Trusts for Russians

Olga Boltenko on the use of common law trusts by wealthy Russians

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The common law concept of the trust is alien to the Russian law. However, Anglo-Saxon common law trusts are often used by well-to-do Russians as a wealth management tool. A typical real-life scenario is when a wealthy Russian individual, often resident for tax purposes in Russia, sets up an Anglo-Saxon trust in one of the international financial centres, such as the Bahamas, the Cayman Islands, the Channel Islands, the Isle of Man or Bermuda. Even when such an individual is tax resident elsewhere, he often has Russian-based assets or family members.

Setting up a trust in any of the above scenarios poses a number of questions, such as the validity of the transfer to a trust in light of the Russian forced heirship rules and also of deemed communal properties of spouses. Tax issues on various stages of 'life' of trust – namely at the moment of transfer of assets into a trust, during life of a trust and at the moment of payment to the beneficiaries of the income and repayment of the capital – present particular challenges.

Despite the fact that trusts are very often used by Russians in practice, analysis of Russian legal consequences of such practice has received surprisingly little attention from legislators and practitioners.

Lack of tax guidance can be partially explained by the fact that Russia is a country with a history of non-tax compliance and although tax is in the spotlight of the Russian government (no surprise here), offshore companies are outside the radar of the Russian taxman (Russia does not tax deemed income of foreign legal entities), so are the trusts.

Misleadingly, Russian civil law has a concept of 'trusted management' (*doveritelnoe upravlenie*), which is often (erroneously) translated into English as 'trust', however, the Russian concept of trusted management and the Anglo-Saxon common law trusts are based on different principles, have different natures and different characteristics and are used for different practical purposes. Hence, the existence of Russian trusted management does not provide any help regarding the Russians' understanding of the use of trusts.

This article attempts to look into current tax issues regarding use of a trust set up by a Russian tax resident individual.

Establishment of a common law trust: tax treatment

Many experts believe that if a transfer of the legal title from the settlor to the private trust is carried-out free of charge, from a Russian law perspective, the transfer is likely to be characterised as a gift made by the settlor to the trust. Such transfer gives rise to the following tax consequences for the settlor, the trust and the beneficiaries of the private trust.

(a) The settlor

(i) There is no inheritance or other gift tax on the gift made by the settlor to the trust. Under Russian law, tax is only paid by a Russian resident recipient of a gift.

(ii)There is no income tax/capital gains tax charged on any gain realised by the settlor, as there is no actual gain realised by the settlor and under Russian tax law there is no deemed disposal at market value of an asset at the time when a gift of the asset is made.

(iii) There is no VAT on the transfer of the assets by the settlor as the settlor in his capacity as a private individual will not be VAT payer.

(b) The trust

Russia has not signed the *1985 Hague Convention on the Law Applicable to Trusts and on their Recognition*. Further, Russian tax residency is still defined only by reference to incorporation of a legal entity and not to its effective management and control.

Russian tax law distinguishes tax obligations of Russian tax residents and Russian tax non-residents. Russian tax non-residents pay Russian tax only on Russian-sourced primarily passive income, such as dividends, interest, royalties, etc. The full list is set up in Article 309 (1) of the *Russian Tax Code* and the transfer of assets from an individual to the trust in principle does not fall into that list. Therefore, we consider that it is unlikely that Russian profits tax will be imposed on the receipts of the assets by the trust from the settlor.

(c) The beneficiaries of the private trust

There should be no Russian personal tax liability imposed on beneficiaries of the private trust at the time of the transfer of the assets into trust for the following reasons.

The liability to Russian income tax arises in a Russian resident taxpayer at the moment when the income accrues to them and they have a right to dispose of that income for value. On the basis that the Russian tax regime will not recognise rights in equity or otherwise look behind the legal title at the time when the assets are transferred to the private trust, a beneficiary (either under a fixed interest trust or under a discretionary trust) does not receive any cash or other assets capable of being realised for value and, therefore, no Russian income tax liability should arise.

