



Russian Tax Outlook:

International business structuring after MLI enters into force on 1 January 2020

In May 2019 Russia adopted a federal law, ratifying Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI, Multilateral instrument) which entered into force in October 2019.

MLI is an international treaty based on the BEPS Actions Plans 6, 7, 14 and 15, which is aimed at combating tax avoidance by means of use of benefits granted by double tax treaties (DTTs) worldwide. MLI updates current tax treaties, complementing them with new instruments forming the minimum standard.

Russia intends to apply MLI provisions to DTTs with **71 countries** with appropriate reservations and statements. Taking into account the bilateral status of MLI amendments to DTTs such provisions are subject to adoption by the other party and are applied to withholding tax payments from **1 January 2020**. Regarding other taxes MLI will be applicable not earlier than from 1 January 2021.

Principle purpose test



Principle purpose test (PPT) is the most widespread instrument of international tax structuring analysis and is included in MLI minimum standards. It allows Russian tax authorities to perform tests of the cross-border arrangements or transactions to investigate, if obtaining a tax benefit was one of the principal purposes of this arrangement or transaction that resulted directly or indirectly in receipt of that benefit. As a result of PPT, the benefit stipulated by a DTT should not be granted, if it is determined that receipt of such benefit was one of the main purposes for an arrangement or transaction.

It is important that all relevant facts and circumstances should be taken into account, such as de-facto relations between the parties, general business reasons for the transactions and benefits of the parties, the risks taken by the parties and functions thereof, the financial status of the parties, etc.

In our practice, Russian tax authorities interpret transactions or arrangements quite aggressively, investigating all facts that could support the intention of the parties to avoid Russian Withholding Tax (WHT). Usually it applies to all kinds of outbound income flows, inter alia: dividend payments, royalties, interests, cross-border capital gains and operations with shares ("passive" income) as well as even some types of "active" income such as various types of services, in particular, intra-group and consulting.

Performing your own PPT analysis of the proposed transactions using a functions, finances and legal method sufficiently increases your chances to respond tax authorities' queries and minimize your WHT risks.

Simplified Limitation on Benefits

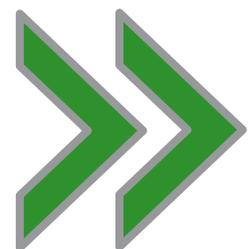


Simplified Limitation on Benefits provision (SLoB) is another measure to fight against the benefits' abuse. Basically SLoB is a number of formal and evaluative criteria that should be met in order to apply the DTT benefit. For example, if a company is considered a qualified person, ie a political subdivision or a non-profit organization of type agreed between the parties to a DTT, it is automatically entitled for the benefits' receipt.

In case the formal criteria are not met, ie the company is not a qualified person, it should confirm it meets any of evaluative criteria, for example, it is engaged in the active conduct of business. In case a company does not correspond to the mentioned criteria, the benefit can only be applied if the competent authority (Russian Ministry of Finance) concludes that neither establishment or maintenance of the company, nor the conducts of its operations meet one of the principal purposes to use the benefits granted by the DTT.

SLoB is implemented by Russia into DTTs with a significantly less number of instances than PPT, though it gives more direct and strict guidelines on whether a person or a company is entitled to the DTT benefits.

Our forecast is that Russian tax authorities will interpret it quite formally and taxpayers should be ready to provide all necessary documents, correct from the Russian legal perspective.



365-Day-Test for Dividend Payments



In addition to the above measures Russia also applies ownership rule for dividend payments. It means that the lower WHT rate of the dividend payment could only be applied in cases where the capital/share ownership conditions described in the relevant DTT provisions are met throughout a 365-day period (that includes the day of the payment of the dividends). Often one of such provisions is an investment criterion. We should observe *from our practice* that this investment criterion from the Russian tax perspective should be met through the entire 365-day period. However, as MLI is based on the mutuality principle, the 365-day-test will be used only against a limited number of DTTs.

Artificial Avoidance of Permanent Establishment status



When the foreign company does business in Russia without establishing a separate legal entity in accordance with the Russian laws but has a fixed place of business through which the business of this enterprise is carried out, it is recognized as a permanent establishment (PE) in the Russian territory. All income received through such fixed place of business is taxed in Russia.

The main point of disputes is the "fixed place" interpretation. Russia has chosen the MLI options that allow combating PE avoidance in three different ways.



1. Leading role of a dependent agent in concluding contracts in the name of the enterprise

PE of an agent type constitutes, if a person or a company in Russia (consequently considered a dependent agent) is acting on behalf of a foreign enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

In our experience, many foreign companies use contracts with Russian entities to develop their business on the Russian market. These contracts should be tested from the perspective of parties' functions, point of management decision, and type of fee to investigate if Russian party's role is in fact supportive or it directly develops the business of the foreign enterprise on the Russian market and it is a good time to think over the option of establishing a Russian legal entity.



