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FISCAL GOALS OF REGULATING THE ACTIVITIES OF THE INSTITUTE OF CONTROLLED FOREIGN COMPANIES IN THE DIGITAL ECONOMY

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Abstract. At the OECD level, within the framework of taxation, relevant documents that directly concern the procedure for enhancing interaction and cooperation among its member states are being developed. The most important ones include the development of recommendations in the field of taxation of controlled foreign companies, including the study of current aspects in the event of a conflict between the provisions on controlled foreign companies and the concluded double taxation treaties. Meanwhile, in the study of the formation of the institute of controlled companies with regard to the manner of their formation and use of modern forms and methods of administrative control and tax liability, it is important to study actions in the sphere of international tax law. However, the emerging problems in this sphere are relevant, since, at the level of national legislation of each state, there are both objective and subjective factors that directly affect the formation of law enforcement practice on controlled foreign companies, with regard to a lack of scientific information in the context of national law. Therefore, in terms of improvement of the tax legislation of countries with developing economies that are reforming the institution of controlled foreign companies and supplementing them with new provisions which cover the basic aspects of the formation of taxation of controlled foreign companies in the digital economy, it is important to mention the urgent measures aimed at improving them, including ways of implementation and modernization of the rules and procedure for determining the profits of controlled foreign companies in terms of clarifying the list of passive taxes, as well as the composition of costs of such companies.

Keywords: tax residents; taxation in the digital economy; profit of controlled foreign companies; double taxation treaties

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1. Introduction

The development of the global digital economy creates new challenges in the field of taxation and accounting, especially in relation to the regulation of the activities of the institute of controlled foreign companies. The use of various approaches to assessing the financial and economic activities of controlled foreign companies (CFCs) can provide sound tax control from the point of view of fiscal administration. What it involves is full compliance with the stages of control and verification of data for such categories of taxpayers (Alm, McKee, 2004), since in this case, it is possible to ensure that the assessment is performed at the appropriate level. As the basic criteria, the volume of assets generated and the amount of profit received can be used, as well as other indicators in the form of floor space, the number of staff, etc.

When recognizing for tax reasons in a particular jurisdiction, it is important to understand the established list of active and passive income, since other things being equal, a clear border between them may be insignificant (in the opinion of Brown & Petersen (2009)). In this case, within a specific legal tax jurisdiction, taxpayers can manipulate the recognition of specific types of income (Comi et al., 2019), for example, when including in the tax base of a CFC the amount of profit received for ordinary activities or "conditional dividends" (Gryzunova & Ekimova 2018). Undoubtedly, this indicates significant problems that arise in terms of the qualification of income received under CFC within national jurisdiction, with regard to the current recommendations of the OECD, as well as subject to double taxation treaties.

2. Literature review

At the OECD activities level, relevant documents that directly concern the procedure for enhancing interaction and cooperation among its member states are being developed. In turn, an important stage is the development of tax rules for CFCs, including the development of recommendations in the case of contradictions between the provisions of the CFC and the concluded double taxation treaties (Perez-Alvarez et al., 2020).

The current provisions of the concluded OECD Convention include theoretical aspects of practical issues in the field of CFC taxation dealt with by economists and not fully developed. Thus, according to Porter (2003) studies, the legal rules of Luxembourg, Ireland, Belgium, and the Netherlands contain provisions contrary to the existing OECD conventions concerning the introduction of a permit for the taxation of CFC profits for persons being tax residents of third countries.

In turn, according to Becker et al. (2016) and Dzenopoljac et al. (2017), these provisions, introduced in the form of legal rules, are not restrictive for the parties to the transaction, as well as persons belonging to a CFC being tax residents in the case of taxation of third parties who are not tax residents of the mentioned states. Meantime, Arunraj & Ahrens (2015) research revealed an important component in relation to the CFC taxation procedure, since regardless of the effect of the residence factor of companies and individuals, the tax itself is calculated only in relation to the received amount of profit (Lehoux et al., 2018). These arguments are probably true. Therefore, the use of this approach for taxing the received amount of CFC profits in EU countries is irrespective of the parties to the transaction located in third countries, with respect to the existing double taxation agreements between the respective states and without the use of the right to tax the amount of "conditionally received dividends" (Abadie et al., 2004; Chae, 2015; Rahman and Bobkova, 2017).

