

A **BENEFICIAL CHANGE** OF INTERPRETATION BY THE RUSSIAN COURT OF THE DIRECT INVESTMENT PROVISIONS OF THE

Cyprus-Russia
Double Taxation Agreement

By Philippos Aristotelous

The current double tax agreement between Cyprus and Russia provides for a reduced rate of withholding tax on dividends paid by a Russian company to a Cyprus-resident shareholder. If the investment is less than \$100,000 the withholding tax rate is 10%: if the investment is more than \$100,000 the withholding tax is only 5% (when the 2009 Protocol to the double tax agreement enters into force the minimum investment threshold will increase from \$100,000 to €100,000).

The issue which has underlain most disputes regarding the minimum investment is the condition that the shareholder must have “directly invested” the requisite amount.

Clarifications issued by the Russian Ministry of Finance over the years define “directly invested” to include an acquisition of shares directly from a Russian entity as a result of the initial or any subsequent issuance of shares and a purchase of shares on the open market or from the previous shareholder. The Ministry of Finance considered that the introduction of shares in a Russian company by their previous owner as a capital contribution to a Cyprus company did not qualify as direct investment. This stance has been upheld by the courts. For example in ruling KA-A40/762-06 of the cassation instance of the Federal Arbitration Court of the Moscow Region dated 26 February 2006 a Cyprus-resident company was unable to obtain a refund of tax withheld in excess of 5% on dividends related to shares in a Russian entity received as a contribution to the Cyprus company’s share capital.

However, the Ninth Arbitration Appeal Court reversed this decision in June 2011 in case 09AP-14151/2011 in which it ruled that a Russian company qualified for the lower rate of 5% even though the shares in the Russian company were introduced to the Cyprus company as a capital contribution.

In arguing its case the taxpayer referred to minutes of meetings in August 2001 between the two countries’ tax authorities in which the term “direct investment” was discussed and defined as an acquisition of the shares of a Russian entity, whether on the open market or from the previous shareholder. The taxpayer argued that this

means that purchase is not the only means of acquisition covered by the term “direct investment”: the company could acquire the shares in other ways, including as a capital contribution, and still pass the “direct investment” test. The court agreed that the direct investment test is satisfied by the introduction of shares of a Russian company by the previous owner of that company in exchange for newly issued shares in a Cyprus company.

The taxpayer successfully argued that the minutes of the meetings should be relied on, on the ground that the minutes were concluded pursuant to the mutual agreement procedure provided for in clause 3 of Article 25 to the treaty and so constitute a valid source of treaty interpretation. The court accepted the taxpayer’s arguments despite the fact that in the minutes of a meeting which took place a few weeks earlier the Cyprus tax authorities included only purchases in their interpretation of direct investment.

The court also noted that the Russian Model Tax Convention approved by Government Decree No. 84 dated 24 February 2010 provides that the only factor relevant in determining eligibility for the reduced withholding tax rate on dividend distributions is the participation interest: the manner in which the shares were acquired by the foreign shareholder is immaterial. It is difficult to see how the Model Convention, which did not exist when the Russia-Cyprus agreement was concluded, can serve as a source of interpretation.

The court also ruled that for minimum investment purposes under the double tax agreement the determining factor is the amount invested by the previous owner in acquiring the shares, not the cost at which the shares were introduced into the Cyprus company. It ruled that the minimum investment test would be satisfied if the previous owner had invested at least \$100,000 in the Russian entity to acquire the shares in it.

The case is subject to review by the cassation court. If confirmed it will represent a very beneficial change of interpretation of the minimum investment requirement when structuring investments into Russia from Cyprus.



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