

# Buletin de analiză al Centrului de Cercetări Financiar-Monetare

**Nr.15/ martie 2017**

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ISSN 2359 – 9014  
ISSN-L 2359 – 9014

# Centrul de Cercetări Financiar Monetare

## International experience of tax administration that is used in the Russian tax system

–Keynote speech at the International Conference on Finance and Banking FI BA 2017,  
March 30th, 2017–

### Introduction

*The Russian tax system was not created from scratch. There were taxes in the USSR. However, some taxes that were already applied in the European countries were not used in the USSR (for example the VAT). As a result, during almost a decade after the collapse of the USSR the Russian tax system was in a transition period. At some point during the history, the amount of taxes reached more than one hundred. The number of taxes decreased up to less than twenty since the adoption of the first part of the Russian Tax Code in 1998 and its second part in the year 2000. However, the problems still existed with regard to the tax administration. The taxpayers tried to trick the tax authorities. In order to prevent the abuse, the tax authorities required some general approaches that could help them to eliminate the tax violations.*

*As a result the international experience of tax administration became especially important. Below is a list of the main approaches that were used in the Russian Tax System.*

- *Codified Tax Legislation (since 1998)*
- *Non-Codified Tax Concepts (since 2006)*
- *Transfer Pricing legislation (2012)*

- *Controlled Foreign Companies rules (2014)*
- *Corporate Tax Residency (from 2015), and*
- *Information Exchange (before and after the year 2018)*

### Tax Concepts

#### Unjustified Tax Benefit

*The concept of Unjustified Tax Benefit was introduced not in the Tax Code, but in the Supreme Court of Arbitration Decision (Ruling No. 53 of the Supreme Court of Arbitration of the Russian Federation of 12 October 2006 “Concerning the Evaluation by Arbitration Courts of the Legitimacy of the Receipt by a Taxpayer of a Tax Benefit”).*

*The Court ruled that a tax benefit can be declared unjustified specifically if it is not related to real economic activity, or if the relevant transactions are not accounted for in accordance with their real economic substance, or transactions were recorded that lack any reasonable economic or other basis (business purpose). Under this concept if the taxpayer can explain why did he conduct this or that operation, it is considered that such a transaction had a business purpose. Otherwise – not.*

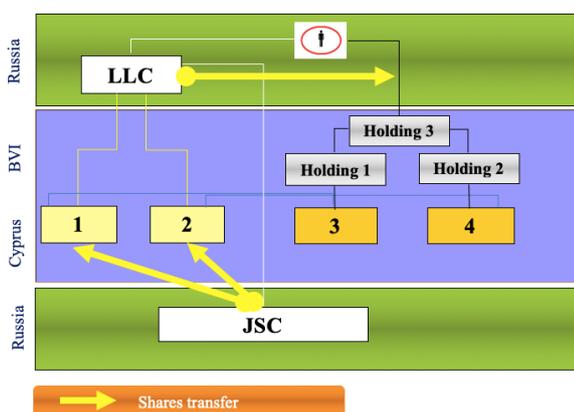
### Substance Over Form

This Concept means that the economic substance of transactions and events must be recorded in the financial statements rather than just their legal form in order to present a true and fair view of the affairs of the entity.

### Ultimate Beneficial Owner Concept

As it could be seen from the Figure 1 below the Beneficial Owner of a Joint Stock Company (JSC) could be either a Limited Liability company, or companies 1 and 2, if they receive shares of the JSC (for example as contributions to their capital). However, in case of further transactions with the shares of the Companies 1 and 2, someone could claim that JSC is jointly owned by Holdings 1 and 2, or indirectly by Holding 3. In order to reveal the real owner the tax authorities will need to know the final (ultimate) beneficial owner. In our example it is actually the same individual.

**Figure 1. Ultimate Beneficial Owner for Tax Purposes**



### **Transfer Pricing (TP) Rules**

Russia's new transfer pricing rules took effect in 2012. The first audits under the new rules were in 2013 and the first disputes reached the courts in 2014. However, following the OECD's base erosion and profit shifting

(BEPS) actions, the Super New Transfer Pricing Rules will be applied in Russia in the nearest future. A three-tiered approach will be applied to the preparation of the transfer pricing documentation for "large" multinational company groups. The legislation requires Russian taxpayers that are part of multinational groups to provide the following information beginning from 1 January 2017. The first tier will include the Master File. The Master file is to be provided by the parent company of the multinational group and is used to disclose in detail information about:

- The structure of the multinational group of companies.
- Activities of the multinational group (including functional analysis and business restructuring data).
- Intangible assets of the group (including a description of their development strategy and pricing methodology in related intercompany transactions).
- Intragroup financing.
- Other documents including financial statements, a list of tax rulings and advance pricing agreements (APAs), and description of their terms.

