BEPS influences investments in Russia?

A brief overview at AEB Finance and Investment committee

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Совершенствуя бизнес, улучшаем мир

BEPS effects in Russia?
Changes in and new legislation

Deoffshorisation is used to denote a broad campaign against the use of foreign (particularly tax haven) companies by Russian businesses. It encompasses measures targeting both the understatement of Russian tax and a lack of transparency in ownership and transaction structures.

In his 2013 annual speech at the Federation Council President Putin announced:

*"Last year in my Address I talked about the goals underlying the **deoffshorisation of the economy.** According to expert estimates, last year $111 billion in Russian goods, which is one fifth of our exports, have gone through offshores and semi-offshores. Offshores syphon off half of Russia's 50 billion dollars of investment into other countries. These figures demonstrate the **flight of capital** that should have been employed in Russia, which is a real loss to the national budget. In the last year nothing that should have been done was done…*

To implement international tax ruels:

- Reducing Russian tax base erosion
- Increasing transparency
- Increasing tax collection
- Reducing the use of tax haven entities

OECD and Russia

What is and what does OECD?

The mission of the Organisation for Economic Co-operation and Development (OECD) is to promote policies that will improve the economic and social well-being of people around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. They work with governments to understand what drives economic, social and environmental change. They measure productivity and global flows of trade and investment. OECD sets international standards on a wide range of things, from agriculture and tax to the safety of chemicals. Drawing on facts and real-life experience, OECD recommend policies designed to improve the quality of people's lives.

Discussions at OECD committee-level sometimes evolve into negotiations where OECD countries agree on rules of the game for international co-operation. They can culminate in formal agreements by countries, for example on combating bribery, on arrangements for export credits, or on the treatment of capital movements. They may produce standards and models, for example in the application of bilateral treaties on taxation, or recommendations, for example on cross-border co-operation in enforcing laws against spam. They may also result in guidelines, for example on corporate governance or environmental practices.

However, further to a meeting of its governing Council on 12 March 2014, the OECD has postponed activities related to the accession process of the Russian Federation to the OECD for the time being...

BEPS and Russia

OECD releases final report on BEPS Action Plan

On October 5th OECD has release the final report on all 15 focus areas in its Action Plan on Base Erosion and Profit Shifting (BEPS).

During the report release process the “post-BEPS environment” was discussed, stressing the importance of focusing on the implementation of the BEPS recommendations in a consistent and coherent manner, monitoring the impact on both double non-taxation and double taxation. The explanatory statement indicates that OECD and G20 countries (and his includes Russia!) have agreed to continue to work together on BEPS until 2020. A robust implementation framework shall be implemented. The G20 has requested a proposal for such a framework by its February 2016 meeting.

This is how BEPS finally comes to Russia and does affect foreign investments in Russia!

BEPS and Action 1

Action 1: Addressing the challenges of the digital economy

(i) modification of the list of exceptions to the definition of Permanent Establishment (PE) regarding preparatory or auxiliary activities as they relate to a digital environment and introduction of new anti-fragmentation rules to deny benefits from these exceptions through fragmentation of certain business activities;

(ii) modification of the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements (See Action 7);

(iii) a correlative update to the OECD Transfer Pricing Guidelines (see Actions 8-10); and

(iv) changes to controlled foreign company (CFC) rules to address identified challenges of the digital economy (See Action 3).

The final report also addresses the indirect tax treatment of certain digital transactions, recommending that countries should apply the principles of the OECD’s International Value-added Tax/ Goods and Services Tax (VAT/GST) Guidelines and should consider introduction of the collection mechanisms included therein.

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BEPS and Action 2

Action 2: Neutralizing the effects of hybrid mismatch arrangements

Part I : The recommendations in Part I include "Specific Recommendations" and "Hybrid Mismatch Rules." The "Specific Recommendations" are modifications to provisions of domestic law aimed at avoiding hybrid mismatches and achieving alignment between those laws and their intended tax policy outcomes (e.g., by not applying a dividend exemption at the level of the payee for payments that are deductible at the level of the payer). The "Hybrid Mismatch Rules" are linking rules aimed at neutralizing one of the following three mismatches in tax outcomes arising out of certain hybrid mismatch arrangements:

- Payments that give rise to a deduction with no taxable inclusion arising from a hybrid financial instrument (including a hybrid transfer), a disregarded payment made by a hybrid entity or a payment made to a reverse hybrid
- Payments that give rise to a double deduction arising from a deductible payment made by a hybrid entity or a dual resident Payments that give rise to an indirect deduction with no inclusion arising from an imported mismatch.

