CENTAUR TRUST

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

Part 2: Recognising foreign organisations as tax residents of Russia

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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 second main area of the law dealing with the recognition of foreign organisations as tax residents of Russia. The other two areas are covered in depth in separate newsletters.

Corporate Tax Residence

Corporate tax residence is the concept by which the taxing rights over a company's profits and gains are determined. Different countries have different ways of defining corporate tax residence, which creates further complexity for companies operating in more than one country. Corporate tax residence is of importance as a company needs to ensure that it is only subject to tax in the jurisdiction it intends to be taxed in. If for any reason the company does not get this right, it can end up having multiple tax liabilities in multiple countries.

Definitions of corporate residence for tax purposes vary considerably from country to country. Some countries determine the residence of a company based on its place of incorporation. Other countries determine the residence of a company by reference to its place of management and control. Some countries use both a place-of-incorporation test and a place-of-management and control test.

When is an organisation recognised as a Russian tax resident?

The place of central management and control as a test of residence is becoming in a number of countries as the first rule that companies need to satisfy in order to avoid any tax adverse consequences. The mere fact that a company has been incorporated in a particular jurisdiction does not automatically imply that the company is tax resident in that particular jurisdiction.

The worldwide financial crisis has led governments to seek mechanisms to protect or increase their tax base, outside their jurisdictions by disputing the tax residency of companies located in countries that are considered as low tax jurisdictions. The Russian government is no exception to this trend and by passing the new law on the taxation of controlled foreign companies and other anti-offshore measures has introduced for the first time in its legislation new rules on residency of foreign companies based on effective management and control criteria. The law imposes a new rule for the determination of a foreign company's tax residence: it shall be the place of the actual management of such companies, unless otherwise stipulated by an international treaty. If it is determined that a foreign company is effectively managed and controlled from Russia, it will become subject to Russian corporate income tax. The place of effective management will be governed by specific rules set in Russian domestic law rather than international practice and principles.

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

i. it is tax resident in Russia under an international taxation agreement, or

ii. its place of effective management is in Russia. The place of effective management is determined according to three main criteria, namely,

    1. the location of the majority of the meetings of the board of directors or equivalent management body,

    2. the location of the executive management of the organization, and

    3. the location in which the key executives principally operate.

The law defines 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 in which it is resident and which has a tax treaty with Russia.

The following secondary criteria are taken into account only if necessary:

iii. the location of financial and management information as well as the location of corporate and other records;

iv. the preparation and the location of the accounting records ;

v. day to day management of human resources functions

vi. the place from which operating and administrative procedures relating to the company's operations (as opposed to any group operations) are issued.

The Powers of the Directors

In seeking an answer to the question of where the exercise of management and control lies, the first natural step is to ask who, in law, has the right and duty to exercise it. A company being an abstraction cannot by itself perform any real acts at all. The abstraction can act only through the agency of other people. In practice, the constitution of the company, its Articles that is, will provide that the power of management lies with the board of directors; the power of management is delegated to the directors as a board.

Of course the shareholders via the General Meeting, have certain rights and duties. They can appoint and dismiss the directors, they can approve the accounts and pass a dividend, they have a voice in such matters as issuing new capital, reduction of capital and in changes to the objects clause of the Memorandum or changes to the Articles. These things do not constitute the management and control of the business. They are rather keeping a critical eye on the interests of the shareholders. It follows that the power of management and control lies in the hands of directors and not with the shareholders.

UK Court Decisions

In most of the countries around the world there is no statutory definition of the meaning of "central management and control" but nevertheless court judgements on the meaning of central management and control can be treated and can be used as guidance on how the courts in a particular jurisdiction will interpret its meaning. Although management and control of a company will generally reside at the place where the directors meet and where the main functions of a company are carried out, there are cases in which these factors are not determinative of the place of central management and control.

For example, the House of Lords held in the case of ***Bullock v The Unit Construction Co Ltd (1960) 38 TC 712*** that, because it was quite clear from the stated case that the board of directors of the UK company's African subsidiaries were standing aside in all matters of real importance, real control and management of those subsidiaries was being exercised by the board of directors of the parent company in London.

In another famous court case ***De Beers Consolidated Mines Ltd Vs Howe, Lord Loreburn*** stated: …the principle that a company resides for the purposes of income tax is where its real business is carried on… I regard that as the true rule, and the real business is carried on where the central control and management actually abide.

