Russia’s State Duma passes De-offshorization draft law

Executive summary

On 18 November 2014, Draft Federal Law No.630365-6 Concerning the Introduction of Amendments to Parts One and Two of the Tax Code of the Russian Federation (Regarding the Taxation of the Profit of Controlled Foreign Companies and the Income of Foreign Organizations) (the Law) was approved in the second and third hearings at the plenary meeting of Russia’s State Duma. The current wording of the Law is final. This week the Law will be submitted to the Federation Council. It is expected that the Law will be passed by the end of the week (21 November 2014) and will come into effect from 1 January 2015.

The text of the Law has not undergone any significant amendments compared to the Draft Law submitted to the State Duma.

The main amendments concern the duration of the transition period in which fewer Russian residents are to be recognized as controlling persons of a controlled foreign company (CFC). The criterion of recognition of a Russian resident whose participation in a CFC exceeds 50% as a controlling person will be applicable only during 2015. From 2016 the threshold will be 25% and an alternative “aggregate” participation criteria will also be in force (a 10% threshold in cases where at least a 50% participation interest in aggregate is held by Russian residents).

In addition, certain technical amendments were introduced in the calculation of the effective tax rate and the blended rate of profits tax applicable in Russia (corrections of inaccurate references and the addition of missing formulae) as well as to the duration allowed for tax-exempt liquidation procedures.

This Alert summarizes the key provisions of the Law.

Detailed discussion

Controlled foreign company rules

Foreign companies are to be treated as controlled if i) they are not Russian tax residents; and ii) they are controlled by individuals or legal entities that are Russian tax residents.
A Russian resident is to be recognized as a controlling person of a CFC if his participation interest is at least:

- 50% during 2015
- From 2016, 10% if his participation interest together with those of other Russian residents constitutes a 50% interest in the CFC and 25% if it does not

Certain types of controlled companies are to be exempt from profits tax in Russia. In particular, the profits tax or income tax base of controlling persons will not include the profit of:

- Active companies (i.e., companies that have more than 80% active income)
- Companies registered in a country where the effective tax rate applicable to the CFC is at least 75% of the blended tax rate of Russian profits tax
- Certain types of foreign structures without the formation of a legal entity (profit will not be tax exempt if the structure has the option of distributing profit under its own private law or foundation documents)
- Banks and insurance companies if they operate in a territory that exchanges information with the Russian Federation
- Issuers of certain types of Eurobonds, if the interest income on such bonds is at least 90% of the issuer’s income
- Companies participating in certain foreign industrial projects, primarily oil and gas (at least 90% of income)

The effective tax rate is to be compared to the blended rate of profits tax applicable in Russia. The threshold for the effective rate is 75% of the blended tax rate calculated for two types of income:

1) The CFC’s total profit, minus dividends paid and dividends received by the CFC or zero if the result is negative (taxed at a rate of 20%)

2) Dividends received by the CFC (taxed at a rate of 13%)

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, nonpayment or incomplete payment of tax due to failure to include CFCs’ profits in the tax base in 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 20 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. Therefore, the first deadline for notification of a CFC is 20 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 1 April 2015.

**Determination of tax residency of foreign legal entities by place of management**

If any of the following criteria is met a company’s place of effective management will be considered to be Russia:

- A relative majority of board meetings (more than in any other country) are held in Russia
- The company’s executive body or bodies regularly conduct company-related activities in Russia (activities are not regarded as regularly conducted in Russia if they are carried on there to a substantially lesser extent than in another country or countries)
- The company’s chief (executive) officers primarily perform their executive management duties in Russia

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Several exclusions from tax residency are provided:

- Foreign companies incorporated in the jurisdictions that have tax treaties with Russia under which the companies are treated as tax resident in the jurisdiction of incorporation
- Foreign companies whose core activity involves participation in production sharing agreements, concession agreements, license agreements or service agreements on a risk basis or other similar agreements with the government of the corresponding state (territory) or with institutions (State authorities, State companies) authorized by that government
- Foreign holding companies subject to several conditions being met
- Foreign companies that are operators of new offshore hydrocarbon deposits (shelf projects) or direct shareholders (participants) in the operators of such deposits

