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Dear readers,

We are glad to welcome you to our new edition of “Korpus Prava.Analytics”.

Articles of our autumn edition answer interesting and topical questions. One of the key topics remains the third stage of the capital amnesty, which will last until February 29, 2020. This time Tatiana Frolova takes a close look at the process of redomicilation of foreign companies to the Russian Federation. It should be noted that redomicilation has become the main condition of the current amnesty.

“Invest one third in real estate, one third in business and another one third in gold”. Is this the right approach to the family capital formation in the long term? Dr. Ariel Sergio Goekmen, a board member of Schroder & Co Bank AG, Zürich, answers inter alia this question regarding the preservation of the family wealth for numerous generations.

Julia Vints dedicates her article to peculiarities of the updated standard for accounting of financial instruments IFRS 9. You will learn about the key changes to classification and evaluation of financial assets, as well as the difficulties companies face when applying new rules for impairment of financial assets.

The latest issue once again returns to BEPS plan, only now we will analyze the issue relevant for 2019 in more detail, i. e. requirements of offshore jurisdictions on arrangement of economic substance as part of the said plan.

In recent years, regulatory authorities have focused a lot on the application of the concept of the beneficial owner of income. For his article, Alexey Oskin, deputy director for tax and legal practice, has prepared an extensive collection of recent court decisions related to the application of this concept.

We hope this feature material will be really beneficial for you. We look forward to your recommendations and questions, and we will do our best to cover them in our next edition or news feed on our website or Facebook page.

Enjoy reading!

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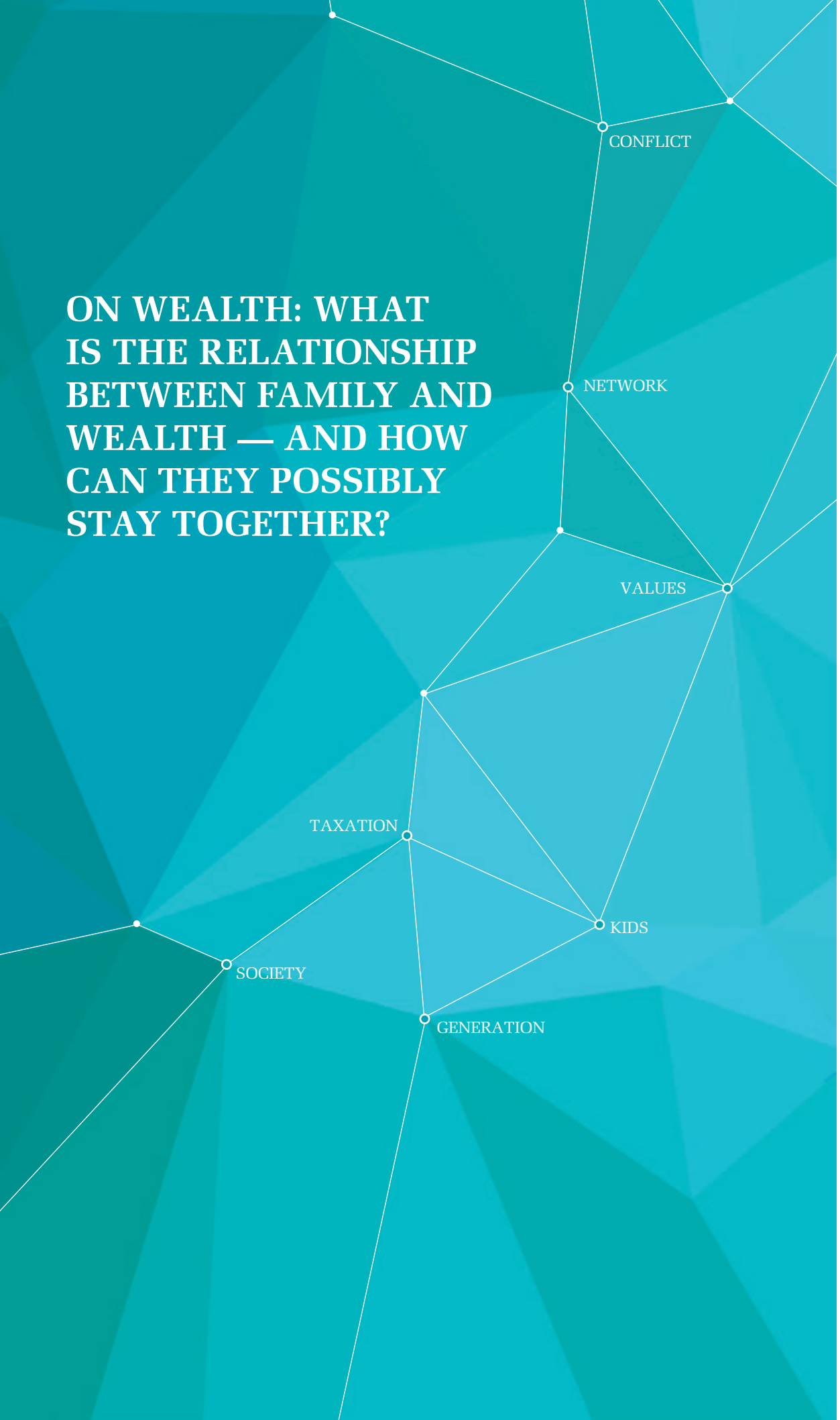


ON WEALTH: WHAT IS THE RELATIONSHIP BETWEEN FAMILY AND WEALTH — AND HOW CAN THEY POSSIBLY STAY TOGETHER?

Dr. Ariel Sergio Goekmen
Member of the Executive Board
Schroder & Co Bank AG, Zürich

Often our clients ask us and seek guidance on how they can keep the wealth in their family over generations and prevent dissipation over time.

Our firm was established by the Anglo-German Schroder family in 1804, maybe this is the reason they come to us.

Usually we begin with what I would describe as the star of doom. The star of doom comprises in its rays all the threats to the family wealth. At its core, the loss of the family fortune looms. The rays carry names.

These rays of the star of doom can be categorized into reasons closely tied to the family itself, ranging from bad investment or business advice to bad implementation, bad business decisions, divorce — Mr Bezos comes to mind — family conflict, which sometimes even blocks a family business from thriving, no mutually shared family values, no discipline, family fertility with many offspring, which have to divide the inheritance, expensive lifestyles, expensive hobbies, drug addiction and drug abuse to mental insanity.

> "I cheat my sons wherever I can."
>
> *— William A Rockefeller, father of John D Rockefeller*

Then there are rays of the star of doom which relate to reasons sometimes outside of the influence by the family. This can be government action including sanctions and confiscations (eg, the Soviet or Nazi regimes), inflation, taxation, revolutions (eg, 1789 or 1917), wars and of course, more benign by comparison, fraud.

> "My firm shall go to male family members only. No daughters or in law."
>
> *— Mayer Amschel Rothschild, stated in his will in 1812*

In order to stay wealthy as a family over generations, the family has either to have the foresight to avoid all the threats the star of doom poses or indeed be very fortunate to navigate the seas of change successfully.

After we have considered the threats, usually we look at the network a wealthy family has around them. This network includes structures to hold family wealth like trusts, foundations, family firms, participation in businesses, real estate, pleasure assets like yachts, investments in art, horses, cars, liquid and securitised wealth — which all need to be supervised and coordinated. It is here that we say

that families do not go bankrupt because they are no longer wealthy.

They go bankrupt because they became illiquid and unable to pay their commitments.

> "Saving is nice, especially if your parents did it for you."
>
> — *Winston Churchill*

Considering the network around the family further, we come into areas of tax domicile, taxation, centre of life, succession and estate planning, who advises the family in which field, whether the family has established a family office and what the role of this office is. Sometimes families use their family office mainly for record keeping, often for asset management and less often for governance.

Further in the family network are the influencers, these are people like other wealthy families, whose advice and view the present family would heed. Then there is the family culture, their values and traditions.

Sometimes they already have a family vision, mission and strategy. All of these points are relevant and define whether a family can remain wealthy over generations.

> "One should have two fortunes: one to keep, one to spend."
>
> — *Winston Churchill*

In the final phase of analysing how to keep the family wealth together, we focus on the family values.

The family values in our observation are the most critical to retain the wealth over generations.

There are, for example, very wealthy Zurich-based families who tell their children: "It doesn't matter, what you do in life. You don't have to go to university. You can be a carpenter. The main thing, you are the best in your field". Others say: "Our family is very privileged for generations. Each child has to create value in society. One becomes a medical doctor, another a scientist, one goes to clergy, one goes to serve in the armed forces."

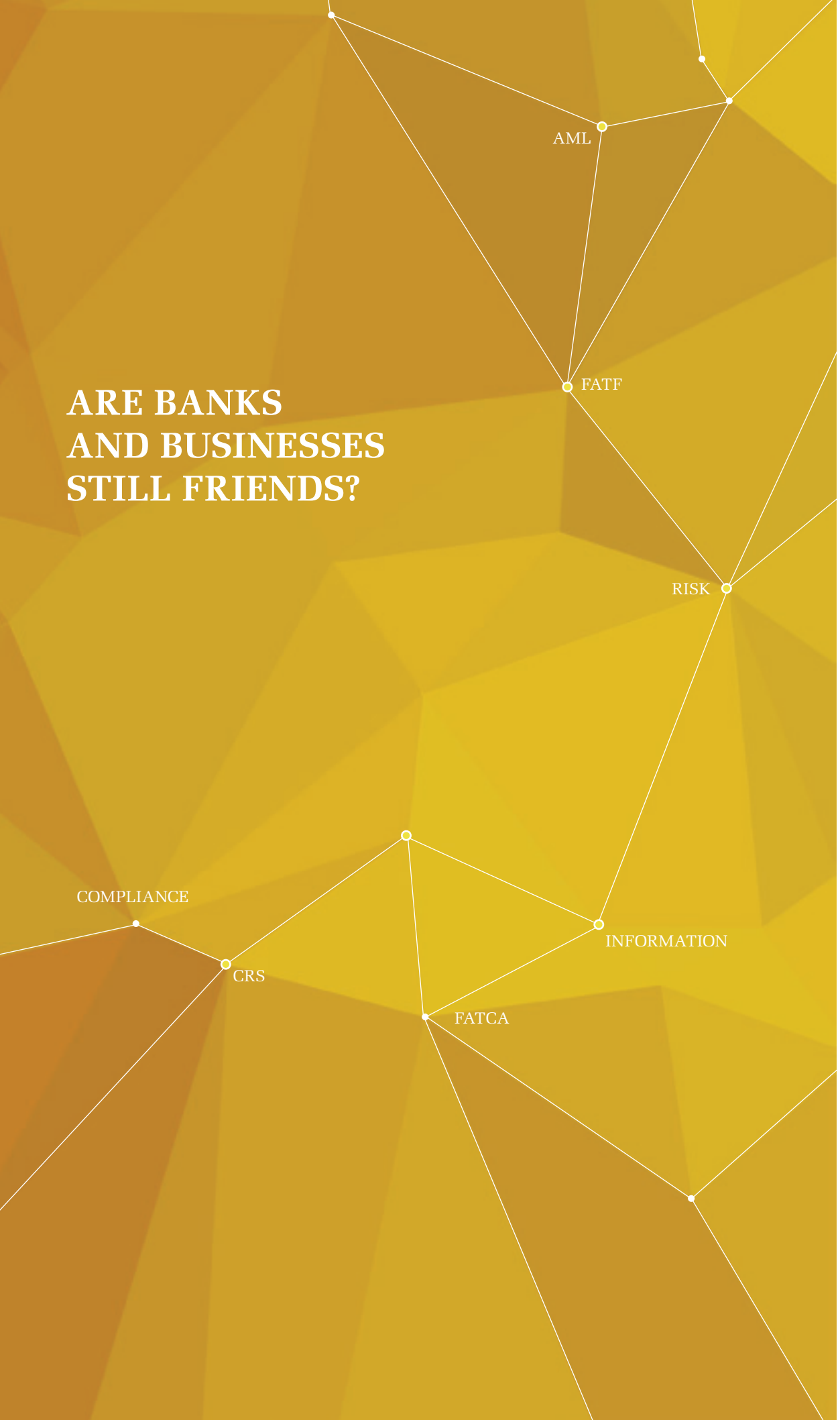
SAVING IS NICE, ESPECIALLY IF YOUR PARENTS DID IT FOR YOU

Lastly, there are those who repeat the mantra of an ancestor: "Never take debt, finance everything yourself", or "One third in real estate, one third in business, one third in gold", or "Never sell a plot of land we own". I tell my own kids: "Goekmens are producers, not consumers".

We all know families who preach austerity and other upright values to their kids. We also all know families who spend money as if it has gone out of fashion, indulge in a consumptive lifestyle, who are morally corrupt and are without governance or vision. If as a parent you do not live the values you preach, they peal out without echoing in future generations. And with that happening, one of the rays of the star of doom is the fate of the family fortune. This is the strongest message this article can convey.

Dr Ariel Sergio Goekmen is on the Executive Board of the Swiss private bank Schroder & Co based in Zurich. The bank specialises in Wealth Management for wealthy families and entrepreneurs, especially from the United Kingdom, Switzerland, Germany, the Nordics, the Middle East and Spain.

