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LT In Focus
Changes in the taxation of profits of controlled foreign companies and foreign organizations

On 29 January 2015, the Russian State Duma approved Draft Federal Law No. 953192-6, which introduces amendments to the Russian Tax Code related to the taxation of controlled foreign companies and foreign organizations (hereinafter, the Draft Law). We expect the Draft Law to be approved by the Federation Council, the upper house of Russia's parliament, and signed by the President in the near future.

The Draft Law envisions a fairly complex enactment scheme. Overall, provisions that improve the taxpayer's position apply retroactively and will cover legal relations that emerged on or after 1 January 2015. Other provisions will be enacted either on the date of the Draft Law's official publication or within a month of its official publication, while yet others will enter into force on 1 January 2017 (provided the relevant law is enacted before December 2016).

The Draft Law introduces amendments to the following provisions of the Russian Tax Code (hereinafter, the Tax Code):

1. **Notification of participation in a foreign organization / founding an entity without a legal personality;**
2. **Taxation rules for the profits of foreign companies that are controlled by Russian tax residents (hereinafter, CFC rules);**
3. **Procedure for acknowledging foreign companies as Russian tax residents;**
4. **Specifics of establishing the beneficial owner of Russian-sourced passive income (dividend, interest and royalty) for the purposes of applying double tax treaties;**
5. **Procedure for taxing profits of foreign companies derived from the indirect sale of real estate located in Russia;**
6. **Non-taxable liquidation of foreign organizations and entities without a legal personality.**

Below we comment on the key amendments and suggestions proposed in the Draft Law.

Notification of participation in a foreign organization / founding an entity without a legal personality

The Draft Law would repeal the obligation to file a notification regarding control over an entity without a legal personality or having a beneficial ownership right to its income. However, the obligation to file a notification regarding the establishment of an entity without a legal personality will still remain in effect.

Taxpayers that participate in foreign organizations solely through Russian public companies will be exempt from filing the notification.

Foreign organizations that have voluntarily acknowledged themselves as Russian tax residents and Russian tax resident entities rendering discretionary asset management services will be obliged to file the notification. In case of the latter, the notification has to be filed only if the assets under management are transferred to a foreign organization or entity without a legal personality.

The Draft Law also extends the due date by which the notification must be filed. It is extended to three months after the grounds to file the notification have arisen. The due date to file a notification of termination of participation in a foreign organization will be extended by three months as well.

Should an individual acquire Russian tax resident status within a calendar year, the notification of participation in a foreign organization or establishment of an entity without a legal personality should be

submitted on or before 1 March of the next year (provided the grounds for submitting the notification are met on 31 December of the year for which the individual is recognized as a Russian tax resident).

The notification of establishment of an entity without a legal personality should contain information as to whether or not the founder of the entity without a legal personality is its controlling person.

CFC rules

Procedure for determining the share of participation in a foreign organization

According to the Draft Law, when determining a person's participation share in an organization, the participation that is carried out through an entity without a legal personality should be taken into account, but only if this person is the controlling person of the said entity. If more than one controlling person exists, the share of each of the controlling persons should be calculated proportionally to its investment in the assets transferred to the entity without a legal personality. Should it be impossible to establish the amount of investment, the controlling persons' shares should be acknowledged as equal, and the size of the share should be established based on the number of controlling persons of the non-legal entity.

This procedure is in line with the clarifications of the controlling authorities that were issued earlier.

Similar rules will be introduced in regards to foreign legal entities that envision no equity participation (i.e. entities with no share capital), thus, eliminating the earlier vagueness as to whether or not CFC rules should apply to foundations.

The Draft Law also clarifies who should be acknowledged as a controlling person of foreign companies that have been transferred to an investment fund or non-state pension fund registered under Russian law. Earlier, there was a view that the fund investor should not be recognized as a controlling person of a foreign entity belonging to the fund due to 1) having no control over the assets transferred into discretionary management and 2) the inability to calculate the investor's share in the fund under the general rules of Article 105.2 of the Tax Code. This view stemmed from the general rule that fund investors have no right to vote on the fund's business/investment strategy or hold a participation share in the fund's capital, as all the fund's assets are common ownership property of its investors. Once enacted, the Draft Law will amend Article 105.2 of the Tax Code to the extent that the participation share in a fund will be established proportionally to the investor's contribution to the fund's assets, and in the event such a contribution cannot be established, proportionally to the number of investors.

Procedure for disclosing CFC-related information

The Draft Law specifies that CFC notification should be filed on or prior to 20 March of the year following the year in which the controlling person recognizes income in the form of CFC profit. The current Tax Code has it as "<…> of the year following the year in which the share of the CFC income is subject to accounting by the controlling party." We understand that despite the suggested amendments, the time period for submitting CFC notification will not be changed.

Importantly, the Draft Law will govern those cases in which the shareholder of a foreign company is not aware of the fact that the total participation share of Russian tax residents in the company exceeds 50% and, thus, this shareholder should be acknowledged as a controlling person of the company.

