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Russian Federal Law № 376-FZ dated 24 November 2014 on the taxation of controlled foreign companies (the 'CFC') and other anti-offshore measures

Part 1: Controlled Foreign Companies (CFC)

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Introduction

On 19 March 2014, in line with the plan for the "de-offshorisation" of the Russian economy, the Ministry of Finance of Russia published a Bill aimed at introducing amendments to parts one and two of the tax code of the Russian Federation Law (regarding the taxation of the profits of controlled foreign companies and the income of foreign organisations). In general terms this law was a set of measures primarily aimed at enhancing transparency and compliance introduced by the Russian government with a view to modernising the country's taxation system and bringing it in line with the tax systems of various European Union countries.

Two new versions of the abovementioned Bill were published in 2014, one that was published in May 2014 and one that was published in September 2014. Towards the end of October 2014, a draft law was presented to the Russian State Duma for consideration, which differed in several aspects from the third draft published by the Ministry of Finance.

The new law on the taxation of controlled foreign companies (the 'CFC') and other anti-offshore measures, better known as the "De-offshorisation Law" (the 'Law') had received presidential assent on Monday 24 November 2014. The new amendments to the Russian Tax Code, in accordance and with article 4 have been effective since 1 January 2015 (Federal Law № 376-FZ, dated 24 November 2014 and entitled "On the Introduction of Amendments to Parts One and Two of the Russian Tax Code").

The legislation framework will introduce changes to the Russian Tax Code in the following five areas:

i. Establish rules and obligations to Russian tax residents to disclose information in relation to controlled foreign companies (CFC)

ii. Establish rules in relation to the taxation of controlled foreign companies by Russian tax residents

iii. Establish rules in relation to tax residency of organisations

iv. Define and establish rules with regards to the introduction of a new beneficial ownership term, concerning passive income (dividends, interest and royalties) paid out from Russian companies to foreign residents for the purposes of the application of double tax treaties; and

v. Establish rules with regards to the taxation of gains from the "indirect" sale of immovable property.

The Law is one of the key instruments for the implementation of the Russian Government's policy of the de-offshorisation of the economy and will be of major significance for the great majority of companies and businessmen with assets or operations outside the Russian Federation.

Deputy Chairman of the Russian Federation Council Committee for Economic Policy, Sergey Shatirov stated in one of his many interviews that, "A large part of the Russian economy is linked to offshore tax shelters in one way or another. The use of offshore tax havens by Russian businessmen caused a large damage to the country's interests," adding that "anonymous ownership of offshore structures were used for criminal activity, including tax evasion and corruption".

The Russian government aims by implementing this new tax law to earn additional yearly tax revenues in the area of 150-200 billion Russian Rubbles. How realistic or over-optimistic this number is, only time will show. Of great importance will be the degree of adherence to the implementation of the law by the Russian authorities, as well as the general geo-political problems that have been affecting the region over the past year, more specifically the situation with Ukraine and the international sanctions imposed on Russia by US and Europe.

Cyprus is deeply affected by the implications of the abovementioned law, since Cyprus is one of the principal portals for investment into Russia. In accordance with the official Statistical Service of the Russian Federation, Cyprus ranked second in 2013 with US$22.7billion of direct inward investment, representing 13.3% of the total percentage of Russian inward investment. Ahead of Cyprus was Switzerland with US$24.6 billion, and ranked below Cyprus was the UK, Luxembourg, and the Netherlands with US$18.8, US$16.9 and US$14.7 billion respectively.

The proposed changes are of great potential importance for investors that use Cyprus structures for direct investment into Russia.

The purpose of this series of newsletters is to provide an in-depth analysis of the Law and at the same time provide an approach based on practical analysis as to the possible implications these changes might have on investors that want to invest into Russia using Cyprus companies. For reasons of practicality we shall divide our analysis of the law into three main areas:

Area 1 – Controlled Foreign Companies (CFC)

Area 2 – Recognising foreign organisations as tax residents of Russia

Area 3 – Beneficial ownership clause and the taxation of shares in property rich companies

In this newsletter we shall analyse the first main area of the law dealing with controlled foreign companies (CFC). The other two areas will be covered in depth in separate newsletters.

CFC rules

Application of the CFC rules

The CFC rules will apply to Russian organizations and physical persons which/who are tax residents of the Russian Federation. It is important to note that, at present, the concept of tax residence is used in the Tax Code only in relation to physical persons, while the concept of tax residence for organisations is a new development along with the CFC rules.

Foreign persons affected by the CFC rules

According to the Law, CFCs are organizations which are residents of countries traditionally considered as "offshore," low-tax jurisdictions, and which are controlled by physical persons or organizations who/which are Russian tax residents.

The new rules do not affect all foreign organizations, but only those which are residents of jurisdictions included in a special list approved by the Ministry of Finance. A similar list of offshore jurisdictions was introduced by the Ministry of Finance a few years ago, although it is used for other tax regulation purposes, such as transfer pricing and the application of preferential rates of dividend taxation, rather than the application of CFC rules. The Finance Ministry is likely to approve a new, extended list, which may even include certain countries with which international double taxation treaties exist. The Finance Ministry has the power to change the list in the future by adding new jurisdictions. No amendments to the Tax Code would be needed for that purpose and as a direct result, this would create a high degree of uncertainty for taxpayers.