'On Wealth: What is the relationship between family and wealth — and how can they possibly stay together?' by Dr Ariel Sergio Goekmen is taken from the eleventh issue of the new The International Family Offices Journal, published by Globe Law and Business, http://ifoj16.globelawandbusiness.com.



ARE BANKS AND BUSINESSES STILL FRIENDS?

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When planning a business, each entrepreneur tries to work out an effective and quick way to set it up and envisage all the difficulties. After the registration of the company, the founder faces the problem of settling payments with counterparties, partners, tax and other state authorities. As a rule, this problem is solved by opening a bank account.

A few years ago, the procedure of opening a bank account for business was not unusual and was not associated with any complex procedures. Relations between businesses and banks were based on trustworthy partnership, but in recent years the world has changed a lot.

Introduction of Anti-Money Laundering and Counter Terrorist Financing (AML/CTF) legislation in various countries worldwide made significant changes to the situation. Earlier, in previous "Analytics" editions we already covered specific regulatory requirements of this legislation in different jurisdictions. It should be noted that the issue of money-laundering and terrorist financing is not just an internal state reference point of financial security. The international community has set general rules for monitoring compliance with AML/CTF legislation; therefore, procedures performed by banks under this legislation in different jurisdictions are generally quite similar.

One of the major international organizations in the field of anti-money laundering and counter terrorist financing is Financial Action Task Force (FATF). The aim of this task force is to develop recommendations in the field of AML/CTF legislation. These recommendations are mandatory for implementation in international and local legislation, and are reflected in such existing legal acts as the so-called AML 4 (European Union Directive No. 2015/849 dated 20.05.2015) aimed at combating money laundering; local legal acts of the member states of the European Union, as well as many others. References to FATF recommendations may even be found in tax regulation, namely Common Reporting Standard. Updated instructions are regularly issued for the financial sector, providing information on the methods that should be used to audit clients based on risk assessment. Measures to control activities of clients are applied depending on the assignment of a client to a particular risk group. This approach is called risk-based approach. Risk assessment should help companies to understand the way they are exposed to the risk of money laundering. Financial institutions should identify

and assess risks under AML/CFM legislation related to products and services provided by the client companies, to jurisdictions in which such companies operates, to clients such companies attract, and to transaction or delivery channels that such companies use to render services to their clients.

Banks, as well as other financial institutions worldwide, have to comply with the anti-money laundering and counter terrorist financing legislation, therefore, when opening an account for the client's company, they have to follow a number of procedures and make requests for a certain amount of information. Let us take a closer look at what requirements and requests from banks clients face when opening an account for their business.

HAVING COLLECTED THE REQUIRED INFORMATION, THE BANK ASSIGNS A CERTAIN LEVEL OF RISK TO THE CLIENT

Measures taken to identify and assess risks under AML/CTF legislation should be proportional to the nature of the business and the size of the company. When opening a bank account, the bank will require the client to provide highly detailed information about the current or planned activities of the company, its structure, estimated operations, and will ask to fill in some relevant bank forms with a large number of questions. In addition, the bank will ask to disclose the beneficial owner of the company and full information on him/her by submitting a number of documents, for example:

- Identification documents (passport/ another ID);
- Documents confirming the residence address (utility bill/bank statement);
- CV containing detailed information on employment;
- Information on sources of income and wealth.

The bank may also request additional documents. Such documents may include:

- Documents confirming the source and amount of income (for example, in the form of certificate 3 — Personal Income Tax (NDFL) for Russian citizens);
- Letters of recommendation from other banks, audit or law firms verifying good reputation;
- Documents confirming ownership of real estate;
- Other documents deemed necessary by the bank.

Having collected the required information, the bank assigns a certain level of risk to the client. The assignment of a client into a particular group is based on the background of the client, the type and nature of their business, the country of origin, the services and financial instruments for which applications are made, the estimated level and nature of commercial transactions, as well as the expected source and origin of funds. Thus, clients are classified into the following groups: low, normal and high risks.

The following companies may be classified as high risk companies:

- Companies with a complex structure of affiliated and related persons;
- Companies registered in offshore centers;
- Companies with Politically Exposed Persons (PEPs) as their beneficiaries;
- Companies interacting with counterparties involved in transactions that include significant amounts of cash;
- Companies registered/incorporated in one of the high-risk countries or countries known for high levels of corruption, organized crime or drug trafficking.

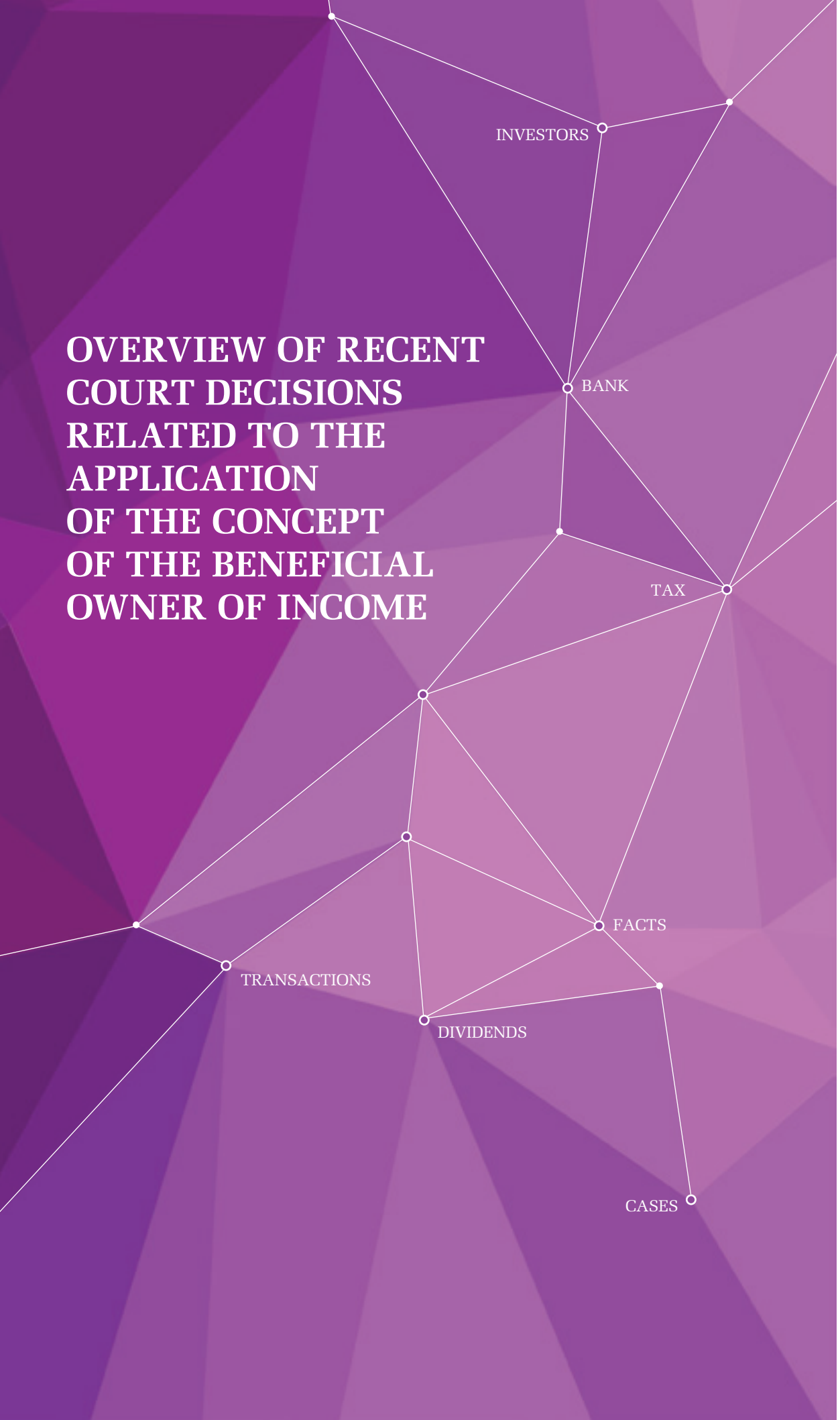
The above list is not a complete list of criteria by which companies may be classified as high risk companies. This list is extended with each amendment to the AML/CTF legislation.

After grouping clients into risk groups, sufficient control measures for

each group are determined. General control measures include monitoring suspicious transactions, maintaining lists containing clients' names, account numbers and the date of commencement of business relations, etc. The bank shall regularly report to the regulatory body on compliance with the AML/CTF legislation.

Furthermore, the bank will ask the client to fill in forms as part of U.S. Financial Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS). The information received from the client after filling in such forms will be sent to the tax authorities for tax reporting. It should be noted that such reporting will take place only between the countries that have signed the relevant agreements, but there are practically no states left worldwide that have not done so.

Therefore, on the one hand, opening of a bank account, as well as its further maintenance is a regulated procedure that takes some time and requires clients to disclose maximum information about themselves and the company. That is the current state of things. On the other hand, competent business structuring and compliance with international recommendations will allow clients and their companies to feel confident in the market when settling payments with counterparties. The client may always contact qualified experts for assistance in developing a competent and effective business scheme, as well as for the company support when opening a bank account.



OVERVIEW OF RECENT COURT DECISIONS RELATED TO THE APPLICATION OF THE CONCEPT OF THE BENEFICIAL OWNER OF INCOME

Alexey Oskin
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Tax and Legal Practice
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Legal cases in which courts have focused on the qualification of the beneficial owner of income have increased significantly in recent years and in most cases have become a rule rather than an exception.

In May 2019, the Federal Tax Service summarized the law enforcement practice in disputes in which the tax authorities established that international agreements had been abused.

In particular, the concept of "person beneficially entitled to income (beneficial owner)" is widely used as a universal instrument to combat abuse.

This concept is based on the prohibition of granting exemption from withholding tax when a foreign company receiving the income acts as a front man for another person who is actually the beneficial owner of income.

In this article, we propose to analyze some of the court decisions of supreme courts, which have become the most representative in recent years.

Case of Credit Europe Bank CJSC

Ruling No. 526-O of the Constitutional Court of the Russian Federation dated 27.02.2018 on refusal to accept complaints of Credit Europe Bank CJSC for consideration.

Structure of business operations (fig. 1).

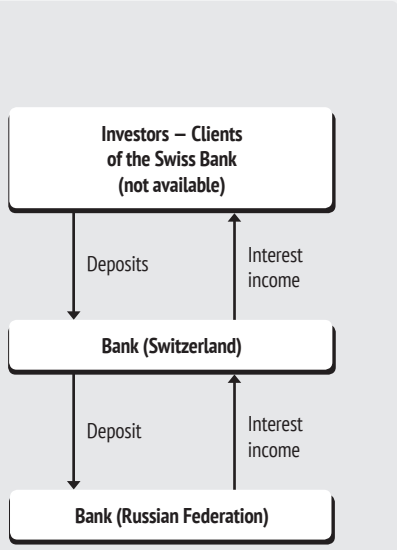


Fig. 1.

Factual allegations

The Russian bank paid interest on the deposits placed by the Swiss ("sister") bank at the reduced rate (5%) under the double tax agreement. In fact, the Swiss bank placed funds on deposits for the benefit of its clients.

Content of the decision

In the case in point, the courts have concluded that beneficial owners of the disputed interest have been individuals (investors) other than the Swiss bank. Therefore, the preferential rate under the agreement (5%) could not have been applied, and the general rate of 20% should have been applied.

The courts (tax authorities) paid attention to the following facts:

- The Swiss bank had no actual right to income (as it acted as an agent for deposits);
- Lack of information on particular beneficial owners of the disputed interest (their residence).

Case of Krasnobrodsky Yuzhny LLC

Ruling No. 304-КГ18-22775 of the Supreme Court of the Russian Federation dated 18.01.2019 in case No. A27-331/2017 of Krasnobrodsky Yuzhny LLC to Interdistrict Inspectorate No. 3 of the Federal Tax Service of the Russian Federation for the Kemerovo Region, Ruling No. 304- КГ17-17349 of the Supreme Court of the Russian Federation dated 25.12.2017 in case No. A27-20527/2015,

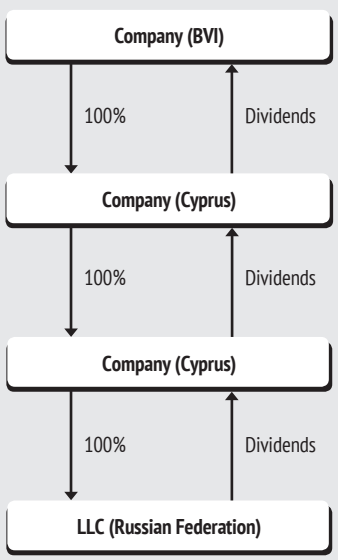


Fig. 2.

Ruling No. 304- КГ17-19528 of the Supreme Court of the Russian Federation dated 25.12.2017 in case No. A27-16584/2016.

Structure of business operations (fig. 2).

Factual allegations

The Russian LLC paid dividends in favour of its shareholder (Cyprus company) at the reduced rate (5%) subject to the provisions of the double tax agreement.

