COMMENTARIES

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DEPENDENT AGENT IN DOUBLE TAX TREATIES OF RUSSIA: A LEGAL ANALYSIS OF CRITERIA

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Abstract: The article is devoted to dependent agent in double tax treaties of Russia. Current market conditions force companies to look for new jurisdictions to expand their activity. Under certain conditions, a foreign company's activity in another jurisdiction may create a permanent establishment (hereinafter – PE). Profits of foreign legal entity (non-resident) is taxable in the Russian Federation if its activity creates a PE. Of course, companies are often concerned that this has not happened as it is related to tax economy. There are two types of PE in Russia – general PE and dependent agent. In this article, the authors conduct a legal analysis of the criteria for determining the agency type of the PE. A special attention is paid to Russian double tax treaties (hereinafter – DTT). The article also discusses the «Oriflame» case which addresses the issue of recognition of a legal entity as a dependent agent.

Keywords: permanent establishment, dependent agent, International Tax Law, double tax treaty, OECD Model Tax Convention, United Nations Model Convention, «Oriflame» case.

Introduction

In the globalization era, companies can no longer carry out their activities under a single jurisdiction, therefore the problem of legal regulation of the status of permanent establishments is of particular relevance in the Russian Federation. Under the Russian Tax Code, profits of foreign legal entities (i.e. non-resident) is taxable in Russia if their business activities create a PE[1]. If no PE exists, foreign entities are exempt from Russian profits tax.

Concept of PE under the Russian law

The concept of PE under the domestic law is defined under Article 306 of the Russian Tax Code, where an affiliate, representation, department or bureau, an office, agency or any other subdivision or other place of activity of this organization through which the organization regularly performs its business activity in Russia.

The following areas of activity are expressly listed as giving rise to the creation of a PE:

- exploration for, or extraction of, natural resources;
- construction, installation, assembly, adjustment, maintenance and operation of machinery and equipment, including gambling equipment;
- sales from warehouses owned or rented by a foreign legal entity in Russia;
- rendering services or performance of any other activity, apart from «preparatory and auxiliary» activities or activities explicitly defined as not creating a PE.

Basically, there are two grounds for creation of a PE in Russia[2].

- *General PE*

A PE includes an affiliate, representation, department or bureau, an office, agency or any other set apart subdivision or other place of activity of this company, through which the company regularly performs its business activity on the territory of the Russian Federation.

- *PE through a dependent agent*

A foreign company shall be seen as having a PE if this company performs business activities through a person (a dependent agent) who, on the grounds of contractual relations with this foreign company, represents its interests in the Russian Federation, acts on the territory of the Russian Federation on behalf of this foreign company, possesses and regularly exercises the powers for concluding contracts or negotiating their essential terms on behalf of the foreign company, thus creating the legal consequences for the foreign company.

Regarding an agent with independent status, all DTTs of Russia contain this concept in a fairly standard wording proposed by the OECD and United Nations Model Conventions, as well as approved in the Russian Federation Model Agreement. Thus,

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[1] Russian Tax Code (second part) of August 5, 2000, No. 117-FZ (version of April 15, 2019), ConsultantPlus, http://www.consultant.ru/document/cons_doc_LAW_28165/ (reference date: 15.04.2019)

[2] Konnov O.Yu., Institute of Permanent Representation in Tax Law: Study Guide, ed. by S.G. Pepelyaev, Moscow: Academic Law University Publ., 2002, p. 38.

an enterprise is not considered to have a PE in another state if it carries out activities in another state through a person who is a broker, commission agent or other agent with independent status, provided that such persons act within the framework of their normal activities.

According to Article 7 of the Russian Tax Code, double tax treaties have priority over the domestic legislation. Provisions of the most DTT which relate to PE issues are very similar to the provisions of the Russian Tax Code.

This article focuses on the dependent agent as a type of PE in double tax treaties. Special emphasis will be placed on the analysis of DTTs.

In 2017 Russia joined the Multilateral Treaty to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting of 24 November 2016 (MLI).

It will enable the signatories to implement BEPS principles swiftly, as it covers a large number of double tax treaties. The instrument is quite flexible. At their own discretion, signatories may define which treaties will be covered and which specific provisions will apply.

The MLI provides for a number of key measures. For example, one of such optional provisions is tightening of the provisions relating to agency (commissionaire) arrangements. It stipulates that where an agent is acting on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts, that enterprise shall be deemed to have a permanent establishment. According to Action 7 of the BEPS Plan it is proposed to recognize organizations operating on the basis of a commissionaire agreement and regularly carrying out business activity as intermediaries of the foreign company, a dependent agent of the latter[1].

