

Draft Federal 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 was prepared by the Ministry of Finance as part of the campaign for the de-offshorization of the Russian economy and submitted to the Government at the end of May 2014. On 25 June 2014 Prime Minister Dmitry Medvedev instructed the Ministry of Finance to reconsider the draft law, in particular with regard to the definition of the persons to whom the law will apply and the possibility to increase the threshold for the control test (up to 50%+one vote) and to implement the law in stages over the next few years. Presumably the draft law will be submitted to the State Duma during its autumn session and in time to become effective as of 1 January 2015. Below we will discuss the most substantial provisions in their current form. The final version of the law is likely to be materially different from the draft prepared by the Ministry of Finance, but we assume that the general concept will not change.

The draft provides for the introduction of an obligation – new for Russian tax law – to declare and pay tax in relation to foreign legal entities and other “structures” held directly or indirectly by a Russian taxpayer. Since the income from such entities and structures is qualified as foreign source income, the tax liability is limited to individuals or legal entities that are deemed Russian tax residents. Under current law an individual is tax resident in Russia regardless of nationality if he/she stays more than 183 days during any twelve consecutive calendar months.

The new rules will apply not only to participations held in foreign legal entities, but also in “structures” if the taxpayer is beneficially entitled to receive revenue (profit) distributions from such “structures”. Visibly the authors of the draft law wanted to catch under the heading “structure” any assets which are beneficially, though not legally owned by the taxpayer without being brought into a separate legal entity. The draft law contains a non-exhaustive list of such structures (funds, trusts, partnerships, other forms of collective investments or fiduciary management). Hereafter the term “foreign companies” shall be used to include both legal entities and structures.

First, starting from next year the taxpayer will have a duty to notify his tax inspection in Russia of any legal entities in which he holds directly or indirectly more than one per cent, respectively of any structures if he is beneficially entitled to their revenues or profit in the event of their distribution. Under the current draft this duty arises regardless of the jurisdiction in which the foreign company is incorporated and of the level of its taxation in its home country. It also applies to foreign corporations listed or traded on a stock exchange.

Secondly, the taxpayer must proceed to a second filing with respect to those foreign companies which he “controls” (so-called “controlled foreign companies” or “CFCs”). A taxpayer is deemed to control a foreign legal entity if he holds more than 10% directly or indirectly, alone or together with other persons (“considering the particular relationship between the controlling person and such other persons”). Control over a structure is defined as the “possibility to exert decisive influence over the decisions taken by the persons managing the assets of such structure with respect to the distribution of its revenues (profit) between its stakeholders or beneficiaries”.

The draft law provides for various exceptions where the foreign legal entity (not structure!) will not be treated as a CFC. The Ministry of Finance abandoned its initial approach where the CFC rules would have applied only to foreign companies incorporated in “black-listed” typical tax haven jurisdictions. Under the new “white list” principle CFC rules would not apply to foreign legal entities domiciled in countries listed by the Federal Tax Service as guaranteeing the exchange of tax information with the Russian Federation (currently no such list exists) provided that they are subject to an effective tax rate exceeding 75% of the Russian corporate profit tax rate ($3/4$ of 20% = 15%) during the relevant financial year. A lower tax rate applies, for instance, in Cyprus and to specific types of companies in Switzerland. The CFC Rules do also not apply to: (i) foreign organizations traded or listed on a stock exchange, nor to foreign organizations indirectly owned by the taxpayer through direct or indirect holdings in a foreign organization traded or listed on a stock exchange (ii) to not-for-profit organizations; (iii) to legal entities permanently resident in the Eurasian Economic Union.

Thirdly, the taxpayers must include the undistributed profit of foreign companies in their Russian tax base: for individuals this is the personal revenue taxed at 13%, for legal entities the corporate profit taxed at 20%. Presumably profits of CFCs will not be taxed under CFC rules if they do not exceed a certain threshold (under the current version of the draft law 3,000,000 RUR for the

relevant financial year). The profit will be taxed in proportion to the percentage of the taxpayer's holding in the CFC and the length of the holding period if the participation is acquired or sold during the relevant tax period. If it is impossible to determine the percentage held in the foreign company (or structure) the tax base is assessed in proportion to the number of stakeholders or in accordance with the organizational documents. The tax rates applicable to CFC profits will be less advantageous than the tax rates applicable to dividends paid from the profits of the foreign company. Moreover, the draft law does not provide for the ultimate deduction of tax paid from profits under CFC rules from tax levied on subsequent distributions (dividend payments) made out of the same profits.

Fourthly, the draft law introduces a liability for "wrongful failure to timely file" the CFC notice (fine of 100,000 RUR) or the notice on holdings in foreign companies (fine of 50,000 RUR) – the fines are due in relation to each company for which the filing was omitted – and a liability for the total or partial failure to pay tax as a consequence of the failure to include the CFC profit in the tax base (fine equal to 20% of the unpaid tax or at least 100,000 RUR).

Apart from the CFC Rules the draft law contains various novel regulations, in particular with respect to the application of the provisions of double tax treaties providing for full or partial exemption of dividends, interest and royalties from Russian withholding tax. Under the OECD Model Treaty, whereon most Russian double tax treaties are based, these revenues are exempt providing the person claiming such exemption is the "beneficial owner" of the revenue. The draft law defines the beneficial owner as the "person who (which), directly or through holdings in other entities or otherwise, has simultaneously the right to take possession of such revenue, to use it and dispose thereof, respectively the person in whose interest another person is authorized to use such revenue and/or to dispose thereof". Such person, "benefitting in fact from the revenue and deciding on its further destiny", must be identified taking into account the functions such person performs and the risks it takes. The exemptions provided by the double tax treaty will not be available, in particular, where the foreign person's authority to dispose of the revenue is limited, or where such person acts as an intermediary or agent paying the revenue directly or indirectly, fully or partially to another person who (which) would not benefit from exemptions under the double tax treaty. The same position, which is based on the OECD Commentary to the Model Treaty, has been outlined in the letter of the Ministry of Finance № 03-00-RZ3/16236 of 09.04.2014, i.e. already applies (and applied!) based on current law. The tax agent (Russian legal entity paying the revenue) bears the liability and risk if it grants an exemption wrongfully.

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