SECRETAN TROYANOV SCHAER SA
MOSCOW LAW OFFICE
MOSCOW 119 048 – ULITSA USACHEVA 33/1
WWW.STS-LAW.RU
TEL. (+7 495) 232.03.01 (+7 499) 245.52.03 – FAX (+7 495) 232.03.02

CONTROLLED FOREIGN COMPANIES
Draft Law dd. 27.05.2014

EXECUTIVE SUMMARY

Under the label "de-offshorization" Russia is currently reviewing several amendments to its tax laws which are expected to take effect from 1 January 2015.

The key element of the tax initiative was – at least initially – the introduction of CFC rules intended to discourage the artificial deferral of income tax payments through the use of off-shore companies in tax planning structures. The CFC rules are intended to apply not only to foreign companies under the taxpayer's direct control, but also to indirect control through trusts, fiduciary arrangements and similar. In order to make the rules effective the initiative requires Russian tax residents to disclose relevant holdings. In the most recent draft law the obligation to disclose foreign assets has been disjoined from the CFC rules.

The draft law prepared by the Ministry of Finance and submitted to the Russian Government was published on 27 May 2014. After a discussion with the Russian business community the Prime Minister ordered the Ministry of Finance to review the draft on several aspects, in particular to better define the scope of the law and to consider the possibility of an increase of applicable thresholds and of a gradual implementation in several steps over a couple of years. In particular, it was proposed that profits of CFCs be taxed only if the Russian resident holds more than 50% of the voting capital (under the current draft 10% is sufficient to consider the foreign company controlled).

Despite these recent and rather encouraging developments we believe that:

- these tax initiatives will become law with effect as from 1 January 2015;
- there will be more or less extensive disclosure requirements;
- while the Government's position appears reasonable it is difficult to predict what will happen to the draft law in Parliament;
- clients should already have started reviewing current structures and developing strategies to respond to the new legislation and should not delay changes which are appropriate considering current legislative trends (e.g.

liquidation of useless companies, simplification of unnecessarily complex structures, creating substance where appropriate, etc.).

I. HISTORY AND PURPOSE:

Traditionally the Russian Federation had a very liberal approach towards the taxation of foreign companies:

- All foreign companies were taxed as separate legal entities, i.e. paid tax in Russia if they operated a business in Russian territory and/or received Russian source revenue. Until recently Russia did not apply "look-through approaches" in order to tax the revenue of foreign companies as income of their Russian shareholders. While the courts started developing concepts which allow to ignore the legal form in favor of the economic substance (in particular, the theory of the unjustified tax advantage[1]) and which potentially can also be applied to foreign corporate vehicles used exclusively to receive and accumulate revenue in the interest of Russian shareholders (i.e. to optimize tax by deferring personal income or corporate profit tax to future periods), such concepts have not yet been applied, at least not systematically and/or on a broad scale. In practice the enforcement of concepts which are not based on clear legal rules meets the resistance of taxpayers and often leads to complex litigation, i.e. means a significant investment in time and resources on behalf of the Russian Tax Service.

- Russia has no general property or wealth tax for individuals. This means, in particular, that most assets (including holdings in foreign companies) must not be disclosed to the Russian tax authorities and the Russian tax authorities have no instrument to match taxpayers' income, expenses and wealth. Today beneficial ownership of individuals in foreign companies must be disclosed only in two cases: (i) to the bank if the company operates bank accounts in Russia; (ii) to the customer if the company supplies products or services to the government or government-owned entities.

- In most cases relief from Russian withholding tax under the large network of double taxation treaties concluded by Russia was granted in the past more or less automatically and in advance based on a tax residence certificate issued by the competent authority of the treaty country. Normally the relief was granted by the Russian party making the payment, i.e. the tax authority could control such relief only *post factum* during a tax audit.

As a result foreign companies, in particular companies incorporated in low tax jurisdictions, were and are still used by Russian and foreign businesses to "optimize" Russian tax. Russian tax law in its current form thus encourages the accumulation of

[1] "Необоснованная налоговая выгода" (cf. Resolution of the Plenum of the Supreme Commercial Court No. 53 of 12.10.2006).

