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LT in Focus

Russian Federal Tax Service clarifies applicability of concept of beneficial ownership

The Federal Tax Service ("FTS") has released Letter No. CA-4-7/9270@ of 17 May 2017 "On the court practice in proceedings relating to wrongful application of withholding tax benefits by withholding agents" (the "Letter").

The Letter is meant as a guidance for the subordinate tax authorities; it formalises the approach applied by FTS and the courts in the tax disputes over the application of the beneficial ownership of income concept.

The Letter contains important comments that should be taken into account by the taxpayers.

OECD's Model Tax Convention and Commentary-as additional instrument for interpreting international treaties

The Letter sets forth that the OECD's Model Convention and Commentary thereto may serve as an additional instrument facilitating the interpretation of the applicable provisions of double tax treaties on a case-by-case basis.

The regulator acknowledges the applicability of the Convention and Commentary, although it does not rule out that in certain disputes they may be applied selectively, depending on the individual circumstances.

The AO Kashirsky Dvor — Severyanin case is an illustrative example of how the approach is applied. Thus, the courts have denied the application of Paragraph 10, Article 15 of the Commentary on Article 10 of the Convention, setting forth that the treatment of interest as dividends as per the thin capitalisation rules entails the treatment of a loan as a contribution to equity capital. The court cited the taxpayer's long-term wrongful failure to apply the thin capitalisation rules and the abuse of right.

At the same time, in the released digest of the court rulings in cases on the applicability of certain provisions of Section V.1 and Article 269 of the Russian Tax Code (the "Digest), the Russian Supreme Court, citing the Commentary on the Convention, ruled on the relevance of a consistent tax re-assessment that implies the accounting of a loan as a capital contribution in case of thin capitalisation rules application. However, after the Digest was released, the commercial courts issued a number of resolutions (e.g., the resolution on the AO Kashirsky Dvor-Severyanin case) which denied the application of the lower withholding tax rates to the payments made to foreign "sister" companies.

Beneficial ownership of income concept as universal mechanism for fighting tax treaty abuse

The FTS clarified that the concept of beneficial ownership of income is regarded as a mechanism to fight the double tax treaty abuse and, therefore, may be applied to any income paid to foreign counterparties.

Thus, the Letter describes a case of Vladimir Region Power Supply Company, in which the beneficial income ownership concept was firstly applied to the disposal of an equity stake. It is worth noting that by implication of the Convention and the Commentary, the concept of beneficial ownership is to be applied solely to the dividends, interest, and royalty payable to foreign recipients. We expect a wider practical use of the beneficial ownership concept, especially in disputes over unjustified tax benefits.

On the other hand, the Convention and the Commentary are geared to protecting the bona fide taxpayers against double taxation and will not apply to the parties aiming solely to gain the benefits envisaged by the treaties. The Letter cites the case of Olekminsky Rudnik as an example of a simultaneous application of the beneficial ownership and unjustified tax benefit concepts. We believe that the tax authorities will be further streamlining their approaches to assessing whether the use of double taxation benefits is justified.

Refinement of beneficial income owner criteria established by courts

The annex to the Letter contains a description of court rulings that sum up the beneficial ownership criteria the regional tax authorities shall be governed by, namely:

- The decision-making independence of foreign entities directors
- The income disposal powers
- The exercise of entrepreneurial functions
- The evidence of economic operations (staff, office, business expenses)
- The economic benefit gained on income (re-investment for business purposes)
- The exposure of assets to commercial risks
- The nature of cash flows between group entities, i.e. the existence or absence of income distribution obligations, legal or not formalised, as well as the frequency of transitory distributions of income from residents of the treaty-member countries to individuals, not qualifying for treaty benefits.

The Letter notes that the treaty benefits shall be granted to the companies having economic substance in a country of residence that have extensive income disposal powers and that re-invest their income for business purposes (generating economic benefits on such income).

Distribution of burden of proof of beneficial income owner status

The Federal Tax Service proposes denying the treaty benefits to income recipients that do not qualify as beneficial income owners. However, the tax authorities shall not be obliged to identify beneficial income owners to define the applicable withholding tax rate. To ensure an objective and full-fledged analysis of a company's operations, the tax authorities must not limit themselves to assessing the disputable income transfers, but shall give an assessment of the group's entire operations. Therefore, to deny a tax benefit, a tax authority will have to analyse the disputable situation, request for additional documents and information which might give the bona fide taxpayers more room for manoeuvre in the dispute and enable them to refer to the group's strategy, the role of concrete income recipients in the group, shareholding relations, and other corporate policies that have not been taken into account previously.

According to the Letter, the commercial databases, open-source registers of foreign corporations, and other public information will now be admitted by the tax authorities and courts as source of evidence of non-beneficial income ownership. The development actually formalises the practice of identifying the nominal company directors, de-facto employed by the companies offering secretarial services, during tax audits.

The beneficial income owner data will be taken into account only if a withholding agent provides the tax authorities with a respective documented verification of beneficial income owner status until the end of a tax audit. Speaking at the beneficial income ownership session of the St. Petersburg International Legal Forum, Sergey Arakelov, Deputy Director of the FTS, named the identification of ultimate beneficiaries as one of the key objectives of the de-offshorisation policy. In light of the above, assigning the burden of proof of status to the taxpayer (withholding agent) appears to be a logical step.

All in all, the Letter of 17 May 2017 formalises the existing approaches established by courts in the disputes over identification of beneficial income owners and is likely to have no significant effect on the taxpayer's position in tax disputes.

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We hope that you will find this newsletter interesting and informative. Please feel welcome to contact us for more information on the topics covered.

Best regards,

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