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Global Tax Alert

Russia publishes revised draft law on de-offshorization

Executive summary

On 2 September 2014, the Russian Ministry of Finance published a substantially revised version of the draft law on the package of tax initiatives collectively referred to as "de-offshorization" (the Draft Law).

The first version of the Draft Law was officially published on 18 March 2014 and was widely discussed by the Russian business community in a variety of forums. Based on these discussions, a second version was published on 27 May 2014.

The new version, published on 2 September 2014, includes a number of important changes affecting such matters as exclusions from classifying companies as controlled foreign companies (CFC), criteria for determining tax residency of foreign companies, and property tax charged as a penalty when the beneficiaries of certain companies are not disclosed among other significant changes.

The key changes in comparison with the previous draft are summarized below.

Detailed discussion

Controlled foreign company rules

Definition of a "controlled foreign company"

The new version of the Draft Law retains only two CFC criteria. A CFC is i) a foreign company that is not tax resident in Russia; and ii) is controlled by organizations or individuals that are Russian tax residents.

The list of CFC exclusions still includes foreign public companies, non-commercial organizations which do not distribute their profits, companies from the Eurasian Economic Union and companies registered in jurisdictions that exchange information with Russia for tax purposes and impose an effective tax rate of over 15%. However, the list of exclusions has now been expanded to include:

- Foreign companies involved in projects under production-sharing, concession and similar agreements in their country of incorporation.

- Foreign structures without the formation of a legal entity (in general, foundations, trusts, etc.). Such structures are excluded only as long as they are unable to distribute profit to participants or beneficiaries.
- Banks or insurance companies operating in a territory that exchanges information with the Russian Federation.
- Issuers of Eurobonds, if the interest on them is at least 90% of the issuer's income.

Persons to which CFC rules apply (controlling persons)

As in the previous version of the Draft Law, CFC rules will apply to Russian tax residents, both legal entities and individuals.

Control criterion

Important changes have been made in thresholds for participating interests in CFCs. The following persons will be treated as controlling persons:

- A person whose direct and/or indirect participating interest in the organization in conjunction with his spouse and/or minor-age children and other interdependent persons is more than 25%.
- A person (as indicated above) that directly and/or indirectly owns over 10% of a company, where all Russian tax residents, jointly with their spouses and/or minor children and other interdependent persons, have a direct and/or indirect interest of over 50%.

For a definition of interdependence, the current version of the Draft Law refers directly to the transfer pricing rules (Clause 2 of Article 105.1 of the Tax Code).

During the transition period (until 1 January 2017), the threshold for both criteria is 50%.

As in the previous version, a Russian person's control over a structure (foundation, trust, etc.), other than a company, refers to his influence on decisions adopted by the person who manages the assets of the structure with respect to the distribution of profit rather than the level of his participation interest. No threshold has been proposed.

The following are not taken into account for the purposes of determining a participating interest:

- Direct (indirect) interest in a foreign public company.
- Participating interest exercised by means of holding securities under REPO and loan agreements (subject to certain conditions).

The Draft Law does not clarify a number of ambiguous terms, including "control," "personal law," "influence" and "particular characteristics." As a result, these terms may be construed loosely by the tax authorities.

CFC notification

The deadline for providing notification of participation in a CFC remains 20 March of the year following the tax period (the tax period is determined as prescribed in the personal tax or profits tax chapter of the Tax Code as appropriate).

Principles of calculating the profit of a CFC

There is a lack of clarity with respect to the rules for calculating the profit of a CFC in the Draft Law. On the one hand, profit of a CFC is still calculated "in accordance with Chapter 25 of the Russian Tax Code." However, new special rules also require that a CFC's profit should be documented in tax reporting prepared in accordance with the CFC's personal law along with financial statements and tax reporting.

The threshold for including a CFC's profit in a Russian taxpayer's tax base is raised from 3 to 10 million RUB. There will also be a transition period: the minimum level of profit is set at RUB 50 million for 2015 and 30 million for 2016.

For the purposes of determining a CFC's profit, income will still be divided into two "baskets" – active and passive – primarily to allow taxpayers an accelerated deduction of investment costs of active business. No change, however, has been made in the way investment costs are determined, and certain important forms of investment (e.g., contributions into companies' capital) are still disregarded.

Offsetting foreign tax

A CFC's profit is reduced by the amount of dividends paid out of that profit and the amount of tax paid on such profit under the laws of the foreign state and/or Russian law as well as by the amount of corporate income tax paid by any permanent establishment of the CFC in Russia.

In contrast to the previous version of the Draft Law, tax paid in Russia on a CFC's profit may now be offset.

