

RUSSIA TAX OUTLOOK

#6, September 2009

Interest-free loan as an effective instrument of intercompany financing

Practice demonstrates that, today, in the times of world economic crisis, companies seek for effective methods of intercompany financing. Various instruments exist, but companies are usually rather conservative and tend to choose those already well-tried, such as interest-bearing loans, subventions, etc. In this respect, companies are reluctant to use interest-free loans as they are concerned about possible negative tax consequences. However, we consider that this instrument can be regarded as an interesting option of redistributing intercompany funds.

Moreover, the increasing number of inquiries concerning interest-free loans addressed by taxpayers to the Russian tax authorities clearly illustrates companies' interest in this instrument.

As a latest development, on **14 July 2009 the Russian Ministry of Finance has issued a Letter No. 03-03-06/1/465** (hereinafter referred to as the "**Letter**") which confirms its position on the rules of interest-free loans taxation and the application of transfer-pricing rules to these kind of loans. Furthermore, the Letter broaches the **possibility of converting an interest-bearing loan to an interest-free one** without adverse tax consequences. Thus the approach shown by the Letter may offer rather advantageous possibilities for companies experiencing a necessity for additional financing in those difficult times.

As a reminder, formerly, Russian tax authorities treated problems relating to tax consequences arising as a result of the use by companies of interest-free loans, rather differently. Indeed, tax authorities used to compute additional tax on the supposed income, in the form of interest computed at "market rated" according to the transfer pricing rules provided by the article 40 of the first part of the Russian Tax Code No. 146-FZ of 31 July 1998.

The aforementioned negative position of the tax authorities concerning the taxation of material gain resulting from savings on interest was supported by court practice (see, for example, the Moscow Federal Arbitration Court's Resolution No. KA-A40/2276-06-2 of 4 April 2004, which stated the said material gain is taxable). However, subsequently, the courts have formed a contrasting opinion on this issue, which appears more favourable to the taxpayers (see, for example, the Moscow Federal Arbitration Court's Resolution of 1 April 2005 N A-A41/2142-05, Resolution of Federal Arbitration Court of the Central region of 2 February 2005 N A09-10504/04-13 etc.). This position was also confirmed by the Presidium of the Russian Supreme Arbitration Court in its Ruling No. 3009/04 of 2 August 2004, which became an important step towards the current approach.

The said court decisions explained that the article 41 of the Tax Code defines a profit as economic gain received in cash or in kind and defined according to the relevant provisions of the Tax Code. However, the Tax Code neither establish any procedures of evaluation, nor any definition of material gain received by a company using an interest-free loan, which means that interest-free loans are not taxable.

The local tax authorities, however, have continued to claim additional tax on interest-free loans.

Despite the position of local tax authorities, the Russian financial and tax authorities published a series of clarifications where they agreed with the above position of the court practice which establishes that the receipt of funds on an interest-free basis should not be liable to corporate profits tax (see letter of the Ministry of Finance of 20.02.2006 No. 03-03-04/1/128, letter of the Russian Federal Tax Service of 13.01.2005 No. 02-1-08/5@). Finally, on 14 March 2007 the Ministry of Finance published an unusually clear letter No. 03-02-07/2-44, which is very favourable for taxpayers and concerns the application of transfer pricing rules.

The said letter relies upon the provision of the article 40 of the Tax Code, according to which Russian tax authorities are entitled to challenge the prices of certain transactions involving goods, works and services and to impose additional tax costs when the sale price deviates from the market level by more than 20% as regards several types of transactions (e.g. transactions between related parties, barter transactions etc.). However, a loan is not considered by Russian financial services as being a good, work or service (ordinary or financial) and that is why these rules should not apply.

Summarising the foregoing, we conclude that at present interest-free loans are not subject to profits tax and the risk of a claim of additional tax based on interest imputed at a supposedly market rate is very low.

The Letter confirmed this position and, last but not least, added the possibility **to convert an interest-bearing loan to an interest-free one**.

The argumentation proposed by the Letter is still the same: as the Tax Code does not provide for specific rules of the material gain taxation, the application of the company profits tax rates is impossible. The approach of the courts on this issue has not yet been established, however, we expect that the possibility offered by the Letter will be widely used, particularly in times of worldwide recession.

We are aware that the following conclusions are based predominantly on the acts of the Russian financial and tax authorities, which do not as such have force of law. Nevertheless, they must be accepted by tax authorities as obligatory. Furthermore, court practice on this matter is both unambiguous and positive for taxpayers.

Obviously, other methods are available for debt restructuring purposes and a review of specific activities and financial characteristics at hand is necessary to define the best strategy. Therefore, if your company is considering an optimization of its costs (e.g. financial) we would be pleased to meet and discuss this in more details with you.

CMS can offer you the following assistance:

- Audit of your current cost structure (existing or planned expenses) with a view to assist you in defining the most suitable and efficient methods of financing or refinancing of your activities;
- Transfer pricing analysis of existing or planned financing structures and transactions;
- Pre-deal and transaction tax and legal structuring services;
- Negotiate, draft and/or review of your loan agreements and auxiliary documentations (pledge and other contracts) to achieve more favorable term sheets.

If you have questions on the matters referred to in this **RUSSIA TAX OUTLOOK**, please do not hesitate to contact Dominique Tissot, Partner, at +7 (495) 786 4000 or Dominique.Tissot@cmslegal.ru or your regular contact at CMS, Russia.

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