



December 2014

## RUSSIA'S "DEOFFSHORISATION" LAW

On 18 November 2014, the Russian President signed a Deoffshorisation law introducing three concepts new to Russian tax law: tax residency for legal entities, controlled foreign companies ("CFC"), and expanding Russia's taxing rights in connection with profit from indirect sales of Russian real estate. The law will be applicable as of 1 January 2015 with a one year transitional period. We set out herein below a summary of the main provisions of the law.

### CFC rules

The rules apply to all Russian tax residents, whether legal entities or individuals. The law provides that Russian tax residents which control ("controlling persons") foreign organizations and/or companies and unincorporated structures (including foundation, partnership, association, trust, any other form of collective investment and/or fiduciary arrangement), to pay Russian taxation on the retained earnings of their CFC.

### Control criteria

A Russian taxpayer that is a controlling person may be either a legal entity with a direct (or indirect interest in the CFC) or an individual Russian tax resident (for individuals: jointly with spouses and minor children and other associates), with the below participation thresholds:

- Ownership or participating interest of more than 25%, or
- over 10%, if total participation of all Russian tax residents in the CFC is over 50%

The law introduces a transition period ending on January 1, 2016, during which the threshold for both tests will be 50 percent.

### Exempt CFCs

A number of categories of companies are excluded from the definition of CFCs, while the obligation to notify the authorities will remain in place. These are as follows:

The most important exemption of a CFC is being a foreign company resident of a treaty country included in the list of countries that exchange information with Russian state agencies and either:

- has an "effective rate" of income (profits) tax, as determined with Russian CFC rules, that exceeds 75% of "average weighted" Russian tax rate (in most instances the effective tax is 15%); the "effective tax rate test", or
- the CFC's income from "passive" operations amount to not more than 20% of its income

## Other exemptions

CFCs whose income is also not taxed are:

- non-profit organizations, under a domestic law, that do not distribute profits to shareholders (members, founders) or other persons
- companies resident of a member state of the Eurasian Economic Union ("EEU")
- a foreign non-corporate structure which meets all of the following conditions:
  - (1) its founder does not have ownership rights to its assets;
  - (2) the founder's rights cannot be transferred to other parties (except for inheritance or universal legal succession) and
  - (3) the founder may not, directly or indirectly, receive profits of this structure
- banks or insurance companies permanently domiciled in a treaty country
- issuers of listed bonds or an organization authorized to receive corresponding interest income; if the interest on them is at least 90 percent of the issuer's income
- an entity which takes part in projects under a product sharing agreement (PSA) provided that income from activities represents at least 90 percent of total income
- operates a new offshore oil and gas field or is a shareholder of such an entity

Public companies are finally not included.

## Notification requirements

Controlling persons must notify the tax authorities of the participations, otherwise submit documents certifying compliance with the conditions, under which CFC income is not taxable in Russia. The notification will be effective from 1 February 2015.

The participation thresholds for notification purposes are:

- Notification on participation in foreign companies (if direct or indirect participatory interest is above 10%). During the transition period which expires on January 1, 2017, the threshold is set at 25%
- Notification of interest or incorporation of foreign non-corporate structures or on control over such structures (certain specific aspects should be taken into account here). The fine for failure to provide this information or provision of misstated information is RR 50.000

- Notification on Russian organizations (with the exception of business partnerships and LLCs) in which they have an interest of over 10 percent
- Notification on CFC (the fine for a failure to provide information or provision of misstated information is RR 100.000 for each CFC)

The law introduces a transition period ending on 1 January, 2016 during which the threshold for both tests will be 50 percent.

## Russian real estate holdings

Foreign companies and structures which own taxable property in Russia (real estate property in Russia) will have to report their participants (founders, beneficiaries, managing parties and at instances the whole "ownership chain"). Failure to provide this information will entail a fine equal to 100% of the property tax assessed on the real property owned by such foreign company. The reporting threshold is direct or indirect participations of more than 5 percent.

