Russian Tax Challenges and Planning Opportunities for US Multinationals with Russian Subsidiaries

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This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.
Content

- The current tax landscape in Russia
- Russia’s controversial new transfer pricing rules and their impact
- Russian de-offshoring initiatives and the authorities’ enforcement approach
- Recent tax challenges relating to ownership of Russian subsidiaries and their effect on profit distribution instruments
- Proposed tax legislative initiatives and tax opportunities
- Update on currency control regulations and restrictions
Profits tax:
- 20% on income less deductible expenditures

VAT:
- 18% on the supply of goods, works, services or property rights in the territory of the Russian Federation
- Input VAT recoverable provided that the respective goods, works, services or property rights are acquired for VAT able operations.

Property tax:
- 2.2% on the value of fixed assets (except land plots) with useful life over 3 years
- For certain types of immovable property the tax is calculated based on cadastral value, e.g., office centers, shopping malls, immovable property owned by foreign organisations.

Contributions to social funds with respect to the remuneration paid to employees:
- Pension Fund (PF) – 22% on the amount not exceeding 711k RUB, 10% from remuneration exceeding this threshold
- Social Insurance Fund (SIF) – 2.9% on the amount not exceeding 670k RUB, 0% from remuneration exceeding this threshold
- Medical Insurance Fund – 5.1%
- Obligatory accident insurance contributions – from 0.2% to 8.5% depending on the class of professional risk
Russian GDP and tax burden rate

Sources:
Federal State Statistics Service,
Ministry of Finance,
Central Bank of Russia

Forecasts: 2-3% decrease

34.85% of GDP
Tax collections by types of taxes, in Bln RUB

January – December 2009

January – November 2014

Source: Ministry of Finance
Tax disputes in Russia

Number of taxpayers' appeals

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<thead>
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<th>Year</th>
<th>Appeals</th>
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<td>2009</td>
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<tr>
<td>2012</td>
<td>50k</td>
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<td>2013</td>
<td>45k</td>
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Number of tax court cases

<table>
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<th>Year</th>
<th>Cases</th>
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<td>2013</td>
<td>45k</td>
</tr>
<tr>
<td>2014</td>
<td>42k</td>
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Sources:
Federal Tax Service,
High State Arbitrazh Court
**Federal Tax Service: 2014 outcome**

- **Tax revenues in 2014:**
  - consolidated budget – RUB 12.7 trillion (11.3% more than in 2013)
  - federal budget – RUB 6.2 trillion (14.7% more than in 2013)

- **Taxes for natural resources, excises:**
  revenues growth rate has slowed down –
  decrease in oil price and excisable products manufacturing

- **VAT and profits tax:** considerable growth (by 17%);
  [mainly due to Ruble devaluation factor]

- **Growth of control measures efficiency:**
  - number of audits was decreased by 13%
  - additional charges per one audit increased from RUB 6.9 million (approx. US $120,000) to RUB 8.3 million (approx. US $145,000)

- **Active use of transfer pricing tools:**
  RUB 1.4 billion was paid to the budget additionally

- **Tax disputes in 2014:**
  - decrease in the aggregate number of disputes – by 6%
  - more than 78% of disputable sums were ruled in favor of the budget

**January-March 2015:**

tax revenues growth **by 10%**,
compared to January-March 2014

![Bar chart showing tax revenues growth from January-March 2014 to January-March 2015]
Reaction of the Russian authorities and political establishment to the US/EU sanctions

“There is nothing tragic about these sanctions. They even may result in something good.”

“Yes, there will be some side-effects.”

“It is all the sanctions fault.”

“I propose to freeze the existing tax parameters as they are for the next four years, not revisit the matter again, not change them. Meanwhile, it is important to implement the decisions that have already been made to ease the tax burden.”

Vladimir Putin
Address to the Federal Assembly, 4 December 2014

“There will be no sanctions. It doesn’t pay the trouble to introduce them.”

“Yes, there will be some side-effects.”

“I sincerely believe that no sanctions will be adopted against Russia. We'll see…”

Alexey Ulyukaev,
Minister of Economic Development
St Petersbourg Economic Forum, 24 May 2014

“A moratorium on worsening is required.”

