



## LT in focus

# Amendments to CFC rules and voluntary declaration of property legislation

On 20 May 2015, the State Duma adopted draft law № 714002-6 "On amending Parts I and II of the RF Tax Code" (hereinafter - the "Draft Law") at its third reading. The Draft Law introduces amendments to the controlled foreign company (CFC) rules and to the definition of tax residency for legal entities, adopts new provisions regarding the voluntary declaration of property by individuals, extends the procedure for applying corresponding adjustments, and introduces amendments to the excise tax regulation rules and determination of depreciable property.

In this alert, we comment on the proposed amendments to the CFC rules, tax residency of legal entities and the voluntary declaration of property by individuals.

Below is a summary of the most essential elements of the Draft Law:

- The Draft law introduces a tax-free liquidation of foreign companies owned by Russian tax resident individuals. In certain cases, such a liquidation can be accomplished even after 1 January 2017.
- The criteria for the recognition of an individual as a controlling person of structures established in any form other than a legal entity have been changed. A person is considered to be a controlling person if this person is the founder of the structure (with certain exceptions) or exercises control over the structure and, at the same time, has the right to receive income or property from it (i.e. beneficiaries keeping control over the structure). These rules also apply to legal entities for which participation in equity is not envisaged by their local law.
- A person will not be considered a controlling person of a foreign company if the participation in this foreign company is structured exclusively through direct or indirect participation in a Russian listed company (one or several).
- The following items are exempt from taxation:
  1. CFC income in the form of dividends from Russian sources when the Russian tax resident controlling person is the beneficial owner of the dividends;
  2. Income of controlled foreign sub-holding companies participating in the capital of foreign companies which receive income (at least 80%) from active business, subject to certain requirements with respect to shareholding and the duration of participation, as well as the jurisdiction of tax residence.
- Holding Board of Directors meetings in Russia will no longer be considered grounds to recognize an entity as a Russian tax resident based on the effective management criteria.
- Secondary criteria for recognition of an organization as a Russian tax resident will apply only in case the main criteria are met both in Russia and another jurisdiction.
- The possibility to voluntarily claim Russian tax resident status has been extended to all foreign organizations (including those registered in low-tax jurisdictions).
- A tax exemption has been introduced with respect to transfers of property from the nominal owner to a Russian individual under the voluntary declaration procedure.
- Procedural warranties have been introduced in relation to the interdiction of using the special declarations as grounds for tax audits or assessment of tax liability and collection of taxes.



Further, we provide detailed comments on the key amendments and propositions.

## 1. Controlled foreign companies (CFC) rules

### *Controlling persons*

- A person is not recognized as a controlling person of a foreign organization if this person's participation in the organization is structured exclusively through direct and/or indirect participation in a Russian listed company (one or several).
- As a general rule, the founder of a structure established in any form other than a legal entity is the controlling person of the structure, except when all of the following conditions are met:
  1. The founder is not entitled to receive (claim) directly or indirectly any profits (income) from the structure;
  2. The founder is not entitled to manage the profit (income) related affairs of the structure;
  3. The assets are contributed to the structure on an irrevocable basis (i.e. the founder does not have a right to reclaim the assets from the structure on the basis of the applicable law or the structure's constituent (formation) documents (contract) during the entire period of this structure's existence, or at the time of its liquidation/termination);
  4. The founder does not control the structure (i.e. does not influence or have the ability to influence decisions regarding the distribution of the profits (income) received by the structure).

In view of the above, a reservation by the founder of any right under items 1-3 would result in the founder being considered a controlling person of the structure established in any form other than a legal entity.

- Apart from the founder, any person exercising control over a structure established in any form other than a legal entity can be considered a controlling person of the structure if any of the following conditions is met:
  1. The person is the beneficial owner of the income of the structure (the concept of "beneficial ownership" should be understood in the sense of paragraph 2 of Article 7 of the RF Tax Code, i.e. it may include a wide range of persons, directly or indirectly receiving economic benefit from a foreign structure established in any form other than a legal entity);
  2. The person has the right to dispose of the structure's assets;
  3. The person has the right to receive the assets of the structure upon its liquidation/termination.
- The Draft Law contains a provision stating that the 'control test' for structures established in any form other than a legal entity also applies to legal entities which, by virtue of the applicable foreign law, have shareholders/members participating in its capital.

### *Exemption of CFC income from taxation*

- The list of conditions for the exemption of CFC income from taxation has been adjusted as follows:
  1. The exemption for certain foreign structures established in any form other than a legal entity has been removed (however, it is compensated by the change in the procedure for determining a controlling person of a foreign structure, as described above).
  2. It has been clarified that to benefit from the exemption, a EAEU company should be a tax resident in the EAEU State;
  3. The profits of *active foreign companies*, *active foreign holding companies* and *active foreign sub-holding companies*. In addition, for the exemption to apply, the tax residency jurisdiction of active foreign holding companies and active foreign sub-holding companies should not be "black-listed" by the Russian Ministry of Finance. With this said, please note the following:

*An active foreign company* is a foreign company with a share of passive income not exceeding 20%.