Part II: The recommendations in Part II with respect to the OECD Model Tax Convention are similar to those included in the 2014 Report, namely:

(i) a change to Article 4 of the Model Tax Convention to deal with dual resident entities;

(ii) a new provision in Article 1 and changes to the Commentary to address fiscally transparent entities; and

(iii) various proposed changes to address treaty issues that may arise from the recommended domestic law changes.

BEPS and Action 3

Action 3: Strengthening Controlled Foreign Company (CFC) rules

The final report provides recommendations in the form of “building blocks” with respect to the constituent elements that are necessary for effective CFC rules.

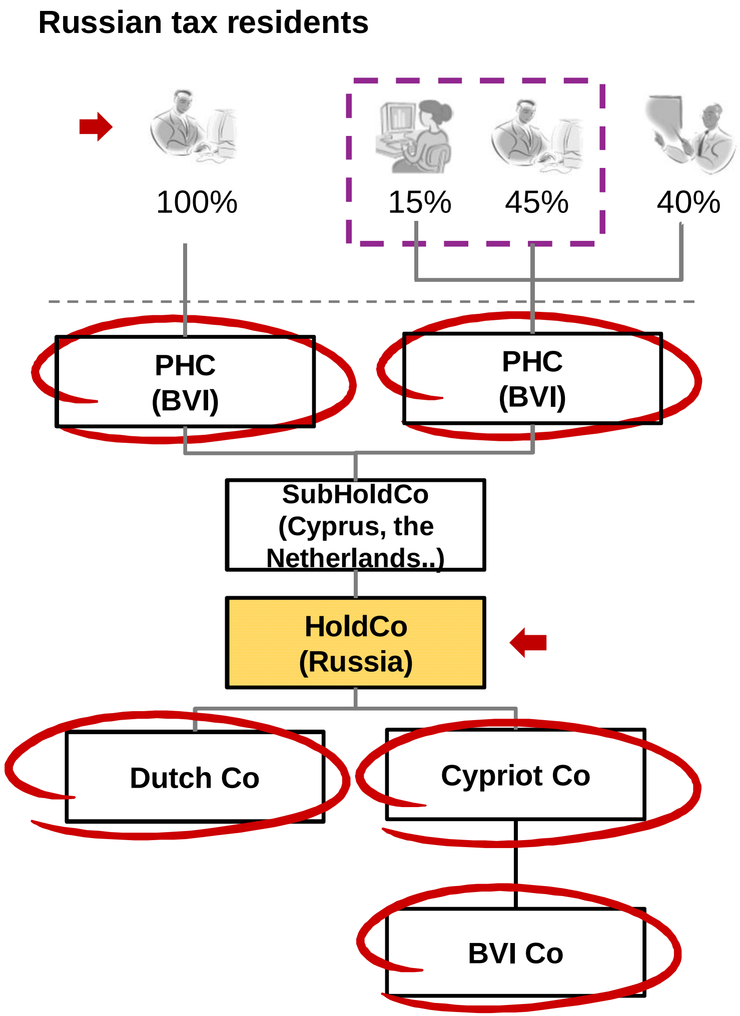
The six building blocks for the design of effective CFC rules are:

- Definition of a CFC (including the definition of control)
- CFC exemptions and threshold requirements
- Definition of CFC income
- Computation of income
- Attribution of income
- Prevention and elimination of double taxation

The final report notes that the recommendations are not minimum standards, but instead are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The report indicates that the recommended building blocks “would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.“

New CFC rules are part of Russia's new De-offshorisation legislation just entered into force 1. January 2015.