The concepts of the “actual right to receive income” and “actual recipient (beneficial owner) of income”

The Law allows the actual owner of income to apply the provisions of a treaty or domestic law to income paid from a Russian source to a foreign person resident in a treaty jurisdiction which is not the actual owner, provided that in the event of the actual owner being resident in Russia, the tax authority in the place of registration of the company which is the source of payment is notified. This applies to both dividends and other types of income. The Law also states that if tax on income of a foreign company is withheld as a result of tax control measures, the actual owner of income may subsequently apply for a refund of excess tax withheld.

Miscellaneous

- 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 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; the foreign company must not be permanently resident in a jurisdiction blacklisted by the Ministry of Finance.
- Income from sales of shares in companies more than 50% of whose assets consist, directly or indirectly, of immovable property in Russia (subject to certain exceptions) is to be taxable for Russian nonresidents and for residents. It should be noted that the mechanism for tax payment is not established in the Law and remains unclear.
- For the purposes of calculating an entity’s interest in a CFC in order to establish whether it is a controlling person, any interests held via foreign structures that are not legal entities are to be taken into account.
- The risk that a CFC’s profits will be subject to double taxation cannot be ruled out if dividends are paid out of retained earnings of prior years as a CFC’s retained earnings are included in the tax base of the Russian controlling person and subject to profits tax/personal income tax in Russia. If dividends are subsequently paid out of this profit, such dividend income will be taxable as well.

What does this mean for Russian taxpayers?

It is extremely likely that the Law will enter into force on 1 January 2015. It will apply to CFCs’ profits beginning with periods starting in 2015. The Law has been passed by the State Duma in all three readings. Therefore, preparations for the changes in the tax law should be initiated as a matter of urgency if not already underway.

Taxpayers should take action to:

- Analyze a group’s corporate structure in order to identify companies affected by the CFC rules, including the proposed exemptions
- Calculate the effective/blended tax rate for CFC purposes and the taxable profit of CFCs in compliance with the new legislative requirements (including determining the percentage of a CFC’s passive income)
- Prepare and submit CFC notifications and notifications of participation in foreign companies
• Introduce centralized collection of information needed to calculate CFCs’ profits for Russian profits tax or VAT purposes, including assessing the need to engage an outside provider to coordinate this process

• Assess the quality of reporting in countries where CFCs are located (including for previous periods) as well as the need to engage an outside provider to check and/or prepare reporting in these countries (including for any previous periods in respect of which losses may be used)

• Analyze the need to outsource reporting in accordance with the standards of the countries in which CFCs are located (applicable to CFCs whose reporting is outsourced)

• Implement software to support these information-gathering and reporting processes

• Review the foreign component of holding, financial, licensing and commercial structures as well as the management structure of a group’s foreign assets in the light of the provisions of the Law

• Develop foreign or Russian structures as an alternative to back-to-back ownership, financing and licensing structures

• Review foreign corporate structures, with a view to streamlining them and reducing the overall costs involved in administering them

• Develop options for consolidating assets at the level of companies that have a sufficient presence at their location; develop and implement step plans

• Undertake formalized business valuation, as needed for restructuring in certain jurisdictions in order to calculate any exit tax (or the equivalent of exit tax)

• Develop a plan to address issues in the current system of management, business processes and document flow between Russian and foreign group companies

• Review personal holding mechanisms and foreign structures that are not legal entities; calculate the overall tax burden for various options

• Analyze the tax implications of restructuring for a business’s beneficiaries (Russian tax residents)

• Analyze the ownership structures of beneficiaries’ personal assets from the point of view of legal and tax risks; calculate the overall tax burden for various options

• Develop positions on reviewing the tax parameters of joint ventures in view of the new rules
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