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## The Russian Ministry of Finance Proposes Amendments on Withholding Taxation of Interest Payments on Eurobonds

### I. OVERVIEW

On February 20, 2012 the Ministry of Finance of the Russian Federation (the “Ministry of Finance”), following consultations with certain participants in the Russian Eurobond market, released its proposed amendments to the Russian Tax Code regarding withholding taxation on Eurobonds of Russian companies (the “Draft Amendments”).<sup>1</sup> The Draft Amendments provide for withholding tax relief for interest payments of Russian borrowers under Eurobonds issued by them directly and payments made by Russian borrowers to special purpose vehicles (“SPVs”) to fund interest payments under Eurobonds issued by such SPVs.<sup>2</sup>

The nature of the proposed relief is different, depending on the status of the Russian borrower, the structure of the Eurobond offering and the time when the Eurobonds were issued. First, the proposed withholding tax exemption for government bonds issued by the Russian Federation, Federation subjects or municipal borrowers applies to both rouble and foreign currency denominated bonds, and is not conditional on such government bonds being listed on any exchange. Second, in an attempt to promote direct Eurobond offerings, the proposed withholding tax exemption for Eurobonds issued by Russian non-governmental entities directly (rather than via some intermediary structure) is subject to very few conditions, including listing of Eurobonds on a foreign exchange and application of foreign governing law. Third, the proposed relief for Eurobonds issued using the SPV structures will be subject to satisfaction of further conditions. However, the Ministry of Finance clarified that any Eurobond offerings completed prior to January 1, 2013 under conventional structures will be effectively grandfathered (subject to the satisfaction of certain conditions discussed below). At the

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<sup>1</sup> When used in this memorandum, the term “Eurobonds” refers to Eurobonds listed on a recognized foreign exchange. As noted below, the Draft Amendments and related public statements by the Ministry of Finance are silent on Russian withholding taxation for ECP and CLN programs, which are traditionally unlisted.

<sup>2</sup> While our Firm does not practice Russian tax law, our lawyers are heavily involved in structuring Eurobond offerings for Russian issuers.

same time, the application of the relief to Eurobond offerings using SPV structures on or after January 1, 2013 is less clear for the reasons discussed below.

This is not the first attempt by the Ministry of Finance to reform the taxation applicable to Eurobond offerings. Prior attempts in the end were not implemented, and there is no assurance that the Draft Amendments will be adopted in the form proposed, or at all. The discussion below is based on the version of the Draft Amendments and related clarification release posted on the Ministry's website on February 20, 2012.

## **II. BACKGROUND**

Currently, Eurobond offerings of Russian companies involve an issuance of bonds (called Loan Participation Notes, or LPNs) by an SPV, either 100% owned by the borrower or an "orphan," established in a jurisdiction with which Russia has a treaty for the avoidance of double taxation that reduces the otherwise applicable 20% Russian withholding tax rate to zero ("double tax treaty").<sup>3</sup> The SPV then on-lends the proceeds of the offering to a Russian borrower and services the LPNs out of funds received from the Russian borrower pursuant to the loan agreement (we refer to this structure below as the "Eurobond Structure").

Until recently Russian borrowers in Eurobond Structures relied on the position that interest payments to the SPVs were eligible for withholding tax relief under the relevant double tax treaty between Russia and the SPV's country of residence. However, on December 30, 2011 the Ministry of Finance issued a clarification letter stating that the SPV in Eurobond Structures should not be entitled to double tax treaty benefits because it is not the beneficial owner of interest payments under the loans that fund payments to holders of the Eurobonds. Instead, pursuant to this clarification, the beneficial owners of the Eurobonds should be viewed as the beneficial owners of such interest, and the double tax treaty relief should be available only to the extent the beneficial owners of the Eurobonds are residents of countries with which Russia has a double tax treaty.

The December 30, 2011 clarification letter attracted a lot of press attention and caused concern in the Russian Eurobond market as it cast doubt on the tax status of existing and future Eurobonds. The Eurobond issuers could be faced with either grossing up the interest payments or prepaying the Eurobonds if the terms allowed this. In addition, the position taken in the clarification letter could have resulted in sanctions on Russian borrowers for failure to withhold tax from payments that had already been made.

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<sup>3</sup> Typical jurisdictions of choice include Luxembourg, Ireland and the Netherlands.

In the wake of the public attention to this issue, on February 20, 2012, after a series of consultations and some provisional statements in the press, the Ministry of Finance posted the Draft Amendments on its official website, together with an accompanying explanatory statement. One important element of the February 20, 2012 press announcement is the stated position of the Ministry of Finance that no claims for tax would be brought or penalties assessed for failure to withhold tax on eligible Eurobonds issued prior to January 1, 2013 that relied on the existing Eurobond Structures.

### **III. KEY IMPLICATIONS**

The Draft Amendments have a number of important implications for Russian Eurobond issuers.

First, the Draft Amendments propose to unconditionally exempt from Russian withholding tax any interest<sup>4</sup> payments under bonds issued by the Russian Federation, Federation subjects and municipalities. The proposed relief would apply to both rouble and foreign currency denominated bonds, and would not be conditional on the government bonds being listed on any platform. Existing Russian Federation Eurobonds already enjoy no withholding (albeit based on a different theory)<sup>5</sup> so this part of the proposal should preserve the status quo.

