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Legal Highlights: New Tax Environment: Will Courts Continue Mistreating Double Tax Treaties?

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A foreign investor operating in Russia through any form of corporate presence faces the need to make use of and rely on at least some international tax law concepts. Having double tax treaty protection is a benefit that, if properly structured, can provide significant tax savings in the long run. Yet enforcing the tax treaty provisions in Russia might be a challenge, considering the gaps in the tax legislation, which courts tend to fill by interpreting tax treaties broadly and borrowing the international anti-avoidance concepts, which often has unexpected results.

This has become more acute than ever in view of the Supreme Commercial Court's (SCC) new position envisaging that tax agents may be charged with full amount of tax not withheld on payments to non-residents. This new position was stated in SCC Plenary Resolution No. 57 dated 30 July 2013 (mandatory for lower-tier courts) and is one recent example of the turnaround in previously accepted tax positions, which will affect many companies and form the new tax environment to work with.

This article goes on to highlight some recent examples of adverse case law interpretations of double tax conventions and to give some practical advice from the perspective of a Russian corporate taxpayer to navigate safely through these blue waters of international tax law implementation.

Adverse Treaty Interpretations: Thin Capitalisation and Non-Discrimination

From our recent practice, we see a general decline in respect of double tax treaty provisions by law-enforcers and growing apprehension and concerns on the part of clients applying tax treaty benefits. We believe that this incorrect interpretation of double tax treaties has been provoked by inaccurate wording of the SCC Resolution on the *Severny Kuzbass* case (No. 8654/11 dd. 15 November 2011). In this infamous ruling, the SCC overthrew the stable case law based on consensus that the Russian thin capitalisation rules could not apply where double tax treaty non-discrimination provisions were in place. The court found the rules applicable to Russian corporates with foreign capital only as being non-discriminatory and stated that the treaties did not interfere in Russia's right to apply domestic thin capitalisation rules as it saw fit.

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The conclusion that a non-discrimination clause in a double tax treaty is not unconditional protection against excessive use of shareholder debt financing is a fair statement as such. This principle is common to the OECD approaches in the Commentary to the Model Tax Convention and all recent law-enforcement practices of developed countries, which go to great lengths to prevent their tax base erosion. However, in making this valid conclusion, the Court failed to properly explain the reasoning to apply the anti-avoidance rules in this particular case. Instead, the SCC stated that domestic anti-avoidance regulations could not be regarded as discriminatory *per se*, since they are aimed to prevent tax minimisation, while international tax law provisions cannot overrule specific domestic rules aimed at combating tax avoidance.

The SCC referred to the OECD Commentary stating that thin capitalisation rules can, indeed, overrule non-discrimination. Even so, read in conjunction with Article 9 "Associated Enterprises" of the Model Tax Convention, the rules can only apply to the extent that the result is at arm's length, so no adjustments are acceptable without regard to the particular circumstances and comprehensive transfer pricing analysis of the borrower's capital structure. Although, from the systemic interpretation of the Severny Kuzbass text, it may be deferred that the reasoning was made owing to case-specific facts that the Court found evidencing tax abuse (continuous negative net assets, deferral of payment, debt hugely disproportionate to the taxpayer's assets, etc.), the Resolution does not clearly explain the criteria and grounds for thin capitalisation rules to apply here.

Unfortunately but quite expectably, the lower-tier courts did not go far enough in interpreting the Resolution and reading between the lines and simply made a 180 degrees turn to crank out decisions where application of thin capitalisation is allowed just because it is written into the Tax Code and is, as such, aimed at combating tax avoidance, it being irrelevant whether or not such avoidance took place. There have been a couple of positive rulings where courts upheld taxpayers, stating that no tax avoidance was found, but these were either overthrown by the cassation instance under the same formalistic approach (see *Severstal* case Resolution No. A40-88761/12-99-495 dated 24 September 2013), or stayed at the lower-tier court (*Boksit Timana* case Resolution No. 09АП-7620/2012-АК dated 24 April 2012).