The second tier will include Local File Requirements. The Local file is to be provided by a Russian company or a foreign company that is a Russian tax resident. The Local file is to cover all intragroup transactions with foreign entities and to include detailed description of these transactions and the results of the respective transfer pricing analysis for the transactions.

Finally, the third tier includes Country-by-Country Report. Country-by-country (CbC)

reports are to be provided by the parent company. The contents of the CbC report are described in the draft legislation as being in line with the requirements of those of the OECD's BEPS Action 13.

The newest Russian legislation authorizes the Russian tax administration to engage in the automatic exchange of CbC reports with the jurisdictions where other foreign companies of the group operate. The information obtained from the CbC report may be used for the purposes of tax audits, but the CbC report itself cannot be considered as an evidence of the underpayment of taxes (which is in line with the provisions of BEPS Action 13).

In addition to evaluating the taxpayer's transfer pricing compliance, the Russian tax authorities can use the information contained in the CbC report about foreign companies of the group (e.g., the number of employees, structure of assets, types of activities, amount of profit received and taxes accrued/paid) to assess:

- Compliance with the Russian controlled foreign corporation (CFC) rules
- Shifting of the tax residency of foreign companies to Russia
- Beneficial owner status for the recipient of Russia-source income
- Existence of permanent establishments of foreign companies in Russia

### **TP Rules vs Unjustified Tax Benefit**

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The Russian Court practice has combined the TP rules and the Unjustified Tax Benefit concept. As a result, the underpayment of taxes caused by the manipulation of prices is proved in the courts with the help of the tax concepts.

For example, in a real case that was shown in Figure 1 above the actual shares' transfer transaction took place between a LLC and Holding companies 1 and 2. Due to the fact that HoldCo 1 and HoldCo2 were located on the BVI and were not protected by the Double Tax Treaty, the LLC was successfully sued by the Russian Tax Administration and had to pay taxes on behalf of the BVI companies as their tax agent.

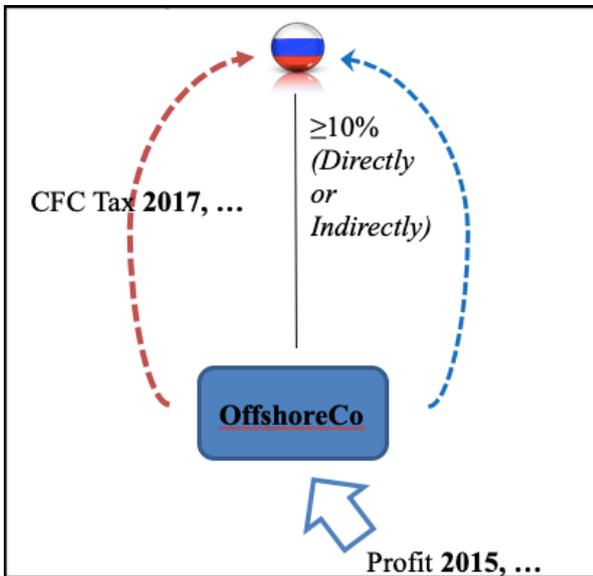
### **Controlled Foreign Companies (CFC) Rules**

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CFC rules stipulate that if an offshore company received a profit since 2015 it should disclose this profit in the tax return of the Russian company and pay tax in Russia if such a profit was not taxed abroad. Tax evasion leads to the administrative and criminal liability of the UBO.

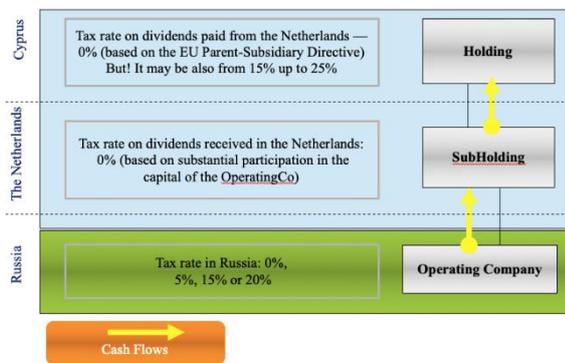
CFC rules have several effects. The first one is a tax deferral. Russian tax resident pays tax on unrealised profit of offshore companies. The second one is a complete disclosure. It means that offshore company and its profit must be disclosed in the Russian tax returns. The minimum percentage of control that should be disclosed is 10%. Control means influence on decision making process in relation to distributions of income in an entity; ability to influence the company's management, to change members of the Board, etc.

