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Court Decision Rocks Intragroup Finance Practice

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In early January, the Russian Federation's Supreme Arbitration Court published Presidium Ruling No. 8654/11 in the case of OAO Coal Company Severny Kuzbass. One of the main issues in the case was the application of Russian thin capitalization rules (in Article 269.2 of the Tax Code) in view of the nondiscrimination provisions of double taxation treaties. These international treaty provisions had for a long time been viewed as an ironclad defense for Russian borrowers against claims from the Russian tax authorities concerning the rate of loan interest deductible for profit tax purposes, but given the Presidium's decision the time has come to reconsider the strength of that defense.

Analysis of the ruling leads to the following conclusions:

- The tax authority did not challenge all interest deductions but only the interest charged by some of the affiliates of the borrower, each of which either held a direct equity participation in the Russian borrower or was a Russian affiliate of the borrower's shareholders. This implies that the ruling's findings cannot be applied to loan financing provided to a Russian borrower by a foreign affiliate that does not have a direct or indirect equity interest in the Russian borrower, since the Tax Code does not include such loans within the scope of thin capitalization rules.
- The ruling does not address the applicable rate of tax on the income of foreign organizations (withholding tax) for the portion of the interest over the limit calculated using the rules in Article 269.2 of the Tax Code (excessive interest). This means that the present court practice, which does not authorize the tax authorities to recharacterize the excessive interest as dividend income for withholding tax purposes, remains unaffected (so, a zero percent rate may still apply to such excessive interest under many tax treaties).
- The Presidium sets out the position that the provisions of double taxation treaties do not

prevent the application of Russian anti-abuse rules. This effectively opens boundless opportunities for the tax authorities to attack the application of benefits provided by double tax treaties based on Russian domestic anti-abuse concepts.
- The Presidium interpreted the provisions of international tax treaties prohibiting discrimination on the basis of whether or not a company has foreign equity participation as making tax procedures the same for all Russian organizations in which there is direct or indirect foreign participation. This means that any provisions of Russian national tax law establishing special rules for Russian organizations with foreign equity participation relative to Russian organizations without direct or indirect foreign equity participation will not be considered discriminatory (irrespective of whether these rules create a greater tax burden for companies with foreign investment).

Conclusions

The Presidium's ruling will undoubtedly have an impact on the structuring of intragroup financing. It seems likely that multinational groups will begin to consider creating, as an independent element of the corporate structure, a central foreign financial company not directly or indirectly participating in the capital of the group's operating companies. In order to strengthen the position of taxpayers in potential disputes with the tax authorities, it could be appropriate to concentrate all intragroup financing in such a financial company (for example, through cash pooling), and raising loan financing from external sources.
The financial company would be advised to finance all group companies, not only the Russian ones. We believe this would show the financial company's activities are genuine and provide solid ground for refuting any tax authority claims that the financial company was established solely to bypass thin capitalization rules.