NEW TAX TREATY SIGNED BY RUSSIA AND JAPAN OFFERS MORE ATTRACTIVE DIRECT INVESTMENT OPPORTUNITIES FOR JAPANESE COMPANIES IN RUSSIA

12 September 2017 | Moscow
Legal Briefings – By **Oleg Konnov and Sergei Eremin**

On 7 September 2017, Russia and Japan signed a new tax treaty (the "**New Treaty**").[1] When it comes into force, the New Treaty will replace the existing Russian tax treaty signed between the USSR and Japan in 1986 (the **"Existing Treaty"**).[2] The New Treaty has not yet entered into force; it will become effective according to its terms upon ratification by both countries and exchange of diplomatic notes.

This a major development aimed at encouraging direct Japanese investment in Russia. Although Russia has succeeded the USSR as a party to agreements concluded by the former Soviet Union, all but two such treaties have been replaced by treaties negotiated directly by Russia. The thirty-year old Existing Treaty is apparently out of date with higher withholding rates, placing Japanese investors in a disadvantageous position as compared to peers from other countries. This has become particularly relevant in recent years when Russia as a member of G20 has joined the BEPS (base erosion and profits shifting) project aimed, in particular, at denying treaty benefits to conduit companies registered at favourable tax treaty jurisdictions. Notably, one of the purposes of the New Treaty is described as the elimination of treaty shopping arrangements aimed at obtaining tax reliefs for the indirect benefit of residents of third jurisdictions.

The New Treaty offers withholding tax rates comparable to the best treaties concluded by Russia with other countries, although some of its other provisions are less favourable. The New Treaty is based on the OECD Model Tax Convention, however it includes some unusual and even unique for Russia provisions that are primarily driven by the general trend to combat tax evasion and aggressive tax planning.

What is new?

- Withholding tax rates on dividends, interest and royalties are substantially reduced (see the table below);
- Gains from the alienation of shares of Russian resident companies may be taxed in Russia if at any time during the 365 days preceding the alienation Russian immovable property represents, directly or indirectly, 50% or more of the value of the entity;
- A detailed limitation on (entitlement to) benefits (LOB) clause is introduced, restricting treaty benefits in respect of dividends, interest and royalties to certain categories of Japanese residents having a sufficient connection with Japan;
- "Other income" (i.e. categories of income not specifically dealt with in the treaty provisions) arising from Russia may be taxed in both Russia and Japan;
- Inclusion of a detailed exchange of information clause in line with the current trends;
- Inclusion of a new clause relating to assistance in collecting taxes;
- Special rules are included to deal with the application of the treaty to fiscally transparent entities, as well as pension funds;
- A "limited force attraction" rule is introduced when attributing profits to the permanent establishment. Profits attributable to the permanent establishment may also be decided based on an apportionment method;
- If a legal entity is deemed a tax resident of both countries, Russia and Japan shall endeavour to determine the entity's residency for treaty purposes by mutual agreement, having regard to its place of incorporation, its place of management, its head office and other relevant factors. Absent of such agreement, the dual-resident entity shall not be eligible for treaty benefits;
- Russia and Japan have agreed to negotiate an arbitration provision to resolve disputes if such a provision is added to any new treaty concluded by Russia;
- A tax residency certificate issued by a Japanese competent authority shall be admitted in Russia without apostil or legalization;

- The New Treaty recognizes attorney-client and similar privilege for the purpose of exchange of information;
- The New Treaty does not restrict application of the Russian controlled foreign corporation (CFC) and thin capitalization rules.

Key features of the New Treaty

- The New Treaty deals with taxes on profits and income of individuals and corporate persons. Unlike most (but not all) of the treaties concluded by Russia, the New Treaty does not apply to property taxes;
- Income from immovable property (as defined in the New Treaty) in Russia may be taxed in Russia;
- The definition of an "agency" permanent establishment is significantly expanded. In particular, when an agent acts exclusively or almost exclusively on behalf of one or more closely related entities, such a person shall not be deemed an independent agent for the purpose of the treaty;
- Similar to the Existing Treaty, construction sites will constitute permanent establishments after 12 months;
- The New Treaty should be read in conjunction with a protocol signed at the same time as the New Treaty;
- The New Treaty has been signed in Russian, Japanese and English. All three texts are equally enforceable, however if there is any discrepancy the English text shall prevail.

When will the New Treaty come into force?

The New Treaty will come into force on the 30th day after Russia and Japan exchange diplomatic notes indicating ratification of the treaty by the respective country. Assuming Russia and Japan ratify the New Treaty and exchange diplomatic notes next year not later than 1 December, the treaty will apply in respect of Russian profits tax and personal income tax from 1 January 2019. Provisions on exchange of information and mutual assistance will become effective upon entry into force of the New Treaty. Until the respective dates, the Existing Treaty will remain in effect. Tax benefits related to individual students, teachers and researchers under the Existing Treaty will be grandfathered.

Conclusions

The New Treaty is a great improvement and makes direct investment by Japanese companies in Russia significantly more attractive. There are many new and unusual provisions in the New Treaty and therefore legal advice should be sought in due course.

Comparative table of Russian withholding taxes[3]

	Russian domestic law	Existing Treaty	New Treaty
Dividends	15%	15%	0%, if the beneficial owner of the dividends is (i) a pension fund which is a resident of Japan, (ii) provided that such dividends are derived principally from administration or pension provisions, retirement benefits or other similar remuneration or earning income for the benefit of other pension funds; 5%, if the beneficial owner is (i) a company which (ii) has owned directly or indirectly (iii) at least 15% of the voting power of the company paying the dividends (iv) for the period of 365 days ending on the date on which the entitlement to the dividends is determined; 15%, if (i) at any time (ii) during 365 days preceding the payment of the dividends (iii) Russian immovable property represents directly or indirectly 50% or more of the value of a company, partnership, trust, mutual investment fund or other investment fund paying dividends; 10%, in all other cases.
Interest	20%	0%, if the beneficial owner is (i) the Government of Japan, (ii) Japanese local authorities or (iii) the Central Bank, Exim Bank or other financial institutions wholly owned by the Japanese Government that may be agreed by the states from time to time, (iv) any financial institutions wholly owned by the Government of Japan, or (v) if the lender is a resident of Japan and the debt is guaranteed, insured or indirectly financed by persons listed above; 10%, in other cases.	10%, if the interest is determined by reference to (i) receipt, sales, income, profits or other cash flow, (ii) change in value of any property or (iii) dividends, partnership distributions or similar payments to the income of a debtor or a related person, or in the case of (iv) any similar interest; 0%, in other cases.
Royalties	20%	0%, in respect of copyright and similar rights; 10%, in respect of patents, trademarks and similar rights.	0%

[1] Convention Between the Government of Japan and the Government of the Russian Federation for the Elimination of Double Taxation With Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance, including protocol (in Russian, in English/Japanese).

[2] Convention Between the Government of the USSR and the Government of Japan for the Elimination of Double Taxation With Respect to Taxes on Income.

[3] Assuming dividends, interest and royalties are not attributable to a permanent establishment that a Japanese investor may have in Russia.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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