



Tax Update

Review of Taxation News
October 2012

Taxation of dividend at the expense of undistributed profit gained in the periods before 2010 and in the periods of 2010

Letter of the Ministry of Finance, dated August 17 2012, No. 03-03-06/2/90

In the said Letter the Ministry of Finance explains that dividends are subject to the 20% profit tax, if they accrue for the periods preceding 2010 and/or for the periods of 2010 and are paid starting from January 1, 2011.

We remind that the Federal Law of December 27, 2009, No. 368-FZ ("**Law No. 368-FZ**") changed the conditions for application of one of the three special rates of the profit tax on dividend, provided for by Article 284(3) of the Tax Code, – the 0% rate. The special rates 9% and 15% were not affected.

The Ministry's approach is based on the following. Article 5(2) of Law No. 368-FZ establishes that Article 284(3) of the Tax Code (as reproduced in Law No. 368-FZ) applies from January 1, 2011 and extends to the profit tax on dividend accrued for 2010 and further periods.

The Ministry indicates that by virtue of Article 5(2) of Law No. 368-FZ none of the special rates of the profit tax on dividend may apply in the given situation. Consequently, subject to application is the 20% general rate of the profit tax (Article 284(1) of the Tax Code).

In our view, the Ministry's approach is disputable. As mentioned above, Law No. 368-FZ only amended the procedure for

application of the 0% rate, leaving the application of the 9% and 15% rates intact. Consequently, the effect of Article 5(2) of Law No. 368-FZ extends exclusively to the 0% rate. Therefore, the possibility or the impossibility of application of the 0% rate on the basis of Article 5(2) of Law No. 368-FZ should not affect the applicability of the 9% and 15% rates. There also exist other arguments against the Ministry's approach.

We believe that in the situation in question dividend may attract the profit rate tax at the rate 9% for Russian companies receiving dividend and at the rate 15% for foreign companies receiving dividend, if such dividend accrued for the periods preceding 2010 and/or for the periods of 2010 and were paid from January 1, 2011. However, the risk of a court dispute due to the poorly formulated Article 5(2) of Law No. 368-FZ cannot be completely excluded.

We also specifically note that disputable is the possibility to apply the 0% rate to dividend that accrued for the periods preceding 2010 and/or for the periods of 2010 where all conditions for application of the 0% rate (including the value of the contribution made by the dividend receiving company to the charter capital of the dividend distributing company) effective in 2008-2010 were complied with.

The profit tax on a participant of the LLC where the charter capital is increased at the expense of the company's property

Letter of the Ministry of Finance, dated July 17, 2012, No. 03-03-06/1/343

In the Letter the Ministry of Finance explains that an increase of the charter capital of a limited liability company (the “LLC”) at the expense of its property (in particular, undistributed profit) brings the sole participant of the LLC income in the amount of the increase of its share in the charter capital of the company, which income attracts the profit tax.

The Ministry makes this conclusion in the belief that Article 25(1)(15) of the Tax Code which determines income exempt from the profit tax in the event of an increase of the charter capital of a joint stock company (the “JSC”) extends exclusively to the shareholders of the JSC and has no effect with respect to the participants of the LLC.

Although the Ministry's approach is based on a literal construction of Article 25(1)(15) of the Tax Code, we believe it is disputable. The difference in the taxation of the LLC participants and the JSC shareholders can hardly be regarded as justified, because it would be a discrimination of the LLC participants as compared to the JSC shareholders, which is prohibited by Article 3(2) of the Tax Code, and a violation of the principle of universality and equality of taxation and the requirement that taxes and duties must be economically grounded and may not be arbitrary (Article 3(1) and Article 3(3) of the Tax Code).

Besides, from Article 25 “The Tax on the Profit of an Organization” of the Tax Code it does not follow that an increase of the charter capital of the LLC at the expense of its property gives rise to income (economic gain). In other words, the LLC participant does not derive any income (economic gain) until the time of disposal of his share in the charter capital. Consequently, such participant has no income attracting the profit tax.

Furthermore, the said approach of the Ministry leads to a violation of the ban on the double taxation of one and the same income (Article 3(1), Article 3(3) and Article 248(3) of the Tax Code).

There is no stable court practice in the matter in question. Some courts, for the reasons stated above, recognize as justified the opinion that the LLC participant derives no income from an increase of the company's charter capital at the expense of its property (Ruling of the Federal Arbitration Court of the Povolzhie Circuit, dated February 16, 2009, No. A65-11409/2006).

Thus, the opinion that an increase of the LLC charter capital at the expense of its property brings no income to the LLC participants may exist, but given the literal construction of Article 25(1)(15) of the Tax Code by the Ministry of Finance a taxpayer should be ready to defend such opinion in court.

Application of the *substance over the form* approach in payments to foreign companies

*Decision of the Moscow Arbitration Court, dated August 29, 2012, No. A40-60755/12
(the case of Eastern Value Partners Limited)*

That case is interesting because it touches upon the issues of taxation in Russia of cross-border payments in favor of third parties and the application of the prevalence of the substance over the form concept in transactions involving foreign jurisdictions.

A Cypriot company which, as can be gathered from the court's Decision, has a permanent establishment in Russia (the "**Cypriot Borrower**") signed a loan agreement with another Cypriot company (the "**Cypriot Creditor**").

On request of the Cypriot Creditor, the Cypriot Borrower remitted the money it owed under the said loan agreement (the "**Loan Agreement**") to a third party, resident of the British Virgin Islands (the "**BVI Creditor**"). The BVI Creditor was also the creditor of the Cypriot Creditor. In that combination, the tax on income of foreign companies from the source in Russia was not paid on the ground of Article 11 of the Russia-Cyprus Double Taxation Treaty of December 5, 1998 which exempted interest paid by the Cypriot Borrower to the Cypriot Creditor from the Russian profit tax.

The Tax Inspectorate decided that the Cypriot Borrower wrongfully did not withhold the Russian profit tax from the income being remitted to the BVI Creditor. The Tax Inspectorate supported its decision by the arguments that interest had been actually remitted to the BVI resident, not the Cyprus resident; the Cypriot Creditor had not been a really existing financial company, because it had performed its obligations under the Loan Agreement at the expense of borrowed money. There were other arguments, such as the operations had been

carried out in one day, the parties had been interdependent, there had been no real economic gain from the transaction, and the operations had been one-time transactions. The Tax Inspectorate wished to support its conclusion that The Cypriot Creditor had been set up to minimize taxes by a formal application of the Double Taxation Treaty, therefore payments under the Loan Agreement could not be exempt from the profit tax.

The Tax Inspectorate imposed a fine on the Cypriot Borrower under Article 123 of the Tax Code for the failure to withhold the profit tax on the income paid to the BVI Creditor and a penalty.

The court found the Tax Inspectorate's decision invalid, having rejected the argument that the activity of the Cypriot Creditor had been fictitious. In particular, the court established that the Cypriot Creditor had received income from the performance of the Loan Agreement, that it had really been an on-going concern and regularly paid taxes in Cyprus – the profit tax and the defense tax.

The court rejected the Tax Inspectorate's separate argument that Article 11 of the Double Taxation Treaty exempting interest from taxation in Russia did not apply because the Cypriot Borrower on request of the Cypriot Creditor had remitted the debt under the Loan Agreement to the BVI Creditor. The court noted that the BVI Creditor should be regarded as a person authorized by the Cypriot Creditor to assume the performance of the Loan Agreement (Article 312 of the Civil Code) and the remittance itself should be regarded as payment under the Loan

Agreement. Therefore, interest must be recognized as paid to the Cypriot Creditor irrespective of who the Cypriot Creditor had authorized to receive the money. The court also noted that according to the Commentaries on the OECD Model Tax Convention on Income and on Capital remittance of money to a third party was of no importance for the application of the Double Taxation Treaty.

The case in question is a demonstrative one, illustrating the attention of tax authorities to transactions of taxpayers with foreign companies. The case evidences that in the struggle of tax authorities against avoidance of taxes the tendency to take recourse to international double taxation treaties has increased. Tax authorities begin to analyze more thoroughly the essence of foreign companies' operations and try to find out whether they are in fact ongoing concerns. The analysis involves modern methods of

struggle against avoidance of taxes, including the substance over the form approach and examination of the counterparts' economic gain. Potentially, such tendency means growing tax risks for a taxpayer that deals with foreign companies. Therefore, it becomes Important to use the services of a tax advisor in the negotiation and execution of contracts with foreign counterparts.

Of interest is the court's conclusion that the payments by the Cypriot Borrower in favor of a third party on request of the Cypriot Creditor are subject to the same taxation as payments to the Cypriot Creditor. It should be noted that applicable laws are not completely clear on that matter.

We note that the Decision cannot be regarded as final so far, because the Tax Inspectorate may still appeal from it to higher instances.

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This newsletter is not intended to provide legal advice and/or any other form of legal assistance that may be rendered by attorney-at-law to client. The exclusive purpose of this review is to make aware its recipient of certain recent changes in Russian laws and regulations, and of the development of law application practice. Any use of the information contained herein for particular purposes may require more detailed case-specific explanations. Further information can be obtained via +7 (495) 933 75 67 or office@agp.ru



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