Russian wealth abroad and its subsequent reinvestment in the Russian economy mainly through loans.

President Putin launched a campaign to bring Russian business back on shore under the label "de-offshorization". In this context the Ministry of Finance was instructed to intensify efforts to tax revenue received off shore, but economically related to business or assets in the Russian Federation. The result is the draft law "on amendments to Parts I and II of the Tax Code of the Russian Federation (with respect to the taxation of the profit of controlled foreign companies and the revenues of foreign companies)". The draft law ("**Draft Law**") was first published by the Ministry of Finance on 18 March 2014. An amended version was submitted to the Russian Government on 18 May 2014 (published on 27 May 2014). The Draft Law was discussed at a meeting with the board of the Russian Union of Industrialists and Entrepreneurs (RSPP) in the presence of the Russian Prime Minister on 18 June 2014. As a result the Prime Minister instructed the Ministry of Finance to reconsider the draft[2], which means, inter alia, that the Draft Law will not be submitted to the Russian Parliament prior to the autumn session of the State Duma.

The Draft Law introduces various important changes:

- a duty to disclose foreign assets;
- taxation of the profit of controlled foreign companies ("CFCs[3]");
- taxation of foreign legal entities at the place of their effective management;
- taxation of the revenue of foreign companies from the sale of companies (both foreign and Russian) owning Russian real estate;
- a definition of the "beneficial owner" of dividends, interest and royalties for the application of double tax treaties (limitation of treaty benefits);
- a broader definition of the cases where loan interest paid by Russian companies to foreign affiliates is treated as a dividend payment with respect to tax.

This paper will discuss only the first two changes as reflected in the Draft Law published on 27 May 2014. We will further summarize the results of the discussion between the Prime Minister and the RSPP at the end of the paper.

It appears highly probable that the Draft Law will be approved in time to apply from 1 January 2015. We believe that further important changes will be made by the Government and the Parliament, but the Draft Law in its present form gives a good idea of what can be expected. It is likely that the law will be enacted in late November 2014 only, which leaves very little time to adapt existing asset holding and business structures. It is therefore extremely important to start preparing already today based on current expectations.

[2] Instruction of the Prime Minister of 23 June 2014, published on http://government.ru/orders/13305.
[3] The Russian term is «контролируемые иностранные компании» (КИК).

II. DISCLOSURE OF FOREIGN ASSETS:

The version of the Draft Law published on 27 May 2014 provides for two types of disclosure notices:

- ***Notification of an interest in foreign vehicles ("Asset Notice"):***

  The duty to notify extends to any qualifying interest held in foreign organizations or structures.

  "Foreign organizations": tax residents of foreign States (including organizations whose tax residence is unknown or uncertain). The term *"organization"* includes legal entities as well as entities without legal personality provided they can act in their own name. A Russian tax resident must notify an interest in a foreign organization if he directly or indirectly holds a participation of ***one percent or more.*** Since the Draft Law does not specify whether the percentage relates to equity or voting capital we would assume that it relates to both.

  "Structures": vehicles which (i) do not have legal personality under the law under which they are established; and (ii) have the right to engage in business activity under the law governing them[4]; (iii) where such business activity[5] aims to generate revenue (profit) in the interests of the participants (unit holder, principals or other parties) or beneficiaries. The Draft Law contains a non-exhaustive list of such vehicles: foundations[6], partnerships[7], trusts, other forms of collective investment[8] and trust or fiduciary management. The definition is broad and probably includes any assets beneficially owned by a Russian tax resident. The notice is required if the Russian tax resident has a ***de facto entitlement*** to the revenue or profit of the vehicle in case of its distribution. The term *de facto entitlement*[9] is not disclosed in the Draft Law, but if we apply by analogy the definition given in the new Point 3 Article 312 Tax Code in relation to the beneficial ownership concept in double tax treaties the term *de facto entitlement* would refer to the beneficial ownership of the revenue, i.e. designate the person effectively benefitting from the revenue and deciding its subsequent economic affectation (as opposed to the formal

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[4] Pursuant to Article 1203 Civil Code a corporate entity without legal personality is governed by the law of the country where such entity is established. This is not necessarily the law governing the entity under its own organizational documents.

