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Recent changes in international taxation and double tax agreements in Russia

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1. INTRODUCTION

The Russian Federation inherited a confusing and inefficient tax system after the breakup of the Soviet Union in 1991. However since then, the Russian tax system has been significantly reformed. In the 1990s, businesses and individuals were generally reluctant to pay taxes promptly, if at all.[1] The restructuring of the tax system was designed to rationalise the tax burden, improve the collection of taxes, and to generally align the system with those in developed market economies.

There are three levels of taxation in Russia: federal, regional and local. Major tax reform commenced in 1999 and resulted in a reduction of the number of official taxes from over 200 to approximately 40, in addition to setting out the administrative framework for the new system.[2] Currently, the principal taxes collected at the federal level are corporate tax (20% on worldwide income),[3] capital gains tax,[4] personal income tax (13% flat tax),[5] social contribution taxes,[6] value added tax (VAT) (standard rate 18%),[7] excise taxes, securities tax (0.8% on nominal value), customs duties and fees, and federal license fees. The tax administration has constantly been improved which, in recent years, has resulted in tax revenue growth at almost 30 percent annually.[8]

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1 For example, in 1996, 26 tax collectors were killed, six were kidnapped, and 41 had their homes burned down. In the first half of 1997, the government only collected 57% of its targeted tax revenues. Sodnomova S. K. 2008. Theory and history of taxation. Irkutsk: Publishing BGUEP.

2 Panskov V. G. 2006. Tax and tax system of the Russian Federation. Moscow, Book World

3 From 1 January 2009, 2% of this rate is paid to the federal budget and 18% to the regional budgets (previously, the federal portion was 6.5%).

4 There is no separate capital gains tax in Russia. Capital gains are taxable as normal business income.

5 Income tax rate for non-residents is 30% (flat rate).

6 Social contribution are payable in connection with employee salaries by employers to the state pension, medical insurance and social insurance funds (34 % starting on January 1, 2011).

7 A 10% VAT rate is applied to food products, children's goods, and printed materials, such as schoolbooks.

8 Rosstat (Russian federal service of government statistics). Available at: http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/finance/

In the international context, the Russian tax code provides double taxation relief by way of a tax credit for foreign taxes paid on foreign sourced income, subject to a limit equivalent to the maximum sum of Russian tax payable on the same income. Any excess foreign tax credits may not be transferred to future or previous periods. Russia is also a party to a number of double taxation agreements (DTA) with various countries. In general terms, it is rather unproblematic to repatriate capital (particularly dividends, interests and royalties) from Russia to other countries. Similarly, it is relatively simple to invest in the Russian economy through low-tax countries (or tax havens – also referred to as 'offshore zones' in Russia) and international holding, financial, licensing and service companies and banks.[9] The largest part of foreign direct investment (FDI) inflow comes from countries which have favourable tax treaties with Russia. Popular locations of offshore companies utilised when conducting international business with Russia include Cyprus, Holland, Switzerland, Luxembourg and the British Virgin Islands. However, the Russian government is currently attempting to tighten the tax law and in this vein, has been updating international tax law and the existing DTA network.

2. DOUBLE TAX AGREEMENTS

From 1970 until 1991, the USSR developed a DTA network including DTAs with India, Finland, Malaysia, the Netherlands, Denmark, Japan, France, the UK, Canada, Spain, Italy, Cyprus, Germany, Sweden, Austria and the USA.[10] However, since there were (almost) no cross-border private businesses, the application of these treaties was relatively low. After the Soviet era, Russia became party to a number of DTAs, and has continued to extend its DTA network vigorously since then.[11] For example, in 1997, Russia had DTAs with 37 countries (including those inherited from the USSR),[12] and by 2010, had increased this number to 77.[13] This includes DTAs with most European countries, Australia, China, the USA, Canada, Japan, India, and other countries important economically and politically.[14]

With some deviations, the treaties of the USSR resembled the Organisation for Economic Cooperation and Development (OECD) or United Nations (UN) model tax treaties of the time.[15] The tax treaties to which the former USSR was a party are honoured by Russia, unless the other party to the treaty has rejected it. The Russian Tax Treaty Model (RTTM) was accepted in 1992 and in general follows the OECD model of that time.[16] By and large, with some exceptions, Russian DTAs have been based on the updated OECD model. This approach corresponds to the general route of the country to join main international economic organisations, including the OECD. It is essential to emphasise that DTAs concluded by Russia with other jurisdictions are an integral part of domestic tax legislation. Russian tax law clearly indicates that if a

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[9] Zhidkova E. Y. 2009. Taxes and taxation. Moscow. Eksmo.
[10] Sodnomova S. K. 2008, above n 1.
[11] Panskov V. G. 2006, above n 2.
[12] International Conventions of Russia. Available at: http://www.taxpravo.ru/zakonodatelstvo/90278-int
[13] Panskov V. G. 2006, above n 2.
[14] International Conventions of Russia, above n 12.
[15] Sodnomova S. K. 2008, above n 1.
[16] Resolution of the Government of the Russian Federation of 28 May 1992, No. 354, "On Conclusion of Inter-Government Tax Treaties on Avoidance of Double Taxation of Income and Capital".