In Russia: new CFC rules



Definition of control

- The ability of a Russian legal entity or individual to exert a decisive influence on decisions affecting a controlled company's distribution of profit and
- In the case of structures that are not legal entities, the ability to influence the entity that manages such structure's assets as regards decisions on profit distribution

Controlling persons

- A person whose direct and/or indirect participating interest in the organization in conjunction with spouse, children or other related persons exceeds 25% and
- A person whose direct and/or indirect interest in a company (with spouse, children or other related persons) exceeds 10%, where Russian tax residents (with spouses, children and other interdependent persons) have a combined direct/indirect interest exceeding 50%

During a transitional period (until 1 January 2016), the threshold for both criteria is set at 50%

BEPS and Action 4

Action 4: Limiting base erosion vis interest deductions and other financial payments

The final report recommends that countries implement a “fixed ratio” rule that would limit net interest deductions claimed by an entity (or a group of entities operating in the same country) to a fixed percentage of earnings before interest, taxes, depreciation and amortization (EBITDA). It provides that this ratio should be somewhere between 10% and 30%, levels that are described as having been designed to provide meaningful caps on net (not gross) interest expense, while still allowing most multinationals to deduct all their third party interest.
The final report further recommends that countries adopt a “group ratio” rule to supplement (but not replace) the fixed ratio rule, and to provide additional flexibility for highly-leveraged groups or industry sectors. Under the group ratio rule, for example, an entity with net interest expense above a country’s fixed ratio could deduct such interest expense up to the level of the net third-party interest/EBITDA ratio of the worldwide group to which it belongs.

Beyond this basic framework, the final report recommends that countries consider the following:

(i) using an average of EBITDA for the current year and prior years, to minimize the impact of earnings volatility on interest deductions;

(ii) providing for carry forward and/or carry back of disallowed interest expense and/or unused interest capacity, within limits;

(iii) providing for exclusions for interest paid to third party lenders on loans used to fund public-benefit (infrastructure) projects and for entities with net interest expense below de minimis thresholds; and

(iv) providing targeted rules that would close down any remaining BEPS opportunities.

BEPS and Action 5

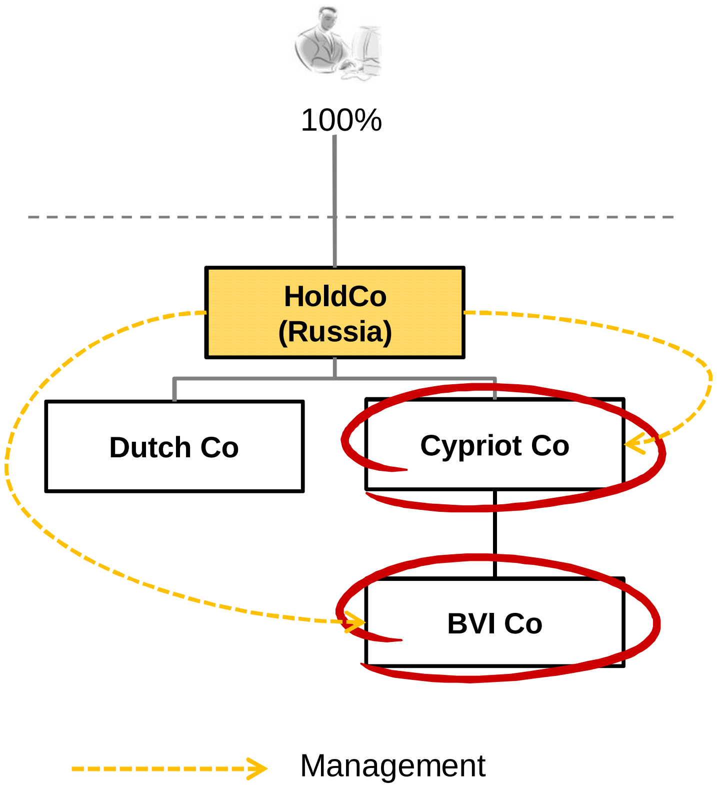
Action 5: Countering harmful tax practices

Action 5 covers two main areas, (i) defining a “substantial activity” criterion to be applied when determining whether tax regimes are harmful; and (ii) improving transparency.

Item (i) covers a variety of topics including substance requirements for intellectual property (IP) and other regimes. In the first instance, the final report defines the substantial activity requirement in relation to IP regimes by presenting the “nexus approach” as the agreed approach. Under this approach, the application of an IP regime should be dependent on the level of research and development (R&D) activities carried out by the taxpayer itself. In addition, IP regimes should essentially be limited to patents (under a broad definition) and copyrighted software. When applying the nexus approach to activities other than IP, there would also need to be a link between the income qualifying for benefits and the core activities necessary to earn the income. The final report lists types of core activities that are necessary to earn the income under different types of regimes focused on financial and other service activities, such as headquarters regimes, distribution and service centres, financing or leasing, fund management, banking and insurance and shipping.

