Thin Capitalization – International Experience and Russian Practice

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Introduction

The thin capitalization rule was integrated into the Russian Tax Code in 2002. This special rule for tax treatment of interest paid on loans was introduced as a means of fighting tax minimization.

It will be noted that the rule of thin capitalization with the same goal (fighting illegal tax optimization and non-payment of taxes) is known to the laws of many foreign states.

In Germany, for example, the thin capitalization rule has been known for long as a way to tackle tax dodgers. To enhance the level of the tax system administration, however, the rule was changed significantly. Germany ended up with two important tax acts changing significant parts of the tax rules in 2007; the so–called Company Tax Reform Act 2008 (CTRA) and the so–called Tax Act 2008 (TA) were adopted. The rules of both acts have basically entered into force with effect from January 1, 2008. The thin capitalization rules are being tightened by the tax reform. The amended version of these rules is generally very important to foreign groups and investors. They apply to corporations with German taxable income, even for foreign PropCos holding German real property.

France is one of the few countries where interest expenses borne in connection with the acquisition of shares or financing (also by the "related parties") are tax deductible. There is also no "catch-all" statutory thin capitalization or interest coverage ratio rule limiting the level of debt or interest expenses which a company may incur. Financial

expenses are therefore, in principle, deductible from the taxable profits of a French company provided the loan is concluded in its best interest, is commensurate with its financial capacity and is at arm's length. Since 2007, the above rules have been subject to amendments that govern the deductibility of interest incurred in respect of loans granted by shareholders and, for tax years beginning on or after 1 January 2007, by "related entities" (introduced by The Finance Act 2006).

The mechanism for enforcing the thin capitalization rule may be found in UK laws, too. These rules, however, were also reviewed and amended in 2004 (The Finance Act 2004). Until the Finance Act 2004, the UK thin capitalization rules normally only applied where borrower and lender, or borrower and guarantor, were liable to tax in different countries. This was because if "too much" tax relief was granted to a UK borrower the "excess" interest or other costs would generally be taxable in the hands of the UK lender. However, as a result of an EU tax case (Lankhorst-Hohorst GmbH v Finanzampt Steinfurt (ECJ case C-324/00)) it became apparent that the UK's thin rules were open to challenge. Rather than remove the UK thin capitalization rules entirely the Inland Revenue by The Finance Act 2004 extended the rules to transactions involving UK lenders.

As for the Russian Federation, according to the general principles of Section 25 of the Russian Tax Code, an organization may reduce its profit for profit tax purposes by the amount of expenditures. Effective Russian tax legislation provides for reducing the profit by the amount of expenditures incurred by payment of interest on loans.

Grounds for applying the special rule for taxing controlled debt interest

Specific aspects of including interest on debt liabilities into expenditures that reduce the taxable base are governed by Article 269 of the Russian Tax Code.

Under Article 269(2) of the Russian Tax Code, a special procedure for deducting interest on debt liabilities applies when interest-bearing profits are paid by Russian organizations with outstanding:

- debt liability with respect to a foreign organization which directly or indirectly owns more than 20 percent of the authorized (share) capital (fund) of this Russian organization,
- debt liability to a Russian organization deemed to be an affiliate of such foreign organization under Russian legislation,
- debt liability with respect to which such affiliate and (or) foreign organization acts as a co-signer or guarantor or otherwise undertakes to ensure the performance of the Russian organization's debt obligations,
- if the controlled debt to a foreign organization is more than three times (for banks and organizations engaged in leasing activity, more than twelve times and a half) bigger than the difference between the sum of its assets and the amount of liabilities of a Russian corporate taxpayer (hereinafter in this paragraph the "one's own capital") as of the latest day of the reporting (tax) period.

The following conditions are necessary (and sufficient) for the obligation to apply "the special rule for tax treatment of interest on controlled debt" to arise:

1. affiliation (interdependency) of the Russian borrower and the foreign creditor (or the guarantor)
2. the loan exceeds the capital of a non-banking organization more than three times.

