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# B2B: Finance Ministry Moves to Fight Abuse of Double Taxation Agreements

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On April 9, 2014, the Finance Ministry issued guidelines on the application of agreements on the avoidance of double taxation (DTAs), which requires tax agents and tax authorities to conduct an assessment of whether foreign recipients of income in Russia have the right to apply a tax exemption in Russia or a lower tax rate.

Combatting the abuse of DTAs has been a priority in Russia's tax policy for a number of years. Given that most Russian DTAs operate on the basis of "actual recipient of income" or "beneficiary owner of income" (translated in various ways), without defining the term, it would appear that regulation of this issue is a matter for the national law of the contracting states.

Unfortunately, to date Russian legislation has not formulated the concept of actual recipient of income. This is perhaps due to the complexity of the subject, as it is no secret that the Organization for Economic Cooperation and Development (OECD), which initially proposed the application of this concept in tax treaties, has also yet to make substantive progress in this matter.

As a result of the absence of a definition of "actual recipient of income", the respective DTA provisions are effectively disregarded. This is probably why the Finance Ministry is trying to boost efforts against the abuse of DTAs, at least at the level of guidance from the competent authority on the application of DTAs.

The Finance Ministry's guidelines emphasize that the term "actual beneficiary of income" is not used in a narrow technical sense, but on the basis of the purpose and objectives of the DTA: the elimination of double taxation, prevention of abuse of contractual provisions, and prevalence of substance over form. Under this approach, the fact that the recipient of the income is a resident of one of the contracting states does not per se mean that that person

should be treated as the actual beneficiary of the income. As examples of cases where a resident of a contracting state should not be treated as the actual beneficiary of income, the Finance Ministry has followed the OECD Commentary on the Model Tax Convention in citing agents and nominee holdings. The Finance Ministry's logic is that agents and nominee holders of assets cannot apply the benefits provided by a Russian DTA with the state of which the agent or nominee holder is resident, if the beneficiary (principal) is not also a resident of that state.



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Another example in which the formal recipient of the income does not have the rights of the beneficiary owner (and therefore the right to apply benefits under a Russian DTA with the state in which the formal recipient of the income is located) given by the Finance Ministry is the use of conduit (intermediary) companies with "narrow authority" with respect to the income received, that is, acting, in the opinion of the competent authority, on behalf of interested third parties.

The Letter's authors assume that the actual recipient of the income must meet both the following criteria:

a) have a legal basis for receipt of the income; and

b) have the ability to determine the subsequent economic use of the income. In order to determine whether the formal recipient of the income meets this criterion, the functions performed by this person and the economic risks it undertakes are to be taken into consideration.

If the recipient of the income does not meet these requirements, then the RF Finance Ministry believes it should not be permitted to apply benefits under a Russian DTA with the state of which the formal recipient is resident. The indicator of taxpayer abuse in this case should be whether the person to whom the income was transferred by the actual recipient of the income had the right to receive the same benefit under the same DTA in the event that the income was paid directly to the said person. In other words, if a person that is not the formal recipient of the income and which may on the basis of the criteria above be considered the actual recipient of the income is not a resident of the same state as the formal recipient of the income, the application of the respective DTA may be denied.

The Finance Ministry provides some examples of such situations:

a) the formal recipient of the income has an obligation to pay all or most of the income to a third party that is a tax resident of a state that does not have a DTA with the RF, or has a DTA with the RF that provides less favorable conditions of taxation than the DTA with the state in which the formal recipient of the income is resident;

b) back-to-back transactions. This mainly applies to the provision of loans and licensing.

It should be noted that the tax authorities have previously already attempted to apply a similar approach in Eastern Value Partners Limited (case No.A40-60755/1220-388), without much success. The Russian courts turned out to be unready for such radical steps. Time will tell whether the RF Finance Ministry is able to change this trend.

For now, it should be noted that absent legal regulation of the concept of actual recipient of income, the Finance Ministry letter leaves many practical questions open, for example:

a) Does a refusal to apply the DTA with the state in which the formal recipient of the income is located mean it is not possible to apply the DTA with the state in which the third party recognized as the actual recipient of the income is located? In this case, who is required to present the tax residence certificate for the person recognized as the actual recipient of the income?

b) What documents does the tax agent need to request from the formal recipient of the income to ensure that the said person meets the criteria for actual recipient of the income?

c) What steps can and should the tax agent take in cases where the formal recipient of the income refuses to supply any documents on its activities (in particular, citing commercial secrecy), or states that with respect to the income paid from Russia it has no relations with third parties? How can a tax agent verify such assertions?

Unfortunately, these and certain other matters have been overlooked by the RF Finance Ministry. If the notion of actual recipient is applied in practice, these questions are likely to become crucial.

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