Liability
The fine for nonpayment or underpayment of tax as a result of non-inclusion in the tax base of a share in the profit of a CFC remains unchanged: 20% of the amount of unpaid tax, but no less than RUB 100,000.

The Draft Law establishes a transition period: fines will not be charged for the tax periods 2015–2017 when decisions are made to impose tax liability for such tax offenses.

There will be a liability for failing to notify the tax authorities of participation in a CFC: RUB 100,000 for each such a company.

A fine of RUB 100,000 will also be charged for failing to provide the tax authority with information or for submitting documents containing inaccurate information on a controlled entity.

Amendments to Article 23 "Obligations of Taxpayers"
Notification of participation in Russian and foreign companies
The Draft Law no longer makes it a blanket requirement for companies and individual entrepreneurs to notify the tax authorities of their participation in Russian and foreign organizations. With respect to foreign organizations companies and individual entrepreneurs must now notify the tax authorities of their participation in:

- Foreign organizations in which they have an interest of over 10%.
- Foreign structures without the formation of a legal entity (including cases in which the taxpayer is a founder of such a structure or is a beneficial owner of income (profit) distributed.

Companies and individual entrepreneurs are still required to notify the tax authorities of their participation in Russian organizations (with the exception of business partnerships and limited liability companies) in which they have an interest of over 10%.

The deadline for notifying the tax authorities of participation in foreign organizations has been increased from 20 days to one month.

The Draft Law provides a transition period for notification of participation in foreign organizations. Before 1 January 2017, notification will be required of direct and/or indirect participating interests of 25% or more.

Ownership exercised via Russian and foreign public companies is not taken into account in determining share interest in foreign companies for notification purposes, unlike in the case of participating interest for CFC purposes. This inconsistency may be an oversight that may be corrected later.

The Draft Law also requires that the tax authorities be notified within one month of a participating interest in a foreign organization being terminated.

Failure to notify the tax authorities of participation in foreign organizations entails a fine of RUB 50,000 for each foreign organization. The Draft Law, as currently worded, requires taxpayers to submit such notifications from 1 February 2015.

Notification on a foreign company's participants that own property in Russia
The Draft Law requires foreign companies and foreign structures without the formation of a legal entity that have property taxable in Russia to provide the local tax authority to such property with information on the foreign company's participants (the founders, beneficiaries and managers of a foreign structure without the formation of a legal entity), including disclosing the indirect participating interest of any individual or public company whose direct and/or indirect interest exceeds 5%.

Taxpayers failing to provide such information or providing it late will be fined an amount equal to 100% of the tax calculated on the company's property (the fine will be calculated in proportion to the interest held in the company or to the number of participants).

Determination of the tax residency status of foreign legal entities by place of management
Tax residency criteria for legal entities are clarified in the new version of the Draft Law. These criteria appear to better reflect the management realities of major Russian groups with foreign assets and limit the ability of the tax authorities to interpret certain criteria loosely.

A foreign company is to be regarded as tax resident in Russia if:

- It is tax resident in Russia under an international taxation agreement;

Or

- The place of effective management of the foreign organization is in Russia.

As in the previous draft, three key criteria are used to determine where a company is actually managed:

- The board of directors or another management body meets primarily in Russia. The draft specifies that the number of meetings held in Russia should exceed half of all meetings in a calendar year (although, as before, there is no guidance on meeting format or on how to treat situations in which directors are in different countries at the time of a meeting).
- Executive management of the organization is primarily exercised from Russia.
- The company's chief (executive) officers perform their duties for this company primarily in Russia.

The draft explains "executive management" as the adoption of decisions and the performance of other actions pertaining to the organization's current activities which fall within the competence of the executive management bodies. The executive management of a foreign company will be considered to be exercised outside Russia if it carries out business using its own qualified personnel and assets in a country (territory) in which it is resident and which has a tax treaty with Russia.

Preparation and/or adoption of decisions in Russia involving issues within the competence of the general shareholders' meeting cannot be regarded as executive management of a foreign company.

The draft introduces the concept of chief (executive) officers. These are authorized persons with responsibility for planning, managing and overseeing a company's activities.

If the criteria for determining where a foreign company is managed are met by a number of countries, additional criteria are to be considered:

- Accounting or management records are maintained in Russia.
- The company's records are managed in Russia.
- Orders or other administrative documents on the company's operations are issued in Russia. This excludes standards, methodologies and/or policies that apply to the group or are strategically important for shareholders, i.e., documents required in practice for shareholder control.
- Day-to-day personnel management takes place in Russia (instead of hiring personnel, as in the previous version).

