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The Cyprus/Russia Double Taxation Agreement: Impact Of The Protocol

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The Protocol to the double taxation agreement between the Republic of Cyprus and the Russian Federation entered into force on January 1, 2013, following the completion of formal ratification procedures in 2012. Now that the protocol has been in force for almost a year it is a suitable opportunity to assess its impact.

Many of the changes made by the Protocol were of a detailed nature, reflecting the changes in practice that have occurred since the double taxation agreement was agreed in the late 1990s. However, most discussion of the Protocol centred on the substantial changes regarding information exchange and the taxation of capital gains. It is also important not to overlook what did not change, particularly the favorable withholding tax rates available under the original agreement.

Exchange Of Information

The new exchange of information provisions reproduce Article 26 of the OECD Model Tax Convention *verbatim*, creating an obligation to exchange information that is foreseeably relevant to the correct application of the DTT and for facilitating the administration and enforcement of domestic tax laws of the contracting states. Neither contracting state may engage in "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 to obtain the information concerned.

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. Finally, where information is exchanged it is subject to strict confidentiality rules: information communicated must be treated as secret and may only be used for the purposes provided for in the DTT.

In fact, Cyprus had already created a mechanism for information exchange under Article 26 even before the new Protocol was concluded. Law 72(I) of 2008 amended the Assessment and Collection of Taxes Law ("the ACT Law") to incorporate the exchange of information provisions of Article 26 of the OECD Model Tax Convention of 2005 in double taxation agreements between Cyprus and other jurisdictions, and to lay down the procedural framework for information exchange.

The ACT Law as amended contains the following important safeguards for the taxpayer:

- The Cyprus tax authorities may provide information 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 of information on request involves a specific response to a specific request. Such requests are dealt with exclusively by the International Tax Relations Unit ("ITRU") of the Department of Inland Revenue. Exchange of information may take place only through the ITRU: direct exchange of information between tax officers on an informal basis is prohibited.

When the ITRU receives a request for information, it forwards it to the District Tax Office which deals with the tax affairs of the taxpayer concerned. The District Tax Office gathers all the requested information and forwards it to the ITRU. The Cyprus tax authorities may institute inquiries to gather the information requested in accordance with the ACT Law, which empowers them to require any person, by notice in writing, to provide such particulars as they may require for the purposes of the ACT Law with respect to the taxpayer's affairs for any year of assessment, or to attend and give evidence and produce any accounts, books or other documents in his custody or under his control relating to such matters. The tax authorities may apply to the court for a search warrant if there is reasonable cause to believe that an offence under the ACT Law has been or is being committed and that legally admissible evidence regarding the commission of the offence may be found in the premises for which the warrant is requested. The 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.

Furthermore, the requirement that requests to the Cyprus tax authorities for information must be accompanied by detailed information rules out "fishing expeditions" based merely on suspicion. A request must be much more than a brief note of 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 already have a well-founded case before they request the information. It will not be possible to follow up a suspicion without first gathering significant evidence.

Capital Gains

Following the dissolution of the Soviet Union in 1991 most of the newly independent states which emerged, including Russia, initially adopted the Cyprus-USSR double taxation agreement which had previously applied to them. In 1998 the old Cyprus-USSR agreement was replaced by a new agreement between Cyprus and Russia. One of the greatest attractions of the Cyprus-USSR treaty is its highly favorable provisions regarding capital gains on disposal of shares, and the new 1998 agreement left these in place. It provides that movable property including shares is taxable only in the country of residence of the owner and, unlike most modern double tax agreements, made no exception for shares in "property-rich" companies, that is, companies whose assets principally comprise real estate. Since Cyprus imposes no tax on disposals of shares except and to the extent that the gain is derived from real estate in Cyprus, Cyprus companies became an ideal means of holding real estate in Russia, effectively allowing property to be disposed of free of capital gains tax or transfer charges by selling the shares in the company that owns the property rather than selling the property itself.

