Korpus Prava

#2 / Summer, 2016

Analytics

Tax & Law Journal for Top Executives

Transparency Elixir: OECD Exploring Alchemy

Co-publisher

VAT without Borders: A Dangerous Carousel

CRS: Beginning of the Transparency Era

Struggle for Cyprus: How Authorities Save the Island's Goodwill

A Time to Scatter Stones, A Time to Gather Them (CFC Calendar)

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МГЮА

Dear readers,

This is the latest edition of our corporate journal “Korpus Prava. Analytics”, where we tried to collect the most trending topics of this summer.

In this issue you will learn why 2015 became a turning point for the owners of foreign companies, how to get through the transition period and pay taxes under the new rules. Whether to abandon using foreign companies for business and tax optimization or pay taxes under the rules established for taxation of income of foreign companies, what today holds for us?

The Automatic Exchange of Information is one of the most burning topics today. Information exchange has become the latest ingredient of the OECD “cocktail”, which made Russian business believe that a new reality has come. In this issue we will discuss how the information exchange will be carried out and what to expect from it in the future.

Our senior lawyer responds to the question why for many years Cyprus remains an almost non-alternative jurisdiction in international tax planning for Russian business.

We continue our series of publications about the value-added tax imposition system in the European Union and have examined violations related to the VAT evasion.

We hope that in this edition each reader will find some useful information. As always, we welcome your questions, suggestions and criticism — feel free to contact us in whichever way is most convenient to you.

See you on the pages of “Korpus Prava. Analytics”!

Artem Paleev
Managing Partner
Korpus Prava


a hot stove

Founder and Publisher

Korpus Prava
Law & Tax

МГЮА

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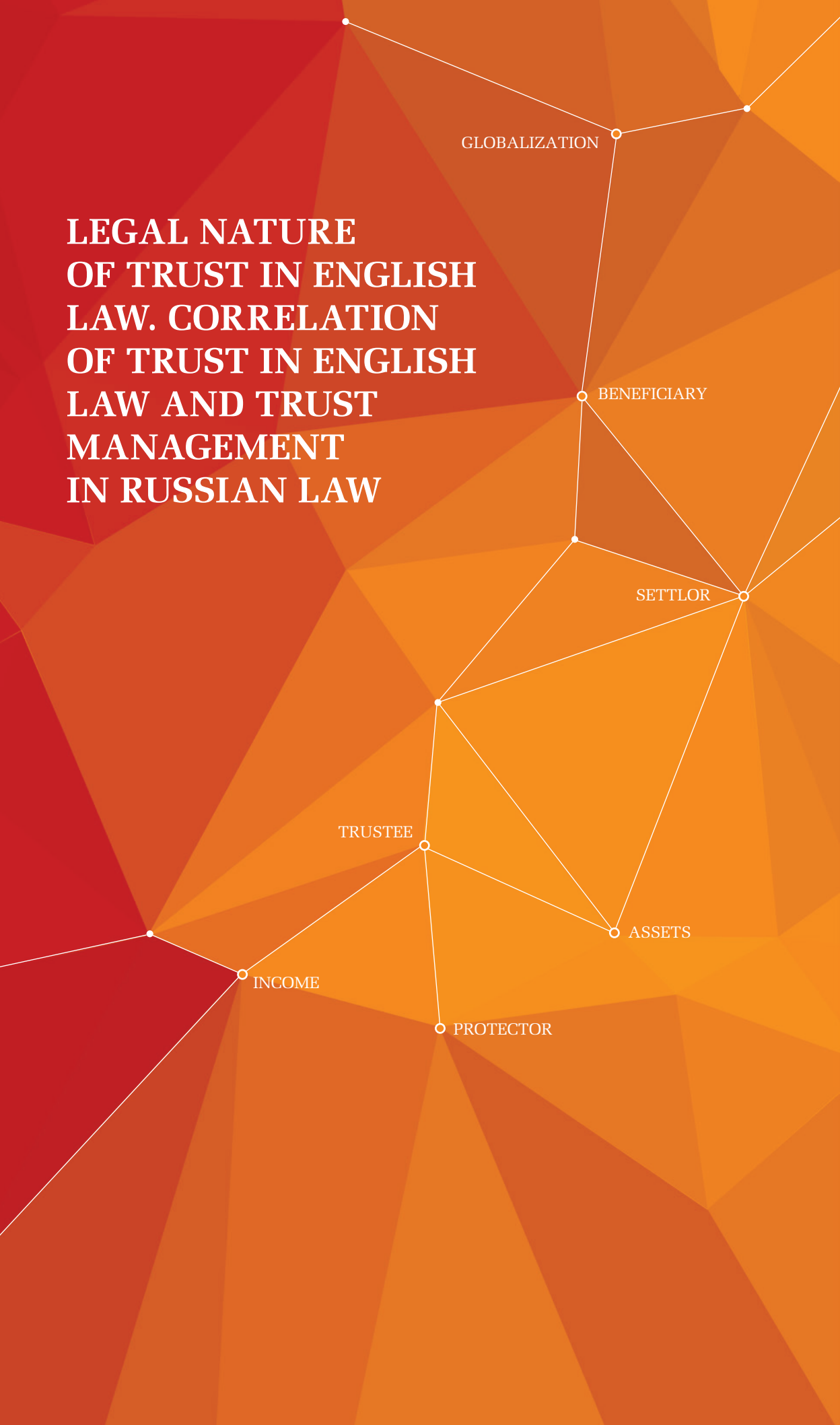
LEGAL NATURE OF TRUST IN ENGLISH LAW. CORRELATION OF TRUST IN ENGLISH LAW AND TRUST MANAGEMENT IN RUSSIAN LAW



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Dynamic business development amid active globalization forces entrepreneurs and modern market players to pay attention to institutions of law used in international practice, including in common law systems. Trust institution is one of such institutions. There is no denying the leading role of trust in the common law system, which defines the relevance of its study. Processes associated with international expansion further promote the relevance of study of this institution and the problems of its practical application according to legislations of the countries outside the common law system.

Trust Institution. The Concept of Trust

The concept of trust is the fundamental concept of Anlgo-Saxon law system. Trust is regulated on the basis of equity, and the notion of trust itself can also be interpreted literally as trust. The classical model of trust looks as follows: a settlor of the trust seeks to establish a special regime in respect of his/her property, the contents of which would include management of such property by one or more trustees, for the benefit of one or more parties being beneficiaries.

Trust institution is not just popular in England, it has there the required legal basis for the application of the relevant regulations. It is applicable as it can be used to achieve the whole range of different practical purposes.

In England trust institution goes back to the 11th–12th centuries. There are several theories of its origin, but they all are inextricably linked to the will of the owner for the other person to manage his/her property. Trust was also consolidated in the countries of Romano-Germanic law system, but only in the 20th century. However, it was not consolidated in its classic form the concept and contents of this institution were used with exceptions.

The concept of trust is not legally formalized. But based on the legal nature of trust institution and the existing doctrinal interpretations, it is possible to identify certain features of trust in English law:

- First, trust is regulated by equity;
- Second, beneficiary's rights to property are protected by ownership, whilst liabilities are entrusted with the trustee in equity;
- Third, obligations of the trustee are fiduciary due to their legal nature.

Thus, trust relations look as follows:

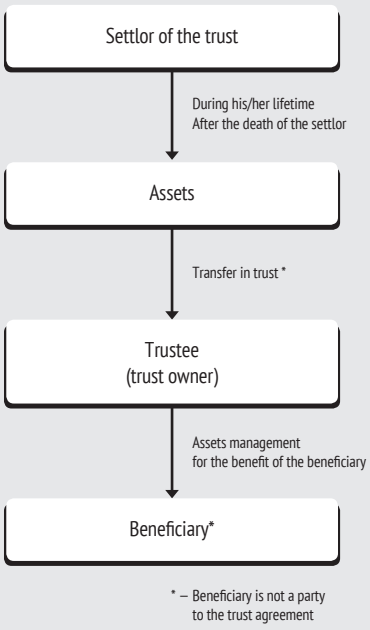


Chart 1. General model of trust relations

Trust Agreement

Trust agreement is the legal form of trust consolidation. Like any other civil agreement, trust agreement contains a number of certain elements and prerequisites, and sometimes even a number of specific conditions.

Subject is a mandatory element of the trust agreement. Although initially mostly land and immovable property were a subject of trust, at present time it can be any property of the owner.

Parties to Trust Relations. Parties to the Trust Agreement

Parties to the trust agreement include the founder (owner, settlor of the trust) and trustee/settlor (a person controlling the subject of the trust agreement for management purposes).

Within the developed legal culture and subject to a large number of security procedures, another party to trust relations emerged — a *protector,* whose presence is not essential for the agreement. Nevertheless, the possibility of his/her inclusion into the agreement results from a range of important functions, which he/she can perform (the settlor may appoint him/her for the purposes of control over the actions, which the trustee makes for the benefit of the beneficiary, or review of their reasonability and empower him/her to dimiss the trustee and appoint the new one, or to change beneficiaries taking into account opinion of the trust settlor). However, in practice, powers of the protector are quite limited and mostly come down to observation.

Back to parties to the trust agreement

Founder is a person, who creates trust management by transferring all his/her property or parts thereof to the trustee (trust owner) who, in his/her turn, shall own, use and dispose of the transferred property for the benefit of the beneficiary. Founders can be both individuals and legal entities subject to certain statutory exceptions.

Trustee is the analogue of a notion of the "trust owner" (not to be confused with the "settlor" under the Russian

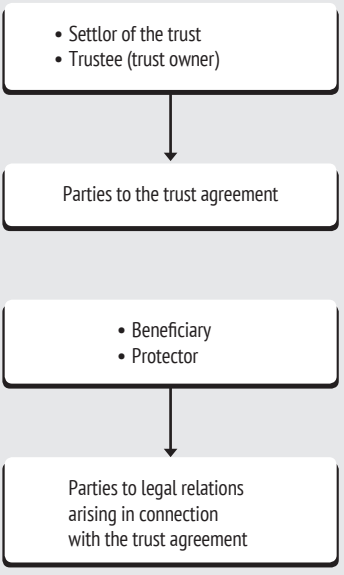


Chart 2. Parties to trust relations and parties to the trust agreement

legislation). Trustee is a person professionally performing duties of the trustee, or a person, who is in trust relations with the founder without performing such functions professionally and permanently. In the first case, a lot of professions somehow related to legal activities meet the criteria of a person rendering such services: providers of corporate services, lawyers, legal advisers, notaries public, auditors, and etc. A specific feature of trust agreement is a possibility to adjust independently the number of trustees. The only condition is that their total number shall not exceed four people. The subject of the trust agreement may be transferred to them by turn or divided among all trustees. The trustee may be both a person, appointed on a contractual basis based on the will of the founder, and a person appointed by the law, i.e. based on court decision.

The fact that the trust owner is empowered to manage property and dispose of it according to theoretical foundations of English law suggests that the trust owner becomes the owner of the property along with the founder of trust. In England the exact set of elements of ownership is not determined, and the number of combinations of such elements as well as the number of owners of the same object or other property is also not limited. Not all of them, but only some of the elements and combinations thereof can be reasonably deemed the elements constituting full-fledged ownership. Practicing lawyers and scientists estimate more than 1 500 of such combinations.

However, the following thesis is best suited for clear understanding and application of trust relations in practice: "The owner shall not lose his/her rights while reserving his/her status, however,

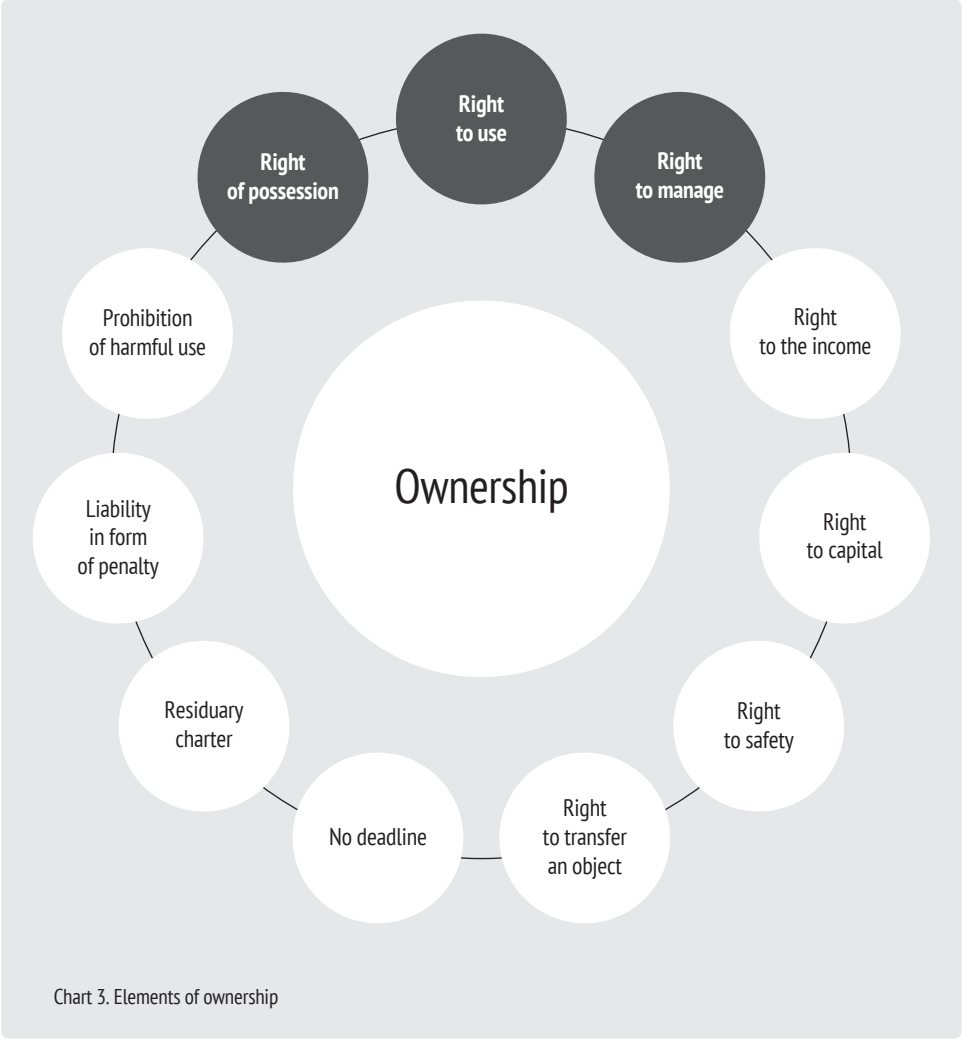


Chart 3. Elements of ownership

Appendix to chart 3:

Elements of ownership	Explanation
Right of possession	Right to an exclusive physical control over an object; if it cannot be in physical possession (for instance, due to its incorporeal nature), the possession can be understood metaphorically or simply as a right to exclude other persons from any use thereof
Right to use	Right to personal use of an object, which does not include the next two powers
Right to manage	Right to decide how and who can use an object
Right to the income	Right to benefits deriving from the previous personal use of the object and from the permission to use it granted to other persons
Right to capital	Right to alienate, consume, modify or destroy an object
Right to safety	Immunity from expropriation
Right to transfer an object	Similar to right of disposal in the Russian law
No deadline	Perpetuity of ownership
Prohibition of harmful use	Obligation to prevent use of an object by means harmful to others
Liability in form of penalty	A possibility to withdraw objects in settlement of debt
Residuary charter	Existence of rules regulating the restoration of violated ownership

he/she shall not exercise the powers of the owner or act as the owner in relations with third parties, while trustee shall fully exercise the powers of the owner, while meeting the terms of distribution of performance results and other terms stipulated by the trust agreement".

