

November 2016

Decision of the Arbitrazh (Commercial) Court of Moscow dd. October 31, 2016 in Case No A40-113217/2016

The Arbitrazh Court of Moscow has rendered a decision declaring lawful the denial of application of a concessionary tax rate to dividends payable to companies being residents of the Republic of Cyprus. The denial is motivated by the tax authority’s opinion to the effect that the Cypriot shareholders served as a “conduit company”, i.e. were flow-through companies specially established to make benefitting from the Double Taxation Treaty (DTT) with Cyprus possible. The said decision is especially important in the light of the fact that the tax authority had been auditing liabilities of a Russian company which was the source of dividends, over the period that preceded the introduction in the Russian Tax Code (from the year 2015) of the concept of “beneficial ownership of the income” (the audit covered the year 2011). To substantiate its findings the Court invoked the concept of unjustified tax benefit.

Beneficial Ownership of the Dividends

Most of DTTs to which Russia is a party (including the DTT with Cyprus of April 02, 2012) stipulate that concessionary rates of the tax on dividends are applicable to the beneficial owner of such dividends. The concept of “beneficial ownership” is articulated in the official Comments to the OECD Model Tax Convention on the basis of which bilateral DTTs are developed. According to those Comments (as amended), **beneficial owner of the income** is a person who has the valid right to use and dispose of such income; and concessionary tax rates are not applicable to a **conduit company** (a person acting as a bare intermediary for payment of the income).

In 2015 this rule was incorporated in the Tax Code (in particular, Art. 7(2), Art. 312(3) of the RF TC), whereby the right to apply relevant concessionary tax rates under a DTT is afforded to the “beneficial owner” (the word-by-word translation of the term as it is used in the RF TC is “person holding the actual right to the income”), while a person acting as an “intermediary in favor of another person” (i.e. a conduit company) does not enjoy such right.

Details of the Tax Dispute

Upon examination of the tax dispute the court determined that the Cypriot companies, being shareholders of the Russian company, were not beneficial owners of the income because they did not conduct any independent financial or business activities, the dividends were the only financial resources available to them and were remitted (by way of payment of their own dividends or repayment of loans) to BVI companies. Following this line of reasoning the court came to the

conclusion that the Russian company (the tax agent) was obligated to withhold the dividend tax at the general tax rate of 15%.

Letters issued by Cypriot tax authorities, that confirmed independence of the Cypriot companies, were held refutable by the discovered evidence and thus were not taken into consideration. To substantiate applicability of the reduced tax rate provision of the DDT with Cyprus only to those companies which are beneficial owners of the income the court referred to the Comments to the Model Convention. In this context it is noteworthy that the version of the DDT with Cyprus which was applied to the tax period at issue (the year 2011) took effect only in 2012. A special place in the decision of the court is given to proving of the argument about gaining of unreasonable tax benefit from holding of shares in the Russian company through the Cypriot companies.

Conclusions

This legal case is one in a series of judicial precedents relevant to application of the concept of “beneficial ownership of the income” while the situation at hand is typical for many Russian companies the ownership of which is structured through foreign holding companies. This is why many Russian shareholders face the necessity of proving that their foreign companies are independent entities in terms of their organization (so-called “substance”) or of proving by way of disclosure of information about the ultimate beneficiary that they have the right to apply a relevant tax rate.

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