INFORMATION LETTER

Update on legislative developments in Russia.

Governmental De-offshoring initiatives. Proposed new CFC and tax residency rules

When it was first revealed by President Vladimir Putin a few years ago that the offshore-backed *modus operandi* for the Russian economy could no longer be tolerated, very few could have predicted that the Government would be making a serious legislative effort to fight the offshore structures that had essentially crippled all industry sectors in Russia, both public and private.

Why does Russia need it? In his message to the Federation Council delivered on 12 December 2012 President Putin had particularly focused on the need for de-offshorisation[1]: *"Our entrepreneurs are often reproached for being unpatriotic. The offshore nature of Russia's economy has become a household word. Experts call this escaping the jurisdiction. According to some estimations, nine out of every ten major deals by large Russian companies, including the state-owned ones, are not subject to national laws. We need a whole system of measures for the de-offshorization of our economy. I order the Government to submit appropriate comprehensive proposals on the subject."*

In his next, 2013 annual speech at the Federation Council President Putin had followed up by saying[2]: *"Last year in my Address I talked about the goals underlying the de-offshorization of the economy. This is yet another topic which I would like to draw your attention to and which, as I reckon, we need to get back to today...*

According to expert estimations, last year $111 billion in Russian goods, which makes one fifth of our exports, have gone through offshores and semi-offshores. Offshores syphon off half of Russia's 50 billion dollar investments into other countries. These figures demonstrate the flight of capital that should have worked in Russia, which is a real loss for the national budget.

Since over the year nothing that should have been done was done, I have some suggestions…"

It could have not been said any better. The "suggestions" seemed to have been heard by those whom they were addressed to and the engine of the administrative system was revved up. The Russian Government was tasked to prepare and submit in 2014 for consideration to legislators a package of all "necessary" normative acts with an aim to align domestic legislation with "best practices" used in other jurisdictions and international regulatory standards that can help, if not eradicate, to substantially reduce enormous tax leakage for the Russian budget from profits shifting techniques and use of offshore companies.

De-offshoring Objectives and Directions

One of the first measures presented in February 2014 by the Russian Ministry of Finance was a tentative road map setting out its objectives and highlighting priorities for the regulator in de-offshoring the economy. Amongst others, these drafting measures are supposed to include the following new taxation concepts and proposals:

- Introducing controlled foreign companies (CFC) rules and principles of taxation of CFCs to ensure taxation in Russia of unallocated profits of foreign companies controlled both by Russian organizations and/or individuals. This initiative has been promulgated in a draft Federal Law "On the introduction of changes to the Tax Code of the Russian Federation" (discussed in the second part of this information letter).
- Developing tax residency rules for organizations and criteria for the determination of tax residency for legal entities and organisations, as opposed to individuals, present in Russia.
- Creating an adequate legislative framework for measures aimed at counteracting an abusive application of international tax treaties granting preferential tax rates.

[1] http://kremlin.ru/transcripts/17118#sel=127:1,127:60

[2] http://kremlin.ru/news/19825#sel=128:1,128:52;126:1,126:31;129:1,129:15

- Focusing on the appropriate legal base to enhance the efficiency of cooperation between the Federal Customs Service of Russia and foreign tax authorities in relation to the exchange of information on tax matters.

- Ratification of the Convention on Mutual Administrative Assistance in Tax Matters.

- Adoption of the resolution of the Government of the Russian Federation on the Approval of the Model Agreement on the Exchange of Information on Tax Matters.

- Negotiating and entering into agreements on the exchange of information on tax matters with jurisdictions listed among states and territories offering preferential tax treatment and/or those which provide for no disclosure of information regarding financial operations (offshore zones) approved by Order of the Ministry of Finance of Russia No. 108н dated 13 November 2007.

- Introducing the "beneficial owner of income" definition to legislation of the Russian Federation on taxes and levies, including, *inter alia*, for the purposes of the application of international tax treaties.

- Improving mechanisms for the disclosure of information about beneficiary owners of Russian legal entities and creating a centralized Register of beneficiary owners. Organising access to this Register to the Federal Customs Service and the Russian tax authorities, including in relation to those organizations that participate in the implementation of state and municipal programmes.

