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Taxation of Cross-Border Mergers and Acquisitions

Russia

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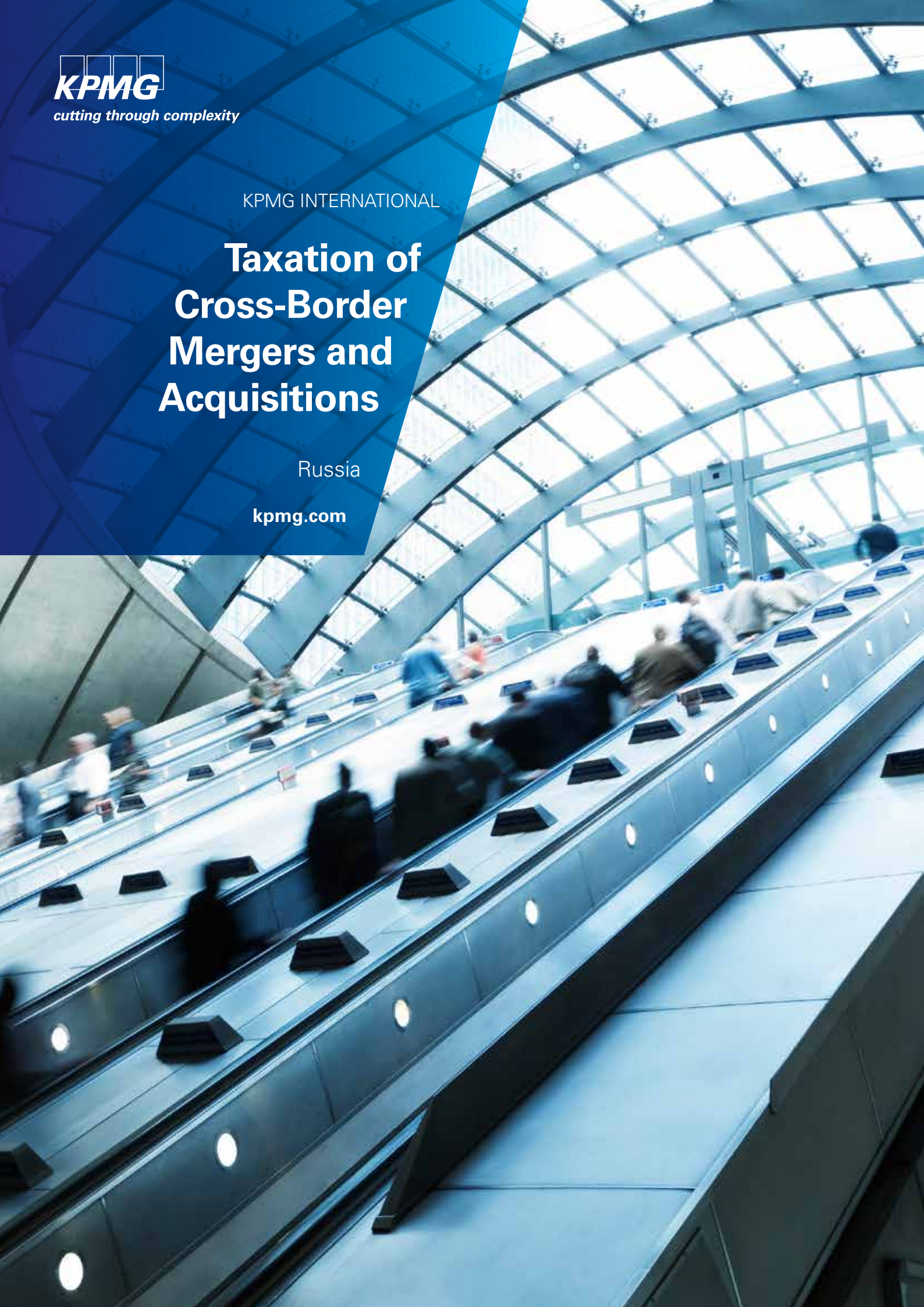

Russia

Introduction

Mergers and acquisitions (M&A) have become increasingly common in Russia in recent years. A number of legal and tax issues should be considered when such transactions are planned. This chapter summarizes the applicable provisions in Russian legislation. M&A issues are complex, so, in each case, the transactions should be planned taking into consideration all the facts and circumstances.

Recent developments

The following summary of Russian tax considerations is based on current tax legislation as of the end of January 2014.

Anti-offshore tax policy

In December 2013, the President of Russia proposed a number of initiatives to discourage offshoring of the Russian economy. Among other things, these initiatives include the introduction of:

- controlled foreign company (CFC) rules
- definition of tax residency based on place of effective management
- disclosure of information about beneficiaries of companies.

The respective draft laws are expected to be developed in 2014.

In January 2014, a draft bill for ratification of the Organisation for Economic Co-operation and Development (OECD) Convention on mutual administrative assistance in tax matters was presented to the Russian government. Ratification of the convention will expand the Russian tax authorities' options for gathering information from their foreign colleagues, participate in tax audits abroad and levy tax liabilities from companies owning assets abroad.

Tax rules for reduction of charter capital

As of 1 January 2014, income in the form of property and property rights received by a shareholder on the reduction of charter capital of a subsidiary is exempt from profits tax (provided certain conditions are met).

On the sale of shares and participation interests, capital gains realized should be increased by the amount of previously exempt income.

Social insurance contributions

As of 1 January 2011, unified social tax (UST) was replaced by social insurance contributions. As of 1 January 2012, the maximum rate of social insurance contributions is 30 percent of the annual remuneration of each employee, up to 512,000 Russian rubles (RUB) and 10 percent of the annual remuneration over RUB512,000. The threshold for applying the 30 percent rate rose to RUB568,000 in 2013 and to RUB624,000 in 2014.

Another major change is that employers have to pay part of the insurance contributions on payments in respect of foreign employees whose salaries are subject to the insurance contributions (i.e. foreign nationals temporarily staying in Russia), provided their employment contract is concluded for indefinite period or a period of no less than 6 months. However, where foreign nationals are employed under the Highly Qualified Specialist regime, employers pay insurance contributions at the rate of 22 per cent on their income up to RUB512,000 in 2012, RUB568,000 in 2013, and RUB624,000 in 2014, and at the rate of 10 per cent on their income that exceeds the above threshold.

