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
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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 more recent versions of the draft law the obligation to disclose foreign assets has been disjoined from the CFC rules.

The draft law submitted by the Ministry of Finance 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 initial draft 10% was sufficient to consider the foreign company controlled). The revised draft law was published on 2 September 2014. While some thresholds have been increased, some transitory provisions added, and some aspects clarified the draft law has become even more complex and is at times very difficult to read and understand.

We believe that:

- the tax initiative will become law with effect as from 1 January 2015;
- there will be extensive disclosure requirements for Russian tax residents;
- it is difficult to predict further changes to the draft during hearings 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 and paid tax in Russia only 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 to ignore the legal form in favor of the economic substance (in particular, the theory of the unjustified tax advantage[1]) 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, which means a significant investment in time and resources for the Russian Tax Administration.

- 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 latter 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. More extensive disclosure duties exist only for civil servants.

- 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.

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

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 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 first draft was 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) and later 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. The RSPP subsequently even published its own draft law.[2] As a result the Prime Minister instructed the Ministry of Finance to reconsider the draft.[3] The revised draft ("**Draft Law**"[4]) was finally submitted to the Government on 26 August and published on 2 September 2014. It will probably be submitted to the Russian Parliament during the autumn session.

The Draft Law introduces various important changes to existing tax laws:

- a duty to disclose holdings in both foreign companies and non corporate structures such as trusts, investment funds and simply fiduciary arrangements;
- taxation of the profit of controlled foreign companies (**"CFCs"**[5]);
- 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), with interesting new rules under which the ultimate owner can still claim benefits if he is resident in a treaty country or in Russia and the legal recipient of the revenue could/did not claim treaty benefit;
- a new 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 2 September 2014.

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 possibly be made by

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[2] http://rspp.ru/news/view/5151.
[3] Instruction of the Prime Minister of 23 June 2014, published on http://government.ru/orders/13305.
[4] http://minfin.ru/common/upload/library/2014/09/main/proj_FZ_izm_NK.pdf.
[5] The Russian term is «контролируемые иностранные компании» (КИК).

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.

II. DEFINITION SECTION:

Unlike earlier versions the Draft Law integrates the CFC into the existing system of the RF Tax Code. In particular, the definition section, which defines the main taxpayer categories, would be completed by a new category – **"foreign structures without formation of a legal entity" ("foreign structures")**. The Draft Law defines a foreign structure as an organizational form established in accordance with the legislation of a foreign State (territory), which, without being a legal entity, under its governing law has the right to conduct an activity aiming to generate revenue (profit) in the interests of the structure's members (unit holders, principals or other parties) or its other beneficiaries. The Draft Law contains a non-exhaustive list of such structures: foundations[6], partnerships[7], trusts, other forms of collective investment[8] and/or trust/fiduciary management. Under the new definition the structure must no longer have an "entrepreneurial" (business) activity. The term "organizational form" has no precise meaning, which means that the definition is probably comprehensive and covers all situations where beneficial and legal ownership of assets does not coincide. In our view it is designed to include also purely contractual arrangements.

The Tax Code will therefore define three categories of taxpayers: individuals, organizations and foreign structures. The term **"organization"** includes legal entities organized under Russian or foreign law, companies and other corporate formations which can act in their own name (have legal capacity), international organizations, Russian branches and representative offices of foreign companies and international organizations.

Foreign structures will be liable for tax in the cases where the Tax Code so provides. Under the Draft Law this would be the case where the foreign structure owns real estate in Russia. Logically this should mean that foreign structures (in particular, trusts) should not be treated as transparent from a Russian tax perspective and the beneficiary of such structure should incur no direct tax liability (except under CFC rules, see below). Curiously enough the Draft Law does not complete the Tax Code with respect to tax registration of foreign structures and appears to limit their tax liability to property tax on real estate, e.g. ignores the question of liability with respect to taxes on revenue from the use and sale of such real estate and other taxes.

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

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

[8] This would include mutual funds.