In this context, should the tax authorities identify a taxpayer as a controlling person of a foreign company based on the above criterion, the taxpayer will be allowed to submit clarifications and/or documents along with the CFC notification that demonstrate his inability to know that the participation share of all Russian tax residents in the foreign organization exceeded 50%. However, the Draft Law fails to provide any list of documents that could be used as a valid proof of this. Additionally, taxpayers will be exempted from liability under the Tax Code for failing to timely submit the CFC notification if it is filed within the term established by the tax authorities (which cannot be less than 30 days after the tax authorities' request to submit the notification has been received by the taxpayer).

Minor changes will also be introduced to the information to be provided in the CFC notification. Taxpayers will have to include information on companies and/or entities without a legal personality for which they have submitted the notification of participation/founding. In addition, the date of the audit report will only need to be submitted in those cases where the law of the CFC's jurisdiction or founding (corporate) documents envision mandatory auditing, or where such an audit is conducted voluntarily.

Procedure for taxing income of the controlling person of a CFC

One of the long-awaited amendments provided for in the Draft Law is the elimination of double taxation of controlling persons on distributions of previously taxed CFC income. According to the Draft Law, the dividends distributed by a CFC will be exempt from taxation if they are paid out of previously taxed CFC income, provided the controlling person is able to substantiate this.

It will also be possible to reduce the tax payable on the CFC income by the amount of tax calculated on this income under the laws of Russia and foreign states, irrespective of whether the CFC income is calculated based on its financial reports or under the rules of the Tax Code.

In addition, should the participation share of a controlling person in a CFC be different from the share in the CFC income to which the controlling person has the beneficial ownership right, the latter should be used for taxation purposes.

The Draft Law specifies 31 December of the year following the tax period in which the CFC financial year ends (in the absence of dividend payments) as the date for calculating CFC income subject to tax and for including CFC income in the tax base of its controlling person.

Procedure for calculating CFC income

No mandatory auditing of CFC reports will be required in order to use them for calculating CFC income. After the Draft Law enters into force, it will be possible to calculate CFC income based on the financial reports if one of the following conditions is met:

- An unqualified auditor's report on the CFC financials has been submitted by the taxpayer;
- The CFC is a tax resident of a foreign state with which Russia has a double tax treaty in effect, and with which Russia exchanges tax information.

Please note that the list of states and territories not exchanging tax information with Russia has not yet been approved by the Russian Federal Tax Service. However, the draft list contains such respectable jurisdictions as Switzerland, the United Kingdom, Austria and Malta.

The Draft Law details the requirements for CFC financial reports. It notes that CFC income should be calculated based on standalone reports prepared in accordance with the standards stipulated by the laws of the CFC's jurisdictions. If the standards are not stipulated, either IFRS or the standards acknowledged by stock exchanges or depository and clearing organizations should be used.

Additionally, CFC income may be calculated under the rules of Article 25 of the Tax Code at the discretion of the taxpayer that is the CFC's controlling entity. In this case, the taxpayer will be obliged to use the selected approach for 5 years.

The following types of income (expenses) will not be used for calculating CFC profit (losses) based on financial reports:

- Revaluation of participation interest in the share capital, units in certain investment funds, securities, and derivatives held at fair value under applicable financial reporting standards (CFC income should be adjusted to the above amounts only in regards to the amounts recognized since 2015);
- Income (losses) of subsidiary (associated) organizations (excluding dividends) recognized in the CFC financial reports under the laws of the CFC's jurisdiction (its accounting policy);
- Expenses on reserves and income from restoring reserves (CFC income will be reduced by the expenses that reduce the earlier formed reserves; should the CFC financial reports recognize a loss, the expenses that decrease the amount of the earlier formed reserve will increase the amount of the loss).

The following income from passive sources will be excluded from CFC income subject to tax:

- Income from leasing or sub-leasing underground gas storage facilities and pipelines used for hydrocarbon transportation;
- Income from transactions with financial futures instruments (derivative financial instruments) derived by a foreign bank conducting its primary activity and acting under a special permit (license).

In addition, income of entities without a legal personality in the form of property (including monetary funds) and/or property rights obtained as a contribution or investment by the founder and/or individuals who are his family members and/or close relatives, as well as from a CFC in which at least one of the above individuals is a controlling person, should be excluded from the CFC income subject to tax. If the assets are transferred by the CFC, the value of these assets will not be recognized as expenses for calculating the CFC income subject to tax. Similar rules will apply to legal entities for whom no participation in capital is envisioned.

Exemption from taxation

The Draft Law details the procedure for exempting CFC income from taxation in Eurobond structures and suggests limiting the exemption period for organizations entitled to receive interest income payable on Eurobonds. This benefit will expire on 1 January 2017 (provided the relevant federal law will enter into force before December 2016). However, the benefits with regards to Eurobond issuers and organizations that are assigned the rights to Eurobonds will remain in place.

