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Tax planning in Russia

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Investment in Russia can be effected by means of various international tax planning structures. The following article considers some of these in the light of recent developments.

I. Introduction

With its steady growing economy, Russia is one of the BRICS success stories. For foreign investors seeking above average returns, the country remains very attractive. Russian businesses are also looking for expansion abroad. This article deals with the main aspects of tax efficient structuring of both inbound and outbound investments involving Russia. In particular, the need for and proper use of international investment structures are explained, taking into account the rapidly developing Russian tax administration and court practice.

II. Commonly used jurisdictions for international corporate tax planning in Russia

Both Russian groups expanding their activities, whether abroad or domestically, and foreign investors entering the Russian market look for optimisation of their overall tax position. Where investments in Russia are involved, withholding taxes are a particular concern. On dividends paid to a non-Russian recipient withholding tax is due at a rate of 15 percent, and on interest and royalties, at a rate of 20 percent. Moreover, a 20 percent tax is levied in connection with the sale of shares in Russian companies, that hold significant real estate, by either Russian or foreign sellers. With regard to Russian investment (whether domestic or external), the 9 percent Russian dividend tax applies. The relatively heavy conditions to apply participation exemption can be a hurdle. For dividends, participation exemption is available provided that (in brief) a minimum participation of 50 percent is continuously held for at least a year. For capital gains, an exemption from the 20 percent corporate income tax is available if the gain is connected with the sale of shares in a Russian LLC or JSC (but only if unlisted or active in high-technological businesses) which were acquired after January 1, 2011 and held for at least five years.

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When structuring Russia inbound and outbound investments, investment platforms should be established in a jurisdiction that provides for:

(i) a broad participation exemption;

(ii) a wide high quality tax treaty network;

(iii) low or no withholding taxes on dividends, interest, royalties and capital gains;

(iv) low or no capital taxes and stamp duties.

The commonly recognised alternatives in the Russian market are Cyprus, Netherlands and Luxembourg. Each of the three has a broad participation exemption on both dividends and capital gains, a good tax treaty with Russia (and a beneficial treaty network with other states), no or limited withholding taxes on dividends, interest and royalties and no (material) capital taxes or stamp duties. In particular Cyprus provides for a very attractive tax regime as, unlike the Netherlands and Luxembourg, it does not have a withholding tax on dividends (for both the Netherlands and Luxembourg, either a reduction under a tax treaty or the EU Parent-Subsidiary Directive is required). Other options include Singapore, Austria and Switzerland.

Obviously, many non-tax reasons are at least as important when deciding how to structure an investment, such as investment protection (bilateral investment treaties), a good (financial) infrastructure, not too much administrative obstacles and (likely the most important nowadays) political and financial stability.

III. Recent developments in Russia

The Russian tax authorities and tax courts are developing rapidly, with internationally recognised tax concepts increasingly used in Russian law and court practice. A summary of these developments is provided below.

A. Blacklist of "offshore jurisdictions"

With effect from January 1, 2008, a so-called blacklist of "offshore jurisdictions" was introduced to restrict the application of participation exemption for dividends from such "offshore" jurisdictions. This list includes about 40 jurisdictions and territories which are known as "tax havens" for non-cooperation in information exchange. Cyprus was on this list until January 1, 2013 (when the amendments to the Cyprus-Russia tax treaty became effective).

The "blacklist" is now used as a reference to more severe rules also in the context of the new transfer pricing rules (see below).

B. Tax residence

Russia operates the "incorporation" based concept of the tax residence although the switch to "place of management and control" has been under discussion for quite a while. Likely in connection with this "switch", a few important Russian tax treaties (these include treaties with Switzerland (amended with the effect as of January 1, 2013 and Luxembourg (amendments are expected to become effective as of January 1, 2014) were amended to include the set of tests to identify the "place of effective management" (including the references to place of board of director meetings, place where executives usually work, place where key managerial decisions are taken). It is thus expected that place of effective management will become much more important over time, which obviously also affects foreign holding and financing companies that may yet have limited substance.

C. Permanent establishment

After more than 20 years of foreign businesses having operated actively through representative offices in Russian, Russian tax authorities have, in the recent years, shown willingness to question the scope and nature of Russian operations and their permanent establishment ("PE") status in greater depth. The most widely discussed case is the *Bloomberg* case[1] in 2010 (the PE status of an office engaged in the collection of information for Bloomberg's analytical articles and database); more cases were resolved through tax audits and were not brought to court. Interestingly, Russia demonstrated an intention to extend the definition of PE to include the concept of "services PE" (this is the case with a few Russian tax treaties, including those with Cyprus and Luxembourg). The PE rules (including those for "services PE") are, for Russian tax authorities, a potential tool (although not an easy one) to dispute the tax relief within the group structure where tax residence could be questioned if the "effective place of management" concept were incorporated in Russian tax laws.

