

The President of the Russian Federation has signed federal laws amending the Tax Code in so far as relevant to taxation of controlled foreign companies' profits and "thin capitalization" rules.

Amendments to Controlled Foreign Companies Laws (hereinafter "CFC")

Federal Law of February 15, 2016 N 32-FZ introduces a number of revisions in the procedure for the determination of tax liability of persons controlling foreign companies. Since some of the above referenced amendments, as envisioned by lawmakers, are targeted at the improvement of taxpayers' situation, such amendments are made retroactive, i.e. they apply to relationships that arouse starting from January 1, 2015. Below we offer a brief summary of revisions which we consider the most essential.

The Rule of Beneficial Ownership of Income Applies to CFC

In accordance with the amendments, not only legal entities and individuals but also an unincorporated foreign structure having the right to independently use and (or) dispose of the received income may be recognized as the person who is the beneficial owner of the income, for the purposes of the RF TC and application of international taxation treaties of the Russian Federation (hereinafter "ITT"). Such revision allows for extension of the preferential treatment under an ITT to CFCs (Art. 7(2) of the RF TC applies to relationships that arouse starting from the year 2015).

Harmonization of the Date of Determination of the Share in a CFC and the Date of Recognition of CFC's Profit in Accounting Records

The legislative revisions specify what date is the date of determination of controlling person's share in a CFC and recognition of CFC's profit in controlling person's accounting records. It is established that such date is: (a) the date of taking of a decision on distribution of CFC's profit; or (b) December 31 of the year following the calendar year on which CFC's fiscal year end date falls. Therefore the date of determination of the share held by the controlling person in the CFC and recognition of CFC's profit in controlling person's accounting records are to considerable extent harmonized with the date

of receipt of income in the form of CFC profit (December 31 of the year following the calendar year on which the date of CFC's fiscal year end falls).

Simplification of CFC's Profit Verification Procedure

If a CFC is located in a foreign state which is a party to an ITT with Russia and ensures exchange of information with Russia for taxation purposes¹, then CFC's profit (loss) may be determined on the basis of CFC's unaudited financial statements. If at least one of the above conditions is not met, for the computation of CFC's tax basis CFC's financial statements are used, provided they have been audited pursuant to a mandatory or voluntary audit procedure.

The Procedure for Taxation of Dividends Received from CFC is Specified

Art. 217(66) of the RF TC expressly excludes from the taxable base for personal income tax (hereinafter "PIT") incomes in the form of CFC's distributable profit (dividends), if the taxpayer being a controlling person has declared a relevant CFC's income and paid tax thereon as prescribed by the procedure for taxation of CFC's profit. A similar norm of law is provided for the profit tax purposes (Art. 250(1.53) of the RF TC). Thereby an ambiguity in tax legislation, which could result in double taxation of one and the same profit (CFC's profit and dividends received from the CFC) is eliminated.

Revisions Relevant to Certain Categories of Incomes from CFC

Under certain conditions payments made by "family" trusts (foundations in which equity participation is not provided for) within the limit of earlier invested assets (including moneys) and property rights (Art. 217(67) of the RF TC) are excluded from profit on which the PIT is assessed. However, any payments made by a trust (foundation) within the limit of its undistributed profits are recognized as profit distribution irrespective of particularities of legal formalization thereof and the said exclusion does not apply thereto.

A transfer of rights of CFC's beneficiaries among family members is excluded from the list of taxable activities for the assessment of the PIT (Art. 210(1) of the RF TC applies to relationships that arose starting from the year 2015).

Income in the form of financial benefit from a purchase of securities at a below-market price in case of CFC liquidation is PIT exempt. This norm has been introduced for the sake of PIT-free liquidation of CFCs.