**Figure 2. CFC Rules in Russia Anti-Abuse Rules**



Russian Anti-abuse rules are presented in the Figures 2 and 3.

**Figure 3. Anti-abuse rule in Russia**



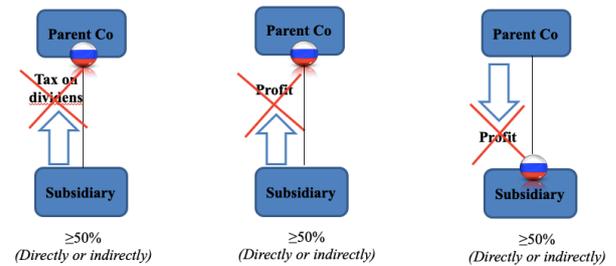
As it could be seen from Figure 3, withholding taxation at the level of a Russian operating company could be absolutely different. It depends on the grounds, under which money are paid to the SubHolding company. For example, interests and royalties are not taxed in Russia and dividends could be taxed only at 5% rate based on the Dutch-Russian Double Tax Treaty. This income could be pushed up to the level of the Holding company with the minimum taxation based on EU tax rules.

However, if the Russian Tax Authorities reveal that all this structure had an artificial nature, it will be taxed at the highest possible rates based on the anti-abuse rules.

### Parent-Subsidiary Exemption

The Parent-Subsidiary Exemption is widely used in the European tax legislation and was successfully implemented in Russia as well. Below are the schemes, describing how it works.

**Figure 4. The Parent-Subsidiary Exemption in Russia**



### Corporate Tax Residency – New Rules

Under the newest legislation, foreign legal entities managed from Russia can be recognized as Russian tax residents. Russian tax residency means that the worldwide income of such entities is taxable in Russia. This approach overrides a long standing rule that the place of incorporation is the main factor to determine corporate tax residency.

#### Criteria for the Place of Effective Management

1. The majority of meetings of the board of directors (or a similar body of the company other than an executive body) are held in Russia. For this purpose a majority means more are held in Russia than in any other state (so

sending the board on tour will not help if there is no state in which more meetings are held than are held in Russia).

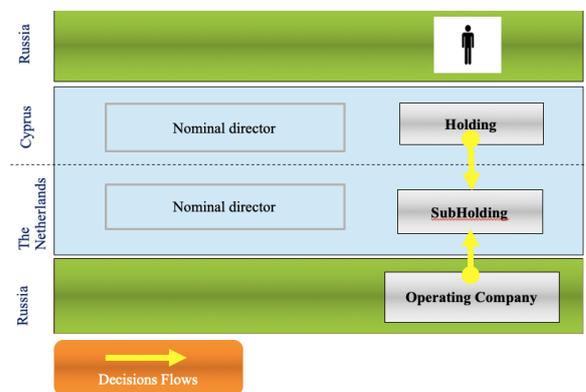
2. The executive body of the company regularly carries on its activities in relation to that organization from Russia. For this purpose, activities will not be deemed to be carried on regularly where activities are carried on in Russia to a substantially lesser extent than in another state (other states).
3. The chief (executive) officers of the company (persons who are authorized to carry out and responsible for planning, management and oversight of an enterprise's activities) primarily carry out their activities in the form of executive management of that foreign company in Russia. For this purpose, executive management of a company means the adoption of decisions and the performance of other actions pertaining to the company's current activities which fall within the authority of the executive management bodies.

Where none of the above conditions are satisfied or only the first or second condition is met, the foreign company will be deemed to be tax resident in Russia if any of the following criteria are met:

- The maintenance of the company's accounting records or management records (with the exception of activities associated with the preparation of consolidated financial statements) takes place in Russia.
- The company's records are managed in Russia.

- Day-to-day management of the company's personnel takes place in Russia.

**Figure 5. Place of Effective Management**



### **Information Exchange and Administrative Assistance in Tax Matters**

The global information exchange between the tax administrations is based on the Convention on Mutual Administrative Assistance in Tax Matters. This Convention ("the Convention") was developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010. The Convention is the most comprehensive multilateral instrument available for all forms of tax co-operation to tackle tax evasion and avoidance. As of the year 2017 it includes more than 100 countries/jurisdictions. Russia will begin automatic exchange of financial accounting information under the OECD/G20 Common Reporting Standard in 2018.

