

THE LEGAL FRAMEWORK TO COMBAT OFFSHORES: INTERNATIONAL AND RUSSIAN EFFORTS

Tatiana Yugay^{1*}

SUMMARY: 1.- Terms and Definitions; 2.- Historic background of the modern international tax law; 3.- Two pillars of the international anti-offshore legislation; 4.- Russia's anti-offshore package

1. - Terms and definitions

In reports of international organizations, as well as in scientific literature, along with the concept of offshore, there are used such terms as "offshore area", "offshore jurisdictions", "offshore business", "offshore financial center", "tax haven" and others. At the same time, international organizations such as the IMF, OECD and UNCTAD, have been developing terminology to fit their own needs. Thus, the OECD examines OFCs through the prism of tax evasion. The IMF, along with elaborating a working definition of OFCs explores their impact on the international financial system. The UNCTAD studies mechanisms of foreign direct investment (FDI) with the use of OFCs.

Since 1998, the OECD has become an international legislator in the field of anti-offshore fight. Due to that, the organization is credited with developing special terminology in this area. The OECD report on harmful tax competition defines key factors for identifying tax havens:

- a) No or only nominal taxes;
- b) Lack of effective exchange of information;
- c) Lack of transparency;
- d) No substantial activities².

The IMF gave a multiple definition of the offshore financial center. "OFC is a center where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counter-parties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents". Thus, OFCs are usually referred to as:

- Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;
- Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies;
- More popularly, centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity³.

The Working Group on Offshore Centres under the Financial Stability Forum presumes that "Offshore financial centres (OFCs) are not easily defined, but they can be characterised as jurisdictions that attract a high level of non-resident activity. Traditionally, the term has implied some or all of the following (but not all OFCs operate this way):

- Low or no taxes on business or investment income;
- No withholding taxes;
- Light and flexible incorporation and licensing regimes;
- Light and flexible supervisory regimes;
- Flexible use of trusts and other special corporate vehicles;

^{1*} Tatiana Yugay, PhD, professor of finance at the Department of Finance, Plekhanov Russian University of Economics. The main ideas and conclusions of this study were presented at the International conference "Threats and risks to global economy" dedicated to the 15th anniversary of the Federal Financial Monitoring Service, Moscow, 3 November 2016, and at the International Forum «Financial centers: Capital travelling around the world» at the Plekhanov Russian Economic University, Moscow, 4 October 2016.

² OECD, *Harmful Tax Competition. An Emerging Global Issue*, Paris 1998, 182s.

³ *Offshore Financial Centers*. IMF Background Paper. (2000)
<https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm>

- No need for financial institutions and/or corporate structures to have a physical presence;
- An inappropriately high level of client confidentiality based on impenetrable secrecy laws;

and

- Unavailability of similar incentives to residents”⁴.

Since the main feature of offshore is its high secrecy or, better saying, lack of transparency, it is impossible to estimate precisely the scope of offshorization of the world economy. International organizations, governments, non-governmental organizations and scientific community can make evaluations only on the basis of indirect indicators.

One of the major roles of secret jurisdictions is the facilitation of illicit financial flows. According to the UNCTAD, “large proportion of illicit financial flows... goes through offshore financial centres, based in “secrecy jurisdictions”. Approximately 8–15% of the net financial wealth of households is held in tax havens, mostly unrecorded. The resulting loss of public revenue amounts to \$190–\$290 billion per year, of which \$66–\$84 billion is lost from developing countries, equivalent to two thirds of annual official development assistance”. The UNCTAD states that “the main vehicle for corporate tax avoidance or evasion and capital flight from developing countries is the misuse of “transfer pricing” (i.e. when international firms price the goods and services provided to different parts of their business to create profit–loss profiles that minimize tax payments). By this means, developing countries may be losing over \$160 billion annually, well in excess of the combined aid budgets of developed countries”⁵.

The UNCTAD draws a deplorable conclusion, “The international tax architecture has failed, so far, to properly adapt to this reality, thereby allowing a massive haemorrhaging of public revenues. The opacity surrounding tax havens may partly explain the difficulties faced by policymakers in collecting public revenues, but the main obstacle is political: the major providers of financial secrecy are to be found in some of the world’s biggest and wealthiest countries, or in specific areas within these countries. Indeed, offshore financial centres and the secrecy jurisdictions that host them are fully integrated into the global financial system, channelling large shares of trade and capital movements, including FDI”⁶.

The Tax Justice Network (TJN) in its report “The Financial Secrecy Index” states that an estimated \$21 to \$32 trillion of private financial wealth is located, untaxed or lightly taxed, in secrecy jurisdictions around the world⁷. Christian Aid’s research has found that FTSE100 companies have created 29,891 subsidiaries. The research also highlights FTSE100 companies’ heavy use of tax havens. More than 90 per cent of their subsidiaries are based in places defined as ‘secrecy jurisdictions’⁸.

With minor differences all above mentioned definitions feature three main characteristics of offshore financial centres, namely, 1) low or zero tax rates, 2) high secrecy or lack of transparency and 3) providing these benefits to non-residents. The current anti-offshore crusade is concentrated on cracking down these artificially created advantages which inflict harmful tax competition. The main battlefields are tackling base erosion and profit shifting, unveiling beneficial ownership and promoting transparency.

2. - Historic background of the modern international tax law

Concerns about the role of tax havens in money laundering and tax evasion arose as early as at the beginning of 1920th. Many national and international rules addressing double taxation of individuals and companies originated from the principles developed by the League of Nations in the 1920s. However, it took the international community almost a century to join forces in combating

4 *Financial Stability Forum Report of the Working Group on Offshore Centres*. (2000) 71s. http://www.financialstabilityboard.org/publications/r_0004b.pdf

5 UNCTAD/PRESS/PR/2014/032. Geneva (2014) <http://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=201>

6 UNCTAD, *Trade and Development Report 2014*, Geneva 2014, 242s.

7 <http://www.financialsecrecyindex.com/introduction/introducing-the-fsi>

8 *Report: the black hole at the heart of London’s FTSE100*. (2014) <http://www.taxjustice.net/2014/05/13/report-black-hole-heart-londons-ftse100/>

tax avoidance via offshores.

Initially, international legislative efforts were focused on preventing double taxation in order to promote international investment process. During 1923-1927, the group of international experts under auspices of the League of Nations drafted the Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes dealing with income and property taxes, the Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, the Bilateral Convention on Administrative Assistance in Matters of Taxation and the Bilateral Convention on [Judicial] Assistance in the Collection of Taxes. This work led to drawing up in 1928 the first Model bilateral convention and later on the Model Conventions of Mexico (1943) and London (1946). Neither of these Model Conventions, however, was fully and unanimously accepted.

Specifically, the League of Nations group decided that international tax issues should be addressed not by a multilateral, global agreement, but at the bilateral level. As a result, since the 1920s countries have signed thousands of bilateral “double-tax treaties” that follow the general League of Nations guidelines of source-based taxation and arm’s length pricing, but differ in a myriad of specific ways. While international trade has been governed by a multilateral agreement since 1947—the General Agreement on Tariffs and Trade (GATT)—to date no such multilateral treaty exists for corporate taxes⁹.

In 1954, the focus of action in the field of international taxation shifted from the League of Nations to the Organization for European Economic Co-operation and the further on to the OECD. On 30 July 1963, the Council of the OECD adopted the Recommendation concerning the avoidance of double taxation and published a new Model Convention and Commentaries in 1977.

According to the OECD, “International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries”. Correspondingly, “the main purpose of the OECD Model Tax Convention on Income and on Capital is to provide “a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation”¹⁰. Since 1963, the OECD Model Convention has extended its influence far beyond the OECD area serving as a pattern for tax treaties between member and non-member countries and even between non-member countries.

In the mid-1960s, the United Nations renewed its interest in the problem of double taxation as part of its action to promote flows of foreign investment to developing countries. The UN stated that “The growth of investment flows from developed to developing countries depends to a large extent on what has been referred to as the international investment climate. The prevention or elimination of international double taxation—i.e. the imposition of similar taxes in two or more States on the same taxpayer in respect of the same base—whose effects are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate”¹¹.

In 1980, the United Nations published the UN Model Double Taxation Convention between Developed and Developing Countries, which was preceded in 1979 by the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries. Like all model conventions, the UN Model Convention is not enforceable, i.e. its provisions are not legally binding. The UN Model Convention reproduces many Articles of the OECD Model Convention.

9 G. Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, in *Journal of Economic Perspectives*, 28.4 (2014) 160ss.

10 OECD, *Model Tax Convention on Income and on Capital: Condensed Version*, Paris 2014, 26s.
http://dx.doi.org/10.1787/mtc_cond-2014-en

11 *United Nations Model Double Taxation Convention between Developed and Developing Countries* New York, 2011, 493ss.

Ironically enough, the UN and OECD Conventions not only boosted flows of foreign direct investments but had created a legal basis for massive tax avoidance. Multinational corporations took advantage of legal loopholes and skillfully used aggressive tax planning in order to hide their assets and profits in offshore. That became possible due to concluding bilateral tax treaties on avoiding double taxation. Shortly after successfully creating a worldwide network of more than 3,000 bilateral tax treaties, the OECD had committed itself to developing an anti-offshore legislation.

