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"Actual recipient (beneficial owner) of income" concept

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In connection with the implementation of deoffshorisation measures for the Russian economy, on April 11, 2014 the RF Ministry of Finance published a letter (No. 03-00-RZ/16236 dated April 9, 2014, hereinafter the "Letter") on its official website regarding the application of reduced withholding tax rates or taxation exemption (hereinafter, the "Tax Benefits") to "passive income" (dividends, interest and royalties) as stated in double tax treaties (hereunder, "DTTs").

The Letter consolidates previously issued clarifications and contains some additional comments. In particular, it provides a list of extra criteria which may be used to determine the "beneficial owner of income" and an open list of examples of conduit transactions which tax benefits prescribed by DTTs cannot be applied to. Moreover, in the Letter the RF Ministry of Finance underlines the responsibility of the tax agent when it comes to assessing and withholding tax at source (including the correct application of tax benefits provided by DTTs) when distributing income to a foreign entity.

General provisions

According to most DTTs, along with several other requirements, an entity must be the actual recipient (beneficial owner) of the corresponding income to benefit from favorable provisions of a DTT. Such an entity may be designated under various terms in different DTTs, which partly explains that there is no uniform approach to defining and interpreting the term "actual recipient of income".

Background

The concept of "beneficial owner of income", developed over several decades is defined in the Commentaries to the OECD Model Tax Convention on income and capital. The main purpose of this concept is to restrain the aggressive use or abuse of tax benefits stated in DTTs. In autumn 2014, in an effort to oppose tax base erosion and profit shifting (often designated as "BEPS") through cross-border transactions, the OECD plans to provide further clarifications on this concept. Draft OECD documents have already been made public for discussion and consultation purposes.

Existing practice

As for Russia, the RF Tax Code currently does not include any definition of the notion of "actual recipient of income", nor provides a list of criteria that may be used to determine the "beneficial owner of income" to apply properly the provisions of DTTs. As a direct consequence, the tax authorities have so far proved reluctant to challenging the application of tax benefits on those grounds.

At the same time, the Letter is not the first attempt to clarify the procedure supposed to organize the

application of the concept of "actual recipient of income" in Russia. The competent authorities previously published a number of clarifications[1] on the concept of "actual recipient of income", in particular:

- The RF Ministry of Finance has repeatedly emphasised that the term "beneficial owner" should not be used in a narrow "technical" sense, but rather ***should be understood in a context and in light of the objectives and purposes of the DTTs***, including avoiding double taxation and preventing tax evasion through ***"anti-abuse" rules*** and ***"substance-over-form" principles of DTTs***. This approach is generally in line with international practice where the entity claiming application of tax benefits stated in a DTT may not always be the actual recipient of the distributed income.
- According to the RF Ministry of Finance, an example of operation where the ***tax benefits*** provided by a DTT ***shall not be used***, could be, in particular, the situation in which the ***agent or the nominal holder of income*** is not recognised as an "actual recipient of the income".
- In addition, in order to recognise a foreign legal entity as the "beneficial owner of income", that entity should not only have the right to receive that income, but also ***be a direct beneficiary***, i. e. an entity with the power ***to determine*** the further ***"economic fate" of the income***.

[1] RF Ministry of Finance Letters No. 03-08-02 of 21 April 2006, No. 03-08-05 of 1 April 2010, No. 03-08-13/1 of 30 December 2011, No. 03-08-05 of 6 August 2012; RF Ministry of Finance and Federal Tax Service Joint Letter No. ED-4-3/8688@ of 1 June 2011

Additional criteria

In addition to the aforementioned provisions, the Letter contains the following list of criteria, which are necessary to treat an entity as the actual recipient of income:

- The recipient of income cannot be recognised as its beneficial owner if it bears ***very limited power in respect of the contemplated income***. Formally, one may be neither an agent nor a nominee holder, but in fact act as an intermediary or appear as a trustee or manager acting on behalf of another entity that actually benefits from the corresponding income.
- When determining the actual recipient (beneficial owner) of income, one should take into account ***functions performed and risks taken*** by the entity seeking to apply tax benefits provided by the DTTs.
- The tax benefits provided by the DTTs should not be applied if, ***in the course of executing the transaction or series of transactions*** the foreign entity seeking to apply the benefits distributes, ***directly or indirectly, in part or in its entirety, the income*** in the form of dividends, interest and royalty ***(at any time and in any form) to another entity*** that would not be able to apply the tax benefits provided by the DTTs concluded with Russia, should that income be distributed directly in favour of that entity.