- Monitoring results caused by the introduction of new transfer pricing rules. Introducing additional tax rules to enhance efficiency of control over cross-border transactions, including those with offshore entities.

- Expanding the scope of Russian regulations to capture by Russian profits tax capital gains generated from sale of Russian organizations' shares having more than 50 per cent of their assets in the form of real estate property located in the Russian Federation and to include into the scope of taxation rules capital gains from sales of both directly and indirectly owned property-rich Russian businesses.

- Elaborating on the *procedure* of *property tax* collection and tax debt recovery from foreign organizations being taxpayers with respect to real estate properties located in the Russian Federation.

- Enabling access by tax authorities to information and documents constituting an audit secret received or composed by an audit firm and individual auditor in connection with rendering services related to corporate taxation. Creating the legislative framework for cooperation between audit firms and individual auditors with supervisory authorities by amending Federal Law "On Audit Activities" in the Russian Federation.

- Refining requirements with respect to disclosure in accounting (financial) documents of an organization of information about its owners, intermediate and ultimate beneficiaries regardless of whether any operations are conducted with them or not. This is planned to be achieved by enacting an Order of the Ministry of Finance of Russia "On the introduction of changes to RAS 11/2008 "Information on related entities".

- Drafting proposals aimed at enhancing the transparency of legal entities and organizations, subsequent bringing the mechanism of establishing the identity of beneficiary owners of organizations closer to provisions 10 and 24 of the Recommendations of FATF, including, *inter alia*, subject to decisions of the G8 summit in Lough Erne on 18 June 2013.

- Making proposals to introduce into legislation of the Russian Federation specific changes focused on defining *prima facie* the concept of an "offshore company", the restriction of legal capacity of offshore companies, including to the extent related to participation in state programs, the acquisition of state and municipal property, receiving budgetary funds and restriction of possibility to receive budgetary funds to those organizations that failed to furnish information about their beneficiary owners.

- Creating recommendations to audit firms and individual auditors with respect to the verification of information about owners, intermediary and ultimate beneficiaries of organizations in the course of the audit of accounts (financial statements) of organizations.

- Suggesting a comprehensive Concept for the Development of a System of Counteraction of Legimatization (Laundering) of the Proceeds of Crime and the Financing of Terrorism in the Russian Federation up to 2020.

- Increasing criminal liability on the management of banks, insurance companies, pension funds, other financial institutions for furnishing knowingly incorrect, incomplete data.

- Drafting proposals to halt the use of legal concepts permitting the receipt of funds through bearer instruments from civil legislation of the Russian Federation.

Except for a few action points, most of these directions are set to be formalised before July 2014. The process is currently underway. Some experts believe that this was initially driven by an intent to increase cooperation backed by the Moscow G20 meeting of finance ministers and to develop a comprehensive action plan with coordinated strategies for countries concerned with BEPS, however in the context of the existing tension between Russia and some Western counties de-offshoring is now more by what **Immanuel Kant** would have called as a *"thing-in-itself"*, as it has been submerged into the Russian national "economy protection" plan and became an independent catalyser for the increasingly growing campaign to reduce foreign and quasi-foreign held assets by Russian private individuals and Russian corporations.

It remains to be seen if, how and when all these efforts will sail through parliament, however some of the critical items in the plan have been recently promulgated in a draft regulation by the Russian Ministry of Finance. These cover the following:

a) tax residency rules for legal entities;

b) capital gain taxation rules for proceeds from sale of indirectly owned Russian real estate property-rich companies;

c) CFC regulation.

These legislative initiatives are being currently discussed within the business community and commented on by experts.

New tax residency rules for legal entities

As a long-waited attempt the Ministry of Finance suggests to introduce specific changes to Chapter 25 Part II of the Tax Code of the Russian Federation, adding points 5-6 to article 246. These changes seem to enact the principles, what many experts believe Russian domestic law needed a while ago, about tax residency for legal entities as opposed to individuals-taxpayers.

Definition of corporate tax residents

The draft law seeks to categorise all legal entities and organisations which shall be recognised as tax residents of the Russian Federation. These should include:

1. Russian organisations;
2. foreign organisations recognised as tax residents of the Russian Federation under an international tax treaty (agreement);
3. foreign organisations whose effective management seat is the Russian Federation.

New criteria for the effective management seat test

New set of criteria are proposed by the new draft law to assert the effective management seat definition. This will be the case if at least one of the following conditions is met:

a) meetings of the board of directors (another corporate governing body) are held in the Russian Federation;

b) the organisation is *usually managed* from the Russian Federation;

c) the key (managing) officers of the organisation carry on their activity in the Russian Federation;

d) corporate accounting records are maintained in the Russian Federation;

e) corporate archives are kept in the Russian Federation.

The draft law also sets out that unless otherwise provided by an international tax treaty to which the Russian Federation is a party, a foreign organisation may independently recognise itself as a tax resident of the Russian Federation.

Practical comments

Obviously, the above definition is far from certain. As is the case with any new, poorly drafted or insufficiently explicable, tax concept in Russia, the new term of tax residency for legal entities will inevitably bring about various practical issues and interpretation problems. For example, neither Russian tax law, nor civil law explain what is meant by the "usual" character for any commercial activity process and, accordingly, how the authorities can ascertain and evidence "usual" nature for management activity.

Further, the new draft law limits the residency criteria only to an "effective management" test, rather than "effective management and control". Control is presented more as a concept about recognising foreign company's profits tax Russian taxation under as the new CFC rules, which are in parallel contemplated by the Russian Ministry of Finance. While both of these legal notions are referred to in the new draft law, they do not seem sufficiently defined and isolated from each other. This will give rise to adverse implications. For example, any management assistance and support services rendered in Russia for the benefit of a foreign organisation under any compensating agreement, often undertaken to avoid a Russian permanent establishment, may cause questions as to what extent this assistance is part of the management process and whether it is "usual" enough to then expose the foreign organisation to tax residency in Russia.

The ultimate downside is that under the revised Chapter 25, foreign organisations recognised to be Russian tax residents shall be equated to Russian organisations and shall pay Russian profits tax under the general rate(-s), as applicable depending on the type of income received.

This legal change would have a far-reaching effect for any typical joint venture structures set up with Russian partners, where a joint venture (JV) vehicle is placed, for some commercial and legal, not necessarily tax, reasons into a non-Russian jurisdiction with a Russian project company made 100% owned by that JV. If a Russian partner takes part in the operative management of the JV from the Russian soil, it may expose the JV to these new taxation rules. This will necessitate some additional thinking and proper structuring of JV agreements and, in some cases, revisiting the parameters of the existing non-Russian shareholders agreements. No doubt, for simple holding and sub-holding companies owned by Russian businesses and private individuals some restructuring may be needed, regardless of the non-Russian jurisdiction (offshore or reputable one) in which the foreign holding company operates.

Setting aside the new tax residency rules, any restructuring should take into account a permanent establishment risk, which in practice often involves a very similar approach by the Russian tax authorities to the problem of what constitutes *de-facto* management. There have been cases where the Russian tax authorities sought to prove a foreign organisation has Russian permanent establishment where it operates with Russia and is also managed out of Russia. With the Russian authorities being very creative to interpretational theories, assumptions behind recognition of a foreign organisation as having a Russian permanent establishment via-a-vis Russian tax resident may overlap.

Proposed law change for capital gains taxation from the sale of indirectly owned Russian property-rich companies

The new draft law aims to restate point 1 (5) of article 309 of the Tax Code so as to read that Russian source income should also include income generated from the sale of shares (participation interests) in organisations where 50% of assets are both directly or indirectly made up of real estate property located in the Russian Federation. The proposed new rules extend also to financial instruments, the derivatives of such shares (interests), except for the shares recognised as shares traded on an organised securities market in accordance with point 9 of article 280 of the Tax Code.

