ALTENBURGER

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Protocol amending the double taxation Agreement between the Swiss Confederation and the Russian Federation with respect to taxes on income and capital: entry into force november 9, 2012

In March 2009, Switzerland decided to withdraw its reservation to article 26 of the OECD Model Convention ("MC") and to adopt the MC standards on exchange of information ("EI"). In this context, the Swiss Government started renegotiating several Double Taxation Treaties ("DTT"), including the DTT of 1995 with the Russian Federation.

As you may be aware, the novelties to be found in the Protocol Amending the Double Taxation Agreement between the Swiss Confederation and the Russian Federation with Respect to Taxes on Income and Capital ("Protocol") will unquestionably have an impact on Russian taxpayers, as well as on companies or legal entities related to a Russian taxpayer, holding an account in a Swiss bank.

The major amendments are:

- List of Russian taxes concerned
  Article I of the Protocol, income and wealth tax including profit on sale of movable assets or real estate; Art. VII, in the context of the exchange of information, also Value Added Tax, "VAT";
- New article on dividends;
- Introduction of a zero rate on interest payments, in order to promote investments;
- Removal of the residual tax on dividends paid to pension funds and central banks;
- New definition of "resident";
- Exchange of information but no "fishing expedition"[1];
- Rules against the abuse of treaties.

[1] Requests presented without a specific investigation purpose in the hope for the tax authorities to receive useful information.

We will limit our comments to the three last items.

1. RESIDENT

In article II of the Protocol a resident is defined, in accordance with the MC, as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". The annex to the Protocol stipulates that "the place of effective management of a person other than an individual is situated where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made". The sentence replicates the official terminology of the OECD and is included in most of the DTTs ratified by Switzerland.

We can expect that Russia will, in the near future, adapt its legislation to these changes. Consequently, if a foreign entity is effectively managed out of Russia, even if it is not registered in Russia, chances are that its activities conducted on the Russian territory will be subject to taxes by the Russian tax authorities.

2. EXCHANGE OF INFORMATION

The Protocol implements the OECD international standards in the field of **exchange of information** ("EI") including all ongoing amendments. The Swiss authorities will extend administrative assistance to tax evasion not limiting it anymore to tax fraud.

This said, the EI is not going to be automatic (at this stage at least); it will be allowed only on a case-by-case basis. The Russian tax authorities will not address their request to the banks directly.

a. Procedure

According to the defined procedure, the requests shall:

- Be deposited by the Russian Finance Minister, or by his representative, with the Director of the Swiss Tax Authority ("STA")[2];
- Be limited to the taxes covered by the DTT;
- Specify the name and the address of the relevant person (or company). The person must be identifiable without any doubt[3];
- Specify the name and address of the bank (or any other holder of information), alternatively the number of the bank account;
- Indicate the reason for the request, the taxable period and the type of information sought.

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[2] the STA will then analyze the request in order to establish whether it meets the conditions set by the Protocol for the exchange of tax information, upon which the STA will decide whether it is appropriate to transfer the request to the designated bank(s), to reject the request or to ask the Russian Tax Authorities for additional information.

[3] On this aspect, the Tax Committee of the OECD has proposed changes to the text and the Official Commentary of Article 26 of the MC which were approved by the Council on the 17th of July 2012, asking Member States to accept in certain cases "investigations into a particular group of taxpayers not individually identified" and not only to cases dealing with one taxpayer. In the case of such "group requests", the group of persons concerned and the facts that led to the request must be described by detailed and specific criteria. Switzerland is on the verge of introducing this new evolution in its EI policy. It has already experienced this type of request in the procedure of the US Tax Authorities against UBS: the taxpayers were not identified individually, but by means of the entities set-up by the bank for the holding of the assets in the bank account.
Given this recent development, the distinction between admissible "group requests", on the hand, and prohibited "fishing expeditions", on the other hand might be difficult to assess! For the time being, the Article VII of the Protocol merely specifies that the information requested must be "**foreseeably relevant**".

b. Limits

The requests are limited by the following basic principles stated in the Protocol and confirmed in the Swiss ordinance on executing administrative assistance in accordance with DTTs – soon to be replaced by a Federal Law on international assistance in tax matters:

- **No retroactivity**, the request can only apply to the fiscal year starting after the entry into force of the revised DTT. The Russian authorities will be able to introduce requests relating to the tax period starting January 1st, 2013;
- **Confidentiality**, information given must remain with the tax authority;
- EI cannot be based on **stolen data**;
- **The rights of the taxpayer** must be reserved (right to be informed, right to be heard, to appeal the decision).

c. Right of Appeal

The taxpayer as well as any other person or entity holding information may file an appeal to the Swiss Federal Administrative Court against any final decision of the STA to transmit information. This appeal has a **suspensive effect**, meaning that no communication can be made to the Russian authority before a decision has entered into force.

d. Special case: Swiss or foreign legal entity owned by a Russian taxpayer

Should the Russian Tax Authorities file a request relating to a **Swiss or a foreign company – or another legal entity** – recognized as a separate legal entity distinct from its shareholder(s) EI is, in theory, not possible.

