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The Chimera of the Beneficial Ownership Rule in Russia

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To apply tax treaty benefits, foreign companies must now provide beneficial ownership confirmations to Russian payers of income. Confirming beneficial ownership under Russian rules may go beyond the OECD test on proving legal ownership and having no connected obligation to pass on payments. What makes Russia's beneficial ownership approach different based on recent vibrant court practice?

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At the beginning of 2017, Russia introduced the additional requirement for foreign recipients of passive Russian source income to confirm that they are beneficial owners of income to be entitled to tax treaty benefits. This concept, indicated in most tax treaties, had caught the attention of Russian authorities and was developed into a standalone, anti-treaty shopping rule.

Since 2015 Russia has applied its domestic definition of the term, and does not recognize foreign companies as beneficial owners if they exercise intermediary functions and have limited powers to dispose of the income, do not exercise any other functions, take no risks, and pass on income to another party having no access to the same benefits. The rule applies both to intragroup operations and transactions between unrelated parties.

Importantly, the Russian tax authorities take the position that since the beneficial ownership wording was included in most of the tax treaties long ago, and the OECD commentary describes beneficial owners as persons getting the income not through an agency or

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nominee relationship and not simply acting as a conduit for another person who in fact receives the benefit, the rule needs to be considered in accordance with the object and purpose of the tax treaty and could be equally applied to past periods. This seems to be a considerable change in practice, putting at risk operations with Russia for the past three years opened for tax inspections.

According to the position circulated by the Russian Federal Tax Service to local tax inspectorates, the beneficial ownership requirement does not only apply to income received by a resident of a contracting state in the form of dividends, interest and royalties subject to a tax exemption or reduced withholding tax rates provided that the recipient meets the express requirement of being the beneficial owner of the income under the relevant tax treaty.

The beneficial ownership requirement will be effectively applied to all Russian source income, including capital gains from the sale of shares in property-rich companies, income from real property, international shipping, penalties and late payment interest, and other similar income (which tends to be interpreted broadly).

Recent court cases show that the Russian tax authorities frequently request information on foreign companies receiving Russian source income. There is no list of information or detailed guidance on what specific documents would be sufficient to prove that the recipient is entitled to tax treaty benefits.

The Russian Ministry of Finance has stated that taxpayers must prove their beneficial ownership rights in substance, and that the authorities do not want to restrict the confirmation process. Although this may be driven by good intentions, companies effectively have to disprove that they are not passing income to other persons; the information gets quite detailed and can include endless descriptions of functions, risks, commercial assets, owned or leased office space, and number of employees.

Tax agents are also encouraged to examine the financial statements of recipients and to check whether the income was accounted for, taxed, and not passed on to another party. Russian payers of income effectively have to bear a higher burden of proof compared to the OECD position outlined in the 2014 update of the Commentary to the Model Convention, where it is sufficient to confirm that the receipt of income is not dependent on the contractual or legal obligation to transfer the payment. The OECD has stated that the beneficial ownership rules are not intended to substitute limitation of benefits provisions in tax treaties or to deny benefits to "stepping-stone" conduits (See OECD Model Tax Convention on Income and on Capital: Commentary on Articles 10, 11, 12. Models IBFD. 2014).

Russia seem to extend the beneficial ownership limitation to a wider range of situations. For example, Russian tax authorities have denied application of the reduced 5 percent withholding tax on dividends for 2011 to four historically used Cypriot holding companies of a major steel manufacturer.

The tax authorities claimed that the Cypriot companies only held shares in Russian companies, that there was no sufficient substance, and that the authority of the Cypriot directors to dispose of the income was limited by charter documents, which in combination made them technical transit companies. Because the Cypriot companies were subsequently distributing dividends to personal companies of the beneficiaries in the BVI, the Russian tax authorities disregarded the Cypriot recipients that provided their tax residency certificates and applied the 15 percent Russian withholding tax (though without consistently applying full transparency and attributing income to the Russian ultimate beneficiary). Although this may have been an example of outdated, aggressive tax planning, such structures are not uncommon for Russia and have not been previously subject to such attacks.

