



RUSSIAN TOLL

Amendments introduced in February 2016 prompt Ekaterina Lazorina and Diana Kalyaeva to review Russia's controlled foreign company regime

➔ KEY POINTS

WHAT IS THE ISSUE?

Russia's adoption of controlled foreign company (CFC) legislation and promotion of 'deoffshorisation'.

WHAT DOES IT MEAN FOR ME?

The February 2016 CFC amendments provide certain clarifications and exemptions for taxpayers transferring assets to overseas personal structures.

WHAT CAN I TAKE AWAY?

Trusts and similar structures still serve an important non-tax purpose for Russian clients.



Two years ago, Russian tax law was amended to introduce so-called 'deoffshorisation' rules aimed at preventing aggressive tax planning and tax avoidance by Russian tax residents. In particular, controlled foreign company (CFC) rules were adopted. This tax reform was one of a series of measures with the aim of making Russian businesses more transparent and, ultimately, inducing high-net-worth individuals (HNWIs) to hold both their business and private assets directly in Russia without involving foreign holding structures. In February 2016, a further amendment was introduced to give Russian individuals an opportunity to wind up their CFCs and similar structures, and exempt the assets derived from liquidation from tax.

DEOFFSHORISATION

Russian currency-control rules have also been a factor in the deoffshorisation regime, with exorbitantly prohibitive penalties for violations and tighter

reporting requirements for individuals on their foreign bank account balances, among other things.

Moreover, some Russian residents opted to participate in the so-called 'amnesty' programme, under which they declared their foreign structures, overseas bank accounts and other offshore assets to ensure future relief from any liability on potential violations, particularly of Russian tax and currency-control laws for previous periods. June 2016 marked the end of this amnesty in Russia.

CFC RULES

Russian CFC rules stipulate that, in certain circumstances, a Russian tax resident must pay taxes in Russia on the retained earnings of foreign legal entities and non-corporate structures (e.g. trusts, foundations, funds and partnerships) they control. There are different criteria for recognising foreign legal entities and non-corporate structures, such as CFCs. Generally, a non-corporate foreign structure should be treated as a CFC ➔



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for a Russian tax resident if they exercise control over the structure. Control is defined as either exercising, or having the opportunity to exercise, a significant influence over decisions on income distribution made by the person managing the property of the structure, e.g. a trustee or private foundation council. The law establishes much stricter criteria for recognising an overseas structure as a CFC for its settlor.

Certain provisions of the CFC rules, such as the definition of control and the rules for calculating a CFC’s tax base, are rather vague and leave room for interpretation. Moreover, the Russian tax authorities have virtually no practical experience in applying the CFC rules to, among other things, controlled foreign structures, and official clarifications on such matters are very limited.

CAN WE STILL TRUST IN TRUSTS?

As a result of these changes, Russian HNWI’s have been forced to revise their foreign structures and take other actions to reduce the tax and legal risks that could arise from disclosure of their assets based on CFC requirements and/or via Common Reporting Standard information-exchange provisions.

Revision of structures is often associated with the clients’ wish to understand if the old concepts are workable, considering the new challenges they have to meet. In our experience, Russian HNWI’s often ask if trusts and similar offshore structures will still adequately serve their primary purpose of protecting assets and ensuring effective succession.

In many cases, the answer to that question is yes. Here are some examples:

- **One of the main and most obvious reasons that Russian clients may consider transferring assets to trusts**

is the higher level of asset protection they afford in cases of unjust claims by third parties against the client or the business. The lack of confidence in the Russian judicial system is still an issue in such cases for many HNWI’s.

- Sometimes, it is not a third party that causes business conflicts, but rather the family members themselves. Trust structures may provide better solutions for tackling disputes that arise between spouses. They prove especially useful given that Russian family law is not very flexible on spousal property matters.
- It is not a simple matter for an heir to inherit property, even in the absence of any dispute between heirs, and especially if that property is located abroad. If the deceased resided in Russia at the date of their death, generally Russian law would apply to the disposition of the inheritance of the deceased’s estate. From a practical perspective, this could create significant difficulties for wealthy families with different types of assets in various jurisdictions around the world. There are a number of open questions concerning the application of Russian inheritance law to foreign assets, i.e. related to safekeeping and managing assets within the period of acceptance of the inheritance estate; and the appointment, and determination of powers, of executors of wills and fiduciary managers of the estate.
- Russian residents may open a bank account with overseas banks; however, they are not allowed to dispose their funds into these accounts freely. From a currency-control perspective, use of foreign structures may be a good solution.
- Russian tax legislation was recently amended to specify tax aspects related to transferring assets to foreign structures and benefiting from them.

It is important to understand, however, that certain issues cannot be resolved using a trust. Moreover, it is important to ensure that the settlor of the structure complies with statutory requirements in Russia at every stage of establishing and using a structure, from transferring assets to benefiting from them. Legal

requirements and Russian tax consequences must be considered at all times.

FAMILY TRUSTS AND SIMILAR STRUCTURES

The February 2016 changes to the CFC rules introduced certain exemptions for the use of family trusts and similar structures. Under one of the most important amendments, assets transferred by a Russian individual, their spouse or a close family member or their CFC to another CFC that is a non-corporate structure – i.e. a trust or private foundation – should not be deemed to constitute income of the latter when calculating its tax base under the CFC rules. The *Russian Tax Code* contains certain anti-avoidance provisions in this respect.

This exemption provides for the possibility of establishing, for example, a foreign trust for the benefit of a member of the settlor’s family, and of transferring assets to a trust that is a CFC of the settlor or the beneficiary with no tax liability for the entire amount of assets transferred. This planning opportunity was unclear under the previous tax law.

Another exemption gives tax-free status to asset distributions that do not exceed the amount of assets initially contributed to the relevant structure for Russian individuals receiving such distributions. This exemption works in a similar vein if the given individual initially transferred assets to the structure, or to their spouse or a close family member.

These exemptions, subject to certain conditions, may serve as an effective way of restructuring the assets of Russian clients using foreign structures.

WINDS OF CHANGE

The new rules create significant uncertainties, as there will be many possible ways to apply the law. It is always difficult for clients to adapt to new requirements while maintaining adequate protections for their families and family wealth. We have, nevertheless, seen steady interest in establishing foreign structures for such purposes. Our advice is to ensure that structures are compliant from a tax and legal point of view, and to emphasise that extra care must be taken when designing and establishing them.



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