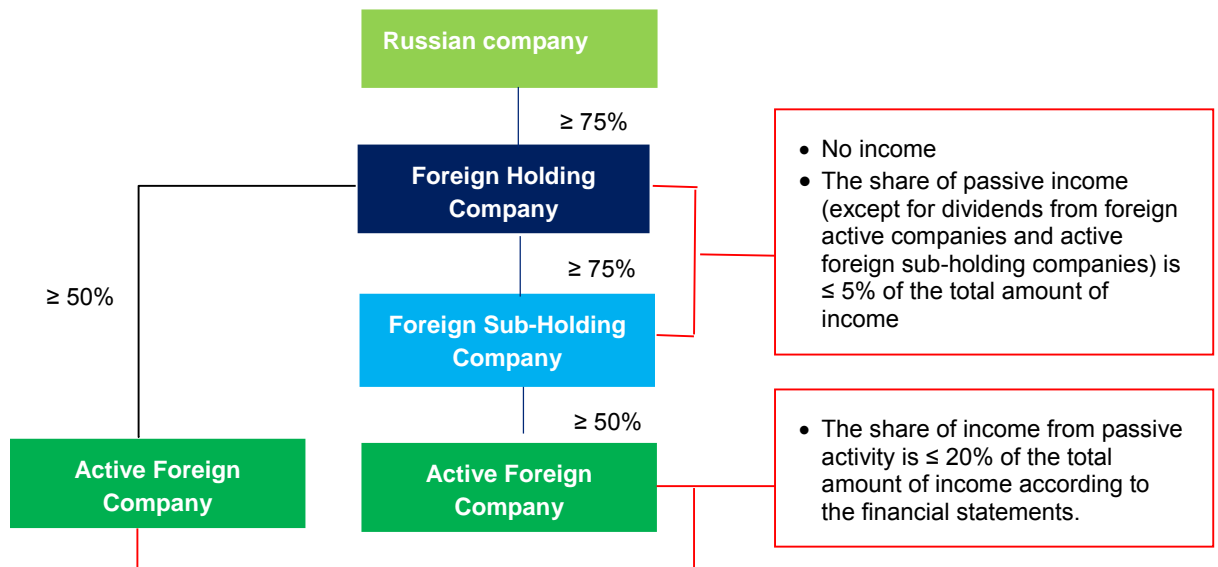
*An active foreign holding company* is a foreign company meeting all the below conditions:

- It is directly owned by a Russian company by more than 75% for a period of at least a year;
- It has no income, or its share of passive income (apart from the dividends received from active foreign sub-holding companies or active foreign companies) does not exceed 5%.
- It has a direct interest of at least 50% in active foreign companies for an uninterrupted period of at least a year;
- It has a direct interest of at least 75% in active foreign sub-holding companies for an uninterrupted period of at least a year.

Similarly, a foreign company is recognized as an active foreign sub-holding company when:

- It is directly owned by a foreign holding company by more than 75% for a period of at least a year; and
- It has no income, or its share of passive income (apart from the dividends received from active foreign companies) does not exceed 5%.
- It has a direct interest of at least 50% in active foreign companies for an uninterrupted period of at least a year.

Below is an illustrative example of a holding structure where the CFC income is exempt from taxation in the hands of the Russian tax resident controlling person:



Please note that, provided the definition of an “*active foreign holding company*” prescribes the need for simultaneous fulfilment of all the conditions, it is unclear whether the exemption may apply to a foreign holding company participating in active foreign companies, but without any interest in active sub-holding foreign companies.

- A new provision has been introduced stating that the dividends paid by Russian companies will not be included in CFC income if the Russian resident controlling person is the beneficial owner of the Russian-sourced dividends;
- The Draft Law still does not address the double taxation issue regarding the dividends paid out of previously taxed CFC profits.

#### *Other provisions*

- The documents that a controlling person must submit along with the individual income tax (corporate income tax) return has been clarified as follows:
  - A CFC’s financial statements must be submitted for the period for which the CFC profits are being

reported.

- The auditor's report prepared either due to either the mandatory requirements of the applicable local law, or on a voluntary basis. The Draft Law does not, however, contain any corresponding amendments to Article 309.1 of the RF Tax Code, i.e. it does address whether CFC income may be determined based on the financial statements subject to a voluntary, rather than mandatory, basis.
- A new provision has been introduced stating that proceeds from the liquidation of foreign organizations (structures) will not be considered taxable income for individuals if the following conditions are met:
  1. Together with the tax return, the individual taxpayer has filed an application for the exemption and provided documentation evidencing the book value of the property distributed to the taxpayer as per the records of the liquidated organization (structure); and
  2. The foreign organization (structure) is liquidated prior to 1 January 2017.
- At the same time, the Draft Law states that the tax exemption for income received by an individual upon liquidation of a CFC can be applied even if the liquidation of the CFC is finalized after 1 January 2017, provided that the decision to liquidate the company was made prior to 1 January 2016, and:
  1. The liquidation of the CFC cannot be completed prior to 1 January 2017 due to the restrictions of the CFC's local law, or due to its participation in a court proceeding; or
  2. The local law of the CFC sets a shareholding period which, if not observed upon liquidation, results in the obligation to pay tax in the CFC's tax residency jurisdiction, and the beginning of this period falls on the date prior to 1 January 2015, while its end falls on the date after 1 January 2017.
- Moreover, a provision has been introduced allowing individuals to reduce their taxable income on disposition of the property received from the liquidated CFC by its book value, as indicated in the documents attached to the application for the above tax exemption, capped at the FMV of the property.
- Please note that the Draft Law does not include any provision allowing legal entities to exempt income derived from a CFC liquidation outside of the transition period (i.e. after 2017) from taxation.