Another decision of the Special Commissioners' of the UK Inland Revenue has, however, highlighted how important it can be for the directors of a company to make informed decisions, rather than merely "rubber-stamping" resolutions, if they are to demonstrate that they are exercising effective management and control of their company. In their decision in ***Mr. R and another v Holden (Inspector of Taxes) SpC 422***, the Special Commissioners stated:

"We do not consider that the mere physical acts of signing resolutions or documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum level of information. The decisions must at least to some extent be informed decisions. Merely going through the motions of passing or making resolutions and signing documents does not suffice.

Where the geographical location of the physical acts of signing and executing documents is different from the place where the actual effective decision that the documents be signed and executed is taken, we consider that the latter place is where 'the central management and control actually abides'."

In our experience, the position can be improved by appointing directors who have knowledge and experience in the area of business in which the company is engaged and who are thus better qualified to take decisions on matters affecting the company.

This case emphasises how important it can be for the directors of a company that is being managed and controlled in a jurisdiction, to be fully involved in any proposed transaction from the earliest stages and for them to have full knowledge and a thorough understanding of the transaction, including the anticipated benefits and liabilities. It is certainly not good practice for the directors to be presented at a late stage with a fully worked-out set of proposals and documentation that they are asked to sign off without any prior involvement in negotiations on the transaction; indeed, that is likely to put the company's tax residence in jeopardy.

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Establishing effective management and control

In our experience, in order to establish effective management and control of a company in a particular jurisdiction, we need to show this as manifested in the below general list of guidelines. The below list is not exhaustive and obviously it does not mean that all the guidelines should be followed in all cases. The list is just a broad guideline to be used depending on the jurisdictions involved, the activities of the company and a number of other factors. These factors will determine whether the below list can be shortened or expanded accordingly:

- All or at least the majority of the board of directors should be residents in the jurisdiction where the company intends to be taxed in. If only the majority of directors reside there, then the majority should be sufficient to form a quorum for the conducting of the board meetings under the Articles of Association. The minority directors who are not resident(s) should consider traveling to the country of the company's residence for occasional board meetings.
- Board meetings should be actually held in the country of residence and must be properly documented.
- The general policy of the company should be formulated in the country of residence. The place of effective management is generally understood to be the place where the Head Office is: the Head Office in the sense of - not the registered office - but the central directing source. That is major/important decisions such as the provision of loan facilities, the purchase of a significant interest in other companies etc should be taken by the board in the country of residence.
- The appointed directors of the company should be fit to hold office or be employed in the administration of the company's affairs. When appointing a board of directors, the individual members should be persons of high caliber, such as successful business men, Chartered and Certified accountants, lawyers, or persons with a relevant background in relation to the company's proposed activities. The directors should in reality have the knowledge and expertise to really understand and know the business activities of the company and they should actually be part of the strategic decision making process of the company. They should not just "rubber stamp" any decisions taken by the shareholders or their advisors. They should formulate and implement the strategy of the company.
- With regards to decision making at Director level, a minimum level of information should always be provided, that would enable the directors of a company to consider whether or not they should make a decision. The directors should be given sufficient time to consider the implications of any contracts to be signed and take advice where necessary. It is also prudent to ensure that board minutes properly document the information the directors

have used to consider and then make decisions. In relation to negotiations with third parties directors should have a say in the negotiation process and should be kept abreast of developments during negotiations and should be given the opportunity to provide their input. At the stage of actually signing the contract, the directors of the company should actually sign the contract in the chosen place of effective management of the company. It may be possible however, that very occasionally, the company grants a specific power of attorney to an agent, to sign the contract in question on its behalf;

