

'Deoffshorisation' of Russian Economy: Draft Law on Controlled Foreign Company legislation and other measures

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On the 18th of March the Russian Ministry of Finance published a draft law on anti-offshore measures (the Draft). The Draft introduces three concepts:

- Controlled foreign companies rules (CFC);
- Russian tax residence for foreign companies based on tests of management and control; and
- New rules on taxation of the indirect disposal of Russian real estate.

Implementation of the new legislation will provide the Russian tax authorities with legal mechanisms for taxing international corporate and private structures. Increased international exchange of information will allow the authorities to track down those structures and tax their Russian owners. Consequently, we strongly recommend that you review and revise both your corporate and private international arrangements as a matter of urgency.

We have set out below the key provisions of the Draft and our summary comments.

Highlights

The draft law's definitions of 'controlled foreign companies', 'controlling persons' and 'control' are very broad. Controlled foreign companies include not only companies controlled by Russian tax residents, but also 'structures' (including funds, partnerships and other forms of collective investment entities) set up in any of the "blacklisted" jurisdictions with the purpose of undertaking commercial activity in the interests of participants and beneficiaries. Broadly, the current version of the "black list" includes off-shore jurisdictions and does not include jurisdictions with which Russia has a double tax treaty. It is unclear at the moment if the existing "blacklist" will be used, or a new list will be adopted for purposes of CFC regulations, possibly comprising a longer list of jurisdictions.

The definition of a controlled foreign company does not refer directly to Anglo-Saxon trusts. However, trusts might be treated as a 'structure', depending on their governance and control. Similar analysis will apply to all types of wealth planning vehicles, including private foundations.

Effectively, controlling persons, both corporate entities and private individuals, will be taxed in Russia on undistributed income of controlled companies and structures.

Importantly, it is proposed that a very wide scope of reporting obligations should apply to Russian tax residents, including the obligation to notify tax authorities of:

- 1) Direct or indirect participation from 1% up in any companies registered in "blacklisted" jurisdictions (irrespective of control over such legal entities)
- 2) Participation in any foreign company where a Russian tax resident is a controlling person. Moreover, in relation to "blacklisted" foreign structures, reporting obligations are also set up not only for controlling persons, but also for any persons who have the actual right to receive income (profits) from the structure, in case such income is distributed.

A combination of definitions of ownership and identification of the controlling person for the purpose of the Draft is likely to make it applicable to a very large number of taxpayers.

Another set of rules defines Russian tax resident companies not only as companies registered in Russia, but also companies which are managed and controlled from Russia. Foreign companies will be treated as Russian tax residents based on very broad criteria, with corresponding obligations of registration, tax reporting and payment.

Further, new rules on taxation of the indirect disposal of Russian real estate are proposed. Their aim is to stop the current use of tax efficient offshore sale and purchase transactions for Russian real estate owned via foreign holding structures.

The proposed law will impact most international structures owned by Russian resident taxpayers, in particular individuals using offshore private companies, collective investment structures and potentially wealth planning structures, such as Anglo-Saxon trusts and private foundations, as well as Russian companies with any offshore subsidiaries. It is clear from the Draft that management and control of international groups will become the determining factor in identifying their Russian tax liability. It is important to review international structures in order to identify risks associated with the proposed CFC rules and also with the rules on the indirect disposal of Russian real estate.

The Draft proposes that the amendments come into force no less than one month from the official publication of the law and not earlier than the first day of the tax period for Russian personal income tax purposes following the date of publication. This means that if the law is introduced this year, the earliest it should come into force is the first of January 2015. The Draft does not contain any transitional or grandfathering provisions.

CFC rules

The Draft provides key definitions, such as 'controlled foreign company' and 'controlling person', as well as obligations of Russian taxpayers to notify the Russian tax authorities of their participation in foreign entities. The Draft also provides tax assessment rules in relation to the undistributed income of controlled foreign companies.

