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Recent Developments in International Taxation

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1. RECENT LEGISLATIVE DEVELOPMENTS OF INTEREST

Between 1999 and 2005 the Russian tax system has undergone significant changes and now it enjoys a period of relative stability.

During the last year, many important changes were made to the Russian tax system, such as a blacklist of foreign jurisdictions was issued, issues of deductibility of expenses and tax avoidance were further clarified, VAT reverse charge mechanism was developed.

On May 26, 2008 the Russian Government approved tax policy guidelines for 2009-2011. The goal of tax policy in the medium term is to improve the system of tax administration in Russia. Various measures are proposed to combat transfer pricing abuses. Other important areas in which tax policy development is proposed include:

- Introduction of a controlled foreign company's regime.
- Introduction of management and control test as grounds for acquiring Russian tax residency.
- Introduction of consolidated tax returns for the calculation of tax on the profit of group of companies.

It was also clearly stated that the flat personal income tax rate of 13% for Russian tax residents has proven its efficiency and should remain unchanged in future.

It is unclear when and how the declared intentions will be implemented. Nevertheless, the above clearly demonstrates the intention to continue to amend the tax laws of Russia, to keep positive improvements and to close down existing gaps.

1.1 PARTICIPATION EXEMPTION - BLACKLIST OF FOREIGN JURISDICTIONS ISSUED

On May 16, 2007 Federal Law No. 76-FZ on the participation regime was passed, to be effective from January 1, 2008. According to the regime, a 0% profits tax rate applies to dividends received by a Russian company, if it owns at least 50% of the share capital of the subsidiary (both Russian and non-"blacklisted" foreign companies) for a period of not less than 365 days and the cost of purchase or receipt of this stake is not less than Rbl 500 mln (approximately USD $20 mln).

The law obliges the Ministry of Finance to issue a "black-list" of states, residents of which are not entitled to enjoy the 0% rate: such list was issued on November 13 2007 by way of an order No. 108n.

The list includes several jurisdictions which are widely used for establishing foreign subsidiaries as a result of the low domestic tax rates. The most significant of these is practice is probably Cyprus, which in addition to low domestic tax rates has a favorable double tax treaty with Russia and a participation exemption for dividends received from foreign subsidiaries, as well as being an EU Member State. These factors have made it a valuable jurisdiction for holding investments in many different countries.

Inclusion in the list will make jurisdictions less attractive for establishing a holding company in cases where there is a desire to repatriate profits to Russia as dividends. Furthermore it is likely that the Russian tax authorities will pay more attention to transactions involving residents of jurisdictions included in the blacklist. As widely expected, the list corresponds with the draft developed in connection with proposed transfer pricing legislation.

The ministry's list of states and territories which grant preferential tax treatment and (or) do not require the disclosure and provision of information in relation to financial operations carried out (offshore zones) is as follows:

Anguilla; Andorra the Anjou an Islands; Antigua and Barbuda; Aruba; the Bahamas; Bahrain; Belize; Bermuda; Brunei-Darussalam the British Virgin Islands; the Cayman Islands; the Channel Islands (Islands of Guernsey, Jersey, Shark and Aldermen); the Comoros; the Cook Islands; Cyprus; Dominica; Gibraltar; Grenada; Hong Kong; the Isle of Man; Labuan Island; Liberia; Liechtenstein; Macau; Malaysia the Maldives; Malta; the Marshall Islands; Mauritius; Monaco; Montserrat; Nauru; the Netherlands Antilles; Niue; Palau; Panama; Samoa; San Marino; Saint Vincent and the Grenadines; Saint Kitts and Nevis; Saint Lucia; the Turks and Caicos Islands; the United Arab Emirates; and Vanuatu.

1.2 THE MINISTRY OF FINANCE ALLOWS IMPLEMENTATION OF A VAT REVERSE CHARGE MECHANISM

It has been a long time since the place of supply rules were introduced for VAT purposes in Russia. Instead of introducing a standard reverse charge mechanism, which might have

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been expected to accompany the place of supply rules, the previously-existing VAT withholding mechanism was adopted.

VAT withholding has been criticised for a long time, and finally on October 16, 2007 the Ministry of Finance issued a letter[1] where it announced that a Russian taxpayer[2], who purchases goods (works and services) from a foreign entity, which is not registered for tax purposes in Russia, should "independently increase the value of the acquired goods (works and services) by the amount of the tax". It should be noted that the letter specifically provides that this approach can be taken if the contract with the foreign entity does not mention the amount of VAT payable to the budget. The ministry further explains that such VAT is regarded as a tax withheld from the taxpayer's (i.e., the foreign entity's) "potential" income.

This position is based on a different from an earlier one interpretation of Article 161 of the Tax Code. The Tax Code defines the tax base as "income from sales of goods (work and services), adjusted for tax", which the Ministry reads for the purposes of this letter as "the value of goods (works and services) sold, increased by the amount of VAT which is payable by the tax agent to the Russian budget." For over a decade the ministry has taken the view that the tax base was the value of goods inclusive of VAT. Given that the provisions of Article 161 have not changed since its enactment in 2001, such a modification of the ministry's views is really surprising.

Finally, the Ministry concludes that the tax agent can offset VAT calculated in addition to the foreign company's remuneration, provided that the tax agent has remitted such VAT to the budget in due course and has recorded the acquired goods (work and services) in its books. In a number of previous clarifications the Ministry denied the Russian customer's right to offset VAT paid by the customer using its own funds, based on the fact that VAT had not been withheld as required by the Tax Code.

On October 31, 2007 the Federal Tax Service forwarded the Ministry's letter to the subordinate tax authorities.[3] One might therefore expect that in future local tax authorities would not challenge the offset of self-assessed VAT (or VAT paid from the tax agent's own resources). However, from a practical standpoint it is difficult to believe that the local tax authorities would actively apply such revolutionary guidance, especially given that the letter

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[1] Letter No. 03-07-15/153 of the Ministry of Finance of October 16, 2007.

[2] Technically, in the context of cross-border supplies the term "tax agent" should have been used instead of the term "taxpayer".

[3] Letter No. ShT-6-03/844 of the Federal Tax Service of October 31, 2007.

was distributed for information purposes rather than for “information and guidance” or “for information and action”.

1.3 INTERACTION OF DOUBLE TAX TREATIES WITH RUSSIAN THIN CAPITALIZATION RULES

In January 2008 the Ministry of Finance issued a significant letter concerning the taxation of interest paid by taxpayers which falls into ambit of Russia’s thin capitalization rules.

In the past the tax authorities have often disregarded relevant tax treaties in applying the thin capitalization rules. This was, for example, the basis for a dispute settled by Decision of the Federal Arbitration Court for the North-West Region No. A56-19578/2006 of April 9, 2007. There the tax authorities had claimed that none of the interest payable to a Dutch parent company was deductible and it should have been treated as dividends for the purposes of calculating tax to be withheld at source (the Russian subsidiary had negative net assets). However, the courts ruled that the Russian thin capitalization rules had no force in the situation in question, and the interest payable to the Dutch parent company should be treated as interest for the purposes of the Dutch Treaty and therefore, exempt from taxation at source.[4]

In January 2008 the Ministry of Finance issued Letter No. 03-03-06/1/9 (the “Letter”) which states the following:

- the portion of a foreign organization’s income equal to the maximum interest calculated under Article 269.2 of the Tax Code should be taxed at source at the rate applicable to interest with reference to the provisions of the relevant double tax treaty (if any); and
- the excess interest calculated under Article 269.2 of the Tax Code should be taxed at source at the rate applicable to dividends with due regard to the provisions of any applicable double tax treaty.

The definitions of the terms “interest” and “dividends” vary depending on the wording of the relevant treaty. Taxpayers should also consider whether the treaty’s “non-discrimination clause” is helpful. Based on the model clause (Article 24.5 of OECD Model Convention[5]),

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[4] See the Russian Tax Brief for May 2007 for further information on this case.
[5] Adopted by OECD Committee on Fiscal Affairs on July 15, 2005.

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"enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected". The wording of this clause is much the same as the wording of the equivalent clauses of the UN and U.S. Model Conventions.[6] The Russian tax authorities and courts are somewhat inconsistent in their interpretations of the corresponding provisions of bilateral double tax treaties concluded by Russia.