However, when the Russian beneficial ownership test is applied, it is difficult to draw the line between legal planning and tax avoidance. For example, the Russian tax authorities challenged the withholding tax exemption on interest payments made by a Russian subsidiary of a Spanish bank to a Luxembourg treasury company.

In 2005–08, the Luxembourg company received a purpose loan from the Spanish bank; the funds were subsequently loaned to the Russian company as was intended by the Spanish shareholder. Subsequent loans provided by the treasury company out of its own funds replaced initial financing. The company had an office, increased the number of employees from three to seven in 2010, provided financing, and concluded swap transactions with other group companies.

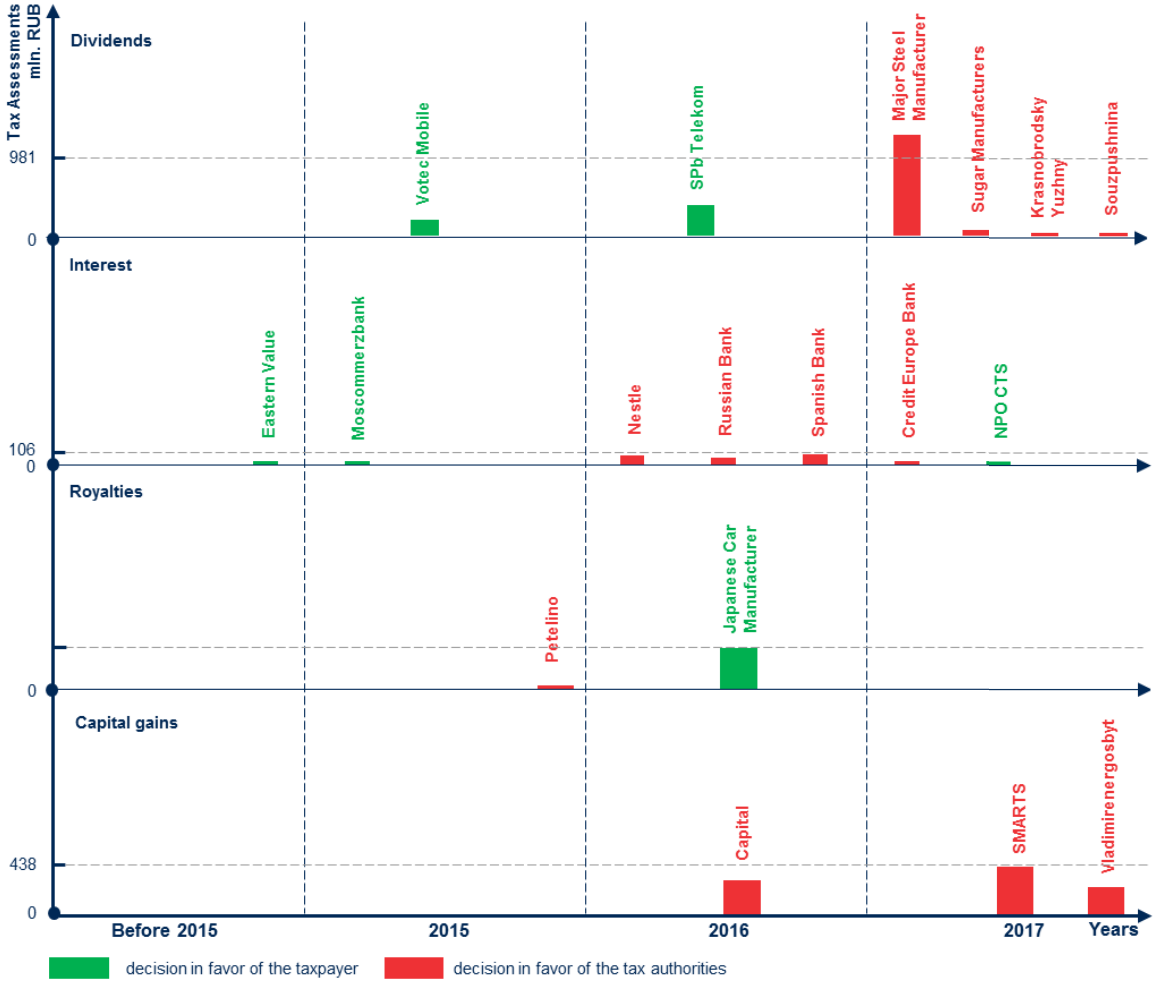
Yet the Russian authorities successfully claimed that the Spanish bank used the fact that the Luxembourg company was not the beneficial owner of income in order to get access to the withholding tax exemption compared to the 10 percent tax on interest payments to Spain. The Spanish loan was subsequently contributed to the equity of the treasury company, resulting in no taxation in Luxembourg, which was misrepresented as an indication of the double non-taxation and tax abuse.