The Convention on Mutual Administrative Assistance in Tax Matters represents a kind of transitional law from protecting MNEs against double taxation to preventing double non-taxation by the same MNEs. The Convention was developed jointly by the OECD and the Council of Europe in 1988 and amended by the Protocol in 2010. The Convention provides for administrative co-operation between states in the assessment and collection of taxes, in particular with a view to combat tax avoidance and evasion. This co-operation ranges from exchange of information, including automatic exchanges, to the recovery of foreign tax claims¹². 106 jurisdictions currently participate in the Convention, including 15 jurisdictions covered by territorial extension. This represents a wide range of countries including all G20 countries, all BRICS, all OECD countries, major financial centres and an increasing number of developing countries.

However, it wasn't until the late 1990s that world powers began their first coordinated attack on offshore shell games.

Notably, first measures to prevent harmful tax competition from the part of low tax jurisdictions were undertaken by the European authorities. On 1 December 1997, the EU Council of Economics and Finance Ministers (ECOFIN) adopted the Code of Conduct for business taxation. The Code is the EU's main tool for ensuring fair tax competition in the area of business taxation. It sets out clear criteria for assessing whether or not a tax regime can be considered harmful. All Member States have committed to adhering to the principles of the Code. The Code of Conduct requires Member States to refrain from introducing any new harmful tax measures ("standstill") and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ("rollback"). The code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the EU.

The criteria for identifying potentially harmful measures include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
- lack of transparency¹³.

In 1998, the OECD published the report 'Harmful Tax Competition: An Emerging Global Issue'. The report distinguishes between preferential tax regimes and harmful tax competition. Preferential regimes "generally provide a favourable location for holding passive investments or for booking paper profits. In many cases, the regime may have been designed specifically to act as a conduit for routing capital flows across borders. These regimes may be found in the general tax code or in administrative practices, or they may have been established by special tax and non-tax legislation outside the framework of the general tax system". Further on, the OECD defines "four key factors assist in identifying harmful preferential tax regimes:

- (a) the regime imposes a low or zero effective tax rate on the relevant income;
- (b) the regime is "ring-fenced";

12 <http://www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm>

13 http://ec.europa.eu/taxation_customs/business/company-tax/harmful-tax-competition_en

(c) the operation of the regime is nontransparent;

(d) the jurisdiction operating the regime does not effectively exchange information with other countries”¹⁴.

The report contains guidelines for dealing with harmful preferential tax regimes in member countries, similar to those of EU's Code of Conduct, including:

1. To refrain from adopting new measures, or extending the scope of, or strengthening existing measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices;

2. To review their existing measures for the purpose of identifying those measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices;

3. To remove, before the end of 5 years starting from the date on which the Guidelines are approved by the OECD Council, the harmful features of their preferential tax regimes etc.¹⁵

The turning point occurred in the middle of 2000, when two international organizations - the Financial Action Task Force on Money Laundering and the Organization for Economic Co-operation and Development – almost simultaneously published reports about offshore jurisdictions. The FATF published its Review to Identify Non-Cooperative Countries (June 22, 2000) based upon 25 Criteria promulgated by the FATF's Report on Non-cooperative Countries and Territories. The OECD published the Report on Progress in Identifying and Eliminating Harmful Tax Practices (June 26, 2000) prepared by the Forum on Harmful Tax Practices. From June 2000, the FATF and the OECD had started issuing “black” and “gray” lists of “non-cooperative” jurisdictions.

The OECD acknowledged as a huge problem the practice of double non-taxation, as well as cases of no or low taxation resulting in multinational enterprises paying global corporate tax rates of just 1 or 2% due to sophisticated tax schemes including offshores. The OECD presumes that, “when reporting their global earnings, too many multinational companies can artificially (and legally) move their profits around in search of the lowest tax rates, often undermining the tax bases of the jurisdictions where the real economic activities take place and where value is created”¹⁶. The OECD estimated in 2013 that global corporate income tax revenue losses could be between 4% to 10% of global revenues¹⁷, i.e. almost a quarter of a trillion dollars annually¹⁸. The main reasons behind cross-border tax evasion have been aggressive tax planning by some multinational enterprises, the interaction of domestic tax rules, lack of transparency and coordination between tax administrations, limited country enforcement resources and harmful tax practices. The affiliates of MNEs in low tax countries report almost twice the profit rate (relative to assets) of their global group, showing how BEPS can cause economic distortions¹⁹.

