International Tax Associates: tax alert

New interpretation of thin capitalization rules: case LLC "Naryanmarneftegas"

The ruling of Cassation Court of Arbitration of Moscow region on the case of tax dispute between LLC "Naryanmarneftegas" and Federal Tax Service became one of the first rulings of a Court of Cassation after Supreme Arbitration Court of Russia (hereinafter SAC) delivered judgment on thin capitalization rules in case of "Severny Kuzbass". The conceptually new point in this case is i) the extension of the use of thin capitalization rules to loans through foreign sister companies and ii) collecting tax on interest payments (recharacterized into dividends) from the withholding agent himself. The analysis of such a court ruling is important for proper comprehension of tax risks in similar structures of financing and therefore it will help to take the right steps to minimize such risks.

If you have any questions we will be glad to help you.

Kind regards,

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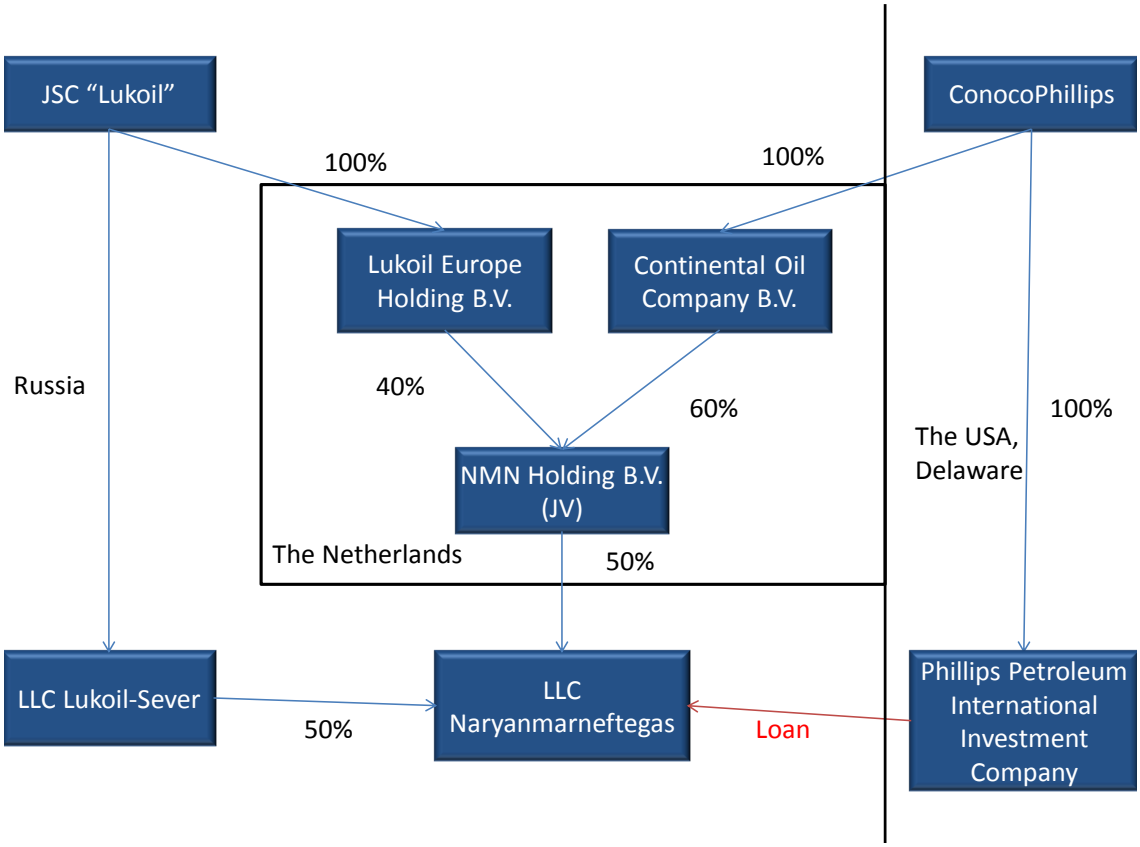
International Tax Associates: informs you on latest court ruling on application of thin capitalization rules in the context of international tax treaties.

The ruling of Cassation Court of Arbitration of Moscow Region was published on February, 28th. The Court dismissed complaint of LLC "Naryanmarneftegas" on (including) the interpretation of thin capitalization rules by tax authorities (Art. 269 of the Russian Tax Code).

It is remarkable that the ruling of the Court was issued in the light of the ruling of SAC on "Severnyi Kuzbass" and during the court session tax authorities referred to this ruling of. Unfortunately, the taxpayer's representatives were not present in the court's hearing and the trial was held in absence of taxpayer's defense. This may be the reason why the ruling appeared to contain fewer details than it was expected.

Facts: in 2004 "ConocoPhillips" established a joint venture with "Lukoil" in order to obtain 30% stake in "Naryanmarneftegas" through indirect participation and also to acquire some entitlements to oil and gas related activities in Russia.

The structure of companies presented in the simplified form is as follows:



It must be noted that under existing rules, thin capitalization rules shall be applied (including) in cases where a Russian company has an outstanding debt to the foreign company which possesses (directly or indirectly) more than 20% of shareholder capital in such a Russian company.

Questions before the Court: the Court had to answer whether thin capitalization rules can apply in case where loans are provided through the foreign company which does not directly or indirectly own any shares of the borrower. Up to the present day the court practice on this issue was favourable for taxpayers and courts declared that in such cases thin cap rules cannot apply. Another important question was if the tax can be collected from the withholding agent.