The time allowed is one month and 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.

## Applicable tax rates

CFC income will be subject to a 20% rate if the CFC is controlled by a legal entity and a rate of 13% if controlled by an individual.

Russian tax will be imposed only on the profits of CFCs determined in periods starting in 2015. Such profit will be declared for the first time by Russian legal entities on 28 March 2017 in their corporate income tax returns for 2016 (individuals, respectively, will declare CFC profits on 30 April 2017).

## Inclusion of CFC profits in the owner's tax base

CFC profit is taxed in Russia if it exceeds the threshold of RR 10mn as of 1 January 2017. Transitional thresholds will apply in 2015, RR 50 mn and in 2016, RR 30 mn.

## CFC profit calculations

Profits of a CFC taxed in Russia shall be determined on the basis of:

- financial statements prepared in accordance with its respective local law (on the condition that said financial statements are subject to mandatory audit under the CFC's local law and that the company is permanently domiciled in a treaty country) or
- under Russian Tax Code (Chapter 25) rules in other cases

Profits are 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.

First a, "de minimis" test has been introduced, whereby a CFC's profit would be included in the tax base. CFC profit is included in Russian tax base if it exceeds the applicable thresholds, as stated above.

Secondly, the law calls for the introduction of Article 309.1 of the Tax Code that would introduce special rules for calculating a CFC's profit, including the division of income into two "baskets" – active and passive. It is important to note that, regardless of the basket, a CFC's profits will be taxable in Russia, although active operations will qualify for a number of expense deductions.

The tax bases for income from passive and active operations are to be determined separately. The list of "passive" income is not exhaustive and includes not only such typical passive income as dividends, interest, royalties, proceeds from real estate sales and rental income, but also proceeds from the sale (redemption) of mutual fund shares and income from consulting, legal, accounting, auditing, engineering, advertising and other services.

### Offsetting foreign tax

Dividends paid out of a CFC's profits and tax paid on such profit under the laws of a foreign state may be deducted from the CFC's profits. This includes corporate tax on income in the CFC's jurisdiction or taxes at source that may be withheld from a CFC's profit in other foreign states. The law furthermore provides for offsets of Russian withholding tax that may be withheld from a CFC's income.

### Penalties

A fine for underpayment of CFC tax is set at 20% of the underpaid tax amount, but not less than RR 100.000. Tax shall not be levied during the transitional period (as pertaining to CFC profits of 2015-2017).

A penalty of RR 100.000 will be imposed for failure to notify the tax authorities of participation, or for submitting inaccurate information.

### Accounting losses

The law sets special rules for accounting for CFC losses, and also allows for credit of tax paid by CFC under foreign or Russian laws (including tax paid by permanent establishment of CFC in Russia).

Moreover, the law permits to deduct profits of the CFC already accounted for by other Russian controlling parties in case of indirect participation in CFC (with regard to participatory interest).

A tax relief is proposed for groups, which will decide to liquidate foreign structures falling under the CFC rules.

### Tax residence of legal entities by place of management

Residency rules for legal entities are changing. Starting from 2015, a foreign company managed from Russia can be recognized as Russian tax residency. Russian tax residency means that worldwide income of such companies will be taxed in Russia.

The rules sets three key criteria and three additional criteria, which, if met, is sufficient for a foreign company to be regarded as effectively managed in Russia:

- Meetings of the board of directors (or other executive management body) are predominantly (over 50% of meetings in a year) are held in Russia
- High-level executive management is predominantly performed in Russia
- The Chief (Executive) officers (persons authorized to perform and responsible for planning, management and control over the entity's activities) operate predominantly in Russia with respect to the given foreign organization.

If the criteria are met in relation to a number of states, additional criteria for determining the place of effective management of a foreign company are as follows:

- The accounting or management records are maintained in Russia
- The company's records are managed in Russia
- The place from which operating and administrative procedures (HR management) relating to the company's operations (as opposed to any group operations) are issued in Russia

Note that, in international practice, this list of residency criteria is not exhaustive, and it makes sense to rely on a broader range of practical factors in doing an internal risk analysis and developing internal policies. Such factors may include the jurisdiction in which bank accounts are opened, the place where business negotiations are conducted, information from websites, internal regulations on the allocation of authority, etc.