Asset purchase or share purchase

An acquisition in Russia can be structured as an asset or share deal. The main difference is that, in a share deal, all rights and obligations of the target company (including all historical tax liabilities) remain in the company acquired by the purchaser, whereas, in an asset deal, historical liabilities remain in the selling entity, with certain exceptions.

A share deal could be performed by acquiring shares in Russian joint stock company (AO) or by acquiring the so-called participations in Russian limited liability companies (OOO). Share deals can also be affected by acquiring shares in the foreign holding companies of Russian targets.

An asset deal is usually a purchase of certain assets of the target company (generally, tax risks other than customs risks are not inherited). Alternatively, the deal could involve the purchase of an enterprise as a property complex, where all the assets and liabilities are assumed as well. This procedure is more complex and rare in practice (in many cases, the purchase of an enterprise as a property complex occurs when a bankrupt company sells its business). Note that where parties sign a sale and purchase contract of all the target's assets, there is a risk that the deal could be re-classified as a purchase of an enterprise as a property complex (as has happened), which would cause the liabilities as well as assets

to be transferred. In this case, the Russian tax authorities could claim that all historical tax liabilities are inherited by the purchaser.

An asset deal is generally subject to valued added tax (VAT) and profits tax, whereas a share deal, if performed in Russia, is only subject to profits tax.

The implications of both types of purchase are summarized at the end of this chapter.

Purchase of assets

Assets of a Russian business may be acquired by a foreign legal entity directly or through a Russian branch. The acquired assets may also be contributed to the charter capital of a Russian subsidiary of the purchaser. In kind contributions to the charter capital of joint stock companies must be valued by independent valuers, unless otherwise stipulated by law. In kind contributions to the charter capital of limited liability companies must also be valued by independent valuers if the nominal value of the in kind contribution exceeds RUB20,000. Alternatively, a special purpose vehicle may be set up in Russia to acquire the assets of the target company.

Purchase price

Generally, the purchase price is determined by the mutual consent of the parties (under the so-called freedom of contract concept). However, the tax authorities could challenge the applied prices using the transfer pricing rules applicable to an asset deal.

Goodwill

Goodwill could arise in a purchase of an enterprise as a property complex. Goodwill is defined as the difference between the purchase price of an enterprise as a property complex and the net book value of its assets. Where the purchase price is higher, the positive difference (positive goodwill) could be deducted for profits tax purposes over 5 years from the month following the month of the state registration of the property complex transfer.

For statutory accounting purposes, goodwill is subject to impairment over 20 years or until the company's dissolution, whichever is sooner.

Where the purchase price is lower than the value of assets, the negative difference (negative goodwill) is subject to profits tax in the month of the state registration of the property complex transfer.

The seller can deduct a loss on the sale of an enterprise as a property complex for profits tax purposes.

Depreciation

Depreciation of assets is generally deductible for profits tax purposes in Russia. Depreciation rates depend on the assets' useful life.

The useful life of an asset is determined at the date when the fixed asset is put into operation, based on the Classification of Fixed assets Included in Depreciation Groups. Where a particular fixed asset is not included in the classification, the taxpayer should determine the fixed asset's useful life, taking into account the technical characteristics of the asset and recommendations of the manufacturer.

According to Russian tax legislation, a taxpayer is entitled to apply either a straight-line or a reducing-balance method of depreciation.

A depreciation premium of 10 to 30 percent of the acquisition cost of fixed assets is available as an immediate deduction when the fixed assets are commissioned.

Tax attributes

Generally, neither tax losses nor tax liabilities of the target company are transferred to the purchaser under an asset deal (subject to certain limitations, e.g. inheritance of customs risks).

Value added tax

The sale of most assets is subject to 18 percent VAT. Where a foreign legal entity acquires an asset directly and wishes to transfer the acquired asset to its business in Russia (e.g. contribute the asset to the charter capital of its subsidiary in Russia) and where the foreign legal entity is not tax-registered in Russia, the amount of the input VAT paid on the acquisition is a cost to the investor. Where the asset is acquired by an investor's Russian subsidiary, the input VAT on the acquired asset may be offset against the subsidiary's output VAT.

The contribution of an asset to the charter capital of a Russian company is not subject to Russian VAT. However, the Russian subsidiary contributing the asset to the charter capital should reinstate previously offset VAT (for fixed assets, at their net book value). Reinstated VAT should be shown separately in the transfer documents and can be offset against output VAT of the company that received the in kind contribution.

The sale of enterprise as a property complex is subject to specific VAT rules. For example, the tax basis should be defined as the net book value of assets per statutory accounting multiplied by a special ratio (where the purchase price differs from the net book value of the assets sold). Where the purchase price is lower than the net book value of assets, the correcting ratio is determined by the proportion the purchase price is of the net book value. Where the purchase price exceeds the net book value, the correcting ratio is calculated in the same way but the numerator and denominator of the proportion are reduced by the value of accounts receivables and the value of securities (if no decision about their revaluation has been made).

The seller must provide the purchaser with an inventory report and a consolidated invoice grouped by type of asset.

Property tax

Generally, property tax is levied at a maximum rate of 2.2 percent (set by the regional authorities) of the average net book value of the taxpayer's fixed assets. The net book value of fixed assets is determined based on statutory financial statements. Movable property recorded in the taxpayer's financial accounting on or after 1 January 2013 is not subject to property tax. As of 1 January 2014, the property tax base for the following immovable properties is determined based on their cadastral value:

- administrative, business and shopping centers and premises situated in them
- non-residential premises to be used or intended to be used for offices, commercial facilities, catering and domestic services
- any immovable property owned by foreign companies that do not carry out business activity through a permanent establishment in Russia
- immovable property owned by foreign companies that does not relate to business activity carried out through the permanent establishment by the foreign company.