It should be mentioned that in the context of digitalization of all spheres of the economy and taking into account the difficult macroeconomic situation in recent years, including the current one, primarily due to COVID-19, the problem of expanding the national tax law in relation to the taxation of CFCs (Edeigba et al., 2020) and narrowing the role of CFCs (Kiy & Zick 2020) arises for many states.

At least on a practical level, the existing double taxation treaties (DTTs) contain a reference to national legislation on the application of the right to income. This is about such countries as Canada (Article 91, Income Tax Law), France (Article 209, Tax Code). Simultaneously, exceptions on DTT are also contained in the tax laws of South Africa and Venezuela, Brazil, and Mexico. In this regard, in practice, the current CFC taxation procedure can be applied not only as a tool against "deferred taxation", as it was originally provided in the US legislation, and the goals and methods may be quite different. This is clearly stated in the OECD recommendations, since "they depend on whether a country adheres to the principle of export neutrality or import neutrality". Therefore, it is important to consider the further influence on cross-country relationships in the global digital economy when setting the ultimate goal of qualifying the recognition procedure for taxation of active and passive income at the level of national legislation.

3. Theoretical background

The study of the formation of the institute of controlled companies, taking into account the order of their formation and the use of modern forms and methods of administrative control in relation to the activities of CFCs, as well as implemented measures of tax responsibility, is an important aspect of the research performed by both theorists and practitioners in the field of international tax law. However, the emerging problems in this sphere are relevant, since, at the level of national legislation of each state, there are both objective and subjective factors that directly affect the formation of law enforcement practice in relation to CFCs, with regard to a lack of scientific information in the context of national law.

The global digital economy cannot be imagined without interconnected relations with major corporations (Korableva et al., 2018). In particular, the annual growth in the number of multinational corporations in the world that produce a significant number of goods (works, services) has significantly increased. Based on practical research data from Forbes' current rating of The World's Largest Public Companies, the top 100 largest multinational companies (MNCs) in the world for 2018 included 4 Russian companies: Gazprom, Sberbank, Rosneft, and Lukoil. The leading positions are occupied by MNCs that are actually located in the territory of the United States (30 corporations) and the PRC (21 corporations).

The current processes of economic integration directly concern the legislation of each country, on the basis of which financial relations are regulated with regard to the forms and methods of control over the activities of subjects of financial relations. Therefore, the current processes in the field of international finance should be controlled by the states, since this is necessary, first of all, in order to prevent tax violations. This is about increasing the potential for capital withdrawal to offshore jurisdictions and tax evasion by companies that operate in the international market (Fig. 1).

