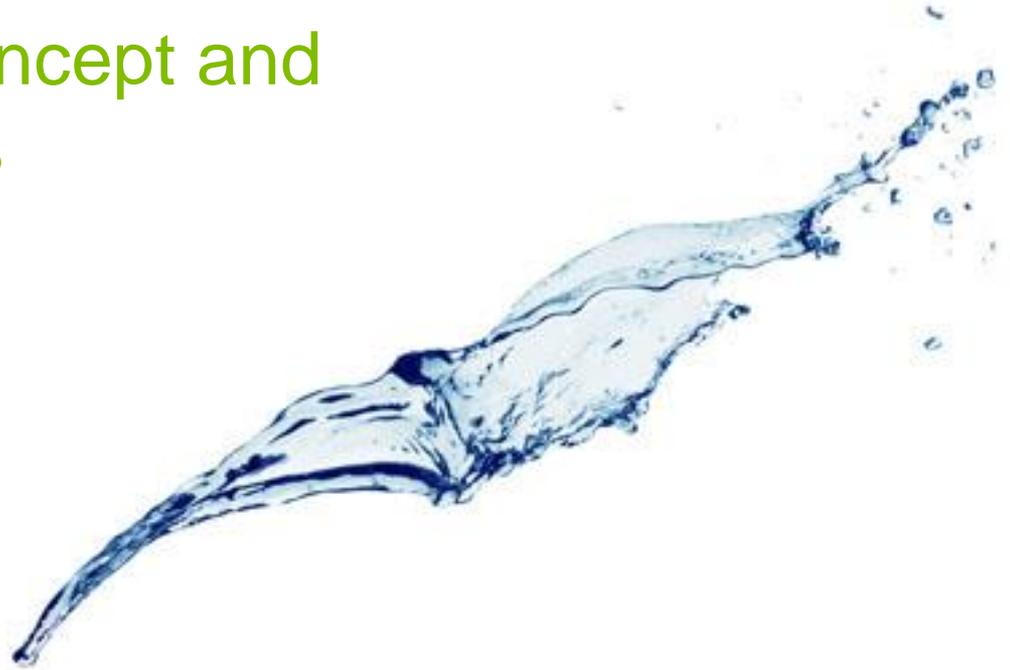




# Beneficial ownership concept and substance requirements



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# Legislative provisions



# Legislative provisions

RF Tax Code Article 7 “International treaties on tax issues”

## **Beneficial owner of income:**

### **person which**

- due to direct or indirect participation in the organization; or
- due to control over the organisation; or
- due to other circumstances

### **has right to**

- use and/or dispose such income;

### **or person for whose benefit such right is used.**

When determining beneficial ownership on income the following is considered:

- Functions performed;
- Risks undertaken.

# Legislative provisions

RF Tax Code Article 7 “International treaties on tax issues”

**Income recipient is not recognised beneficial owner of income for DTT’ purposes if it:**

- has limited powers regarding disposal of the income received;
- performs intermediary functions in respect of the income received without performing any other functions and undertaking any risks;
- directly or indirectly transfers the income (fully or partially) to another person who, if the direct recipient of this income, would not be entitled to apply the provisions of a double tax treaty.

# Legislative provisions

RF Tax Code Article 7 “International treaties on tax issues”

## **“Look through” approach in determining the beneficial owner of income**

If at the moment of payment of income tax agent knows that the income recipient is not the beneficial owner of income:

### Russian tax resident is beneficial owner of income

- For income other than dividends, tax agent would not have an obligation to withhold the tax due;
- For dividend income tax agent would be obliged to withhold the respective tax due;

but would have to inform the tax authorities respectively.

### Foreign tax resident is beneficial owner of income

- Tax agent may apply the DTT signed between Russia and the country of residence of beneficial owner.

# Legislative provisions

## RF Tax Code Article 312 “Special provisions”

### **Beneficial owner of income:**

- Actually benefits from income;
- Determines subsequent economic fate of income.

When determining beneficial ownership on income the following is considered:

- Functions performed;
- Authority given;
- Risks undertaken.

### **Request of confirmation that foreign company is beneficial owner of income**

Tax agent has right to request from foreign company confirmation that it is actually entitled to receipt of such income.

#### Note:

Obtaining by tax agent from foreign income recipient documents confirming its status of the beneficial owner of income (prior payment of income) may be considered as exercising due diligence by tax agent, as such it is strongly recommended practice.