Content of the decision

In the case in point, the courts have concluded that none of the Cyprus companies operate in Cyprus, and therefore, the Cyprus company (LLC member) is a conduit company, not the beneficial owner of income.

Therefore, the preferential rate under the agreement (5%) cannot be applied.

The courts (tax authorities) paid attention to the following facts:

- The Cyprus company does not dispose of the funds received as dividends in full (net of current administrative expenses);
- Further reallocation of dividends to other founders (Cyprus, BVI);
- One of the further founders also registered in the territory of the Republic of Cyprus does not carry out financial and economic activities and reallocated dividends received in full (net of current administrative expenses) further to its founders, which indicates that none of the entities under the jurisdiction of the Republic of Cyprus carried out actual business activities;
- There were no transactions defining business activities of the Cyprus company;
- Independent auditor's reports, according to which the Cyprus company depends on the constant financial assistance of its shareholders, without which there would be a debt, which would not allow the companies to continue as a going concern and fulfill their obligations on the current activities.

Case of Rusjam Steklotara Holding LLC

Ruling No. 301-ЭС19-2319 of the Supreme Court of the Russian Federation dated 25.04.2019 in case No. A11-9880/2016 of Rusjam Steklotara Holding LLC to the Interdistrict Inspectorate of the Federal Tax Service for the largest taxpayers in the Vladimir region.

Structure of business operations (fig. 3).

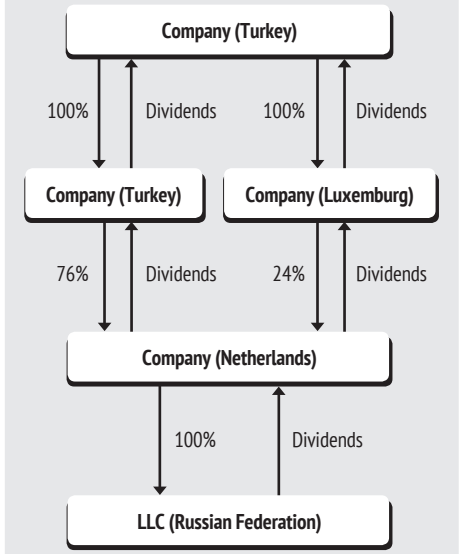


Fig. 3.

Factual allegations

The Russian LLC paid dividends in favour of its shareholder (Dutch company) at the reduced rate (5%) under the agreement.

Content of the decision

The courts have established that the company, which is a resident of the Netherlands, is not the beneficial owner of the dividends paid by the company; it is only an intermediate (technical) link and is not the ultimate beneficiary of the income received on its account, which is transferred in transit to the address of two entities registered in Turkey. The Turkish company (ultimate shareholder) has been recognized as the ultimate beneficiary.

The courts (tax authorities) paid attention to the following facts

When considering the dispute over this case, the courts paid attention to the following circumstances:

- Dutch tax authorities have provided information that the Dutch company acts as an intermediate holding and investment company;
- Average staff number of the Dutch company is 0 persons;
- The company, which is a resident of the Netherlands is only the member of the company;
- The director of both the company, which is a resident of Turkey, and the company, which is a resident of the Netherlands, is the same individual;
- Activities of the Dutch company and other companies as part of the funds transfer have been controlled by the Turkish holding company;
- According to the financial statements of the Dutch company for 2012–2013 (submitted by the Dutch tax authorities), the only income of the company is dividends from the company, and the fixed assets are the shareholders' funds, which serve as a source for the formation of the company's share capital;
- In 2011–2012, the company incorporated in the Netherlands paid no taxes due to the carry forward of losses of previous years; in 2013, it recorded the minimum taxes to be paid; in 2014, it recorded no taxes to be paid, as well as the dividend income for 2014;
- According to the settlement account statement of the company, which is a resident of the Netherlands, all dividends received from the company were transferred within a few days to the accounts of foreign companies which have no direct participation interest in the company.

Case of Polosukhinskaya Mine OJSC

Ruling No. 304-КГ18-19526 of the Supreme Court of the Russian Federation dated 03.12.2018 in case No. A27-27287/2016 of Polosukhinskaya Mine OJSC to Interdistrict Inspectorate No. 2 of the Federal Tax Service of Russia for the largest taxpayers in the Kemerovo region.

Structure of business operations (fig. 4).

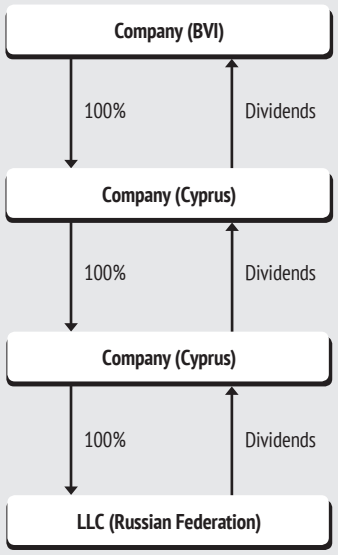


Fig. 4.

Factual allegations

The Russian LLC paid dividends in favour of its shareholder (Dutch company) at the reduced rate (5%) under the agreement.

Content of the decision

The court have concluded that formal conditions (for example, residence of the counterparty) for the possibility of using the double tax agreement for the main purpose of obtaining tax benefits alone indicate the misuse of this agreement and entail a reasonable refusal to provide tax benefits.

When considering the dispute over this case, the courts paid attention to the following circumstances:

- Dividends have been transferred in transit to the entities registered in the British Virgin Islands;
- The Cyprus companies have been incorporated as formal owners of the company and had no funds to acquire the company's shares, therefore, they could not invest in the share capital;
- The only transaction made by the Cyprus companies was a transit transfer of funds through the "chain" of shareholders.

Case of Melnik JSC

Ruling No. 304-КГ18-25280 of the Supreme Court of the Russian Federation dated 18.02.2019 in case No. A03-21974/2017 of Melnik JSC to the Interdistrict Inspectorate of the Federal Tax Service of Russia for the largest taxpayers of the Altai territory.

Structure of business operations (fig. 5).

Fig. 5.

Factual allegations

The Russian LLC paid dividends to its sole shareholder, which is a foreign company, disguised as the transaction to redeem its own shares under the securities sale and purchase agreement.

Content of the decision

The court has concluded that, as a result of the above actions, a part of the profit has been withdrawn in favour of a foreign legal entity, while the scope of rights of the foreign company in relation to the company has not changed. And since the payment of passive income (dividends) has taken place in this case, the Company should withhold tax.

The courts (tax authorities) paid attention to the following facts:

- The company has had significant retained earnings and has paid no dividends to its shareholders for several years;
- A foreign company has become the shareholder of the company shortly before disputable transactions were made (with the share of 99.86%, subsequently 100%);
- Immediately after the conclusion of the share sale and purchase agreement, the foreign company opened a bank account with the bank which is a resident of the Republic of Latvia, to which the funds were transferred with the comment "redistribution of funds within the holding";
- The Court of Appeal annulled the decision of the Court of First Instance on invalidation of the decision of the tax authority, and concluded that, as a result of the above actions, a part of the profit has been withdrawn in favour of a foreign legal entity, while the scope of rights of the foreign company in relation to the company has not changed;
- The foreign company, which is the sole shareholder of the taxpayer during the audited period, had limited powers with respect to the disposal of the income received;
- There were no transactions defining business activities;
- The foreign company obtained no benefit from the income and had no saying in defining its future economic fate;
- Coordination of actions between the taxpayer and its sole shareholder.

Case Active Rus LLC

Ruling No. 310-КГ18-15460 of the Supreme Court of the Russian Federation dated 15.10.2018 in case No. A62-3777/2017 Active Rus LLC to Interdistrict Inspectorate No. 6 of the Federal Tax Service of Russia for the Smolensk region.

Structure of business operations (fig. 6).

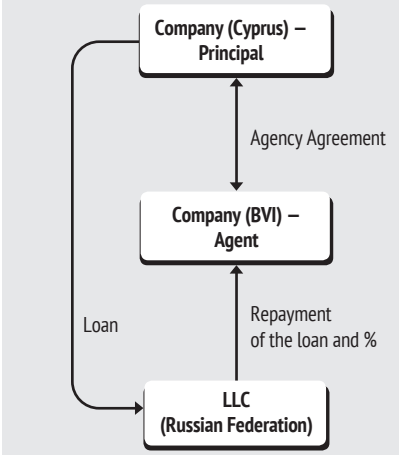


Fig. 6.

Factual allegations

The Cyprus company granted a loan to the Russian company. The loan and accrued interest were repaid on behalf of the Cyprus company to the account of a third party, which is a company registered in the BVI.

According to the taxpayer's legend, the BVI company is the paying agent of the Cyprus company, which is responsible for keeping the client's funds on the agent's account, managing the current account and making payments to third parties.

Content of the decision

Activities of the Cyprus company have been recognized as technical. The company registered in the BVI has been recognized as the beneficial owner of income.

When considering the dispute over this case, the courts paid attention to the following circumstances:

- Proof of the fact that related parties have created the scheme aimed at obtaining an unjustified tax benefit by the company;

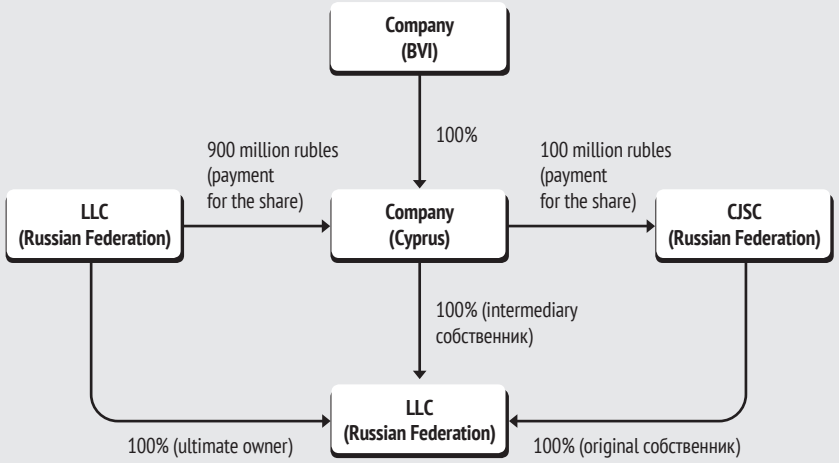


Fig. 7.

- Absence of reliable evidence that the Cyprus company has qualified the disputed interest as its own received income and recorded it in the financial statements;
- According to the information from public sources, the Cyprus company is an industrial company, there is no data on its financial profile and audit, there is no information on its shareholders and there is no information on the subsidiaries of this company;
- Cyprus company's activities are of technical nature, the Cyprus company does not carry out activities other than receiving and transferring funds from taxpayers, and the direct beneficiary is an offshore company registered in the British Virgin Islands;
- Under the notice to the Cyprus company, the company has transferred funds to a resident of the British Virgin Islands in payment of the loan and the interest thereon under the financial services agreement. The funds have been transferred to the bank account opened in Israel. No funds have been received in the Republic of Cyprus.

Case of Vladimir Energy Retail Company PJSC

Ruling No. 301-КГ17-18409 of the Supreme Court of the Russian Federation dated 14.12.2017 in case No. A11-6602/2016 of Vladimir Energy Retail Company PJSC to the Interdistrict Inspectorate of the Federal Tax Service for the largest taxpayers in the Vladimir region.

Structure of business operations (fig. 7).

Factual allegations

The CJSC (Russian Federation) was the sole member of the Russian company. The specified share was transferred to the ultimate buyer, which is also a Russian company, not directly, but through inclusion into the flow of operations of the Cyprus company.

Content of the decision

The activities of the Cyprus company have been recognized as technical. The company registered in the BVI (the sole shareholder of the Cyprus company) has been recognized as the beneficial owner of income.

The courts (tax authorities) paid attention to the following facts:

- The Cyprus company was a "technical" (conduit) entity and was not the beneficial owner of income from the transaction with the company, but acted only as a transit link for the acquisition and subsequent sale of the share in the authorized capital of the Russian entity with the purpose of obtaining the relevant preferences in the Russian Federation and the Republic of Cyprus;
- Actions for the transfer of ownership to 100% share in the authorized capital of the Russian entity from the original owner (closed joint-stock company) to the ultimate recipient (company) were carried out within a short period of time without an objective need to make transactions through a non-resident Cyprus company with the characteristics of a "technical" entity;
- Affiliation of the transaction parties.