  The Letter does not contain any clarification on the meaning of "indirect distribution" (it may refer to consecutive payments of income via several tax residents of jurisdictions that are parties to the respective DTTs). The position of the authors of the Letter is considered to be quite harsh, as it does not allow for the time interval or the form of the subsequent distribution of income to another entity to be taken into account.

Examples of conduit transactions

According to the RF Ministry of Finance, a

transaction is considered to be conduit if a tax resident of a jurisdiction that is party to the DTT simultaneously meets the following criteria:

1. It receives income in any of the following form:
   - Russian-sourced dividends;
   - interest payments on loans from a Russian entity; or
   - royalties from the use of intellectual property rights under a sublicensing agreement.
2. It transfers, or is obliged to transfer, directly or indirectly, in part or fully, the income to a third party (or to several, in the case of dividend distributions) which is tax resident in a jurisdiction that has not concluded any DTT with Russia (or a jurisdiction whose DTT results in a less beneficial tax regime), and also:
   - for interest payments: funds provided in the form of a loan to a Russian entity by the first mentioned foreign resident were initially received by that foreign resident from the third party which is tax resident in a third State; or
   - for royalty payments: a foreign entity receiving Russian-sourced income under a sublicensing agreement and claiming tax benefits provided by a DTT transfers this income, in part or fully, under a licensing agreement concluded with another entity which is tax resident in a third State.

In practice, the aforementioned examples essentially aim at putting an end to the classic three-layer structures of "linked" consecutive financing and transfer of intellectual property under licensing or sublicensing agreements from low-tax jurisdictions (so-called "back-to-back" structures).

Duties of tax agents

The RF Ministry of Finance refers to the Supreme Arbitration Court Plenum Resolution No. 57 dated July 30, 2013 "On some issues related to arbitration courts' application of Part I of the RF Tax Code" (hereinafter, "the Resolution") and underlines that the tax agent is responsible for the correct assessment and withholding of tax at the source of payment (***including the correct application of tax benefits provided by DTTs***). In practice, this means that the tax agent may be obliged to pay underwithheld tax and fines (20% of unpaid tax) at its own expense, even in cases where payment was made in favour of a tax resident of a contracting state to the DTT, if the recipient is found out not to be the beneficial owner of the income. Therefore, the Letter indirectly stipulates that the tax agent is responsible for collecting and analysing information relating to the second party to the transaction, as well as for taking a decision regarding the status of that party as the actual recipient of the distributed income.

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As we mentioned before, the approach taken by the competent authorities with respect to beneficial ownership is based on Commentaries to the OECD Model Tax Convention on income and capital. Their legislative force is not quite clear, as Russia is not a member of the OECD and is not formally obliged to follow its guidance. Nevertheless, in practice, Russian tax authorities and arbitration courts (including the Supreme Arbitration Court) regularly refer to OECD guidelines and clarifications to back their positions. One of the reasons for the significant role of the OECD clarification is the possibility to follow the trends of the tax legislation of countries which Russia has signed agreements with.

Contrary to regular legislation, Letters of the RF Ministry of Finance do not have legislative force but rather provide clarification. However, we can not completely exclude the possibility that the provisions of these letters may be applied ***retrospectively***. In particular, when performing tax audits covering previous tax periods, the tax authorities may refer to clarifications of the RF Ministry of Finance in order to support their position in disputes with taxpayers. We cannot exclude the possibility that the tax authorities may try to refuse the application of tax benefits to taxpayers for transactions similar to those mentioned above even if those were conducted before the Letter was published.

Taking into account the wide practice of intragroup financing transactions with the participation of foreign entities, as well as the broad use of multi-layer licensing structures, the application of the concept of

beneficial ownership is now an essential matter for reflection. As a result, entities need to assess (including retrospectively) the level of risk in executed transactions, in particular in terms of powers, functions and risks in the jurisdiction of their tax residency, as well as the amount of income left at disposal of the foreign entity claiming tax benefits provided by the DTTs.

Please note that the Letter does not provide any clarifications on the issues of applying DTTs in cases where the beneficial owner of the distribution income is the entity behind the actual recipient. For example, when a loan is provided to a Russian entity by a UK bank via an entity that is resident in Cyprus, the possibility to apply the provisions of the UK-Russia DTT to that income is still unclear. No clarification currently exists in Russian domestic law with respect to the possibility to apply the DTT between the first and the third country in the chain of payment. At the same time, special rules stipulating a “transparent” approach (the so-called “look-through approach”) have recently been included into the Russian tax legislation, such as Federal Law No. 306-FZ which governs the cascade tax regime applicable to the depositary.

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