



## Don't run before you can walk – Russian deoffshorisation uncertainties

By: **Alexis Tsielepis**, Director & Head of Taxation and **Daniil Ruderman**, Tax Consultant and Representative, Moscow

**Costas Tsielepis & Co Ltd**

### 1. Introduction

We were impressed with the speed with which, after several months of debates and discussions, the legislation, affectively known as 'deoffshorisation' of the Russian economy, passed through the Russia's State Duma and the Federation Council, and was signed by President Putin, all in the time span of a week and half, effectively meaning that it comes into force on 1 January 2015.

As you may well be aware, this Russian legislation resulted in the introduction of new fundamental rules, concepts and principles to the Russian domestic legislation such as controlled foreign company (CFC) rules, Russian tax residency rules for legal entities and the 'beneficial owner of income' concept.

In layman's terms, the legislation deals with the taxation of profits received and held by Russian-owned businesses in non-Russian low tax jurisdictions.

Currently, there is no doubt that this piece of legislation would affect most of the businesses owned by Russian tax residents through various non-Russian vehicles.

Perhaps due its urgency though, the deoffshorisation legislation is far from being clear in many aspects and requires further elaboration. It lacks official guidance and official forms that are required for the underlying effective working. In fact, the devil is in the details, but the more we read the legislation, the more questions, rather than answers, arise. This should not be the case, especially given the significance of the relevant provisions. This legislation was clearly rushed, evident from the many grey areas in the final law.

Now, tax consultants are required to analyse their clients' legal structures, advise these clients on how the law affects them and, possibly, provide solutions on how to reduce the effect of the law. However, in many cases, such advice may not be optimal, or even enforceable, given the underlying uncertainties that still exist. With the issuance of certain clarifications from the Ministry of Finance in the near future as well as with the adoption of relevant forms, some of these questions may be answered.

However, it looks like the fundamental questions may still remain for some time to come. There is also the likelihood that further (possibly, taxpayer friendly) amendments to the law may be introduced in the spring of 2015, as per public statements to this effect from Deputy Minister of Finance of Russia, Sergei Shatalov, although nothing specific has officially been confirmed.

Costas Tsielepis & Co Ltd

205, 28th October Str., Louloupis Court, 1st Floor, 3035 Limassol, Cyprus | P.O. Box 51631, 3507 Limassol, Cyprus  
T: +357 25871000 | F: +357 25373737 | E: info@tsielepis.com.cy | www.tsielepis.com.cy

Registration No. HE195250 | Licensed Statutory Auditors, ICPAC Certificate No. E165/A

**George Tsielepis**, BSc, FCA, **Alexis Tsielepis**, BSc, FCA, **Antonis Christodoulides**, BSc, FCCA, **Costas Constantinou**



This article highlights some of the uncertainties of the current legislation, and should be used as food-for-thought by professionals and taxpayers alike.

## **2. Deoffshorisation measures uncertainties**

### *2.1 CFC Rules*

#### Conflict of CFC provisions with relevant double tax treaties

The first major question that may well come to a tax expert's mind in relation to the CFC rules which were introduced in Russia among other deoffshorisation measures is whether these CFC rules are in contradiction with the relevant double tax treaty provisions? The discussion over a potential conflict between legislation covering CFCs and provisions of double tax treaties (especially, the right to tax resting solely with one contracting state) has been taking place in international tax circles for many years.

Although most countries adopt a position that no conflict exists, with the Organisation for Economic Co-operation and Development (OECD) itself stating this in its commentary<sup>1</sup>, it is still an area of dispute between professional tax advisors. In any case, leaving the theory aside, it would be rather naive, in our opinion, to think that, in practice, a Russian tax resident could successfully rely on double tax treaty provisions to prove that approved CFC rules shall not apply to his/her specific situation.

#### Issues of control

Under the law, a non-Russian company or a non-Russian structure such as a fund, a trust etc. may be treated as a CFC and be subject to all the relevant requirements if it is controlled by a Russian tax resident. This is perhaps clear. But let us look how the controlling persons are defined in the law.

The law provides that a Russian tax resident individual or a Russian tax resident legal entity shall be *deemed* to be controlling persons over the company or the structure (such as fund, trust etc.) if this individual or the legal entity owns more than 50% of the company. The 50% threshold applies in 2015 only.