The Protocol closes this perceived loophole, giving the right to tax capital gains arising on disposal of shares in a property rich company to the country where the property is physically located. The determination of whether shares of a company derive more than 50 percent of their value from immovable property will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without deducting debts or other liabilities.

Furthermore, the source taxation rule will not apply if the share disposal is part of a qualifying reorganization, or if the relevant shares are listed on a recognised stock exchange, or if the seller is a pension fund, provident fund or the government of either country.

The Protocol provides for a transition period of four years for the new provisions regarding capital gains. The relevant 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, giving time to consider and implement measures to mitigate any negative impact of the change.

When the Protocol was signed in 2010 Russia indicated that it intended to amend the agreements with its other important double taxation treaty partners in order to introduce similar provisions regarding source taxation of capital gains on disposal of shares in property rich companies. Russia's agreements with Switzerland and Luxembourg have been amended, and the new provisions on capital gains on disposal of shares in property rich companies take effect immediately, without any transition period. The agreement with the Netherlands has not been amended, but that agreement already contains a provision effectively eliminating the loophole in most cases.

Withholding Tax Rates

One of the key elements of the Protocol is that the current beneficial withholding tax rates applicable to dividends (five percent on investments above the qualifying threshold and 10 percent otherwise), interest (zero) and royalties (zero) have not been increased.

The definition of the term "dividend" has been clarified 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 (for example under thin capitalization rules) will be subject to the same withholding tax rates as dividends.

Removal Of Cyprus From The Russian "Blacklist"

One of the benefits of the Protocol's entry into force was the removal of Cyprus from the "List of the States and Territories providing preferential tax treatment and (or) not requiring disclosure and furnishing of the information upon conducting of financial transactions (offshore zones)" appended to Order 108n of the Ministry of Finance of the Russian Federation dated November 13, 2007.

When Cyprus was deleted from the list with effect from January 1, 2013 companies incorporated in Cyprus became eligible to benefit from the participation exemption introduced by Russia with effect from January 1, 2008, under which dividends received by Russian companies from qualifying participations will be exempt from tax, provided that:

- The recipient holds at least half the equity of the distributing entity and the participation confers the right to receive at least half of the dividend distributed;
- The recipient has held the investment for at least one year at the time the decision is made to distribute the dividend; and
- The cost of the investment is RUR500m (approximately EUR13.6m) or more.

Furthermore, transactions between unrelated Russian and Cyprus companies will no longer be subject to the automatic transfer pricing control scrutiny in Russia that applies to locations included in the "blacklist."

With effect from January 1, 2013 the "blacklist" of countries ineligible to benefit from the exemption is: Andorra, Anguilla, Anjouan, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Belize, Bermuda, British Virgin Islands, Brunei Darussalam, Cayman Islands, Channel Islands (Guernsey, Jersey, Sark, Alderney), Cook Islands, Dominica, Gibraltar, Grenada, Hong Kong SAR, Isle of Man, Labuan, Liberia, Liechtenstein, Macau SAR, Maldives, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Palau, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and Grenadines, Samoa, San Marino, Turks and Caicos Islands, United Arab Emirates and Vanuatu.

The Impact Of The Amendments

The signing of the Protocol was generally welcomed as a positive development which removed a source of contention (namely information exchange) that had threatened to harm the cordial relations between Cyprus and Russia. It was recognised that the move to source taxation of capital gains on disposal of shares in property rich companies was inevitable, and by being the first to agree to this, Cyprus gained a significant advantage compared with Switzerland and Luxembourg, its main competitor jurisdictions. Access to the Russian participation exemption gives Cyprus an advantage over most other international financial centers such as the British Virgin Islands, the Channel Islands, the Isle of Man, Malta and Mauritius. Finally, despite the predictions of the doom-mongers, the "bail-in" of depositors in Cyprus's two largest banks in March 2013 did not result in an exodus of Russian business. Overall, therefore, it is fair to conclude that the Protocol has had a benign effect.