

RUSSIA TAX OUTLOOK

3, May 2009

Amendments to the Russia-Cyprus Tax Treaty – towards the end of Cyprus as Russia’s preferred investment platform?

On 16 April 2009, representatives from the Republic of Cyprus and the Russian Federation signed a new Protocol (hereinafter the “**Protocol**”) aimed at introducing key amendments into the Russia – Cyprus Agreement on Avoidance of Double Taxation of 5 December 1998 (hereinafter “**DTT**”) as well as removing Cyprus from Russia’s tax “black list”.

Removal of Cyprus from the Black-list

The “black list”, introduced by a Decree of the Russian Ministry of Finance dated 13 November 2007 N 108H, contains a list of countries that provide a preferential tax regime and/or do not disclose fiscal information in connection with taxpayers operating within their borders. On this basis, to date Russian companies have been denied the right to benefit from the participation-exemption regime upon repatriation of dividends from their subsidiaries registered in black-listed jurisdictions, e.g. Cyprus. This restriction has been cancelled with respect to Cyprus and the amendment is expected to be enforced once the Protocol is ratified, i.e. most probably on or about **1 January 2010**.

Taxation of capital gains from the sale of shares in property companies

Based on the DTT provisions, capital gains derived by a Cypriot company from the sale of shares in a Russian company are exempted from taxation at source in Russia. Since Cypriot taxation legislation also exempts such capital gains from taxation, Cyprus has been widely used over the past years as a platform for most property investment structures in order to achieve tax-free acquisition and disposal strategies.

The Protocol will align the DTT with the OECD model principles in that capital gains derived by a resident of a contracting state (e.g. Cyprus) from the sale of shares in a company the value of which is by more than 50% linked to immovable property situated in another contracting state, may be taxed in that other state (e.g. Russia). This means that the sale by a Cypriot company of a qualifying stake in a Russian company would be subject to a Russian withholding tax rate of 20 percent. In practice however, this provision will not apply to gains derived from alienation of shares (i) in listed companies, (ii) as part of corporate reorganizations; or (iii) in Cypriot holding companies that own Russian property assets directly or indirectly via a Russian property company. Moreover, this provision should not become effective before **1 January 2014**, leaving more than four years for Russian companies to take appropriate measures to mitigate against this risk.

Exchange of information

The risk of losing its status as the traditional location-of-choice for Russian multinational companies due to the Russian “black list” limitations was one of the reasons why Cyprus passed specific legislation last year facilitating the exchange of information between the tax authorities of Cyprus and other foreign states. This Cypriot disclosure legislation served as a foundation for the re-negotiation of key DTT provisions (article 26: Information exchange, article 27: Assistance in the collection of tax). It is envisioned that the Cypriot taxation authorities would now be required to share not only tax-related information (as provided by the former reading of the Treaty), but also to disclose any financial information possessed by financial institutions, banks, nominal directors and/or corporate agents regarding specified taxpayers. This information could, first of all, be used by the Russian tax services to disallow the treaty benefits (reduced or zero-rated taxation) in cases where the treaty-shopping strategy or other schemes of tax avoidance would be established. This being said, in reality, the limitation of the benefits clause, per se, will not apply automatically; rather it will provide a mechanism to counter the cases of DTT abuse by promoting mutual consultations, on a case by case basis, between the fiscal authorities of the two states.

Miscellaneous changes

Overall, the general tax rules applicable to passive income (interests, dividends, royalties) remain unchanged except inter alia that the required capital investment amount to benefit from reduced rates upon dividend distributions will be changed (from 100,000 US dollars to 100,000 Euros) and the DTT definition for dividends will be aligned on that of the OECD model treaty (e.g. by including shares of mutual investment funds and other collective investment structures).

Among other amendments worth mentioning is the introduction of new criteria for the recognition of a “permanent establishment” to services rendered by a foreign company through individuals (e.g. when the latter spend more than 183 days in Russia within a 12-month period under certain circumstances).

In order to initiate some thought on these matters, you may consider the following FAQs:

- What is the level of capital investment of your Cypriot holding company in its Russian subsidiaries?
- If your Cypriot company operates as a real estate developer in Russia and/or conducts Russian property assets management functions, does it contemplate a sale of assets in the short or to medium term?
- If your Cypriot holding company owns Russian real estate, would it be in a position to support with sufficient economic rationale (apart from pure tax considerations) the transfer of its real estate portfolio?

If you are uncertain, or see any opportunity to improve your existing structures, we would be pleased to meet with you and discuss this further.

CMS can offer you the following assistance:

- Reviewing operations and financial statements with a view to determining whether your company qualifies as a company whose assets comprise more than 50% immovable property;
- Reviewing your group structure in order to identify potential options whereby your group's current chain of ownership can be optimized (e.g. through the transfer of your real estate portfolio into another tax efficient jurisdiction).

If you have any questions on the matters referred to in our RUSSIA TAX OUTLOOK, please feel free to contact Dominique Tissot, Partner, or your regular contact person at CMS, Russia.

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