Dateline-Russia

Automatic Information Exchange with Russia: Conditions and Implications

Author: KIRILL VIKULOV

Kirill Vikulov, PhD, is a Senior Associate with Baker & McKenzie, Moscow, Tax Practice. Members of Baker & McKenzie are frequent contributors to the Journal.

The "deoffshoring" of the economy and bringing holdings of businesses from various offshores back to Russia has become the most important tax trend. Experts continue to argue about the core objectives of this process: "a campaign against offshore companies," "increase of budget revenues by raising additional tax income," "repatriation of assets to Russia," and so on. It is obvious that "deoffshoring" covers a range of state goals and developments of various laws (e.g., tax, currency control and anti-money laundering regulations, government procurement). As various ministries generally work on laws within their authority and do not always pursue the same goals, "deoffshoring" may have multiple directions. This multidimensional model is yet to be embedded into the current economic environment.

Despite being radically different and more complex, many "deoffshoring" measures were copied from their foreign equivalents and incorporated into the Russian legislation within a very short timeframe. Their revolutionary nature is explained as an attempt to understand and, in certain cases, affect legal relations existing outside the Russian territory where the Russian authorities have limited or no control. Controlled foreign company (CFC) rules are a good example of such "ex-territoriality." Thus, the major challenges for Russian tax authorities will be receiving information on foreign income (profits) and assets of Russian persons and a correct interpretation of this data for tax audit purposes.

Current Experience in Receiving Information From Abroad

The main sources of information on foreign income and assets are currently (1) from taxpayers themselves (e.g., in tax returns, reports on opening foreign bank accounts and turnover balances) and some publicly available information; (2) from tax audits of Russian subsidiaries and counterparties; and (3) results of information exchange under tax treaties. The latter information flow has increased drastically over the past few years. A fair share of the 5,000 information requests that the Russian Federal Tax Service sends every year is used against taxpayers in litigations.

However, exchange of information on request is a sort of manual command not capable of covering vast numbers of Russian businesses and their foreign assets. Hence, the Russian tax authorities have high hopes for the Multilateral Competent Authority Agreement on the Automatic Exchange of Financial Account Information (AEoI), signed on May 12, 2016, and for the country-by-country reporting for transfer pricing purposes (CbCR). Since the CbCR will apply only to major multinationals, many Russian taxpayers are concerned mostly about the AEoI. The AEoI is based on the Common Reporting Standard (CRS) that should allow tax authorities (including Russian tax authorities) to receive information automatically on foreign financial accounts directly or indirectly (through intermediary companies) held by individuals who are Russian tax residents.

More than 100 states, including many offshore, have either activated or committed to activate the automatic exchange of financial information. The list of participating jurisdictions includes EU members where major banks and financial institutions used by Russian businesses keep their assets (e.g., Switzerland, Germany and Austria). Russia has committed for the first information exchange by 2018. Respective draft legislation has been published recently and is being discussed currently. However, the CRS information may not flow immediately. Russia will need to agree on the mutual application of the CRS with each participating country and, at this point, certain difficulties may arise.

Scope of the AEoI

A wide range of "Financial Institutions," including banks and brokers, as well as "Investment Entities" (this category may include ordinary private offshore companies and increasingly popular private trusts and foundations if they are managed by an Investment Entity and are investing in securities and other financial assets) are required to collect and provide automatically (without requests) information on the "Financial Accounts" to their local authorities. Sheltering behind a company or a trust is no longer possible due to the look-through effect of the new rules: disclosure occurs up to the individual-the beneficial owner of the Financial Account or the controlling person of a company or a trust with such account ("Reportable Persons").

CRS is known primarily for disclosing information on bank accounts, which is only partially correct since the disclosure covers a broad range of "Financial Accounts." Apart from bank and broker accounts, this group includes nominee accounts (e.g., depositary accounts) as well as shares or participation interest in Investments Entities (including private companies managed by professional corporate administrators, e.g., private offshore companies with discretionary accounts in foreign investment banks) and debt

interest, which is sensitive information that individuals prefer not to share with anyone. Thus, the AEoI covers practically all types of foreign financial assets.

