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DON'T RUN BEFORE YOU CAN WALK

RUSSIAN DE-OFFSHORISATION UNCERTAINTIES REMAIN

By Alexis Tsielepis and Daniil Ruderman

The new de-offshorisation legislation, passed at lightning speed through the Russian Parliament and then hastily signed by President Putin within a week and a half, came into force on 1 January 2015. It introduces fundamental new rules, concepts and principles to Russian domestic legislation such as controlled foreign company (CFC) rules, 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.

Perhaps due to its urgency, however, it is far from being clear. Further clarifications and amendments, possibly taxpayer-friendly ones, may be introduced in the spring, as has been hinted by Russia's Deputy Minister of Finance, Sergei Shatalov, although nothing specific has been officially confirmed.

ANY SOLUTIONS AIMED SOLELY OR PREDOMINANTLY AT MINIMISING TAX ARE OPEN TO CHALLENGE BASED ON RUSSIAN ANTI-AVOIDANCE DOCTRINE

On CFC rules, there is a general question of whether they contradict Double Tax Treaty provisions. Although most countries and the Organisation for Economic Co-operation and Development believe that no conflict exists, it remains an area of dispute among professional tax advisors.

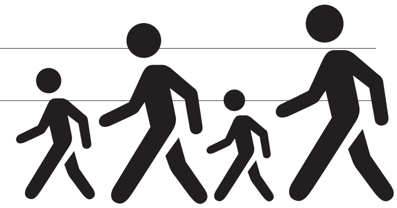
More specifically, the law states that a non-Russian company or structure such as a fund or a trust may be treated as a CFC if it is controlled by a Russian tax resident. A Russian tax resident shall be deemed to be a controlling person of the company or structure if he/she owns more than 50% of that company or structure. The 50% threshold applies in 2015 only. From 2016, the threshold becomes 25%, or 10% if Russian tax resident shareholders jointly own more than 50% of the company.

It is not entirely clear how these thresholds apply to structures such as trusts. Presumably, in the case of trusts, taxpayers would be required to apply the general definition of «control» provided in the law, which translates as the possibility to affect decisions on the distribution of profits.

However, in the case of a Russian tax resident transferring shares of a non-Russian company into an irrevocable discretionary trust with his/her child (a Russian tax resident as well) being a beneficiary, neither the founder nor the beneficiary has the legal possibility to affect the distribution of profits. This is a decision that rests solely with the trustees. In practice, however, it would be difficult to convince the Russian tax authorities that CFC rules do not apply here.

Furthermore, under the law, a participation held by spouses is included in that of the individuals. Thus, where a non-Russian tax resident spouse owns 100% of the shares in a non-Russian company, her Russian tax resident husband may be deemed to exercise control and subject the company to Russian CFC rules where, in fact, he has no control at all.

The law provides for the profits of a CFC being calculated based on its financial statements, where the CFC is registered in a treaty partner jurisdiction of Russia, and the financial statements are



subject to an obligatory audit, as in the case of Cyprus. In all other cases, the CFC's profit for Russian tax purposes is calculated based on domestic tax rules (Chapter 25 of the Russian Tax Code).

The new legislation provides for losses incurred by a CFC in 2012-2014 to be carried forward for tax purposes. Should, however, retained earnings be treated any differently? In other words, should retained earnings be subject to Russian tax? The law provides no guidance. 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. These do not take retained earnings into account.

Profit of the CFC which is subject to Russian taxation shall be reduced by the amount of dividends paid by this CFC. But should a dividend that is distributed from retained earnings received before the law comes into effect reduce the amount of the CFC's profit? The law again provides no guidance.

The law states the profit of a CFC shall be exempt from Russian taxation if the CFC is:

1) a non-commercial organisation which does not distribute profits;

2) established in a country which is a member of the Eurasian Economic Union (i.e. Belarus, Kazakhstan or Armenia);

3) tax resident in a tax treaty partner jurisdiction, which provides for the exchange of tax-related information and the effective tax rate for the profit of this CFC is not less than 75% of the average weighted Russian domestic tax rate;

4) tax resident in a tax treaty partner jurisdiction, which provides for the exchange of tax-related information and the share of passive income received by this CFC does not exceed 20%;

5) a structure (such as a trust or a fund) and all the following conditions are met: (i) the founder is not able to take back the assets transferred to this structure, (ii) the founder's rights cannot be transferred to a third party except in cases of inheritance or legal succession, (iii) the founder is unable to receive any profit from this CFC and (iv) the structure is unable to distribute profits among its participants;

6) a bank or an insurance company, tax resident in a treaty partner jurisdiction which provides for the exchange of tax related information;

7) the issuer of traded bonds;

8) a participant in a production sharing agreement, or a concession agreement and other similar types of agreement with the State;

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

PERHAPS DUE TO ITS URGENCY, THE NEW LEGISLATION IS FAR FROM BEING CLEAR

There are exemptions from paying tax in Russia but even in the above cases, a CFC would still be subject to various reporting requirements. Further, these exemptions are far from being 'one-size-fits-all' solutions. Solutions must be tailor-made to the client's specific and unique circumstances. Plus, it should be noted that any solutions aimed solely or predominantly at minimising tax are open to challenge based on Russian anti-avoidance doctrine.

There are further considerations on items 3 and 4 which may, to some extent, provide certain solutions. With item 3, the law stipulates the formula calculating the effective tax rate for CFC's profit. If the effective tax rate applicable to the CFC's profit is high enough, the profit would be exempt from Russian domestic tax. However, would this still be the case if the CFC subsequently received a tax refund in its jurisdiction of residency? The law is silent on this matter.

In terms of item 4, besides 'standard' and 'non-standard' types of passive income, including consulting, legal, audit and marketing services, there is also a category listed as 'other similar income'. This may be used subjectively by the Russian tax authorities to include types of income which are not directly listed in the law. If a taxpayer disagrees, he may have to prove his position in a court, which is not in itself an attractive course of action.

New Russian tax residency rules for legal entities provide that non-Russian companies managed from Russia could be treated, under certain conditions, as Russian tax residents. This would require them to calculate and pay Russian profit-tax. However, the law is silent with regard to other Russian taxes which are ordinarily paid by Russian companies.

In addition, could non-Russian companies, which acknowledge that their management is undertaken from Russia, be assessed as a Russian permanent establishment (PE) for the period before 2015? Although there is currently no established practice on assessing a Russian PE as a non-Russian company based on the place of effective management test, this cannot be excluded.

In terms of the beneficial owner of income concept, the law clarifies that Double Tax Treaty benefits shall not apply where the company recipient of income has limited authority with respect to this income, does not take any business risks in relation to it and actually transfers this income to another company. The issue here is that, unlike many other jurisdictions, Russia has no clear criteria which are applied when examining beneficial ownership.

Another aspect of the new rules applies to the taxation of a non-Russian company's income, which 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. There question remains how this tax could practically be assessed and collected in a situation where the seller and the purchaser are both non-Russian companies, without any representation in Russia.

Another real concern is whether, after non-Russian companies as well as their financials are disclosed to the Russian authorities, there is a likelihood that the owners will be questioned on whether they have paid all taxes relating to the company's historic capital.

Given the uncertainties, it is preferable not to act hastily but form a strategy based on facts and not assumptions, implementing only when ready.

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

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