Draft Law on CFCs: edition dated 26 August 2014

8 September 2014

On 2 September 2014 the latest edition of the Draft Law on taxation of the profits of controlled foreign companies ("the Draft Law") was published on the official website of the RF Ministry of Finance. According to the information published on the site, the Draft Law was introduced for discussion to the RF Government on 26 August 2014.

We cannot exclude the possibility that the current edition of the Draft Law may be close to the final version. For this reason, we highly recommend paying close attention to its provisions when developing your business strategy.

Previous issues of *LT: In Focus* dealing with the Draft Law (27 May 2014; 30 May 2014) covered editions officially published on 19 May 2014 and 27 May 2014 respectively. In this issue, we cover the main distinguishing features of this latest edition of the Draft Law.

A number of provisions of the Draft Law have remained unchanged. These include provisions stating that a company is considered a controlled foreign company ("CFC") if the jurisdiction of its tax residency is not included on the so-called "white list" of jurisdictions (i.e. if a company is tax resident in a jurisdiction with which Russia does not implement tax information exchange), and/or if its effective profits tax rate is not greater than 15 percent. The tax rates applicable to the profits of CFCs remain at their previous level (13 percent for individuals; 20 percent for legal entities). In addition, provisions stating that the profits of CFCs from previous periods are not subject to inclusion in the tax base of the controlling party remain unchanged in the latest edition of the Draft Law, as does the approach to determining the beneficial owner of income.

It is worth mentioning that the RF Ministry of Finance has taken into account some comments and ideas provided by the business community, including those reflected in the edition of the Draft Law prepared by the Russian Union of Industrialists and Entrepreneurs (see *LT: In Focus* dated 12 August 2014), such as:

- All publicly-listed (on Russian and foreign stock exchanges) companies are excluded from categorisation as CFCs, as are their direct and indirect foreign subsidiaries, as well as organisations participating in projects under production sharing agreements, concessionary agreements or other similar agreements concluded with authorised bodies of a foreign state.
- The minimal threshold that the profits of a CFC must reach in order to be included in the income of the controlling party is set at the level of 10 million RUB (50 million RUB in 2015; 30 million RUB in 2016).
- The Draft Law provides for the exemption of taxpayers from the payment of fines incurred due to failure to include the profits of a CFC in the tax base, effective until 2018.
- The Draft Law introduces the "look-through" principle, applied when determining the status of the beneficial owner of income in the form of dividends. It should be noted that if the beneficial owner of income in the form of dividends distributed by a Russian company to a foreign company is a Russian tax resident, this income may be taxable at source at a rate of 0 percent or 9 percent. Provided the beneficial ownership right of said Russian tax resident to receive these dividends is confirmed upon the distribution of the dividends by the Russian company to the foreign company, they are exempted from taxation upon their actual receipt in Russia.

The new edition of the Draft Law also contains the following distinguishing features:

Controlled foreign companies

- The following organisations are excluded from categorisation as CFCs:
  - Banks and insurance companies that are tax resident in countries cooperating with Russia in the international exchange of tax information (i.e. countries on the "white list").
  - Eurobonds issuers, organisations authorised to receive interest on bonds, and organisations which were assigned the rights and responsibilities with regard to Eurobonds issued by another foreign organisation.
  - The structures which are not separate legal entities, provided they meet certain conditions, in particular:
    - The settlor of a structure which is not a separate legal entity is ineligible to take ownership of the structure's property following its establishment in accordance with the regulations and constituent documents of the structure.
    - The rights afforded to the settlor of the structure which is not a legal entity due to the settlor's personal status (including the right to dispose of property, determine beneficiaries, etc.) cannot, in accordance with the regulations and constituent documents of the structure, be transferred to another party following the establishment of the structure, except by means of inheritance or universal legal succession.
    - The settlor of the structure which is not a legal entity does not have the right to receive, either directly or indirectly, any of the profits of the structure that are distributable among its participants (interest holders, trustees, etc.) or beneficiaries.