[5] In many jurisdictions foundations or trusts cannot engage in business activities, and not all jurisdictions would consider asset management generating passive revenue (dividends, interest, royalties, rental revenue and similar) as a business. However, it is not clear whether the term "business activity" should be defined under Russian or foreign law.

[6] Under most laws foundations (including Russian law) are legal entities, i.e. can also be qualified as "foreign organizations" under the Draft Law.

[7] A partnership would be a legal entity in some countries, not in others. Irrespective of that it can be a tax transparent entity. See also 6 above.

[8] This would include mutual funds.

[9] The Russian "*de facto* right" (фактическое право) is a contradiction in terms.

owner of the revenue). In many trusts or similar structures beneficiaries appointed by the settler do not have any vested entitlements, only expectations (discretionary trusts). Normally a pure expectation should not give rise to taxation.

The Asset Notice must be filed by the Russian tax resident holding the interest within 20 days from the moment when such interest arises (changes). Presumably it must also be filed retroactively before 20 January 2015 with respect to interests existing at the time when the Draft Law will become effective. The notice must not be renewed on an annual basis provided the interest remains unchanged. The taxpayer must further inform the tax authority when the interest ceases (no formal requirements).

It should be noted that the Draft Law provides practically no exception. In particular, the Asset Notice must also be filed if the interest is held in a company listed on the stock exchange (but not with respect to companies in which the taxpayer holds an indirect interest as a result of his direct or indirect ownership of the shares of the listed company).[10]

- ***CFC Notice:***

The CFC Notice must be filed by Russian tax residents deemed ***"controlling persons"*** of CFCs (see below for the definition).

The CFC Notice must be filed on an annual basis before 20 March of the year following the relevant Russian fiscal period (calendar year).[11] If a CFC Notice is filed it is not necessary to file an Asset Notice with respect to the same foreign company or structure (this appears uncertain as the Asset Notice would be due earlier than the CFC Notice).

If the Russian tax resident holds a direct or indirect participation in a foreign or Russian company the shares of which are listed and/or traded on a stock exchange ("listed company") no CFC Notice is required with respect to companies in which the tax resident holds an indirect participation through such a listed company.[12]

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[10] The qualifying stock exchanges are currently listed in a document approved by Order No. 12-91/pz-n of 25.10.2012 of the Federal Financial Markets Service. Future changes (if any) can be made by the Central Bank (new supervisory authority of the financial market).

[11] The filing seems due regardless whether the CFC holding gives rise to Russian tax. The relevant fiscal period would probably (the Draft Law is unclear) be the year during which the CFC profit could be taxed under the CFC rules. Based on Articles 223 and 271 of the Draft Law, if the interest were acquired during the financial year of the CFC ending on 31 December 2015, the profit of the CFC could be taxed in Russia only during the year 2016, which would mean that the CFC Notice must be filed before 20 March 2017. As the law would apply only to financial periods beginning after 1 January 2015, this considerably delays its effects. It is not entirely clear why a separate filing is required and it is not sufficient to include the CFC profit in the tax return (or at least to have the filing date coincide with the date of the tax return).

[12] See note 10.

Both Asset and CFC Notice must normally be filed at the taxpayer's domicile, i.e. the place where the taxpayer is registered for tax purposes. The filing can be done in paper form (e.g. by post) or electronically. An electronic filing is required if the controlling person is a legal entity. The format and procedures will be defined by the Federal Tax Service in coordination with the Ministry of Finance.

The Asset Notice includes the following information:

- period covered and date when the interest was acquired (respectively the circumstances giving rise to the notice arose);
- corporate name or designation of the foreign organization or structure;
- registration number, code or similar in country of origin (if available);
- size of the share in the foreign organization (if the holding is indirect also disclosure of the manner in which the interest is held).