Ongoing liabilities and obligations of the trust

A Russian tax liability with regard to income or gains received directly by the trust may arise in the trust only in the two following cases – if

the trust (i) has a permanent establishment (PE) in Russia or (ii) receives passive income from Russia.

(a) The PE is a tax status, which is attributed to a foreign company's presence in Russia. The essential requirement for a PE to appear is that some form of recurring business activity is carried out from a fixed location in Russia, which has some degree of permanence. PEs are taxable on both Russian-source and foreign-source income related to the PE. As discussed above, in light of the fact that Russia is not a signatory to the Hague Convention, even if a trust has Russian-based trustees and/or protector, provision of the trust services should not lead to establishment of a PE of the trust in Russia.

(b) If the trust receives passive income from sources in Russia, it is subject to a withholding tax in Russia. It is withheld by a payor company who acts as a tax agent. The rate of tax varies from 15 per cent on dividends to 20 per cent on other categories of income. In practice, however, in order to reduce Russian withholding taxes on the passive income of a trust, such as dividends, interest and royalties, an intermediate holding company is interposed between the trust and the Russian operational company in a treaty jurisdiction (Cyprus, the Netherlands and Luxembourg are the most popular choices).

There will be no Russian tax liability in the trust itself in respect of income received by an underlying holding entity. Nor will there be any Russian tax liability in the trust in respect of non-Russian source income, such as a dividend received by the trust from a non-Russian company.

Liabilities and obligations of the settlor

There is no guidance available as to the taxation of settlors. In the absence of any special provisions, general provisions of Russian law should apply. We believe that under current Russian tax law and practice a settlor and a beneficiary will be viewed as different parties. Each of the transactions – transfer of assets into the trust and payment of income or capital to a beneficiary – will be viewed separately. The fact that a settlor and a beneficiary may be the same person is irrelevant.

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Specifically, once the settlor in his capacity as a settlor ceased to be the legal owner of the assets, he (a) has no ongoing Russian tax liabilities in respect of the income and/or gains of the private trust and its underlying holding entities arising from those assets; and consequently, (b) has no ongoing reporting and disclosure obligations to the Russian tax authorities regarding income and/or gains of the private trust and the underlying holding entities.

Liabilities and obligations of the beneficiaries

The *Russian Tax Code* does not provide for a specific regime for the taxation of income or capital received from trust. Further, there is no division under Russian law between taxation of income or capital.

Therefore, in order to determine how the beneficiary will be taxed, we need to apply the general principles of the *Tax Code*. Article 41 of the *Tax Code* provides a general definition of income: it is defined as any economic gain in money or in kind. Specifically, taxable income received by a private individual is determined in accordance with the provisions of Chapter 23 of the *Tax Code* on Personal Income Tax. The tax base is defined in Chapter 23 as all income a taxpayer has received both in cash and in kind or the right to dispose of which he/she has acquired and also income in the form of benefits-in-kind (Article 210 of the *Tax Code*). A Russian resident beneficiary is subject to Russian income tax on his worldwide income. He has to declare such income and pay income tax himself in the usual way.

Importantly, Russian tax law does not define the 'capital' category and there is a substantial risk that a distribution of trust capital to the beneficiary will be taxable as 'income' in the hands of the beneficiary at the rate of 13 per cent.

Future developments

The Russian tax treatment of a common law trust structure is unclear and difficult to analyse. The lack of relevant provisions taking the peculiarities of a typical trust structure into account makes the taxation consequence in Russia sometimes unjustified from the economic point of view.

However, the *Russian Tax Code* is developing fast. Presently, the concept of an Anglo-Saxon common law trust and correspondingly of a settlor, trustee and beneficiary, are neither defined nor clearly understood by the Russian tax authorities. Incidentally, some attempts were recently made by a Russian Ministry of Finance to apply the concept of 'beneficial owner' to the application of double tax treaties to dividends paid via a depository. The conclusion the Ministry of Finance reached in that instance is not directly relevant to the issue in question here. However, it indicates that equitable concepts and issues of the taxation of trusts might be addressed in the future so to provide a specific regime for the taxation of trusts.