**Table 1. Jurisdictions participating in the Convention on Mutual Administrative Assistance in Tax Matters. Status – 3 January 2017**

| COUNTRY / JURISDICTION <sup>1</sup> | ORIGINAL CONVENTION                 |   |                  | PROTOCOL (P) / AMENDED CONVENTION (AC) |   |                  |
|-------------------------------------|-------------------------------------|---|------------------|--|---|------------------|
|                                     | SIGNATURE<br>(Opened on 25-01-1988) | DEPOSIT OF INSTRUMENT OF RATIFICATION, ACCEPTANCE OR APPROVAL | ENTRY INTO FORCE | SIGNATURE<br>(Opened on 27-05-2010)    | DEPOSIT OF INSTRUMENT OF RATIFICATION, ACCEPTANCE OR APPROVAL | ENTRY INTO FORCE |
| 21. CHINA (PEOPLE'S REPUBLIC OF)    |                                     |   |                  | 27-08-2013 (AC)                        | 16-10-2015  | 01-03-2016       |
| 22. COLOMBIA                        |                                     |   |                  | 23-05-2012 (AC)                        | 19-03-2014  | 01-07-2014       |
| 23. COOK ISLANDS                    |                                     |   |                  | 28-10-2016 (AC)                        |   |                  |
| 24. COSTA RICA                      |                                     |   |                  | 03-03-2012 (AC)                        | 09-04-2013  | 01-06-2013       |
| 25. CROATIA                         |                                     |   |                  | 11-10-2013 (AC)                        | 28-02-2014  | 01-06-2014       |
| 26. CUBA <sup>2</sup>               |                                     |   | 10-10-2010       |  |   | 01-09-2013       |
| 27. CYPRUS                          | 10-07-2014                          | 19-12-2014  | 01-04-2015       | 10-07-2014 (P)                         | 19-12-2014  | 01-04-2015       |
| 28. CZECH REPUBLIC                  |                                     |   |                  | 26-10-2012 (AC)                        | 11-10-2013  | 01-02-2014       |
| 29. DENMARK                         | 16-07-1992                          | 16-07-1992  | 01-04-1995       | 27-05-2010 (P)                         | 28-01-2011  | 01-06-2011       |
| 30. DOMINICAN REPUBLIC              |                                     |   |                  | 28-06-2016 (AC)                        |   |                  |
| 31. EL SALVADOR                     |                                     |   |                  | 01-06-2013 (AC)                        |   |                  |
| 32. ESTONIA                         |                                     |   |                  | 29-05-2013 (AC)                        | 08-07-2014  | 01-11-2014       |
| 33. FAROE ISLANDS <sup>3</sup>      |                                     |   | 01-01-2007       |  |   | 01-06-2011       |
| 34. FINLAND                         | 11-11-1989                          | 15-12-1994  | 01-04-1995       | 27-05-2010 (P)                         | 21-12-2010  | 01-06-2011       |
| 35. FRANCE                          | 17-09-2003                          | 25-09-2005  | 01-09-2005       | 27-05-2010 (P)                         | 13-12-2011  | 01-04-2012       |
| 36. GABON                           |                                     |   |                  | 03-07-2014 (AC)                        |   |                  |
| 37. GEORGIA                         | 12-10-2010                          | 28-02-2011  | 01-06-2011       | 03-11-2010 (P)                         | 28-02-2011  | 01-06-2011       |
| 38. GERMANY                         | 17-04-2008                          | 28-08-2015  | 01-11-2015       | 03-11-2011 (P)                         | 28-08-2015  | 01-11-2015       |
| 39. GHANA                           |                                     |   |                  | 10-07-2012 (AC)                        | 29-05-2013  | 01-09-2013       |
| 40. GIBRALTAR <sup>4</sup>          |                                     |   |                  |  |   | 01-03-2014       |
| 41. GREECE                          | 21-02-2012                          | 29-05-2013  | 01-09-2013       | 21-02-2012 (P)                         | 29-05-2013  | 01-09-2013       |
| 42. GREENLAND <sup>5</sup>          |                                     |   | 01-04-1995       |  |   | 01-06-2011       |
| 43. GUATEMALA                       |                                     |   |                  | 05-12-2012 (AC)                        |   |                  |
| 44. GUERNSEY <sup>6</sup>           |                                     |   |                  |  |   | 01-08-2014       |

*Replies from these foreign tax authorities were already widely used by the Russian Federal Tax Service in the tax litigations with the Russian taxpayers.*

*In conclusion, I would like to state that Russia is moving forward in fighting tax evasion. The best international practices are widely used in Russia and tax transparency is becoming the main trend globally.*