CFC Notices will additionally include the following:

- end of the financial year of the CFC under the applicable law;
- date of the financial statement of the CFC under applicable law (presumably this means the deadline under the applicable law for the preparation of the financial statement);
- date of the audit report of the CFC if the audit is compulsory under applicable law (presumably this means the deadline under the applicable law for the preparation of the audit report);
- prospective date of the CFC's general meeting which decides on the distribution of dividends;
- the reasons for considering the taxpayer a controlling person of the CFC.

III. TAXATION OF CFCS:

1. Scope of the Draft Law (CFC definition):

Russian CFC rules will apply to a ***foreign company***[13]:

- If the company is not considered tax resident in the Russian Federation under domestic law or an international tax treaty (which excludes foreign companies considered Russian tax residents because the place of their effective management is deemed to be in Russia); and
- If individuals or organizations deemed Russian tax residents under domestic law or an international tax treaty are "controlling persons" of such company; and
- If the company is not a listed company[14].

[13] See definition of foreign organization above (includes also corporate structures without a separate legal personality if they can act in their own name).
[14] See note 9 above.

A structure (see definition above) will equally be considered a CFC if Russian tax residents under domestic law or an international tax treaty are deemed controlling persons of such structure.

"***Controlling person***" means a person who (which) – alone or together with associated persons[15] - exerts control over the CFC in his (its) own interests or the interests of associated persons.

*"**Control over an organization**"* means that the controlling person exerts or has the possibility to exert decisive influence over the decisions of the CFC with regard to distribution of after tax profits. Control can be based on direct or indirect equity ownership, contract or the particular relationship between the CFC and the controlling person(s). This is the case, in particular, for persons who own, directly or indirectly (including through a vehicle like a trust, foundation, etc.), alone or together with the spouse and/or minor children and/or other persons (depending on the relationship with such persons), more than 10% of the CFC. However, a holding of 10% or below the 10% threshold does not necessarily exclude control.

*"**Control over a structure**"* means the possibility to exert decisive influence over the decisions of the person managing the assets of such structure with respect to the distribution of the profit (revenue) in favor of the participants or beneficiaries. The influence can be based on the provisions of the applicable law or on a contract. It should be noted that the "*controlling person*" of a trust or similar structure is normally not the beneficiary, but typically the settler provided he retains power over the trust assets. Discretionary trusts should be outside the scope of the Draft Law because the settlor would not retain any control over the distribution of the trust's assets.

CFC Rules ***do not apply to***:

- listed companies (the interest in a foreign company held through a direct or indirect participation in a listed foreign company is also not relevant to determine whether the taxpayer is a controlling person of such foreign company);

- not-for-profit organizations and other entities which cannot distribute profits under their applicable law;

- companies permanently resident in countries of the Eurasian Economic Union;

- legal entities permanently domiciled in jurisdictions guaranteeing the exchange of tax information and subject to ordinary taxation (as the Draft Law is written this exception would apply only to foreign legal entities excluding structures).

[15] The definition is the same as for the purposes of transfer pricing rules.

The list of jurisdictions guaranteeing the ***exchange of tax information*** will be approved by the Federal Tax Service taking into account whether the authorities of the respective jurisdictions respond to requests for information from the Russian Federal Tax Service under applicable international tax treaties. The list would therefore include only countries with which Russia has a double taxation treaty or which are a party to the multilateral CE/OECD Convention on Mutual Administrative Assistance in Tax Matters (provided the Convention will be ratified by Russia). The assessment by the Russian tax authorities of such "responsiveness" can change over the time.

Ordinary taxation means that the effective tax rate for the foreign company at the end of the financial year (as determined under the applicable foreign law) in the country where the foreign country is established (*"country of domicile"*) exceeds 75% of the Russian corporate profit tax (rate 20%), i.e. is higher than 15%. The *"effective tax rate"* is the ratio between the CFC's tax liability under the laws of the country of domicile and its aggregate revenue (profit) before tax[16]. If there is an operational loss the effective tax rate is equal to the ratio between the CFC's tax liability under the laws of the country of domicile with respect to its passive revenue and the aggregate passive revenue (calculated as per the Draft Law - see below). The effective tax rate is not calculated if there is no revenue.

