LT in Focus

Tax & Legal

Transferring funds abroad is getting riskier: a look at how the tax dispute landscape evolved in 2022

In 2022, new trends shaped tax litigations over distributions to foreign persons, to name but a few:

- more types of outbound payments were treated as passive income
- withholding tax was increasingly charged at a 20-percent rate applicable to Other Income
- payments for services that were not effectively rendered were treated as illegitimate foreign currency transaction
- tax treaty benefits were disallowed on the mere account of ‘tax abuse’.

On top of that, mutual agreement procedures involving Russia nearly came to a halt.

Therefore, even if a taxpayer believes that the Russian taxation is inconsistent with the objectives and principles of a tax treaty, the dispute would be hard to solve at the transnational level.

We recommend thoroughly assessing the potential risks and their impact when planning any cross-border transactions, even with non-hostile states.

Please see below an overview of the arguments put forward by the tax authorities and courts.

More payout types treated as passive income

How it started: intragroup service fees reclassified into dividends

The case of Ruscam Glass Packaging Holding OOO was the first high-profile dispute over intragroup fees reclassified into passive income (Case No A11-9880/2016).

Based on the controversial, one-size-fits-all service acceptance reports and the correspondence of the service fees to retained earnings, the tax authorities successfully challenged the fact that the services were effectively provided, treated service fees as dividends, and charged back taxes.

The tax authorities have since disallowed fees for intragroup services (consulting, use of the shared services centre, management, agency, etc.), if the evidence of their genuineness was insufficient (Cases No A11-11199/2017, A50-16961/2017, A50-16960/2017, etc.).

Such practice is getting more diverse each year, the courts taking the taxpayers' side less often.

How it continued: disputed intragroup restructuring

For several years, the tax authorities have been quite successful in challenging the business purpose of intragroup restructurings.

Thus, in Case No A11-16028/2018, the court treated payments under a loan as dividends. The loan originated from a novated share (ownership interest) purchase agreement, where the amount was due by a Russian taxpayer to a foreign person. As a result, Russian tax was withheld not only on the interest, but on the principal amount as well.

Outbound payments under agreements for the purchase of ownership interests (Cases No A40-118135/2019, A40-118073/2019) and shares (Case No 40-6299/2022) may well suffer the same fate, regardless of the value derived from the Russian real estate.

Based on the existing precedents, we can assume that risks may arise, if:

- the restructuring effectively leads only to the optimisation of the organisational structure, but does not change the shareholding structure or liabilities or affect the relationship of the parties and the management's decision-making capacities
- the transaction is preceded by certain preparatory operations, indicative that the restructuring is aimed at profit shifting abroad the consolidation of assets and liabilities as an ultimate objective could have been achieved in a different, less costly for the tax authorities, manner, not requiring the purchase of shares or interests.

New round: non-arm's-length margin

We are witnessing the tax authorities' increasing interest in the "active" import operations with related trading companies abroad.

The attention of regulators is drawn by:

- an unreasonably high agent's markup
- non-payment of income tax in the recipient's country of residence
- contract terms differing from the normal business terms (no pre-payment, an extensive payment grace period, etc.)
- the conduit role of the foreign trader, which includes the transfer of the markup to third parties and the involvement of the Russian company's officers in the negotiation of contracts and coordination of supplies.

The tax authorities obtain information on producers' prices and, therefore, markups, from different sources:

- foreign databases (e.g, infodriveIndia.com);
- foreign exports declarations for goods purchased by traders, if such must be provided to the Russian customer according to the contract with the trader
- foreign trader's bank statements
- the price at which the taxpayer had previously purchased goods directly from the manufacturer, if the supply contract was later on switched to the trader, etc.

The overpricing of purchased goods by an conduit trader was previously challenged only with regard to tax-deductible expenses (see Case No A40-189344/2014).

Currently, the tax authorities tend to consider the markup also as a free-of-charge transfer of property, that is, a taxable passive income from the Russian sources.

Referencing these arguments, regulators had won disputes with two pharmaceutical companies (Cases No A19-14604/2022, A60-26858/2022) and a chemical manufacturer (Case No A82-15839/2021).

Furthermore, the tax authorities managed to prove a hidden payment of passive income to foreign companies under contracts deemed as fictitious: an agency agreement (Case No A40-19162/2022), international shipping container leasing agreement (Case No A51-3822/2022), supply agreement with respect to the pre-payment made (Case No A40-52890/2021).

In these cases, the arguments were mainly the formality of the supporting documents and the nominal nature of the foreign counterparty's operations.

Interestingly, in Case No A19-14604/2022, the court rejected a reference that a trading company performed real economic activity with foreign counterparties. In the court's view, it was not disproving that the particular transaction with the Russian taxpayer was an artificial arrangement.

Noteworthily, tax amendments are being discussed that would enable charging Russian withholding tax on foreign entities' income arising from the adjustment of prices with the Russian related parties. The amendments are announced by the fiscal policy priorities for 2023–2025.

It may well be that the amendments, if implemented, will transform the courts' approach to disallowing non-arm's length prices of not only import transactions involving foreign intermediaries, but other controlled transactions as well, including loans.

Withholding tax charged at a twenty-percent rate envisaged for Other Income

Previously, the tax authorities aimed to reclassify disputable payments into dividends and charge a 15-percent withholding tax.

However, in 2022, the regulatory approach was reconsidered — in all landmark cases of the year, the disputed payments were recognised as gratuitously received 'other similar income' within the meaning of Paragraph 10, Article 309 of the Russian Tax Code, taxed at the rate of 20 percent (Case No A40-6299/22-108-102, A82-15839/2021, A40-19162/2022, A51-3822/2022, A71-7014/2021, A19-14604/2022, A60-26858/2022, A82-15839/2021).

Importantly, not only payments to persons/entities without direct or indirect interest in the Russian payor are treated as gratuitously transferred income, but distributions to shareholders as well (e.g., Case No A40-6299/22-108-102).

At the same time, neither the possibility of treating such distributions as dividends (to decrease the amount of tax arrears) nor establishing the beneficial income owner were considered in the above-mentioned disputes.

In other words, the courts choose the taxation scenario that is most beneficial for the budget and disallow treaty benefits that generally exempt Other Income from Russian taxation (see below).

Payments for services that were not effectively rendered treated as illegitimate transactions from forex control perspective

The tax authorities have been increasingly using the argument that the agreement, under which funds are transferred abroad, had been already recognised as fictitious prior to the tax audit and the transfer was deemed illegitimate from the FX control perspective (Cases No A40-6299/2022 and A51-3822/2022).

The companies that lost disputes over the legitimacy of transactions in terms of forex control may well expect back tax charges now (e.g., Case No A51-10899/2022).

Most often, the courts cite the following:

- the supporting documents are not detailed enough and the business operations of a foreign counterparty are nominal
- the subject matter of an underlying contract does not meet the established requirements (e.g., no proof that containers were used solely for international shipping, Case No A51-3822/2022; the licensed rights do not meet the know-how criteria, Case No A51-10899/2022)
- the contract is generally void (e.g., a license agreement was not registered with Rospatent, Case No A51-10899/2022) or the transaction has been treated as an artificial arrangement (Case No A40-6299/2022).

Therefore, on top of the additional tax charges (disallowed expenses, assessment of withholding tax), the taxpayer's total cost may potentially include a penalty for making illegitimate payouts to non-residents of up to 40 percent of the transfer value.

Treaty benefits disallowed in tax abusive situations

Previously, when reclassifying transactions, the tax authorities and courts used to allow treaty benefits for them from time to time.

Occasionally, they would even independently determine the beneficial owners and apply the particular treaty rates.

For instance, in Case No A11-9880/2016, a Dutch parent company was considered as a shell structure, having no beneficial ownership over the deemed dividends from Russia. Yet, a ten-percent tax rate was allowed for such dividends under the tax treaty with Turkey – residence state of the companies that were in fact managing the Russian payer.

Now, most reclassification cases result in a disallowance of treaty exemptions or reduced tax rates (Case No A40-6299/22-108-102, A40-19162/2022, A51-3822/2022).

If previously the courts cited conduit nature of the recipient and absence of beneficial ownership as the main reasons for disallowing tax treaty benefits, now they are increasingly referring to the concept of tax abuse.

The concept is envisaged by the tax treaties themselves (treaty benefits may not be claimed for tax abusive transactions) and by Article 54.1 of the Russian Tax Code, referenced when a payment is reclassified.