In this context, a 2005 Decision of the Federal Arbitration Court of the Moscow Region ("the Decision") is noteworthy.[7] In brief, the tax authorities challenged the deductibility of interest accrued by a Russian subsidiary of a German parent company under a loan agreement. Despite the fact that the interest accrued by the subsidiary deducted the interest accrued in full and withheld no tax at source on interest paid to a German participant. The courts of all three instances supported the company's position.

According to Clause 3 of the Protocol to the Russia-Germany Double Tax Treaty ("the German Treaty"), interest paid by a company which is resident of a Contracting State (in this case Russia) and in which a resident of the other State (i.e. Germany) participates, regardless of whether such interest is paid to a bank or another person, and regardless of the term of the loan, should be fully deductible in the first-mentioned State (i.e. Russia) in determining the taxable profits of such company. However, the amount so deducted should not exceed the amount which independent enterprises would agree to under similar circumstances.

The tax authorities failed to prove that the interest accrued by the subsidiary exceeded the interest which independent parties would agree to under comparable circumstances. Consequently, the taxpayer was permitted to deduct the interest in full based on the German Treaty.

Not all double tax treaties concluded by Russia contain such a "deductibility clause". A taxpayer should therefore scrutinize the provisions of the relevant double tax treaty in order to form a view as to whether a treaty override applies in a given case.

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[6] Article 24.5 of Model Taxation Convention between Developed and Developing Countries adopted by the United Nations Group of Experts on January 11, 2001, and Article 24.5 of Model Tax Convention on Income adopted by the United States on November 15, 2006 respectively.

[7] Decision of the Federal Arbitration Court of the Moscow Region No. KA-A40/6616-05 of July 25, 2005.

The key point is that both the tax authorities and the courts have now confirmed that double tax treaties in certain cases override the thin capitalization rules.

2. RECENT COURT DECISIONS OF INTEREST

2.1 FURTHER CLARIFICATION OF RUSSIAN ANTI-AVOIDANCE RULES

Article 169 of the Russian Civil Code states that transactions made with an objective knowingly contrary the fundamentals of public order or morality shall be void, if (i) the subject matter of the deal is contrary to legal or moral regulations; (ii) the character of the deal is intentional, and (iii) illegal and/or immoral purpose for the parties at the time of execution. The consequences of a deal falling into the ambit of Article 169 are very severe: it provides for a recovery to the state revenue of all income and gain received or to be received by a party or parties involved. Article 169 was notoriously applied in well-known tax cases, such as NK Russneft, Bashneftekhim and others.

Until recently Article 169 of the Russian Civil Code was interpreted so to apply to taxation. However, recently the Plenum of the Supreme Arbitration Court has issued a Ruling No. 22 of 10 April 2008 “Concerning Certain Issues Relating to the Procedure for the Examination of Disputes Associated With the Application of Article 169 of the Civil Code of the Russian Federation”.

The new ruling emphasis that the right of the tax authorities to file a claim for the confiscation of revenue from a transaction by the state under Article 169 of the Civil Code is limited to cases in which such a claim is aimed at the performance of certain specific functions of the tax authorities. An example provided is the monitoring of the production and circulation of ethyl alcohol and alcoholic and alcohol-containing products when contesting transactions which are directed at the production and sale of products which pose a hazard to the life and health of consumers.
The key assertion made in the ruling is that a claim made by a tax authority for the application of the consequences of the invalidity of a transaction which are envisaged by Article 169 on the grounds that the transaction was concluded for the purpose of evading taxes, goes beyond the scope of the tax authority’s powers. This ruling is clearly excellent news for the taxpayers. This ruling could be very useful for the companies mentioned above whose cases

are still being heard. Whether this ruling will be accepted consistently by tax authorities and the courts remains to be seen.

2.2 CLARIFICATION ON THE ISSUE OF DEDUCTIBILITY OF EXPENSES FOR CORPORATE INCOME TAX PURPOSES – MANAGEMENT SERVICES

The Russian Tax Code states that expenses are deductible as long as they are economically justifiable. The issue of what constitutes an "economically justifiable" expense was subject to a long-standing debate between Russian taxpayers and tax authorities.

