Summary and conclusions

A number of hybrid financial instruments are currently used by Russian businesses, although their use is probably not as popular as in other countries. These instruments include preferred shares, convertible bonds, subordinated loans and floating rate bonds.

Surprisingly, the debt–equity conundrum does not seem to be a hot topic for Russian tax lawyers. Russian tax law contains statutory definitions of both dividend and interest income. Article 43(1) of the Russian Federation Tax Code defines dividends as any income received by a shareholder (participant) from a company upon distribution of profits in connection with shares (interest) owned by this shareholder (participant) pro rata to the share of the shareholders (participants) in the capital of the company. Distribution of profits in connection with the preferred shares is explicitly mentioned as an example of dividend income. Article 43(3) of the Tax Code defines interest income as any predetermined income (including discount) received under a debt arrangement of any kind (notwithstanding the form thereof). Therefore, where income characterization is concerned, both the tax authorities and courts would probably start from an analysis of whether particular income qualified under either of the two definitions and this analysis would generally be decisive. As a supporting tool, classification of a financial instrument for civil law/corporate law purposes could be invoked. From this perspective convertible and floating rate bonds, as well as subordinated loans, would most probably qualify as debt instruments while preferred shares and other corporate rights would qualify as equity.

Reclassification of business transactions is considered an effective anti-abuse measure. In principle the tax authorities are allowed to reclassify the business activities of a taxpayer, provided that the collection of taxes, interest and penalties arising from the reclassification may only be performed through the court (this does not apply to reclassification of excessive debt into equity under the thin capitalization rules). Should the court agree with the reclassification performed by the tax authorities it has to determine the tax liabilities of the taxpayer based on a new classification of its activities. Successful reclassifications are relatively rare in practice, as the courts are rather conservative about opening this Pandora’s box.

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Apart from statutory reclassification under the thin capitalization rules, reclassification may generally take place if the classification of activities by the taxpayer contradicts the economic substance of these activities. Given that the purpose of this tool is to combat tax abuse, the application of reclassification will very much depend on the facts and circumstances in each particular case. It should be noted that reclassification should not change the general income characterization rules, as described above, as this is only a correction mechanism (to bring the form into line with economic substance) rather than an alternative set of characterization rules.

Apart from reclassification of income, transfer pricing rules can limit the scope of debt–equity play. The new Russian transfer pricing law (to be effective from 1 January 2012) is intended to cover debt financing (subject to certain statutory criteria). Thus, if the terms of debt financing between companies are not arm’s length, deductibility of interest could be limited, thus effectively converting some portion of the debt into equity from the borrower’s perspective. This, of course, should not lead to recharacterization of the interest income in the hands of the lender.

As the Russian financial markets are rapidly developing, the reporters expect that the use of hybrid financing tools will expand. The government will probably have to react by introducing more sophisticated rules of taxation of hybrid instruments in order to preserve tax fairness and the balance between public and private interests.

1. Overview of regulatory and market conditions

Although the Russian financial markets are not as mature as those of most developed countries, a number of hybrid financial instruments may still be found.

1.1. Preferred shares

Russian joint stock company law (Federal Law no. 208-FZ of 26 December 1995) provides for the issuance of one or several classes of preferred stock. The nominal value of the preferred stock should not exceed 25 per cent of the total nominal value of statutory capital of a joint stock company. Both ordinary and preferred shares should be issued in the name of a particular shareholder (in other words, issuance of bearer shares is not allowed).

As a general rule preferred shareholders have no voting rights and do not participate in the general meetings of shareholders (subject to certain exceptions). The law requires that corporate documents (in particular the charter) determine the amount of dividends and the amount of liquidation proceeds due to each class of

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1 In particular, preferred shareholders may participate in the general meetings of shareholders in the case of reorganization or liquidation of a company, as well as where the rights of these shareholders are affected, in particular if calculation of dividends and/or liquidation proceeds changes or the sequence of payment of dividends and/or liquidation proceeds between different classes of the preferred shares is changed. Also the preferred shareholders receive voting rights immediately after the annual meeting of shareholders of the company fails to declare the dividend income due to these shareholders until they receive such dividends in full.
preferred shareholder. This amount may be calculated either as a lump sum or as a certain percentage of the nominal value of the preferred shares. Alternatively the charter may provide for the methodology of calculation of these amounts. If the charter does not specify the amount of dividends due to a particular class of preferred shareholders they have the right to receive dividends as if they owned ordinary shares.

If a joint stock company issues several classes of preferred shares, the charter of this company should determine the sequence of payment of dividends and liquidation proceeds in respect of each of these classes of preferred shares. The law allows a joint stock company to delay payment of dividends declared in respect of the preferred shares of certain class until a specified date. Such shares are called cumulative preferred shares.

