

PwC Law Firm Services

News Alert for Law Firms Doing Business in Russia



Russian Court Issues Ruling Addressing How Permanent Establishment of a U.K. Law Firm should calculate its Russian taxable profits

Our colleagues at PwC Russia have informed us of a recent court case that has the potential to impact greatly our law firm clients with branches in Russia. The case addresses how foreign companies operating in Russia through a permanent establishment (“PE”) should determine taxable income and deductible expenses. As discussed below, the case has resulted in firms reexamining their engagement procedures.

<p>Background:</p>	<p>The case involves a determination of</p> <p>Branch is a PE of a U.K. resident company that provides legal services to clients worldwide, including in Russia. Both U.K. and Russian lawyers provided legal services in Russia, and U.K. legal service fees were included in invoices issued to Russian clients by the Branch. Based on monthly invoices issued by the head office, the Branch then deducted the U.K. lawyers’ service fees from its profits tax base (i.e., the U.K. lawyers’ service fees were included both in taxable income and deductible expenses of the Branch).</p>
<p>The parties’ arguments:</p>	<p>The Branch assumed that this method was in compliance with the relevant legislation, including the Russian-U.K. Double Tax Treaty of February 1994 (the “Treaty”)</p> <p>The Russia tax authorities argued that deducting the U.K. lawyers’ service fees was unjustified since these expenses could not be deemed to be the Branch’s costs under Article 7 of the Treaty. Their position was that legal services rendered by the Branch involving U.K. lawyers from the head office represented the activity of the Branch solely, and the engagement of foreign specialists did not exempt the Branch from paying a profits tax on these activities in Russia.</p>

Court decisions:

[1] Moscow Arbitrazh Court Decision on Case No. A40-138835/10-118-799 of 02 March 2011; and Ninth Arbitrazh Appeals Court Ruling of 09 June 2011 and Moscow Circuit Federal Arbitrazh Court Ruling of 09 September 2011 on the same case.

The lower court -- the Moscow Arbitrazh Court -- upheld the position of the Branch, ruling that procedures used by the Branch in accounting for the relevant income (expenses) were in line with Article 7.2 of the Treaty.

Article 7.2 provides that the income of a PE of a foreign company includes income that the PE could have earned if it were a stand-alone entity, engaged in the same or similar activities under the same or similar conditions, as if it were acting independently of the parent entity.

In the lower court's opinion, the Branch's expenses for retaining the services of the head office lawyers represented direct expenses for legal services and should be recognized for tax purposes as if the services had been obtained from third parties.

The lower court stated further that if the branch had been an independent entity, then expenses for engaging U.K. lawyers on projects would have been booked as expenses for subcontracted legal services provided to the Branch, which clearly would have allowed the Branch to make similar deductions.

The Appeals Court, however, overturned the lower court's ruling and found for the Russian tax authorities. The Appeals Court ruled that the payment of amounts by the Branch to the head office as expenses was in fact a mechanism for transferring the Branch's income to the head office. The Appeals Court stated further that the head office lawyers were not acting independently when working on the Branch's projects.

The conclusion of the lower court (that if the Branch were an independent entity, then the relevant expenses would have been recognised as expenses for subcontracted services) was deemed unsubstantiated by the Appeals Court. The Appeals Court concluded that the nature of the company's activities on the whole, and the way the firm distributes its expenses among the various offices, only confirms that the law firm operates in Russia as a single organization and not as two separate entities. The Court found supportive of this position the fact that the foreign lawyers' service fees, a portion of the head office's management expenses, as well as expenses for head office maintenance, professional risk insurance, etc., were on-charged to the Branch, which would not have been possible if the Branch were an independent entity.

The Court of Appeals decision is now the final holding in the case.

What's next for law firms with a branch in Russia?

[2] Moscow Arbitrazh court Decision on Case No. A40-37463/07-127-218 of 22 October 2007; Ninth Arbitrazh Appeals Court Ruling of 09 January 2008 and Moscow Circuit Federal Arbitrazh Court Ruling of 17 April 2008 on the same case.

In an earlier case involving the same issue, the Russian lower and appeals courts affirmed the position of the taxpayer[2]. PwC Russia interprets this later ruling as representing a shift in the courts' thinking on the issue.

Foreign law firms with a branch in Russia that use similar procedures when accounting for the income (expenses) of a Russian branch (representative office) where services are provided to Russian clients by attorneys in other firm offices outside of Russia should consider options for minimizing potential issues should the Russian tax authorities file similar claims against them. In particular, these firms should consider whether the current structure of their Russian operations would support a similar finding as the Appeals Court decision. Firms should reconsider how they are engaged by Russian clients and how legal services provided by lawyers outside Russia are billed.

For more information, please contact Stanley Kolodziejczak at 646-471-3160, Gregg Sincoff at 646-471-1335, or Nancy Regan at 646-471-6104 in New York; and Alan Broach at +7 (495) 967-6063 and Olesya Kiseleva at +7 (495) 223-5173.

Solicitation

© 2011 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved.

PwC refers to the US member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

General Disclaimer:

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.