

24 March 2014



On 18 March 2014, the RF Ministry of Finance (hereinafter, “the Ministry of Finance”) presented a draft Federal Law “On amending Parts I and II of the RF Tax Code (in respect of taxation of profits of controlled foreign companies and increasing the efficiency of tax administration with respect to foreign companies)” (hereinafter, “the Draft Law”).

The provisions of the Draft Law are the results of work undertaken by the Ministry of Finance in order to implement measures previously announced under the RF Government’s action plan to counteract the offshorisation of the Russian economy. In particular, the new rules cover the following issues:

1. Taxation of the profits of controlled foreign companies (hereinafter, “the CFC rules”).
2. Determination of the tax residency status of legal entities.
3. Taxation of income from the indirect sale of shares in real estate rich companies (more than 50% of the value of the assets of which directly or indirectly consists of real estate located in Russia).

Please see more detailed comments on the issues outlined below.

## 1. Taxation of the profits of controlled foreign companies

### Controlled foreign companies

For the purposes of applying the CFC rules, a *controlled foreign company* is defined as:

- A foreign legal entity that meets all of the following requirements simultaneously *during any period, that starts or finishes within a calendar year*.
  - The legal entity is not considered to be a Russian tax resident based on the RF Tax Code (hereinafter, “the Tax Code”) or in accordance with the provisions of a double tax treaty (hereinafter, “DTT”);
  - The legal entity is considered to be a tax resident of a country (territory) included on *the list of countries and territories providing favourable profits tax regime* approved by the Ministry of Finance;
  - The controlling persons of the legal entity are legal entities and/or individuals considered to be Russian tax residents in accordance with the Tax Code or a DTT;
  - Shares in the legal entity are not listed and/or have not been admitted to listing on one or more stock exchanges included on the list approved by the Central Bank of Russia (hereinafter, “the

CB RF”) in coordination with the Ministry of Finance<sup>1</sup>;

- A structure (in particular a *fund, partnership, or other form of collective investments*) (hereinafter, “the structure”):
  - Set up in accordance with the legislation of a country (territory) included *on the list of countries and territories providing favourable profits tax regime* approved by the Ministry of Finance;
  - Is not a separate legal identity;
  - Which is, in accordance with its personal law, entitled to carry out profit-generating business activity on behalf of its participants (beneficiaries, partners, principals and other persons);
  - Has controlling persons that are legal entities and/or individuals considered to be Russian tax residents in accordance with the Tax Code or a DTT.

#### Note:

- *There is currently no clear understanding as to whether the “list of countries and territories providing favourable profits tax regime, approved by the Ministry of Finance”, is analogous to the so-called “blacklist” approved by RF Ministry of Finance Order No. 108n of 13 November 2007. Therefore, debates on the possible introduction of a special “extended” or “grey” list of countries and territories, where companies, resident for tax purposes, may be covered by the CFC rules, that may include other non-offshore territories (e.g. Cyprus, Luxembourg), remain relevant.*
- *The definition of a “structure” provided herein is not clear when it comes to determining whether or*

*not trusts are covered by the CFC rules. However, we understand that the intention of the Ministry of Finance was to extend the application of these rules to trusts.*

- *It is still unclear whether certain agreement structures created in accordance with foreign legislation which are not allowed to perform business activities (e.g. “family foundation”, created for strictly defined noncommercial purpose, namely to provide financial support to members of one or more families, charity, etc.) may be considered as formally not covered by the CFC rules.*

#### Controlling persons and control

As regards *the controlling persons of an entity – including structures, as mentioned above – established under the laws of a foreign jurisdiction, the Draft Law provides the following definition:*

- A person who, either alone or in conjunction with other persons, exercises control over a company (structure).

Under the CFC rules, exercising control **over a company** involves the following:

- effectively exercising or being able to exercise *decisive influence* over decisions taken by this company:
    - *in relation to the distribution of its profits (income) after tax;*
  - due to direct or indirect participation in this company reaches more than 10%, including that in conjunction with spouse and/or minor children as well as other persons (taking into account the relationship between the parties involved)
- or
- due to participation in a contract (agreement) whose subject is the management of the company or other features of the relationship between a person and the company and/or other persons.

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<sup>1</sup> The RF Federal Service for Financial Markets Order No. 12-91/pz-n of 25 October 2012 “On approving the list of foreign stock exchanges and foreign depository-clearing organisations used for the purposes of confirming the qualification of bonds and other debt securities as circulated on the organised market in accordance with Article 310 of the RF Tax Code” (registered with the RF Ministry of Justice on 7 December 2012 No. 26040).

