Beneficial ownership concept: how it could affect your business in Russia

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Nearly every Russian company belonging to a multinational group of companies has inter-company or cross-border arrangements which might be especially attractive due to applicable double taxation treaty (DTT) incentives allowing reduced withholding tax rates or taxation only in the country of the recipient of such income. Russian companies may also pay out dividends subject to participation exemptions provided in the DTTs.[1] In order to apply such DTT incentives, a foreign recipient should provide a Russian company with the certificates of tax residency and, starting from 2017, with confirmation of the recipient's actual right to such income.[2]

Confirmation is *de facto* one more step in further implementation of the beneficial ownership concept in Russia. Importantly, both documents should be submitted prior to the moment that payments are effected. The tax certificate should be provided at least annually, sealed with the apostille, translated into Russian, and notarized. The minimum requirement for confirmation is the income recipient issuing it with signatures of the authorized parties and its translation into Russian. There is no clear position regarding the regularity of submission of confirmation. Based on the conservative approach, it should be submitted before each payment. Considering the real practice in the MNEs groups, this should be done at least quarterly. If a Russian company fails to obtain at least one of these documents prior to payment to the relevant foreign entity, then it must withhold the relevant withholding tax amount based on the Russian Tax Code. Later on, a foreign company may still claim back the relevant withholding tax.[3]

Confirmation of the actual right to income

There is no statutory form for confirmation. The Russian Tax Code[4] simply states the need for such confir-

[1] Participation exemption makes it possible to apply a reduced withholding tax rate (usually 5%) in the country of payor of income if certain thresholds regarding the capital or investment share are met.
[2] Paragraph 1 of Article 312 of the Tax Code of the Russian Federation
[3] Paragraph 2 of Article 312 of the Tax Code of the Russian Federation
[4] Paragraph 1 of Article 312 of the Tax Code of the Russian Federation

mation and it is up to the taxpayer to decide on the extent of the details of information/documents to be provided. It might be reasonable to prepare a less detailed paper, which, however, should contain all the necessary data regarding the recipient company (information on employees, assets, office, financial information, etc.) in line with beneficial owner criteria (see below) and be adjusted to a specific transaction(s). Further, more detailed information may be prepared as a so-called "defense file" and may be provided later upon request of the tax authorities. Such approach would give a taxpayer certain leeway and may serve for a better and more flexible position in case of disputes with the tax authorities. There is no statutory list of the defense file's documents that may support confirmation. According to the Ministry of Finance[5], the following documents may be required: agreements, arrangements, and contracts of any kind concluded with a third party that can provide confirmation of the active business of the foreign company; tax returns and reporting, other similar documents confirming tax payments in the country of residence; and audited IFRS financial statements and any other documents evidencing the real power to dispose of the received income. The formal availability of both documents (the certificate and the confirmation) seems to not always be helpful, as the Russian company should also be able to prove that the foreign recipient is a beneficial owner. Failure to provide the relevant proof can completely disallow DTT incentives, which will result in an additional tax charge together with penalties and late payment interest.

In order to apply double taxation treaty incentives, a foreign recipient should provide a Russian company with the certificates of tax residency and with confirmation of the recipient's actual right to such income.

Beneficial owner concept in Russia

The concept of beneficial ownership of income was implemented in the Russian Tax Code in 2015.[6] In general, this concept means that the foreign recipient of income may be denied DTT benefits if it has no independent right of use and/or enjoy such income, or if this right is limited, or if it bears insignificant risks and has intermediary functions. There are also provisions on beneficial ownership in DTTs between Russia and other countries. Several guidance letters issued by the Russian Federal Tax Service and the Russian Ministry of Finance have interpreted the beneficial owner (BO) concept more broadly that the one provided by the OECD. Notably, the letters of the Federal Tax Service serve mainly as mandatory guidelines for the local tax authorities in order to ensure the uniform application of tax legislation. They are generally not binding for the taxpayers. In reality, they may affect the practice by changing the interpretation and causing new controversies.

Beneficial owner criteria for tax purposes

The Russian Federal Tax Service emphasises a substance-over-form approach to fighting tax avoidance. The criteria[7] for proving that a foreign entity is a beneficial owner of income derived in Russia include, but are not limited to:

- independence of directors in decision-making;
- power to dispose of the received income;
- real business activities;
- sufficient resources for such activities (office, employees, assets);
- no back-to-back transactions (lack of obligation of the recipient to transfer the income onwards);
- actual assumption of risks by the recipient regarding its assets.

