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a closer look

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a closer look

Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

Unique contributions from the Big4 and other leading firms provide unparalleled insight into the issues that matter, from today's thought leaders.

Topicality, thoroughness and relevance are our watchwords: CCH's network of expert local researchers covers 130 countries and provides input to a US/UK team of editors outputting 100 tax news stories a week. GTW highlights 20 of these stories each week under a series of useful headings, including industry sectors (e.g. manufacturing), subjects (e.g. transfer pricing) and regions (e.g. asia-pacific).

Alongside the news analyses are a wealth of feature articles each week covering key current topics in depth, written by a team of senior international tax and legal experts and supplemented by commentative topical news analyses. Supporting features include a round-up of tax treaty developments, a report on important new judgments, a calendar of upcoming tax conferences, and "The Jester's Column," a lighthearted but merciless commentary on the week's tax events.

The Implications Of The Latest Russian De-Offshorization Proposals For Users Of Cyprus Holding And Finance Structures

by Philippos Aristotelous and Stavros Supashis, Andreas Neocleous & CO LLC

In September 2014, the Russian Ministry of Finance published a third version of the draft law on the package of tax initiatives generally referred to as "de-offshorization". The first draft law was officially published in March 2014, for consultation, and based on the results of the consultation, a second version was published towards the end of May 2014. The third draft differed from its predecessors in areas including the controlled foreign company ("CFC") rules (particularly, but not only, the parameters for classifying companies as CFCs), criteria for determining tax residence of foreign companies, and penalties for non-disclosure.

Towards the end of October, a draft law was presented to the Russian State Duma for consideration, which differs in several respects from the third draft published by the Ministry of Finance.

Since Cyprus is one of the principal portals for investment into Russia (in 2013 it accounted for USD22.7bn, more than 13 percent of Russian inward investment), the proposed changes are of great potential importance for users of Cyprus structures. In the following paragraphs we set out the main proposals in the law submitted to the Duma and consider their possible implications.

The Current Proposal

The main proposed changes are as follows:

Definition Of A CFC

The latest draft law defines a CFC as a foreign company that is not tax resident in Russia and that is controlled by organizations or individuals that are Russian tax residents.

A number of categories of company are excluded from the definition of CFC. These are as follows:

- non-commercial organizations that do not distribute their profit;
- companies resident in the Eurasian Economic Union;
- companies resident in jurisdictions that exchange information with Russia for tax purposes and impose an effective tax rate in excess of 75 percent of the entity's average Russian tax rate on income calculated in accordance with the formula set out in the CFC legislation. In most cases this will equate to 15 percent;

- companies resident in jurisdictions that exchange information with Russia for tax purposes, at least 80 percent of whose income comprises active income. Passive income is defined in the draft legislation and includes dividends, royalties, and proceeds from the sale of shares or real estate;
- foreign companies involved in projects under production-sharing, concession and similar agreements in their country of incorporation, provided that income from such activities represents at least 90 percent of total income;
- foreign structures in which there is no formation of a legal entity, such as trusts, as long as they are unable to distribute profit to participants or beneficiaries;
- banks or insurance companies operating in a territory that exchanges information with the Russian Federation;
- issuers of listed bonds or organizations authorized to receive interest on listed bonds issued by another foreign company, if the interest on them is at least 90 percent of the issuer's income;
- the company is an operator or a direct shareholder of newly developed sea-based hydrocarbon deposits.

Control Criteria

As in the previous draft laws, the CFC rules will apply to all Russian tax residents, whether legal entities or individuals. However, the participation thresholds have been substantially increased, and are now as follows:

- ownership of a participating interest (direct, indirect, or direct and indirect combined) of more than 25 percent in the organization in his or her own right or in conjunction with close relatives (his or her spouse and minor-age children) and other associates (as defined in the transfer pricing rules set out in cl 2 of Art 105.1 of the Tax Code);
- ownership of a participating interest (direct, indirect, or direct and indirect combined) of more than 10 percent in the organization in his or her own right or in conjunction with close relatives (his or her spouse and minor-age children) and other associates, if Russian tax residents, alone or jointly with their spouses, minor children and other associates directly or indirectly have an interest of over 50 percent.

The latest draft also introduces a transition period ending on January 1, 2017, during which the threshold for both tests will be 50 percent. In addition, an individual or entity may be treated as a controlling person despite these conditions not being met if they exercise a decisive influence on the distribution policy of a CFC either due to their participation in its share capital under an agreement governing its functions, or due to implications of their relationship with the CFC.

As in the preceding draft, control over a structure other than a company is assessed by reference to the degree of influence the person concerned exercises over the person who manages the assets of the structure with regard to the distribution of income, rather than the level of their participation interest, and no specific percentage is included in the draft law. The latest draft law leaves this concept and a number of other terms undefined, leaving room for differences in interpretation to arise.

Notification Requirements

The latest version of the draft law requires taxpayers to notify the tax authorities of relevant interests in Russian and overseas companies and structures with effect from February 1, 2015. Earlier versions of the draft law imposed a blanket requirement to notify any participation of more than 1 percent in all Russian and foreign organizations. The latest version of the draft law removes this obligation and replaces it with an obligation to notify the tax authorities of participation in:

- foreign organizations of more than 10 percent (25 percent for an initial transition period expiring on January 1, 2017);
- foreign structures not involving the formation of a legal entity (whether as a beneficiary or in any other capacity); and
- Russian organizations (with the exception of business partnerships and limited liability companies) in which they have an interest of over 10 percent.

