



Tax Directors Forum

“Navigating through the financial crisis – Tax issues”

Session 3: Hedging financial risks

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Derivative instrument vs transaction with delayed delivery

Specifics of documentary support

VAT matters

Tax law in view of Financial Center development program



Tax treatment of derivatives

- Broad definition of a derivative in the Tax Code (article 301)
- Separate corporate tax baskets for quoted and non-quoted derivatives
- Expenses/losses on non-quoted derivatives concluded for hedging purposes go to the general corporate tax basket
- Derivatives are marked-to-market for corporate tax purposes
- Special rules for banks in relation to deliverable “forex” derivatives
- Companies decide how to qualify derivatives: (a) as derivatives; (b) as deals with delayed execution

Derivatives vs. delayed execution

	Derivative	Transaction with delayed execution
Revaluation	Subject to revaluation	May be subject to revaluation
Corporate tax/loss carry forward	Separate tax base unless hedging	General tax base if justified
Transfer pricing	Special rules	General rules
Tax policy	No requirements	Qualification criteria should be reflected
Justification	Special report / calculation	Explanation of loss



Specifics of documentary support

- Documentation is important for two reasons: (a) tax legislation explicitly provides for a special report/calculation for hedging; (b) normally losses are incurred, therefore, such transactions attract attention
- Special report / calculation: object of hedge, type of hedged risks, actions planned with object of hedge (sell/buy), beginning date and expiry date of hedge, interim settlements, volume, amount and price of the deals with the object of hedge and derivatives, expenses. Such report/calculation should be created for each hedging transaction. Report/calculation should confirm that derivative helps to reduce losses
- High risk of challenge due to little experience and absence of clear requirements
- Other documents: buy/sell agreements on derivatives; hedging policy / strategy, tax policy, effectiveness testing



Specifics of documentary support

- Tax policy: “general” and “specific” approaches. Tax authorities expect that hedging transaction will match transaction with the hedged object
- Tax authorities expect that hedging transaction will match transaction with the hedged object (volumes, terms, amounts). Not infrequently mismatches exist
- Reasons for mismatches: (a) planned versus real; (b) limited instruments available on the market; (c) hedging of “aggregated” risks. Letter of the Ministry of Finance of 22 April 2009 № 03-03-06/2/89 suggests that objects of hedge include “cash flows connected with assets and liabilities and expected transactions”. The above letter concludes that hedging by the banks of an open currency position under requirements of the Central Bank of Russia is acceptable



Hedging: court practice

- Decision of the Regional Arbitration Court of Volga-Vyatsk Region of 16 June 2008 № A43-11550/2005-35-399 regarding paper company “Volga”. “Volga” acquired “put” options on Saint-Petersbourg Currency Exchange to hedge the price of the paper. Total costs – approximately US\$ 2.8 mln. Decision in favour of “Volga”
- Decision of the Regional Arbitration Court of Moscow Region of 5 July 2008 № KA-A40/5144-07 regarding company “Resilux investment”. “Resilux Investments” concluded forwards to hedge currency fluctuations. Forwards were qualified for tax purposes as deals with delayed execution. Decision in favour of “Resilux Investments”
- Decision of the Regional Arbitration Court of Moscow Region of 25 September 2008 № KA-A40/8014-08-П regarding “Avon Beauty Products Company”. “Avon” concluded forwards with ZAO “Citibank” and OOO “HSBC Bank” to hedge currency fluctuations. Total loss – approximately US\$ 2.6 mln. Decision in favour of “Avon”



VAT

- Operations with derivatives are likely to be treated as VAT exempt transactions. It will be necessary to expense (rather than recover) part of input VAT
- Separate accounting of costs and respective input VAT related to VATable and VAT exempt activities need to be maintained. Not obliged to perform separate accounting only in the tax periods when the expenses associated with VAT exempt activities do not exceed 5 % of total expenses for such tax period
- Costs should be divided into the following categories: (a) directly related to VATable and VAT exempt transactions; (b) indirect costs (a portion of overheads related to VAT exempt activities. Indirect costs should be allocated based on revenue attributable to VAT exempt activity
- No clarity regarding how revenue should be determined. No official clarifications and no common practice on the market. Hedging agreement may determine how revenue is recognised

Conclusions

- There is positive practice when companies and banks hedge risks and deduct losses. This practice is supported by a number of letters from the Ministry of Finance
- Documentation is important to ensure if derivatives are qualified as hedging



Tax law in view of Financial Center development program

Amendments to tax law. VAT

- Specific exemption for amounts due under derivative deals other than consideration for delivery of underlying assets
- Application of transfer pricing rules to delivery of an underlying asset under a marketable derivative vs non-marketable deal
- Transfer pricing rules for delivery of assets under non-marketable deals should be reviewed
- Specific rules for SE option contracts
- Calculation of proportion between VATable and non-VATable activity is complicated

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Amendments to tax law. Profits tax

- 3 day term as a criterion for classification of deals as financial instruments of term transaction (FISS)
- Netting of initially deliverable deals does not lead to reclass into FISS
- Enhanced deductibility for professional participant of securities market
- Alternative approaches to valuation of FISS
- Revaluation of option contracts is abandoned
- Hedging transactions need a more precise definition
- Revaluation of FISS requires mark to market approach



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Court practice

- FX trading is categorized as non-deliverable FISS when:
 - counterparties confirm netting by transaction documentation
 - FX rates not at market level (economic justification is challenged)
- If delivery of currency is provided court supports a taxpayer
- Tax audits
- Tax authorities challenge FX losses when:
 - parties set off deals equal in amounts of an asset (foreign currency)
 - parties lack sufficient amounts on accounts on valuation date
 - roll-over of FX non-deliverable contracts is exercised

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