The powers of trustee and the real owner cannot be equated. However, consideration of these aspects allows implementing new mechanisms of use of trust peculiarities.

Beneficiary, as well as the protector, is more a party to legal relationship rather than a party to the trust agreement, as the agreement is executed directly by the founder and the trustee. Usually rights of beneficiaries do not appear directly in the agreement, but they correspond to obligations of the trustee established by equity and trust agreement.

Trust institution can be implicitly called an applied legal institution, as it is used to achieve a whole range of different practical purposes: safety of family property, income security of disabled or partially disabled persons without the transfer of the right of control over property to them, donations, gifts, money management for the benefit of third parties, or guarantee of confidentiality of the person receiving income.

Today, the most relevant objective is to protect assets from creditors. Transfer of property to trust means a formal separation of property from the owner, and, therefore, from his/her obligations. Such mechanism is usually used in order to exclude the possibility of execution against such property. Within Russian legislation application of this mechanism is impossible, which further complicates the correlation of two different in content, but homonymous concepts of "trust" in English law and "trust" in law of the Russian Federation. Many firms providing legal services offer to use "benefits" of trust to entrepreneurs, legal entities and now, with the introduction of bankruptcy of individuals, also to such customers. Conventional definition of trust, its specific features, and translation of notions related to relations regulated by English law, developed under the influence of the process of harmonization of national legal systems, fail to clarify the definition of essential differences between trust management in Russian law and trust in English law.

Trust (English Law) and Trust Management in Russian Law

To separate the notions of "trust" and "trust management", let us try to compare the two definitions.

The following features can be identified in the legal definition of trust management:

1. Urgent nature.
   This feature is not inherent in trust agreement, as urgency is an additional condition, while it is essential in the trust management agreement.
2. The trustee acts in his/her own name and for the benefit of the founder or beneficiary.
   This feature is common, which creates the illusion of identity of the given concepts.
3. Founder retains the ownership.
   In the event of transfer of property into trust management, the trustee does not become the property owner. The management founder becomes the owner. The Russian law does not contain the model of parallel ownership, which exists in English law, which is why it is impossible to apply the abovementioned mechanisms for the protection of assets from creditors, recovery and for the establishment of confidentiality of persons in practice. In addition, the founder shall retain the status of the owner of the property transferred by him/her and, therefore, shall be entitiled to determine the powers of the trustee, or impose restrictions in terms of disposal of the transferred property. Thus, in applicable registers, which reflect information about the owners, it is stated that the property has been registered with the nominee holder and is under trust management. Such regulation provides the greatest transparency in the application of the institution of trust management in Russia.
4. The trustee shall have rights and obligations in respect of the actions taken.
5. Trustee's liability to the founder and third parties.
6. When taking actions with the transferred property, including transactions, trustee shall specify his/her status (trustee).

Suppression of such fact shall entail personal liability of the trustee with all his/her property.

Subjects of trust management include a wide range of items, which is open and can be represented by property complexes, immovable property, exclusive rights, securities, and etc. with certain legal exceptions (property under the party's economic management or operational administration cannot be transferred into trust management — it is possible only upon termination of rights of economic management or operational administration due to liquidation of legal entity or other grounds stipulated by law and upon return of the property into the owner's ownership).

In contrast with trust as the phenomenon of English law, in Russia the so-called non-commercial trust manage-

ment is quite common. In this type of trust management, relations are outside the business sector, and the party owns and disposes of property of other person without any material benefits for itself, it acts by helping others, or by performing its civil duty. A person entitled to become a founder of management by law, does not have any subjective civil right to the property transferred by it to the trustee. Such trust management agreements may be executed in respect of property of a ward, a person under patronage, a missing person, i.e. in cases when grounds for the origin of the considered relations are stipulated by law.

Provisions of legal acts of the Russian Federation dedicated to regulation of legal relations arising out of trust management agreement do not contain direct reference to the trustee's obligation to derive income from property management. But, as a general rule, trust management agreements, being pro-bono, include an essential condition of the amount and type of remuneration paid to the trustee. The main obligation of the management founder is to ensure the payment of the remuneration stipulated by the agreement and of compensation for necessary expenses incurred in the course of property management. However, the law stipulates that the source of reimbursement of the specified payments is income received from the use of property transferred into trust management. Which means that in the event of poor management, trustee shall be entitled to receive neither the remuneration for his/her services nor the compensation for the necessary expenses.

Article 1022 of the Civil Code of the Russian Federation is dedicated to liability of a trustee, which seems to be reasonable — a wide scope of authority involves considerable liability. Thus, it requires payment of compensation for the loss of profit during the trust management to the beneficiary in the event of failure to display due care of the beneficiary's or founder's interests, and compensation for losses incurred by loss or damage of property with regard to its natural wear-and-tear as well as for the loss of profit to the founder.

Of great practical importance is the statutory presumption of guilt of a trustee, who is exempt from liability only if he/she proves that the damages resulted from actions either of the beneficiary or the founder, or due to force majeure. This provision corresponds to all logical laws, however, it is quite difficult to calculate the loss of profit in practice. It could be calculated based on the minimum profit specified in the agreement, but such indication would be contrary to the trust management relations and would unreasonably bring it close to the commission, credit, loan agreements or diapositive agreement. Rate of profit is also directly related to the inflation rate which is impossible to be foreseen within the economic conditions in our country.

Trustees can be individual entrepreneurs and commercial organizations except unitary enterprises, while individuals can act as such only in cases expressly stipulated by law (if trust management is established for the purposes of management of inheritance property, for the purposes of management of ward's property, and etc.). As mentioned earlier, English trust has no such restrictions.

In judicial practice, there are issues concerning the powers of the management founder regarding the management subject during the validity term of the agreement. On the one hand, transfer of property into trust management does not involve the transfer of ownership thereof to the trustee. On the other hand, provisions contain reference to the right of the trustee to take any legal or physical acts regarding the property pursuant to the agreement for the benefit of the beneficiary and exercise powers of the owner. In this regard the property transferred into trust management shall be separated from other property of the management founder as well as from the property of the trustee. In addition, most notably, it cannot be seized for the settlement of debts of the management founder except insolvency (bankruptcy) of this person, and, which is especially important, including an individual who is not an individual entrepreneur. With reference to the foregoing, in judicial practice the question arises as to the possibility of the

management founder to exercise powers of the owner regarding the management subject, particularly powers to own, use and dispose of the property in accordance with law setting forth the relevant scope of rights. The practical conclusion which can be made from judicial practice is that the transfer of property into trust management does not restrict the right of the management founder to dispose of the management object, including if the person has become a management founder as a result of acquisition of property encumbered with trust management.

Creation and contents of powers of trustee to own, use and dispose of the property transferred to him/her shall be determined by the agreement executed between the parties, but not by law as is the case in proprietary interests. There are also no other essential features of proprietary interests, like compulsory recognition of this right in law as proprietary, absolute nature of the right, its perpetuity, and the holder's possibility to influence the object without any assistance of any other person. Thus, transfer of property to the trustee does not mean that the founder shall lose the ownership, but it constitutes a form of exercise of the owner's rights. In this regard, the main difference of trust management from trust under English law is that the owner does not transfer his/her powers to the trustee, but imposes certain liabilities regarding property management on him/her by executing an agreement.

It is known that initially Russia planned to follow the same path, which was once selected by the USA, i.e. use the trust institution to organize major corporations and holding companies: Decree of the President of the Russian Federation On Trust (dated December 24, 1993) offered introduction of the concept of trust into national civil turnover, and stipulated that only blocks of shares of joint stock companies established in the course of privatization of state enterprises were subject to transfer into trust. It is believed that the essential contradiction of trust to the Russian proprietary interest led to inability to establish this institution in Russia.

Based on the history of the Russian trust and dynamics of current changes in civil legislation, it is possible to distinguish a practically important process — the process of mutual influence of the common law and civil law institutions. Thus, changes in Chapter 4 of the Civil Code of the Russian Federation (dated 2014) dedicated to legal entities consolidated the division of business entities into public and non-public, which is absolutely new to the Russian law but more common in the United States. Hence, a step has been taken to approximation to the U.S. legal framework.

Despite the inclusion of provisions concerning trust management of property, the alleged equivalent of trust, into the Civil Code of the Russian Federation, Russian lawyers and representatives of business continue to pay close attention to the specified item. As already mentioned herein, the institution under consideration is increasingly used in acquisition of movable and immovable property abroad, which is then transferred to the management of trustees, but with a focus on legislation of other countries which, due to a number of considered reasons, may be in conflict with the legislation of the Russian Federation.

Legal experts are mostly focused on practical side of the issue by analyzing the potential of the trust institution in various areas, including inheritance, family and liability relations. In its turn, the reality is that the considered institution, being quite flexible, may be applied to relations regulated by the provisions of common and other law. However, it is not feasible to apply it in a similar way as in the English law system.

PRACTICAL ASPECTS OF RISK MANAGEMENT IN M&A TRANSACTIONS

Maxim Nikitin
Chief Legal Counsel
Virgin Connect

Management of risks typical of M&A transactions (mergers and acquisitions) can be easily structured according to stages of this business operation. There are three main stages of the M&A project:

1. Due diligence of a company being the subject of the transaction, including documentary.
2. Negotiation and execution of the company sale and purchase agreement.
3. Integration of the acquired company into the existing business.

This division is quite provisional, as the mentioned stages may coincide, intersect in time or be supplemented by other tasks.

Identification of Risks at the Stage of Prior Due Diligence of the Company

Due diligence is usually carried out before the execution of the transaction. It may include financial, legal and operational and technical parts. The main purpose of due diligence is to identify the risks.

Among the major risks subject to identification, the following can be singled out:

- Title;
- Corporate;
- Regulatory;
- Financial;
- Operating;
- Property;
- Technical;
- Labor;
- Tax;
- Judicial.

Such typology is rather generalized. Different business areas may contain other specific risks.

The buyer determines the period of the company activity subject to due diligence and the extent of the latter as well as the criteria of risk substantiality for business. If the level of identified risks is acceptable for the buyer, it shall decide on continuation of negotiations, formation and revision of the sale and purchase agreement. Without going into the theoretical concepts of risk acceptability, in this case "acceptable" shall be the risk, which is, first, subject to management and, second, the costs of eliminating the negative effects of which will not exceed the expected positive effects of the trans-

action. Risks, which are usually considered unacceptable, are the risks related to the defect of title, the existence of disputes over the ownership of share/shares, or improper powers of sellers under the transaction, i.e. risks, which can lead to the loss of acquired business in the whole or a substantial part thereof.

Risks identified in the course of due diligence are classified and assessed according to the criteria of substantiality and probability, following which the list of terms of the sale and purchase agreement is drawn up.

Risks Management in the Company Sale and Purchase Agreement

Terms aimed at minimization and elimination of risks may be implemented through the use of various contractual structures: first, risks may be regulated by establishing conditions precedent to the completion of the transaction, which oblige the seller to take certain actions for elimination or reduction of identified risks. For example, according to the results of due diligence in one of the transactions in the telecommunications sector, the seller's obligation to terminate or amend agreements with affiliates, which indebt the company being the subject of the transaction, was secured as a condition precedent. Other transaction secured the seller's obligation to bring the SORM system in accordance with the requirements of Federal Law On Communications. In both cases it was more profitable for the sellers to fulfill these conditions rather than to agree to a reduction of the purchase price.

The other risk management tool is payment terms under the transaction. The structure of the transaction may involve deferred payments, which amount and payment is contingent upon the fulfillment of certain actions by the seller or neutralization of risks after the transaction completion. For instance, in a number of transactions sellers were to carry out consolidation of their business — accumulate subscribers, receipts, equipment within one legal entity. After these requirements had been fulfilled, the seller received the deferred payment, the amount of which depended on the fulfillment of the conditions.

Third, minimization of risks may reside in the seller making representations and warranties as well as in a *priori* exemption of the buyer from liability. Such mechanism stipulates that in the event of any breach of the provided warranties, the buyer shall be entitled to claim compensation for the resulting damage. Obviously, it is more profitable for the buyer to combine the seller's representations and warranties with the deferred payments mechanism as it makes possible to withhold part of the purchase price as compensation. For example, under the terms of certain transactions the buyer may be entitled to reduce the price unilaterally in the event of breach of warranties and, therefore, provide the seller with a possibility to litigate the relevant settlement. In other transactions more complex mechanisms are used engaging the third party, which could confirm the accuracy of claims; a condition that the buyer's right to withhold the deferred payment is not created automatically, but must be established judicially is also possible. In the latter cases, the amount of deferred payments can be deposited to escrow account.