The Draft Law as published on 27 May 2014 has definitively abandoned the approach based on a "black list" of tax haven jurisdictions[17], i.e. its scope is no longer limited to CFCs incorporated in black-listed jurisdictions. It now appears that the CFC rules will not apply to "white-listed" companies and that companies will be "white-listed" based on two criteria: (i) the availability of tax information through international information exchange; and (ii) the level of the foreign tax. This means that companies in jurisdictions like Cyprus, Switzerland, Luxembourg or the Netherlands[18] can also fall under the Draft Law. The criteria used by the Draft Law to "white-list" companies appear controversial and may well be subject to further change.

2. <u>Calculation of taxable revenue:</u>

In our opinion the revenue taxable under CFC Rules will no longer be calculated according to the section of the Russian Tax Code on corporate profit tax. Instead the Draft Law defines autonomous rules to assess the revenue taxable under CFC Rules, which is calculated as income minus expenses. Moreover, we would assume that CFC profit will have to be assessed based on the financial information contained in the company's annual report. However, the rules as currently defined in the Draft Law are not yet clear in these respects.

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[16] It is unclear under the Draft Law whether the revenue before tax should be calculated under the rules of the Draft Law (Article 309[1]) or under the law of the country of domicile.

[17] "List of States and territories granting preferential tax treatment and (or) not providing for the exchange of information on financial operations (offshores)", approved by Ministry of Finance Order No. 108n of 13.11.2007.

[18] termed "transit countries" in the professional slang.

"Income" includes:

(i) dividends and other profit distributions including liquidation proceeds;
(ii) debt interest including interest on convertible bonds and profit-sharing bonds;
(iii) royalties from the use (license) of intellectual property rights (copyrights, patents, trademarks, designs, secret information and processes, know how);
(iv) proceeds from the sale of shares in companies (respectively the assignment of an interest in entities without legal personality);
(v) proceeds from the sale of real estate;
(vi) proceeds from the lease or sublease of assets including leasing operations, lease or sublease of aircraft, ships and containers;
(vii) proceeds from the sale (redemption) of units in mutual funds;
(viii) revenue from consultancy, legal, accounting, audit, engineering, advertising, marketing, data processing services and R&D activities;
(ix) revenue from the lease of personnel;
(x) other analogous revenue;
(xi) other revenue.

The income listed under (i) to (x) is considered *"passive income"*, the income under (xi) *"active income"*. The income listed under (ii) is considered active for licensed banks.

"Passive revenue" is passive income minus the expenses incurred to generate such income, respectively payments from such income to third parties.

"Active revenue" is active income minus those expenses which can be deducted from the taxable profit under the tax legislation in the country of domicile (except expenses already deducted from passive revenue). If the applicable tax legislation does not allow the deduction of the cost of investments, such cost can be deducted. The cost of investments includes effective expenses to finance investments in fixed assets (used for operations) or in intellectual property, interest on bank loans obtained and used for such purposes, the construction of objects of infrastructure.

Losses from passive, respectively active operations can be carried forward. If the revenue of the CFC was corrected as a consequence of the application of Russian transfer pricing rules, such corrections also apply when calculating the profit taxable under CFC Rules. Taxes paid in foreign jurisdictions are deductible.

As we understand the Draft Law the profit taxable under CFC Rules would be the sum of the active and passive revenue calculated according to the preceding paragraphs. The profit would be calculated for the relevant financial year as defined by the country of domicile. The dividends distributed from such profit can be deducted. The net retained profit would be converted into Russian Rubles at the average rate quoted by the Central Bank of Russia for the financial year of the foreign company under the laws of the country of domicile and would be taxable under CFC Rules. The net retained

profit is fully taxable, i.e. the Russian company cannot deduct losses or expenses incurred in relation to its other activities.

The controlling person will be taxed on his (its) share in the taxable profit, normally in proportion to the percentage of his (its) shareholding, and pro rata temporis where the participation is not held during the entire fiscal year of the Russian taxpayer. If the share in the CFC (e.g. trust) cannot be determined the taxable profit would be divided by the number of shareholders. If this is not possible the share of the controlling person in the taxable profit would be determined according to the law of the country of domicile of the CFC.