However, as stated in the existing version of article 309, income from the sale of securities on foreign stock exchanges (via foreign trade organisers) or from the sale of financial instruments derived from such securities traded on these stock exchanges shall not be recognised as Russia-sourced income.

As a result, sale proceeds from the disposal of all indirectly owned Russian property-rich companies should be subject to Russian tax, unless they are treaty protected. This would be a significant change in the law and current tax treatment. Russia has been actively looking to renegotiate tax treaties with some of the foreign jurisdictions which permit one to avoid withholding tax on capital gain generated from the sales of Russian businesses with real estate assets exceeding 50% of the net book value of all assets in the target company or companies. A very recent example include interests to amend Russian-Dutch tax treaty in this regard[3].

Accordingly, following these new rules, any capital gain deemed realised from the sale of a Russian property-rich company or companies effectuated through a foreign sub-holding entity but at the level of a second tier non-Russian holding company may be taxable in Russia, unless still protected by any favourable tax treaty. Careful planning will be required to structure any real estate-driven corporate transactions, as simple and currently practiced "drop-down" of Russian property-rich company's shares before the sale into a treaty-friendly jurisdiction may no longer help much, if these changes are eventually legislated.

Draft CFC regulations proposed by the Russian Ministry of Finance

Definition of a CFC

According to the draft law, a CFC shall be a foreign organisation which during any period beginning or ending in a calendar year continues to meet all of the following criteria concurrently:

a) the organisation is not recognised as a tax resident of the Russian Federation under the Russian Tax Code or under an international tax treaty;

b) the organisation is a tax resident of a state (territory) granting preferential tax treatment with respect to profits (income) according to a list of jurisdictions approved by the Ministry of Finance;

c) the controlling persons of the organisation are organisations and/or natural persons recognised as tax residents of the Russian Federation under the Tax Code or under an international tax treaty;

d) the shares of the organisation have not gone through the listing process and/or have not been admitted to trading on one or more stock exchanges from the list of those approved by the Central Bank of the Russian Federation in consultation with the Ministry of Finance of the Russian Federation in accordance with point 2^1 (1) of article 310 of the Tax Code.

Foreign structures and trusts as a CFC

The draft law introduces a new legal notion called "structure". While this terminology has been widely used by experts and tax practitioners in day-to-day advisory activity, it is not properly construed in tax law, particularly, in general rules established by Article 11 of the Tax Code which define for tax purposes various institutions, concepts and terms such as organisations, foreign organisations, taxpayer, source of income, etc.

[3] http://www.rbc.ru/rbcfreenews/20140317115654.shtml

Despite the foregoing, the draft describes that for the purposes of this regulation, a CFC shall also mean an unincorporated structure (including a fund, co-partnership, partnership or another collective investment scheme) set up in accordance with the laws of a Russian Ministry of Finance "blacklisted" foreign jurisdiction (territory) that grants preferential tax treatment with respect to profits (incomes).

Again, this definition appears to be extremely broad. It does not have any objective criteria other than that the qualifying structure should be: (i) legally entitled to carry on entrepreneurial activity aiming at making incomes (profits) and (ii) this activity should be performed in the interests of its members (beneficiaries, stakeholders, trustees, and others), whose controlling persons are organisations and/or natural persons which are recognised as Russian tax residents.

It is likewise not defined in the draft law what may constitute the preferential tax treatment with respect to profits (incomes) for the purposes of CFC. It is therefore possible that the Russian Ministry of Finance can be arbitrarily include and exclude any jurisdictions from the list on an "as wished" or more on an "as needed" basis. Moreover, this "black list" does not need necessarily to be consistent with the list of offshore zones approved by Order of the Ministry of Finance of Russia No. 108н dated 13 November 2007 and a risk is that it can extend beyond the typical "plain vanilla" jurisdictions.

Definition of control for the purposes of a CFC

According to the draft law, a controlling person of an organisation (including the structure set up in accordance with the laws of a foreign state shall mean a person which exercises control over this organisation (the structure) whether individually or jointly with other persons.

