The Russian Permanent Establishment: A Trap for Foreign Distributors?

The author discusses the Oriflame decision, which held that both a tax deduction for licence fees and input VAT should be denied, as Oriflame OOO was the PE of its Luxembourg grandparent company. The case is discussed from an international perspective considering, inter alia, OECD Action Point 7 on preventing the artificial avoidance of PE status.

1. Introduction

The dispute at issue in this article, which entered into a new phase as a result of the cassation decision of 11 June 2015 of the Federal Arbitrazh Court of the district of Moscow, has often been mentioned in the international press in recent years. It concerns the manner in which the Swedish multinational Oriflame, on the one hand, distributes cosmetics products on the Russian market and, on the other, makes use of intangible property rights in order to shift their Russian profits via the Netherlands to Luxembourg. Various commentators have expressed the view that this decision, if upheld by the Russian Supreme Court, will have far-reaching consequences for foreign (multinational) enterprises wishing to distribute their products on the Russian market.

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It is useful to examine this decision from a more international perspective for several reasons including the fact that:

1. RU: Federal Arbitrazh Court of the district of Moscow, 11 June 2015, Case no. A40-138879/14. Russia has separate courts for commercial and tax disputes, referred to as Arbitrazh courts. The procedures before these courts are provided for in the Code on the Arbitrazh Procedure. The somewhat confusing name “Arbitrazh” refers to the commercial state courts that existed during the Soviet era when special institutions existed for arbitration between state institutions. See, for example, W.A. Timmermans, Contracteren met Russische partijen. Contracteren I, pp. 25-33 (Mar. 2010).

2. Oriflame also had a similar dispute in Kazakhstan. In Kazakhstan, where it uses the same distribution model, the dispute was limited to the Kazakh withholding tax on royalties (T. Balco, Kazakhstan: The Oriflame Case – Beneficial Ownership in Sub-License Arrangements, in Tax Treaty Case Law Around the Globe 2014 pp. 151-159 (E. Kemmeren et al eds., IBFD/Linde Verlag 2015)).

3. Available at global.oriflame.com.


9. For an overview of products and countries from which Russia imports see https://atlas.media.mit.edu/en/profile/country/rus/.
In short, Oriflame OOO acquires products from the Luxembourg parent company Oriflame Cosmetics S.A. It transfers, furthermore, via the Netherlands intermediary company, licence payments for the use of certain intellectual property rights to Oriflame Cosmetics S.A. This concerns the following payments:

- 2% of the invoiced turnover of products that are imported into Russia for the use of the trademark “Oriflame”, less the transportation expenses, insurance and packaging in respect of the imported products (until 2010, the rate was 5%);
- a fixed yearly fee of EUR 4 million for the use of the commercial name “Oriflame” (as of 2010); and
- a fixed yearly amount of EUR 20 million for the use of certain know-how (as of 2010).

Based on the contents of the decision, it is not clear what the exact object of the licence agreement is. Although this is not mentioned in the text of the decision, the business model of the Oriflame Group is based on a “direct selling” technique via independent consultants. A useful guide is the 2010 annual report of the Oriflame Group, which the Cassation Court referred to in its decision. It mentions on page 60, for example, that, “Oriflame has a decentralised organisation where the local sales companies take full responsibility for managing their sales consultants”.

The licence payments, which were transferred by Oriflame OOO in 2009 and 2010 to the account of Oriflame Cosmetics B.V., and were deducted for tax purposes from revenue, amounted to RUB 1,027,967,403 (approximately, EUR 26,535,666), respectively. The VAT (18%), which Oriflame OOO as tax agent of the foreign company has to pay was imputed in respect of its output VAT.

In addition, the directors of Oriflame OOO were the same as the directors of the Netherlands intermediary company and Oriflame Cosmetics S.A. Moreover, the Russian internet pages of the Oriflame group are part of a global website that is operated, managed and maintained by Oriflame Cosmetics S.A., which can be accessed by consultants and is available for consumers to place orders. Notwithstanding the apparently very good sales results, Oriflame OOO has, for years, been a limited loss making entity, mainly due to the size of the licence payments.

After a tax audit resulting in a formal report of 18 November 2013, the Russian tax authorities disallowed, on 13 March 2014, in the hands of Oriflame OOO, both a tax deduction for the licence fees and a VAT refund. They increased the taxable profit of the company proportionally. According to the tax authorities, Oriflame OOO is the permanent establishment (PE) of the Luxembourg parent company and cannot, in this capacity, deduct the licence fees from its revenue. Furthermore, in that capacity, the company is also not able to be the tax agent and thus impute the input VAT.

A separate issue concerns the fact that, upon importing the cosmetic products, and thus in determining their customs value, the amount was not increased by the licence payments. Under a separate procedure, the courts also ruled in favour of the Russian tax authorities on this issue.

The Cassation Court did not consider this issue.

10. “Direct Selling” is the marketing and selling of products directly to consumers away from a fixed retail location. Modern direct selling includes sales made through the party plan, one-on-one demonstrations and other personal contact arrangements, as well as internet sales (https://en.wikipedia.org/wiki/Direct_selling).