Cases on the dispute between T Danmark, Y Denmark and the Danish Tax Ministry

Decision of the Court of Justice of the European Union dated 26.02.2019 in joint cases C116/16 and C117/16 on the dispute between T Danmark, Y Denmark and the Danish Tax Ministry. <1>

Main conclusions of the Decision of the European Court of Justice:

- A group of companies may be considered a technical structure if the circumstances of its establishment do not correspond to the economic reality and the main purpose of its establishment is to obtain tax preferences set by the tax system of the respective state;
- Circumstances confirming that the company acts as a conduit are that the only activities of the company are the receipt of dividends and their reallocation to the beneficial owner or another conduit company;
- Absence of actual economic activities of the company may be determined after analyzing all factors of the company's activities, including company's management procedure, reporting, structure of income and expenses, number of the company's employees, amount of fixed assets;
- Artificiality of legal relations may be evidenced by the fact that within the group of affiliated companies activities are structured in such a way that the company receiving the dividends shall reallocate these dividends to a third company which does not meet legal requirements due to the fact that it has a minor tax profile and its only activity is the transfer of funds to the beneficial owner of income;
- In order to recognize a person as the non-beneficial owner of income or to establish the fact of abuse, tax authorities do not need to identify the person(s) who is (are) the beneficial owner (s) of income.

Summary

The review of the most recent court decisions taken by the supreme courts shows that:

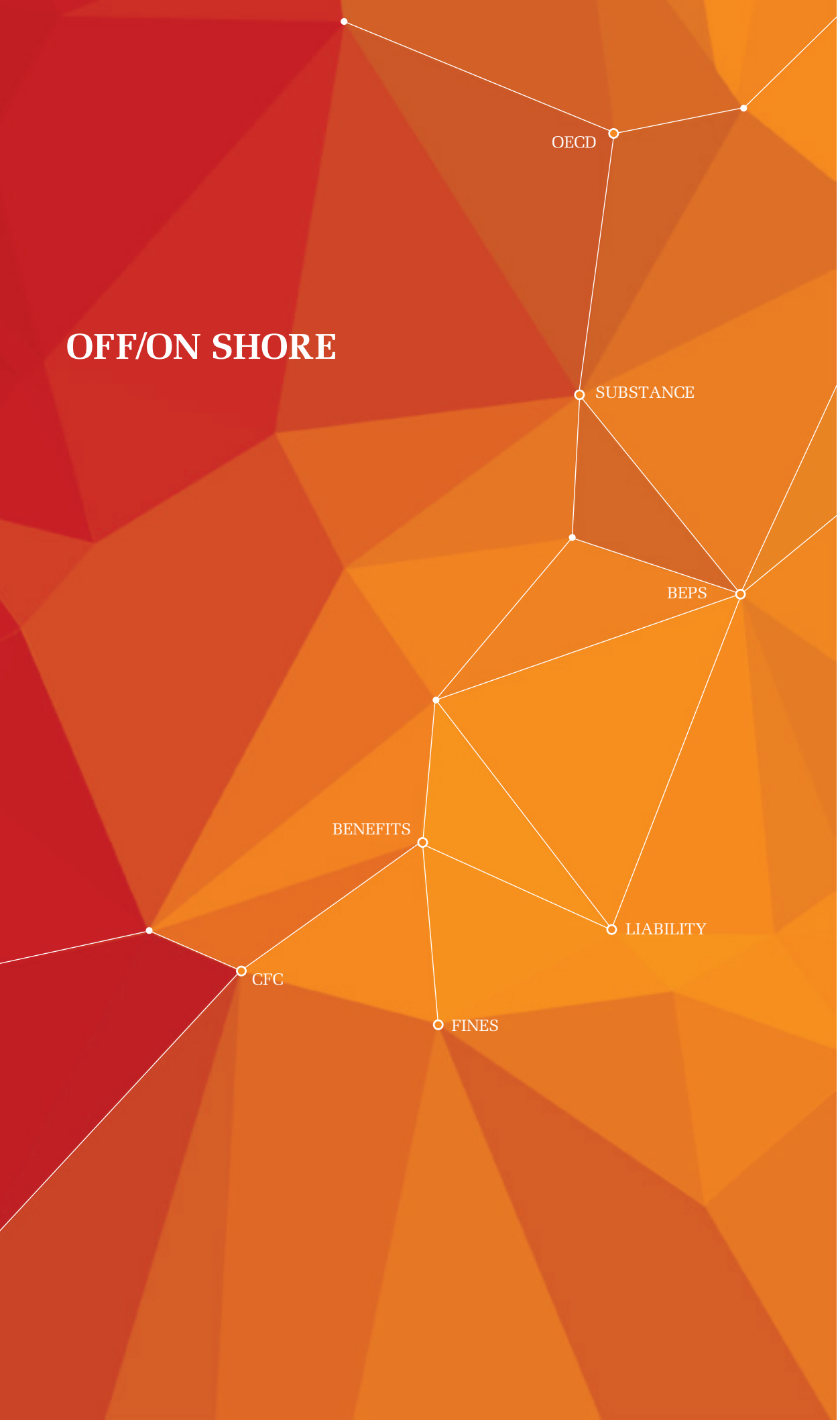
- Practice of courts related to the application of the concept of the beneficial owner of income has not changed. Courts (as well as supervisory authorities) continue to pay due and close attention to this issue;
- No new circumstances/indicators/evidence, which tax inspectors and courts rely on when investigating the issue of qualification of a foreign entity as the beneficial owner of income (compared to previous court decisions and letters of the Ministry of Finance) have appeared;
- Most of cases relate to the period of 2011–2015, i. e. the period when due court practice on these issues has not yet been formed, and taxpayers paid no due attention to the issues of documenting the form and content of transactions with foreign companies.

We are hopeful that now taxpayers have become more conscious about

including foreign companies in the of business transactions flow. In any case, we strongly recommend assessing how the current business structure correlates with the approaches developed by tax authorities to the issue of determining the beneficial owner of income with the purpose of promptly taking measures aimed at minimizing risks.

Specialists of Korpus Prava have extended experience in international tax planning and are ready to provide full assistance in applying the concept of the beneficial owner of income, including analysis and optimization of the existing structure, support of tax audits and legal cases with regulatory authorities.

OFF/ON SHORE



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Since 2013, when the OECD published its report on combating corporate tax base erosion and profit shifting to low-tax jurisdictions, commonly known as the BEPS plan, we have repeatedly returned to issues associated with implementation of the BEPS plan in the pages of "Korpus Prava.Analytics". One of the topical subjects of the current year is requirements of offshore jurisdictions for organization of economic substance. In this article, we will try to answer the questions as to what it means, what is the reason for their introduction, whether they should be observed and what to do next.

Causes for the emergence of the economic substance concept

So, let us remember what the BEPS plan is actually aimed at. The BEPS plan combats non-taxation, which is achieved through moving profit centers away from production centers (the places where such profit is actually earned) and transferring the added value to low-tax or tax-free jurisdictions by legal and illegal means (as well as by abuse of the law). Such targeted actions of a taxpayer lead to the situation when profit calculated to determine the tax base is not formed in companies that have all prerequisites for profit generation. On the contrary, it is accumulated in other companies of the taxpayer which have neither assets, nor resources necessary for profit-making and which often have nothing but instruments of incorporation. The BEPS plan is precisely aimed at combating such effect. According to the BEPS plan, fundamental changes are required for effective prevention of double non-taxation and also of cases of low taxation associated with the practice when taxable income is artificially separated from the activities that generate it.

The creators of the BEPS plan say that the use by taxpayers of double taxation agreements, aimed at providing mutual benefits to tax residents of these countries and enhancing interaction between the countries participating in it, has turned into the situation when taxpayers expand their opportunities by adding to that scheme shelf companies from third countries, which are not parties to double taxation agreements, but which, as the chain links, allow paying no taxes at all and thus abusing the provisions of the agreements. Countries that have entered into double taxation agreements cannot influence the legislation of such third countries since the latter have no contractual relations.

According to the creators of the BEPS plan, abuse of agreements is not advisable for several reasons, including the following:

- The benefits of the agreement agreed between the parties to it economically extend to residents of the third jurisdiction, although it is not a party to these agreements. Thus, the principle of reciprocity is violated and the balance of concessions that the parties make changes;
- Income may become completely tax-free or be subjected to inadequate taxation, which is far from the way the parties to the agreement intended to;
- Residence jurisdiction of the ultimate beneficiary has less incentives to conclude a tax agreement with the jurisdiction of the source of income since residents of the beneficiary's residence jurisdiction may indirectly receive benefits from the jurisdiction of the source of income without the need of the beneficiary's residence jurisdiction to ensure mutual benefits.

Therefore, the OECD has repeatedly explained in the BEPS plan and other documents that it is necessary to supplement the existing standards designed to prevent double taxation with tools that prevent double taxation in areas not previously covered by international standards and which address cases of non-taxation associated with the practice when taxable income is artificially separated from the activities that generate it as well as the fact that international means of putting pressure on third countries and international mechanisms that would limit the abuse of agreements and the ability of taxpayers to separate profit from the places where it arises must be developed.

Since 2013, the OECD has succeeded in implementing its plan and objectives, which has been repeatedly stated in reports that can be found on the organization's website. Automatic information exchange has been introduced, requirements for controlled foreign companies have been strengthened, control over transfer prices has been tightened, conduit schemes have been restricted, certain preferential tax regimes have been abolished. Pressure is being put on jurisdictions by virtue of including the countries that provide low-tax regimes into blacklists, restrictions on transactions with them. In addition, the OECD has made the banks and other financial institutions that also actively contribute to implementation of the BEPS plan both its allies and hostages.

The substance concept became one of such steps. Declaring the need to limit abuse of agreements and profit shifting, the OECD first used the term shelf company meaning a company that has few or no signs of actual existence (actual presence) in the sense of the company having office space, material assets and employees.

Through the provisions of the BEPS plan, particularly through implementing step 6 Prevention of Abuse of Tax Agreements, the OECD has declared war on the companies and schemes in which they are used. Through changes in national legislation and introduction of the concept of actual income recipient as it happened, for example, in Russia, through banks and their refusals to open accounts for companies without the minimum actual presence, the possibilities of using shelf companies have become largely limited. The next major victory on the path of the OECD in combating shelf companies was implementation of the idea to introduce requirements for economic substance in tax-free jurisdictions.

The essence of economic substance

Economic substance is the minimum set of requirements established by national legislation that a company should meet in order for the country to perceive it as actually existing in its jurisdiction, if such company plans to maintain its tax residence in that jurisdiction.

It has already been noted above that a shelf company is a company with a lack of office space, material assets and employees. On this basis, the minimum amount of requirements for economic substance has been formed (fig. 1):

- The company director should be local;
- The company should have employees, whose qualifications should be in line with the activities of the company and who should be local;
- The company has local expenses;
- The company has an office sufficient to carry out profit-generating activities;
- The company carries out activities generating profit in the jurisdiction.

This means that companies registered in the territory, where economic substance legislation is adopted, are required, if they acknowledge their status of a tax resident of such country, to either provide evidence of compliance with the requirements of the legislation or confirm that they are tax residents of another country. In practice, this means that now taxpayers using companies registered in countries that have implemented economic substance legislation are required either to make the company actual and, most importantly, to start carrying out profit-generating activities through it or voluntarily acknowledge their status of a tax resident of another country, that is, start paying taxes in such other country.

Thus, introduction of economic substance legislation basically became the final logical step on the path of the OECD in combating artificial separation of taxable income from the activities that generate it.

Key elements of economic substance

At the end of 2018, economic substance legislation was adopted by the British Virgin Islands (as of today, BVI even published draft economic substance code), Belize, the Cayman Islands, Mauritius, the Bahamas, the Seychelles, the Islands of Bermuda, the English Channel islands of Guernsey and Jersey, the Isle of Man. This list continues to be updated. Basically, low-tax jurisdictions are forced to adopt such legislation since this is a condition for exclusion of such jurisdictions from the list of countries that do not interact and exchange information on tax issues or otherwise simplifies the interaction of companies from these jurisdictions with the outside world. One of the latest countries to speak about adopt-

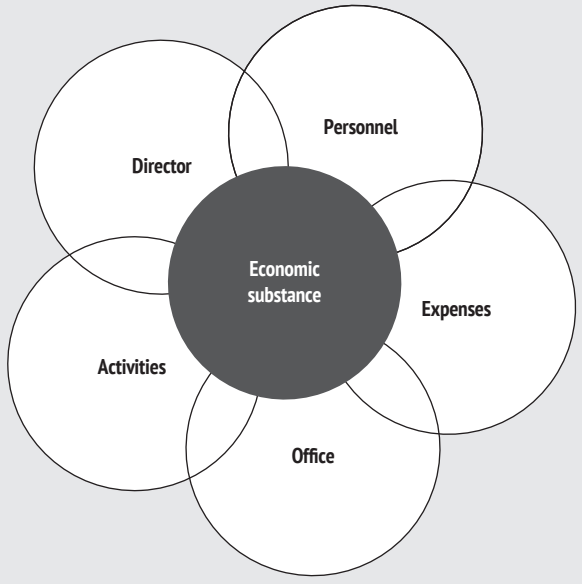


Fig. 1.

ing economic substance so far is the UAE. On April 30, 2019, the UAE Government issued the resolution introducing the relevant regulation. Jurisdictions such as St. Vincent and the Grenadines, the Antilles and others also discuss the possibility of changing their legislation to meet the requirements of the EU.

In general, regulatory acts of different countries concerning economic substance are similar to each other. The provisions differ in terms of timing of the introduction, consequences of violation of the legislation, requirements concerning the substance elements which should be observed.

