LEGAL ALERT

NEW RUSSIAN DE-OFFSHORING RULES. THE IMPACT ON FOREIGN INVESTORS AND RUSSIAN BUSINESSES

The debate over the strength of the de-offshoring initiatives between Russian Government hard-liners and representatives of the business community seems to have been finally resolved as the Russian lawmakers have adopted changes to the Russian Tax Code introducing new controlled foreign corporation (CFC) rules and other highly important amendments to Russian tax legislation. On 18 November 2014 the State Duma passed new law No. 367-FZ ***On the Introduction of Changes to Parts I and II of the Tax Code of the Russian Federation (concerning taxation of profits of CFC and income of foreign organizations)*** and the draft bill was also approved by the Federation Council on 19 November 2014, then signed into law by President Putin on 24 November 2014. Quite tellingly, the law was passed by the State Duma in the second and third reading in less than an hour from the beginning of the session on that day. What had to be supposedly one of the most thorough and careful thought processes to be demonstrated by the State Duma when adopting regulations fundamentally affecting the Russian economy and impacting all business sectors has essentially become just another example of a "legislation printing" exercise. For some reason that did not come as a major surprise to many tax practitioners and experts in Russia.

This law (hereinafter "**the new law**" or "**the new law No. 367-FZ**") has introduced a number of significant legislative changes. Despite its title, the amendments to the new law have extended not only to the new CFC regime, but have also brought certain tax concepts and novelties previously absent in Russian tax legislation. These include:

- Beneficiary owner of income.
- CFC rules.
- Tax residency criteria for legal entities.
- Taxation of capital gains realized from the indirect sale of property-rich companies.

BENEFICIARY OWNER OF INCOME

New definition

The new law No. 367-FZ has amended Article 7 of the Tax Code by adding new paragraphs fixing the definition of the "beneficiary owner of income" for treaty purposes. In various letters and opinions issued by the Ministry of Finance, the Russian authorities have consistently referred to the beneficiary owner of income necessary for a treaty relief, however only in April 2014 did the Russian Ministry of Finance first voice its official position specifically on some of the criteria necessary to qualify for this definition. The new law No. 367-FZ fixes this concept on a legislative basis and sets forth the domestic treatment of the beneficiary owner of income from a Russian tax perspective.

In particular, the beneficial owner of income is defined as a person who by virtue of (i) having participation interest (directly and/or indirectly) in an organisation or (ii) control over an organisation or (iii) by virtue of other circumstances has the right to independently use and (or) dispose of such income.

There is a further attempt to exclude agents and nominees from the treaty benefits, as the new law No. 367-FZ specifies that the functions performed by such a person and risks assumed by the person "must be also taken into account", albeit without describing how and to what extent. In this regard, the amendments introduced in Article 312 of the Tax Code have another, slightly different, definition for the beneficiary owner of income which may have a very important practical context. Specifically, the role of the beneficiary owner of income must be established taking into account the functions and risks particularly in relation to the income being distributed, rather than to those borne by the foreign organization as a whole. In informal discussions Ministry of Finance representatives have indicated that they will rely on the narrower definition contained in the amended Article 312 rather than Article 7 of the Tax Code, albeit they could not explain why the two different definitions have been required to describe the same tax term.

The new law No. 367-FZ determines the consequences arising in case the foreign income recipient does not meet the requirements set for the beneficiary owner of income, where called for by a relevant treaty. Paragraph 3 of the amended Article 7 states that for the purposes of this international treaty the foreign entity will be denied the treaty benefits from a Russian perspective if it has limited authority in respect to disposing of such income, performs intermediary functions in relation to the specified income without performing any other functions and without assuming any risks upon itself, while distributing such income (in full or in part) directly or indirectly to another person who in the case of receiving such income directly from a source in the Russian Federation would not be entitled to apply the provisions of the treaty.

"Look through" approach

The new law No. 367-FZ introduces the so-called "look through" approach, whereby the ultimate beneficiary owner of income (for example, located at the second or upper corporate tier) may still claim benefits for income distribution sourced from Russia if the relevant treaty with the particular foreign jurisdiction in which that ultimate income recipient (as the newly identified beneficiary of income) is residing for tax purposes provides for withholding tax relief and the Russian payor of the income is aware of who is that ultimate income recipient before the payment. The same principle is introduced in the amended Article 312 of the Tax Code, whereby the new point 1.1 permits to claim the treaty relief for dividends by the subsequent participant - the beneficiary owns of income who indirectly owns the Russian subsidiary. Treaty benefits should be available in part corresponding to this participation.

Practical problems

That said, the "look through" approach may be difficult to argue in front of the Russian tax authorities as a practical matter with respect to dividends in certain cases. This is because despite the new rules for the "look through" concept placed in points 1.1. to 1.4. of Article 312 of the Tax Code, many double tax treaties with Russia point to the "direct investment" test, the "minimum cash" and "minimum shareholding percentage" investment tests as additional requirements for applying a reduced withholding tax rate (10% or 5%) on dividends. Obviously, in the case of a multinational enterprise having Russian subsidiaries down the corporate tree, the ultimate parent company would be unlikely to wish to invest in a qualifying minority equity stake in the Russian company in addition to the participation already owned by the direct foreign parent company at the first corporate tier in the group. Having to make another substantial equity injection would otherwise complicate the corporate structure and would create various management issues.

Issues for joint ventures with Russian partners

The issue may get even more problematic in the case of wide-spread joint venture structures involving Russian partners. This is where a joint project is agreed between a Russian and foreign partner with the joint venture vehicle created as a captive company placed in a treaty favourable jurisdiction whose role is to serve as the basis for the joint venture agreement and to control the Russian project company. Practical issues will therefore remain for dividend income channelled from Russia up the chain to each of the partners' tax residency jurisdictions unless the joint venture is built up with the necessary substance with risks and functions found by the authorities adequate enough to be "taken into account" as called for by the new law.