The twists and turns of Russian court practice on beneficial ownership are represented in the chart below, indicating positive (in green) and negative (in red) court cases and respective amounts of tax assessments.

The Russian court practice on the beneficial ownership rule may be considerably different from cases decided in other countries.

For example, in the *Velcro* case the Canadian court recognized the Dutch company as a beneficial owner, as it had the legal right to receive income, bore currency risk and default risks, and mixed royalties received from Canada with other income of the recipient stored in the company's accounts and available to creditors (See, Brian J. Arnold Chapter 3: "The Concept of Beneficial Ownership under Canadian Tax Treaties". Beneficial Ownership: Recent Trends. IBFD. 2013). These arguments were sufficient to prevent recognition of the company as a conduit. However, since the Russian test is more blurred, the same case can be decided against the taxpayer.

How far can this go? There are constant flows of funds in the modern era; management of a group's funds is often optimized and there are separate companies managing cash-pools, aggregating royalties, etc., so it is increasingly difficult to identify a particu-



lar beneficiary of the income if the tax authorities start looking beyond ownership rights.

In a recent court case the Russian tax authorities attempted to deny withholding tax exemption on interest paid to a Cypriot treasury company, saying that the Jersey top holding company of the group was the beneficiary (*NPO CTS* case, Decision No. À21-2521/2017, dated August 2, 2017). So far the Russian court has supported the taxpayer's position that the Cypriot company used the received interest in its commercial operations and did not distribute dividends, and that the mere indirect holding of shares is not sufficient for such aggressive reclassification. But there will certainly be less obvious cases, as any "legal entity" is by definition *fictio juris*. Professor E. Reimer has pointed out that the beneficial ownership rule is inherently unclear and may well reflect a general application to tax law of Heisenberg's uncertainty principle (developed in quantum physics): the more precisely we can measure one characteristic of an object, the less precisely we can measure another characteristic.

As it can be clearly demonstrated that a nominee or an agent with no assets and no employees is not the beneficial owner (clearly measuring this characteristic), once we move from these narrow facts to measuring beneficial ownership of a working company receiving and making multiple payments in the group, the rule gets blurred and infinitely more complicated to apply (see E. Reimer Chapter 18: "How to Conceptualize Beneficial Ownership", Beneficial Ownership: Recent Trends, IBFD, 2013). While the debate over whether beneficial ownership is a suitable anti-avoidance tool is still ongoing, Russian taxpayers already have to adapt.

Application to Independent Parties

The Russian beneficial ownership rule is not formally restricted to payments between related parties, although existing case law is focused on distributions within groups. And it may be more challenging to receive beneficial owner information from an independent company that may need to disclose functions, risks, and the ways that the Russian source income is subsequently used and taxed.

From a commercial perspective, the obligation of an unrelated company to disclose information to a Russian counteragent doesn't make much sense. But the Russian tax authorities claim they don't have any means to check foreign companies that have no presence in Russia or, more importantly, any means to collect taxes from foreign taxpayers (the exchange of information under tax treaties and assistance in collection of taxes are not considered sufficient). As a result, tax liability and penalties of foreign taxpayers can be collected from Russian payers acting as tax agents, who will then have to exercise their right of recourse to foreign recipients. Given this shift of liability, Russian companies now frequently ask that contracts include express obligations to provide all necessary confirmations and information, or to build in a gross-up mechanism to increase payments by the additional tax amount. In this context, beneficial

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owner confirmations may be inadvertently turned into carefully drafted tax indemnities.