The maximum tax rates for such items in 2014 are 1.5 percent immovable property in Moscow and 1 percent elsewhere in Russia.

Transfer taxes

Stamp duty is not applied in Russia, but similar duties are charged. For example, among other things, state duty is levied on the state registration of:

- rights to an enterprise as a property complex, a contract of alienation of an enterprise as a property complex, and limitations of or charges for rights to an enterprise as a property complex at the rate of 0.1 percent of the value of assets, property or other rights being a part of the enterprise as a property complex but not exceeding RUB60,000
- rights, limitations of or charges for rights to immovable property, and contracts of alienation of immovable property (excluding certain legally relevant actions) in the amount of RUB15,000 for legal entities
- issues (additional issues) of registrable securities offered for subscription at the rate of 0.2 percent of their nominal value but not exceeding RUB200,000.

The amount of state duty for registration of transactions relating to land plots and their encumbrances depends on the type of land plot and the entities involved. In most cases, the amount is not significant.

Purchase of shares

Generally, a share deal may be preferable for the seller where the seller is a foreign legal entity since, according to Russian tax legislation, capital gains from the sale of shares are tax-exempt unless more than 50 percent of the assets of a Russian target company consist of immovable property located in Russia.

Tax indemnities and warranties

In a share acquisition, the purchaser takes over the target company together with all its assets and liabilities including contingent liabilities. Therefore, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition. In order to protect itself from potential tax risks, the purchaser may wish to initiate a due diligence procedure and include some indemnities in the sale-purchase agreement.

Tax losses

Losses of the purchased company may be carried forward over for 10 years following the year in which the losses were incurred. The taxpayer is entitled to reduce its taxable profits by the previously incurred losses, provided that during the whole period of their use, the taxpayer retains the supporting documents that prove the losses were incurred.

In a reorganization, a company that takes over all the rights and obligations of the reorganized company is entitled to reduce its taxable profit by the amount of losses incurred by the reorganized company before its reorganization.

Note that the Russian government plans to introduce limitations on loss carry forwards in mergers and takeovers.

Crystallization of tax charges

As the purchaser of shares takes over the target company together with all its liabilities, the purchaser inherits all the target's historical tax risks. Therefore, the purchaser usually obtains an appropriate indemnity from the seller regarding outstanding historical tax liabilities. The purchaser may ask the target company to obtain a reconciliation statement and a statement of personal account from the tax authorities at the latest possible date preceding the date of a share deal. However, where the target company has no outstanding tax obligations according to these documents, the possibility remains that the tax authorities may challenge the accuracy and timeliness of the tax calculations and payments and accrue additional taxes and penalties in the future.

It is also advisable to consider carefully the results of the field tax audits of the target company. Generally, 3 calendar years preceding the current year are subject to field audit by the tax authorities. However, in certain cases, the closed tax periods (from 3 to 10 preceding years) may be subject to repeat tax audits. Among other things, such a repeat audit could be performed where:

- the taxpayer is regarded as inhibiting the exercise of the tax control by the tax authorities
- the higher tax authorities are checking work done by the lower tax authorities
- a criminal case is brought against the officers of the company on the grounds of tax evasion.

Transfer taxes

Stamp duty is not applied in Russia, but similar duties are charged. For example, state duty is levied on the state registration of the issue of securities (e.g. shares, bonds) at 0.2 percent of their nominal value but not exceeding RUB100,000.

Tax clearances

Taxpayers can obtain tax clarifications from the tax authorities on unclear or questionable provisions in Russian tax legislation. If the taxpayer follows such clarifications and the tax authorities then challenge the case, the taxpayer is exempt from penalties (fine and late payment interest) but not the tax itself. However, the authorities may claim that their clarifications were based on insufficient or uncertain information provided by the taxpayer. In this case, the taxpayer is not exempt from paying penalties.

Choice of acquisition vehicle

Several possible acquisition vehicles are available to a foreign investor, and tax consequences often influence the choice.

Local holding company

Where the purchaser uses debt financing to acquire a Russian target, it may be reasonable to set up a Russian holding company as an intermediary. Under Russian tax legislation, interest expenses are deductible for profits tax purposes irrespective of whether a loan was taken out for investment or current business needs. There are certain limitations on interest deductibility (see this chapter's section on deductibility of interest).

A post-acquisition merger of the intermediate holding company and the target company could be considered. This would make it possible to offset the holding company's interest expenses against the target company's income (the holding company would not have such income). It also would reduce the administrative costs of maintaining two companies rather than one. However, such a cascading structure is inefficient from a dividend payment point of view. Dividends are subject to tax at a rate of 0 percent where certain conditions are met or at 9 percent when distributed to the holding company. This tax may not be creditable against further taxation of dividends paid to the foreign shareholder.

Where the merger is mainly motivated by tax considerations, the tax authorities could invoke the concept of 'unjustified tax benefit' and assess additional taxes as if no merger had occurred.

Foreign parent company

A foreign purchaser may wish to acquire the shares of a Russian company without an intermediary, which should be considered where the foreign parent plans to resell the target. Russia does not tax capital gains on shares sold by a foreign legal entity unless more than 50 percent of the assets of the Russian target consist of immovable property located in Russia.

Although Russia levies withholding tax (WHT) on dividends, interest and royalties paid to a foreign entity, the WHT can be reduced or eliminated by an applicable tax treaty. Russia has an extensive network of such treaties.

A foreign investor may acquire shares in a Russian company for cash or in exchange for in kind contributions of property (assets or shares). In this case, the tax basis of the acquired shares in the Russian company is equal to the tax basis of property (shares) given in exchange for the shares and costs related to the contribution.

The tax basis of property (assets or shares) received by the Russian company also is equal to the tax basis of the contributed property stated in the records of the investor on the date of transfer (but not higher than the market value of the transferred property, as confirmed by an independent valuer for transfers made by a foreign investor). Where the Russian company lacks supporting documents for the cost of property received, the tax basis of property is zero for Russian profits tax purposes.

Permanent establishment (PE) issues should also be taken into account. According to the RussianTax Code, the activities of a foreign legal entity may create a PE in Russia where the foreign entity has a place of business in Russia (i.e. branch, office, bureau or other separate division) and regularly engages in business activities through this place (unless the activities are preparatory or auxiliary in character). Most tax treaties between Russia and other countries set similar criteria for determining whether a PE of a foreign legal entity (FLE) exists in Russia.

Non-resident intermediate holding company

A non-resident intermediate holding company could be used to reduce WHT on dividends, interest and royalties by applying a favorable tax treaty with Russia. However, the Russian tax authorities may challenge the deal if they consider that its only objective is to obtain a tax benefit (the so-called unjustified tax benefit concept).

PE issues should also be taken into account.

Local branch

Instead of directly acquiring the target company, a foreign purchaser may structure the acquisition through its Russian branch. The taxation of a branch depends on whether it constitutes a PE in Russia. Acquiring shares or participation units of a Russian legal entity by an FLE is not deemed a creation of a PE in Russia unless other characteristics of a PE are present.

Where the branch does not constitute a PE in Russia, the tax consequences on the subsequent sale of the target are the same as where a foreign parent company is used as an acquisition vehicle: there is no capital gains tax on shares sold by an FLE unless more than 50 percent of the assets of the Russian target consists of immovable property located in Russia.

Where the branch constitutes a PE in Russia, capital gains are taxed in the same way as capital gains of the Russian company (20 percent profits tax).

Joint venture

A joint venture may be corporate (usually in the form of an OOO) or not corporate (joint venture agreement). A corporate joint venture is considered a Russian legal entity and normally is subject to the general tax regime.

Where a joint venture is to be set up as a simple partnership, certain conditions must be met. For example:

- Participants in a joint venture must carry out separate accounting of joint venture operations and operations not related to the joint venture activities.
- If one of the participants is a Russian legal entity, it should carry out the tax accounting of a joint venture.
- Only a Russian participant is entitled to recover input VAT.

Choice of acquisition funding

Typically, acquisitions are financed with debt, contributions to equity, or hybrid instruments. The main tax issues arising for these alternatives are summarized below.

Debt

Debt financing may be preferable from the tax point of view because the purchaser can deduct interest expenses for profits tax purposes (subject to certain limitations). Payment of dividends, by contrast, does not give rise to a tax deduction. However, before using debt financing, the company should thoroughly consider certain financial factors and whether it is better to borrow from a bank or from another legal entity, related or unrelated.

Deductibility of interest

Generally, interest on debt instruments is deductible for profits tax purposes regardless of whether the loan is taken out for investment purposes or current business needs. Exchange losses on loans and interest are fully deductible, and gains are fully taxable. The following limitations based on the arm's length principle should be taken into account:

- The accrued interest should not be 20 percent higher or lower than the average level of interest on comparable loans granted in the same quarter under comparable conditions.
- In the absence of comparable loans, the maximum deductible rate on foreign currency loans is 1.8 times of the Russian Federation (RF) Central Bank rate for loans granted in rubles and 0.8 of the RF Central Bank rate for loans in foreign currency (from 1 January 2011 to 31 December 2014).

As of 1 January 2015, the above limitations will be abolished and new rules will apply.

Thin capitalization rules apply when:

- A Russian borrower receives a loan from a foreign lender that owns directly or indirectly more than 20 percent of its share capital or from a Russian lender affiliated with such a foreign indirect/direct shareholder, or if such a Russian affiliate guarantees the loan.
- The borrower's debt-to-equity ratio is more than 3:1 (12.5:1 for companies that perform only leasing activities).

Technically, the Russian thin capitalization rules should not apply to situations where a loan is received from a foreign sister company or from any other foreign company of the same group that is not the Russian company's direct or indirect shareholder. Thus, the thin capitalization restrictions could be mitigated by appropriately structuring the lender-borrower relationship. However, based on recent adverse developments in the tax authorities' thin capitalization challenges, loans received from foreign sister companies or another foreign group company that is not the Russian company's direct or indirect shareholder could be subjected to thin capitalization rules.

Any interest paid in excess of the debt-to-equity ratio is not tax-deductible and is treated as dividends for tax purposes.

Withholding tax on debt and methods to reduce or eliminate it

The statutory WHT rate on interest income is 20 percent, whereas the majority of tax treaties, which override domestic law, provide for 0 percent or 5 percent rates. To obtain treaty relief, the foreign company receiving the interest income should provide the Russian company, its tax agent, with a tax-residency certificate.

Checklist for debt funding

- The use of a bank loan could help the purchaser eliminate or mitigate thin capitalization and transfer pricing problems.
- The statutory WHT rate on interest income of 20 percent may be reduced by applying the provisions of a tax treaty that provides for a lower rate.

Equity

According to Russian law, the contribution of cash by a shareholder (parent company) to the share capital of a Russian company (the target company) is not a taxable event, but dividends paid to a parent company are subject to WHT. Where a parent company is a Russian legal entity, dividends paid are subject to WHT at a general rate of 9 percent (0 percent if certain conditions are met). Dividends paid to a foreign parent company are subject to WHT of 15 percent, unless reduced by treaty (WHT can be reduced to 5 percent under some treaties).

Forms of reorganization

Generally, the reorganization of a legal entity is tax-neutral. Neither the reorganized company nor the new company created by the reorganization should be subject to any additional taxation.

According to Russian civil law, the reorganization of a legal entity can take one of five different forms: merger, takeover, split-off, spin-off and conversion.

The Russian Tax Code stipulates that obligations to pay taxes and fees of a reorganized legal entity should be fulfilled by its legal successor(s):

- On a merger of several legal entities, the legal entity resulting from the merger should be recognized as the successor regarding the obligation to pay taxes and fees of each of the original legal entities.
- On a takeover of one legal entity by another legal entity, the accessing legal entity should be recognized as the successor to the obligations to pay taxes and fees of the accessed legal entity.
- On a split-off of a legal entity into several legal entities, the legal entities resulting from the division should be recognized as successors regarding the obligations to pay taxes and fees of the original organization.
- On a spin-off from a legal entity, no succession to the reorganized legal entity regarding its obligations to pay taxes should arise. Where the reorganized legal entity cannot fulfill its obligations to pay taxes and fees in full due to the separation from a legal entity by one or more legal entities, then, pursuant to a court decision, the separated legal entities may be obligated jointly and severally to pay the taxes and fees of such legal entity.
- On a conversion of one legal entity into a new one, the legal entity resulting from the conversion should be recognized as the successor to the obligations to pay taxes and fees of the reorganized legal entity.

