NEW DOUBLE TAX TREATY BETWEEN CYPRUS AND RUSSIA

Introduction

On 16 April 2009, the Republic of Cyprus and the Russian Federation signed a Protocol ("the Protocol") to the 1998 treaty for avoidance of double taxation between the two countries. The protocol is expected to be ratified by both countries during 2009 and become effective from 1 January 2010 thus replacing the current Double Tax Treaty (DTT) between the two countries.

The new DTT, which has been largely based on the latest OECD Model Treaty, retains most of the favourable provisions of the current DTT between the two countries ensuring that Cyprus continues to be one of the most favourable jurisdictions for investments in Russia. At the same time Russia has agreed to remove Cyprus from its blacklist and hence dividends received by a Russian company from a Cyprus subsidiary can qualify for the Russian dividend participation exemption.

The most important provisions of the Protocol are the following:

Dividends interest and royalties

The rate of withholding tax on dividends will be 5% if the investment in the capital of the company paying the dividend is €100,000 or more, and 10% otherwise. The rates of the existing treaty are exactly the same however the minimum investment in order for the lower rate to be applicable is US$100,000.

No changes in the withholding tax for interest and royalties which continues to be Nil.

The definitions of dividends and interest have been aligned with the wording used in the OECD Model Treaty definitions. This allows the Russian tax authorities to use “thin capitalisation rules” and reclassify excessive interest payments as dividend distributions, which are subject to withholding tax. There are no thin capitalisation rules in Cyprus.

In accordance to Cyprus tax legislation there is no withholding tax on dividends, interest and royalties (for rights used outside Cyprus) paid from Cyprus companies to non Cyprus tax residents. This provision of the Law prevails over the DTT and hence there is no withholding tax on such payments.
Capital Gains Tax

With the current DTT capital gains derived by Cypriot tax resident shareholders from the sale of shares in companies owning immovable property in Russia were not subject to tax either in Russia or Cyprus.

In accordance to the Protocol this changes, and capital gains of a company in one State (e.g. Cyprus), deriving from the sale of shares in a company of the other State (e.g. Russia) having more than 50% of its value consisting of immovable property in that other State (e.g. Russia), will be taxed in the state where the immovable property is located (e.g. Russia). This is in line with the OECD Model Treaty.

This change, which is the most important in the new DTT, will come into force 4 years after the new DTT becomes effective (i.e. most probably 1 January 2014).

Mutual Investment Funds

Income of Mutual Investment Funds investing only in immovable property is treated as “income from immovable property” and the taxing rights are with the State where the immovable property is located.

Distributions from Mutual Investment Funds are included in the definition of dividends in the Protocol and hence the reduced rates of withholding tax apply, with a maximum of 10%, whereas under current Russian tax law distributions from Mutual Investment Funds are subject to 20% withholding tax.

Limitation of benefits

A “Limitation of Benefits” article has been included in the Protocol to prevent treaty abuse by companies which have been created with the purpose to take advantage of the DTT. The limitation does not apply to companies registered in Russia or Cyprus but to companies that have been registered outside Cyprus, but are tax residents of Cyprus by virtue of the fact that their management and control is exercised from Cyprus.

This limitation does not apply automatically, but offers a mechanism to the tax authorities of Russia and Cyprus to counter perceived cases of abuse of the DTT, by companies which obtained the Cyprus tax residency mainly in order to take advantage of the DTT benefits.
Tax residency of companies

The decisive factor in the DTT to establish the State, in which a company is resident for tax purposes, is the place of its effective management. This place is determined by mutual agreement of the tax authorities of Cyprus and Russia.

Permanent Establishment (PE)

A PE is place of management, branch, office, factory, workshop and building site or construction or installation or assembly project which exists for more than 12 months.

An individual may give rise to a PE for a Company, if present in the other State for more than 183 days in aggregate in any 12 month period, and “responsible” for more than 50% of the gross business revenues of the Company or the services that this person provides to the company are for the same or for connected projects.

Profits of PE are taxed at the State of where the PE is located.

International traffic

The taxing right of income from international traffic is allocated to the Country where the place of effective management of the entity deriving the income is located.

Exchange of Information

The Protocol has included the relevant paragraphs of the OECD Model Treaty on the exchange of information, thus clarifying obligations and powers included in the current DTT.

In order for the tax authorities of one State to comply with an exchange of information request by the tax authorities of the other State, several legislative conditions need to be met (e.g. in the case of Cyprus a written consent by the Attorney General is necessary), the request needs to be specific and not of generic nature (i.e. “fishing expeditions” are not permitted) and the person under investigation is informed.

Conclusion

The treaty remains the most favourable concluded by the Russian Federation and is bound to encourage further growth of the economic relations between the two countries.

Note: The information above serves as a concise guide on the new DTT expected to come into force on 1 January 2010. Persons and entities affected by the changes in the DTT should obtain professional advice.