If a reduced withholding tax rate on dividends is challenged by the authorities due to these *easy-to-prove* lacking attributes such as insufficient capital participation or the absent direct investment by the ultimate parent company owing the underlying Russian subsidiary through a number of foreign sub-holding entities, additional arguments will have to be provided. As a result, more advance tax planning in future will be necessary to cure the issue in substance and to avoid these challenges emerging in the first place.

New documents for proving the beneficiary owner of income for dividends in case of "look through"

In addition to the duly legalised and translated tax residency certificate of the income recipients the Russian tax agent who is paying out dividends for the purpose of applying the reduced treaty rates will be entitled to request a number of newly introduced documents. The latter must be obtained both from the dividend income recipients and the beneficiary owner of income if different to the immediate income recipient. These documents include:

a) documentary proof that the foreign organisation - payee who is receiving dividends acknowledges no beneficiary owner of income status for these dividends;

b) information regarding another foreign organisation which is recognised by that immediate foreign payee of dividends to be the beneficiary owner of income, also (i) indicating the exact participation share and (ii) providing documents to evidence its direct participation in the foreign dividend recipient and indirect participation in the underlying Russian subsidiary.

"Look through" mechanism for royalties and interest income

For interest and royalty income the "look through" approach set by the amended Article 7 of the Tax Code is a long-waited positive change that has brought technical certainty and will play an important role in better aligning Russian tax legislation with the regulations of OECD countries. The new law No. 367-FZ implies no negative tax consequences should arise for the generally treaty protected interest and royalty income assuming that the ultimate beneficiary owner of the interest or royalty income is located in a jurisdiction with a favourable tax treaty with Russia and has no Russian permanent establishment.

Additional documents to support the treat relief for dividends both before and after 1 January 2015

There is very little doubt that the Russian tax authorities will pursue the beneficiary owner of income concept in practice much more aggressively than in previous years. Armed with the quite broad definition offered by the new law, they can also find additional support in the Ministry of Finance opinion letter No. 03-08-05/36499 dated 24 July 2014 which has sought to address the scope of documentation that can evidence the beneficial owner status of a foreign company receiving Russian-sourced dividends. In the view of the Ministry of Finance, the documents that should be requested by a Russian entity paying the dividends from a foreign recipient include:

1) documents (information) confirming (or denying) the recipient's right to dispose of and use the dividends received, including (i) documents confirming (or denying) the existence of contractual or other legally binding obligations before third parties (resident in a foreign state that has no tax treaty with Russia) which

limit the recipient's right to use the dividends received for the purpose of deriving benefits from alternative use of the dividends or (ii) documents confirming (or denying) the inevitability of subsequent transfer of the dividends by the recipient to third parties (resident in a foreign state that has no tax treaty with Russia);

2) documents (information) confirming that the recipient of the dividends incurs tax liabilities in connection with the receipt of dividends and thus there are no savings on Russian withholding tax in the event of the subsequent transfer of the dividends by the recipient to third parties (the resident in a foreign state that has no tax treaty with Russia);

3) documents (information) confirming that the recipient carries out actual business activity in a relevant foreign state.

NEW RUSSIAN CFC RULES

Definition of a CFC

The new law has introduced a new chapter, Chapter 3.[4] of the Tax Code, called ***Controlled foreign companies and controlling persons***. A CFC shall be a foreign organisation which concurrently meets all of the following criteria:

a) the organisation is not recognised as a tax resident of the Russian Federation, and

b) the controlling persons of the organisation are organisations and/or individuals recognised as tax residents of the Russian Federation.

A CFC for Russian tax purposes also includes an unincorporated foreign structure whose controlling persons are organisations and/or individuals which are recognised as tax residents of the Russian Federation. In this regard, the new law amended Article 11 of the Tax Code to outline what should constitute an unincorporated foreign structure. This definition, which remained being rather broadly described for the purposes of CFC rules in the final law compared to the previous three drafts, extends to an unincorporated business form set up in accordance with the laws of a foreign state (territory) (including a fund, co-partnership, partnership, trust, another collective investment and/or fiduciary management form), which in accordance with its personal law is entitled to carry out activity aiming at earning income (profit) in the interests of its members (stakeholders, trustors and others) or other beneficiaries.

Controlling persons for CFCs

For the purposes of CFC rules a controlling person of an organisation (including an unincorporated foreign structure) means the following:

- any individual or legal entity who owns directly or indirectly more than 25% of the organisation in question, and/or
- an individual or legal entity who owns (as calculated for individuals together with their spouses and minors, i.e. taken on a combined basis) directly or indirectly more than 10% in the organisation in question and, further, if the participation of all persons recognised as Russian tax residents in this organisation (calculated analogously, i.e. including the spouses and minors as far as individuals are concerned) exceeds 50%.

The new law contains a "grace period" rule, whereby the above threshold for indirect or direct participation in the Russian CFC has been set at the level of 50% for the period until 1 January 2016.

Further, a person may be deemed as a controlling person for the purposes of CFC not necessarily only where (s)he meets the above two criteria, but where "exercises control over an organisation in his/her interests or interests of the spouses and minors".