Where there is a chain of CFCs (the taxpayer holds an indirect interest in a CFC through companies which are Russian tax residents ("holding companies") and which hold a direct interest in the same CFC) the tax paid under CFC Rules by the Russian holding companies with respect to the foreign subsidiaries can be deducted from the tax due by the taxpayer in proportion to the direct shareholding of the taxpayer in the Russian holding companies. There is no equivalent rule for indirect holdings through foreign holding companies, nor for the Russian holding company itself if it holds an indirect ownership in a foreign company (e.g. in a NL company through a Cyprus company).

3. Procedural Rules:

The net retained profit taxable under CFC Rules must be included (i) for individuals in the income subject to personal income tax (taxed at the rate of 13%); (ii) for legal entities in the profit subject to corporate profit tax (taxed at the rate of 20%).

The net retained profit is calculated based on the CFC's financial statement and audit report (if the audit is compulsory), both of which must be submitted together with the tax declaration. Documents in a foreign language must be legalized and translated into the Russian language. If the audit report is not available at the time when the tax declaration must be filed, it must be submitted within one month from the date indicated in the CFC Notice as the date of the audit report. The Draft Law does not grant the tax authority the right to request further documents, and such documents would normally also not be available to a shareholder. It follows that the calculation of the profit taxable under CFC Rules should normally be made on the basis of the financial statements established under applicable law (subject to additional information obtained through the exchange of tax information with the country of domicile).

Profit under the threshold of 3,000,000 RUR per financial year[19] is not taken into account for the assessment of personal income or corporate profit tax under CFC Rules. It follows that such "smaller" profits would still be taxed in Russia only when distributed to the shareholders or beneficiaries.

[19] The threshold probably applies with respect to the CFC profit as a whole and not the respective share of the taxpayer in such profit.

The net retained profit taxable under CFC Rules is considered earned on the last day of the Russian fiscal year (31 December) following the end of the financial year of the CFC under applicable law[20]. It follows that such profit must be reported in the tax declaration filed before 30 April (for individuals), respectively before 28 March following the relevant Russian fiscal year at the latest (for legal entities).

4. Retroactivity:

The Draft Law in the version published on 27 May 2014 provides that CFC Rules apply in relation to financial periods of the relevant CFC as defined under the laws of its country of domicile beginning after 1 January 2015.

The retained profit taxable under CFC Rules will be calculated separately for each financial year, which means that accumulated retained profits from previous financial years should not be tax relevant. Such profits would be taxed only when they are effectively distributed. ***It follows that the Draft Law should not have retroactive effect except with respect to disclosure obligations.***

5. Sanctions:

The Draft Law provides for the following administrative fines:

(1) 20% of the profit tax due under CFC Rules and not reported in the tax declaration, but at least 100,000 RUR;
(2) 100,000 RUR for the failure to file the CFC Notice (the fine is due for each CFC Notice);
(3) 100,000 RUR if the controlling person does not submit the documents required under the CFC Law (financial statement and audit report of the CFC), or submits documents which it knows to contain inaccurate data;
(4) 50,000 RUR for the failure to file the Asset Notice or for the filing of inaccurate information (the fine is due for each Asset Notice).

The period of limitations is three years.

The fines apply also in case of late or incorrect filings. Many therefore fear that inadvertent omissions or mistakes with the notices can lead to considerable fines. The fines can further become a problem if the Russian resident holds interests in many structures, in particular where interest is held indirectly (e.g. if investments are held in the stock market the taxpayer may well not be in a position to know about such indirect holdings).

[20] Strictly interpreted the Draft Law would mean that, if the financial year of the CFC ends on 31 December 2015 (earliest possible date for the application of the Draft Law), the CFC profit would be taxed in respect of the Russian fiscal year 2016 and would need to be declared in 2017. If the financial year of the CFC begins, for instance, on 1st April 2015 and ends on 31st March 2016, the CFC profit would be taxed in 2017 (tax filing in 2018).

IV. CRITICISM AND OUTLOOK:

CFC provisions are essentially anti-abuse provisions and are generally considered legitimate. As the country implementing CFC provisions does not tax the profit of the CFC in the foreign jurisdiction, but taxes its own residents, CFC provisions are not covered by treaty provisions on the avoidance of double taxation.