As for the types of activities of the company for which economic substance should be confirmed, all jurisdictions look to the list of the relevant types of activities recommended by the OECD with rare exceptions. These activities include:

- Banking business;
- Insurance business;
- Fund management activities;
- Financing and leasing;
- Activities as a parent organization;
- Shipping business;
- Holding activities;
- Activities in profit-making from intellectual property;
- Activities of distribution and service centers.

Such list was used in the BVI, the Cayman Islands, the Islands of Bermuda, the Bahamas, the UAE and in other jurisdictions. Exceptions are found, for example, in legislative regulations of the Seychelles or Mauritius where the requirements apply only to licensed financial institutions so far (in Mauritius, the substance requirements apply to companies with the Global Business Licensed Company status, in the Seychelles — to almost all licensed players on the securities market including activities of investment advisers and portfolio managers). Then, the legislative regulations clarify which specific actions are recognized as relevant (principal types of activities that generate profit). Thus, for instance, ownership of a yacht used for personal purposes is not a relevant activity as well as granting of interest-free loans since no receipt of income is stipulated for that matter.

The list of substance elements that a company with relevant activities should have is also unified across almost all jurisdictions. As noted above, the key elements of economic substance are:

- Actual implementation of profit-generating activities;
- Place of effective management;
- Current local expenses;
- Office rental;
- Full-time employees, whose qualification is in line with the company's activities.

The requirement concerning profit-earning at the company's place of residence is common to all jurisdictions and fundamental to the concept of the BEPS plan. Other elements are combined. For example, in the BVI, the conditions for holding companies are relaxed. The companies are only required to confirm the existence of their employees and office. Companies with other relevant activities are required to have all elements except assets. However, assets (equipment) are required when it comes to managing intellectual property, the use of which involves the use of equipment. Legislative regulations of Guernsey and the UAE contain all abovementioned elements as well as requirements concerning existence of assets; preferential requirements for substance (office and employees) are stipulated for the UAE holding companies, and for high-risk IP companies additional criteria to comply with are established. In Belize, it is required to confirm the existence of employees, expenses and management. In the Seychelles, the key elements are employees and expenses. In Mauritius, additional requirements concerning the amount of local expenses to be incurred, are established.

Then, the legislative regulations establish the time limits, within which the companies should comply with the economic substance requirements and provide the evidence to authorized

persons and liability for the violation of these requirements. The time limits mainly depend on whether the company is new or old, but in any case the deadline for substance confirmation is the end of 2020.

The liability for violation is different: denial of registration, denial of applying preferential tax treatment, warning, demand for an audit, fines ranging from tens to hundreds of thousands of US dollars and even imprisonment. Despite the fact that the extent of liability looks impressive, the issue of bringing to liability remains open as in any case accountability measures would apply to a company through its directors. In most companies, directors are provided by administrative providers (registration agents), part of which are located in these jurisdictions and the other part — in other countries. The matter of applying a fine to a company with its director and account located in the third country is not idle, especially the matter of applying a fine to a director provided by a registration agent who would say at the earliest moment that he/she is not the director. In these circumstances, in practice, non-compliance with the economic substance requirements will, most likely, result in directors, secretaries and shareholders of shelf companies resigning from their positions (including unilaterally through court action), and the companies becoming uncontrollable.

Test for compliance

Given widespread dissemination of economic substance legislation, considerable fines imposed for its violation, clarifications that have appeared, elaborated reporting forms, requirements for organization of economic substance seem no longer phantom. They are more

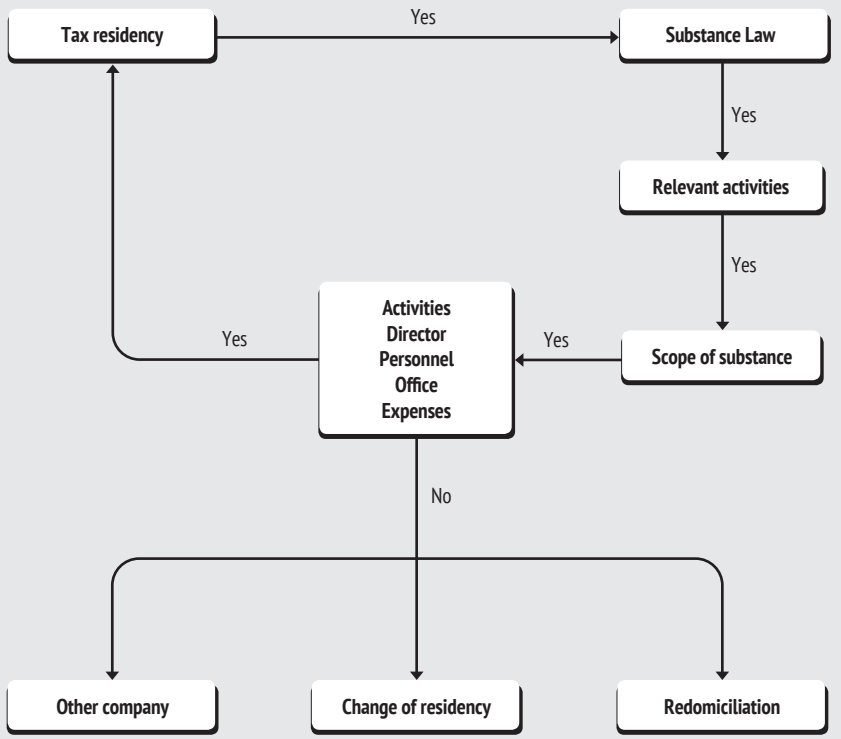


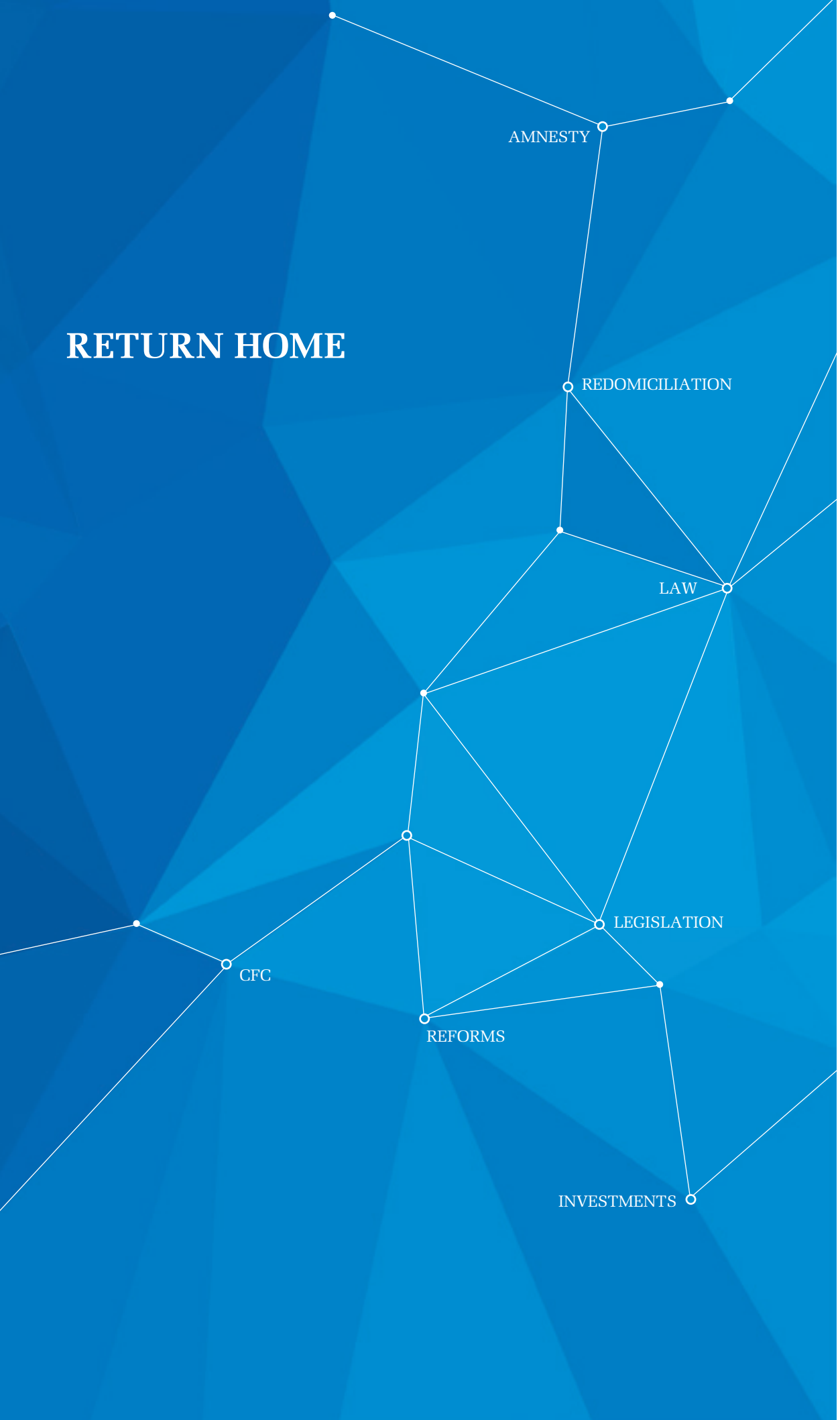
Fig. 2.

than real. In this regard, all companies registered in classic offshore jurisdictions should pass the test for compliance with the requirements for the organization of economic substance. In passing this test, it is necessary to ask yourself the following questions (fig. 2):

1. Are you planning to identify the company as a tax resident in this jurisdiction?
2. If yes, has the jurisdiction adopted economic substance legislation?
3. If yes, are the company's activities (key activities aimed at generation of profit) associated with the relevant activities specified in the legislation?
4. If yes, which substance level is required for these activities?
5. If yes, are you planning to carry out actual management and control in this jurisdiction?
6. If yes, are other elements of substance, the set of which depends on the relevant activities, complied with?
    - Employees;
    - Address;
    - Expenses;
    - Other.

If any requirement mentioned above is not and cannot be complied with, you need to think about changes in the structure of the company, its management and functionality, or about the need to take more radical measures, such as change of tax residence, redomiciliation of the company or transfer of assets/activities to other companies of the group. In any case, the issue should be resolved in view of analysis of expenses that the company has to incur to comply with all requirements and benefits that the taxpayer using an offshore company will eventually receive. Moreover, it is also important to take into account requirements of legislation concerning CFCs, actual income recipients, standards concerning automatic disclosure of information and other provisions of regulations which can and should affect the choice of the taxpayer when assessing cost-effectiveness of substance. It is no longer possible to remain a silent observer of this problem; there is also no use to look for ways to circumvent the direct requirement of the legislation. This is the case when the only way to not comply with the law is to not fall within it, that is, to change the company, jurisdiction or tax residency. Otherwise, you can lose if not the assets, then at least access to them.

RETURN HOME



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In June 2019, Russia started the third stage of the capital amnesty, which will last until 29 February 2020.

The main condition for the current amnesty was the return of the declared assets to their homeland. It should be noted that not all assets are subject to repatriation, but only funds deposited in foreign accounts and foreign companies, which are to be redomiciled to the Russian Federation.

Redomiciliation is a mechanism for changing a company's jurisdiction and transferring a company from one country to another. The result of the change of the legal address is termination of the existence of an entity in the country of initial registration and transfer of its structures to another country to carry out further activities in accordance with the current legislation. At the same time, the company retains its status, structure, property and other rights and contractual obligations.

Redomiciliation is a new page not only in the history of capital amnesty, but in the history of the Russian law.

The Federal Law "On International Companies", which regulates registration of foreign companies in the Russian Federation, was adopted a year ago, in August 2018. In May 2019, the Ministry of Economic Development reported that the number of international companies in the Russian special administrative regions (SAR) reached ten. Eight of them are registered in Oktyabrsky Island in the Kaliningrad region and two of them are registered in Russky Island in Vladivostok.

Given that these companies have been redomiciled before the third stage of the amnesty, therefore, the reason for the "move" was the intention to use the guarantees provided by the Law "On Voluntary Declaration of Assets and Bank Accounts (Deposits) by Individuals and on Amendments to Certain Legislative Acts of the Russian Federation".

It should be noted that the conditions for redomiciliation provided for by the Russian legislation significantly reduce the number of companies that are entitled to receive a new status.

Thus, a foreign company shall:

1. At the time of the resolution to amend its personal law, but in any case not later than 1 January 2018, on its own or through its direct or indirect controlled entities determined in accordance with Chapter XI of Federal Law No. 208-FZ "On Joint-Stock Companies" dated 26 December 1995 and Article 45 of Federal Law No. 14-FZ "On Limited Liability Companies" dated 8 February 1998,

or through other persons belonging to the same group of persons with a foreign person in accordance with Federal Law No. 135-FZ "On Protection of Competition" dated 26 July 2006, on any of the grounds provided by Article 9 of Federal Law No. 135-FZ "On Protection of Competition" dated 26 July 2006, or through branches or representative offices (other separate subdivisions), carry out business activities in the territory of several countries, including the territory of the Russian Federation.