# Legislative provisions

RF Tax Code Article 312 “Special provisions”

## **“Look through” approach to dividend income:**

- Applies when foreign entity receiving dividend income recognizes that it is not actually entitled to this dividend income (i.e. it is not a beneficial owner).
- Applies to the person directly or indirectly participating in Russian entity paying dividend income.
- Specific provisions for Russian tax resident person recognised as beneficial owner of dividend income (including possibility of application of 0% tax rate for legal entities).

## **Documentary confirmation for “look trough” approach to dividend income**

Tax agent has right to request from foreign company and person being beneficial owner of dividend income confirmation, that this company is not entitled to the income received (i.e. is not a beneficial owner of income) and information about the person which the foreign company is recognising as beneficial owner of the income.

# Legislative provisions

Letter No. 03-08-05/36499 of the Ministry of Finance of the Russian Federation of 24 July 2014

## **Documents confirming possession of actual right (beneficial ownership) to dividend income:**

1. Evidence as to whether or not income recipient enjoys discretion with regard to the disposal and use of dividends received, including:
  - Documents confirming (refuting) the existence of contractual or other legal obligations to third parties (whose place of residence or registration is not a treaty jurisdiction);
  - Documents confirming (refuting) the predetermined nature of the subsequent transfer of funds by income recipient to third parties (whose place of residence or registration is not a treaty jurisdiction);
2. Documents (information) confirming that the income recipient whose place of registration or residence is a treaty jurisdiction “incurs tax obligations which are payable and the existence of which confirms that no saving on tax at source in Russia was made upon the subsequent transfer of funds received to third parties” (whose place of residence or registration is not a treaty jurisdiction);
3. Documents (information) confirming that the income recipient carries on actual entrepreneurial activities in the jurisdiction in which it claims tax residence for treaty purposes.

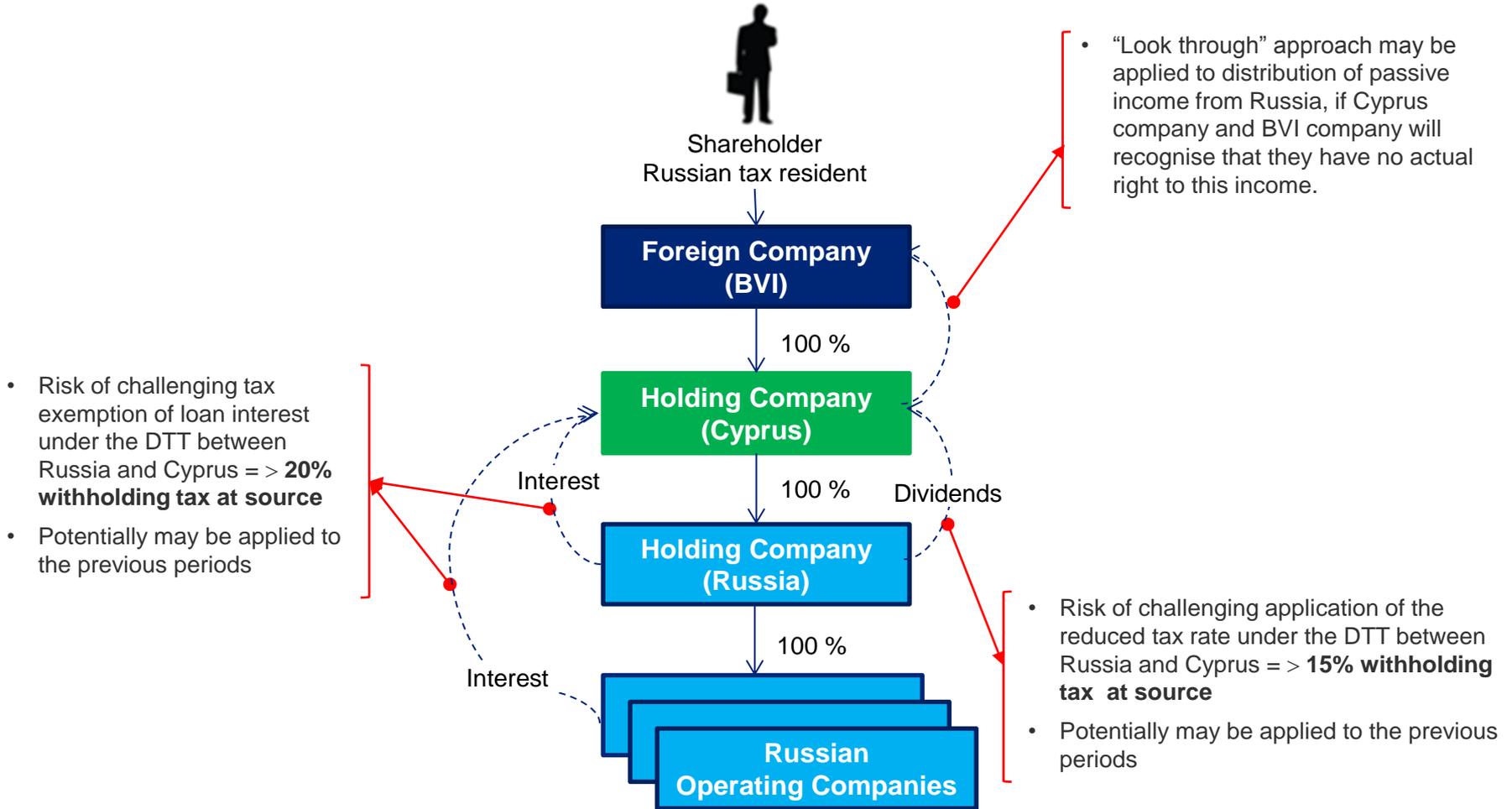
Following the Ministry of Finance’s approach the fact that specific documents necessary for the definition of beneficial owner of income are not mentioned in the Tax Code indicates that legislator does not limit tax agents by any list, giving precedence to the substantial part of the information, received by tax agent.