Hybrids

Hybrid instruments are classified as debt or equity for tax purposes depending on their legal form, rather than on their economic substance. Thus, in principle, hybrid instruments such as profit-sharing loans and interest-free loans are classified as debt for tax purposes. In theory, the tax authorities may challenge the claim that such instruments are not debt in arbitration court by asserting that they are fictional instruments that actually disguise the distribution of profits. However, the tax authorities' chances of being successful in court are very low. Note that hybrid instruments are very rare in Russia.

Discounted securities

According to the Russian Tax Code, any previously determined income (including a discount) received from any kind of debenture is interest income and subject to a 20 percent tax WHT.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. The Russian Tax Code has no specific provisions on the taxation of such transactions; the tax consequences depend on the wording of relevant supporting documentation and the relationships between the parties. Generally, deferred settlement could be taxed as follows (depending on whether foreign or Russian legal entities are involved):

- For a foreign vendor with no PE in Russia, the Russian buyer's obligation to withhold tax arises at the moment of payment. Therefore, deferred settlement payments to foreign companies should be subject to Russian WHT (if any) at the moment of payment.
- The situation where deferred settlement is due to the Russian legal entity is more complicated and depends on the precise contract terms and the tax policy of this Russian legal entity. A tax liability could arise on the receipt or accrual of deferred settlement amounts.

Other considerations

Some of the many other considerations that should be taken into account when structuring M&A transactions are as follows:

- The target's business could be transferred to a new legal entity.
- A simple partnership with joint activities could be formed.
- Many other options and combinations thereof are available, depending on the specifics of the target and the transaction. Non-tax factors, such as company law, anit-monopoly provisions and currency controls should be considered.

Concerns of the seller

The tax consequences for the seller depend on whether it is a Russian legal entity or an FLE.

A seller that is a Russian legal entity is subject to a 20 percent tax on capital gains, provided its expenses are supported by the required documents. Where there is no documentary evidence of expenses, the gross income from the sale is subject to taxation.

A seller that is an FLE is exempt from tax on capital gains unless more than 50 percent of the assets of the Russian target company consist of immovable property located in Russia (otherwise, capital gains are subject to 20 percent profits tax).

Where the seller is an individual, capital gains are subject to 13 percent income tax for Russian residents and 30 percent for non-resident individuals.

Company law and accounting

Commercial entities in Russian are divided into companies, partnerships, production cooperatives, and state and municipal unitary enterprises. The most widespread are AOs and OOOs.

Joint stock company (AO)

- An AO is a legal entity that can be either open (OAO, publicly owned) or closed (ZAO).
- The minimum share capital for an OAO is RUB100,000; for a ZAO, it is RUB10,000.
- The minimum number of shareholders (both OAOs and ZAOs) is one (unless the only shareholder is a legal entity owned by one person).
- The maximum number of shareholders for a ZAO is 50; the number for an OAO is not limited.

Limited liability company (OOO)

- The minimum charter capital for an OOO is RUB10,000.
- The minimum number of participants is one (unless the only participant is a legal entity owned by one person).
- The maximum number of participants in an OOO is 50.
- Participants are not liable for the company's debts.
- Shareholders are not liable for the company's debts.

The taxation regime does not depend on the legal form of the company.

Anti-monopoly legislation

Generally, the anti-monopoly law sets certain restrictions on transactions and contractors. A number of transactions require preliminary consent from the responsible authorities or a simple notification after the event.

For example, prior consent is required for:

- a reorganization in the form of a merger of commercial organizations where:
  - the aggregated net book value of their assets at the last reporting date preceding the request to the anti-monopoly authorities exceeds RUB7 billion
  - the aggregated sales turnover for the year preceding the merger exceeds RUB10 billion
  - one of the merging companies is included in the register of economic entities that dominate or have a share of more than 35 percent of the market of a certain product.
- certain sales of shares (participation units), rights and/or property where:
  - the aggregated net book value of the target and purchaser's assets exceeds RUB7 billion
  - the aggregated sales turnover for the year preceding the deal exceeds RUB10 billion and the net book value of the target's assets exceeds RUB250 million
  - one of the companies is included in the register; in practice, it could be difficult to collect all the necessary documents within a short period of time.

Group relief/consolidation

The conditions that need to be met to obtain group relief effectively mean that there are few consolidated taxpayers in Russia.

For other Russian legal entities that do not form consolidated tax groups but have branches or representative offices, the profits tax is calculated on a consolidated basis by the head office. Profit is attributed to each branch based on a proportion of the average number of employees of the branch and the residual value of the depreciated fixed assets of the branch.

Tax grouping

As of 1 January 2012, tax grouping was introduced in Russia. This regime applies to a group of companies where one company has a direct or indirect participation of not less than 90 percent in the charter capital of each group company. Tax grouping is only available where, for the preceding year, the total amount of taxes paid by the applying companies is not less than RUB10 billion, total sales are not less than RUB100 billion, and total assets as at 31 December of the preceding year are not less than RUB300 billion. Tax grouping is available for profits tax only and should be formalized by an agreement signed by the participating companies. The tax group is formed for a period of not less than two profits tax periods (calendar years).

The accumulated tax losses incurred by the taxpayer before the tax grouping agreement is concluded are not deductible against the consolidated profits of the tax group.

Where the taxpayer chooses to exit the tax group, these losses become available for deduction and their carry forward period is increased by the number of years the taxpayer was a tax group member. Similarly, individual taxpayers cannot utilize part of tax losses incurred by the tax group if they choose to exit the tax group or are no longer eligible for the tax consolidation.

Considering the turnover and assets requirements and the limitations on utilization of accumulated tax losses, KPMG in Russia expects that tax grouping will remain rare in Russia.