The preferred shares of one class may be convertible into the ordinary shares or the preferred shares of other classes (convertible preferred shares). The charter of the joint stock company should stipulate the terms of conversion, including the quantity and the class of shares which could be issued in case of conversion. These terms may not be changed after the convertible preferred shares are issued. The convertible preferred shares may not be converted into any other type of security (in particular they may not be converted into the bonds).

Issuance of preferred stock is routine in large Russian companies, although this instrument is not widely used by medium-sized and small Russian businesses.

### 1.2. Convertible bonds

Apart from the issuance of preferred stock the joint stock company law provides for the issuance of convertible bonds. As a general rule the right to decide on the issuance of convertible bonds is vested in the general meeting of shareholders unless the charter of the joint stock company grants this authority to the board of directors. In both cases the decision should be unanimous. The convertible bonds may either indicate the name of the lender (in this case they are registered by the issuer) or be bearer bonds.

It should be noted that in practice convertible bonds are not widely utilized to attract investment (although the cost of such capital could be lower than in ordinary debt financing), although major Russian corporate players (such as Lukoil, Yukos, Vympelkom) exploited this investment vehicle when they were unable to receive low-cost debt financing due to the high risks attributed to the Russian economy in the past.²

### 1.3. Subordinated loans

Subordinated loans are not unknown in Russian business practice. Although most of them are usually part of global financing arrangements employed by multinational groups of companies (and are thus governed by foreign law), sometimes local subordinated loan arrangements can be found. Russian law does not provide for any special regulatory framework in respect of subordinated loans except that

² See Альбина Атанова. Два в одном: конвертируемые облигации // Финансовый директор, 2008, no. 5.
some banking regulations issued by the Central Bank of Russia (CBR) treat them as some sort of quasi-equity. This, however, should not affect the classification of subordinated loans as debt financing instruments for civil law and tax law purposes.

1.4. Floating rate bonds

It has been reported in the press that some Russian oil and gas companies have attempted to issue bonds with interest linked to the market prices of commodities (primarily oil and gas). However, it seems that the attempts were not successful. It is doubtful whether such instruments would be legitimate under Russian law. Both article 816 of the Russian Federation Civil Code and article 2 of the Federal Law no. 39-FZ of 22 April 1996 define a bond as a security which entitles its owner to receive from the issuer the nominal value of this security and possibly a fixed interest equal to a certain percentage of the nominal value of the security or other proprietary right. It can be derived from this definition that interest may only be set as a percentage of the nominal value of the bond and may not be linked to any other market indicators, such as price of the commodities.

Principal exchange rate linked bonds (named “indexed bonds” in the Russian practice) should also be mentioned; these were used at the end of the 1990s. Due to the significant level of inflation at that time investors preferred low interest hard currency deposits to debt financing of Russian business. In order to make borrowing on the Russian market more attractive some investors issued rouble denominated bonds with an interest rate subject to indexation based on the current level of inflation. Notwithstanding the fact that the level of inflation is now much lower, principal exchange rate linked bonds are still used by some investors.

Although, as can be seen from the above, the joint stock company form provides for more opportunities to utilize hybrid financing tools, in practice limited liability companies (companies which do not issue shares and have their capital divided into participatory interests) are preferred by investors, as the joint stock company form requires more corporate law compliance and joint stock companies fall under the supervision of the Federal Securities Markets Service.

In general, the Russian financial market is a capital importing type of market, i.e. Russia seeks to attract foreign investment. The Ministry of Finance reports that foreign investment in the Russian economy amounted to a total of US$44,349 million as of 1 July 2011, including foreign direct investment of US$3,890 million, portfolio investments of US$122 million and other foreign investments of US$40,337 million. In 2010, the volume of foreign investment amounted to US$114,746 million, including foreign direct investment of US$13,810 million, foreign portfolio investments of US$1,076 million and other foreign investments amounting to US$99,860 million.

3 Paras. 2.1.12 and 3.5 of the Regulations of the Central Bank of Russia (CBR) no. 215-II of 10 February 2003.
4 See the official website of the Ministry of Finance: www.minfin.ru.
2. Summary of key tax principles

2.1. Tax treatment of debt

Income from lending money is generally subject to general tax rates both for corporate income tax (profit tax) purposes and personal income tax purposes. The general profit tax rate equals 20 per cent, whereas the personal income tax rate depends on whether an individual is Russian tax resident (13 per cent) or non-resident (30 per cent). A special rate of 35 per cent applies to interest earned by Russian resident individuals from bank deposits (on interest exceeding: (a) the CBR refinancing rate + 5 per cent, for rouble denominated loans and (b) 9 per cent per annum, for foreign currency denominated loans), deemed income accrued if the actual interest rate borne by an individual is less than two-thirds of the CBR refinancing rate\(^5\) (in respect of rouble denominated loans) or 9 per cent per annum (for foreign currency denominated loans) and certain income from the mutual credit cooperatives.