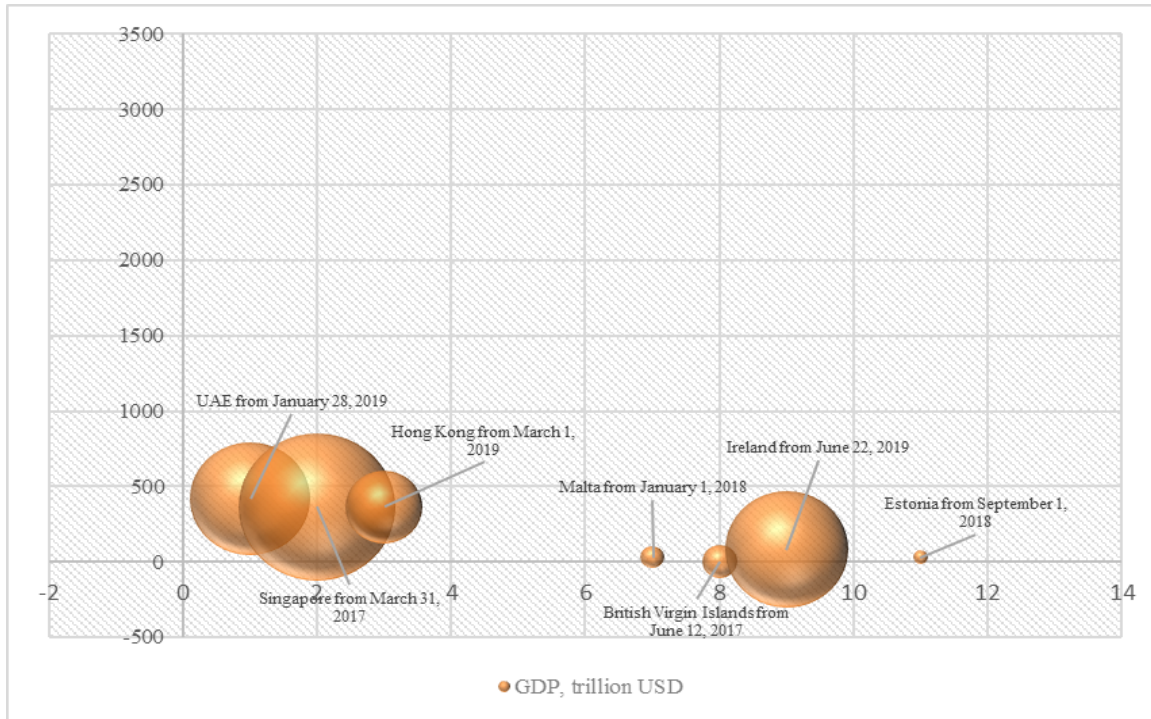


Figure 1. Comparative characteristics of separate offshore jurisdictions that maintain a register of beneficiaries and do not provide open access to the balance of current accounts about the final beneficiaries for 2019.

Source: Made by the authors based on information from <https://knoema.ru/atlas> and <https://www.audit-it.ru>

At the present stage, within the framework of globalization processes, there are stages on the way to the formation of special methods and forms of state financial control of such participants in financial relations. In the national tax practice, the appearance of provisions on CFCs since 2015 has had its own prerequisites both at the legislative level and in the form of economic grounds. At this time, like most countries, the Russian Federation initially provided the principle of separate taxation of profits received from organizations and shareholders/participants in the relevant legal entities, with regard to the principle of residency (Puryaev & Puryaev, 2020; Prodanova et al., 2019).

Thus, in Russia, as in the United States, when performing economic activities through the use of foreign companies, shareholders do not pay corporate income tax until this profit is distributed as dividends (until the amount of profit becomes the income of shareholders), or until the shareholders sell their shares in such a company. In this regard, before the adoption of the CFC tax rules, in Russia, in a similar way to the United States, the legislation allowed the possibility of evading national taxation through the creation of foreign companies with the participation of Russian shareholders.

In advanced economies, foreign company tax laws (CFC rules) are applied in various ways. Among them are: Australia, Great Britain, Germany, and the United States. In turn, the Russian rules for CFCs, which came into force in 2015, were constantly adjusted. Despite the more favorable nature of the amendments, the current approaches to CFC regulation have not been changed significantly, and adjustments have been made in respect of some shortcomings of the original version of the tax legislation.

Thus, within the framework of the national economy's deoffshorization being performed since 2014, the draft law on CFCs was a basic policy aimed primarily at establishing a mechanism for collecting and paying income tax in respect of controlled entities and companies (Abramova et al., 2014), as well as forming the procedure for recognizing legal entities as tax residents of the Russian Federation, with regard to the establishment of appropriate criteria, including the establishment of the procedure for "actual income beneficiary" when applying international double taxation treaties (Zhuravlev et al., 2019; Yemelyanov et al., 2020).

However, the peculiarity of the national legislation is that the profit received by a CFC is equal to the amount of profit received by the organization (individuals' income) recognized as the controlling person of this CFC. Meanwhile, the accounting for the CFC's profits is performed in accordance with the general procedure established by the provisions of national tax law, with certain features. The controlling entity includes legal entities or individuals with a share of more than 25% (before 2016 – 50%), or the participation rate of more than 10% if more than 50% of participating entities are recognized as tax residents of the Russian Federation. In certain cases provided by law, the CFC's profit is subject to tax exemption, in particular, if it belongs to non-profit organizations and is established in an EEU member state. In our opinion, the most relevant legal position is the procedure for calculating the amount of profit received within the CFC. For this, the following options for its definition are provided:

- 1) based on financial statements (subject to certain conditions);
- 2) according to the rules established for Russian companies based on the provisions of national tax legislation.

In determining the net profit received according to financial statements, it is important for taxpayers to comply with the following legal requirements: permanent location of the entity in relation to a foreign state with which the double taxation treaty is concluded or an audit report in respect of the statements without a negative opinion (refusal of opinion) is available. There are also certain types of legal requirements if the CFC's "personal law" does not establish rules for maintaining financial statements, or when a mandatory audit is not provided.

When determining the amount of profit received based on the application of national law, the necessary conditions must also be met for at least five subsequent tax periods. It is necessary to highlight that the amount of profit received from the CFC is subject to reduction by the amount of:

- 1) dividends paid in the current tax period;
- 2) tax paid in a foreign country. This operation should be document-wise, and if the Russian Federation does not have taxation agreement with the state (the location of the CFC), there should be provided a certification of the competent state authority.