    It should be noted that a foreign structure cannot be considered a CFC until it is made possible, in accordance with the regulations and constituent documents of the structure, to distribute profits among its participants (interest holders, trustees, etc.) or beneficiaries.
- The share ownership threshold for the purposes of establishing a controlling party is raised to 25 percent. The 10 percent threshold is retained for cases in which the combined direct/indirect participation of Russian tax residents in the capital of an organisation exceeds 50 percent. There is also a transitional provision, which classifies a party as controlling if the party's participation in a CFC exceeds 50 percent. It is envisaged to remain in effect until 1 January 2017.
- The Draft Law introduces the conditions for determining participation where it is realised via a repo agreement or securities lending agreement.
- When determining the profits of a CFC, only the conditions envisaged by the new Article 309.1 of the RF Tax Code are applied. In should also be noted that there are provisions envisaging the necessity to confirm the profits of each CFC with both its financial and tax accounting records.
- The Draft Law envisages the possibility to claim as an offset the tax paid on the profits of CFCs in accordance with Russian legislation, including profits tax paid by a permanent establishment of a CFC in Russia.
- The controlling party is obligated to notify the tax authorities of the party's participation in all foreign companies in which the ownership exceeds 10 percent (the Draft Law envisages a transitional provision, by which the requirement to notify the tax authorities is restricted to controlling parties whose participation exceeds 25 percent, to remain in effect until 1 January 2017). The notification should be provided regardless of whether the foreign company in question is considered a CFC, i.e. in respect of CFCs the Draft Law introduces the requirement to submit two separate notifications (one on participation in a foreign company; the other on participation in a CFC).
- Taxpayers are also obligated to notify the tax authorities on their participation in all foreign structures which are not legal entities (including when the taxpayer is the settlor or a beneficiary of said structure).
- The deadline for notifying the tax authorities on participation in foreign companies is extended to one month (from the date on which grounds for submitting said notification either arise or change). In addition, a deadline is introduced for submitting notifications on the cessation of participation in foreign companies, set at one month from the date on which participation is terminated.

- The Draft Law introduces provisions stating that, during the liquidation of a foreign company, the income received by its shareholder considered a controlling party in the form of property or property rights is not subject to profits tax. These provisions are planned to remain in effect until 1 January 2019.

Determining the tax residency of entities

- The Draft Law provides clarification regarding the key criteria for determining whether the place of actual/effective management of a company is considered to be in Russia. In particular, these are:

  1) Meetings of the Board of Directors or other management body are primarily (i.e. more than half of the meetings within a calendar year) held in Russia.
  2) Management of the company is primarily conducted in Russia.
  3) The company's main officials (i.e. parties authorised and obliged to plan, manage and exercise control over the activities of the company) primarily conduct their activities with regard to the company in Russia.

- Moreover, clarification is provided regarding the meaning of "management of the company", which refers to decision-making and other actions relating to issues of the current activities of the company and falling within the competency of the management bodies.
- The management of the company will be considered conducted outside Russia if the company is a tax resident of a state with which Russia has concluded a Double Tax Treaty and that company's commercial activities are conducted with the use of the company's own qualified staff and assets in that state.
- The Draft Law clarifies that preparation and/or decision-making conducted in Russia with regard to the competency of the general shareholders' meeting may not be considered as the management of the company.
- This edition of the Draft Law allows companies from low-tax jurisdictions on the RF Ministry of Finance "black list" to independently declare themselves Russian tax residents if they conduct their activities in Russia via a separate subdivision (this right was previously exclusive to companies from jurisdictions not included on the RF Ministry of Finance "black list").

Taxation of capital gains from the indirect transfer of real estate

- The following types of capital gains, connected with the indirect transfer of Russian real estate, are added to the list of income that is not considered Russian-sourced and is thus not subject to withholding tax in Russia:

  - Capital gains from the disposition of shares/interest in foreign companies or structures which are not separate legal entities with at least 50 shareholders/participants, provided each shareholder/participant owns no more than 5 percent of the company/structure.
  - Capital gains from the disposition of shares/interest, provided that on the date of disposition those shares/interest had belonged to the taxpayer for over five years.

- The Draft Law introduces a requirement for foreign companies and structures which are not legal entities that own real estate in Russia to provide the tax authorities with information on their participants (and, in certain cases, on indirect participants; foreign structures which are not legal entities must provide information on their settlors, beneficiaries and trustees). Failure to provide this information or failure to provide it in a timely manner will be met with a fine equal to 100 percent of the amount of property tax payable on that real estate.

Other features

- Provisions stating that debt owed to foreign "sister" companies may be considered controlled for the purposes of compliance with the thin capitalisation rules have been removed from the Draft Law.

- The new edition of the Draft Law includes a requirement stating that, in order to apply the provisions of Double Tax Treaties to the distribution of income to a foreign company, the tax agent must obtain, in particular, the tax residency certificate of the foreign company which is a beneficial owner of that income. Thus, the concept of "beneficial ownership" may apply not only to "passive" income, such as dividends, interest and royalties, for which beneficial ownership rights are required in order to apply Double Tax Treaty provisions, but also to other types of income for which no such requirement exists (e.g. income from the sale of shares in Russian real estate rich companies).

- Finally, the Draft Law removes the favourable profits tax regime by which income received by Russian companies in the form of property transferred free-of-charge is exempt from taxation if the transferring party owns over 50 percent of the charter capital of the recipient party, or if the recipient party owns over 50 percent of the charter capital of the transferring party.

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