Lower profit tax rates apply to certain types of debt instrument:

- certain bonds issued by the Russian Federation government and the government of Belarus, by Russian regions and municipalities and certain mortgage-backed bonds issued after 1 January 2007: 15 per cent;
- certain medium-term municipal bonds and mortgage-backed bonds issued before 1 January 2007: 9 per cent;
- state and municipal bonds issued on or before 20 January 1997: 0 per cent.
- certain foreign currency denominated state and municipal bonds: 0 per cent.

These are bonds that were issued in 1999 to borrow money to repay the domestic foreign currency debt of the USSR and the Russian Federation.

Articles 271(6) and 272(8) of the Tax Code provide that interest income (expense) of companies in respect of a loan continuing for more than one reporting period (calendar quarter) should be recognized for profit tax purposes as of the end of each month of the respective quarters. If the loan is repaid within a given quarter, then the portion of interest income (expense) has to be recognized as of the day of repayment of the loan. Traditionally, this has been interpreted as a requirement to accrue interest income (expense) gradually through the term of the loan agreement and this practice was followed both for statutory accounting and tax accounting purposes.\(^6\)

It was not until November 2011 that the Supreme Arbitration Court gave a remarkable decision significantly affecting the recognition of interest expense for profit tax purposes. In the *SaNiVa* case\(^7\) the court ruled that no interest expense should be recognized by a borrower until the due date (date of payment) of interest, therefore effectively converting the accrual method of recognition of interest expense into the cash method. This affected a significant number of Russian borrowers (who followed the traditional approach) and could also affect the state

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\(^5\) The current CBR refinancing rate is 8.25 per cent per annum.

\(^6\) It should be noted that certain small companies may opt to use the cash method for recognition of their income (expenses) for profit tax purposes. These companies recognize their interest income (expenses) after the respective income is received (expenses are paid) in cash or in kind.

\(^7\) Decision of the Supreme Arbitration Court no. 11200/09 of 24 November 2009.
(as the same principles should then apply to recognition of interest income, which implies significant overpayment of profit tax by companies that followed the traditional approach). The tax authorities expressed their vigorous disagreement with the position of the Court,\(^8\) which may imply that they will stick to the traditional approach. The position of the tax authorities in adhering to the traditional approach was further confirmed by the Ministry of Finance.\(^9\) Later, in the Logopark Mezhdurechye case,\(^10\) the Court attempted to narrow the ramifications of the SaNiVa jurisprudence to situations where, under the terms of a loan agreement, interest should be accrued after the principal amount is repaid; however, uncertainties about the tax treatment of interest income (expenses) remain.

The cash method applies the recognition of interest income (expenses) for personal income tax purposes. It should be noted that deductibility of interest expense by individuals is primarily limited to cases where:

(a) an individual carries out entrepreneurial activities as an individual entrepreneur; or

(b) an individual who is not registered as an individual entrepreneur but incurs interest expense to perform works or render services for the benefit of a third party customer under a civil law contract; or

(c) the underlying loan is received from a Russian company (including a Russian bank) or an individual entrepreneur and relates to acquisition of a house, an apartment or any part thereof, or a land plot used for accommodation of the living premises.

Thus, an individual who receives the loan for his private use would generally be unable to deduct interest for personal income tax purposes.

Although the law on profit tax provides more opportunities for both Russian companies and permanent establishments of foreign legal entities to recognize interest expense (if such expense is linked to income generating activities of these companies and is properly documented), deductibility of interest is still subject to a number of statutory limitations.

Russian tax law generally allows the deductibility of interest if the interest rate applied under a loan agreement does not deviate by more than 20 per cent from the average interest rate applied on comparable loans (i.e. loans with similar principal amounts; in the same currency; with similar terms of repayment; with similar types of security, if applicable) issued by Russian lenders to the same borrower in the same quarter. If no such comparable loans are available the statutory safe harbour threshold interest rates would apply. The statutory safe harbour threshold interest rates are:

- \(1.1 \times \) the CBR refinancing rate (currently the CBR refinancing rate equals 8.25 per cent per annum) for rouble denominated loans;
- 15 per cent per annum for foreign currency denominated loans.

Due to the rise of the cost of borrowing during the days of the financial crisis and the attempts of the Russian government to discourage Russian companies from borrowing money on the foreign financial markets the above safe harbour thresholds

\(^8\) See, for example, Letter of the Federal Tax Service no. 3-2-06/22 of 17 March 2010.
\(^9\) See, for example, Letter of the Ministry of Finance no. 03-03-06/1/57 of 3 February 2011.
\(^10\) Decision of the Supreme Arbitration Court no. 17586/10 of 7 June 2011.
were temporarily substituted by Federal Law no. 229-FZ dated 27 July 2010 which provided the following temporary safe harbour thresholds:

- \(1.8 \times \text{the CBR refinancing rate for rouble denominated loans (from 1 January 2010 to 31 December 2012);}\)
- \(0.8 \times \text{the CBR refinancing rate for foreign currency denominated loans (from 1 January 2011 to 31 December 2012).}\)

Finally it should be noted that the above harbour interest rates may also apply if a taxpayer explicitly chooses this option (usually this option could be stated in the tax accounting policy of the taxpayer).