DTA provides other regulations than the law itself, the regulations of the DTA will prevail.[17] Hence, it is of no surprise that tax treaties significantly influence Russian domestic tax law and fiscal authorities frequently rely on DTA provisions.

2.1 Residency

The relatively large number of DTAs concluded has forced the Russian fiscal authorities to embark upon the problems connected with the application of some their provisions. One of the major issues in the international taxation context relates to concept of residency. The key criterion of fiscal residency (for corporations) in Russia is the place of incorporation. The notion of a Russian/non-Russian tax resident for corporate tax purposes is at present not defined under domestic tax law. Despite the lack of definition, Russian tax law does distinguish between domestic and foreign enterprises. Domestic enterprises are those which are established under the laws of Russia and are taxed on their worldwide income. Foreign enterprises controlled and managed in Russia are subject to tax on profits derived from business activities carried on through a permanent establishment in the Russian Federation. Despite the fact that Russia is not an OECD member state, the definition of permanent establishment under Russian domestic law[18] broadly follows the permanent establishment concept provided in the OECD Model Convention. Generally, foreign companies may have certain advantages in conducting business activities in Russia through a permanent establishment. Contrary to a Russian company, after-tax profit distributions from a permanent establishment to the head office of a foreign company are not subject to dividend withholding tax.[19] Further, currently Russian “thin capitalisation rules” apply to resident borrowers only. This makes a permanent establishment an attractive form of business structure to enter the Russian market.

When determining profit attribution to a permanent establishment, the domestic tax code stipulates the indirect profit allocation method as a general rule. However, the majority of Russian DTAs use the direct profit allocation method. ‘Force of attraction’[20] clauses are present in a small number of tax treaties (with Indonesia, Kazakhstan, the Philippines, and Vietnam) but lacking in treaties with key investment and trade partners (the US, the UK, Cyprus, France, Germany, and the Netherlands). As noted above, international treaties prevail over the domestic law. For that reason, if a permanent establishment of a foreign enterprise utilises the direct profit allocation method, it cannot be forced to use the indirect method unless a relevant DTA stipulates the use of the indirect method.

Notwithstanding the Tax Code allowing the application of the indirect method, the Russian Tax Ministry recommendation[21] stated that the attribution of a foreign enterprise’s profits to its Russian permanent establishment shall be founded on the relevant principles in DTAs. That is, the permanent establishment’s profit is

[17] Russian Tax Code, Article 7. Available at: http://www.info-law.ru/kodeks/12/
[18] Russian Tax Code, Article 306. Available at: http://www.info-law.ru/kodeks/12/
[19] Polezharova L., A Permanent Establishment of A Foreign Company, Russian Tax Courier, May 2003.
[20] Generally, ‘force of attraction clause’ implies that one State may tax the business profits arising to a resident of the other State by virtue of a PE in the first state or otherwise.
[21] Order of the Tax Ministry, No. BG-3-23/150, of 28 March 2003 “On Approval of the Methodological Recommendations for Tax Authorities on the Application of Certain Provisions of Chapter 25 of the Tax Code of the Russian Federation Taxation of Foreign Organisations”.

considered to be a profit made by a separate and independent enterprise. This resemblance between domestic law and the OECD Model illustrates that tax treaties have served as a conduit and influenced the development of Russian domestic tax law on the matter. This situation represented the first time a DTA principle has been officially recognised in domestic law. As a result, this DTA principle is now applied regardless of whether there is a DTA in existence.

2.2 Beneficial ownership

Recently, the Russian fiscal authorities have started focusing on tax avoidance issues involving the use of DTAs. One of the major issue in this context is treaty shopping. The notion of treaty shopping may be defined as an activity where a resident of a third country seeks to gain the benefit of a DTA between two other countries by establishing an entity in one of the countries that is a party of the DTA. Importantly, the unique difference between a 'treaty shopper' and an ordinary business is that in the instance of treaty shopping, economic ties linking the taxpayer and the treaty state are inadequate. In other words, the treaty shopper's occurrence in the treaty country lacks economic substance.

