DEOFFSHORIZATION IN RUSSIA: C.F.C. LEGISLATION COMES INTO EFFECT

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Federal law No. 376 of November 24, 2014, *On Amendments to Part One and Part Two of the Tax Code of the Russian Federation* (concerning the taxation of controlled foreign companies and foreign organizations), and commonly referred to as the "C.F.C. Law," came into force on January 1, 2015. It marks the beginning of deoffshorization of the Russian economy and introduces entirely new tax rules for Russian businesses having affiliates based outside Russia.

The C.F.C. Law introduces the following three new legal concepts, previously non-existent in Russian tax legislation:

- Controlled foreign company ("C.F.C."),
- Russian tax residence for foreign companies, and
- Beneficial owner of income.

The C.F.C. Law establishes the obligation of taxpayers to notify the tax authorities of their participation in foreign entities. It also establishes rules for computing and taxing C.F.C. profit and share transactions of companies that own real estate in Russia. It provides for recognition of foreign non-corporate structures (such as trusts, private foundations, partnerships, etc.) as separate taxpayers.[1]

Following the O.E.C.D. lead in the B.E.P.S. proposals, these amendments have two broad goals: (i) they ensure business transparency and (ii) they combat the use of low-tax jurisdictions to obtain unjustified tax benefits.

CONTROLLED FOREIGN COMPANIES

A controlled foreign company is a foreign entity (or non-corporate structure) that is:

1. Not a tax resident of the Russian Federation and
2. Controlled by Russian tax residents, either legal entities or individuals ("Controlling Persons").

There are three tests for a foreign entity to be considered a C.F.C. Under the general rule, a foreign entity is considered a C.F.C. if a Russian resident holds (directly or indirectly) more than 25% of its shares (50% during the transition period that ends January 1, 2016). Under an aggregation rules, a foreign entity may be a C.F.C. if a Russian resident owns 10% of shares, provided that more than 50% of the entity's

[1] Previously, Russian law did not know the concept of trusts. Russia has not ratified the 1985 Hague convention on laws applicable to trusts and their recognition. Consequently, trusts were not recognized as taxpayers in Russia.

shares are, in the aggregate, owned by tax residents of the Russian Federation.[2] Finally, under an economic substance rule, a foreign entity will be characterized as a C.F.C. if a resident of the Russian Federation can exercise significant influence on the decisions of the entity in terms of distribution of profit. This would include persons managing assets of a foreign non-corporate structure.

When a corporation is a C.F.C., its Controlling Person pays (i) personal income tax in the Russian Federation or (ii) corporate profit tax on that person's share of the C.F.C.'s retained profit.[3] In this manner, a C.F.C.'s profit is attributed to the Controlling Person on a *pro rata* basis.

From 2017 onward, a C.F.C.'s income over 10 million rubles is subject to Russian taxation in the hands of a Controlling Person. A phase in period exists for the imposition of tax. In 2015, the tax is imposed if the C.F.C.'s profits exceed 50 million rubles and in 2016 the tax is imposed if the C.F.C.'s profits exceed 30 million rubles.

The rate of tax will depend on the status of the Controlling Person as an individual or a corporation. If the former, the profit is taxed at the rate of 13% and if the latter, the profit is taxed at the rate of 20%. Before enactment of the C.F.C. Law, Russian tax on the profits of foreign entities was deferred until distributed in the form of dividends.

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The C.F.C. law contains several exceptions under which tax will not be imposed:

- Russian residents controlling a company with a registered office in a country that signed a tax information exchange agreement with the Russian Federation will not be taxed under the C.F.C. law where the effective tax rate on profits 75% or more of the weighted average rate of profit tax in the Russian Federation.[4] To illustrate how this is intended to work, the Russian corporate income tax rate on operating income is 20% and the Russian corporate income tax rate on dividend income is 13% unless the dividend qualifies for the participation exemption regime. It is anticipated that the make-up of the income of the C.F.C. will form the basis on which the hypothetical Russian tax is computed, using both rates if applicable. The hypothetical Russian tax will be compared with the actual paid or accrued by the C.F.C. to determine whether the 75% tax target is reached.
- Similarly, Russian residents controlling a company with a registered office in a country that signed a tax information exchange agreement with the Russian Federation will not be taxed under the C.F.C. law provided that:
    - Russia has concluded a double taxation avoidance agreement with that country and
    - The income from passive activities does not exceed 20% of the total income of the company. Passive activity income includes dividends, interest, royalties, gain from the sale of shares or real estate, and

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[2] Para. 3, art. 25.13, Tax Code of Russian Federation.

