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Guide to the Russian “Deoffshorization” Law

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*The Federal Law No 376-FZ dated 24 November 2014 “Concerning the Introduction of Amendments to Parts One and Two of the Tax Code of the Russian Federation (Regarding the Taxation of the Profit of Controlled Foreign Companies and the Income of Foreign Organizations)” (the **Law**) was signed by President Putin on 24 November 2014. It is expected to enter into force on 1 January 2015. The Law introduces significant changes to the rules governing the reporting and taxation of participation interests by Russian tax residents in controlled foreign companies (**CFCs**) resulting in the profit of a CFC being imputed as taxable profit of a Russian tax resident controlling such a CFC at the usual Russian tax rate being 20 per cent for legal persons and 13 per cent for natural persons. An overview of the key provisions of the Law is provided below.*

Overview of key provisions of the law

Definitions

A CFC is a foreign company or structure which is not a Russian tax resident and is controlled by a Russian tax resident. A Russian tax resident will be deemed to be a controlling person falling within the ambit of the Law if such person’s participation interest is at least 50 per cent during 2015 and 25 per cent thereafter (with the threshold falling to 10 per cent, if the Russian resident’s total shareholding accumulated with that of other Russian tax residents, whether or not related persons, is at least 50 per cent of the CFC).

Exemptions

The below fall outside the scope of the Law and will not be included in the profit or income tax base of Russian tax residents:

- The profit of companies which produce active income in over 80 per cent of their activities;
- The profit of companies registered in a jurisdiction where the effective tax rate applicable to the CFC is at least 75 per cent of the weighted average Russian profits tax rate (calculated on a predetermined formula);
- The profit of foreign structures that do not comprise legal entities such as not-for-profit organizations which cannot, under applicable law or their constitutional documents, distribute profits among their shareholders, members, founders etc;
- The profit of licensed banks and insurance companies operating in a jurisdiction with exchange of information mechanisms with the Russian Federation;
- Issuers of certain traded bonds (ie Eurobonds) if the revenues from such bonds make up at least 90 per cent of the aggregate revenue of the issuer organizations;
- The profit of companies that are involved in certain industrial projects (ie projects concluded at governmental level on matters such as oil and gas) resulting in income of not less than 90 per cent of their total income.

Threshold exemptions apply to including the profits of CFCs in a Russian tax resident's tax base, the threshold for inclusion being set at 50 million RUB in 2015, 30 million RUB in 2016 and 10 million RUB from 1 January 2017 onwards.

Sanctions

Non-payment or partial payment of a tax liability arising as a result of non-inclusion in the tax base of a participation interest in a qualifying CFC will incur a penalty of 20 per cent of the amount of unpaid tax or RUB100,000, whichever is higher. Non-payment or partial payment of tax arising from omission to include a CFC's profits in a tax resident's tax declaration will not entail criminal liability until 2017, provided that the tax resulting from the omission is paid in full to the tax authorities.

Notification requirements

Taxpayers must notify the tax authorities of relevant participation interests in foreign companies and structures one month after the grounds for such notification arise. The deadline for notifying a CFC is 20 March of the year following the tax period in which a share profit of a controlling person of a CFC arises (ie assuming the Law enters into force on 1 January 2015, the deadline is set at 20 March 2016).

Place of effective management

To determine whether the place of effective management of a CFC will be considered to be in Russia, the Law provides the following criteria:

- The majority of the board meetings are held in Russia;
- The company's executive body regularly conducts company-related activities, to a substantially greater extent, in Russia than elsewhere;

- The company's CEO primarily performs his/her executive management duties in Russia.

The Law also defines an “actual recipient (beneficial owner) of income” for the purpose of accessing tax treaty benefits, as follows: “a person who has an actual right to income will be a person who, by virtue of direct or indirect participation in an organization or control over an organization, or by virtue of other circumstances, has the right independently to use or dispose of that income, or a person in whose interests another person has the authority to dispose of the income in question”. In accordance with the Law, income such as dividends, income or royalties earned by a foreign company which is derived from operations or investments in Russia will not reap reduced withholding tax rates as provided for in the double tax treaty network of Russia, if such company is not the “beneficial owner” of the income.

Taxation of indirect transfer of ownership in Russian real estate

In accordance with the Law, companies which derive capital gains from the disposal of shares in Russian and foreign companies whose assets consist, directly or indirectly, 50 per cent or more, in immovable property situated in Russia, will be subject to withholding tax in Russia at a rate of 20 per cent. The existence of conflicting provisions in effective double tax treaties may provide an exemption to this. The Protocol to the Cyprus-Russia double tax treaty for example, provides a grandfathering clause whereby gains deriving from the disposal of shares in property-rich companies will be taxable in the country of residence of the alienator, until 1 January 2017. The provision of the Law conflicts with the Protocol provision, and both treaty partners being bound by the Vienna Convention on the Law of Treaties, will mean that the Protocol provisions will prevail over Russian local legislation.

Significant deadlines to consider

Assuming the Law enters into force on 1 January 2015:

- **1 April 2015** - notification on participations in any foreign entity or and structures set up prior to 1 January 2015.
- **20 March 2016** – first CFC reporting date.
- **31 December 2017** – grace period in which criminal liability is waived for late payment of tax ends.

Further action

The entry into force of the Law is expected to significantly affect many Russian-held international structures. We strongly advise our clients to conduct a preparatory audit of their group structures to identify companies that will qualify as CFCs, persons who may be recognised as controlling Russian tax residents based on their place of management and control, and to consider potential restructuring opportunities to achieve compliance and tax efficacy. For further information please contact:

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