The definition section will also define **“public companies”**. These are Russian or foreign organizations acting as issuers of securities (including depositary receipts) listed and/or admitted for trading on one or several Russian or foreign exchanges. Foreign exchanges must be included in the list of **“foreign financial intermediaries”**, which will be defined as foreign exchanges and depositary/clearing organizations included in a list to be approved by the Central Bank in agreement with the Ministry of Finance.[9]

III. DISCLOSURE OF FOREIGN ASSETS:

The Draft Law does no longer contain special disclosure provisions for foreign holdings, but completes the current list of cases where disclosure notices are required under the Tax Code (see below). The substance of the new disclosure duties has not been changed significantly compared to the previous version of the Draft Law although thresholds have been increased.

Russian organizations and individual businesses (but not individuals) are currently required to notify participations taken in Russian and foreign organizations (except Russian general and limited partnerships and Russian LLCs). In future this requirement will only apply to cases where a direct participation in a Russian company (except general/limited partnerships or LLCs) exceeds 10%. The notice must be given within one month after the acquisition of the participation.

The Draft Law introduces new cases where a notice will be required from all taxpayers (individuals and businesses):

- holdings in ***foreign organizations*** if the participation exceeds 10 per cent[10] or, until 1 January 2017, 25 per cent (the Draft Law does still not specify whether this means 10% of the equity or of the votes, and the requirement is visibly meant to apply whether the interest is held directly or indirectly);

- holdings in ***foreign structures*** including the cases where the taxpayer acts as settler/founder or as beneficiary[11]. Beneficiaries are defined as persons having a *de facto* entitlement to the revenues or profits of the structure in case of their distribution.[12]

  The term *de facto entitlement (фактическое право на получение)* is not disclosed in the Draft Law, but if we apply by analogy the definition given in the new versions of Articles 7 and 312 Tax Code in relation to the beneficial

[9] The qualifying 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. It must be assumed that a revised document will be approved by the Central Bank (new supervisory authority of the financial market).
[10] as compared to more than 1% in the previous draft.
[11] in the previous draft the disclosure requirement applied only to beneficiaries.
[12] The absence of a threshold for foreign structures reflects the idea that the interest of principals or beneficiaries in a structure cannot be defined as a fraction or percentage, contrarily to companies with a share capital (LLCs, JSCs, etc.).

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 or legal owner of the revenue).

The use of the term "holding/participation" (участие) in relation to a structure and of the word "including" makes this definition open-ended, i.e. potentially applicable to all persons having a role (nominal or otherwise) in wealth planning structures (including discretionary trusts): settlers, trustees, beneficiaries[13], or even protectors, etc.

- ***"controlled foreign companies (CFCs)"*** (see below for definition) in relation to which the taxpayer is a "controlling person" (see below for definition). The term includes both controlled foreign organizations and controlled foreign structures.

Like its previous versions the Draft Law distinguishes between notices of holdings in foreign organizations/structures **("Holding Notices"**) and notices of controlled foreign companies (**"CFC Notices"**). It follows from the new Article 25.14 that the notice requirement still applies only to Russian tax residents (Russian companies, foreign companies with effective place of management in Russia, individuals staying in Russia for more than 183 days during twelve consecutive months), i.e. to taxpayers liable for personal income tax or corporate profit tax. The duty to notify exists independently from any tax liability in Russia, i.e. the notice is required even where no tax is due.

Additionally foreign companies and foreign structures owning real estate in Russia will be required to notify the tax authority of their direct and indirect shareholders (above 5%) or, in the case of a structure, of their settlers (founders), beneficiaries and managers (trustees). This disclosure requirement will apply *to all foreign companies and structures* owning real estate including those having a branch or representative office. There is currently no corresponding disclosure requirement for Russian companies.[14]

The ***Holding Notice*** must be filed by the Russian tax resident within one month after the acquisition (change, alienation) of the holding in the foreign company or structure. Presumably it must also be filed retroactively for holdings acquired before 1 January 2015 (possibly until 31 January 2015 – the law does not regulate this). The notice must not be renewed provided the interest remains unchanged.

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[13] In many trusts or similar structures beneficiaries appointed by the settler do not have any vested entitlements, only expectations (discretionary trusts). It seems doubtful that this type of "potential" beneficiaries should be deemed to "participate" in the structure (such beneficiaries may not even know about their expectation).

[14] There is a contradiction between the amended Article 23 and the amended Article 386 of the Draft Law. Article 386 does not require the disclosure of any information other than information on individuals and public companies holding directly or indirectly more than 5% in the foreign company or structure owning the real estate. Article 23 requires disclosure of all shareholders and, for structures, of settlers, trustees and beneficiaries.

