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Amendments to the Double Taxation Treaty With Cyprus

By Roustam Vakhitov

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Roustam Vakhitov
Head of International Tax Service Group
Pepeliaev

On Oct. 7, a protocol to the tax treaty between Russia and Cyprus was signed. The protocol, which significantly altered the contents of the treaty, is expected to become effective in 2011 or 2012, after its ratification by Russia and Cyprus and the exchange of ratification instruments.

Major Developments

1. The minimal amount of investment into a Russian company to qualify for application of the lower dividend withholding tax rate of 5 percent is increasing from $100,000 to 100,000 euros.
2. The excessive interest recharacterized into dividends under Russian thin cap rules will be regarded as dividends also under the amended tax treaty. Previously, taxpayers managed to win cases by appealing to the treaty's definition of dividends, which did not include recharacterized interest.
3. Rendering services with respect to one or several related projects through one or several authorized persons over 183 days during a 12-month period is specifically included under the definition of a "permanent establishment." Therefore, granting powers of attorney for conducting activities on behalf of a Cypriot company leads to increased permanent establishment exposure, especially in the case of management or advisory activities where the authorized person is a beneficiary and works actively in Russia on behalf of the Cypriot company.
4. Income from a mutual fund established primarily for immovable property investments will be regarded as income from immovable property. Tax structuring has often involved using mutual funds for property investments. Once the amendments come into force, income received by corporate and individual non-residents from mutual funds will be

taxed in Russia at 20 percent and 30 percent, respectively. In many cases, such structures will have to be modified.

5. Income on sale of equity interests in Russian companies that have more than 50 percent of their assets in real estate will be taxed at 20 percent in Russia. This provision is designed to combat the widespread way of selling property under the guise of selling equity interests. The provision will become effective four years after the protocol itself comes into force.
6. The article on exchange of information existed but did not work in practice because of bank secrecy and confidentiality restrictions in Cyprus. The amended article expressly stipulates that bank secrecy or confidentiality shall not be grounds for refusing to provide information. Therefore, the Cyprus tax authorities will comply with duly made requests, with sufficient grounds, from the Russian tax authorities. It should be borne in mind that information on the business structure of a Cypriot company may in principle be available to the Russian tax authorities.
7. The article on assistance of collection of tax exists in the present treaty but does not specify any particular rights or obligations of the tax authorities. The new text of the article will allow the Russian tax authorities to send tax collection requests to the Cypriot tax authorities, who, subject to the applicable requirements, will have to comply with these requests without going through any further administrative or judicial procedures. The article will come into effect once Cyprus adopts the appropriate legislation.
8. Limitation of benefits. Under the new article, benefits available under the treaty may not be granted if obtaining benefits under the treaty is the primary purpose or one of the primary purposes for which the company was established. The provision does not apply to companies registered in Cyprus or in Russia. However, the provisions do apply, inter alia, to U.K. or British Virgin Island companies that have chosen to be tax residents of Cyprus. Income received by such companies may be taxed in Russia at rates specified by the domestic tax law, regardless of any benefits that may be available under the treaty.

It is expected that Cyprus will be taken off the Russian Finance Ministry's "blacklist" following the signing and ratification of the protocol. As a consequence, dividends distributed by Cypriot companies will be exempt from Russian tax under the strategic investment income exemption provided by the Russian Tax Code. This should make Cyprus a more attractive jurisdiction for structuring Russian investments abroad.

The signing of the protocol is expected to make Cyprus more transparent for the Russian tax authorities as well. As a result, not all of the solutions currently in use owing to the non-transparent nature of Cyprus will work in future.

Some of the companies may consider undergoing restructuring. However, please note that when undertaking any restructuring in the wake of the signing of the protocol, and also when continuing using structures that involve Cyprus companies, Russian and foreign companies should pay special attention to whether such steps have a business purpose.