The view of the tax authorities[1]:

1. Loan agreements[2] between «Naryanmarneftegas» (hereinafter – «NMNG») и «Phillips Petroleum International Investment Company» (hereinafter – «PPIIC») are similar to the form of loan agreements[3], included in the joint venture agreement between "Lukoil" and "ConocoPhillips". This means that loans are provided by the shareholders of the borrower.
2. The joint venture agreement states that funding is to be provided by the subsidiary company of either "ConocoPhillips" or "Lukoil" and this subsidiary shall be the shareholder of the borrower. As «PPIIC» does not meet this latter requirement, the tax authorities argued that the real lender is "ConocoPhillips" and "PPIIC" is used as technical vehicle[4].
3. Following the analysis of the agreement, "Lukoil" and "ConocoPhillips" agreed that funding of the joint venture is performed through debt financing instead of capital financing. According to the framework agreement, joint venture agreement, principles of funding by shareholders and interloan agreement, funding of NMNG is performed by "Lukoil" and "ConocoPhillips" pro rata their stakes in "NMNG", also through indirect participation. These documents envisage the rules of fixing the participation interest of "Lukoil" and "ConocoPhillips" in NMNG in case where interest payments made by NMNG in favor of one party disrupt the balance of this participation interest. These rules are usually applied when funding is performed through equity capital.
4. NMNG requested money directly from "ConocoPhillips". Exactly the same volume of money was transmitted later by PPIIC to NMNG. Therefore, despite the fact that loan agreement was concluded between NMNG and PPIIC, it appears from the subject matter of the agreement that the funds were obtained by NMNG effectively from[5] "ConocoPhillips".
5. Loan agreements of NMNG are not separate contracts but they form an integral part to the joint venture agreement and the framework agreement which "Lukoil" and "ConocoPhillips" are the parties to.
6. The fact that NMNG was funded by "ConocoPhillips" is also confirmed by publicly available consolidated financial statements of "ConocoPhillips" and "Lukoil" where the terms of consolidated funding are stated. The profits of NMNG were declared in accounting reports of "ConocoPhillips" (published on web-site of "ConocoPhillips").
7. As for the basis for re-characterization of interest payments into dividends for profit tax purposes, the Double Tax Treaty between Russia and the USA of 17 June 1992 refers to national rules of the state in which the income arises (art. 11(2) and 10(3) of the Treaty).

The view of the taxpayer[6]:

1. PPIIC is not the shareholder of NMNG and neither directly nor indirectly owns NMNG.
2. NMNG did not conclude loan agreements with "ConocoPhillips".
3. PPIIC is the resident of the USA that is why Russian-US Double Tax Treaty should apply.
4. Russian-US Tax Treaty does not provide a basis for re-characterization of interest payments in dividends.

[1] In view of the ruling of the 9th Arbitration Appeal Court on Naryanmarneftegas case (pages 17 – 33 contain the arguments of tax authorities).
[2] "Shareholders' loan agreements".
[3] The Form of the "Shareholder's loan agreement for shareholders' loans".
[4] This also points out at the integrated structure of companies in loan agreements.
[5] Tax authorities stated that a loan agreement is a real agreement and this assumes appliance of essence over form principle.
[6] In view of the ruling of the 9th Arbitration Appeal Court on Naryanmarneftegas case (pages 14 - 17 contain the arguments of the taxpayer).

5. The Article 807 of the Russian Civil Code stipulates that under a loan agreement the relationship may arise only between lender and borrower.
6. The losses of the company are justified as they are connected with significant financial investments in exploitation of natural resources in order to make profit in future.

Court decision:

During the court session the arguments of the parties were given a hearing, no additional question were raised by judges. The Court of Cassation agreed with the arguments of tax authorities having emphasized the following:

1. The agreements were concluded with the common goal and by the integrated group of companies and that is why these agreements represent the single obligation themselves while the role of financing company was technical.
2. "Lukoil" and "ConocoPhillips" agreed to fund NMNG activities through member companies of their groups.
3. The accounting reports of "ConocoPhillips" in opinion of the Court reflected profits of NMNG where at the same NMNG activities were lossmaking.

Conclusions

1. This court case indicates new risks in debt financing structures where the lender is the foreign sister company. Up till present it was thought that these structures are safe from application of Russian thin cap rules. However, taking into account all circumstances of this case (which are quite similar to many existing structures) including the fact that there were no independent decision-making at the level of the lender, tax authorities were able to prove that thin capitalization rules can be applied to "technical" companies through which the loans are provided.
2. Tax authorities demonstrated top level expertise within this tax dispute:
    a. Tax authorities made extensive use of taxpayer's documents: framework agreement, joint venture agreement, principles of funding by shareholders, interloan agreement and also the reports of companies which were submitted to Security and Exchange Commission of the USA. It appeared to be clear from the documents that the lender is not an independent element in the system of funding the Russian company by the shareholders. This structure was based on the system of integrated agreements which include loan agreements between borrower (NMNG) and foreign lender.
    b. Financial reports of taxpayers (including those obtained through Internet) were used as evidence and the Court paid special attention to this fact in the ruling. According to these reports taxpayers' activities appeared to be not lossmaking, however pursuant to tax declarations the activities were lossmaking.
3. As for non-discrimination argument, the tax authorities were able to convince the Court that Art. 10(3) "Dividends" of the Tax Treaty between Russia and the USA has a direct reference to the domestic legislation if the latter establishes special rules for the income derived from debt-related obligations which provide participation in revenues. The fact that "ConocoPhillips" received profits was proved with the reports of "ConocoPhillips" itself. Unfortunately, the relevance of Art. 23 "Non-Discrimination" of the Tax Treaty was not separately examined by the Court. At the same time, during the court session, tax authorities pointed out at the Ruling of the Supreme Arbitration Court of Russia on "Severnyi Kuzbass" where the Court made conclusion that the discrimination clause cannot be applied for structures where tax avoidance is the only or main purpose.