Deloitte.

Russia: arbitration court decision may create risks for cross-border licensing arrangements

The Moscow District Arbitration Court issued a controversial decision on 11 June 2015, in which it ruled that expenses associated with the payment of royalties by a Russian company to a foreign affiliate under a sublicensing agreement were nondeductible for profits tax purposes. The arbitration court affirmed the ruling of two lower courts and the position of the Russian tax authorities.

This article overviews the decision and makes some comments on the potential impact of the case for multinational companies charging royalties to Russian subsidiaries.

Background

Oriflame Cosmetics SA (Luxembourg), which owns the “Oriflame” trademark and brand, as well as business-related know-how, granted a license to an affiliated company in the Netherlands (Oriflame Kosmetiek BV) to use the intellectual property (IP). Oriflame Netherlands then concluded a sublicensing agreement with another affiliated company, Oriflame Russia (the taxpayer). Oriflame Russia paid royalties to Oriflame Netherlands for the rights to use the brand and know-how. Oriflame Netherlands transferred most of the royalties to the Luxembourg parent company. Oriflame Russia deducted the royalties paid under the sublicense agreement for Russian tax purposes.

The Russian tax authorities challenged the deduction of the royalties during a tax audit of Oriflame Russia, taking the position that the sublicense agreement was used as a tax-free profit repatriation tool that allowed the taxpayer to reduce its tax burden by deducting the royalties and allowed the Netherlands and Luxembourg affiliates to avoid paying tax in their countries. The tax authorities “pierced the corporate veil” and reclassified Oriflame Russia (a limited liability company) as a representative office of Oriflame Luxembourg based on the following facts:

- Oriflame Russia’s website was a part of the global website of Oriflame Luxembourg and was registered by the latter;
- Advertising materials and catalogues featured the name of Oriflame Luxembourg rather than the taxpayer’s name;
- The taxpayer’s customers received a special brochure (“Oriflame Success Plan”) that described the advantages of working and building a career with a multinational company, but did not contain any references to Oriflame Russia;
- Oriflame Russia’s top management personnel also were employees of Oriflame Luxembourg;
- Oriflame Russia had limited decision-making powers and had to have most of its decisions approved by Oriflame Luxembourg; and
- Oriflame Russia had been operating at a loss for a considerable period of time (despite increasing sales in Russia), yet was able to make significant royalty payments.

The court of first instance, as well as the appeal courts, ruled in favor of the Russian tax authorities and these decisions were subsequently affirmed by the Moscow District Arbitration Court.

The courts concluded that, in substance, Oriflame Russia was acting as a representative office of Oriflame Luxembourg and created a perception among its customers that they were interacting and dealing with a foreign company and not a subsidiary of the foreign company. The fact that Oriflame Russia does not pay corporate tax on its business activities and reported losses for several consecutive years, while the Dutch and Luxembourg entities claimed a tax exemption for a majority of the royalties received in the Netherlands and Luxembourg, respectively, also was relevant to the ultimate conclusion that the main objective of the sub-licensing structure was to achieve a tax-free profit repatriation from Russia. Therefore, the courts disallowed the deduction of the royalty payments.

Comments

This is the first case in which Russian courts have affirmed the disallowance of a tax deduction for royalties on the grounds that the taxpayer was reclassified from a separate legal entity into a representative office of a foreign company, and the decision potentially could create risks for foreign companies operating in Russia through subsidiaries. Licensing arrangements likely will continue to be subject to enhanced scrutiny by the Russian authorities, considering the government's recent initiative to combat tax evasion; new rules adopted at the end of 2014 include the introduction of the "beneficial ownership" concept and give the Russian tax authorities a stronger basis for challenging issues relating to the beneficial ownership of Russian-source income.

Under the beneficial ownership rules, reduced rates or exemptions under Russia's tax treaties will be denied if a foreign company recipient of income:

- has limited authority to dispose of the income;
- carries out intermediary functions in respect of the income and does not bear the economic risks corresponding to its functions; and
- directly or indirectly transfers the income (in whole or in part) to another entity that would not have a right to the treaty benefits if it received the income directly from the Russian payer.

Foreign companies that have licensing arrangements with Russian subsidiaries should review the arrangements to ensure that the royalty rates are on arm's length terms and the total amount of royalties paid corresponds to the scale of the Russian business (this could be confirmed by a transfer pricing study prepared in accordance with the Russian rules).

A properly drafted licensing agreement should be in place that clearly specifies the IP rights transferred and the benefits received by the Russian subsidiary that is licensing the IP rights, and the Russian subsidiary should be able to demonstrate the economic and business substance of such IP rights. Moreover, if the Russian business is operating at a loss, the loss should not be driven by the payment of the royalty; there should be an explanation for the losses (such as business expansion, investments and specific market conditions affecting the business). Finally, the local subsidiary should obtain a beneficial ownership statement from the (sub-)licensor to prove that the latter is a beneficial owner of the royalties and is entitled to benefit from reduced tax rates under a relevant tax treaty. This is especially important in cases where the treaty benefits are claimed by a non-IP owner.