In Russia, MLI will be not be effective until ratified. Thus, currently PE issues are regulated by the DTT and the Russian Tax Code. MLI will be applied after the official ratification.

The main purpose of the concept of agency type of PE is to expand the application of the rules on permanent representation in relation to a foreign enterprise, by adjusting to various forms of business activity in the source state[2].

The Russian Tax Code provides that if the foreign legal entity engages in business activities through a person who, on the grounds of contractual relations with this foreign organization, represents its interests in the Russian Federation, acts on the territory of the Russian Federation on behalf of this foreign organization, possesses and regularly exercises the powers for concluding contracts or for coordinating their essential terms on behalf of the given organization, thus creating the legal consequences for the given foreign organization (a dependent agent).

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[1] Action Plan on Base Erosion and Profit Shifting, OECD Publishing. URL: http://dx.doi.org/10.1787/9789264202719-en (reference date: 18.04.2019)

[2] Yarullina G.R., Agency type of permanent establishment as an extension of the concept of permanent establishment: Russian and international approaches, *Financial Law*, 2016, no. 11, p. 46.

The foreign organization shall not be seen as having a PE if it performs an activity in Russia through a broker, a commission agent, a professional Russian securities market trader or through any other person acting in the framework of his principal (regular) activity.

Describing this type of permanent establishment, the legislator refers to the implementation of activities that meet the requirements of paragraph 2 of Article 306 of the Russian Tax Code. In addition, the provisions on the regulation of the agency type of the permanent establishment are not singled out in a separate article, such as the provisions on the construction site (Art. 308 of the Russian Tax Code).

Model OECD Convention and the UN Convention

Discussions arise in determining the ratio of the main and agency types of PE. The Model OECD Convention and the UN Convention define the agent type of the permanent establishment without using a reference to the characteristics of the main type. Independence is recognized for this type of PE.

The OECD Model Convention uses the following main criteria for a dependent agent as a type of PE (paragraph 5 of article 5):

- acting on behalf of an enterprise;
- habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts in the name of the enterprise (routinely concluded without material modification by the enterprise) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise[1].

The main criteria are specified in paragraph 5 of Article 5 of the UN Model Convention:

- acting on behalf of an enterprise;
- habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts in the name of the enterprise (routinely concluded without material modification by the enterprise) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services[2].

Let us consider the provisions of DTTs concluded by the Russian Federation. Currently, Russia has 84 DTTs[3].

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[1] Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, http://dx.doi.org/10.1787/mtc_cond-2017-en (reference date: 18.04.2019)

[2] United Nations Model Double Taxation Convention between Developed and Developing Countries, https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf (reference date: 18.04.2019)

[3] List of Applicable Double Taxation Treaties, ConsultantPlus, http://www.consultant.ru/cons/cgi/online.cgi?req=doc&ts=104514336401987800293787393&cacheid=8F67CA313925F64E0AF5E1DE9710C265&mode=splus&base=LAW&n=63276&rnd=3DB866D222724FC0BE8BB8ED31E26BCF#h1plmzka3p (reference date: 18.04.2019)

The Russian Government Resolution No. 84 dated February 24, 2010 "On Concluding Intergovernmental Agreements on Avoiding Double Taxation and Preventing Tax Evasion on Income and Property" approved the Model Agreement between the Russian Federation on avoiding double taxation and preventing tax evasion on income and property[1]. The criteria used in the Model Agreement are focused on the criteria used in the OECD Model Convention.

DTTs contain different criteria for the dependent agent. This issue requires further research. A number of Russian DTTs practically repeat the criteria provided for in the Russian Tax Code (except for meeting the general criteria of the permanent establishment) and the criteria of the OECD convention (in particular, with Albania, Austria, Algeria, Belarus, Brazil).

A number of other DTTs are more focused on UN criteria (storing stocks of goods and products belonging to the enterprise, from which these goods and products are regularly supplied on behalf of the enterprise). This is combined with Australia, Azerbaijan, Armenia, Botswana, Venezuela, Vietnam, etc. Also, some DTTs separately specify the criteria for the recognition of the insurance agent as a dependent agent (in particular, Mexico, Ecuador, Chile).

An interesting criterion is specified in Russia-India DTT. It says that the activity of a dependent agent is fully or almost fully on behalf of the enterprise itself or on behalf of this enterprise and other enterprises that control, control, or are subject to the same control as such an enterprise[2].