The definition of controlled foreign companies includes:

1) 'A foreign legal entity'. This is a legal entity which meets all four conditions during any period which begins or ends during a calendar year. The conditions are as follows:

- Such an entity is not a Russian tax resident; and
- It is a tax resident in a state which is included in the "blacklist" issued by the Russian Ministry of Finance; and
- It is controlled by Russian resident legal entities or individuals; and
- Shares of this legal entity are not listed on a stock exchange approved by the Russian Central Bank.

2) 'A structure' (in particular, a fund, a partnership or any other form of collective investments). This is a controlled foreign company for the purposes of the Draft, if

- It is registered in a foreign state, which is on the "blacklist" of jurisdictions issued by the Russian Ministry of Finance;
- It is an entity which can, in accordance with its bylaws, perform entrepreneurial activities for the benefit of its participants (beneficiaries, investors, grantors and other persons); and
- Controlling persons of this structure are Russian tax residents.

Controlling person is defined as a Russian tax resident legal entity or an individual, which/who controls a foreign entity/structure, either singly or jointly.

Control over a foreign controlled legal entity is defined as exerting influence or the ability to exert influence on the decisions of such an entity, related to the distribution of its profits after tax by virtue of direct or indirect participation in the entity, or due to participation in a management agreement, or due to other relations between the controlling person and such an entity. Control over a foreign structure is defined as exerting influence or the ability to exert influence on the decisions of a person managing the assets of this structure, in relation to the distribution of the profits to beneficiaries or participants due to the law or agreement.

Irrespective of the above, a person would be treated as a controlling person if he directly or indirectly holds more than a 10% interest together with his/her spouse and (or) minor children, as well as with other persons (considering special relationships between them).

Key obligations of Russian taxpayers (both legal entities and individuals) in accordance with the new rules are as follows:

- To notify tax authorities of direct or indirect participations from 1% up in any legal entities registered in "blacklisted" jurisdictions (irrespective of control over such legal entities), and participation in any foreign company where a Russian tax resident is a controlling person;
- To notify tax authorities in relation to foreign structures as described above. Importantly, reporting obligations are set up not only for controlling persons, but also for any persons who have the actual right to receive income (profits) from the structure in case such income is distributed; and
- To include undistributed profits (share of profits) of foreign controlled companies in the Russian income tax base of controlling persons at the rate of 13% for individuals and 20% for legal entities.

Rules related to calculation of Russian income of CFC are strict and cover all income of CFC (not only passive) and such income should be determined in accordance with the Russian corporate income tax rules.

Management and control test

The definition of Russian resident legal entities for tax purposes is extended to foreign legal entities which have Russia as a place of actual management, and also to foreign legal entities, which are treated as Russian tax residents in accordance with international tax agreements.

Russia will be treated as the place of management of a foreign legal entity if at least one of the following conditions is satisfied:

- Meetings of the board of directors or other management body of the legal entity are held in Russia;
- Principal management is usually undertaken from Russia;
- Key officers of the entity perform their activities out of Russia;
- Accounting is performed in Russia; or
- Archive records of the company are stored in Russia.

Indirect disposal of Russian real estate

The Draft amends the list of income considered to have a Russian source, in particular, item 1.5 of article 309 of the Russian Tax Code. The current law provides that the income of foreign legal entities is subject to Russian tax at source if they sell shares in Russian companies with more than 50% of assets comprised of Russian real estate. Therefore, disposal of shares in a non-Russian company, holding Russian real estate, will not trigger Russian tax.

The draft proposes to treat the disposal of such shares (either in a foreign or in a Russian company) as Russian income. A number of Russian double tax treaties (including treaties with Cyprus, Switzerland and Luxembourg) allow for this type of income to be taxed in Russia. However, the actual mechanism for the implementation and enforcement of the new rules has not yet been proposed in the Draft.

We are monitoring further developments in regards to taxation and deoffshorisation closely. If you are concerned about your current situation or would like to discuss your next steps, please contact Olga Boltenko or any other member of the Withers' CIS team and let us know how we can help you successfully plan your strategies.

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