13. RU: SC, 16 Dec. 2014, Case no. 305-KG 14-78. On 16 Dec. 2014, the Russian Supreme Court referred the case, due to violations of procedural provisions, to the Arbitrazh Court of the city of Moscow. This Court will have to rule on the case in the first instance.
3. Decision

The cassation decision of 11 June 2015 of the Federal Arbitrazh Court of the district of Moscow is the result of a cassation request submitted by Oriflame OOO against the decision of the Arbitrazh courts of the city of Moscow. These local courts ruled in favour of the Russian tax authorities (on 4 December 2015, in the first instance, and on 6 March 2015, upon an appeal).

In the request, Oriflame OOO argued that the decisions were made without taking into account the factual circumstances. Firstly, the activities in Russia do not constitute a PE for the foreign company Oriflame Cosmetics SA. Secondly, even if it were accepted that the local company represents the Luxembourg company, it would still be eligible to deduct the payments under the licence agreement, the amounts being at arm’s length. Finally, it does not matter, for VAT purposes, whether or not the company is a tax agent because the tax, which benefited the budget of the Russian Federation, was withheld from the licence payments.

The Cassation Court rejected the request. According to the Court, the Russian tax authorities could rightfully conclude that, taking into account the PE criteria provided for in article 306(2) of the Tax Code of the Russian Federation (hereinafter TC/RF), the local company is a dependent agent of the Luxembourg company:

1. Firstly, the Russian tax authorities correctly decided that Oriflame OOO does not perform its activities in an independent manner, an essential criteria of a company having a separate legal personality distinct from its members. The tax authorities arrived at this conclusion on the basis of the factual finding that the Board of Oriflame OOO consists of employees of the company Oriflame Cosmetics SA, which are also appointed as directors of the Netherlands intermediary company.

2. Secondly, Russian consumers understood, taking into account the fact that during the 2009 and 2010 taxable periods the company Oriflame Cosmetics S.A. was the most important supplier of Oriflame OOO, that the local company was a representative of the foreign company, namely Oriflame Cosmetics S.A., and that they (the consumers), in reality, maintained direct relations with this foreign company. This point of view is, among others, based on the fact that the Russian internet pages are operated, managed and maintained by Oriflame Cosmetics S.A., the company that is also mentioned in the catalogue (according to Oriflame it is literally a “shop without walls”).

The Cassation Court, in support of its decision, refers to paragraphs 34, 37 and 38.3 of the Commentary on Article 5 of the OECD Model (probably the 2010 version). Paragraphs 34 and 37 provide, firstly, that if a dependent agent is considered to be a PE, this applies not only to the agreements 34 and 37 provide, firstly, that if a dependent agent is considered to be a PE, this applies not only to the agreement it has entered into on behalf of the principal, but also to all other activities that could be attributed to that principal and, secondly, the agent will not constitute a PE of the enterprise on whose behalf he acts only if he is independent of the enterprise both legally and economically and acts in the ordinary course of his business when acting on behalf of the enterprise. Paragraph 38.3 provides that:

An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

Oriflame OOO is, according to the Russian tax authorities, clearly a dependent agent because consumers assume, apparently, that they are purchasing products from a Luxembourg company, implying that the Russian and Netherlands companies are merely intermediaries that are fully controlled by the foreign company. The cassation decision clarifies that the conclusion that “the activities of Oriflame OOO, having the special features of a dependent agent, are the activities of the foreign company” is legally valid.

The argument that, in establishing the taxable profit of Oriflame OOO, one has to take into account the expenses incurred via the sublicence agreement and paid to Oriflame Cosmetics S.A., was rejected by the court based on two counterarguments:

1. Based on the fact that the principal amount of the licence fees received by the Netherlands company under the sub-licence agreement are transferred to the Luxembourg company, the Russian tax authorities rightfully established that the Netherlands company is merely a (technical) intermediary between the Russian company and the Luxembourg company Oriflame Cosmetics S.A. The Court referred to paragraph 3 of Resolution no. 53 of the Plenum of the Supreme Arbitrazh Court of the Russia Federation of 12 October 2006, which holds that a tax advantage can be unlawful if transactions that do not coincide with economic reality do not have any reasonable economic or other motive (purposes of a business nature). According to the Court, there are no sound business motives that justify the existence of the Netherlands intermediary company.

2. Secondly, Oriflame OOO did not demonstrate that the licence payment covers head office expenses, expenses which, while chapter 25 of the TC/RF does not allow for this, still qualify for a tax deduction based on article 7 of the Russian model treaty (and, thus, in this instance, the Luxembourg-Russia Income Tax Treaty (1993)). The Court also clarified that the determination of an arm’s length consideration for the licence payment is not possible due to the lack of a relevant market. Furthermore, it
confirmed the statement of the Russian tax authorities to the effect that, in accordance with the Russian Civil Code, there would be no protected know-how. Such know-how would concern information that is publicly and readily available.

Also, in respect of the deductibility of the input VAT, the Federal Cassation Court agreed with the statements of the lower courts. The deductibility is, according to Resolution 53 of the Plenum of the Supreme Arbitrazh Court of the Russian Federation of 12 October 2006, not allowed because it would confer an unlawful tax advantage.

4. Formal and Quality Aspects

4.1. Procedural aspects

One fact that can be gleaned from the decision is that Russian tax disputes, in comparison to, for example, Belgian disputes, are apparently settled extremely quickly. Following the administrative phase (the 2011 and 2012 tax audits), the formal report of 18 November 2013 and a decision of 13 March 2014, this case took only 15 months for the cassation request to be rejected.