[3] Para. 2, art. 25.15, Tax Code of Russian Federation.

[4] Subpara. 3, para. 7, art. 25.13, Tax Code of the Russian Federation.

income from the performance of personal services such as consulting, legal, accounting, and audit services.[5]

- Finally, in a foreign non-corporate structure, a Russian resident that is the settlor of the structure will not be taxed when the resident is not entitled to benefit from the assets within the structure. Examples include the inability to obtain ownership of the entity's assets or to sell rights in the entity to a third party.[6]

RUSSIAN TAX RESIDENCY FOR A FOREIGN COMPANY

In certain instances, foreign entities can be considered to be Russian tax residents. For a foreign company, this means registration in the Russian Federation for profit tax purposes, reporting obligations, and its own profit tax calculation and obligation to pay profit tax of 20%. If a foreign company is recognized as a resident of the Russian Federation, it can no longer be considered a C.F.C. with respect to the Russian Controlling Persons.[7]

Unless otherwise provided by an applicable income tax treaty, a foreign company can be a tax resident of the Russian Federation by operation of law. Alternatively, it can become a tax resident of the Russian Federation on its own initiative.

In the first case, a foreign company is recognized as a Russian tax resident if the place of actual management of the company is located in the Russian Federation. According to the C.F.C. Law, the place of actual management is located in the Russian Federation if one of the following conditions is met:

- Most of the board of directors meetings are held in the territory of the Russian Federation;
- Executive board/senior (managing) officers perform their activities in the territory of the Russian Federation; and
- Accounting or managerial accounting, records management, and personnel operating management are located in Russia.

If an entity can provide documents, confirming that actual management is performed outside the Russian Federation (*i.e.*, commercial activities are conducted abroad using its own personnel and assets), it cannot be considered as a tax resident of the Russian Federation.

In the second case, a foreign entity can become a tax resident of the Russian Federation on its own initiative in the following instances:

- It is registered in a country with which an agreement on tax matters has been signed;

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[5] Subpara. 4, para. 7, art. 25.13, Tax Code of the Russian Federation.

[6] Subpara. 5, para. 7, art. 25.13, Tax Code of the Russian Federation.

[7] Subpara. 1, para. 1, art. 25.13, Tax Code of the Russian Federation.

- It is involved in projects under production sharing contracts, concessional, license and service agreements with the government of the respective country; and
- A shareholder owning at least 50% of the share capital in the company is a Russian resident and has owned these shares for at least 365 days and:
  - Over 50% of the company's assets are investments in foreign subsidiaries that are at least 50% owned and
  - The foreign entity either has no income or dividends from the subsidiaries account for 95% of the entity's total income.

"If a foreign company cannot demonstrate that it is the beneficial owner of the income, Russian source income will be taxed at normal rates provided under domestic law."

BENEFICIAL OWNER OF INCOME

According to the new provisions of the, the application of reduced taxation rates or tax exemptions provided by income tax treaties will not apply to income from sources in the Russian Federation if the foreign entity is not the beneficial owner of the income.[8] If a foreign company cannot demonstrate that it is the beneficial owner of the income, Russian source income will be taxed at normal rates provided under domestic law.

For this purpose the income recipient is considered to be the beneficial owner ("Beneficial Owner") only if it can demonstrate that, by reason of direct or indirect participation in the Russian company or by reason of control over the Russian company, or due to other circumstances, it is entitled to independently use and/or dispose of the income, taking into account the functions performed and risks assumed.

A person is not the Beneficial Owner of income if it:

- Has limited authority;
- Carries out an intermediary function; and
- Does not perform any other functions and does not assume any risks because it is a conduit of the income to others.