In turn, control over an organisation shall mean the following:

- exercise or, importantly, the *possibility* to exercise decisive influence on decisions made by such an organisation;
- these decisions relate to the distribution of after-tax profit (income) received by the organisation;
- these decisions extend to taxation by virtue of having both a direct or indirect participation interest in such an organisation;
- the control may also be established via operating under a contract (agreement) the subject matter of which is the management of this organisation;
- finally, the draft law also contains a *"capture-all"* provision, whereby the control may be established by virtue of *"another relationship between a person and the organisations and/or other persons"*.

Judging how broadly the control is determined under the draft law in its current version, it is not impractical to expect that the authorities would seek to argue that various complex compensation and management non-Russian instruments including those premised on the use of non-classical trusts, call-options, bearer shares, different classes of shares may well be exposed the same way as conventional participation rights.

With respect to trusts, foundations and similar structures, the exercise of control shall mean the exercise or, as in the case of the company, *the possibility* to exercise decisive influence on decisions made by the person managing the assets of such a structure with respect to the distribution of after-tax profit (income) among its members by virtue of law or by virtue of a contract.

Participation threshold for a CFC Controlling person

A controlling person of an organisation is defined, *inter alia*, a person whose direct or indirect participation interest in the CFC jointly with the spouse and/or underage children and other persons (considering the relationship between this person and other persons) is 10%.

Regardless of the 10% participation test, a person may, according to the draft law, individually elect to recognise him/herself as a controlling person of an organisation or a structure set up in accordance with the laws of a foreign state for the purposes of Russian CFC.

Specific CFC Notification requirement

Taxpayers - Russian tax residents will be required to notify the tax authority of their participation interest in a foreign controlled organisation in the manner established by the draft law.

The requirement to serve notice of participation interest in foreign organisations must be served by taxpayers in relation to a CFC organisation provided the taxpayer's direct and/or indirect participation interest in these organisations is 1% or more.

With respect to unincorporated structures (including funds, co-partnerships, partnerships or other collective investment schemes) notification must be filed provided the taxpayer is a person that has a *de facto* right (beneficiary right) to the income (profit) of this structure in the case of its distribution or is recognised to be a controlling person of this structure.

While it is clear that the notification requirements for CFC organisations established in the form of a "structure" (fund, foundation, etc) are essentially new under Russian tax regulation, it may conflict with obligations imposed on Russian taxpayers by Article 23 of the Tax Code. Under the norms already in force, all Russian taxpayers have to inform the tax authorities within one month about any obtained participation(-s), regardless of the owned percentage, in Russian and non-Russian organisations. It appears that the intent of the authors of this draft law is to reinforce this requirement and to put in place a mechanism for implementing this requirement including via penalties for non-compliance.

Timing for serving Notice on participation

Notice of a participation interest in a foreign organisation shall be served not later than within 20 days from the date when grounds arise for the service of such notice in accordance with the draft law.

This notification requirement is set to be of a recurring nature. Specifically, the draft law establishes that in the event that (a) during a calendar year the taxpayer's participation interest in a foreign organisation has not changed or (b) grounds for the service of notice have arisen before the beginning of the calendar year, notice of participation interest in a foreign organisation shall be served not later than on March 1st in the year following that calendar year.

Taxpayers shall serve notice of their participation interest in foreign organisations on the tax authority at their location (at their place of residence). As regards taxpayers who fall under the category of the qualifying "major taxpayers", they shall serve notice of their participation interest in foreign organisations on the tax authority at the place of their registration as major taxpayers.

Notice Form

Notices on foreign organisations shall be served on the tax authority by corporate taxpayers electronically to the established forms (formats). Individual taxpayers may serve the specified notices in hard copy.

The forms (formats) of notices on CFC as well as the form completion procedure and the procedure of service of notices on CFCs in electronic form shall be adopted by the federal executive body responsible for control and supervision in the field of taxes and levies in consultation with the Ministry of Finance of the Russian Federation.