Sergey Lavrov,
Minister of Foreign Affairs
Interview with Bloomberg TV, 27 September 2014

“The damage is huge: it's time to have something done.” *

Igor Shuvalov,
First Vice-Prime Minister
Moscow Exchange Forum, 4 April 2015

“I'm not nervous about this. And we would not cry uncle, I can assure you. We'll find the ways to substitute for the loss, which would be a loss for those who introduced sanctions, first of all.”

Prof. Igor Nikolaev, Higher School of Economics
Blog published on 28 April 2014 at the Echo of Moscow website
Overview of the current Russian tax landscape (I)

Russia is not a high **tax rate** country. It is a high **tax risk** country

Tax risks driven by:

- Rapidly changing rules (various examples of a "legislation printing" exercise)
- Negative change often comes with the retroactive force
- De-facto *case law* on tax matters
  - Russia is a *civil law* jurisdiction
  - Precedent is not intended to be a source of law
  - However, wrongly understood and ruled one-off case often shapes up an adverse tax practice going forward
- Selective application of law by authorities to groups of taxpayers or a single taxpayer

Russia is no longer a "form over substance" country. It is a "form **AND** substance" jurisdiction
Overview of the current Russian tax landscape (II)

- Generally, quite reasonable and progressive tax legislation. Many domestic taxation rules have been brought closer to OECD principles (PE, transfer pricing, etc.)
- However, creative interpretation of tax legislation by local tax authorities
- Misbalance between business and public interests
  - Russian courts seem to favor more tax collections-driven argumentation by the authorities
  - Presumption of wrongdoing
  - Burden of proof shifts to taxpayers
- Continued misconception by the authorities of *tax avoiding* vs. *tax evading* structures
- The economy is sliding back to pre-2005 “shadow” mode, shown particularly by Russian domestic businesses
- The authorities focus more on easy money. More challenges of significant (cash-wise) cross-border pre-tax profit repatriation techniques (debt interest, royalties and intra-group services)
- Direct impact on multinationals which maintain aggressive tax planning strategies once adopted for Russia (double dips, forceful transfer pricing, treaty shopping, etc.)
Recent changes to the Tax Code

- **Federal Law No. 284-FZ dated 4 October 2014**: the rules for taxation of property of physical persons were introduced
- **Federal Law No. 347-FZ dated 4 November 2014**: changes to the electronic document flow, changes to property tax in relation to property which taxable base is cadastral value
- **Federal Law No. 348-FZ dated 4 November 2014**: introducing a new form of tax control - tax monitoring
- **Federal Law No. 376-FZ dated 24 November 2014**: new CFC rules, rules for determination of the Russian tax residency and beneficial owner of income are established
- **Federal Law No. 380-FZ dated 29 November 2014**: introduces tax regulations for the territories of advance social and economic development
- **Federal Law No. 382-FZ dated 29 November 2014**: introduction of trade levy, changes to the personal income tax in relation to property tax deductions
- **Federal Law No. 462-FZ dated 29 December 2014**: changes to personal income tax in relation to taxation of income from bank deposits
- **Federal Law No. 366-FZ dated 24 November 2014**: significant changes to the taxation of natural resources industry; changes of the profits tax rate applicable to dividends
- **Federal Law No. 32-FZ dated 8 March 2015**: changes to the interest deductibility rules and thin cap rules
- **Federal Law No. 85-FZ dated 6 April 2015**: deferring the first CFC reporting date from 1 April 2015 to 15 June 2015 and making other changes
Update on Russian transfer pricing rules and practical issues (I)

