

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

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Following wide public discussion of the draft anti-offshore law (covered in detail in our press release [here](#)), the Russian Ministry of Finance published a revised draft on the 27th of May (hereinafter – 'the new Draft') which was submitted for consideration to the Russian Government.

We set out below the key provisions and amendments proposed in the new Draft.

## Highlights

The new Draft proposes a new approach to defining controlled foreign companies (hereinafter – 'CFC') and, instead of a 'black list' approach, includes all foreign persons controlled by Russian residents, unless they are specifically exempt from the new rules. Those exempted from the CFC rules in particular include foreign companies registered in a 'white list' of jurisdictions that also meet the effective tax rate test, which significantly limits the list of CFC neutral jurisdictions.

The definition of 'structures' falling into the CFC scope has been extended and now includes **any** structures meeting CFC conditions, irrespective of their governing laws.

Further, the scope of reporting obligations has been clarified and extended to include two types of reporting obligations: 1) on participations of 1% and above in all foreign organizations and on structures where Russian residents have an actual right to income, and 2) on participations in CFCs. Effectively, these new rules impose reporting obligations on the participation of Russian tax residents in majority of foreign legal entities and structures. It is still unclear, however, if participations in foreign listed companies are exempted from reporting.

The new Draft provides that the CFC rules should apply to profits of CFC's determined for tax periods starting in 2015.

The rules related to the definition of Russian tax residence for foreign organizations have also been revised. The new Draft divides tax residence criteria into key and additional sets of criteria. The proposed criteria are still subject to interpretation.

The rules on taxation of the indirect disposal of Russian real estate have not been significantly revised. However, the new Draft still does not provide for a mechanism to administer and collect this tax.

As part of recent tax policy developments, the new Draft introduces and defines new concepts of 'factual right to income' and 'beneficial owner' in the context of applying international tax treaties. The proposed wording is subject to interpretation and increases the practical risk of the Russian tax authorities rejecting the application of double tax treaties to existing and new arrangements. This is an important change which could impact all international tax structures in the future.

The new Draft also proposes using a definition of 'interrelated parties' instead of 'affiliated persons' in the context of thin capitalization rules. This provision can make certain structures subject to thin cap rules going forward.

The new Draft considers a number of technical comments provided by experts in the course of public discussion; however, certain revised provisions have become much stricter and put a limit on planning opportunities. Irrespective of the CFC rules, the management and control of international groups will become the determining factor in identifying their Russian tax liability. Wealth planning structures will require full reviews and potential restructuring to comply with the proposed legislation and clients should consider their planning options. It is important to review all existing international corporate structures in order to identify risks associated with the proposed new rules and put measures in place in advance of 2015.

## 1. CFC rules

The approach to the definition of a CFC has been changed.

The definition of **controlled foreign companies** still includes foreign organizations and structures. However, **'a foreign organization'** will be considered as a CFC if it meets all three of the following conditions:

- The legal entity is not a Russian tax resident; and
- It is controlled by Russian resident legal entities or individuals; and
- Shares of the legal entity are not listed on a stock exchange approved by the Russian Central Bank.

However, a foreign legal entity is subject to exemption from the CFC rules if it falls into one of the following categories:

- Foreign organizations which are listed on a stock exchange approved by the Russian Central Bank;
- Non-commercial organizations or organizations which do not distribute profits to their participants in accordance with their governing law;
- Organizations with permanent residence in the Eurasian Economic Union, which currently includes Russia, Belorussia and Kazakhstan;
- Organizations with permanent residence in jurisdictions included in the list of states which exchange tax information with Russia (hereinafter – the 'white list') AND the effective tax rate of these organizations exceeds 15%.

The proposed approach to calculating the effective tax rate of a foreign organization applies to its gross income (profits); therefore for foreign companies receiving primarily tax exempt passive income, the effective tax rate would most likely be lower than 15%. As a result, a significant section of current international structures using holding companies which are registered in non-blacklisted jurisdictions will become CFCs.

The definition of **'a foreign structure'** has been changed by the new Draft and proposes that any structure, irrespective of its governing law, will become a CFC if it meets the following conditions:

- It is not a legal entity and is set up in accordance with the law of a foreign state; and
- Its activity is aimed at profit generation for the benefit of its participants or beneficiaries; and
- It is controlled by Russian tax residents.

Trusts are now explicitly included in the list of examples of structures covered by these rules. However, in our view, this reference does not explicitly state that all trusts will be covered by the new rules, unless trust structures meet the above conditions.