Furthermore, the Draft Law suggests ignoring currency differences and income excluded from the CFC tax base, including that derived from the revaluation of shares, profits/losses in respect of subsidiaries and reserves, when calculating the share of passive income for applying the corresponding CFC tax exemption.

Procedure for acknowledging foreign companies as Russian tax residents

The Draft Law details the procedure for defining the first tax period for profit tax purposes of foreign organizations that have voluntarily acknowledged themselves as Russian tax residents:

- For foreign organizations that have voluntarily acknowledged themselves as Russian tax residents as of 1 January of a calendar year, the first tax period is the period that begins on 1 January of this calendar year until the end of this calendar year;
- For foreign organizations that have voluntarily acknowledged themselves as Russian tax residents as of the moment of submitting the relevant application to the tax authorities, the first tax period will start on the date of the application and last until the end of this calendar year (should the application be submitted in the period from 1 to 31 December, the first tax period will be the period from the date of this application until the end of the calendar year following the year in which the application has been submitted).

Foreign organizations that have voluntarily acknowledged themselves as Russian tax residents may waive their tax resident status by filing an application, and will forfeit their status after the tax authorities study the reasons for forfeiting it.

Importantly, the benefit allowing Russian organizations to exempt dividends from taxation will only apply to those foreign entities that have acknowledged themselves as Russian tax residents on a voluntary basis.

The list of foreign companies that can be regarded as tax residents only on a voluntary basis is extended to companies that lease and/or sublease marine vessels, mixed river/sea-going ships, aircrafts, vehicles and containers, international cargo companies and companies that lease and/or sublease containers used in international transportation.

The Draft Law extends until 1 January 2018 the period in which a foreign company will not be recognized as a Russian tax resident if liquidated by the above date. It will be possible to postpone the deadline further if particular conditions are met.

Specifics of establishing the beneficial owner of Russian-sourced passive income (dividend, interest and royalty) for the purposes of applying double tax treaties

The Draft Law will introduce additional provisions to Article 7 of the Tax Code, which specifies that an entity without a legal personality can be recognized as the beneficial owner of income. On the other hand, no relevant amendments are envisioned to Art. 312 of the Tax Code, which makes it unclear whether or not these types of entities will have to submit documents that prove their beneficial ownership right to income or the absence thereof, as well as how the information on participation in an entity without a legal personality will have to be provided.

In order to claim a tax exemption and/or apply reduced withholding tax rates stipulated by double tax treaties, the foreign company **must** provide the withholding tax agent with proof that it is the beneficial owner of the income received.

In addition, minor changes will be introduced to the procedure for applying the so-called "look-through approach."

Procedure for taxing profits of foreign companies derived from the indirect sale of real estate located in Russia

The Draft Law specifies that the tax on income derived from the indirect sale of real estate located in Russia falls within a withholding tax category. However, no mechanism is envisioned for tax withholding for those cases where the buyer is a foreign company.

It is specified that foreign organizations/entities without a legal personality will have to submit information on their participants (founders, beneficiaries and managers) only in regards to the real estate actually owned by such organizations/entities.

Non-taxable liquidation of foreign organizations and entities without a legal personality

Liquidation by individuals

The Draft Law suggests extending until 1 January 2018 the period during which the shareholder's income derived from the receipt of property and/or property rights upon liquidation of a foreign organization/entity without a legal personality will not be taxed. In some cases, it will be possible to complete such tax-free liquidation after 1 January 2018, provided the decision to liquidate is made before 1 January 2017.

Controlling individuals will be treated as deriving no taxable benefit from acquiring underpriced property, including securities, or property rights from a CFC if the CFC is liquidated before 1 January 2018. If resold

further, the historical cost of the securities will be established as the lower of the following: documented cost of the securities based on the CFC records, or their market value as of the date of transfer to the taxpayer. In a further resale of property rights, the taxpayer will be able to deduct the acquisition costs based on the data from the CFC records.

Upon the disposal of securities received from a liquidated foreign organization/entity without a legal personality, the individual will be allowed to deduct expenses from his income. These expenses will be calculated as the cost of the securities on the books of the liquidated organization/entity, but not exceeding the market cost. The current Tax Code provides no such benefit in respect of securities.

Liquidation by legal entities

The Draft Law extends the period during which shareholders of foreign companies/entities without a legal personality can liquidate them with no tax consequences. Similarly to the liquidation of foreign organizations/entities without a legal personality by individuals, the income of legal entities in the form of property (property rights) received from a liquidated foreign organization/entity without a legal personality may be excluded from the tax base, provided that the liquidation is completed before 1 January 2018. Unlike provisions of the current Tax Code, the Draft Law regards this benefit as a right rather than an obligation of the taxpayer.

The Draft Law abolishes the current provision of the Tax Code that limits the tax deduction on a capital gain realized on the sale of the property (property rights) obtained from a liquidated company/entity without a legal personality to the actually paid documented cost of shares (participation interest, units) of the liquidated company/entity.

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We hope that you find this information interesting and informative. Please feel free to contact our experts with any questions related to this subject.

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