Transfer pricing rules

As of 1 January 2012, new transfer pricing rules were introduced in Russia. These rule differ significantly from the previously used formal approach and generally correspond to OECD principles. In particular, the tax authorities should calculate price adjustments:

- based on prices available on comparable transactions having the same or similar financial or commercial conditions, including functions performed, assets employed and risk undertaken by the parties of a transaction
- by applying the most suitable pricing method, which in the facts and circumstances enables a justified conclusion regarding the level of prices
- based on market price intervals or profitability intervals estimated based on available information regarding transactions between unrelated parties
- as symmetrical adjustments for both parties of the transaction (e.g. if sales revenue of one party of the transaction is increased, cost of sales of the other party should be increased accordingly).

Under the Russian transfer pricing rules, as 1 January 2012, the following transactions are subject to transfer pricing regulation (so-called controlled transactions):

1. cross-border transactions between related parties (any materiality)
2. cross-border transactions with oil and oil products, ferrous and non-ferrous metals, precious metals and precious stones (e.g. goods traded on international stock exchanges) where proceeds from transactions with the same counterparty exceed RUB60 million in one calendar year
3. transactions where one of the parties is a tax resident in a country included in the RF Ministry of Finance's blacklist where proceeds from transactions with the same counterparty exceed RUB60 million in one calendar year
4. transactions between related parties where:
   a) the total proceeds from the transactions exceed RUB1 billion in 2014 and later years (in 2012, RUB3 billion; in 2013, RUB2 billion)
   b) one of the parties is subject to the mineral extraction tax provided that the total proceeds from the transactions exceed RUB60 million
   c) one of the parties to the transactions is subject to the unified tax on imputed income or unified agricultural tax regime while the other party does not apply these tax regimes and the total proceeds from the transactions exceed RUB100 million (effective 2014)
   d) one of the parties to the transactions applies a 0 percent profits tax (e.g. currently is a resident of the innovation center Skolkovo) while the other party does not apply this tax rate and the total proceeds from the transactions exceed RUB60 million

e) one of the parties to the transactions is a resident of a special economic zone in Russia while the other party is not a resident of a special economic zone and the total proceeds from the transactions exceed RUB60 million (effective 2014).

The following transactions are not subject to transfer pricing regulation:

- transactions between companies that simultaneously meet the following criteria: (a) are registered in the same region of the RF, (b) do not have separate divisions in different Russian regions or outside the RF, (c) do not pay profits tax in different regions of the RF, (d) do not have tax losses, (e) none of the parties are a payer of the mineral extraction tax, and where such transactions do not fall under points 4.b-4.e above
- transactions between members of a consolidated group of taxpayers.

Controlled transactions involve goods, works and/or services. When analyzing the comparability of the commercial and financial terms of these transactions with the terms of uncontrolled transactions, a number of indicators should be taken into account, including:

- characteristics of the goods, services or works
- functions of the parties to the transaction
- terms and conditions of the contracts
- economic environment
- market (commercial) strategies of the parties to the transaction.

Fines are being introduced for violating the transfer pricing law. For example, if taxes are underpaid because of non-arm's length prices, the following fines apply:

- for 2012-2013 – no fine
- for 2014-2016 – fine of 20 percent of the unpaid taxes but not less than RUB30,000
- from 2017 – fine of 40 percent of the unpaid taxes but not less than RUB30,000.

The following methods can be used to determine the range of arm's length prices: comparative uncontrolled price (CUP) method, re-sale price method, cost plus method, comparable profitability method, and profits allocation method

The CUP method usually is the preferred method. However, for transactions in which goods are purchased and re-sold without any modification, the re-sale price method is the preferred method. Where the preferred method cannot be applied, the method that is most appropriate for the transaction should be applied

Taxpayers must keep transfer pricing documentation as evidence that the prices used are within the range of arm's length prices and submit information to the tax authorities for all controlled transactions.

For taxpayers who qualify as major taxpayers (as defined in the Russian Tax Code), the new law introduced the possibility of concluding advance pricing agreements with the tax authorities (i.e. where the taxpayer and the tax authorities agree in advance to apply a specific methodology to calculate the range of arm's length prices). A duty of RUB 1.5 million is payable for the signing of a pricing agreement.

In view of the recent changes, Russian transfer pricing legislation has become more detailed and well developed, which could enable the tax authorities to more successfully defend their positions in court.

Tax-free sale of shares

Starting 1 January 2011, a 0 percent profits tax rate applies to income received from the sale of shares in companies that are not publicly traded (and publicly traded shares in high technology companies) if the taxpayer held the shares for more than 5 years. The tax authorities interpret this provision as applying to shares acquired after 1 January 2011.

Dual residency

Generally, dual residency conflicts are resolved by the relevant tax treaty by means of tax credit or exemption. Since obtaining these usually involves certain bureaucratic and time-consuming procedures, intentional dual residency is usually not used by Russian companies (the Russian residency of which is defined by registration).

Foreign investments of a local target company

Russian legislation limits the activities of non-Russian investors participating in companies that are of strategic value to Russia (so-called strategic companies). These activities include:

- exploration of subsoil and extraction of mineral resources on land plots of national significance
- aerospace activities
- certain services provided by a natural monopoly or a company with a dominant position on the Russian market
- harvesting of live aquatic resources
- activities controlling hydrometeorological and geothermal processes and events
- certain activities related to the use of nuclear and radiation-emitting materials
- certain activities related to the use of encrypting facilities and bugging equipment
- military-technical activities.

Non-Russian investors (i.e. non-Russian private companies, non-Russian individuals and Russian companies controlled by non-Russian companies or individual(s)) are permitted to carry out transactions that would result in their obtaining control over a strategic company. However, such transactions, among others, must be approved by state authorities.

