

Application of the new provisions in Article 269 of the Russian Tax Code



Background

On 8 March 2015, the President of the Russian Federation signed Federal Law No. 32-FZ *On amendments to Part Two of the Russian Tax Code, introducing, inter alia, amendments to Article 269 of the Russian Tax Code. This has created many questions on how the Article is to be applied, especially when it comes to determining interest rates on intra-group liabilities, as currently there is no clear approach.*

KPMG professionals therefore prepared this information letter together with its analysis of the provisions in Article 269, as well as recommendations on how to apply the provisions when seeking to recognise income/expenses on debt obligations.

We hope that this letter will be helpful to you. KPMG will be glad to discuss with you in more detail any particular challenges you face, or to discuss how we can provide your organisation with comprehensive support with transfer pricing and general corporate tax issues.

Provisions of Article 269 of the Russian Tax Code that have come into effect

The new provisions in Article 269 introduce the following procedure for recognising income and expenses on debt obligations (including credit, trade and commercial credit, loans, bank deposits, bank accounts or other borrowings, regardless of their form):

Transactions which are not treated as controlled under Article 105.14 of the Russian Tax Code*

Interest calculated based on the **actual rate** (clause 1 of Article 269 of the Russian Tax Code) shall be recognised as income/expenses. Article 269 does not provide for any additional analysis and/or other ways of validating the interest rates on these obligations.

Controlled transactions according to Article 105.14 of the Russian Tax Code

General rule

Interest calculated based on the **market level range** shall be recognised as income/expenses. The market level range is determined in accordance with **the transfer pricing rules** established by section V.1 of the Russian Tax Code (clause 1 of Article 269).

Special provisions for legal relations arising from 1 January 2015

Approach 1: Using the upper and lower range limits provided for by Article 269 of the Russian Tax Code

Interest that exceeds the minimal value of the next range shall be recognised as income, while interest which is less than the maximum value within the same range shall be recognised as an expense (clause 1.1 of Article 269 of the Russian Tax Code). *For the steps to determine interest rates as part of this approach, see below.*

Approach 2: Using a market interest rate range calculated in accordance with transfer pricing rules

If the interest rate on debt obligations goes beyond the range limits set out in Approach 1, the interest calculated based on the interest rate within a market level range (determined in accordance with the transfer pricing rules established by section V.1 of the Russian Tax Code) shall be recognised as income/expenses (clause 1.1 of Article 269).

* i.e. (i) arm's length transactions (excluding transactions with counterparties incorporated in offshore jurisdictions); and (ii) transactions with Russian related parties that do not qualify as controlled transactions.

If a taxpayer opts for **Approach 1** and uses the limits provided for by clause 1.2 of Article 269 of the Russian Tax Code, income/expenses on debt obligations shall be determined as follows:

Currency	Procedure for determining the interest rate
RUB (between residents of Russia)	<ul style="list-style-type: none"> ■ 2015: from 0% to 180% of the Central Bank's key interest rate* (currently 14%); ■ Effective from 2016: from 75% to 125% of the Central Bank's key interest rate*;
RUB (between a Russian resident and a foreign entity, including – according to the Russian Ministry of Finance – the branches / representative offices of foreign entities in Russia. Letter No. 03-01-18/35774, dated 30 August 2013):	<ul style="list-style-type: none"> ■ 2015: from 75% to 180% of the Central Bank's key interest rate*; ■ Effective from 2016: from 75% to 125% of the Central Bank's key interest rate*;
EUR	EURIBOR* + 4–7% markup
CNY	SHIBOR* + 4–7% markup
GBP	LIBOR GBP* + 4–7% markup
CHF or JPY	LIBOR* in a respective currency + 2–5% markup
Other currencies	LIBOR USD* + 4–7% markup

* When using these rates it is necessary to keep in mind the following:

Date of settlement: the above key interest rate of the Central Bank or of a market interest rate indices (LIBOR, EURIBOR, etc.) is determined as of the date that funds are raised if the interest rate on a debt obligation is fixed. If the rate is floating, the above rates are determined as of the date of recognition of income/expenses in the respective transaction;

Settlement period: the period of a market indices shall to the maximum extent possible match the period of a debt obligation. The key interest rate is used without taking into consideration the period of time a debt obligation lasts.

Application of the Article 269 provisions to debt obligations NOT treated as controlled under Article 105.14 of the Russian Tax Code

Subject to Article 269 of the Russian Tax Code, a taxpayer is entitled to recognise income/expenses on the above obligations based on the actual interest rate set for the respective transaction. In practice, there is no obligatory documentary evidence that can be used to validate this rate. Nevertheless, should the tax authorities investigate, KPMG believes taxpayers can provide as evidence documents containing discussions on the interest rate between the parties (e.g. email messages, different versions of agreements with amendments, etc.).

However, in cases when transactions between related parties do not satisfy the criteria for being controlled (as provided by Article 105.14 of the Russian Tax Code), KPMG recommends that at least a summary document is prepared describing the approach used to determine the interest rate and the results of the respective

calculations. KPMG believes that this is necessary because:

- formally, under Article 105.3, the prices for these types of transactions are not treated as market prices;
- Article 269 does not establish any interest rate thresholds for these types of transactions;
- thus we can not exclude the possibility that the tax authorities will request that the tax rate used in these types of transactions is justified and, if no justification is provided, will attempt to challenge the rate on the grounds that the parties are related (referring to provisions in the Russian Tax Code mentioned above), which may affect the deal prices.