However, with the entry into force of the Protocol, the legal validity of the company – more specifically that the company has been validly set up according to the laws of its place of incorporation, and recognized as a separate legal person – will not be sufficient anymore. The tax authorities will examine the management of the company in order to establish where the "brain" is and may establish the existence of an **effective residence**, as defined under 1.

Russian law is not familiar with this concept of residence but, as already mentioned under 1. changes are expected.
It is foreseeable that a foreign entity, holder of a bank account in Switzerland, but controlled by a Russian taxpayer, or with its principal place of business located in Russia, may in the future be subjected to an EI request by the Russian authorities in application of the Protocol.

3. ABUSE OF THE DTT: CONDUIT ARRANGEMENTS

Article VIII of the Protocol introduces the concept of **"beneficial owner"** already present in the MC. This refers to the person who ultimately controls the attribution of income.

The OECD wishes to prevent a form of abuse which arises when a resident of a non contracting state willfully introduces a person or a company domiciled in a contracting state, as "conduit", for the sole purpose of benefiting from the advantages of the DTT. Such a structure may thus be recognized as abusive, even if legally incorporated, since it does not reflect an economic reality (substance over form). The tax advantage of the DTT will in such case not be applicable.

For example, the Swiss Federal Court ("SFC")[4] refused to reimburse the Swiss withholding tax to a Danish company which was the 100% shareholder of a Swiss company.
In that specific matter, the Swiss company distributed a dividend to its Danish mother company which a few days later transferred the same amount to its shareholder incorporated in Guernsey. The SFC refused to apply the Swiss/ Danish DTT for the reimbursement of the Swiss withholding tax; indeed it considered that the Danish company did not have any real power of disposal and merely acted as a conduit. In particular, the SFC pointed out that the Danish company had no employees, no infrastructure and no economic activity in Denmark. The Danish company was only set up to benefit from the DTT.

4. PRECEDENTS

The SFC has recurrently ruled on the notions of beneficial owner and effective residence in the DTTs.

a. Trusts

In the presence of an **irrevocable discretionary trust**, the SFC[5] recognized the trustee as the effective holder of a Swiss bank account and the EI was not granted. In the specific case under review, the trustee of the trust, neither the settlor nor the beneficiaries, was the only one with discretionary powers to decide who would receive a distribution, how and when income or capital out of the trust fund would be attributed to one or more beneficiaries (full discretionary power). In conclusion the trust could definitely not be considered as "controlled" by another person than the trustee.

In the case of a **revocable trust**, the settlor was not found to be totally separated from the funds transferred into trust because he had the power to revoke the trust and thus maintained control. The beneficiaries were not the beneficial owners[6].

b. Foundations

The same type of reasoning as for the irrevocable discretionary trust, was applied in the case of a **Foundation** structured in such a way that the foundation Council effectively controlled the attribution of distributions.

By contrast, the EI was granted in the case of a Foundation in which the taxpayer was the "first beneficiary"[7].

[4] Decision of the SFC, 28 November, 2005
[5] SFAC, 18 March 2011, A-7013/2010
[6] SFAC, 28 June 2011
[7] SFAC, 10 January 2011, A 6053/2010

5. CONCLUSION

The changes in the Protocol reflect the efforts undertaken these last years by the Member States of the OECD to achieve internationally accepted standards for transparency. In the context of DTTs, Switzerland has increasingly limited its bank secrecy. However, the courts will continue to carefully analyze the cases brought to them in the context of an EI in order to protect a rightful confidentiality and the stability of the Swiss legal system.

It is also foreseeable that Russia will modify its legislation and we therefore strongly advise our clients to analyze the structuring of their assets held in Switzerland and to contemplate making the necessary adaptations. We are at their disposal to assist in this matter.

6. CONTACTS

The content of this newsletter is for information purposes only and does not constitute a legal advice or opinion. Should you require specific advice in this matter, please get in touch with your usual contact at ALTENBURGER or with one of the below authors of this newsletter:

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