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Structuring Acquisitions in Russia

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Russia has been and remains (notwithstanding the current economic crisis) an interesting place for direct investments and acquisitions. However, structuring remains a challenge as Russian legislation does not yet offer the full range of tools with which Western investors are familiar. For example, a foreign investor in Russia will need to take into account the absence of tax consolidated groups, restrictions on deduction of certain business expenses, important rules related to corporate restructurings, the impossibility to achieve direct conversion of debt to equity, the absence of classic debt push down techniques, and currency control. In addition, group restructurings require anti-trust approval, while related party debt is subject to thin capitalization restrictions. Add to this uncertain transfer pricing guidance, over-reaching anti-abuse rules, and legal issues related to shareholder agreements and you have an environment in which creative thinking by investors and tax practitioners is required.

This article suggests ways in which investors can structure their transactions to take into account the above-mentioned legislation.

Investment into an Existing Russian Company with Multiple Business Lines

When an investor wants to acquire different parts of different business lines of the same Russian legal entity, the split up of that entity needs to be considered. Under current Russian reorganization rules, it is possible to conduct a tax free split up, however such demerger raises substantial legal issues and, sometimes, issues related to value added tax. Therefore, it may be worth contributing shares of the Russian business entity to, say, a Luxembourg or Cypriot or French holding company and then playing with tracking preferred shares at the level of such holding company. Each class of preferred tracking shares would track the specific business and be allocated in the desired proportions between the investors. It is clear that such a structure does not ensure the structural separation of risks between various businesses which has to be dealt with contractually. Thus, it should be built into the specifications of the preferred shares that they may be redeemed, at the holder's option, by delivery of the tracked assets if and when the investor disagrees on the common strategy.

Acquisition of a Group of Companies

A traditional goal of any acquisition structuring is to bring acquisition debt as close as possible to the profit generating assets so that interest on the acquisition debt can offset such profits. However, the absence of tax consolidation in Russia is an important structuring constraint. In addition, under Russian tax rules it is impossible to push acquisition debt down to the target using techniques such as distribution of reserves - interest on such debt will not be deductible by the target. The debt push down may, however, be achieved through a step by step acquisition structure when one of the Russian target entities is used as the acquisition vehicle for all other Russian target entities. For instance, if the business is split geographically and vertically into legal entities running production facilities on the one hand, and distribution channels on the other hand, it may be possible to consider that the main distribution legal entity acquires the shares of the production entities and converts them into contract manufacturers in order to pool maximum profits at one single acquisition entity level. This pool of profits would be available to offset interest on the acquisition debt. Obviously, purchase price allocation and future transfer pricing between the various entities would have to be structured properly in order to avoid dispute. Each individual acquisition would need to amount to at least 500 million rubles in order to take advantage of the Russian dividend received exemption.

In addition, thin capitalization rules have to be considered: Russia imposes three to one debt/equity ratio with respect to the related party debt which is defined as debt from 25% and more direct parent entities or third party debt with such parent entities guarantees. Debt coming from a sister entity is not captured by the thin cap restrictions as of yet. A decent level of equity is highly advisable. Its implementation at the closing date may be challenging due to the absence of corporate rules allowing conversion of debt into the share capital of a Russian legal entity.

Conversion to a Joint Venture of an Existing Russian Company

Until recently, Russian law did not offer the possibility to use a shareholders agreement with legal certainty. For this reason, the typical structure for joint ventures is to use a foreign entity which owns 100% of the Russian operating company. It is important to ensure that the jurisdiction of the holding is linked by a double tax treaty with Russia to avoid undue tax burden on dividends and capital gains. The contribution of shares of the Russian operating company to the new foreign holding by the Russian partner is a tax free transaction under Russian tax rules. The important issue is the motivation of such structuring to avoid challenges under anti-abuse rules.

This very quick case study shows the challenge of the exercise in the current environment. Needless to say, in addition to Russian constraints, the Western investor or JV partner will need to factor in its own rules, such as CFC, exemption of dividends, such that the structuring becomes a complex LEGO play.

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