Fourth, the agreement may contain other specific conditions, which are also aimed at minimization of risks, for example, no competition, no enticement of employees, and etc. Such terms may be used when there is a risk that upon acquisition of the company the buyer will face competition on the part of the seller that has already established himself/herself as a successful entrepreneur who has established the company, and in this regard his/her potential is now enhanced thanks to financial resources received from the buyer. In this regard employees are inclined to continue working with the familiar director rather than stay with the new owner. These conditions together with other mechanisms of risk reduction can work quite effectively.

Fifth, the choice of the applicable law and jurisdiction over disputes can be used

as a risk management tool. Of course, the Russian law is the only applicable law in transactions between the Russian companies. However, the inclusion of arbitration clause into the text of the agreement makes it possible to subordinate the dispute to the competence of arbitration or intermediate court at the parties' option. If there is a foreign element within the transaction, the choice of both applicable law and jurisdiction is much wider. Foreign law, such as English law, is often chosen as an applicable law, and therefore, the dispute is subordinated to international arbitration or a court of the state of the applicable law. In this way the risks related to political and legal situation in the country of investment, as well as risks related to possible abuse of rights of the counterparty under the transaction are minimized, since the proceedings in international arbitration are usually incomparably more expensive and take more time than dispute consideration carried out by Russian courts.

In addition to the abovementioned warranties provided directly by the seller, his/her beneficiary may provide warranties on his/her behalf — this option is used if the seller is a structure, the recovery of funds from which is a definitely difficult task, for example, a company registered in a low tax jurisdiction.

Identification and Management of Risks after Business Acquisition

After the company sale and purchase agreement becomes effective, it is expedient to gain control over the business as quickly as possible, and at the same time examine in depth the state of affairs of the company. In this case control means the aggregate of corporate, financial and operational control.

To exercise corporate control it is important to have documents of title (constituent documents; corporate resolutions of boards of directors, general meetings of shareholders or members). Absence of these documents creates certain difficulties in making decisions related to legal registration of the company. Although it is not critical since the documents can be restored, it creates additional time and financial expenses. Regarding foreign offshore companies it is also important to ensure no powers of attorney and instructions from the previous owners had been issued earlier to companies offering secretarial services.

It is expedient to resolve the corporate control issues at the time of transaction completion.

To gain operational control it is required to ensure:

1. The control over the new owner of the sole executive body. Upon the completion of the transaction it is recommended to change the sole executive body. In this regard the previous director general may remain in the company management, but by virtue of power of attorney. It makes it possible, if necessary, to gain quickly control over the company by terminating the power of attorney without the need to comply with deadlines for termination of powers of director general set in the employment and corporate legislation.
2. Control over the equipment, for example, over the communication and network equipment in the telecommunications sector. It is important to control network in the area of broadband Internet service in order to prevent unauthorized access. Certain difficulties may arise with determination of rights to certain fibers within the optical cable by which traffic is transmitted.
3. Loyalty of employees. First of all, this problem affects the top management and other key employees for business. It is obvious that if the company instantly loses key personnel, it will affect the continuity and may create serious problems for business. As a rule, most employees of the acquired company tend to continue working at the same place. The goal of the new owner is to keep competent staff and strengthen the team, if necessary, by hiring new employees and transferring part of the staff from

the existing business to the acquired company.

4. Availability of information on key customers and other counterparties of the company and on contacts with them. It is important to gain control over the customer base as quickly as possible. It is obvious that deterioration of customer service even for a short time can result in the loss of a key customer and in losses. The same applies to important suppliers of the company.
5. Access to information on previously established rules and procedures. It is useful to study the existing rules and procedures of the acquired company, its business processes in order to reduce the number and consequences of violations of its ordinary activities at the stage of integration of the company into the parent organization.

Financial control means control over income and expenses for which the following is required:

1. Bank signatory — accordingly, signature cards should be changed in banks.
2. Control over bank accounts — access keys to online banking and passwords must be received at the time of transaction completion.
3. The right to sign documents involving occurrence of liabilities for the company (agreements, guarantees, promissory notes, and etc.). It is expedient as early as at the stage of preliminary due diligence to collect information on persons in the company authorized to make relevant decisions. If necessary, terminate issued powers of attorney by restricting the scope of such authorized persons.
4. Control over the rate policy (control over the cost of services and goods, particularly for major clients) and control over procurement process. This task must be accomplished to rule out the possibility of abuse as well as inefficient pricing.
5. Physical access to accounting systems (accounting, billing, production process, and etc.). It means to access keys, source codes in case of self-recording systems, and etc.
6. Control over channels of income proceeds (receipt of money in cash, through payment systems or agents). This process should be taken under control from the very beginning of integration of the new company.

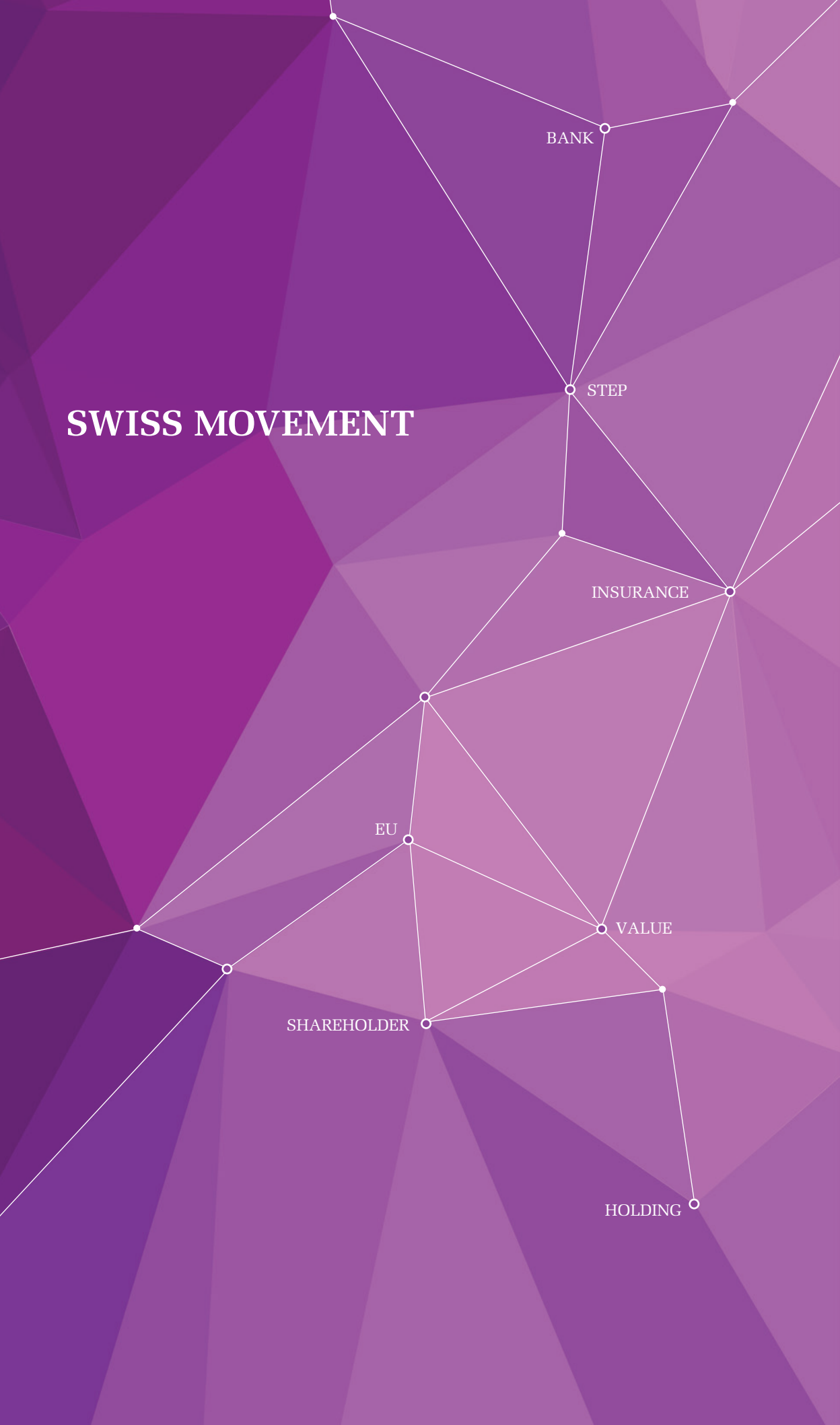
Also after the transaction completion it is expedient to conduct a complex analysis of the acquired company to achieve several purposes: first, verification of conformity of factual information about the company, which was previously received, in order to be able to exercise the right to compensation in case of violation of the warranties stipulated under the sale and purchase agreement; second, for the purposes of identification of new risks and an in-depth study of previously identified risks.

Post-completion due diligence may include:

1. Inventory of property. This process may be quite complex and long depending on the company size and amount of property. It is desirable that such work would be carried out prior the company acquisition, but in practice this measure takes a long time, requires serious involvement of staff and eventually turns out too expensive. Therefore, at the stage of agreement execution the buyer is usually limited to obtaining warranties of the seller, and the inventory is carried out upon the transaction completion.
2. Verification of accounting and reporting systems and accounting policies — the specified systems are brought to conformity with the applicable procedures of companies within the group.
3. Verification of documentation which includes review of contractual framework, internal regulatory documents (decrees, regulations, instructions) and primary accounting documents.

4. Verification of IT systems — document management, billing, CRM, ERP, and etc. Systems must be controlled, clear, transparent and manageable. If technically possible, it is useful to make the database backup. It is necessary in order to reduce the risk of loss of information in the event of human factor in the first place.
5. Analysis of the customer base and suppliers: it is important to understand who are the major clients and suppliers, have tools for collaboration with them (contact details, history of relations, formal and informal conditions of working with them) as well as the analysis of procurement process.
6. Composition and quality of staff — it is important to analyze the employees' reaction to the change of the owner, the degree of conformity of the staff to the goals of the new owner; the willingness of every employee to continue working in the new environment.

SWISS MOVEMENT



Ariel Sergio Goekmen
Member of the Executive Board
Schroders Wealth Management

Can the Swiss private banking sector survive the major regulatory changes it currently faces? Dr. Ariel Sergio Goekmen says it can, if it returns to its core values.

The dramatic recent developments in the Swiss banking sector seem to point in only one direction: south. The financial crisis in 2007–2008 took its toll on Switzerland, with the number of banks decreasing from 331 in 2006 to 275 in 2014[1].

According to a study by PwC[2], the decrease in gross-revenue margins at Swiss banks, which have fallen by about 20 per cent since 2006 and today are down to less than 100 basis points on assets under management, is attributable to: the negative press around the Swiss private banking sector (including the non-prosecution agreements that Swiss banks have negotiated with the US Department of Justice and the unauthorised sale of client data); the obligation of banks to make kickbacks[3] on products transparent to clients; and automatic exchange of information, starting in 2018, which means an end to banking secrecy for clients resident in the EU, and most likely in many jurisdictions that are signatories to the OECD's Common Reporting Standard.

At the same time, securities holdings in Swiss banks have remained nominally stable since 2007 for all clients, at around CHF 5 000 billion. However, adjusted for outflows of client funds and performance, the holdings are about 15 per cent lower. In 2014, 26 private banks reported losses, compared to none in 2008[4]. A publicly accepted initiative against mass immigration poses another threat to the Swiss banking industry, as qualified foreigners might be more difficult to attract.

It would appear Swiss private banking faces an increasingly tough environment and that the sector is declining quickly. But is this true?

Seeing eye to eye with the EU

Switzerland has now accepted exterior political challenges and adapted rapidly[5]. It is leading the way in certain regulatory areas — e.g. in the regulation of systemically relevant banks. Its banking industry

1. Swiss National Bank, Banks in Switzerland 2015.
2. PwC, Private Banking Switzerland: From Yesterday to the Day After Tomorrow (2014).
3. Product-related financial inducements.
4. KPMG, Clarity on Performance of Swiss Private Banks (2015).
5. Swiss Bankers Association and Boston Consulting Group, Actively Shaping. Transition — Future Prospects for Banking in Switzerland (2014).

has also accepted requirements contained in Basel III to support bank capital adequacy, stress testing and market liquidity risk, and local laws have been redesigned to harmonise with EU directives[6], e.g. those around consumer protection[7], and investment funds[8].

There are many other initiatives but, in summary, it can be said that Switzerland and its banking industry have fundamentally changed course and are now taking a much more flexible stance towards EU regulatory matters, due to their wish to gain access to the EU market.

New Business models

In January 2015, the Swiss National Bank gave up its fixed peg to the euro. This meant that the Swiss franc immediately gained value, thereby reducing Swiss banks' revenues and, as such, increasing the cost of foreign clients banking in Switzerland by about 10 per cent. This has not helped export the "private banking product". How can the banking sector adapt to the falling revenue trend and cope with declining margins?

One solution is to return to the core values of Swiss banking, which made Switzerland the biggest private-banking financial centre in cross-border wealth-management globally, with a market share of 26 per cent[9]. The values focus on quality and diligence, professionalism, innovation and delivering value for clients and shareholders. "Delivering value" means achieving investment performance and putting relevant, integrated know-how at the immediate disposal of clients. This concerns all aspects of client work, from relocation to mergers and acquisitions, from portfolio diversification to art collecting and structuring solutions.

Swiss banks remain the best capitalised in the world, which, together with the country's AAA rating, means that Switzerland is frequently selected as a location for custody, advisory and asset-management services, even by very demanding institutional clients, such as pension funds, insurance companies, sovereign wealth funds, family offices and corporations. It was the Swiss banking industry's reputation that helped to make renminbi clearing services available in Switzerland from 2015.

Deloitte suggests that banks follow one of five business models in order to remain competitive[10]. Besides the traditional, universal bank model that offers all services in-house, there are the managed solution, transaction champion, product leader and trusted advisor models.