Content of the Notice

According to the draft law, a filed notice of participation interest in foreign organisations must contain the following information:

1) the period over which information on the participation interest in foreign organisations is provided or date when grounds for serving the notice arise;

2) the name of the foreign organisation (structure) in relation to which the notice is served;

3) the registration number (numbers) as may be assigned to the foreign organisation in the state (territory) of its registration (incorporation) and the code (codes) of the foreign organisation in the state (territory) of its registration (incorporation) (or analogues thereof), if any;

4) the date of the foreign organisation's financial statements in accordance with the personal law of that organisation;

5) the date of the auditor's opinion with respect to the foreign organisation's financial statements (if the audit is mandatory in accordance with the personal law of that organisation);

6) the taxpayer's participation interest in the foreign organisation, disclosure of the structure of taxpayer's participation in the foreign organisation in the case of an indirect participation interest;

7) a description of grounds for recognising the taxpayer as a controlling person of the CFC in the case that notice is served by such persons.

In the event of discovering incomplete data, inaccuracies or errors in the completed notice of participation interest in foreign organisations that has already been served, the taxpayer may serve an adjusted notice.

Profit subject to CFC taxation

The draft law contains provisions that many experts believe will be extremely difficult to comply with, unless the profits earned by a CFC represents passive income (such as dividends, royalties, etc) with no material tax deductions claimed against these profits at the level of the CFC. One of the major troubles in this regard is that for the purposes of the Tax Code, profit of a CFC will always have to be adjusted as it shall be calculated in accordance with Russian rules (i.e. under the Chapter 25 of Part II two of the Tax Code) net of the outbound dividends already paid.

Further, the allocable profit must be documentarily backed up by the financial statements of such a CFC over the respective period (periods) and by other documents. Finally, the profit of a CFC denominated in a foreign currency shall be converted into roubles at the official exchange rate of a foreign currency to the Russian rouble as may be set by the Central Bank of the Russian Federation as of the last day of the calendar year.

Finally, the draft law also introduces a separate "income basket" taxation rule for CFC's taxable profit. In particular, it suggests to amend point 21 of article 274 of the Tax Code so as to read that the tax base determined by controlling persons with respect to the profits of CFCs controlled by them shall not be reduced by expenses relating to other activities and losses incurred in connection with other activities of such persons.

A similar rule would apply to qualifying taxpayers - individuals; no general personal income tax deductions provided for by the law will be available against the taxable CFC profits imputed to the taxpayer - individual.

Procedure of allocating profit for CFC rules

The draft law stipulates the following key points for determining the allocable portion of CFC taxation:

- The profit of a CFC shall be added to the tax base of a taxpayer as a percentage that corresponds to the participation interest of this person in the CFC and to the period during which the taxpayer is being recognised as a controlling person in it if the duration of such a period is shorter than that of a tax period.
- Where it appears impossible to determine the participation interest of a taxpayer, being a controlling person, in a CFC, the profit of this company shall be included in the tax base for the taxpayer to a full amount.
- Allocation of profit of a CFC held via indirect participation shall be made on a proportionate basis, whereby the taxable profit for the taxpayer of this CFC shall be accordingly (pro-rata) reduced by the amounts of profits that have been already subjected to tax in the hands of these other controlling persons interposed in the second or upper tier(-s).

In this regard, one of the first question marks should be posed to practicalities of how this mechanism can be functioning, given the relatively low participation threshold for CFC set at the level of 10%. This is particularly relevant as the draft law is premised on the assumption that information on profit earned in the qualifying CFC should be obtained in the manner to be established by *an agreement between the taxpayer being the controlling person and the organisation*, via which its indirect participation in the CFC is exercised. It is likely that this mechanism dictating such an agreement to be brokered and enforced can hardly work in real life for a minority shareholder where (s)he owns the CFC indirectly together with other unrelated shareholder(s). The latter may, for various good or not reasons, simply wish not to enter into any such agreement with a qualifying taxpayer.

Penalty for non-compliance

The law introduces a new penalty regime, whereby (i) failure to file, where required, notice on CFCs over a calendar year by the due date or (ii) filing of a notice on CFCs that contains false data entails shall give rise to a fine of 100,000 roubles per each CFC which data have not been provided.

