Client Alert

Tax

December 2014

"Deoffshorization" measures

On 24 November 2014 the Russian President signed Federal Law No. 376-FZ "On amending parts one and two of the Tax Code of the Russian Federation (in the part related to taxation of profits of controlled foreign companies and income of foreign companies)", which enters into force on **1 January 2015**.

The Law is aimed at preventing the abuse of "offshore" structures and introduces new rules in the following areas into the Tax Code:

- Taxation in Russia of controlled foreign companies' profits ("**CFC rules**")
- Disclosure of participations
- Tax residency of foreign companies
- "Actual right to" (beneficial ownership of) income
- Taxation of income from disposal of property-rich shares/LLC interest
- Additional condition for tax exemption for free-of-charge receipts of property from affiliates

The Law requires group structures to be reconsidered, in particular, with regard to the purpose of foreign companies, their functions and "substance" and the form of their presence in Russia and in the relevant foreign country.

CFC rules

The CFC rules will require Russian tax residents (individuals and companies) to disclose their foreign participations and to pay tax on profits generated by controlled foreign companies (even before such profits will be distributed to Russia).

The Russian Tax Code will treat as a *controlled foreign company* ("**CFC**"):

- a foreign company that is not a Russian tax resident ("**CFC-company**");
- a "foreign structure" which does not have a legal personality (*fund/foundation*, *partnership*, *trust or other form of collective investment or trust management*) and which is entitled to conduct profit generating activities in the interests of its participants or other beneficiaries ("**CFC-structure**").

For more information, please contact:

Irina Dmitrieva
Partner
+ 7 495 787 3003
idmitrieva@whitecase.com

White & Case LLP
4 Romanov Pereulok
125009 Moscow
Russia
+ 7 495 787 3000

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Russian tax residents (legal entities and individuals) will be recognized as *controlling persons*, if with regard to a CFC, they hold:

- a *participation*[1] of above 25% (in 2015, above 50%), or above 10% if the participations of all Russian tax residents in the CFC in aggregate exceed 50%; or
- *control* (in their own interests or in the interest of spouse and underage children) which implies exercise (possibility to exercise) of influence on decisions on distribution of CFC's net profits.[2]

The profits of the following categories of CFC are *exempt* from taxation as income of controlling persons:

(i) the CFC established in member-countries of the Eurasian Economic Union;[3]

(ii) the CFC with a permanent place of residence in a tax treaty country[4] (except for "grey list" countries),[5] if:

- the CFC is a bank or an insurance company; or
- the *effective income tax rate* of the CFC ≥ 75% of the *average Russian weighted tax rate*;[6]

(iii) the CFC with a permanent place of residence in a double tax treaty country (except for "grey list" countries), if:

- *passive income*[7] of the CFC does not exceed 20% of its total income;

(iv) the CFC that is a non-commercial organization which *lex societatis* does not permit income distribution;

(v) the CFC that is a Eurobond issuer and qualifies for exemption from withholding of Russian tax at source (according to Article 310 of the Tax Code), if:

- at least 90% of the income of the CFC is derived from its main activity;

(vi) the CFC that is a participant in projects with foreign governments (e.g., product sharing, concession, license, or service agreements), if

- at least 90% of the income of the CFC is derived from its main activity;

(vii) the CFC that is an operator of new hydrocarbon fields (or direct shareholders of such operator);

(viii) the CFC-structure which *lex societatis* and foundation documents limit the founders' rights (including the rights to receive assets from the "structure", transfer the right to determine beneficiaries, receive directly/indirectly[8] income from the "structure").

1 An individual's participation will be deemed to include participations of his spouse and underage children.

2 *Control* is meant to be exercised by virtue of direct/indirect participation, contract, applicable law or other special relations.

3 The Eurasian Economic Union unites Russia, Belarus, Kazakhstan, Armenia.

4 The Law refers to countries that have an agreement on tax matters with Russia (the "**tax treaty countries**"). These include (as of 1 January 2015) 82 countries that have double tax treaties with Russia (the "**double tax treaty countries**"). It is possible that the Law means to include also countries that have agreements on administrative assistance in tax matters (including information exchange) with Russia; clarification of the Ministry of Finance on this point would be helpful.

5 The Federal Tax Service will compile the list of countries that do not cooperate with information exchange (the "**grey list**"). This list will be in parallel to the list of "offshore" countries that was approved by the Ministry of Finance on 13 November 2007 and serves as a "black-list" for the 0% Russian profit tax on incoming dividends (the "**black-list**").

6 The *effective income tax rate* is calculated according to the CFC's *lex societatis*, including taxes withheld at source; is determined only if there is profit at the financial year-end.

