Tax Flash
by PwC experts

January 2021 / Issue No. 3

Thin capitalisation: applying the 12.5 coefficient on leasing-related income

In brief

In a case involving OOO De Lage Landen Leasing (the "Company"), the Russian Supreme Court has overturned lower court decisions adopted in favour of the tax authorities and sent the case for a re-trial.[1] The dispute concerned the application of the 12.5 thin capitalisation coefficient by the leasing company to income generated from related activities. In the audited period, only companies engaged *exclusively* in leasing activity were eligible to apply the 12.5 coefficient. The Company and the tax authorities disagreed on the issue of exclusiveness.

In detail

Facts of the case

The Company, which is engaged in leasing activity, had debt to a foreign sister company. When calculating the cap for interest, the Company applied the 12.5 coefficient.

According to the tax authorities, the Company should have applied the standard coefficient of 3, because it was engaged in other activities in addition to leasing. It earned income not only from leasing payments but also from commission fees for arranging lease agreements and from selling equipment and machinery on instalment plans.

Lower courts' position

Courts of three instances upheld the tax authorities' position. In the audited period, Article 269 of the RTC was laid down in such a way that only companies engaged *exclusively* in leasing activity were eligible to apply the 12.5 coefficient (however, Russian tax legislation does not spell out the term).

Russian Supreme Court's position

The Supreme Court upheld the taxpayer's position, finding it possible to qualify the Company's other activities as related to leasing (it referred, among other things, to the provisions of Federal Law No. 164-FZ of 29 October 1998 "On Financial Lease (Leasing)"). Furthermore, it pointed out that passive income, such as dividend and interest income, does not constitute operating income at all and is qualified as non-operating income.

The takeaway

Russian tax legislation is not perfect. When provisions are applied based on a subjective assessment or qualification of ambiguous notions/evidence of business activity (in the case at hand, it concerned the qualification of certain business activity), disputes are inevitable.

[1] https://kad.arbitr.ru/Kad/Card?number=%D0%9040-123840%2F2019

Since 2017, thin capitalisation rules have become more clearly and fairly stated.[2] The word "exclusively" has been removed and a maximum threshold for other activities in addition to leasing has been introduced (however, the list of permissible types of leasing activity per se has not been prepared yet). The likelihood of disputes is significantly lower now.

Applying the new rules to the case at hand, it can be assumed that the threshold is not so important. Even if the Company had gone beyond the limit (income from other activities was more than 10%), it would not have changed the situation and such activity would most likely be qualified as leasing. We will monitor the re-trial.

Such disputes arise from specific circumstances (contract wording, etc., is important here). Each activity should be considered on an individual basis. Furthermore, if the tax authorities present factual evidence of tax avoidance, the outcome of the case might be different. The Supreme Court's refusal to apply a formal approach in analysing the activities of taxpayers and a consistent reminder from the tax authorities based on good faith principles inspires some optimism regarding further development of practice on similar matters.[3]

Join PwC **TaxPro** – our tax and legal Telegram channel

We would be happy to answer any questions you may have.

PwC Tax Leaders:
https://www.pwc.ru/ru/services/tax-consulting-services/our-team.html

PwC Legal Leaders:
https://www.pwc.ru/ru/services/legal-services/people.html

Be legal. Pay taxes. – New section of tax and legal news on YouTube

Would you like to be in the know of recent high-profile litigations? Visit our Precedent Case Library.

Tax Guru is a mobile application that will help you keep up with the latest developments in the Russian laws, search for information and enable you to get tax news quickly, wherever you are and at any time.

www.pwc.ru **app store**

[2] "Where the taxpayer's controlled debt exceeds … by more than three times (for banks and entities engaged ~~exclusively~~ in leasing activity, by more than 12.5 times). An entity whose income from the leasing activity… account for at least 90% of income included in the tax base is qualified as an entity engaged in the leasing activity…" (as amended by Federal Law No. 25-FZ of 15 February 2016).

[3] The Supreme Court pointed out in the court ruling that in the course of the audit, the tax authority incorrectly calculated the capitalisation ratio and the cap for interest recognised for tax purposes – the values were calculated on a cumulative basis and not as of the end of respective periods, as earlier laid down by the Supreme Arbitrazh Court of the Russian Federation.