Apart from general deductibility limitations which apply to any Russian borrowers in respect of all sorts of borrowings, Russian law provides for thin capitalization rules which primarily target Russian companies with foreign investments. Generally Russian thin capitalization rules affect deductibility of interest if:

(a) debt financing is provided by a foreign legal entity which directly or indirectly owns more than 20 per cent of the Russian entity financed (“qualifying shareholder”); or
(b) debt financing is provided by a Russian affiliate of the foreign entity; or
(c) debt financing is provided by any other person (whether related or unrelated to the borrower) but repayment of the loan is guaranteed or secured in any other way by the foreign entity or its Russian affiliate (such debt is defined as the “controlled debt”); and
(d) in any of the above scenarios the controlled debt–equity\(^{11}\) ratio of the borrower exceeds 3:1\(^{12}\) as of the last date of each reporting\(^ {13}\) (tax)\(^ {14}\) period.

Based on the above it could be concluded that the thin capitalization rules would apply when a loan was extended from (a) a foreign parent company, (b) a foreign grandparent company, (c) a foreign great-grandparent company and so forth up the holding tree, if the ultimate holding of the foreign lender in the capital of the Russian borrower exceeded 20 per cent.

The thin capitalization rules may also be applicable if the loan is extended by some Russian lenders. The tax law itself does not define the term “affiliate”. Therefore, reference is usually made to Russian anti-monopoly legislation which contains a rather broad definition of this term.\(^ {15}\) From this definition one can easily derive that the mere fact that a loan is extended by one Russian company to another Russian company (e.g. between sister companies) may not in itself save the Russian borrower from the application of the thin capitalization rules. Moreover, the borrower may even be under threat where the lender is an independent Russian or foreign financial institution (e.g. bank) but the loan is secured by a foreign direct or

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\(^{11}\) In this case equity equals net assets of the borrower increased by the amount of accrued tax liabilities.

\(^{12}\) The debt–equity ratio equals 12.5:1 for banks or financial lease companies.

\(^{13}\) The reporting period is generally a calendar quarter.

\(^{14}\) The tax period for profit tax purposes is a calendar year.

\(^{15}\) Federal Law no. 948-I of 22 March 1991 and Federal Law no. 135-FZ of 26 July 2006. The affiliates, \textit{inter alia}, include a company and its board members or CEO; companies in which one individual or one legal entity has more than 50 per cent of the stake in capital or voting rights (in each of them); companies with the same person (individual or legal entity) acting as CEO, companies in which the CEO has been nominated by the same person (individual or legal entity); companies in which the same people constitute more than 50 per cent of the board, etc.
indirect qualifying (more than 20 per cent) shareholder in a Russian sister company of the borrower.

Although Russian thin capitalization rules seem rather comprehensive, they have two gaps in their scope. First, they do not apply to permanent establishments of foreign legal entities. Also they do not apply to foreign affiliates of qualifying shareholders. In practice the reporters see many multinational businesses financing their Russian subsidiaries through foreign sister companies. Although the Russian tax authorities try to extend the scope of the thin capitalization rules to combat such structures, they have not been successful until now (as amendments to the law are required to close this loophole).

In general, the thin capitalization rules have a twofold effect:
• limitation of deductibility of interest expenses for the borrower;
• reclassification of the excess portion of interest into dividend income (“deemed dividends”) of the lender and making this income subject to 15 per cent profit tax. This rate should apply in respect of the deemed dividends due to both Russian and foreign lenders.16

The thin capitalization rules should not apply to individuals. However, individual entrepreneurs could potentially be subject to general limitations on deductibility of interest.17

It should be finally mentioned that neither the extension of a loan, nor the repayment of the principal amount is subject to tax.

2.2. Tax treatment of equity

Capital contributions are generally tax neutral, meaning that they trigger no tax implications either for the receiving or for the contributing party.

Dividend income received by a Russian company or a Russian individual from a Russian or foreign subsidiary is generally subject to 9 per cent profit or personal income tax.

Zero per cent profit tax rate may apply to dividend income received by a Russian company from its Russian or foreign subsidiary, provided the following criteria are met as of the day of declaration of the dividends:
(a) the Russian company owns at least 50 per cent of the capital of the subsidiary (“qualifying interest”) or owns depositary receipts which entitle the company to receive at least 50 per cent of dividends distributed by the subsidiary; and
(b) the qualifying interest in the capital or depositary receipts is held for an uninterrupted period of 365 calendar days; and
(c) if the dividend income is received from a foreign subsidiary, this foreign subsidiary should not be resident in a state included in the list of non-cooperative tax havens introduced by the Ministry of Finance (the list currently covers 42 jurisdictions).