The ability for a foreign company to independently declare itself to be a Russian tax resident is retained, with the clarification that this applies only to foreign companies that operate in Russia via an autonomous subdivision. Such a company is not subject to CFC rules in this case.

This ability does not apply to companies that are tax residents of low-tax jurisdictions (included in a Minfin list established in Article 284 of the Tax Code) or countries that do not have double tax and/or information exchange treaties with Russia.

## Gains on disposal of shares in property-rich companies

Foreign companies are currently under obligation to pay Russian income tax on the sale of non-exchange-traded shares/participation interests of a Russian company if more than 50% of the assets of such Russian company constitute real estate situated in Russia.

The rules extend this obligation to pay tax on the sale of shares/participation interests of Russian companies also to foreign companies if more than 50% of their assets “directly or indirectly” constitute Russian real estate.

Income from disposal of shares of companies holding Russian real estate (50% capital) is exempt for:

- Shares of listed companies in any recognized stock exchange
- Shares of companies/interest in non-corporate structures with at least 50 shareholders/participants, provided that each of them hold not more than 5%
- Shares (interest, units) in companies owned over five years (continuously)

Also any exemptions applicable to the relevant income, under certain double taxation treaties (such as that between Russia and the Netherlands, Russia and Cyprus until January 1, 2017) will prevail even if this rule is introduced.

## First impressions of the law

Apart from the obvious tax implications for Russian companies with interests in foreign companies, the more interesting issue is likely to be the impact of the law on typical beneficial ownership schemes for Russian assets, which often provide for the use by Russian resident individuals of foreign trusts and offshore companies.

In particular, it is not clear from the current wording of the law whether trusts not controlled by beneficial owners (so-called “discretionary trusts”) will fall under the definition of a CFC, although the Ministry of Finance has previously stated its opinion that such trusts must be included in the scope of the law. By definition, the beneficiaries of a “discretionary trust” have no control over it, and so some other test apart from control will be required. They will be exempt as long as they are not in position to distribute profits to their beneficiaries.

In addition, the new rules could also change the principles on which beneficial ownership schemes are structured, shifting the focus from the tax effectiveness of foreign holding companies to reducing the risk of the beneficial owner being held personally liable for payment of taxes in respect of the CFC.

## Effects on Cyprus structures

Cyprus is a “white-listed” country for Russian tax authorities in respect of information exchange arrangements. The Cyprus corporate tax rate of 12.5 percent is below the effective tax rate (generally 15 percent) required for exemption on the basis of effective tax rate. Companies that are holding companies and whose income is principally “passive” will not be subject to the “management and control” test in respect of tax residency but will be affected by the law.

Trading companies with more than 80 percent of their income from trading operations will be exempt from CFC rules, but should enhance their presence in Cyprus to meet the “management and control” test. Our double tax treaty with Russia provides that until January 1, 2017 gains on shares in property-rich companies will be taxable only in the country of residence of the seller, so it is expected that this will prevail over the deoffshorisation rules.



## Practical implications - Taxation of CFCs

- All structures must be reviewed and risks/options considered
- Consider exemptions
- Implement two sets of accounting standards for profit calculation for Cypriot and Russia tax reporting purposes
- Keep monitoring clarifications on how structures should account for CFC profits for Russian tax purposes
- Consider restructure and planning solutions reducing exposure to the CFC tax rules
- Potential CFCs should have accounts and records for past years

## Legal tax residency and the importance of substance for trading companies and/or groups

- Develop new approach to management and corporate governance to comply with new rules
- Increase substance and ensure that factual and corporate documentation reflect the proposed concepts
- Consider current structures holding Russian real estate – asset risks and possibly restructure and/or obtaining listing
- Seek advice to ensure group financing structure complies with Russian thin capitalization rules
- Ensure that no general powers of attorney (POAs) are in issue
- No POAs to manage bank accounts in Russia

