Will Russians Run The Risk Of Asset Appropriation In 2015?

by Charlotte Brambilla, Director, Hawksford

Nine out of ten major deals undertaken by large Russian companies, including those which are state-owned, are not subject to Russian laws and therefore not contributing taxes to the Russian economy. To combat this issue, the Russian Ministry of Finance is looking to introduce amendments to the Tax Code of the Russian Federation (RF). However, with the current sanctions in force against Russia, it is unclear at this stage if these proposals will go ahead.

According to expert estimates, over one-fifth of Russian exports and over half of Russia's USD50bn investments into other countries made in 2012 were channeled through offshore centers.

Several years ago the Russian President, Vladimir Putin, revealed that the offshore-backed "*modus operandi*" could no longer be tolerated. He ordered the Government to align domestic legislation with "best practices" in other jurisdictions, to reduce enormous tax leakage from the Russian economy.

In February 2014, the Russian Ministry of Finance developed a 17-point plan, which has become unofficially known as the "national plan against offshore companies," or "de-offshorization." Some experts believe this was initially driven with the intention of increasing cooperation with other European countries in the exchange of information. Russia has been actively looking to renegotiate tax treaties with many foreign jurisdictions.

Russian de-offshorization policy is expected to have the following main consequences:

- An increase in the tax burden on many Russian holding structures organized with the use of foreign holding companies and on many operating structures associated with foreign sales and financing;
- Disclosure of beneficial owners in accounting statements by a systematic information exchange with EU countries and many offshore zones and allowing Russian tax authorities access to information constituting audit secrecy.

Significant amendments to the Russian Tax Code and other legislation were proposed in a "Draft Law" with a view to making changes by the end of 2014.

The Draft Law establishes principally new and sophisticated definitions, as follows:

1. CFC (Controlled Foreign Company)

A **CFC** is defined as:

- any company which is a non-Russian tax resident (based on the RF Tax Code, or in accordance with the provisions of a double tax treaty ("DTT"); and
- any company which has controlling persons that are Russian tax residents (companies or individuals);

The definition of a CFC also covers structures which are not separate legal entities, that are controlled by Russian tax residents (companies and individuals).

Foreign companies are **not** regarded as a CFC if they are:

- public companies listed on Russian and foreign stock exchanges, as are their direct and indirect foreign subsidiaries, as well as organizations participating in projects under production-sharing agreements, concessionary agreements, or other similar agreements concluded with authorized bodies of a foreign state;
- non-commercial organizations that do not distribute their profit among their shareholders or other persons under the laws of their jurisdiction;
- companies that are established under the terms and conditions of the Eurasian Economic Union;
- resident in a country included in the "white list" of jurisdictions exchanging tax information approved by the Federal Tax Service AND its income/profit is subject to taxation at the rate exceeding 75 percent of Russian Tax Law profit rate;
- banks and insurance companies that are tax resident in countries cooperating with Russia in the international exchange of tax information (*i.e.*, countries on the "white list");
- Eurobonds issuers;
- structures that are not separate legal entities, provided they meet certain conditions, in particular:
  - the settlor of a structure which is not a separate legal entity is ineligible to take ownership of the structure's property following its establishment in accordance with the regulations and constituent documents of the structure;
  - the rights afforded to the settlor of a structure which is not a legal entity due to the settlor's personal status (including the right to dispose of property, determine beneficiaries, *etc.*) cannot, in accordance with the regulations and constituent documents of the structure, be transferred to another party following the establishment of the structure, except by means of inheritance or universal legal succession;
  - the settlor of a structure which is not a legal entity does not have the right to receive, either directly or indirectly, any of the profits of the structure that are distributable among its participants (interest holders, trustees, *etc.*) or beneficiaries.

It should be noted that a foreign structure cannot be considered a CFC until it is made possible, in accordance with the regulations and constituent documents of the structure, to distribute profits among its participants (interest holders, trustees, *etc.*) or beneficiaries.