The Russian tax authorities have been disputing the deduction of management services for several years. Eventually, group management companies were created by the Russian group of companies and their costs started to be reimbursed via payments for management services made by group income-generating companies. The approach chosen by many Russian group of companies for allocation of management charges among the group entities is based on the cost-plus method whereby the group entities have to cover all the costs incurred by the management company.

The tax authorities tend to view management service agreements as tax planning tools and rarely pass up the opportunity to increase a tax assessment during tax audits by aggressively, persistently and “creatively” challenging a deduction for such services.
A recent decision of the Federal Arbitration Court of the West-Siberian Region (Case No. F04-5904/2006 (37326-A27-31) of August 28, 2007) provides a useful summary of the nature of the claims from tax authorities for which a taxpayer deducting management fees should be prepared.

The taxpayer won the case in the courts of all instances having contested all the tax authorities’ arguments, which were as follows.

Documentation of Expenses. The existence of invoices and acts of acceptance signed by the provider and the recipient of services is not sufficient in the tax authorities’ view to prove that the services have actually been provided. Even though the Tax Code states that services are an activity the results of which do not have a tangible form, the tax authorities usually require a company to demonstrate the results of the services consumed.

In this case the taxpayer presented to the court monthly acts of acceptance with a list of services performed and a calculation of management fees for the given month. The taxpayer also had letters and instructions received from the management company, template agreements and budgets drawn up or approved by the management company. Based on the analysis of these documents the court agreed that the services were documented properly.

Economic Justification. The "economic justification" criterion is always contentious since in practice no specific criteria for an economically justified expense exist. The Tax Code states that economically justified expenses are expenses incurred with the aim of generating income (revenue).

The taxpayer demonstrated that its production and revenue increased in the period when it purchased management services and the court considered this fact proof that the management costs were economically justified.

Unjustified Tax Benefits. The Supreme Arbitration Court introduced the concept of an unjustified tax benefit in October 2006 (Ruling No. 53 of the Plenum of the Supreme Arbitration Court of October 12, 2006) and gave the tax authorities another instrument for identifying unlawful reductions of tax liabilities. The tax authorities accepted this instrument with enthusiasm and a rare tax audit finishes without claims arising from this concept now (there are approximately 1,000 published cases by the cassation courts alone which mention unjustified tax benefits).

The concept of an unjustified tax benefit is applied by the tax authorities in various ways. In this case the tax authorities insisted that the taxpayer received an unjustified tax benefit via deduction of management services because the general director was an employee of the management company, the management company was a related part to the taxpayer and the taxpayer had yet to pay for the management services.

The court ruled that these circumstances do not prove that the management agreement was concluded for the avoidance of taxes and dismissed the tax authorities' arguments as groundless.

To conclude, this court case stated that the Russian tax authorities continue to challenge deductions for management services using various arguments, some of which may be viewed

as unreasonable. Companies should consider their line of defense for securing the deduction of management fees before entering into such agreements.

2.3 DIVIDEND DISTRIBUTIONS: INTERPRETATION OF THE MINIMUM INVESTMENT CRITERION

Under most double tax treaties concluded by Russia, the amount of tax to be withheld by a Russian company distributing dividends to a resident of the other contracting state depends on the size of the investment made by the foreign company in the Russian company. For example, under the treaty between Russia and Switzerland, the rate of taxation at source of dividends distributed by a Russian company to a Swiss company is capped at 5% if the Swiss company owns directly at least 20% of the Russian payer and the foreign capital invested in the Russian company exceeds 200,000 Swiss francs (approximately USD 170,000). Otherwise, the withholding tax rate should be 15%.

In practice, the amount of the investment made by a foreign company in a Russian company may be unclear, due to the diverse nature of the transactions through which ownership of an interest in a company may be achieved and capital contributed. The simplest form of investment is when the founder finances its Russian subsidiary through a direct contribution to the charter capital in exchange for shares (or, in the case of an LLC, a participation interest). In this case, the amount invested is easily quantified as it corresponds to the value of the contribution[8]. Uncertainty as to the relevant amount may arise in situations where a foreign investor was not founder of its Russian subsidiary but has acquired its shares from a previous shareholder (in which case the Russian subsidiary's share capital was unchanged by the transaction). Even more controversial are those cases in which the nominal value of the shares held by a foreign shareholder in a Russian company exceeds the minimum investment requirement but the foreign shareholder received its shares as a result some form of reorganization within a group, effectively without having disbursed any funds in exchange for such shares.

