

Legal Alert

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Tax Reforms Towards the Creation of an International Financial Center in Russia

Changes to the Russian Holding Companies Regime

In December 2009 the Russian Parliament adopted important changes further promoting the Russian holding companies regime. Starting from January 1, 2011 Russian holding companies will no longer be required to meet the present 500 million ruble threshold for investments made into companies qualifying as "strategic investments" to receive tax benefits.

Under the amended rules, Russian holding companies will be exempt from profits tax on dividends payable by foreign and Russian subsidiaries qualifying as "strategic investments", provided that, on the day the corporate decision to pay dividends is taken, the following conditions are met:

- (1) the recipient of the dividends has continuously held shares for not less than 365 days;
- (2) the recipient of the dividends owns not less than 50% of the shares in the company paying the dividends; and
- (3) the company paying the dividends is not located in a jurisdiction included in a "black list" of offshore jurisdictions adopted by Order No. 108n of the Russian Ministry of Finance, dated November 13, 2007 (the "black list" includes most of the offshore low-tax jurisdictions and territories, including Cyprus).

In the absence of a high investment threshold, structuring of both domestic and foreign investments on the basis of a Russian holding company will not be associated with additional tax costs on dividends. However, the Russian holding companies regime does not extend to capital gains on sales of shares in subsidiaries, which makes Russia less attractive than some of the typical holding jurisdictions.

Changes in Taxation of Securities and Derivatives

At the end of 2009 the Russian Parliament passed Federal Law No. 281-FZ, dated November 25, 2009, introducing a number of important changes to the tax treatment of securities and derivatives trading, repo transactions and stock loans in Russia as well as other related laws ("Law 281-FZ"). The majority of its provisions became effective as of January 1, 2010. The major amendments affecting companies in Russia are discussed below.

Taxation of Securities

Under the new rules, securities must have a market quotation calculated within the three months prior to the transaction to be recognized as tradable securities.

The procedure for determining the market price for securities has been amended. The maximum period for determining the transactions included in the pricing range for tradable securities (in the absence of trades on the transaction day) is limited to three months. This decreases the risk of a transaction price significantly deviating from the reference price in case of high market volatility. For non-tradable securities the reference price can no longer be determined based on the price of similar securities, which eliminates the risk of the Russian tax authorities choosing undue comparables. If the transaction price deviates by more than 20% from the reference price, the profit/loss of a taxpayer is calculated based on the reference price and the allowed deviation. The procedure for calculating the reference price for non-tradable securities is to be established by the Federal Service on Financial Markets ("FSFM") subject to approval by the Ministry of Finance.

Taxpayers are no longer allowed to apply the LIFO method in tax accounting of securities trading. Companies that previously applied the LIFO method will need to make amendments to their tax accounting policy.

Taxation of Derivatives

Law 281-FZ defines derivatives by referring to a new concept of a derivative, introduced in the Federal Law "On the Securities Market". The list of derivatives (including forwards, futures, options and swap-contracts) is to be adopted by the FSFM. Derivatives that are not on this list will not be recognized for tax purposes in Russia. Derivatives having an underlying asset calculated based on changes in statistical information or environmental indicators (e.g., weather derivatives) are not recognized as derivatives for tax purposes in Russia.

The Tax Code literally establishes that contracts not subject to judicial protection in accordance with Russian legislation are not to be recognized as derivatives for tax purposes, which would disallow costs, in particular losses on derivatives, from being recognized for tax purposes. This regulation refers to Article 1062 of the Russian Civil Code, under which a number of derivative contracts enjoy judicial protection. However, when a transaction is not governed by Russian law, it is unclear whether it is sufficient for tax purposes that it is subject to protection in accordance with some other law, and not with Russian law, or whether it would be necessary that it has features that would allow it to be protected under Russian law.

As previously, legal entities are entitled to combine financial results on transactions with derivatives tradable on an organized stock exchange together with the results of their ordinary operations. Financial results on transactions with non-tradable derivatives form a separate tax basis which cannot be combined with other financial results (exceptions are made for banks and professional dealers), unless they qualify as hedging. The criteria for transactions to be classified as hedging have been expanded: now it is enough to prove that a derivative or a series of derivatives is aimed at decreasing the taxpayer's potential losses. Law 281-FZ has established a procedure for recognizing financial results on hedging transactions in case of early termination of an underlying (hedged) contract.

The new rules have clarified some previously unclear issues. In particular, deliverable derivatives and contracts with differed maturity are not reclassified as non-deliverable derivatives in case of netting; changes in prices, market quotations, currency exchange rates, indexes or other indicators do not trigger revaluation of tradable and non-tradable derivatives. The procedure for determining the market price of derivatives has been amended in a way similar to the procedure for determining the market price of securities.

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The new rules have clarified the application of VAT to derivative transactions. VAT is not levied on the sale of derivatives (but is levied on the delivery of commodities subject to VAT). VAT is accrued on the value of the commodity indicated in the deliverable derivative.

Other Issues

Law 281-FZ has introduced new detailed rules clarifying the tax treatment of repo transactions (including cross-border repo transactions) and stock-lending.

Law 281-FZ has also improved the tax regime of securities and derivatives trading for individual investors. The law has introduced new rules for recording financial results on transactions with different categories of securities and derivatives for tax purposes. Individual investors have received the right to carry forward losses on tradable securities and tradable derivatives for ten years.

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