Exercising control **over a structure** means the following:

- Effectively exercising or being able to exercise decisive influence over decisions taken by a person managing the assets of the structure,
  - in relation to the distribution of its profits (income) after tax between its participants (beneficiaries, partners, principals and other persons) in accordance with the legislation of a foreign jurisdiction or an agreement.

**Note:**

- *We assume that the criteria established in the Draft Law of a participation threshold of 10% may be subject to further discussion with the business community. In accordance with international practice, a 10% stake in a foreign company/structure is not in line with commonly accepted interpretation of control over its activities. In this regard, CFC legislation in various foreign jurisdictions provides participation threshold which exceeds 10% (with the exception of Kazakhstan and a few other jurisdictions).*
- *The terms of “decisive influence” and “ability to exercise influence” over decisions used for definition purposes are ambiguous. The Draft Law does not provide clarifications with respect to criteria that may be used to assess the degree of influence held by a person as decisive for making decisions regarding the business of a CFC.*

**Profits of a CFC**

- The profits of a CFC are defined as the profits of the company, *calculated in accordance with the provisions of Chapter 25, Part II of the Tax Code*, less the amount of dividends distributed from these profits.
- The amount of the profits of a CFC should be confirmed by its financial statements for the period (periods) under consideration and other supporting documents.
- The profits of a CFC expressed in a foreign currency must be recalculated into rubles using the

official currency exchange rate set by the CB RF on the last day of the calendar year.

**Note:**

- *The procedure for determining the profits of a CFC is ambiguous, as the profits of a CFC must be calculated in accordance with Russian tax accounting rules while being confirmed by the financial statements of a foreign company, which could lead to discrepancies.*
- *During the preliminary discussions on the CFC rules, it was assumed that, for the purposes of the rules, the profits of a CFC may be limited to passive income of the company (as provided by CFC legislation in many foreign jurisdictions). However, under the current Draft Law, the CFC rules extend to any income received by companies in low-tax jurisdictions, including income derived from active commercial activity.*
- *Moreover, it was initially supposed that in order to determine the profits of a CFC, the Russian tax authorities would be limited to reviewing the ownership structure of controlling persons at the level of foreign companies located in reputable jurisdictions. For this purpose it was assumed that a company in a low-tax jurisdiction that is the subsidiary of a company located in a reputable tax jurisdiction should not be recognised as a CFC. However, these provisions are not included in the Draft Law.*
- *The Draft Law does not contain a clarification of which standards (e.g. IFRS, U.S. GAAP) may/should be followed by a CFC when preparing its financial statements. The issue of the relevance of the accounting data of the CFC for the purposes of calculating profits tax remains open, especially in cases where the legislation in the foreign jurisdiction does not provide a requirement to perform an audit of the financial statements.*
- *The requirement to express the profits of a CFC in rubles using the official exchange rate set out by the CB RF on the last day of the calendar year contradicts the definition of “CFC”, which suggested that the criteria for recognising a controlled company should be fulfilled during*

during any period, that starts or finishes within a calendar year. We assume that this issue will require further clarification from the Ministry of Finance.

#### Accounting for profits of a CFC for tax purposes

- According to the Draft Law, the profits of a CFC should be taken into account when determining the tax base of taxpayer which is the controlling person proportionally in accordance with to that person's ownership interest in the controlled company, and in on the basis of the period for which the taxpayer has been recognised as a controlling party (if less than the duration of the tax period).
- If it is impossible to determine the ownership interest of a controlling person for the purposes of applying the CFC rules, profits should be accounted *for in full* when determining the tax base of the controlling person.
- If dividends are distributed by a CFC from the retained earnings of previous years, and if the actual recipient (beneficial owner) is a Russian tax resident, the tax base for dividends is reduced by the amount of profits of the CFC that were previously accounted for the tax base of this person as a result of application of the CFC rules.
- The tax base determined by controlling person with respect to the profits of a CFC cannot be reduced by expenses related to other activities or losses resulting from other activities of those persons.

#### Note:

- *The Draft Law does not contain any criteria defining the term of "actual recipient" ("beneficial owner") of dividends, so the interpretation of this term is subject to uncertainty.*
- *There is no clarification as to whether the profits of a CFC from before the introduction of the Draft Law may be excluded when determining the tax base of the controlling person.*

#### Applicable tax rates

- For individuals – 13%.
- For legal entities – 20%.

#### Note:

- *The tax rate applicable to the profits of a CFC is higher than the tax rate on actually distributed dividends (9% or 0%).*
- *Considering the fact that when paying dividends from the profits of a CFC that have previously been accounted for the tax base of its controlling person, the offset is ensured by reducing the dividend tax base, but the tax paid "in excess" is non-refundable, we believe that the intention of the authorities is to stimulate the actual flow of dividends in Russia on a regular basis.*

#### Notification on participation in foreign companies

According to the Draft Law, Russian resident taxpayers are obliged to notify the tax authorities on their participation in a CFC within 20 days of this obligation arising.