Unlike many examples in global practice, the Law does not establish any wide spectrum of special circumstances as to the disapplication of the law in certain circumstances, such as companies which carry on an active business or are involved in industrial projects. The exceptions it does make are for companies whose shares are listed on approved stock exchanges (as included in a list published by the Central Bank) and companies which are recognized as tax residents of the Russian Federation.

Obligations of Russian tax residents to disclose information in relation to controlled foreign companies (CFC)

The Law introduces the obligation for tax residents of Russia to submit notifications of their participation in foreign organisations and/or structures established in any form other than a legal entity to the Russian tax authorities

According to the Law, the CFC rules will apply not only to organizations but also to so-called "structures." In particular, the CFC category includes "foundations, partnerships, partnership associations and other collective investment vehicles which have the right to carry out entrepreneurial activities in the interests of their beneficiaries," where they are tax residents of "blacklisted" countries. Although it is not clear from the proposed wording of this provision whether the definition includes foreign trusts, it appears that it does not rule out the application of the CFC rules to foreign trusts, including certain participants in such arrangements

Notification Requirements

The time allowed for notifying the tax authorities of participation interests in foreign companies has been increased from 20 days to one month after the grounds for such notification arise. Further notifications are to be submitted only if relevant changes occurred, (change in shareholding/disposal of participation, etc.).

In relation to CFCs, the notification must take place no later than March 20 of the year following the tax period in relation to which the profits of the CFC must be accounted for. Since the law has entered into force on 1 January 2015, the deadline

is set at 20 March 2016. The notification should include information such as the name of the foreign organisation, its registration number, the date of occurrence of the reason for notification, the participation interest in the organisation (in case of indirect participation, the entire chain of ownership should be disclosed).

Definition of control

Control Criteria

As in the previous draft laws, the CFC rules will apply to all Russian tax residents, whether legal entities or individuals. However, the participation thresholds have been substantially increased, and are now as follows:

- ownership of a participating interest (direct, indirect, or direct and indirect combined) of more than 25 percent in the organization in his or her own right or in conjunction with close relatives (his or her spouse and minor-age children) and other associates (as defined in the transfer pricing rules set out in cl 2 of Art 105.1 of the Tax Code);
- The law introduced a transition period for 2015, during which the threshold for the abovementioned test will be 50 percent.
- ownership of a participating interest (direct, indirect, or direct and indirect combined) of more than 10 percent in the organization in his or her own right or in conjunction with close relatives (his or her spouse and minor-age children) and other associates, if Russian tax residents, alone or jointly with their spouses, minor children and other associates directly or indirectly have a collective interest of over 50 percent.
- In all other situations where a physical person or organization exercises any other type of "control" over a foreign organization for his, her, or its own benefit or for the benefit of a spouse and/or minor children and other associates (this condition may be determined by the tax authority, but may be challenged in court).
- Control over a "structure" other than a company is assessed by reference to the degree of influence the person concerned exercises over the person who manages the assets of the structure with regard to the distribution of income, rather than the level of their participation interest, and no specific percentage is included in the law.
- Control over a company is recognized to be the exertion of or the ability to exert a decisive influence on the decisions being adopted by such a company on the distribution of the after-tax profits (income).

The law leaves a number of terms undefined, leaving room for differences in interpretation to arise which could result in expansive interpretation by the tax authorities, and consequently, additional risks for taxpayers. One of the many examples is the definition of "other associates", which is not defined in the law and it does not establish criteria in accordance with which relationships with "other associates" may be regarded as grounds for aggregating a participating interest with the participating interests of such persons.

Exemptions

A number of categories of companies are excluded from the definition of CFC. These are as follows:

- non-profit organisations that do not distribute their profits among their shareholders/participants;
- organisations that are formed in accordance with the legislation of the Eurasian Economic Union (Belarus, Kazakhstan, Russia, Armenia and Kyrgysztan as from May 2015);
- organisations resident in jurisdictions that exchange information with Russia for tax purposes and impose an effective tax rate on their income (profits) in excess of 75% of the weighted average Russian tax rate on income calculated in accordance with the formula set out in the CFC legislation. In most cases this will equate to 15% but in the case of an organisation whose only income is dividends, the effective rate should be at least 9,75% (75% * 13%);
- organisations resident in jurisdictions that exchange information with Russia for tax purposes, and at least 80 percent of whose income comprises active income. Passive income is defined in legislation and includes dividends, royalties, and proceeds from the sale of shares or real estate; Please note that in this clause, passive income also includes receipts from legal, accounting,

auditing, marketing, advertising and engineering services;

- foreign structures in which there is no formation of a legal entity, such as trusts. A pre-condition here is that the founder does not have the right to possess assets of this structure or to obtain any profit from this structure either directly or indirectly and cannot transfer his or her rights to other persons;
- banks or insurance companies having an appropriate banking or insurance license and are operating in a territory that exchanges information with the Russian Federation;
- foreign companies involved in projects with foreign governments under production-sharing, concession and similar agreements in their country of incorporation, provided that income from such activities represents at least 90 percent of total income;
- issuers of listed bonds or organizations authorized to receive interest on listed bonds issued by another foreign company, if the interest on them is at least 90 percent of the issuer's income;
- the company is an operator or a direct shareholder of newly developed sea-based hydrocarbon deposits.