Clearly, treaty shopping is considered offensive to the spirit of tax law. As a result, a number of measures have been developed in international tax law to avert or reduce treaty shopping practices. The beneficial ownership concept is one such mechanism. Fundamentally, the beneficial ownership concept requires taxpayers to demonstrate genuine economic control over the income received so as to obtain the benefits under the DTA. The beneficial ownership mechanism mostly affects passive income, that is, dividends, interest and royalties.

Most Russian DTAs, as noted above, follow the OECD Model, and thus include the beneficial ownership concept. Nonetheless, the concept is rarely applied in practice, even though many Russian businesses utilise low-tax jurisdictions to reinvest their capital in Russia. Sporadically, Russian fiscal authorities have attempted to apply the beneficial ownership concept, but the impact on the business activities of both Russian and foreign investors were rather limited.[22] Recently however, the Russian President ordered the government to develop measures counteracting treaty abuse. Following this order, the Finance Ministry proposed amendments to Article 7 of the Russian Tax Code concerning eligibility for treaty benefits.[23] Specifically, under the proposed amendments, the beneficial owner of certain Russian source income must be determined in order to receive benefits under a DTA. Formally, these amendments aimed to structure the legislative mechanisms necessary to counteract the exploitation of DTAs by the final beneficiary which is not a resident of either of the countries that is a party of the DTA. The amendments to Article 7 would essentially introduce the concept of beneficial ownership to Russian domestic law. However, the proposed provisions do not specify the criteria and mechanism to identify a foreign company as the beneficial owner.[24]

[22] Zhidkova E. Y. 2009, above n 9.

[23] The draft federal law "On Amending Part I of the RTC for Counteracting Treaty Shopping when Carrying out Operations with Foreign Companies and Individuals" prepared by the Russian Ministry of Finance, in accordance with paragraph 39 of the Russian President's Budget message 2009.

[24] Ibid.

As noted above, a number of DTAs concluded by the Russian Federation include requirements to apply preferential withholding tax rates to dividend, interest and royalty payments only if they are being paid to the actual beneficial owners (see for example, the payment of dividends under the Russia – Cyprus DTA). However, the treaties do not specify a mechanism to facilitate the identification of the actual beneficial owner of certain income. Therefore, the proposed amendments to Article 7 of the Russian Tax Code would not solve the problem. Some jurisdictions adopt a mechanism and specific criteria in domestic law for identifying beneficial ownership status. For example, in the US, the beneficial ownership test is rather extensive: questionnaires must be completed and information provided on the foreign income beneficiary. The Russian tax authority is likely to apply the OECD approach, suggesting that a company cannot be regarded as the beneficial owner if it acts as an agent, nominee or a 'conduit' company for another person, who is the actual recipient of the benefit.[25] However, OECD principles are not mandatory in Russia which could easily lead to ambiguous interpretation of the amendments to Article 7.

The Russian fiscal authorities are also likely to experience difficulty obtaining information on the identity of the ultimate beneficiary of dividends, interest and royalties. Hence, the proposed amendments would be of limited assistance to the Russian government in combating tax avoidance and treaty shopping. Instead, the Russian government should introduce an explicit regulation specifying the beneficial ownership test. This regulation should not be subject to the discretion of the tax authorities. However, even if the current proposal is significantly improved in Russia, it may take more than one amendment to create the necessary legislative structure. As at November 2011, the amendments to Article 7 of the Tax Code have not been submitted to the State Duma (Russian Parliament), and it is therefore unclear when the draft law will be enacted. For the time being, the Russian fiscal authorities have to rely on tax treaties to counteract treaty shopping.

3.0 TAX AVOIDANCE AND DTAS

In many OECD countries, fiscal consolidation practices, controlled foreign corporation (CFC) rules and transfer pricing legislation all aim to restrain the use of offshore international financial centres (OIFCs). Generally, these mechanisms counteract tax avoidance practices such as retaining untaxed profits in the taxpayer's foreign subsidiaries, pricing international sales in an attempt to maximise profits in low-tax countries, and mixing foreign profits and losses in the taxpayer's home jurisdiction to reduce tax payments. Such anti-avoidance mechanisms are immature in Russia. For example, there are no general anti-avoidance provisions in Russian tax law. Further, there are no CFC rules, tax consolidation is restricted to very limited circumstances and the transfer pricing regulations are ineffective, although new regulations may be introduced in 2011-2012.[26] Russian courts have attempted to

[25] OECD Model Tax Convention on Income and Capital 2010, Commentary to Article 10/12 and Art. 11/4.

