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Global Tax Alert

Russian Supreme Court addresses withholding tax on lease payments and classification for tax treaty purposes

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Executive summary

The ruling made by the Economic Disputes Panel of the Russian Supreme Court (Supreme Court) on the case involving *Coiltubing Service LLC* (the Company) was published on 6 October 2020. The Supreme Court referred the case for retrial, asserting that the lower courts had failed to make a proper assessment of the terms of the leasing agreement and the potential applicability of the provisions of a bilateral tax treaty to the lessor's fee.

This is a landmark ruling in terms of understanding the Supreme Court's approach to the taxation of "passive income," and in particular income from leasing activities.

Detailed discussion

Background

The tax authorities challenged the position of the Company in connection with an international financial leasing agreement with a Belarus-resident lessor. The Company did not withhold tax in Russia from the lease payments based on Article 7 – Business Profits – of the double taxation treaty between Russia and Belarus (the Treaty). The tax authorities asserted that the Company was obliged

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to withhold tax at source on the lease payments since income under the leasing agreement must be regarded as "other income" not exempt from taxation in Russia in accordance with Article 18 of the Treaty.

Position of the lower courts

The courts of three instances supported the tax authority's position, maintaining that since the Russian Tax Code treats lease payments as income that is taxable at source in Russia, while the Treaty does not contain specific rules concerning the taxation of such payments, the income in question should be treated as other income not expressly mentioned in the Treaty. Since the Treaty does not provide for other income to be exempted from withholding tax, the courts agreed that the lessor's income in the instant case should be taxed at 20% in Russia.

However, the courts also noted that double taxation is eliminated in this case by the offsetting of withholding tax against the lessor's tax obligations in Belarus.

Position of the Supreme Court

The Supreme Court did not support the courts' conclusions regarding the classification of lease payments for the purposes of the Treaty, citing the following grounds:

Application of Article 7 – Business Profits – of the Treaty: This article establishes that an enterprise should be taxed in the state in which it carries on business. Exceptions are made for certain categories of income for which the Treaty sets forth special taxation rules. It follows that Articles 8 to 17 of the Treaty (dividends, interest, royalties, etc.) must be regarded as special rules that have priority over the general rule of Article 7 of the Treaty. The Supreme Court also points out that a similar approach is provided in the Russian Tax Code as far as the taxation of passive income is concerned.

Application of Article 18 – Other Income – of the Treaty: In order for this article to be applicable, it is essential to make sure that the payments in question are not among the particular types of income expressly mentioned in the Treaty. Since the courts did not make a proper assessment of the terms of the leasing agreement and the possibility of the lease payments being covered by Articles 8 to 17 of the Treaty, the classification of payments under the leasing agreement as other income cannot be considered justified.

In referring the case for retrial, the Supreme Court asserts that the courts must establish to which category of income covered by the Treaty, the lessor's income belongs. In particular, the Supreme Court notes the article of the Treaty on the taxation of interest as potentially applicable to the disputed amounts of lease payments, which constitute income of the lessor from the provision of financing.

Implications

The retrial should result in a definitive clarification of the courts' position regarding the classification of lease payments as interest or other income for the purposes of the application of double taxation treaties. Even now, however, it is clear that there may be a change in approach with respect to the interpretation of international leasing arrangements for tax treaty purposes. The majority of treaties do not make separate reference to the tax treatment of payments under leasing agreements, although Russia does have a few treaties in which this matter is specifically addressed, including some in which payments for the leasing/rental of equipment are treated as royalties.

Given that the tax rates for interest income are to be raised from 0% to 15% in tax treaties with a number of countries (Cyprus, Malta, Luxembourg and certain others), the classification of income under leasing agreements as interest income may lead to such payments being taxed in arrangements in which they were previously exempted as business profits or other income.

Businesses should assess the implications that possible changes in the classification of lease payments might have for existing cross-border leasing agreements, including in view of the expected amendments to tax treaties with jurisdictions that are most frequently used in cross-border leasing arrangements.

The importance of this ruling goes far beyond the specific matter of the tax treatment of leasing arrangements under the Treaty. Businesses should also consider other cases where the "Business Profits" and "Other Income" articles are applied in relation to income.

The OECD Commentaries on the Model Tax Convention remain an important source for the interpretation of international treaties. It is to be hoped that developments in Russian case law on this issue will not be at odds with global trends in the interpretation of international treaties.

Future Alerts will report on developments related to this issue.

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