From 2016, the threshold becomes 25%, unless there are overall Russian tax resident shareholders who jointly own more than 50% of the company, in which case the threshold becomes 10%. It is not entirely clear how these 50%, 25% or 10% thresholds work with respect to non-Russian structures such as trusts.

*Presumably* (this is not stated in the law clearly) in case of trusts taxpayers would be required to apply general definition of "control" provided in the law. The control is generally defined as the possibility to affect decisions on the distribution of profits. In other words, if a person may affect

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<sup>1</sup> Paragraph 23 of Commentary on Article 1, Paragraph 14 of Commentary on Article 7, Paragraph 37 of Commentary on Article 10, Model Tax Convention on Income and Capital, OECD



decisions on the distribution of profits from the trust, he or she is treated as a person who exercises "control" over the trust and thus is treated as a controlling person to such trust.

Let us, however, imagine the situation where a person being a Russian tax resident transferred shares of a non-Russian company into an irrevocable discretionary trust with his/her child (a Russian tax resident as well) being a beneficiary. In the above situation, from a legal perspective, neither the founder individual nor the beneficiary individual have the possibility to affect the distribution of profits of the trust.

However, practically speaking, we can hardly imagine the situation where the Russian tax authorities would easily agree that such trusts are outside the scope of the Russian CFC rules. The situation could be even more complex, if, say, the founder of the trust is a Russian tax resident and the beneficiary of the trust is not. What route would the Russian tax authorities follow in such a case? Would they agree that the founder of the trust who is a Russian tax resident would not be subject to CFC tax?

There is another tricky issue relating to the controlling persons. Under the law, for individuals, the abovementioned participation thresholds (25%, 10% or 50% in 2015) shall be calculated inclusive of shares owned by their spouses and underage children.

The question may potentially arise in situations where a Russian tax resident individual does not own any shares but his/her spouse, being a non-Russian tax resident owns, say, 100% of the shares in the company. Logically, in this situation, a non-Russian tax resident individual should be a controlling person to this company (i.e. Russian CFC rules should not apply). However, based on the current wording of the law, it may be argued that the Russian tax resident individual, together with his/her spouse, jointly own 100% of the company. Thus Russian CFC shall potentially apply.

#### Issues of calculation of the CFC tax base and the CFC related tax

The law provides that the profit of a CFC, for Russian profits-tax purposes, shall be calculated based on the financial statements of this CFC if (i) this CFC is registered in a jurisdiction which has a double tax treaty with Russia and if (ii) its financial statements are subject to an obligatory audit, which is the case for Cyprus, for example. In all other cases, the CFC's profit for Russian tax purposes is calculated based on Russian domestic tax rules, being Chapter 25 of the Russian Tax Code.

At first sight, the provision appears unambiguous. However, in the case where profits are based on the audited financial statements of a company, this provision generates a discussion on whether the retained earnings of the company are themselves subject to tax under the Russian CFC rules. In other words, there is a question on whether the retained earnings as of December 31, 2014 constitute a part of the CFC profit calculated for 2015 based on the financial statements of the company.

The current law does not address this issue directly. We may therefore only wonder on how this matter would be treated by the Russian tax authorities. The new legislation specifically provides that losses, incurred by such companies in the previous years (2012 – 2014), can be carried forward for



CFC tax purposes. We therefore ask the question: why should retained earnings be treated any differently? This issue contrasts sharply where the companies are not subject to mandatory audit, and the provisions of Chapter 25 of the Russian Tax Code kick-in. In this case, the profits for CFC purposes are calculated based on Russian domestic tax rules which do not take into account retained earnings.

The law further provides that a profit of the CFC which is subject to Russian taxation shall be reduced by the amount of dividends paid by this CFC. Let us assume that the CFC had retained earnings for previous years (say 2014), received profit in the current year (say 2015) and distributed certain dividends from the retained earnings (of 2014). The question then arises whether such dividends would reduce the amount of CFC's profit of 2015 subject to Russian taxation, if we assume that retained earnings brought forward are not subject to CFC tax. Currently, again, there is no definite answer to this question in the law and clarifications are required. These however are important questions when advising clients on how to plan or reorganise for the CFC rules.

