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# RUSSIAN LAW ON 'TAX REPATRIATION'

**Pepeliaev Group advises that the Russian law on "tax repatriation"[1] has been signed and will come into force from 2015. This new law may have the following implications:**

**1) control by Russian persons over foreign structures, including non-corporate ones, will have to be disclosed to the Russian tax authorities; and**

**2) profits received by foreign structures managed or controlled out of Russia will be taxed in Russia.**

## Overview

Our preliminary analysis of the law suggests that either or both of the above implications may arise for various corporate structures that include foreign entities. However, in particular circumstances, it is also possible that neither of the above will arise.

The law is directly aimed at changing the previous belief that, if a Russian business structure has a foreign element, then Russian tax that would have been due without this foreign element may be postponed, reduced or even avoided altogether, irrespective of the extent to which the existence of such foreign element may be justified (including if it is purely nominal and/or mainly tax-driven). In practice, often where no tax was payable in the relevant foreign jurisdiction this resulted in a double 'non-taxation'. However, given that such structures have in formal terms been legal, one could view them as a type of a tax benefit that a taxpayer may set at its own discretion.

The new law will be applied extremely broadly.

The new rules extend to any jurisdiction, not only to foreign structures from the previously approved 'black list' of offshore jurisdictions[2]. Therefore, substantively the law has a much broader reach than its declared objective of "de-offshorization". Moreover, even foreign structures carrying out actual business abroad may be caught under the new rules. The very few exceptions that may be available will depend more on certain specific circumstances (a high effective tax rate, a high portion of operating income, etc.) rather than on a 'white list' of jurisdictions.

The law uses four basic tools for 'tax repatriation':

1) giving certain foreign companies the status of a Russian tax resident;
2) creating the status of a 'controlled foreign company' ('CFC'), which may apply both to corporate and non-corporate structures;
3) applying a "true beneficiary" test when a foreign entity receives income from a Russian taxpayer; and
4) taxing in Russia income received from a foreign seller's indirect sale of Russian real estate (i.e. where shares are sold in a company owning real estate instead of the real estate facility itself being sold directly).

[1] Federal Law No. 376-FZ 'On amending the first and second part of the Russian Tax Code (to the extent of taxing the profit of controlled foreign companies and the income of foreign organisations)' dated 24 November 2014.

[2] Article 284(3)(1) of the Russian Tax Code, Order No. 108n of the Russian Ministry of Finance dated 13 November 2007.

Certain proposals discussed at the drafting stage were not included in the law (for example, the adjustment of tax limitations on interest with regard to 'thin capitalisation'). A number of amendments to the draft law proposed by the Russian Government were rejected by the State Duma on formal grounds, although at least some of them are likely to be adopted later in a separate law.

It is already obvious that there are certain gaps and inconsistencies in the law, and therefore, it may be expected to be further fine-tuned and adjusted to improve the position of taxpayers. However, this is unlikely to change the general orientation of the law. It is also possible that the law will become stricter, but such changes may not have retroactive effect.

## 1. Status of a Russian tax resident for foreign companies

To start with, certain of the new rules that are relatively easy to understand, a foreign company may be treated as a Russian tax resident if its place of management is Russia.

The criteria for management are formulated broadly in the law: it is enough to determine that any level of management, either strategic or day-to-day, takes place in Russia. The Commentary to the OECD Model Convention on avoidance of double taxation suggests that priority should be given to strategic management. Some countries give priority to day-to-day management. The same approach was suggested in proposed amendments by the Russian Government; these have not yet been enacted, but may be in future.

For a foreign company to be treated as a Russian tax resident, the company must be managed in Russia on a permanent basis.

However, a foreign company may of its own accord choose to be treated as a Russian tax resident. If it does so, it may later renounce this status.

If a foreign company is treated as a Russian tax resident, this means that it must pay taxes and perform other associated obligations of a Russian taxpayer (registering with the tax authority, submitting its financial statements, etc.) in the same way as a Russian company.

On the other hand, such a foreign company may apply a 0% rate of withholding tax on dividends (provided that it meets certain conditions).