D. Limitation on benefits / main purpose test

It has become more and more common for Russian tax treaties to include a limitation on benefits clause which prohibits treaty benefits in cases where one of key factors in the incorporation and existence of a company (recipient of Russian-source payments) is to avail oneself of treaty benefits (this is the case with Russian treaties with Luxembourg, Switzerland and, in limited cases, with Cyprus). Hence, it is important to consider the genuine business reasons when it is envisaged that a company will benefit from tax treaties that contain such clause.

E. Beneficial ownership

Russian tax laws and practice have not yet developed the beneficial ownership ("BO") concept (in particular, the set of criteria for recognition of BO). At the same time, the intensive discussions between the Ministry of Finance and businesses in early 2012[2] regarding tax relief for Russian-source interest paid within the so-called Eurobond structures demonstrate that the Ministry of Finance has adhered to the OECD principles. Remarkably, the government exempted the interest payments within the Eurobonds structures altogether (first for issuances made until January 1, 2014 and now with no time limits); this is obviously in response to the Russian government's strategic considerations and acknowledging the size and importance of Russian corporates' borrowings through Eurobond issuances.

F. Thin capitalisation

The practice of tax authorities and courts over the last two years has indicated a more aggressive approach in combatting various "structures" around the Russian thin cap rules. In some instances (see the *Naryanmarneftegas* case)[3] the tax authorities investigated deeply the wide corporate and business structures of the affiliated lenders and borrowers and even attempted to test a "conduit" concept.

G. Transfer pricing

In effect as of 2012, the new transfer pricing rules focus, in particular, on cross-border transactions if they are (a) with blacklisted offshore jurisdictions, (b) with respect to exchange-traded commodities and (c) with affiliates persons (in cases (a) and (b) – with the value threshold of RUB 60m p.a.)

H. CFC rules

Currently there are no controlled foreign company ("CFC") rules in Russia, but introduction of CFC (or similar) rules is on the agenda. One of the legislative drafts proposed by the Federal Tax Service in spring 2012 (but which did not proceed any further) focused on payments to blacklisted "offshore companies" and aimed to encourage the disclosure of ultimate beneficiaries of such offshore companies.

The foregoing shows that investors should realise that more effort will need to be made when it comes to international tax structuring. Working with simple holding or financing companies with limited substance may not stand the test now or in the future. Also, international reputation (e.g. blacklisting) is an important aspect to take into account when investing into Russia, but also for Russian groups looking for international expansion. For Russian real estate subsidiaries, an additional important element is the change in the Russia–Cyprus tax treaty, which will allow Russia (starting January 1, 2017) to tax capital

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gains realised on shares or similar rights deriving more than 50 percent of their value from immovable property situated in Russia. These factors, in combination with political developments, made many investors reconsider the use of Cypriot holding companies. Currently, there is an increased interest in migration of Cypriot holding companies to the Netherlands and Luxembourg. The next section describes in which ways such migration can be effected.

IV. Migration from Cyprus to Netherlands

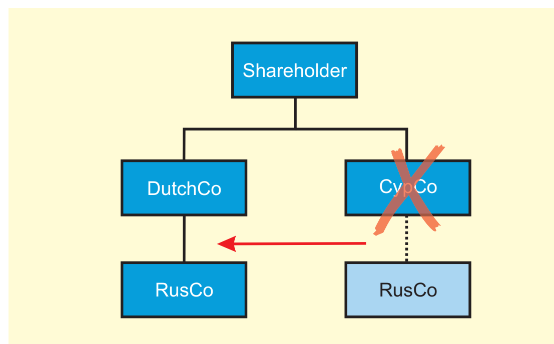
As mentioned in the previous section of this article, many investors that have owned their Russian assets via Cyprus are nowadays considering whether the jurisdiction is still the best option for them. In practice, we see a great interest in migrating Cypriot holding (and/or financing, as the case may be) companies to either Netherlands or Luxembourg. This section deals with migrations from Cyprus to Netherlands, but similar possibilities are available in Luxembourg. In essence, the three main alternatives are (i) a simple sale and transfer of assets (followed by liquidation of Cypriot company), (ii) a cross-border merger, or (iii) a cross border conversion of the company).[4]

