

## New CFC Rules: Avoiding Tax Evasion

**Evgeniy Viktorovich Bushmin, Natalia Borisovna Pochinok,  
Valeria Vyacheslavovna Efremova, Olga Jurjevna Bakhtina<sup>2</sup>  
and Aleksandra Andreevna Kalinina**

<sup>1</sup>Plekhanov Russian University of Economics, 36, Stremyanny pereulok, 117997, Moscow, Russia

<sup>2</sup>Russian State Social University, 4,1, V. Pika, Moscow, 129226, Russia.

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**Excessive tax burden contributes to tax evasion. The level of development of the shadow economy depends on the level of the tax burden. Many entrepreneurs leading international activities, move their business or its parts in the countries with the lowest tax burden. Most states strictly control the activities of their companies in offshore areas. At the moment, Russia has agreements on avoidance of double taxation with 80 countries. On March 18, 2014 the Ministry of Finance of the Russian Federation according to the plan for a de-offshoreization of the Russian economy published a bill that enforces the rules of controlled foreign companies (CFC) in the Russian Federation. In the article analyzes the major issues of this bill.**

**Key words:** tax burden, tax evasion, offshore zones, CFC rules.

In modern specialized literature allocate the intrastate and interstate tax competition. The establishment and allocation of intrastate taxes by authorities independent of, and uncooperative toward one another, can lead to intrastate tax competition. Interstate tax competition often results in a contest among numerous fiscal jurisdictions for the right to attract “global taxpayers” into the national economy (Starodubrovskaya *et al.*, 2005; Goodspeed, 1998; Pogorletsky, 2005).

The purpose of the interstate tax competition is attracting of the maximum quantity of tax resources under influence of the national tax law. The essence of both the intrastate and interstate tax competition consists in creation of such mode of the taxation which will lead to movement of part of tax base on other territory. In

other words, the tax competition is a competition in granting the best conditions for taxpayers for the purpose of their attraction on the jurisdiction.

Thus a tax competition is considered unfair if it involves the creation of privilege for nonresidents, as well as a violation of the international standards of informational exchange. Tax competition not only effective, but also very disputable way of influence on the movement of financial streams. The consequences of tax competition contribute to a drain of capital and labor, negatively enhancing the growth of shadow economies. In addition, tax competition violates the distribution of public benefits and creates numerous other problems. Processes which develop aspects of financial globalization, and the internationalization of markets, also have led to an escalation in interstate tax competition. This, in turn, has led to increased international tax optimization by many organizations. This optimization quite often manifests itself in ventures involving illegality (Pochinok and Kalinina, 2014). Using shortcomings

\* To whom all correspondence should be addressed.

of the tax and customs legislation, the Russian business for minimization of taxes widely uses offshore financial and production networks. Their functioning stimulates outflow of the capital and reduces profitable capacity of the Russian Federation. The indirect indicator characterizing losses of the Russian Federation from these factors, the indicator “unauthorized export of the capital by the private sector” which volume following the results of 2012 made 49,1 billion US dollars, or 90% of total amount of pure import (export) of the capital the private sector (54,6 billion US dollars), and in January – September, 2013 (according to Bank of Russia) – 33,4 billion US dollars, or 69,4% of total amount of pure import (export) of the capital the private sector (48,1 billion US dollars).

Tax offenses, being a component of shadow economy, make negative impact on a condition of economic safety. Providing economic safety can be considered as process of creation and hardening of the conditions providing reliable functioning of national economy during its development. Considerable grants from the state budget are necessary for conducting similar activity. In turn the leading place in formation of resources of the state is taken by taxes. So the share of taxes and fees in the sphere of the income of the federal budget for 2014 makes over 90%. According to Art. 1 of the Federal law of the Russian Federation of December 2, 2013 N 349-FZ “About the federal budget for 2014 and on planning period 2015 and 2016” the volume of the income of the federal budget for 2014 is provided in the sum of 13,6 trillion rubles (Federal law of December 2, 2013 N 349-FZ). So high share of a tax component of the budget allows to draw a conclusion that financial and economic security in general considerably is defined by a condition of tax system of the country, its safety.

#### **Historical digression**

It is necessary to consider unnatural aspiration of the owner to saving of the income or property. Still A. Smith defined tax evasion as the “synthetic”, not natural violation. To treat such violation as to a criminal offense contradicts to the nature laws. The one who evades from taxes, writes A. Smith, often is the person, not capable to commit criminal offenses, and in every respect is the beautiful citizen. If only the laws of his country

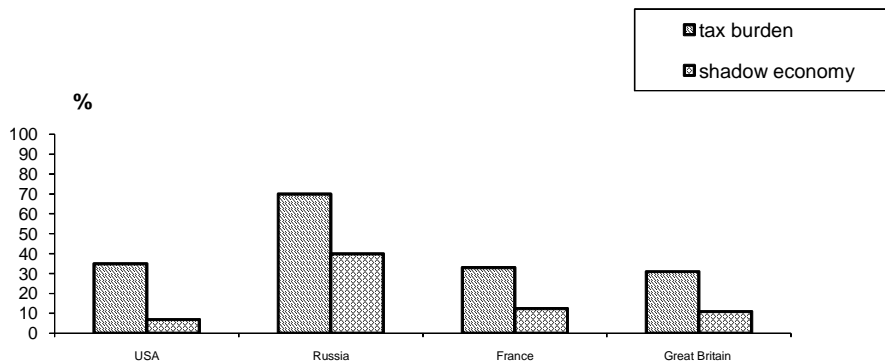
didn't carry to a crime what in fact is not a crime according to the nature. In the corrupted states concerning which at least there is a suspicion that they spend means in vain and use the most part of the national income, to laws which forbid this situation, have no respect not for designated purpose (O'Rurck, 2010).

#### **Explore Importance of the Problem**

It has been proven that an excessive tax burden promotes the emergence of potential situations in which a payer has a desire to avoid the payment of excessive, (from a subjective viewpoint), taxes. Scientists estimate that this share of a country's respective shadow economy constantly increases. In Scandinavian countries this share comprises 10–18% of real Gross Domestic Product. In Mediterranean countries it can reach 20–25%. In the former socialist countries of Eastern Europe this level often reaches – 36–39% (Baranova and Dubovik, 2013). A common belief states that the level of a shadow economy is directly proportional to the level of a country's tax burden. There is no definite answer, what value of tax withdrawal is optimum, too high or low. Research shows that a withdrawal of more than 35–40% of the value added can force unprofitable investments into an expansion of production. Therefore, in modern conditions, the tax-loading level in developed countries should not exceed 40%. An illustration of this can be found in the tax burden of the USA – 35%. In France – 33%, in Great Britain – 31%, and in Russia it reaches 70%. At the same time, the shadow economy, according to official figures, encompasses 7% of Gross Domestic Product in the United States, and – 40% in the Russian Federation (Kalinina, 2013; Vechkanov, 2007; Bogomolov, 2010).

#### **State Hypotheses and Their Correspondence to Research Design**

Therefore it is quite natural that businesspeople and entrepreneurs conducting their business in an international arena often move their businesses or attached subsidiaries to countries providing the lowest possible tax burden. At present, there are roughly 70 offshore financial centers providing havens for offshore companies. The greatest number of these centers are located in the British Virgin Islands, Hong Kong, Panama, and Ireland. To the countries with minimum, and sometimes a zero level of the taxation also belong



**Fig. 1.** Correlation of tax burden and shadow economy [Enterprise Surveys, 2014]

Bahama, Kaymanova and the Seychelles, Monaco, Gibraltar, Lebanon and Belize.

Offshore business is actively applied at the international tax planning and most often in its illegal forms. Therefore using the offshore companies meets active resistance from the states with the high and average level of the taxation which introduce various restrictions, forbid certain schemes of business with use of the offshore, etc. Most states rigidly control financial activity and demand increases in the transparency of financial schemes from companies registered in their offshore zones. Even the most “opaque” offshore companies would be closely monitored by watchdog agencies, including the OECD and FAFT (Pochinok and Kalinina, 2014). In Russia there is a single legal mode establishing the norms of working with any foreign company, independently of their location. Russia’s legal system does not provide any sanctions by interfering with the interaction of offshore companies.

It should be noted that the Russian legislation doesn’t provide any sanctions interfering interaction with the offshore companies. Currently, the Russian Federation has double taxation avoidance agreements with 80 countries – which allow applications for the right to obtain information— which may be needed for an investigation of tax offenses. In general, there are no agreements with jurisdictions that are taxed at a lower level.

## METHOD

On March 18, 2014 the Ministry of Finance of the Russian Federation devised a plan for a de-

offshoreization of the Russian economy, establishing new concepts of the Russian tax law - “the controlled foreign companies” (“CFC”), “tax residence” for legal entities, and also expanded rules of the taxation of profit on indirect sale of the Russian real estate. A bill was published in which the rules governing controlled foreign companies (CFC rules) would be allowed into the Russian Federation. CFC rules have already been applied in Great Britain, Germany, France, Spain, and some other countries. The CFC rules, and the order of recognition of foreign organizations in a place of management, are directed by tax residents against tax evasion in the form of the movement of the centers of profit from countries in which they have been directly created in low-tax jurisdictions.

These rules have also now been revised within the BEPS project.

The version of the rules offered by the Ministry of Finance does not differ conceptually from analogous foreign versions, but at this stage, has a considerably smaller degree of elaboration.

The bill received a big resonance in the Russian business community and was actively discussed at a number of discussion platforms.

## RESULTS

What changes the new law will bring for business?

Some of the Russian tax residents will increase the level of tax burden in connection with inclusion in base on a tax of profit of CFC . The profit of CFC will be assessed at the usual rates – 13% for physical and 20% for legal entities.

The most critical situation of the bill of

CFC rules is its 10% share as a norm for recognition as a CFC and its 1% share as a norm for a notice of participation in foreign organizations. It is to be expected that these threshold values, and many other critical aspects, will be discussed again and that a certain compromise between all offered options will be found. For instance, on June 26, the Ministry of Economic Development offered their own version of the bill (Draft of the rules of controlled foreign companies June 26, 2014).

The future will reveal which version of the bill will be brought to the State Duma of the Russian Federation. According to the Government's plans, and to CFC rules and other provisions of the bill, it should enter into force in Russia beginning on January 1, 2015.

It is expedient to use the remained time for preparation for introduction of the new rules and, perhaps, reorganization of your business.

## DISCUSSION

Public discussion of the bill began in March of 2014. Over the next few months, the text of the bill underwent considerable changes. On May 27, a new version of the bill appeared on the Russian Federation's Ministry of Finance website. Though many actively discussed moments hasn't change. For example, the Ministry of Finance of the Russian Federation left 10% share as criterion for CFC recognition, and 1% share as criterion for the notice of participation in the foreign organizations (any, and not just CFC).

### *4.1 Who is considered CFC – approach “from the return”*

The “black list” of states has now been replaced with two “white lists”.

According to the new version CFC the foreign organization, which isn't:

- a) has continuous stay in the member state of the Euroasian economic union;
- b) has continuous stay in the state which provides exchange of information with Russia (the list of such states will create FNS of Russia) And the effective rate of a tax at this concrete organization makes more than 15% (these are three quarters of the Russian rate).

Existence two “white”, but not one “black” list, and also a higher level of taxation,

(15%), might lead to an extension of the list of countries whose organizations and structures would be recognized as CFC (in comparison with expectations proceeding from existence of the “black” list).

### **CFC - bad news to business**

According to the revamped version of rules offered by the Ministry of Finance and dated May 27, a business will need to provide two types of notice: a notice of participation in foreign organizations and a notice of CFC's (if the provides the notice of CFC, the notice of participation in the foreign organizations concerning the same organization isn't required to be submitted). Thus it is necessary to report about all foreign assets (if direct or indirect participation in them makes not less than 1%), not only about assets of the “black” list as the previous version of the bill assumed. Thus the first notice isn't provided if, for example, indirect participation is carried out through the organization which actions underwent listing procedure.

The penalty for failure to comply with the submission of notices will result in penalties of 50,000 and 100,000 rubles, respectively.

In addition to the requirement that now counts taxable profit, (by the rules of the Chapter 25 Tax Code of the Russian Federation), two tax baskets of CFC's will be defined—the profit from active, and the profit from passive activity (material losses on one basket won't be to become engrossed in reading in profit on other basket, but will be postponed to the future).

### **Concept of tax residence of legal entities**

Norms of residency are divided between the main and the additional, the main norms are softened, additional, on the contrary, are strengthened.

The main norms of residency in the Russian Federation:

- a) a place meetings of the Board of Directors (or the other governing body of the organization) are usually held in the territory of the Russian Federation;
- b) the leading control of the organization usually is exercised from the Russian Federation;
- c) the leading officials of the organization carry out the activity concerning this foreign organization in the Russian

Federation.