Obligation to Identify All Beneficial Owners

The Russian Federal Tax Service takes the position that in order to deny a tax exemption or reduced withholding tax rate it is sufficient for the tax inspectorate to disprove that the indicated foreign company - recipient of income is not the beneficial owner. This was already demonstrated in the case of a Russian bank that had been making interest payments on bonds to its Dutch parent bank. The Russian tax authorities claimed that the Dutch bank had only been a nominee with respect to a portion of payments that had gone to other recipients in Turkey and Romania—recipients that had not been properly disclosed by the bank despite having had the opportunity to do so. As a result, the treaty benefits were rejected in full (without considering reduced rates treaty rates with Turkey and Romania) (*Credit Europe Bank* case, decision no. À40-442/2015, dated July 25, 2017).

In a recent dividend case, the Russian tax authorities denied the application of the 5 percent reduced dividend withholding tax to a Russian fur auction company on its dividend distributions to its Cypriot parent company (*Souzpushnina* case, decision no. A40-73573/17-20-612, dated October 11, 2017). The Russian tax authorities not only determined that the Cypriot participant was owned by an offshore company in Belize, but they also received information from the bank and Cypriot tax authorities on almost mirror payments to Belize. In the course of the police investigation they received all electronic documents and correspondence of the Russian company employees, confirming that the Cypriot shareholder was a technical company and identifying the ultimate Russian beneficiary behind the Belize company. Although the tax authorities did not dispute that the Russian individual ultimately owned the business, they refused to "look through" the offshore company (similarly having a technical role) and to apply the 9 percent individual income tax directly stating that there was no evidence of payments to the individual. It remains to be seen if the taxpayer can provide confirmation on receiving income in order to avoid multiple tax events.

The lack of a clear, "look through" approach also creates risks where the Russian subsidiary applies 5–10 percent reduced withholding tax on dividends paid to a direct shareholder that made a compulsory direct investment in the company. If the direct shareholder lacked substance, and the grandparent company was considered the beneficial owner of the dividend stream, the Russian tax authorities would previously deny application of the qualified tax treaty rates, arguing that the investment thresholds (which apply under some tax treaties with Russia) were not met. This seems to be a contradiction since the Russian Tax Code now expressly allows treating the next entity in the shareholding chain meeting the test as a beneficial owner, and all investments made using assets of the 100 percent subsidiary should be ultimately considered to be the property of the shareholder, if simple logic is followed.

This may also undermine the fundamental approach that in case the Russian tax authorities reclassify a transaction for tax purposes (as denying a tax treaty benefit to the direct recipient and reattributing the income to another person amounts to tax reclassification), they must perform a full reclassification and determine the "true" taxpayer's tax obligation (Resolution of Supreme Arbitrazh Court No. 17152/09, dated July 6, 2010).

This may not be achieved if the Russian tax authorities are not motivated to identify the relevant foreign taxpayer—beneficial owner, and they merely deny tax treaty benefits and collect taxes from the Russian tax agent. In case of this short-sighted approach, foreign groups may inadvertently lose tax treaty benefits even if companies that are ultimate recipients of income and have access to the same or similar benefits as a beneficial owner cannot be clearly ascertained, or if such confirmations are not duly provided. Instead, the burden to disprove that there is tax abuse is shifted to taxpayers, the income is transferred offshore, and no company in the chain having access to tax benefits would meet the tax treaty requirements.

Russian rules currently lack the idea that beneficial ownership can be proven with respect to a group of companies (e.g. a fiscal unity), but the Russian Federal Tax Service has declared that it is open to arguments and discussions based on the principle of transparency. However, the relevant court practice is not so straightforward. In some past cases on thin-capitalization rules for sister company loans, the Russian tax authorities reclassified excess interest as dividends but also reattributed the income flows to foreign ultimate parent companies, allowing Russian payers to apply the qualified 5 percent reduced withholding tax rate. This approach was not specifically explained in the court decisions, but suggested some liberal interpretation of tax treaties based on the concept of transparency.

