Ratification of the Protocol to the Cyprus–Russia Double Tax Treaty

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The Double Taxation Treaty between Russia and Cyprus, which took effect in 1998, replaced a treaty between the former Soviet Union and Cyprus dating back to 1983, but it proved inadequate with regard to information sharing between jurisdictions, to the concern of the Russian tax authorities. The forthcoming Protocol aims to resolve these concerns.

The Protocol to the double tax treaty between Cyprus and Russia is making progress towards entry into force. The Protocol, which was agreed in 2009 and which has already been ratified by Cyprus, was submitted to the Russian State Duma, the lower house of parliament, in September 2011. On February 15, 2012 a law ratifying the protocol was adopted by the State Duma. The law now requires approval by the Federation Council, the upper legislative chamber, and signature by the Russian President. If both countries complete the formal ratification procedures and exchange instruments of ratification this year the protocol will take effect from January 1, 2013. Certain provisions, particularly those relating to taxation of gains on disposal of interests in "property-rich" companies described below, will not take effect until four years later.

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III. Summary of the main changes introduced by the Protocol

In the following paragraphs we summarise the main changes introduced by the Protocol.

A. 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. However, the minimum investment required in order to qualify for the lower rate of 5% on dividends has been increased from USD 100,000 to EUR 100,000.

The terms "dividends" and "interest" have also been amended to be in line with the wording of the latest version of the OECD Model Treaty. The revised term for "dividends" in particular includes payments on shares in collective investment schemes (other than investment funds organized primarily for the purpose of investing in immovable property) as well as depository receipts on shares. The new definition permits the Russian tax authorities to apply domestic thin capitalization rules to characterize part of interest payments as dividends (if deemed excessive) rendering interest taxable at source under the treaty rates applying for dividends.

B. 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 the other 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.

C. Capital gains

The Protocol maintains the general rule that the country of residence of the disponor has the right to tax gains from the disposal of assets, but modifies it in certain circumstances. Specifically, the Protocol provides that gains derived by a resident of one contracting state from the disposal of shares or similar rights deriving more that 50% of their value from immovable property situated in the other contracting state may be taxed in that other state. This provision follows the OECD Model Tax Treaty and the general principle of giving the right to tax capital gains on immovable property to the state which is entitled under the double taxation convention to tax both the property and the income derived from it. 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 assessment of whether shares or other similar rights in a company derive more than 50% of their value from immovable property will normally be made by comparing the value of such immovable property to the value of all the property owned by the company on a "gross" basis, that is without taking into account debts or other liabilities of the company.

The source taxation rule will not apply if the share disposal is part of a qualifying reorganisation, or the relevant shares are listed on a recognised 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.

The amended capital gains article will not become effective until the first day of the calendar year following four years after the protocol as a whole takes effect. This will be January 1, 2017 if ratification is completed during 2012 and the Protocol enters into force on January 1, 2013. This gives time to consider and implement measures to mitigate any negative impact of the change.

Russia has undertaken that by the time the change becomes effective, it will have introduced similar modifications into all its important double taxation agreements, and similar protocols modifying both the Russia-Luxembourg and Russia-Switzerland agreements have already been signed.

D. Exchange of information

It was Russia's concerns over the perceived deficiencies of the current arrangements that were the main driver for negotiation of the Protocol, and the Protocol includes a revised article on exchange of information reproducing Article 26 of the OECD Model Tax Convention verbatim, suggesting that the article is intended to be interpreted in accordance with the spirit of the OECD Model.

The exchange of information under Article 26 of the DTT is primarily directed at information required for the levying and collection of taxes covered by the DTT. Article 26 embodies 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 DTT and for the application of specific provisions of the DTT. The text of the Article makes it clear that the exchange of information is not restricted by Article 1. This means, for example, that the information exchanged may include particulars about non-residents. In order to keep the exchange of information within the framework of the DTT, a limitation to the exchange of information is set out so that information should be provided only insofar as the taxation under the domestic taxation laws concerned is not incompatible with the DTT.

The obligation to exchange information arising under Article 26 is limited to information that is foreseeably relevant to the correct application of the DTT as well as for the purposes of facilitating the administration and enforcement of domestic tax laws of the contracting states. Neither state may engage in "fishing expeditions", nor may they request information that is not demonstrably 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 to obtain the information concerned.