The concept of Beneficial Ownership is directed against practices that abuse the provisions of international treaties. The law is enforced by imposing tax obligations on the withholding agent. The withholding agent has the right to request confirmation that the recipient is the Beneficial Owner that is entitled to such income for application of the provisions of the tax treaties.[9] If it is subsequently determined that the foreign payee is not the Beneficial Owner, the tax agent will be held responsible for the tax and penalties can be imposed.[10]

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[8] Art. 7, Tax Code of the Russian Federation.

[9] Para. 1, art. 312, Tax Code of the Russian Federation.

[10] According to the position set out in the decision of Russian Federation Superior Commercial Court Plenum No. 57 of July 30, 2013.

SHARE DEALS WITH COMPANIES OWNING RUSSIAN REAL ESTATE

The new law adopts a "F.I.R.P.T.A." concept on share sales of Russian real property holding companies. The income of foreign companies from the sale of shares in any company is subject to profit tax if more than 50% of the value of the assets of the target company consists of Russian real estate, directly or through other companies.[11]

NOTIFICATION

The C.F.C. Law provides for a new obligation of Russian tax residents to notify tax authorities of involvement in certain in foreign structures:[12]

- Participation in foreign entities if the ownership is more than 10%; if the ownership drops below 10%, reporting is also required;
- Setting up foreign non-corporate structures and control over them or beneficial entitlement to the income; and
- A C.F.C. with regard to which the resident is a Controlling Person.

"The C.F.C. Law provides for a new obligation of Russian tax residents to notify tax authorities of involvement in certain in foreign structures."

Notification regarding participation in foreign entities including non-corporate structures is to be made within one month after the one of the foregoing conditions is first met. For existing structures, the deadline for submission of the notification of participation is April 1, 2015. The notification deadline regarding a C.F.C. is March 20th of the year following the tax period in which the profit share of the controlled foreign company is subject to registration with the supervisory authorities.

In addition, foreign entities owning real estate in Russia must submit information regarding their participants to the tax authorities at the place where the real estate is located. For foreign non-corporate structures this includes information on settlors, beneficiaries, and managers.

If a Russian Controlling Person has not filed a notification with regard to a C.F.C. and the tax authorities obtain information indicating control exists, the tax authority will notify the resident that information must be provided within 20 days. If, the tax authority establishes a basis to conclude the resident is a Controlling Person in regard to a C.F.C. Controlling Person, the taxpayer will be notified and will have the right to contest the determination within three months. Until a final decision of a court is reached, a taxpayer cannot be recognized as a Controlling Person.

TAXATION OPTIMIZATION IN LIGHT OF NEW CIRCUMSTANCES

Due to changes in the tax law, Russian tax residents who own foreign entities or non-corporate structures and use them in their activities should review existing

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[11] Subpara. 5, para. 1, art. 309, Tax Code of the Russian Federation.

[12] Para. 3.1, art. 23, Tax Code of the Russian Federation.

business structures promptly in order to identify possible risks. Once risks are identified, the Russian resident has three basic options:

1. Refuse to use offshore entities and transfer assets to the Russian Federation;
2. Retain the existing business structure and disclose information; and
3. Reorganize the holding, change the business model, and disclose information.

Let's look at each of these options.

Option 1: Abandoning Offshores

Such a decision is appropriate if, for example, there are no real activities abroad, no business purpose for using offshore companies, or if the existence of an offshore company in the holding simply becomes unprofitable in the new conditions. The benefits of this solution are the reduction of offshore company maintenance costs and tax risks.

Once the decision is made to abandon offshore entities, they must be liquidated before January 1, 2017.[13] The law provides for a mechanism for preferential return of offshore assets in the case of liquidation. Income resulting from liquidation of a foreign company is not included in the tax base of a shareholder who is recognized as a Controlling Person.[14] In addition, the Controlling Person of a Russian organization can receive property from a foreign company at no cost. In the case of a Russian Controlling Person holding a share of more than 50%, the property will not be taken into account when determining the profit tax base.[15]

Option 2: Retaining the Existing Business Structure

When a foreign company is used for asset protection advantages of a foreign jurisdiction may include the application of foreign law or effective judicial protection, the existing structure of the group of companies may be preserved. This will allow the company to retain the existing business ties and continue to be protected by a foreign country's laws. In this situation, payment of taxes in the Russian Federation is effectively a charge for the soundness of the asset.

