Rules for Controlled Foreign Corporations:

CFC Bill published

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On 18 March 2014, the Russian Ministry of Finance (MinFin) published the text of a bill [1] that would introduce rules for Controlled Foreign Corporations (CFC) in Russia (the “Bill”). The period for public discussion of the Bill’s provisions ends on 22 March. The business community and general public have a unique opportunity to comment on the Bill online [2].

Given that the Russian Government is planning for the CFC rules and other provisions of the Bill to take effect on 1 January 2015, and how Russian lawmakers currently view these rules [3], we believe that the business community should play an active role in the public discussion of the Bill while simultaneously building new business models that could mitigate the prohibitively high tax burden associated with the Bill.

CFC rules exist in many countries, such as the United Kingdom, Germany, France, Spain, and others. It is generally believed that CFC rules, as well as the tax residency rules based on place of management, are aimed at combating tax avoidance when profit centres are transferred from countries where profits are generated to tax havens.

Currently, such rules are being revisited in accordance with BEPS (an OECD project aimed at counteracting tax structures and practices used for tax base erosion).

In essence, the proposed Russian CFC rules do not differ conceptually from their foreign counterparts; however, at this stage they are not as elaborated and in certain aspects are quite restrictive.

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Highlights of the rules

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[3] It’s clear that the Bill and many of its provisions will likely be subject to numerous amendments and fine-tuning of details.

[4] The wording of the Bill states: “For the purposes of this Code, a Controlled Foreign Corporation is also an entity (including, a fund, partnership, association, or other vehicle for collective investments) ... without creation of a legal entity, which may under its own law conduct business aimed at generating income/profit for the benefit of its members (beneficiaries, shareholders, grantors and other persons), and which is controlled by entities and/or individuals that are deemed to be Russian tax residents ...”

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Essentially, the CFC rules mean that a Russian tax resident (either an individual or legal entity) must pay tax in Russia on the retained earnings of any offshore entities and structures controlled by the given entity or individual [4], if such entity has not paid out dividends. Any profits of a CFC, according to the lawmakers’ intent, is calculated under the rules set out in Chapter 25 of the Russian Tax Code after deducting the amount of any dividends paid out.

Meanwhile, offshore jurisdictions are understood to be those that are included in the relevant MinFin list. However, at this stage it is unclear whether the list established by Russian Ministry of Finance Order No. 108n of 13 November 2007 would be applied in this context.

Control means exercising a determining influence (or the relevant ability to do so) on decisions made by a CFC regarding profit distribution (in particular, when over 10% of the shares or interest in a CFC is owned directly or indirectly by a Russian tax resident, factoring in any interest owned jointly with a spouse, minor children or others).

The Bill allows for some options for reducing a CFC’s tax base by deducting any distributed dividend amounts, and other forms of tax offsets, when the chain of ownership consists of several controlling residents.

Please note that Russian individuals and entities would be liable to report to the tax authorities all cases of direct or indirect ownership exceeding 1% of interest or shares held in foreign corporations, which are resident in any jurisdictions on the MinFin list, or with undisclosed tax residency status, or entities which are, as officially recognised, controlled by Russian individuals or entities. The penalty for non-compliance with reporting requirements (or reporting inaccurate information) would be RUB 100,000 per year.

Further, the Bill provides for material penalties for failure to pay (or not pay in full) any tax due on CFCs: 20% of a CFC’s profit, which is 100% of the outstanding tax amount for entities and approximately 150% of the outstanding tax amount for individuals.

What’s at the heart of Russia’s version of CFC rules?

Recognising foreign entities as Russian tax residents by their place of management

Another innovation worth noting is the ability to recognise foreign entities as Russian tax residents [5] if they are managed from Russia. When a company is recognised as a tax resident it is obligated to register, calculate tax on its worldwide income, and comply with other tax-related rules established for Russian entities. Russia may be recognised as the place of management in this context, including instances when a company’s board of directors or other management body meets in Russia; when “corporate governance” is usually conducted in Russia; when executives carry out their activities in Russia; or if a company’s accounting function or corporate archive is maintained in Russia. Under the Bill, any one of the above criteria may be grounds for recognising a foreign entity as a Russian tax resident.

Taxation of indirect Russian real estate sales

The Bill considers the options for taxing income earned by foreign companies from sales of shares or interests in any entity in which over 50% of the assets are directly or indirectly composed of Russian real estate.

This reflects the Russian tax authorities’ long-standing concern about practices that dilute the tax base through indirect sales of Russian real estate.

Who will be affected by the Bill?

