Russian Government submits legislation on tax residence, CFCs and treaty benefits to the State Duma

Executive summary

On 21 October 2014, Draft Law No. 630365-6 (the Draft Law) on the taxation of profit of controlled foreign companies (CFCs) and income of foreign organizations was submitted to Russia’s State Duma. The first hearing is scheduled for 11 November and Mr. Shatalov, Deputy Minister of Finance has said that the second reading is likely to be on 14 November. This confirms the possibility that in less than two months’ time, foreign companies with Russian income and controlling persons of CFCs may be subject to a profits tax regime which has just undergone its most significant changes since 2002 when the Profits Tax chapter of the Tax Code came into force.

This Alert summarizes the relevant provisions for foreign investors.

Detailed discussion

Changes to the application of treaty benefits

Amendments will restrict the application of benefits under international tax treaties, such as exemption from tax and reduced withholding tax rates, to what the Tax Code will refer to as the “actual recipient (beneficial owner) of income.” This is a key change for recipients of Russian-source income.

- A person who has an actual right to income will be a person who, by virtue of direct or indirect participation in an organization or control over an organization, or by virtue of other circumstances, has the right independently to use or dispose of that income, or a person in whose interests another person has the authority to dispose of the income in question.

- The functions performed and the risks assumed by persons will be considered in deciding to which person, if any, treaty benefits apply in relation to Russian-source income.
• A foreign person will not be deemed to have an actual right to income if that person possesses limited powers in relation to the disposal of the income and carries out intermediary functions in relation to it in the interests of another person without performing any other functions and without assuming any risks, directly or indirectly paying the income in question (in whole or in part) to that other person who, were that income to be received directly from sources in the Russian Federation, would not have the right to the application of the provisions of a tax treaty under which a reduced tax rate or exemption from Russian tax would apply.

There is a long-established requirement for a tax agent to obtain a confirmation of the residency of the recipient of income prior to applying treaty benefits. The draft introduces an additional prerequisite for reducing tax withheld at source which is confirmation from a foreign recipient that the organization has an actual right to receive the income in question. If the tax agent has not received both documents prior to the date of payment of the income it should not apply any preferential tax treatment. The foreign taxpayer would then have to satisfy the Russian tax authorities of its residence and actual right to receive the income in order to claim a refund of any excess tax withheld over the amount applicable to the income under the terms of the relevant tax treaty.

When dividends are paid (subject to certain conditions) the beneficial owners of the income may be able to apply treaty provisions or provisions of domestic law even if they are not the direct foreign recipients of income. If, for example, 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. This kind of look-through could prove helpful in structuring joint ventures with foreign investors.

Taxation of foreign companies based on residence
Currently, management activity of a foreign company taking place in Russia is significant for profits tax purposes only if the activity gives rise to a permanent establishment. This will cease to be the case under the proposed rules. A tax-resident foreign company will be subject to profits tax on its worldwide income. Furthermore, all payments made by a tax-resident foreign company will be subject to withholding tax in Russia. Under the draft, foreign companies will be treated like Russian companies for profits tax purposes if they are deemed to be tax resident, which will be the case if:

• They are deemed to be tax resident in Russia in accordance with an applicable international tax treaty for the purposes of that treaty; or

• Their place of effective management is Russia, except as otherwise provided by an international tax treaty.

Place of effective management
The place of effective management will be governed by specific rules in Russian domestic law rather than international practice and principles.

The place of effective management will be considered to be Russia if any of the following conditions is met (previously it was unclear how many criteria needed to be satisfied):

1. The majority of meetings of the board of directors (or a similar body of the company other than an executive body) are held in Russia. For this purpose a majority means more are held in Russia than in any other state (so sending the board on tour will not help if there is no state in which more meetings are held than are held in Russia).

2. The executive body of the company regularly carries on its activities in relation to that organization from Russia. For this purpose, activities will not be deemed to be carried on regularly where activities are carried on in Russia to a substantially lesser extent than in another state (other states).
3. The chief (executive) officers of the company (persons who are authorized to carry out and responsible for planning, management and oversight of an enterprise’s activities) primarily carry out their activities in the form of executive management of that foreign company in Russia. For this purpose, executive management of a company means the adoption of decisions and the performance of other actions pertaining to the company's current activities which fall within the authority of the executive management bodies.

Where none of the above conditions are satisfied or only condition 1. or 2. is met, the foreign company will be deemed to be tax resident in Russia if any of the following criteria are met:

- The maintenance of the company's accounting records or management records (with the exception of activities associated with the preparation of consolidated financial statements) takes place in Russia.
- The company's records are managed in Russia.
- Day-to-day management of the company's personnel takes place in Russia.

This appears to be a step backwards in the development of the proposals, with the new draft giving too much weight to record-keeping and record management in determining the place of residence. It is also unclear why additional criteria are needed in the case of a company satisfying one of the requisite conditions, given that under the current wording of clause 2 of Article 246.2 satisfying one condition is sufficient for the place of effective management to be considered to be Russia.

