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# Russia: Will "de-offshorisation" measures be the undoing of international-based structures?

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The Russian government has increased efforts to combat tax base erosion by discouraging the use of offshore jurisdictions to mitigate tax liability. The following article analyses the means employed by Russian authorities and examines their impact.

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Like its counterparts in other major economies, in order to counter tax base erosion, the Russian government has stepped up its efforts towards so-called de-offshorisation of Russian investments. This initiative is spearheaded by President Putin, who has frequently expressed the view that Russian corporations and individuals must contribute to the economy in which they operate by paying Russian taxes.

The following is an outline of the steps taken by Russia to date in order to discourage tax mitigation by the use of offshore jurisdictions and to analyse within the Russian context the concepts of "beneficial ownership" and "controlled foreign corporations" ("CFC") rules, which are the major means at the disposal of the Russian authorities to counter the loss of tax revenue from the use of offshore jurisdictions.

Russia has also been attempting to limit aggressive tax planning and downright tax evasion by incorporating limitation of benefits and exchange of information clauses into its double taxation agreements. The tax authorities are also monitoring developments in the OECD's Base Erosion and Profit Shifting initiative.

## I. Current state of Russian tax legislation

Russia has adapted quickly to the "marketisation" of its economy. Its tax system is becoming increasingly sophisticated and the tax authorities have grown in confidence and readiness to challenge what they see as abuse of the tax laws. Unlike most jurisdictions, Russia does not have a general anti-abuse rule for countering tax avoidance. Instead, the tax authorities rely heavily on the notion of "unjustified tax benefit" as defined from time to time by the Russian courts. Over the years, courts in Russia have developed practical criteria that they use in order to identify transactions or circumstances associated with unjustified tax benefit, such as the practical inability of one party to adequately adhere to specific contractual obligations


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(e.g. due to the lack of specialised personnel or equipment) and the non-recurrent nature, exceptional size or lack of commercial justification of certain transactions.

Russian tax authorities have given a number of specific examples of transactions which they consider as being used to obtain an unjustified tax benefit, including an agency arrangement under which the agent's sole function was to create a paper trail to misrepresent the commercial reality of the underlying transactions, and the issue by foreign companies of securities which were contributed to the capital of a Russian company which subsequently disposed of the securities to a specific purpose, limited duration company at a substantial artificial loss.

Apart from the notion of "unjustified tax benefit" in recent years the Russian tax authorities have begun to challenge international tax mitigation structures on the basis that the recipient of funds in a transaction is not the beneficial owner of the income from which the funds are derived. A number of cases have come before the courts, with mixed results.

The first instance of the Russian tax authorities using the beneficial ownership concept for the purpose of challenging treaty benefits (in this case unsuccessfully) is the 2012 case of *Eastern Value Partners Limited*, which concerned back-to-back debt financing provided by one Cyprus company to a related Cyprus company with operations in Russia. The first Cyprus company was not the economic source of the finance, but merely an intermediary — the funds that it on-lent to the second Cyprus company were provided to it by a related entity resident in the British Virgin Islands (BVI). The first Cyprus company on-lent the funds to the second Cyprus company on the day on which it received them. It had no other transactions in the year concerned. Furthermore, it instructed the borrower that repayment of the loan and of interest accruing on it should be made direct to the company in the BVI.

In the light of these facts, the Russian tax authorities contended that the double tax agreement did not apply, and that withholding tax at 20 percent was due on the interest paid from Russia to the BVI. The Moscow Arbitration Court ruled in favour of the taxpayer, saying that the banking arrangements for the remittance of interest should not affect the attribution of income to the person who has legal and economic power in respect of that income. The mere fact that the funds were transferred to the BVI did not make the BVI company the beneficiary of the underlying income. The second Cyprus company continued to be the beneficiary of the income, regardless of the banking arrangements and consequently was considered as beneficially owning the income.

Another area to which the Russian tax authorities have recently begun to devote attention is transfer pricing. Transfer pricing rules were introduced with effect from January 1, 2012, requiring Russian taxpayers to provide the authorities with information on transactions between related parties during a given financial year (controlled transactions). The rules contain wide-ranging definitions of what constitutes a related party and a controlled transaction (including transactions exceeding RUB2 million (approximately US$57,000) in a given tax year and transactions with a sole purpose of concealing a controlled transaction).

Additionally Russia has a very strict approach towards jurisdictions offering preferential tax treatment which do not adhere to their reporting obligations. Jurisdictions that the tax authorities consider deficient are included in a so-called black list (the "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)" appended to Order 108n of the Ministry of Finance of the Russian Federation dated November 13, 2007). Companies resident in any of the 42 blacklisted countries (which include Bahamas, Bermuda, BVI, the Channel Islands (Guernsey, Jersey, Sark, Alderney), Gibraltar, Hong Kong SAR, the Isle of Man, Malta and the United Arab Emirates) are not entitled to the Russian participation exemption and are subject to special transfer pricing control scrutiny in Russia.