Comparison of asset and share purchases

Advantages of asset purchases

- The price of purchased assets can be depreciated for profits tax purposes.
- If the acquiring company is in a loss position, such losses may be used against profits generated by the acquired business in the case of merger or takeover.
- Possible to acquire only those assets that the purchaser really needs (which could be useful, among other things, where the purchaser wants to acquire only part of a business).
- Tax liabilities and tax exposures of the target company should not generally be transferred to the buyer.
- Where the target merges with its shareholder after the sale of its assets, the profits of the target accumulated before the transfer of assets are transferred to the shareholder without additional taxation. Under a share purchase, such profits, when distributed, are subject to WHT at 9 (0) or 15 percent, or less in accordance with a tax treaty.

Disadvantages of asset purchases

- The sale of assets is subject to VAT, which may result in a negative cash flow impact for the buyer. If the buyer's business is VAT-exempt, the input VAT is capitalized.
- Profits tax could be due if assets with a high market value and low-tax basis are sold.
- Accumulated tax losses remain with the vendor.
- Losses incurred on the sale of fixed assets are not immediately deductible and are recognized evenly over the period of the remaining useful life of the assets.
- Customs risks cannot be eliminated.
- An asset deal could be reclassified as the sale and purchase of an enterprise as property complex, resulting in inheritance of all liabilities thereof.
- It may not be possible to transfer all assets to another company where, for example, some assets are used as collateral securing loans and borrowings.
- Transfer of licenses might be impossible.
- Assets not reflected in the Russian accounting principles (RAP) balance sheet may not be transferred.

- Difficulties in interrupting a long production cycle or construction in progress for the transfer of assets.
- Difficulties in obtaining consent from minority shareholders for the sale of assets.
- Long registration process of some asset deals.
- Significant VAT and customs duties clawback.

Advantages of share purchases

- Capital gains from the sale of shares could be tax-exempt in certain cases if the deal is properly structured.
- Sale of shares is not subject to VAT.
- Tax losses accumulated by the target prior to acquisition may be used after the changes in shareholding of the target.
- The share acquisition procedure is technically less complicated than an asset deal; however, it may be necessary to perform anti-monopoly procedures.

Disadvantages of share purchases

- All tax liabilities and tax risks of the target are inherited.
- Capital gains received by the vendor could be subject to taxation in Russia: 20 percent profits tax payable by a corporate vendor or 13 percent personal income tax payable by an individual vendor who is a Russian tax-resident.
- Goodwill cannot be depreciated for profits tax purposes; only the net book value of assets can be depreciated.
- Consolidation of profits and losses of the acquirer with the profits and losses of the target company is not allowed (except in the case of a post-acquisition merger or takeover).

Russia – Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under Russia's tax treaties. This table is based on information available up to 26 November 2013.

Source: *International Bureau of Fiscal Documentation, 2014*

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Domestic rates				
Companies:	15	15	9/15/20	20
Individuals:	15	N/A	30	30
Treaty rates				
Treaty with:				
Albania	10	10	10	10
Algeria	15	5	0/15[3]	15
Argentina	15	10	15	15
Armenia	10	5[4]	0	0
Australia	15	5[5]	10	10
Austria	15	5[6]	0	0
Azerbaijan	10	10	10	10
Belarus	15	15	10	10
Belgium	10	10	0/10[7]	0
Botswana	10	5	10	10
Brazil	10/15[8]	10	–/15[9]	15
Bulgaria	15	15	15	15
Canada	15	10[10]	10	0/10[11]
Chile	10	5	15	5/10[12]
China (People's Rep.)	10	10	10	10
Croatia	10	5[13]	10	10
Cyprus	10	5[14]	0	0
Cyprus (new Protocol)	10	5	0	0
Cuba	15	5	10	5
Czech Republic	10	10	0	10
Denmark	10	10	0	0
Egypt	10	10	15	15
Finland	12	5[15]	0	0
France	15	5/10[16]	0	0
Germany	15	5[17]	0	0
Greece	10	5	7	7

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Hungary	10	10	0	0
Iceland	15	5	0	0
India	10	10	10	10
Indonesia	15	15	15	15
Iran	10	5	7.5	5
Ireland	10	10	0	0
Israel	10	10	10	10
Italy	10	5	10	0
Japan	15	15	10	0/10[18]
Kazakhstan	10	10	10	10
Korea (Dem. People's Rep.)	10	10	0	0
Korea (Rep.)	10	5	0	5
Kuwait	5	0/5[19]	0	10
Kyrgyzstan	10	10	10	10
Latvia	10	5[20]	5/10[21]	5
Lebanon	10	10	5	5
Lithuania	10	5	10	5/10
Luxembourg[22]	10/15[23]	10	0	0
Macedonia (FYR)	10	10	10	10
Malaysia	–/15[24]	–/15	15	10/15[25]
Mali	15	10[26]	0/15	0
Mexico	10	10	0/10[27]	10
Moldova	10	10	0	10
Mongolia	10	10	10	–[28]
Montenegro29	15	5	10	10
Morocco	5/10[30]	5	0/10[31]	10
Namibia	10	5	10	5
Netherlands	15	5[32]	0	0
New Zealand	15	15	10	10
Norway	10	10	10	0
Philippines	15	15	0/15[33]	15
Poland	10	10	10	10
Portugal	15	10[34]	10	10
Qatar	5	5	5	0
Romania	15	15	15	10

	Dividends		Interest[1] (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies[2] (%)		
Saudi Arabia	5	0/5	5	10
Serbia	15	5	10	10
Singapore	10	5[35]	7.5	7.5
Slovak Republic	10	10	0	10
Slovenia	10	10	10	10
South Africa	15	10	10	0
Spain	15	5/10[36]	0/5[37]	5
Sri Lanka	15	10	10	10
Sweden	15	5[38]	0	0
Switzerland	15	0/5[39]	0	0
Syria	15	15	10	4.5/13.5/18[40]
Tajikistan	10	5	10	0
Thailand	15	15	10/–[41]	15
Turkey	10	10	10	10
Turkmenistan	10	10	5	5
Ukraine	15	5[42]	10	10
United Arab Emirates[43]	–[44]	0[45]	0	–[46]
United Kingdom	10	10	0	0
United States	10	5	0	0
Uzbekistan	10	10	10	0
Venezuela	15	10	0/5/10[47]	10/15[48]
Vietnam	15	10[49]	10	15

