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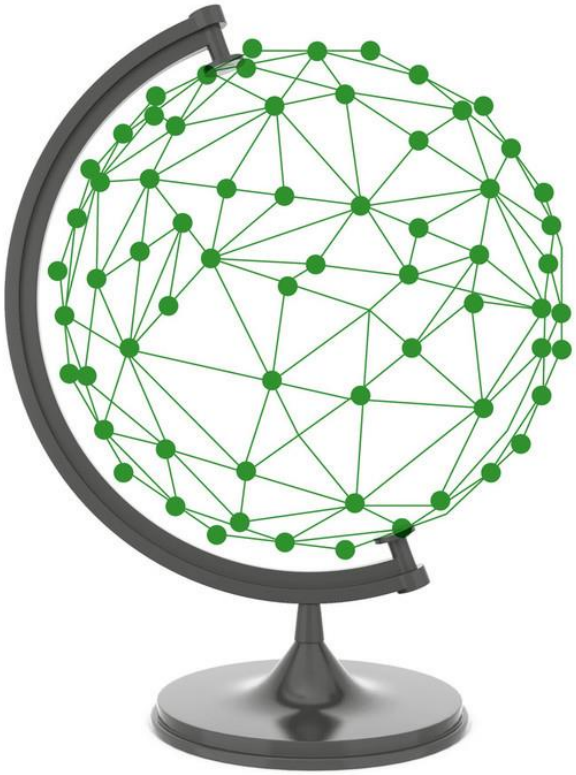


