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 1: Controlled Foreign Companies (CFC)

Part 2: Recognising foreign organisations as tax residents of Russia

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

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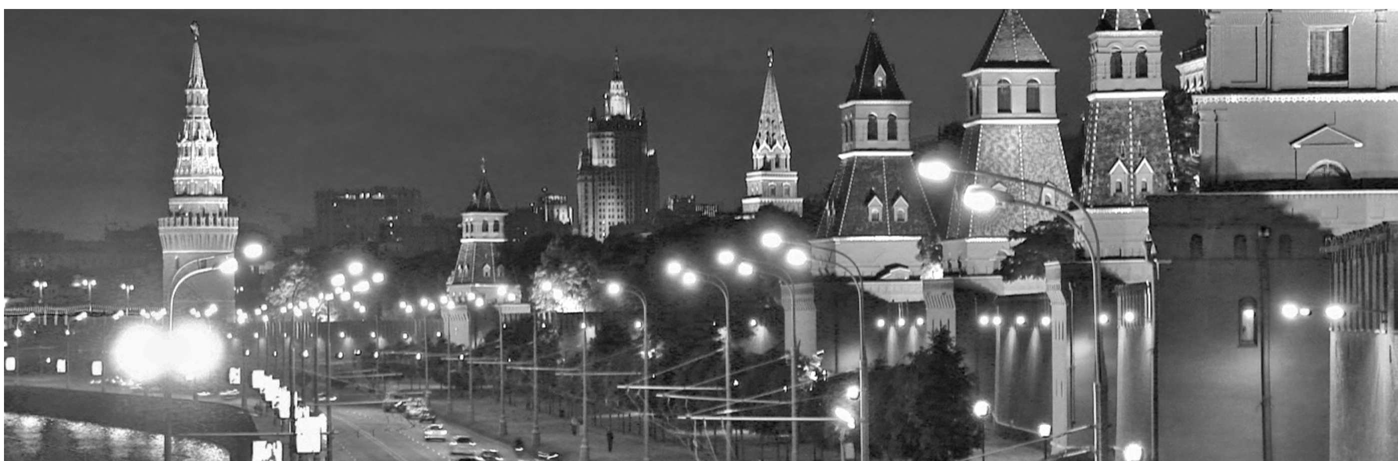

Introduction

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$22.7billion 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 publication 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 parts:

Part 1: Controlled Foreign Companies (CFC)

Part 2: Recognising foreign organisations as tax residents of Russia

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

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Part 1: Controlled Foreign Companies (CFC)

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

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.

Part 2: Recognising foreign organisations as tax residents of Russia

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,

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

   b. The location of the executive management of the organization, and

   c. 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:

i. The location of financial and management information as well as the location of corporate and other records

ii. The preparation and the location of the accounting records

iii. Day to day management of human resources functions

iv. 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.

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.

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.

Physical Presence

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

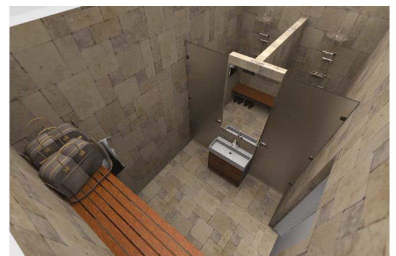
processes. We do this by streamlining the key processes, so that together with our clients to be in a position to generate and maintain the kind of ordered, accurate, consistent and timely financial and non-financial data about all aspects of their business.

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.



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

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.

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 publication 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, ie 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.

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