[26] In 2010 the Russian Ministry of Finance proposed a draft law on transfer pricing. The key amendments include the introduction of: 1) an "arm's length" concept (the existing rules are based on more than a 20 % deviation from market prices); 2) "functional analysis" as a key method for definng which transactions are relevant for comparison purposes; 3) the option of "advance pricing agreements" with the tax authorities, to avoid disputes and increase certainty and some other important amendments. Additionally, a consolidated group treatment is proposed to allow corporate groups to consolidate

combat tax avoidance through the development of the so-called 'unjustified tax benefit'[27] concept. However, there are no structured administrative or legal regulations concerning the application of this concept and other anti-avoidance provisions to tax treaties.

As already mentioned, Russian investors often utilise OIFC companies for business activities in Russia or abroad. Normally, foreign asset income will be locally taxed but profits collected by the OIFC company may linger untaxed as a result of the lack of CFC regulations, given that they are not repatriated to Russia. Similarly, the indulgent Russian transfer pricing rules permit a large amount of the profit inbuilt in the imported goods to be collected by an intermediate OIFC company. Furthermore, if a Russian investor reinvests capital to Russia[28] through an intermediary company in one of the OIFCs that has a favourable DTA with Russia, the remittance of Russian profits, royalties or interest will be taxed at a minimum level. It is not surprising then, that in the 1990s many Russian banks set up branches in Cyprus, in support of schemes to expatriate Russian capital and profits. Subsequently, the Netherlands, Luxemburg, Malta and Gibraltar became popular for the same reasons.[29] Nowadays, Russian holding companies are established in a wide range of OIFCs.

An investor from one of the countries that has a DTA with Russia may invest directly in Russia, and rely on the DTA to diminish Russian withholding taxes on dividends, interest or royalties. Typically, withholding tax rates are in the range of five to 15 percent on dividends, and zero to ten percent on interest or royalties. Examples of OIFC countries that have DTAs with Russia include Cyprus and Luxembourg. Under the Russian-Cyprus DTA, the rate of withholding tax on dividends is five percent if the investment was greater than US$100,000 and ten percent if not, whereas the rates for interest and royalty payments are zero.[30] Under the Russia-Luxemburg DTA, the rate of withholding tax on dividends is ten percent for a greater than 30 percent ownership of the company paying the dividend, and 15 percent in all other cases. The withholding tax rates on interest and royalty payments is zero. Generally, Cyprus and Luxembourg are not high tax jurisdictions. Moreover, if a non-resident is a beneficial owner of the holding company he is not taxed at all in these countries. Thus, it is no surprise that Cyprus appears to be a very popular place to establish a holding company for Russian businesses.

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profits and losses earned by different subsidiaries. For the detailed discussion see: Variychuk, E. 2011. Russia – In Search of Effective Regulation: Draft Bill on Transfer Pricing. Bulletin for International Taxation Vol. 65 (2).

[27] The 'unjustified tax benefit' concept means that tax benefits (tax deductions, tax refunds or lower tax rates) may be rejected if application of those benefits is the only or one of the main reasons of the activities of a taxpayer.

[28] At present, many Russian companies reinvest capital to Russia.

[29] For example, only in January and Februrary of 2011, a net outflow of capital from Russia amounted to US$ 17 billion. Vedomosti, 16 March 2011. Available at: http://www.vedomosti.ru/finance/news/1232209/iz_rossii_prodolzhaet_utekat_kapital

[30] Agreement between the Government of the Russian Federation and the Government of the Republic of Cyprus from 05.12.1998 on "The Avoidance of Double Taxation with Respect to Taxes on Income and on Capital" Available at: http://www.taxpravo.ru/zakonodatelstvo/statya-90420-soglashenie_mejdu_pravitelstvom_rf_i_pravitelstvom_respubliki_kipr_ot_05121998

As noted above, the Russian government is attempting to update domestic tax law to counteract tax avoidance. Also, more anti-abuse provisions have been included in the more recent Russian tax treaties. Such provisions can be seen in the Russia-Cyprus DTA, and it is therefore worth discussing this treaty in greater detail.

3.1 Russia-Cyprus DTA

The DTA between Russia and Cyprus was signed in 1998.[31] This DTA was one of the major causes of the massive flow of Russian investment through the Mediterranean island in the past two decades. Cyprus is a leader in terms of investments in Russia. At the peak of investment in 2008, Cyprus' investments in Russia reached US$56.9 billion.[32] This represents more than 20% of all foreign investments in Russia.[33] Most of these investments, however, are repatriated Russian capital.