The *average Russian weighted tax rate* is calculated according to the Russian Tax Code based on a 20% general rate and a 13% dividend rate (which applies instead of 9% rate for individuals and legal entities, from 1 January 2015).

7 *Passive income* is defined broadly and includes: (i) dividends; (ii) income from the distribution of profits/property (including upon liquidation); (iii) interest income (except for foreign banks); (iv) royalties; (v) income from the sale of shares/LLC interests /assignment of rights in a foreign company that is not recognized as a legal entity; (vi) income from transactions with derivatives; (vii) income from the sale of immovable property; (viii) income from the lease/sublease/financial lease of property (except for transport vehicles used in international carriage); (ix) income from the sale (including by redemption) of investment units in unit investment funds; (x) income from consulting, legal, accounting, audit, engineer, advertising, marketing and information processing services, and research and development works; (xi) income from secondment of personnel; (xii) other analogous income.

8 Through a related party.

The profit of the CFC will be calculated and included in the income of its controlling person in accordance with the following rules:

- Profit is calculated (a) separately with respect to each CFC, (b) with respect to profits for the reporting financial years,[9] from 2015, (c) if the CFC has a permanent place of residence in a tax treaty country and its financial statements are, by applicable law, subject to mandatory audit—on the basis of the CFC's non-consolidated financial statements, with certain corrections[10] (otherwise—on the basis of a calculation in accordance with rules in the Russian Tax Code).
- A CFC's profit is included in the controlling person's tax base if it exceeds RUB 10 mln (in 2015 – RUB 50 million, in 2016 – RUB 30 million).
- The profit of the CFC will be reduced by (a) the amount of any dividends distributed at the end of the financial year (within certain time frame)[11] as well as profits which may not be distributed in accordance with CFC's *lex societatis*, (b) profit that has been included in the tax base of other Russian controlling persons.
- The profit of the CFC will be included in the controlling person's tax base (a) pro rata to its participation in the CFC, (b) as of the 31 December of the year following the tax year in which the financial year ends,[12] (c) together with income which is subject to 20% profit tax (organizations) or 13% income tax (individuals).
- Russian tax calculated on a CFC's profit will be reduced by the amount of the CFC's foreign and Russian taxes which were withheld at source or paid through its permanent establishment.

For the period until 1 January 2017, special rules will be introduced to soften the impact of the tax regime on the *liquidation of a CFC*:

- exempt a controlling person from taxation of income in the form of property and/or property rights received as a result of CFC's liquidation;
- exempt from transfer pricing control the sale of securities and property rights (including LLC interest and investment units) by a CFC to its controlling person (or its Russian affiliates).[13]

The following *tax fines* will be introduced for violation of the CFC rules by controlling persons:

- failure to file (or filing an incorrect) tax return—a fine of RUB 100,000;
- non-payment (in full or in part) of tax on a CFC's profit—a fine of 20% of the tax amount (subject to a minimum of RUB 100,000).[14]

9 The financial year is determined in accordance with CFC's *lex societatis*.

10 The corrections relate to the conversion of foreign currencies into rubles and require the use of the annual average exchange rate of the Bank of Russia, re-valuation of securities and derivatives and formation/recovery of reserves, corresponding adjustments in the circumstances provided by transfer pricing rules, and loss carry-forward.

11 With respect to *CFC-"structure"*: reduction is possible only if controlling persons and beneficiaries have paid tax on dividend income.

12 As of 31 December 2016, if the financial year of the CFC ends on 31 December 2015.

13 The wording of the relevant provision is not perfect and requires additional analysis.

14 The liability applies to the tax periods starting from 2018.

Disclosure of participations

The Law establishes requirements to disclose certain information and establishes liability for non-notification:

Responsible person	Subject of notification/disclosure	Term for submission	Fine
Taxpayers (companies and individual entrepreneurs)	Shareholding of above 10% in a Russian joint-stock company	within a month	RUB 200
Russian tax residents	Participation of above 10% in a foreign company Formation of "foreign structures", entitlement to control or income	within a month (requirement applicable from 1 April 2015)	RUB 50,000
Controlling persons (who are Russian tax residents)	CFC	by 20 March the year following the tax year in which the CFC's profit is subject to taxation[15]	RUB 100,000
Foreign companies and "structures" that have taxable property (real estate) in Russia	Founders, participants, beneficiaries and managers (including individuals and public companies that own directly or indirectly above 5%)	Together with filing property tax return	100% of annual property tax

Tax residency of foreign companies

The Law will introduce the concept of "*tax residency*" for foreign companies by reference to their *place of actual management*. The place of actual management will be Russia if the following take place in Russia (to certain extent):[16]