In case the main norms are carried out concerning several states, estimated additional norms:

- a) conducting accounting or management accounting of the organization in the Russian Federation;
- b) record keeping of the organization in the Russian Federation;
- c) the publication of orders and other organizational and administrative documents concerning activity of the organization is carried out in the Russian Federation;
- d) employment of employees and human resource management is carried out in the Russian Federation.

The concept of the beneficial owner of the income for application of privileges under contracts on avoidance of the double taxation

Entered the conception of the beneficial owner. The beneficial owner of the income will admit the person who directly or through the direct and (or) indirect participation in other organizations or otherwise at the same time has the right of possession, using or the order such income, or the person in which interests other person is competent to use and dispose of such income possesses.

When determining the actual recipient (the beneficial owner) the income will be considered the functions which are carried out by the foreign person, applying for application of tax privileges (the lowered rates, releases from the taxation) on the basis of the international agreement Russian Federation concerning the taxation, and also risks accepted by such person.

Privileges under contracts on avoidance of the double taxation won't be applied if the foreign person applying for their application, possesses limited powers concerning the order this income, carries out mediatorial functions, without carrying out any other functions and without assuming any risks, directly or indirectly paying such income (in whole or in part) to other person who at direct obtaining such income from a source in the Russian Federation wouldn't have the right for application of privileges.

The position of the Ministry of Finance of the Russian Federation on beneficial property

was dentally described in the letter of April 9, 2014 No. 03-00-RZ/16236, and now it transforms to a legislative initiative.

#### **Rules of thin capitalization**

Will change the conditions of the application with thin capitalization rules, (instead of a share of direct or indirect participation at 20%, there will be an estimated interdependence between the Russian borrower and the foreign lender organization). Also under control will get the debt to the Russian organization recognized as interdependent with the foreign organization, or the debt pro-guaranteed by such Russian organization. In the current version of the bill affiliation of such Russian organization with the general foreign participant estimated in according of the Federal law of March 22, 1991 No. 948-1 "About the competition and restriction of monopolistic activity in the commodity markets".

The bill also provides for taxation on the income of foreign organizations, and the implementation of shares or interests in any (not only Russian) organizations if more than 50 % of the property of these organizations directly or indirectly consists of real estate in the Russian Federation. At the same time, the mechanism of taxation has not been entirely settled yet. Continuing forthwith on the subject of operations with stocks, it is important to note that, since 2016, Russia will enforce its new exemption entered by the Federal law of 28.12.2010 N 395-FZ related to the sale of shares. The profits from the sale of the actions and shares of Russian organizations, such as the hi-tech (innovative) sector of the economy, acquired later than January 1, 2011, and under ownership for more than 5 years, will be taxed at a zero rate, (instead of the usual rate of 20%). For application of a privilege any of following conditions has to be carried out:

- 1) actions weren't quoted during all term of possession;
- 2) actions are quoted, but during all term of possession were actions of hi-tech (innovative) sector of economy;
- 3) for date of their acquisition actions weren't quoted, and for date of their realization are the quoted actions of hi-tech (innovative) sector of economy.

Thus reference of the quoted actions to actions of hi-tech (innovative) sector of economy



will be carried out by the exchanges (according to the statement of the issuer) by the rules established in the Resolution of the Government of the Russian Federation of 22.02.2012 No. 156.

Thus, granting tax allowance profit of investors, the Russian legislator in fact helps the companies which are engaged in hi-tech development. It will be easier for them to attract investors as it is favorable to invest in from the tax point of view. We will look, how many investors will use this privilege in 2016 (Efremova and Pochinok, 2014).

### CONCLUSION

Use of the unfair tax competition is one of the factors promoting evasion of taxes. It is quite natural that the businesspersons conducting the international activity move the business or its separate parts to the countries, where less tax burden of business.

However, the unfair tax competition cannot be considered as the only factor leading to growth of the tax evasion, it having the international character. Development of society is involuntarily connected with contention for resources, including the taxes. "Whenever, each tax for the taxpayers, it's a sign of the freedom, not the slavery sign. It designates that this person, though submits to the government, but in practice he is the full owner of the property, and itself isn't property of any owner" (O'Rurck, 2010).

Thus, attempt of increase of welfare of the state by conducting the unfair tax competition is capable to lead to the serious consequences, which are showing in expansion of shadow sector of economy.

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