Russian tax disputes between the Russian tax authorities and legal entities and entrepreneurs are, following an obligatory administrative phase that typically includes a tax audit, handled by three instances of Arbitrazh courts. If, thereafter, the parties are still not satisfied with the cassation decision, they can submit the case to the Russian Supreme Court (since 2014). The Supreme Court is not, however, obliged to rule on every case submitted to it. The cassation decision is first scrutinized by a single judge. It is only heard by the plenum if the decision of the Arbitrazh court violates:

1. the integrity of the interpretation and application of the legal provisions;
2. human and civil rights and freedoms, as stipulated in general principles and provisions of international law and the international treaties of the Russian Federation; or
3. the rights and legal interests of the people or other rules of public interest.

As the case, in the interim, has been submitted to the Russian Supreme Court, the Supreme Court will have to determine, among other things, whether or not the viewpoint expressed in the decision in cassation violates the applicable income tax treaties that the Russian Federation has entered into with Luxembourg and the Netherlands.

4.2. Application and interpretation of income tax treaties

Although the text of the cassation decision clearly demonstrates that the Federal Cassation Court has taken notice of the applicable tax treaties, it did not actually examine those treaties. The Court, in applying the national tax provisions, limited itself to a few selective references to the Commentary on the OECD Model.

This legally questionable working method seems to be symptomatic. Based on recent case law and scholarly comments, one can conclude that Russia, as an observer-member, is not consistently giving much heed to the manner in which income and capital tax treaties should be applied and interpreted. One example is the decision of the Plenum of the Supreme Arbitrazh Court on thin capitalization in Severny Kuzbass (2011), wherein the Court held that international tax treaties should not influence national provisions that combat tax evasion (i.e. fraud).

The consequence of this decision, according to Timofeev and Zelenskaya (2013), is that even in disputes where there is no tax evasion, the national thin capitalization provisions have priority over the treaty provisions.

According to Konnov, Smirnova and Smith there is also a need for clear rules in respect of the determination of the taxable profit of a PE (2015). Reference could be made, for example, to the CMS Cameron McKenna (2011) case wherein a Russian branch of an English law firm was not allowed to deduct head office fees from revenue from its Russian projects, which was recorded as turnover of the branch.

Another recent questionable case concerned the position that the head office expenses of a UK partnership were not deductible because the entity, as such, could not invoke the relevant Russia-United Kingdom Income Tax Treaty (1994).
It is at least a consolation that the Commentary on the OECD Model can act as a guide in respect of Russian inbound activities and investment, which, however, means applying this guidance from a Russian perspective. To put it in the words of Professor Hinnekens, “[w]hat is considered law on one side of the border does not necessarily count as law on the other side”. In other words, foreign enterprises must not rely on the manner in which tax treaties are applied in most Western countries. They have to examine, from a local perspective, whether or not their (distribution and business) model entails tax risks (VAT, customs duties and income taxes) and are thus viable.

5. The Russian Permanent Representation

5.1. In general

The Russian PE provisions, known as “permanent representation” provisions (Постоянное представительство), closely match, from a textual perspective, the provisions of the applicable treaties and the OECD Model (2010). Article 306 of the TC/RF contains a non-exhaustive list of activities that qualify as a “permanent representative” (a branch or representation office, an office, a workplace, an agency, a building or construction site, etc.) and a negative list, i.e. OECD based auxiliary and preparatory activities. Further, the concept of a “place of management” is considered a permanent representation. For instance, the Arbitrazh Court of the District of Moscow, on 2 August 2012 in cassation, confirmed that the representation office of the Swiss company Medas Trading AG is a PE, as the directors of the Swiss company make commercial decisions in the representation office, as well as the fact that 100% of the profitable activities of the company are performed in Russia. Furthermore, the national agency provisions are more or less the same as the provisions of article 5(5) and (6) of the OECD Model (2010). Typically, a PE will only arise if the following criteria are met (article 306(9) of the TC/RF):
- the foreign company carries on, on a regular basis, through another legal or physical person (the agent) commercial transactions in Russia;
- the agent has a fixed establishment;
- the agent has the authority, which it usually exercises, to conclude contracts for the foreign company and negotiate their material conditions;
- the acts of the agent bind the foreign company; and
- the person is not an agent or broker who acts in the normal course of its business.

What is noteworthy is the fact that paragraph 1 of the Protocol to the new Belgium-Russia Income and Capital Tax Treaty (2015) states that:

In the interpretation of the provisions of the Convention which are identical or in substance similar to the provisions of the OECD Model Tax Convention on Income and on Capital of 1977 (with later amendments), the tax administrations of the Contracting States shall follow the general principles of the commentary of the Model Convention provided the Contracting States did not include in that commentary any observations expressing a disagreement with those principles and to the extent the Contracting States do not agree on a divergent interpretation in the framework of paragraph 3 of Article 24 of the Convention.

Burk and Konnov (2009) noted that there is still not much case law on the PE concept in Russia and that, partly based on the Grinsley Holdings Limited case, the Russian tax authorities take the view that a dependent agent is only a PE if it actually acts in the name of the foreign company. The case law published since 2009 is, in any event, indicative of the finding that, in Russia, primary importance is attached to the factual (and not so much the legal) circumstances under which a foreign company is active on the Russian market. This approach was recently confirmed in the Astellas Pharma Europe (2015) case, wherein the taxpayer argued that preparatory and auxiliary activities related to product registration market research and promotion gave rise to a PE under the applicable treaty because these activities were, according to the Court, factually performed for the benefit of the Russian distributor of the products.