The Cyprus Government was successful in building a favourable offshore tax regime, with nearly 50,000 offshore companies being registered in Cyprus since 1975.[34] Nevertheless, in 2004, Cyprus joined the European Union (EU) which signified a reform of their tax regime. Cyprus has the lowest corporate tax in the EU, with resident companies paying ten percent tax. (This is similar to non-resident companies, but income from foreign sources is exempt for non-residents).[35] Interestingly, Cyprus has signed DTAs with many OECD states (around 50 in total) including major high-tax countries.[36] This is unusual for an offshore financial centre and distinguishes Cyprus as a convenient place for establishing holding and investment companies intended for developing markets.

Many large Russian businesses utilise Cyprus holding companies in some way.[37] For example, Aleksei Mordashov controls Severstal[38] through the Cyprus company Frontdeal Ltd. Another Russian oligarch, Viktor Rashnikov, holds 87 percent of the shares of MMK[39] through two Cyprus companies – Mintha Holding Ltd and Fulnek Enterprises Ltd. Realising that businesses often use Cyprus companies in tax structuring arrangements, the Russian government added Cyprus to a 'blacklist' in 2008, on the basis that it was an 'uncooperative territory'. The black list was introduced through an amendment to the Russian tax code.[40] It provides a tax

[31] Ibid.
[32] Rosstat (Russian federal service of government statistics) http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/enterprise/investment/foreign/index.html
[33] Ibid.
[34] Cyprus Company Formation. Available at: http://www.ukincorp.co.uk/s-O8-offshore-cyprus-company-formation.html
[35] Ibid.
[36] Ibid.
[37] Zaharov A. 2009. How Cyprus will exchange of tax information? Available at: http://www.taxpravo.ru/analitika/statya-72030-kak_kipr_budet_obmenivatsya_nalogovoy_informatsiey
[38] Sverstal is a Russian steel and mining company. As of 2009, it is the largest steel company in Russia according to the Metal Bulletin. Severstal revenue in 2009 was US$ 13.01 billion.
[39] MMK is abbreviation for Magnitogorsk Iron and Steel Works company. MMK produced 21.8 million tonns of steel and steel products in 2010. MMK revenue in 2009 was US$ 5.081 billion.
[40] The list was published on June 18, 2007 and included 59 jurisdictions, such as the offshore Caymans, Maldives, British Virgin Islands and others countries. Similar list was earlier issued by the Bank of Russia (Directive 1317-Y of the Bank of Russia of August 7, 2003).

exemption on the repatriation of dividends from foreign subsidiaries of Russian businesses, but excludes Russian subsidiaries founded in countries on the blacklist. Some countries, (for example, Ireland, Luxembourg and Switzerland), lobbied the Russian government and were excluded from the blacklist.[41] However, Cyprus continually failed to provide information to the Russian tax authorities and thus has stayed on the blacklist.

In April 2009, Russia and Cyprus initiated a revision of double taxation treaty, with the amending protocol to the Russia-Cyprus DTA[42] signed during a visit to Cyprus by Russian President Dmitry Medvedev in October 2010. The Russian President suggested that the new protocol would provide business transparency and confirmed that Cyprus would be removed from the Russian blacklist. The importance of this DTA for Russia necessitates exploring the treaty amendments to identify its major developments.

3.1.1 Amendments to the Russia – Cyprus DTA

The new protocol to the Russia-Cyprus DTA is intimately in line with the latest version of the OECD Model and commentaries thereto. Several protocol provisions are especially significant for the development of the Russian international tax regime. One of the key developments is that the term 'permanent establishment' (Article 5) was further clarified in the protocol to the DTA.[43] The term was extended by including the following supplementary conditions:

- provision of services through an individual, if such individual is present in Russia for more than 183 days during any 12-month period, and income from such services constitutes more than 50% of the Cyprus company's income from active business activities during the relevant period; or
- provision of services, in respect of one or connected projects, through one or more individuals, for a period exceeding 183 days (in aggregate) during any 12-month period.[44]

The Russian fiscal authorities, like many other countries, want to increase their revenues. However, instead of increasing the tax base of Russian companies that pay management fees to Cypriot companies, the protocol redefines fees earned by Cypriot companies for the provision of management services as Russian sourced income. According to the protocol, a Cypriot company cannot provide management services if they lack the presence of representatives in Russia. Hence, a Cypriot company providing management services and charging the relevant fees to a Russian company is considered to have a representative in Russia, and thus having a permanent establishment in Russia. In other words, the protocol specifies that the provision of