- Continued problems with finding local comparables and justification for the use of non-Russian comparables. In particular, problems for use of TNMM in relation to agents and intermediary activities.
- Focus by authorities on related parties cross-border transactions. Royalties and intra-group services are at risk.
- First successful examples of true-up payments (usually structured as sales-based retro-bonuses) into Russia to increase Russian LRDs' net profit margins in line of the arms-length basis under TNMM.
- True-downs still do not work in the cross-border supply context.
- Challenges for use of the portfolio approach for supply of goods and services. The Russian Tax Code does not explicitly provide for this approach, however opportunities exist arising from the general definition of transactions for TP purposes (Articles 105.3 and 105.14 of the Tax Code).
- Russia is planning to align domestic TP regulations with the recently voiced OECD country-by-country reporting tasks. Russian FTS has allowed Russian tax authorities to request from local taxpayers group Master file(s), if necessary.
- The Ministry of Finance now requires credit rating of a borrower to be used in determining the arms-length basis for related party debt interest.
- Impact of the existing sectoral sanctions on the level of intra-group debt interest (both inbound and outbound debt financing).
- TP compliance is transitioning to come under control by local tax authorities, as opposed to the Russian specialized tax inspectorate responsible under the Tax Code for TP audits.
Update on Russian transfer pricing rules and practical issues (II)

- 18 APAs signed with FTS as of the end of 2014; however mostly for supply of goods in Oil & Gas and Natural Resources industry (one in air traffic - by Aeroflot). Skepticism over APAs' functionality by other industries and economy sectors

- Local authorities seek to apply TP rules to out-of-TP-scope (no-controlled) transactions executed after 01.01.2012 (after new TP regulations came in force)
  
    **Russian OAO KTK case**: The Komi Republic State Arbitrazh Court ruling No. A29-10095/2014 of 3 March 2015
  
    Re-assessment of income in relation to interest-free loan between two Russian related parties under the new TP rules although the statutory financial threshold of RUB 1 bln for domestic transactions is not exceeded

- Increased number of cases where local tax authorities request TP documentation from taxpayers as part of their "request for information" probes, without formal TP audits. This is not supported by the Tax Code

- Practical risks for using the TP reports for non-TP purpose by tax authorities (e.g., PE)

- As part of regular tax audits local authorities look to resort to questionable 3rd parties' expert opinions and local valuation reports to prove their wished "market-based levels" of relevant payment(s) under CUP method
Update on Russian transfer pricing rules and practical issues (III)

- New TP controversies are now about battle of expert opinions
  - **Russian Mazda case**: The Moscow State Arbitrazh Court ruling No A40-4381/13 of 17 December 2014
  - **Russian BAT case**: The Moscow Region Federal Arbitrazh Court ruling No. A40-62131/12 of 25 March 2013, as supported by High Arbitrazh State Court ruling No. VAS-7048/13 of 15 July 2013

- Discord between TP and customs valuation. Double trap: high customs values adjustments by customs authorities, which are disregarded for TP purposes

- No arms-length pricing used in a related party transaction may lead to tax authorities claiming an unjustified tax benefit (a concept similar to substance over form or no business purpose doctrines)
  - The Russian Ministry of Finance letter № АС-4-2/13622 dated 25 July 2013
  - Re-classification of related party transactions for tax purposes, regardless of their controlled or uncontrolled treatment

- Plans to introduce criminal responsibility for failure to submit documents required and for misrepresentation of facts in the documents in relation to controlled transactions for TP purposes
  - Draft federal law # 599584-65 passed in the second (substantive) reading by Russian State Duma
Transfer pricing update – conclusions and impact on multinationals

- For established operations there is the need to re-visit the TP compliance and risks, if any exist for Russian subsidiaries for both prior years and 2014-2015 reportable years
- Avoid over-relying on OECD concepts relevant to TP. There are many similarities, but Russia has its own way
- Need of very solid argumentation for the use non-Russian comparables for cross-border transactions (IT sector, license fees, etc.)
- More thorough analysis and risk-averse approach are required. Avoid pushing for NOLs in Russian subsidiaries, unless dictated by very valid business reasons (e.g., startups, FX losses for 2014)
- Having limited TPD or no TPD for any given prior year(s) because of the costs of other reasons is no longer a possible viable strategy
- Documenting justification of business purpose is a must do element for any transaction re-structuring or reorganization process
Federal Law № 376-FZ

Federal law No. 325-FZ ratified Multilateral Convention on Mutual Administrative Assistance in Tax Matters