According to the courts, the reclassification of income under Article 54.1 of the Russian Tax Code makes claiming treaty benefits nearly impossible, especially for transactions that are taxed neither in Russia nor in the recipient's state ("double non-taxation") (Case No A40-6299/2022).

Here we are witnessing a reversal of the Supreme Court's previous position that the reclassification of a transaction does not necessarily disqualify the taxpayer from tax treaty benefits (e.g., Case No A50-16961/2017).

However, taxpayers sometimes still manage to retain tax treaty benefits even under reclassified transactions.

Thus, in Case No A40-47086/2022, interest in a debt-push-down arrangement that was recognised as a hidden distribution of dividends was still taxed at a five-percent rate envisaged by the tax treaty with Cyprus.

Our services

The tax authorities have been increasingly tightening forex controls and taxation of international transfers, making the structuring of outbound intragroup transactions more and more challenging.

Risk indicators	What we can do to help
• The transaction unreasonably increases the costs of the Russian payor and can be carried out in a less burdensome way. • The transaction is not at arm's length (features a high trade margin, no pre-payment or an extensive grace period, overpricing of shares/interests). • The transaction's structure differs strongly from the ordinary intragroup practice: as part of the restructuring, one of the assets is transferred differently from the others; goods are purchased through a foreign intermediary despite direct contracts with the manufacturer. • The supporting documents (acceptance reports, statements) do not precisely state the nature of services (are one-size-fits-all and controversial), do not evidence the effective provision of services and/or do not fully satisfy the forex control requirements. • The company's employees are unable to explain how they interacted with the foreign counterparty and what the objectives of the service agreement were; they were involved in the negotiation of the transaction's terms and its implementation, sidestepping the foreign counterparty. • The taxpayer does not deduct service acquisition expenses, thus demonstrating the lack of relation between the services and its business activity. • The taxpayer does not pay dividends – making, however, regular payouts under a service/trade agreement with a foreign related party; the payment amount coincides with that of retained earnings. • The reorganisation does not change the shareholding and liabilities structure, the relationship between the parties and the management's decision-making process, etc. • The foreign counterparty appears nominal (has no personnel, fixed assets or office, bears minimal administrative expenses; the Russian-sourced income is shortly transferred to third parties; its directors are not independent decision-makers). • The foreign counterparty is not subject to income tax under the laws of its country of residence.	• Advise on properly formulating the contract's subject matter and preparing the necessary confirmation documents Review the as-is structure of the group/operations; identify risk areas; consult on the restructuring of arrangements with foreign counterparties, including import and export transactions • Provide support across the entire tax audit cycle: from responding to tax inquiries to support during interrogations and court proceedings • Prepare transfer pricing paperwork and/or support with other TP matters: — conduct benchmark studies for new intragroup operations — revise the pricing policy for new transactions with related parties — prepare transfer pricing documentation, including with the use of digital tools — prepare a defense file; assist with the signing of bilateral and multilateral pricing agreements and liaise with the tax authorities — process and respond to transfer pricing inquiries; provide assistance with the economic and technological aspects.

Our credentials

We are committed to standing by our clients, no matter how turbulent the times are.

In 2022, we successfully defended the position of several companies in the tax disputes over international payments at the pre-trial stage.

In most cases, we successfully sought the withdrawal of claims, partial or full, in relation to intragroup service fees that the tax authorities treated as a non-deductible compensation for shareholding activities and wanted to withhold tax at source on deemed dividends.

When preparing to disputes, we analysed the services, worked on proving the Russian company's economic benefit and documented the collected arguments.

In most of our appeals to tax audit resolutions, we were able to prove that the expenses were incurred to acquire services.

If the expenses were rightfully treated as the compensation for shareholding activities based on the clarifications of the Russian Tax Service, we managed to claim treaty benefits.

For instance, in one of the cases, a tax inspectorate disallowed the deduction and treated the payment as 'other similar income', subject to a 20-percent withholding tax, denying the treaty exemption on account of the tax abuse.

Already at the pre-court stage, we proved that the income was wrongfully considered as Other Income and that the treaty benefits did apply.

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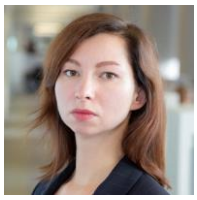

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