- Related to the point above, care should be taken to ensure that the board meetings are properly documented, i.e. detailed notes taken contemporaneously, outlining the matters for consideration of the board, the information provided in the board pack to enable them to make their decisions.
- Company bank accounts should be controlled and operated by the resident directors. This entails that movements of money in the accounts are properly documented, so that they are seen to be done under the control of the directors.
- Day to day management is actually carried out in the country of residence.
- Any issuance of POAs to third parties should be limited and when this is done the scope of the services assigned should be limited and specific. Of course the board of directors can still appoint agents and as long as they are mere agents they do not, by the bare fact of being there and fulfilling their agencies, detract from the management and control of the board. However if the board assign all its powers to a person, i.e. by issuing a general power of attorney so that the person purports to confer exclusive powers without expressly reserving a right of supervision, then that person is the Board and the management and control of the company is carried out by that person. It follows then that a company's residence status should be where that person resides. That is the place where he takes all decisions concerning the administration of the company.
- It may also be advisable to show a physical presence in the country of residence. This will make the case for demonstrating management and control stronger. The company should not be just a "paper" company. This can be achieved by:
- The company renting an office.
- Applying for telephone and fax lines to be installed and subscribing for a listing in the local telephone directories.
- Employing people and paying monthly salaries and social insurance contributions
- Ensuring that all corporate, accounting, human resource and other records are prepared and kept in servers located in the country where the company is resident.
- Last but not least, the company should have a valid commercial reason for its existence. Even though this can sometimes be a tax oriented reason, there should also be commercial benefits for setting up a company in a particular jurisdiction and the decision to establish a company in a particular jurisdiction should not be taken solely based on tax considerations.

Conclusion

A company can very easily inadvertently become tax resident and subject to tax in a different jurisdiction from the one it intends to be taxed in and thus incorporated. Basically it is essential that the structure does not fall foul of the abovementioned concepts. It is not sufficient to only have the directors (management and control) sitting in the chosen jurisdiction such as Cyprus, rather it is essential that the day to day (effective control) activities are also conducted by the directors from a "permanent establishment" in Cyprus.

Our experience has shown us that many companies seek tax advice on corporate tax residence matters prior to establishing an offshore business, however, few seek further advice on implementation and maintenance of these structures. It is often during the implementation phase and thereafter that mistakes are made with regard to residence.

At Centaur Trust our focus is on the effective implementation of international tax structures related to the use of Cyprus

or other companies, as standalone vehicles or as part of an international tax structure. When we act as directors we take our role very seriously and have an unprecedented depth of insight in relation to our clients' activities. We appoint directors that are fit to hold office or be employed in the administration of a company's affairs. When appointing a board of directors, the individual members are persons of high calibre, such as successful business men, Chartered and Certified accountants, lawyers, or persons with a relevant background in relation to the company's proposed activities. Our directors are able to rely on the assistance and support of 7 specialised and distinct departments within our firm, enabling them to genuinely have the knowledge and expertise to understand and know the business activities of the company. They are actually part of the strategic decision making process of the company. They do not just "rubber stamp" any decisions taken by the shareholders or their advisors. They are involved in formulating and implementing the strategy of the company, and they make sure that the company is fully compliant and operates within the myriad of laws which apply in the jurisdiction of residence.

Our integrated, client-focus oriented approach essentially combines insight and innovation from multiple disciplines;

- Legal, Tax, Accounting, Banking, IT, Secretarial, Compliance, Human Capital

Our aim is to have the appropriate business and client industry knowledge, so as to recognise the specific needs of our clients, and then to identify and create practical solutions in relation to specific administrative, regulatory, compliance and other corporate processes. We do this by streamlining the key processes, so that together with our clients to be in a position to generate and maintain the kind of ordered, accurate, consistent and timely financial and non-financial data about all aspects of their business.

We have so far discussed the first criterion, namely the location of effective management and control by way of the appointed directors and all the factors relating to their location and fulfilment of their powers, duties and responsibilities.

The second major criterion relates to **physical substance**.

We have recently completed the process of expanding our business centre, The Idalion Business Centre, through which we offer all our physical office services. The new extension is constructed on two floors, and has doubled our capacity, having been built according to the latest specifications for comfort, as well as IT & communication facilities.

The Idalion Business Centre is situated in over 4,500 sq. meters of landscaped gardens, providing an ideal stress free environment for our staff and clients. In addition to the 1,200 sq. meters of office space, the Idalion Business Centre also offers an in-house gym, a swimming pool, a small chapel, a large kitchen and dining area, a fully interactive auditorium, as well as recreation and barbeque area.

For clients who require a real physical presence in Cyprus, with individual offices of a very high standard, in an ideal location we have the ability to accommodate their requirements to relocate management and staff to Cyprus, and to work from fully equipped and established offices.