

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



Part 3: Beneficial ownership clause and the taxation of shares
in property rich companies

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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\$22.7 billion 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.

Beneficial Ownership of Passive Income

Application of the new rules

In accordance with Article 7 of the Russian Tax Code, the Law introduces the concept of a person having the actual right to income (in international practice – “beneficial owner”), for the purposes of applying a double tax treaty.

According to the introduced definition, a person that has the actual right to income for the purposes of Russian Tax Code and the application of international treaties of the Russian Federation is:

- the person that has the right, by virtue of direct and/or indirect participation in the organization; or
- the person that has control over the organization; or
- the person that by virtue of other circumstances has the power to use for itself and/or dispose of such income; or
- the person for whose benefit another person has the power to dispose of such income.

In defining whether the person has the actual right to receive and dispose of the income, all the functions being exercised

by the person should be considered, and also the risks being assumed by them.

When a Russian company is going to pay income to a foreign person in accordance with an international treaty of the Russian Federation, and the relevant tax treaty provides for the application of reduced tax rates or an exemption from taxation, then the reduced rates should only be applied if the foreign person has the actual right to receive such income. F

For the purposes of applying the international treaty a foreign person shall not be treated as having the actual right to such income if such person has:

- limited power to dispose of the income; or
- exercises intermediary functions relating to the income for the benefit of another person, without performing any other functions and without itself assuming any risks, paying such income directly or indirectly (in full or in part) to such other person.

The Law introduces a “look-through” approach in determining the beneficial owner of income. According to this approach, if, at the moment of payment of dividends, interest, and royalties, the payee company as tax agent, knows that the beneficial owner of income is not the direct recipient of income, the tax agent may apply the double tax treaty and the respective rates signed between Russia and the country of residence of the beneficial owner, provided the tax authorities are duly informed.

The procedure to be followed by the tax agent should be the following:

- If the person that has the actual right to the income to be paid (or part thereof) is recognized as a tax resident of the Russian Federation, the income to be paid (or part thereof) shall be paid gross without the withholding of the corresponding tax, subject to notification of the tax authority at the place of the tax agent registration. In the case of dividends the tax agent is obliged to withhold the respective tax due (0% or 13%) and such dividends would not be included in the tax base of the Russian resident beneficial owner.
- If the person that has the actual right to the income to be paid (or part thereof) is a foreign person covered by



an international treaty of the Russian Federation, the provisions of the international treaty of the Russian Federation shall apply to the person that has the actual right to the income to be paid (or part thereof) in accordance with the procedure stipulated by the international treaty of the Russian Federation

Important Considerations

In order to mitigate possible risks that the application of a double tax treaty could be challenged, it is recommended that taxpayers:

- i. Must review all existing structures and perform a critical analysis of existing foreign holding, finance and intellectual property licensing structures for the purpose of identifying companies – which are recipients of passive Russian sourced income, and in respect of which there is a risk that they might not be recognized as the beneficial owners of such income.
 - ii. Develop alternative structures that ensure the required level of tax efficiency.
 1. For holding structures make sure that the recipient of income has adequate substance to prove that it should also be regarded and as the beneficial owner of the income.
 2. For Financing structures involving the well-known back to back Cyprus financing structures where the taxable income left in the Cyprus company was only a required margin in accordance with the Cyprus law of 0,35% for amounts up to Euro50 million, it is important to understand that this structure no longer works. The recipient company does not have the right to income as we have explained above and thus the reduced rates of the double tax treaty cannot be applied. As a result the following steps should be undertaken:
 - a. Review all such financing structures and convert the loans provided to the Cyprus company to equity without affecting significantly the tax efficiency of the structure. This is not a simple exercise and proper tax advice should be received prior of any steps being undertaken.
 - b. Provide financing to Russian companies from Cyprus companies that use their own funds (out of its own capital and not from third party loans).
 - c. In cases where the structure cannot be changed, then the interest margins that should be applied should be such that the recipient of the income is regarded also as the actual beneficial owner of the interest. Important considerations such as risk undertaken, default considerations, substance requirements etc should be carefully be implemented.
 - d. Prepare a detailed plan for the transition of the target structures and ensure their timely implementation.
3. For Royalty Structures it is important for the licensor to be also the owner of the Intellectual Property asset that generates the royalty income. The relevant substance requirements as described in Part 2 of this series of articles should carefully be taken into consideration.



Taxation of the sale of shares (equity interests) of a foreign organization more than 50% of the assets of which consist directly or indirectly of immovable property in Russia

The situation before the enactment of the Law, was that the shares of companies that owned immovable property in Russia were regarded as “movable property” and therefore the taxing right from the sale of these shares was in the jurisdiction of the seller.

Pursuant to the Law, foreign companies earning income from the sale of the shares (equity interests) of Russian or foreign organizations, where more than 50% of whose assets consist directly or indirectly of immovable property in Russia, with the exception of securities trading on an organized securities market in accordance with clause 9 of article 280 of the RF Tax Code, will be taxed at the 20% rate in the Russian Federation.

The Law introduces an obligation for foreign companies (and structures that do not involve the establishment of a legal entity) owning real estate to submit information to the Russian tax authorities on their participants (in the case of structures that do not involve the establishment of a legal entity – on their founders, beneficiaries and managers). The failure to submit (late submission of) such information will result in a fine in the amount of 100% of the total property tax due on such real estate.

Important Considerations

- At present the mechanism for enforcing such new rules remains unclear. For example, in order to apply the norms on the taxation of income from the sale of the shares of a company, more than 50% of whose assets consist of immovable property in Russia, within the framework of a transaction between two foreign organizations not registered in the Russian Federation, there needs to be an obligation for the foreign company-seller or buyer, accordingly, to pay or to withhold the taxes.
- When a Cyprus company was used to own shares in property rich companies in Russia, then in accordance with the double tax treaty with Russia the taxing right from the sale of these shares was with Cyprus as the

jurisdiction of the seller. However, since the signing of the new Protocol of the Double Tax Treaty with Russia, as from 2017 such disposals will be taxed in Russia, i.e. the jurisdiction where the immovable property is situated.

What the new Law does is that it incorporates into local legislation the above provision with regards to the change of the taxing rights at the place of where the property is situated.

- In order to mitigate the possible tax consequences in Russia as a result of this provision, the ownership of immovable property in Russia should be restructured so as to rely on favourable double tax treaties, which exempt income from taxation in Russia. It is worth mentioning that both the local legislation as well as the double tax treaty provisions between Russia and Cyprus exempts the sale of shares of listed property-rich companies, on a recognised stock exchange from the above provisions. The Cyprus Stock Exchange and particular the Emerging Companies Market can be a good market for listing Russian or other foreign companies that own property in Russia. The low costs of listing, the flexible and well known Cyprus legal system (based in the vast majority on UK Common Law), as well as the manageable administrative burden of ongoing listing costs might make such listing quite attractive.