Tax alert

Recent trends in taxation of cross-border transactions in Russia

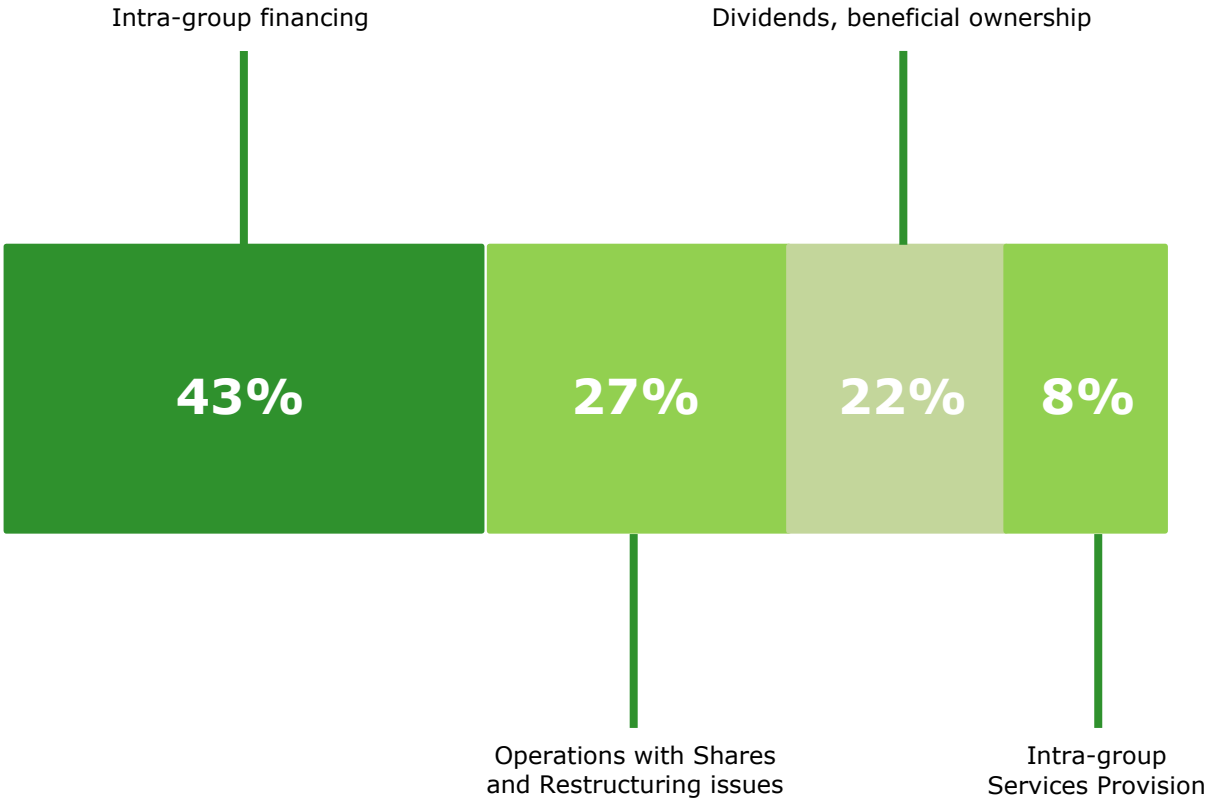
Background

Russian tax authorities have recently been paying particular attention to cross-border tax planning: including actively fighting "treaty shopping" by application of general anti-avoidance rules and principal purpose test. In this regard, on 5 May 2019, the Russian Federal Tax Service issued an overview of recent court practice on taxation of cross-border transactions. In addition, on 27 December 2018 new amendments with regard to a beneficial owner concept entered into force, and on 18 June 2019, Russia deposited their instrument of ratification for the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting ("**MLI**").

Considering the above, a number of pervasive cross border operations, such as intra-group financing and services provision, operations with shares and payment of dividends are currently subject to Russian tax authorities' pressure and might entail the following risks.

Cross-border tax disputes in Russia
Second half 2018 - First half 2019

Most disputable transactions



Intra-group financing

Because of the stagnation period in the Russian economy, many Russian subsidiaries of multinational corporations tend to receive loans from foreign affiliated companies. In many cases, these intra-group loans are unsecured or granted without duly ensuring their return and payment of interest (there is no fine for the delay in loan repayment or absence of claims for such fines, when they are legally ensured).

As a result, Russian tax authorities might treat such intra-group loan as a fake transaction that actually covered for the investment of a foreign affiliated company in the share capital of a Russian company and for which the only reason was to receive ungrounded tax benefits through the exemption of loan interest from the withholding tax ("**WHT**") in Russia.

Consequently, loan interest has to be taxed as dividends and is not, therefore, subject to exemption from WHT under a treaty on avoidance of double taxation ("**DTT"**). The above-mentioned approach was reflected, for instance, in *Mon'delis Rus' LLC* and *Firma Radius-Service LLC cases*.

In other cases, tax authorities are more conservative, just claiming that loan interest as well as loan servicing costs will not be considered expenses of a Russian borrower for the profits tax purposes.

The above means that Russian taxpayers should bear more attention to the fair cost of the loan, properly documenting and justifying the agreed conditions for tax authorities.

Intra-group services provision

It is quite common in practice that a parent company or a shared service center ("**SSC**") have some shared global services, eg, IT support, consulting, management, etc., and then allocate their cost between the companies of the group. However, such allocation of costs based on the global policies ("**Cost allocation**") does not work in Russia from the tax perspective without special justification of any costs incurred by Russian entities.

Taking that into account might cause the following problems:

- **the cost of services will not deduct the profits tax base of a Russian customer** unless there is a documental proof that (1) the services were actually provided by a foreign contractor, (2) the Russian customer had an economical reason in receiving these services from business and financial perspective

- moreover, lately Russian tax authorities **tend to consider the cost of services as a hidden payment of dividends that are subject to withholding tax in Russia** (*GaloPolymer Kirovo Chepetsk LLC* case, Ruling by the Supreme Court of the Russian Federation dated 07 September 2018 in the case *No. 309-KT18-6366*). In case the Russian company did not make proper documentation and justification of costs and did not consider the cost of services as its expenses for the profits tax purposes, Russian tax authorities will try to dispute that there were no services and that all the payments for them are in fact payment of dividends.

- This risk is especially high if the cost of intra-group services is comparable with the amount of a Russian company's retained earnings or payments for the services are not compatible with the course of services provision (if the payments are made too early or too late), or the cost of services is not consistent to the benefit of a Russian company from these services (*Rusjam Steklotara Holding LLC case*).

