Corporate Tax - Cyprus

What qualifies as direct investment under Cyprus-Russia double tax agreement?

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Introduction

Article 10 of the Russia-Cyprus double tax agreement grants taxing rights over dividends to the state of residence of the company paying the dividends (in addition to the state of residence of the recipient). The tax that may be imposed in the state in which the dividends originate is limited to 5% of the gross amount of the dividends if "the beneficial owner has directly invested in the capital of the company paying the dividends at least 100,000 euro". If this condition is not met, tax may be imposed at up to 10% of the gross amount of the dividends.

The corresponding provision of the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention is much simpler. It stipulates that in order to qualify for the reduced rate, the recipient should 'hold directly' at least a specified percentage of the capital of the company paying the dividends.

The difference in wording has given rise to ambiguity in interpreting the relevant article of the Russia-Cyprus double tax agreement, particularly in relation to the term 'directly invested'. It has been argued that the term should be given the broadest possible interpretation in order to reflect the intentions of the OECD as set out in its commentary on the OECD model – namely, that "it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and facilitate international investment".

Case study

In a recent case involving a Cyprus company that had received a dividend from a Russian company in which it held a shareholding, the Russian tax authorities contended that the qualifying criteria for the 5% rate set out in Article 10 of the double tax agreement between Cyprus and Russia were not satisfied. The authorities therefore sought to impose withholding tax at 10%. Since an agreement could not be reached, the issue was brought before the courts (in this case the Federal Arbitration Court of the East-Siberian Circuit) to resolve the issue.

Facts
The Cyprus-resident company concerned (CyCo) had acquired shares in a Russian company (RusCo) in consideration for transferring its shareholding in another company to the investee company, rather than in consideration for cash. The Russian tax authorities contended that this share-for-share exchange did not constitute the direct investment needed in order to qualify for the reduced rate of 5%; dividends paid by RusCo to CyCo should therefore be subject to withholding tax at the higher rate of 10%.

Decision
The court found in favour of the taxpayer, based on Section 7.3 of the Russian Tax Code, which states that in the case of unavoidable ambiguities and doubts regarding the application of any provision of the code, the provision in question must be construed in a way that is favourable to the taxpayer. The court also noted that for the first few years, the new shareholder had decided to retain the profits of RusCo within the company for reinvestment, rather than immediately distributing them as dividends, which helped to confirm the commerciality of the entire transaction.

Comment

While the decision in this case is fact sensitive and restricted to a limited range of circumstances, it provides useful guidance on the interpretation of the relevant article of the double tax agreement and will serve as a valuable precedent for the sizeable number of organisations that, due to the financial environment and lack of liquidity, have structured their investments in a similar way over the past few years, allowing them to benefit from the reduced withholding tax rate.

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