Main conditions[17]	Additional conditions[18]
(i) meetings of the board of directors (ii) activities of the executive body (iii) activities of key top officials (incl. decision making)	(i) accounting/management accounting (ii) record-keeping (iii) operative management of human resources

Certain categories of foreign companies will be tax resident in Russia only if they *elect* so:

(i) a company that is a tax resident in a tax treaty country;

(ii) a holding company if:

(a) the participation of a Russian controlling person in it is (directly/indirectly) 50% or more and has been held for 365 calendar days or more; and

(b) more than 50% of its assets are in the form of investments in foreign subsidiary companies (provided that each such subsidiary is held at least 50%; has permanent place of residence in a double tax treaty country (except for "grey list" countries); has passive income of no more than 20%); and

(c) above 95% of income is in the form of dividends (or no income at all);

(iii) a participant in projects with foreign governments;

(iv) an operator of new hydrocarbon fields (or direct shareholders of such operator).

15 I.e., apparently, for the first time, by 20 March 2017.

16 The following activities *as such* are not recognized to be actual management: preparation or adoption of resolutions on matters within the competence of the general shareholders' meeting; preparation for holding board meetings; certain planning and control functions.

17 Fulfilment of one condition is sufficient.

18 Applicable if main conditions in (i) or (ii) are not fulfilled; fulfilment of one condition is sufficient.

However, foreign companies may *elect* for Russian tax residency *only* if they have permanent place of residence in a tax treaty country and conduct operations in Russia through a subdivision.

Not recognized as Russian tax residents are:

- Eurobond issuers that qualify for exemption from withholding of Russian tax at source (according to Article 310 of the Tax Code), if they derive at least 90% of income from their main activity;
- foreign companies that are liquidated before 1 January 2017.

A foreign company which is *recognized* as a Russian tax resident will be treated "equally" with Russian companies for profit tax purposes[19] and will not be recognized as a CFC (only if tax residency status is *elected*).

"Actual right" to income ("Beneficial ownership")

The Law introduces the concept of the "actual right" to income ("beneficial ownership") as a condition for tax treaty relief and allows Russian payors of income to request relevant confirmations (in addition to tax residency certificate).

A person will *have* the "actual right" to income if it:

- is a "direct beneficiary" of income (i.e., it benefits from income and determines its economic destiny), and
- has the right, on its own, to use or dispose of income (by virtue of direct/indirect participation, control or other circumstances) or another person is authorized to dispose of income for such person's benefits.

On the contrary, a foreign person will *not have* the "actual right" to income if it has (i) limited powers to dispose of the income, (ii) performs intermediary functions for the benefit of another person (without performing any other functions or accepting any risks, and directly/indirectly transferring income fully/partially to that other person), and (iii) that other person, if received the income directly would not be entitled to tax treaty reliefs.

Where a foreign recipient of dividends[20] is resident in a tax treaty country, but has no "actual right" to income, the Russian Tax Code permits taxation of the dividends on the basis that they are income of the person that has the "actual right" to such dividends and has indirect shareholding (through a chain of companies) in the company distributing such dividends:

- for tax residents: by self-assessment at a tax rate of 13% or 0% (legal entities, subject to certain conditions);
- for non-residents: by withholding tax at source in accordance with an applicable tax treaty.

Sale of property-rich shares/LLC interests

Currently the Russian Tax Code requires *foreign* companies to pay tax upon sale of shares/LLC interests in a Russian company only if assets of that company consist of more than 50% of real estate. From 2015, the *Russian nationality* requirement and *direct* ownership of real estate requirement will be abolished which significantly extends the scope of Russian taxation for transactions related to Russian real estate. In addition, the obligation to pay tax will be imposed on the seller- foreign company (formerly this obligation was imposed on the purchaser as a tax agent).

The exemption from tax for *Russian* companies selling shares in Russian companies will be abolished in the circumstances when more than 50% of the target company's assets are real estate.[21]

Free-of-charge transfer of property

An additional condition will be introduced for the profit tax exemption for free-of-charge receipts of property from subsidiary companies in which the recipient has a 50% or more participation, namely: the exemption will not apply if the subsidiary company is resident in a "black-list" country.

19 Additional analysis is required as to whether such tax residents (foreign companies) will be eligible to apply reduced tax rates for dividends (13% and 0%) and as to whether distribution of dividends by such tax residents will be subject to Russian withholding tax.

20 The applicability of this procedure to other types of income (e.g. interest, royalty) should be clarified.

21 This exemption was introduced in 2011 for transactions with shares/LLC interest acquired after 1 January 2011 and held for more than 5 years.)

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