The Russian Supreme Court even clarified that for the purposes of reclassified interest under the thin-capitalization rules, the loan amount can be treated as an investment qualifying for the reduced dividends withholding tax. In contrast, in some recent cases courts supported a very formal approach by denying the 5 percent reduced dividends withholding tax: in one instance, denying it to a Dutch ultimate holding company indirectly owning more than 25 percent in a Russian oil service subsidiary due to lack of direct participation, and in another case denying it to a Cypriot company of a major Russian steel company on similar grounds without extensive review of the taxpayer's arguments. So if the beneficial owner position of an intermediary company receiving dividends is challenged, this may well result in a higher tax liability compared to direct shareholding. This might have been a conscious step to motivate groups to simplify shareholding chains, but it may prove to be inappropriate and discriminatory.

Foreign corporations may face situations where the information requested up front to confirm beneficial ownership cannot be provided, e.g. if a company is part of a consolidated group of companies within one jurisdiction for tax purposes, and such group prepares and discloses only consolidated financial statements so that there are no available accounts on a per company basis, and no financial and tax statements are prepared for a particular taxpayer.

The income of the receiving company may also be absorbed by losses of other group companies, resulting in no effective taxation than can be shown on a bill. Moreover, as part of the ordinary course of business, Russian-source income paid to a foreign company may be utilized in a cash-pooling arrangement or distributed on various legal grounds to other related companies in the same or in a different treaty jurisdiction (e.g. listed active operating or holding companies, or IP companies not engaged in distribution) that may be entitled to the same tax treaty benefits but have not provided a tax agent with beneficial owner confirmation in advance, i.e., before the payment. In practice, if a group takes the position that a recipient aggregating and redistributing money flows does not have much substance and is not the beneficial owner, it is forced to show a number of upper-tier companies, and each would need to evidence beneficial ownership, which would dramatically increase the amount of documents.

Under these circumstances, some international groups acting in good faith may struggle to identify in advance, and to confirm with a high degree of certainty, the beneficial rights of one particular foreign company-beneficial owner of income, and thus will technically risk being denied tax treaty benefits even if the income is absorbed by companies in jurisdictions that have the same tax treaty rates with Russia. Therefore, planning the beneficial owner disclosure becomes critically important.

Interaction with Limitations of Benefits

Although the Russian tax authorities initially took the beneficial owner concept out of the tax treaties, its application does not seem to be restricted by the relevant limitation of benefits provisions if we look at the Russian court practice. Otherwise, it would seem that the Russian tax authorities would need to grant tax treaty benefits to intermediaries used for non-tax purposes, or to qualifying companies (under the U.S.-type Limitation on Benefits, "LOB"), which may be more complicated comparing to merely proving a transit payment.

It is fair to say that in most cases where foreign companies were recognized as not being beneficial owners of Russian source income, these companies lacked actual substance (e.g. used nominee directors serving in this position to dozens of other companies) and were used in aggressive tax structuring. Therefore, the use of the LOB provisions for proving tax treaty abuse would have yielded the same results and would be a more appropriate tool for denying unintended tax benefits. In some cases the Russian tax authorities successfully proved receipt of "unjustified tax benefits" (in accordance with the Resolution of the Plenum of the Russian Supreme Court No. 53) and tax treaty abuse under Article 1 of the OECD Model Convention without heavily relying on the lack of beneficial ownership argument.

The Russian Ministry of Finance has been requested by the professional community to consider the correlation between the limitation on benefits provisions and the beneficial ownership test. In the meantime, it may be presumptuous to automatically assume that meeting the LOB test would guarantee beneficial owner qualification.

Mandatory Beneficial Owner Confirmation

The new requirement for recipients of income to provide confirmation on beneficial ownership rules may be currently met by either preparing an extensive form, indicating all sorts of information about the company, e.g. value of fixed assets, number of employees, risks borne (default risk, credit risk, etc.) and functions exercised (demonstrating the management's authority to dispose of the income) in connection with the income and financial information demonstrating the absence of conduit payments. All information may be carefully gathered to form a thick booklet signed by the representative of the recipient. However, thick booklets need to be updated. Consistently obtaining this much information may be overly complicated. And unrelated companies may simply refuse to provide this data.