Effective management test Russian style

Capital gain taxation on indirect sale of companies with 50%+ book value in real estate assets

Beneficiary owner of income

Indirect property-rich business taxation

Taxation of passive and active income streams ultimately owned by Russian tax residents

Piercing the corporate veil for tax purposes

Tax obligation may be found to exist on the basis of facts and circumstances
3 elements to determine where beneficial ownership lies:

- Control
- Right to independently use income
- Right to dispose of such income

- Both: (a) (in)direct participation and (b) control by virtue of other circumstances qualify
- Functions and risks of the income-recipient must be "taken into account"
- Functions and risks should be assumed with regard to the income being distributed, not of the income-recipient in general

- Applies to dividends, interest and royalties
- Look through approach introduced
- Onerous documentary requirements to confirm beneficial ownership
- List of information required is not exhaustive
New tax residency rules

- Tax residency of Russian entities remains on the basis of incorporation situs
- First tier and second tier rules are introduced for establishing the effective management situs
- Fall out rules for treaty country based foreign organizations having: (a) qualified personal and (b) necessary assets
- Sufficient substance requirement
- Double tax treaty provisions may still overrule the local tax residency recognition
- Self-claim of tax residency by a foreign organization is available

- Problems for set-ups involving the outsourced booking and documentary support by Russian entities to their foreign counterparties
- Changes are being discussed to simplify the tax residency criteria
Other notable tax changes from 1 January 2015

- From 1 January 2015 the dividend tax rate is 13% for both (i) Russian individuals - tax residents and (ii) legal entities Russian tax residents
- No limitation for reclaim of VAT accrued on expenses which are tax deductible within certain norms
- Clarification for the start date of the 3 year limitation period for VAT reclaims
- Changes for property tax in relation to fixed assets classified under the 1st and 2nd tax depreciation groups - not subject to tax
- Movable property booked as fixed assets since January 2013 is treated as taxable starting from 2015 but included into the list of tax concessions subject to some exemptions (before 2015 such property was tax exempt)
- Trade levy is introduced (applicable to retail and wholesale operations as well as to sales through stock warehouses)
- Regional authorities (Moscow, St. Petersburg and Sevastopol) are entitled to establish the trade levy rate in order to apply it after 1 July 2015. At this stage the trade levy is introduced only in Moscow (starting from July 2015) and the rates vary depending on the type of trading facility and its location (Moscow Law On Trade levy No. 62 dated 17 December 2014)
Changes for debt interest structures

- The rules differ for the transactions subject to transfer pricing control (controlled transactions) and non-controlled transactions

- **Interest on controlled transactions:**
  - Subject to the thin cap rules compliance, the borrower shall have the right to deduct interest expenses calculated at the actual interest rate in case this rate is below the maximum value of the safe-harbor range set forth in Section 1.2 of Article 269 of the Tax Code of the Russian Federation
  - In case the actual interest rate exceeds the maximum value of the range set forth in Section 1.2 of Article 269 of the Tax Code of the Russian Federation, the borrower may still deduct interest expense calculated at the actual rate provided that it is in compliance with the Russian transfer pricing (TP) rules, i.e. within the market prices range

- Section 1.2 of Article 269 of the Tax Code of the Russian Federation contains, in particular, the following safe-harbor ranges for debt obligations nominated in various currencies:
  - in rubles for loans provided by a Russian company or tax resident individual - from 0% to 180% of the Central Bank's key rate in 2015, from 75% to 125% of the Central Bank's key rate from January 1, 2016
  - for other loans in rubles - from 75% of the refinancing rate to 180% of the Central Bank's key rate in 2015, from 75% to 125% of the Central Bank's key rate from January 1, 2016
  - in euro - from EURIBOR rate plus 4 percentage points to EURIBOR plus 7 percentage points
  - in US dollars - from LIBOR rate in US dollars plus 4 percentage points to LIBOR rate in US dollars plus 7 percentage points

  The current Central Bank's key rate is 14% (as at 16 March 2015)
Recent tax challenges relating to ownership of Russian subsidiaries and their effect on profit distribution instruments (I)