The time allowed for notifying the tax authorities of participation has been increased from 20 days to one month. In relation to CFCs, the notification must take place no later than March 20 of the year following the tax period in relation to which the profits of the CFC must be accounted for.

Inclusion Of CFC Profits In The Owner's Tax Base

The threshold for including a CFC's profit in a Russian taxpayer's tax base will be RUB50m (approximately EUR956,000) for 2015 and RUB30m (approximately EUR574,000) for 2016. Following the expiry of the transitional period, from January 1, 2017, the threshold will be RUB10m, a substantial increase on the amount in earlier drafts.

CFC Profit Calculations

The profit of a foreign CFC that is resident in a country with which Russia has a double tax agreement will be calculated in accordance with its audited financial statements and otherwise in accordance with Chapter 25 of the Russian Tax Code.

A CFC's profit is reduced by the amount of dividends paid out of that profit and by Russian and overseas tax paid on the profit of the CFC, including Russian corporate income tax on the profit of any permanent establishment it has in Russia. The previous draft did not allow any deduction for Russian tax.

Penalties

The penalty for non-payment or underpayment of tax as a result of non-inclusion in the tax base of a share in the profit of a CFC remains unchanged at 20 percent of the amount of unpaid tax or RUB100,000, whichever is higher. However, a grace period has been introduced in the latest version of the draft law: no penalty will be charged for the tax periods 2015 to 2017 inclusive.

A penalty of RUB100,000 will be imposed for failure to notify the tax authorities of participation in a CFC, or for failing to provide the tax authority with information or for submitting inaccurate information on a controlled entity.

Disclosure Of Participants In Companies And Structures That Own Property In Russia

Foreign companies and structures not involving the formation of a legal entity that have property taxable in Russia are required to provide the tax office responsible for the area in which the property is located with information on the participants in the company or structure, including disclosing the indirect participating interest of any individual or public company whose direct or indirect interest exceeds 5 percent.

Failure to provide this information or delay in providing it will incur a penalty equal to the tax calculated on the company's property, which will be allocated between the participants by reference to their participation percentage.

Determination Of Tax Residence Of Legal Entities By Place Of Management

The latest version of the draft law includes rules for determining the tax residence of legal entities, providing greater certainty and consistency than hitherto.

A company incorporated overseas is to be regarded as tax resident in Russia if (i) it is tax resident in Russia under an international taxation agreement, or (ii) its place of effective management is in Russia.

As in the previous draft, the place of effective management is determined according to three main criteria, namely, the location of the majority of the meetings of the board of directors or equivalent management body, the location of the executive management of the organization, and the location in which the key executives principally operate.

The draft defines executive management as the adoption of decisions and the performance of other actions pertaining to the organization's current activities which fall within the competence of the executive management bodies. The executive management of a foreign company will be considered to be exercised outside Russia if it carries out business using its own qualified personnel and assets in a country in which it is resident and which has a tax treaty with Russia.

The following secondary criteria are taken into account only if necessary:

- the location of financial and management information;
- the location of other records; and
- the place from which operating and administrative procedures relating to the company's operations (as opposed to any group operations) are issued.

The CFC rules will not apply to companies that voluntarily choose to be treated as tax resident in Russia. Foreign companies that are resident in a country that has a tax treaty with Russia and that are tax residents of that foreign country under the treaty may opt for such treatment. Similarly, foreign companies involved in production-sharing and similar agreements or that have an autonomous subdivision in Russia may choose to be treated as tax resident in Russia.

Gains On Disposal Of Shares In Property-Rich Companies

The latest version of the draft law provides that gains derived from the sale of shares and similar interests in foreign companies deriving more than 50 percent of their value from real estate in Russia will be taxable in Russia, unless the securities concerned are traded on a recognized stock exchange.

Thin Capitalization Rules

The earlier amendments to the thin capitalization rules have been removed in the draft law submitted to the Duma.

Effects On Cyprus Structures

Although it has a comprehensive double taxation agreement with Russia, which includes up-to-date information exchange arrangements, the Cyprus corporate tax rate of 12.5 percent is below the effective tax rate (generally 15 percent) required for exemption on the basis of the effective tax rate. Companies that are holding companies and whose income is principally characterized as passive will also be affected by the proposals as they stand.

The current double taxation agreement between Cyprus and Russia provides that until January 1, 2017, gains on shares in property-rich companies will be taxable only in the country of residence of the disponor. The proposal to tax such gains in the country in which the property is located is incompatible with this, and under the Vienna Convention on the Law of Treaties, to which both Russia and Cyprus are parties, Russia is bound by its obligations under the agreement.

These issues will clearly need to be resolved at an early stage. In the meantime, it would be prudent for users of Cyprus structures (and indeed structures involving other jurisdictions) for investment into Russia, to carry out an analysis of the companies and other entities involved in order to assess the possible implications in terms of future tax costs and develop strategies for mitigating them. However, the significant differences between the draft law published by the Ministry of Finance in September and the version submitted to the Duma only a few weeks later demonstrate that the law is very much a work in progress and that further significant changes are likely to emerge during the legislative process. It would not be prudent to take any firm, irreversible steps until there is much more clarity regarding its final provisions.