5.2. Profit

The Russian tax authorities and the Arbitrazh courts are, in this case, of the opinion that solely head office expenses can be deducted from the profits of a PE. To the extent that the licence fees do not represent head office expenses, they are not tax deductible.

This position, which is based on the argument that legally no transactions can take place between a head office and its branch, can clearly be criticized. These criticisms are certainly justified given that although, in Russia, the taxable profit of a PE is usually determined on the basis of the “direct allocation method”, the Russian tax authorities take (at least towards Oriflame) the (opposite) position in

37. Burk & Konnov, supra n. 32, at p. 533.
38. For example, RU: Arbitrazh court of the North-West district, 16 Dec. 2010, Case A56-6861/2010. Gide Loyrette Nouel Vostok, a cassation decision in which the main argument was that the Russian activities were equal to the main activities of the foreign enterprise (and thus were not preparatory and auxiliary activities). See, for an overview of this case law, Konnov, Smirnova & Smith, supra n. 25, at sec. 2.1.4.
39. RU: Arbitrazh Court of the district of Moscow, 6 Feb 2015, Case no. A40-155695/12, discussed in V. Vitko, Treaty between Russia and Netherlands – Federal Arbitration Court of Moscow: Circuit determines that auxiliary and preparatory activities may create PE under certain circumstances (31 Mar. 2015), News IBFD.
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The rationale behind this is to help ensure that the independence of a company, for purposes of national and international tax law, is safeguarded. Paragraph 40 of the Commentary on the OECD Model (2010) states the following:

It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

The first argument of the Cassation Court, which is that Oriflame OOO is directed by persons working for the Luxembourg parent company and, therefore, is a dependent agent within the meaning of the applicable treaty provisions, can clearly only be upheld if the second argument (i.e. that Oriflame OOO concludes contracts in the name of Oriflame Cosmetics SA) is valid.

Practically, this distribution model also means that when the fees for the intellectual property rights are already included in the purchase price of the products (the calculation for the customs value), they would, subject to a transfer pricing adjustment, not be part of the profits of the subsidiary or PE. What is notable in this context is the Cassation Court’s failure to take into account this issue.

5.4. Direct representation

Taking into account the previous sections, the question that arises is why, and on what legal grounds, the Russian tax authorities have deviated from the usual rules. By factually accepting that Russian customers legitimately assume they are interacting with the foreign company, it seems that the Russian tax authorities have accepted the theory of direct representation, which could create direct claims between the principal (Oriflame Cosmetics S.A.) and the co-contracting party (the consumer), which would create a personal PE for the principal. They seem, notwithstanding the fact that, from a legal perspective, this is a buy-sell distribution model, to take the position that the foreign enterprise is bound by the acts of the agent Oriflame OOO.

The decision in cassation does not, regrettably, contain any further analysis of this position. In any event, the position is contrary to the position taken by the French Supreme Administrative Court in Zimmer (2010) and the Norwegian Supreme Court in Dell (2011). According to the French Administrative Supreme Court, which employs a strict legal approach fully endorsed by Wustenberghs and Puncher (2011), it is a requirement that the contracts be


43. See the case law referred to by Konnov, Smirnova & Smith, supra n. 25, at 4.1.1.


45. Circulare MinFin, 7 May 2008, No. 03-03-65.


47. Sec. for an extensive discussion: T. Wustenberghs, Heffingsbevoegdheid bij grensoverschrijdende ondernemingswinsten; De vaste vordering op de heffing para. 597 et seq. (Lancier 2005).


concluded “in the name of” the foreign enterprise.51 The transactions must, in other words, be directly attributable to the principal, creating rights and obligations for the latter. Such a view is consistent with the original intent of the model treaties, which are of a civil nature and thus emphasize the legally binding nature of the action of the agent.52 The Norwegian decision confirms this position while concluding that Dell AS does not constitute a personal PE of the Irish company Dell Product due to the fact that the latter is not bound by the transactions of the Swedish company Dell AS.53

5.5. Some thoughts

The question arises whether the case at hand follows a “substance-over-form” approach. According to paragraph 32.1 of the Commentary on Article 5(5) of the OECD Model this would, for example, nonetheless require that Oriflame Cosmetics S.A. be effectively bound.54 Also a “common law” approach does not really seem appropriate. The Russian legal system is mainly based on principles of civil law.55 Furthermore, this approach also requires that the representative be able to bind the principal. The argument of the Russian tax authorities and the Arbitrazh courts does no coincide with these requirements. It is, after all, Oriflame Cosmetics S.A., the “principal”, that is acting via its website and, therefore, creating a situation that could bind it. Or do these elements play a role after all? Wilkie (2010) observes, while commenting on the Zimmer case, that treaty provisions that are based on article 5(5) of the OECD Model (2010) do “not necessarily confine themselves to any particular kind of representation such as agency, and indeed may be more broad and elusive of a variety of representation arrangement”.56

Another useful reference in this respect can be made to Avery Jones and Lüdicke (2014) concerning the origins of article 5(5) and 5(6) of the OECD Model and the difference between common and civil law.57 In this respect, the text of the first draft of article 5(5) is of particular interest:58

4. An agent acting in one of the territories on behalf of an enterprise [pour le compte d’entreprise] of the other territory — other than an agent of an independent status to whom paragraph 5 applies — shall be deemed to be a permanent establishment in the first-mentioned territory if the agent:

(a) has and habitually exercises a general [26] authority to negotiate and enter into [27] contracts on behalf of the enterprise [pour le compte de l’entreprise] unless the agent’s activates are limited to the purchase of goods or merchandise, or

(b) habitually maintains in the first-mentioned territory a stock of goods or merchandise belonging to the enterprises from which he regularly delivers goods or merchandise on its behalf.

