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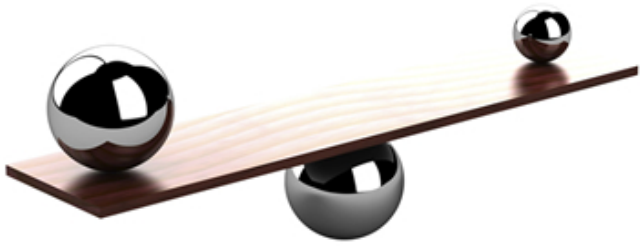

Update on the *Oriflame* case: the Russian Supreme Court rejects cassation appeal review

February 2016 For Russian version click here

On 14 January 2016, the Russian Supreme Court ruled in favour of the tax authorities in a controversial case involving the qualification of a legally separate Russian entity (a limited liability company) as a permanent establishment of its foreign affiliate (**case No. 305-KG15-11546** – in Russian).

The Supreme Court upheld the decisions of the lower commercial courts but based its conclusion on a substantially different rationale. As a result, **the risks caused by their unprecedented approach in the interpretation of the "permanent establishment" notion under Russian laws have been reduced**.

Background

In this case, the Russian tax authorities challenged the deduction of expenses for profits tax purposes and VAT on royalties paid by a Russian taxpayer acting under a sub-franchise contractual scheme ("**RussiaCo**") via an intermediary holding company in the Netherlands ("**HoldCo**") to its affiliated Luxembourg contractor ("**LuxCo**"). The authorities considered that the respective payments amounted to an unlawful tax optimisation tool aimed at transferring funds abroad.

In June 2015 the Commercial Court of the Moscow District held that RussiaCo had been acting as a dependent agent conducting business on behalf, and in the interests, of LuxCo and this constituted the ground for requalifying RussiaCo as a permanent establishment of the above foreign entity. A more detailed background of the case can be found in our previous Alert (**here**).

Supreme Court's rationale

The Supreme Court rejected RussiaCo's reasoning and did not submit the case in question for the consideration of its judicial chamber based on the following arguments:

- RussiaCo's affiliation to LuxCo (via a 100% indirect participation in RussiaCo's charter capital through HoldCo) influenced the economic substance of their relationship and the respective tax consequences;
- LuxCo participated in the management of RussiaCo (even without its employees being physically present in Russia); and
- substantial royalty amounts had been paid under the sub-franchise scheme and RussiaCo suffered systematic losses.

The Supreme Court therefore treated the royalties paid by RussiaCo pursuant to the sub-franchise agreement with HoldCo as a tax avoidance scheme by applying the doctrines of "*lifting the corporate veil*" and "*unjustified tax benefit*", just as the Commercial Court of the Moscow District had done.

Even though **the Supreme Court supported the courts of lower instances, it did not refer to the qualification of RussiaCo as a permanent establishment of LuxCo. Instead, it alluded to transfer pricing principles**.

According to its argumentation, due account taken of RussiaCo's and LuxCo's interdependence, as well as the very high royalty amounts paid by RussiaCo under the sub-franchise agreement, RussiaCo had to prove (i) the reasonable economic rationale behind concluding such an agreement; and (ii) the arm's length character of the agreement.

The Supreme Court therefore actually **reversed the burden of proof on RussiaCo** by requiring it to prove that the transaction had been entered into on market conditions – which is rather surprising because the arm's length character of the transaction had not at all been challenged or questioned by the tax administration.

Comment

It is too early to say what impact the January decision in the commented case will have on the Russian tax authorities' practice in applying the law since RussiaCo still has the possibility to once again refer the case to the Supreme Court for review in the supervision instance. If it does, other arguments may be brought forward in the context of the review.

However, initial comments by the representatives of the Russian Federal Tax Service (as published in the Russian press – see **here**) indicate that the case is unlikely to set a precedent since the latest verifications carried out by competent tax inspectorates with respect to other Russian taxpayers did not reveal the use of such straightforward schemes as the one applied by RussiaCo.

In any case, the Supreme Court's decision may be perceived as a positive development since it opens up the possibility for international groups of companies conducting businesses in Russia under schemes similar to the one in the commented case **to justify their business structures by applying transfer pricing principles**.

Therefore, it becomes even more important than before to **implement a proper transfer pricing policy** and to ensure compliance with the Russian transfer pricing rules, both in terms of notification and documentation requirements. In this respect, Russian companies should be reminded that their transfer pricing files (and, notably, the respective economic studies) must be **updated on an annual basis**.

Moreover, the Supreme Court's reasoning should encourage foreign companies to pay more attention as to how they structure and formalise their contractual relations with their Russian counterparties. In this context, it is advisable to conduct **systematic audits of intragroup contractual relationships** between foreign group companies and their Russian affiliates, both from business and legal perspective. The aim of such audits is to **check the rationale and substance of the business operations** and **prepare, when required, proper supporting documentation** (e.g. from the transfer pricing perspective).

If you have any questions on the matters referred to in this Alert, please do not hesitate to contact CMS, Russia experts **Dominique Tissot** and **Anastasia Prozor** or your regular contact at CMS, Russia.

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