TAXAND

Contributed by Pepeliaev Group

New practice of applying a beneficial rate under a DTT to intra-group loans

Pepeliaev Group advises of an improvement of the position of taxpayers in court disputes relating to the application of beneficial rates under DTTs in the context of intra-group loans.

While the cases of SUEK-Kuzbass JSC[i] and Kashirskiy Dvor – Severyanin JSC[ii] are being prepared for reconsideration, the commercial ('arbitration') courts of Russia's constituent entities are already supporting taxpayers in disputes relating to the application of beneficial rates under double taxation treaties (DTTs) when maximum interest under controlled debt is reclassified as dividends and the beneficial ownership of income is identified. Only within the last month, two court decisions have been issued which are positive for taxpayers: in the case of SUEK-Kuzbass JSC[iii] (the same company as referred to above, but in a case concerning another tax audit period) and in the case of StroyMarket LLC and HyperMarket LLC[iv].

The specified cases are similar since they have to do with the applicability of beneficial rates under DTTs in cases when sister companies provide intra-group loans. However, there are some specific features.

In the case of SUEK-Kuzbass JSC the taxpayer did not challenge the very fact that the maximum interest on intra-group loans was reclassified as dividends, whereas in the case of StroyMarket LLC and HyperMarket LLC the taxpayer tried to prove the absence of controlled debt, and therefore, that payments needed to be reclassified.

In the case of SUEK-Kuzbass JSC the court proceeded on the basis of an indirect 100% participation of the foreign sister company in the capital of the Russian company referring to the provisions of article 269 (2 and 4) of the Russian Tax Code (the 'Tax Code') when reclassified interest is recognised as dividends for taxation purposes, i.e. as income from participation in the capital of the Russian company. The Court referred to article 10 'Dividends' of the DTT between Russia and the Republic of Cyprus and concluded that the specified interest that was reclassified should be treated as income from direct investments in the capital of the Russian company, despite the fact that in terms of civil legislation the foreign company is not recognised as a member of the Russian company and is not entitled to any dividends. The court also noted that it was reasonable for the taxpayer to apply the beneficial rate under the DTT since if a different approach was applied, the foreign company that had actually invested into the capital of the Russian company would be deprived of the right to apply a reduced tax rate under the DTT only because the financial relationships between the companies were not documented as corporate (shareholder) relationships.

In the case of StroyMarket LLC and HyperMarket LLC the taxpayer denied the very fact that there was controlled debt. The court partially agreed since the tax authority did not take into account the restrictions provided for by the version of article 269(2) of the Tax Code that was in force up to 1 January 2014:

- the foreign company did not directly or indirectly own more than 20% of Russian companies' issued capital;
- the Russian companies did not have any outstanding debt to Russian companies recognised as affiliated with the foreign entity;
- the debt relationships did not involve suretyship or guarantee relationships or any other security for debt obligations.

The court pointed out that the foreign company did not have any participation in the capital of the Russian companies. However, the court agreed with the positive difference between the interest accrued and the maximum interest on the outstanding debt being reclassified as dividends and pointed out that there were grounds for tax to be assessed at the rate of 5%. Since the foreign entity was a resident of the Republic of Cyprus, the court referred to the provisions of the DTT and concluded that all of the conditions for the beneficial rate to be applied had been proved:

- the foreign company directly invested over EUR 100,000 in the capital;
- the beneficial ownership of income was confirmed by a certificate of tax residence in the Republic of Cyprus[v].

Moreover, with reference to clause 14 of the Overview[vi] and to the Ruling of the Judicial Board for Economic Disputes of the Russian Supreme Court in the cases of Kashirskiy Dvor – Severyanin JSC and SUEK-Kuzbass JSC as well as to the analysis of articles 3 and 10 of the DTT, the court concluded that when income in the form of loan interest is considered as dividends based on Russian legislation, the amount of such loan or deposit must also be treated as capital and, therefore, be recognised as a direct investment in the capital.

Therefore, Russian companies had to pay tax on dividends reclassified from loans at the beneficial rate of 5%

Pepeliaev Group's comments

Based on an analysis of the above court cases, the conclusion can be made that following a comprehensive analysis of Commentary on the OECD Model Convention the courts are forming a positive practice of the application of beneficial rates under DTTs.
Court decisions are tending more frequently to refer to clause 14 of the Overview. This clause has become a starting point for the trend, which is positive for taxpayers, to develop in the application of beneficial rates under DTTs.

We believe that in the case of StroyMarket LLC and HyperMarket LLC, the Ulyanovsk Region Commercial ('Arbitration') Court marked the start of the development of a new practice relating to the application of beneficial rates under a DTT in situations when a foreign entity does not have any participation in the capital of a Russian company at all.

Based on clause 14 of the Overview of the Presidium of the Russian Supreme Court the court concluded that, when interest is reclassified as dividends, the foreign entity's participation in the capital of the Russian company is presumed to be confirmed since dividends are income from participation in a company's capital.

Thus, sister companies of one group may be allowed to invest in the capital of Russian companies and to subsequently apply beneficial tax rates without making direct investments into the capital de-jure provided that there is a DTT between the investor's country of residence and Russia containing such condition for the beneficial rate under the DTT to be applied.

Following the Russian Supreme Court, the courts of lower instances started to use the concept of 'substance over form' more often when analysing cross-border transactions. Thus, from the decision in the case of StroyMarket LLC and HyperMarket LLC it follows that the provisions of chapter 25 of the Tax Code do not contain the concept of a 'direct investment', which is one of the conditions for a beneficial rate under a DTT to be applied. Thus, this concept is to be construed taking account of the context of the DTT itself.

The court described a similar position in the case of SUEK-Kuzbass JSC specifying that the concept of 'capital' for the purposes of a DTT includes everything that relates to capital under civil (corporate) legislation and, additionally, a number of elements to which civil (corporate) legislation does not apply directly.

What to think about and what to do

When carrying out cross-border transactions, a Russian company, in order to be able to apply beneficial rates under a DTT, must request and obtain from the foreign entity not only a certificate of tax residence, but also documents confirming beneficial ownership of income. Otherwise, the Russian company risks being held liable for failing to perform the obligation of a tax agent.
In addition, consideration should be given to what constitutes the list of documents that confirm beneficial ownership of income.

[i] Ruling of the Panel of Judges for Economic Disputes of the Russian Supreme Court dated 6 March 2018 in case No. A27-25564/2015.
[ii] Ruling of the Panel of Judges for Economic Disputes of the Russian Supreme Court dated 5 April 2018 in case No. A40-176513/2016.
[iii] Resolution of the Kemerovo Region Commercial ('Arbitration') Court dated 17 April 2018 in case No. A27-2682/2017.
[iv] Resolution of the Ulyanovsk Region Commercial ('Arbitration') Court dated 14 May 2018 in case No. A72-12851/2017.
[v] The audit period until 1 January 2015.
[vi] Overview of the practice of courts examining cases relating to the application of individual provisions of section V.1 and of article 269 of the Tax Code approved by the Presidium of the Russian Supreme Court on 12 February 2017 (the 'Overview').