The Holding Notice includes the following information:

- the date when the holding was acquired (respectively when the situation giving rise to the duty to notify arose);
- the name of the foreign organization or structure;
- the registration number, code or similar in the country of origin (if available);
- the size of the share in the foreign organization (if the holding is indirect also the manner in which the participation is held);
- the date when the interest ceased (where applicable).

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

The ***CFC Notice*** must be filed by Russian tax residents deemed *"**controlling persons**"* of CFCs on an annual basis before 20 March of the year following the relevant Russian fiscal period (calendar year).[15] This filing date does not coincide with the deadline for the tax return (28 March for companies, 30 April for individuals).

Contrarily to the previous version of the Draft Law the CFC Notice will need to be filed even if a Holding Notice was filed earlier with respect to the same holding. The CFC Notice appears not necessary in those cases where the foreign company or structure is not considered a CFC (see below list of exceptions), but the law appears contradictory also on this point. If the Russian tax resident holds a direct or indirect participation in a foreign or Russian public company no CFC Notice is required with respect to companies in which such tax resident holds an indirect participation through such public company.

CFC Notices will include the following:

- the period for which the notice is filed;
- the name of the foreign organization or structure;
- the registration number, code or similar in the country of origin (if available);
- the end of the financial year of the CFC under the CFC's own law;
- the date of the financial statement of the CFC under the CFC's own law;
- the date of the audit report of the CFC if the audit is compulsory under the CFC's law;

[15] The relevant fiscal period would probably (the Draft Law is unclear) be the year during which the CFC profit can be taxed under the CFC rules. Based on Articles 223 and 271 of the Draft Law, if the CFC holding existed 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 would have to be filed before 20 March 2017. 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). The idea is maybe to systematize information beforehand in preparation of tax audits.

- the prospective or actual date of the CFC's general meeting which decides on the distribution of dividends;
- the size of the share in the foreign organization (if the holding is indirect also disclosure of the manner in which the interest is held);
- the reasons for considering the taxpayer a controlling person of the CFC.

Both the Holding Notice and the CFC Notice must normally be filed at the taxpayer's domicile, i.e. the place where the taxpayer is registered for tax purposes (for companies this is the place where they are registered in the Company Register, for individuals the place where they are registered with the migration authorities). 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.

IV. TAXATION OF CFCS:

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

Russian CFC rules will apply to a ***controlled foreign company (including both organizations and structures)***:

- if the company is not considered tax resident in the Russian Federation (this should exclude foreign companies with effective place of management in Russia if they are registered as Russian tax residents, which would normally happen pursuant to a tax audit or based on a self-declaration[16]); and

- if individuals or organizations deemed Russian tax residents are ***"controlling persons"*** of such company.

The Draft Law normally uses the word "company" to include organizations and structures, but this use is not consistent and sometimes the word "organization" appears to also include structures.

"***Controlling person***" means a person who (which) – alone or together with associated persons - exerts control over the organization or structure in his (its) own interests or the interests of associated persons. The Draft Law refers to the definition of "associated persons" under transfer pricing rules (Articles 105^1 and 105^2 Tax Code).

"Control over an organization" means that the controlling person exerts or has the possibility to exert decisive influence over the decisions of the organization with regard to the distribution of its after tax profits. Control can be based on direct or indirect equity ownership, a contract on the management of the organization or the particular relationship between the controlling person(s) and the controlled

[16] Again the Draft Law is unclear. While Article 25^{13} appears to exclude all tax resident companies, Article 246^2 appears to limit this benefit only to those which have acknowledged their tax residency voluntarily.

organization and/or other persons. In particular, persons who own, directly or indirectly (including through a structure such as a trust, foundation, etc.), alone or together with their spouse and/or minor children and/or other associated persons, more than 25% of the organization[17] are deemed to have control. For the calculation of the 25% threshold only persons deemed associated based on the specific situations defined in part 2 of Article 105[1] Tax Code (equity holdings above 25%, possibility to appoint directors, etc.) are taken into consideration (excluding persons who (which) can be considered associated by application of the general clause pursuant to which any person can be considered an associated person of another person if the former is capable of influencing the terms on which the latter conducts its business because of the particular relationship existing between both persons). However, a holding of 25% or below the 25% threshold does not necessarily exclude control. In addition a holding over 10% is sufficient if more than 50% are held by Russian tax residents together with their spouses, minor children and associated persons. ***Until 1 January 2017 the threshold for control would be more than 50%***, however the relevant transitory provision does not exclude the application of the general clause pursuant to which any person exerting or capable of exerting decisive influence (e.g. through a management contract) is a controlling person.

