NEOCLEOUS

Cyprus Business Headlines

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RUSSIAN TAX MATTERS!

This special issue of our newsletter outlines two recent cases in the Russian courts which potentially affect clients doing business in Russia and which highlight the importance of thorough planning and careful, detailed practical implementation of tax-effective structures, so as to avoid unforeseen and unwelcome consequences.

We shall continue to monitor the situation closely and notify clients and contacts of developments, but if you require advice regarding specific circumstances please do not hesitate to contact Elias Neocleous or any member of our tax team.

A Russian case on the application of the Cyprus-Russia double tax agreement highlights the need for thorough planning and careful compliance

Russia's Tax Code includes thin capitalisation rules which limit or disallow the deduction of interest paid by a Russian company which fails to meet the prescribed debt-to-equity ratio. In relevant cases Russian companies have resisted challenges by the tax authorities to the deductibility of interest by invoking the non-discrimination clause of a relevant double tax agreement, and until recently the Russian courts have upheld their contention that the non-discrimination provisions established by double tax agreements prevail over the thin capitalisation restrictions contained in national legislation. However, in a recent case (Number KA -A40/13648-10 of 18 November 2010) on the issue the Arbitration Court of Moscow region found in favour of the tax authorities and ruled that the taxpayer in question, a company which was the wholly-owned subsidiary of a Cyprus parent company, was ineligible for treaty benefits.

Following a tax audit of the Russian subsidiary, the deduction of interest on loans made by the parent company was disallowed on the grounds that the interest was on a controlled loan and in excess of the amount deductible under the Tax Code. The investee company claimed that the interest should be deductible on the basis of the non-discrimination clause of the Cyprus/Russia double tax treaty. The tax authorities rejected this argument. In their view, the Russian investee was not covered by the non-discrimination clause because it should not be treated as a Russian enterprise for the purposes of the treaty. On the basis of clause 1(e) of Article 3 of the treaty, which provides that the term “enterprise of a Contracting State” means an enterprise carried on by a resident of that contracting state, they contended that the Russian investee should be treated as a Cypriot enterprise for treaty purposes, as it was 100% owned and controlled by its Cyprus-resident parent company.

The company litigated against the authorities’ stance and both the court of the first instance and the appeal court rejected the tax authorities’ arguments that it should not be regarded as a Russian enterprise for treaty purposes. However, the tax authorities appealed to the Federal Arbitration Court (cassation instance), which accepted their arguments, annulled the decisions of the lower courts and remitted the case to the first instance court for a new hearing.

The decision of the Federal Arbitration Court appears to have been based on Article 47 of the Joint Stock Company Law, which provides that “The highest management body of a company shall be the general meeting of shareholders.” It therefore determined that management was exercised by the parent company in Cyprus rather than the general director in Russia and that the company was a Cypriot enterprise. The court’s ruling does not provide any information on why it came to this conclusion, and in particular on how the company was managed in practice.

It is too early to say whether this is a one-off aberrant decision or whether the same reasoning will be applied in other cases. It does illustrate the need in all cases to establish that there is no discrepancy between the form and the substance of transactions and arrangements, and that companies are demonstrably managed and controlled from where they claim to be. It further underpins the global trend of tax jurisdictions worldwide requiring companies to have a necessary degree of business substance in the jurisdictions where they are active, rather than existing merely for the purpose of gaining access to double tax treaty benefits.

This is in fact also our position and advice to clients before proceeding with the establishment of Cyprus companies and structures involving investments into Russia. Cyprus also follows the ‘substance over form’ and ‘business purpose test’ doctrines which allow the Cypriot tax authorities to recategorise an artificial or fictitious transaction or structure.

Moreover, the Assessment and Collection of Taxes Law, which was amended to transpose the EU Mutual Assistance Directive 77/799/EEC into domestic legislation, contains general anti-avoidance rules under which the Commissioner of Inland Revenue may disregard artificial or fictitious transactions and assess the person concerned on the proper object of tax. The provisions apply to local or international transactions, and to residents and non-residents.

Finally, Cyprus’s own rapidly developing body of anti-avoidance legislation is aimed at denying companies without any significant business substance or commercial rationale for existing in Cyprus, (i.e. mere letterbox or brass-plate companies) the benefits available under the island's tax laws and double tax treaties. Where an intermediate holding company is superimposed on operating companies merely to obtain savings in withholding taxes, the tax authorities may be able to set aside the structure by applying a general anti-avoidance doctrine. In this respect ‘substance over form’ issues should be considered carefully in order to avoid any possible challenge by the tax authorities using the general anti-abuse legislation.

