

Branch and Representative Offices in Russia from a Tax Perspective

By Luke Johnson, SCHNEIDER GROUP

The difference between a branch office (BO) and a representative office (RO) conceptually should be clear: a representative office is intended to engage in “non-commercial activity” whereas a branch is intended for “commercial activity”. It logically follows that the taxes they file will be different; however, this is not necessarily the case. Those looking to enter the Russian market are often confronted with uncertainty since the line between an RO and BO is not always clear, and ROs in Russia operate slightly differently than their western counterparts. This article is intended to shed light on subdivisions in Russia from a legal and tax perspective.

Tax optimization is a priority for any company. When a company is looking to establish a new entity in a foreign country, a key consideration is how to balance the range of legal functions with tax costs. In some cases, if the company needs to import, needs manufacturing, real localization, then an LLC is the clear answer.

For many international business owners who decided that these functions are not in their interest, they will instead consider a representative office or a branch office. With this, they are trading some functions (manufacturing or import capabilities) for an expected decrease in (tax) costs.

But simply choosing to set up a Branch or Representative Office is only half the story in terms of complying with the Russian Tax Code and not being subject to pay the taxes that they are hoping to avoid. The second half of the story to comply with the Russian Tax Code is related to “Commercial Activity” and Permanent Establishments (PE).

(To start, it is worth noting that the tax law does not mention “Commercial Activity” as a defining point for the existence or inexistence of a PE. Instead, it uses “preparatory or auxiliary”. “Commercial activity” is a term consultants use as a better description, and it will be used for the purposes of this article.)

The Russian tax code refers to a Permanent Establishment as an “affiliate, representation, department or bureau, an office, agency or any other set-apart subdivision or other place of activity” of a foreign organization which are engaged in “business activities.”

These “activities” are defined further in the code, and are related to (1) using natural resources, (2) performance of “contract-envisages works,” (3) selling commodities from store-houses in Russia and (4) “the performance of other works, rendering

services and carrying out other kinds of activity”. Here, both the list of kinds of establishments and services are quite vague. Luckily, the code elaborates on what specific activity does *not* constitute a PE.

The code also explicitly states that, among others, “collecting, processing and (or) dissemination of information for bookkeeping, for marketing or advertising, or for studying the market of commodities” is *not* grounds for definition as a permanent establishment (assuming these activities are not the principle activity of the organization). For instance, if the activities of your employees at the RO are just marketing, these activities do not constitute a PE (again, assuming this is not your principle form of business, such as a marketing company).

In 2010, Bloomberg got into trouble with the Russian Tax Authorities for collecting data, which, it was later determined, is considered one of their main business practices - they are a news company, after all.

Looking at ROs and BOs from an accounting and tax point of view, there is no intrinsic difference between a RO and a BO when determining the status “Permanent Establishment.” It would follow to ask, therefore, “Legally, is there something which prohibits a Representative office from engaging in activity which would define a PE?”

The short answer is no. According to the civil code, an RO is designed to “represent the interests of the [mother] company, and carry out their defense”; whereas a branch office is designed to “carry out *all* the functions, or its part of the functions, including the function of the enterprise.” (emphasis added). Again, these are not particularly clear definitions.

In practice, a branch office and representative office can be very similar in terms of scope of activity, and are often lumped together. In fact,

when registering a company, the very first question on the form is: Mark '1' for Branch and '2' for Representative, with no further reference to an RO or BO made throughout the rest of the form. Since the tax authorities conduct the incorporation, this could be the first clue to how similar these companies are from their point of view.

But amongst consultants, there is still a conceptual understanding that ROs cannot engage in commercial activities, while a BO is expected to. But in practice many representative offices do engage in commercial activities without causing any problems (assuming they pay taxes). They have a good case to do so considering how vague the definition for each subdivision is.

One revealing point is that of the many reports obligatory for ROs and BOs to submit, many involve points which would connect the RO directly to commercial activity. After all, the tax authorities *expect* a "Profit Tax of the Foreign Legal Entity" submission for both ROs and BOs (one among many reports which would indicate commercial activity). It is a very hard case to say that commercial activity in an RO is illegal when every time an RO submits a non-zero profit tax return, they are clearly demonstrating that they are engaging in illegal activity for an RO.

Instead, the advantage of an RO over a BO has been gradually waning. In the past, it used to be cheaper to set up an RO (a BO required a minimum fee to register), but these have since been enforced for the RO as well; there were some advantages for the RO in getting TPP visas, but this advantage has also have blurred over time; also, it use to not be possible to get a Highly

Qualified Specialist Visa (HQS) for foreign employees of a RO, but this also changed last year.

A logical question to ask is if the BO has the potential to be a non-PE, just like the RO, but also has its own advantages, then why would anyone choose an RO?

The answer is somewhat subjective. If you establish a BO, the authorities will *expect* to see some profit, since it is generally accepted that you would engage in commercial activity. With a RO, these suspicions would not arise. Therefore, if it is clear that the legal presence to establish is not intended for commercial activity, it is recommended that you set up an RO. From a strictly tax and legal point of view, however, there is very little difference.

By way of a quick summary:

- The kinds of 'establishments' which could potentially be considered as a PE are vague, and include both a representative office, and a branch office.
- The kinds of activities which defines a PE are vague
- There is a specific list of activates which do *not* warrant the creation of a PE
- An RO and a BO does not affect whether or not they are deemed a PE
- An RO and a BO, both can and do engage in activities which would warrant a PE, and tax authorities expect tax submissions equally from both
- The primary difference between them is subjective: the authorities certainly expect taxable income in a BO, but not necessarily an RO.

SCHNEIDER GROUP supports companies on matters concerning doing business in Russia, Kazakhstan, Belarus, Ukraine, Poland and Germany, irrespective of their size or industry sector. Their team of 500 experts, speaking English and/or German, advises on market entry structure, accounting and reporting, IT / ERP solutions, import and tax consulting.

www.schneider-group.com