Second, the Draft Amendments propose to exempt from Russian withholding tax any Eurobonds issued by Russian non-governmental entities directly (rather than via some intermediary structure) as long as those Eurobonds are (a) listed on a foreign exchange from a list approved by the Russian securities regulator, (b) cleared through an international clearing system from a list approved by the Russian securities regulator and located in a country with which Russia has appropriate double tax treaty, and (c) governed by foreign law. We believe that this is a step in a wider reform initiative to allow direct Eurobond issuances by Russian entities. In addition to amendments to the tax law, however, this wider reform will require certain amendments to existing Russian law.<sup>6</sup>

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<sup>4</sup> The Draft Amendments define “interest” to include not only conventional interest but also other payments made in relation to Eurobonds, such as issue discount or payments made upon the change of the terms of Eurobonds or the underlying loan or their early prepayment (such as premium or interest step-up).

<sup>5</sup> Pursuant to clarifications of the Ministry of Finance issued in a letter dated October 8, 2010 and addressed to the Russian Federal Tax Service, (i) no tax is required to be withheld on interest payable on Russian Federation Eurobonds held by non-resident holders, as such tax is required to be withheld only by an “organization” within the meaning of the Russian Tax Code that pays income in the form of interest, and the Russian Federation is not an “organization” for these purposes, and (ii) none of other parties participating in the transfer of interest payments (including the Ministry of Finance) should be deemed to be paying interest on those bonds and thus none is required to withhold tax on the interest payments made on them.

<sup>6</sup> We believe that such amendments to Russian law should include, among others, amendments exempting directly issued foreign law-governed Eurobonds from a number of Russian securities law requirements, such as, for

Third, the Draft Amendments contain a grandfather clause for Eurobonds issued under Eurobond Structures prior to January 1, 2013, as long as those Eurobonds are (a) listed on a foreign exchange from a list approved by the Russian securities regulator, (b) cleared through an international clearing system from a list approved by the Russian securities regulator and located in a country with which Russia has appropriate double tax treaty, and (c) issued by an SPV located in a country with which Russia has a double tax treaty. We believe that most if not all existing Eurobonds should be able to fit within the above requirements, and the February 20, 2012 explanatory statement of the Ministry of Finance confirmed this view.

Fourth, the Draft Amendments contain a set of proposed conditions that would exempt from Russian withholding tax Eurobonds issued via Eurobond Structures after 2012. This element of the Draft Amendments has attracted the most discussion. In addition to the requirements outlined above for Eurobonds issued prior to January 1, 2013, the Draft Amendments propose tax relief only when (x) holders of Eurobonds issued by the SPVs are legal entities whose title is recorded directly in the international clearing systems, (y) the international clearing systems provide documentation evidencing title to the Eurobonds, and (z) these entities are either Russian residents or residents of countries with which Russia has a double tax treaty (residency can be ascertained from public sources).

These additional requirements raise various issues. One issue is that, as written, the Draft Amendments may be interpreted to require that all owners of Eurobonds hold them directly through the relevant international clearing system (and not through a chain of securities intermediaries). The market practice is clearly different and it is unlikely that investors will change their ownership structures solely for this purpose. This particular issue may be a reflection of imperfect drafting, as the explanatory statement of the Ministry of Finance seems to contradict it, when it states that Russian companies “*will not have any onerous obligation of identifying the entire Eurobond ownership chain and it will be sufficient to identify the first level of owners registered in depository/clearing systems*”.

Another issue relates to the practices of the international clearing systems. We understand that many of such organizations, as a matter of their normal course and existing confidentiality obligations, will not issue confirmations that would contain the identity or details of their participants. We believe that this particular requirement for title and residency certification will be the subject of further discussions between the Ministry of Finance and Eurobond market participants, and may result in further legislative proposals.

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example, (i) a requirement that the bonds be constituted by an issuance decision, the terms of which may be amended only in very limited circumstances, and (ii) exemptions from certain limitations on foreign placement of securities by a Russian issuer.

#### **IV. CONCLUSIONS**

If enacted in its current form, the Draft Amendments will have a number of implications for the Russian Eurobond market. While the Draft Amendments would provide more clarity on government bonds, Russian corporate issuers will need to consider how to structure near-term Eurobond offerings, including by way of proposing terms that would allow for the change of structure to fit the changes in the tax law. Russian borrowers will also need to develop the mechanisms that would allow them to get from the international clearing systems information on the registered holders of Eurobonds and to identify tax residency of such registered holders.

In light of the above, direct Eurobond issuance by Russian borrowers looks like a convenient solution, and it may become a reality if there are corresponding amendments to existing Russian law. We suspect that the Russian regulators will be actively promoting such changes.

Finally, because the Draft Amendments are very clear that they apply only to Eurobonds that are listed on a recognized foreign exchange, they leave open a significant issue of applicability of Russian withholding tax to Euro-commercial paper (ECP) and credit-linked note (CLN) programs, which are normally unlisted.

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Please feel free to discuss any questions regarding this memorandum with your usual contacts at the Cleary Gottlieb or any of the lawyers in the Moscow Office at +7 495 660 8500.

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