

## Russian De-Offshorisation Laws

### Introduction

The lower chamber of the Russian Parliament passed a new de-offshorisation law on the 18<sup>th</sup> of November 2014. For several months this law has been one of the main topics of discussion between the business community and the Ministry of Finance in Russia. The law's main purpose is to prevent tax avoidance through the use of tax havens and low-tax jurisdictions by Russian tax residents. However, it also includes measures that affect foreign investors owning equities in, or receiving income from, Russian entities.

The key developments in the de-offshorisation law include:

- Introduction of the concept of beneficial ownership for the purposes of applying double tax treaty (DTT) benefits
- A tax on indirect sales of immovable property in Russia
- Introduction of the concept for legal entities, based on place of management
- A regime for controlled foreign companies (CFC)

On the 25<sup>th</sup> of November Russia's President, Mr. Vladimir Putin, signed the new law approved by the upper chamber of the Parliament intended to return Russian capital and assets from foreign tax shelters. The law is expected to be effective from the 1<sup>st</sup> of January 2015.

### Beneficial Ownership

Foreign persons will no longer be able to access treaty benefits if:

- They have limited powers to dispose of the income or fulfil intermediary functions and do not perform any other duties or undertake any risks, OR
- The income is subsequently transferred, partially or in full, directly or indirectly, to another person who would not be entitled to treaty benefits if that person directly received the income from a source in Russia.

Beneficial ownership will be tested by tax agents and the tax authorities when granting treaty benefits.

If the direct recipient of the income is not the beneficial owner, but a Russian tax agent is aware of the party acting as the real beneficial owner of the income, then:

- If the **beneficial owner is a Russian resident**, the tax agent should not withhold tax but should inform the tax authorities about the payment
- If the **beneficial owner is a non-Russian resident**, the agent must apply the DTT with a country where the beneficial owner is located subject to certain conditions. The method for identifying a beneficial owner in this case and which documents to provide to the Russian tax authorities to confirm this fact is unclear.

### Changes Impacting Russian Real Estate Owners

Foreign corporations, trusts, partnerships and funds which hold property subject to Russian corporate property tax are required to notify the Russian tax authorities of their shareholders (for corporations) and founders, beneficiaries and managers (for trusts, partnerships and funds).

A penalty equal to 100% of the property tax may apply upon failure to provide the information.

The indirect sale of Russian real estate through the sale of shares in a foreign entity directly or indirectly owning such property will now be taxable in Russia if assets of the entity consist of more than 50% of Russian real estate (owned directly or indirectly). Previously, only the sale of shares in a Russian company owning real estate was taxable.

The Law includes a provision that would exempt income in the form of property transferred to a Russian company without consideration by a shareholder (participant) individual or a legal entity that has an equity interest exceeding 50%. Property received from a foreign company must pass an additional test to qualify for exemption under the Law. This means that the foreign company cannot be permanently resident in a jurisdiction blacklisted by the Ministry of Finance.

The mechanism for collecting withholding tax on sales between two non-Russian entities not registered in Russia is currently unclear.

## **Tax Residency**

A legal entity may now be Russian tax resident based on its place of management. If a company is Russian tax resident it must register for Russian tax and pay tax on its worldwide income (as well as comply with other tax legislation for Russian entities).

Three main criteria and three additional criteria are used to determine the place of an entity's management. These are:

- i. Meetings of the board of directors are predominantly held in Russia
- ii. The executive management of the organization predominantly performs its functions in Russia
- iii. The people authorized to perform management and control over the entity's activities operate predominantly in Russia.

The additional criteria include:

- i. The accounting and management reporting of the entity (excluding preparation of consolidated financial statements) are done in Russia
- ii. The entity's records are kept in Russia
- iii. Human resources management is performed in Russia.

There is uncertainty over how many of the above criteria must be met to become Russian tax resident.

An entity may choose to obtain Russian tax residency in a number of situations. In order to obtain Russian tax residency, the entity must notify the tax authorities at the place of registration of its separate Russian subdivision using the form provided by the Federal Tax Service. The existence of a subdivision is mandatory to comply with the procedure.

## **CFC Rules**

Russian tax residents, both individual and legal entities, must now pay Russian tax on the retained earnings of a Controlled Foreign Company (CFC), if the company has not paid a dividend. If the CFC's profits are less than RUB 10 million (RUB 50 million in 2015, RUB 30 million in 2016), the profits should not be recorded in the tax return.

There will be no penalty for failure to pay tax on CFC profits for 2015-2017. From 2018 onwards, the penalty will be 20% of the underpaid tax or RUB 100,000 if higher.

The profits of CFCs registered in jurisdictions that have a tax treaty with Russia are to be calculated based on the company's financial statements prepared in accordance with its personal law (provided that the financial statements are subject to a statutory audit). In all other cases, profits are to be calculated in accordance with the Profits Tax Chapter of the Russian Tax Code.

The Law permits a CFC's losses to be carried forward indefinitely provided that the controlling entity submits a CFC notification for the period in which losses arose. The Law explicitly allows individuals and legal entities to offset tax paid on a CFC's profit under the laws of a foreign country and/or Russia.