Previously, with a view to a foreign company being taxed in Russia, the criteria of a permanent establishment could be used, which meant that the company carried on business activities (i.e. income-generating transactions) in Russia. The criteria for a permanent establishment (signing contracts, etc.) mainly relate to active operating income (sale of goods, etc.), while new criteria may be applied to entities whose income is passive (dividends, interest, royalty, rent, etc.).

The law does not yet oblige foreign companies treated as Russian tax residents to disclose the persons that actually control them. Such an obligation applies only to foreign companies that perform financial transactions via Russian banks or other financial institutions, and it is set out in anti-money laundering legislation. In this regard, it cannot be ruled out that, if a foreign company is treated as a Russian tax resident, this may in certain situations lawfully help it to avoid disclosing the person that actually controls such company. However, each situation of this kind should be carefully analysed in terms of the remaining risks.

The law provides for sector-based exceptions from the rules of tax residence for extracting hydrocarbons and obtaining debt financing abroad.

## 2. Rules regarding controlled foreign companies

According to the adopted law, if a foreign company is controlled by a Russian person, the former is treated as a 'controlled foreign company' ('CFC') and its profit that has not been distributed to the controlling entity is taxed at the level of the controlling entity as if the profit had been received by the controlling entity itself.

The tax is payable at the rate set for ordinary income (13% for individuals and 20% for legal entities), including if the CFC's profit is formed using dividends received by the CFC. The rate for dividends, which starting from 2015 will be 13%, applies only if the profit has been distributed.

The law encourages profit to be distributed to Russian controlling entities ('if you wish to work offshore, do what you please, but the money goes here', citing the Russian President’s opinion on the issue ).

The same approach applies to foreign structures which are created without a legal entity being formed, including, among other things, trusts and funds.

However, the CFC rules will not apply to those foreign companies that are not just controlled companies, but are also managed from Russia and which, as a result, are treated as Russian tax residents.

For the new CFC tax rules to be applied, profit thresholds have been set for the profit generated by CFCs:

RUB 50 million in 2015;
RUB 30 million in 2016;
RUB 10 million from 2017.

**2.1. Tests for determining control by a Russian resident over a foreign entity or structure**

For foreign companies, the main test for whether it is controlled out of Russia is that the threshold of the direct or indirect participation interest must be 25 % for individual ownership (50 % in 2015) or 10 % if Russian residents hold an aggregate of more than 50%, even if such Russian residents are not inter-related (a quantitative criterion).

The participation interest of close relatives (spouses and underage children) is counted on an aggregate basis.

The participation interest threshold may not be applied to structures which are created without a legal entity being established, but the law will most likely be amended in future to take account of this.

A person or an entity is treated as controlling a company or structure irrespective of the participation interest threshold, if such person or entity exercises or may exercise a determining influence over decisions taken with regard to distributing the profit (income) generated by the CFC among its beneficiaries pursuant to legislation or a contract (a qualitative criterion).

Controlling parties may include foreign entities that are recognised as Russian tax residents pursuant to the new rules.

A 25% participation interest, whether held alone or in coordination with related parties, may confer little influence over the decisions adopted, while a 10% participation interest confers even less. However, the law does not provide for the right to prove that no control takes place; this may give rise to a contradiction between tax implications and the actual business standing.

**2.2. Exceptions for highly taxed CFCs**

The profit of CFCs is exempt from Russian tax if the effective rate of the foreign tax for CFCs is at least 75% of the average weighted Russian rate that would be applied to the CFC if Russian profit tax was accrued (the 'highly taxed' CFC).

Additional conditions for this exemption are that the CFC should be established in a jurisdiction with which Russia has a double tax treaty and that the jurisdiction in question must not be included in the “black list” of “non-transparent” jurisdictions that do not share tax information with the Russian tax service.

### 2.3. The importance of actual business being conducted in the country of incorporation

The profit of a CFC is exempt from Russian tax, if the portion of the CFC's operating income not included in the list of income set out in the law (which in essence, i.e. according to the meaning of the law, is investment income) is at least 80% (an “operating” CFC).

