THE GOVERNMENT INSPECTORS

Kira Egorova and **Zaurbek Timaev** chart Russia's progress on implementing the exchange of information

ON A GLOBAL level Russian tax legislation is in its infancy, but it is constantly developing in line with the latest global trends and OECD recommendations. These developments have given the Russian tax authorities tools to challenge aggressive tax planning. However, to use these tools the authorities need to be well informed. The Russian tax authorities used to be disadvantaged in this respect: they were often unable to obtain information on foreign companies' corporate structure, including the beneficial owners. In the past, Russian authorities were preoccupied with the domestic arrangements of taxpayers and didn't request this information from foreign authorities.

This is why, until recently, tax disputes in Russia over profit repatriation to foreign companies mostly involved formal arguments, such as absence of a proper tax residence certificate, or the level of investment to apply for a lower withholding tax rate. Moreover, the Russian tax authorities lacked the experience and resources to challenge these international cases. The notion that tax authorities could never prove that a Russian individual was the beneficial owner of a foreign company lay behind the development of many Russian structures.

Progress

Offshore vehicles are common in Russian corporate structures; even some state companies have affiliated structures registered offshore. Rosneft, for example, has an affiliate registered in the BVI. Russian companies use offshore structures for tax purposes, but also for asset protection and to attract foreign investment. However, the increase in cooperation between Russia and the OECD, together with Russia's membership of the G20, changed Russia's attitude to the exchange of information. The tax authorities and fiscal bodies now recognise and request information on 'beneficial owners'; the term is also incorporated in anti-money laundering law.

Recently the tax authorities have been targeting structures that exploit offshore vehicles for treaty shopping. The Russian tax authorities' ability to ask foreign tax authorities for information on foreign corporate structures, cash flow and beneficial owners has enabled them to overcome these arrangements. Receipts of loans by Russian companies from affiliated structures registered in low-tax jurisdictions, payment of royalties to these structures, and transfer of IP rights to foreign companies are red flags for the tax authorities. These details are disclosed in tax audits and then analysed. It is now common for the tax authorities to request information from several countries so they can examine related companies. They rely on the business-purpose doctrine or the substance-over-form doctrine for challenging these structures.

Despite the legal priority of international agreements over domestic law, the courts sometimes disregard double-tax treaties (DTTs). In one case, the court disregarded DTTs with Germany and France on unlimited deduction of interest, and applied domestic thin-cap rules instead.

Information exchange with Cyprus

In the past, many Russian structures used Cypriot companies. Russian authorities have since started challenging payments to these companies using information received from the Cypriot authorities.

In the *Monetka* case (A60-32327/2010), a retail chain paid royalties to a Cypriot company for the use of a trade mark. During the tax audit the tax office discovered that the trade mark was initially registered in Russia and later sold to a BVI company, which sublicensed it to the Cypriot company. The Russian tax authorities requested information from Cyprus on the Cypriot company's shareholders. Crucially, the request was not made via the tax authority, but through Interpol. The information received revealed that one of the shareholders of the Cypriot company was the girlfriend of the retail chain's beneficiary. Based on this, the Russian tax office argued that the beneficiary arranged the transfer of the trade mark offshore to push profits to the controlled Cypriot company. However, the Russian authorities lost the case: the court disregarded the information from Interpol as it was received in a way that contravened Russian law (the tax authorities cannot request this type of information from Interpol), and it regarded the secretary of the Cypriot company's statement that the girlfriend had never been on a shareholder register as reliable evidence.

In the *Kellog* case (A52-4072/2012), the Cypriot authorities provided inaccurate information. In a tax audit of a Russian company, UB, the authorities found out that UB took a loan from a Luxembourg company (LuxCo1). If LuxCo1 indirectly owned stock of UB, the Russian thin capitalisation rules would apply and the interest on the loan would not be deductible. The direct parent of UB was a Cypriot company, so the tax authorities requested information to find out if LuxCo1 was related to the Cypriot company. The Cypriot authorities said LuxCo1 was a direct parent of the Cypriot company. The Russian authorities did not accept this and made a second request for information. The Cypriot authorities replied that LuxCo2, not LuxCo1, was the parent of the Cypriot company. However, as LuxCo1 and LuxCo2 were sister companies, tax limitations were not applicable.

Successful requests

In the *Kamchatka* case (A24-3165/2012), foreign authorities provided crucial information that was successfully used by the Russian tax authorities.

A Russian company trawled, packed fish and sent it to a Norwegian buyer. The buyer was asked to remit payment to a Korean company. The Russian company never reported the shipments to the Norwegian buyer to the tax authorities, as it thought there was no paper trail in Russia. However, during a tax audit the tax office learnt about the shipments, as Russian safety certificates for the fish had been issued. The main difficulty for the Russian authorities was to link the Russian company to the Korean company, as no payments had been received by the Russian company.

The Russian authorities requested information on the managers of the Korean company's bank account. Korea's authorities provided this, plus copies of passports and cash flow statements. It turned out that the same people managed the Russian company and the Korean company's bank account.

> "Russia started renegotiating its tax treaties after amendments were made to the **OECD Model Tax Convention on Income and on Capital**"

Renegotiating tax treaties

Russia started renegotiating its tax treaties after amendments were made to the OECD *Model Tax Convention on Income and on Capital*. New protocols to treaties, effective from 2013/2014, were signed with Switzerland, Luxembourg and Cyprus. The protocols, *inter alia*, changed article 26 on the exchange of information. The new provisions were introduced to ensure the treaties complied with the OECD Model; it is possible that prospective amendments to the OECD Model will be reflected in Russia's DTTs.

The protocols ensure contracting states cannot refuse to supply information solely because it is held by a bank, other financial institution, nominee or person acting as an agency or fiduciary. The protocols with Switzerland and Luxembourg include special rules on the validity of a request: a request should be submitted only when domestic procedures have been exhausted; the reason for the request should be explained; automatic exchange and fishing expeditions are not allowed. Group requests are not mentioned in these protocols, but they are acceptable if permitted by the contracting state's domestic legislation. Theoretically, from 2014, the Russian tax authorities will be able to send a group request to the Swiss authorities, as Swiss domestic law allows group requests.

Conclusion

Expect the Russian tax authorities to make more extensive use of exchange of information provisions. Recent G20 initiatives on tackling base erosion and profit shifting imply that these initiatives will never be effectively implemented in Russia if the Russian tax authorities do not have access to information on Russian companies and individuals' foreign structures. Controlled foreign companies rules, which the Russian government plans to introduce in 2013-2014, will also be ineffective if the Russian authorities have no information on the beneficial owners of foreign companies. This is why the development of exchange of information is a priority for the Russian Ministry of Finance.

Russia is on the verge of ratifying the OECD *Convention on Mutual Administrative Assistance in Tax Matters*, which will enhance exchange of tax information among participating countries. In the tax annex to the St Petersburg G20 leaders' declaration, this convention is named as a tool for automatic exchange of information. The government has also announced plans to conclude exchange of information treaties with low-tax jurisdictions. Moreover, Russia's President has declared that offshore mechanisms will be challenged, and it is likely that the tax authorities will reconsider their treatment of traditional offshore structures. If court practice develops in the same direction, new precedents may arise.

Foreign corporate structures need to respond to these new challenges. Some structures will need to be reviewed to ensure they meet these higher standards of tax transparency. They must have solid economic grounds, be transparent from the cash flow and beneficial ownership, and have sound business purposes. ■

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