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Corporate Tax - Cyprus

New Protocol Added to Cyprus-Russia Tax Treaty

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On April 16 2009 representatives of the Cypriot and Russian governments signed a new protocol amending the existing Cyprus-Russia double taxation treaty. The protocol will not come into effect until it has been fully ratified by the legislatures of both countries. The ratification process is expected to be completed by the end of 2009 and the protocol should come into force during 2010.

This update analyzes the changes to Cypriot law introduced by the protocol.

Exchange of Information

Revised Article 26 of the treaty reproduces the exact wording of Article 26 of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention, and therefore should be interpreted in accordance with the spirit of the OECD convention.

The exchange of information under Article 26 of the treaty is primarily directed at information required for the levying and collection of the taxes covered by the treaty. Article 26 sets down the rules under which information may be exchanged to the widest possible extent, with a view to establishing a sound basis for the implementation of the domestic laws of the contracting states concerning taxes covered by the treaty and for the application of specific provisions of the treaty. The text of the article makes it clear that the exchange of information is not restricted by Article 1 - for example, the information exchanged may include particulars about non-residents. In order to keep the exchange of information within the framework of the treaty, Article 26 provides that information should be provided only insofar as taxation under the domestic taxation laws concerned is compatible with the treaty.

Article 26 creates an obligation to exchange information that is foreseeably relevant to the correct application of the treaty, as well as for the purposes of facilitating the administration and enforcement of domestic tax laws of the contracting states. Neither may engage in so-called 'fishing expeditions'; nor may they request information that is unlikely to be relevant to the tax affairs of a given taxpayer. When formulating any requests for information, the state making the request should demonstrate the foreseeable relevance of the requested information. In addition, it should have exhausted all reasonable and proportionate domestic means for obtaining the information concerned.

Revised Article 26 makes clear that a contracting state cannot refuse a request for information solely because it has no domestic tax interest in the information or purely because the information is held by a bank or other financial institution. Bank secrecy is not incompatible with the requirements of Article 26 and virtually all countries have bank secrecy or confidentiality rules. Meeting the standard set by Article 26 requires only limited exceptions to bank secrecy rules and would not undermine the confidence of citizens in the protection of their privacy. Finally, where information is exchanged it is subject to strict confidentiality rules. Article 26 expressly provides that communicated information must be treated as secret and that it may be used only for the purposes provided for in the treaty.

The underlying presumption of revised Article 26 is that sufficient information-gathering powers are in place for domestic purposes in both contracting states and there is no need to create new or quicker mechanisms to access and exchange information under the treaty.(1)

Cyprus recently passed Law 72(I) of 2008 amending the Assessment and Collection of Taxes Law to incorporate the exchange of information provisions of Article 26 of the OECD Model Tax Convention in double

taxation agreements which have been concluded between Cyprus and other jurisdictions. In other words, Cyprus had already created a mechanism for the exchange of information under Article 26 before the conclusion of the new protocol.

Once the protocol comes into force, the new mechanism will be used for the purposes of Article 26. In regard to this, the law sets out the following important safeguards:

- Information may be provided by the Cypriot tax authorities only where the other contracting state involved is under a reciprocal obligation to disclose information.
- The prior written consent of the attorney general is required for the tax authorities to exercise their powers to collect the information requested.
- The right to legal professional privilege is maintained and any information passing between professional legal advisers and their clients may not be disclosed to third parties.

Requests to the Cyprus tax authorities for information must include:

- the identity of the person under examination;
- a description of the information requested and the form and manner in which the requesting state wishes to receive it;
- the tax purpose for requesting the information;
- the reason for believing that the requested information is held by the Cypriot tax authorities or is in the possession or under the control of a person within the jurisdiction of Cyprus;
- the name and address of any person who may hold the information requested, if known; and
- a declaration that the provision of such information is in accordance with the legislation and the administrative practices of the requesting state and that, where the requested information is found within the jurisdiction of the state in question, the relevant authority may obtain the information according to its laws and the terms of its ordinary administrative practices.

Exchange on request involves a specific response to a specific request. The policy of the Cypriot tax authorities is that, in principle, every proper request made by a competent authority concerning a specific taxpayer or relating to a specific transaction must be properly dealt with. The competent authority for Cyprus is the International Tax Relations Unit (ITRU) of the Department of Inland Revenue of the Ministry of Finance. The exchange of information may take place only through the ITRU - the direct informal exchange of information between tax officers bypassing the competent authority is prohibited.

