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UPDATE ON TAXATION OF RUSSIAN 'CONTROLLED FOREIGN COMPANIES'

"knowledge"

Facts, information and skills acquired through experience or education; the theoretical or practical understanding of a subject.
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Update on Taxation of Russian 'Controlled Foreign Companies'

1.0 Introduction

In our Tax Update v.4 i.4 - Taxation of Russian 'Controlled Foreign Companies' dated 4 April 2014, we discussed the initial proposal of the Ministry of Finance of the Russian Federation (Minfin) in relation to various tax measures aimed at the "deoffshorisation" of the Russian economy. These measures included the introduction of Controlled Foreign Company (CFC) rules, introduction of tax residency rules for legal entities and changes to withholding tax rules applicable to non-Russian businesses selling shares of companies owning Russian real estate.

As this legislation is perhaps the most important amendment to the Russian tax legislation of the past decade, and given the potential impact it can have on how Russian businesses and business persons use overseas jurisdictions, the tax advising team of Costas Tsielepis & Co is keeping a close eye on developments. The purpose of the present tax update is to inform our esteemed clients and associates on where the legislation proposal stands at the moment and how it is likely to develop.

2.0 Background

During April and May the draft law published by Minfin was heavily debated by various interested parties including the business community, tax practitioners and various Russian governmental bodies. Minfin revised the draft several times in order to incorporate comments made and propose additional "deoffshorisation" measures. Finally, on 27 May, Minfin introduced an updated version of the draft law (the Draft) which is currently under discussion.

That said, businesses were still not satisfied with Minfin's Draft and lobbied for further amendments in an attempt to tone down the provisions of the Draft, which were considered damaging to businesses. Some of these proposals found the support of the Russian Ministry of Economic Development (MED), which prepared its own draft law. This draft is based along the same lines as that of the Minfin, but also incorporates suggestions put forward by businesses.

It is reported that Minfin, together with MED, are going to further improve the Draft by 1 September. Currently, it is planned that the deoffshorisation law will become effective starting from 2015, although there are certain discussions on potential deferral of its entering into force (see Section 8 below for further details).

3.0 Beneficial owner of income concept

Measures relating to the concept of beneficial ownership of income were absent in the first draft of the law prepared by Minfin in March, but did appear in the updated Draft.

Generally, the concept relates to the taxation of income under double tax treaties and is aimed at combating various treaty shopping structures. Let us take as an example a structure where a company, which is registered in a jurisdiction with a favorable double tax treaty with Russia (e.g. Cyprus), is interposed between the Russian operational company and a company registered in a tax heaven (e.g. BVI), with the only purpose to minimize taxation on dividends, or indeed any other passive income, and without any substantive business functions on behalf of the Cyprus company.

The beneficial ownership concept allows to prove that in this case, the Cyprus company may not be treated as a beneficial owner of the income and thus is not eligible to double tax treaty benefits. This would therefore result in 15% Russian withholding tax on dividends as opposed to 5% or 10% withholding tax under the Russia - Cyprus double tax treaty.

In this respect, the Draft provides that a person (an individual or a legal entity) shall be deemed to be the beneficial owner of the income if this person, directly or indirectly, actually possesses ownership rights to this income and is able to define its future designation.

The Draft further clarifies that, in particular, double tax treaty benefits shall not apply 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 registered in a non-treaty jurisdiction. It is assumed that such an intermediary company cannot be treated as a beneficial owner of the income received.

4.0 Controlled Foreign Company (CFC) rules

Measures relating to controlled foreign companies (CFC) were introduced by Minfin in March. However, subsequently the initial Minfin's concept and wording were changed significantly.

The substance of CFC rules is to allow Russia to tax undistributed profits of non-Russian legal entities (and certain structures) if such entities and structures were controlled by Russian tax residents. Such measures are aimed at combating structures where profits ultimately belonging to Russian tax residents are realized and kept at the level of certain non-Russian companies often (although not always) registered in low tax jurisdictions. Measures such as these are common in tax legislations around the world.

What companies / structures shall be treated as CFCs?

Initially, Minfin proposed to treat companies as CFCs if they were established in jurisdictions included in the "blacklist" composed by Minfin. The updated Draft moved away from the "blacklist" concept and currently the CFC criteria are the following:

- the company is not a Russian tax resident; and
- the company is not listed; and
- the company is controlled by a Russian tax resident.

At the same time, a company shall not be treated as CFC if (i) it is registered in a jurisdiction which supports the exchange of tax-related information and if (ii) its effective income tax rate exceeds 15%.

Furthermore, besides non-Russian companies, Russian CFC rules shall apply to certain non-Russian structures controlled by Russian tax residents, which structures, in particular, include funds, partnerships and trusts. We note that, as opposed to the initial Minfin draft, the updated Draft directly mentions trusts as a structure which is subject to CFC.

How control over the company is defined?

Control over the company or the structure by a Russian tax resident shall generally mean the possibility to influence the distribution of profits by this company or the structure.

However, the Draft specifically provides that such control exists if a Russian tax resident, together with

his/her spouse, under-age children and other related persons, directly or indirectly own more than 10% of the CFC. Currently, this provision represents one of the most debated points in the Draft. A 10% ownership rarely provides actual controlling rights to the holder of this stake. Businesses argue that this percentage should be increased.

Notifications

Another highly debated point is the obligation of Russian tax residents to notify the Russian tax authorities of (i) their participation in any non-Russian company, (ii) structures such as funds, trusts etc. if the Russian tax resident has an actual right to receive income from such structures and (iii) CFCs.