- Attend board meetings in Cyprus with all strategic decisions to be taken from Cyprus
- No control or decision management of the activity of the foreign company or structure from Russia

## Foreign wealth planning structures

- Settlor/founder must report participation in the structure irrespective of residency status of beneficiaries
- Russian resident beneficiaries are subject to tax of undistributed profits
- Limit level of control:
  - (1) settlor reserves powers to remove the initial beneficiaries
  - (2) Various levels of control by Russian persons/entities
  - (3) Russian resident beneficiaries entitled to distributions

## Calculation of effective tax rate and determination if exempt from CFC rules

Two formulae have been included for the calculation of the effective tax and weighted average tax rates.

The effective tax rate on income (profit) of a foreign organization is to be determined as follows:

**Reff (effective tax rate) = T/I**

**T:** is the amount of tax (profit) amount calculated by the foreign company and its economically autonomous subdivisions in accordance with the local law and income tax withheld on income (profit) of the organization in question at the source of payment of that income.

**I:** is the amount of total income (profit) of the foreign company



The weighted average tax rate for profits tax is to be determined as follows:

$$R_{wav} = \frac{R1 \times I1 + R2 \times I2}{I1 + I2}$$

- I1:** is the amount of total profits less dividends received. If this results in a negative value, I1 shall be taken to be zero.
- I2:** is the amount of dividends received by the foreign company
- R1:** is the general Russian statutory rate of profits tax (20%)
- R2:** is the Russian rate of profits tax which is established for certain dividends received by Russian companies (currently 9% to be increased to 13% from 1 January, 2015: the same rate will apply to Russian companies and individuals)

Compare the effective tax to the weighted average tax rate. Under the new rules, undistributed CFC profits are tax exempt and not included in the Russian tax base of the company or individual if the CFC is located in country DTT partner of Russia and which exchanges information with tax authorities and CFC's effective tax rate comes to at least 75% of the average weighted rate.

We would be happy to help if you should have any questions about the potential impact of the new rules on your business from a Cyprus perspective and would be glad to suggest solutions, bearing in mind that we are not Russian tax advisors, therefore any proposals have to be reviewed and confirmed by your local tax consultant.

## Personal investment companies

Many taxpayers formed personal companies for the purpose of investing in securities via foreign bank accounts. This option made it possible to avoid breaching currency law, lower the tax rate from 13% to 9% and take a flexible approach to dividend distribution. Although the first two mechanisms will continue to operate, accumulating income within a company will no longer be possible under the CFC rules. Income will have to be distributed annually as dividends and taxed at 9% (with effect 1 January, 2015 will increase to 13%) or it will be taxed at 13% as undistributed profit of the company concerned.

Another complication will be the administrative burden of notifications and reporting of CFC profits.

## Tax planning for individuals

We can advise on possible planning options, according to individual circumstances, with possible solutions being terminating Russian tax residence, relocating to another jurisdiction, restructuring or re-domiciling personal holding companies to "white-list" jurisdictions. Limiting control over companies and unincorporated structures (through a trust, foundation), investing through different classes of shares or the involvement of debt financing or through the use of funds or even delegating the asset management of the assets to regulated third parties (under discretionary asset management agreements).

### ONEWORLD LTD

There are no typical Oneworld clients. From dynamic young enterprises to global corporations, from high worth individuals to their families and consultants. We serve them all. We are not just looking after their fortunes but their futures. We are not just their advisors, we are their partners. Which is why we are prominent in fiduciary, business and financial services.

Our services include:

- Corporate and Trust
- Financial Advisory
- Business Services
- Tax and Legal
- Global Compliance
- Family Office

For more information you can contact:

Savvas Shiatis [sshiatis@oneworldweb.net](mailto:sshiatis@oneworldweb.net) mobile +357 99597339