When the ITRU receives a request for information, it forwards it to the district tax office where the taxpayer concerned is registered for income tax purposes. The district tax office collects all the requested information and sends it to the ITRU. If a request from the competent Russian authorities concerns income taxable in Cyprus, the Cypriot tax authorities may request a taxpayer's auditors to provide information and clarifications. Such a request should make clear its underlying scope, reason and purpose.

The Cypriot tax authorities may institute enquiries to gather the information requested by Russia in accordance with the law, and may request the taxpayer or third parties (recordkeepers) to provide the requested information to them. In this respect, the director of the Department of Inland Revenue has the general power (as provided in the law) to require any person by written notice to provide such particulars as may be required for the purposes of the law with respect to the tax affairs of such person for any year of assessment, or to give evidence to the director as to such object and produce any accounts, books or other documents in that person's custody or under his or her control relating to such matters. The director may apply to the district court to obtain a search warrant if there is reasonable cause to believe that an offence under the law has been or is being committed, and that legally admissible evidence regarding the commission of the offence may be found in the premises. The district court may issue a search warrant authorizing any police officer to enter the building specified in the warrant, except a building of a person who, according to the Law of Evidence, is bound to observe professional secrecy.

Thus, the exchange of information under Article 26 will take place based only on specific requests. This will prevent 'fishing expeditions'. A request must be much more than a brief email containing the name and identifying information of the individual concerned. Instead, a detailed case must be made, with the criteria set out in a lengthy legal document. In effect, this means that the authorities requesting the information must have a strong case even before they request the information. Accordingly, it will not be possible to follow up a suspicion without first gathering significant evidence. This sets the bar high for tax authorities wanting to make a request.

Capital Gains

The protocol preserves the general rule that the right to tax income from the disposal of shares is given to the country of residence of the seller, but modifies it in certain specific circumstances. Under the new rules, taxation of capital gains derived on the sale of shares in a property-rich company will be vested in the country

where such property is located. It is normal to give the right to tax capital gains on immovable property to the state which is entitled under the treaty to tax both the property and the income derived therefrom.

The protocol follows this general principle as it is established in the OECD Model Tax Convention. It provides that gains derived by a resident of one contracting state from the disposal of shares deriving more than 50% of their value from immovable property situated in the other contracting state may be taxed in that other state. The protocol allows taxation of the entire gain attributable to the shares to which it applies, even where part of the gain is derived from property other than immovable property located in the source state. The determination of whether shares of a company derive more than 50% of their value from immovable property will normally be done by comparing the value of such immovable property to the value of all property owned by the company, without taking into account debts or other liabilities of the company. Unlike some other states, Russia and Cyprus have not broadened the scope of this amendment so that the source taxation of capital gains also extends to gains from the alienation of interests in other entities that do not issue shares, such as partnerships and trusts. In this respect, it will be interesting to see whether Russian limited liability companies will be caught by the new rule.

The protocol provides for a grace period of at least four years regarding the new rule. The amended capital gains article will not become effective until the first day of the calendar year following four years after the whole protocol takes effect. This will be January 1 2014 at the earliest, thus allowing plenty of time to consider and implement measures to mitigate any negative impact of the change.

The source taxation rule will not apply if:

- the share disposal is part of a qualifying reorganization;
- the relevant shares are listed on a recognized stock exchange; or
- the seller is a pension fund, provident fund or the government of either of the two countries.

In addition, the protocol provides for the source taxation of the income of mutual equity funds investing exclusively in immovable property.

Withholding Tax Rates

One of the key elements of the protocol is that the current beneficial withholding tax rates applicable to dividends, interest and royalties have not been amended.

The definition of the term 'dividend' has been enhanced to include distributions made by mutual funds and payments to the holders of depositary receipts over shares. Any interest reclassified by the Russian tax authorities as dividends (eg, under thin capitalization rules) will be subject to the same withholding tax rates as dividends.

Permanent Establishment

The definition of a 'permanent establishment' is extended to include, subject to certain conditions, the provision of services in one country by a resident of another country through an individual or a group of individuals, who are present in the first country for more than 183 days in any 12-month period. Due regard should be given to this change when structuring agency and services arrangements.

For further information on this topic please contact Olga Mikhailova at Andreas Neocleous & Co LLC by telephone (+357 25 110 000) or by fax (+357 25 110 001) or by email (olgam@neocleous.com).

Endnotes

(1) This presumption explains, for example, the apparently paradoxical announcement by the Swiss authorities that Switzerland would accept OECD standards, but that its banking secrecy would not be affected.

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