Hence, in many cases, companies choose to provide shorter beneficial ownership confirmations. Many companies have developed their own short beneficial ownership forms or get them from legal firms. These forms tend to focus on what the Russian Tax Code is actually requesting: confirmation of functions, confirmation of risks related to the income stream, and demonstrated absence of the passing of income to another party not having access to the same tax benefits. This approach is advocated by lawyers as giving excessive information that may limit litigating opportunities if the case goes to court. Although sample forms can be helpful, some tailoring is usually required to match a company's profile and income type.

For example, functions and risks in respect of dividends would dictate an emphasis on ownership rights, voting powers and investment risks, whereas for interest payments the recipient's capital structure is more relevant. When funds travel through a chain of companies, with each company playing its own function in a cross-border group and exposed to different tax benefits, a bespoke beneficial ownership confirmation is needed to provide correct facts and to avoid statements that can be discredited.

Collecting Defence File Data

Shorter forms are easier to maintain, and can be consistently applied to various payments and recipients. At the same time, because a Russian payer is responsible for tax withholding, it bears liability for tax underpayments, and its management may request more documents in order to get comfortable with the tax position and to prepare a "defence file" for tax audits and potential litigation.

The content of the defence file may need to be tailored to a particular type of income, group structure, and other facts and circumstances. Because the defence file does not need to be disclosed up front, and its content may be revealed depending on the questions and position of the tax authorities, it is a more flexible and delicate tool compared to the formal beneficial ownership confirmation. Although the content is mainly dictated by the facts of the case, it may include the following main building blocks:

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(i) information on substance, e.g. on employees, office and assets sufficient for maintaining the recipient's operations;
(ii) non-tax business reasons for keeping the recipient in the structure;
(iii) standalone or consolidated financial information evidencing that the Russian-source payments are reflected as proprietary income on the balance sheet of the recipient and are taxed;
(iv) any suitable information confirming ownership of the asset, e.g. proprietary funds, statements from trademark registers, etc.; or
(v) evidence that the recipient is not a mere agent or nominee, that it performs functions and bears risks, and that it is not transferring income to low-tax jurisdictions that would not otherwise get the same tax benefits.

It should be borne in mind that the tax agent can only make its judgment based on pre-payment business arrangements and surrounding circumstances (which may demonstrate the absence of intentional tax avoidance), whereas the tax authorities may also look at after-payment parameters that may distort the group's original intentions.

Obviously, the more substance, functions and risks that are demonstrated by the recipient, the stronger the taxpayer's position would be under the current blurred rules, pursuant to the above-cited Heisenberg's uncertainty principle. The Russian courts have not yet developed a position on the appropriate level of functions and risks for pure holding companies or group treasury centers.

There is already an Italian precedent in which the court stated that the recipient was the beneficial owner and as a holding company it was not required to maintain many employees and have multiple operations (Decision of the Supreme Court of Italy No. 27113, dated December 28, 2016). At some point these arguments may need to be considered by Russian courts, who have previously showed little sympathy toward foreign tax cases.

At the same time, the Russian Federal Tax Service seems to have restricted the use by local tax inspectorates of the beneficial ownership arguments in tax audits, effectively taking it under its manual command. Representatives of the Russian Tax Service have confirmed that they are open to arguments on the absence of the withholding tax reductions, which is critical for a large number of cross-border structures that have various business reasons for keeping transactions in separate entities (which may mitigate the risk that the Russian tax authorities could fail to make a full reclassification and determine "true" tax obligations).

International groups will be unlikely to go and revise their entire business models because of the changes in the Russian beneficial ownership approach; self-declaring a look-through approach with respect to some holding or financing entities may also interfere with the adopted transfer pricing or other tax positions in the group in other jurisdictions, and may go beyond the responsibility of the Russian subsidiaries. Therefore, all of these international tax issues will need to be carefully considered when building a Russian beneficial ownership position, issuing beneficial ownership confirmations, and building an appropriate defence file.

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