

Corporate Tax - Cyprus

Withholding taxes on interest under Cyprus-Russia double tax agreement

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A recent case relating to debt financing provided by one Cyprus company to another offers insight into the way in which interest is taxed under the double tax agreement between Cyprus and Russia, and into the general applicability of the agreement.

The case⁽¹⁾ concerned back-to-back debt financing provided by one Cyprus company to a related Cyprus company that had operations in Russia. The first Cyprus company was not the economic source of the finance, but merely an intermediary - the funds that it on-lent to the second Cyprus company were provided to it by a related entity resident in the British Virgin Islands. The first Cyprus company on-lent the funds to the second Cyprus company on the day on which it received them. It had no other transactions in the year concerned. Furthermore, it instructed the borrower that repayment of the loan and of interest accruing on it should be made direct to the British Virgin Islands.

In light of these facts, the Russian tax authorities contended that the double tax agreement did not apply, and that withholding tax at 20% was due on interest paid from Russia to the British Virgin Islands. The Russian court ruled in favour of the taxpayer, saying that the banking arrangements for the remittance of interest should not affect the attribution of income to the person who has legal and economic power in respect of that income. The mere fact that the funds were transferred to the British Virgin Islands did not make the BVI company the beneficiary of the underlying income. The second Cyprus company continued to be the beneficiary of the income, regardless of the banking arrangements. In this respect, the court followed the approach that has been generally accepted internationally.

The court then alluded to a newly developed limitation on the benefits provision of the double tax agreement (the new Article 29), which limits access to the benefits under the agreement for Cyprus-resident companies that are not incorporated under the laws of Cyprus, in the event that the competent authorities of Cyprus and Russia identify, on a case-by-case basis, that abuse of the agreement is the sole reason (or one of the major reasons) for the use of such companies. Since the second Cyprus company was not established outside Cyprus, the court ruled that the anti-abuse provisions of Article 29 were inapplicable. However, it was a surprise to some that the court mentioned or even considered the provisions of Article 29, since they will not take effect until January 1 2013.

Finally, the court rejected the application of Articles 9 and 11(5) of the agreement, which provide for the possibility of adjusting the amount of interest due between associated enterprises to which zero withholding tax could apply, if the interest charges are not at arm's length.

The tax authorities made some attempt to argue that the second Cyprus company was merely an intermediary between the lender residing in the British Virgin Islands and the borrower, the only purpose of which was to obtain access to zero withholding tax under the double tax agreement, but they did not focus on this issue or press it. Most modern double tax agreements restrict benefits to the beneficial owner of the income or assets in question and deny them to mere intermediaries, such as nominees and agents. Although the article of the double tax agreement that deals with dividends stipulates that only the beneficial owners of dividends are entitled to the benefits of the agreement, the corresponding article relating to interest contains no similar restriction. The concept of beneficial ownership is mentioned elsewhere in the article relating to interest, but there is no explicit restriction of benefits to beneficial owners. The protocol to the agreement, which has not yet entered into force, does not refer to beneficial ownership, but its limitation of benefits provisions may well be relevant to such situations.

This case highlights the care needed when putting in place Cyprus structures in order to ensure that the full benefits of the Cyprus-Russia agreement are achieved.

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Endnotes

⁽¹⁾ *Eastern Value Partners Limited*, Moscow Arbitration Court, A40-60755/1220-388, August 29 2012.

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