An employee of the enterprise shall be deemed to be a permanent establishment of the enterprise if he also satisfies the further conditions of (a) and (b) [...].

Contrary to the current text of article 5(5) of the OECD Model, it is not the activities of the agent that constitute a PE for the foreign enterprise but the agent itself who constitutes the PE, which is the same position taken by the Russian tax authorities and the Arbitrazh courts. Paragraph 35 of the Commentary on Article 5(5) of the OECD Model (2010) seems to be relevant:

[...] It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

5.6. The Philip Morris case

As explained in section 7.3, the position of the Russian tax authorities and the cassation decision are not based on the question of whether Oriflame OOO has the capacity of a dependent agent, but on whether the activities of the Oriflame group in the Russian territory (with possible abuse of the legal personality of Oriflame OOO) give rise to a PE. The Cassation Court explicitly concludes that, based on the circumstances, one could rightfully conclude that the activities of Oriflame OOO, having the specific features of a dependent agent, are the activities of the foreign company.

The cassation decision is comparable to the decision of the Italian Supreme Court in the Philip Morris (2002) case.59 A German Philip Morris group company obtained royalties from the Italian tobacco administration for, among other things, the use of the Philip Morris trademark. An Italian Philip Morris group company, which also produced and distributed cigarette filters, supervised the execution of the licence agreement. According to the Italian Supreme Court, an Italian company can constitute a multiple PE of foreign companies that, based on a global strategy, belong to the same group. In this instance, the analysis should be performed at the group level. Furthermore, supervisory and control activities are not regarded as being of a preparatory and auxiliary nature. The participation of representatives or employees of an Italian company in the phase where the agreement between the foreign company and

45. Some thoughts


54. This is also the position that Witsenengbergh & Puncher take in supra n. 50, at p. 245.

55. The Russian legislator, when drafting the new Russian Civil Code, received extensive advice from foreign legal scholars, including American, French, Italian and German lawyers, but mostly from Netherlands legal professionals. Moreover, Russian contract law is based on the Vienna Convention on the Law of Treaties (23 May 1969), Treaties IBFD, as well as the UNIDROIT Principles of International Commercial Contracts. See W.A. Timmermans, Contracten met Russische partijen, Contracten 1, p. 23 (Mar. 2010).

56. IS Wilkie, Constructive Permanent Establishments: Canadian Comments on the Zimmer Case, 17 Intl. Transfer Pricing 1, p. 353 (2010), Journals IBFD.

57. J.F. Avery Jones & J. Lüdicke, The Origins of Article 5(5) and 5(6) of the OECD Model, 6 World Tax J. (2014), Journals IBFD.

58. FC/WP1(56)1 (17 Sept. 1956).

another Italian company is being concluded could fail with the concept of the authority to conclude contracts in the name of the foreign company, even when there is no formal capacity to represent. The analysis of the existence of a PE, including the notion of dependency and participation in the conclusion of agreements, should not only be made based on formal considerations, but from a factual perspective.

At a conference of the Italian University of Castellanza, which took place in October 2007, the president of the tax section of the Italian Supreme Court, Enrico Altieri, expressed his astonishment that this decision has been so heavily criticized. The activities of the Italian company were artificially split off, allowing the group to invoke the exceptions provided for in article 5(4) of the OECD Model (preparatory and auxiliary activities).60,61

A similar analysis can be found in two 2012 Spanish cases (the Roche62 and Dell63 decisions) where the emphasis in assessing the position of the group company was also on the factual substance. The Roche case concerned, for example, a restructuring of a fully fledged distributor into a contract manufacturer and commissionaire agent. The Spanish Supreme Court ruled that Roche had a PE because it produced products in Spain and promoted its products in Spain. Although the local entities were not allowed to conclude contracts in the name of Roche, based on other and connecting activities it was concluded that, globally, a PE existed.64

6. Base Erosion and Profit Shifting

6.1. The business model

The actual business model of the Oriflame group, as described in section 2., clearly leads to the result that the profit on the sale of cosmetics products is being "taxed" in Luxembourg instead of in Russia. Although this cannot be derived from the text of the cassation decision, it is likely that, in Luxembourg, the Oriflame Group could benefit from the favourable tax regime for income from intellectual property rights (at an effective tax rate of 5.7%).65

In this respect, it is useful to consult the annual report of the Oriflame Group, which describes the group’s approach to the market. The 2014 annual report contains the following description:

A sales force of over 3 million independent Oriflame Consultants has seized this opportunity and is consuming or marketing Oriflame’s extensive portfolio of beauty products, creating combined annual net sales of around €1.3 billion. The basis for Oriflame has always been social selling. The business model is evolving and is today to a large extent an online model with a digital strategy aiming to support the overall vision of becoming the number one direct selling beauty company. As demand for online availability increases, the Oriflame Consultants are provided with new, efficient tools to enable them to conduct their business activities in an efficient way. Moreover, the digital arena provides an increasingly important brand building channel. Today 90 percent of the Consultants are active online and over 90 percent of all orders are placed online.66

The 2010 Oriflame annual report, the year in which the group had 2.1 million independent consultants in the CIS countries, mentions the following.67

The Oriflame catalogue is how the brands and products come to life for Oriflame’s consultants and consumers. The catalogues are literally shops without walls, providing the consultants with their most important, tangible sales tool – making the whole difference between good sales and great sales. By providing the ultimate shopping experience to consumers, the Oriflame catalogue supports the business opportunity to its consultants. The stronger the consumer offer, the greater the potential to sell and grow the business.

The question arises how this working method relates to, among other action points, 1 ("Address the tax challenges of the digital economy"), 6 ("Preventing the artificial avoidance of PE status") and 8 ("Guidance on Transfer Pricing Aspects of intangibles") of the OECD Action plan on Base Erosion and Profit Shifting and the various discussion reports and proposals that have been drafted on these points.68

6.2. Digital economy

From the OECD’s Report on the Digital Economy69 it can be concluded that the analysis of the manner in which a foreign enterprise is active in a country should primarily be factual.70

The PE concept effectively acts as a threshold which, by measuring the level of economic presence of a foreign enterprise in a given State through objective criteria, determines the circum-

61. The scope of this case law (under the influence of the Zimmer case) would, according to Pistone, be limited considerably by the Italian Supreme Court in respect of commissioner structures. The mere act of entering into an agreement by the commissioner is not sufficient to decide whether or not there is a PE. P. Pistone, Italy: an agent activities of an Italian Subsidiary constitute a Permanent Establishment of Its Foreign Parent?, in Tax Treaty Case Law around the Globe 2013 pp. 73-80 (IBFD/Linde Verlag 2013).
64. “The court should”, according to Soler Roch, “analyse whether the subsidiary does or does not meet the requirements necessary for it to be considered a PE according to the relevant treaty provisions. That is what the courts did in these two cases” (M.T. Soler Roch, Spain: Permanent establishment – The concept of ‘fixed place of business’ and the concept of ‘dependent agent’, in Tax Treaty Case Law around the Globe 2013 supra n. 61, at pp. 81-95. See also F. Carreño & R. Rodriguez, Supreme Court Decision: New Criterion for Deemed Permanent Establishment while Acting through a Subsidiary Company, 19 Intl. Transfer Pricing J. 4 (2012), Journals IBFD.
70. Id.
In the report, the position is taken that an enterprise has a PE when it is "substantially digitally present" in the economy of the source state. A proposal has been put forward to replace the PE concept with a "substantial presence test," which would necessitate a certain degree of physical presence before taxation can take place in the source state. Indicators of "substantial presence," according to the report, would include, among other things: (1) maintaining client relations for more than 6 months, coupled with a certain degree of physical presence (either directly or via a dependent representative), (2) the supply of goods and services via a website in the local language or deliveries through a local supplier, etc. 71

It cannot be denied that the Russian internet pages of the Oriflame Group, managed and operated by Oriflame Cosmetics S.A., are being consulted and have an economic impact in Russia, in particular where orders are placed via these pages and delivered locally by the group. The decision of the Federal Arbitrazh Court seems, therefore, to be a forerunner to the approach set out in the BEPS report on the digital economy.

6.3. Treaty abuse

According to the OECD, treaty abuse is one of the most fundamental causes of the BEPS problem. 72 Against this background it is, at first glance, not clear why the Oriflame group used a Netherlands intermediary company. In any event, it was not to avoid any source tax on royalties (first type of abuse). The competence to tax is allocated to the residence state in both the Netherlands-Russia Income Tax Treaty (1996) and the Luxembourg-Russia Income Tax Treaty (1993). The purpose of the intermediary company was probably to mitigate the possible PE and customs risks. 73

Such forms of avoidance (as the case may be) are also being targeted (second type of abuse). The 2014 BEPS Report concerning treaty abuse is clear. 74 It states that:

[... the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that may result from the work on other aspects of the Action Plan [and] [...]

6.4. Permanent establishment

The purpose of Action Point 7 of the BEPS Action plan is to amend the PE definition to avoid abuse (more precisely the artificial avoidance of PE status). 75 The discussion reports of January 2015 and June 2015 are limited primarily (and logically) to commissioner structures and structures whereby functions and risks are being split off (in order to rely on the exceptions provided for preparatory and auxiliary activities). 76

The method and structure used by the Oriflame group is not explicitly mentioned in the 2014 report and published discussion reports. Hence, the question arises whether the approach of the Russian tax authorities, as confirmed three times by a Russian court, fits within Action Point 7. Does the case, in fact, concern an artificial evasion of a "permanent establishment"? As discussed, the approach of the Russian tax authorities is contrary to the general opinion that a subsidiary, as such, is a separate legal entity with legal integrity of which should be maintained for tax purposes. Secondly, it is customary that, within a multinational group of companies, the head office control and manage the enterprise.