[41] Zhidkova E. Y. 2009, above n 9.
[42] Protocol to the Agreement between the Government of the Russian Federation and the Government of the Republic of Cyprus on the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital Available at:
http://www.taxpravo.ru/zakonodatelstvo/statya-90417-protokol_k_soglasheniyu_mejdu_pravitelstvom_rossiyskoy_federatsii_i_pravitelstvom_respubliki
[43] Ibid.
[44] Ibid.

management services gives rise to a permanent establishment in Russia. This is a novel provision for Russian DTAs, and implemented specifically to increase permanent establishment exposure. Additionally, the 183 days test relates specifically to presence and not provision of services, meaning the provision of services for less than 183 days may be sufficient to create a permanent establishment. However, it is surprising that the wording of the protocol does not cover Cyprus companies with managers based in Russia.

Another important amendment to the Russia – Cyprus DTA concerns the taxation of income from immovable property (Article 6).[45] Tax structuring has frequently involved utilising mutual funds for property investments.[46] Article 10 of the DTA has been amended, and provides that payments on shares of 'mutual funds or similar forms of collective investment'[47] shall be treated as dividends and, consequently, are subject to either five or 10 percent Russian withholding tax. The amendments to Article 6 specify that income of mutual funds 'investing only in immovable property' shall be treated as income from immovable property and, as a result, subject to 20% Russian withholding tax. Apparently, the intention of the Russian fiscal authorities is to characterise such income as income derived from immovable property. In this case, Article 6 rather than Article 10 is applied and income distributed by Russian real estate mutual funds to Cypriot investors is subject to 20% withholding tax in Russia. Nonetheless, the protocol does not provide clear definitions of mutual funds or similar forms of collective investment and whether income from Russian real estate mutual funds will fall within the scope of income from immovable property.[48] Thus, the scope of these amendments will need to be further clarified by the fiscal authorities of the DTA parties.

The amendment to the taxation of income from international traffic (Article 8) corresponds to that in the OECD Model Tax Convention. Under the previous version of the DTA, income from international traffic (by ships, aircrafts or road vehicles in certain circumstances) was exempt from Russian withholding tax if the recipient was a resident in Cyprus. The Amended version of the DTA stipulates that the recipient of such income is exempt only if they have their place of effective management in Cyprus.[49]

The protocol has also broadened the definitions of dividends (Article 10) and interest (Article 11). The dividend taxation regime has been extended to:

- income from depositary receipts (though it is not clear if this means income received by the nominee holder of shares or income received by the beneficial owners of shares);
- any payments on shares of mutual investment funds or similar collective investment vehicles, and

[45] Ibid.
[46] Zaharov A. 2009, above n 37.
[47] Protocol to the Russia-Cyprus DTA, above n 42.
[48] Protocol to the Russia-Cyprus DTA, above n 42.
[49] Protocol to the Russia-Cyprus DTA, above n 42.

- interest which, in accordance with domestic laws of the source State, is treated as dividends.[50]

The new amendments imply that income from mutual funds or similar investment vehicles will be deemed to be dividends (with the exception of income from such mutual funds investing only in immovable property as discussed above). This amendment also clarifies the question as to whether interest deemed as dividends under Russian tax law should still qualify as interest under the DTA or whether the treaty should follow the domestic law characterisation.[51] However, it is not clear whether other Russian DTAs will be amended to overcome the above ambiguity. Further, interest income would continue to enjoy an exemption from withholding tax. However, this exemption does not apply to interest which constitutes a constructive dividend under Russian thin capitalisation rules.[52] The definition of interest has been extended to embrace interest on profit-participating loans, premiums and prises associated with government securities, bonds and debentures. Nevertheless, penalty charges for late payment are not included in the definition of interest and are therefore likely to be considered as 'business profits' or 'other income'.