- General perception is that from 2014 tax authorities have been re-focusing their attention on foreign businesses as opposed to Russia's owned
- Tax authorities' claims of dividend distribution payments being not compliant with treaty based requirements:
  - Failure to meet beneficial owner test in relation to pre-2015 (de-offshoring law) periods. Mainly, conduit character of income-recipient
  - Issues with direct investment test required by some double tax treaties
  - Timing issues for contributing funds to increase capital for "minimum cash test" with immediate dividend distribution back to the contributor
- Problems with thin capitalization of Russian subsidiaries owned by foreign multinationals
  - Change of the practice for debt interest deduction and taxation
  - Foreign sister company debt is no longer a valid exception from general rules and debt-to-equity 3 to 1 ratio
  - Plans to amend Article 269 of the Tax Code to specifically address sister company debt financing. Probably, just a question of time
Recent tax challenges relating to ownership of Russian subsidiaries and their effect on profit distribution instruments (II)

- Growing campaign by tax authorities to challenge international royalty structures from a Russian tax deductibility perspective

- Trend seen from February 2015: Questionnaires on IP group relations are being sent by tax authorities to Russian taxpayers having intra-group license and royalty agreements with multinational group companies.

- The focus is on non-tax attributes such as whether (i) the licensed IP exists as a true legal object, (ii) has commercial value and (iii) was created / developed / acquired by the contracting party.

- One of the key arguments by tax authorities is that the Russian WHT relief (0% rate under most of the Russian double tax treaties) for pre-tax profit repatriation instruments (passive income), as opposed to 5%-15% WHT rate on dividends, is a proof in itself of the tax violation by the Russian income payee.

- Soft IP (commercial and production know-how, software IP and other unpatented IP) license structures are at particular risk.

- Tax authorities realize a complex strategy, not a transaction - by - transaction approach when challenging license structures of multinationals.


  - **San IvBev court case.** *The Moscow Region Federal State Arbitration Court Ruling of 24 April 2014 No A40-104549/13.* Negative court practice for the taxpayer.
Possible tax strategies and opportunities

Tax strategies are being centered around:

- Aligning of customs valuation with Russian transfer pricing posture of Russian subsidiaries
- Maximizing the WHT relief opportunities by moving the cross-border income-generating instruments to jurisdictions with the necessary substance for the non-Russian income recipients
- Managing the growing tax residency risks for non-Russian legal entities used as captive vehicles for Russia only supply and product distribution chains
- Rearranging the group financing (back to back and similar) structures and operations with Russian subsidiaries
- Avoiding VAT leakage on services charged by Russian subsidiaries to foreign group companies on cost plus operations by re-packaging of the nature of services (sales and marketing into information processing and marketing, etc.)
- Maximizing opportunities for VAT reclaim on expenses with limited tax deduction
- Considering various forms of repaying excessive capital from Russia such as via buy-back of shares and return of APIC
- Ministry of Finance rulings on the absence of PEs, no VAT on IP operations, royalty deduction and other tax structures
### Discussed changes of the Russian tax legislation

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<thead>
<tr>
<th>More likely</th>
<th>More unlikely</th>
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<tbody>
<tr>
<td>- Simplification of tax residency rules set for foreign legal entities</td>
<td>- Tax on Internet operations (3%-5% tax rate on revenue earned by a supplier from sales of software licenses in Russia)</td>
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<td>- Revisions to the legislative approach regarding CFC’s active income taxation and relaxing tax reporting requirements for all audited CFCs</td>
<td>- Returning to the former payroll-based taxation with regard to Medical Insurance fund (the maximum threshold for 5.1% tax rate)</td>
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<td>- Criminal responsibility for incompliance with CFC Notification rules and TP reporting</td>
<td>- Progressive personal income tax rate system (0%-35% instead of flat 13% personal income tax)</td>
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<td>- Moratorium on trade levy in Moscow</td>
<td>- Taxation of individuals with regard to luxury items (cars and residential properties)</td>
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<tr>
<td>- Enhancement of <strong>domestic</strong> tax residency criteria for Russian individuals (adding habitual abode to the existing 183 day a year rule)</td>
<td>- Changes to TP legislation with regard to loans, guarantees and suretyships by related parties</td>
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<tr>
<td>- Changes to thin capitalization rules (sister company debt financing)</td>
<td>- Introduction of GAAR into domestic legislation / codifying the business purpose of transaction (unjustified tax benefit) doctrine</td>
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Proposed tax legislative initiatives

