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May 29th, 2014

Dear Sirs,

As we informed you earlier in our newsletter as of March 21st, 2014, the Ministry of Finance of the Russian Federation ("**MinFin**") published the draft law on proposed amendments to the Tax Code of the Russian Federation introducing the CFC rules, tax residency rules for companies and some other new regulations.

The draft law was open for public discussion, and on May 27th MinFin published the revised draft (the "**Revised Draft**"). Even though the main aspects remained unchanged, significant amendments and additions were made to the Revised Draft as compared to the initial one. For example, a combination of the "white list" approach and the effective tax rate is suggested as the criterion for not treating a company as a CFC instead of the "black list" approach contained in the previous draft. The Revised Draft is supplemented with a definition of the "beneficial owner" whereas the initial draft contained no such definition.

Below we outline most important aspects of the Revised Draft.

CFC

The Revised Draft establishes the definition of a CFC that is a foreign _company_ that:

(A) Is a non-Russian tax resident; *AND*

(B) has *controlling persons* that are Russian tax residents (companies or individuals); *AND*

(C) is not listed on any stock exchange included into the list of stock exchanges issued by the Central Bank of the Russian Federation jointly with MinFin.

The definition of a CFC also covers structures (including, but not limited to, trust, partnership, association, or other forms of collective investments) that:

- are established under the laws of a foreign country;
- carry out profit-making activities for the benefit of their participants (beneficiaries, stockholders, principals and other persons);
- are controlled by Russian tax residents (companies and individuals).

The controlling person of a corporation / structure is a person who individually or jointly with other persons exercises *control* over such corporation /structure. *Inter alia*, the controlling person is a person who has direct or indirect participation interest (individually or jointly with his/her spouse and/or infant children and other persons by virtue of their specific relations) exceeding 10%.

Any taxpayer shall bear two basic obligations with regards to a CFC:

- to notify the relevant tax authorities on CFC; and
- to pay tax on CFC's profit at the base rates (13% for individuals, 20% for companies) if such profit exceeds RUR 3 mln (approx. EUR 64 K).

Taxable profit shall be defined in accordance with the provisions of the Tax Code of the Russian Federation and reduced by dividends paid therefrom. The calculated tax is further reduced by taxes paid in the foreign jurisdiction on such a profit. The amount of profit shall be confirmed by such foreign company's financial statements, auditors' statement and other documents.

Please note that a foreign company is not regarded as a CFC if it is:

- a non-commercial organization or any other organization that does not distribute its profit among its shareholders or other persons under the laws of its jurisdiction;
- a resident in Belarus or Kazakhstan;
- a resident in a country included into the "white list" of jurisdictions exchanging tax information approved by the Federal Tax Service AND its income/profit is subject to taxation at the effective rate exceeding 15%. An effective tax rate shall be calculated as the ratio of taxes payable in any foreign jurisdiction and the amount of taxable profit/income. It is not clear if the amount of taxable profit/income should be calculated based on the Tax Code of the Russian Federation or (which is more beneficial for the taxpayer) based on the laws of its jurisdiction.

The Revised Draft is supplemented with transitory provisions under which CFC's profit tax shall be calculated in respect of the profit gained starting from 2015, i.e. such tax shall be paid in 2016.

Beneficial owner

The Revised Draft proposes introducing a definition of the "beneficial owner" for the purposes of applying tax treaties: the beneficial owner is a person that is directly or indirectly entitled to possess, use and dispose of any income gained or a person to the benefit of which another person can use and/or dispose of such income. Functions performed and risks assumed by the taxpayer are analyzed to determine if such taxpayer is the beneficial owner of the income.

Thin capitalization rules

The Revised Draft also intends to broaden the scope of the Russian thin capitalization rules. Currently, such rules apply to loans issued by foreign direct/indirect shareholders and their Russian affiliates. The new version of the rules proposes that limitations additionally apply to loans issued by all interdependent foreign companies, not only by shareholders.

Tax residence for companies

As in the initial draft, it is suggested that foreign companies are recognized as Russian tax residents and taxed in Russia in respect of their worldwide income if they are managed from Russia. A foreign company is deemed to be managed from Russia if one of the below conditions is met:

- Meetings of the Board of Directors (or other governing body of the company) are held on the territory of the Russia;
- Management of the company is usually performed from Russia;
- Chief officers of the company carry out their activities with regards to the company in Russia

If the above conditions are fulfilled in several countries, additional criteria are applied:

- Accounting of the company is conducted in Russia;
- Record keeping is performed in Russia;
- Internal documents governing the company's activities are prepared in Russia;
- Recruitment and HR management is conducted in Russia.

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The Revised Draft is submitted to the Government that will review it and pass it over to the Parliament to undergo legislative procedures. It is likely that there will be further changes to the Revised Draft but, given a clear message from the President, such changes may be rather of a technical nature.

Application of the effective tax rate approach gives more clarity as to what jurisdictions will not give protection against the CFC rules even though they are on the “white list”. Hence, taxpayers may already review the existing structures, calculate the effective tax rates, identify possible exposure to tax residency, thin capitalization risks and adjust their structures to the new requirements.

Structures relying upon the use of tax treaties with Russia should be carefully reviewed to establish if a foreign company is the beneficial owner of the income.

Should you have any questions, please contact directly Maxim Alekseyev, Senior Partner **malekseyev@alrud.com**.

Kind regards,

ALRUD Law firm

Note: All information was obtained from publicly available sources. The author of this newsletter assumes no liability for the consequences of decision-making based on such information.