

The new Russian tax approach: Russia and Luxembourg path the same way



Russia has finally decided to significantly change their tax approach towards cross-border transactions, by amending their domestic tax law and pursuing a significant anti-offshore policy.

The origins of this change are to be found in recent economic history.

Back to the 1st quarter of 2013, the Cypriot crisis put the enormous wealth of the Russian high net worth individuals (HNWIs) stored in Cyprus on the global hotspot.

The big majority of the Foreign Direct Investments (FDI) made by Russian oligarchs was passing through Cyprus. Though the crisis broke out in March 2013, Cypriot financial issues were predictable as from the start of that year. Russian HNWIs urged to find a new jurisdiction to secure their moneys.

The big majority of the Foreign Direct Investments (FDI) made by Russian oligarchs

It is significant in the first three months of 2013, out of USD 67.2 Bln Russian FDI, almost half (i.e. USD 31.66 Bln) were directed offshore (notably, to the British Virgin Islands). The second largest investment hit the onshore jurisdiction of Luxembourg: 21%, i.e. USD 13.9 Bln. Cyprus saw USD 2.7 Bln only.

On top of that, in February 2013, the Russian Central Bank released a report on Russian tax evasion. In 2012, the report says, 1 trillion of roubles (approx. GBP 20 Bln) were lost by the Russian administration because of tax evasion; with an additional loss of GBP 32 Bln of illicit transfers. Basically, 2.5% of the entire Russian GDP.

The abovementioned events brought the Russian government to encourage domestic companies to repatriate their moneys from offshore jurisdictions and to plan measures so as to prevent tax evasion and avoidance.

Such “deoffshorization” shall drive Russian HNWI and multinationals to choose an onshore jurisdiction.

Luxembourg then results the “best-in-class” onshore jurisdiction when it comes to compliance with international tax law requirements.



But practically, why does the choice of the holding jurisdiction become a key issue for Russian investors now?

One of the main amendments to the Russian tax law concerns the determination of tax residence of a legal entity as from Russian tax purposes.

The tax residence of a legal entity would not depend on the place of registration any longer. The place of the company's effective management shall be the main factor.

As a consequence, a foreign company/organization might be deemed as tax resident in Russia and thus liable to Russian profit tax, even if incorporated in another country.

In this sense, the choice of an offshore jurisdiction creates issues as it happens the management is effectively elsewhere. It is clear this is one of the relevant anti-offshore measures.

At this stage then, Russian investors need to select onshore jurisdictions, with developed means to demonstrate the effective management is really over there - thus jurisdictions where substance requirements comply with the international tax law.

Within the EU, quite a few Countries have gained credit as onshore holding jurisdictions, on the purpose of structuring cross-border investments – e.g. Luxembourg, Netherlands, and Cyprus.

Although its corporate tax attractiveness, this latter one will take time to be elected as a holding jurisdiction again.

When it comes to picking up the best onshore holding jurisdiction, Netherlands and Luxembourg are often head to head.

Luxembourg stands out for an over 20-year experience in setting up holding structures fully compliant with the rules determined via the OECD model convention, which is at the base of the international tax law.

Moreover, Art. 4 of the amended Double Tax Treaty (DTT) between Luxembourg and Russia already underlined the place of effective management as the main factor to determine in which of the two contracting states, the entity should have been liable to tax. We also note that said DTT would provide the tools to solve any conflicts in case of supposed double tax residence.

Luxembourg compliance with solid substance requirements is also secured by the concept of “central administration” stated by art. 159 (1) of the Luxembourg Income Tax Law. By that term, the legislator intends a number of facts and circumstances far beyond the day-to-day management (e.g. appropriate premises, staff, equipment and effective decision making).

Another element attracting the Russian business community to Luxembourg is the direct airlines connection from Luxembourg to Russia.



Among the envisaged changes, Russian tax administration plans to implement Controlled Foreign Companies (CFC) rules.

A CFC can be defined as that entity which is not tax resident in the Country (in this case Russia), but that is “controlled” by an individual or a legal entity which is a Russian tax resident.

Pursuant to the current proposal, in case of recognition of such CFC, the Russian controlling entity/individual would be taxed on the retained earnings of the CFC, if this latter one has not paid out dividends.

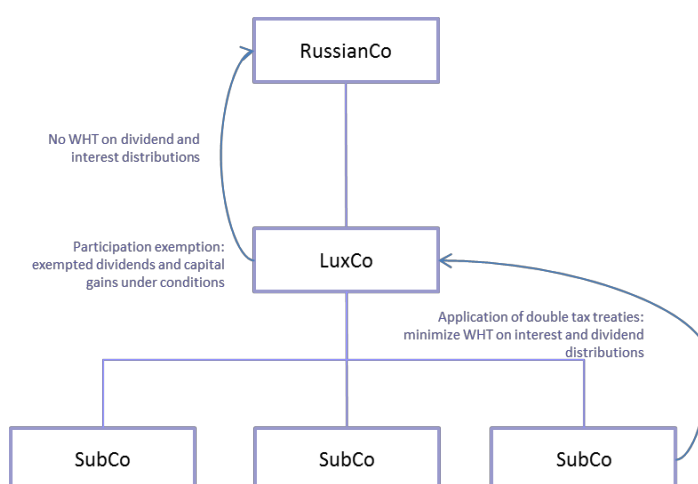
There are still several open questions on the subject, and it is confirmed a number of exclusions to the CFC rules will be available.

The Russian Ministry of Finance shall release a black list of countries which are deemed to grant an excessively preferential tax treatment of income. Companies resident in countries which are not included in such black list should not be subject to CFC rules.

The black list should be similar to the Order No. 108n of the Ministry of Finance of the Russian Federation dated 13 November 2007.

It is worth to note Luxembourg is not contemplated in such list.

On top of all the above, the Luxembourg financial platform offers several tax efficient opportunities with extreme flexibility. As per below, the Russian top holding might receive proceeds from the target with no liability to tax in the foreign jurisdictions.





Conclusions

The whole amendments' package has several points under discussion, yet.

Strongly in line with the Russian anti-offshore policy, it is clear they shall strengthen the role of Luxembourg as holding jurisdiction for Russian investors moving out from offshore countries (e.g. BVI).

Luxembourg offers safety, efficient tax planning ideas and professionalism to Russian investors. After the crisis, Cyprus, once the traditional hub for Russian HNWIs, and potentially to be included in the CFC black list, might leave the place to the Luxembourg platform.

In light of the above, we foresee an increase of interest in structuring and restructuring via Luxembourg at the advantage of Russian investors and stakeholders.

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