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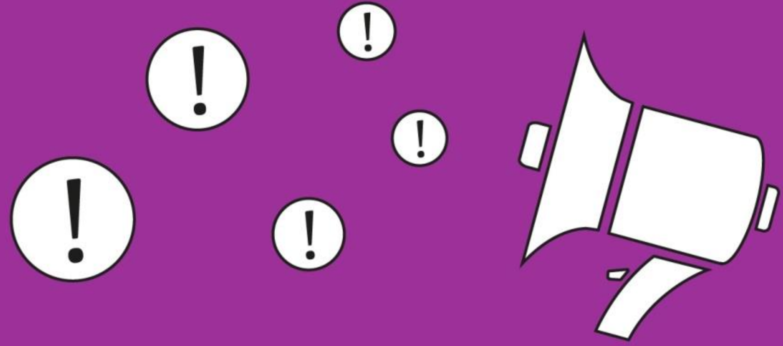

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NEW APPROACHES OF THE RUSSIAN SUPREME COURT TO INTRA-GROUP FINANCING

FAO: CEOs, chief accountants, and employees in finance, legal, and tax departments

Pepeliaev Group advises on a 'substantive' change in the approaches to the use of thin capitalisation rules

The reason behind the change is a precedent case, namely: Ruling of the Russian Supreme Court dated 14 September 2020 in case No. A60-29234/2019 (Mega-Invest LLC).

What was earlier?

An exceptionally formal approach was used. If the situation could be qualified using 'thin capitalisation' rules[1] (the "TC Rules"), a portion of the interest was reclassified as dividends and was not subject to deduction. If interest was paid abroad, a withholding tax was charged on such interest at the rate established for dividends.

The aim of such provisions was to prevent situations when a contribution to the issued capital was concealed on paper as a loan. However, it was also applied when no such concealment took place, i.e. in the situations when independent parties would also issue loans on similar terms. *In other words, there was no point in proving that no goal of substituting loan for the contribution was pursued.* This is precisely why we call such an approach a mathematical (computational) approach, where the statutory ratio between assets and liabilities triggers an unconditional application of the TC Rules.

Moreover, such a formal approach benefited only fiscal authorities. It did not deny a tax inspectorate the opportunity to qualify interest as dividends in cases when 'the math doesn't add up', i.e. when there is no ratio required by the TC Rules. In such cases, the inspectorate cannot refer to the ratio, but it can argue that:

– there was no intention to return the loan,

[1] Article 269(2) of the Tax Code

- no funds were repaid, or some funds were repaid if and when sufficient net profits were generated, i.e. substantially in the form of dividends.

How should it be now?

The question came up in the Mega-Invest case, whether the TC Rules should be applied, if 'the math adds up' in a situation for which these rules have not been designed. Under the former approach, the facts refuting concealment by the group of the relationships which contradicted the essence of a loan were excluded from the scope of examination in similar situations.

The change introduced by the new approach means that these facts are critical for the implications envisaged by the TC Rules. In other words, the formal application of the TC Rules can be set aside not only for the benefit of a tax authority, but also for the benefit of a taxpayer.

In addition to the above, the Russian Supreme Court stated that in cases when no reclassification should take place by the TC Rules but the inspectorate has proven concealment, the reclassification must be conducted by the TC Rules, rather than arbitrarily.

> For example, a lender and a borrower (Russian residents) are sister companies belonging to the same foreign company. The lender does not have any debt obligations to foreign affiliates. Since 2017, article 269(8) of the Tax Code excludes such debts from controlled debts and rules out the application of the TC Rules to them.
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> Suppose, the inspectorate has proven that the debt had no substantive features of a loan agreement. In such a situation, formerly it would have excluded the interest from the borrower's expenses without applying the TC Rules under article 54.1(1) or article 54.1(2)(1) of the Tax Code. Now, it should ignore the exemption from the TC Rules granted under article 269(8) of the Tax Code and apply such TC Rules. If the 3:1 ratio from the TC Rules has not been surpassed, the interest must be treated as interest. In any case, this version is worth noting based on the wording of the Ruling at issue.

The main conclusions in the Ruling of the Supreme Court and comments to them

1. The TC Rules are specific rules aimed at fighting against abuse in tax relationships.

   That the Supreme Court recognises these rules as specific means that the relationships they regulate are subject to the TC Rules rather than the general rules. The general rules are set out in article 54.1 of the Tax Code and cannot be applied to the relationships that are regulated by article 269 of the Code. To achieve the public interest protected by the TC Rules, these TC Rules must be applied rather than article 54.1 of the Tax Code.

The Supreme Court has also outlined the interests protected by the TC Rules: exclude the possibility of *"shifting profits to foreign jurisdictions as a result of manipulations with how the capital is raised, namely: in situations when the source of financing is a foreign company that dominates in various aspects of the operations of the Russian borrower, and the capitalisation of the Russian borrower is recognised to be insufficient to raise debt financing, i.e. it would be impossible to borrow the money if there are no special relationships between the above parties"*.

Therefore, in such situations tax authorities must conduct reclassification by the TC Rules. The calculation by these rules determines the portion of interest that should be reclassified as dividends. The calculation by the TC Rules should be used for *"bringing the profit taxable in Russia to the level as if no abuse of right took place"*.

2. The reason for including debt to the Russian affiliated lender from the same group in the controlled debt is that *"the foreign entity is able to influence the decision-making of its affiliated Russian entity regarding the issue of a loan"*. If there is no such practical (let alone legal) ability, the debt cannot be treated as a controlled debt.

   It seems there was no such ability in the case at hand. The foreign company did not have any other resources than 'nominal shareholdings' and only served as a vehicle for Russian residents who controlled the company to attain their goals.