The application of the CRS to individual accounts is quite clear. They have been subject to disclosure by Russian individuals for a long time. Income from personal individual accounts (deposits) is included directly in individual tax returns. Turnover reports on these accounts have been introduced recently. The automatic disclosure of information on foreign bank accounts may allow the Russian authorities to prosecute individuals who have overestimated bank secrecy or forgotten to pay Russian taxes on foreign source income. In addition, there is no guarantee that only tax liability (20%-40% penalty plus late payment interest) will apply. Russian currency control laws operations penalize several transactions not normally restricted in the EU, e.g., receiving income from securities trading directly via individual foreign bank accounts and not via local (Russian) banks. Nothing in the Russian laws would currently preclude using the CRS data to impose severe penalties up to 100% of the amount of such illegal currency transfers.

However, for a long time now, a significant part of the investments and commercial activities of Russian businessmen has been held or orchestrated through foreign companies rather than directly. The use of entities limits commercial risks to the investment amounts and gives access to more flexible and predictable foreign law and foreign courts ensuring asset protection. Besides, the use of foreign companies allows for maintaining a high level of confidentiality for holding assets, which is often crucial for businesses to reduce hostile takeovers, corruption, and other risks still existing in Russia. The AEoI will decrease confidentiality substantially. Disclosure will cover Russian individuals-"controlling persons" that hold directly or indirectly the majority vote or determine the decisions of foreign companies' executive bodies (i.e., ultimate beneficial owners (UBOs) for know-your-customer (KYC) purposes).

Information covered by the AEoI will not be limited to the personal information on the owners of Financial Accounts or controlling persons of foreign companies (i.e., names, addresses, dates of birth and tax IDs). Account balance, income, or the value of financial assets (including value of shares in private companies consolidating financial assets) at year-end will also be disclosed as part of this "turning out pockets" process. This information may be compared with assets and income reported in Russia. The Russian tax authorities announced explicitly that they plan to run these automatic comparisons. This is likely to lead to tax audits for individuals, resulting in heavy tax assessments.

Foreign banks and other financial institutions have already started verifying information on their clients. Many Russian clients received requests to confirm disclosure of information on holding foreign companies/CFCs or requests regarding whether their current holding structures meet local tax laws. Banks and other financial institutions serving millions of clients will be forced to maximize the automatic collection and processing of information, and are unlikely to consider specific features in non-typical situations resulting in identifying several clients/controlling persons and imputing the whole amount of income or assets of a foreign passive company (structure) to each of these persons for information exchange purposes. This may well result in conflicts between the taxpayers and tax authorities, who may be willing to assess additional taxes based on this over-simplified data.

Conditions for Russia to Participate in the AEoI

It is no secret that high-tax jurisdictions (France, Germany, Great Britain) initiated the AEoI and that historic financial centers are less willing to draw on their banking and tax secrecy. Although the majority of countries have joined the Multilateral Competent Authority Agreement on the AEoI under pressure from the G20, certain jurisdictions, including Switzerland, require passing additional requirements by other countries to be accepted as information exchange partners. Apart from the EU, Switzerland already has agreements with other states and is conducting consultations on this with Russia. Singapore declared that it is ready to exchange financial information with those states that sign bilateral treaties.

Can states refuse to exchange information automatically with Russia? The conditions that the AEoI set include confidentiality and security of tax information ensured by the state. However, this is not about isolated information leakages or various law abuses by state officials; it is about the confidentiality and security of the IT systems against hacker attacks. The Russian tax authorities are using advanced technologies and have already obtained respective certification in relation to the AEoI.

EU states have inherent responsibility to meet requirements of the EU Convention of Human Rights, which is at the core of the information exchange. **1** The Convention imposes a minimum standard for jurisdictions that participate in international relations, which is translated into domestic laws. For example, under the national laws of Switzerland, AEoI agreements may be signed only with states that meet the minimum constitutional requirements: (1) national legislation and law enforcement comply with the European Convention on Human Rights and International Covenant on Civil and Political Rights; and (2) the state ensures a fair trial. **2** Other EU countries e.g., the UK and Germany, also apply fundamental principles. In this respect, Russia may face substantial difficulties. The problem here is not so much related to the Magnitsky case or the Hague arbitrage decision in the Yukos case; **3** it is more in relation to the notorious decision of the Russian Constitutional Court not allowing the execution of judgments of the European Court of Human Rights. **4**

There is an evident trend for Russian courts to decide more cases in favor of the tax authorities. A substantial part of these cases involves foreign companies and the application of double tax treaties, including treaties with countries that could be future AEoI partners. Most of the notorious decisions have been entered in this area such as (1) application of the thin-capitalization rules covering "sister company loans" long before the respective amendments to the Russian Tax Code (the *North Kuzbass* and *Naryanmarneftegas* cases); **5** (2) treating a subsidiary as a permanent establishment of its parent (the *Oriflame* case); **6** and (3) tax withholding on payments to companies classified as "conduits" with no beneficial rights to income (the *Intesa* case). **7** In practice, these cases reversed the existing court practice.