2. Misuse of specific activity exemptions

MLI emphasizes that exemptions provided in DTTs for activities of preparatory or auxiliary character, made by the branch or representative office of a foreign enterprise should not be misused for the purposes of PE avoidance.

Choosing between two possible options (Option A & Option B) Russia has opted for Option A, ie all the activities listed in a DTT are bound to be of a preparatory or auxiliary character not to constitute the PE while Option B provides that not all services should be of a preparatory or auxiliary character.

In our opinion, Russian tax authorities will spread the substance over form approach on this topic. Mainly tax inspections use the interview of personnel and request of all business documents to investigate how direct the support of branch (representative office, place of management) is. To be prepared for these actions a Company closely working with Russian branch should perform a functional analysis, exclude any ambiguity in the activities of a Russian branch (representative office), and think over the option of establishing a Russian legal entity.





3. Anti-splitting of contracts provisions

A building site or construction or installation project in Russia usually constitutes a PE, if it lasts more than 12 months (could differ between DTTs).

MLI prescribes that in the case of conducting supervisory or consultancy activities on a building site related to such site and in case these activities are carried out during one or more period that in the aggregate exceed 30 days, such periods of time are added to the period of time when the first-mentioned enterprise was carrying out the activities on the building site.

This so-called anti-splitting mechanism is combating the attempts of various companies to become exempt from PE in Russia.

We suppose that Russian tax authorities might treat a number of contracts as increasing the time period to reach 12 months. To be prepared for that a Company should analyze the types of activities on the building site, their length and clearly distinguish standalone activities in the contract wording and personnel functions.

Mutual Agreement Procedure



Mutual agreement procedure (MAP) is a procedure aimed at resolving the issues related to violation of the taxpayer's rights. Where an entity considers that the actions of one or both of the states - parties to a DTT result or will result for that person in taxation not in accordance with the provisions of the DTT, that entities may, irrespective of the remedies provided by the domestic law of those states, present the case to the competent authority of either state.

The main purpose of MAP is to eliminate situations when the source jurisdiction, ie a jurisdiction where an item of income is earned and a residence jurisdiction, ie a jurisdiction where another party resides, have different taxation rules ending up in double taxation of a certain transaction. For those instances MLI has introduced the following modifications to the existing provisions:

- taxpayers should have a specific period (normally three years) to present a case to either authority. If the authorities cannot resolve a dispute, it can be escalated to a formal procedure - irrespective of time limits prescribed by the domestic legislation (Article 16 of MLI)
- MLI requires downward adjustment to reflect an upward transfer pricing adjustment in the other state (Article 17 of MLI)
- mandatory binding arbitration can be included in the DTTs (Articles 18 - 26 of MLI)

Russia applies provisions mentioned in Article 16 & 17 of MLI. Moreover, on 30 January 2019 the Russian Ministry of Finance published its Guidance on Mutual Agreement Procedure¹, which should also contribute to practical fulfilment of MAP. According to the OECD on 31 December 2018, Russia had 24 open MAP cases, which is ten times more than in a three-year-perspective.

In our opinion, MAP will be a developing institute in the next couple of years, helping taxpayers to overcome the situation where Russian tax authorities are trying to increase the tax burden of transaction or arrangement without fair analysis of double taxation. Before starting this procedure, a Company should be prepared to clarify all the details of disputable transaction to competent authorities of both instances.

Who is who in MLI?

MLI is applicable for some of Russia's trade partners with the following peculiarities.

Country/MLI instrument	PPT	SLoB	365-day rule for dividends	PE			MAP (procedure)
				agency rules	specific activity exemptions	anti-splitting-up rules	
Austria	✓	✗	✗	✗	✓ ✗ Option A applies. Other provisions do not apply.	✗	✗ MAP exists in the DTT
Cyprus MLI not ratified	✓	✗	✗	✗	✗	✗	✗ MAP exists in the DTT
Finland	✓	✗	✗	✗	✗	✗	✓ ✗ specific provisions do not apply
Germany MLI not ratified. DTT with Germany is not a CTA by Russia	✓	✗	✗	✗	✓ ✗ Option A applies. Other provisions do not apply.	✗	✗ MAP exists in the DTT
France	✓	✗	✓	✗	✗	✗	✓ ✗ specific provisions do not apply
Ireland	✓	✗	✗	✗	✗	✓	✓ ✗ specific provisions do not apply
Luxembourg	✓	✗	✗	✗	✗	✗	✓ ✗ specific provisions do not apply
Netherlands	✓	✗	✓	✗	✓ ✗ Option A applies. Other provisions do not apply.	✓ ✗ does not apply to exploitation of resources	✓ ✗ specific provisions do not apply
Republic Korea MLI not ratified	✓	✗	✗	✗	✗	✗	✓ ✗ specific provisions do not apply
Switzerland MLI ratified, but DTT with Switzerland is not a CTA by neither states	✓	✗	✗	✗	✗	✗	✗ MAP exists in the DTT
UK Automatic Exchange of Information is not applied.	✓	✗	✗	✗	✓ ✗ Neither Options apply. Other provisions do apply.	✗	✓ ✗ specific provisions do not apply
USA MLI not signed	✗	✗ Simplified LOB exists in the DTT	✗	✗	✗	✗	✗ MAP exists in the DTT