#### Issue of exemptions

The law provides that the profit of a CFC shall be exempt from Russian taxation in the following cases:

- 1) if the CFC is a non-commercial organisation which does not distribute profits;
- 2) if the CFC is established in the country which is a member of the Eurasian Economic Union (i.e. Belarus, Kazakhstan or Armenia);
- 3) if the CFC (i) is a tax resident in a jurisdiction which has a double tax treaty with Russia, (ii) this jurisdiction provides for the exchange of tax related information with Russia and (iii) the effective tax rate for the profit of this CFC is not less than 75% of the average weighted Russian domestic tax rate;
- 4) if the CFC (i) is a tax resident in a jurisdiction which has a double tax treaty with Russia, (ii) this jurisdiction provides for the exchange of tax related information with Russia and (iii) the share of *passive* income received by this CFC does not exceed 20%;
- 5) if the CFC is a structure (such as a trust, a fund etc.) and all the following conditions are met: (i) the founder of the structure is not able to receive back the assets transferred to this structure, (ii) the founder's rights cannot be transferred to any third party except in the cases of inheritance or legal succession, (iii) the founder is not able to receive (directly or indirectly) any profit from this CFC and (iv) the structure is not able to distribute profits among its participants;
- 6) if the CFC is a bank or an insurance company and such a company is a tax resident in a jurisdiction which has a double tax treaty with Russia and this jurisdiction provides for the exchange of tax related information with Russia;
- 7) if the CFC is the issuer of traded bonds;



8) if the CFC is a participant to a production sharing agreement, or a concession agreement and other similar type of agreement with the State;

9) if the CFC is treated as the operator of new hydrocarbon sea block or if CFC is the shareholder of such operator.

We would like to highlight that these do *not* constitute exemptions that result in the respective non-Russian company losing its CFC status. No, it would still be treated as a CFC and the Russian tax residents controlling such CFCs would still be subject to various reporting requirements. Meeting the above criteria just means that no tax would be due.

We may further highlight that most of these exemptions are narrow and specific and thus not too many businesses would actually benefit from them, despite the fact that some professional consultants advertise these exemptions as possible "solutions". Exemptions 3 and 4 listed above may certainly constitute, to some extent, tax planning tools, although these are not 'one-size-fits-all' solutions. Not all the existing businesses can easily benefit from them. We should also bear in mind that any "solutions" aimed solely or predominantly to minimise tax, are open to anti-avoidance doctrine and may be disallowed by the Russian tax authorities.

We would like to draw your attention to some uncertainties connected with exemptions 3 and 4 above, which are widely regarded as the most promising exemptions from the overall list.

In terms of item 3, the law provides for a formula calculating the effective tax rate for a CFC's profit. Generally, this formula takes into account the amount of tax paid in the jurisdiction of the CFC and the amount of tax withheld from income received by such CFC. If the effective tax rate applicable to the CFC's profit is high enough (i.e. it at least 75% of the average weighted Russian domestic tax rate), such CFC's profit would be exempt from Russian domestic tax in the hands of the Russian tax resident. However, what about tax refunds? Would it count if the CFC pays a certain amount of tax in its home jurisdiction, resulting in the Russian tax resident obtaining the exemption provided in item 3 above, but then subsequently the CFC received a tax refund from the tax authorities of its jurisdiction of tax residence?

Some commentators think that this is possible. We are not entirely sure that they are correct. The law, as in many other cases, does not address this issue directly at this stage. However, we cannot exclude that the Russian tax authorities could try to cut off this practice by their clarifications which, we are sure, will follow.

In terms of item 4, we find it particularly interesting to look into the types of passive income provided by the law. Besides "standard" types of passive income such as dividends, interest, royalties etc., the law includes in this category income from rendering consulting, legal, accounting, audit, engineering, advertising and marketing services, scientific research works and secondment services. Not a standard approach to passive income, we would say!

However, this is at least clear. What is less clear (or simply vague) is the type of passive income called "other similar income". In other words, the Russian tax authorities could be very conservative



and treat some types of income which are not directly listed in the law to be passive. If a taxpayer disagrees, he may have to prove his position in a court, which is not in itself an attractive course of action!

## 2.2 *Russian tax residency rules for legal entities*

The new CFC rules are not the only part of the law which contains uncertainties. In terms of Russian tax residency rules for legal entities, the law, in particular, provides that non-Russian companies which are actually managed from Russia, could be treated as Russian tax residents, provided that certain conditions are met. As a consequence of Russian tax residency, such non-Russian companies would be required to calculate and pay Russian profits-tax based on rules provided by Chapter 25 of the Russian Tax Code. However, the law is simply silent on whether such companies would be required to pay other Russian taxes which are ordinarily paid by Russian companies.

Further, let us assume that a certain non-Russian company was established some years ago. After January 1, 2015 it was treated as a company managed from Russia and became a Russian tax resident. This scenario raises the very real threat that the Russian tax authorities could potentially assess a Russian permanent establishment (PE) to this company for the preceding years, especially considering the company's acknowledgement that it is managed from Russia.

Of course, one may argue that as of today there is no established practice on assessing a Russian PE to a non-Russian company based on the place of effective management test. We agree, but may this practice change if a non-Russian company itself acknowledges the fact of management from Russia? We cannot exclude this.

## 2.3 *Beneficial owner of income concept*

The law introduces a *beneficial owner of income* concept. In this respect, an individual or a legal entity shall be deemed to be the beneficial owner of income if this person, directly or indirectly, actually possesses ownership rights to this income and is able to define its future designation.

The law clarifies that double tax treaty benefits shall not be applicable to the company which, despite being registered in a jurisdiction with a double tax treaty in place, has limited authorities with respect to the income received, does not take any business risks in relation to this income and actually transfers this income to another company. It is assumed that such an intermediary company cannot be treated as a beneficial owner of the income received.

Limiting treaty benefits is nothing new and the beneficial ownership concept exists in many developed jurisdictions. Most of these, however, such as Austria or Germany, have very clear guidelines as to what criteria are applied in examining who the beneficial owner is. At present, the new Russian legislation introduced the concept with provisions that are vague and with no clarifications. In practice it is not so easy to define and prove whether a company has (or not) an actual right to income or takes (or not) business risks relating to such income. This suggests that taxpayers should expect complications when trying to prove their position in court in cases of related disputes with the Russian tax authorities.

## 2.4 *Other uncertainties*

### Issue with the sale of real estate companies

Besides the introduction of CFC rules, Russian tax residency rules for legal entities and the beneficial owner of income concept, the law introduced wider rules relating to the taxation of non-Russian companies selling shares of real-estate-rich companies. Under this wider rule, Russian tax applies to a non-Russian company's income, that is derived from the sale of shares of Russian or non-Russian companies, whose assets, directly or indirectly, consist of more than 50% of immovable property located in Russia.

The question, however, remains how this tax could practically be assessed and collected in a situation where the seller and the purchaser of the shares are both non-Russian companies, without any representation in Russia. What is also interesting is that the new law specifically provided that income of a non-Russian company in the above situation is taxable in Russia but this tax shall not be collected at source (i.e. this tax is not a withholding tax by its nature). Unfortunately, as of today, the procedure for paying this tax is unclear, even non-existent.

### Potential issue for historic capital

Besides all the issues discussed above, certain Russian businessmen are worrying about potential risks relating to capital historically contributed to non-Russian companies. If these companies as well as their financials are disclosed to the Russian authorities, is there any chance that the owners would be questioned on whether they had paid all taxes relating to such historic capital? Time will tell.

## **3. Conclusion**

After all, taking into account the above uncertainties and questions, a wise Russian businessman may ask a simple question: "Ok, everything is vague and unclear, so what shall I do?"

Our recommendation would certainly be to review the current legal structure. However, persons should not rush into action, and should be sceptical of accepting risky solutions, which may become obsolete with certain clarifications from the Russian tax authorities, that may be issued in the near future. Of course, there could be situations where certain actions must be taken urgently. However, in other cases, it may be preferable, even wise, to delay action, form a strategy based on facts and not on assumptions, and only implement when ready. There are solutions and we stand ready to help.

Hand in hand, let's learn to walk before we run.