3. - Two pillars of the international anti-offshore legislation

The current international tax agenda relies on two building blocks: tackling tax avoidance via the OECD/G20 Base Erosion and Profit Shifting (BEPS) project; and promoting transparency and exchange of information among jurisdictions for tax purposes.

3.1. Addressing base erosion and profit shifting.

The OECD coined the term “base erosion and profit shifting” (BEPS) and focused its efforts on creating legal framework to deal with this problem. The OECD report “Addressing Base Erosion and Profit Shifting” states that “Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit

14 OECD, *Harmful* cit. 25.

15 Id. *Harmful* cit. 72.

16 <http://www.oecd.org/tax/global-tax-transparency-we-have-the-tools.htm>

17 Id.

18 OECD Secretary-General Report to G20 Leaders. Antalya, Turkey November 2015, Paris 2015, 80s.

19 <http://www.oecd.org/tax/global-tax-transparency-we-have-the-tools.htm>

shifting”²⁰. The report analyzes the main causes of BEPS and identifies «six key pressure areas: 1) hybrids and mismatches which generate arbitrage opportunities; 2) the residence-source tax balance, in the context in particular of the digital economy; 3) intragroup financing, with companies in high-tax countries being loaded with debt; 4) transfer pricing issues, such as the treatment of group synergies, location savings; 5) the effectiveness of anti-avoidance rules, which are often watered down because of heavy lobbying and competitive pressure and 6) the existence of preferential regimes”²¹.

The BEPS package developed by the OECD upon the request of G20 leaders covers three unifying tasks:

- to align rules on taxation with the location of economic activity and value creation;
- to improve coherence between domestic tax systems and international rules;
- to promote transparency.

The BEPS package was introduced in Kyoto, Japan, in June 2016. The BEPS Project delivers solutions for governments to close the gaps in existing international rules that allow corporate profits to «disappear» or be artificially shifted to low or no tax environments, where companies have little or no economic activity²².

In line with the OECD BEPS package, the European Commission has adopted on 17 June 2015 the Action Plan for fair and efficient corporate taxation in the EU which also deals with issues related to harmful tax practices. On 28 January 2016, the European Commission presented the Anti Tax Avoidance Package and the Council adopted the Anti Tax Avoidance Directive on 12 July 2016. The Directive proposes six legally-binding anti-abuse measures to counteract some of the most common types of aggressive tax planning, which all Member States should apply against common forms of aggressive tax planning.

Key features of the Anti Tax Avoidance Package include:

- legally-binding measures to block the most common methods used by companies to avoid paying tax;
- a recommendation to Member States on how to prevent tax treaty abuse;
- a proposal for Member States to share tax-related information on multinationals operating in the EU;
- actions to promote tax good governance internationally;
- a new EU process for listing third countries that refuse to play fair²³.

Political agreement on the Anti-Tax Avoidance Directive (ATAD) was reached by the EU Member States at the meeting of Economic and Financial Affairs (ECOFIN) Council on 17 June 2016. The agreement requires all Member States to enact laws that largely implement G20/OECD base erosion and profit shifting (BEPS) outcomes on interest limitation rules, hybrid mismatches and controlled foreign companies (CFCs) as well as additional measures on exit taxation and a general anti-abuse rule (GAAR). Member States will generally be required to adopt these ATAD measures in their domestic law by 31 December 2018.

3.2. Promoting transparency

Transparency is crucial to identifying aggressive tax planning practices by large companies and to ensuring fair tax competition. Measures to combat BEPS would be inefficient without resolving the problem of high offshore secrecy. “The veil of secrecy can too easily be used to hide the beneficial owners of legal arrangements from tax administrations and other law enforcement agencies”²⁴. The latest standard for identifying beneficial owners was developed by the Financial

20 OECD, *Addressing Base Erosion and Profit Shifting*, Paris 2013, 46s.

21 OECD, *Addressing* cit. 9.

22 <http://www.oecd.org/tax/first-meeting-of-the-new-inclusive-framework-to-tackle-base-erosion-and-profit-shifting-marks-a-new-era-in-international-tax-co-operation.htm>

23 http://europa.eu/rapid/press-release_IP-16-159_en.htm

24 OECD Secretary-General Report to G20 Finance Ministers. Chengdu, People’s Republic of China, 23 - 24 July, Paris 2016, 28s.

Action Task Force in 2012. The FATF published the new Guidance on Transparency and Beneficial Ownership in 2014.