The additional conditions set out above apply: the CFC must be established in a jurisdiction with which Russia has a double tax treaty and this jurisdiction must not be in the “black list”.

At the same time, income from advisory and other similar services is treated as investment, not operating, income. In general, the list of investment income is broader than the list of “passive” income taxed at source in Russia when it is paid abroad. Only some types of income that are usually treated as investment income may be treated as operating income if the CFC’s principal activity is to generate this income (for example, interest payable to a foreign bank).

The law establishes a strict operating income share threshold for a CFC's profit to be exempt from Russian tax, and this operating income share is calculated, as a rule, based on the abstract type of income rather than on the specific circumstances in which it was generated. If the threshold is not met, no exemption from Russian tax can be obtained even if it is proven that the activity is actually carried out abroad. This may create a contradiction between tax implications and the relationship that actually exists.

### 2.4. Sector-based exceptions

The profit of a controlled bank or an insurance company is exempt from Russian profit tax in a jurisdiction that has a double tax treaty with Russia.

An exemption may also be provided for with regard to the placement of bonds.

However, there was an exception from the CFC rules that was discussed previously, but that did not make the final text of the law. This exception would have applied to foreign entities whose shares had been admitted to trading on foreign stock exchanges.

Therefore, the CFC rules do not apply to debt financing abroad. As for raising capital through issuing / offering the shares to the public, the legislature in effect suggests that this should be done in Russia.

The law grants exceptions to the extraction of hydrocarbons, similar to exceptions from tax residency rules.

The CFC rules exclude foreign charitable organisations and trusts that cannot distribute profit or return property to their founders.

We believe that, for this exemption to apply, it needs to be ensured that a charitable CFC’s activity is in line with its declared objectives. If this CFC actually provides to its controlling persons the same possibilities as an ordinary CFC (for example, to hire controlling persons to provide investment management services and in essence to distribute profit by paying for services), then the Russian tax authorities may reclassify its status.

### 2.5. Reporting to the tax authority

The controlling entity must notify the tax authority of the control it exercises. As for structures that are created without a legal entity being established, the controlling entity must also report that such a structure has been established and whether the controlling entity is entitled to receive income from it.

According to the law, controlling entities must also report CFCs that fall under the above exemption from tax. A report must be filed even if a CFC incurs losses; without this, it is not possible to carry such losses forward.

The CFC itself, if it has taxable property in Russia, must report this fact and provide basic information about itself, including information about its controlling entities and beneficiaries.

If Russian tax residents have a participation interest of 10% or higher in foreign companies, they will have to report this (so as to make splitting the participation interest pointless). As for structures which are created without a legal entity being established, no threshold has been established for filing a report.

A fine has been set for failure to report.

### 2.6. Calculating taxable profit

The CFC's profit for tax purposes is calculated as follows:

- in line with the CFC's “personal law” (i.e. the law of the jurisdiction where it is resident), if the CFC's financial statements must be audited and if Russia has a double tax treaty with the CFC's jurisdiction; no account, however, is taken of any revaluation of securities and other financial instruments, as well as of reserves; the law does not yet impose limitations on other accruals (for example, depreciation of goodwill);
- in other situations, the amount of the CFC's taxable profit is calculated in accordance with Russian tax rules. To this end, the controlled entity should bring into line with Russian tax accounting the bookkeeping records and financial statements compiled in accordance with the rules of the country where such controlled entity is resident.

Tax on the CFC's profit is calculated for the year following the year when this profit is to be distributed (i.e. the year following the year in which it was generated).

Various rules provide for double taxation of the same profit to be avoided (the offset of foreign tax paid by the CFC or of Russian tax withheld when a payment is made by the Russian company, etc.).

However, the law does not allow for the profit and losses of several CFCs controlled by one person or entity to be consolidated.

## 3. Concept of the “beneficial ownership of income” being enacted

The Ministry of Finance has begun to implement in Russian administrative and judicial practice the concept of a “true beneficiary” (the actual recipient or beneficial owner) and a “conduit” (transitory or transitional) recipient of income when “passive” income (dividends, interest, royalties, rent and so on) is paid outside Russia. Under Russian tax legislation, such income is subject to withholding tax.

