



## Contacts

### Cyprus

Pieris Markou  
pmarkou@deloitte.com  
+357 22 360 607

Antonis Taliotis  
ataliotis@deloitte.com  
+357 25 868 820

Paul Mallis  
pmallis@deloitte.com  
+357 22 360 617

### Russia

Lioudmila Katulevskaya  
lkatulevskaya@deloitte.ru  
+7 495 580 9686

Vladimir Gidirim  
vgidirim@deloitte.ru  
+7 495 580 9755

## International Tax

# Cyprus-Russia Tax Alert

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## New Protocol to Cyprus-Russia Tax Treaty and Removal from Russian “Blacklist”

On 16 April 2009 representatives from the respective Ministries of the Republic of Cyprus and the Russian Federation signed a Protocol to the 1998 tax treaty between the two countries. The Protocol is expected to be ratified by both countries in 2009 so that it will become effective as from 1 January 2010.

The outcome of over 12 months of negotiations, the Protocol is viewed as very beneficial to international business and will continue to foster and encourage economic relations between Cyprus and Russia through one of the most favourable treaties the Russian Federation has concluded.

### Removal of Cyprus from the blacklist

Russia has also agreed to remove Cyprus from its blacklist which will mean that dividends received by Russian companies from Cypriot subsidiaries can qualify for the Russian dividend participation exemption.

### Generally unchanged: dividends, interest and royalties

Importantly, there are no changes to the nil rates of withholding tax on interest and royalties. In respect of dividends, the withholding tax rates of 5% or 10% remain unchanged; the only change to the conditions for eligibility for the 5% rate is that rather than a minimum USD 100,000 investment in the capital of the company in whose shares are held, the minimum investment is now EUR 100,000.

The definitions of dividends and interest are amended to align substantially with the wording of the latest OECD Model Treaty definitions with an addition to the definition of dividends to include

payments on shares of mutual investment funds and similar collective investment vehicles (see below), as well as depository receipts over shares.

However the new definitions of dividends and interest will not prevent the Russian tax authorities from applying domestic 'thin capitalization' rules to reclassify 'excessive' interest payments as dividends and tax such amounts in Russia at source, albeit at the reduced dividend withholding tax rates under the treaty.

### The big change: not until at least 2014

The major change to the existing treaty is the taxation of capital gains on the sale of shares in real estate property-rich companies. Currently, the treaty provides for the country of residence of the selling entity to have the taxing right (e.g. Cyprus for Cypriot companies selling shares in Russian property-rich companies). The Protocol moves to the latest OECD Model Treaty principle that such gains should be taxable in the country where the real estate is situated.

The taxing right will remain with the country of residence of the selling entity where that entity is a pension fund, a provident fund, the government of Cyprus or the Russian Federation, or the gains are from the disposal of shares in a listed company or in the course of a corporate reorganisation.

The good news is that we do not expect this amendment to the treaty to apply until 1 January 2014 as the Protocol provides for the amendment to become effective on the first day of the calendar year following four years after the Protocol as a whole enters into force. In the meantime, there are likely to be planning opportunities available to mitigate any negative implications of this change.

### The perceived 'limited' limitation of treaty benefits

A new limitation of benefits article is introduced that seeks to dis-apply benefits of the treaty that would otherwise provide a reduction or exemption in tax to an entity that was created with the main purpose of obtaining such benefits *and* the entity is not registered in Russia or Cyprus (as appropriate).

This limitation should therefore not apply to companies incorporated in Russia or Cyprus. As a Russian resident company is one that is always incorporated in Russia, the limitation will most likely only apply to companies incorporated outside Cyprus but tax resident in Cyprus by virtue of the exercise of their management and control in Cyprus.

The good news is that the denial of treaty benefits does not apply automatically by virtue of the new article, but rather offers a mechanism to the tax authorities of both Cyprus and Russia to counter some perceived treaty abuses and only as a result of consultations between the tax authorities.

## Distributions from mutual investment funds

The Protocol amends the dividend article to provide that dividends shall include payments on shares of mutual investment funds so that such distributions would have a maximum tax of 10% withheld by the paying entity. Under Russian domestic law, such distributions are currently subject to 20% withholding tax. As a result, the uncertainty under the existing treaty on whether such distributions could be classified as 'other income' is removed.

Importantly, the amendment to the article on income from immovable property seeks to allocate taxing rights to the source state with respect to income of a mutual investment fund investing only in immovable property. The possible reason for this construction is a potential concern of the Russian authorities in respect of structures created where income from real estate contributed into such real estate investment funds lead to a possible 'double non-taxation' effect within those structures.

We are hoping that the breadth of application of these amendments, especially in respect of distributions from Russian real estate funds, will be clarified by the tax authorities in the coming months.

## Other amendments

Other changes to the existing treaty brought about by the Protocol include:

- Under the existing treaty, for the purpose of the definition of "resident" (other than an individual), residence is determined by the entity's place of effective management. A new paragraph is added by the Protocol with the objective of making the 'tie-breaker test' more effective so that where the place of effective management of such a person cannot be determined, the Russian and Cypriot tax authorities shall endeavour to determine this by mutual agreement.
- The meaning of permanent establishment is extended to allow for the taxation of profits from services performed in one country by an entity of the other country through an individual or individuals present in the other country for more than 183 days in a 12-month period in certain circumstances. The new paragraph follows the wording circumscribed by the OECD Model Treaty Committee in the Commentary to the latest Model Treaty for countries which wish to include such a provision.
- The existing treaty's article regarding taxation of income from international traffic (i.e. shipping and aircraft) is replaced. The existing treaty provides that the taxing right for such income shall belong to the country in which the person deriving such income is resident, whereas the Protocol changes this to the OECD Model Treaty principle of the taxing right belonging to the country where the effective place of management of the person deriving such income is situated.

- The article on exchange of information is replaced by the latest OECD Model Treaty equivalent and the article on assistance in collection is replaced by wording almost identical to the latest OECD Model Treaty equivalent. The difference from the current article on exchange of information is largely understood to be clarifications of existing obligations and powers. The new article on assistance in collection will apply only once Cyprus has made certain amendments to its domestic law to allow for certain aspects of such assistance.
- Amendments to the article on mutual agreement procedures are made to largely adopt the latest OECD Model Treaty equivalent article.

### To think about...

You should consult your tax adviser if you think you are affected by the new Protocol, in particular if:

- You own shares in a Russian company with a cost of less than EUR 100,000.
  - You own Russian or Cypriot real estate directly or indirectly through shares of a company or a collective investment vehicle.
  - You are a company that is tax resident in Cyprus but not incorporated in Cyprus.
  - You are looking to benefit from the reduced withholding tax on distributions from mutual investment funds.
  - You provide services through an individual present in either Russia or Cyprus for extended periods of time.
  - You currently benefit from the international traffic article of the treaty but your country of residence differs to where your place of effective management is situated.
  - You are concerned about the obligations and powers of the tax authorities to exchange information and for one authority to assist in the collection of taxes for the other.
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