Bloomberg BNA

TAX PLANNING INTERNATIONAL

EUROPEAN TAX SERVICE

International Information for International Business

AUGUST 2017

www.bna.com

Russia Declares "Treaty Shopping" Over

Petr Popov
Pepeliaev Group, Russia

This is an article on how the approach on the applicability of international tax treaties on the avoidance of double taxation ("double tax treaties" or "DTTs") has recently changed in Russia.

DTT Benefits: Overturn of Approach in 2014

As known to any experienced tax practitioner, DTTs contain several exemptions or lowered rates applicable to income taxable at source in a Contracting State, such as interest, dividends or royalties, if such income is paid to a resident of the other Contracting State. Some DTTs contain a provision that limits the applicability of such benefits to the entities that are the beneficial owners of the income. Other DTTs do not contain such provisions; we refer to such other DTTs as "bare-bones" treaties for the purposes of our analysis below.

The approach the Russian fiscal authorities take to the issues in question has been completely overturned in recent years. In 2003, "methodological guidelines" were issued by the Ministry for Taxes and Duties, the predecessor of the Federal Tax Service, in which it was stated that the "beneficial ownership" concept is applicable under treaties that contain such a provision (which could mean that under the "bare-bones" treaties no such requirement was implied). In these guidelines the concept of 'beneficial ownership' effectively meant that it was sufficient to have legal title to own the income and to be able to produce a contract, a corporate resolution or a similar legal document to confirm such legal title. These guidelines were revoked at the end of 2012, but even today some tax managers are still influenced by the "legal title" approach, despite this concept having been jettisoned and reversed years ago.

In April 2014 the Russian Ministry of Finance issued a letter espousing a "substance-over-form" approach, stating that a "beneficial ownership" requirement is implied in any DTT, including "bare-bones" DTTs. This requirement means that a counterparty receiving income is expected to enjoy not only legal title to but also a substantive discretion to determine the "economic fate" of the income. Similar positions were expressed by the Ministry of Finance in earlier letters, but the April 2014 letter is widely considered to mark the decisive turnaround in approach.

Petr Popov is a Senior Associate at Pepeliaev Group, Russia

TPETS ISSN 1754-1646

New Letter by the Federal Tax Service

The Russian Federal Tax Service has recently issued a new clarification letter dated May 17, 2017. The letter is formally addressed to local tax departments but may as well serve as guidance for taxpayers on how the tax authorities would view certain transactions. The letter cites recent case law in favor of tax authorities. The Federal Tax Service further evolves the new substance-over-form practice by stating that 'beneficial ownership' of income implies an 'economic presence' in the relevant jurisdiction in the forms of the directors exercising their own judgment in making commercial decisions, commercial functions being performed, assets used and risks taken, local personnel and office space being hired, and administrative expenses being borne.

At the same time, the key aspect in determining the beneficial ownership of income is the actual cash flow, which is understood to mean the absence of any transit of funds to a third party. The letter cites 'legal or factual obligations' to transfer funds to a third party, meaning that even if there are no 'legal' obligations (i.e. contractual or similar formal arrangements in writing) but there are, at the same time, actual transits that are systematic in nature, then beneficial ownership is absent. This opinion is in line with the OECD guidance on the issue, but several practitioners insist that if no formal obligation to transfer is proven, then no question as to beneficial ownership should arise. The latter approach, despite being more formally definitive for business, has a very slim chance of sustaining practical scrutiny, as its application is contrary to the general substance-over-form trend in taxation.

Some tax practitioners also believe that the tax authority may only hand down a "constructive refusal" to accept a counterparty as a beneficial owner of income, i.e. it may refuse the treaty benefits only if another beneficial owner of income is determined in a definitive way, and such other beneficial owner does not have the same benefits (this may be called an "obligatory look-through").

The letter, however, imposes a different approach: it is sufficient for a tax authority to prove that the "nominal" owner of income is not the beneficial owner, while the burden is on the parties that pay and receive the income to disclose and confirm that the third party is indeed a beneficial owner (a "taxpayer-initiated look-through"). A disclosure is to be made before the tax authority hands down a formal resolution that ends the procedure of the tax assessment, and, rather than being a mere declaration, it should also be supported by the relevant confirmations.

The letter cites court cases in which the position of tax authorities has been supported.

In our opinion, in some of these cases, there was no actual need to have recourse to the beneficial ownership requirements. The transactions in question looked like unsophisticated cover-ups for transactions between Russian counterparties with no actual foreign involvement, other than the formal establishment of foreign companies with no due local substance in their business activity.

At the same time, other cases, such as the *MDM Bank* case, demonstrate that while the beneficial ownership requirement was formally introduced into the Russian Tax Code only since 2015, such requirement has indeed been applied by the courts as an implied requirement in earlier fiscal years, even in the context of "bare-bones" DTTs.

Russian Supreme Court Supports the New Approach

The Russian Supreme Court in its case law overview dated July 12, 2017 (paragraph 13) confirms that the benefits under a DTT are not applicable if the principal purpose of structuring payments through an entity was to obtain such benefits without an actual connection with the economic activity performed by such entity in its own interest.

This is essentially a principal purpose test ("PPT") known to most leading international tax practitioners, supplemented with the "own interest" test that is similar to the 'economic fate' test established by the Ministry of Finance in its 2014 letter cited above.

Any other understanding, the Supreme Court writes, would contradict the aim of DTTs to facilitate economic cooperation (which is understood to mean engagement in a substantive economic activity rather than obtaining tax benefits).

The wording of the Supreme Court's overview hints that such approach may apply to any fiscal year and any DTT. The relevant paragraph of this overview cites income in form of royalties, but the reasoning may apply to any income to which an exemption might apply (interest, dividends, etc.).

What a Prudent Tax Manager Would Do

It is not yet clear how to prove beneficial ownership. Before 2017, a paying entity had a right to request evidence of beneficial ownership from an entity that receives income. Between related parties, however, such "right" was in practice an obligation, as the tax authorities tended to take the view that this right should be exercised as a matter of due diligence and arm's length compliance. Since 2017, however, the legislature has imposed an obligation on paying parties to obtain such evidence in all cases, regardless of whether or not the parties are related. This is viewed with justification by the Russian business community as a very harsh rule, as it treats arm's length transactions, e.g. paying out interest under bonds to thousands of bondholders, in the same fashion as intra-group payments that used to be structured in ways that were known to be controversial.

In practice we advise that, where a transaction is entered into between related parties, a mere declaration of beneficial ownership is not sufficient: it is advisable to perform a functional analysis, supported by the relevant contractual or corporate documents, as well as to prepare and to present the cash flow reports.

It is widely believed that when a multilateral instrument for the avoidance of double taxation enters into force (to which Russia is already a signatory), practice might be altered once again. Nevertheless, we strongly advise against sticking to the outdated "treaty shopping" arrangements and to adapt to a new reality where the burden of proof is imposed on taxpayers to prove that the beneficial ownership requirement is complied with.

Petr Popov is a Senior Associate at Pepeliaev Group, Russia.

TPETS ISSN 1754-1646