*"**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 members 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 (sometimes also the protector) provided he retains power over the trust assets. Discretionary trusts should therefore still be outside the scope of the Draft Law because the settlor and/or beneficiaries would not retain any control over the distribution of the trust's assets. According to the definition the trustee (trust manager) should not be considered a controlling person, otherwise he would control himself. However, this is also not entirely certain (in practice, trustees will rarely be Russian tax residents).

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

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

2) not-for-profit organizations which cannot distribute profits among their shareholders, members, founders or other persons under the law which governs them;

3) companies organized under the laws of a country of the Eurasian Economic Union;

[17] as compared to 10% in the previous draft.

4) foreign companies permanently domiciled in jurisdictions guaranteeing the exchange of tax information and subject to ordinary taxation (this exception should now also apply to foreign structures[18] although the language is confusing);

   The list of jurisdictions guaranteeing the ***exchange of tax information*** will be approved by the Federal Tax Service. This list will presumably include countries with which Russia has a double taxation treaty or which have ratified the multilateral CE/OECD Convention on Mutual Administrative Assistance in Tax Matters (provided the Convention will be ratified by Russia as well). However, contrarily to the previous version the Draft Law does no longer contain any precise criteria for the inclusion of a country into such list.

   Ordinary taxation means that the effective tax rate for the foreign company for the relevant financial year exceeds 75% of the Russian corporate profit tax (rate 20%), i.e. is higher than 15%. The *"effective tax rate"* is calculated in relation to the *"foreign company's financial year"*, which is determined in accordance with the law under which the CFC is organized (*"foreign company's personal law"*[19]). The effective tax rate corresponds to the ratio between the tax assessed in accordance with the foreign company's personal law and its total pre-tax revenues (apparently determined under the foreign company's personal law). If there is a loss the effective tax rate is equal to the ratio between the company's tax liability with respect to its passive revenue (the tax liability is determined in accordance with the company's personal law) and the company's aggregate passive revenue (passive revenue is defined as per the Draft Law - see below). The effective tax rate is not calculated if there is no revenue, but in this case the company or structure will be considered a CFC.

5) foreign structures which satisfy the following conditions:

   - the settler (founder) of the structure does not have the right to receive assets in accordance with its organizational documents and the law under which the structure is organized;
   - in accordance with the organizational documents and the law under which the structure is organized the rights of the settler (founder) in relation to the structure (including the right to alienate assets, to appoint beneficiaries etc.) cannot be assigned except by inheritance or universal succession (this seems limited to those rights which are linked to the settler's personal status – e.g. as a settler, etc. - in the structure);
   - the settler (founder) of the structure is not directly or indirectly entitled to any revenue (profit) distributed between the members (unit holders, principals or other persons) or beneficiaries ("indirectly" means that the benefit is obtained by an associated person of the settler in the latter's interest).

[18] See part 7 of Article 24[13].
[19] Article 1202 Civil Code.

The exemption applies until the structure can distribute its profit among its members or beneficiaries in accordance with its organizational documents and the law under which the structure is organized (the clause is not clear, but may mean that the exemption applies only as long as the structure cannot distribute its assets; logically and pursuant to general principles the exemption should apply until the beneficiaries acquire an enforceable claim to the assets).

The idea behind the exemption is unclear. The conditions which must be met (above) appear to exclude *per se* any control over the structure by persons external to the structure.

6) licensed banks and insurance companies permanently domiciled in jurisdictions guaranteeing the exchange of tax information;

7) foreign companies issuing bonds, or organizations authorized to receive interest from bonds, or organizations to which the rights and obligations under bonds issued by another foreign organization were assigned, if the revenues from such bonds make up at least 90% of the aggregate revenues of such organizations (the bonds must be listed or admitted for trade on an exchange included in a list approved by the Central Bank in agreement with the Ministry of Finance, or have been issued on the international bond by Russian organizations through foreign SPVs domiciled in countries with which Russia has a double tax treaty);

8) foreign companies participating in production sharing agreements, concession agreements or other agreements with the government of the respective State (territory) or the entity authorized by such government for such purpose.