A Russian court ruling on permanent establishments confirms the importance of careful planning

On 8 December 2010 the Moscow State Commercial Court decided that the collection of information by Bloomberg LP's representative office in Moscow resulted in the creation of a permanent establishment under Russian law and the double tax treaty between Russia and the United States.

The taxpayer, Bloomberg LP, produces information products, including analytical databases. Between 2006 and 2007 it maintained a representative office in Moscow, where a number of employees gathered information which was incorporated into its databases.

The main question which concerned the tax office and the court was whether activities related to information gathering result in an entity creating a permanent establishment, given that under the US - Russia tax treaty the collection of information as a preparatory and auxiliary activity is excluded from the general definition of the activities of a permanent establishment. There was a secondary question concerning the attribution of the profits to Russia, but that is not considered in detail here.

The tax authorities' view was that a permanent establishment existed since the activities carried out by the employees in Russia were an integral part of the taxpayer's core activities given the nature of the taxpayer's business (which is connected with the collection and trading of valuable information) rather than being an auxiliary or preparatory activity.

Bloomberg's position was that the collection of information is mentioned in the list of exclusions from the general definition of the term "permanent establishment" under the relevant tax treaty. As this activity was auxiliary and preparatory in nature the fact of collecting the information should not, in Bloomberg's view, create a permanent establishment.

The court ruled that the activities of collecting information and selling products based on such information in fact fall within the ambit of Bloomberg's core business. The Russian office's activities could not be regarded as auxiliary or preparatory; therefore the taxpayer had a permanent establishment in Russia in 2006 and 2007. The court which decided the matter was a first instance court and no appeal was filed.

It is also significant that on this point the court referred to the Organisation for Economic Cooperation and Development (OECD) Commentary to the Model Tax Treaty, despite the fact that Russia is not an OECD member. This does not mean that the court considers itself bound by the OECD Commentary in any specific way: rather, it will decide each time on a case by case basis.

While the case in question concerned the application of the US-Russia double tax treaty, the underlying principles and issues examined are highly relevant and important in the context of Cyprus, since substantial investments are channelled through Cyprus into Russia either through the establishment of subsidiaries or through the use of branches or representative offices. Careful planning should be made in structuring investments, taking account of the relevant provisions of the 1998 Cyprus – Russia double tax treaty (the "RCDTT") to ensure that no permanent establishment in Russia is created unless this is specifically intended.

The provisions set out in the RCDTT (including the respective PE provisions) are to a large extent also based on the OECD model treaty. In addition, the provisions contained in the Protocol amending the 1998 treaty which was signed during 2010 but which has not yet been ratified by Russia and Cyprus ("the 2010 Protocol") are largely based on the OECD model.

This, together with the fact that the Russian authorities have for the first time examined the issues in such depth and made such detailed reference to the OECD Commentary, suggests that the Russian tax authorities may be losing some of their previous reluctance to refer to the OECD Commentary in order to resolve disputes with taxpayers. This development may promote and ensure stability and consistency given the comprehensiveness of the OECD Commentary on the interpretation of complex double tax treaty provisions.

Articles 5(4) (d) and (e) of the RCDTT contain similar provisions to those included in the US-Russia treaty to the extent that activities such as collecting information or the carrying out of any other activity of a preparatory or an auxiliary character do not constitute a permanent establishment. However, the definition of a permanent establishment is extended by the 2010 Protocol to include, subject to certain conditions, the provision of services in one country by a resident of another country through one or more individuals who are present in the first country for more than 183 days in any 12-month period. Care should be taken that the representatives of the company in Russia will not be treated as falling within this category, or otherwise a taxable permanent establishment will be created in Russia for tax purposes.

In view of the outcome of the Bloomberg case as well as the wider definition of "permanent establishment" in the 2010 Protocol, the activities of Cyprus companies in Russia through a representative office should be re-assessed carefully. In particular, investors should:

- re-examine the structure and scope of activities carried out by Cyprus companies in Russia without a registered branch in Russia;
- take action to mitigate the risk that activities that the Cyprus company regards as auxiliary and preparatory might be considered as giving rise to classification as a permanent establishment;
- ensure that such an entity is properly registered if its activities may meet the standard for being classified as a permanent establishment; and
- undertake a thorough, detailed examination of the accounts of the Cyprus company as well as the profits attributed to its Russian permanent establishment, and be prepared to justify or substantiate the profit attribution if required to do so.

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