Groundless refusal by a taxpayer to provide documents necessary for the authorities' tax control over the CFC compliance shall result to a similar fine of 100,000 roubles. The same penalty also extends to violations arising from any other way of avoiding production of such documents or in the production of documents that contain knowingly false data.

Importantly, (i) non-payment or (ii) incomplete payment of tax by a controlling person, being an individual or corporate taxpayer, as a result of failure to add into the tax base the qualifying profit of a CFC shall give rise to a fine to the amount of 20% of the CFC's profit which should have been taxed under the CFC rules. The draft law sets 100,000 roubles as a minimum penalty for this specific violation.

This penalty regime is fairly criticized for its draconian nature, as it assumes a tax fine calculated using the tax base (20% of the CFC's profit), rather than the tax liability itself crystallised in the hands of the qualifying taxpayer. Under Russian tax rules, a 20% penalty (or a 40% penalty as applicable in certain cases) normally applies to underpaid tax liability itself. Further, it is not directly addressed in the draft law, but this excessive tax penalty is assessed on the back of a separate "income basket" rule under amended Article 274 may (given the CFC taxable profit treatment) be not tax deductible against profits earned from other on-going operations of a Russian taxpayer - legal entity. This tax treatment would even further contribute to a risk of doubling irreversible non-compliance losses in case of violating CFC rules. Such a construing of the law makes it clear that if the draft law is introduced in its current version and with its penalty regime, ignoring the tax risk or relying on a "wait-and-see" approach may, mildly speaking, no longer be a cost-effective option to consider.

Concluding remarks on draft CFC rules

Many experts have little trouble in agreeing that the adoption of the CFC rules as envisaged by the draft law would revolutionise the whole risk assessment approach to cross-border operations and tax planning for Russian investors and their partners.

There have been some comments made that a solution for Russian investors can be easily found in merely distributing all profits from non-Russian offshore jurisdictions into Russia in order then to have the actually received income taxed by a standard 9% Russian profits tax on dividends, rather than 20% otherwise applicable to CFC's profits for Russian companies - controlling persons, or 13% for private individuals - Russian tax residents. We believe that the problem is far more complex. Looking at how tax matters are administered in practice one can anticipate that in addition to maximizing taxation by Russian profits tax on all in-flows to ultimate Russian investors under the new CFC rules, income generated by Russia assets and paid as outflows may be exposed to excessive Russian tax.

In particular, armed with CFC rules the Russian tax authorities will receive a legislative instrument to much stronger argue that any outbound interest, royalties or dividends could not be exempt from Russian withholding tax or benefit from a reduced rate under a relevant treaty because they are distributed all the way up to the chain to a CFC controlled by the Russian taxpayer, so the first non-

Russian income recipient is thus not a beneficiary owner to this income but a conduit entity. Note that the beneficiary owner of income is called for in Russia's double tax treaties to qualify for treaty benefits, but is yet to be introduced into the domestic tax law, hence leaving a lot of interpretation issues in practice[4]. Such a legal position can result in double taxation of the same income, first at the level of payments made out of Russia by Russian withholding tax and second - by imputing this income, net after withholding tax, to CFC's tax base under the new rules.

Another point of critics shared by tax practitioners is that the new draft law over-simplifies the CFC regime, contrary to how it should normally function. There are no "50% ownership" and "active business" tests to apply for a qualifying CFC. Nor does the new draft law distinguish the related-party transactions from buying and selling assets as income subject to CFC taxation. The scope of the new draft law is blatantly wide and seems to capture all in-flows going into a CFC.

In this regard, many Russian taxpayers and their non-Russian partners who cooperate or do joint-venturing with Russian taxpayers on any projects should review their existing structures and consider taking timely actions to reduce their CFC exposure and also related tax risks arising for their cross-border operations.

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4 A letter of the Ministry of Finance dated 9 April 2014 №03-00-P3/16236 signed by Mr Shatalov provides for some general guidance, but is still lacking sufficient criteria for recognising a foreign company - counterparty as a beneficiary owner of income. In general, it repeats that the beneficiary owner of income has to be ascertained subject to assigned risks and functions carried out by the foreign income recipient and shall be distinguished from conduit companies.