It is not clear what was the basis for Russian lawmakers to exclude parents and adult children from the scope of the new rules. Interestingly, the previous version of the law, developed by the Ministry of Finance in May 2014, used to refer to "other persons" who, in addition to spouses and minors, should be covered by the definition of controlling persons. For some reason the reference to "other persons" was dropped from the new law during the enactment process. Therefore, if the control is, for example, exercised in the interests of parent(-s) and they are the owners of an organisation, yet they are not Russian tax residents, there is a position that technically this seems to allow the respective structures to circumvent the restriction of the new law applicable to the controlling person and by doing so to possibly avoid the organisation falling into the classification of being a CFC.

Control for the purpose of CFC rules

Control effectively means the exercise of (or, importantly, the possibility to exercise) a critical influence on decisions made by such an organisation with respect to the distribution of after-tax profits (income) received by the organisation (i) by virtue of having a direct or indirect participation interest in such an organisation or (ii) by virtue of a contract (agreement) the subject matter of which is management of this organisation or (iii) by virtue of another relationship between a person and the organisation and/or other persons. The last criterion is essentially a "capture-all" rule as it is worded in such a way that it permits one to apprehend all different forms of contractual and non-contractual control & management instruments, including bearers shares, call-options, nominee shareholders structures with irrevocable open-ended powers of attorneys for the beneficiary, any tacit agreements, etc. Importantly, it is the establishing of the fact of control that will dominate the test, rather than how the control is instituted.

There will be no escape for unincorporated structures either. In particular, the new law sets forth that when the CFC is an unincorporated foreign structure, similar rules should apply, whereby the exercise of control is equated to the possibility to exercise critical influence on decisions made by the person managing the assets of such a structure with respect to the distribution of after-tax profits (income) among its members (stakeholders, trustors or others) or other beneficiaries by virtue of the laws of a foreign state or by virtue of a contract.

Tax exempt CFCs

Contrary to the previous legal formulations contained in earlier drafts, the law No. 367-FZ has not excluded certain entities from the CFC definition, rather it has introduced a new category of foreign organizations. These can be called as 'CFCs with tax exempt incomes'. According to Point 7 of the amended Article 25.[13] of the Tax Code, these include:

a) Non-commercial organizations, which in accordance with its personal law do not distribute earned profit (income) among its stakeholders (participants and founders) or other persons.

b) Entities created in accordance with the legislation of the Eurasian Economic Union (i.e. currently Kazakhstan and Belarus; possibly also Armenia from 1 January 2015 and Kirgizia from May 2015).

c) Organizations that (i) have their corporate situs (domicile) in a jurisdiction with which Russia has a double tax treaty in place, except for territories that fail to cooperate in the area of the exchange of information with the Russian Federation for the purpose of taxation, and (ii) the effective tax rate of profit (income) determined for these organizations on an annual basis and calculated based on the relevant financial statements is 75% or more, compared with the weighted-average tax rate on Russian profits tax. As a result, currently any effective tax rate of the foreign state below 15% will be captured by the second criteria of this taxing right.

   It is expected that the above noted "black list" of foreign jurisdictions deemed failed to have cooperated in the area of the exchange of information with the Russian Federation for the purposes of taxation is to be established by the Russian Ministry of Finance. Obviously, this is one of the most criticized novelties of the new law, as there are no objective legal grounds for the Ministry of Finance governing how to form such a list. This is going to be an absolutely new and likely different list to the one set by the Ministry of Finance in its Order No 108-n of 13 November 2007 and it can be both created and amended on an "as wished" basis, thus exponentially raising the instability and uncertainty risk for foreign companies operating in so "penalized" jurisdiction(-s).

d) Organizations that (i) have their corporate situs (domicile) in a jurisdiction (territory) with which Russia has a double tax treaty in place, except for territories that fail to cooperate in the exchange of information with the Russian Federation, and (ii) the income of those organizations determined under sub-points 1-12 of point 4 of Article 309.[1] of the Tax Code (specifically, various passive income streams) does <u>not</u> exceed 20%.

e) Foreign structures (some experts believe this term shall cover certain righty set up discretionary trusts) formed without creating a legal entity in which all the following consequences are simultaneously met:

   – The founder (settlor) of such structures after the creation (establishment or set-up) in accordance with the personal law of relevant structure is no longer entitled to receive assets from these structures back in his/her ownership.

   – The founder's or settlor's rights (including those connected with selecting the beneficiaries, rights to dispose of the property and other rights) in accordance with the personal law and the foundation documents of this structure cannot be transferred to other persons except for in cases of assigning these rights through inheritance or universal succession.

   Interestingly, it is not a question of fact but a question of statute that prevails in this definition. The new law says that the mere possibility for the structure to distribute income (profits) to beneficiaries, trustees or other persons arising from the regulations governing such trusts / organizations or ensuing from foundation documents (e.g. trust instrument) from the outset should disqualify the organization from being a 'tax exempt CFC'.

f) Banking or insurance organizations carrying out activities in accordance with their personal law under a license or other relevant permit and which are located in a state (territory) with which Russia has a double tax treaty in place, except for "black-listed" territories. This "black list" of these territories is the same as to be set by the Ministry of Finance for earlier noted other tax exempt CFCs.

g) The issuers of bonds or organizations entitled to interest income payable on negotiable securities as well as organizations who receive assigned rights and obligations under such securities issued by other foreign issuers provided that they meet the criteria established by sub-point 8, point 2 and point 2.[1] of Article 310 of the Tax Code. However, the tax exemption for such CFCs will be available provided that their finance income determined pursuant to financial reporting for the respective year is not less than 90% of the total income earned.

h) Organizations participating in product sharing agreements, concession agreements or license agreement and service contracts at risk or other agreements analogous to product sharing agreements signed with the Government of a particular state or with the authorized Government state bodies or state companies. Again, this criteria is deemed to have been met on the condition that 90% of the total income earned is income specifically from the mentioned agreements determined pursuant to financial reporting for the respective year.

i) Organizations which are recognized as operators of new sea hydrocarbon deposits or a direct shareholder (participant) of an operator of new sea hydrocarbon deposits.