Affiliation of the creditor or guarantor

The procedure for determining affiliation contains three rules:

The first rule of affiliation is included in Clause 2, Article 269: the creditor directly or indirectly (through participation in other companies) owns more than 20% of the borrower's shares or participatory interest.

The second rule refers to Russian civil legislation, specifically Law No. 948-1 "On Competition and Limitation of Monopolistic Activities on Commodity Markets" of March 22, 1991, under which individuals and legal entities capable of influencing the operation of legal entities and (or) individuals engaged in entrepreneurial activities are deemed to be affiliated. Specifically these are:

- members of the Board of Directors (supervisory council) or another collegial governing body, a member of its collegial executive body, as well as a person acting as a sole executive body;
- persons belonging to the same group which includes such legal entity;
- persons authorized to dispose of more than 20% of the total number of votes represented by voting shares, or of contributions or participatory interest in such legal entity that make up the authorized or share capital;
- a legal entity in which such legal entity is entitled to dispose of more than 20 percent of the total number of votes represented by voting shares, or of contributions or participatory interest in such legal entity that make up the authorized or share capital;
- if a legal entity is a member of a financial and industrial group, its affiliated persons include also members of the Boards of Directors (supervisory councils) or other collegial governing bodies, collegial executive bodies of the members of such financial and industrial group, as well as persons acting as the sole executive bodies of the members of such financial and industrial group; etc.

In other words, effective Russian legislation provides for a maximum range of signs of a borrower/creditor affiliation.

According to the third rule, for tax purposes under the special rule of Clause 2, Article 269 of the Russian Tax Code, not only the creditor's affiliation, but also affiliation (in respect to the borrower) of the person acting as the co-signer or guarantor or otherwise required to ensure the performance of the borrower's debt obligations is subject to control. This rule is designed to prevent attempts to "bypass" the main rules above.

Insufficient own capital

Under Article 269(2) of the Russian Tax Code, one's own capital is determined as "the difference between the amount of an organization's assets and the amount of its liabilities".

Moreover, under Article 269(2) of the Russian Tax Code, when determining the size of one's own capital, the amount of debt liabilities in the form of tax and duty arrears, including current tax and duties liabilities, the amount of deferments and installments and investment tax credits are not taken into account.

However, tax and duty arrears do not include overdue mandatory pension contributions (paragraph 2 of the Russian Finance Ministry Letter No. 03-03-06/1/23 of January 23, 2007).

According to the Finance Ministry's Letter No. 03-03-06/1/36 of January 26, 2007 and Letter No. 03-03-04/1/322 of October 31, 2005, a non-banking organization's own capital, as a general rule, is the difference between the bottom line in the balance sheet and the sum of the bottom lines in Section IV "Long-Term Obligations" and Section V "Short-Term Obligations" in the balance sheet.

If there are signs of affiliation (interdependency) between a Russian borrower and a foreign creditor (or guarantor) mentioned in 2.1. above, and if the loan exceeds one's own capital more than three times (2.2. above), the debt due on the loan is deemed to be a "controlled debt", where the "special rule for tax treatment of interest paid on loans in a controlled debt situation" applies.

If, as of the last day of the reporting period, a controlled debt is more than three times (for banks and organizations engaged in leasing activities, more than twelve times and a half) bigger than one's own capital, the following steps have to be taken in order to determine the interest to be deducted:

Determining the capitalization ratio (CR)

This ratio is determined as controlled debt divided by the amount of one's own capital corresponding to the foreign organization's direct or indirect participatory interest in the authorized capital of a Russian organization, and as the obtained result divided by three, i.e. as described in the formula below:

$$CR = CD / (OC \times PI) / 3,$$

where ***CR*** *is the capitalization ratio;*
CD *is the controlled debt;*
OC *is one's own capital; and*
PI *is the participatory interest of a foreign organization in the taxpayer's authorized capital.*

Calculating the maximum interest recognized as expenditures

The actual interest computed in the reporting (tax) period with respect to the controlled debt should be divided by the capitalization ratio, using the following formula:

$$MI = AI / CR,$$

where ***MI*** *is the maximum interest that may be included into expenditures;*
AI *is the actually accrued interest for the controlled debt;*
CR *is the capitalization ratio.*

Comparing the actually accrued interest (AI) with the maximum interest (MI).