Application of the Article 269 provisions to controlled transactions under Article 105.14 of the Russian Tax Code (controlled intra-group debt obligations and transactions with independent offshore companies)

We believe that the Article 269 provisions should be used as follows:

Approach	Supporting documents
Legal relations that arose BEFORE 1 January 2015	
Article 269 of the Russian Tax Code provides a general rule to be applied in relation to these types of debt obligations. This means that a transfer pricing analysis in accordance with section V.1 of the Russian Tax Code shall be conducted for this type of transaction.	Transfer pricing documentation, as explicitly required by Article 105.15 of the Russian Tax Code.
Legal relations arising AFTER 1 January 2015	
In relation to these debt obligations, a taxpayer is entitled to apply both (1) interest rates within the range limits stated above as well as (2) other interest rates. The latter option applies if the level of the rates is validated by a respective analysis based on the transfer pricing rules provided for by section V.1 of the Russian Tax Code. At the same time, please consider our recommendations below and take into account other provisions in Russian legislation and international regulations.	
Approach 1: Using the range limits provided for by Article 269 of the Russian Tax Code	Transfer pricing documentation, as explicitly required by Article 105.15 of the Russian Tax Code.

Approach	Supporting documents
	However, given the specifics of this approach, preparation of the full documentation is not feasible. KPMG thus recommends that a brief description (1-2 pages) is prepared, setting out the approach used and referencing the relevant provisions of the Russian Tax Code testifying to its appropriateness.
Approach 2: Using a market level interest rate range that is supported by transfer pricing rules (supported with a relevant study)	Transfer pricing documentation, as explicitly required by Article 105.15 of the Russian Tax Code.

Actions during the transition period

We also understand that many taxpayers already use a particular methodology to determine the interest rates on intra-group debt obligations. As such, the need to amend this methodology should also be considered when taking into account the new provisions of Article 269.

KPMG believes that, based on the effective provisions of the Russian Tax Code, taxpayers can use the limit ranges set by Article 269 and continue applying their own methodology¹, as both options are available under Article 269.

At the same time it must be noted that when entering into transactions with foreign counterparties, it is

necessary to comply not only with Russian tax legislation, but also with international regulations. In particular, the provisions in most double tax treaties apply only to consideration amounts that are in line with the market level range. As such, even if the interest rate has been determined using the range limits established by clause 1.2 of Article 269 of the Russian Tax Code, in order to recognise expenses on transactions with foreign counterparties, KPMG recommends that a separate analysis on the market level range for interest rates is conducted to correctly calculate the tax ("withholding tax") to be withheld if the rates deviate from the market level range.

¹ If this methodology is in line with market principles.

Key issues for further consideration

Taxpayers may potentially select any of the approaches provided for by Article 269 to recognise income or expenses for tax purposes. However, given the amendments to Article 269, the effective transfer pricing rules in the Russian Tax Code, and the concept of an 'unjustified tax benefit', KPMG recommends paying special attention to the following aspects when applying the abovementioned provisions:

1. Determine the date legal relations were established. In particular, a taxpayer needs to determine whether the Article 269 provisions can be applied to debt obligations that were agreed and entered into before 1 January 2015, or are only applicable to new agreements.
2. Prepare transfer pricing notices for controlled transactions. Specifically, the determination of interest rates in accordance with the limit ranges established by Article 269 does not release taxpayers from responsibilities they have arising from their tax control over the prices in these transactions (i.e. responsibilities to prepare notices and relevant documentation).
3. Check the requirements established by Article 252 of the Russian Tax Code in relation to the economic justification of expenses (in the case of 'mirror' loans).
4. Check the latest court cases ruling in favour of the tax authorities regarding additional tax charges on interest-free loans.
5. How have thin capitalisation rules been applied (clauses 2–3 of Article 269 of the Russian Tax Code) when calculating expenses on debt obligations?
6. How double tax treaty provisions have been applied when concluding a deal with a foreign related counterparty. In particular, since the provisions of these treaties generally apply only to market interest rates, an additional analysis of market level interest rate ranges may be needed to correctly calculate the withholding tax.
7. Consider the possibility of applying Ruling No. 53 of the Plenum of the Russian Federation's Supreme Court of Arbitration dated 12 October 2006 *On the Assessment by Courts of Arbitration of the Justification for a Taxpayer to Obtain a Tax Benefit*. For this, the particular circumstances of a taxpayer need to be considered. Specifically, KPMG recommends:
 - do not set interest rates at levels leading to any of the parties in a transaction incurring losses;
 - do not set different interest rates on intra-group liabilities having comparable terms, based on the criteria set forth under clause 11 of Article 105.5 of the Russian Tax Code (the borrower's capacity to pay, the term, currency, type of interest rate, collateral and its value);
 - do not make significant amendments to the interest rates on existing liabilities (e.g. in the event of transition from the current methodology for determining the interest rates to applying the limits provided for by Article 269 of the Russian Tax Code);
 - do not take any other actions which may lead to the parties of the transaction obtaining an unjustified tax benefit.

The information herein is of a general nature and not directed to any particular circumstances of any individual or company. Although we endeavour to provide timely and accurate information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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