Item (i) shall improve transparency through a framework for the compulsory spontaneous exchange of information on certain rulings. This framework will apply to taxpayer-specific rulings that are (i) rulings on preferential regimes, (ii) unilateral Advance Pricing Agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits (in particular excess profit and informal capital rulings), (iv) PE rulings or (v) related party conduit rulings.

In Russia: Tax residency
General provisions



Definition

- A foreign company can be treated as Russian tax resident if:
  - it is tax resident in Russia under an applicable double tax treaty; OR
  - the place of management of the foreign company is in Russia

The introduction of the “place of management” principle would enable Russian taxes to be levied on worldwide income of foreign companies, if they are effectively managed from Russia

BEPS and Action 6

Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

Action 6 introduces changes to the OECD Model Tax Convention and related changes to the Model Commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios. The final report notes that a number of changes have been made to the report that was issued in September 2014 and that further work will be required with respect to certain provisions, including the limitation on benefits (LOB) rule. In this regard countries have committed to a “minimum standard” to provide a minimum level of protection against treaty shopping. Under the minimum standard, countries would implement: (i) the combined approach of a principal purpose test (PPT) rule and LOB rule; (ii) a PPT rule alone; or, (iii) an LOB rule, supplemented by specific rules targeting conduit financing arrangements.

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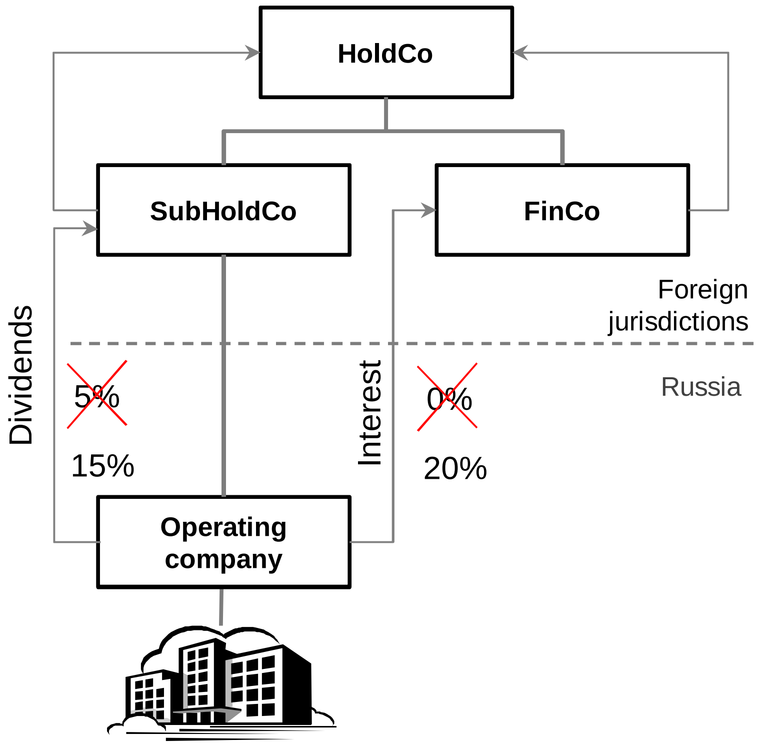
In Russia: Beneficial ownership (i)