In particular, a notification on participation in a CFC must be submitted by Russian resident taxpayers with respect to the following:

- Foreign companies that are tax residents of a country (or territory) included on the list of countries and territories approved by the Ministry of Finance or for which no data related to tax residency is available, *provided direct and/or indirect ownership interest in these companies is 1% or more*, and foreign companies for which the taxpayer is recognised as a controlling person (e.g. by virtue of participation in the management contract);
- Any structure, provided the taxpayer is the beneficial owner of income distribution from this structure, or is recognised as the controlling person of the structure.

## Types of tax offense and sanctions

### Failure to provide the tax authorities with the information necessary to carry out tax audit

- Failure to submit information to the tax authorities regarding direct or indirect participation in a CFC and corresponding profits, resulting from refusal to submit all available documents, evasion of proper submission of documents or submission of documents containing deliberately false information will lead to a fine of *RUB 100,000* being imposed on the controlling person.

### Non-payment or incomplete payment of tax due to the non-inclusion of the profits of a CFC in the tax base

- The non-payment or incomplete payment of tax by the controlling person as a result of the failure to include the profits of a CFC into the tax base will lead to a fine of *20% of the CFC profits*, to be included in the tax base, with a minimum of *RUB 100,000*, being imposed on the controlling person.

### Illegal failure to notify the Russian tax authorities regarding a CFC, submission of false information regarding a CFC

- Illegal failure to notify the Russian tax authorities regarding a CFC within the established timeline for a given calendar year, or the submission by a controlling person of a notification containing false information regarding a CFC, shall result in a fine of *RUB 100,000* being imposed on the controlling person in respect of each CFC for which no correct notification was submitted.

#### Note:

- Please note that this fine also applies to persons with direct or indirect participation in a CFC if their stake amounts to 1% or more.

## 2. Definition of “tax residency” for legal entities

- The Draft Law introduces new criteria for determining the tax residence of a legal entity. In particular, the following legal entities shall henceforth be treated as Russian tax residents:

- Russian legal entities;
- Foreign legal entities considered Russian tax residents based on an applicable DTT;
- Foreign legal entities with *their place of effective management* in Russia.
- The place of effective management of a foreign legal entity is considered located in Russia if at least one of the following conditions is met:
  - Meetings of the Board of Directors (or other governing body of an entity) are held in Russia;
  - Management of the entity is habitually exercised in Russia;
  - Key managers and employees perform their duties in Russia;
  - Accounting books and records are kept in Russia;
  - Archives are kept in Russia.

#### Note:

- The Draft Law provides for the recognition of a foreign entity as a Russian tax resident if at least one of the above conditions is met.

## 3. Taxation of income from the indirect sale of shares in real estate rich companies (more than 50% of the assets of which consists of real estate located in Russia)

- According to the Draft Law, income from the sale of shares in an entity (including a foreign legal entity), more than 50% of the assets of which directly or indirectly consists of real estate located in Russia, as well as financial instruments derived from those shares, except for shares that are publicly traded, will be taxed at the source in Russia.

#### Note:

- The Draft Law does not contain clarifications regarding the mechanism of collection of tax at source with respect to income from the sale of shares in a foreign legal entity that indirectly (through one or more entities) owns real estate located in Russia.

- *There are no comments on how to determine the value of assets with regard to the 50% threshold rule (net book value/market value).*
- *The date on which the provisions of the current version of the Draft Law come into effect is unclear, as it varies for individuals and legal entities:*
  - *For individuals: no earlier than the first day of the following tax period for personal income tax;*
  - *For legal entities: no earlier than one month after the official publication date of this Federal Law.*

**Note:**

- *Due to these provisions, legal entities may be obliged to notify the tax authorities regarding participation in a CFC in 2014, and individuals – from 1 January 2015.*
- *Depending on the final version of the Draft Law, the following steps and actions may be taken to minimise tax consequences and risks:*
  - *Distribution of dividends to the controlling persons in 2014 and respective taxation of these dividends in Russia;*
  - *Reinvestment of retained profits into other projects in 2014, or their capitalisation;*
  - *Optimisation of the corporate structure, including steps to liquidate CFC or migrate it to respectable tax jurisdiction;*
  - *Diagnostics of the group's corporate structure, documents, facts of activities and processes with respect to operations involving foreign companies, in order to assess the applicability of the concept of "tax residency"; in the event of identification of tax risks, modification of approach to the group's presence abroad, as well as to the structure and nature of the operations of foreign companies.*

# Contacts

If you have any questions in regard with the information provided in this review, please feel free to contact our Tax & Legal specialists:

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