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Potential impact of Russian de-offshorisation on Cyprus holding and finance structures

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Cyprus has a long-standing history as the portal of choice for investment between Russia and Eastern Europe and the rest of the world. However, Russia's recent moves to discourage the use of offshore jurisdictions to mitigate tax liability could see Cyprus-based holding and finance structures impacted.

In the period of perestroika Cyprus carved itself a niche as the natural intermediary for investment into the newly-marketised economies of Russia and Eastern Europe, based not only on commercial factors but also on a shared Orthodox heritage. Over the ensuing two decades it consolidated its position as the portal of choice for investment between Russia and Eastern Europe and the rest of the world. Initially the investment flow was almost exclusively from West to East, but as the Russian economy has developed, Russian businesses are increasingly investing abroad and numerous Russian companies, including many state-owned companies and household names such as Gazprom and Aeroflot, use Cyprus-based holding and finance structures for outward investments.

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In recent years Cyprus has widened its horizons and has attracted substantial volumes of business from the developing economies of Africa, Asia and South America, but nevertheless Russia and Eastern Europe remain the largest markets. Under these circumstances, the highly-publicised "de-offshorisation" initiative commenced by Russian President Vladimir Putin in 2013 is of immense interest to users of Cyprus holding, finance and other structures, and to their advisers.

I. New draft law

In February 2014 the Russian Ministry of Finance published its plan setting out the key areas for attention in order to achieve its objective of reducing abuse of offshore tax and finance structures (see "Russia: Will 'de-offshorisation' measures be the undoing of international-based structures?" [41 TPIR 7, 4/30/14]). The plan envisages the introduction of draft legislation in the second quarter of 2014 with a view to amending the Tax Code and other legislation with effect from the beginning of 2015.

On March 18, the ministry published a draft law to regulate CFCs, intended to take effect by the beginning of 2015, beginning a two-week consultation period. Many other countries (including the United Kingdom, Germany, France and Spain) have CFC rules in place, intended to counter abusive transfer of

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profits from high-tax to low-tax (or no-tax) jurisdictions. The draft Russian rules are conceptually similar, but less sophisticated and consequently generally more rigid.

No doubt the draft law will undergo much fine-tuning of details during the legislative process, but its key provisions, and their potential relevance to companies using Cyprus (or indeed other intermediary jurisdictions such as the Netherlands, Luxembourg, Malta, Singapore and Switzerland) as a route for investment into and out of Russia, merit consideration now, in order to ensure that the benefits of these structures are maintained.

II. Proposed CFC rules

The draft law defines a CFC as a company or an unincorporated entity (including, a fund, partnership, association, or other vehicle for collective investments) resident in a designated offshore jurisdiction which may under its own law conduct business aimed at generating income or profit for the benefit of its participants and which is controlled by Russian tax residents.

Control is defined by reference to the ability to influence the distribution of the CFC's profit. A Russian tax resident that owns more than 10 percent of the shares or interest in a CFC, whether directly or indirectly, and whether alone or in conjunction with close relatives and associates, is deemed to have control. This 10 percent threshold for control is low by comparison with most other countries. Many, including France, the UK and the US apply a threshold of 50 percent (with a lower rate of 40 percent in the UK for joint ventures). Some countries, such as Germany and Israel, have a low individual threshold, but still require aggregate relevant holdings to amount to 50 percent. While a 10 percent holding is undoubtedly material, in most cases it gives the holder no effective control.

A Russian tax resident that controls a CFC will be subject to Russian tax at 20 percent on the CFC's retained earnings, calculated under the rules set out in Chapter 25 of the Russian Tax Code, after deducting any dividends paid by the CFC. These broad rules may require refinement in order to cover CFCs.

The draft law requires Russian tax residents to notify the tax authorities of all direct or indirect holdings of more than 1 percent in entities which are resident in any designated jurisdiction, or with undisclosed tax residency, or certain other designated entities, with a penalty of RUB100,000 (US$2,800) for non-compliance. It also provides for penalties for non-payment of any tax due on CFCs. For an individual the penalty is 150 percent of the unpaid tax and for an entity it is 100 percent of the unpaid tax.