All court cases have their own history and a complex set of facts, and need to be discussed in as much detail as possible. At the end of the day, it is up to the court to decide. However, there is evidently a negative trend. In a significant number of court cases involving MNEs, taxpayers have argued that the

tax inspectors read selectively and misinterpret not only the Russian Tax Code but also tax treaties, commentaries to the OECD Model Tax Convention, and OECD reports de facto treated as sources of interpretation in Russia. They also argue that the tax inspectors make little of transfer pricing and other documentation that corporations use globally and that tax authorities in other jurisdictions accept, as well as actual "substance" including office, qualified personnel, historic treasury, and licensing roles in the group. Court decisions do not usually comment on these arguments, or they are simply omitted, while a significant part of the court decision will relate to detailed argumentation on the affiliated nature of relations between the parties, having foreign parent companies, and payments abroad, which are not direct evidence of tax avoidance and are common for cross-border businesses. This creates an impression that not all of the taxpayers' arguments are taken into account and the principles of equality of arms and judicial impartiality, which are essential for a fair trial, are disregarded.

Can we conclude that the fair trail principle is being violated in Russia? It depends on the point of view. On paper, Russian legislation provides for equal procedural rights for the litigating parties. In addition, the courts are not really required to comment extensively on each taxpayer's argument. Busy court schedules should also be taken into account, which is not a problem unique to Russia. At the same time, certain universally acknowledged principles must be observed. Consistent ECHR practice indicates that court decisions should be reasonably motivated. The extent of this obligation should be determined case by case (*Garcia Ruiz v. Spain*). **8** Reasonable grounds to believe that the court did not properly consider all case materials (e.g., due to late submission of documents) or for any other reason may have ignored a party's arguments may result in reversing the court's decision (*Kraska v. Switzerland*). **9** Therefore, when delivering a judgment on the merits, the court must examine all the arguments of the parties, otherwise the decision may be challenged as lacking sufficient reasoning (*incogruenca omisiva*) (*Hiro Balani v. Spain*). **10** In fact, a lack of clear and logical reasoning even undermines the fairness of a trial on formal grounds as this should be the basis for the conclusion.

Requirements for examining thoroughly the parties' arguments should be even stronger for information received from foreign sources and requiring appropriate interpretation for tax purposes. For example, the Russian tax authorities argued that if a company is registered in Delaware (U.S.), Luxembourg, or another state, it should be included in the "black list" of offshores. In addition, there are [only] references to mass media stating that companies in these jurisdictions are often used for tax evasion. These types of arguments are often included in court decisions while the actual tax burden of the counterparties is not investigated.

Another example would be claims of noncompliance with the arm's-length principle. In these cases, courts rejected the expert opinions of international audit firms confirming the market level of the interest rates on loans, where the tax authorities were disproving exactly arm's-length dealings of the parties. It is important not to ignore such arguments from taxpayers. The tax inspectorates, as state authorities, have an advantage in any litigation and should be under stricter requirements to prove their position. The Tax Code puts the burden of proof on the tax authorities, but the criteria are increasingly blurred. Arguments from taxpayers disproving tax audit results must not be ignored. The court has a right to

request reexamination if there are reasonable doubts regarding the accuracy of the expert opinion or the qualification of the taxpayer's expert. This may contribute to a thorough examination of the case and may support the reasoning of the judgment. This is also true for the opinions of eminent scholars of international tax law, which are often used by foreign courts, including the ECHR. However, the Russian courts consider these opinions irrelevant to cases. In each of these instances, there is a critical issue of the lack of uncompromised and logical reasoning in court decisions. This is not a criticism of judges, but an indication of a fundamental flaw in the whole judicial system, which seems to have shifted from the above-discussed internationally accepted principles.

How can foreign states evaluate whether Russia meets the fair trial requirement? They will likely judge this from their own perspective, and may even be biased. It is no secret that international banking and holding centers, such as Austria, Luxembourg, Singapore, Switzerland, and others, compete for providing better investment protection to their investors, including those with Russian passports. They do this by decreasing the amount of commercially sensitive information being let out and reducing automatic exchange to the minimum acceptable G20/OECD standard. More simply, these states may now or later seek ways to avoid exchanging information with Russia.

