Tax Circular 15 October 2010

NEW PROTOCOL TO THE DOUBLE TAX TREATY BETWEEN RUSSIA AND CYPRUS

SIGNED IN CYPRUS DURING OFFICIAL VISIT OF PRESIDENT MEDVEDEV

CYPRUS SOON TO BE REMOVED FROM THE RUSSIAN "BLACK LIST"

The Protocol to the Double Tax Treaty between Russia and Cyprus was signed in Nicosia on 7 October 2010 during the official visit of the President of Russia to Cyprus.

The economic relations between the two countries are gaining even greater momentum as the Joint Declaration signed by the two presidents in November 2008 in Moscow has now been promoted into a Three-Year Action Plan aimed at enhancing the cooperation between the two countries at all levels.

As a result of these developments, the government of Russia is expected to announce the removal of Cyprus from the Russian "Black List", such removal coming into effect simultaneously with the provisions of the Protocol. Formal ratification is expected to happen before the end of 2010 so that the Protocol could come into effect on 1 January 2011.

As from the effective date of the removal from the black list, dividends received by Russian shareholders from eligible equity participations in Cyprus subsidiaries will be eligible for the Russian participation exemption.

The main aspects of the Protocol are the following:

1. No changes to Withholding Tax rates

One of the most beneficial as well as key aspects of the Tax Treaty is the favorable withholding tax rates applying to cross-border payments of dividend, interest and royalties.

There is a very positive and important decision not to change the current withholding tax rates which will continue to apply as follows:

Dividends	–	5%*
Interest	–	0%
Royalties	–	0%

* The current provision that a direct investment in the capital of the Russian entity of less than US$100.000 results in a 10% withholding tax rate to apply, is amended such that the 10% withholding tax applies if the direct investment is less than €100.000.

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The Protocol also introduces a new definition for dividends and interest.

It clarifies that distributions from mutual funds and similar collective investment vehicles (other than real estate investment trusts or real estate investment funds or similar vehicles primarily investing in immovable property) will be subject to the normal withholding tax rates applying to dividends, ie. 5% / 10%. This clarifies an uncertainty that existed regarding the withholding tax rates that should apply on such distributions.

The definition of dividends has also been extended to cover distributions from shares held in the form of Depositary Receipts.

The Protocol clarifies with regard to interest, that the term "interest" also covers income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits but it does not include penalty charges for late payment of interest which is reclassified as dividends by virtue of other provisions.

Any interest reclassified by the Russian Tax Authorities as dividends (e.g. due to Russian thin capitalization rules) will be subject to the withholding tax rates for dividends.

2. Changes relating to Capital Gains, expected to be effective from 2015

In general, capital gains from the disposal of shares remain under the exclusive taxing right of the country of residence of the seller.

The important change relates to disposals by a resident of one country of shares of companies which derive a substantial part of their value (more than 50%) from immovable property which is situated in the other country. In this particular case, the country in which the immovable property is situated will also have a right to tax the resulting gain. This change is in line with the OECD Model Tax Convention on Income and Capital.

The following aspects of this change should be noted:

- This change will come into effect four years after the date the Protocol will come into force, i.e. it is expected to be applicable from 2015.
- The exclusive taxing right will remain with the country of residence of the seller if:
  - (1) the disposal qualifies as a corporate reorganisation or
  - (2) the disposed shares are listed on a recognised stock exchange or
  - (3) the seller is a pension fund, provident fund or the government of either of the two countries.
- The Russian Federation has undertaken that, by the time the Protocol will come into force, it will have adopted the OECD Model Tax Convention on Income and Capital provision for capital gains in its tax treaties with all States which are regarded as main investors in the Russian Federation.

3. Exchange of information – Assistance in Collection – Mutual Agreement

This article has been revised in line with the article 26 of the OECD Model Tax Convention on Income and Capital and reflects the changes that have already been introduced in the Cypriot tax legislation since 2008.

The changes are towards alignment to OECD policy standards on fiscal transparency and exchange of information on taxation matters.More clarity has been introduced in relation to powers and obligations of the Tax Authorities of the two countries which are generally aimed at improving the administrative procedures through which information can be collected and exchanged between the Tax Authorities of Russia and Cyprus.

It is now clearly provided that the fact that one country may not need information for its own purposes should not prevent it from collecting this information in reply to a request from the other country.

At the same time, it also remains clear that information cannot be supplied which is not obtainable under the laws or in the normal course of the administration of a contracting state.

It is further clearly provided that professional secrecy rules (e.g. by a bank or a person acting in an agency or fiduciary capacity) cannot be used as an excuse for refusing to supply information. However, the circumstances under which such professional secrecy rules can be lifted and the process that must be followed in this respect are subject to the detailed provisions of the domestic legislations of the two countries. In the case of Cyprus, the approval of the Attorney General is needed before any information is exchanged.

The article on "Assistance in Collection" has also been aligned to the OECD Model Tax Convention on Income and Capital. This will come into effect only upon the introduction by Cyprus of the necessary legal framework necessary to provide the Assistance in Collection.

The amendments to the article on Mutual Assistance procedures are also towards bringing this article in line with the OECD standard.

4. Limitation of treaty benefits

The limitation of benefits introduced does not apply to Russia or Cyprus registered companies.

Limitation of benefits applies to tax residents of Russia or Cyprus which are not registered companies in either of the two states and only in cases where the Tax Authorities of the two countries agree that the main purpose or one of the main purposes of the company was to obtain the benefits of the agreement.

5. Other changes

- The Protocol introduces a clarification of the existing "tie-breaker" clause in relation to residency so that in cases where the effective management cannot be determined, the Tax Authorities of Russia and Cyprus should consult between them and come to a mutual agreement in this respect.
- The Protocol extends the definition of Permanent Establishment to cover activities of an enterprise resident in one country through services performed by individuals present in the other country for more than 183 days in a 12-month period, with certain specific criteria having to be met prior to such services being deemed to give rise to a Permanent Establishment in the other country.
- Income from international traffic will be subject to tax in the country where the effective place of management of the person deriving the income is situated.
- It has been clarified that income received through a real estate investment trust, a real estate investment fund or a similar collective investment vehicle which is organised under Russian Laws primarily for the purposes of investing in immovable property would be treated as "Income from Immovable Property" as per article 6 of the Treaty and may not be subject to tax in the country where the immovable property is situated.