¹ I.e. is not entered in the Russian Federal Tax Service's list of states which do not ensure exchange of information for taxation purposes

A PIT Amount Assessed on CFC's Profit May be Reduced by Amounts of a Number of Earlier Paid Taxes

A PIT amount assessed on CFC's profit may be reduced by an amount of:

- tax assessed on such profit in accordance with laws of foreign countries or those of Russia (including by an amount of withholding tax); and
- corporate profit tax assessed on CFC's Russian permanent representation's profit, in proportion to controlling person's participatory interest in that CFC.

Tax-Free Acquisition of CFC's Assets

For the profit tax purposes the term during which a taxable person is entitled to obtain without incurring any tax consequences ownership of assets of a CFC going into liquidation has been extended. The set time limit (generally until January 1, 2018) may be extended where there were real obstacles to liquidation of the CFC (in particular in case a lawsuit or legislation of CFC's country of residence prevented earlier completion of liquidation of the CFC) (Art. 277 (2.2 – 2.3) of the RF TC).

The Method of Deduction of Expenses for the Purposes of Assessment of Assets Related PIT Has Been Prescribed

A controlling person may decrease taxable income from sale of securities acquired from the CFC, by an amount of expenses determined as the lesser of (Art. 214.1(13.1) of the RF TC):

- documented value as per CFC's accounting records; or
- market value of those securities.

"Mitigation" of Liability for Failure to Give a Notice About a CFC and to Pay Tax

A controlling person possessing a certain participatory interest in a CFC², who has failed to give a notice about the CFC in due time, is released from fines and penalties for the failure to give such notice and failure to pay the PIT (profit tax) in respect of CFC's profit (Art. 25.14(11), Art. 129.5 and Art.129.6 of the RF TC), provided however that such person subsequently gave such notice at tax authorities' request³.

The said provision will allow the taxpayer to avoid a fine of 20% of the amount of unpaid tax on CFC's profit (Art. 129.5 of the RF TC), a fine of 100 thousand rubles for failure to give a notice about the CFC

² A controlling person whose interest in a CFC exceeds 10%, in case Russian tax residents' share in that CFC exceeds 50%

³ In view of vagueness of the said regulation, there is a risk that only such taxpayer will be released from liability who did not know that the CFC participation criteria were applicable to him

(Art. 129.6 of the RF TC) and a penalty for failure to pay the PIT or profit tax with respect to CFC's profit, if the controlling person which, though it had evaded fulfilling its obligation to give a notice about the CFC in a timely fashion, thereafter at tax authorities request gave such a notice within time specified in the request. It is remarkable that the above is true with respect to a situation in which a tax authority learns about a connection between a taxpayer and a CFC through tax authority's own investigation.

New "Thin Capitalization" Rules

Federal Law of February 15, 2016 N 25-FZ restates items 2-4 of Art. 269 of the RF TC, prescribing that expenses should be accounted as total amounts of interest on controlled debt.

The novelties extend the list of grounds for recognition of a debt as controlled one: it now comprises a debt to a foreign creditor who is related to taxpayer's mother company.

Courts have also been afforded the right to extend the list of grounds for recognition of a debt as a controlled one where it is proved that the ultimate purpose of the relevant loan is payment of interest to the controlling person (this novelty follows up the legal precedents).

At the same time the law introduces a number of exceptions to the controlled debt rules:

- A debt stemming from placement of so-called "Eurobonds" is not recognized a controlled one;
- A debt to a bank which is not related to the taxpayer is not recognized as a controlled debt because of availability of a guarantee extended by a person related to the taxpayer, provided that such person did not discharge taxpayer's obligations;
- A debt to a creditor being a Russian tax resident related to the taxpayer's "mother" company is not recognized as a controlled debt if such creditor has no commensurable debt to that "mother" company.

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This overview is not intended to provide legal advice and/or any other form of legal assistance that may be rendered by attorney-at-law to client. The exclusive purpose of this review is to make aware its recipient of certain recent changes in Russian laws and regulations, and of the development of law application practice. Any use of the information contained herein for particular purposes may require more detailed case-specific explanations. Further information can be obtained via +7 (495) 933 75 67 or office@agp.ru



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