Relocating to a Special Administrative Region (SAR) will become easier, but obtaining eligibility for additional benefits more difficult

In brief

On 20 January 2020, the Russian Ministry of Finance (MinFin) introduced a draft law that expands the eligibility criteria for receiving multinational holding company (MNHC) status and introduces additional benefits, including tax exemption on exchange differences, 5% income tax on all income received, and 10% tax on dividends, interest or royalties paid to the MNHC. However, companies will need to invest and meet physical presence requirements in a given Special Administrative Region (SAR).

In detail

What are SARs and what are they for?

SARs were set up in 2018 on Oktyabrskiy Island in the Kaliningrad Region and on Russkiy Island in Primorsky Krai. Companies registered at SARs are eligible for MNHC status, provided that they meet certain criteria. MNHCs are granted a more attractive holding regime, including:

- 0% tax on dividends received if they hold an ownership interest of more than 15% (the general benefit applies where the shareholding is at least 50%);
- sales of shares and equity in Russian and foreign companies are tax exempt if the holding is more than 15% and the holding period is longer than one year (the general benefit applies where the holding period is longer than five years);
- a number of other benefits, including benefits for controlled foreign companies (CFCs).

As many as 39 companies have become SAR residents since the introduction of the SAR regime, including 37 on Oktyabrskiy Island and two on Russkiy Island. In the context of changing tax treaties that Russia has with Cyprus, Luxembourg, Malta and the Netherlands, and, potentially, tax treaties signed by Russia with other jurisdictions, interest in relocating to SARs is growing.

In our August 2020 Tax Flash, we reviewed a draft law prepared on amending SAR legislation based on the Roadmap for Transforming the Business Environment (the “Roadmap”). However, the draft law was later removed from the regulation.gov.ru website. In November 2020, the MinFin

1 https://regulation.gov.ru/projects#search=%D0%BC%D0%B7%D0%B6%D0%B4%D1%80%D0%BE%D0%B7%D1%8B%D1%85%20%D0%BA%D0%BE%D0%BC%20%D0%BF%20%D0%BD%20%20
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developed a Framework for Improving Legal and Tax Regimes in Special Administrative Regions (the “Framework”) that was overall consistent with the Roadmap. However, the new draft law provides for significant novelties in comparison with the Roadmap and the Framework.

**Proposed amendments to the eligibility criteria for MNHC status**

Foreign companies may be eligible for MNHC status if they are registered in Russia as a multinational company (MNC) under the redomiciliation procedure and meet certain criteria. The table below compares the current requirements with those stipulated by the draft law. The proposed amendments would cover more companies that, hypothetically, would be eligible for MNHC status and, consequently, the additional tax benefits.

<table>
<thead>
<tr>
<th>Current legislation</th>
<th>Draft law</th>
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<tbody>
<tr>
<td>The company was established before 1 January 2018.</td>
<td>The company was established before 1 January 2020 and at least three years have elapsed between establishment and relocation.</td>
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<tr>
<td>The controlling entities of the MNC as of the date it was registered under the redomiciliation procedure were also the controlling entities before 1 January 2017.</td>
<td>The controlling entities of the MNC as of the date it was registered under the redomiciliation procedure were also the controlling entities before 1 January 2020. In order to meet the requirement, at least 75% of the entities that directly or indirectly control the MNC must remain unchanged.</td>
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<tr>
<td>No new entity may appear in the list of controlling entities of the MNC for 365 calendar days after it was registered.</td>
<td>No new entity may appear in the list of controlling entities of the MNC for 365 calendar days after it was registered, except in cases of succession or reorganisation in the form of spin-off, split-off or transformation of entities that are qualified as controlling entities of the MNC as of the date it was registered.</td>
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Thus, some practical aspects remain unregulated, e.g., the possibility of relocating to an SAR if the controlling entities in the chain of ownership have been liquidated and the ultimate beneficiaries remain unchanged. It is not quite clear how to calculate the 75% share of entities that directly and/or indirectly control a given MNC.

**New condition for the loss of MNHC status**

The current version of the draft law introduces a new provision in the Tax Code under which a company might lose MNHC status. If a company is registered in an SAR and has obtained MNHC status but failed to deregister from the foreign jurisdiction where it was previously registered within six months for some reasons, it will lose MNHC status.

The current version of the amendments does not take into consideration potential objective factors that may delay an entity’s removal from a foreign register after redomiciliation (for example, a complex or lengthy tax audit of periods from the date when the company decided to change its domicile to the date when it was registered in an SAR, creditors’ claims, technical/public health-related and other delays on the registrar’s side). In other words, even good faith taxpayers might face the risk of failing to meet the deadline and losing their eligibility for benefits.

**Additional benefits and physical substance requirements**

The current version of the draft law provides for a number of additional benefits to MNHCs:
MNHCs may apply the 5% tax on received income (including inward dividends) if they meet the criteria for regional investments and physical presence (see below). The rate may be applied until 31 December 2028;

MNHCs may apply the 10% tax on dividends, interest and royalties paid from the MNC if the latter applies the 5% rate, i.e. meets the criteria for regional investments and physical presence (see below);

a grandfather clause stipulating that reduced rates of corporate income tax and personal income tax will not be increased, repealed or modified for MNHCs.

tax exemption on exchange differences (except for securities denominated in foreign currency);

tax exemption on income earned by branches that are engaged in mineral extraction projects, with such tax-exempt transactions simultaneously qualified as controlled from a transfer pricing perspective;

a transition period for the pass-through approach to dividends received by the MNHC.

In order to be eligible for the first two benefits, companies must meet the following criteria:

1) investments of at least RUB 300 million in the construction of social, transport, energy and/or utility infrastructure in the Russian region where the SAR is located;

2) the MNHC’s passive income should make up at least 90% of its total income;

3) it must employ at least 15 full-time employees who permanently or temporarily reside in the Russian region where the SAR is located;

4) it must have an office (owned or leased) of at least 100 sq. m. located in the SAR.

Given the location, accessibility and current infrastructure, the SAR on Oktyabrsky Island appears to be the more realistic option for physical presence in comparison with the SAR on Russkiy Island. From a practical perspective, however, it remains unclear just what type of functions can be performed by 15 employees (as per the requirement above) when the level of passive income is so high. Furthermore, RUB 300 million should be invested exclusively in social, transport, energy and/or utility infrastructure and not in activities that are necessarily in the taxpayer’s interest (e.g., investments in the construction of buildings and offices, leasehold improvements, etc.) In effect, such investments appear to be a hidden tax.

The takeaway

Given that more companies can hypothetically become SAR residents, we recommend that you analyse the possibility of redomiciliation and consider the advantages in light of the potential tax benefits and new requirements on physical presence.

It should also be noted that the draft law might be significantly amended at a later stage. We will monitor further developments.

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3 the share of income specified in Article 309(4) of the RTC.
We would be happy to answer any questions you may have.

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