The revised Article 26 makes it clear that a contracting state cannot refuse a request for information solely because it has no domestic tax interest in the information or solely because it 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 of 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. It is expressly provided in Article 26 that information communicated must be treated as secret and that it may only be used for the purposes provided for in the DTT.

The underlying presumption of the 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 mechanisms to access and exchange information under the DTT.

Cyprus had already created a mechanism for the information exchange under Article 26 before the new Protocol was concluded, by amending its Assessment and Collection of Taxes Law in 2008 to incorporate the exchange of information provisions of Article 26 of the OECD Model Tax Convention then in force into its existing double taxation agreements.

The Assessment and Collection of Taxes Law, which will be used as the framework for exchange of information, contains the following important safeguards for taxpayers:

- information may be provided by the Cyprus 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 of Cyprus 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 advisors and their clients may not be disclosed to third parties.

Requests to the Cyprus tax authorities for information must include the following particulars:

- 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 Cyprus 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;
- 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 according to the terms of its ordinary administrative practices.

Exchange on request involves a specific response to a specific request. The policy of the Cyprus 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. Exchange of information may only take place via the ITRU: 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 Cyprus tax authorities may request the auditors of a taxpayer concerned to provide information and clarifications. Such request should make clear its underlying scope, reason and purpose.

The Cyprus tax authorities may institute inquiries to gather the information requested by Russia in accordance with the Assessment and Collection of Taxes Law and may request the taxpayer or third parties such as corporate service providers to disclose the requested information.

It follows from the foregoing analysis that exchange of information under Article 26 will take place only on the basis of specific requests and that so-called "fishing expeditions" will not be entertained. 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 formal legal document. This means that the authorities requesting the information must already have carried out substantial research and accumulated significant evidence before requesting information: unsubstantiated suspicions and "hunches" will not suffice.

The revised exchange of information provisions represent a positive move in the direction of alignment with globally acceptable best practice standards in the context of mutual assistance and transparency while retaining sufficient safeguards and deterrents against abuse. Proper structures with substance and a genuine business rationale and economic purpose do not face any increased risk as a result of the amendments.

II. Conclusion

An important consequence of the Protocol entering into force is the anticipated removal of Cyprus from the Russian Ministry of Finance's List of States and Territories Which Grant Preferential Tax Treatment and (or) Do Not Require the Disclosure and Provision of Information in Relation to Financial Operations Carried Out (Offshore Zones). This so-called "blacklist" was approved by Order No. 108n of the Russian Ministry of Finance dated 13 November 2007. Dividends received by Russian entities from companies resident in countries included in the list do not qualify for the participation exemption available under Article 284(3) of the Russian Tax Code and all transactions involving either a company resident in a blacklisted country or a Russian entity with a permanent establishment in a blacklisted country will be subject to transfer pricing control under Article 105.14(1)(3) of the Tax Code.

Entry into force of the Protocol and the consequent removal of Cyprus from Russia's black list will significantly improve the investment climate between the two countries. Historically, the vast majority of investments via Cyprus between Russia and the rest of the world have been inbound investments into Russia. The availability of the participation exemption for dividends paid from Cyprus to Russian companies is expected to substantially increase the volume of outbound investments from Russia through Cyprus, given the other benefits available under the double tax agreement.

Just as important is the fact that removal from Russia's black list will also remove Cyprus companies from the provisions of the latest Russian transfer pricing rules which automatically classify entities located in blacklisted jurisdictions as "related entities" regardless of whether there is any actual link between such entities and their corresponding Russian counterparty in a transaction. Removal from the blacklist should result in substantial savings and cost reductions for Cyprus resident companies, in terms of transfer pricing compliance costs.

The potential negative aspects of the new arrangements are principally confined to two areas, namely exchange of information and taxation of gains on shares in property-rich companies. As we have said above, proper structures with substance and a genuine business rationale and economic purpose have nothing to fear from the new exchange of information provisions. The four year transition period for the new provisions on capital gains gives plenty of time to plan to mitigate their effects, and the same arrangements will apply to all Russia's double tax agreement partners. These potential disadvantages are far outweighed by the benefits likely to accrue from removal from any Russian blacklists.

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