During a transitional period, non-payment or incomplete payment of tax due to failure to include CFCs' profits in the tax base from 2015 to 2017 will not entail criminal liability, provided that the resulting loss to the Russian budget is compensated in full.

The deadline for notifying the tax authorities of participation in a foreign company is one month after the grounds for such notification arise. The deadline for notification of a CFC is the 20<sup>th</sup> of March of the year following the tax period in which a share profit of a CFC is required to be taken into account for a controlling person. In other words, the first deadline for notification of a CFC is the 20<sup>th</sup> of March 2016.

If grounds for notification of participation in foreign companies have arisen before the Law enters into force, the tax authorities must be notified by the 1<sup>st</sup> of April 2015.

### **Definition of Control**

A person controls a CFC if:

- Prior to January 1, 2016, the direct and/or indirect interest of a person/entity in the entity, jointly with a spouse and/or minor children, exceeds 50%.
- After January 1, 2016,
  1. a person/entity whose direct and/or indirect interest in the entity exceeds 25%
  2. a person/entity whose direct and/or indirect interest in the entity (for individuals jointly with a spouse and/or minor children) exceeds 10%, if the direct and/or indirect interest of all parties recognized as Russian tax residents in this entity, jointly with their spouses and/or minor children, exceeds 50%.

A Russian taxpayer is treated as controlling a CFC irrespective of their ownership share, if in practice they control the CFC for their own benefit or for the benefit of his/ her children or spouse.

### **Entities Not Considered CFCs**

A foreign entity is not considered a CFC if:

1. It is a non-profit organization that does not under its bylaws distribute profit (income) earned among its shareholders (participants, founders) or other parties;
2. It is established under the laws of a member state of the Eurasian Economic Union;
3. It is permanently domiciled in a country which has signed a DTT with the Russian Federation, the country is not included in the list of countries which do not exchange information with the Russian Federal Tax Service (the black list) and the effective tax rate of the entity is at least 75% of the average weighted rate profits tax rate<sup>1</sup>;
4. It is permanently domiciled in a country which has signed a DTT with the Russian Federation, the country is not included on the black list and the entity's passive income is less than 20% of its total income;
5. It is a non- corporate entity which meets the conditions:
  - the founder does not have an ownership right to the entity's assets after its establishment under the entity's bye laws and founding documents
  - the founder's rights (including the right to alienate property, determine beneficiaries and other rights) may not be transferred after its establishment to any other party, unless the rights are transferred by inheritance or universal succession procedures
  - the founder may not, directly or indirectly, receive any income that is distributed among all its participants (unit holders, grantors or other parties) or beneficiaries.
  - The provisions of point 5 apply until the foreign entity ceases to be able to distribute its profit among its beneficiaries.

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<sup>1</sup>The formulas for calculating the effective tax rate and weighted averages profits tax rates are also stipulated in the de-offshorisation law. The weighted average rate is calculated with reference to the base tax rates established by the Russian Tax Code for different types of income (20% for general basket, 13% for dividends).

6. It is a bank or an insurance company permanently domiciled in a country which has signed a DTT with the Russian Federation and the country is not included on the black list;
7. It is an issuer of listed bonds, an organization authorized to receive interest income payable on listed bonds or an organization that was assigned the rights and obligations related to the listed bonds issued by another foreign company (subject to certain conditions);
8. It participates in projects under product sharing agreements, concession agreements or other contract signed with the government of the relevant country and income from such activity is more than 90% of the entity's total income.
9. It operates a new off-shore oil and gas field or is a shareholder of such entity.

#### **Notifications on participation in foreign entities**

Russian tax residents participating in foreign entities will have to file two notifications to the Russian tax authorities:

1. List of interests in foreign entities and
2. List of CFC interests.

The penalty for failure to file the notification will be RUB 50,000 for each foreign entity interest and RUB 100,000 for each CFC.

#### **Conclusions and Proposed Services**

We strongly recommend that the proposed changes soon to be implemented require a detailed tax advice in Russia and clear analysis of the current legal structure. This has to be done in close coordination with us in Cyprus to ensure correct and timely implementation of possible changes as well as a correct management of this new structure in the future.

Please inform us as a matter of urgency if you are already obtaining formal tax advice in Russia from your own tax advisors.

We are currently working with all the top 4 global accounting firms (PWC, Deloitte, KPMG and Ernst & Young) and tax advisors in Moscow and we will be happy to arrange a meeting with one of these firms to discuss the tax implications and possible solutions for the current structure.

We are currently coordinating the following actions for a number of our clients:

- i. Analysis of the tax issues with appointed tax advisors
- ii. Coordinating meetings for initial review in Russia or Cyprus
- iii. Implementation of the tax advice
- iv. Implementing and monitoring ongoing changes affecting substance and management and control.

We are looking forward to being of service on this major issue.

Contact us at [info@aspentrust.com](mailto:info@aspentrust.com) to discuss how we can assist you with the evaluation of your current structures.