The effective tax rate and weighted-average tax rate for CFC purposes

In order to check whether a foreign organisation falls into the definition of the taxable CFC (i.e. if it is covered by the above "75% or more" rate test) the effective rate of tax on income (profit) of a foreign organization shall be computed under the following formula:

EFFR = T/P

where:

EFFR is the effective rate of tax;

T is the amount of (i) tax on income (profit) calculated by the foreign company and its tax subdivisions in accordance with its personal law and (ii) income tax withheld on income (profit) of that organization at the source of payment;

P is the amount of income (profit) of the foreign company which is determined in accordance with paragraph 1 of newly introduced Article 25.[15] of the Tax Code.

Period-related adjustments to the effective tax rate are allowed by the new law. At the same time, a dormant or loss making company where P is zero or a negative number shall be automatically recognised as a CFC with the above "75% or more" rate test not being applied.

As for the weighted-average tax rate for profits tax required by the same test, it shall be computed using the following formula:

$$\mathbf{WAVR} = \frac{\mathbf{R1xP1 + R2xP2}}{\mathbf{P1 + P2}}$$

where:

P1 is the amount of profit of the foreign organization which is to be determined in accordance with paragraph 1 of clause 1 of Article 25.[15] of the Tax Code, less P2. If this results in a negative number, P1 shall be taken to be zero.

P2 is the amount of income which shall be determined pursuant to paragraph 1 of point 4 of Article 309.[1] of the Tax Code.

R1 is the rate of profits tax as established for regular dividends domestically received by Russian companies (currently 9%, revised to 13% from 1 January 2015).

R2 is the general statutory rate of profits tax (currently 20%).

Notifications on participation in the CFC

The new law brought to life a new reporting requirement, whereby in cases stipulated by the Tax Code, taxpayers which are recognised as tax residents of the Russian Federation must serve notifications of their participation interest in both (i) foreign organisations and unincorporated strictures and (ii) all CFCs in which they are recognised to be controlling persons.

Notification on participation in foreign organisations shall be served not later than within a month's time of the date when grounds arise (change) for the service of such notice in accordance with the Tax Code.

Notification on the CFC shall be served not later than on the 20th of March of the year following the tax period in which the relevant share of profit in the hands of the controlling person shall be declared, i.e. the reporting year.

If following the service of notification on participation in foreign organisations the grounds for the service of such notice have not changed, no repeated notice needs to be served.

In the case of the termination of participation in foreign organisations the taxpayer shall inform the tax authorities of this not later than within a month's time of the date of the termination of such participation.

Taxpayers shall serve notice on their participation interest in foreign organisations and of controlled CFCs on the tax authority at their location (at their place of residence).

Taxpayers which in accordance with Article 83 of the Tax Code come under the category of major taxpayers shall serve notice on their participation interest in foreign organisations and of the CFC to the tax authorities at the place of their registration as major taxpayers.

The forms (formats) of notices on the participation interest in foreign organisations and notices on controlled foreign companies as well as the form completion procedure and the procedure of service of notices on participation interest in foreign organisations and on CFCs in electronic form shall be adopted by the federal executive body responsible for the control and supervision in the field of taxes and levies in consultation with the Ministry of Finance of the Russian Federation.

Content of the notification (notice)

The new law sets although similar, but nevertheless formally separate, requirements for the content of the notifications.

The notice on participation interest in foreign organisations must contain the following information:

1) the date when grounds arise for the service of the notice;
2) the name of the foreign organisation (that of the unincorporated foreign structure) notice on participation interest in which was served by the taxpayer;
3) the registration number (numbers) as may be assigned to the foreign organisation in the state (territory) of its registration (incorporation) and the code (codes) of the foreign organisation as a taxpayer in the state (territory) of its registration (incorporation) (or analogues thereof), if any;
4) the taxpayer's participation interest in the foreign organisation, disclosure via a special procedure of the structure of the taxpayer's participation in the foreign organisation in the case of having indirect participation;
5) the date of the termination of participation in a foreign organisation (an unincorporated foreign structure).

The notice on the CFC must contain the following information:

1) the period over which the notice is being served;
2) the name of the foreign organisation (that of the unincorporated foreign structure);
3) the registration number (numbers) as may be assigned to the foreign organisation in the state (territory) of its registration (incorporation) and the code (codes) of the foreign organisation as a taxpayer in the state (territory) of its registration (incorporation) (or analogues thereof), if any;
4) the date being the last day in the period over which the financial statements of the organisation (those of an unincorporated foreign structure) are drawn up in

accordance with its personal law;

5) the date of the foreign organisation's financial statements in accordance with the personal law of that organisation;

6) the date of the auditor's opinion with respect to the foreign organisation's financial statements (if the audit is mandatory in accordance with the personal law of that organisation);

7) the taxpayer's participation interest in the CFC, disclosure via a special procedure of the structure of the taxpayer's participation in the CFC in the case of having indirect participation;

8) description of the grounds for recognising the taxpayer as a controlling person for the CFC in question, and

9) description of the grounds for exempting the income of the CFC being reported as a tax exempt CFC pursuant to the new rules.

Forced disclosure on CFC

The law seems to operate on the presumption of the *bona fide* nature of the taxpayer as it allows in point 7 of new Article 25.[14] of Tax Code that in the event of discovering incomplete data, inaccuracies or errors in the completed notice on the participation interest in foreign organisations or the CFC that has already been served, the taxpayer may file an adjusted notice.