Again a reference to paragraph 35 of the Commentary on Article 5(5) of the OECD Model (2010) seems to be relevant (see section 5.5.). Most likely, based on an analysis of the factual circumstances in light of the provisions of Article 5(1) and (2) of the Luxembourg-Russia Income Tax Treaty (1993) it can be concluded that the Luxembourg company has a PE in Russia. The phrase from the 2010 annual report: "The catalogues are literally shops without walls" bridges and connects the digital presence with the physical presence.

71. Id., p. 146. See also J. Luts, Base erosion and profit shifting: een stand van zaak, Fiscoloog Internationaal 369, pp. 1-5 (2014).
73. The extent to which the licence payments have to be part of the customs value has not yet been determined, as mentioned in sec. 2. See in respect of valuation for customs purposes and whether royalties should be included in general T. Lyons, EC Custom Law (Oxford University Press 2001).
74. OECD, BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances (OECD 2014).
75. Recently, the Belgian Supreme Court also took the position that an income and capital tax treaty solely has as its purpose the avoidance of double taxation (BE, SC, 4 June 2015, Case no. F 14 0164 F.) The case concerned the tax sparing provisions of Belgium’s treaties with Korea and Italy. C. Buyse, Koreaanse obligaties en FBR: Cassatie eist effectieve bronheffing, Fiscoloog 1493, p. 9 (2015).
77. OECD, Action Plan, supra n. 5, at p. 48.
6.3. Intangible assets

Could the Russian tax authorities have limited the discussion to disallowing the royalty expenses? As also recognized by the Federal Cassation Court, no know-how is being granted. On the basis of this conclusion the tax base might already have been increased. This approach has been applied successfully in similar cases. In the Equant (2015) case, a deduction for licence fees concerning know-how in the field of telecommunications technology was disallowed because the information was supposedly publicly and readily available.80

Such an approach (regardless of whether or not it is correct)81 would be more straightforward and would also fit within the approach of BEPS Action Point 8 (“Guidance on Transfer Pricing aspects of Intangibles”).82 The 2014 report states that “[t]he value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret” (paragraph 6.20) and “even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non-unique know-how” (paragraph 6.10).

7. Anti-Avoidance

7.1. In general

The previous sections demonstrate that the legal arguments and approach leading to the conclusion that Oriflame OOO is an agent/representative of the foreign enterprise Oriflame Cosmetics S.A. are not convincing on all points.

A careful reading of the decision shows, however, firstly, that the Cassation Court, in several places refers to Resolution no. 53 of the Plenum of the Supreme Arbitrazh Court of the Russian Federation from 12 October 2010 (“unjustified tax benefit”),83 and secondly, that the activities of the agent are the activities of the foreign enterprise (“piercing the corporate veil”). These two aspects are further explained below.

7.2. Unjustified tax advantage

The Russian tax legislation does not contain a general anti-abuse provision. The Russian tax authorities and courts rely, in this regard, on concepts and principles of civil law, often broadly interpreted and applied through court decisions or resolutions of a general nature.

Until 2006, the concept of the “bad faith taxpayer” was applied.84 This approach has resulted, however, in very subjective decisions. The Plenum of the Supreme Arbitrazh Court remedied this in its resolution no. 53 of 12 October 2010, providing several objective elements that focus on the facts and activities of the taxpayer rather than on his intentions. These elements, if present, are indicative of tax evasion, which could imply an unjust tax advantage. Under this new concept, it is assumed that the taxpayer is acting in good faith. According to Burk and Vakhitov (2010) this approach is substantially based on several internationally used techniques, such as “substance over form”, the “business purpose test”85 and the sham theory.86

Thus, there is an unjustified tax benefit if:

1. the underlying documents do not coincide with the economic reality;
2. the transactions do not have a business rationale;
3. the taxpayer does not have the resources (personnel, equipment, etc.) and time available to carry out the proposed transactions; and
4. the contract party of the taxpayer is involved in tax evasion.

Supplementary elements are unusual transactions, the use of intermediary persons, tax crimes committed in the past, doing business with contractors that have committed tax crimes and the execution of transactions outside the seat of the taxpayer.

In examining the working method of the Oriflame Group in light of these elements, the question indeed arises whether (1) there are business motives that could be invoked for the existence of the Netherlands intermediary company; (2) if indeed know-how was put at the disposal of Oriflame OOO; and (3) whether the licence fees had to be included in the customs value. The cassation decisions seem to indicate that these elements are present.

Although one may expect that the Oriflame Group has endeavoured to show the opposite in its pleadings before the various instances, the decision of the Federal Cassation Court is, as such, not sufficiently justified and substantiated.

80. RU: Ninth Arbitrazh Court in appeal, 25 Feb. 2015, Case no. A40-28065/13, discussed in EY, Russian Tax Brief, Mar. 2015, 4 and Arbitration Appeal Court decides that payments made under a sham transaction are not tax deductible (6 May 2015), News IBFD.

81. Verhinder, Meersman & Mondelaers point out that it is not evident to transfer knowledge related value drivers, or even to possess such drivers (prohibiting the use thereby by others). See I. Verhinder, J. Meersman & Y. Mondelaers, De Transfer Pricing aspecten van "Brainpower": internationale ontwikkelingen met betrekking tot de kwaliteit van “intangibles”, TFR 393, p. 7 (2011).