The main benefits of using a Dutch holding company in relation to Russia are (i) the low dividend tax rate under the Netherlands–Russia tax treaty (5 percent in case of a participation of at least 25 percent and investment of at least EUR 75,000, the lowest rate available under any tax treaty concluded by Russia) and full protection against Russian capital gains taxation (even for real estate companies). Moreover, the source state cannot tax interest and royalties paid to a beneficial owner recipient of the other state. Another potential benefit is provided by article 25, paragraph 4 and section IV of the protocol to the Netherlands–Russia tax treaty. These provisions may be taken to argue that the Russian thin capitalisation rules do not apply for borrowings obtained by Russian companies with Dutch participation. Such position had been upheld by Russian courts for quite long time,[5] but should not nowadays be relied upon in the context of more recent court practice, when the courts took the position that Russian thin capitalisation rules are not contradictory to the "non-discrimination" clause commonly seen in tax treaties[6] and that special deductibility rules in protocols to a few Russian tax treaties (such as with the Netherlands) should be applied in conjunction with the "Associated Enterprises" clause[7] (i.e., by proving that the borrowings are at arm's length terms regarding the interest rate and loan amount).

A. Sale and transfer of assets followed by liquidation of Cypriot company

A sale and transfer of assets is in itself a relatively straightforward process, which may be the preferred solution if there are a limited number of assets and the asset(s) to be transferred are either assets that generate tax free income (i.e. participations qualifying for the participation exemption) or assets that do not contain an excess value (and thus do not trigger taxation upon transfer). If the Cypriot company were, for example, the owner of Russian real estate, which has a

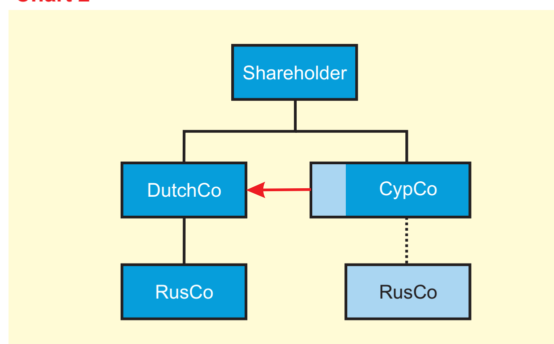
Chart 1



fair market value exceeding the book value, a simple sale and transfer, if made after January 1,2017, would not lead to the desired result.

B. Cross-border merger

Chart 2



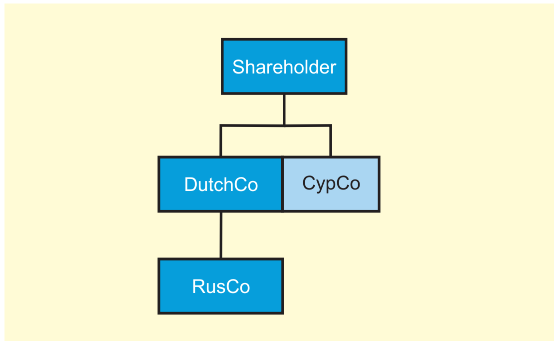
A cross-border merger allows for a transfer of assets and liabilities under universal title (by operation of law). The cross-border merger procedure is specifically regulated in statute. As a result of the cross-border merger, the Cypriot company will cease to exist. Depending on the assets of the company, the cross-border merger may trigger exit taxes. The Russian Tax Code, however, considers the merger as a tax exempt transaction with a rollover of potential capital gains; hence, assuming that the merger rules apply equally to non-Russian companies, there are no withholding tax implications for the transfer of Russian shares through a cross-border merger. One important condition for Russian tax relief for dividends is the minimum investment of a certain value (usually of EUR 75,000 or EUR 100,000) which is often interpreted by Russian tax authorities as requiring investment to be made either directly into the capital of the Russian company or as a payment of a purchase price for shares in the Russian company (both are recognised by Russian tax authorities as eligible methods of "direct investment"). Any other method of "investment" (e.g. exchange of Russian shares for newly issued shares in a foreign company) may run the risk of disputes with the tax authority. In the case of a cross-border merger of a foreign shareholder, it should be possible to argue that the initial "direct investment" of the dissolved shareholder should be recognised as permitting the succeeding shareholder to claim the tax relief for dividends.

