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New Russian tax rules for Beneficial Owners

21 August 2018 - **The Russian Tax Authorities have recently issued updated rules on the beneficial ownership concept, which are mainly based on Russian court rulings. These rules, which serve as a guidance with immediate effect, significantly increase requirements for foreign recipients of Russian-sourced income in order to qualify as beneficial owners eligible for tax treaty benefits.**

The rules provide for specific criteria that the tax authorities should consider when determining the beneficial ownership status, provide practical examples of when tax treaty benefits should be denied and summarize tax controversy practice regarding the application of the whole concept.

Through these new rules the Russian Tax Authorities expressly state that the Russian beneficial ownership test represents general anti-avoidance rules and can be used to deny tax treaty benefits to companies receiving passive Russian source income, as well as against complex anti-avoidance schemes for the transfer of such income abroad.

It may no longer be sufficient for companies to confirm the existence of assets and employees, the absence of pass-through cash-flows and decision-making capabilities on the management of the recipient. The Russian tax authorities may seek to deny tax treaty benefits to foreign recipients that do not have an actual, operating/trading business. The new rules further indicate that pure holding and treasury activities for the benefit of affiliated companies may not be sufficient to show independent business activity, and may be insufficient to support a company being recognized as a beneficial owner. Taxpayers must now justify the particular form of their transactions and the involvement of foreign recipients of income, and must present reasonable grounds for bearing commercial risks. This significantly departs from the earlier practice and position of the Russian Courts that limited the rights of the Russian tax authorities to use hindsight to challenge the rationality of commercial decisions, and places the burden of proof on taxpayers.

The key interpretations and conclusions of the Russian Tax Authorities' new rules are as follows:

- The Russian Tax Authorities could deny tax treaty benefits if they can demonstrate that the recipient of the Russian source income does not meet the beneficial ownership criteria.
- It is under the discretion of the Russian Tax Authorities to ascertain the identity of the real beneficial owner of the income. If the taxpayer discloses the beneficial owner and provides supporting documentation that the actual beneficial owner is entitled to the reduced withholding rates under the relevant tax treaty, the Russian tax authorities must confirm whether the actual beneficial owner received the Russian source income by examining the evidence presented by the recipient of the income to them.

- The new rules also state that the Russian Tax Authorities should also confirm that the actual beneficial owner reported the indirectly received Russian sourced income to his country of tax residency and paid the relevant taxes (if any). If the taxpayer cannot prove that the Russian-sourced income was declared and taxed in the country where the actual beneficial owner is a tax resident, tax treaty benefits may be denied.
- Where a tax dispute arises on the application of tax treaty benefits, the tax authorities should be in a position to analyze the nature of the relevant transaction and whether it can be commercially justified. Treaty benefits will be denied where a transaction or series of transactions was carried out with the main purpose of eroding the tax base or where arrangements/structures were set up in such a way to allow treaty shopping and the application of treaty benefits.
- The application of the new rules in conjunction with the Russian GAAR allows the Russian tax authorities to expand the application of the beneficial ownership concept beyond cases involving treaty abuse. The Russian tax authorities have now the right to reclassify an arrangement (e.g. debt into equity) and apply tax rules relevant to the reclassified income, and interpret a series of transactions as hybrid structures resulting in the application of the relevant local rules preventing base erosion.
- The beneficial owner concept could also be applied to other types of trading income and not only to passive income.
- Treaty benefits could be denied where financing activities and income repatriation are not sufficiently connected with the investment of foreign capital into the Russian economy.
- Holding companies generally should not be treated as beneficial owners because their business activities are limited to investing in affiliated entities and financing (treasury) activities, and they receive only passive income (such as dividends, interest and royalties). One-time business transactions of holding companies (e.g. consulting services, foreign currency exchange gains, purchases of preferred shares, participations in other companies, etc.) are irrelevant in the overall beneficial ownership analysis.
- Taxpayers should be able to substantiate why their transactions are executed in a certain form and the participation of a foreign entity in their business and transaction structure, and provide a reasonable and commercial justification for such structure and the risks assumed.
- The Russian Tax Authorities should consider all of the following factors when analyzing whether a foreign recipient of income is the beneficial owner:

    - Commercial justification for including the foreign entity in the structure, and whether the entity operates as an independent business unit
    - Whether the foreign entity has economic substance, such as ownership of sufficient tangible and intangible assets, personnel and offices, and whether it incurs a material amount of expenses to maintain its operations, etc.
    - Evidence that the foreign company receiving the income does not pass on the income to another nonresident company

- Ability of the foreign company's officers to exercise power and authority with respect to the use and disposal of the income received from Russia
- Level of business activities and entrepreneurial risks assumed
- The actual cash flow, which is understood to mean the absence of any transit of funds to a third party

According to the Russian Tax Authorities, the foreign company should not be treated as a beneficial owner of income if the foreign company's activities cannot be viewed as a separate business unit, the company is not engaged in or bears no financial or other risks customary for entrepreneurial activities, the payments received flow through to other affiliated entities, the company earns no benefit from the use and disposal of the income received and the company's employees do not exercise management and control over the company's operations. If the tax authorities determine that some or all of these factors are present, they likely will conclude that the company does not meet the BO requirements.

Actions to consider:

The aggressive approach of the Russian Tax Authorities may affect a wide range of multinational groups operating through foreign companies in Russia. Taxpayers may want to consider the following:

- review their group structure and identify companies that perform solely or mostly holding, treasury or intragroup financing/licensing functions which may fail the Russian beneficial ownership rules as applied in light of the new, stricter approach. Confirm whether such companies may be considered as beneficial owners of Russian source income for tax treaty purposes.
- consider identifying and collecting additional documents and making changes to the holding, financing and cash-flow structure in the group of companies in order to justify the economic rights of foreign companies to Russian source income (preparation of a so-called "defence file").
- consider applying a "look-through" approach and potentially disclosing a higher tier company or final shareholders where appropriate with more substance as the beneficial owner in the group, and considering all relevant complications and tax implications in other jurisdictions.
- evaluate the possibility of including the appropriate gross-up provisions on payments to be made by Russian companies.
- in case of increased tax risks for past and future periods, consider a tax dispute scenario, including challenging the validity of the rules based on procedural and material grounds

- monitor significant trends in court practice in view of the new, strict approach of the Russian Tax Authorities, and consider further restructuring opportunities to mitigate withholding tax risks in Russia.

The Department of Taxation of Costas Tsielepis & Co Ltd is at your disposal should you require any further information, clarifications or assistance with the above.