SPECIAL FEATURES OF THE PROPOSED NEW CYPRUS – RUSSIA TAX TREATY

In an effort to keep Cyprus off the "blacklist" Russia and Cyprus have entered into negotiations to amend the existing tax treaty. The result is the signing of the Protocol to the Double Tax Treaty between the two countries was signed in Nicosia on 7th October 2010 during Russian president Medvedev's official visit to Cyprus. Formal ratification is expected before the end of 2010, with the Protocol expected to come into force on 1st January 2011. If not ratified until the 1st January 2011 then it will be effective as of the 1st of January following the year of ratification. As from the effective date of the removal from the black list, dividends received by Russian shareholders from eligible equity participations in Cypriot subsidiaries will be eligible for the Russian participation exemption.

Most important features of protocol:

WITHHOLDING TAX: Interest & Royalties.

Under the existing tax treaty the withholding tax rate is set at **zero**. This will continue to be the case under the proposed treaty. This is certain to encourage more business to use Cyprus as a base for holding patents and other rights as well as providing finance activities.

It is important to note that in Cyprus there is no withholding tax on interest or royalty payments to non residents irrespective of treaty provisions.

WITHHOLDING TAX ON DIVIDENDS:

The current withholding tax rate of 5% or 10% (depending on level of investment remains unchanged. However, under the current treaty the minimum level of investment, in order to be eligible for the 5% withholding tax, is US$100,000. Under the new treaty the minimum will be €100,000).

In addition there is a change on the definition of dividends in line with the OECD model treaty definition. There is an addition to the definition of dividends to include payments on shares of mutual investment funds and similar collective investment vehicles (dividends include payment on shares of mutual investment fund with a maximum withholding tax of 10% (currently 20% under Russian law) as well as depository receipts over shares.

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However, the new definition 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.

Distribution from "mutual investments funds" that are investing only in immovable property will be treated as income from immovable properties.

CAPITAL GAINS TAX:

The major change is the taxation of capital gains on the sale of shares in real estate property companies. The existing 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 companies). The Protocol states 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 where that entity is a pension fund, a provident fund, the government of Cyprus or the Russian Federation, or the gains are from the disposal of shares in a listed company or in the course of a corporate reorganisation.

It is important to note however, that we expect this amendment to the treaty to apply after **1 January 2015** as the Protocol providing for the amendment to become effective on the first day of the calendar year following four years after the protocol as whole enters into force.

In addition there are tax planning opportunities that can apply to mitigate any negative impact of this article.

Limitation of treaty benefits:

A new limitation of benefits article is introduced that seeks to restrict benefits of the treaty that would otherwise provide a reduction or exemption in tax to an entity that was created with the main purpose of obtaining such benefits and the entity is not registered in Russia or Cyprus (as appropriate).

This limitation should therefore not apply to companies incorporated in Russia or Cyprus. As a Russian resident company is one that is always incorporated in Russia, the limitation will most likely only apply

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to companies incorporated outside Cyprus but tax resident in Cyprus by virtue of the exercise of their management and control in Cyprus. (Such an example is a UK non-resident company with tax residency in Cyprus).

The good news is that the denial of treaty benefits does not apply automatically by virtue of the new article, but rather offers a mechanism to the tax authorities of both Cyprus and Russia to counter some perceived treaty abuses and only as a result of the consultations between the tax authorities.

RESIDENCY:

- Under the existing treaty, for the purpose of the definition of "resident" (other than an individual), residence is determined by the entity's place of effective management. A new paragraph is added by the Protocol with the objective of making the 'tie-breaker test' more effective so that where the place of effective management of such a person cannot be determined, the Russian and Cypriot tax authorities shall endeavour to determine this by mutual agreement.

PERMANENT ESTABLISHMENT:

- The meaning of permanent establishment is extended to allow for the taxation of profits from services performed in one country by an entity of the other country for more than 183 days in a 12-month period in certain circumstances. The new paragraph follows the OECD Model Treaty.

INTERNATIONAL TRAFFIC:

- The existing treaty's article regarding taxation of income from the international traffic (i.e. shipping and aircraft) is 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.

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EXCHANGE OF INFORMATION:

- The article on exchange of information is replaced by the latest OECD Model Treaty equivalent and the article on assistance in collection is replaced by wording almost identical to the latest OECD Model Treaty equivalent. The difference from the current article on exchange of information is largely understood to be clarifications of existing obligations and powers. Such requests must be very specific and should not be of a general nature attempting to gather information and/or supporting evidence.

CONCLUSION:

The proposed treaty ensures the continuation of benefits (such as zero or low withholding taxes etc.) and provides scope for using of Cyprus as an excellent base to investing in Russia.

With proper tax planning the changes to the treaty that appear to be negative (e.g. capital gains tax on immovable property from 2015 or after) can be mitigated.

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained.