

NEW PROTOCOL TO RUSSIA-CYPRUS INCOME TAX TREATY

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To Our Clients and Friends:

Russia and Cyprus are in the final stage of negotiation of a new protocol (the “Protocol”) amending the existing Russia-Cyprus income tax treaty (the “Treaty”). The Protocol will come into force only after ratification by both countries, and most provisions will be applicable to tax years beginning on or after January 1 of the year following ratification. At this point, no official version of the Protocol is available and the Russian Ministry of Finance has not confirmed that the Protocol has already been signed (despite media reports to the contrary). Based on the available draft of the Protocol, the key changes are as follows.

LIMITATION ON BENEFITS

The Protocol introduces a “limitation on benefits” (“LOB”) article intended to prevent potential abuses of the Treaty. Under the LOB provision, a resident of Russia or Cyprus will not be entitled to the benefits of the Treaty if, as a result of consultations between the competent authorities, it is established that obtaining Treaty benefits was the main purpose (or one of the main purposes) of the establishment or maintenance of such resident.

The Protocol clarifies that the LOB provision is restricted to companies that are not “registered” in Russia or Cyprus. Since Russian resident companies are always registered in Russia, it appears that the scope of the LOB provision would be limited to companies that are resident in Cyprus by virtue of having a place of effective management and control in Cyprus, but are not otherwise registered in Russia or Cyprus.

As there is no specific provision relating to the application of the LOB provision to existing structures, such structures could presumably be tested under the LOB provision from the time it becomes effective.

GAINS FROM SALE OF REAL ESTATE COMPANIES

Under the current Treaty, gains derived by a Cyprus resident from the sale of shares in a Russian company are not subject to Russian tax. The Protocol provides, instead, that gains derived by the resident of one state (*e.g.*, Cyprus) from the sale of shares deriving more than 50% of their value from immovable property situated in the other state (*e.g.*, Russia) generally may be taxed in that other state (*e.g.*, Russia).

There are a few exceptions to this rule. Among other things, it will not apply to gains from (i) the transfer of shares in a corporate reorganization or (ii) the sale of shares listed on a recognized stock exchange.

This provision relating to real estate companies will become effective on the first day of the calendar year following the expiration of a four-year period starting from the date on which the Protocol enters into force (*i.e.*, January 1, 2014, if the Protocol is ratified in 2009). Note, however, that certain potentially abusive structures involving real estate companies could be denied the benefits of the Treaty prior to that date under the new LOB provision described above.

DIVIDENDS AND INTEREST

The definitions of “dividends” and “interest” have been amended by the Protocol. In particular, the definition of dividends is expanded to include:

- any payment on shares of mutual investment funds or similar collective investment vehicles;
- any payment to the holders of depositary receipts over shares; and
- any payment in the form of interest subject to the same tax treatment as dividends in the source state, which, for instance, in Russia would apply to the portion of interest re-characterized as dividend under the Russian “thin capitalization” rules.

The definition of interest is expanded to include, specifically, interest on profit participating loans.

Although the withholding tax rates on dividends and interest are not modified by the Protocol, the application of the 5% withholding tax rate on dividends will require a minimum investment of €100,000 into the capital of the paying company – instead of U.S. \$100,000 as provided under the current Treaty.

OTHER CHANGES

The Protocol makes a number of other changes to the Treaty, in particular:

- Permanent Establishment. A resident of one state will be deemed to have a PE in the other state, in certain circumstances, if it performs services in the other state for periods of more than 183 days in a 12-month period through one or more individuals.

- Shipping and Air Transport. The income from international shipping and air transport will be taxable exclusively in the state where the person deriving the income is effectively managed, instead of its state of residence as provided under the current Treaty. This change follows the OECD model.
- Mutual Investment Funds. The income of mutual investment funds investing only in immovable property will be taxable in the state where the immovable property is located.
- Exchange of Information. The scope of the exchange of information article will be expanded to include all taxes (*e.g.*, indirect taxes) and not only taxes covered by the Treaty. In addition, a state could not decline to provide information to the other state on the basis of banking secrecy alone.
- Tie-breaker for Residency. The Russian and Cyprus authorities will determine the place of effective management of an entity by mutual agreement, if such place cannot otherwise be determined.

Finally, it is reported that Cyprus will be removed from the “blacklist” of countries and territories with a beneficial taxation regime and/or not disclosing and providing information on financial operations (offshore zones) adopted by the Russian Ministry of Finance. As a result, dividends received by Russian companies from their Cyprus subsidiaries would become eligible for the Russian dividend participation exemption regime and, therefore, exemption from tax in Russia, provided that certain minimum holding period, minimum shareholding and other requirements are met.

Please feel free to contact us with any questions.

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