# Impact on application of benefits of DTT between Russia and Cyprus



# Impact on application of DTT between Russia and Cyprus

## Identification of beneficial owner: possible effect



# Impact on application of DTT between Russia and Cyprus

Identification of beneficial owner: key factors increasing the risk

- Income recipient has no substance in the country of tax residency (no office, no duly qualified employees, etc.);
- Income recipient does not bear usual commercial risks related to its activity;
- Existence of legal obligations of transfer (distribution) of income received to the benefit of other person;
- Nominal directors or limited competency of the board of directors;
- «Mirror» transactions on the same or substantially similar conditions (e.g. back-to-back financing);
- Provision of loans to Russian companies only by means of loans received from companies incorporated in countries, having no DTT with Russia (e.g. BVI);
- No other activities, besides that one which income is tax exempt (taxable at reduced tax rates) under provisions of DTT.

# Impact on application of DTT between Russia and Cyprus

## Identification of beneficial owner: general recommendations

- Cyprus companies should have substance relevant to their functional business activity (e.g. have office and duly qualified employees in Cyprus);
- Cyprus companies should possess a sufficient degree of independence in disposal of income;
- Cyprus companies should not distribute all or almost all income received to companies incorporated in countries, having no DTT with Russia;
- Cyprus companies should bear risks associated with performed activities, independently take decisions and exercise control over the received income.
- Cyprus companies should earn market level of margin from carrying on financial activities.
- Carrying on other types of activities and earning other types of income may serve as a positive factor for Cyprus companies.

# Final clauses



# Final clauses

## Why now?

- Concept of Beneficial Ownership has been codified effective 1 January 2015;
- Potentially very broad application with limited guidance from authorities;
- Increased fiscal scrutiny over treaty abuse;
- A number of unfavourable court cases;
- “Look through” rules are introduced but subject to additional documentation requirements.

# Final clauses

## Who is affected?

- Multinational companies with Russian operations;
- Russian OpCo making outbound dividend, royalties, interest payments to foreign group companies;
- Foreign income recipients having insufficient substance, decision-making power or otherwise not qualifying as “beneficial owners of income” according to the new Russian rules;
- Russian OpCo or Foreign Recipient benefiting from provisions of the Double Tax Treaty (DTTs), e.g.:
  - i. reduced/zero withholding tax (WHT) rates;
  - ii. unlimited deduction of certain expenses which otherwise would have been limited under domestic law.

# Final clauses

## Risks

- Loss of treaty protection for outbound dividends, interest, royalties;
- Penalties for the withholding agent;
- Potential loss of other treaty benefits (e.g. unlimited deduction of marketing expense under Russian-German DTT, etc.) through application of unjustified tax benefit concept;
- Increased compliance burden.

# Final clauses

## How we can help

- To analyse corporate governance mechanisms, focusing on organization of decision-making processes in the Group (governing body, residency of individuals in the body, place of the Board);
- To analyse the substance of foreign income recipients, their main activities, functions and risks, ability to independently operate and determine future economic destiny of income received, contractual or any other limitations/ commitments;
- To review and understand funding flows;
- To understand business process of the structure, including fund flows, jurisdictions of shareholders and income recipients;
- To develop documentary support needed for substantiation of beneficial ownership rights;
- To affect functional, substance, other structural changes, if and as required.

# Thank you for your attention!

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