Any taxpayer shall bear two basic obligations with regards to a CFC and is required to:

- notify the tax authorities on their participation in all foreign structures that are not legal entities (including when the taxpayer is the settlor or a beneficiary of said structure);
- pay tax on the CFC's profit at the base rates (13 percent for individuals, 20 percent for legal entities) if such profit exceeds RUB50m in 2015, RUB30m in 2016, and RUB10m thereafter. The Draft Law provides for the exemption of taxpayers from the payment of fines incurred due to failure to include the profits of a CFC in the tax base, effective until 2018.

2. Beneficial Owner, Controlling Party And Actual Right To Income

The draft legislation proposes introducing a new definition of ***beneficial owner*** for the purposes of applying tax treaties as "any person who is directly or indirectly entitled to possess, use and dispose of any income gained or a person to the benefit of which another person can use and/or dispose of such income."

As regards the ***controlling parties*** (beneficial owners) of a foreign entity, including a structure established under the laws of a foreign jurisdiction, the Draft Law provides the following definition: "a party who, either alone or together with related parties, exercises control over a company (structure) in its own interests or the interests of those related parties."

- The share ownership threshold for the purposes of establishing a controlling party is raised to 25 percent. The 10 percent threshold is retained for cases in which the combined direct/indirect participation of Russian tax residents in the capital of an organization exceeds 50 percent. There is also a transitional provision, which classifies a party as controlling if the party's participation in a CFC exceeds 50 percent. It is envisaged this will remain in effect until January 1, 2017;
- The controlling party is obligated to notify the tax authorities of the party's participation in all foreign companies in which the ownership exceeds 10 percent (the Draft Law predicts a transitional provision, by which the requirement to notify the tax authorities is restricted to controlling parties whose participation exceeds 25 percent, to remain in effect until January 1, 2017). The notification should be provided regardless of whether the foreign company in question is considered a CFC, *i.e.*, in respect of CFCs the Draft Law introduces the requirement to submit two separate notifications (one for participation in a foreign company; the other for participation in a CFC).

In order to determine the actual right to income, the following should be taken into account: the functions performed, the existing powers, and the risks taken on by the foreign entity.

3. Tax Residency Status For Legal Entities

The following legal entities shall be treated as Russian tax resident:

- Russian legal entities;
- Foreign legal entities considered Russian tax resident pursuant to the provisions of a DTT.

Clarification is provided regarding the meaning of "management of the company," which refers to decision-making and other actions relating to issues of the current activities of the company and falling within the competency of the management bodies.

The Draft Law allows companies from low-tax jurisdictions on the RF Ministry of Finance "black list" to independently declare themselves Russian tax resident if they conduct their activities in Russia *via* a separate subdivision (this right was previously exclusive to companies from jurisdictions not included on the RF Ministry of Finance black list).

4. Taxation Of Income From The Indirect Sale Of Shares In Real

Estate Companies

According to the Draft Law, income from the sale of shares in an entity (including a foreign legal entity), more than 50 percent of the assets of which directly or indirectly consist 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 source in Russia.

The Draft Law introduces a requirement for foreign companies and structures which are not legal entities that own real estate in Russia to provide the tax authorities with information on their participants (and, in certain cases, on indirect participants; foreign structures which are not legal entities must provide information on their settlors, beneficiaries and trustees). Failure to provide this information or failure to provide it in a timely manner will be met with a fine equal to 100 percent of the amount of property tax payable on that real estate.

So Where Does Jersey Fit In?

Whether or not the proposed amendments, as explained above, are introduced, or whether there are some further changes, we can be certain Russia is fully committed to bringing in new legislation which will dramatically alter how Russians manage their onshore and offshore affairs. Russians will need to decide if they wish to bear the costs of setting up and maintaining offshore structures, or run the risk of asset appropriation maintaining onshore structures. It will push many Russians into choosing one route or the other, as a "half-and-half" approach will no longer be viable if asset protection is key to requirements.

Jersey can offer prospective Russian clients political and economic stability, a highly respected judicial system, a robust regulatory regime, skilled professional advisors who are highly expert at proper management, and control of offshore structures for clients and asset protection planning for a global client base. Jersey's regulatory regime means risks are understood and managed effectively and promptly. Jersey also offers clients the option for full-disclosure at very little cost.