The FATF gives the following definition: “Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement”. Further on, the Guidance gives a more detailed interpretation: “an essential element of the FATF definition of beneficial owner is that it extends beyond legal ownership and control to consider the notion of ultimate (actual) ownership and control. In other words, the FATF definition focuses on the natural (not legal) persons who actually own and take advantage of capital or assets of the legal person; as well as on those who really exert effective control over it (whether or not they occupy formal positions within that legal person), rather than just the (natural or legal) persons who are legally (on paper) entitled to do so”²⁵.

The FATF explains that “legal and beneficial ownership information can assist law enforcement and other competent authorities by identifying those natural persons who may be responsible for the underlying activity of concern, or who may have relevant information to further an investigation. This allows the authorities to “follow the money” in financial investigations involving suspect accounts/assets held by corporate vehicles. In particular, beneficial ownership information can also help locate a given person’s assets within a jurisdiction”²⁶.

The FATF Recommendations provide measures to address the transparency and beneficial ownership of legal persons (Recommendation 24) and legal arrangements (Recommendations 25). Countries should take measures to prevent the misuse of legal persons and arrangements from being misused for criminal purposes, including by:

- Assessing the risks associated with legal persons and legal arrangements
- Making legal persons and legal arrangements sufficiently transparent, and
- Ensuring that accurate and up-to-date basic and beneficial ownership information is available to competent authorities in a timely fashion²⁷.

Recently, the UNCTAD carried out a comprehensive study of beneficial ownership dedicating its annual World Investment Report 2016 to the problem of investor nationality and policy challenges. The report states, “More than 40 per cent of foreign affiliates worldwide have multiple “passports”. These affiliates are part of complex ownership chains with multiple cross-border links involving on average three jurisdictions. The nationality of investors and owners of foreign affiliates is becoming increasingly blurred”. According to the UNCTAD, “Multiple passport affiliates” are the result of indirect foreign ownership, transit investment through third countries, and round-tripping. About 30 per cent of foreign affiliates are indirectly foreign owned through a domestic entity; more than 10 per cent are owned through an intermediate entity in a third country; about 1 per cent are ultimately owned by a domestic entity. These types of affiliates are much more common in the largest MNEs: 60 per cent of their foreign affiliates have multiple cross-border ownership links to the parent company. The larger the MNEs, the greater is the complexity of their internal ownership structures. The top 100 MNEs in UNCTAD’s Transnationality Index have on average more than 500 affiliates each, across more than 50 countries. They have 7 hierarchical levels in their ownership structure (i.e. ownership links to affiliates could potentially cross 6 borders), they have about 20 holding companies owning affiliates across multiple jurisdictions, and they have almost 70 entities in offshore investment hubs”²⁸.

The UNCTAD presumes that the phenomenon of multiple cross-border ownership creates political challenges, particularly, on the eve of future trade and investment mega deals. The report warns that “Policymakers should be aware of the de facto multilateralizing effect of complex ownership on IIAs [international investment agreements]. For example, up to a third of apparently intra-regional foreign affiliates in major (prospective) megaregional treaty areas, such as the Trans-

25 *FATF Guidance. Transparency and Beneficial Ownership*, Paris 2014, 48s.

26 *Id.* *FATF Guidance* cit 3.

27 <http://www.fatf-gafi.org/documents/news/transparency-and-beneficial-ownership.html>

28 UNCTAD, *World Investment Report 2016. Investor Nationality: Policy Challenges*, Geneva 2016, 232s.

Pacific Partnership (TPP), the Transatlantic Trade and Investment Partnership (TTIP), and the Regional Comprehensive Economic Partnership (RCEP), are ultimately owned by parents outside the region, raising questions about the ultimate beneficiaries of these treaties and negotiations. Policymakers should aim to avoid uncertainty for both States and investors about the coverage of the international investment regime²⁹.

Co-operation between tax administrations is critical for promoting transparency. On 19 April 2013, the G20 Finance Ministers and Central Bank Governors endorsed automatic exchange of tax information. Global tax transparency agenda was further enhanced in 2014 when under a mandate from the G20 the OECD developed the global Common Reporting Standard (CRS) for Automatic Exchange of Information (AEOI), which 101 jurisdictions have now committed to implement, with the first such exchanges to begin by 2017³⁰.

The Standard provides for annual automatic exchange between governments of financial account information, including balances, interest, dividends, and sales proceeds from financial assets, reported to governments by financial institutions and covering accounts held by individuals and entities, including trusts and foundations. Countries have already identified almost 55 billion euros in additional revenues through voluntary disclosure programmes and other initiatives targeting offshore evasion³¹. Finally, 31 countries signed the Multilateral Competent Authority Agreement (MCAA) for the automatic exchange of Country-by-Country reports as part of continuing efforts to boost transparency by multinational enterprises (MNEs) on January 27, 2016.

