TAXAND

The Russian Supreme Court on withholding tax at source when services of a foreign company are paid for

According to the Russian Supreme Court payments under cross-border agreements for services (work) are treated as passive income if no operations have actually been performed.

The Judicial Board for Economic Disputes of the Russian Supreme Court examined the case of HaloPolymer Kirovo-Chepetsk LLC (the "Company") and concluded that the taxpayer could not book the expenses in the form of payments under a cross-border transaction for the provision of services when calculating its own tax base, since the taxpayer was aware that there would be no consideration under such transaction. Moreover, such payments are classified as other passive income not relating to active entrepreneurial operations, both for the purposes of double taxation treaties and for the purposes of article 309 of the Russian Tax Code (the "Tax Code"). Therefore, when the Company acted as a tax agent, it was obliged to withhold tax at source.

From the facts of the case it follows that the Company and the foreign company entered into agreements for services and work to develop a project that involved creating, determining and selling carbonic assets. Pursuant to the specified agreements the Company transferred over RUB 130 million to the foreign company. Following a field tax audit, the tax authority did not acknowledge such expenses and additionally assessed profit tax.

The additional assessment was made on the grounds that the tax authority reclassified both the transactions in dispute and the income paid to the foreign entity within the framework of such transactions. The agreements for services (work) were recognised as sham agreements and the income was reclassified as other passive income for which article 309(1)(10) of the Tax Code provides. The court proceeded on the basis that the foreign company received the money free of charge, since such entity did not supply the services for which the agreement provided and no intention to supply such services followed from the facts of the case. Thus, the specified money in actual fact was part of the Company's property (capital) that was formed within Russia and distributed in favour of the foreign company, with the knowledge of the Russian company, on non-repayable terms, i.e. in fact passive income was paid.

The Company did not agree with the reclassification of the transaction and pointed out that there was a court judgment issued by the Supreme Court of Quebec (Canada) dated 30 July 2015. According to the specified judgment money was recovered from the foreign entity in favour of the Company owing to the non-performance of obligations under the disputed agreements for services (work). The Company believed that this judgment proved that the concluded transactions were real.
The Russian Supreme Court, in turn, did not agree with the prejudicial effect of the judgment of the foreign court, since the claim in favour of the Company was considered and satisfied on the basis of an affidavit containing general information on the transactions and in the absence of the representatives of the defendant (the foreign entity).

Based on the information obtained from the tax service of Canada it was identified that: the foreign company was registered in the province of Quebec (Canada) and was a "mailbox" company; over 700 companies were registered at the same address; the company had no assets or income; and in the audit period it provided declarations with zero figures. Based on the above circumstances the

Russian court concluded that the Company deliberately appealed to the Supreme Court of Quebec (Canada) to have a judgment passed in favour of the Company without aiming to have any debt actually recovered and consciously knowing that in actual fact the counterparty was not in Canada. The court made an important conclusion that the Company did not take any actions to disclose information about the real (actual) recipient of income.

Conclusions

The Russian Supreme Court pointed out that the interpretation of the aggregate of the provisions of article 54.1 of the Tax Code and of Resolution No. 53 of the Plenum of the Russian Supreme Commercial ("Arbitration") Court does not rule out the possibility that the tax authority may change the classification of the payments made to the foreign company if the income from the alleged active operations is in fact a hidden form of payment of passive income and is to be accordingly reflected in the tax and accounting records. This is because discretion in civil law must not be regarded by bad-faith parties to civil law relationships as an option to undermine public interests protected by the law.

The Russian Supreme Court supported the tax authorities striving to identify the actual economic sense of payments in cross-border legal relationships. It follows from the above that if the taxpayer, when entering into a cross-border transaction, did not mean that such transaction would be consummated, or if the tax audit identified signs of disputed transactions being a sham, the risk arises that the income from the active operations will be reclassified as other passive income of a foreign entity. In other words, the tax authorities reclassify the active entrepreneurial operations as passive, and the company which is the source of income in this case becomes justifiably obliged to withhold the tax at source.

The position of the Russian Supreme Court regarding the above contains the following key positions regarding cross-border payments:

1. From a systematic interpretation of article 309 of the Tax Code (taking into account that the list specified in clause 1 of the article is open - subclause 10 "other similar income") it follows that profit tax is imposed on any and all income of a foreign company received from sources in Russia, except for income from active entrepreneurial operations.
2. The reclassification of legal relationships is beyond the framework of formal tax reconstruction because the emphasis has shifted to checking the actual economic nature of disputed legal relationships.
3. The tax authorities are now targeting not only dividends and interest under loan and royalty agreements, but also the income from active operations if the distribution of profit is disguised as payments from such active operations.
4. If the tax is not withheld when money is paid to a foreign entity, the tax agent may become subject to tax as well as default interest assessed before the obligation to pay the tax is performed in spite of the fact that the Russian tax authorities now have a wide range of tools to recover taxes directly from a foreign taxpayer, not from the Russian tax agent.
5. Disallowing the application of benefits under double taxation treaties must be based on an economic analysis of the actual cross-border relationships of the parties involved in the business activity, rather than on a formal analysis of corporate and contract and legal relationships. In such actual cross-border relationships the foreign company is only an intermediary, representative or agent without the right to apply benefits under double taxation treaties.

What to think about and what to do

The decision of the Russian Supreme Court demonstrates that the tax authorities devote close attention to cross-border transactions. In disputes over the taxation of such transactions, courts are taking the side of the tax authorities with increasing frequency.

It is another serious warning for the taxpayers that when cross-border transactions are structured and cross-border payments without withholding tax at source or with the application of a reduced rate under a double taxation treaty are planned, confirmation is required of both the business (economic) purpose as well as of the fact that saving on withholding tax is not the only purpose. In other words, the principal purpose test must actually be performed in accordance with the Multilateral Convention to implement the BEPS Plan measures and with the provisions of article 54.1 of the Tax Code.