It is interesting that the Russian Ministry of Finance agreed with such an expanded concept of a dependent agent with India and Kuwait. The conclusion of DTT with an extended list of criteria for recognition of a person as a dependent agent by some researchers is explained by the level of economic development of the states with which such agreements are concluded. Most often, an extended list of criteria is used in agreements with countries with a low level of economic development.

As for the wording "wholly or almost wholly" in Russia-India DTT, such vague wording is found in other DTTs as well. For example, in Russia-South Africa DTT on the regular execution of orders exclusively or almost always for the enterprise[3].

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1 Decree of the Government of the Russian Federation of February 24, 2010 No. 84 (version of the act of April 26, 2014) "On the conclusion of international agreements on the avoidance of double taxation and on the prevention of tax evasion on income and property", ConsultantPlus, http://www.consultant.ru/document/cons_doc_LAW_98013/ (reference date: 17.04.2019)

2 Agreement between the Government of the Russian Federation and the Government of the Republic of India of March 25, 1997 "For the avoidance of double taxation with respect to taxes on income", https://www.dezshira.com/library/treaties/double-taxation-agreement-between-india-and-russian-federation-3712.html (reference date: 18.04.2019)

3 Agreement between the Government of the Russian Federation and the Government of the Republic of South Africa of November 27, 1995 "For the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income", *Bulletin of international agreements*, No. 9, 2001.

In Russia-Italy DTT, the exception for recognizing a person's activity as a dependent agent is to restrict this activity solely to the purchase of goods or products for this enterprise[1]. In the Russia-Malaysia DTT, the processing of goods or products is also noted as a criterion[2].

When using the design of a dependent agent in practice, there are often contradictions. An example of one of these contradictions is the «Oriflame» case. Oriflame Cosmetics LLC filed a claim for invalidation of the FTS decision on additional accrual of income tax and VAT. The basis was the analysis of royalties transferred by Oriflame Cosmetics LLC to Oriflame Holding BV (Netherlands) as a tax optimization tool, which allowed the Russian company not to pay income tax in Russia[3].

The court established a scheme of relations between the organizations of Oriflame Cosmetics SA (Luxembourg) and its subsidiary organization Oriflame Cosmetics B.V. (The Netherlands) (Fig. 1).

Thus, for 2009-2010, the Russian company transferred over 2 billion rubles to Oriflame Cosmetics BV (Netherlands) and included these payments as expenses that reduce the amount of income received when determining the income tax base for the years 2009-2010.

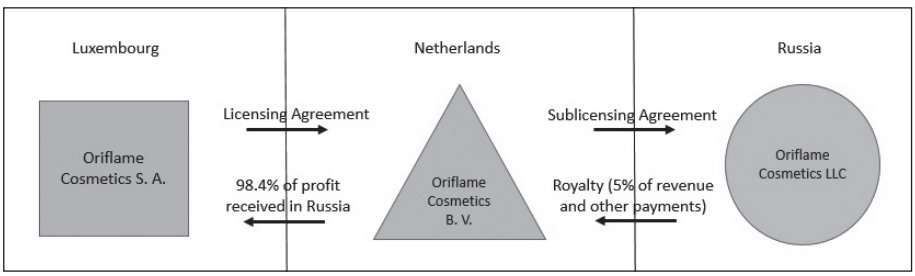

Fig. 1. The contractual relationship between organizations

When exercising tax control, the tax authority determined that the above-described business building scheme is not motivated from the point of view of entrepreneurial

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[1] Convention between the Government of the Russian Federation and the Government of the Italian Republic of April 9, 1996 "On avoidance of double taxation with respect to taxes on income and on capital and prevention of fiscal evasion", https://www.nalog.ru/html/sites/www.eng.nalog.ru/treaties/italy.pdf (reference date: 18.04.2019)

[2] Agreement between the Government of Malaysia and the Government of the Union of Soviet Socialisn Republics of July 31, 1987 "For the avoidance of double taxation with respect to taxes on income", *Acting intergovernmental and interstate agreements of the USSR with other countries on taxation issues*, issue 2, Moscow, 1989.

[3] Moscow Arbitration Court Decision of 04.12.2014 in case No. A40-138879/2014, Kadarbitr., https://kad.arbitr.ru/PdfDocument/837554e8-24a2-4cde-a55f-babf9107c22f/01d83dc7-c12a-4e7d-9a6a-fbd170f847a4/A40-138879-2014_20141204_Reshenija_i_postanovlenija.pdf (reference date: 17.04.2019)

activity and its goal is only to obtain unjustified tax benefit. The tax authority argued this conclusion by saying that Oriflame Cosmetics LLC is not an independent organization, but a permanent representative office (dependent agent) of a Luxembourg company.