4. - Russia's anti-offshore package

Recently, Russia has joined international efforts in fighting offshore tax evasion. Though the country's economy has been hemorrhaging due to offshore tax evasion since 1990s, Russia couldn't start combating tax havens unilaterally.

According to Russia's Bank for Foreign Trade (Vnesheconombank), offshore companies have become one of the main channels of capital flight from Russia abroad since the beginning of liberal economic reforms. Russian business began actively using offshore jurisdictions from 1990th. Most of Russian businesses had established offshore companies in the European countries and especially in the Isle of Man (UK), Cyprus, Gibraltar, Ireland, Switzerland and Liechtenstein. Offshore structures of Russian business are, first of all, centers for concentration profits which are generated in Russia but evaded from paying tax in Russia and serve as reliable "vaults" for fortunes of Russian "oligarchs" received both by legal and criminal means³².

The IMF highlights the main channels of illegal capital flight from Russia which "have included (i) under-reporting of export earnings, including through transfer pricing schemes; (ii) overstatement of import payments, including through fake import contracts for goods and services; (iii) fake advance import payments; and (iv) a variety of capital account transactions, often effected through the correspondent accounts of nonresident banks with Russian banks"³³.

The Global Financial Integrity report (GFI) had traced illicit financial flows (IFF) from developing countries in 2002-2013. Unfortunately, Russia was among top countries hit by illegal flows. Three emerging markets - China with cumulative illicit financial flows of \$1,4 trillion during 2002-2013, Russia with more \$1 trillion and Mexico (\$ 528 billion) - were worst hit by IFF³⁴. The GFI report stated in January, 2014, that "approximately 61% of Russia's \$403 billion in outward foreign direct investment (FDI) is held in tax havens and the amount of FDI coming into Russia is also dominated by tax havens. Approximately 53% FDI invested in Russian companies comes from

29 UNCTAD, Id, *World* cit. xii.

30 <http://www.oecd.org/tax/global-tax-transparency-we-have-the-tools.htm>

31 *OECD Secretary-General Report to G20 Leaders. Hangzhou, China September 2016*, Paris 2016, 30s.

32 ВНЕШЭКОНОМБАНК, *Макроэкономические тенденции*, Москва 2014, 16с.

33 IMF, *Russian Federation: Staff Report for the 2012 Article IV Consultation, IMF Country report No. 12/217*, (2012) 60s. <https://www.imf.org/external/pubs/ft/scr/2012/cr12217.pdf>

34 D. Kar, J. Spanjers, *Illicit Financial Flows from Developing Countries: 2004-2013*, Washington 2015, 72s. http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final.pdf

entities located in tax havens”³⁵. At that, the GFI didn't take into account the Netherlands, a low tax jurisdiction which is often used by tax evaders in various sophisticated schemes involving so called prestigious jurisdictions along with classical offshore.

The GFI study outlines a strong connection between illicit financial flows and use of offshore jurisdictions. The report states that offshore financial centers and developed country banks are the major points of absorption of illicit financial flows from emerging market and developing countries³⁶.

On December 12, 2013, in his annual address to the Federal Assembly, President Putin proposed to introduce amendments to Russian legislation to stipulate that the income of companies located in offshore jurisdictions will be taxed if those companies do not distribute income they receive to the Russian owners of the companies in question.

Russia has recently introduced significant changes to the Tax Code adopting the so called "deoffshorization law". Federal Law #32-ФЗ "On Introducing Amendments to Parts 1 and 2 of the Tax Code of the Russian Federation (Regarding Taxation of Controlled Foreign Companies' Profits and Foreign Organizations' Income)" is intended to restrict the use of offshore corporate and trust structures controlled by Russian taxpayers³⁷.

A rule concerning foreign controlled companies is included in tax legislation of many developed economies such as the USA, UK, Germany, Sweden, Japan, Australia. According to international legal practice, a company registered in a foreign state which belongs to shareholders or a group of shareholders who are resident in another state may, under certain conditions, pay taxes in the country where its shareholders are resident. The tax treatment of CFCs introduced by the Russian law corresponds to the world practice.

The objectives of the above mentioned Law are the following:

- to create the mechanism preventing use of low-tax jurisdictions for the purpose of enjoying unreasonable preferences and obtaining unjustified tax benefits;
- to improve tax laws in terms of taxation and control of foreign organizations.

The law is applied to both organizations and individuals participating in foreign companies or controlling them in any other way. According to the Law, from 1 January 2015, a Russian tax resident should pay income tax on the undistributed profits of any foreign entity controlled by him, in proportion to such controlling stake or participation, at the rate of 13% (if an individual) or 20% (if a corporate entity).