Trusted advisor banks offer advisory financial services for end clients. Trust is acquired by in-depth knowledge of the client, gained by a customer-comes-first attitude. The services are delivered by a pool of highly qualified internal and external experts, such as STEP members.

I believe there is more than just hope for the Swiss banking sector. There is a clear indication that the industry is focusing on what it has always done best: putting the client's interests first and providing high-quality performance.

6. PwC, Neue Regeln für den Schweizer Finanzplatz durch FIDLEG und FINIG (2015).
7. MiFID II.
8. Undertakings for Collective Investment in Transferable Securities Directive; Alternative Investment Fund Managers Directive; European Market Infrastructure Regulation.
9. Boston Consulting Group, Global Wealth 2014: Riding a Wave of Growth.
10. Deloitte, Swiss Banking Business Models of the Future.

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PRIVATE WEALTH

ON THE ACQUISITION OF REAL ESTATE BY FOREIGNERS IN SWITZERLAND

Ariel Sergio Goekmen
Member of the Executive Board
Schroders Wealth Management

Swiss real estate for private use has been en vogue for some time now. Many foreign passport holders who move to Switzerland are interested in acquiring property and others their own holiday homes for private use. There are regulatory changes planned at the federal level and the potential impact is at this stage still uncertain. Therefore, we have asked renowned real estate expert Dr. Francis Nordmann of Zurich law firm Walder Wyss Ltd to comment on what is about happened and how this may influence the freedom of movement of a buyer or owner of Swiss real estate.

Key rules regarding jurisdiction and applicable law

Foreign investments in Swiss real estate are regulated by the federal law on the acquisition of real estate by persons abroad, the so-called Lex Koller. This law requires persons qualifying as a "person abroad" to meet certain conditions, primarily in case residential real estate is involved, in order to obtain a permit allowing them to make a direct or indirect investment in real estate in Switzerland. However, should a person want to make an investment in residential real estate, the criteria for the granting of such a permits are rather restrictive.

In deals involving both assets and shares, a transaction requiring the granting of a Lex Koller permit may only be completed once the permit has been granted. Should the buyer not hold the requisite permit, the following consequences shall apply:

- The entry of the buyer into the land registry may be denied;
- A complete transaction may become null and void;
- The parties to an already fulfilled contract can claim back their contributions;
- The competent Lex Koller authorities are obligated to correct the unlawful situation by either revoking the transaction, or by forcing the buyer to sell its investment in residential real estate in Switzerland;
- The persons involved may face severe criminal charges in Switzerland.

Conditions requiring a Lex Koller permit

Real estate investments are subject to a Lex Koller permit, if:

- The purchaser or financing party (or any persons involved up to the beneficial owner of the acquiring entity) is a person abroad within the meaning of the Lex Koller;
- The acquisition object qualifies as real estate with respect to its non-commercial use within the meaning of the Lex Koller;
- The type of right in the property to be acquired qualifies as real estate.

If there are any doubts as to whether a permit must be obtained or not, a ruling request can be made to the competent authority, asking it to issue a decree stating that a permit is not needed for the specific transaction.

Person abroad

A person abroad within the meaning of the Lex Koller is:

1. An individual person resident or domiciled abroad, or an individual person living in Switzerland who is neither citizen of an EU/EFTA member state nor holder of a valid permanent Swiss residence permit (C permit).
2. A legal entity that is either domiciled abroad or controlled by a person abroad.
3. The control of a legal entity by people abroad is assumed by law if people abroad:
    - Hold or control, either directly or indirectly, more than one-third of the entity's equity capital or voting rights;
    - Provide significant amounts of debt capital to the entity, which amount to at least half of the difference between the company's assets and its debts with respect to people that are not subject to the Lex Koller.
4. Individuals or legal entities are considered as people abroad if they purchase real estate at the expense of people abroad, even though they personally do not qualify as people abroad. Such fiduciary investments in residential real estate are prohibited and may result in criminal sanctions.

Commercial/non-commercial use

Commercial use: A purchaser does not require a permit to acquire Swiss real estate if the real estate serves as a permanent business establishment for the exercise of an economic activity. Economic activities include industrial production, trading or service activities. The building, sale or rental of residential property does not qualify as an economic activity within the meaning of Lex Koller.

Exceptions:

1. Real estate relating to a permanent business establishment can include residential property, if:
    - The residential property is necessary for the business establishment;
    - A separation from the business establishment is impossible or unreasonable;
    - The residential property is mandatory due to housing unit quotas under planning or zoning regulations.
2. People abroad can purchase commercial real estate with land reserves without a permit, as long as the land reserves do not exceed one-third of the property surface area.
3. Land for development purposes can be purchased by a person abroad if the construction of buildings situated on the acquired land and dedicated to economic activities (excluding any residential use) begins within a year.
4. Any person abroad can acquire residential real estate by way of acquisition of, or merger with, a company

whose main business purpose is not the acquisition, holding or sale of the residential property, and provided the value of the residential property is less than 30% of the company's assets.

5. A person abroad subject to the granting of a Lex Koller permit may acquire a holiday apartment, provided it is located in a cantonally recognised tourist resort and there is a number of properties available. Further restrictions apply with respect to such holiday apartments (e.g. regarding size, letting possibility, etc.).

Relevant transactions

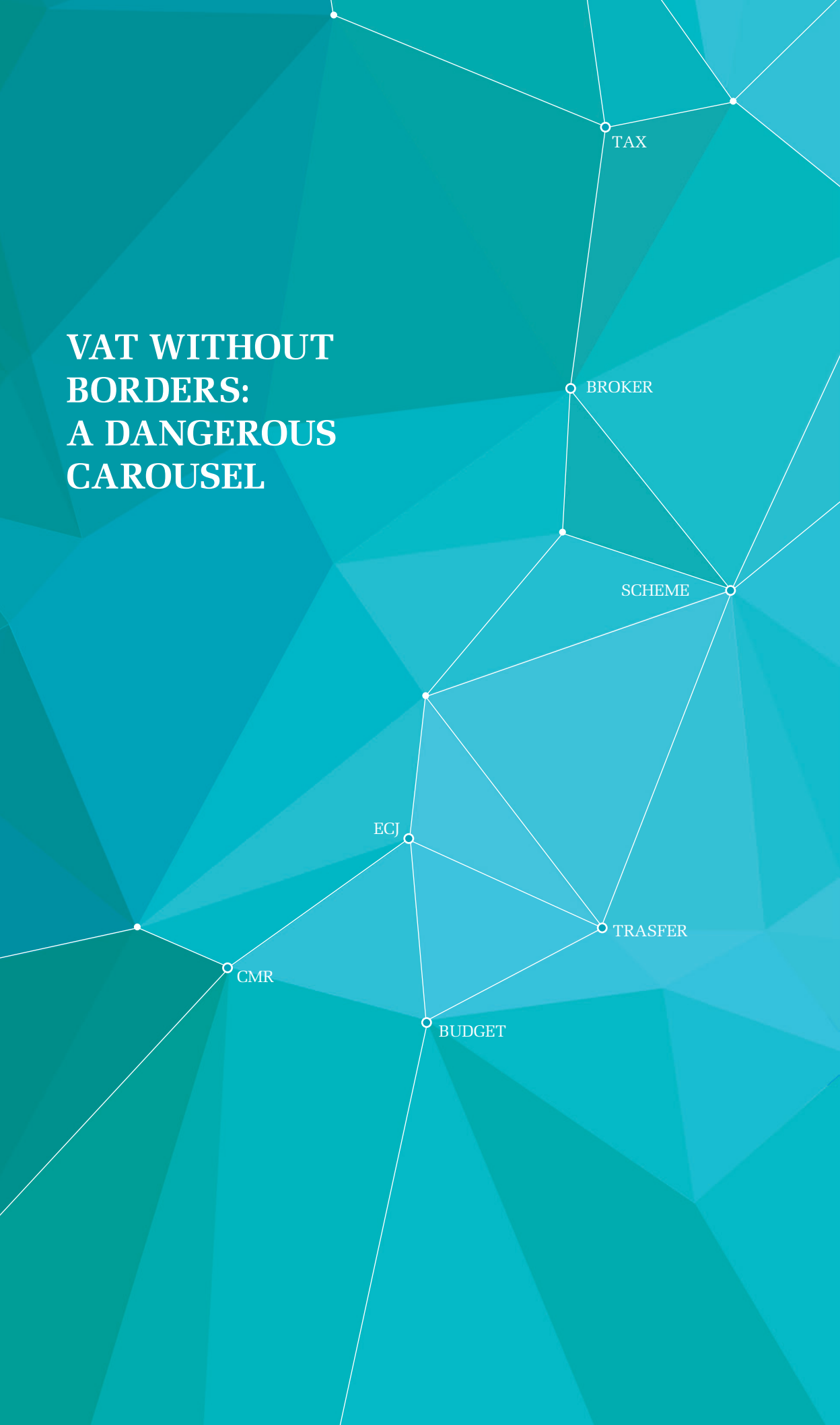
Purchasing real estate within the meaning of the Lex Koller not only means the direct purchase of real estate, but also covers transactions that give people abroad de facto control over Swiss real estate. Examples of relevant transactions are:

- Receipt and exercise of a purchase or repurchase right or a right of first refusal;
- Granting of financing;
- Change of commercial into residential real estate Furthermore, de facto control over real estate can also be obtained through:
  - Joint ownership or co-ownership;
  - Occupancy or usufruct rights to real estate;
  - Acquisition of voting or non-voting shares in a legal entity, of an interest in a company without any legal personality or of a unit of an investment vehicle whose actual purpose is the acquisition or holding of real estate.

However, there is no obligation to obtain a Lex Koller permit upon acquisition of shares listed on a stock exchange in Switzerland or regularly traded real estate investment fund units (even if such trading is off- exchange) or if Swiss real estate is inherited by closely related relatives.

As foreign persons are often not in a position to assess whether a Swiss real estate related transaction is subject to a Lex Koller restriction or is not feasible at all, legal advice should be sought prior to entering into any respective commitment.

VAT WITHOUT BORDERS: A DANGEROUS CAROUSEL



Yana Karausheva
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This article continues the series of publications about the system of taxation with value-added tax in the European Union. In this issue, we look into a matter of tax violations related to VAT evasion.

In most cases VAT evasion schemes exploit the privilege stipulated by law for transactions concerning cross-border supply of goods when goods are transported from one state of the European Union to the other (hereinafter — the IC supply). Such transactions are taxed at the rate of 0%[1]. At further resale, the cost of such goods does not include the amount of tax paid to the seller at the purchase of goods from the other state. It allows reselling them at the price more attractive than the current market prices. The participant of such fraud, who performed such resale, accumulates the amount of VAT paid by the buyer at the standard rate, fails to declare it and "disappears" by the moment tax authorities detect underpayment to the budget. Hence the name given to this type of fraud schemes — missing trader intra-community fraud (MTIC fraud)[2]. Apart from the "disappearing" intermediary, several firms acting as a "buffer" in the resale chain usually participate in the fraud before the goods are again exported from the country to the other EU state. The second IC supply is again taxed at the rate of 0%, therefore, the so-called "broker" carrying out the IC supply accumulates the input VAT, which is not set off against by the VAT amount charged to the buyer. The "broker" becomes entitled to VAT refund from the budget in the amount, which he/she has paid to the previous participant of the fraud.

To implement such illegal operations, expensive, but small-sized products, such as mobile phones, processors, and etc. are mostly used. Services are not a convenient instrument as expensive services involve a high degree of professionalism of the principal, who is not inclined to risk his/her reputation for the sake of short-term illegal profits[3].

Carousel fraud has its name because goods, during the sale of which a tax violation is committed, are not sold to the ultimate consumer, but repeatedly "circulate" among the participants of the fraud, and thus increase the amount of tax underpaid to the budget.

A large number of buffer companies may be involved in the resale chain, and

1. Article 138 (1) of Directive 2006/112/ EC.
2. https://www.gov.uk/hmrc-internal-manuals/vat-fraud/vatf23520
3. Joep Swinkels, Carousel Fraud in the European Union// International VAT Monitor, Mar.–Apr. 2008, p.103.

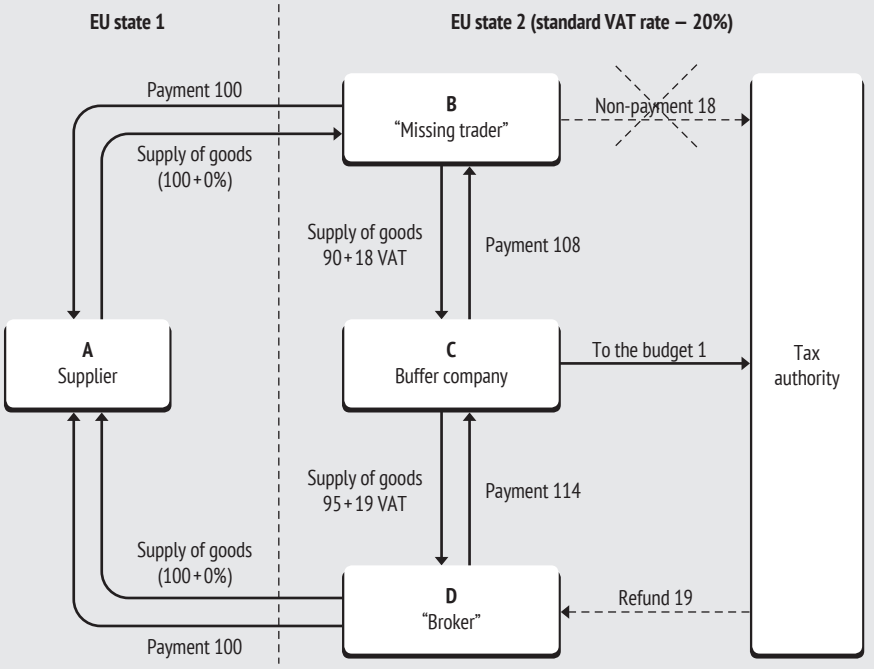


Figure 1

some of them may not even be aware that they are participating in the fraudulent scheme. By the moment the tax authority reveals the scheme, Company B (see Figure 1), which has not declared the supply, "disappears", and tax authority can compensate this non-payment by two means:

- Reject the refund claim made by the "broker" who has carried out the IC supply;
- Contest the 0% rate used by the "broker" at the IC supply.

