Russian deoffshorisation law – impact on foreign investors

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In 2015, Russia introduced several amendments to its tax rules aimed at preventing profit shifting of Russian profits to preferential tax jurisdictions and at re-routing funds back to Russia (deoffshorisation law). The Russian deoffshorisation law, and more specifically the introduction of Controlled Foreign Companies (CFC) rules, requires Russian tax residents to disclose any relevant information on their foreign holding structures, meaning both foreign companies and non-corporate structures. Typically, foreign holding structures were and are still used by Russian beneficiaries for confidentiality reasons and to reduce (or even to evade) Russian taxes. A typical holding structure controlled by Russian beneficiaries would include Russian-based operating companies held by a Cypriot, Dutch or other foreign holding company which, in turn, is held by one or a chain of companies (usually incorporated in low tax jurisdictions). Such companies are usually treated as CFC for their beneficiaries. The new disclosure obligations with respect to such structures effectively eliminate the tax effects of their use, as the profits of Russian CFC are now to be taxed in Russia. Nevertheless, we cannot say that this has led to the mass liquidation of foreign structures. Many Russian businesses are still using the existing structures, and in many cases do not disclose information about them in accordance with the new rules.

What does this mean for foreign investors that plan to acquire an interest in Russian businesses?

First of all, the deoffshorisation law did not make the use of foreign holding structures illegal for Russian residents. As far as legally possible, foreign investors can acquire shares in foreign holdings controlled by their Russian partners. If a Russian group already has a foreign investor, for example an investment fund as a minority shareholder, the participation of this fund is often structured through a joint venture holding company in a foreign jurisdiction. When the investment fund exits from the Russian group, its shareholding in the joint venture company is usually offered for sale.

Furthermore, an investment in a Russian group, if it is structured through a chain of foreign holdings, including those incorporated in a low-tax jurisdiction, does not necessarily entail negative consequences such as an increase in the tax burden for the foreign investor. A German investor, for example, would need to disclose the entire corporate structure, including all intermediate companies, to comply with the reporting obligations in Germany. The overall tax burden, however, would not be higher than a direct investment in a Russian group, at least as long as the German investor holds no more than 50% of the shares (or voting rights) in the Russian group. If the acquired interest exceeds 50%, the offshore structure becomes unprofitable for the German investor (again compared with a direct investment) due to the German national regulation applicable to interest participation in foreign passive companies. There is similar regulation in other European jurisdictions. Consequently, investors may force the Russian groups to restructure their offshore holdings, either at the time when

the interest in the group is acquired by the investor or later.

Another aspect to keep in mind when deciding on the investment and its terms is violations of the deoffshorisation law – by both the company and its shareholders – that may negatively affect the investor.

Where the foreign holding companies of the Russian group are managed and controlled from Russia, for example, by Russian-based management and/or beneficiaries, such foreign companies can be treated as Russian corporate tax residents. The consequence of this is that payments to the foreign companies (for example, interest income, and license or service fees) cannot be exempted from Russian withholding tax through the application of double tax treaties, which would, in turn, lead to additional tax exposure for the Russian group and, indirectly, for the investor.

On the other hand, according to Russian CFC rules tax residents must generally notify the Russian tax authorities of any existing direct or indirect participation in foreign entities and, in some cases, the tax authorities will charge Russian tax on the CFC profits. If the notifications are not filed and/or profits are not taxed in accordance with the rules, these violations do not necessarily constitute an obstacle to the investment. Liability (in the form of financial fines) for the violation of CFC rules is imposed on the company's shareholder, not on the company itself, meaning that there should not be any significant impact on the company's financial results or on the foreign investor.

Based on the above, investors should be advised to diligently assess the level of risk associated with the acquisition of an interest in Russian companies through existing offshore structures. However, potential violations of the deoffshorisation law by their Russian partners should not constitute significant obstacles to investing in Russian businesses.