

## Russia's Thin Capitalisation Rules in light of the Russia-Cyprus Double Tax Treaty

Russian thin capitalisation rules do not permit a tax deduction for excessive interest payments between related parties. The rules set a maximum debt to equity ratio of 3:1 meaning that if the amount of the controlled debt is three times greater than the borrowing entity's own capital as of the last day of the relevant reporting/ tax period, then Russia's thin capitalisation rules are applicable.

A controlled debt under loan obligations accrues in the following cases:

- 1) the Russian entity is indebted to a foreign entity controlling more than 20% of the Russian entity's registered capital;
- 2) the Russian entity is indebted to a Russian entity recognised as an affiliate to the above foreign entity under Russian law; and
- 3) the above affiliate and/ or foreign company is/are a surety or guarantor for a debt obligation of a Russian entity or otherwise undertake to ensure the performance of its debt obligation.

If all of the conditions for applying these rules are met, a Russian entity may recognise interest as an expense only within limits established by the Russian tax legislation.

Russia's double tax treaties with countries such as Germany and the Netherlands expressly provide for unlimited deductibility of expenses such as interest, i.e. Russian companies which pay interest to German or Dutch creditors may recognise such interest payments as expenses without any limitations. Accordingly, the thin capitalisation rules are not applicable, as the rules would contradict the provisions of the relevant double tax treaties.

However, the Russia-Cyprus double tax treaty does not include a similar provision, potentially rendering the thin capitalisation rules applicable to interest payable by a Russian company to a Cyprus creditor. Nevertheless, on the 23rd September 2009, the Federal Arbitration Court of Moscow issued a decision <sup>1</sup> on the unlimited deductibility of expenses in relation to the Russia-Cyprus double tax treaty based on

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<sup>1</sup> Resolution of the Federal Arbitration Court for the Moscow District No. KA-A40/9453-09-2

the anti-discrimination provisions (Clauses 3 and 4 of Article 24 of the Russia- Cyprus Double tax treaty).

According to these provisions the income payable by a Russian company to a company registered in Cyprus for the purpose of determining the taxable profit of the Russian company should, as a rule be deducted on the same basis as if this income had been paid to another Russian company. Further, Russian companies whose capital is fully or partially, directly or indirectly owned by one or several Cypriot companies should not be subject to a different tax regime or more onerous taxation in Russia than the tax regime that is or may be applied to other similar Russian companies inter se.

In Cyprus, there are no specific transfer pricing regulations but according to the Cyprus Income Tax Law, transactions between related and connected parties should be undertaken at arms' length.

More specifically, interest rates imposed on loan agreements between related parties should be consistent with market rates and with rates imposed between unrelated parties.

The Cyprus Income Tax Commissioner has recently clarified that interest-free back-to-back loans will be subject to a deemed interest margin of 0.35% and that a minimum margin of 0.125 – 0.35% on the loan amount received between related parties may be included in the taxable income of a company depending on the loan amount (up to €50 million the minimum interest margin will be 0.0035, between €50 million – €200 million the minimum interest margin will be 0.0025 and over €200 million the minimum interest margin will be 0.00125).

It is worth noting that the decisions of the Federal Arbitration Courts are not final and that the Supreme Arbitration Court has the final say on the applicability or inapplicability of the Russian thin capitalisation rules. In the meantime, the ruling of the Federal Arbitration Court means that with effective tax planning unlimited deductibility of interest payments by a Russian company to a Cyprus creditor may be achieved.

## FURTHER INFORMATION

Please contact the following lawyer if you require additional information on the above topic.

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