Indirectly the Draft Law not only taxes the accumulation of undistributed profits, but taxes them disadvantageously – in the first place by a higher tax rate (for individuals 13% instead of 9%; for legal entities 20% instead of 9% and, for qualifying participations, 0%). Secondly, the Draft Law does not exempt the future distribution of retained profit from Russian tax, which means that profit can be taxed several times. Foreign tax withheld on dividend distributions can be deducted under double tax treaty rules only from the Russian tax paid in relation to these dividends.

The Draft Law can thus be seen not only as a measure to increase tax revenues, but also as a measure against capital flight. It is intended to encourage the (at least temporary) repatriation of cash to Russia and to "punish" those who believe in hiding assets abroad in non-transparent jurisdictions.

The Draft Law will further increase the costs of foreign structures. Many companies incorporated in traditional off-shore jurisdictions do not keep books. This will now be required in order to comply with the Draft Law. The preparation of financial statements and their translation into the Russian language as well as the additional filings will cost money.

At the same time the Draft Law appears to be relatively balanced. The duty to notify an interest in a foreign structure (such a duty already exists, but only for companies and not for individuals) will apply in most cases (except maybe discretionary trusts), but appears not more onerous than the duty to notify foreign bank accounts.

While the definition of the *"foreign company"* or *"structure"* is very broad and the levels of control required rather low, many foreign companies may still not be covered, or be covered only partially by CFC Rules:

- It can be assumed that CFC Rules will not apply to companies subject to an effective profit tax rate of more than 15% in jurisdictions which have double tax treaties with Russia and/or are parties to the CE/OECD Convention (except maybe – but probably only at a later stage - countries which are deemed by Russia not to fully cooperate with Russian tax authorities notwithstanding their international obligations).

- CFC Rules should not apply to discretionary trusts and similar instruments if properly structured.

- CFC Rules (including – if we interpret the Draft Law literally - the obligation to submit financial statements) should not apply below a threshold of 3,000,000

RUR profit calculated as per CFC Rules. This will include many SPVs (e.g. holding private assets such as residential property, yachts, bank accounts, etc.), holding companies, royalty companies, etc., in particular all companies whose role is to hold and administer assets rather than to generate profit and optimize tax. However, it will still be necessary to file a CFC Notice.

Although we consider that the Draft Law is a fair attempt to fight existing abuses, serious problems remain:

- We consider that the Draft Law is too ambitious, which leads to exceedingly complex, partly inconsistent and sometimes imprecise rules.

- The application of the CFC Rules can lead to double taxation even in cases where structures pursue legitimate business objectives. In particular, substantial problems arise as a consequence of the application of CFC rules at several levels of group structures (indirect ownership).

- The taxpayer must calculate the CFC profit when preparing the tax declaration and incurs all related risks. However, the rules set forth in the Draft Law to calculate the CFC profit appear unclear and subject to interpretation.

- Risks also arise where holdings in foreign companies and structures must be notified. It may not be easy to decide (or even know) in all cases whether a notice is required under the law (e.g. holding of 10% with "other persons"). In cases of doubt the taxpayer may decide to proceed with the filing "just in case", but this may not always be a good solution (the taxpayer may be bound by confidentiality undertakings, etc.).

It will obviously be difficult for the Russian authorities to enforce CFC rules without obtaining the relevant tax information:

- as a result of the disclosure provisions of the Draft Law;

- under bilateral double tax treaties most of which now include Article 26 of the OECD Model Treaty on the exchange of tax information (the treaties with Switzerland, Cyprus and Luxemburg, which were more restrictive, have all been amended);

- through the mechanisms provided under the multilateral CE/OECD Convention on Mutual Administrative Assistance in Tax Matters[21] (the ratification law for the Convention was submitted to the Government early 2014 and will probably be approved in the same package as the Draft Law).

[21] The Convention will apply to several important low tax jurisdictions including the British Virgin Islands.