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16 Letter of the Ministry of Finance no. 03-08-05 of 24 December 2009; Letter of the Ministry of Finance no. 03-03-06/1/435 of 2 July 2009. In respect of foreign lenders the tax authorities allow reduction of this rate under the dividend provisions of the applicable DTTs.
17 Art. 221 (1) of the Tax Code.
The national tax regime for dividend income should generally be extended to dividends attributable to permanent establishments of foreign legal entities.\textsuperscript{18}

The profit or personal income tax due in respect of dividend income received from a Russian subsidiary is generally withheld by the payer. Dividends received from foreign subsidiaries have to be declared and paid by Russian recipients (both Russian companies and individuals) on a self-assessment basis.

Where dividends are paid by a Russian subsidiary to its Russian shareholders (both Russian companies and individuals), the amount of profit or personal income tax due is determined under the following formula:

\[
\text{Tax} = C \times R \times (d - D)
\]

where C is the share of the respective shareholder in the total amount of dividends to be distributed by the subsidiary; R is the applicable tax rate; d is the total amount of dividends to be distributed by the subsidiary; D is the total amount of dividend income received by the subsidiary prior to distribution of dividends to its own shareholders. This amount does not include dividend income which was subject to a zero per cent profit tax rate.

In summary, the above formula implies the partial imputation of dividend income.

Foreign taxes paid in respect of dividend income received from foreign subsidiaries could be credited against Russian profit or personal income tax but only if such a credit was available under an applicable DTT.

Dividends are treated as non-deductible items for profit tax purposes.

2.3. Withholding rates and tax treaty policy

Under Russian domestic tax law the gross amount of interest income payable to the foreign lender is subject to 20 per cent withholding tax. The rate could be reduced to zero under many Russian DTTs. Still some DTTs (e.g. the 1995 Russia–Ukraine DTT; the 1995 Russia–Switzerland DTT; the 1994 Russia–Israel DTT) provide for a reduced tax rate which may, for example, constitute 5 per cent or 10 per cent. Interestingly, the Russian model tax convention\textsuperscript{19} which outlines the domestic tax policy in respect of conclusion of DTTs does not provide for elimination of withholding tax on interest and offers a reduction of the applicable withholding tax rate to 10 per cent. This will probably become the position of the Russian competent authorities in negotiating treaties in the future.

In respect of dividend income Russian DTTs provide for reduced withholding tax rates which do not drop below 5 per cent for companies and 10 per cent for individuals. The Russian model tax convention is less generous in reducing the dividend withholding tax to 10 per cent.


\textsuperscript{19} As adopted by the Decree of the Government no. 84 of 24 February 2010.
Until now the provisions of DTTs have also been used extensively by taxpayers as a defence against Russian thin capitalization rules which, as described here, target Russian companies with foreign capital.

The first landmark case on this matter, the Ferrotek case, reached its final stage in July 2005. The court rejected the application of the thin capitalization rules to the loan extended to the Russian borrower by its 76 per cent German shareholder based on the following arguments.

The court examined the definition of dividend income under the 1996 Germany–Russia DTT (which is similar to that in the OECD model tax convention) and identified no room for extension of this term to interest income reclassified into dividends under Russian domestic tax law. Essentially, the court imported an autonomous interpretation of the term.

The court further referred to the special provision of paragraph 3 of the protocol to the DTT which supports the unlimited deductibility of interest and confirmed that this provision should prevail under any provisions of Russian domestic tax law.

As the result of these two arguments the court concluded that the Russian borrower should enjoy unlimited deductibility of interest and that interest income should not be reclassified as dividends for treaty purposes, thus protecting the interest from Russian withholding tax. Notably the court mentioned one of the non-discrimination provisions of the treaty but no clear statement on the importance of this provision in protecting against domestic anti-abuse measures was made.

The Ferrotek case was soon followed by another similar case (a loan between a Russian subsidiary and its 99.99 per cent Dutch parent company) but on a different circuit; it concerned the application of the 1998 Netherlands–Russia DTT. Although the courts used many of the same arguments, the judicial pronouncements in Swedwood Tikhvin were more explicit in terms of interpretation of provisions of the DTT. In particular the Court of Appeal provided some discussion regarding the application of non-discrimination provisions of the treaty. Probably this was the first time that the non-discrimination provisions, which were previously considered by many tax scholars and practitioners as no more than declaratory wishes, were given true legal weight. The court chose the “source of financing” and “holding” non-discrimination provisions to rule that Russian thin capitalization rules were not in line with non-discrimination principles due to the fact that the thin capitalization rules would not be applicable if the borrower was owned by Russian shareholders. The autonomous interpretation of dividend provisions was further backed up by analysis of the definition of interest income under the treaty. The court came to the conclusion that the definitions of dividend income

21 Section IV of the 1996 Netherlands–Russia DTT contains a provision supporting deductibility of interest which is similar to that in the German treaty (although this provision does not contain the word “unlimited”).
24 Those inspired by paras. 4 and 5 of art. 24 of the OECD model tax convention.
and interest contained in the treaty clearly separated the two types of income and therefore did not authorize any reclassification.