The fact that the Cypriot company ceases to exist could potentially lead to change of control issues in

contracts of the Cypriot company, or issues with licenses or permits. This may be a reason to opt for a different alternative (i.e. the cross-border conversion explained below).

C. Cross-border conversion

Chart 3

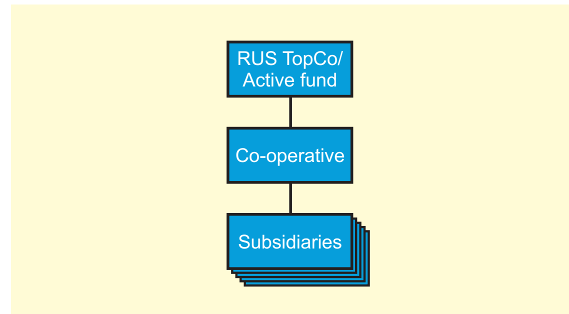


In a cross-border conversion, the Cypriot company is migrated to the Netherlands with legal continuity. In other words, the company remains in existence but continues its 'life' in the Netherlands. The benefit would be (as mentioned above) that, arguably, no change of control issues would arise and that any licenses and permits may remain valid (but note that the name of the company would slightly change as it turns from a Limited into a *Besloten vennootschap, BV)*. The procedure to execute the cross-border conversion is based on case law from the European Court of Justice, most notably the *Cartesio* and *Vale* cases.[8] Although the procedure is not laid down in Dutch law, practitioners agree that the ECJ case provides for sufficient basis to execute the cross-border conversion, as long as the jurisdiction from which the company migrates allows for such conversion (which is the case with Cyprus, although a so-called 'strike-off' procedure must be completed).

V. Exit from the Netherlands

The Netherlands levies a 15 percent withholding tax on dividends based on its domestic law. This is a clear disadvantage for investors compared with the absence of a dividend withholding tax in Cyprus. However, there are many ways to mitigate the Dutch dividend withholding tax. The most commonly used possibilities relate to the application of (i) a tax treaty or the EU Parent-Subsidiary Directive or (ii) the use of a co-operative. The co-operative is a Dutch legal entity that issues membership interests instead of shares. As a result, its members are in principle not subject to Dutch dividend tax (as opposed to shareholders in a company with its capital divided into shares). This is different if the co-operative is part of a passive investment structure and used with the main purpose or one of the main purposes of avoiding Dutch dividend tax or foreign tax.[9] To benefit from the co-operative structure, it is required that both at the level of the (direct or indirect) member(s) of the co-operative there is an active business, as well as at the level of the (direct or indirect) subsidiaries of the co-operative. Moreover, there should be an involvement through the chain of entities of the active business 'on top' with the active business 'at the bottom'. Typically, multinational groups (solely or in joint venture) and active investment funds with involvement in the target companies can benefit from the co-operative investment structure. Chart 4 depicts such typical structure.

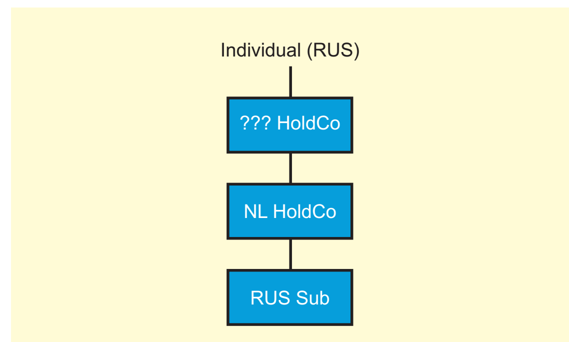
Chart 4



A point of attention is the Russian participation exemption rules that allow a 0 percent tax rate on a qualifying (at least 50 percent) participation in the share (charter) capital of a Russian or a foreign (not resident in a blacklisted country) organisation. A Dutch co-operative does not have capital divided into shares, but membership rights and "member capital accounts", which raises a question of whether distributions from a Dutch co-operative qualify for Russian participation exemption. It seems that this question has not yet been sufficiently tested in practice. As an alternative, the co-operative could (in such situations) be replaced by a combined Netherlands limited liability company with a Luxembourg limited liability company investment structure on top. The end result (no taxation in Netherlands and Luxembourg, both on incoming and outgoing dividends, as well as capital gains) would be the same.

In case of passive investment structures, an exemption from Dutch dividend withholding tax should be obtained based on the relevant tax treaty or based on the application of the EU Parent-Subsidiary Directive, as the co-operative will be deemed to have a capital divided into shares in such situation (and thus, will need to withhold dividend tax). The same applies for privately held structures that only have an active business below the holding structure. An example is depicted in Chart 5.