The Bill would undoubtedly affect all market players. The new legislation would have the greatest impact on the following categories of taxpayers:

- Individuals that use offshore vehicles (such as both personal companies as well as potentially trusts and other similar forms of ownership) for owning assets in both Russia and abroad. The Government has stated that this piece of legislation is mainly aimed at taxing such individuals in Russia before income is distributed directly to them.
- Russian entities conducting transactions abroad, including through foreign subsidiaries. The current wording of the bill does not contain any exemptions for Russian entities with active operations in those countries that are included in the official list approved by the Ministry of Finance.
- Russian strategic investors that own minority but substantial equity stakes or interests in foreign companies and corporate groups. The 10% threshold for recognition of control over an entity is unprecedentedly low in international practice. In the vast majority of cases, holding an equity stake of this size does not give the shareholder any material influence on corporate policies regarding distributing profits or other aspects of corporate operations. When making investments, strategic investors must use structures established by majority shareholders and have no opportunity to change them. At the same time, however, such shareholders may face difficulties in obtaining information from foreign companies. For this reason, holding minority but substantial equity stakes may entail significant tax and administrative costs for shareholders.

Our ideas and proposals

In our view, formulating such conceptually complex rules in such a brief period of time [6] must have been a Herculean task on the part of the Bill’s authors. We believe that this Bill is likely to be significantly amended even before it is submitted to the State Duma for formal consideration.

So, our comments should not be taken as criticism but rather as ideas and proposals aimed at making these rules more efficient and more in compliance with the principle of single taxation while at the same time not hindering business growth or encouraging tax avoidance.

Controlling individuals

The simultaneous application of ownership and control criteria may lead to situations where more than one entity/individual could be recognised as exercising control with respect to then same interest in an entity. The Bill does not call for regulating such situations, which could result in double taxation.

Procedure for determining the CFC tax base

The lack of clear rules regarding opportunities for offsetting profits earned at various structure layers if there are several CFCs within a corporate structure, as well as taxes that could be payable in a CFC’s host country, could potentially lead to multiple taxation of profits.

The current version of the Bill does not stipulate any minimum profit level for CFCs that would serve as the basis point for calculating the tax base. However, a number of countries do have such restrictions, which are intended to reduce the administrative burden borne by the tax authorities and taxpayers alike.

[6] The MinFin began the actual work of drafting the Bill in late December 2013 as part of the Russian Government’s campaign to de-offshore the domestic economy, as announced by President Putin in his State of the Nation address to the Federal Assembly.
Tax administration issues

Enactment of the Bill would lead to a significant increase in Russian companies’ tax administration expenses, related to CFC identification and reporting rules.

Calculating the tax base under Chapter 25 rules without any exemption for earnings from "active" transactions will create an unprecedented burden on Russian entities engaged in active transactions abroad, especially in jurisdictions that may be deemed “low-tax”.

The need to translate all documentation, which would have to be filed with the tax office under the proposed law, into Russian would only exacerbate the administrative burden and lead to higher costs for companies if the Bill becomes law.

The proposed penalties for incomplete tax assessments based on the CFC rules are substantial and range from 100% of the relevant tax amount for legal entities up to 150% for individuals. The introduction of such strict sanctions is rooted, it appears, in the principle of self-reporting, on which the draft law is based. Nonetheless, the Bill does not provide for any leniency in cases where underpayment of tax is not premeditated and occurs because of:

- ambiguity in the wording of the law (which is highly likely given that such rules are entirely new for the Russian market);
- lack of clarity in specific provisions of the law; or
- the impossibility of obtaining required information from foreign entities given Russian individuals’ lack of influence over them (remember that a 10% ownership threshold is very low and is frequently insufficient for a shareholder to exercise any control at all over a foreign entity).

The Bill would impose very tough tax filing deadlines for CFCs, which do not take into account the time required for preparing a CFC’s own financial statements, as well as those cases when a foreign company’s reporting year does not coincide with the calendar year.

Recognising an entity’s tax residency by its place of management

The list of conditions contained in the Bill include both such traditional global practices as methods for recognising an entity’s place of management (where board of directors’ meetings are held, where key company executives are permanently based, etc.), and recognition methods that are considerably less significant for business, e.g. where the company’s accounting function or archive is located.

What should you do now?

- First of all, we recommend that you take advantage of this unique opportunity to voice your opinion and make your comments and suggestions regarding the Bill known during the public discussion period.

- Second, you should closely examine your foreign assets in light of the additional tax burden that the introduction of these new CFC rules would usher in, as well as the new rules for recognising a foreign entity’s tax residency by its place of management and the rules for taxing indirect real estate sales. As well, we urge you to give some thought as to whether you may need to restructure your holding arrangements, as well as make any changes in structuring cash flows and accumulating book profits. Additionally, you should assess how much time and money it would take to make such changes in your existing structures. In short, now is the time to take action!

In the near future, we will definitely be holding seminars for a more in-depth discussion of the Bill and its implications.
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