If the taxpayer serves an adjusted notice prior to becoming aware of the fact that the tax authorities discovered inaccurate data in the notice, the taxpayer shall be relieved of liability under Article 129.[6] of the Tax Code.

However, the Russian tax authorities will be entitled to force the taxpayer to recognize itself (himself/herself) as a controlling person for the purposes of the CFC in accordance with the special procedure established by the new law. This procedure does not appear too excessively formalistic and commences with sending a demand by the tax authorities to the delinquent addressee if the tax authorities have been able to obtain the appropriate information from various sources including *inter alia* from a foreign state through the exchange of information mechanism suggesting that the respective person is in fact a controlling person of that unreported foreign organization. The taxpayer may provide various explanations and clarification to counter-argue against the tax authorities' demand and may also appeal the decision by the tax authorities about recognizing the respective taxpayer as being a controlling person. The appeal is permitted to go straight to court within 3 months' time from the receipt by the claimant of the tax authorities' decision.

Determining taxable profit of the CFC

<u>Minimum taxable profit threshold</u>

According to Point 7 of Article 25.[15] of the Tax Code, in order to be taxed the CFC profit determinable pursuant to the rulethe Tax Code must be in excess of RUB 10 million for the respective tax period. However, under certain transitional rules introduced by point 2 of Article 3 of the new law this "minimum taxable profit" threshold is set to be:

- RUB 50 million for 2015, and
- RUB 30 million for 2016.

<u>Separate income basket rule for CFCs</u>

The new law has essentially introduced a new "separate income basket" rule, whereby the CFC profit is the profit calculated in accordance with the special rules of Article 309.[1] of the Tax Code and cannot be mixed with other taxable profits (offset against other losses) of the taxpayer. In this regard, the new law has made an effort to avoid some double taxation saying in the new Article 25.[15] of the Tax Code that this taxable profit must be reduced by the amount of dividends (taking into account any preliminary dividends) that have been actually paid out by that CFC in the calendar year following the year for which the CFC composed the financial statements in accordance with its personal law.

The profit of a CFC where the latter is an unincorporated foreign structure can be reduced by the amount of distributions made to the controlling persons and (or) for the benefit of stakeholders, trustors or other persons) or beneficiaries. This reduction is not automatic and is available only if the relevant payees have paid their share of tax as long as they are also deemed as controlling persons for the purposes of the CFC.

The profit of a controlled foreign company shall be factored into the tax base for a taxpayer being a controlling person as a percentage that corresponds to the participation interest of this person in the CFC as at the date of the decision on the distribution of profit. If such a decision is not made on the 31[st] of December of the year in which the period over which the financial statements of such a company are drawn up in accordance with its personal law ends the tax base shall be formed at the end of the respective period.

Indirect participation cases are specifically addressed by the new law. Point 4 of Article 25.[15] of the Tax sets forth that if a taxpayer, being a controlling person, has an indirect participation interest in a CFC and such participation is exercised via organisations which are also the controlling persons of this CFC, yet are recognised as tax residents of the Russian Federation, the profit of this CFC, which is factored into the tax base for such a taxpayer, shall be reduced by the amount of profit that was taken into account for tax purposes in relation to these other controlling persons, via which indirect participation of such a controlling person in the controlled foreign company is exercised.

Specific rules for back-up documents supporting CFC profits

The earlier noted "separate income basket" rule is further clarified in Article 309.[1] of the Tax Code as having two different, at least formally, approaches for back-up documents supporting the calculated amount of CFC profit:

- The first category assumes that CFC profits can be supported by the <u>financial statements</u> which are appropriately <u>audited</u> on the condition that (i) a mandatory audit is in fact required for such a CFC according to its personal law and (ii) this CFC is located in a jurisdiction with which Russia has a relevant double tax treaty in place. The new law then adds certain particularities for computation rules as established by Article 309.[1] of the Tax Code;

- The second category are those CFC profits which cannot be supported by a mandatory audit opinion prepared in the foreign jurisdiction or which are earned by a CFC located in a non-treaty country. In this case, the new law says that the profits of such CFCs shall be determined with all supporting documents as may be required by Russian rules and, save for a few very limited cases, without invoking the particularities allowed by CFC computation rules in that article 309.[1] of the Tax Code.

It is not clear why such complex segregation was necessary in the new rules in the first instance. One of the views has been that the authorities do not trust taxpayers' activities outside Russia and accordingly limit the ability of the controlling persons to refer to an audit opinion of financial statements in general, even that it can be voluntarily prepared by the CFC in question, rather than as part of the statutory requirement of the relevant treaty country. One would not need to be a great seer to predict a lot of practical problems with forming a tax base by CFCs looking for support in the foreign back-up documents that the Russian tax authorities will have to review and accept for compliance with the new rules.

Passive and active CFC income

One of the most criticized areas in the new law is that for the purpose of applying the tax computation formula it differentiates between passive income and active income, but the list of passive income categories is not exhaustive. In particular, under point 4 of Article 309.[1] of the Tax Code, passive income includes:

1) dividends received;
2) income earned in the form of the distribution of profits or property of organisations, other persons and their associations, including as a result of liquidation proceeds;
3) interest income from debt instruments of any kind, including bonds, participation bonds and convertible bonds;
4) license fees from the use of intellectual property rights including *inter alia* collected payments of any kind for copyrights, patents, trademarks, industrial design, utilisation models, plans, secret formula or commercial process of information of an industrial, business or scientific character;
5) capital gains from the sale of shares (participation interest) and/or assignment of participation interests in a foreign organisation being not a legal entity under foreign law;
6) income from the operations of term finance instruments (derivatives finance instruments);
7) real estate sale income;
8) income from the rent or sub-rent of property including from qualifying lease operations (save for income from lease/sub-lease of sea vessels or aircraft and/or transport means as well as containers used in international traffic);
9) income from realisation including the redemption of shares in collective investment funds;
10) income from the rendering of consulting services, legal services, accounting, audit, engineering, marketing services, data processing service as well as R&D works;
11) income from secondment services;
12) other incomes analogous to types of income enumerated in points 1-11 above.