Although both decisions marked a trend towards resolving the thin capitalization issue, they were not considered full precedents due to the specificity of the underlying treaties (i.e. special provisions enhancing deductibility of interest). Although some other treaties contain similar rules enhancing the deductibility of arm’s length debt financing costs (or even the provisions covering a broader list of business expenses), the majority of treaties do not make such additional protection available. It was interesting, therefore, whether the non-discrimination argument could play on a stand alone basis.

It was not long before this issue crystallized in two court pronouncements which were remarkably issued on the same day. The AEK case concerned a loan granted by a Finnish company to a Russian to its 96.4 per cent subsidiary; the Field Invest case dealt with parent–subsidiary debt financing from Cyprus. Neither the 1996 Finland–Russia DTT nor the 1998 Cyprus–Russia DTT contain any special provisions enhancing deductibility of interest. However, the non-discrimination and the “autonomous interpretation” arguments were enough for the courts to provide protection against assessments made by the tax authorities. This looked like the establishment of a solid basis for relief from the discriminatory provisions of Russian thin capitalization rules.

Remarkably the court in the Field Invest case implied obiter dictum that treaty protection was not absolute and that a treaty could not override the general statutory limitations on the deductibility of interest (as discussed above). Therefore, these should be observed when developing cross-border debt financing structures.

Over the years the Russian tax authorities have become more and more sophisticated in arguing in thin capitalization cases, which was demonstrated in the recent Gidromashservice case. The case concerned a group of companies which were involved in property development projects in Russia. The group included a Cyprus parent company and its two subsidiaries: a Russian company and a Hungarian company. The parent company went for an initial public offering on the London Stock Exchange. In addition the Cyprus company traded its bonds on the Tel Aviv Stock Exchange. The funds made available to the company were used to finance the Russian project. Some financing was provided to the Russian company directly from the parent company; however, most funds were received through the Hungarian sister company.

The tax authorities applied the thin capitalization rules and the taxpayer went to court. The lower court followed by the Court of Appeal sustained the position of the tax authorities but that was finally reversed the Federal Moscow District Arbitration Court.

The Gidromashservice case led the professional community to believe that the treaty protection from the thin capitalization rules was strong enough to rely upon

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25 See, for example, Russian treaties with Belgium (1995), France (1996), the USA (1992).
28 Decision of the Federal Moscow District Arbitration Court no. KA-A40/7211-10 of 13 July 2010.
but that was not the end of the story. In mid-2011 a new thin capitalization case became a hot topic. In the *Northern Kuzbass Coal Mining Company* case\textsuperscript{29} the taxpayer won in the court of the first instance, the Court of Appeal and the Federal District Arbitration Court. However, the tax authorities were successful in persuading the Supreme Arbitration Court to take the case. The preliminary pronouncement of the bench of three justices of the Supreme Arbitration Court\textsuperscript{30} criticized the position of the lower courts when deciding that a further appeal should be allowed, which may imply that the position of the Supreme Arbitration Court could be negative for taxpayers and that treaty arguments could no longer be available. The hearing of the final appeal was scheduled for the middle of November 2011 and the results of the hearing were not known by the reporters as of the day of completion of the report.

Apart from seeking an appeal in the Supreme Arbitration Court, the Russian government has decided to ensure the application of the thin capitalization rules by amending treaties.\textsuperscript{31} The Czech Republic and Cyprus became the first victims of the new tax policy. The recently signed protocol to the 1998 Cyprus–Russia DTT (not yet ratified) specifically puts reclassified interest income under the umbrella of dividends and moves it outside the scope of the “interest” article of the treaty. It may also be expected that the same clauses will be included in new Russian treaties as well.\textsuperscript{32}

Based on the above, it could be concluded that although Russian taxpayers currently successfully invoke treaty protection against domestic thin capitalization rules, this opportunity may become limited or even no longer available in the future.

### 2.4. Other considerations

#### 2.4.1. Rate structure

As may be see from the above, taxation of dividend income is more generous in the domestic context (i.e. when dividend income is received by a Russian company, a Russian individual or is attributable to a permanent establishment of a foreign company). From this perspective equity financing will probably be preferred. It should be noted, though, that lack of deductibility of equity could affect the choice of investors, as the positive tax effect from lower income tax rates on dividends may


\textsuperscript{30} Decision of the Supreme Arbitration Court no. BAC-8654/11 of 12 August 2011.

