Russian Tax Brief

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Deductibility of Interest Based on Tax Treaties

Russian tax law contains special limitations to the deductibility of interest expenses for profits tax purposes where borrowings are high by comparison to equity capital, i.e. so-called "thin capitalization" rules. Application of these thin capitalization rules may result in part of the interest incurred by the taxpayer being characterised as dividends and taxed accordingly, i.e. considered non-deductible for profits tax purposes and prima facie taxable at the rate of 15% at source.

Treaty Provisions Concerning Interest

As a general rule, provisions of international treaties concluded by Russia override local tax legislation[1]. If an applicable treaty contains appropriate provisions it could prevent the characterisation of interest as dividends, increasing their deductibility and changing the income tax to be withheld on payment.

Based on the Cyprus-Russia treaty, for example, the treatment of interest paid by a Russian company to a Cypriot resident for profits tax purposes should be the same as if it were paid to a Russian resident, and a Russian subsidiary (direct or indirect) of a Cypriot company should not be subject to Russian taxation or tax-related requirements more burdensome than those applied to other similar entities in Russia[2]. These provisions apply unless the amount of interest paid exceeds the amount which would have been agreed upon by independent parties in similar conditions[3].

Consequently, when a loan subject to the Russian "thin capitalization" rules is provided to a Russian subsidiary of a Cypriot company on arm's-length terms, a taxpayer might expect that the total amount of interest would be deductible in full and not subject to taxation at source as dividends.

However, the Russian tax authorities have asserted in several letters that treaties do not exclude the application of the thin capitalization rules. In these letters the tax authorities cite various treaty provisions in support of their position, but the conclusion is always the same – thin capitalization rules should be applied irrespective of the wording of any applicable treaty since in the case of indebtedness to related parties it is presumed that liabilities did not arise on an arm's-length basis.

A recent clarification and court case demonstrate the continuing controversy generated by this issue.

Deductibility of Interest Under the Netherlands-Russia Tax Treaty

The protocol to the Netherlands-Russia treaty specifically provides for the deduction of interest for profits tax purposes. On 17 July 2009 the Russian Ministry of Finance issued letter No. 03-08-05 clarifying the application of the treaty to interest payments made by a Russian tax resident to an affiliated Dutch resident.

The letter asserts that the treaty's provisions do not prevent the contracting states from applying their national thin capitalization rules to interest paid on debts between affiliated Dutch and Russian legal entities. The non-discrimination clause (article 25) and any reliefs provided by the protocol should not apply in such cases due to a special relationship existing either between the payer of interest and the beneficial owner thereof or between both of them and a third person. The provisions of article 11 limiting the taxation of interest at source apply only to the arm's-length amount of interest paid, while any excess over this amount remains taxable according to the laws of each contracting state.

In the case of Russian-source interest, this means that in the ministry's view the provisions of the

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[1] Article 7 of the Tax Code.
[2] Article 24 clauses 3 and 4 of the Cyprus-Russia tax treaty.
[3] Article 9 clause 1 and Article 11 clause 5, ibid.

Tax Code providing for excess interest to be recharacterized as dividends may apply.

The letter notes that the arm's-length principle should apply not only to the interest rate, but also to the other loan terms. The amount of debt financing raised, for example, should not exceed the amount that would have been agreed upon in the absence of a special relationship. This position is confirmed by the official commentaries to article 11 of the OECD Model Tax Convention, which stipulate that "if the state of source permits, the excess amount can be disallowed as a deduction, due regard being had to other provisions of the Convention".

Paragraph 4 of the protocol to the treaty establishes that interest paid by a legal entity residing in one contracting state whose capital is owned or controlled (wholly or in part, directly or indirectly) by residents of the other contracting state is deductible in computing the legal entity's taxable income, unless such interest relates to tax-exempt income. Based on this, the ministry asserts that a Russian legal entity may deduct from its taxable income the interest payable to a Dutch resident *without* considering the restrictions established by clause 1 of article 269 of the Tax Code, but with due regard to Russian thin cap rules. This constitutes a positive change relative to the approach laid out in the ministry's letter No. 03-08-05 of 20 December 2006 that implied the obligatory application of the caps on deductibility established by clause 1.

Russia-Cyprus Treaty Overrides Thin Capitalization Rules

Court practice gives taxpayers grounds to hope for success in challenging the tax authorities' point of view, although there are few relevant cases[4]. Recently the Moscow 9th Appellate Arbitration Court has confirmed this position in a case concerning the provision of a loan by a Cypriot company to an affiliated Russian entity.[5] The court cited the non-discrimination clause and the definition of the term "dividends" contained in the Russia-Cyprus treaty, and rejected the tax authority's claim that the terms of the loan were not consistent with the arm's-length principle.

The existence of such court practice is welcome from the taxpayer's perspective. However, due to the limited number of relevant court cases and the absence of a binding law of precedent, the risk of a different conclusion being reached in future cases remains.

Baffling Court Ruling on the Deductibility of Interest

The Federal Arbitration Court of the Moscow Region recently considered a case in which the tax authorities challenged the deductibility of loan interest accrued and deducted in periods in which no interest payments were to be made per the loan agreement[6].

The taxpayer in the case in question concluded a loan agreement in 2001 under which the loan principal amount was to be repaid over the period from 2005 to 2010. The interest charged was to be paid over the period from 2010 to 2014.

The company accrued and deducted interest in equal portions every year during the period of the loan agreement. The tax authorities disallowed the deduction and the company litigated to challenge this decision. On 27 January 2009 the trial court satisfied the taxpayer's claims in full and on 27 March the appeal court upheld that decision. However, the cassation court supported the tax authorities' view asserting that no obligations arise until 2010. It therefore

[4] Decree № KA-A40/6616-05 of the Federal Arbitration Court ("FAC") of the Moscow Region of 25 July 2005 (Russia-Germany treaty); and Decision № A56-19578/2006 of the FAC of North-West District of 9 April 2007, (Russia-Netherlands treaty).

[5] Decision № 09АП-8641/2009-AK of the 9th Appellate Arbitration Court of 10 June 2009.

[6] Decision № KA-A40/5982-09 of the FAC of the Moscow Region of 22 July 2009.

amended the decisions of the trial court and appeal court with respect to the issue.

The decision states that in 2005-2006, the period to which the case relates, no interest costs were actually incurred and no documents were presented by the taxpayer to support the costs incurred. The court seems to have concluded that since the interest was to be paid from 1 April 2010 to 1 November 2014 based on the provisions of the loan agreement, that is the time when the expense will be incurred and therefore the period when it may be recognised for profits tax purposes. This is extraordinary given that the loan should have been repaid in full by 1 April 2010 so the use of funds with respect to which the expense is incurred will have finished.

This conclusion is very surprising since it is contrary to both legislation and practice concerning the deduction of loan interest. The Tax Code provides that if a loan agreement is valid for more than one year then the loan interest accrued for the actual time of the use of the borrowed resources within an accounting period may be regarded as an expense for profits tax purposes, calculated on an accrual basis. Interest expenses recognised in an accounting period accordance with the profits tax chapter of the Tax Code is included in expenses of that period irrespective of when the interest liability was actually settled.

An analysis of the provisions of civil legislation[7] supported by a Joint Decree of the Plenum of the Supreme Court and the Plenum of the Supreme Arbitration Court[8] shows that loan interest is a fee for the use of the monetary resources granted in the form of a loan. Therefore the interest on the loan in the case clearly relates to the periods from 2001 to 2010.

The Ministry of Finance has confirmed that it is correct to deduct loan interest on an accruals basis[9].

The court's decision is baffling. If a petition to conduct a supervisory review of the case were submitted to the Supreme Arbitration Court, we would hope it will be overturned.

Can an Extract from a Trade Register Confirm Residence?

Ruling No. KA-A40/13393-08 of the Federal Arbitration Court of the Moscow Region of 5 March 2009 addresses a controversial issue in Russian court practice, namely, what documents may be used to confirm foreign residence for treaty purposes.

The court issued a decision in favour of the taxpayer having concluded that an extract from the French Trade Register may confirm the country of residence of a French company for tax treaty purposes.

Arguments of the Court

The Tax Code stipulates that in order to benefit from provisions of a tax treaty, e.g. apply a reduced withholding tax rate, a foreign company should provide the tax agent with confirmation of its permanent location in a country with which Russia has an effective tax treaty. The confirmation should be certified by the competent authority of the state in question.

Since the Tax Code does not specify the foreign competent authorities which should issue such confirmations or the form and content of those confirmations, the court came to a rather questionable conclusion that foreign legal entities are free to choose the documents that confirm their permanent residency in a foreign state for tax purposes.

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[7] Article 809.1 of the Civil Code.
[8] Decree № 13 of the Plenum of the Supreme Arbitration Court and Decree № 14 of the Supreme Court of 8 October 1998
[9] Letter № 03-03-06/1/417 of the Ministry of Finance of 21 July 2008.

The Russian tax authorities are of the opinion that only a confirmation of permanent residency issued by the foreign competent authority defined by the tax treaty (the Ministry of Finance is named as the relevant competent authority in most Russia tax treaties) and including particular wording confirms foreign permanent residency.

The tax authority's arguments based on guidance provided in methodological recommendations were dismissed by the court on the basis that regulations issued by the federal executive authority on tax matters cannot amend or supplement tax legislation.[10]

Hence, the conclusion of the court was that an extract from the Trade Register may serve as confirmation of a foreign permanent location for tax treaty purposes.

Furthermore, the court ruled that the form of this confirmation and the foreign authority should be determined by the national legislation of a respective foreign state and may not be established by the Russian Tax Service.

Similar Court Cases and Tax Practice

A number of recent court rulings assert that an extract from the Trade Register or the certificate of incorporation may be used as confirmation of the residence of a foreign company for tax treaty purposes.[11]

However, there are also a number of court cases[12] supporting the position of the Russian Ministry of Finance and tax authorities. Therefore taxpayers should always seek a certificate specifically certifying tax residence for treaty purposes issued by the relevant competent authority.

When "Similar" Income is Subject to Withholding Tax

Income received by foreign organizations from Russian sources not relating to the entrepreneurial activity of the organization in Russia (including activities carried out through permanent establishments) may be subject to withholding tax. The default rate for income for which no specific tax rate is provided is 20%.

The list of Russian-source income of foreign organizations subject to withholding tax is provided in Article 309 of the Tax Code. It includes among others such income as dividends, interest, royalties, income on disposal of shares, income from immovable property and income from international transportation. The list finishes with the item "other similar income". The interpretation of the word "similar" is often the key point in deciding whether tax applies to income not specified elsewhere in the list. Various interpretations are possible. Income considered "other similar income" for this purpose is subject to the default tax rate of 20%.

On 11 August 2009 the Ministry of Finance issued an explanatory letter No. 03-08-05 regarding taxation of income of a foreign organization received from sources in Russia. The letter addresses the taxation of bonuses paid to a Belarusian organization due to purchase of a certain amount of goods. It concludes that the

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[10] The same argument was used in the Ruling № KA-A40/7304-07 of the FAC of Moscow District of 16 August 2007.

[11] Ruling № A57-4863/07-9 of the FAC of Povolzhsky District of 30 October 2008, Ruling № A56-37381/2007 of the FAC of the North-Western District of 25 July 2008, Ruling № KA-A40/7304-07 of the FAC of the Moscow District of 16 August 2007, Ruling № F09-10091/08-C3 of the FAC of the Uralsky District, and Ruling № A56-3000/2007 of the FAC of the North-Western District as of 20 December 2007.

[12] Ruling № KA-A40/4956-09 of the FAC of the Moscow District of 11 June 2009, Ruling № A56-45861/2006 of the FAC of the North-Western District of 23 June 2008, and Ruling № F08-2574/2006-1074 of the FAC of the North-Caucases District of 13 June 2006.

bonuses represent "other similar income" and therefore are taxable at source in Russia.

Explaining its position the Ministry asserts that "similarity" does not refer to the types of income listed previously in Article 309.1 of the Tax Code. Similarity lies in the fact that income does not relate to the activity of foreign organization in Russia, including the activity carried out through the permanent establishment. This is a highly controversial interpretation of the wording.

In Letter No. 03-03-06/1/478 of 11 July 2007 the ministry applied the same reasoning in concluding that a number of other types of income are "other similar income" for the purposes of Article 309.1 and hence subject to taxation at source in Russia. Among them there are income received from the secondment of personnel working in Russia and from the sale of goods in Russia on the basis of an intermediary trading agreement.

The double tax treaty between Russia and Belarus provides that income not mentioned in other articles of the treaty may be taxed in the country of source of such income (Article 18). Therefore no treaty relief is available with respect to bonuses earned by a Belarusian organization from a Russian source.

Do Directors in Russia Create a Taxable Presence of a Company?

A perennial issue in agreeing management structures for foreign companies with Russia-based decision-makers is the extent to which such individuals' activities create tax risk for the foreign company. Day-to-day involvement of a Russia based individual in the main activities of a company is almost certain to give rise to a taxable presence in Russia of the company in question. If Russia-based individuals were only to act in their capacity as officers or employees of a foreign company when outside Russia this would clearly create no Russian tax exposure for the company. However, it is not always possible to impose such a policy in practice.

A balance is often struck in which companies try to limit activity in Russia to a level at which a risk of giving rise to a taxable presence may exist but is considered acceptably remote.

Letter No. 03-08-05 of the Ministry of Finance of 7 May 2009 addresses the issue of whether meetings of an American company's board of directors give rise to a permanent establishment in Russia. The company in question is 50% owned by a Russian company and a number of Russian citizens considered tax-resident in Russia have been appointed to the board of the American company. Their participation in board meetings takes place in Russia under two scenarios: a meeting might take place in Russia or Russian board members might participate by means of a video or telephone link without leaving Russia.

The letter cites the definition provided in the commentaries to the OECD Model Tax Convention as a basis for determining whether or not a company has a permanent establishment. The key issue is whether it has a fixed place of business through which the enterprise conducts all or part of its commercial activities. The conclusion is positive for the taxpayer:

"in the opinion of the Department, the holding of a meeting of the board of directors of a foreign company in the territory of the Russian Federation, irrespective of the tax residence of the members of the board of directors, does not create a fixed place of business in the Russian Federation through which the foreign company should be treated as carrying out commercial activities in the Russian Federation."

It is noteworthy that the letter does not end with this statement. While the Department accepts that the mere participation in board meetings of the directors of this company does not give rise to a permanent establishment, it is clear that other factors are also relevant to its conclusion. The letter notes that the American company possesses production assets and personnel and conducts business activities aimed at the derivation of profit outside Russia. The existence of such substance, presumably in the USA, is

clearly considered relevant to the conclusion that no permanent establishment arises from board meetings.

A company lacking substance outside Russia in the form of production assets and personnel and business activities aimed at the derivation of profit would likely be at greater risk of activities of officers or employees in Russia being perceived by local tax authorities as giving rise to a permanent establishment. Another negative factor would be if a foreign company has a fixed place of activity in Russia for the purpose of carrying out activities constituting the normal core activities of the foreign company concerned. Some holding companies have little activity outside of that conducted at board meetings. Such companies would be at much greater risk of regular board meetings at a fixed place in Russia being deemed to give rise to a permanent establishment.

The Ministry's letter may, therefore, provide reassurance to companies with significant substance in their country of residence and no activity in Russia beyond occasional participation in board meetings, but it would be unwise to assume that directors' activities in Russia do not create serious tax exposures for other enterprises.

Clarifications Concerning Reporting an Accelerated Capital Allowance

The Ministry of Finance has recently explained how accelerated capital allowances should be reflected in profits tax declarations[13]. While "depreciation premium" is a literal translation of the term used in the Tax Code, the deduction in question is more properly an accelerated capital allowance as it changes the timing of deductions relating to capital expenditure rather than the total amount potentially deductible over the life of an asset.

The form of the profits tax declaration for Russian legal entities was approved by the Ministry of Finance on 5 May 2008. At that time, item 1.1. of article 259 of the Tax Code provided that taxpayers might deduct 10 per cent of the historical cost of fixed assets. The allowance should be reflected by taxpayers in line 044 "Expenses for capital investments in accordance with clause 1.1 of Article 259 of the Tax Code" of the Appendix No. 2 to Sheet 02 of the profits tax declaration[1].

Item 1.1 of the article 259 was abolished with effect from 1 January 2009[14] and the provisions related to accelerated capital allowances transferred to item 9 of article 258[15]. However, the wording of line 044 of Appendix No. 2 to Sheet 02 of the profits tax declaration has not been changed. Line 044, therefore, refers to a provision which no longer exists.

In its letter of 10 August 2009, the Ministry of Finance addresses this inconsistency, explaining that taxpayers should still reflect the accelerated capital allowance in line 044 Appendix No. 2 to Sheet 02 of the profits tax declaration.

The Offset of Input VAT when it is Initially Unclear to What Activities it Relates

Taxpayers are obliged to maintain separate accounting records if they perform VATable and non-VATable activities unless the amount of expenses associated with non-VATable activity is less than 5% of total production expenses.[16] In the absence of separate accounting records, input VAT is neither offsettable nor deductible for a taxpayer. No problems should arise when a taxpayer knows which part of input VAT directly relates to VATable transactions. In such cases the relevant input VAT can be offset directly.

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[13] Letter № ShS-22-3/626@ of the Ministry of Finance of 10 August 2009.

[14] Federal Law № 224 – FZ of 26 November 2008.
[15] Federal Law № 158 – FZ of 22 July 2008.
[16] Articles 149.4 and 170.4 of the Tax Code.

The question arises as to how the taxpayer should determine the amount of offsettable input VAT if it cannot know to which type of activities (VATable or non-VATable) the input VAT relates until sales are made. The tax authorities tend to require that a taxpayer is entitled to offset input VAT relating to VATable activities in an appropriate proportion only after revenue is received. However, in some cases (for example, when a taxpayer operates under a long-term contract) the period between a purchase being made and revenue received may be rather long.

In a recent court case a taxpayer took a different approach which was supported by the cassation court.[17] The taxpayer was involved in wholesale and retail trade. The wholesale business is subject to the general tax regime while the retail business is subject to unified tax on imputed income (so no VAT is paid).

The taxpayer made purchases and paid input VAT to suppliers but did not determine to which activity it related at the moment of purchase. All input VAT paid by the taxpayer was claimed for offset. The part of input VAT attributable to retail trade was subsequently restored as goods were transferred to retail shops and documented by bills of lading for internal distribution. Input VAT relating to administrative costs was allocated and offset based on the proportion of revenue arising from VATable and non-VATable activity.

The tax authorities claimed that the taxpayer did not maintain separate accounts and challenged the input VAT claimed by the taxpayer for offset. The court stated that the Tax Code does not envisage specific provisions regulating how separate accounting for VAT purposes should be performed and concluded that the taxpayer's approach conformed to the provisions of the Tax Code.

[17] Decision № A82-125/2009-37 of the FAC of the Volgo-Vyatskiy Region of 22 June 2009.

VAT Reporting by Tax Agents on Cancellation of a Contract

In Letter No. 03-07-05/25 of 2 July 2009, the Ministry of Finance clarified how a tax agent should complete a VAT declaration when an agreement is cancelled and prepayments made by tax agents are returned.

The Ministry refers to point 5 of Article 171 of the Tax Code, according to which amounts of VAT withheld from prepayments and paid to the budget by buyers (taxpayers, who fulfil the duties of tax agent), may be offset if the relevant contract has been amended or cancelled and the amounts of prepayments in question are refunded.

The Letter notes that amounts of VAT offset in cases provided for in point 5 of Article 171 of the Tax Code are reflected in column 4 in line 320 of the VAT declaration (based on point 25 of the procedures for completion of VAT declaration forms, approved by Order No. 136n of the Ministry of Finance of 7 November 2006.

These procedures stipulate the reflection of tax offsets of VAT on advance payments in this line by taxpayers and their legal successors only. However in accordance with the ministry's position as stated in the Letter, tax agents may also use this line to reflect offsets of VAT on prepayments in cases of termination of or changes to the terms and conditions of contracts and the refund of prepayments.

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