For more detailed information on other jurisdictions, please visit the OECD [webpage](#).

We recommend reviewing your corporate structure, cross-border contracts and flow of income between foreign and Russian entities (from the perspective of the changes listed above) to assess the risks that could arise following the application of MLI rules in Russia. We also recommend making the necessary changes to group structure and flow of income in view of these rules.

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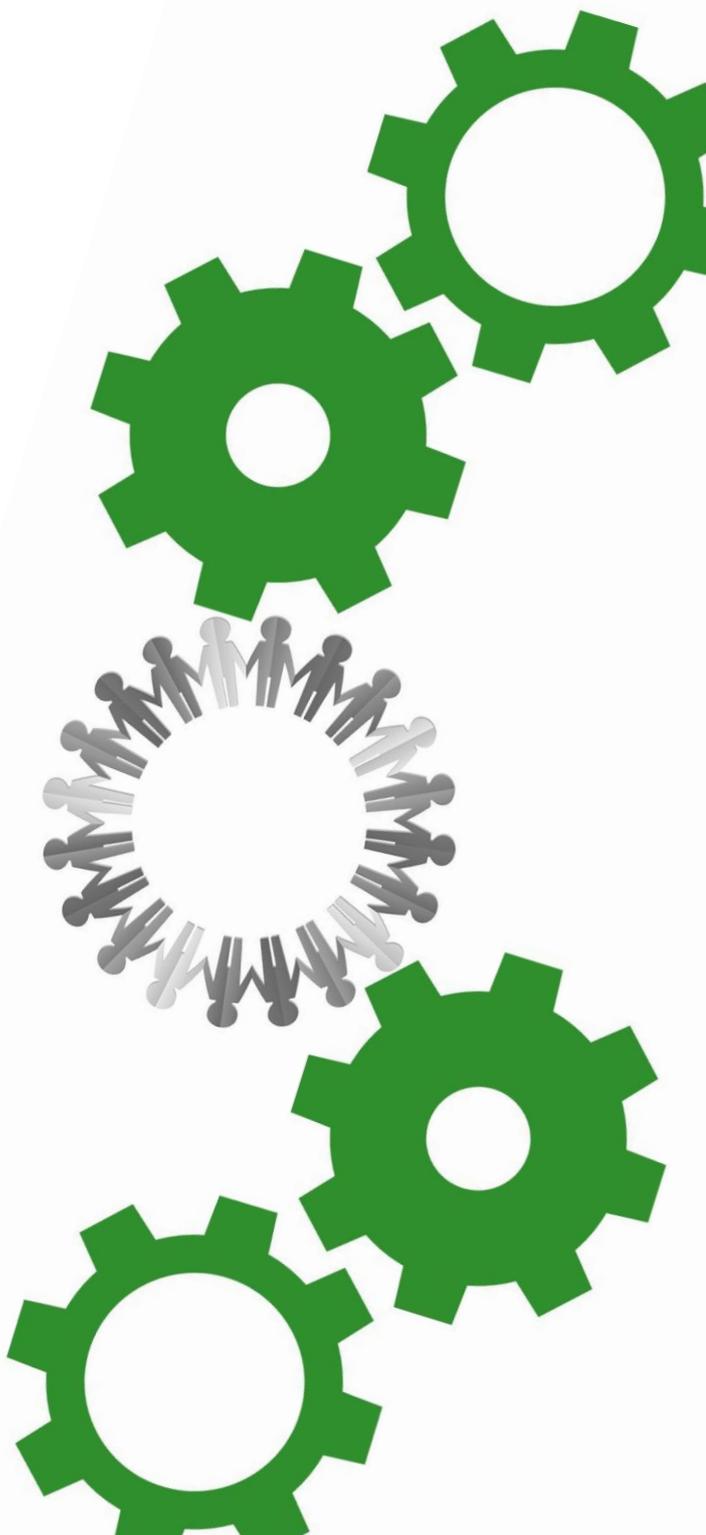
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