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Russian Parliament Passes Temporary Withholding Tax Exemption for Eurobonds

Amendments are more favorable to borrowers than those recently proposed by the Ministry of Finance, but they provide an exemption only for bonds issued before 1 January 2014.

On 6 June 2012, the Russian parliament (the Duma) passed amendments to the Russian federal Tax Code (the Tax Code) that provide an exemption from withholding tax for Eurobond offerings from Russia that are made prior to 1 January 2014. It is currently unclear to what extent, if at all, future changes to the Tax Code will be made that address the withholding tax treatment for offerings made on or after 1 January 2014.

Background

Currently, the most commonly used structures for Eurobond offerings by Russian companies are (i) loan participation notes issued by non-Russian special purpose vehicles (SPVs) and (ii) note offerings by subsidiary SPV issuers with guarantees by Russian parent companies. In both of these structures, the actual issuers of the Eurobonds are located outside of Russia, and the proceeds of the offering are transferred to the Russian companies, typically in the form of a loan. These structures benefit from double tax treaties between Russia and the jurisdiction of the relevant SPV issuer (typically Luxembourg or Ireland), which enable interest payments to be made by the Russian company to the SPV issuer free of Russian withholding tax. Similar offering structures have been used in the Russian market and other markets in emerging Europe for many years. Historically, market participants in Russian offerings have generally acknowledged and accepted that the Russian withholding tax treatment of these structures is subject to uncertainty and a corresponding risk that the Russian tax authorities could challenge the structures and impose Russian withholding tax on interest payments.

Ministry of Finance's Letter and Proposal

In December 2011, the Ministry of Finance of Russia (the Ministry of Finance) issued a letter to the Russian Federal Tax Service stating that interest payments to non-Russian SPVs, such as those made in the context of Eurobond structures, should not be eligible for double tax treaty relief, and confirmed its position in a 27 January 2012 press release. The issuance of the letter and press release raised the possibility of a 20% withholding tax being applicable to Russian Eurobonds, potential penalties being imposed on borrowers for past failure to withhold, and possible early redemptions of Eurobonds for taxation reasons. Understandably, these developments caused significant concern among market participants. According to press reports, following the issuance of the letter and press release, a number of major Russian banks and corporations engaged in lobbying efforts with the Ministry of Finance in an attempt to persuade it to retreat from its position.

Following consultations with Eurobond borrowers and investors and with the working group on the formation of the Moscow International Financial Center (MIFC), the Ministry of Finance published on 20 February 2012 a proposal, including draft amendments to the Tax Code, with respect to withholding tax on Russian Eurobonds. The proposal provided that, for bonds issued on or after 1 January 2013, a Russian borrower would not be required to withhold tax on interest payments made to a foreign SPV provided that (i) the SPV is incorporated in a jurisdiction that has a double tax treaty with Russia providing for no withholding tax on interest payments, (ii) the bonds are listed on an approved foreign stock exchange or clear through an approved international clearing system, and (iii) the relevant "first level" holders of the bonds in respect of which the interest payments are being made reside in jurisdictions that have double tax treaties with Russia providing for no withholding tax on interest payments. According to the proposal, “first level” holders means the relevant accountholders in the clearing systems rather than the ultimate beneficial owners of the Eurobonds.

While the Ministry of Finance’s proposal represented a retreat from the positions it expressed in its letter and press release, there continued to be a degree of uncertainty and cause for concern in the market following the proposal. First, it was unclear how the provision of accountholder information by the clearing systems would work in practice, as arrangements would need to be made with the clearing systems to ensure that accountholder information could be provided in a timely manner prior to an interest payment being made on a Russian Eurobond. Second, even if Russian borrowers were able to obtain the necessary “first level” holder information from the clearing systems, to the extent that such holders resided in jurisdictions that did not have double tax treaties with Russia providing for no withholding tax on interest payments, Russian borrowers would have needed to withhold a certain amount of tax from interest payments and would have been required to “gross up” the relevant interest payments.

Tax Code Amendments Passed by the Duma

In May 2012, the Budget and Tax Committee of the Duma (the Committee) approved amendments to the Tax Code that would have effectively exempted Eurobonds from withholding tax indefinitely. These amendments did not include a requirement that the relevant “first level” holders of the bonds reside in jurisdictions that have applicable double tax treaties with Russia, which reflected a rejection of this central element of the Ministry of Finance’s proposal.

However, as a result of political confrontations over this issue that took place in May and early June, the amendments that had been approved by the Committee in May were revised to provide that the exemption would apply only in respect of bonds issued before 1 January 2014, rather than indefinitely. The amendments were passed in this form by the Duma on 6 June 2012.

The amendments provide that, for offerings that close prior to 1 January 2014, there is no requirement for withholding of income tax in a Russian Eurobond structure if the following two conditions are met:

- The SPV issuer is incorporated in a jurisdiction that has a double tax treaty with Russia (providing for no withholding tax on interest payments).
- The bonds are listed on an approved foreign stock exchange and clear through an approved international clearing system.

The exemption is applicable to both loan participation notes structures and guarantee structures involving SPV issuers, and applies retroactively to interest payments in connection with Eurobonds made on or after 1 January 2007.

A list of approved stock exchanges and clearing systems for this purpose is to be adopted by the Ministry of Finance and the Russian Federal Service for the Financial Markets (FSFM). Until this list has been approved, listing on any foreign stock exchange and clearance through any foreign clearing system will be acceptable for purposes of this exemption.

In order to become effective, the amendments to the Tax Code that were passed by the Duma need to be approved by the Federation Council of Russia and signed by the President of Russia. According to Russian law, the Federation Council has two weeks in which to approve the amendment into law and the President has two weeks in which to sign the amendments into law.

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Impact

The Eurobond market has been, and likely will continue to be, an important source of financing for Russian corporations. However, for the time being, the question of the withholding tax treatment of Eurobonds from Russia remains unsettled. If they become effective, the amendments to the Tax Code will temporarily resolve the confusion and anxiety in the market that began in December 2011 with the Ministry of Finance's letter. On one hand, market participants will be relieved by the amendments, as the new regime proposed by the Ministry of Finance in February would likely have been cumbersome and may have increased borrowing costs and, as a result, could have adversely affected the Russian Eurobond market. On the other hand, as the exemption only applies until 1 January 2014, the amendments provide only a temporary solution, and there will continue to be uncertainty in the market regarding what the position will be after that date.

The Ministry of Finance's positions expressed in its December 2011 letter and January press release were based on a view that, in order for interest payments under a Eurobond structure to benefit from a double tax treaty, the actual owner of the interest (rather than the SPV issuer) should be resident in a qualifying jurisdiction. This position was significantly watered down in the February proposal, which required looking to "first level" holders in the clearing systems rather than actual owners, as the latter approach would have been impracticable. The recently passed Tax Code amendments temporarily reverse the Ministry of Finance's positions entirely by indicating that only the SPV's jurisdiction of incorporation is relevant to the withholding tax treatment.

The manner in which—within a period of approximately six months—the Ministry of Finance took a sudden and dramatic position on the Russian Eurobond withholding tax issue, then largely retreated from its position and subsequently had its position temporarily reversed by the Duma is an indication of the unpredictability that exists in the general Russian legislative and tax system. The recently passed amendments will provide clarity regarding the withholding tax treatment of Eurobonds—but only on a temporary basis. While there will be a lower level of withholding tax risk associated with Russian Eurobond transactions that close before 1 January 2014, there continues to be uncertainty about the future beyond that date.

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