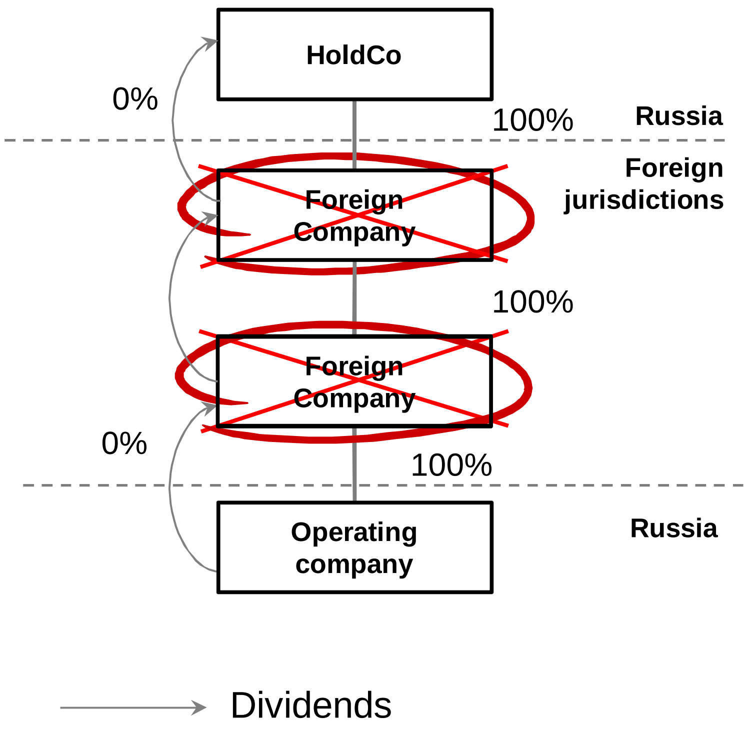


Definition

- A "beneficial owner" of income is a person who:
  - by virtue of participation (direct and/or indirect) in a company or control over a company, or by virtue of other circumstances, has the right to independently use and/or dispose of that income or
  - a person in whose interests another person has the authority to dispose of the income in question
- The functions performed and the risks assumed by that person will be taken into account

Under this concept, where a foreign company which receives income (for example, dividends, interest and royalties) is not the beneficial owner of that income, the company does not have the right to enjoy the benefits of a tax treaty's provisions exempting the income from withholding tax or establishing reduced tax rates

In Russia: Beneficial ownership (ii)



- When income is paid (subject to certain conditions) and the direct recipient does not have an actual right to receive that income, the provisions of Russian double tax treaties or the provisions of domestic law maybe applied in relation to another person that is the beneficial owner of the income if the relevant conditions are met
- If a Russian holding company owns Russian operating companies through a chain of foreign intermediary companies, and the Russian holding company is the beneficial owner of certain income, the tax implications will be the same as they would be if the Russian holding company received the income directly from the Russian operating companies (“Look-through”)
- Domestic rules can be applied (no tax is withheld at source) provided that the Russian tax authority is informed

BEPS and Action 7

Action 7: Preventing the artificial avoidance of PE status

The final report on Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status,* proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention to prevent the use of the following arrangements and strategies that are considered to enable a foreign enterprise to operate in another country without creating a PE:

- Commissionaire arrangements and similar strategies
- The use of specific preparatory or auxiliary activity exemptions, including the artificial fragmentation of so-called “cohesive” business activities into several smaller operations such that each part is able to benefit from the use of such specific activity exemptions

The final report also proposes the use of the PPT rule (principal purpose test*) that will be included in the OECD Model Tax Convention under Action 6 to deal with strategies involving the splitting-up of contracts between closely related enterprises in the context of construction contracts, and an alternative provision in the Commentary consisting of an automatic rule requiring the aggregation of time spent by closely related enterprises at the same building site or construction or installation project to calculate the 12 month threshold.
Also the acting person (authority to conclude by habitually play the principal role) and independent agent concept (connected parties by closely related parties) shall be revised

* The paper proposes a broadly drafted general purpose rule aimed at removing treaty benefits where one of the principal purposes of arrangements or transactions is to obtain treaty benefits

BEPS and Action 8 - 10

Action 8 – 10: Transfer pricing aspects

The OECD has included its updated transfer pricing guidance in one report under Actions 8-10, covering:

- Amended guidance on applying the arm's length principle (revisions to section D of chapter I of the OECD Transfer Pricing Guidelines), notably providing guidance on the identification of the actual transaction undertaken, on what is meant by control of a risk, and on the circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes;
- Guidance on comparability factors in transfer pricing, including location savings, assembled workforce, and MNE group synergies (additions to chapter I of the OECD Transfer Pricing Guidelines). This guidance remains unchanged from the guidance issued as part of the 2014 report on transfer pricing for intangibles;
- New guidance on transfer pricing for commodity transactions (additions to chapter II of the OECD Transfer Pricing Guidelines);
- A new version of chapter VI of the OECD Transfer Pricing Guidelines addressing intangibles, including new guidance on the return to funding activities and on hard-tovalue intangibles
- New guidance on low-value adding intragroup services (revisions to chapter VII of the OECD Transfer Pricing Guidelines)
- An entirely new version of chapter VIII of the OECD Transfer Pricing Guidelines, covering cost contribution arrangements In addition, the Actions 8-10 package describes additional work to be conducted by the OECD to produce new guidance on the application of the transactional profit split method. The aim is to produce a discussion draft in 2016 and final guidance during the first half of 2017.