Cyprus was removed from the Russian blacklist at the beginning of 2013 and has improved its exchange of information facilities in order to remain off the list.

## II. Options available to the Russian authorities

Currently, Russian authorities are considering a number of measures in order to prevent Russian corporations from improperly conducting their business through offshore jurisdictions. These include the introduction of CFC rules, a more detailed and exhaustive definition of the notion of beneficial ownership and a prohibition on offshore companies dealing with the State and State-owned bodies.

CFC rules have been introduced by numerous countries in order to counter artificial reduction or deferral of tax liabilities by accumulating value in low-taxed offshore entities that is not attributed to (and taxable in the hands of) their owners. They allow states to impose tax on resident taxpayers who control a foreign CFC even though they have not actually received income from it, generally by taxing the income of the CFC as deemed income of the taxpayer. While CFC rules vary widely between jurisdictions, a common factor is the degree of control that the beneficiary has over the disposition of the income of the overseas company.

Some countries identify CFCs by comparing the tax rate (whether effective or nominal) in the home jurisdiction with the rate in the overseas jurisdiction. Others publish a list of designated jurisdictions, entities or regimes. In either case the principle is the same, that the overseas burden of tax is unduly lower than in the home country. CFC rules are predominantly a domestic matter and over the years there has been an ever increasing debate as regards their compatibility with double tax agreements. The official position of the OECD is that they are compatible, but there is a considerable weight of opinion to the contrary.

Although the Russian tax authorities are paying increasing attention to the concept of beneficial ownership and although most of Russia's double taxation agreements include the concept, Russia has not yet incorporated it into its domestic tax legislation, except in relation to government and Eurobond issuances.

For all other purposes the Russian authorities rely on the interpretation of the concept under the OECD model. Again, there is no clear definition of what is a "beneficial owner" in the current OECD Model but the concept must be construed and applied in the light of the original intention of the OECD which was to counter tax evasion. A definition of the term is expected to be incorporated in Russian domestic law in the near future and this will make the position much clearer.

According to Russian media reports, Russia's Ministry of Economic Development has embarked on drafting legislation that bars offshore companies from bidding for state purchases. This legislation targets companies that are resident in the 42 countries on the black list of non-cooperative jurisdictions referred to above. It should not, therefore, affect the use of entities resident in jurisdictions which the Russian authorities judge to have adequate information exchange arrangements, such as Cyprus.

The scope of the Russian de-offshorisation initiative and the extent to which it is pursued are very much a political matter, and will be determined by the ultimate goals and objectives of the Russian state. Should the Russian authorities decide to eliminate or significantly curtail the scope for businesses to channel inbound and outbound investments and do business in Russia by establishing and using international structures (something that will also amount to a *de facto*, if not also a *de jure* denouncement of Russia's major double tax treaties), then the long-term adverse effects on the Russian economy, such as the discouragement of inward investment, may outweigh the benefits.

Much of the current public antipathy towards offshore jurisdictions and other European financial centres such as Cyprus, Switzerland and Luxembourg is the result of misunderstanding (often promoted by governments) of the reason for their use. Contrary to the general perception that the motive for using offshore structures is tax avoidance or money laundering, the reality is that in most cases the "diversion" of capital through intermediary financial centres to the ultimate destination of the investment is driven by pure business, political, commercial or legal reasons. For example, the reason why so much foreign investment into South-East Asia is routed through Singapore is foreign investors' perception that Singapore provides a much more reliable, transparent, predictable and secure environment than direct investment into a country whose legal system they are unfamiliar with and do not have confidence in. Cyprus built its success as an international financial centre on offering a similar benefit for investors into Eastern Europe.

## III. Comment

Russian businesses are no different in seeking out the jurisdictions offering the greatest degree of political certainty and financial advantages, such as access to loan financing and investment. Legal infrastructure is a particularly important part of the mix, and they favour jurisdictions offering a legal system which is well-adapted for use in international business transactions and which they can rely on to protect their legitimate legal rights and interests. This does not mean that the funds concerned are not being reinvested in Russia: on the contrary the tendency is to utilise such offshore structures to conduct business within Russia, in which Russian businesses have an advantage due to their deep knowledge of the intricacies of the market. However, the investors also have the added reassurance that, if disputes or other problems should ever arise, they will be resolved through a transparent, predictable and reliable legal system.

In conclusion, structures in transparent jurisdictions which are established for proper business purposes and meet the substance requirements satisfactorily should not be affected by the de-offshoring initiative. Concerted action is required on the part of foreign governments in respect of effective exchange of information and foreign professionals in respect of proper and well-structured planning of their clients' business in order to ensure that all structures properly established and managed will remain unaffected by any changes in Russian tax policy and practice.

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