In 2006 the European Court of Justice (ECJ) passed a judgment on the joint case C-354/03, C-355/03, C-484/03 Optigen Ltd, Fulcrum Electronics Ltd, and Bond House Systems Ltdv Commissioners of Customs and Excise [2006] ECRI-483, the subject matter of which was the right to refund VAT by the "brokers" who turned out to be the participants of a fraudulent scheme. The UK tax authority denied the refund citing the fact that illegal transactions, regardless of the presence or absence of fault of their participants, could not be deemed economic transactions subject to VAT taxation. The European Court of Justice took up a slightly different stance, which was that the right to VAT compensation could not be canceled because there was a tax violation committed in the supply chain, a part of which was the transaction under consideration, except the case when the taxpayer knew or should have known about such violation. Thus, the so-called knowledge test, which is aimed at revealing the negligence of the taxpayer as a basis for denial in refund, has been developed.

The same year the European Court passed a judgement, where it detailed its stance on this case (C-439/04 and C-440/04, Kittelv Belgian State and Belgian Statev Recolta Recycling [2006] ECRI-6161). It was specified that the taxpayers taking all precautionary measures which could have been reasonably required from them to prevent their participation in the fraudulent scheme, may rely on the legality of their transactions without any risk of losing the right to the VAT-refund. Thus, the role of the prior due diligence of the counterparty before the execution of an economic transaction has been strengthened. Moreover, the court ruled that the taxpayer who knew or should have known the fact that in

the course of conclusion of the purchase transaction he/she was involved in the VAT evasion scheme, shall be deemed a participant of such scheme regardless of whether he/she received an economic benefit from such transaction or not.

If it is impossible to prove the taxpayer's lack of diligence in the course of purchase of the goods circulating in carousel scheme and to deny the refund, the tax authority may question the 0% rate in case of the repeated IC supply. Reduced rates may be applied only on the condition that the goods have really been transported to the other EU state[4]. It was ruled that the burden of proving the legality of the application of the reduced rate shall rest upon the taxpayer who cannot refer to the system of interaction of the EU tax authorities, within which a request on actual transportation of goods across the border must be sent[5]. The European Court of Justice specified that if a tax authority of the state, where the goods were sent from, received a reply to the request containing the confirmation of the fact that the buyer has declared the transaction as IC purchase, it is not a proper evidence of transportation of goods across the border. Thus, in order to minimize the risks in the event of application of the 0% rate to an IC supply, the supplier must have confirmation of the fact of transportation of goods, for example, an international consignment note (CMR).

What are the limits of due diligence of the counterparty, which the taxpayer must carry out in order not to be deprived of the rights granted by law? The Court has drawn up a general principle of legal certainty and proportionality, according to which the application of legal regulations should be predictable for the taxpayer. Thus, the tax authority shall not be entitled to deny application of the 0% rate to the IC supply and credit additional taxes because the registration number of the counterparty as a VAT payer in the other state has been revoked with retroactive effect, but it has been valid at the time of the transaction[6].

In most cases, at the detection of the "carousel scheme" the goal of the tax authority is to compensate the VAT amount, which has not been paid at the beginning of the chain by the supplier, who has "disappeared" by that moment, by denying the recognition of fundamental rights (whether it is the right to deduction or the right to apply the reduced rate) of the taxpayer standing "at the top or at the bottom of the chain"[7].

However, the schemes used in practice often include several such chains aiming at paying off the output VAT in one of them by the input VAT in the other chain. The "basic" chain, where the "broker" purchases the goods at the standard rate and accumulates the input VAT, and then sells them to the other EU state at the 0% rate, and a parallel contra-chain, where the same participant purchases the goods at the 0% rate and resells them further at the standard rate, thus generating the output VAT from this resale, are used.

The "contra-chain" is used if the tax authority denies refund of the input VAT in the "basic" chain on the above-mentioned grounds. Then the "broker 1" purchases the other batch of goods at the 0% rate in the other EU state and resells them to the "broker 2" at the standard rate, thus generating the output VAT, which is set-off against the input VAT in the "basic" chain. Now "broker 2" claims his/her right to compensation of the amount of tax paid by him/her for the purchase of "clear" goods, which have not been the subject matter of transactions of the "missing trader" in the "contra-chain". There is a legal dispute as to whether the tax authority is entitled to deny the refund to the person not involved in the resale chain from the "missing trader".

According to judicial practice, they are mostly entitled. There are no precedents of settling such disputes at the European Court of Justice level, which

4. Article 138 (1) of Directive 112/2006/ EC.
5. Twoh International BV v. Staatssecretaris van Financien, C-184/05.
6. Mecsek-GabonaKft. v. NemzetiAdó- ésVámhivatalDél-dunántúliRegionálisAdóFőigazgatósága, C-273/11.
7. Bonik EOOD v DirektornaDirektsia 'Obzhalvaneiupravlenienaizpalnenieto', C-285/11.

means that national courts do not consider them fundamentally new and unregulated by existing legislation, and thus settle them by analogy of law. In the Fonecomp Limited case[8] the court of the first instance ruled that the company had not concluded transactions with the "missing trader" (Softlink Limited) and

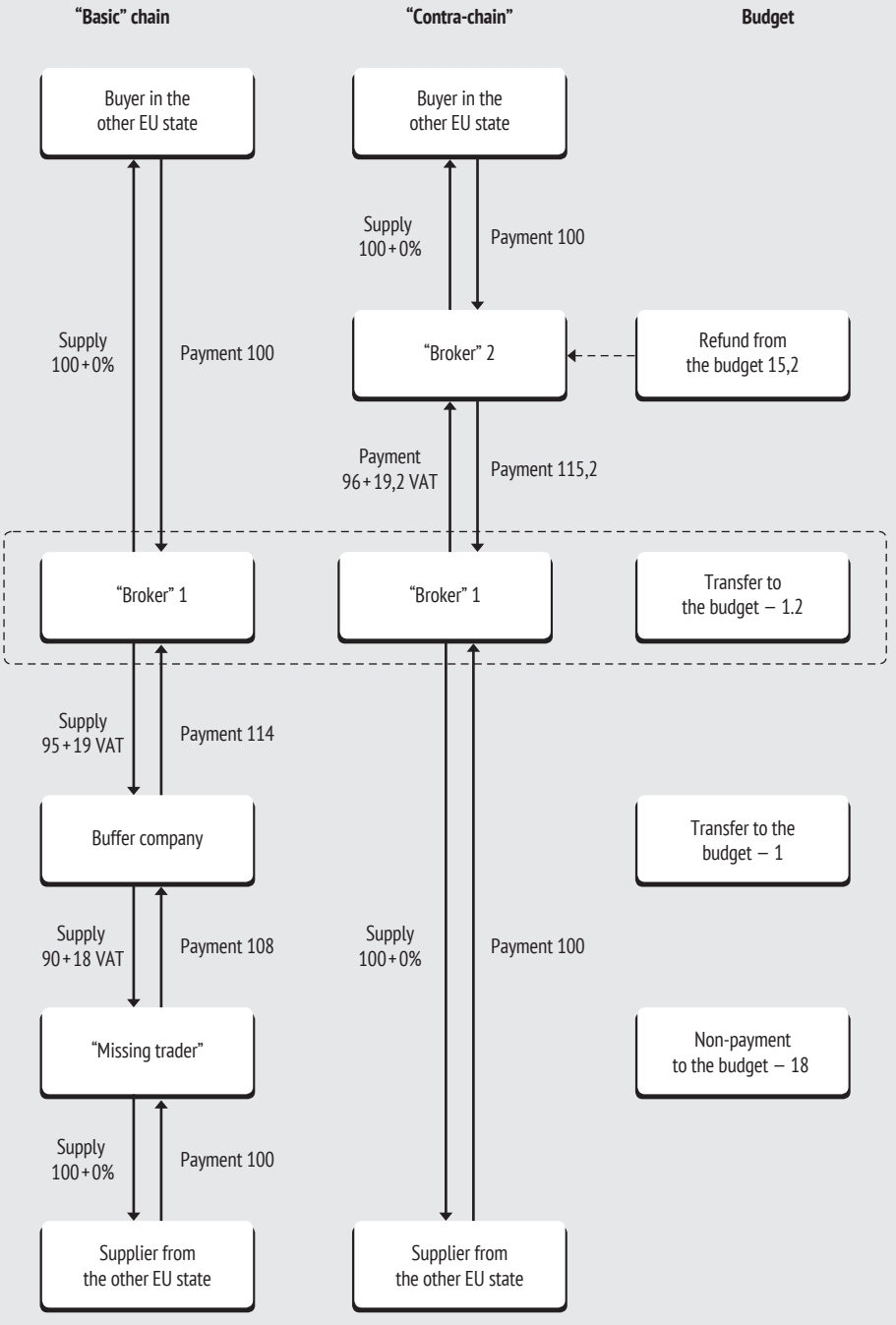


Figure 2

8. Fonecomp Limited [2015] EWCA Civ 39.

the "broker" that organized the "contra-chain" (Klick Limited), but it was related to the "missing trader" as follows (Fig. 2).

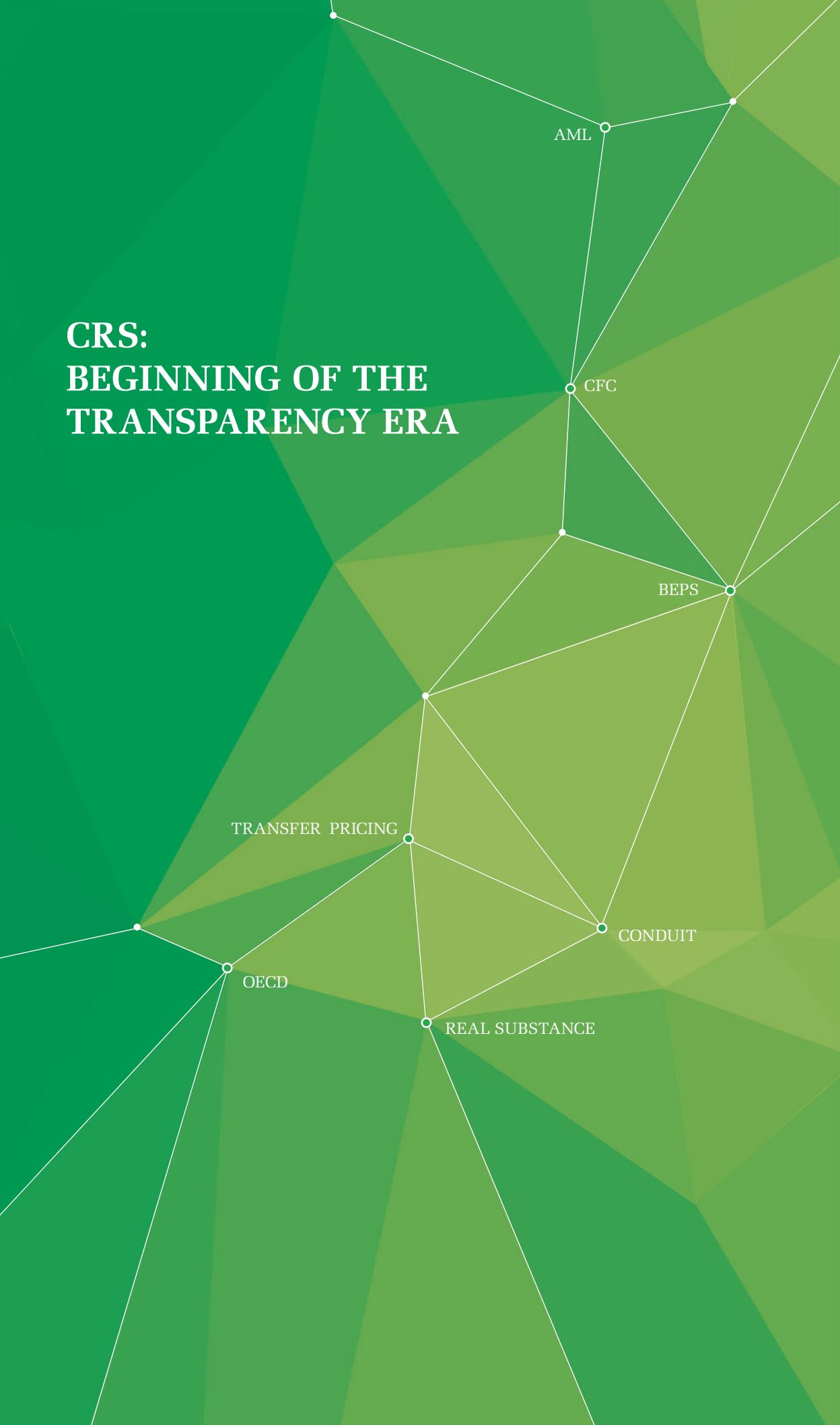
- The goods that Fonecomp Limited purchased (mobile phones) belonged to the same batch of goods, which Klick Limited was reselling;
- The output VAT was set-off against the input VAT in the returns of Klick Limited.

The Court of Appeal dismissed objections of Fonecomp Limited and did not find in the precedents of the European Court of Justice any indications to the fact that the principle of reasonable diligence of the participant in the transaction, developed in the Kittelv Belgian State case, should be interpreted narrowly in respect to the only supply chain where the party to the case participated. The Supreme Court of the United Kingdom dismissed the appeal of Fonecomp Limited. The Court took the position, under which the participant of the "anti-chain" can also be liable for events of the "basic" chain, if the real purpose of transactions concluded in the "anti-chain" is to hide the fraudulent scheme. The expression "knew or should have known about the violation" was interpreted in such a way that it is enough to be aware of the fact that the concluded transaction is related to the fraudulent VAT evasion to lose the right to refund.

The practice of fighting against the VAT evasion in the European Union has developed the principle that the rights granted by law of the European Community cannot be used for the purposes of abuse or fraud[9]. The key element of this approach is the "test" of knowledge of tax violation. If the taxpayer has failed to take reasonable measures to identify a fraudulent component of economic transaction, his/her right to compensation of the input VAT or application of the reduced rate may be contested by the tax authority.

9. Redmar Wolf, Mecsek-Gabona: The Final Step of the ECJ's Doctrine on Reliance on EU Law for Abusive or Fraudulent Ends in the Context of Intra-Community Transactions// International VAT Monitor, Sep.–Oct. 2013, p.286.

CRS:
BEGINNING OF THE TRANSPARENCY ERA



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"JUSTICE WILL OVERTAKE FABRICATORS OF LIES AND FALSE WITNESSES"
HERACLITUS

Russian business is a young substance, which had to come through a lot even over this short period. The time has proved that a Russian entrepreneur, who survived in the early 90s, and came through 1998 and 2008, is prepared for anything and knows like no other that the only constant thing is changes. Today a Russian entrepreneur is offered a new cocktail. It consists of a mix of exotic ingredients: AML, CFC, BEPS, real substance, transfer pricing, controlled indebtedness, AVD, conduit, and CRS.

CRS — common reporting standard — is a document issued by the OECD in the course of implementation of the BEPS plan and establishing general rules of international automatic data exchange — the last ingredient of this cocktail, which made the Russian business believe that the new era has finally come.

Fishing expeditions

Information exchange as such is no news. It existed earlier, but had been carried out on request.

How does disclosure of information on request or, in other words, fishing expeditions work? A competent authority of one state, carrying out investigation of a violation or a crime, makes a request concerning a particular taxpayer to a competent authority of the other state. Subject to a bilateral or a multilateral agreement on information exchange, the other state makes requests to national authorities, which can provide the necessary information: local registers, tax authorities, police, banks, or corporate service providers. In response to such requests, authorities provide available information, which is not kept as commercial or professional secret. The said information is further submitted to the requesting authority. Thus, to obtain information on request, the following conditions should be met simultaneously:

- Existence of an investigation concerning a particular person in the country of request;
- Existence of agreement on information exchange between the country of request and the country of response (for example, agreement of mutual assistance in civil cases, or agreement on tax information exchange);
- Availability of information with national authorities;
- Willingness and possibility of such authorities to disclose information.

That is, to disclose information, apart from observing all formalities, the interested authority needs luck just like in any fishing. The following charts outline information exchange within fishing expeditions (Fig. 1 and Fig. 2).

Automatic Exchange

Yet, automatic information exchange does not make the receipt thereof contingent upon luck. Moreover, it does not make the receipt of information contingent upon the fact that the person has committed a violation or a crime.

The automatic information exchange means that all authorities, obliged to disclose information, will automatically provide such information immediately upon the receipt thereof. The following chart outlines the automatic information exchange (Fig. 3).

YET, AUTOMATIC INFORMATION EXCHANGE DOES NOT MAKE THE RECEIPT THEREOF CONTINGENT UPON LUCK. MOREOVER, IT DOES NOT MAKE THE RECEIPT OF INFORMATION CONTINGENT UPON THE FACT THAT THE PERSON HAS COMMITTED A VIOLATION OR A CRIME

As recently as few years ago, Russian business had to deal with hardening of liability for violation of foreign exchange legislation by individuals, last year — with legislation on controlled foreign companies and actual income recipients, this year — with the necessity to provide reports on foreign accounts. As a result of

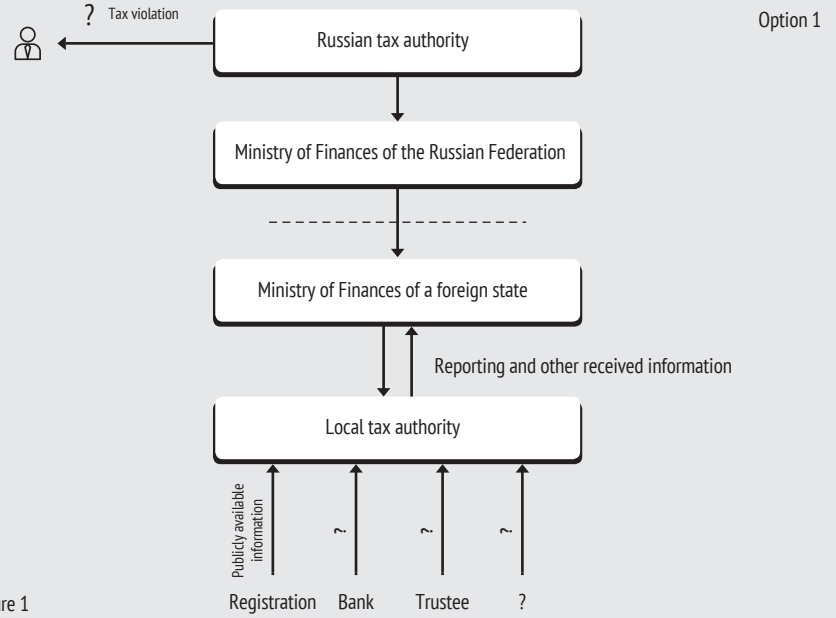


Figure 1

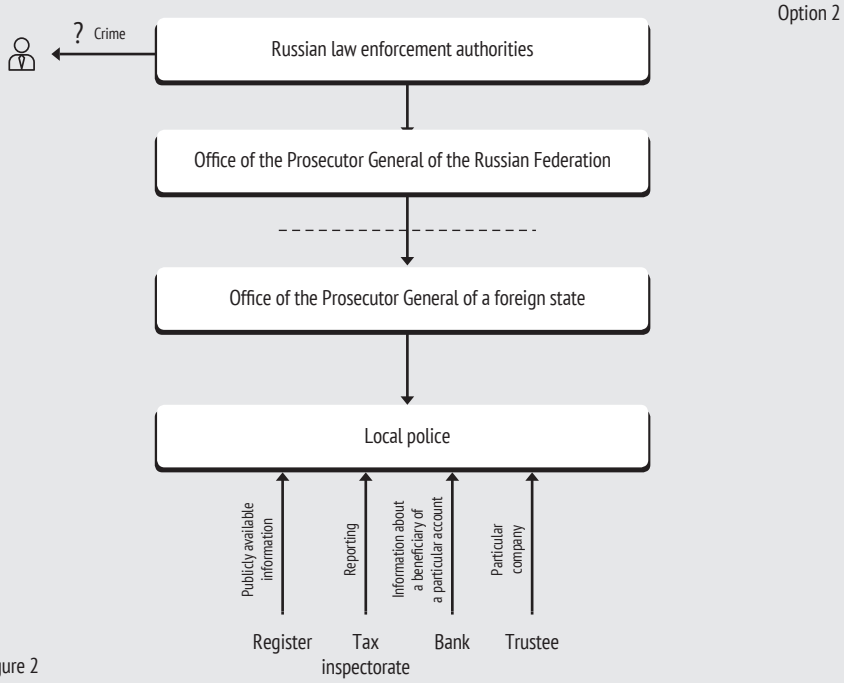


Figure 2

such changes, Russian tax residents faced a number of new responsibilities related to disclosure of information about their activities abroad. Everyone wondered whether our tax authorities possessed resources to search and collect information about participation of Russian tax residents in foreign entities. The only source to adopt similar experience from was the Internal Revenue Service. In 2014, the Foreign Accounts Tax Compliance Act also known as FATCA came to effect. It was adopted in 2010 by the US authorities for the purposes of combating tax evasion by US entities owning foreign financial assets and offshore bank accounts. This Act has caused extreme concern of financial institutions around the world, as one

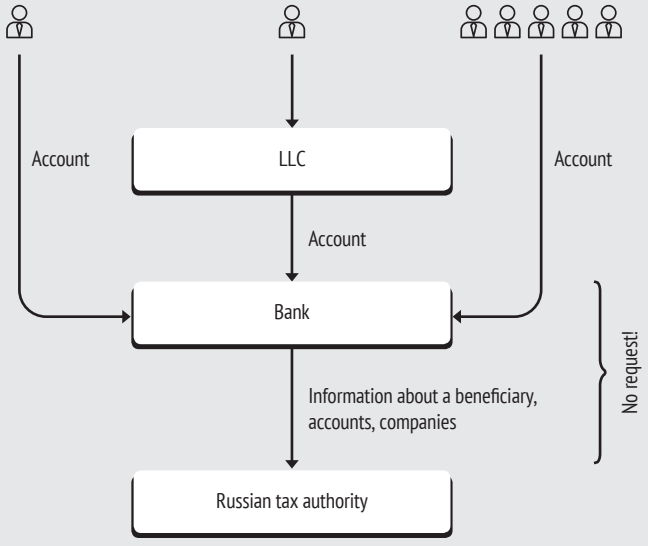


Figure 3

of the measures to combat tax evasion by US entities stipulated the obligation of non-US financial entities to report to the Internal Revenue Service about financial accounts directly or indirectly owned by US entities. Failure to submit the specified information to the US tax authorities or failure to observe the rules stipulated by FATCA may lead to the retention of fine in the amount of 30% from certain payments from the US sources received by a financial entity that has not joined FATCA or violates its provisions.

However, most experts agreed that for this step Russia lacked both leverage on the global stage and the experience in implementing similar projects. Political differences existing on the global stage at the time suggested that Russia's access to the channels of international information exchange was questionable. Accordingly, depending on the degree of optimism, the taxpayer decided on whether to disclose or not to disclose the information. Most of the business regarded these innovations with caution and adopted wait-and-see attitude. While representatives of the Russian financial authorities repeatedly stated Russia's intention of full inclusion into the process of automatic information exchange as a rightful participant from 2018. Promises materialized on May 12, 2016.

Who? What? When?

The Russian Federation ratified OECD Convention on Multilateral Administrative Assistance in Tax Matters on November 04, 2014, and it became effective from July 01, 2015. Under Article 6 of the Convention, the parties can automatically exchange information between each other pursuant to procedures determined by mutual agreement. Thus, Competent Authority Agreements determine deadlines, scope and procedures for information exchange among the signatory jurisdictions.

There are three types of model agreements:

1. "Mutual" bilateral: is applied in conjunction with Article 26 of model agreement on double taxation avoidance.
2. Multilateral: requires no execution of separate bilateral agreements and is applied by parties to the Convention, which have joined the agreement. Signed by the Russian Federation on May 12, 2016.
3. "Non-mutual" bilateral: particularly with jurisdictions where there is no income tax.

Moreover, for any of the abovementioned mechanisms to work, the base of local (national) legislation which must stipulate the following aspects is required:

- Identification procedure;
- Submission of reports to the Russian Federal Tax Service;
- Liability for violation of the standard;
- Existence within financial institutions of internal documents aimed at compliance with requirements of the standard;
- Procedures for protection of personal data and other information transmitted in the course of cross-border exchange.

Information exchange is scheduled to begin from 2017. About 60 countries have declared their intention to start automatic information exchange from then on. Other countries plan to ensure the information exchange from 2018. This group includes without limitation Russia, Austria, Switzerland, Monaco, UAE, Saudi Arabia, Singapore, Israel, Andorra.

USA, which in fact initiated the process of creation of global network of financial information exchange by pinning down the world community to the fact of FATCA entry into force. Since Russia is not a US partner in FATCA, in practice it means that Russia cannot receive information from US financial institutions, whilst Russian financial structures actively provide US authorities information about the US entities.

Today, in addition to the USA, such countries as Bahrain, Kuwait, the Maldives, Panama, Thailand, Moldova, and the majority of countries located in the post-Soviet region, such as Armenia, Azerbaijan, Belarus, Bulgaria, Geor-

gia, Kazakhstan, Ukraine, Kyrgyzstan, Uzbekistan, Turkmenistan and Tajikistan have refused to support and joint the Standard. However, they can change their mind in the future. It should also be borne in mind that the information exchange with these countries is possible through other channels of tax information exchange (for example, by virtue of Double Taxation Avoidance Agreements).

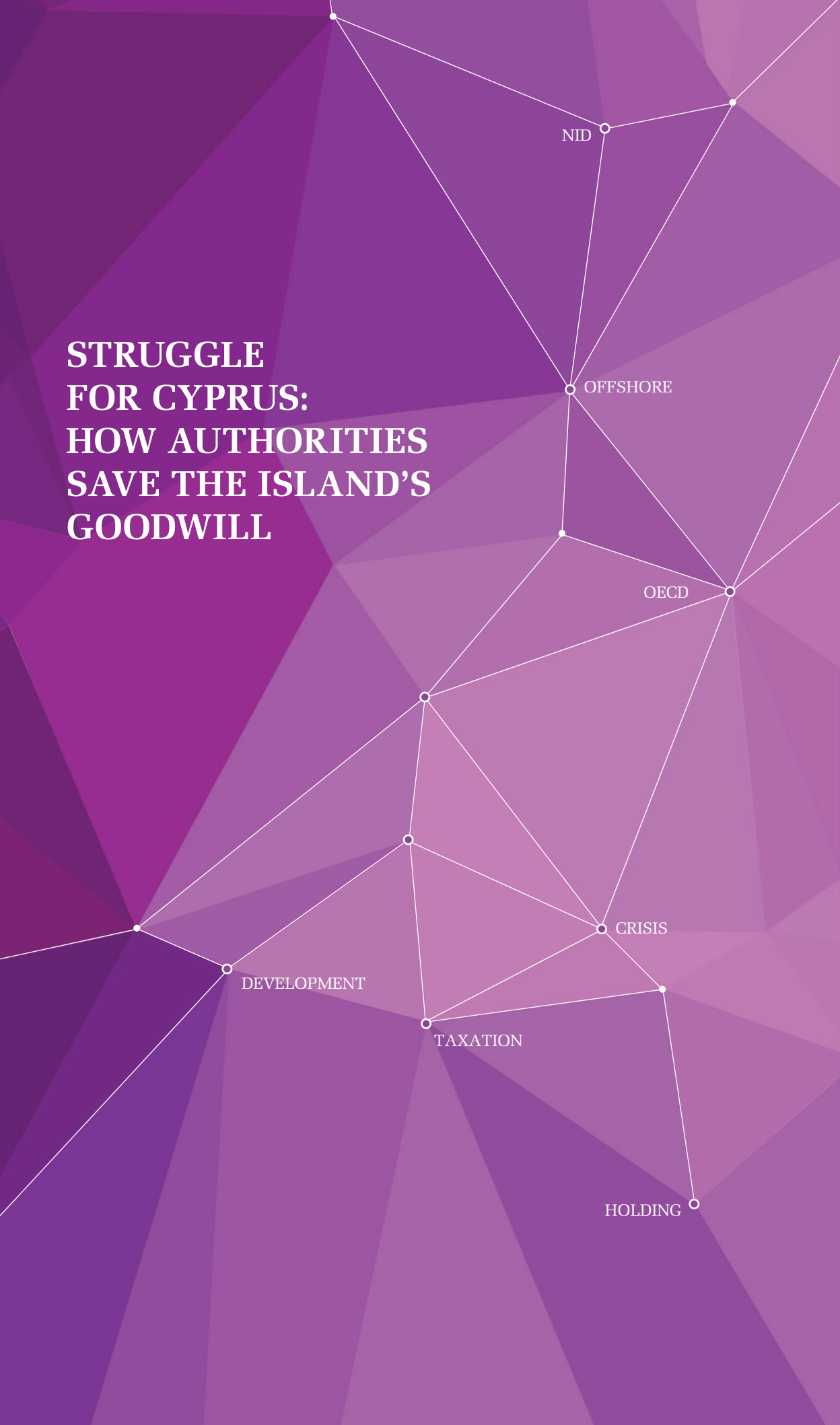
At the same time, the so-called early adopters (for example, the UK, BVI, Cyprus) will start exchanging information for 2016 in 2017. Jurisdictions included into the "Non-early adopters" group (Russia and Switzerland, in particular) will start exchanging information for 2017 in 2018.

To ensure that information for a certain year is received by Russian tax authorities from other jurisdiction, both countries should develop the necessary legislation and processes and submit notification on their willingness to exchange information related to this year.

If legislation of other jurisdiction requires submission of reports for 2016, while the Russian legislation does not, the Russian Federal Tax Service shall start receiving information from foreign jurisdictions for 2017 presumably from 2018.

The obligation to provide information will first affect banks, and then it will be extended to other financial entities, brokers, and trustees. The beginning of automatic information exchange will mean for the Russian taxpayer that in the event of opening an account for himself/herself as an individual or for a company, whose beneficiary he/she is, the bank located in the country, which has signed the international agreement, will automatically send information thereon to the Russian tax authorities. The specified information will be further used by tax authorities for general tax administration. All violations related to illegal currency transactions or failure to include the CIC's income into the tax base, will be soon available for investigation by Russian tax authorities. What seemed impossible a few years ago has become a reality. In this situation, Russian taxpayers can no longer exercise their wait-and-see attitude, they need to change their approach to management of assets, foreign companies and private finances. Until 2018, taxpayers still have time to enter the new era by diversifying their old risks.

STRUGGLE FOR CYPRUS: HOW AUTHORITIES SAVE THE ISLAND'S GOODWILL



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Let us start with a well-known fact: for many years Cyprus has been and still is an almost single-option jurisdiction for international tax planning for Russian business. There are many reasons for this, starting with highly favorable tax system and ending with affordable prices for the establishment and maintenance of business of legal entities. Minor inconveniences often associated with a lack of understanding of the very form of relations with Cyprian companies or insufficiently open contacts with administrators of corporate services were compensated by the simplicity of establishing corporate structures and simply favorable climate conditions, which made it possible if not actually bring some of its staff to this country, at least to supervise independently the work of administrators with comfort by visiting their favorite resorts.

Many businessmen remember what a major breakthrough was the exclusion of Cyprus from the "black list" of offshore zones,[1] which made it possible to fully use the benefits of Double Taxation Avoidance Agreement executed between the governments of the Russian Federation and the Republic of Cyprus. Although for this to become possible, a number of amendments had to be introduced to the Agreement, and Cyprus in its turn had to ensure its participation in tax information exchange. Anyway, the result was beyond any expectations: Cyprus officially lost its offshore zone status in Russia, which means, from the goodwill point of view, that it received an advantage over its potential competitors.

Even introduction of pricing rules in transactions between related parties into the Russian tax legislation could not overshadow these achievements, though precisely these transactions have become a forerunner of a crackdown and combating disinvestment.

The Cyprian success did not last long — perhaps hardly anybody forgot the consequences of the banking crisis that affected the island in 2013. They included not only mass outcome of Russian clients from banks, but also prompt restructuring of holdings. Clients sought to fully exclude or limit their presence within unreliable jurisdiction.

In fact, despite difficult financial situation, at the same time the Cyprian

1. This is referred to the List of Countries and Territories That Offer Preferential Tax Regime and (or) Not Stipulating Disclosure and Provision of Information in the Course of Financial Operations (Offshore Zones) approved by Decree of the Ministry of Finance of Russia No. 108н dated November 13, 2007, from which Cyprus has been excluded since January 01, 2013.

authorities started another campaign, which was intended not only to preserve and improve the investment attractiveness of Cyprus, but also to win the competition of full-fledged offshore jurisdictions. Let us discuss below the measures that the state has been taking over the past several years and how these measures can win the interest of the Russian business.

Double Taxation Avoidance Agreements

Cyprus has been actively expanding its diplomatic ties with governments of different countries concerning double taxation exemption. Provided that in Cyprus a wide range of income is already exempt from taxation (for instance, dividend and interest income, capital gains, and etc.), such agreements create a great base for international tax planning and structuring of holdings. There is no doubt that currently signed 60 (!) double taxation avoidance agreements make the island state a unique platform to work on holding companies. Below is dynamic of changes of signed and effective tax agreements over the last 30 years (Fig. 1).

SIGNED 60 DOUBLE TAXATION AVOIDANCE AGREEMENTS MAKE THE ISLAND STATE A UNIQUE PLATFORM TO WORK ON HOLDING COMPANIES

As can be seen in the diagram, over the past 6 years the number of executed double taxation avoidance agreements and effective agreements, a party to which Cyprus is, has increased by one-third. Today Cyprus has relevant agreements with such offshore territories as Mauritius, the Seychelles, San-Marino, Qatar, the United Arab Emirates, i.e. with those states, which companies can become tax-exempt profit aggregators. Of course, the recent structuring of holding companies with participation of such "profit centers" is complicated by the introduction of automatic tax information exchange systems, but this instrument remains effective, albeit in a much modified form. In its turn Cyprus has its own interest in what is going on by getting additional bonuses in the form of companies, which now must not only be opened in its territory, but also confirm its real activities — real substance — this approach helps the island to benefit again.

Preferential Tax Regimes

Another way to interest business in remaining within Cyprian jurisdiction was created at the level of internal tax policy. In this respect in Cyprus there are two similar tax regimes designed for different types of income.

Notional Interest Deduction (NID) is the deduction of notional interest in the amount corresponding to the amount of new investments made in the Cyprian company. How does it work? Beginning from the 2015 tax period Cyprian companies and permanent representative offices of foreign companies operating in Cyprus in calculation of income tax can use the deduction of notional interest equal to the product of new investments to the authorized (added) capital and notional interest rate. New investments in the capital mean the authorized

	Executed agreements	Effective agreements
Before 1990	19	18
1991–2000	36	35
2001–2010	41	40
2011–2016	60	57

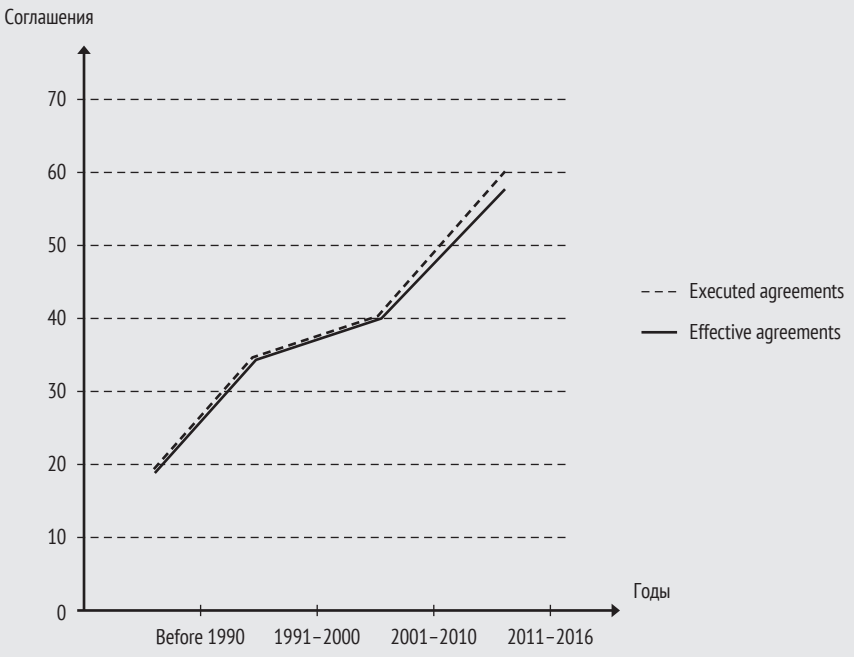


Figure 1

(added) capital paid after January 01, 2015 (both in cash and in kind). The notional interest rate is an interest rate on a 10-year government bond of the country, where new investments have actually been implemented, increased by 3%. In this regard the minimum amount of deduction is calculated based on yield on the 10-year Cyprian government bond increased by 3%.

Use of such deduction is not allowed, if it exceeds 80% of the taxable profits of the company, accordingly, this deduction cannot form losses. Moreover, the law contains provisions that prevent tax evasion using this deduction, namely:

1. Notional interest cannot be calculated in respect of new investments in the capital, the source of which are reserves existing as of December 31, 2014; authorized capital existing as of December 31, 2014; revaluation of assets of the company.
2. To avoid double application of deduction in respect of the same investments in the capital, where the new investments of the company have been directly or indirectly received from the new investments of the other company, deduction of notional interest will be possible only for one of the companies.
3. Deduction of notional interest of one company shall be subject to reduction by the amount of actual interest accepted as expenses by the other company, if the source of formation of new investments of the first company is the amount of debt financing of the latter company.

Thus, in order to apply deduction, precisely "new capital" shall be invested in the Cyprian company, i.e. funds that had not been in its possession until the beginning of 2015. In this regard the Tax Department of Cyprus explains that the capital in the form of released debt or an offset of creditor's claim paid as the investment will be considered a proper basis for the deduction, if such release (offset) has been carried out since 2015, even if the creditor's claims regarding the indebtedness arose before December 31, 2014 inclusively.

The advantage received by the Cyprian company may also be applied, if after the receipt thereof there was a change of shareholders in the company.

It has also been confirmed by the official position of the Ministry of Finance of Cyprus.

THE NID REGIME MAKES IT POSSIBLE TO REDUCE THE TAX BASE ON INCOME TAX PAID BY THE CYPRIAN COMPANY BY 80%

Thus, the NID regime makes it possible to reduce the tax base on income tax paid by the Cyprian company by 80%. In this regard, unlike previous schemes stipulating "mirror" loans from offshore companies, investments in the company must be real, free of charge and increase the amounts of authorized or added capital of recipient of the investments.

Intellectual Property Tax Regime (IP Tax Regime) — is a preferential tax regime existing in Cyprus since 2012, but it truly interested Russian business only when Russia began actively combating offshores. The essence of IP Tax Regime is that the Cyprian tax legislation exempts from taxation about 80% of profit of Cyprian companies, which receipt is associated with the use of intellectual property items. Such generosity is explained by the fact that regardless of the specific amount of investment in such items, the authorities have established the 80% rate as notional and requiring no documentary proof. To apply the exemption the company only needs to prove that it is entitled to use the intellectual property item. Moreover, the Cyprian company may be both the owner of the item or hold it by virtue of license. No matter where the intellectual property item was registered and its specific features (it can be a patent, trademark, franchise, computer program or any other item).

Attention should be drawn to the fact that conditions, which Cyprus offers regarding this tax regime, seem fantastic. By using it, the Cyprian company is not restricted in methods and amounts of payment of royalties, distribution of dividends and it is entitled to use all advantages of double taxation avoidance agreements executed by Cyprus and EU Directives exempting from a range of taxes. In Cyprus corporate tax is maintained at the rate of only 2.5% of the amount of all income received from the use of the intellectual property items.

However, not everything in the garden is rosy.

As known, there is an organization, one of the main objectives of which is to prevent illegal and unfounded use of preferential tax regimes and patterns of international tax planning, aimed solely at tax avoidance. This organization, famous OECD (Organization for Economic Co-operation and Development), carefully monitors and thwarts any attempts of its members to grant preferences to taxpayers, such as the abovementioned IP Tax Regime. The OECD reaction to introduction of such regime is unambiguous and leaves no reason for doubt that the international community will fight it by any available means.

CYPRUS IS NOT AN OECD MEMBER; HOWEVER THE ADHERENCE TO ITS PRINCIPLES REMAINS AN IMPORTANT ITEM ON THE AGENDA OF THE ECONOMIC POLICY OF THE ISLAND

Cyprus is not an OECD member; however the adherence to its principles remains an important item on the agenda of the economic policy of the island. As it was announced in the Statement of the Ministry of Finance of Cyprus dated December 30, 2015, taxpayers using IP Tax Regime need to decide and choose other taxation regime for themselves until July 01, 2016. As for IP Tax Regime, it will be abolished as not complying with the rules of the OECD. It was assumed that during the first half of 2016 actions of legislative bodies of Cyprus would be focused on changing the legal framework in respect of intellectual property

pursuant to the recommendations of the international organization.

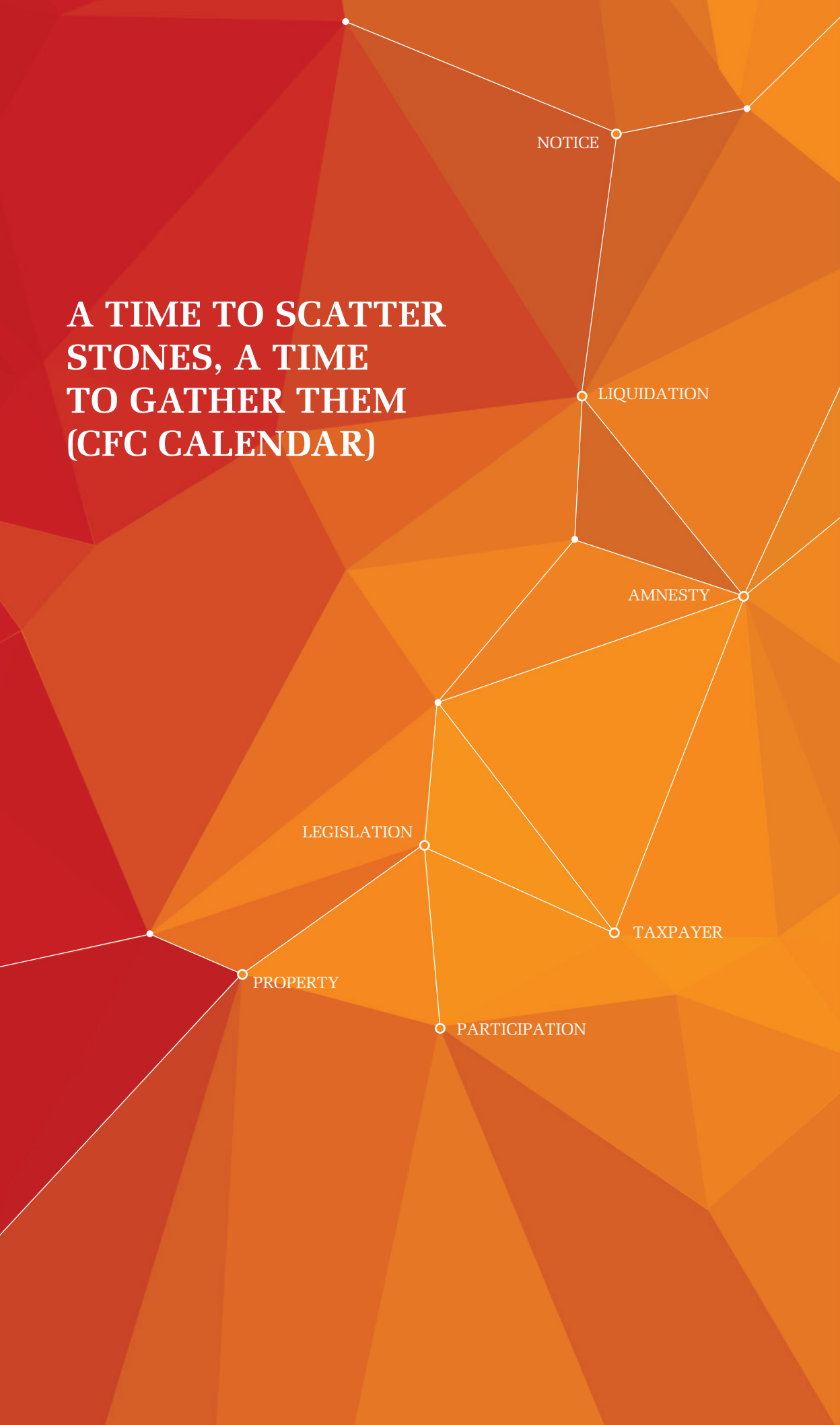
Nevertheless, until now there is no information about adoption of any amendments related to the use of IP Tax Regime. Today we can definitely say that the companies, that have been using this preferential regime before, can still use it this year. We will see what happens next. If the Cyprus authorities decide to follow the common path of the OECD, in the near future we will see a complete rejection of the IP Tax Regime or such revision thereof that will make it possible to apply deductions only in the amount of proven costs for acquisition or maintenance of the intellectual property item. It is entirely possible that IP Tax Regime may be applied only concerning items that have been registered with the Intellectual Property Office of Cyprus. Thus, everything will depend on what interests the island government pursues.

In this article we have considered only measures, which the authorities of Cyprus use to keep the business in Cyprus and attract additional investments in corporate institutions of the island. Measures related to keeping Cyprus attractive as a place of residence for individual taxpayers is a subject for a separate discussion.

Particular attention should be paid to an opposite topic concerning possible tightening of legislation of Cyprus primarily related to the need of the island to prove its openness and commitment to international principles of combating tax evasion and money laundering. These issues will be discussed when the legislative body or the Ministry of Finance of Cyprus will go for serious measures.

Anyway, when making a decision to enjoy any advantages of the Cyprian jurisdiction it is worth to refer to experts and get the most up-to-date information about possibilities the existing taxation conditions provide.

A TIME TO SCATTER STONES, A TIME TO GATHER THEM (CFC CALENDAR)



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For the owners of foreign companies 2015 became crucial. President Vladimir Putin's statement on the need to pay taxes from offshore companies slowly, but steadily comes true, and now the country is going through the so-called transition period, when everyone learns to live and pay taxes according to new rules.

The main objective of the changes that have been introduced into the tax legislation is that tax residents of the Russian Federation should either refuse of using foreign companies for business and optimization of taxation or pay taxes under the rules established for income taxation of foreign companies.

Notice of Participation in a Foreign Company

The foundation for the new era was laid by the introduction of liability for tax residents of the Russian Federation to inform about their participation in foreign entities, if the share of such participation exceeds 10%.

The deadline set for the submission of notices regarding the existing foreign companies was limited by June 15, 2015. Precisely until this day taxpayers had to inform tax authorities on their foreign assets in the form of stocks or shares of foreign companies.

For newly registered foreign companies period for notice submission was initially one month, and later the legislator extended it up to three months from the date of accrual of the grounds for notice submission (participation in a foreign company).

Thus, the key period, which the owners of foreign companies should keep in mind, is as follows:

- June 15, 2015 — deadline for the submission of notices of participation in a foreign company registered before June 15, 2015;
- Three months — deadline for notice submission for newly registered foreign companies.

For entities, which decided to hold their horses in disclosing information, there is a rather substantial fine of 50 000 rubles stipulated.

"Tax-Free" Liquidation of a Controlled Foreign Company

Upon the receipt of information about foreign assets of Russian taxpayers, legislator has fixed a grace period, which

specifies tax exemption of income in form of property and property rights received in the course of liquidation of foreign entities. Thus, if the procedure of liquidation of the company is completed before January 01, 2018, the income received by the taxpayer in the course of liquidation shall be exempt from taxation[1].

If the decision on liquidation was made before January 01, 2017, but the liquidation procedure cannot be completed until January 01, 2018 due to restrictions established by personal law of this entity or by its participation in judicial proceedings, the grace period shall be extended until the end of such restrictions and (or) judicial proceedings.

If the private law of the foreign entity stipulates a condition in the form of a minimum period of ownership by the taxpayer of shares (stocks, equities) of this entity and (or) its subsidiaries and (or) foreign structures without formation of a legal entity, failure to observe which results in creation of obligation with such taxpayer to pay the relevant amount of a foreign tax, and upon that the beginning of this period fell on the date before January 01, 2015 and the end of this period falls on the date after January 01, 2018, the temporary condition shall be deemed fulfilled, if liquidation of such foreign entity is completed within 365 consecutive calendar days starting from the ending date of such minimum period of ownership.

In addition to observing the abovementioned deadlines, along with tax returns the taxpayer must submit to the tax authority an application drawn up in any format on tax exemption of income specifying the features of the received property (property rights) and of the liquidated (dissolved) foreign entity (foreign structure without a legal entity) attaching documents containing information on the cost of property (property rights) according to accounting data of the liquidated foreign entity (foreign structure without a legal entity) as of the date of receipt of property (property rights) from such foreign entity.

Thus, there has been a deadline for deciding on the future of the company set for the owners of foreign companies. If the taxpayer intends to use the preference in the form of exemption of income received from the foreign entity from individual income tax, the foreign entity must be liquidated before January 01, 2018. If it is impossible for objective reasons, the decision on liquidation must be made before January 01, 2017.

In addition to the fact that the income in the form of property or property rights received by the taxpayer upon liquidation of the foreign entity is exempt from taxation, subsequently, upon disposal of property (property rights) the individual income may be reduced by the amount equal to the cost of property (property rights) according to accounting data of the liquidated foreign entity as of the date of receipt of property (property rights) from such entity, specified in the documents attached to the taxpayer's application, but not more than the market value of such property (property rights)[2].

However, it should be noted that if as a result of liquidation of the controlled company the tax payer received a property right in the form of a right of claim, against which cash funds have been subsequently received (for example, under a loan agreement), such income shall be subject to taxation following the standard procedure[3].

If the decision on liquidation of the foreign company is not made within the specified deadline, there is a risk that the foreign entity may be deemed a tax resident of the Russian Federation based on the place of company management[4].

If a foreign entity is deemed a tax resident of the Russian Federation, it shall be governed by regulations of the Tax Code of the Russian Federation in terms of income taxation of the company with all that it entails in the form of tax payment.

1. Clause 60 of Article 217 of the Tax Code of the Russian Federation.
2. Sub-clause 2.1 of Clause 2 of Article 220 of the Tax Code of the Russian Federation.
3. Letter of the Ministry of Finance N 03-04-05/54046 dated September 21, 2015.
4. Article 346.2 of the Tax Code of the Russian Federation.

Capital Amnesty

Grace or transition period for shareholders and members of foreign entities consists not only of possibility to receive the company property without paying income tax. Since mid-2015, there has been a capital amnesty campaign taking place in Russia. The essence of the campaign is that taxpayers are given once an opportunity to file an application to the tax authority about all assets including foreign accounts belonging to individuals by virtue of ownership or registered with nominees.

Persons who have declared their assets in the course of capital amnesty shall be relieved of administrative, tax and criminal responsibility for violations and certain crimes committed during the formation of the capital before January 01, 2015.

Initially the amnesty period was established until January 31, 2015, however, the legislator has resolved to extend this period until July 01, 2016.

Currently there is a bill, which stipulates the extension of the amnesty period for one more year, pending in the State Duma of the Russian Federation.

Submission of Notice of CFC

In view of the above mentioned, it can be noted that taxpayers enjoy the most favorable conditions for refusal to use foreign companies in their business for the purposes of optimization of taxation.

A shareholder or a member of the foreign entity may exercise the capital amnesty by specifying the foreign entity in a special declaration and therefore, get a guaranteed relieve of liability for violations committed before January 01, 2015. After that he/she may submit a notice of a foreign entity (if it has not been done within the established deadline) and then decide on liquidation of the foreign company upon the receipt of the company property without paying the individual income tax.

If the shareholder (member) of a foreign entity does not intend to terminate the company activity and is deemed a controlling party of a controlled foreign company as of December 31, 2016, such taxpayer shall submit the notice until March 20, 2017.

The deadline for notice submission is justified by the fact that taxpayers, which have been deemed controlling parties, shall take into the account retained earnings of the controlled foreign company for the first time at determining its tax base for financial year 2016, if the financial year of the company is determined as from January 01, 2015 until December 31, 2015. The controlling party must take into the account the retained earnings of the foreign company for the first time at determining its tax base for 2016 and accordingly, submit the notice of controlled foreign company not later than on March 20, 2017.

In order to determine whether the taxpayer is a controlling party, a combination of the two following conditions is necessary:

1. The shareholder (member) of the foreign company must be a tax resident of the Russian Federation.
2. Meet the criteria established by tax legislation:
   - Participation interest in a foreign entity exceeds 25%;
   - Participation interest in a foreign entity (for individuals — together with their spouses and minor children) exceeds 10%, if the participation interest of all persons deemed tax residents of the Russian Federation in this entity (for individuals — together with their spouses and minor children) exceeds 50%[5].

The controlling party of the foreign entity shall also be deemed a person, whose participation interest in the entity fails to comply with the conditions expressed in fractions of participation interest, but who at the same time exer-

5. Clause 3 of Article 25.13.

cises control over such entity for his/her own benefit or for the benefit of his/her spouse and minor children.

In order to apply the exemption of its profit from taxation, the taxpayer being the controlling party of the foreign entity shall submit to a tax authority together with the notice of controlled foreign company documents confirming compliance with conditions for such exemption.

Documents confirming compliance with the grounds for tax exemption of the profit of the controlled foreign company may be as follows:

- Tax accounts of the controlled foreign company for the relevant period;
- Calculation of the effective taxation rate of income (profit) of the controlled foreign company and average weighted rate of tax on profit of entities determined pursuant to Article 25.13-1 of the Tax Code of the Russian Federation;
- Certificate of tax residency of the controlled foreign company for the relevant period.

If the profit is not subject to tax exemption, the taxpayer (controller) shall submit tax returns on the tax in determination of the tax base, on which the profit of the foreign company controlled by this person is taken into the account, together with the following documents:

- Financial statements of the controlled foreign company;
- Auditor's report on financial statements of the controlled foreign company.

The profit of the controlled foreign company shall be taken into the account in determination of the tax base for the tax period on the relevant tax, if it exceeds 10 000 000 rubles[6].

The following increased minimums of profit of the controlled foreign company, which are not taken into account in returns on the applicable tax, have been established for the transition period:

- For 2015 — 50 million rubles;
- For 2016 — 30 million rubles.

In summary of the above mentioned, we can say that now all owners of foreign assets in the form of shares or participation interests in foreign companies face a dilemma: to liquidate a controlled foreign company and use preferences on tax exemption of income received as a result of such liquidation or annually submit to the tax authority financial statements of the foreign company and pay taxes from retained earnings of the company to the Russian budget.

There is still time to make a decision, and such decision will be a personal choice of everybody.

Major dates

- June 15, 2015 — Notice of Foreign Company.
- January 01, 2017 — deadline for decision on liquidation of the company.
- March 20, 2017 — Notice of CFC.
- April 20, 2017 — submission of tax returns on individual income.
- January 01, 2018 — liquidation of the company in order to use the tax preference (the deadline may be extended for objective reasons.

6. Clause 7 of Article 25.15 of the Tax Code of the Russian Federation.

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