The following foreign companies may be regarded as Russian tax residents only on a voluntary basis:

- Foreign companies that are resident in a country that has a tax treaty with Russia and that are tax residents of such foreign country under the treaty.
- Foreign companies whose main activities involve projects carried out in the country (territory) where such companies are registered (incorporated) under production-sharing and similar agreements.

A foreign company with an autonomous subdivision in Russia may choose to recognize itself as tax resident in Russia. Unlike in the previous draft, there are no other restrictions on such voluntary recognition.

The CFC rules will not apply to companies that choose to recognize themselves as tax resident in Russia.

The draft, like its predecessor, deals directly with tax implications for foreign companies that are Russian tax residents only in regard to corporate income tax and does not introduce provisions to regulate the tax accounting procedure for foreign companies treated as tax resident in Russia.

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

Important changes affect the concept of "actual recipient (beneficial owner) of income."

When dividends are paid (subject to certain conditions) the beneficial owners of the income may now apply treaty provisions or provisions of domestic law (even if they are not the direct foreign recipients of income).

Thus, for example, if a Russian holding company owns Russian operating companies via a chain of foreign intermediary companies, and the Russian holding company is regarded as the beneficial owner of dividend income, the tax implications will be the same as they would be if the Russian holding company received dividends directly from the Russian operating companies.

Taxation of the indirect sale of shares and interests in companies, over 50% of whose assets are real estate located in Russia

Under the Draft Law, proceeds from sales of shares and participating interests in foreign companies, over 50% of whose directly or indirectly owned assets are real estate in Russia as well as financial instruments derived from such shares (participating interests) will be taxable in Russia (with the exception of traded shares).

Additional types of income not regarded as income subject to taxation at source are specified as follows:

- Income from sales of securities (participating interests, units) in foreign companies or structures that are not legal entities, where there are at least 50 shareholders (participants) and each person owns no more than 5%;

Or

- Income from sales of securities (participating interests, units), on condition that, when they are sold or otherwise disposed of (including redeemed), they have been continuously owned by the taxpayer by right of ownership or another right *in rem* for over five years.

The new draft still does not formally provide an expanded tax mechanism for such indirect sales of Russian real estate.

Taxation of liquidation payments

The value of property (property rights) received when a CFC is liquidated is to be exempt from profits tax. Special rules are provided for determining the value of assets for tax accounting purposes. This is a transitional provision (valid until 1 January 2019) designed to encourage Russian groups to restructure to adapt to the new CFC requirements.

Other

- The 0% tax rate (in cases of disposals after ownership for over five years) is to be extended to shares making up the authorized capital of Russian companies, no more than 50% of whose assets directly or indirectly consist of real estate in Russia (with the exception of traded shares in the high-tech sector of the economy).
- The provision exempting income in the form of property transferred to a Russian organization without consideration by a shareholder (participant) owning over 50% is to be eliminated.
- The fact that a company managing an investment fund, mutual fund or other collective investment vehicle is tax resident in Russia will not mean that the fund is a CFC or tax resident in Russia.
- As regards Russian thin capitalization rules, a greater than 20% direct or indirect share interest is reinstated as a criterion for controlled debt in place of the much broader wording in the last draft. However, the thin capitalization rules are expected to be revised in connection with loans from foreign "sister companies."

Implications

If the Draft Law is adopted this year, it will enter into force on 1 January 2015. This is assuming that the new version applies to CFC profits starting with periods beginning in 2015. Although the Draft Law is likely to undergo further revision, and its formulations are thus not final, taxpayers should begin preparing for these changes.

Preparations may include the following:

- An analysis of a Group's foreign companies to determine whether any meet the CFC criteria (whether they qualify for exclusions, including a calculation of the effective tax rate for such foreign companies).
- A quantitative assessment of future tax costs and preliminary development of strategies for reducing them, including by potentially transferring a number of operations and companies

with Russian ownership to a Russian tax jurisdiction. One priority area is the development of plans for eliminating tax haven companies from structures or for restructuring.

- An assessment of the documentation required to meet the new legislative requirements and development of new processes for collecting and preparing such documentation.
- An analysis of management processes (including legal and organizational aspects) and an assessment of Russian tax residency risks as well as development of related risk management strategies, including the transfer of actual management to locations outside Russia where feasible.
- A diagnostic of current licensing and financial structures and development of options for converting from "back-to-back" structures into single-level structures with the corresponding level of business activity.
- An analysis of current and planned payments to foreign counterparties and an assessment of related tax risks entailed by the concept of "actual recipient of income" (beneficial owner). Development of alternative structures and options for organizing contractual structures in connection with a higher risk profile. Structuring information-gathering processes in connection with substantiating the status of the actual recipient of income.
- An analysis of the tax implications of restructuring for individual beneficiaries.

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