Given the already challenging political environment, the drawbacks of the Russian judicial system may only make it worse. As money and liquid assets are fairly easy to transfer, a substantial portion of Russian individuals' undisclosed assets may end up in a jurisdiction that considers the Russian judicial system unfair for AEoI purposes. Even one such state will be sufficient. If, on this basis, a state refuses to exchange information under the CRS, it may also extend to CbCR reporting.

At the end of the day, the lack of reporting may have a direct impact on choosing locations for some Russian group's holding and financing companies to effectively avoid Russian tax control. Refusing to apply the CRS with Russia due to the lack of a fair trial may also challenge the existing information exchange on requests. This issue may arise while Russia is in discussions with the states to be included in their lists for automatic information exchange, e.g., with Switzerland or even later as states have a right to suspend the exchange if the relevant requirements are not met. Failing to do so may theoretically give rise to claims against such states exchanging information, if information is misused and results in damages to taxpayers. **11**

A state claiming its right to participate in international tax relations alongside developed states should have a developed tax system of its own supported by accessible law enforcement respecting fair trial principles. It should be important for Russia not to fail this test before the foreign states during the economic downturn. Otherwise, this boils down to a question of who should bear the increasing tax burden: workers by way of an increased pension age and compliant companies (investors) by way of increased taxes, or the tax-evading businesses sheltered in offshores that should be taxed and penalized by law. This discussion seems to be already building in Russian media around the recent high-profile law allowing dual-resident Russian individuals included in the sanctions lists in foreign states to not be recognized as Russian tax residents avoiding reporting on their wealth and avoiding paying taxes in Russia as of 2014. According to estimates of one of the members of Parliament, resulting

shortfall in taxes can reach 2-3% of the Russian state budget.

Russia clearly needs urgent tax and legal changes. The Russian President articulated this general instruction to Parliament previously. However, given the rapid evolution of international tax rules, Russia needs to improve significantly the quality of its tax administration and judicial system. Fair trials, impartial consideration of all parties' arguments, and a high level of court reasoning may prove to be a worthy goal and an opportunity to regain trust of individuals and businesses. Otherwise, the inherent drawbacks of the judicial system may become fatal for foreign and Russian private investments, and fiscal authorities will deprive themselves of the opportunity to identify tax violations based on the AEoI and effectively repatriate assets to Russia.

1 Directorate-General for Internal Policies, "Overview of Legislation Practices Regarding Exchange of Information Between National Tax Administrations in Tax Matters" (2015), section 8.2, www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU(2015)563452.

2 Matteotti, *Verfassungskonformitat des automatischen Informationsaustauschs*/Constitutional Grounds for Automatic Exchange of Information in Switzerland (2015).

3 See U.S. Treasury, Office of Foreign Assets ControlSanctions Actions Pursuant to the Sergei Magnitsky Rule of LawAccountability Act of 2012, 82 Fed. Reg. No. 9 (January 13, 2017), page 4460; Altenkirch and Frohloff, "The Hague District Court Sets Aside Yukos Awards," Global Arbitration News (Baker & McKenzie), April 26, 2016.

4 See Kleimenov, "Judgment of the Constitutional Court of the Russian Federation No. 12-P/2016: Refusal to Execute Judgments of ECHR or the Search for Compromise Between Russian and International Law?," QIL (October 31, 2016).

5 See Baker & McKenzie, "Russian Thin Capitalization Rules Revised" (February 2016).

6 See Mortier, "The Russian Permanent Establishment: A Trap for Foreign Distributors?," IBFD European Taxation Journal (December 2015), Thomson Reuters/Checkpoint.

7 See Kogut, "Russian Arbitration Court Rules Tax Treaty Benefits Cannot Apply to Interest Income Received by Foreign Company That Is Not Beneficial Owner of Income," IBFD Daily Tax News Service (April 29, 2016), Thomson Reuters/Checkpoint.

8 See www.tandfonline.com/doi/abs/10.1080/13642989908406832.

9 See http://echr.ketse.com/doc/13942.88-en-19930419.

10 See http://hrlibrary.umn.edu/undocs/1021-2001.html.

11 Note 1, *supra*, page 38.