It should be noted that there is a need to disclose information on participation in foreign companies, as well as to ensure compliance with the criteria of "real presence" in a foreign jurisdiction, in order to prevent such foreign companies from being recognized as Russian tax residents.

1. To maintain a reasonable tax burden, it is possible to optimize the taxation of the group in the following ways:
2. Dividends distribution[16] (possible application of a tax rate of 0%[17]);

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[13] Para. 3-5, article 3, C.F.C. Law.

[14] Paragraph 2.2, art. 277, Tax Code of the Russian Federation.

[15] Subpara. 11, para. 1, art. 25.15, Tax Code of the Russian Federation.

[16] Para. 1 and 4, art. 25.15, Tax Code of the Russian Federation.

[17] Subpara. 1, para. 3, art. 284, Tax Code of the Russian Federation.

3. Admission of the factual right of Russian resident to income in the form of dividends;[18]

4. Apportionment of losses incurred by a C.F.C.;[19] and

5. Credit for foreign tax paid.[20]

Option 3: Restructuring the Business

If a group of companies is active abroad and participates in international projects, then the companies and financial flows within that group should be structured so as to prevent the foreign entities or non-corporate structures from being recognized as C.F.C.'s or their profits from being taken into account with regard to taxation of Russian Controlling Persons. This will optimize the taxation and business processes and adapt them to the new circumstances.

The options for group and financial flow restructuring are as follows:

1. Change the jurisdiction of the companies that are profit centers to transfer such centers to another company in a country with a favorable tax regime, which meets the criteria set out in subparas. 3 and 4, para. 7, art. 25.13 of the Tax Code of the Russian Federation. The country must have signed an agreement on exchange of information on tax matters and the company's effective profit tax rate must not be less than 75% of the weighted average rate of profit tax in the Russian Federation. Alternatively, that country and the Russian Federation must have signed a Tax Information Exchange Agreement and concluded an income tax treaty. The profits of such companies will not be taxed with the Russian Controlling Persons.

2. Change the residence of an individual who is a Controlling Person. This method carries some tax risks. For example, the person may become tax resident of a country imposing tax at a rate that exceeds the Russian tax rate of 13%. In addition, he may lose personal income tax privileges in Russia when engaging in transactions involving Russian property.

3. Transfer the assets to a discretionary trust[21] where the settlor has no right to dispose of property and income of the trust, the beneficiary is not specified, and all decisions are made by an independent trustee.

4. Subdivide financial flows in such a way that the profit made by a C.F.C., is less than 10 million rubles (50 million in 2015 and 30 million in 2016, respectively). However, this is inconvenient in case of large financial flows.

5. Reduce the participation interest in a foreign company (based on the requirements of para. 3, art. 25.13 of the Tax Code of the Russian Federation). This method is associated with an increase in expenditures on company maintenance and nominee service, and risks recognition of the companies as tax residents of the Russian Federation.

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[18] Para. 1.1-1.4, art. 312, Tax Code of the Russian Federation.

[19] Para. 6-7, art. 309.1, Tax Code of the Russian Federation.

[20] Para. 3, art. 232; para. 11, art. 309.1, Tax Code of the Russian Federation.

[21] Subpara. 5, para. 7, art. 25.13, Tax Code of the Russian Federation.

CONCLUSION

Ultimately, the amendments to the Tax Code of the Russian Federation related to deoffshorization signify a new approach to tax planning and optimization – without the use of offshore companies, and only through tax relief and deduction.

Russian residents will have to give up semi-legal schemes and nominees, use “white” (legal onshore) jurisdictions, and act in compliance with the framework established by the law.

The comfortable offshore days are gone and will never be back. Therefore, over the next few years, Russian entrepreneurs will have to change their mentality and business models.