III. Determination of tax residence

The draft law also provides for foreign entities that are managed from Russia to be deemed to be Russian tax residents, and consequently required to register, calculate tax on worldwide income, and comply with other requirements of Russian tax legislation. Key determinants of the place of management are the location of directors' or other management meetings, where corporate governance is centred, where executives carry out their duties and where the accounting and administrative functions are based.

In concept, this is similar to the "management and control" test used by most countries to determine corporate tax residence, but certain aspects of the tests (for example the location of the accounting and administrative functions) are not widely used elsewhere.

IV. Taxation of property-rich companies

The draft law also provides for Russian tax to be imposed at a rate of 20 percent on gains earned by foreign entities from disposal of shares or other interests in any entity of which more than 50 percent of the assets directly or indirectly comprise real estate located in Russia. It does not say how the tax will be collected if the sale and purchase of the shares takes place outside Russia.

V. Potential impact on Cyprus and users of Cyprus structures

Any consideration of the potential impact of the proposed new law on Cyprus holding structures, or indeed structures involving any country with which Russia has a double taxation agreement in force, must take into account the fact that the internal laws of a company cannot override its obligations under international agreements. Double taxation agreements allocate taxing rights between the contracting states concerned and have inherent rules of interpretation which cannot be circumvented by any domestic law of any state. Any new legislation will therefore have effect only to the extent that it is consistent with Russia's existing double taxation agreements, unless Russia is prepared to terminate them, which seems highly unlikely, given the potential impact of such an action.

Subject to this general comment, the crucial question for users of Cyprus structures is whether Cyprus will fall within the scope of the CFC legislation. The draft law refers to a list of jurisdictions compiled by the Ministry of Finance, but as yet there is no definitive word on whether this means the existing Russian tax "blacklist" or a new list to be compiled for the purposes of the new legislation.

The Russian tax blacklist (formally "List of the States and Territories providing preferential tax treatment and (or) not requiring disclosure and furnishing of the information upon conducting of financial transactions (offshore zones)") was appended to Order 108n of the Ministry of Finance of the Russian Federation dated November 13, 2007. Companies incorporated in blacklisted countries are ineligible for the participation exemption introduced by Russia with effect from January 1, 2008, and transactions with such companies are subject to special transfer pricing control scrutiny in Russia. Cyprus was formally removed from the blacklist with effect from January 1, 2013, when the protocol to the Cyprus-Russia double taxation agreement took effect, and the blacklist currently comprises almost 50 jurisdictions, including Andorra, Bahamas, Belize, Bermuda, British Virgin Islands, Cayman Islands, Channel Islands, Cook Islands, Gibraltar, Hong Kong SAR, Isle of Man, Liechtenstein, Malta, Mauritius and the Netherlands Antilles.

Clearly, if the scope of the new law is restricted to companies resident in countries appearing on this blacklist Cyprus structures will not be directly affected. While there are anecdotal reports of officials saying that a more extensive list will be compiled, there is no official proposal to do this.

The new provisions regarding determination of corporate tax residence by reference to the place of management and control will not affect Cyprus structures, since Cyprus already adopts a similar approach.

The 2010 protocol to the Cyprus-Russia double tax agreement introduced changes to taxation of gains on shares in property-rich companies, allowing them to be taxed in Russia with effect from January 1, 2017. Until then, under the agreement, such gains are taxable only in Cyprus, where there is no tax on such gains.

Cyprus international trusts under the International Trusts Law of 1992 to 2012 are widely used by Russian settlors. It is not clear to what extent, if any, they will fall within the scope of the proposed CFC rules and, if so, how the rules will apply. By definition, the beneficiaries of a discretionary trust have no control over it, and so some other test apart from control will be required.

VI. Conclusion

While the draft law will no doubt undergo much fine-tuning during the legislative process it is prudent to be aware of its key provisions and their potential relevance to Cyprus companies and other structures in order to ensure that the benefits of those structures are maintained, and to take the appropriate steps at the earliest opportunity. However, it should be stressed that at this stage there is no official indication that Cyprus will fall within the scope of the new law. Given that there is a newly-updated double taxation agreement in place between Cyprus and Russia that includes effective information exchange and anti-abuse provisions, it would seem illogical to introduce new, contradictory measures.

Indeed, the new law could represent an opportunity for Cyprus, as a well-regulated, transparent jurisdiction that provides investors with security and a level playing field, as long as the arrangements comply with substance and business purpose requirements.

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