The Federal Arbitration Court of the Moscow District examined a case in which the relevant foreign investment was not made directly to the charter capital of the Russian company distributing dividends[9]. Under an investment agreement concluded between a Turkish company and a Russian municipal entity, the two investors agreed to create a jointly owned

[8] A valuation by an independent valuer is required under Russian corporate law in cases of non-monetary contributions of significant value.
[9] Case No. A 40-58956/06-87-307 of May 14, 2007.

company for the purpose of the construction of a cultural centre. The Turkish company had to invest 3.2 million US dollars for the compulsory relocation of the inhabitants of the land and finance the construction of 20,000 square meters of the building. In exchange, the Turkish company received 52% of the shares of the Russian company, the nominal value of which was 11,000 USD. The Turkish company subsequently sold its 52% stake to a Swiss company.

The tax authorities disallowed the application of a reduced withholding tax rate due to the fact that the charter capital of the Russian company on the date the dividend was paid was far less than the required minimum level of foreign investment under the Swiss treaty.

The 20% minimum shareholding criterion was clearly satisfied since the Swiss company owned a 52% interest in the Russian company. The court had to decide whether the Swiss company's investment qualified as a direct investment in the Russian company for the purpose of deciding the applicable rate of withholding tax under the Swiss treaty. The court adopted a decision confirming the right of the Swiss company to benefit from the 5% tax rate.

The court took a broader view than the tax authorities in defining the level of foreign investment in the Russian company: it ruled that the foreign investment should be considered to equal the total amount of funds invested under the investment agreement and not be limited to the value of the charter capital contribution. In addition, the court ruled that by acquiring the Turkish company's stake in the Russian company, the Swiss company became a qualifying investor through reimbursement of a portion of the sums invested by the Turkish company. The court invalidated the tax authorities' decision and ruled that the actual amount paid for the shares in the Russian company by the Swiss company qualified as an investment of more than 200,000 Swiss francs for the purposes of the Swiss treaty.

The reasoning applied in this decision could be regarded as implicitly confirming that when the shares of a Russian company are issued at a premium, the amount of the share premium paid by an investor should also be considered to qualify as part of the amount invested for the purpose of applying the double tax treaty. However, in the absence of a law of judicial precedent, the tax authorities are to free to continue to base claims on a narrower interpretation forcing taxpayers to appeal to the courts to confirm their right to treaty benefits.

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3. RECENT TRANSACTIONS OF INTEREST

3.1 Following the *Yukos* case, recent BP-TNK dispute and other examples of voluntary application by the Russian state of Russian tax rules in order to achieve politically-motivated goals, Russian companies and foreign investors are very cautious about using any tax planning, including tax planning not directly prohibited by the law.

3.2 There is a growing trend for groups of Russian companies to centralize their operations, which will be further enhanced by the introduction of participation exemption for dividends received from subsidiaries.

3.3 Many Russian companies are considering the introduction of stock option plans to incentivise their employees. As Russian tax law does not provide any tax benefits or indeed certainty for the treatment of stock options plans, most stock option plans are offshore plans.

3.4 In light of the forthcoming changes to the rules on tax residence of Russian companies on the basis of management and control test and also contemplates introduction of CFC rules, Russian companies and individuals are concerned with the effect such rules might have on their operations.

4. THE SINGLE MOST IMPORTANT TAX DEVELOPMENT THIS YEAR: FURTHER CLARIFICATION OF RUSSIAN ANTI-AVOIDANCE RULES

It is a common knowledge that voluntary application by the Russian state of the Russian tax rules in order to achieve politically-motivated goals significantly affects Russian investment climate. One of the most "dangerous" tools formerly available to the Russian tax authorities is unlikely to be used to taxation pursuant to the recent decision of the Plenum of the Supreme Arbitration Court.

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consequences of a deal falling into the ambit of Article 169 are very severe: it provides for a recovery to the state revenue of all income and gain received or to be received by a party or parties involved. Article 169 was notoriously applied in well-known tax cases, such as NK Russneft, Bashneftekhim and others.

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