2. File an application for the conclusion of an agreement on carrying out activities as a member of a special administrative region defined in accordance with the Federal Law "On Special Administrative Regions in the Territories of the Kaliningrad Region and Primorsky Krai".
3. Assume obligations to make investments in the territory of the Russian Federation, including on the basis of a statement of intent to make investments in the territory of the Russian Federation, special investment contract, concession agreement, agreement on public private (municipal private) partnership or another agreement.
4. Be registered (established) in the state which is a member or observer of the Financial Action Task Force (FATF) and/or a member of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe (Moneyval).

Therefore, beneficiaries of new (established after 1 January 2018) foreign companies as well as those whose companies are registered in the British Virgin Islands, Marshall Islands or Seychelles will not be able to benefit from the capital amnesty. Among the popular among Russians jurisdictions only Hong Kong and Singapore are included in FATF, while Cyprus, Malta, the Isle of Man, Jersey, Guernsey and Eastern Europe are included in Moneyval.

As for investments in the Russian economy, the legislator has indicated the amount of 50 million rubles. It should be noted that this figure may also become a significant barrier for mid-level entrepreneurs who, perhaps, would like to transfer their business to Russia, but are not ready to make such large investments now.

Investments in the Russian economy may be as follows:

- Capital investments, i. e. investments in capital assets (fixed assets), including costs of new construction, reconstruction and technical re-equipment of existing enterprises, acquisition of machinery, equipment, tools, inventory, design and survey works and other costs;
- Investments in the authorized capital, fund or contributions to the property of business entities that are Russian legal entities engaged in the activities not prohibited by the legislation of the Russian Federation.

The two criteria described above significantly reduce the number of persons that will be able to declare their participation in a controlled foreign company (CFC). However, it should be remembered that the third stage of the amnesty has already been arranged, and if compatriots have not taken advantage of the previous opportunities, it means that they have no big need in it. The current amnesty sets specific goals, namely the return of citizens' assets to their homeland.

It will be very interesting to analyze the figures at the end of the amnesty period and to establish the amount of filed special declarations and redomiciled companies. However, the second stage is most likely to remain the most effective stage of the capital amnesty. According to the statistics, about 7,200 declarations were filed in the first wave of the amnesty, and about 11,800 declarations were filed in the second one. To be fair, it should be noted that no citizen activity has been currently observed.

But what about taxes?

It is well known that the amnesty does not only exempt from criminal and administrative liabilities, but also restricts the ability of tax authorities to collect taxes.

Thus, according to Article 45 of the Tax Code, the tax is not collected in case of non-payment or incomplete payment of tax by the declarant recognized as such in accordance with the Federal Law "On Voluntary Declaration of Assets and Bank Accounts (Deposits) by Individuals and on Amendments to Certain Legislative Acts of the Russian Federation", and/or by another person, information about which is contained in a special declaration filed in accordance with the said Federal Law.

No tax collection shall be made subject to one of the following conditions:

1. If a declarant has been obliged to pay such tax as a result of transactions made before 1 January 2015, related to the acquisition, use or disposal of the property of controlled foreign companies, the information on which is contained in a special declaration filed within the period from 1 July 2015 to 30 June 2016, or related to the opening of and crediting funds to the accounts, the information on which is contained in such special declaration, i.e. a special declaration was filed during the first stage of the amnesty.
2. If a declarant and/or another person have been obliged to pay such tax before 1 January 2018, and such person has taken advantage of the second stage of the amnesty, but this provision did not apply to the obligation to pay taxes payable in respect of the profit and/or property of controlled foreign companies.
3. If a declarant and/or another person has been obliged to pay such tax before 1 January 2019 and such person intends to benefit from the third stage of the amnesty, while the CFC's profit is still not exempt from taxation.

The last note seems a little strange against the fact that a declarant should not have any CFC at the time of filing a special declaration.

Thus, if as of 31 December 2019, a declarant will no longer be a controlling person of a foreign company, then this person will no longer be subject to the obligation to submit a notification on CFC and, as a result, to include retained earnings of CFC into the tax base in 2019. This clause most likely serves as an incentive for doubtful citizens who are in no hurry to leave CFC and plan to redomicile a foreign company at the end of the amnesty period, having managed to complete everything in the first two months of 2020.

It is interesting that at the end of 2018, when no one believed in the third stage of the amnesty, the Ministry of Finance issued a letter that shed light on one of the most controversial issues of both stages of the amnesty.

The issue concerned the period for which it was possible not to pay taxes if a special declaration was already submitted. The Tax Code states that no taxes are subject to collection if the obligation to pay them has arisen before 1 January. Then when does this obligation actually arise? Opinions of legal experts were divided. Some believed that the obligation arose directly at the moment of income receipt, i.e. before 1 January, and therefore, there was no need to pay taxes. Others believed that the obligation arose from the moment of filling a tax return and it was necessary to fulfill this obligation before 15 July of the year following the reporting period, and in this case, despite a special declaration, taxes for the year preceding the year of submission were to be paid.

In its letter No. 03-04-05/93986 dated 24.12.2018, the Ministry of Finance indicated that the obligation to pay personal income tax was imposed on a taxpayer from the moment of receipt of such income. Therefore, when filling a special declaration in 2019, taxes on income received in 2018 are not subject to collection, as they have been received before 1 January 2019.

It should also be noted that an amendment to the article on exemption of certain types of income from taxation was made together with the announcement of the third stage of the amnesty. This article was supplemented by clause 75, according to which income in the form of profit of a controlled foreign com-

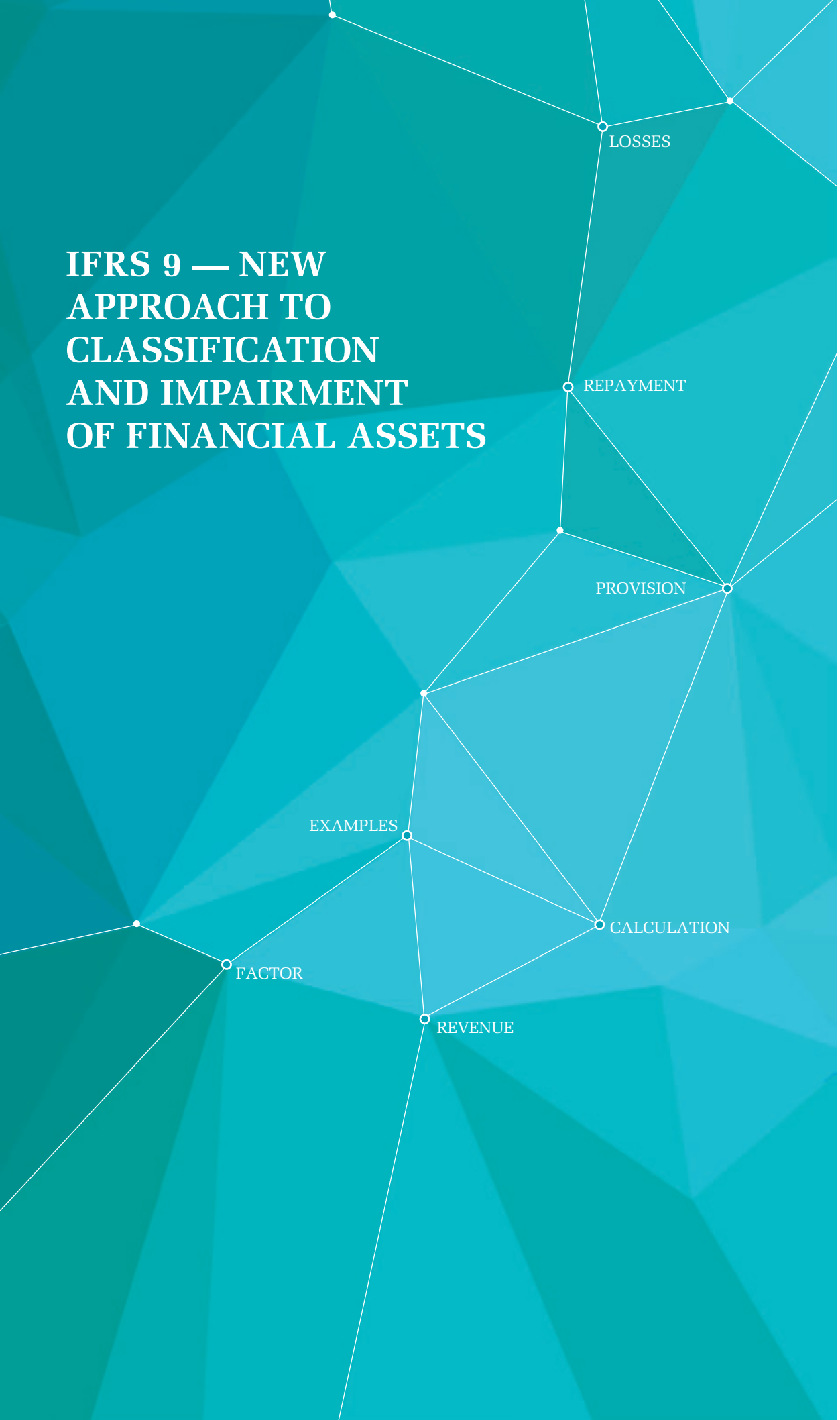
pany taken into account when determining the tax base in 2019 for a taxpayer who is a controlling person of such a controlled foreign company, is not subject to taxation.

Such income is exempt from taxation, if a taxpayer has not been recognized as a tax resident of the Russian Federation following the results of the tax period of 2018.

Apparently, the legislator tried to return not only the capital, but taxpayers themselves to Russia.

It is known that anti-offshore reforms resulted in many of our compatriots deciding that they could afford to reside outside the homeland for the most part of the calendar year and to take profits of foreign companies away from the control of the Russian tax authorities (tax non-residents are known to pay taxes only on the income received in the Russian Federation, while foreign companies, unless they are recognized as tax residents of Russia, do not belong to such sources). This amendment allows those who lost their tax residency in 2018 to regain their tax residency in the Russian Federation in 2019 in order not to pay taxes on the retained earnings of the CFC in 2019, and again not to pay taxes related to the activities of a foreign company in 2020.

It seems that the actions of the authorities are quite understandable and logical, but we will see whether they yield any results in the spring of 2020. A



IFRS 9 — NEW APPROACH TO CLASSIFICATION AND IMPAIRMENT OF FINANCIAL ASSETS

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In preparation of financial statements in accordance with IFRS (International Financial Reporting Standards) for 2018, all companies faced with a new financial instrument accounting standard IFRS 9.

Financial instruments have traditionally raised the greatest number of questions and presented many challenges.

IFRS 9 mandatory for use since January 01, 2018 was intended to eliminate the shortcomings of then applicable IAS 39, simplify the logic of classification of financial instruments, increase reliability of information about impairment of financial assets. However, it has raised even more questions.

Key changes have occurred in the classification and measurement of financial assets and even more significant changes concern asset impairment.

From now on, financial assets are divided into three groups, depending on the method of their measurement and accounting:

- FVTPL: fair value through profit and loss;
- FVOCI: fair value through other comprehensive income;
- AMC: amortized cost.

The principles that the company applies when referring an asset to a particular group are shown in figure 1.

Already after the first year of application, an amendment to IFRS 9 appeared which became effective on January 01, 2019. According to this amendment, loans and borrowings with the early repayment option in the agreement cannot be classified at amortized cost, that is, they should be measured at fair value.

However, companies face the biggest difficulty in applying new rules of impairment of financial assets.

First, impairment applies to virtually all companies, even those that do not include securities, equity or derivative financial instruments in their financial statements. After all, receivables of a trading company are also a financial instrument.

Provision for impairment should be created for all financial assets, except for those carried at fair value through profit or loss as changes in their fair value reflect their impairment. The provision is created as of each reporting date and is a cumulative value. An increase or decrease in the provision is recognized in profit or loss. And the provision itself reduces the amount of financial assets in the statements.