\textsuperscript{31} It should be noted that some existing treaties already have special provisions protecting domestic anti-abuse measures in general (1996 Italy–Russia DTT) or thin capitalization rules in particular (2004 Mexico–Russia DTT; 2000 Portugal–Russia DTT; 1998 Spain–Russia DTT) from override by the treaty.

\textsuperscript{32} The Russian model tax convention also explicitly states that reclassified interest income will be treated as dividends. The model also explicitly states that the non-discrimination provision should not affect the application of domestic thin capitalization rules. This means that Russia will be pursuing this approach in its negotiations with the new treaty partners or renegotiations of the existing treaties. Therefore, one could expect that similar provisions will generally become the law unless the treaty partner vigorously opposes it (which is unlikely).
be eroded by the negative tax effect of equity on taxable profits of the borrowing entity.

In the international context debt financing would probably be the preferred solution. Although some Russian DTTs do not protect Russian source interest income from withholding tax, many do, so cross-border debt financing could usually be structured in a tax efficient manner (to compare with equity financing). At the same time the reduction of the profit tax base of Russian operating companies provides an additional attraction for debt financing.

In both scenarios due regard should be given to the thin capitalization rules, as reclassification of interest into dividends may reduce the positive tax effect of debt financing.

2.4.2. Tax treatment of business entities

Russian tax law does not provide for the fiscal transparency concept. All legal entities, both Russian and foreign, which bear separate legal personality under applicable corporate law, should qualify as distinct persons for tax purposes.

Therefore, the tax status of business entities should not, in the view of the reporters, affect the choice between debt and equity financing.

3. Classification as debt or equity

3.1. General approach to characterization

Both dividend and interest income are defined under Russian domestic tax law. Article 43(1) of the Tax Code defines dividends as any income received by a shareholder (participant) from a company upon distribution of profits in connection with shares (interest) owned by this shareholder (participant) pro rata to the share of the shareholders (participants) in the capital of the company. Distribution of profits in connection with preferred shares is explicitly mentioned as an example of dividend income.

In respect of income received from foreign companies Russian tax law provides that these profits will qualify as dividend income for Russian tax purposes if they qualify as such in accordance with the applicable foreign law. The Tax Code, however, remains silent on the classification of income if different treatment is assigned to income under the corporate and tax law of the respective state (if, for example, income is treated as dividends under corporate law but qualifies as interest under tax law of the same state).

The following items are explicitly excluded from the scope of definition of dividends:

- liquidation proceeds due to a shareholder (participant) of a company to an amount not exceeding the amount of capital contributions received from this shareholder (participant);
- issuance of additional stock to the existing shareholders;
- profit distributions to non-commercial organizations from their wholly owned subsidiaries.
Article 43(3) of the Tax Code defines interest income as any predetermined income (including discount) received under a debt arrangement of any kind (notwithstanding the form thereof).

In principle the tax authorities are allowed to reclassify the business activities of a taxpayer; the collection of taxes, interest and penalties arising from the reclassification may only be performed through a court.\(^{33}\) Should the court agree with the reclassification performed by the tax authorities it has to determine the tax liabilities of the taxpayer based on the new classification of its activities.\(^{34}\) In particular, reclassification may take place if the classification of activities by the taxpayer contradicts the economic substance of these activities.\(^{35}\)

3.2. Role of the tax authorities

Overview of the current court practice indicates that apart from reclassification of interest into dividends under the thin capitalization rules (which is directly sanctioned by Russian domestic tax law) the tax authorities also sometimes use the reclassification mechanism from time to time to increase the tax liabilities of taxpayers. In particular, attempts at reclassification of dividends into other income,\(^{36}\) reclassification of payroll (bonuses) into dividend income\(^{37}\) and reclassification of royalties paid to the shareholder for use of knowhow into dividend income\(^{38}\) may be found. As may be seen from available court practice the courts are usually cautious in supporting reclassification for tax purposes.

The reporters identified no cases where interest income was reclassified into dividends (outside the scope of the thin capitalization rules) or vice versa. However, the existing practice suggests that the tax authorities and courts will probably refer to definitions of dividends and interest as the initial step of their classification analysis. If a certain financing instrument does not meet the statutory criteria of debt financing the tax authorities may in principle attempt to apply the definition of dividend income to this instrument. If the instrument does not qualify as either a debt financing vehicle or dividend distribution, then it will probably be characterized as general taxable income. If the debt instrument is sophisticated (i.e. consists of a number of related transactions) it is difficult to predict whether this instrument will, nevertheless, be viewed as an integral whole for tax purposes.

