

Update Memo

This publication should be used as a source of general information only. For the specific applications of the Law, professional advice should be sought. Our directors would be glad to address any questions you may have.

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Tax Alert – New Protocol to Cyprus-Russia Tax Treaty and Removal from the Russian “Blacklist”

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Introduction

New Protocol to Cyprus-Russia Tax Treaty

On April 16, 2009, representatives from the relevant Ministries of the Republic of Cyprus and the Russian Federation signed a Protocol to the 1998 tax treaty between the two countries. The Protocol is expected to be ratified by both countries in 2009 and to become effective as from January 1st, 2010.

The Protocol, which is the result of over one year of negotiations, will benefit international business and will continue to promote and encourage financial relations between Cyprus and Russia. It is one of the most favourable tax treaties ever agreed by the Russian Federation.

Removal of Cyprus from the Russian “Blacklist”

Russia also agreed to remove Cyprus from its blacklist. This means that dividends received by Russian companies from Cypriot subsidiaries can now qualify for Russia’s dividend participation exemption.

Dividends, Interest and Royalties

Tax on Interest and Royalties - No major changes

It is important to note that there are no changes to the nil rates of withholding tax on interest and royalties. With regards to dividends, the withholding tax rates of 5% or 10% remain unchanged. The only change to the conditions for eligibility for the 5% rate is that instead of a minimum of USD 100,000 investment in the capital of the company in whose shares are held, the minimum investment is now EUR 100,000.

Amendments to Definitions

The definitions of dividends and interest have been amended to be aligned with the wording of the latest OECD Model Treaty definitions. An addition was made to the definition of dividends to include payments on shares of mutual investment funds and similar collective investment vehicles (see Section E: Distributions from Mutual Investment Funds), as well as, depository receipts over shares.

However, the new definitions of dividends and interest will not prevent the Russian tax authorities from applying domestic “thin capitalization” rules to reclassify “excessive” interest payments as dividends and tax such amounts in Russia at source, albeit at the reduced dividend withholding tax rates under the treaty.

Taxation of Capital Gains

The Major Change - To be Effective in 2014

The major change to the existing treaty is the taxation of capital gains on the sale of shares in real estate property-rich companies. Currently, the treaty provides for the country of residence of the selling entity to have the taxing right (e.g. Cyprus for Cypriot companies selling shares in Russian property-rich companies). The Protocol moves to the latest OECD Model Treaty principle where such gains should be taxable in the country where the real estate is situated.

The taxing right will remain with the country of residence of the selling entity when that entity is:

- A pension fund
- A provident fund
- The government of Cyprus or the Russian Federation

Or when the gains come from the disposal of shares in a listed company or in the course of a corporate reorganisation.

This amendment to the treaty is not expected to apply until January 1st, 2014, because the Protocol provides for this amendment to become effective on the first day of the calendar year following four years after the Protocol as a whole enters into force. In the meantime, planning opportunities are likely possible to mitigate any negative implications of this change.

The Perceived Limitation of Treaty Benefits

New article introduced

A new limitation of benefits article has been introduced. It denies benefits of the treaty to entities that are not registered in Cyprus or Russia and that were created with the main purpose of benefiting from a reduction or exemption in tax.

Therefore, this limitation should not apply to companies incorporated in Cyprus or Russia. Since a Russian resident company is one that is always incorporated in Russia, the limitation will most likely only apply to companies that are incorporated outside Cyprus but that are tax residents in Cyprus by virtue of the exercise of their management and control in Cyprus.

This denial of treaty benefits does not apply automatically by virtue of the new article, but it offers a mechanism to the tax authorities of both Cyprus and Russia to oppose some perceived treaty abuses, and only as a result of consultations between the tax authorities.

Distributions From Mutual Investment Funds

Amendments to Existing Articles

Dividends – The dividends article has been amended to provide that dividends shall include payments on shares of mutual investment funds so that such distributions would have a maximum tax of 10% withheld by the paying entity. Under Russian domestic law, such distributions are currently subject to 20% withholding tax. As a result, the uncertainty under the existing treaty on whether such distributions could be classified as “other income” is removed.

Income from immovable property – This article has been amended to allocate taxing rights to the source state with respect to income of a mutual investment fund investing only in immovable property. The possible reason for this construction is a potential concern of the Russian authorities with regards to structures created where income from real estate contributed into such real estate investment funds lead to a possible “double non-taxation” effect within those structures.

We expect that the breadth of application of these amendments, especially in respect of distributions from Russian real estate funds, will be clarified by the tax authorities in the coming months.

Other Amendments

Other changes to the existing treaty brought about by the Protocol include:

- **The definition of resident** - Under the existing treaty, residence is determined by the entity’s place of effective management. A new paragraph has been added by the Protocol with the objective of making the “tie-breaker test” more effective. When the place of effective management cannot be determined, the Russian and Cypriot tax authorities shall endeavour to determine this by mutual agreement.
- **The meaning of permanent establishment** – Has been extended to allow for the taxation of profits from services performed in one country by an entity of the other country through an individual or individuals present in the other country for more than 183 days in a 12-month period, in certain circumstances. The new paragraph follows the wording circumscribed by the OECD Model Treaty Committee in the Commentary to the latest Model Treaty for countries that wish to include such a provision.

- **The article regarding taxation of income from international traffic** (i.e. shipping and aircraft) – This article has been replaced. The existing treaty provides that the taxing right for such income shall belong to the country in which the person deriving such income is resident, whereas the Protocol changes this to the OECD Model Treaty principle of the taxing right belonging to the country where the effective place of management of the person deriving such income is situated.
- **The article on exchange of information** – Has been replaced by the latest OECD Model Treaty equivalent. The difference from the current article is largely understood to be clarifications of existing obligations and powers.
- **The article on assistance in collection** - Has been replaced by wording almost identical to the latest OECD Model Treaty equivalent. The new article will apply only once Cyprus has made certain amendments to its domestic law to allow for certain aspects of such assistance.
- **The article on mutual agreement procedures** – Amendments have been made to largely adopt the latest OECD Model Treaty equivalent article.

Considerations

You should consult your tax adviser if you think you are affected by the new Protocol, and in particular if:

- You own shares in a Russian company with a value of less than EUR 100,000.
- You own Russian or Cypriot real estate directly or indirectly through shares of a company or a collective investment vehicle.
- You are a company that is tax resident in Cyprus but not incorporated in Cyprus.
- You are looking to benefit from the reduced withholding tax on distributions from mutual investment funds.
- You provide services through an individual present in either Russia or Cyprus for extended periods of time.
- You currently benefit from the international traffic article of the treaty, but your country of residence differs to where your place of effective management is situated.
- You are concerned about the obligations and powers of the tax authorities to exchange information, and for one authority to assist in the collection of taxes for the other.

Our Services

We see this protocol as a positive development in the relation between Cyprus and Russia. It further strengthens the position of Cyprus as the key investment partner into Russia.

We can assist in the evaluation of a current structure to assess any impact of the implementation of the protocol.

Further, we can assist in the set up of a new structure that mitigates any checks of this protocol.

We look forward to being of service.

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