Russia will certainly intensify its efforts to obtain foreign tax information. It may well focus on the automatic exchange of tax information because the country does probably not have the infrastructure to efficiently exchange information on a case by case basis (at least not on a large scale).

Clients should therefore also assess the consequences of the information becoming available as a result of the Asset Notice or the CFC Notice as such information can be used not only for the application of the CFC Rules, but also, for instance, for transfer pricing control or as a basis for information requests to foreign tax authorities. Alternatively the automatic information exchange can provide the Russian tax authorities with the information needed to enforce CFC Rules.

New Developments – Position of the Russian Government:

On 25 June 2014 the Russian Government asked the Ministry of Finance to reconsider the Draft Law from the following angles:

- the definition of the persons falling under the scope of the Draft Law;
- gradual implementation of the CFC provisions;
- whether the law effectively encourages the transfer of foreign assets to Russia;
- increase of the profit threshold (3,000,000 RUR under the current Draft Law);
- improving the mechanism to define control (e.g. by increasing the minimal threshold from 10% to 50%+1 vote);
- optimization of the level of foreign tax which is relevant for the CFC rules (currently 15%);
- criteria to white-list countries;
- assessment of the impact of the Draft Law on the Russian economy.

These instructions are based on the matters raised by RSPP on 18 June 2014 :

- RSPP asked that the law do not target the honest taxpayer, but those who evade tax, that it should not affect the competitiveness of Russian business in the global market and that the Government should make sure that the provisions work in practice and can be administered efficiently and without ambiguity.
- Initially the law should apply only to resident individuals and not to Russian legal entities.
- The control threshold should initially be 50% and then gradually decrease, but not lower than 25%.
- No fines should apply during the first years of implementation to allow time to adapt to the law and to understand how it works in practice.

Recommendations:

The strategy chosen by individual taxpayers will largely depend on their attitude to Russia in general. Those who distrust the country and current ruling elite or who in general do not believe in paying tax will always seek ways to better hide their assets whatever the new rules will be.

On the other hand we have the general feeling that the Draft Law can be an excellent occasion to disclose previously undeclared assets. Considering current developments in the world such disclosure may well become inevitable sooner or later, and this may be one of the last "good" occasions to "come out into the open". Clients should also consider that the laws will probably become tougher and sanctions (including under criminal law) will become more severe. In general, legislative developments in Russia are currently rather unpredictable, and other initiatives restricting investments into foreign assets, broadening disclosure obligations or taxation are already pending or could be submitted to Parliament in the near future.

There are also various possibilities to mitigate the impact of CFC Rules:

- Potential CFCs should have accounts and records for past years to avoid the retroactive application of the Draft Law.

- It may be a good idea to eliminate structures which are no longer necessary or useful, respectively to transfer business operations to "white-listed" jurisdictions.

- In some cases a transfer of assets back to Russia may be worth considering. In cases where it is desirable to continue using a foreign jurisdiction for purposes other than tax optimization (legal security, asset protection, etc.) it is maybe possible to achieve this by a transfer of the place of effective management to Russia[22] or by using a Russian holding company. The use of a Russian holding company can be interesting from a tax perspective.

- The application of CFC Rules can be avoided by a transfer of the tax residence (relocation) of the controlling person where the controlling person is an individual. The same objective can maybe be achieved by transferring assets to family members (e.g. children) who are resident outside Russia.

- A good solution can also be the regular distribution of profits, but this will obviously lead to a Russian tax liability.

It will be important to take CFC Rules into account when Russian tax residents sell or acquire an interest in foreign structures.

[22] However, under the Draft Law companies registered in black-listed jurisdictions or in countries which do not have a double taxation treaty with Russia cannot declare themselves voluntarily tax resident based on the place of effective management.

CFC legislation taxes the shareholder and not the CFC, which means that the CFC, its directors, banks, advisors etc. should not be responsible for compliance. However, financial intermediaries (banks, attorneys, etc.) will increasingly need to verify their clients' tax compliance.

This document is a summary and cannot reflect all nuances. It should therefore not be used as a basis for taking legally relevant decisions. Legal terminology is translated from the Russian language. Russian and English legal terms are not always equivalent.