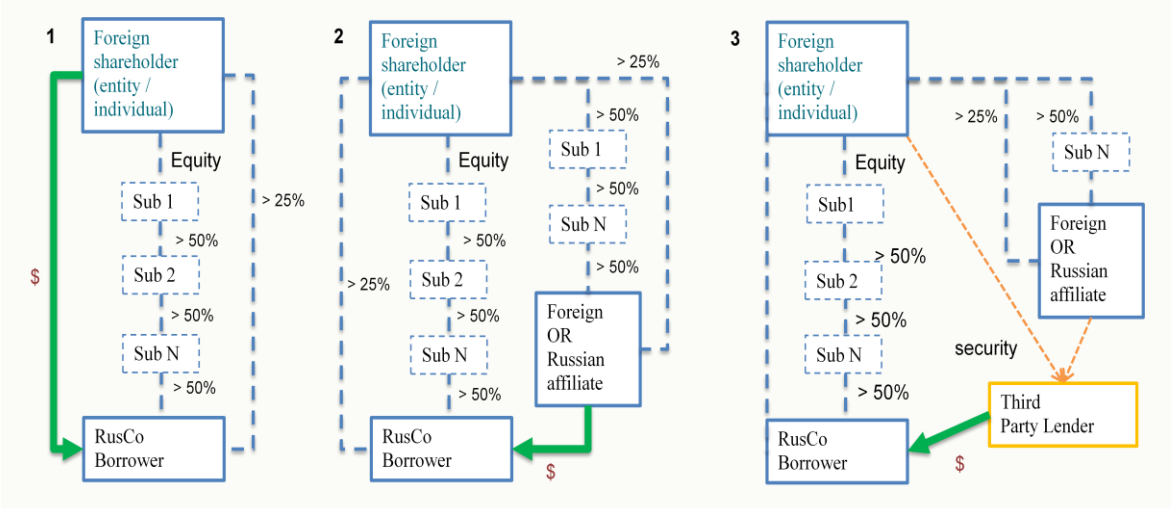
The Amendments bring the definition of affiliation (for the purposes of thin cap) into line with the Russian transfer pricing rules. The good news is that the holding threshold triggering the application of the thin cap rules has been increased from 20% to 25%. The affiliation criteria, however, have been supplemented by the so-called "*50% rule*", according to which persons in a chain of holdings are deemed to be affiliated with one another if each person in the chain directly owns at least 50% in the next subsidiary

down the chain. The "*50% rule*" may effectively set the holding threshold lower than 25%.

Unless one of the exemptions discussed below applies, the thin cap rules after modification by the Amendments will capture the following indebtedness (please see Figure 1 below):

1. loans from a foreign person (entity or individual) ("*foreign shareholder*") that owns directly or indirectly more than 25% in a Russian borrower OR where the foreign shareholder is affiliated with the Russian borrower under the "50% rule";
2. loans from a Russian or foreign affiliate (entity or individual) ("*shareholder affiliate*") of a foreign shareholder (with affiliation based on the 25% direct/indirect holding OR the "*50% rule*"); and
3. loans from a third party lender secured by a foreign shareholder or shareholder affiliate.

*Figure 1. New thin cap structures*




While increasing the holding threshold to 25%, the Amendments *de facto* tighten the rules and effectively cover most of the commonly used "sister financing" structures. The rules will apply to interest accrued under loans made before the Amendments were enacted. This means that for many existing loans the thin cap treatment needs to be re-assessed.

**Additional grounds for thin cap application**

The Amendments introduce a new ground for application of thin cap rules based on the general anti-avoidance concept of *substance over form*. The tax authorities will have the right to request a court to apply thin cap rules even if a loan is not legally captured by the thin cap rules, but payments under the loan (presumably interest) are effectively being paid to a foreign shareholder or a shareholder affiliate. Thus, the definition of thin cap becomes fairly open-ended.

**New exemptions**

The Amendments provide for three main exemptions from the thin cap rules. The following loans will not be captured:

(a) loans from a shareholder affiliate that is a Russian entity or individual, provided that the shareholder affiliate has no comparable debts vis-a-vis a foreign shareholder or another shareholder affiliate. The Amendments provide for loan comparability tests (e.g., amount of indebtedness, tenor of the loans);

(b) loans made by a Russian or foreign unaffiliated bank, where the principal or interest under such loans are not repaid by a foreign shareholder or shareholder affiliate providing security; and

(c) loans exempt from withholding tax based on the Eurobond exemption rules.

The exemptions under paragraphs a) and b) above will be available for borrowers upon obtaining written confirmation from the lenders that all the applicable conditions for their application are fulfilled. The Amendments, however, are silent as to the form and specific wording of such confirmation, and also as to how often such confirmation must be presented. Borrowers will likely start seeking such confirmations from their lenders in preparation for future interest payments / accruals with respect to 2017 and onwards. It is also likely that borrowers will seek to reflect Russian thin cap rules requirements in the respective loan agreements.

## Time to act

While most of the Amendments will apply to interest accruing starting from 2017, the Amendments do not provide for any grandfathering with respect to existing loans. This means that businesses should start considering the implications of the Amendments to their existing lending structures and search for ways to eliminate their exposure associated with application of the thin cap rules.

The good news for banks and borrowers is that secured bank loans are exempt from the thin cap rules with effect from 1 January 2016. No written confirmations will be required with respect to 2016.

## Authors

**Alexander Anichkin**
Partner

E: alexander.anichkin
@cliffordchance.com

**Dmitry Tolkachev**
Senior Associate

E: dmitry.tolkachev
@cliffordchance.com

Clifford Chance, Ul. Gasheka 6, 125047 Moscow, Russia


www.cliffordchance.com