83. Resolution of the Plenum of the Supreme Arbitrazh Court of the Russian Federation of 12 Oct. 2006, no. 53 “On arbitration courts assessing the reasonableness of the tax benefit received by the taxpayer”.


7.3. Piercing the corporate veil

The application of the concept of an unjustified tax benefit seems more difficult in respect of the relationship between Oriflame Cosmetics S.A., the principal and Oriflame OOO, the agent. Oriflame OOO has the necessary means, conducts its own business in accordance with its underlying documents and its existence is clearly motivated by business reasons.

Notwithstanding this, the Russian tax authorities and the Arbitrazh Court do not seem to make a formal distinction between the taxpayer “Oriflame OOO” and the foreign company “Oriflame Cosmetics S.A.”. Legally, all transactions, revenue and expenses of Oriflame OOO are imputed to the Luxembourg company.

Although this is not explicitly mentioned in the cassation decision, this position is (at least in the appeal) apparently based upon the “piercing the corporate veil” theory, as confirmed, inter alia, in the Supreme Arbitrazh decisions in Dvortsovy Ryad-MS (2009), Syktyvkar'sky Dairy Factory (2010) and Parcex Bank (2012). The most important elements that, in Russia, could lead to disregarding the separate legal personality of the company are, according to Burk (2010), among others:

1. the companies being related;
2. the management of the related companies consisting of the same persons;
3. the enterprise of the company not being conducted in an independent manner; and
4. the lack of business motives for the existence of the company.

It is difficult to understand why the first three elements are relevant to setting aside the legal personality of a (Russian) company. These elements are essential features of most multinational enterprises. Besides, the existence of Oriflame OOO, which clearly has commercial substance, is motivated by business reasons. It, therefore, seems evident that the Russian Supreme Court should review the correct application of this theory in light of the circumstances of this case.

7.4. Application under an income tax treaty

The approach of the Russian tax authorities, moreover, is contrary to the purpose and objectives of articles 5(7) and 7 of the Luxembourg-Russian Income Tax Treaty (1993) and the Netherlands-Russia Income Tax Treaty (1996). The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

The Cassation Court does not justify, in its decision, the basis on which these provisions can be set aside. This issue, including the question of whether or not such general anti-abuse theories can apply in the treaty context where the treaty itself does not contain an anti-abuse provision,95 should be presented to the Russian Supreme Court. In this respect, it should be noted that the treaties at issue were concluded before 2003 and the Commentary on the OECD Model from before 2003 states that income and capital tax treaties should explicitly provide that national anti-avoidance provisions may be applied.96 The treaties at issue do not provide for such a provision.

Note that the Luxembourg-Russia Income Tax Treaty (1993) does contain a specific anti-abuse provision (article 29), which is worded as follows:

It is understood that a resident of a Contracting State shall not be entitled to a reduction of or exemption from tax under this Convention in respect of income arising in the other Contracting State if, as a result of consultations between the competent authorities of the Contracting States, it is established that the main purpose or one of the main purposes of the creation or existence of such resident was to obtain the benefits of this Convention which would otherwise not be granted.

Setting aside the separate legal personality of Oriflame OOO seems to violate this provision since a direct consequence of the approach of the Russian tax authorities is that the licence payments will not be exempt in Russia even though they should, in the hands of Oriflame Cosmetics S.A., be exempt in accordance with article 13 of the Luxembourg-Russia Income Tax Treaty (1993).

To date, except for a position on specific national anti-avoidance provisions (see section 4.2.), the Russian Supreme Court has not taken a position in this respect.97 In view of the changed position of the OECD,98 it is likely that the Supreme Court will confirm this position.99

What is noteworthy is that Russia is including anti-abuse provisions in its newly negotiated treaties. This is, for....
example, evident in the newly negotiated Belgium-Russia Income and Capital Tax Treaty (2015): 100

Notwithstanding the provisions of any other Article of this Convention, a resident of a Contracting State shall not receive the benefit of any reduction in or exemption from tax provided for in the Convention by the other Contracting State if the main purpose or one of the main purposes of such resident or a person connected with such resident was to obtain the benefits of the Convention.

8. Concluding Remarks

The position of the Russian tax authorities, which has been confirmed by the Federal Arbitrazh Court of the district Moscow, seems to limp between two different opinions. While, on the one hand, it is reproachful of any tax evasion on the part of the taxpayer, it, on the other, uses the same factual circumstances to conclude that Oriflame OOO is a Russian representation. The question arises whether the Russian tax authorities could simply have disallowed a deduction for the licence fees or have Oriflame Cosmetics S.A. taxed on the basis of article 5(1) of the Luxembourg-Russia Income Tax Treaty (1993) 101 as a ("shops without walls"). This case is, therefore, reminiscent of the Yukos case in respect of which Russia was condemned by the European Court of Human Rights because the means employed were disproportionate to the goal. 102

That the method of the Oriflame Group, particularly in light of the BEPS Action Plan, is not appreciated in Russia, is (certainly if there is tax evasion) understandable. In any event, this case shows, once again, that foreign enterprises should inform themselves of the risks of a particular business model or structure from a local perspective. They should not sail too close to the wind. Whereas in the west one can act mainly based on the legal reality, in Russia one acts mainly based on the factual circumstances, which naturally can be viewed subjectively. The BEPS Action Plan seems to approve of this approach.


101. Compare Soler Roch, supra n. 64, at p. 81-95.