Liability for Russian Taxation and Inclusion of CFC profits in the Controlling's Person Tax Base

Once a company will be considered as a CFC, the controlling person in Russia will be liable for taxation on the undistributed profits of the CFC at a rate of 20% for corporations and 13% for individuals (instead of 9% which is the standard taxation rate of dividends).

For CFCs situated in non-blacklisted countries that perform statutory audits (these countries are countries with which Russia has enacted a double tax agreement) such as Cyprus, the Russian Tax Authorities will accept the audited Financial Statements as prepared in accordance with Cyprus Law. In all other cases, such as the BVI, the Russian Tax Authorities will need to calculate profits in accordance with Chapter 25 of the Russian tax code.

A CFC's profit is reduced by the amount of dividends paid out of that profit and by Russian and overseas tax paid on the profit of the CFC, including Russian corporate income tax on the profit of any permanent establishment it has in Russia.

The threshold for including a CFC's profit in a Russian taxpayer's tax base will be RUB50 million (approximately EUR760,000) for 2015, RUB30 million (approximately EUR457,000) for 2016 and as from the 1st of January 2017, the threshold will be RUB10 million (approximately EUR152,000.

Penalties

The penalty for non-payment or underpayment of tax as a result of non-inclusion in the tax base of a share in the profit of a CFC is 20% of the amount of unpaid tax or RUB100.000, whichever is higher. However, a grace period until the end of 2017 has been introduced and thus no penalty will be charged for the tax periods 2015 to 2017 inclusive, provided that the underlying tax liability is settled.

A penalty of RUB100.000 will be imposed for failure to notify the tax authorities of participations in a CFC, or for failing to provide the tax authorities with requested information or RUB50.000 for each controlling entity for which inaccurate information has been submitted. In some cases criminal liability may potentially be applied. Such liability will not be sought during the transitional period of 2015-2017, provided the damage to the Russian budget is fully compensated.

Important Areas to be considered

Safeguarding of assets and asset protection

This is an area that is considered much more important and for most investors is considered to be more important than any tax savings. Investors should carefully consider this area first, even at the cost of sacrificing of any tax savings, in order to ensure asset protection.

Ensure the reduction or minimisation of any imputed tax liabilities in Russia from controlling foreign entities in foreign jurisdictions.

- In accordance with the Russian tax laws, lower tax rates are applicable on dividend income received by a Russian company instead of a CFC on undistributed profits. Also in accordance with the Russian participation holding company exemption, if the subsidiary company of a Russian holding company meets the relevant participation

criteria, then any dividends will not attract any tax in Russia.

- Furthermore it is important to make sure that the subsidiary company is a real company, with real activities and it is not managed and controlled by Russian residents residing in Russia. Please read part 2 of this series of articles for more information on management and control issues and how this affects current structures.
- In cases where the CFC rules will be applicable by the Russian tax authorities, then it is important to make sure that CFC profits should be calculated in accordance with the foreign jurisdiction rules and not the Russian rules, since the Russian tax rules are much more stringent in most of the cases. To this effect if there is a CFC risk with foreign companies located in a jurisdiction where the Russian tax authorities do not accept their financial statements (usually jurisdictions that do not perform statutory audits), it is of significant importance to either re-domicile these companies to a jurisdiction like Cyprus (Audited Financial Statements in Cyprus are accepted by the Russian Tax authorities), or proceed with the immediate liquidation of these companies.

Re-domicile to a new jurisdiction

Russian tax residents that have significant participations/ shareholdings in foreign organisations should consider changing their tax residency by becoming residents in a favourable tax and not only jurisdiction or consider selling their shareholdings to third parties if they don't want to get involved and adequately address all the areas discussed within. Re-locating or becoming a tax resident of another country should not be a decision that is based solely on tax reasons. Other more important reasons should be taken into account, such as languages spoken, quality of life, country profile with regards to education, political and economic stability etc etc. There are jurisdictions that offer the so called citizenship by investment programs (Cyprus, UK, Malta, Belgium, St.Kitts and Nevis etc). Even though this process is not easy, it will secure ultimately the Russian individual against any Russian claims under CFC rules.

Merge or Mix activities of stand-alone companies

As is common business practice, Cyprus companies have been used as stand-alone vehicles with regards to different activities of different groups. It was not unusual to have a single Cyprus company to hold participation shares in one Russian company. This was mainly done for security and protection purposes. Even though this tactic is still valid today, steps should be taken in order to put in place proper substance, and to establish the so called "raison d'etre" for these companies. Strategies such as merging the activities of one or more foreign companies of a particular group might be carefully undertaken to mitigate the risk of any of these companies being presumed as tax residents of Russia. This restructuring should carefully be undertaken as there might be adverse tax or vat consequences. Proper tax advice should be undertaken prior of any steps being taken.