Conversely, active income extends to all other income left uncovered by the passive income definition and where the above passive income is particularly earned through banking activity carried out under an appropriate license. Based on the rather poor legal techniques used in the Article, it is not clear what characteristics the active income must have in order to distance itself from the "capture-all" passive income category No 12.

Certain types of income are specifically excluded from the formation of the CFC tax base.

CFC loss carry forward

The loss carry forward is generally allowed for a CFC in the full amount under Russian rules unless the controlling person fails to submit the Notification on the CFC for the year in which the loss was suffered.

Loss generated before 1 January 2015 as evidenced by the financial statements of the relevant CFC may be carried forward in an amount not exceeding the total amount of loss for the 3 preceding years prior to 1 January 2015.

Technically, the new Article 309.[1] of the Tax Code does not restrict the loss carried forward for CFCs to a 10 year maximum period generally established by point 2 of Article 283 of the Tax Code for Russian taxpayers of profits tax. It is possible, however, that this 10 year general limitation rule will apply despite the proclaimed "separate income basket" rule for CFC taxation.

Certain transition rules for taxation of CFCs profits

In an effort to ease up a negative outburst by the Russian business community the new law has outlined some transitional rules in relation to:

- Taxation of liquidation proceeds received by a controlling person from a foreign organisation going into liquidation (point 2.2. of Article 277 of the Tax Code).

  The liquidation proceeds in the form of property or property rights in such a case will not be subject to Russian tax. The recipient of liquidation proceeds may account for the received property using the carrying value according the accounting data of the distributing entity but not exceeding (a) the current market value (as can be defined by Russian Transfer pricing purposes) and (b) the tax cost basis sitting in the shares of that foreign organisation. Under point 5 of Article 4 of the new law, this rule is applicable only before 1 January 2017.

- Taxation of capital gains from the sale of securities and participation interest and shares to a controlling person or a related party of that person (point 10 of the new Article 309.[1] of the Tax Code).

  Under these rules, the historical cost basis can be taken for determining tax liability on such capital gains. Also, the gross income from such a sale can be adjusted on an arms-length basis pursuant to Russian transfer pricing rules even if the transaction is executed fully outside Russia. This taxation regime is applicable as long as both (i) the decision to liquidate the respective CFC that has accumulated qualifying capital gains and (ii) the liquidation process are completed before 1 January 2017.

  Interestingly, the Russian Ministry of Finance believes that specifically this provision, coupled with no tax for qualifying liquidation proceeds of a CFC, is a significant incentive to businesses. A rather challenging assumption. If capital gains from intra-group sales are fully taxed by CFC rules anyway with only the cost basis being deductible, the question remains why this *prima facie* should encourage the repatriation of assets to Russia through restructuring and liquidations of CFCs before 1 January 2017, keeping in mind that under these rules no step-up in the cost basis is allowed in the hands of the Russian controlling person - the buyer.

Penalties for non-compliance with new CFC rules

The new law No. 367-FZ has introduced new penalties to the Tax Code. These penalties separately relate to:

- Violation of the Notifications rules, and
- Non-payment of taxes a result of the violation of CFC rules.

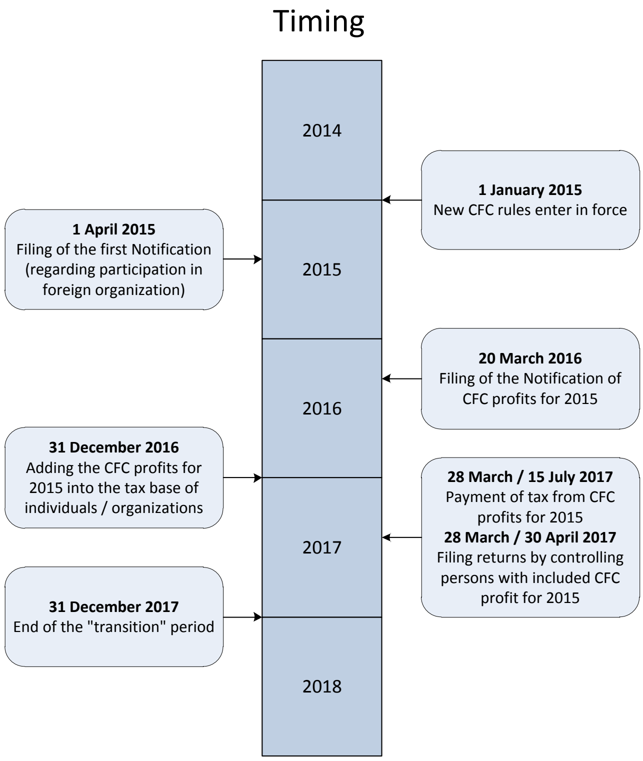
Specifically, Article 129.[6] of the Tax Code has been adopted to set forth that an illegitimate non-service, by the controlling person of a notice on CFCs over a calendar year to the set date, entails the imposition of a fine of 100,000 roubles for each CFC data in relation to which it had not been provided. The same penalty will apply for the provision of false data in a notice on each relevant CFC.