- On 27 March 2015 Russian Government submitted to the State Duma a draft law on Voluntary Declaring of Assets and Bank accounts

- The idea behind this law is to stimulate the disclosure of foreign structures and repatriation of foreign assets by individuals

- Primarily addressed to Russian nationals, but will apply to non-Russian nationals
  - Under certain conditions, no criminal responsibility to apply for any tax and currency violations if occurred before 1 January 2014
  - Special declaration to be filed prior to 31 December 2015
  - No tax or duty to be paid to legitimize the ownership over the foreign structure
  - No any Russian taxation of legal transfer of assets, if required, from nominees to real beneficiary-holders
  - Importantly, no need to repatriate the foreign assets to Russia as long as they are not located in (i) FATF black-listed country and (ii) no Russia’s double tax treaty jurisdiction

- Questions remain as to how this draft law is FATF compliant and how it will be implemented and what can be its final wording, if enacted

- One of the key points to address: protection from tax and criminal (administrative) penalties for incompliant operations of continuous nature through foreign structures carried out after 1 January 2014 until the date of the new law entry in force?
Update of currency control regulation oil price and RUB/USD exchange rate correlation

Sources: Bloomberg, NAANS-MEDIA, Central Bank of Russia
Update on currency control regulation
capital flight out of Russia

Source: Central Bank of the Russian Federation
Currency control regulation update

- September 2014 - first concerns that Russian Central Bank may tighten currency control regulation
- December 2014 - Russia was just one step away from re-enforced currency control restrictions
- Measures to fight capital flight out of Russia:
  - Letter of Bank of Russia No 236-T of 31 December 2014 On Increasing the Attention by Credit Organizations to Certain Operations by Clients
  - More scrutiny (attention) over cross-border operations are required by the Bank of Russia from local banks as agents of currency control if, *inter alia*, the following facts have been established:
    - before making cross-border transfer, the Russian payor receives funds from a large number of other residents
    - the Russian payor makes a wire transfer within one or two days since the collection of funds on its bank account
    - the Russian payor performs regular (daily) cross-border operations, but pays minimal taxes to the Russian state budget
- State-owned and large private companies in oil and gas sector have been asked by the Government to re-convert ≈ 50% of their hard currency reserves built up during November-December 2014
- No officially voiced initiatives by the Government to re-instate pre-2005 Currency control regulation with its restrictive regime (obligatory conversion of hard currency export proceeds or Central Bank licensing of certain operations)
- Other measures are discussed, but the realization will depend on retention of US/EU sectoral sanctions, Ruble exchange rate in the next 6 - 12 months and oil prices
ANY QUESTIONS?
THANK YOU!
Selected DLA Piper Honors

- **Tier 1 in tax in Russia**  
  (Legal 500, 2013-2014)

- **Highly recommended corporate and tax practice in Russia**  
  (Chambers Europe, 2007-2014)

- **Highly recommended tax team in Russia**  
  (Who's Who Legal 2011)

- **Top-listed in Russia in tax with 4 attorneys**  
  (Best Lawyers 2013)

- **Ruslan Vasutin named the Lawyer of the Year in Tax in Russia**  
  (Best Lawyers 2014)
Ruslan Vasutin advises on transaction structuring and the reorganization of companies. He possesses international experience in the field of cross-border tax planning and inbound investments into Russia, participates in the regulation of tax disputes including on transfer pricing issues and provides transactional tax support to both domestic and multinational clients.

He assists multinational companies with their transfer pricing strategies for Russia and supervises the preparation of transfer pricing defense documentation required to comply with new Russian transfer pricing rules.

Ruslan co-heads the Tax practice at DLA Piper in Russia.