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Double tax agreement decision highlights need for planning and careful compliance

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The Russian 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 on the issue the Arbitration Court of the Moscow region ruled that the taxpayer in question - a wholly owned Russian subsidiary of a Cyprus parent company - was ineligible for treaty benefits 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, the tax authorities contended that the Russian investee should be treated as a Cyprus enterprise for treaty purposes, as it was 100% owned and controlled by its Cyprus-resident parent company. This argument was rejected in the lower courts and the tax authorities appealed to the Federal Arbitration Court (cassation instance), which determined that management was exercised by the parent company in Cyprus rather than the general director in Russia, and that the company was a Cyprus enterprise. The court's ruling provides no 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. However, it illustrates the need in all cases to establish that there is no discrepancy between the form and 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 in which they are active, rather than existing merely for the purpose of gaining access to double tax treaty benefits.

This case confirms the need for thorough planning before proceeding with the establishment of Cyprus companies and structures involving investments into Russia, and for careful implementation of the plan in order to avoid unforeseen and undesired results.

Cyprus also follows the 'substance over form' and 'business purpose test' doctrines, which allow the Cyprus 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 with no significant business substance or commercial rationale for existing in Cyprus (ie, 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.

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