The discussed incorrect interpretation of *Severny Kuzbass* leads to application of rules to cases where, given a proper reading of the double tax treaties, they should not apply. We see lots of our clients suffering from the effect of thin capitalisation rules that are now interpreted as disallowing interest under group financing or even guaranteed independent borrowings where they are fully arm's length regardless of what the treaties say. This often includes purely domestic structures where no potential "deemed dividend income" can arise at all.

Currently, the SCC is loaded down with claims for supervisory review of similar thin capitalisation cases and can be expected to issue a resolution to clarify its position that thin capitalisation adjustments are acceptable subject to other treaty provisions, including guarantee of adjustments to arm's length, but not under a formal approach. Yet the court remains silent and keeps declining claims consideration. In terms of practical risk management, we recommend taking conservative positions in the meantime, but regularly monitoring the case law in the expectation of an improvement that would allow adjusted returns to be filed and the tax overpayment subsequently claimed back (keep an eye on just the three year term for tax refund).

Reclassifications and Substance over Form: Closing the Loopholes

Interestingly, where courts notice alleged tax base erosion, they try to go further than the existing legislation allows and expand it by referring to tax treaties. Among recent examples is the United Bakers case, where the court ruled that thin capitalisation rules may apply to a foreign sister company, a case not envisioned in the Tax Code, by referring to Article 9 of the Luxembourg-Russia Double Tax Treaty, claiming that these are associated enterprises (see No. A52-4072/2012 dated 18 September 2013).

This is a fundamental mistake in applying double tax treaties, since, under international tax doctrine, their role is to apportion and limit the sovereign authority of the state to tax income at source. If any right to tax is reserved under the treaty but not used at the national level under the relevant domestic legislation, the treaty should not be read as supplementing the domestic law to provide a "second chance" to the treasury.

Again, the courts use wrong argumentation to support a valid conclusion: this misinterpretation could be easily avoided if the rationale were based on substance over form/conduit company approach claiming that the sister company has no substance, no valid business reason to exist (if such was the case). A successful application of this approach is illustrated by the *Naryanmarneftegaz* case, where, in a similar situation, the court expanded on the reasons for reclassifying the transactions as lacking substance and showing that loans provided by companies should be regarded as *de facto* shareholder financing (see Resolution No. A40-1164/11-99-7 dated 27 February 2012), although, in this case, this was done on extremely questionable grounds. This case is also connected with some other examples of "corporate veil piercing" in the non-tax cases of *Skakovaya* 5 and *Parex Bank*, which might be indicative of a certain trend (See Resolutions No. 14828/12 dated 26 March 2013, No. 16404/11 dated 24 April 2012).

The above adverse interpretations are not in the last place due to the fact that there are still lots of known loopholes that the legislators are in no hurry to close, thin capitalisation sister company issues being only one example. Yet the trend of trying to cure legislative loopholes using dodgy approaches in law-enforcement is not only frustrating for taxpayers but also highly destructive, since it has a fundamentally destabilising effect on the legal environment and law abidance.

In practice, these developments mean, however, that building a structure that is formally beyond the scope of the domestic rules can, though, be disregarded and reclassified if the court finds it to be sham and artificial, which will lead to an unsatisfactory result whatever reasoning — correct or otherwise — the court might choose. So, growing attention to beneficiary ownership issues and treaty shopping not result in any change in the law but engender a complete change in law enforcement, which will bring the business into a completely new tax environment where formalistic structures no longer work.

Are Formalities Still Important for Tax Agents?

The turn in the direction of denying formal approaches discussed above does not work equally in all respects. Given the above SCC position that the full amount of tax not withheld can be claimed from the tax agent, it is in the interests of Russian paying entities to invest sufficient efforts in ensuring the formal side of the matter where a double tax treaty exemption applies. The core recommendation is simple: to obtain, in a timely fashion, an adequate and duly apostilled tax residence certificate for the payee that is entitled to double tax treaty exemption. If this seems natural with independent parties, it is often an annoying routine with group companies: why bother obtaining new certificates if the parties are quite sure where the parent company is located and tax resident? Yet it is crucial to prepare all the documents beforehand, since these formalities might take a substantial time and, if you fail to present the documents during a tax audit, you might lose the case.

Whereas, previously, the SCC and the courts supported taxpayers that were able to present tax residence certificates only at the litigation stage, there has been a recent negative precedent when a taxpayer was penalised for failure to provide the document during the tax audit, although it eventually turned out that there were no grounds for withholding tax under the treaty (see the *Nestle-Kuban* case Resolution No. A32-30502/2010 dated 29 June 2012, supervisory review denied). This risk has drawn closer owing to the recent changes to the Russian Tax Code Article 140-4, allowing higher-tier tax authorities to disregard and not accept documents that a taxpayer provided at the appeal stage but failed to present during the tax audit, unless they were objectively unable to provide these earlier.

This change in the legislation and case law poses a very serious doctrinal question of whether a person can be fined for failure to withhold tax if, per a tax treaty, no tax obligation of the taxpayer existed in the first place and there was only lack of proof at that time. Yet, from the practical perspective, the message is that the formalities should be respected and collection of tax residence certificates can no longer be postponed until a court claim is filed.

Other Treaty Interpretation Mistakes in Case Law

Further to the above issues that have a degree of uncertainty requiring court analysis and judgement, sometimes you can face fairly odious errors in tax treaty application. These include such "casualties" as the *Promleasing* case, where both the taxpayer and the tax authorities were drawn into an embarrassing discussion proving that a Russian LLC is a Russian enterprise because its CEO is a Russian citizen, evidently misinterpreting the term "enterprise" for treaty purposes (see Resolution No. KA-A40/6805-11 dated 08 July 2011). Another renowned case included a court ruling that the Protocol to the Russia-Germany Double Tax Treaty expressly specifying an additional guarantee of unlimited interest cost deduction could not apply at all, because this benefit discriminates against Russian companies qualifying as Russian subsidiaries of German residents (See the *Rulog* case No. A40-37344/11-107-160 dated 19 November 2012). This statement is as outrageous as the suggestion that an international tax treaty is required for Russia not to discriminate its Russian companies against one another. No practical advice can be given for avoiding such an odd situation other than ensuring that development and presentation of the legal position in a tax dispute is assigned to adequate professionals.

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To summarise this overview, we are now witnessing a fundamental change in law-enforcement approaches to interpreting double tax treaties and the grounds for their application. Previously, "double tax treaty" was a word combination that put a spell on the court to rule in favour of the taxpayer, but it has now become, in the eyes of the judiciary, a sort of suspicious instrument in the hands of a potentially *mala fide* taxpayer.

Still, the progress in substance over form approaches will hopefully help overcome these side effects of treaty interpretation and growing attention will be paid to other authoritative sources of international tax concepts, including the OECD Transfer Pricing Guidelines. Demand for change may come from an unexpected side: it cannot be excluded that the need for transfer pricing cooperation will give a new impetus to developments in double tax treaty application and, in a few years, we may see corresponding cross-border adjustments and mutual agreement procedures becoming a reality in Russia.

* Goltsblat BLP is the Russian practice of Berwin Leighton Paisner (BLP), an award-winning

international law firm headquartered in London and with offices operating in major commercial and financial centres throughout the world — Moscow, Abu Dhabi, Beijing, Berlin, Brussels, Dubai, Frankfurt, Hong Kong, Paris and Singapore.
The firm has a team of 100 Russian, English and US law qualified lawyers based in Moscow and over 800 lawyers in the other international offices.
Goltsblat BLP currently has over 700 clients among the major international investors operating in Russia, including 23 Fortune 500 companies.

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