A true beneficiary is a party that receives income and uses and disposes of it according to its own will and in its own interests. A recipient which transfers the income to a third party (a "conduit") is not the beneficiary of income and may not use the benefits granted by international treaties.

It was proposed that this approach be applied to all international treaties which grant exemptions from withholding tax or reduce the amount of it, rather than only to those treaties which contain a beneficial ownership or any other similar clause.

To justify this approach, the Ministry of Finance cites the Commentary to the OECD Model Convention on avoidance of double taxation[3].

The law enacts this approach.

[3] See, for example Letter No. 03-00-RZ/16236 of the Ministry of Finance dated 9 April 2014.

The law includes several different wordings for this concept. Also, we note that the concept of the 'actual recipient of income', 'person actually entitled to receive income' and 'beneficial owner' are used in some translations of international tax treaties, but are not fully in line with the Russian legal terminology. Therefore, it is highly likely that the law will be clarified in this respect.

In accordance with international practice, the law provides that it is possible to “look through” a conduit recipient:

- if it receives income on behalf of a Russian resident, the income is regarded as received by the Russian resident and, therefore, may be exempt from withholding tax;
- if it receives income on behalf of another foreign entity, including an entity from another jurisdiction, then tax benefits may be applied that such other foreign entity would apply if it received the income directly.

**4. Charging Russian tax on indirect sales of real estate**

Under the current rules[4], Russian profit tax is charged on foreign residents' income derived from the sale of a participation interest (shares) in Russian entities which own more than half of their fixed assets in the form of real estate located in Russia.

The law provides that in Russia tax is charged on income that any foreign companies derive from selling participation interests (shares) in any companies which own, directly or indirectly, real estate in Russia. The foreign company is responsible for calculating the tax.

This amendment implies that the state is seeking to tax in Russia any sale of any Russian real estate, irrespective of whether such transaction is executed:

- directly, via a sale and purchase transaction for real estate; or
- indirectly, via a sale of the shares (participation interests) in entities which directly or indirectly own real estate in Russia.

It remains unclear how the proportion of indirect ownership of real estate should be identified and how taxes should be recovered if the seller owns the real estate indirectly and is not registered with the Russian tax authority.

**To think about, to do**

The options for changing existing structures so that they are in line with this law may include:

- a CFC's profit being distributed at a tax rate lower than the generally set rate; such lower rate may apply to CFC's profit, including a 0% rate for companies which receive dividends;
- structures being “repatriated” if there is no continuing business need to conduct their activities abroad. Foreign companies which fall under the new law may be liquidated and their assets may be “repatriated” through membership being sold in Russia or a liquidation surplus being received. The law allows for such actions to be performed without Russian tax being paid, provided that the liquidation of the foreign companies is completed before 2017.

The flip side of no tax being charged on the “repatriated” assets is that if they are sold again, they are assessed at their historical values.

In other words, it is impossible to avoid paying tax on the increased value of assets (as compared to their historical value) when they are “repatriated”, and also to sell the assets at a later stage while booking the reassessed, as opposed to the historical, value.

[4] Article 309(1)(5) of the Russian Tax Code

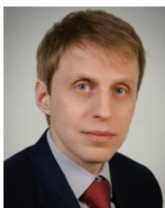
(according to Ruling No. 53 of the Plenum of the Russian Supreme Commercial ('Arbitration') Court dated 12 October 2006), while there is an analogy to the way in which the rules of section V.1 of the Russian Tax Code are applied when transfer pricing control is exercised in disputes concerning article 40 of the Russian Tax Code. Moreover, our specialists are already aware of such practice.

**Help from your adviser**

Pepeliaev Group's lawyers have extensive experience of analysing corporate and tax matters relating to the structures used to mitigate any risk you may face.

Should you have any questions in terms of need to adapt to this law, please do not hesitate to contact your manager at Pepeliaev Group. All the tax practices of our firm are ready to conduct a practical analysis of the implications of the “tax repatriation” law.

## Contact details

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