The Law introduces a number of new concepts such as "controlled foreign company", "controlling entity", "beneficial ownership", "place of effective management".

According to the Law, a controlled foreign company (CFC) is a non-Russian entity which is not a tax resident in Russia; and is controlled by legal entities and/or individuals that are treated as Russian tax residents. The definition of a CFC covers pass-through entities (such as funds, trusts, partnerships and collective investment vehicles) which generate income for the benefit of their participants/settlors or beneficiaries, as well as corporate entities. The "beneficial ownership of income" test can be applied to a foreign company (including a CFC) to determine whether the company serves merely as a conduit function.

The Law defines "control" over a corporate entity as exercising influence (or having the ability to exercise influence) over the distribution of profits of that entity through direct or indirect participation in the capital of that entity (e.g. as a shareholder); and having rights under a shareholders' agreement regulating the management of that entity, or other criteria.

A controlling entity of a foreign organization is an individual or a legal entity:

35 B. LeBlanc, *Russian Foreign Direct Investment and Tax Havens*, (2014) <http://www.gfintegrity.org/russian-fdi-tax-havens>

36 D. Kar, D. Cartwright-Smith, A. Hollingshead, *The Absorption of Illicit Financial Flows from Developing Countries: 2002-2006*, Washington 2010, 52s.
http://www.gfintegrity.org/storage/gfip/documents/reports/absorption_of_illicit_flows_web.pdf

37 Федеральный закон от 24.11.2014 N 376-ФЗ «О внесении изменений в части первую и вторую Налогового кодекса Российской Федерации (в части налогообложения прибыли контролируемых иностранных компаний и доходов иностранных организаций)» http://www.consultant.ru/document/cons_doc_LAW_171241

- whose participation interest in an organization is more than 25% (before 1 January 2016 – more than 50%), or

- whose participation interest in an organization (for individuals along with their spouses and minor children) is more than 10%, if a direct and (or) indirect participation interest of all entities recognized as tax residents of Russia in this organization (for individuals along with their spouses and minor children) is more than 50%, or exercising control over such an organization in their own interests or the interests of their spouse and minor children.

The income of a controlled foreign company:

- will be treated as income of the relevant Russian controlling party (whether corporate or individual) of the CFC in proportion to the interest of that controlling party in the capital of the CFC;

- will be deemed to be received by the relevant Russian controlling party when it is distributed by the CFC or, if there is no such distribution in the relevant tax year, on 31 December in that tax year;

- will be calculated on the basis of the financial reporting period of the CFC under the laws applicable to the CFC.

The income of a CFC will not need to be accounted for by a Russian controlling party if the income of the CFC does not exceed 30 million Rubles in the year ending 31 December 2016; or 10 million Rubles thereafter.

CFC's profit reduced by an amount of paid dividends is included as a portion corresponding to participation interest in CFC into tax base of a controlling entity - resident of the Russian Federation:

- for controlling entity as an individual – on personal income tax;
- for controlling entity as a legal entity – on corporate income tax.

In broad terms, the CFC rules would apply in relation to non-Russian tax resident corporations (and other entities) controlled by one or more Russian tax residents. The rules would:

- deny double tax treaty benefits to CFCs;
- instead treat the income of a CFC as taxable in the hands of a Russian controlling party when received by the CFC, regardless of whether an actual distribution to any Russian controlling party took place;

- require Russian tax residents to report their interests in foreign companies to the Russian tax authorities.

The Law also introduces a new test of “place of effective management” in order to determine whether a foreign company is a tax resident in Russia. This test establishes the basis for determining whether a foreign company is tax resident in Russia.

A foreign company will not be treated as a Russian tax resident (unless it elects to be so treated) if:

- it is treated under the provisions of a double tax treaty to which Russia is a party as being tax resident in another state;

- it is engaged in activities under production sharing agreements, concession agreements, licensing or service agreements or certain other prescribed agreements with a foreign government; or

- it has a separate branch in Russia.

As for individuals, they are recognized as tax residents of the Russian Federation in the same way as before on the basis of their actual stay in Russia for at least 183 calendar days within 12 consecutive months.

In order to facilitate the repatriation of hidden assets to Russia's economy, the Federal Law #140-FZ “On the Voluntary Declaration of Assets and Bank Accounts/Deposits by Individuals and on Introducing Amendments to Various Legislative Acts of the Russian Federation” has been adopted in June 2015³⁸.