A further significant amendment relates to the taxation of gains from the alienation of property (Article 13).[53] Specifically, the rules on the taxation of capital gains were modified in accordance with the OECD Model Tax Convention. According to the protocol, income from the alienation of shares deriving more than 50 precent of their value from Russian real estate is subject to 20 percent Russian withholding tax. However, in the following three cases, there is an exemption from Russian withholding tax:

- alienation of shares in the course of corporate reorganisation;
- alienation of shares listed on a recognised stock exchange; and
- alienation of shares by a pension fund, a provident fund or the government of Cyprus.[54]

A similar provision for the alienation of shares exists in the Russian Tax Code.[55] However, that provision does not specify the mechanism of paying withholding tax for a non-resident company that is lacking a presence in Russia. Further, the provision does not cover the indirect possession of Russian immovable property through a chain of Russian or Cypriot companies. It also excludes the alienation of interests in a Cypriot business holding more than 50 percent of immovable property assets in Russia and owned through a branch. As a result, this amendment appears to focus on direct

[50] Protocol to the Russia-Cyprus DTA, above n 42.
[51] This approach was confirmed by Russian arbitration court in the cases involving the tax treaties with Germany and the Netherlands. See Decision of the North-Western Federal District Arbitration Court No. A 6-19 78/2006 of 9 April 2007 and Decision of the Moscow Federal District Arbitration Court No. KA-A 0/6616-0 of 2 July 2005.
[52] Russian Tax Code. Article 269(2). Available at: http://www.info-law.ru/kodeks/12/
[53] According to the previous version of Article 13 of the DTA, income of Cyprus companies from the sale of shares in Russian companies is exempt from Russian tax.
[54] Protocol to the Russia-Cyprus DTA, above n 42.
[55] Russian Tax Code. Article 214 (1). Available at: http://www.info-law.ru/kodeks/12/

real estate ownership structures only and is unlikely to affect indirect holdings. These loopholes may be addressed in the future, considering that this provision will not come into effect until January 1, 2014 at the earliest. This delay is intended to allow Russia to adjust its current DTAs with other countries.

Other amendments to the Russia-Cyprus DTA that are worthy of discussion include Articles relating to mutual agreement, exchange of information, and reciprocal assistance. According to Article 4 of the, the resident status of a company is to be defined by its place of management (the tax residency criterion in Cyprus) or place of registration (the tax residency criterion in Russia).[56] Thus, if the company is a tax resident of both States, the place of effective management is a key factor to determine residency. The protocol has introduced a mutual agreement procedure (Article 25) in the case that the place of effective management cannot be determined.[57] However, it appears that the protocol wording does not specify the mutual agreement procedure for a situation where one state questions whether the place of effective management was the other state. The introduction of a mutual agreement procedure is still a positive development, as taxpayers are now allowed to present their case to the fiscal authority of either State within three years if they believe that a state is in breach of the DTA.[58] The previous version of the DTA permitted a taxpayer to apply only to the fiscal authority of the state where he was a resident.

Another key provision of the DTA is the exchange of information article (Article 26).[59] Article 26 uses the identical wording as the OECD Model Tax Convention. Similar amendments were also introduced to Russia's DTAs with the Czech Republic and Germany (in effect from 1 January 2010).[60]

Specifically, the adjustments to the provision on exchange of information are:

- information exchanges are no longer limited to taxes covered by the DTA;
- information requests are permitted where it is 'necessary for carrying out the provisions of the agreement', and also where it is 'foreseeably relevant' for the 'administration and enforcement of domestic laws';
- information requests would need to be processed, even where the requested information is held by a bank, nominee or a person acting in an agency or fiduciary capacity or relates to the identity of the owners of the company.[61]

The revised provision broadens the scope of information that can be requested. In particular, either State may request information concerning taxes not only covered by the DTA (as provided in the previous DTA) but also information concerning domestic taxes. A state is obligated to provide information even though it 'may not need such information for its own tax purposes'.[62] These amendments demonstrate the increasing

[56] Protocol to the Russia-Cyprus DTA, above n 42.
[57] Protocol to the Russia-Cyprus DTA, above n 42.
[58] Protocol to the Russia-Cyprus DTA, above n 42.
[59] Protocol to the Russia-Cyprus DTA, above n 42.
[60] These DTAs are available at: http://www.taxpravo.ru/zakonodatelstvo/90278-int
[61] Protocol to the Russia-Cyprus DTA, above n 42.
[62] Protocol to the Russia-Cyprus DTA, above n 42.

attention of the Russian fiscal authorities to the factual substance of Cypriot companies. Some commentators suggest that the basis for this exchange of information was the newly revised legislation of Cyprus, including the law 'On the Assessment and Collection of Taxes'.[63] The new Article 26 also provides that both States should follow procedures of collecting information in accordance with their domestic laws. According to the Cypriot Law the Director of the Inland Revenue should provide information to the other State only if foreign fiscal authorities have provided extensive details about the taxpayer along with the justification for the request of information.[64] This clause exists to prevent foreign fiscal authorities from engaging in 'fishing expeditions' lacking any genuine evidence against the concerned taxpayer.[65] In relation to Russia, it is not clear how the exchange of tax information with other jurisdictions will be performed in practice since, at present, there are no appropriate arrangements in the Russian tax authorities' systems.[66]