   The application of this legal position is not limited by the case the Supreme Court has reviewed. Specifically, a controlled debt can be challenged with respect to the loan from a foreign entity referring, for example, to the transit of money through such foreign entity from the Russian affiliate of the same group and/or to the loan beneficiary being a Russian resident who passed the loan through the controlled foreign company (CFC).

3. The part is densely written whether the tax authority is released from an obligation to independently (be the first one to) apply the substantive approach in cases when formally the debt falls within the scope of the TC Rules.

   It is clear that the substantive issues are examined in cases when a taxpayer would put forward the relevant argument, and

   – it has valid evidence to support it, or

   – if the taxpayer has indicated where the tax authority can obtain evidence unavailable to it.

   It is unclear, however, whether the tax authority itself should take into account the circumstances excusing the taxpayer. The Ruling has a conclusion that it should not and that it should.

4. Losses to the state budget must be included in the facts at issue in the dispute of the above category (reclassification of loan relationships). It seems that the

Ruling does not allow for the TC Rules (reclassification) to be applied if there are no such losses.

For example, a Russian company issued a loan controlled by the foreign company of the group. When it is reclassified as a contribution to the issued capital, it will exclude interest from expenses, on the one hand. Yet, the interest reclassified as dividends can be taxed at a zero rate for the lender.[2] The loan model would yield more favourable tax results for the group. Therefore, the TC Rules cannot be applied as they have not been developed to be applied in such a case.

Should the same approach be applied if the money were shifted abroad and were taxed at a higher rate (as compared to dividends) there? We believe it should. The TC Rules cannot be applied in a situation when reclassification of a loan as a contribution produces the same or even more favourable result for the group. This refutes the abuse. When a loan is used in such situations it does not provide any tax benefits and, hence, using the loan was not dictated by the tax saving.

5. It was held illegal to shift income towards a loss-making company resulting in a situation when a recipient of income pays virtually no profit tax to the state budget, or if it does, the tax it pays is incomparably lower than the amount of the tax benefit for the source of income.

   We believe it is debatable in such a case whether the same tax benefit is retained as redistribution of income provides. The amount of losses which are carried forward is generally reduced in such a situation. The tax benefit here manifests itself not in a non-payment of the tax (the tax will be paid in the next period when the loss reduced by the amount of interest will be deducted) but in the payment at a later date. Therefore, such instruments for bringing the parties to the original state should be used here which would deprive the group of the benefit of the deferral.

6. The Supreme Court stated that not only a contribution to the issued capital, but also a contribution to assets could be reclassified. Formerly, tax inspectorates did not reclassify a contribution to assets.

   This part gives room for disputes. What will interest accrued on the amounts reclassified as contribution into assets be recognised: dividends or other income? What should a principal amount of the loan be reclassified where such a loan was reclassified as a contribution to assets?

   This broadens the range of already existing similar issues regarding the amounts reclassified as a contribution to issued capital: whether the loan repaid is recognised as a repayment of the contribution to the issued capital, provided that it is classified as dividends. These questions are particularly appropriate when a loan is repaid in the form of dividends (as and when net profit is generated, etc.)

7. The facts stated in the Ruling are included in the facts to be proven under the substantive approach:

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[2] Article 284(3)(1) of the Tax Code.

- the existence of the business purpose of raising financing under loan agreements. For example, the business purpose exists if *the money obtained under loan agreements were used for capital investments, namely: construction and acquisition of fixed assets (commercial premises, distribution centres, transport infrastructure facilities) without which it was impossible for the taxpayer and the group on the whole to conduct business in Russia*;
- non-repayment of loans for a long period of time and payment of interest in connection with the extension of the agreements. This can be *"relevant for determining the genuine economic substance of transactions providing financing to the taxpayer"* and requires *"evaluation of whether the taxpayer's conduct was reasonable when the loan maturity has been extended".*

What to think about and what to do

The recipients of intra-group loans should assess the impact of the new approach on the tax consequences of such loans which were determined earlier. The Supreme Court's approaches should be taken into account when intra-group financing is structured for the future.

Following the approaches set out in the Supreme Court's Ruling, it proves expedient to develop the defence files which will substantiate:

- the business purpose of obtaining financing under loan agreements;
- the source of freely available funds which allow counting on repaying the loan within the timeframes set in the agreement;
- no losses for the state budget when a taxpayer chooses such method of financing as obtaining funds under loan agreements, including taking account of, among other things, the evaluation of the tax burden of the parties to the transaction.

Help from your adviser

Pepeliaev Group's lawyers are ready to provide comprehensive legal assistance in view of the amendments to legislation, and to advise on all aspects of intra-group financial transactions. Specifically, we can:

- check whether debt obligations qualify for the Ruling (substantive approach);
- facilitate in determining those liabilities which qualified for the formal approach of applying the TC Rules but failed to qualify for the substantive approach; help to devise the most suitable strategy with respect to the amounts paid in excess owing to the TC Rules applied in such situations;
- prepare counter-arguments against the reclassification of loans into dividends without the TC Rules being applied in cases when according to the Ruling such reclassification must be carried out by the TC Rules based on the substantive approach; help to defend the position favourable for the taxpayer in such cases;
- facilitate the identification of debt obligations to which, on the contrary, the TC Rules were not formally applied but which are covered by them now based on the

new (substantive) approach; facilitate the development of a new strategy on taxes that were underpaid with respect to such obligations;

- check the defence files as to their compliance with the new approach and eliminate the deficiencies;
- check for and close the gaps in procedural documents, clarifications and objections under existing disputes with the tax authorities, or draft such documents;
- facilitate the development of a playbook (i.e. the rules by which intra-group financing will be carried out and record the facts in it which are relevant for the tax classification).

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