New Russian 'anti-offshore' law means changes for Russian treaties and real estate owners

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In brief

The lower chamber of the Russian Parliament passed a new 'anti-offshore' law on November, 18 2014. The law has been one of the main topics of discussion between the business community and the Ministry of Finance in Russia for several months. The law's main purpose is to prevent tax avoidance by Russian tax residents through the use of tax havens and low-tax jurisdictions. However, it also includes measures that affect foreign investors owning equities in Russian entities or receiving income from Russian entities.

The key developments in the 'anti-offshore' law include the introduction of:

- a beneficial ownership concept for the purposes of applying double tax treaty (DTT) benefits
- a tax on 'indirect' sales of immovable property in Russia
- a tax residency concept for legal entities, based on place of management
- a controlled foreign companies (CFC) regime

The law requires approval by the upper chamber of the Parliament and the President. It is expected to be effective from January 1, 2015.

In detail

Beneficial ownership

Foreign persons will no longer be able to access treaty benefits if:

- they have limited powers to dispose of the income or fulfill intermediary functions and do not perform any other duties or undertake any risks or
- the income is subsequently transferred (partially or in full) directly or indirectly to another person who would not be entitled to treaty benefits if that person directly received the income from a source in Russia.

Beneficial ownership will be tested by tax agents and the tax authorities when granting treaty benefits.

If the direct recipient of the income is not the beneficial owner, but a Russian tax agent is aware of the party acting as the real beneficial owner of the income, then:

- if the beneficial owner is a Russian resident, the tax agent should not withhold tax but should inform the tax authorities about the payment

- if the beneficial owner is a non-Russian resident, the agent must apply the DTT with a country where the beneficial owner is located subject to certain conditions. The method for identifying a beneficial owner in this case and which documents to provide to the Russian tax authorities to confirm this fact is unclear.

Changes impacting Russian real estate owners

Foreign corporations, trusts, partnerships and funds which hold property subject to Russian corporate property tax are required to notify the Russian tax authorities of their shareholders (for corporations) and founders, beneficiaries and managers (for trusts, partnerships and funds).

A penalty equal to 100% of the property tax may apply upon failure to provide the information.

The indirect sale of Russian real estate through the sale of shares in a foreign entity owning such property (directly or indirectly), will now be taxable in Russia if assets of the entity consist of more than 50% of Russian real estate (owned directly or indirectly). Previously, only the sale of shares in a Russian company owning real estate was taxable.

The mechanism for collecting withholding tax on sales between two non-Russian entities *not* registered in Russia is currently unclear.

Tax residency

A legal entity may now be Russian tax resident based on its place of management.

If a company is Russian tax resident it must register for Russian tax and pay tax on its worldwide income (as well as comply with other tax legislation for Russian entities).

Three main criteria and three additional criteria are used to determine the place of an entity's management.

The main criteria are:

i. meetings of the board of directors are predominantly held in Russia

ii. the executive management of the organization predominantly performs its functions in Russia

iii. the people authorized to perform management and control over the entity's activities operate predominantly in Russia.

The additional criteria include:

i. the accounting and management reporting of the entity (excluding preparation of consolidated financial statements) are done in Russia

ii. the entity's records are kept in Russia

iii. human resources management is performed in Russia.

There is uncertainty over how many of the criteria must be met to become Russian tax resident.

An entity may choose to obtain Russian tax residency in a number of situations.

In order to obtain Russian tax residency, the entity must notify the tax authorities at the place of registration of its separate Russian subdivision (the existence of a subdivision is mandatory to comply with the procedure) using the form provided by the Federal Tax Service.

CFC rules

Russian tax residents (individuals and legal entities) must now pay Russian tax on the retained earnings of a CFC, if the CFC has not paid a dividend. If the CFC's profits are less than RUB 10 million (RUB 50 million in 2015, RUB 30 million in 2016), the profits should not be recorded in the tax return.

There will be no penalty for failure to pay tax on CFC profits for 2015-2017. From 2018 onwards, the penalty will be 20% of the underpaid tax or RUB 100,000 if higher.

Definition of control

A person controls a CFC if:

prior to January 1, 2016,

the direct and/or indirect interest of a person/entity in the entity, jointly with a spouse and/or minor children, exceeds 50%.

on or after January 1, 2016,

1) a person/entity whose direct and/or indirect interest in the entity exceeds 25%

2) a person/entity whose direct and/or indirect interest in the entity (for individuals jointly with a spouse and/or minor children) exceeds 10%, if the direct and/or indirect interest of all parties recognized as Russian tax residents in this entity, jointly with their spouses and/or minor children, exceeds 50%.

A Russian taxpayer is treated as controlling a CFC irrespective of their ownership share, if in practice they control the CFC for their own benefit or for the benefit of his/her children or spouse.

Entities which are not CFCs

A foreign entity is *not* a CFC if:

1) it is a non-profit organization that does not under its bylaws distribute profit (income) earned among its

shareholders (participants, founders) or other parties

2) it is established under the laws of a member state of the Eurasian Economic Union

3) it is permanently domiciled in a country which has signed a DTT with the Russian Federation, the country is not included in the list of countries which do not exchange information with the Russian Federal Tax Service (the 'black list') and the effective tax rate of the entity is at least 75% of the average weighted rate profits tax rate[1]

4) it is permanently domiciled in a country which has signed a DTT with the Russian Federation, the country is not included on the black list and the entity's passive income is less than 20% of its total income

5) it is a non- corporate entity which meets the conditions:

- the founder does not have an ownership right to the entity's assets after its establishment under the entity's bye laws and founding documents
- the founder's rights (including the right to alienate property, determine beneficiaries and other rights) may not be transferred after its establishment to any other party, unless the rights are transferred by inheritance or universal succession procedures
- the founder may not, directly or indirectly, receive any income that is distributed among all its participants (unit holders, grantors or other parties) or beneficiaries.

The provisions of point 5 apply until the foreign entity ceases to be able to distribute its profit among its beneficiaries.

6) it is a bank or an insurance company permanently domiciled in a country which has signed a DTT with the Russian Federation and the country is not included on the black list

7) it is an issuer of listed bonds, an organization authorized to receive interest income payable on listed bonds or an organization that was assigned the rights and obligations related to the listed bonds issued by another foreign company (subject to certain conditions)

8) it participates in projects under product sharing agreements, concession agreements or other contract signed with the government of the relevant country and income from such activity is more than 90% of the entity's total income.

9) it operates a new off-shore oil and gas field or is a shareholder of such entity.

Notifications on participation in foreign entities

Russian tax residents participating in foreign entities will have to file two notifications to the Russian tax authorities:

(1) list of interests in foreign entities and

(2) list of CFC interests.

The penalty for failure to file the notification will be RUB 50,000 for each foreign entity interest and RUB 100,000 for each CFC.

The takeaway

The Russian tax authorities will likely increase their focus on the beneficial owner of Russian source income. Thus the process for obtaining treaty benefits is expected to become more onerous.

Therefore, US multinational companies (US MNCs) with holding, financing, intellectual property and real estate holding structures which receive income from Russia should re-analyze these structures to check whether they satisfy the beneficial ownership test for accessing DTT benefits. If not, US MNCs should calculate the potential impact and consider restructuring.

US MNCs that own Russian real estate should comply with the reporting procedures and be aware of the tax on indirect sales of Russian real estate for future restructuring plans/sales.

[1] The formulas for calculating the effective tax rate and weighted averages profits tax rates are also stipulated in the 'anti-offshore' law. The weighted average rate is calculated with reference to the base tax rates established by the Russian Tax Code for different types of income (20% for general basket, 9% for dividends).

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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