38 Федеральный закон от 8 июня 2015 г. N 140-ФЗ "О добровольном декларировании физическими лицами

The main objective of the Law was to ensure legal security of capital and property owned by individuals, protect property interests of Russian citizens, including property outside the territory of the Russian Federation as well as in compliance with the transition to the automatic exchange of information in tax matters at the international level (BEPS legislation).

According to the Law, individuals had to declare their foreign property (real estate, vehicles, shares in companies, securities and etc.) and foreign bank accounts. In exchange the declarant is not subject to criminal or administrative responsibility and is exempt from the payment of historical taxes, committed before January 1, 2015. The information provided by the declarant was recognized as confidential. The Law required those applying for amnesty to fully declare their offshore assets. Upon declaration, that had to be filled before the end of 2015, there would be no penalty for unauthorised expatriation.

The Law did not cover assets acquired through illegal means, only assets expatriated for tax purposes. The Law was developed in close cooperation with the FATF. However, the latter has certain concerns about the lack of disclosure and information sharing. This is a serious matter, as failure to comply with FATF regulations can get Russia blacklisted. Russia's role within the FATF has been actively positive in recent years.

C.Gurdgiev gives the following classification of Russia's offshore assets. He presumes that globally-allocated Russian capital, held by private individuals, can be divided into 3 (unequal in volume) types:

- Type 1 - an unknown quantum of assets acquired by using illicit gains from activities in Russia and illegally shifted out of the country. This bit is not covered by the Law, but the Russian Government has already said it plans to introduce a separate piece of legislation to cover these assets, and it has promised that it will fully comply with FATF.
- Type 2 - an unknown quantum of assets, probably similar to that covered by Part 1 and, together with Type 1 accounting for more than 2/3rds of all Russian-owned assets held abroad, has been expatriated to minimise tax exposures. Some of them legally, some illegally. This bit is covered by the Law.
- Type 3 — a smaller share of Russian assets abroad is perfectly legal and is not covered by the Law. To-date, FATF had no complaints with Russia on these assets³⁹.

The deadline for returning capital to Russia was originally Dec. 31, 2015, but it was extended until July 1, 2016 by the Federal Law # 401-FZ «On introducing amendments to article 5 of the Federal Law «On voluntary declaration of assets and bank accounts (deposits) by natural persons and on introducing amendments to certain legislative acts of the Russian Federation»⁴⁰.

Abstract. - This study is dedicated to a very painful problem of the global economy, namely, tax evasion resulting from hiding assets in offshore financial centers (OFCs) which are featured by 1) low or zero tax rates, 2) high secrecy or lack of transparency and 3) providing this benefits to non-residents. Correspondingly, the main challenge for the international organizations and national governments has been to develop legal tools for tackling base erosion and profit shifting, unveiling beneficial ownership and promoting transparency. The retrospective analysis of the international legal framework to combat tax evasion via low-tax jurisdictions finds out that Russia's recent laws have been, generally, in line with international efforts.

Questo contributo è dedicato a un problema molto doloroso dell'economia globale, vale a

активов и счетов (вкладов) в банках и о внесении изменений в отдельные законодательные акты Российской Федерации" (с изменениями и дополнениями) Система ГАРАНТ:

http://base.garant.ru/71066748/#block_3#ixzz4PhvVOE62

39 C. Gurdgiev, *Russian Offshore Capital Amnesty Law Proposal*, (2015)

<http://trueeconomics.blogspot.ru/2015/04/5415-russian-offshore-capital-amnesty.html>

40 Федеральный закон "О внесении изменения в статью 5 Федерального закона "О добровольном декларировании физическими лицами активов и счетов (вкладов) в банках и о внесении изменений в отдельные законодательные акты Российской Федерации" от 29.12.2015 N 401-ФЗ.

http://www.consultant.ru/document/cons_doc_LAW_191305/

dire, l'evasione fiscale derivante dall'uso di offshores per nascondere l'attività commerciale. I centri finanziari offshore sono caratterizzati da 1) bassa o pari a zero le aliquote fiscali, 2) alta segretezza o la mancanza di trasparenza e 3) prestazione questi vantaggi ai non residenti. Di conseguenza, l'impresa difficile per le organizzazioni internazionali e i governi nazionali dovrebbe essere in via di sviluppo gli strumenti legali per affrontare l'erosione di base fiscale e lo spostamento di profitto, svelando proprietà effettiva e promuovere la trasparenza. L'analisi retrospettiva del quadro giuridico internazionale per la lotta contro l'evasione fiscale attraverso offshores conclude che le recenti leggi adottate dalla Russia sono stati, in generale, in linea con gli sforzi internazionali.