Notes:

1. Many treaties provide for an exemption for certain types of interest, e.g. interest paid to the state, local authorities, the central bank, export credit institutions or in relation to sales on credit. Such exemptions are not considered in this column.
2. Unless stated otherwise, the reduced treaty rates given in this column generally apply if the recipient company holds directly or indirectly The lower rate applies if the recipient owns directly at least 25 percent of the capital or the voting power in the Russian company, as the case may be.
3. The zero rate applies to interest paid by the contracting state or its local authorities.
4. The rate applies if the value of the holding is at least percent 40,000 US dollars (USD).
5. The rate applies to dividends paid out of profits that have borne the normal tax rate to an Australian company holding directly at least 10 percent of the capital in the Russian company, the Australian company's holding being at least 700,000 Australian dollars and the dividends being exempt from tax in Australia.
6. The rate applies if the recipient company owns directly at least 10 percent of the capital in the Russian company and the value of the holding exceeds USD100,000.
7. The lower rate applies to interest paid to banks and other financial institutions.
8. The 10 percent rate applies if the recipient (individual or company) owns directly at least 20 percent of the capital in the Russian company.
9. Interest from securities, bonds or debentures issued by the government of Russia or its political subdivision is taxable only in Russia.
10. The rate applies if the recipient company owns at least 10 percent of the capital or voting power in the Russian company, as the case may be.
11. The lower rate applies to copyrights (including films and television programs), computer software, patents and know-how.
12. The lower rate applies to equipment rentals.
13. The rate applies if the recipient company owns at least 25 percent of the capital in the Russian company and the value of the capital investment is at least USD100,000.
14. The rate applies if the value of the holding is at least 100,000 Euros (EUR).
15. The rate applies if the recipient company owns directly at least 30 percent of the capital in the Russian company and the value of the holding is at least USD100,000 (EUR100,000 from 1 January 2013).
16. The 5 percent rate applies if the French company (i) has directly invested at least EUR76,225 in the Russian company and (ii) is subject to tax in France, but is exempt with respect to the dividends (i.e. participation exemption). The 10 percent rate applies if only one of the requirements is fulfilled.
17. The rate applies if the German company owns at least 10 percent of the capital in the Russian company and the value of the holding is at least EUR80,000.

18. The lower rate applies to copyright royalties including, films and television programs.
19. The zero rate applies to dividends distributed to governments, state authorities, public financial institutions or public entities where state participation is at least 25 percent.
20. The 5 percent rate applies if the beneficial owner is a company (other than a partnership) which holds directly at least 25 percent of the capital of the company paying the dividends and the capital invested exceeds USD75,000.
21. The 5 percent rate applies to interest on loans of any kind granted by a bank or other financial institution of one contracting state to a bank or other financial institution of the other contracting state.
22. The treaty does not apply to exempt Luxembourg holding companies. From 1 January 2011, this provision will be obsolete because the transitional regime for existing holding companies expires on 31 December 2010.
23. The 10 percent rate applies if the Luxembourg individual or corporate recipient owns directly at least 30 percent of the capital in the Russian company and the value of the holding is at least EUR75,000.
24. The 15 percent rate applies to profits of joint ventures. Otherwise, the domestic rate applies; there is no reduction under the treaty.
25. The lower rate applies to industrial royalties.
26. The rate applies if the value of the holding is at least 1 million French francs.
27. The lower rate applies to interest paid in respect of a loan for a period of at least 3 years granted, guaranteed or insured by the specified banks.
28. The domestic rate applies; there is no reduction under the treaty.
29. The treaty concluded between Russia and the former Yugoslavia (Fed. Rep.).
30. The 5 percent rate applies if the value of the holding of the recipient (individual or company) is at least USD500,000.
31. The lower rate applies to interest on foreign currency deposits.
32. The rate applies if the recipient company holds directly at least 25 percent of the capital in the Russian company and the value of the capital investment is at least 75,000 European currency units (ECU) or its equivalent in the national currencies of the contracting states.
33. Interest paid by Russia to the government of the other state, a political subdivision or local authority is taxable only in that other state.
34. The rate applies if the Portuguese company has owned directly at least 25 percent of the capital in the Russian company during an uninterrupted period of at least 2 years prior to the payment.
35. The rate applies if the Singapore company owns at least 15 percent of the capital in the Russian company and has invested in it at least USD100,000.
36. The 5 percent rate applies if (i) the Spanish company has invested at least EUR100,000 in the Russian company and (ii) the dividends are exempt in Spain. The 10 percent rate applies if only one of the conditions is met.
37. The lower rate applies to long-term loans (minimum 7 years) granted by a bank or another credit institutions resident in a contracting state.
38. The rate applies if the Swedish company owns 100 percent of the capital in the Russian company (or in the case of a joint venture, at least 30 percent of the capital in such a joint venture) and the foreign capital invested exceeds USD100,000.
39. The rate applies if the Swiss company owns at least 20 percent of the capital in the Russian company and the value of the holding exceeds CHF 200,000. With effect from 1 January 2013, a 0 percent rate applies if the beneficial owner of the dividends is (i) a pension fund (or similar institution; (ii) the Government of the other State, any political subdivision or local authority thereof; or (iii) a Central Bank.
40. The 4.5 percent rate applies to films and broadcasting programs. The 13.5 percent rate applies to copyrights on items of literature, art or science.
41. The 10 percent rate applies to interest paid to financial institutions (as defined). The domestic rate applies in other cases; there is no general reduction under the treaty.
42. The rate applies if the value of the holding is at least USD50,000.
43. Effective from 1 January 2014.
44. The treaty is not applicable to individuals receiving dividends.
45. The rate applies only if the recipient is a financial or investment institution.
46. The treaty does not cover royalties.
47. The zero rate applies, inter alia, to interest paid by (or to) public bodies. The 5 percent rate applies to interest paid to a bank.
48. The lower rate applies to fees for technical services.
49. The rate applies if the Vietnamese company has invested directly in the capital of the Russian company at least USD10 million.

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