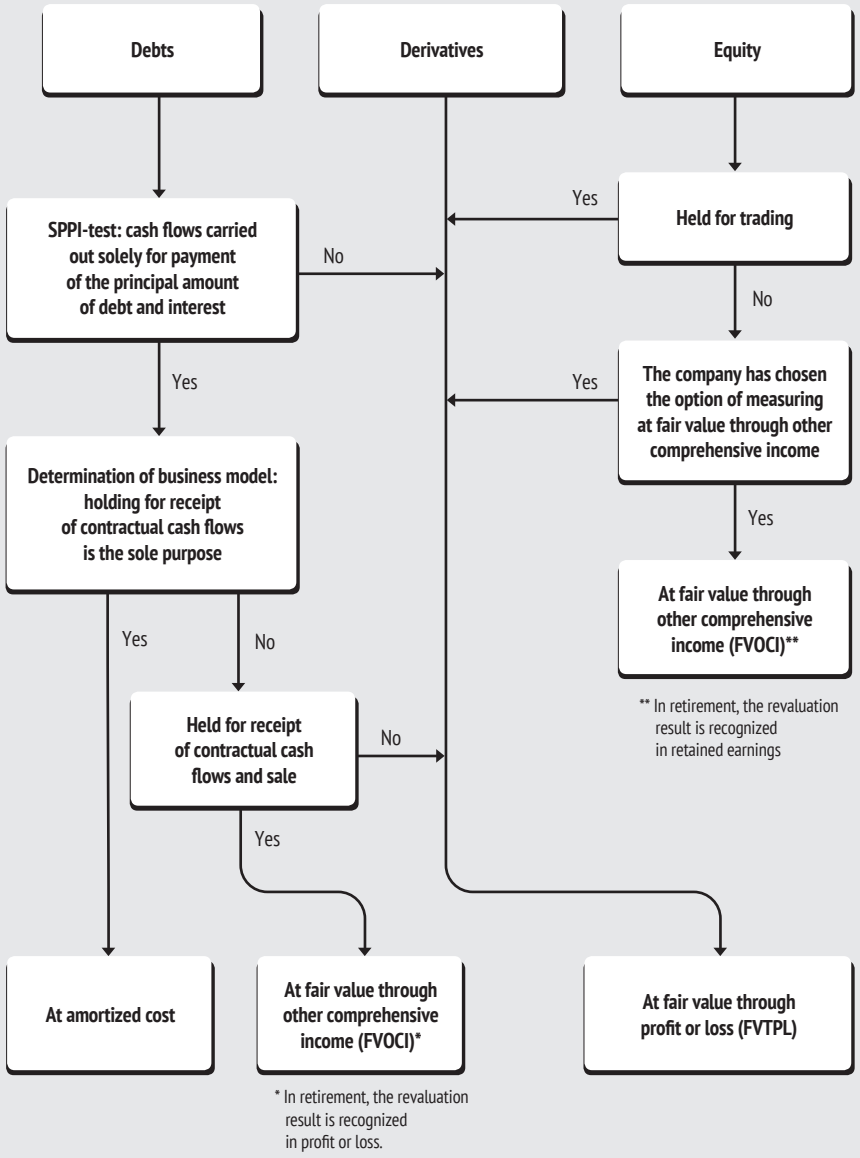

Fig. 1. Classification of financial assets

Second, the model of losses incurred has been replaced by the ECL model: expected credit loss. What does this mean in practice?

Previously: receivables were generally grouped by maturity, and interest was applied to them which depended on the period of delay in debt repayment (the longer the period of delay, the bigger the interest) based largely on historical information. Or the provision was not created at all.

Example (table 1).

Currently: impairment of financial assets should be recognized in the amount of expected credit loss (ECL). Now companies must take into account not only historical information, but also perspective information.

Credit loss is the value of cash flows for a financial instrument, that will not be received, which was discounted at the reporting date. IFRS 9 stipulates two

Table 1

Repayment period	Interest rate
0–30 days (without delay)	2%
31–60 days	5%
61–180 days	10%
181–360 days	25%
more than 360 days	100%

approaches to determination of ECL: general and simplified (see figure 2).

According to the general approach, impairment loss is recognized depending on the stage at which the financial asset currently is. It is important to note that income is accrued on a financial asset (for example, loan interest) to its full value, excluding the provision for financial assets with regular credit risk or assets showing signs of a significant increase in credit risk. Income on a defaulted financial asset is accrued to its cost in view of the provision.

The text of the standard contains refutable assumptions that:

- Credit risk on a financial asset has significantly increased if the payments stipulated by the agreement are in arrears for more than 30 days (clause 5.5.11); and
- Default occurs on or before the date when the financial asset is in arrears for 90 days unless the organization has reasonable information to apply larger arrears in the payment (clause B5.5.37).

Simplifications have been developed for certain types of receivables. The simplified approach is stipulated for:

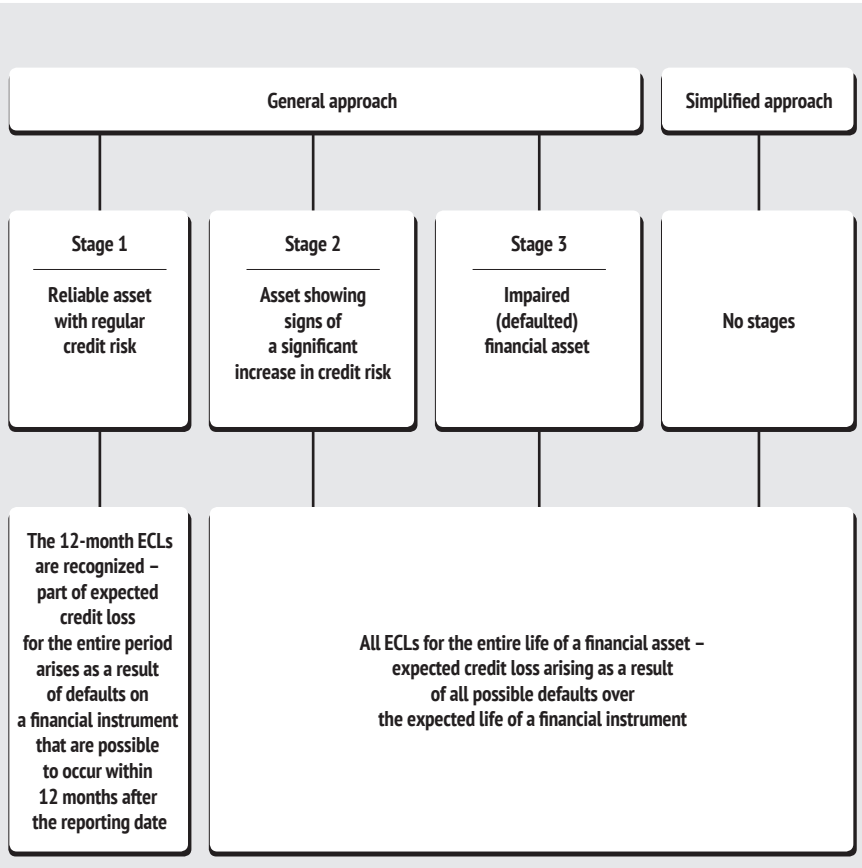

Fig. 2. Two approaches to ECL determination

Table 2

Individual clients		Clients that are legal entities	
Air transportation	Ground transportation	Air transportation	Ground transportation
Group 1	Group 2	Group 3	Group 4

- Trade receivables without a significant financing component (that is, payment deadlines do not grant significant benefit from financing the transfer of goods or services for the buyer);
- Lease receivables;
- Assets under contracts without a significant financing component (the company's right to receive compensation for goods/services that have already been transferred/rendered to the buyer but payment for them depends on the occurrence of a certain event that is not associated with time).

To understand what companies are now dealing with, we will consider fundamental steps of calculating the estimated provision for credit loss using the simplified approach.

Example: Company 1 which principal activities are cargo transportation. The company's policy grants a delay of 30 days for its customers to repay their receivables and according to it, the debt is deemed defaulted if it is not repaid within 360 days. As of December 31, 2018, the company has total receivables for air transportation of goods from individuals in the amount of 7,500,000 Rubles. Let us calculate the provision that the company should accrue on this debt by 31.12.2018.

Grouping of receivables with similar credit risk features

The standard does not contain clear instructions as to how to group receivables. Companies themselves should determine the most important criteria which affect credit risk. For a transport company, those may be the geographical region of customers, type of customers (individuals or legal entities), type of cargo transportation (domestic or international, air or rail…), type of goods transported, whether the transportation is carried out by the company itself or through contractors, etc.

As to Company 1, it was resolved to divide the debt into 4 groups (there may be more groups) (table 2):

To determine the expected credit loss by the total amount of the debt, the company should determine them for each group separately and sum them up. But for clarity, let us consider Group 1 only.

Table 3

Debt maturity date	Repayment amount	Amount of revenue in this period	Amount of revenue carried forward	Credit loss ratio
Less than 30 days (without delay)	30 000 000	50 000 000	20 000 000	1.6%
31–60 days	12 000 000	20 000 000	8 000 000	4%
61–180 days	4 800 000	8 000 000	3200 000	10%
181–360 days	2 400 000	3 200 000	800 000	25%
More than 360 days	—	800 000	write-off	write-off

Table 4

Debt maturity date	Amount of receivables as of 31.12.2018	ECL ratio	ECL estimated ratio
Less than 30 days (without delay)	3 500 000	1.76%	61 600
31–60 days	2 000 000	4.4%	88 000
61–180 days	1 500 000	11%	165 000
181–360 days	500 000	27.5%	137 500
Total	**7 500 000**	—	**452 100**

Determination of credit loss ratios for the prior period

The prior period should be reasonable and most appropriate, not too short or too long. In practice, it is usually not less than a year and not more than five years.

The ratios should be determined for each group separately. To do this, we break down the total receivables in accordance with the maturity dates and determine the amount in each period of delay.

Total sales in 2018 for Group 1 were 50,000,000 Rubles. Total credit loss for Group 1 was 800,000 Rubles.

The debt was repaid as follows (table 3).

Credit loss ratios are calculated by dividing the total amount of credit losses of 800,000 Rubles by the amount of revenue (debt) in each period.

Determination of future expected credit loss ratios.

The most difficult and contentious issue is determination of the impact of future economic conditions on credit loss. These ratios are largely based on professional judgment and analysis.

Let us perform this step for illustration purposes only. And let us assume that Company 1 expects an increase in credit loss in the amount of 10% due to rising fuel prices. Each company individually determines which indicators affect credit risks (exchange rates, rising unemployment, inflation, etc.).

In this case, historical credit loss ratios calculated in the previous clause increase by 10%, and as of December 31, 2018, the provision is 452,100 Rubles (table 4).

The new approach to impairment of financial assets further bridges the gap between financial statements in accordance with IFRS and management statements. IFRS 9 largely makes it possible to use a specialist's professional judgment. The need to rely on substantiated and verifiable information available without undue cost or effort is repeatedly stressed in the text of the standard.

But auditors acknowledge that in some cases, companies willingly agree to a reservation in auditor's opinion since calculation of the loss allowance on a financial instrument under the new rules is overly complicated. The auditors often have difficulties due to inability to confirm professional judgments used to estimate expected credit losses.

In general, it is difficult to dispute the fact that the application of the IFRS 9 rules hurt companies noticeably. Calculation of impairment of financial assets sometimes simply goes beyond the capabilities of accountants, requires the involvement of specialists from other departments (financial managers, analysts), significant costs for modernization of the accounting system. Let alone the fact that it takes a lot of time and leads to an increase in losses for companies. This is especially important to understand for users of reporting and business owners.

FINANCIAL LEASE: DIFFICULTIES IN ACCOUNTING BY THE LESSEE

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When making a decision to purchase property (fixed assets) under the financial lease (leasing) agreement, a business owner rarely thinks about peculiarities of accounting and tax consequences that this method of acquisition will entail.

In the financial lease agreement, it is necessary to indicate on whose balance sheet a leased asset is accounted, as this affects accounting and tax accounting of the purchased car.

Rules of accounting of leased assets are determined by Order No. 15 of the Ministry of Finance of the Russian Federation dated 17.02.1997, and rules of tax accounting are determined by Articles 256-258 of the Tax Code of the Russian Federation.

Order No. 15 was last amended in 2001, that is why it contains many outdated issues (for example, numbers and titles of accounts). Nevertheless, there is no other "instruction" on leasing accounting published.

The procedure of accounting and tax accounting for the acquisition of non-current assets under financial lease (leasing) agreements should be set in the accounting policy.

Balance sheet of the lessor

In this case, the buyer (lessee) cannot record a purchased car on the balance sheet accounts until the full redemption. The value of the leased property received by the lessee shall be recorded on off-balance sheet account 001 "Leased Fixed Assets" as in the case of an ordinary lease.

In accounting and tax accounting, the lessee shall record monthly lease payments and VAT deductible.

In case a leased asset is returned to the lessor (in practice, it is very rare), the asset is written off from off-balance sheet account 001 "Leased Fixed Assets" (see table 1).

In this case, tax accounting expenses coincide with accounting expenses, i. e. there are no differences (neither temporary nor permanent).

Balance sheet of the leasee

If under the agreement a vehicle is recognized on the balance sheet of the lessee, accounting and tax accounting of such asset is carried out in different ways, i.e. there are some differences.

Table 1

Description of transaction	Debit account	Credit account
Receipt of a leased asset	001 “Leased Fixed Assets”	–
Accrual of lease payments (monthly)	20, 23, 25, 26, 44 (costs accounts)	76 “Debt on Lease Payments”
VAT when acquiring valuables (monthly)	19 “Input VAT”	
Making lease payments	76 “Debt on Lease payments”	51 “Settlement Accounts”
Return of a leased asset upon the termination of the agreement	–	001 “Leased Fixed Assets”
Redemption of a leased asset (entry to the accounting records)	01 “Fixed Assets”	02 “Amortization of Fixed Assets”
	–	001 “Leased Fixed Assets”

Accounting

Acquisition of a leased asset shall be reflected in the accounting records under the sale and purchase agreement.

The cost of the asset shall be determined as the sum of all expenses on the asset acquisition, namely, as the sum of all lease payments in total accruable under the schedule (term of the agreement)[1].

Useful Life (UL) shall be determined on the basis of:

- Expected period of use (classification of fixed assets included in amortization groups is often used[2]);
- Regulatory and legal restrictions (e. g. leasing period);
- Expected physical depreciation;
- All write-off methods of amortization expenses specified in RAS 6/01 “Accounting of Fixed Assets” may be applied to leased assets. In practice, the straight-line amortization method is mostly applied (see table 2).