Special grounds on which effective management is not considered to be in Russia

The draft includes a number of exceptions which are most likely aimed at addressing the concerns of Russian groups that normal shareholder activities should not result in a foreign subsidiary being deemed to be tax resident. In particular, the carrying out of the following activities in Russia will not in itself be considered as signifying that effective management of a foreign company is exercised in Russia:

- Preparation and adoption of decisions on matters falling within the authority of the general meeting of shareholders (participants) of the foreign company
- Preparation for the holding of a meeting of the board of directors of the foreign company
- Performance in Russia of particular functions pertaining to planning and control of the activities of the foreign company, including: strategic planning, budgeting, the preparation and drawing-up of consolidated financial statements, internal auditing and internal control and the adoption (approval) of standards, methodologies and policies which apply to all or a substantial proportion of subsidiary organizations of the organization in question

Another exception is for any foreign company permanently resident in a treaty jurisdiction (a state with which Russia has concluded a tax treaty) which carries on its commercial activities in that state using its own qualified personnel and assets. Effective management of such companies will be considered to be exercised outside Russia. The extent to which this rule will protect companies which also have activities in other states including Russia is unclear.

Companies for which effective management in Russia will not give rise to residence

Further exclusions are included in clause 6 of Article 246.2, many of which were not in earlier drafts:

1. The foreign company has permanent residence in a treaty jurisdiction and is deemed to be tax resident there in accordance with the tax treaty between Russia and that jurisdiction.
2. The foreign company, as its main activity, participates in projects in accordance with production sharing agreements, concession agreements, license agreements or service agreements (contracts) 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. In earlier drafts the project had to be in the foreign company's state of incorporation.
3. A foreign company which has as a (direct or indirect) shareholder a Russian controlling person whose equity interest in that foreign company is at least 50% for not less than 365 calendar days, provided that all the following conditions are met:

- According to the foreign company’s financial statements, more than 50% of its assets consist of investments in foreign subsidiary companies which meet the requirements of subsection 4 of clause 7 of Article 25.13 of the Tax Code and are not tax resident in Russia and whose state or territory of permanent residence is not included in a list of states and territories approved by the Ministry of Finance.

- The foreign company’s equity interest in such subsidiary companies is not less than 50%.

- No more than 5% of the foreign company's income (profit) consists of income dividends directly or indirectly received from such subsidiary companies.

4. The foreign organization is an operator of a new offshore hydrocarbon deposit (qualifying oil and gas project on Russia’s continental shelf) or a direct shareholder (participant) of such an operator.

A further new exclusion is provided in clause 9 of Article 246.2, for companies which are issuers of circulated bonds or which have been authorized to receive interest income payable on such bonds and any company to which rights and obligations in respect of issued circulated bonds whose issuer is another foreign company have been ceded. Such companies may not be deemed to be tax resident in Russia if the requirements established by subsection 8 of clause 2 and clause 2.1 of Article 310 of the Tax Code in relation to such foreign organizations and circulated bonds are met. The amount of the above-mentioned income for the period for which financial statements for a financial year are prepared in accordance with the personal law of the foreign organization must account for not less than 90% of the total income of the organization in question for that period.

**Taxation of indirect sales of property-rich companies**

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). The draft excludes such indirect sales of Russian real estate from income of foreign companies subject to withholding tax but does not specify a direct tax mechanism. Additional reporting requirements for participants in foreign companies which own real estate situated in Russia and penalties for nondisclosure of the required information will make it easier for the tax authorities to identify and keep track of such participants.

**Notification of participants in foreign companies and structures 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 with information on the foreign company's participants (the founders, beneficiaries and managers in the case 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 which fail to provide such information or provide 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).

**Taxation of transfers of assets free-of-charge from shareholders**

The previous draft, dated 26 August, proposed the abolition of subsection 11 of clause 1 of Article 251 of the Tax Code. This exempts transfers of assets to a Russian company from tax if they are from a majority shareholder or a subsidiary in which the recipient is the majority shareholder. The current draft restricts the exemption rather than abolishing it. It will not apply.
to assets received from a parent company permanently resident in a jurisdiction on the Ministry of Finance’s blacklist or from a subsidiary.

**Controlled foreign company rules**
The controlled foreign company (CFC rules) will apply to Russian tax residents – both legal entities and individuals. The rules will not affect inbound investors (nonresidents) directly but may influence the structuring of joint investments with Russian partners.

**Impact for investors in Russia**
If the Draft Law is adopted this year, it will enter into force on 1 January 2015. Although the Draft Law is likely to undergo further revision, and its provisions are thus not final, preparations for the changes should proceed without delay.

Foreign investors in Russia should consider actions including the following:

- 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.

- Analyzing current licensing and financial structures and the development of options for converting from “back-to-back” structures into single-level structures with the appropriate level of risks and functions to justify tax benefits.

- An analysis of current and planned payments to foreign counterparties and an assessment of tax risks which may arise with the application of 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 assessment of the documentation required to meet the new legislative requirements and development of new processes for collecting and preparing such documentation.

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**Endnote**

1. This is one of the criteria included in the draft CFC regime for exemption of profit of a CFC from inclusion in the tax base of a Russian controlling person. The foreign company must be resident in a treaty jurisdiction whose tax treaty with Russia provides for the exchange of information for tax purposes. Also, no more than 20% of the foreign company’s income for a financial year can be income which is to be deemed to be passive income for the purposes of the CFC regime (specified in subsections 1 to 12 of clause 3 of Article 309.1 of the Tax Code and including income from some kinds of services).
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