BEPS and Action 11 - 15

Action 11: Collecting and analyzing data on BEPS

Action 12: Disclosing aggressive tax planning arrangements

Action 13: Guidance of transfer pricing documentation and country-by-country reporting (this covers the “TP master file”, the specific “local file” and a CbC reporting template)

Action 14: Making dispute resolution mechanisms more effective

Action 15: Developing a multilateral instrument to modify bilateral tax treaties

BEPS and Implication on the local legislation

- These final reports represent the culmination of work on the BEPS project. These reports include recommendations for significant changes in key elements of the international tax architecture. Such changes are reflected in revisions to the OECD Transfer Pricing Guidelines and the OECD Model Tax Convention and in recommended domestic law provisions. Participating in the discussions that led to these consensus recommendations were ALL OECD and G20 countries and about a dozen developing countries.
- With the release of the OECD final reports, attention will now turn to countries, which must determine whether, when and how to implement the various recommendations. Countries have already begun taking action in anticipation of the OECD recommendations, and there has been significant BEPS-driven legislative and tax administration activity around the world since the OECD issued its Action Plan on BEPS in July 2013.
- Moreover, the G20 Finance Ministers have asked the OECD to develop an inclusive framework for monitoring the implementation by countries of the BEPS recommendations. That framework is to be developed by early 2016. At the same time, the OECD will be completing follow-on technical work related to several of the BEPS focus areas, including interest limitations under Action 4, treaty abuse under Action 6, permanent establishment under Action 7 and transfer pricing under Actions 8-10.
- Companies must evaluate the implications of the recommendations contained in the final reports for their business models and operating structures. Companies also need to closely monitor legislative and tax administrative developments in the countries where they operate or are considering investing. In addition, companies should focus on the new reporting requirements, including the requirement for CbC reporting, in order to assess whether the necessary data is available, what must be done to gain access to such data in the required form, and how tax administrations are likely to interpret such data. Now is the time for companies to be preparing for significant potential changes in the international tax environment.

Overview of OECD Action Plan
In a nutshell

Comprehensive action plan impacts majority of existing multinationals structures.
*Main themes are **consistency, substance and transparency.***

- **Action 2:** Neutralize the effects of **hybrid mismatch arrangements**
- **Action 3**: Strengthen **CFC rules**
- **Action 4:** Limit base erosion via **interest deductions** and other financial payments
- **Action 6:** Prevent treaty abuse
- **Action 7:** Prevent the artificial avoidance of **permanent establishment** status

- **Action 1:** Address the tax challenges of the digital economy
- **Action 8:** Consider **transfer pricing for intangibles**
- **Action 9:** Consider **transfer pricing for risks and capital**
- **Action 10:** Consider **transfer pricing for other high-risk transactions**
- **Action 13:** Re-examine **transfer pricing documentation**

- **Action 5:** Counter harmful tax practices more effectively, taking into account **transparency and substance**
- **Action 11:** Establish methodologies to collect and analyse data on BEPS and actions addressing it
- **Action 12:** Require taxpayers to **disclose** their **aggressive tax planning arrangements**
- **Action 14:** Making dispute resolution mechanisms more effective
- **Action 15**: Develop of a multilateral instrument for amending bilateral tax treaties

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Russia’s actions:
Tax vs non-tax measures

TAX MEASURES

- Controlled Foreign Company rules
- Tax residency
- The beneficial ownership concept

NON-TAX MEASURES

- The restriction of business opportunities of offshore companies, including participation in state programs, receiving budgetary funds etc.
- Increasing the criminal liability of the management of banks and other financial institutions for knowingly furnishing incorrect or incomplete data.
- Criminal liability for non-payment of taxes due to a failure to provide proper information concerning CFCs

The new rules have come into force on 1 January 2015 and cover some of the items addressed in the BEPS OECD Actions – more to come!

Thank you for listening