The court «pierced the corporate veil» and reclassified Oriflame Russia (a limited liability company) as a representative office of Oriflame Luxembourg based on the following facts:

- Russian company's website was a part of the global website of Oriflame Luxembourg;
- advertising materials and catalogues featured the name of Oriflame Luxembourg;
- Russian company's top management personnel also were employees of Oriflame Luxembourg;
- Russian company had limited decision-making powers and had to have most of its decisions approved by Oriflame Luxembourg and other facts.

Summing up, the court of first instance established that the taxpayer actually performs the functions of a permanent representative office of the Luxembourg Oriflame Cosmetics SA, and therefore the additional charge of income tax and VAT is justified.

The case began to gain rapid turnover, when the Plaintiff, not agreeing with the decision of the ACLU, filed an appeal. The 9th Arbitration Court of Appeal also disagreed with the applicant's arguments and upheld the decision, and the complaint was not satisfied[1].

The court of appeal in its ruling emphasized that an agent with authority to conclude contracts on behalf of a foreign company is recognized as independent only if it does not depend on the principal either legally or economically.

Thus, there is an automatic equating of the notions PE and "dependent agent" to a Russian company with a majority share of foreign participation, which is incorrect.

Then Oriflame Cosmetics LLC was lodged with the cassation instance. It became clear that such a practice could soon touch many international investors doing business in Russia under a similar scheme. The importance of the outcome of this case is noted by the fact that in order to assist justice, specialists in the field of tax law sent letters to the Arbitration Court of Moscow District "Amicus curiae". However, the court of cassation also dismissed the complaint of Oriflame Cosmetics LLC[2].

The Supreme Court of the Russian Federation did not recognize the taxpayer as a dependent agent but denied the company to satisfy the complaint on the basis of

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[1] Ninth Arbitration Appeal Court Ruling of 06.03.2015 in case No.A40-138879/14, Kadarbitr., https://kad.arbitr.ru/PdfDocument/837554e8-24a2-4cde-a55f-babf9107c22f/f7439f50-9d49-47ed-8242-f2b730cc0136/A40-138879-2014_20150306_Postanovlenie_apelljacionnoj_instancii.pdf (reference date: 17.04.2019)

[2] Moscow District Arbitration Court Decision of 11.06.2015 in case No. A40-138879/14, Kadarbitr., https://kad.arbitr.ru/PdfDocument/837554e8-24a2-4cde-a55f-babf9107c22f/6e80aaa3-adc8-419d-9961-d769e85021e2/A40-138879-2014_20150611_Reshenija_i_postanovlenija.pdf (reference date: 17.04.2019)

an overestimated amount of payments, which was not economically justified[1]. This definition caused a mixed reaction from legal scholars[2].

Thus, the focus of the case shifted from the question "on the presence of a permanent establishment (dependent agent)" to the question "on the advisability of license payments made" since the tax authority could not get information about the reasons for concluding such concession contracts involving large license payments. In our opinion, in this dispute, the use of the concept of a PE was not justified.

Summing up the work done, it is worth saying that the considered case is contradictory. Acknowledging the obviousness of building a business along such a structure for tax optimization purposes, the positions of the tax authority and the courts raise doubts. The courts have left a lot of room for arguing about who can be considered a dependent agent.

Thus, the dependent agent as a type of PE at the moment is a deep scientific and practical problem that requires in-depth study. Of particular interest are the criteria of the dependent agent used in several Russian DTTs, since they are presented in a wide variety.

It seems that in the future the courts, and equally the legislator, still have to face a number of problems associated with the application of the criteria of a dependent agent in practice. The "Oriflame case" is a kind of measure, by the example of which the instability of the position of subsidiaries of foreign companies is demonstrated, as well as the existing problems of determining PE.

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[1] Supreme Court of Russian Federation Ruling of 14.01.2016 No.305-КГ15-11546 in case No.A40-138879/14, File of arbitration cases, https://kad.arbitr.ru/PdfDocument/837554e8-24a2-4cde-a55f-babf9107c22f/e3766a93-2271-4635-88df-7dc51e5d83e8/A40-138879-2014_20160114_Opredelenie.pdf (reference date: 17.04.2019)

[2] Kopina A.A., Tax control in foreign economic activity, *Laws of Russia: experience, analysis, practice*, 2017, No. 7, p. 34.

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