As far an illegitimate non-service, by the taxpayer of a notice on the participation interest in foreign organisations (that do not qualify as CFCs) to the set date or the service of a notice on a participation interest in foreign organisations that contains false data, this entails the imposition of a fine of 50,000 roubles for each foreign organisation data in relation to which it had not been provided or in relation to which false data had been provided.

Failure to pay the CFC's tax in Russia has been addressed by the new law in the new Article 129.[5] of the Tax Code, whereby non-payment or incomplete payment of tax by a controlling person, being an individual or a corporate taxpayer, as a result of the non-inclusion of the percentage of profit of a CFC in the tax base shall entail a 20% fine imposed the on CFC's profit which must be included in the personal income tax base for controlling persons being individual taxpayers and in the corporate profits tax base for controlling persons being corporate taxpayers, but not less than 100,000 roubles.

That said, under the specific "grace period" rules (point 3 of Article 3 of the new law) these penalties envisaged by the new Article 129.[5] of the Tax Code for non-payment or underpayment of CFC profits for the period from 2015 through 2017 will be inapplicable for these tax violations. The underlying tax liability must however be settled. Also, criminal responsibility shall not arise if the damage to the state budget has been compensated in full by the delinquent taxpayer.

Timing of the first regulatory action points under the new CFC law



NEW TAX RESIDENCY CRITERIA FOR LEGAL ENTITIES

Historically the Russian tax doctrine has operated on the basis that tax residency for legal entities must be determined by the place of incorporation as the only key criterion. With the new rules set forth in Article 246.[2] of the Tax Code as introduced by the law 367-FZ, this has changed. Accordingly, from 1 January 2015 Russia will apply (i) the effective management test for foreign legal entities and (ii) the place of corporate situs for Russian legal entities. Specifically, point 1 of Article 246.[2] of the Tax Code envisages that the term "Russian tax resident" for corporate tax purposes will mean:

1) Russian organisations;
2) foreign organisations recognised as tax residents of Russia according to the relevant double tax treaty in place and for the purposes of applying this double tax treaty;

3) foreign organisations whose effective place of management is the Russian Federation unless otherwise established by an applicable double tax treaty.

Effective management test criteria

"First tier" rule

The place of effective management shall be recognised to be in Russia provided that at least one of the following 3 criteria is met by the foreign organisation:

a) a majority of the Board of Directors meetings (or meetings of an analogous corporate body except for the executive body) is carried out in Russia. The majority shall mean the relative surplus of the meetings actually held in Russia vis-a-vis those carried out in a foreign state;

b) the executive body (or the executive bodies) of the organisation regularly performs its/their activities in relation to this organisation within Russia. The new law refers to the term "*extent*" of activities which must be substantial (rather than time length or other factors) defining the 'regularity' aspect. It is not known how the extent will be (or objectively can be) measured for the purpose of the new residency rules, rather that the law says that if this extent of involvement is "*substantially lower*" in Russia than that demonstrated outside Russia, then this criterion is not met;

c) the top executives (management) of the organisation (i.e. the people who, by the definition of the new law, are authorised to take and, accordingly, to bear responsibility for taking corporate decisions) predominantly carry out their activities in Russian and this is done in the form of "lead management" over this foreign organisation. "Lead management" is defined as it extends to making decisions and carrying out actions relating to the matters of the current activities of an organisation where these matters are placed within the competence of the executive bodies of the organisation.

"Second tier" rule

The new law stipulates in a very convoluted way that in the case where (i) the foreign organisation meets neither of the criteria set above as general rules (a) and (b) or (ii) it meets only one of them, the following 3 additional conditions, each taken on a stand-alone basis, shall lead to the effective management place to be deemed as being in Russia if:

- The financial accounts or management accounts of the foreign organisation (except for consolidated financial statements purposes) are kept in Russia.
- Document flow is organised in Russia.
- Operative management (this term does not exist in Russian tax law) of the personnel is carried out in Russia.

"Fall-out" rules for the effective management test

Point 3 of new Article 246.2 of the Tax Code regulates that the following activities shall *prima facie* fall-out from the definition of the effective management place:

a) Preparation of and (or) making decisions on matters relevant to the competence of the General meeting of Shareholders (participants) of the foreign organisation;

b) Preparation for conducting the Board of Directors meetings;

c) Executing certain functions in the Russian Federation within the framework of planning and control over the foreign organisation. These functions may include, *inter alia*, strategic planning, budgeting, preparing and composing consolidated financial statements, internal audit and control, as well as working out (and approving) of standards, methodologies, and (or) policies which apply to all or some subsidiaries of this organisation.

Additionally, a foreign organisation cannot be recognised as a tax resident taxpayer who's place of management is located in Russia if its commercial activity is carried out "*with the use of its own qualified personnel and assets based in a state (jurisdiction) of its permanent location with which there is a double tax treaty with Russia in place*." Availing of this exemption stated in Point 4 of Article 246.2 of the Tax Code must be supported by the appropriate documents. Obviously, this formulation may well happen to overlap with those stated as 3 main general criteria for tax residency and as a result many problems can be expected in practice for foreign companies with insufficient substance in any treaty country.

Self-claim of the Russian tax residency status

Unless otherwise stated in the relevant double tax treaty and subject to the contrary in Article 246.[2] of the Tax Code, a foreign organisation can self-claim the recognition of the Russian tax residency status. This is possible where (i) the foreign organisation is permanently located in a treaty country with Russia and (ii) operates in Russia via a permanent establishment. The organisation is free to both self-claim the tax residency status and cancel it in accordance with the special procedure to be established by the Ministry of Finance of Russia.

If the foreign organisation has recognised itself to be a Russian tax resident, it shall no longer, by virtue of point 7 of Article 246.[2] of the Tax Code, be treated as a CFC for tax purposes in Russia.