If, upon comparison, AI turns out to exceed MI, the general rule of taxation will apply to the maximum interest (MI) (reducing the taxable profit), while the difference between AI and MI will be taxed by a special procedure that does not reduce the taxable profit and equals to the dividends subject to the dividend tax.

Withholding taxes from interest and dividend payments to a foreign company is a tax agent's obligation

It should be noted that there are some peculiarities in Russian legislation with respect to taxation of dividends.

As has been stated above, under Article 269(4) of the Russian Tax Code the positive difference between Accrued Interest (actually paid interest) and Maximum Interest (maximum permissible interest) is equaled to dividends and is subject to profit tax at a rate of 15% as prescribed by Article 284(3) of the Russian Tax Code (other rules may apply if envisaged in Double Tax Treaties). If the receiver of interest recognized as dividends is a foreign organization, the corporate borrower is to act as a tax agent that deducts and pays tax to the government.

Under the general rules of Article 309 of the Russian Tax Code, the profit tax on a foreign organization's profit is withheld from the sources of said profit (including with respect to dividends), i.e. a Russian organization paying profit to a foreign organization acts as a tax agent.

Under Article 310(1) of the Russian Tax Code, a tax agent is to independently calculate tax and pay it to the government.

Applying Double Tax Treaties (Conventions)

The above discussion described general provisions of the Russian Tax Code. In practice, however, foreign investors and founders face situations when special rule exceptions contained in the Double Tax Treaties (Conventions) exceed the situations governed by the general rules contained in the Russian Tax Code.

It will be noted that some of the Double Tax Treaties (Conventions) between Russia and a number of other states provide for a special stipulation to the effect that loan interest should be expensed (paid out of pre-tax profit) at all events and in full. This means that the "special rule for taxing controlled debt interest" (the thin capitalization rule) may be non-applicable with respect to some states.

The notions of "interest" and "dividends", as used in the Treaties (Conventions) with respect to appropriate payments, are defined in an abundantly clear and strict manner, which prohibits their expansive interpretation with the use of general provisions of articles 269, 284 and other articles of the Russian Tax Code.

For example, the Double Tax Treaties (Conventions) concluded by Russia with France and Cyprus exclude it completely that any payments due to a foreign investor or participant are subject to an expansive interpretation contained in article 269 of the Russian Tax Code, when positive difference between the AI (actually paid interest) and the MI (maximum interest) are equated to dividends. In this case, general provisions of article 7 of the

Russian Tax Code will apply stipulating priority of an effective international agreement over the national legislation of the Russian Federation, and appropriate provisions of the Treaties (Conventions), under which article 269 of the Russian Tax Code may not be applied in practice.

Or, for example, it maybe noted with respect to the Treaty between Russia and the Federal Republic of Germany that this treaty contains similar provisions, but their wording and interpretation make it virtually impossible to apply them with respect to controlled debt.

It has to be emphasized strongly that use of the rules prescribed in Double Tax Treaties (Conventions) that make it virtually possible to treat part of the received profit as not subject to the Russian Tax Code still causes disputes with Russian tax authorities. The case law on this kind of cases remains contradictory, too.

Conclusion

The above prompts a conclusion that introduction, in 2002, of the thin capitalization rules designed to fight non-payment of tax, asset stripping, etc. hit the law-abiding taxpayers and, primarily, foreign investors, strongly. The rules still cause disputes. Yet, justified claims for minimizing tax burden, competent tax advisors and uncertain case law on the issue would allow, eventually, ensuring effective use of investments, deriving profit and minimizing tax payments legally.

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About Vegas Lex

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