**The definition of a 'controlling person'** has not been significantly changed and still includes Russian tax resident organizations or individuals, which/who control a foreign organization/structure, either individually or jointly. However, joint control now refers to the definition of 'interdependent persons' used for Russian transfer pricing purposes and provides at least some certainty on how these persons can be identified.

**The definition of 'control'** has not been significantly changed from the first version of the Draft. Control over a foreign organization is defined as 'exerting determining influence or the ability to exert determining 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 organization or other persons'. Control over a foreign structure is defined as 'exerting determining influence or the ability to exert determining 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 in accordance with the law or agreement'.

There is also no change to the default control definition where Russian residents own over 10% (directly or indirectly), together with spouses and minor children (and other persons), in a foreign organization for CFC purposes.

Importantly, the scope of **reporting obligations** of Russian taxpayers (both legal entities and individuals) has been clarified and extended. The new Draft explicitly provides for two type of reporting obligations: 1) on participation in foreign organizations and 2) on participation in CFCs.

Reporting on participation in foreign organizations covers:

- Participation in foreign organizations which are tax residents in foreign jurisdictions or where the tax residency is unknown – if the direct or indirect participation of a Russian tax resident is 1% and above;
- Participation in foreign structures if a Russian tax resident has the factual right to receive income (profits) from the structure when it is distributed.

It is still unclear if participations in foreign listed organizations are exempted from reporting.

The new Draft confirms that the intention of the Russian Ministry of Finance is for the reporting obligations to cover almost every participation of Russian tax residents in foreign companies.

**The rules related to the calculation of Russian tax from CFC's income** are still linked to the Russian corporate income tax rules, although they have been significantly revised, in particular:

- CFC's profits up to 3 mln RUR are exempt, i.e. if a CFC's annual profit does not exceed this amount, it should not be included in the tax base of a Russian taxpayer;
- CFC's income (profits) should be calculated separately for active and passive types of income. Although both types of income (profits) should be included in the Russian tax base, it is possible to offset respective annual losses and carry them forward, but only separately within these two categories of income;

- CFC's profits are offset by the amount of distributed dividends; the amount of Russian tax due on CFC's profits is offset by the amount of tax paid on profits in foreign jurisdictions.

However, there is no provision to allow for the deduction of Russian withholding tax, which can be applied to CFC's passive income received from Russian sources.

## 2. Management and control test

The conditions for determining the Russian tax residence of a foreign organization are divided into 'key criteria' and 'additional criteria'.

The key criteria are as follows:

- Meetings of the board of directors or other management bodies of the legal entity are usually held in Russia;
- Principal management is usually undertaken from Russia;
- Key officers of the entity perform their activities from Russia.

If the key criteria are met in several jurisdictions, there are additional criteria to determine tax residence:

- Statutory and management accounting is performed in Russia;
- Documentation management is performed in Russia;
- Orders or other administrative documents concerning the organization are issued in Russia; or
- Recruitment and personnel management is performed in Russia.

The new Draft does not provide a right for the voluntary recognition of Russian tax residency to foreign organizations registered in 'blacklisted jurisdictions'.

## 3. Indirect disposal of Russian real estate

There are no principal changes in this part. The new Draft still does not provide for a mechanism to administer and collect this tax.

## 4. Implementation of 'factual right on income' and 'beneficial owner' concepts

The new Draft provides for new tax concepts to be used in relation to the application of double tax treaties.

'Factual recipient of income' ('beneficial owner') is defined as a person who directly, or through their direct or indirect participation in other organizations, or in any other way, simultaneously has the rights of ownership, use or disposal of income; or a person on behalf of which another person has the right to use or dispose of the income. Further, it is stated that for purposes of determining a beneficial owner, the functions and risk profile of a foreign person claiming double tax treaty benefits should also be considered.

At the same time, the new Draft law provides that a foreign organisation has a 'factual right to income' if this organisation is an actual beneficiary of the income, i.e. is a person who receives actual benefits from distributed income and has a right to dispose of this income.

In addition to the obligations of Russian tax agents to obtain a tax residence certificate from a foreign organization (as provided by the current legislation), the Draft provides Russian tax agents with a right to request confirmation of the 'factual right to income' from foreign organisations.

The above provisions are in line with the position of the Russian Ministry of Finance, as set out in recent communications. However, the current wording is rather vague and subject to interpretation.

## 5. Amendments to thin capitalization rules

The new Draft also proposes using a definition of 'interrelated parties' instead of 'affiliated persons' in the context of thin capitalization rules. As noted above, 'interrelated persons' are defined by the current legislation. This provision will make certain structures subject to thin cap rules going forward.

We are closely monitoring further developments with regards to taxation and deoffshorisation.

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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