33 Art. 45 (2-3) of the Tax Code.
34 Para. 7 of the Decision of the Plenary Session of the Supreme Arbitration Court no. 22 of 10 April 2008.
35 Para. 7 of the Decision of the Plenary Session of the Supreme Arbitration Court no. 53 of 12 October 2006.
Where the nature of the instrument may change over time (i.e. convertible bonds may be converted into shares), income from the instrument will probably be classified each time based on the current nature of relationships between the parties. Once the convertible bond is issued, it will be treated as a debt instrument (income will be classified as interest) until conversion takes place. So any distributions from the debtor after the bonds are converted into shares will be classified as dividend income.

The taxpayers may apply to the Ministry of Finance for clarification of tax treatment of the financing instruments. These clarifications should generally safeguard the taxpayer from late payment interest and penalties (but not from assessment of tax), if the taxpayer follows them and the clarifications are based on correct information. The problem is that the Ministry provides clarifications with regard to interpretation of the law and does not provide rulings in respect of specific cases. So, in practice the taxpayer may find it difficult to formulate its application in such a manner as to be able to obtain clear classification of the financing tools for Russian tax purposes.

4. Targeted government approaches to address issues raised by classification rules

4.1. Targeted rules

Apart from general limitations on the deductibility of interest and the thin capitalization rules, there is probably only one rule which specifically addresses the deductibility of interest under hybrid financing tools. As described above, Russian domestic tax law treats preferred stock interest as dividend income and taxes such income accordingly.

Currently Russian transfer pricing rules do not apply to debt financing. With the new transfer pricing law becoming effective starting from 1 January 2012, this practice may change in the future (at least, this is the intention of the government). Thus, deductibility of interest could become challengeable not only on the basis of general limitations on the deductibility of interest and the thin capitalization rules but also based on general transfer pricing principles. It is unlikely that existing Russian DTTs will provide any protection in respect of the new Russian transfer pricing rules.

4.2. Interaction of thin capitalization rules with reclassification

As may be seen from the above description of Russian thin capitalization rules, reclassification of debt into equity is one of the key features thereof. From this perspective it could be concluded that reclassification is the tool utilized by the thin capitalization rules to achieve its primary goal, i.e. prevention of erosion of the profit tax base of Russian companies. At the same time classification of income does not generally depend on the capital structure of a Russian company.

On the other hand, the thin capitalization rules apply only in respect of interest. Thus, income should first qualify as interest income to become potentially subject
5. Financial market responses to tax and other constraints on achieving desired goals

As the range of hybrid financing instruments available in Russia is rather limited, traditional debt financing instruments are preferred in practice. This, however, does not mean that no hybrid financing instruments are used in Russian inbound investment projects.

As an example, Luxembourg or the Netherlands are often used to finance Russian operations of a multinational group of companies. Whereas ordinary loans are extended from a Luxembourg/Dutch financing vehicle to Russian operating companies, the profit participating loans are widely used to make financial resources available to the Luxembourg/Dutch company.

As a response to application of the thin capitalization rules, the reporters see more and more investors using foreign sister companies to provide debt financing to Russian operating entities. As pointed out above, Russian thin capitalization rules do not apply to foreign affiliates of Russian borrowers. Another trend is the more extensive use of the permanent establishment of foreign legal entities as tools for carrying out commercial activities in Russia (in particular, in respect of landed property projects). Although a number of other commercial and tax reasons could be behind this choice, one of the reasons is greater flexibility for financing permanent establishments.

6. Structural changes to address the debt–equity distinction

Although no major structural changes affecting the distinction between debt and equity are currently planned by the government, certain steps are supposed to make the Russian financial market more attractive from a tax point of view:

- the introduction of exemption of Eurobonds issued by federal, regional or municipal governments from withholding income tax to facilitate direct subscriptions (instead of using foreign special purpose vehicles);
- the introduction of exemption of capital gains from the alienation of qualifying shares publicly traded on the Russian market from Russian withholding income tax.

39 See the 2012–2014 Tax Policy Main Directions issued by the Ministry of Finance, the official website of the Ministry of Finance: www.minfin.ru.
40 Under Russian domestic tax law gains from alienation of shares by a foreign company having no permanent establishment in Russia are subject to Russian withholding tax if the target company is
the introduction of a neutral tax regime in respect of GDRs, ADRs and Russian depositary receipts, in particular in respect of conversion of depositary receipts into shares (nowadays the tax regime of these instruments remains unclear);

- the facilitation of deductibility of losses in respect of promissory notes when the issuer becomes insolvent (this is a hot topic now, in particular for the banks).

cont.

a Russian company having more than 50 per cent of its assets represented by immovable property located in Russia (“qualifying shares”). However, the gains from alienation by foreign companies of qualifying shares on the foreign stock exchanges are deemed foreign source income and are exempt from Russian withholding tax.