CLIENT UPDATE

RUSSIAN "DE-OFFSHORIZATION" NEWS: PUBLICATION OF DRAFT OF SIGNIFICANT AMENDMENTS TO TAX LAW

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On March 18, 2014, the Russian Ministry of Finance ("MoF") published a draft law that introduced significant amendments to tax legislation as part of the de-offshorization of the Russian economy (the "Draft Bill"). In general terms the new focus on "de-offshorization" envisages the removal of tax advantages for Russian residents using offshore companies and the provision of incentives for Russian beneficiaries to give up offshore ownership schemes for Russian assets.

The Draft Bill introduces new, unprecedented rules into Russian law for assessing the income tax of "controlled foreign companies" ("CFC") and for qualifying a foreign company as a Russian tax resident. The current draft of the Bill takes a rather hard-line approach to these issues, but these provisions may still change before it is tabled to the State Duma of the Russian Federation. The new rules are expected to take effect from January 1, 2015.

Below we provide a summary of the key provisions of the Draft Bill.

CONTROLLED FOREIGN COMPANIES (CFC)

Under the Draft Bill, Russian tax residents will be required to pay tax on the retained earnings of their CFC in accordance with the following rules:

- A taxpayer that is a controlling person may be either a legal entity or an individual Russian tax resident.
- CFC whose income is taxed: a company (or an unincorporated entity such as a fund, partnership, etc.) that simultaneously meets all of the following criteria:
  - is not a Russian tax resident;
  - is resident in a jurisdiction included in the MoF list of territories offering beneficial taxation of income (gains) (this list is expected to be more extensive than the current "offshore blacklist",[1] and it may include Cyprus, the Netherlands, and Switzerland);
  - company shares are not listed and/or admitted to trading on one or more stock exchanges included in a list approved by the CBR in consultation with the MoF.
- Control in relation to a CFC is defined as acting or the ability to act, whether jointly or severally, to have a determining influence on decisions taken by an entity in relation to the allocation of its after-tax profit. Control in relation to unincorporated entities is defined as having an influence on similar decisions of the person managing the assets of such entity. The participation threshold for meeting the formal criteria for control is set at 10%.
- Taxable profit: the income of a CFC is determined under the general rules of the Russian Tax Code, i.e., with deduction of expenses (but only in respect of the activities of the CFC and not the controlling person), and is reduced by the amount of the dividend distribution. Income must be substantiated by the CFC's financial statements.
- Method of assessment: a CFC's profit is allocated to the controlling person and taxed as if it was its / his / her ordinary income (and not dividends) pro rata to the participation interest in the CFC. If the participation interest cannot be determined, the controlling person pays tax on the full amount of the CFC's assessed income. If a dividend is subsequently paid on previous years' profits that were included in the taxable income of the controlling person, the taxable income is reduced accordingly.
- Sanctions: failure to pay the tax in full or in part will attract an unprecedented high fine of 20% of the CFC's taxable income.
- Notice of interest in a foreign company: Russian residents must notify the tax authorities if they directly or indirectly hold an interest of 1% or more in foreign companies resident in the jurisdictions included in the MoF's list. Violation of this requirement will attract a fine of RUB 100,000.

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[1] MoF Order No. 108n dated November 13, 2007.

QUALIFYING A FOREIGN COMPANY AS A RUSSIAN TAX RESIDENT

- Apart from Russian entities (i.e., those established in the Russian Federation), tax residents will also be deemed to be those foreign entities that are recognized as residents under international treaties, as well as foreign entities that are effectively managed from Russia.
- Foreign entities will be deemed as being effectively managed from Russia if at least one of the following criteria is met:
  - meetings of the board of directors or other governing body are held in Russia;
  - executive management usually operates in Russia;
  - the principal executive company officers conduct their work in Russia;
  - the company's accounts are maintained in Russia;
  - the company's records are kept in Russia.
- A foreign company (including a CFC) may choose to be qualified as a Russian resident, unless otherwise provided for by an international treaty to which Russia is a party.
- For tax purposes, foreign companies that are Russian tax residents are treated the same as Russian entities.

ASSESSING TAX ON THE TRANSACTIONS OF FOREIGN COMPANIES THAT INDIRECTLY OWN RUSSIAN REAL ESTATE

- Foreign companies are currently under an obligation to pay Russian income tax on the sale of non-exchange-traded shares/participation interests of a Russian company if more than 50% of the assets of such Russian company constitutes real estate situated in Russia.
- The Draft Bill extends this obligation to pay tax on the sale of shares/participation interests of Russian companies also to foreign companies if more than 50% of their assets "directly or indirectly" constitute Russian real estate. However, the Draft Bill does not specify a mechanism for determining the percentage share of real estate (especially in the case of indirect ownership) included in the assets of a company being sold, or a mechanism for withholding or collecting such tax if the transaction takes place between foreign persons.
- Any exemptions applicable to the relevant income under certain double taxation treaties (such as that between Russia and the Netherlands) will prevail even if this rule is introduced.

FIRST IMPRESSIONS OF THE DRAFT BILL

Apart from the obvious tax implications for Russian companies with interests in foreign companies, the more interesting issue is likely to be the impact of the Draft Bill on typical beneficial ownership schemes for Russian assets, which often provide for the use by Russian resident individuals of foreign trusts and offshore companies.

In particular, it is not clear from the current wording of the Draft Bill whether trusts not controlled by beneficial owners (so-called "discretionary trusts") will fall under the definition of a CFC, although the MoF has previously stated its opinion that such trusts must be included in the scope of the law.

In addition, the new rules could also change the principles on which beneficial ownership schemes are structured, shifting the focus from the tax effectiveness of foreign holding companies to reducing the risk of the beneficial owner being held personally liable for payment of taxes in respect of the CFC.

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We would be happy to help if you should have any questions about the Draft Bill or the potential impact of the new rules on your business.

March 24, 2014