In the cases 2, 5, 6 and 7 supporting documents need to be filed together with the CFC Notice in order to benefit from the exemption (again this does not seem logical: if the company is not considered a CFC the CFC Notice should not be necessary, at least that would follow from a literal reading of the Draft Law).

If the manager, management company, managing partner or other person managing the assets of a foreign investment fund (mutual fund or other collective investment scheme) will be deemed a Russian tax resident this does not automatically mean that the fund itself is a CFC and the fund manager a controlling person.

The Draft Law has definitively abandoned the approach based on a “black list” of tax haven jurisdictions[20], i.e. its scope is not limited to CFCs incorporated in black-listed (of-shore) jurisdictions. The CFC rules will not apply to “white-listed” companies. Companies will be “white-listed”, in particular, based on two criteria: (i) the availability of tax information through international information exchange; and (ii) the level of the

[20] “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.

foreign tax (to be assessed based on concrete financial figures and on an annual basis). This means that companies in jurisdictions like Cyprus, Switzerland, Luxembourg or the Netherlands[21] can also fall under the Draft Law.

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

In our opinion the Draft Law now clearly states that the CFC profit taxable in Russia should be calculated in accordance with Article 309.1 Tax Code, i.e. the general Russian tax accounting rules will not be applicable. The profit taxable under CFC rules should be calculated as income minus expenses, after deduction of profit distributions (dividends) paid in relation to the foreign company's financial year (regardless whether profit is distributed during the financial year itself or during the year following its close). The profit would be converted into Russian Rubles at the average rate quoted by the Central Bank of Russia for the CFC's financial year.

"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.

The profit taxable under CFC rules must be calculated separately for passive revenue and active revenue.

"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 income). If the applicable tax legislation does not allow the full deduction of the cost of investments for tax purposes, the costs which were

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

not deductible under the law of the country of domicile can be deducted from active income. 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. Otherwise income and expenses related to active business can be taken into account in accordance with the foreign company's personal law. Losses from active operations can be carried forward.

"Passive revenue" is passive income minus the expenses incurred to generate such income, respectively payments from such income to third parties. It would be for Russian tax law to decide what expenses are allowed for deduction (i.e. how to interpret "expenses related to obtaining such revenues"). Losses from passive operations can be carried forward, but losses from active operations cannot be deducted from passive operations.

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.

The profit taxable under CFC rules can not be reduced by losses or expenses which the controlling person incurred in relation to its other activities (or other CFCs).

As we understand the Draft Law the profit taxable under CFC Rules would need to be assessed separately for active and passive income (except apparently where the taxpayer does not use the possibility to deduct investment expenses from active income). The profit (i.e. the sum of active and passive revenue) would be calculated for the foreign company's financial year. Tax paid in any jurisdictions (including Russia) as well as corporate profit tax paid by a permanent establishment of the foreign company in Russia (if the company has such a permanent establishment) can be fully deducted from the Russian tax due on the CFC holding based on a certificate issued by the tax authority of the relevant country.

The controlling person will be taxed on his (its) share in the taxable profit, normally in proportion to the percentage of his (its) shareholding at the date when the decision on the distribution of the profit is taken or, if such decision is not taken prior to 31 December of the year during which the foreign company's financial year ends, at the end of such financial year (period).[22] If the share in the CFC (e.g. trust) cannot be determined the share of the controlling person is equal to his (its) share in the distributed profit (or the profit which could have been distributed).

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

[22] This provision seems illogical. It appears to signify that the relevant date is the last day of the financial year unless profit is already distributed earlier during such financial year. It would still be the last day of the financial year if the profit were to be distributed by the annual general meting following the close of the financial year.

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 also introduces some ambiguity here by adding a reference to the foreign company's tax accounts/reporting, which would also have to be submitted in Russia. If the CFC has no obligation to draft financial statements under its personal law, it would seem acceptable to submit other documents as evidence of the profit (bank statements and similar).