Special tax residency recognition rules

Point 6 of new Article 246.[2] of the Tax Code introduced by the new law No. 367-FZ refers to special rules where a foreign organisation can be recognised to be a Russian tax resident. These rules entail that obtaining the residency status may only be achieved via a self-claim by those organisations. This is possible where:

1) The foreign organisation is based in a treaty country with Russia and is recognised as a Russian tax non-resident according to this treaty.

2) As its principal activity the foreign organization participates in projects under product sharing agreements, concession agreements, license agreements or risk service agreements (contracts) or other similar agreements concluded with the government of the respective country (territory) or bodies authorized by

such a government (state authorities, public companies).

3) The foreign organization has a Russian controlling person who is a direct (indirect) shareholder (participant) and the share of direct (indirect) participation of such a Russian controlling person in the charter (contributed) capital (fund) of such a foreign organisation equals at least 50% within at least 365 calendar days. This rule is applicable if in addition all the following conditions are simultaneously met:

   - according to the financial statements of such a foreign organisation more than 50% of its assets are comprised of investments to those foreign subsidiaries that meet the requirements of paragraph 4 of clause 7 of Article 25 of the Tax Code and are not tax residents of the Russian Federation and the country or territory of domicile of such subsidiaries is not included in the list of countries and territories approved by the Ministry of Finance pursuant to paragraph 1 of clause 3 of Article 284 of a Tax Code;
   - the participatory interest of such a foreign organisation in the charter (contributed) capital (fund) of such qualifying subsidiaries equals at least 50%;
   - such a foreign organisation either has no income (profits) or, conversely, such income (profits) (if any) is/are for more than 95% comprised of the income (profits) set out in sub-point 1 of point 4 of Article 309.[1] of the Tax Code and this income (profits) is/are directly or indirectly received from such qualifying subsidiaries.

4) The foreign organization is an operator of new sea hydrocarbon deposits or a direct shareholder (participant) of an operator of new sea hydrocarbon deposits.

TAXATION OF CAPITAL GAINS REALIZED FROM THE INDIRECT SALE OF PROPERTY-RICH COMPANIES

The new law No. 367-FZ has amended sub-point 5 of point 1 of Article 309 of the Tax Code extending the definition of Russian sourced-income which is not connected with entrepreneurial activities carried out in Russia (passive income for withholding tax purposes).

Specifically, the new law has introduced a rule that capital gains from the sale of shares (participation interests) in organisations whose assets directly or, importantly, indirectly represent 50% of real estate property located in Russia as well as finance instruments backed by these shares or participation interests, except for shares traded on the stock exchange according to point 9 of Article 280 of the Tax Code, shall be captured for taxation by Russian 20% profits tax, unless they stay treaty protected.

It is not known how this 50% threshold should be calculated in part relating to this newly instituted 'indirect representation' in real estate assets. There will be many questions in practice if it should it be the book value of the real estate property itself or can also be the fair market value of shares forming the investment in a subsidiary, i.e. that Russian property-rich company. Also, many experts believe that as long as there remains no statutorily established mechanism for the fulfilment of the tax liability, if taxable gain nevertheless crystallises, in the hands of the foreign seller (other than through withholding by a tax agent) there can be no tax assessed at all.

This conclusion remains rather debatable, as the Russian tax doctrine has been shifting towards an understanding that the absence of the mechanism to pay the tax does not *per se* eliminate the tax liability. Further it is a widespread misconception to believe that Russian law does not provide for this conclusion. One of the legislative arguments in support of this position has been once voiced by the Constitutional Court in its Decree No 10-P of 22 June 2009, whereby it ruled that the absence of the statutorily fixed procedure to pay the tax by a budgetary institution does not negate the liability to settle the tax and the authorised state bodies may, until such procedure has been established by law, administer the payment mechanism through their sub-laws. It is not excluded that in the event of a pure non-Russian (foreign seller with foreign buyer) transaction the Russian tax authorities (with reference to an opinion from the Ministry of Finance or the Tax Authority) will send a tax bill to the foreign entity-seller if it has been deemed liable to pay the Russian tax on such a capital gain.

Failure to respond by the foreign seller to such a tax claim may conceivably lead to any lien or arrest of any other Russia-based assets, if available, owned by the former non-Russian seller as can be imposed by the tax authorities. Further, the **Multilateral Convention on Mutual Administrative Assistance in Tax Matters** signed by Russia on 3 November 2011 and ratified very recently, on 4 November 2014 by Federal law No. 325-FZ, may serve as a form of particular enforcement support to the Russian tax authorities in this regard.

Concluding remarks

The adoption of the new law No. 367-FZ has raised an unprecedentedly large number of problems and issues to consider. Aside from the earlier noted challenges for conventional foreign JV structures with Russian partners requiring the revision and rethinking of the management platforms and operational strategies in relation to Russian operative companies owned by such JVs, various complexities will have to be resolved by multinational businesses transacting with Russia. The immediately required action points should in particular include:

- reviewing the "beneficiary owner of income" criteria in transactions involving payment of Russia-sourced passive income (dividends, interest and royalties) in terms of risks and functions attached to the foreign payees;
- restructuring operations to move the cross-border income-generating instruments to jurisdictions with the necessary substance for the non-Russian income recipients;
- managing the growing tax residency risks for non-Russian legal entities used as captive vehicles for "Russia only" supply and product distribution chains;
- rearrangement of financing ('back to back' and similar) structures and operations with Russia keeping in mind

greater transparency via the new Notification rules and the extremely broad "capture-all" definitions offered by the new law.

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