In order to separate objects in the ownership from those acquired under financial lease (leasing) agreements, the lessee is recommended to open additional sub-accounts to accounts 01 “Fixed Assets” and 02 “Amortization of Fixed Assets”.

Tax accounting

For the purposes of profit taxation (to determine the depreciation rate), the value of a leased asset is the amount of expenses of the LESSOR for the acquisition of a leased asset. Such value shall be specified in the agreement or annexes thereto. In practice, a copy of the sale and purchase agreement under which the lessor has acquired a leased asset is usually provided. Based on the above, the value in tax accounting is always lower than in accounting.

The useful life is determined in accordance with the classification of fixed assets included in amortization groups[3].

1. Clause 8 of Russian Accounting Standard (RAS) 6/01 “Accounting of Fixed Assets”.
2. Order No. 1 of the Government of the Russian Federation “On Classification of Fixed Assets Included in Amortization Groups” dated 01.01.2002.
3. Clause 10 of Article 258 of the Tax Code of the Russian Federation.

Table 2

Description of transaction	Debit account	Credit account
Receipt of a leased asset	08 “Investments into Non-Current Assets”	76 “Leasing”
Entry of a leased asset to the accounting records	01 “Fixed Assets Acquired under Leasing Agreements”	08 “Investments into Non-Current Assets”
Accrual of amortization expenses (monthly)	20, 23, 25, 26, 44 (costs accounts)	02 “Amortization of Fixed Assets”
VAT when acquiring valuables (monthly, according to invoices)	19 “Input VAT”	76 “Leasing Settlements”
Making lease payments	76 “Leasing Settlements”	51 “Settlement Accounts”
Accrual of lease payments	76 “Leasing”	76 “Leasing Settlements”
Return of a leased asset upon the termination of the agreement (after making all due payments)	91.2 “Other Expenses”	01.09 “Disposal of Fixed Assets”
Redemption of a leased asset	01 “Fixed Assets in the Ownership”	01 “Fixed Assets Acquired under Leasing Agreements”
	02 “Amortization of Fixed Assets Acquired under Leasing Agreements”	02 “Amortization of Fixed Assets in the Ownership”

The lessee has the right to provide for an increase in the multiplying factor not exceeding 3 for some assets, provided that the asset to be acquired belongs to first-third amortization groups[4].

In tax accounting, lease payments are recognized in the amount exceeding the amount of accrued amortization within the amount of lease payments stipulated by the agreement[5].

Table 3

Indicator	Amount
Value of a leased asset under the agreement	RUB 5 000 000
Lessor’s expenses on acquisition of a leased asset	RUB 4 500 000
Useful life under the classification of fixed assets	36 months
Leasing period	18 months
Amount of lease payments for the first 12 months of the agreement period	RUB 3 333 333

4. Sub-Clause 1 of Clause 2 of Article 259.3 of the Tax Code of the Russian Federation.
5. Sub-Clause 10 of Article 264 of the Tax Code of the Russian Federation.

Differences between accounting and tax accounting (RAS 18/02)

The procedure for generation of differences between accounting and tax accounting is illustrated by the example of acquisition of a vehicle under the following terms (see table 3).

In total, the lessee recognizes expenses in the amount of RUB 5,000,000 related to the acquisition of a vehicle under the financial lease (leasing) agreement in accounting (A) and tax accounting (TA). Differences arise only during the period of recognition and allocation of expenses between amortization and lease payments. Let us compare the amounts of expenses that will be recognized in the first 12 months of the leasing agreement with different accounting methods.

Option 1

The useful life of a leasing asset for accounting and tax accounting is the same in accordance with the classification of fixed assets included in amortization groups. The organization applies multiplying factor 3 to the depreciation rate (see table 4).

Monthly amortization in tax accounting exceeds the amount of monthly amortization in accounting. Since the reason is the different value of a leased asset in accounting and tax accounting, the difference is permanent. In the first year of ownership of a leased asset a permanent tax asset (PTA) shall be formed in the account records.

Since multiplying factor 3 is applied to the depreciation rate, the actual amortization period in tax accounting shall amount to 12 months instead of 36 months. When amortization is no longer accrued in tax accounting, the difference will be reversed. In accounting, amortization will continue to be accrued, and there will be no amortization expenses in tax accounting, i. e. a permanent tax liability (PTL) will be formed.

In the current reporting period, the amount of amortization in tax accounting exceeds the amount of lease payments, so lease payments in the amount of RUB 500,000 may be recognized only in the following reporting period. Upon the recognition of lease payments in expenses, a permanent tax asset (PTA) is formed, because in accounting amortization expenses are recognized instead of lease payments.

Option 2

The useful life of a leased asset for accounting is set in accordance with the leasing period — 18 months, and for tax accounting purposes — in accordance with the classification of fixed assets included in amortization groups. The organization applies multiplying factor 3 to the depreciation rate (see table 5).

Table 4

Indicator	A	TA	Difference	Type of difference
Monthly amortization	138 889	375 000	—	—
Amortization for a year	1 666 667	4 500 000	-2 833 333	Permanent difference, permanent tax asset (PTA)
Lease payments for a year	0	0	0	Lease payments are not recognized in A (amortization is accrued). In TA, lease payments are recognized only if the amount of lease payments exceeds the amount of amortization
Total expenses for a year	**1 666 667**	**4 500 000**	**-2 833 333**	**Permanent difference, permanent tax asset (PTA)**

Table 5

Indicator	A	TA	Difference	Comments
Monthly amortization	277 778	375 000	—	—
Amortization for a year	3 333 333	4 500 000	-1 166 667	Permanent difference, permanent tax asset (PTA)
Lease payments for a year	0	0	0	Lease payments are not recognized in A (amortization is accrued). In TA, lease payments are recognized only if the amount of lease payments exceeds the amount of amortization.
Total expenses for a year	**3 333 333**	**4 500 000**	**-1 166 667**	**Permanent difference, permanent tax asset (PTA)**

Amortization expenses for a year in tax accounting exceed amortization expenses for the leased asset in accounting; therefore, a permanent tax asset is formed.

Moreover, as in the first option, the actual amortization period in tax accounting shall amount to 12 months, while in accounting — 18 months. A year after the acquisition of the leased asset a permanent tax liability (PTL) will be formed instead of PTA.

In the current reporting period, the amount of amortization in tax accounting exceeds the amount of lease payments, so lease payments in the amount of RUB 500,000 may be recognized only in the following reporting period. A permanent tax asset (PTA) will be formed.

Option 3

The useful life of a leased asset for accounting is set in accordance with the leasing period, and for tax accounting purposes — in accordance with the classification of fixed assets included in amortization groups. The organization applies no multiplying factors (see table 6).

In this case, amortization expenses in accounting are more than two times higher than amortization expenses in tax accounting. A permanent tax liability (PTL) is formed. After the termination of

Table 6

Indicator	T	TA	Difference	Type of difference
Monthly amortization	277 778	125 000	—	—
Amortization for a year	3 333 333	1 500 000	1 833 333	Permanent difference, permanent tax liability (PTL)
Lease payments for a year	0	500 000	-500 000	Permanent difference, permanent tax asset (PTA)
Total expenses for a year	**3 333 333**	**2 000 000**	**1 333 333**	**Permanent difference, permanent tax liability (PTL)**

the financial lease (leasing) agreement, the reverse difference and permanent tax asset (PTA) will be formed in accounting, since amortization expenses will be recognized in tax accounting for 36 months. Since the amortization amount for the reporting period in tax accounting is less than the amount of lease payments for the same period, the lessee is entitled to recognize expenses on lease payments in excess of the amortization amount.

No procedure for recognition of lease payments in excess of accrued amortization is set in the tax legislation (lump sum or straight-line basis). Therefore, it is acceptable to recognize the entire difference in the amount of RUB 500,000 in one reporting period (within the excess of lease payments over accrued amortization). The lessee may decide to recognize lease payments on a straight-line basis during the leasing period. A permanent tax asset (PTA) is formed.

It should be noted that it is required to recognize lease payments in excess of the recognized amortization in tax accounting to minimize risks of disputes with tax authorities during the period of the financial lease agreement (leasing), but not after its termination.

Option 4

The useful life of a leased asset for accounting and tax accounting is the same in accordance with the classification of fixed assets included in amortization groups. The organization applies no multiplying factors (see table 7).

In this case, amortization expenses in accounting exceed amortization expenses in tax accounting. A permanent tax liability (PTL) is formed.

Since the amortization amount for the reporting period in tax accounting is less than the amount of lease payments for this period, the lessee is entitled to recognize expenses on lease payments in excess of the amortization amount. A permanent tax asset (PTA) is formed.

What is the difference?

By choosing one of the options above, the lessee may reduce the tax burden in the current and/or subsequent periods. It is particularly important to make a preliminary calculation of the tax burden for all periods covered by the financial lease agreement (leasing) in case of significant investments in the acquisition of leased assets.

Redemption value

As a rule, financial lease (leasing) agreements provide for a minimum redemption value at the end of the leasing period.

Table 7

Indicator	A	TA	Difference	Type of difference
Monthly amortization	138 889	125 000	–	–
Amortization for a year	1 666 667	1 500 000	166 667	Permanent difference, permanent tax liability (PTL)
Lease payments for a year	0	500 000	-500 000	Permanent difference, permanent tax asset (PTA)
Total expenses for a year	**1 666 667**	**2 000 000**	**-333 333**	**Permanent difference, permanent tax asset (PTA)**

Accounting

In the legislation on accounting there are no instructions on accounting of the redemption value of the leased asset.

Generally, the redemption value may be recognized as expenses on acquisition of fixed assets and, accordingly, should determine the initial cost of the asset. However, if at the end of the leasing period the leased asset is returned to the lessor, the lessee will have to make adjustments to the accounting.

Tax accounting

In the Tax Code of the Russian Federation there are no instructions on recognition of expenses in the form of redemption value of the leased equipment.

According to the Ministry of Finance of the Russian Federation[6] such expenses determine the initial cost of depreciable property upon the transfer of ownership of the leased asset to the lessee.

If the redemption value exceeds RUB 100,000, the lessee should determine the initial cost of the fixed asset, set the useful life and recognize expenses by amortization accrual.

If the redemption value is less than RUB 100,000, expenses shall be recognized as a lump sum.

Advance under the financial lease agreement

If the financial lease (leasing) agreement provides for advance payments, such advance shall be recognized as expenses during the entire leasing period, but not as a lump sum upon its payment (distributed evenly throughout the entire leasing period).

VAT deductable from the amount of advance payment may be recognized, provided there is an invoice for advance payment. Upon recognition of expenses on lease payments, VAT on the advance payment is restored pro rata to recognized expenses (to the extent of the distributed advance payment).

Things are about to change

For the purposes of accounting of leasing operations, Federal Standard of Accounting 25/2018 “Accounting of leasing” has been developed, and since January 1, 2022, it shall terminate Order of the Ministry of Finance of the Russian Federation No. 15 dated 17.02.1997 “On Reflection of Operations under the Lease Agreement in Accounting” analyzed in this article. A

6. Letter of the Ministry of Finance of the Russian Federation No. 03-03-06/1/4571dated January 28, 2019; Letter of the Ministry of Finance of the Russian Federation No. 03-03-06/2/79754 dated November 6, 2018; Letter of the Ministry of Finance of the Russian Federation No. 03-03-06/3/7617 dated February 12, 2016.

About the Company

Korpus Prava was established in 2003 in Moscow, Russia. Together with our offices in Russia, Cyprus, Latvia and Hong Kong we offer clients a truly international service. Our highly qualified and friendly staff is available to provide to the clients a flexible, reliable and efficient service.

The mission of the Company is to raise the business value of the client and bring down risks.

Korpus Prava offers services in:

- Legal and tax consulting
- Transformation of financial statements to IFRS
- International tax planning
- Project consulting
- Corporate services
- Capital transactions / M&A
- Tax disputes
- Economic disputes and bankruptcy
- Real estate transactions
- Intellectual property
- Financial Consulting

The company is mentioned in the rankings of the leading international directory “Legal 500” that is completely and comprehensively overtaking the global scope of legal services.

Korpus Prava was nominated as the best legal firm in Russia according to the authoritative magazine “The Lawyer”; it takes one of the leading positions amongst Top 50 legal firms in Cyprus, and it has also been recognised as the best international legal firm for tax planning in Cyprus. Korpus Prava Private Wealth Practice has taken fifth place in Private Banking and Private Wealth sector in Russia, in the category of Succession Planning Advice and Trusts according to the annual rankings of Private Banking Russia Survey 2016 of the prestigious magazine “Euromoney” (as of February, 2016).

Korpus Prava is a member of Cyprus Fiduciary Association (CFA) and Franco-Russian Chamber of Commerce and Industry (CCIFR). It takes part in the development of business community, business presentations and the exchange of professional experience.

Our certified specialists conduct seminars and consultations for accountants and the representatives of company financial services; they act as experts, and they are published in popular financial publications.

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