In terms of (i) notification is required if direct or indirect participation exceeds 1%. Businesses complain that this threshold is very low and unreasonable. Practically speaking, in the case of indirect participation through several intermediary companies, one could even be unaware of a certain participation which formally requires notification. In terms of (iii) businesses argue that in certain cases, having only a 10% stake in a CFC, they would not be able to obtain information required to effect the disclosure as per the provision of the Draft.

Taxation

Undistributed profit received by a CFC shall be taxable in the hands of the Russian tax resident deemed to be controlling such CFC, if such profits exceed RUB 3 million (less than US$ 100,000). The Draft provides the procedure for how the profit should be calculated. The tax rate should be 13% for Russian tax resident individuals and 20% for Russian tax resident legal entities.

Sanctions

Finally, the Draft establishes significant sanctions for Russian tax residents for non-compliance with the CFC rules mentioned above

5.0 Tax residency for legal entities

As with the CFC, measures relating to the definition of a tax residency for legal entities were introduced by Minfin in March. However, subsequently the initial Minfin's concept was changed.

Currently there is no definition of tax residency for legal entities in the Russian law. According to the Draft, such definition will be introduced into the Tax Code. In this respect, (i) Russian-incorporated legal entities and (ii) non-Russian legal entities actually managed from Russia shall be treated as Russian tax residents.

A non-Russian entity shall be treated as actually managed from Russia if all the below conditions are met:

- the board meetings of the entity are ordinarily held in Russia;
- the guiding management of the entity is ordinarily performed from Russia;
- top management of the company conducts their duties from within Russia.

That said, at this stage, the terms "ordinarily" or "guiding management" are not clearly defined in the Draft.

If the above three conditions are met in more than one State (i.e. not only in Russia), then the following additional criteria would be reviewed:

- whether the bookkeeping of the entity is performed in Russia;

- whether the management of the records of the entity is performed in Russia;
- whether the issuing of internal orders in relation to the entity is made in Russia; and
- whether the hiring of personnel is performed from Russia.

If, based on the above criteria, a non-Russian company is deemed to be a Russian tax resident, it shall pay Russian profits tax similar to Russian companies (based on Chapter 25 of the Tax Code).

6.0 Withholding tax rules applicable to non-Russian businesses selling shares of companies owning Russian real estate

The measure was initially introduced by Minfin in March. It remained unchanged in the updated Draft.

The substance is as follows: if a Russian or a non-Russian company has more than 50% of its assets, either directly or indirectly, constituting of Russian immovable property, then any disposal of an interest in such company by a non-Russian seller shall be subject to Russian withholding tax.

The Draft, however, still does not clarify how the

7.0 Closure of a loophole in Russian thin capitalization rules

Similar to the beneficial owner of income concept, a measure relating to Russian thin capitalization rules was absent in the first draft of law prepared by Minfin in March. This was added to the updated Draft. It is aimed at closing a loophole used by some companies to avoid application of the Russian thin capitalization rules.

Under the current wording of the Tax Code (Article 269.2), a loan may become subject to Russian thin capitalization rules, in particular, if it is provided by a non-Russian company owning (directly or indirectly) more than 20% of the Russian borrower or if it is guaranteed by such a non-Russian company. Non-Russian "sister" companies of Russian borrowers were technically outside the scope of thin capitalization rules. Practically, such "sister" companies were sometimes used by businesses to provide intra-group financing to Russia, although there was a reduction in the number of such cases due to recent negative Russian court decisions on this issue.

The "more than 20% direct or indirect ownership" criterion is changed to an "interdependency" criterion, as per the Draft. This is a much wider concept. In other words, according to the Draft, a loan to the Russian company may become subject to thin capitalization rules, in particular, if it is provided by a non-Russian company interdependent with the Russian borrower. There is no doubt that non-Russian "sister" companies of Russian borrowers shall be covered by this new wording.

8.0 Further potential changes to the Draft

Currently, businesses and various governmental bodies are still discussing potential changes to the Draft.

Among these are the following potential changes:

- the possibility to defer the entering into force of the whole Draft (or at least certain of its provisions) until 2019;
- the increase in the CFC's minimum taxable profits threshold from current RUB 3 million (being less than US$100,000) to RUB 50 million (being approximately US$ 1.4 million) in 2015 with gradual reduction during subsequent years;
- increase in the stake evidencing control over the company to 50% with gradual reduction during subsequent years;

- increase in the notification requirement threshold;
- the deferral of sanctions for non-compliance with the new CFC rules.

9.0 Conclusion

As mentioned in our April Tax Update, all the above "deoffshorisation" measures, if finally approved, will impact significantly Russian businesses with legal structures involving non-Russian elements. It is strongly recommended to conduct a review of the existing structures in order to define potential weaknesses in terms of the anticipated measures and carefully monitor the development of the issue.

From our side, we would be happy to assist you in performing such a review (from Cyprus and Russian tax perspectives) and advise you on potential solutions if certain weaknesses are identified. In the meantime, we will continue to keep a close eye on any developments in relation to "deoffshorisation" measures proposed by the Russian government and, as always, will keep you informed.

Note:

The tax information contained in this publication is accurate as at the date of its publication and it is issued as guidance only. It should not be solely relied upon to structure business transactions without expert advice.

For professional consultation, please contact the Taxation Department of Costas Tsielepis & Co.