## **2. Recognition of foreign entities' Russian tax residency status**

- Holding the majority of the Board of Directors meetings in Russia has been removed from the list of criteria for the recognition of a foreign entity as a Russian tax resident.
- Preparation of management accounts and analysis of the foreign organization's activity in Russia is not considered effective management carried out in Russia (i.e. is not considered as grounds for the recognition of a foreign company as a Russian tax resident).
- It has been clarified that a foreign entity is not considered a Russian tax resident if it carries out business activities by means of its own personnel and assets both in the country of its residence and in countries where its separate fixed places of activity are located.
- Meeting at least one of the secondary criteria for recognition of Russia as the jurisdiction of tax residency of a foreign company (bookkeeping and managerial accounting, work paper management, operational personnel management) is sufficient for such recognition, if the main criteria are simultaneously met in Russia and in any other country (which is confirmed by the foreign organization through the provision of respective documents).
- Legal entities established in jurisdictions with no double tax treaty with Russia are also entitled to voluntarily claim for tax residence in Russia, provided such legal entities have a registered presence (separate subdivision) in Russia. A foreign organization claiming tax residency in Russia is required to have documentation serving as the basis for the computation and payment of respective taxes available at its separate subdivision on the territory of Russia. The Draft Law also clarifies that the possibility of voluntary claims for Russian tax resident status covers active foreign holding and sub-holding companies.
- A foreign company has the right claim itself as a Russian tax resident either from the date of the

submission of the corresponding application or from the 1st of January of the year when the application was filed. A foreign company that has elected to become a Russian tax resident may renounce this status only after the Russian tax authorities have verified the grounds for the renunciation.

- A voluntary claim for Russian tax residency and the subsequent renunciation of such would not impact the right of the Russian tax authorities to consider a foreign company as a Russian tax resident provided the respective grounds exist.

### **3. Changes to the RF Tax Code as per the draft law "On voluntary disclosure by individuals of property and accounts (deposits)" (hereinafter - the "Draft Law on voluntary disclosure")**

- A provision has been introduced ensuring that transfers of property from a nominal owner to the beneficial owner within the scope of the Draft Law on voluntary disclosure should not be considered a taxable disposal (realization) of such property, provided an individual files a respective declaration.
- An individual cannot be assessed or charged any tax on transactions that took place prior to 1 January 2015 relating to the acquisition (forming the source of acquisition), use or disposal of any property, accounts (deposits) and (or) CFCs, provided they are listed in the respective declaration and supporting documentation. However, any tax paid by the nominal or beneficial owner with respect to such property is not considered an overpayment of tax.
- The special declaration cannot constitute grounds for a desk or field tax audit, and information contained either in the declaration itself or in any supporting document cannot be used as evidence of any tax offenses.
- In addition, an individual cannot be held accountable for a tax offense if it was committed upon the acquisition (forming the source of acquisition), use or disposal of the property and (or) the CFC, as well as accounts (deposits), provided they are listed in the special declaration and supporting documentation. The Draft Law does not specify the period(s) covered by the exemption from liability for tax offenses.
- A strict tax secrecy regime has been established for any information included in the special declaration and supporting documentation. The breach of the established tax secrecy regime would lead to criminal liability. The tax authority officials are released from bearing witness to the information and the circumstances, which they became aware of due to the special declaration and supporting documents filed by an individual.
- Should any officials of the State authorities require any confirmation of the information included in the special declaration, they are required to approach the tax authorities that would proceed with the reconciliation/confirmation and deliver a respective opinion. The officials of the State authorities do not have the right to request the special declaration and supporting documents from the tax authorities.

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Taking into account the current legislative activity regarding the deoffshorisation of the Russian economy, we expect further changes in the provisions the RF Tax Code regulating the taxation of foreign companies. The version of the Draft Law under discussion contains only a part of the amendments developed by the Russian Ministry of Finance (see [our newsletter dated 24 March 2015](#)). The issues relating to the determination/calculation of CFCs' profits, the concept of the actual recipient (beneficial owner) of income and a number of other aspects have not been covered. In addition, amendments on the approximation of the CFC rules for individuals and legal entities considered controlling persons are expected.

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