The Draft Law does not grant the tax authority the right to request further documents (except tax certificates for tax paid by the CFC), 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 (and tax reports/accounts) 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 10,000,000 RUR per financial year (in the previous version of the Draft Law the threshold was 3,000,000 RUR) is not taken into account for the assessment of personal income or corporate profit tax under CFC Rules. The threshold probably applies with respect to the CFC profit as a whole and not the respective share of the taxpayer in such profit. During 2015 and 2016 even higher thresholds will apply (50,000,000 RUR during 2015 and 30,000,000 RUR during 2016). If the profit is under this threshold it appears - based on a strictly literal interpretation of the Draft Law - also not necessary to submit the financial statement, respectively audit report (that is at least how we read the Draft Law), but it is still necessary to file the CFC Notice, which probably means that the tax authority can still require these documents during a tax audit. It follows that "smaller" profits can be taxed as under current law only when eventually distributed to the Russian shareholders or beneficiaries.

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[23]. 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 provides that CFC Rules would apply in relation to the "profit of CFCs determined commencing from the periods starting in 2015." In our opinion this would mean that the law applies only to profit taxable under CFC rules which was earned starting from the foreign company's first financial year commencing after 1 January 2015. This interpretation would also correspond to the principle of non-retroactivity. However, the relevant transitory clause does not contain language of exemplary clarity or grammar (it is not clear whether "period" refers to the Russian fiscal year or the foreign company's financial year).

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.

5. Sanctions:

The Draft Law provides for the following fines:

(1) 100% of the tax assessed with respect to the real estate owned by the foreign company or structure if such company did not notify the tax authority of its direct and indirect shareholders (more than 5%), respectively the structure of its founders, managers or beneficiaries (the fine is applied pro rate to the share of the shareholders in relation to which the company or structure failed to provide the information);
(2) 20% of the profit tax due under CFC Rules and not reported in the tax declaration, but at least 100,000 RUR;
(3) 100,000 RUR for the failure to submit the CFC's financial statement and other information or documents required under the Tax Code (the wording seems to imply that the fine is incurred only for those documents which the taxpayer has in his possession, respectively which are available to the taxpayer);
(4) 100,000 RUR for the failure to file the CFC Notice (the fine is due for each CFC Notice);
(5) 50,000 RUR for the failure to file the Holding Notice (the fine is due for each Holding Notice).

[23] Strictly interpreted the Draft Law would mean that, if the financial year of the CFC ends on 31 December 2015 (presumably the 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).

The period of limitations is three years.

The sanction listed under (2) will not apply for the fiscal periods 2015-2017. However, all other sanctions will apply without any transitory periods.

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. No fine is due if the notice has been corrected before the inaccuracy was discovered by the tax authority.

V. 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.

The Draft Law, however, 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 and risks in relation to the use of foreign companies and structures. The preparation of financial statements and their translation into the Russian language as well as the additional filings will cost money. The services of tax consultants will probably be required as the law is hardly understandable for non-specialists.

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, but appears (though perhaps only at first sight) 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.

- 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 10,000,000 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 exceedingly complex, partly inconsistent and creates uncertainties through imprecise rules and wordings.

- 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. 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., or the tax authorities may simply request additional information based on the notice).

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[24] (the ratification law for the Convention was submitted to the Parliament in June 2014 and will probably be approved in the same package as the Draft Law).

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 Holding 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.

Has the Draft Law improved compared to earlier versions?

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.

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

These instructions were 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.

As we have seen some of these recommendations (in particular the increased thresholds) have been implemented, but our general feeling is that the scope of the Draft Law has become broader, in particular as concerns disclosure requirements.

We further consider that the Draft Law is exceedingly complex and in some cases difficult to comply with. Many rules are now less clear (not to say less logical) than previously. This is at least partly due to the clear intent to capture all possible wealth planning structures.

Until 1 January 2019 proceeds from the liquidation of foreign companies will not be taxed to the extent they do not exceed the initial investment (it seems even possible to distribute assets of the company under liquidation at their book – and not market – value). This may certainly be an incentive to repatriate assets to Russia. A similar incentive are new rules which will allow Russian companies paying dividends, interest or royalties to a Russian resident via foreign intermediary companies to treat such payments from a Russian tax perspective as if they had been made directly to the Russian tax resident (provided the intermediary companies waive any potential tax treaty benefits).

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 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.

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.