



## **New Protocol to the Cyprus- Russian Federation Double Tax Treaty**

TAX UPDATE

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## Introduction

On 16<sup>th</sup> April 2009, government representatives from both Cyprus and the Russian Federation signed a protocol to the 1998 double tax treaty between the two countries. The protocol is expected to come into effect on 1<sup>st</sup> January 2010 subject to its ratification by both governments in 2009.

Advantages of the new protocol include the removal of Cyprus from the Russian blacklist which means that dividends received by Russian companies from Cyprus subsidiaries will finally be able to qualify for the Russian dividend participation exemption. With the removal of Cyprus from the Russian blacklist, the Russian government no longer views Cyprus as an ‘uncooperative territory’ being the ground for originally placing it on the list which includes 53 countries.

## The Changes introduced by the Protocol

The favourable zero rates of withholding tax currently applicable on interest and royalties have remained unchanged, while the maximum withholding tax rates of 10% have been reduced to 5% if the beneficial owner has directly invested in the capital of the company paying dividends a minimum investment equivalent to EUR 100.000 (this was previously USD 100.000).

The protocol has fine-tuned certain definitions in the treaty to accord with the latest OECD Model Treaty. ‘Dividends’ have been given a broader definition in the new protocol to include payments on shares of mutual investment funds or other similar collective investment vehicles and depository receipts for shares. ‘Interest’ has also been given a broader definition which now includes debt claims of any kind which may or may not be secured by mortgage and may or may not be profit participating loans (penalty charges for late payments or interest are not classified as interest but dividends).

Clarity has been provided on the procedure to be followed in the case where the ‘effective management’ of a person (other than an individual) cannot be determined. Under the existing 1998 treaty a person is considered to be a resident of the country in which the effective management is situated with the new protocol introducing a provision to the effect that if the effective management of a person cannot be determined, the competent authorities of the two countries will agree to reach a mutual decision on the matter at hand.

The definition of ‘Permanent Establishment’ has been expanded to include the taxation of profits from services performed in one country by an entity of another country through an individual(s) present in the other country exceeding in aggregate 183 days in any 12 month period.

A new limitation of treaty benefits article has been introduced disallowing benefits accruing to a company which was created for the specific purpose of obtaining such benefits provided that the company is not registered either in the Russian Federation or in Cyprus. This limitation will therefore not apply to companies incorporated in Russia or Cyprus but will likely impact companies not incorporated in Cyprus but which for the purposes of taxation are resident in Cyprus by having their management and control in Cyprus.

The nature of distributions from mutual investment funds has been clarified and the new protocol provides that such distributions are to be treated as dividends. This is a welcome change as dividends are subject to a maximum

withholding tax of 10% whereas under current Russian law, distributions from mutual funds are subject to a 20% withholding tax.

The most substantial change introduced by the new protocol to the treaty has been in relation to the taxation of capital gains on the sale of shares in companies which hold more than 50% of their assets in Russian immovable property. This new provision was inserted to ensure alignment with the latest OECD Model Treaty with the gains from the sale of shares now being taxable in the country in which the immovable property is situated, (therefore the Russian Federation where they will be taxable and not Cyprus where they would be exempt). The above provision does not include gains from the alienation of shares listed on an approved stock exchange or from a corporate re-organisation and further does not include gains derived from a pension fund, provident fund or from the governments of either the Russian Federation or Cyprus.

This provision will come into effect until 4 years after the protocol is ratified by both governments, therefore the earliest date being in 2014 if the expected 2009 ratification takes place. Tax planning structures may be proposed upon request to clients with the purpose of mitigating the tax implications of this change.

#### Exchange of Information between Cyprus and the Russian Federation

The provision on the exchange of information in the 1998 treaty has been revised with wording almost identical to article 26 of the latest OECD Model Treaty. The inquiring jurisdiction may request a confirmation of identity of a person under investigation as a beneficial owner of a company but may not inquire as to the identity of a beneficial owner of a particular company without having submitted identification. This means that while a confirmation may be obtained, an inquiring jurisdiction is not permitted to commence a fishing expedition on an individual. This position has been also established in Cyprus' domestic legislation, Law 72(I)/2008 (the 'Law'). In accordance with the Law the inquiring country must provide the Commissioner of the Inland Revenue Tax Office of Cyprus (the 'Commissioner') with (among identification of the individual under investigation and other stipulated matters), the tax reasons and evidence why the requested information is required. A declaration from the inquiring country must be provided to the Commissioner, that the request for information is in accordance with its domestic legislation and administrative practice and the Commissioner will not release the requested information unless he/she has been satisfied of that respective disclosure is also permitted under the laws of the inquiring jurisdiction.

Finally, the Commissioner shall not by Law provide the requested information unless the written consent of the Attorney General of Cyprus has been applied for and has been obtained.

#### Conclusion

While there have been various amendments to the 1998 Cyprus-Russia double tax treaty, these amendments are not considered substantial enough to affect the current flow of investments between the two countries. The effects of the only major amendment being the capital gains tax amendment to be introduced in 2014 can be limited by seeking timely tax advice. The exchange of information provisions do not substantially alter the current position and the nature of the inquiry will be in the form of a confirmation request rather than in the form of a request for information. The treaty remains the most favourable concluded by the Russian Federation and retains the attractive 5% withholding tax on dividends for investments equivalent to EUR 100.000. All in all, the protocol, contrary to initial expectations, may indeed may foster the further growth of economic relations between the two jurisdictions.

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