The profit received from the CFC does not include the amount of profit aimed at increasing the authorized capital of the organization's participants. Another important aspect when establishing tax legislation in relation to CFC was the procedure for paying income tax on income received in the form of dividends from the CFC, if the amount of profit received from the corresponding CFC was previously reflected in tax return. In this case, taxpayers are required to provide regulatory authorities with payment documents confirming the payment of tax (Nagoyev, 2012).

Note that the established legal procedures related to the procedure for notification of participation in a CFC provide a general period for taxpayers – no later than 3 months from the date when the share of income received reached 10%. The opposite is also true: when the participation is stopped, the notification period will be the same. However, taxpayers are required to submit a CFC notification for the tax period no later than March 20 of the following calendar year. For its part, the tax service (if there is relevant information about such taxpayers) is obliged to send a corresponding request for explanations and notification about the CFC. Nevertheless, attention should be paid to the practical aspect of obtaining relevant legal information from Russian tax authorities in relation to the CFC, since the sources may include:

1. Information contained in the notice provided by the taxpayer.

2. Data received from the foreign competent authorities on the basis of an agreement on the exchange of tax information of the relevant state or on the basis of the OECD Convention on mutual administrative assistance in tax matters.

3. When tax control measures are implemented by the local tax services within the framework of inspections connected with the collection of relevant evidence. When identifying the fact of control over a foreign company, the procedure for identifying the actual circumstances indicating such control is crucial. The following can be used for this purpose: witness statements, the results of the request/seizure of documents, other sources of information.

In this regard, it is necessary to analyze the greatest impact of existing tax and legal aspects in the qualification of active and passive income when regulating the determination of profits in respect of CFCs and their accounting for tax purposes.

4. Results

Based on the special report of the OECD adopted in 2015 in the form of "Designing Effective Controlled Foreign Company Rules", the most difficult aspect is the need to develop uniform unified rules for CFCs while maintaining freedom in relation to EU member states and the ability to develop their own regulations with regard to national specifics.

Certain it is that the established uniform approach in the field of legal regulation of CFCs in the EU countries is manifested in most member states on the basis of provisions that define:

- (1) concept of CFC and controlling person,
- (2) procedure for determining the main elements in relation to the taxation of CFC profits.

The OECD Report highlights current legislative approaches to regulating CFC taxation, including several main approaches that have the most practical application. The first option is a jurisdictional one, according to which the CFC tax regime is applied to companies based on their location with regard to the formation of a "white list" and "black list". The first refers to territories with high-tax jurisdictions, the second – to offshore or low-tax jurisdictions where the level of applicable tax rates is lower or even applies a rate of 0%, compared to the state of the controlling person. The jurisdictional approach is used in Germany, France, China, and other countries (Andersson, 2019). However, these states have different views regarding the criteria for the exercise of low-tax jurisdiction. For example, in France, a difference of 50% of the effective tax rate is set, while in Brazil there is no such order.

Another option is transactional, that is, the CFC tax regime is applied based on the type of activity performed by the CFC and the type of income received by the relevant company. In particular, in France, there are rules according to which the regime under consideration will not apply to a CFC if it is engaged in industrial activities (in other words, business).

When conducting a comparative analysis between the EU states and the procedure applied in the national jurisdiction of the Russian Federation with respect to the rules provided by the current tax legislation, the ratio to any of the mentioned options (approaches) is incorrect. In this case, the term "mixed approach" is preferable. I.e., with respect to the application of the jurisdictional approach, the main provisions related to CFC will apply. Especially emphasize that the application of a mixed approach is more characteristic of the German tax system, where only the passive income of a CFC is taxed, but at the same time, this type of income will be taxed if the effective tax rate for this type of income in the country of location of the CFC is less than 25% of the rate set in the country (Savitskiy, 2015).

Within the framework of the analysis of the most significant areas, with regard to the procedure for improving national legislation in the field of taxation of CFCs, it is important to highlight that significant changes have been made since 2019, which directly affected the current procedure for determining the profit of CFCs. In this regard, these provisions will be applied by the business for at least the next five tax periods, starting from 2020, so it is important to mention the most important ones. Since a number of changes have been made to the tax legislation in recent years related to the adjustment of the current procedure for applying the CFC rules in the field of taxation, these innovations, based on current practical experience, are harder in relation to the taxpayer, since they only increase control over it.

Within the main directions for improving the current legislation in the field of CFC taxation in the Russian Federation, it concerns an important provision in the procedure for determining CFC profits. Until the tax period of 2019 in determining the profits of a CFC, the income received in the form of dividends sourced from the Russian organization were not considered, but it was required to comply with the mandatory conditions: the controlling person for such a CFC should have had the actual right to dividends.

Based on changes made since 2019, when determining the profit of a CFC, the amount of passive income from Russian companies was not taken into account, if their actual recipient was a person controlling the CFC. The list of passive income includes loan interest, as well as royalties from the use of intellectual property.

As a comparative characteristic, the changes in the current tax procedure for CFCs will be considered through the example of Austria, which came into effect in 2019 relative to adjustments made for passive income received. The current CFC rules provide the inclusion of income in the tax base of an Austrian corporate shareholder who directly or indirectly owns a controlling stake in a foreign enterprise if such an enterprise generates passive income with a low level of taxation (offshore jurisdictions). However, tax control is performed if the Austrian company owns, directly or indirectly, with its subsidiaries more than 50% of the share rights or capital. The following types of CFC passive income are subject to mandatory inclusion in the tax base of the Austrian parent company from 2019, namely:

- 1) interest or other income from financial assets;
- 2) royalties or other income from intellectual property;
- 3) dividends and income from the disposal of shares;
- 4) income from financial leasing;
- 5) income from insurance, banking, and other financial activities;
- 6) income received when invoicing companies that receive income from the sale of goods (services) purchased and sold to associates, that do not contain their own added value (economic value) in their cost. In this regard, the list of passive income in the Russian and Austrian tax systems is different (Fig. 2).

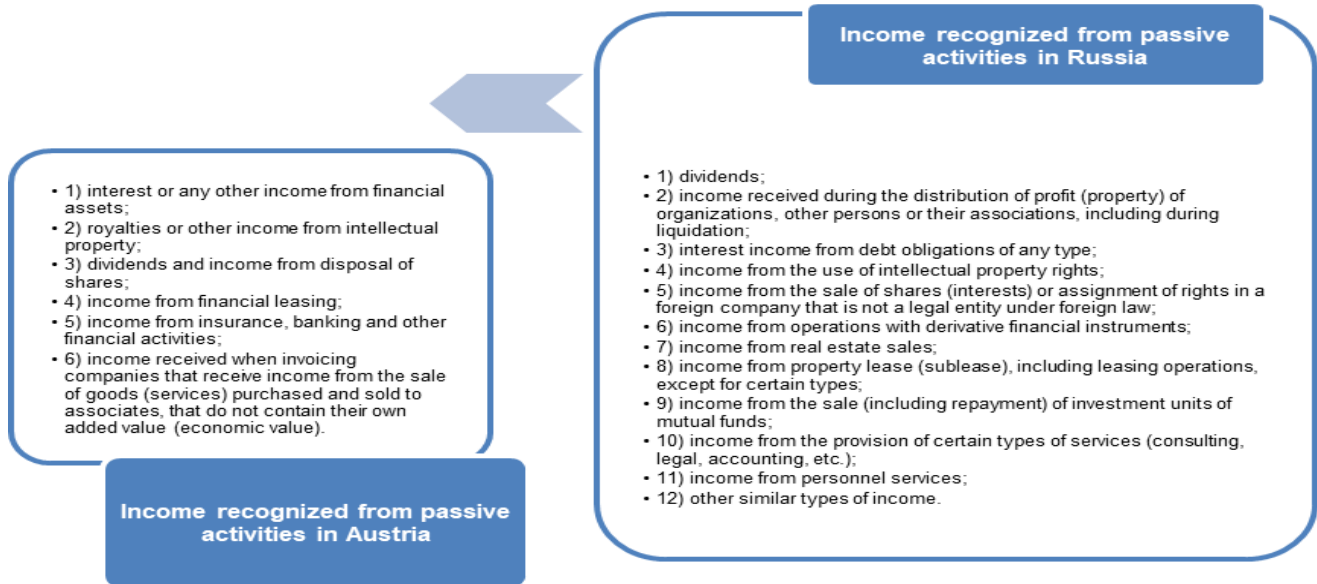


Figure 2. Comparative analysis of the types of income recognized from passive activities when making a CFC profit

Source: developed by the authors

5. Discussion

One of the important directions for improving the tax legislation in relation to CFCs is the inclusion of "capital amnesty" in the legal doctrine. This refers to the return to the national jurisdiction of the income of persons who do not live in the country for any reason (Almas, 2012). Nonetheless, according to Akamah et al. (2018), the tax incentive is the right for such categories of persons not to pay tax on the CFC's profits under the defined conditions.

A new direction in the studies of Coolidge (2012) is that in the case of a voluntary provision of CFC tax return by its controlling person (entity), the taxpayer will be exempt from penalties caused by delayed reporting. Besides, guarantees regarding the preservation of the CFC will be provided (apart from disclosure) if the CFC changes the country of registration, preserving all existing business relationships within specific jurisdiction through the procedure of re-domiciliation.

Therefore, in the authors' opinion, such a CFC can be registered as an international holding company (hereinafter IHC). However, with respect to statutory provisions, such a company shall make an investment in the national economy in the amount of not less than the threshold value (not less than 50 million rubles) within at least six months from the date of state registration of the respective company as an IHC. In this case, the capital amnesty procedure is a voluntary declaration in relation to a CFC, with regard to the provision of guarantees of exemption from penalties after redomiciling (Ferziger, 2013).

The conducted research aimed at improving the tax regulation of CFC activities has an important goal of stimulating the redomiciliation of CFCs into national jurisdiction only in special administrative regions located on Russky Island (Primorye Territory) and Oktyabrsky Island (Kaliningrad Region) for the purpose of obtaining the IHC status. It is important to take into consideration that, in practical terms, the redomiciliation procedure is possible not from all states (Leoncini et al., 2020). In particular, a company registered and operating in the territory of the British Virgin Islands (so-called BVI companies) cannot be re-domiciled (change of jurisdiction) to the Russian Federation directly. However, this is possible from other jurisdictions, for example, Cyprus (Akhmadeev et al., 2016; Akhmadeev et al., 2019). Therefore, in practical terms, it is possible to implement a two-stage redomiciliation from the British Virgin Islands through the jurisdiction of Cyprus.

Conclusion

According to the results of the study, it can be concluded that as part of improving tax legislation, countries with developing digital economy are reforming by adding new provisions regulating the basic aspects of the formation of CFC taxation. As for the Russian Federation, the main directions are to clarify the tax legislation for a more practical determination of the amount of profit received by a foreign company calculated in accordance with financial statements based on the company's personal law for the corresponding financial year. The term "personal law" originally referred to the operation of the legislation of the state, at the place of incorporation of the legal entity. At the same time, the profit received by a foreign company in foreign currency must be recalculated for the period based on the average exchange rate of the Bank of Russia. According to Bykanova et al. (2018) and Lehoux et al. (2019), this approach implied the formation of basic approaches to DE offshorization of the economy, according to which, the Russian legal doctrine established for the first time that the profits of foreign companies owed to Russian shareholders could be taxed even before the distribution as dividends (Ghosh & Maji, 2015).

An important tax change for taxpayers is also the consideration of the practical situation when interacting with offshore jurisdictions. These are cases when a CFC is registered in the territory of the relevant offshore territory and does not submit financial statements, and does not pay taxes. In this case, the CFC will not have the right to reduce the calculated profit tax. This approach of regulatory authorities has been analyzed when considering the general procedure for the interaction of companies with offshore jurisdictions and the list of states and territories that do not provide information exchange with national states for tax purposes is updated annually at the legislative level. In this regard, the following are the priority measures aimed at improving the legislation in the field of taxation of CFC activities.

First, the modernization of the rules and procedure for determining the CFC's profit in terms of clarifying the list of passive taxes, as well as the composition of the CFC's expenditures.

Second, the list of states and territories that do not exchange tax information with other jurisdictions should be periodically updated.

Third, the use of capital amnesty in the framework of voluntary provision of tax return of a CFC by its controlling individual, which will allow such a person (subject to a number of conditions) to be exempt from penalties that were caused by a violation of the reporting terms.

Fourth, the elimination of inconsistency of CFC rules in the EU countries, since the legal regulation of various areas of taxation reveals a trend leading to the gradual rejection of tax sovereignty in the European economic community, and against the background of quite consistent and successful unification of EU tax rules in specific areas, the problem of inconsistency of CFC rules in the national jurisdictions of EU member states remains unresolved and urgent. Therefore, the pursuit of a fiscal goal by the state in terms of regulating CFC legislation is

acceptable in the short term, while in the long term, it may have a negative impact on the country's economic development and, as a result, on the development of the digital economy in general.

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