- WHT in Russia is up to 20% of the income paid and depends on a foreign company's share in the capital of a Russian company, the amount of its direct investments in a Russian subsidiary and the DTT between Russia and the jurisdiction in which a foreign investor resides

- since this **tax violation** is committed within the group of companies (services agreements are concluded between affiliated companies), it is subject to an **increased 40% fine**

The above means that Russian taxpayers should focus on reality and the actual business goal of the services, properly documenting and justifying them for tax authorities.

Operations with shares and payment of dividends

Operations related to the change in the Russian companies' ownership structure or acquisition of new legal entities also raise the suspicions of Russian tax authorities if these operations result in payments abroad. The most widespread types of such restructuring is buyback operations (when a Russian company buys back its own shares from foreign shareholders) and debt push down operations (when a Russian buyer borrows funds to acquire shares in another Russian company (usually having valuable assets) from the foreign shareholder). Since the purpose of such payments and their connection with the business of a Russian buyer is often not obvious, Russian tax authorities treat these payments as dividends, which are subject to taxation in Russia.

Amendments concerning the beneficial ownership rules

A significant number of foreign companies invest in Russia indirectly, ie through intermediate companies registered in other jurisdictions, e.g., in the Netherlands, Luxembourg, Cyprus, etc. In this case, beneficial ownership rules will apply to the payments of a Russian company to the above-mentioned intermediate companies. Pursuant to these rules, a Russian taxpayer may enjoy tax benefits granted by the DTT only with regard to the jurisdictions in which individuals or legal entities that actually dispose of the income received from a Russian company reside. As a result, Russian tax authorities may challenge the application of DTT tax benefits by a Russian company when multi-level structures of investments were used.

In accordance with the recent amendments:

- a Russian subsidiary should determine the existence of the beneficial ownership right for each separate payment of dividends and/ or a group of income payments made under a single agreement
- the look-through approach applies to the payments where the beneficial owner resides in a country, which has no DTT with Russia. Such payments are subject to Russian WHT at the standard rate of 15% applicable to dividends
- the look-through approach may apply not only to the dividends but also to all types of income from the sources in Russia
- the look-through approach is now applicable to individuals regardless of their residence

Tax interview

Russian tax authorities widely use tax control instruments such as holding interviews with the company's non-tax specialists, clarifying the commercial, marketing, financial, operational aspects of all interesting transactions. Later they use all the received information to challenge the wording in the transaction documents and investigate the principal purpose of the transaction and its actual substance.

Information exchange with European tax authorities

The enhanced co-operation between Russian and European tax authorities through the Automatic Exchange of Information (AEOI) is a working instrument actively applied in the tax audits. It is successfully used by Russian tax authorities to challenge intra-group services or beneficial owner of income issues, taking into account the usually different tax and legal treatment of these transactions in Russia and abroad.

MLI application

On 18 June 2019, Russia deposited the instrument of ratification for the MLI, which was submitted together with a list of reservations and notifications made by Russia upon signing the MLI. Thus, MLI will come into force for Russia from 1 October 2019. However, the time when the MLI take effect differs from the date of entry into force. For withholding taxes, the new rules will apply from 1 January 2020 in relation to those DTTs that have been ratified by the partner state. For all other taxes, the new rules will come into operation no earlier than 1 January 2021.

The key point of MLI is to limit the use of tax benefits granted by DTT, in particular, exemption from WHT and reduced tax rates of dividends, interest and royalty. Russia have chosen two mechanisms of tax benefits restriction: principal purpose test (PPT) and simplified limitation of benefits (simplified LoB). The PPT allows tax authorities to refuse the use of tax benefits under a DTT if the application of such benefits was the main or one of the main purposes for the operations structuring. Simplified LoB means that the income receiver should comply with some strict formal criteria. However, since most of the countries having DTT with Russia, which are subject to the MLI have chosen only PPT, only this mechanism will apply to DTT with such countries.

As of today, the MLI will cover seventy-one DTTs concluded by Russia. This list includes Austria, Cyprus, Luxembourg, Netherlands, United Kingdom, France, Hong Kong, etc. However, DTTs concluded by Russia with, for instance, Germany, Switzerland, Japan and Sweden are not presently subject to the MLI.

For more information on any of the above cross-border tax issues, please contact us.

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