In the view of the Federal Tax Service, the tax authorities are allowed to deny tax treaty benefits when a foreign entity has no active operating business. They may not investigate who the real BO is, and so the mere fact that the first recipient is not a BO is sufficient for applying domestic withholding tax rates.

[5] Letter of the Russian Ministry of Finance No. 03-08-05/76939 dated November 21, 2017

[6] Article 7 of the Tax Code of the Russian Federation

[7] Letter of the Federal Tax Service No. CA-4-7/10261 dated May 17, 2017

In the view of the Federal Tax Service, the tax authorities are allowed to deny tax treaty benefits when a foreign entity has no active operating business.

The list of criteria has been expanded recently[8]: it is now important for the taxpayer (or tax agent) to prove the non-tax purpose of a transaction, i.e. that the main aim of the transaction is not to obtain tax benefits. Furthermore, in the view of the Federal Tax Service, a foreign recipient company may not be a BO, but rather an intermediary (conduit) entity, and, thus, having no right to DTT benefits, if the major part of the income of such company originates from Russian sources, whereby such company has no ordinary business other than receiving dividends and/or further redirecting of income to persons who may not obtain the relevant DTT benefits. Further indicators of the intermediary function may be: the absence of typical business payments; insignificant operating expenses; most of the costs are administrative and relate to the formal fulfillment of statutory requirements of the country where such company is residing; income from Russian sources is taxed at low rates or is tax exempt in the recipient's country. Notably, the Russian tax authorities apply the BO concept not only to dividends, interest, and royalties, but also extend it to any other source income, and they also apply it to both related and non-related parties' transactions. The Russian court practice on BO matters usually upholds the tax authorities, whereby decisions in favour of the taxpayers also exist, but are rather rare.

OECD approach matters

Though not a member of the OECD, Russia upholds most of the OECD initiatives. Generally, the tax authorities and courts accept references to OECD Model Tax Convention Commentaries.[9] Russia has also joined the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting[10] ("MLI"). MLI is aimed at implementing DTT measures to update international tax rules, and it should also reduce tax avoidance by multinational enterprises (MNEs). MLI is currently in force, and Russia is very close to ratifying it. MLI contains provisions on limitation of benefits (LOB) and outlines the application of the principle purpose test (PPT). The LOB clause sets forth several conditions to be met by a company claiming DTT benefits. If none are met, the company is not a "qualified person" and shall not be entitled to DTT benefits, even if that company qualifies as a resident of one of the contracting countries under DTT. The presence of an active, operating business run by the company, similar to the BO criteria envisaged by the Russian Federal Tax Service, is also among LOB conditions. The PPT should help to determine whether "one of the main purposes of an arrangement or transaction" is to obtain the benefits of the tax treaty, and, if so, the tax authorities may deny treaty benefits unless it is established that granting that benefit in that circumstance would be in accordance with the object and purpose of the relevant DTT. The ratification of MLI might give even more power to the tax authorities since the ratified MLI is a legal act unlike guidance in the form of letters issued by the tax authorities.

Conclusions and practical considerations

With the Federal Tax Service's approach becoming more strict and aggressive, new challenges for MNEs will likely arise. In particular, local tax authorities may more closely examine the cross-border payments made by Russian subsidiaries to foreign affiliates, and also examine backwards regarding the periods that are still open for field tax audits (three years preceding the year in which the audit is designated).

The main consequences of application of the BO concept can be the limitation of benefits under DTTs as well as reclassification of the transaction in question for tax purposes. For example, when loan interest is considered as a dividend under the relevant

[8] Letter of the Federal Tax Service No. CA-4-9/8285 dated April 28, 2018

[9] Commentaries on the Articles of the Model Tax Convention on Income and on Capital. The latest version of the Convention is available in the condensed version from 2017: OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, Paris, https://doi.org/10.1787/mtc_cond-2017-en. It is also questionable whether it is justified to refer to Commentaries in the later version of the Convention if the relevant DTT was signed before this later version.

[10] http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm