Executive summary

The Tax and Customs Tariff Policy Department of the Russian Finance Ministry (the Ministry) recently published a letter clarifying the application of the “look-through approach” in relation to dividend payments. The Ministry considers a situation in which the actual recipient of dividends is a foreign company whose participation in the capital of the Russian company paying the dividends is not direct but indirect (structured via a series of intermediate holding companies). In the letter, the Ministry took the view that the application of a lower tax rate for dividends was conditional on the actual recipient having made a direct contribution to the Russian company’s capital. In many cases, this position would prevent a lower withholding tax rate from being applied under the look-through approach by virtue of the fact that a foreign shareholder made its investment in a Russian company not directly, but through intermediate foreign companies which are not the actual recipients of the dividends.

The Ministry’s letter addresses the Russian-Spanish tax treaty, but many other Russian tax treaties contain a similar investment criterion. Furthermore, a similar approach might also be taken in relation to the ownership interest criterion, which also figures in a number of treaties. The letter therefore has considerable importance from the point of view of the development of practice in the application of the actual recipient rules.

This Alert summarizes the Ministry’s clarification.
Detailed discussion

Applicable Law
The actual recipient rules introduced in the Tax Code with effect from 1 January 2015 establish a set of criteria which a recipient of income must meet in order to qualify for benefits under Russian tax treaties.

The core principle of the look-through approach consists in applying tax treaties not to the immediate recipient of income, but to the final recipient with the actual right to that income.4

In order for the look-through approach to be applied to dividends, the following conditions must be met:5

- The entity to which the payment is made must acknowledge that it does not have an actual right to the income.
- The entity which has an actual right to the income must hold a direct and/or indirect interest in the Russian company paying the dividends.
- The entity which has an actual right to the income must provide the following documents to the tax agent before the date on which the income is paid:
  - Confirmation of residence of a state with which Russia has an international tax treaty, certified by a competent authority of the relevant foreign state (tax residence certificate)
  - Confirmation that the company has an actual right to receive the income in question6

The Finance Ministry’s Clarification
In the recent letter, the Finance Ministry examines a situation in which the actual recipient of the dividend income paid by a Russian company was a Spanish tax-resident company.

The tax treaty between Russia and Spain provides for a lower withholding tax rate of 5% to be applied in relation to dividends provided that the following conditions are met:

- The person possessing an actual right to the dividends is a company which has invested in the capital of the company paying the dividends at least 100,000 euros or the equivalent amount in any other currency
- The dividends in question are exempt from tax in the other contracting state

If only one of these conditions is met, the applicable rate is 10%.

The Ministry asserts that in order to qualify for the 5% rate, a Spanish tax resident, which is the actual recipient of dividends, must have invested at least €100,000 directly in the capital of the Russian company paying the dividends. In the situation described, therefore, under the look-through approach the Russian tax agent would have to withhold tax at the rate of 10%.

However, there is support for the taxpayer’s position that the lowest tax rate is applicable, since the look-through approach as such is an expression of the substance-over-form principle, and using it as a basis for applying a selectively formal approach to individual criteria is questionable.

Implications
Practice in regard to the application of the actual recipient concept is constantly developing.8 In addition to the difficulties over the application of the look-through approach, there are numerous other issues that are not satisfactorily dealt with at the legislative level.

It is therefore advisable for companies which pay dividends, royalties and other income from Russia and apply lower withholding tax rates:

- To analyze existing structures and assess their susceptibility to the “actual right to income” concept
- To gather evidence (documents, reports, transaction records) that foreign recipients of income are the actual owners of the income, so as to be in a good position to defend the application of lower withholding tax rates if questions arise during an audit
- If necessary, to carry out restructuring in order to minimize future risk
- To request foreign recipients of income to provide documentary confirmation of their status as the actual recipients of income. Clause 1 of Article 312 of the Tax Code now makes it a requirement for such confirmation to be obtained before income is paid
Endnotes

1. Letter No. 03-08-05/73316 of the Tax and Customs Tariff Policy Department of the Ministry of Finance of 7 December 2016.

2. The actual recipient rules introduced by the deoffshorization amendments to tax law have been in effect in Russia since 1 January 2015. The rules do not allow lower withholding tax rates provided for in Russia’s tax treaties to be applied where a foreign company receiving income is an intermediate (conduit) entity.

3. New versions of Articles 7 and 312 of the Tax Code.


5. Clauses 1 to 1.4 of Article 312 of the Tax Code.

6. The form of the confirmation is not prescribed in law. For advice on what it should contain see, for example, Letter No. 03-08-05/78852 of the Ministry of Finance of 28 December 2016.


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