

Client Update

Russian Tax Changes Impose New Risks on Aircraft Lessees

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On 1 January 2017, amendments to the Russian Tax Code (the “Tax Code”) came into force that elaborate on when someone receiving a payment will be respected as the “actual recipient” of the income (“beneficial owner”). These amendments are of material significance to Russian companies acting as withholding tax agents, especially airlines that make payments under aircraft leases to foreign counterparties. Under the new rules, in order to apply a double taxation treaty (“DTT”) to reduce withholding tax on the lease payments, Russian payors are now required to determine whether the foreign entity receiving the payments has an actual right to the income.

RUSSIAN PAYORS ARE NOW REQUIRED TO CONSIDER FOREIGN ENTITY DOCUMENTS

Under the new rules, Russian taxpayers that make payments to a foreign entity claiming the benefits of a DTT are required to determine whether the foreign entity has an actual right to the income.

According to the Russian Finance Ministry, Russian payors must determine based on the available information and documents if the recipient of income is a beneficial owner. A comfort letter from a foreign entity that it is a beneficial owner in respect of the income received may not be sufficient. At present, there are no court decisions applying the beneficial owner rules to lease payments.

The position taken by the Federal Tax Service of Russia (the “FTS”) is that the tax authorities may refuse to apply the DTT if it can be proved that the immediate recipient of income is not a beneficial owner. In so doing, the tax authorities are not required to identify the actual recipient of such income.

The Russian withholding agent is fully liable for the failure to withhold taxes. Therefore, Russian companies acting as agents should now request and evaluate

documents provided by their foreign counterparties to ensure that they qualify as beneficial owners.

On 7 June 2017, Russia joined the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. The convention will take effect after ratification by the Federal Assembly of the Russian Federation and will establish new rules to counter DTT abuse. These rules will also have to be taken into account when considering existing lease structures and proposed new contracts.

ACTUAL RECIPIENT OF INCOME IDENTIFICATION CRITERIA

The Tax Code establishes only general beneficial owner criteria. The Russian Finance Ministry and the FTS have outlined a number of more specific indicators of a beneficial owner. To qualify as a beneficial owner, a counterparty:

- should not have a legal or *de facto* obligation to transfer income to other persons that are tax residents in jurisdictions that have not entered into a DTT with Russia;¹
- should bear tax liability as a result of receiving the income;
- should conduct actual operations in the jurisdiction of tax residency and use the income received for business purposes;
- should have independent directors that make decisions; and
- should bear risks in respect of the assets giving rise to the income.

Based on administrative guidance and court decisions related to other types of income (dividends, interest, royalties), more specific indicators may be derived when analysing documents provided by a foreign entity to determine whether it can qualify as a beneficial owner. Such indicators include:

- whether there are any assets recorded on the books of the counterparty;
- whether there are any third-party loans (bank financing demonstrates that the counterparty bears risks and that it conducts business operations);
- whether income is received from various sources (e.g., under several leases and/or from other operations);

¹ The tax authorities may challenge structures where the recipient of income transfers such income to a jurisdiction that has a DTT with Russia providing for a less favourable tax regime.

- whether taxes are paid in the jurisdiction of tax residency;
- whether there are any independent (rather than nominal) directors; and
- whether there are any employees, offices or general administrative expenses.

To consider whether an entity qualifies as a beneficial owner, documents containing information on its assets, financing, payment of taxes in the jurisdiction of tax residency, sources of income or restriction of the powers of directors can be requested, such as:

- cash flow and financial statements;
- constitutional documents;
- minutes of the board of directors meeting approving the lease; and
- other documents, as appropriate in the specific case.

According to the Russian Ministry of Finance, the Russian withholding agent is not bound by a specific list of items and should make judgements based on the substance of the information received. The FTS notes that commercial databases, public registers and publicly available information can be used.

LEASE STRUCTURES AT RISK

There is a risk that the tax authorities may determine that the application of a DTT to lease payments is not justified if, inter alia:

- the lessor is an intermediate company that does not own the aircraft;
- the lessor uses solely intra-group financing; and
- the lease payments are made to an account of a finance operations company of the group rather than to an account of the lessor.

POSSIBLE SOLUTIONS FOR LEASE STRUCTURES AT RISK

Russian lessees should determine the beneficial owner status of counterparties on a case-by-case basis. The appropriate risk reduction solution will depend on the specific features of each lease, but may include:

- preparation by the Russian withholding tax agent of a supporting (so-called “defense”) file (for example, obtaining the tax residency certificate of the financing company);
- requiring title to the aircraft to be transferred to a lessor;

- applying a “pass-through” approach to the identification of a beneficial owner; and
- adjustments to the lease arrangements and contract restructuring.

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Please do not hesitate to contact us with any questions.

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