Chart 5



The obvious solution to the issue would be to structure the ownership of the Dutch entity via a holding company established in the EU, without a dividend withholding tax based on domestic law. However, the Netherlands has specific anti-abuse rules incorporated in its corporate income tax act. Based on these

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rules, which can arguably set aside the application of the EU Parent-Subsidiary Directive as article 1, paragraph 2 of the Directive allows member states to apply domestic rules to combat fraud or abuse, the Netherlands levies corporate income tax from substantial interest holders (in brief, 5 percent stake in the Dutch entity) in relation to Dutch source income (e.g. dividends, interest, capital gains). These rules only apply if the substantial interest holder (i) cannot attribute its interest in the Dutch entity to its active business enterprise, and (ii) owns the substantial interest with the main purpose or one of the main purposes of avoiding Dutch dividend tax or personal income tax from another person. To reduce the risk of application of this provision, the substantial interest holder of the Dutch entity in the passive investment structure should own the Dutch entity via a jurisdiction that has a favourable tax treaty with the Netherlands allowing for a reduction (preferably exemption) of Dutch tax on dividends (and interest and capital gains, preferably). Common alternatives include Luxembourg (a full exemption can be available based on Dutch domestic case law), Slovakia (full exemption on dividends based on the tax treaty) or Singapore (full exemption on dividends in case remittance to Singapore takes place).

VI. Conclusion

Due to steep withholding taxes and the imperfect participation exemption system, investments made in Russia can be tax inefficient without proper structuring of the investment. A mere interposition of a holding company to benefit from the relevant tax treaty does, however, not provide for a solid solution. As set out in this article, the Russian tax administration has developed over time, and has introduced, or is about to introduce, legislation and practice that require investors to invest more effort in their legal structure. A common trend is the reconsideration of using Cyprus when structuring Russian investments, not only because of new Russian legislation, but also (or perhaps mainly) because of the currently less stable political system. Often, investors look at jurisdictions such as the Netherlands or Luxembourg as a safe environment for their assets. Luckily, the conversion of the Cypriot investment structures to the Netherlands and/or Luxembourg can be effected smoothly and without losing the attractive tax benefits that investors were used to in Cyprus.

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NOTES

[1] Decision of the Commercial Court of Moscow, No. A40-94391/10-142-134, dated December 17, 2010.

[2] Letter of the Ministry of Finance No. 03-08-13/1, dated December 30, 2011; Press-release of the Ministry of Finance dated January 27, 2012.

[3] Ruling of the Supreme Commercial Court of the Russian Federation, No. VAS-7104/12, dated June 21, 2012; Resolution of the Federal Commercial Court of the Moscow District in case No. A40-1164/11-99-7, dated February 20, 2012; Resolution of the Ninth Commercial Court of Appeal in case No. A40-1164/11-99-7, dated October 28, 2011, No. 09AP-23751/2011-AK, 09AP-25741/2011-AK; Decision of the Commercial Court of Moscow in case No. A40-1164/11-99-7, dated August 5, 2011.

[4] From a tax perspective, the transfer of the place of effective management could be a (relatively straightforward) alternative as well, but if the investor would like leaving Cyprus not only from a tax perspective, but also legally, this may not be the best alternative.

[5] E.g., *Svedvud Tikhvin* case: Resolution of the Federal Commercial Court of the North-West District in case No. A56-19578/2006, dated April 9, 2007.

[6] E.g., *Severny Kuzbass* case: Resolution of the Federal Commercial Court of the West-Siberian District in case No. A27-7455/2010, dated March 11, 2011; Resolution of the Presidium of the Supreme Commercial Court No. 8654/11, dated November 15, 2011.

[7] E.g., *Gurovo-Beton* case: Resolution of the Federal Commercial Court of the Central District in case No. A68-7455/2012, dated May 30, 2013.

[8] European Court of Justice of 16 December 2008, C-210/06 Cartesio and European Court of Justice of July 12, 2012, C-378/10 Vale.

[9] A member in a co-operative can also become subject to Dutch dividend tax if it is not part of a passive investment structure. This is only the case, however, if the co-operative obtains ownership of a Dutch entity with existing Dutch profit reserves (with a Dutch dividend tax claim on it). In case the co-operative is used as an investment platform for Russian or other foreign (i.e. non-Dutch) investments, this provision should not apply.