The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

B2B: The Power to Tax Is the Power to Destroy

By Boris Bruk

July 15, 2013

The MT Conferences section did not involve the reporting or the editorial staff of The Moscow Times.

Boris Bruk
Of Counsel
Dentons

In the world of unstable economies, the Russian Government is seeking out new tools to mobilize the financial resources necessary for it to meet its public liabilities. Increasing the nominal tax burden (by cutting tax benefits or increasing tax rates) is not considered an option for a number of political and economic reasons. Consequently, the government is exploring indirect ways to boost its fundraising capacity.

Anti-abuse rules are deemed one of the most attractive mechanisms for shearing the sheep. First, these rules do not require any substantive changes in the existing tax system, thereby maintaining formal stability. Second, anti-abuse measures can easily be sold to society by referring it to the bad guys who do not understand their social responsibilities. Finally, anti-abuse doctrines are pliant enough to allow flexibility of enforcement and can easily be tightened or weakened from time to time.

It is not surprising then that the Russian Government sees the development of all sorts of anti-abuse rules as one of the priorities of its strategic tax agenda. Taxpayers can expect legislation on the beneficial ownership concept and the foreign-controlled corporation concept shortly, together with the further development of the domestic transfer pricing rules.

Russian courts tend to keep pace with the executive and legislature, and anti-abuse court practice is flourishing. Although the use of anti-abuse language has become routine in the court room, one can still derive something new and interesting from a recent bunch of court rulings discussing tax law abuses.

The latter part of 2012 and first half of this year were no exception. They included a couple of landmark anti-abuse cases, which took anti-abuse jurisprudence to a new level.

Although the use of anti-abuse language has become routine in the court room, some insight can be gained from recent rulings.

The National Bank Trust case (Decision of the Moscow City Arbitration Court No.A40-11909/12 of 28.02.2013 (upheld by the Decision of the 9th Circuit Arbitration Court of Appeals on 23.05.2013) involved the Russian General Anti-Abuse Rule (GAAR), normally referred to as the unjustified tax benefit concept. This is essentially a mix of substance over form, the business purpose test and other similar concepts widely known in many developed and developing countries. The core of the concept is straightforward: If any activities of a taxpayer are tax driven, i.e. the taxpayer acts with the sole or predominant purpose of obtaining a tax benefit, these activities may be disregarded for tax purposes and the corresponding tax benefit may be denied. Typically this doctrine is used to combat abuses of input VAT offset (refund), the application of reduced tax rates and the deductibility of expenses for profit tax purposes. The National Bank Trust case, however, expanded the scope of the Russian GAAR to the reattribution of income.

The background to the case was as follows. A Russian bank (the Bank) assigned its credit portfolio to an affiliated Cyprus company for consideration. At the same time, the Bank deposited funds in amounts close to the nominal value of the assigned portfolio with Luxembourg and Austrian banks, which then on-lent the deposited funds to the Cyprus company. The funds were deposited and on-lent at fairly low interest rates. The courts found the essence of the structure to be abusive, since the Bank had substituted the high interest rate credit portfolio with lower interest rate deposits. The benefit to the group was evident: High yield generating instruments were taxed in Cyprus (subject to a general CIT rate of 10%), while the lower rate of interest was taxed in Russia. The taxpayer was unsuccessful in explaining the sound economic reasoning behind the structure. The outcome of the court's reasoning was that the assignment of the credit portfolio would be deemed null and void (as a series of sham transactions) and that the interest accrued by the Cyprus company would effectively be attributed to the Bank.

Although the case is still far from closed, since the taxpayer retains several appeal options, it clearly demonstrates the willingness of the tax authorities and readiness of the courts to use the anti-abuse provisions in a broad variety of situations. However, the good intentions in combatting tax fraud may sometimes drive the courts in the wrong direction. The Pirelli Tire Services case (Decision of the Moscow City Arbitration Court No.A40-58049/12-107-325 of 19.12.2012) is indicative of this.

The facts of the Pirelli case are simple. A Russian company forming part of a group received debt financing from its non-Russian sister company through an intra-group cash pooling arrangement; both were indirectly owned by an Italian parent. On the facts presented at court, a non-Russian sister company appeared to be a genuine intra-group financing vehicle, which managed the funds raised by the group companies to improve the utilization of these funds from the group's perspective.

Much has been said about the drastic changes in the thin capitalization jurisprudence since the RF Supreme Arbitration Court passed down its ruling in the Northern Kuzbass case in the autumn of 2011. First, taxpayers lost their non-discrimination protection under Russia's double tax treaties, albeit Russian thin capitalization rules are discriminatory by all other counts (at least when compared to the developed European jurisprudence). In the second round of the thin cap battle taxpayer reliance on the special provisions of some of the double tax treaties enhancing unlimited deductibility of interest for tax purposes suffered a defeat. Now the tax authorities and the lower court feel bold enough to disregard explicit statements of Russian tax law.

Article 269 (2) of the Tax Code (which embeds the domestic thin capitalization rules) is very clear that it only applies where a loan is extended to a Russian borrower or secured in favor of the Russian borrower by (i) direct or indirect non-Russian shareholders of the borrower or (ii) Russian affiliates of such non-Russian shareholders. Thus, the law itself is clear that loans received from or secured by non-Russian affiliates of non-Russian shareholders of a borrower are outside the scope of Article 269 (2). The lower court, however, ignored this detail and invoked Article 269 (2) in this case.

Pirelli is not the first piece of thin cap jurisprudence involving intra-group financing received from a non-Russia sister company. The pioneer case was that involving Naryanmarneftegaz, cited in Pirelli. There is, however, a major difference between the two cases, making the court's reliance on Naryanmarneftegaz in Pirelli questionable. In Naryanmarneftegaz the court found that a foreign sister company was merely a conduit and that the actual source of financing was an indirect foreign parent of the Russian borrower (a situation to which the thin cap rules apply without a doubt). The case was therefore presented as an attempt by the taxpayer to circumvent the thin cap rules by introducing an artificial intermediary, resulting in a protective decision of the court with regard to the domestic rule of law.

However, nothing of the kind was found in Pirelli (or at least the court was silent about it). As such, the court had no reason to attack the financing structure that merely utilized a loophole in Russian tax law. This could be a matter for consideration by the Russian legislature, which may decide to amend the law. It should not, however, be at the discretion of the courts to legislate on what they consider to be gaps in the law by extending the scope of legislative provisions, whose wording is unambiguous.

The Pirelli case raises the question of the stability of the Russian legal framework. The application of anti-abuse provisions can sometimes be justifiable from a fiscal point of view, but it is extremely detrimental to the investment climate, as it undermines predictability, a key feature of the law. If businesses cannot be sure that their current practices, based on a bona fide interpretation of the law, will not be overturned retroactively by the government (as was the case with the thin capitalization jurisprudence), would they feel comfortable enough to invest in the local economy? As a result, the questions arises: does the power to tax mean the power to destroy?

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