A further appealing aspect of the new Russian-Cyprus DTA is the development of the institution of reciprocal assistance in tax collection (Article 27).[67] The scope of assistance in the collection of taxes will be extended to allow tax authorities to verify the legitimacy and amount of the tax requirements of one State in the courts and administrative bodies of another State. The request for assistance in collection however, may be refused on various grounds - for example, if the requested measures are contrary to the domestic laws of a State. The new version of Article 27 enters into force as soon as the appropriate legal foundation is implemented by Cyprus.[68]

The Russian fiscal authorities are aware that a number of Russian taxpayers use Cypriot companies for tax avoidance, but until now they rarely challenged DTA benefits on these grounds. A new provision on the limitation of benefits (Article 29) provides a mechanism to combat treaty shopping. Similar provisions are quite widespread in international tax practices. For example, many US DTAs include a limitation of benefits provision, but there are only a few of its kind in the Russian DTA network. The Australia-Russia DTA is one of these, containing a limitation of benefits clause in Article 23. The new provision implies that a treaty benefit will not be granted to a resident of a Contracting State if the competent authorities of Russia and Cyprus establish that "the main purpose or one of the main purposes of the creation or existence of such resident was to obtain the benefits under this Agreement that would not otherwise be available".[69] The scope of application of this article is somewhat limited: it will only be applicable to companies that are registered outside of a contracting State. However, the provision applies to companies that establish a tax residency in Cyprus (that is, a company that has its place of management and control in Cyprus).

[63] Zaharov A. 2009, above n 37.
[64] Ibid.
[65] Ibid.
[66] The Department of International Cooperation and Information Exchange at the Federal Tax Service of Russia used to deal with the exchange of information requests but as a result of restracturing of the tax service it was suspended.
[67] Protocol to the Russia-Cyprus DTA, above n 42.
[68] Zaharov A. 2009, above n 37.
[69] Protocol to the Russia-Cyprus DTA, above n 42.

Interestingly, Article 29 is not meant to apply to resident individuals. Rather, this provision appears to target corporate tax residents of Cyprus that were incorporated elsewhere and afterward acquired tax residency in Cyprus by moving their place of management and control. In this context it is worth noting that there is Russian case law dealing with non-Cypriot incorporated residents that have effectively claimed benefits under the DTA.[70] These structures are considered to be offensive by the Russian fiscal authorities and consequently, it is logical that this provision target identical arrangements.

It is also worth noting that a probable rejection of DTA benefits can only arise as a result of mutual agreement between Russia and Cyprus about the offensive character of the exploitation of tax residence in the case in question. This approach differs considerably from the approach taken in other Russian DTAs. For instance, the Russia–US DTA provides certain criteria for the availability of treaty benefits and the taxpayers can only apply to the fiscal authorities to confirm that these criteria are applicable in their particular cases. Additionally, Article 29 does not specify the applicability of the DTA where the fiscal authorities of Cyprus and Russia disagree in a certain case. A taxpayer may be deprived from the DTA benefits only if the fiscal authorities of both countries regard the taxpayer's case to be offensive. Consequently, neither DTA party may invoke this provision unilaterally, which critically limits the application of Article 29.

4.0 CONCLUSION

Russian international tax law may be characterised as rather fractional and curtailed. However, the Russian tax system is in the process of reform, and recent updates in the rules related to tax avoidance as well as provisions preventing misuse of tax treaties represent a positive advancement. Unfortunately, the proposed draft regulation integrating the beneficial ownership concept into Russian tax law is not comprehensive enough to cover all the related issues. The proposed amendments will provide little assistance to the Russian government in combating treaty shopping and tax avoidance in the international arena. Clear guidelines and procedures should be set out instead, with comprehensive regulations specifying a mechanism and criteria for the beneficial ownership test. Without the introduction of such regulations, and imposing a legal responsibility on individuals for the reliability of disclosed information, international tax schemes will not be eliminated. Nonetheless, this draft law and other observed efforts of the Russian government represent the ongoing shift to the 'substance over form' standard in Russian domestic and international tax law.

It is debatable that the Russian government has implemented a tougher approach to the applicability of the benefits available under the Russia-Cyprus DTA. The growing level of business activities between the two countries provides reasonable incentives to the Russian authorities to maximise their revenues by extensively restricting the scope of the DTA. However, the discussed loopholes of the protocol considerably weaken this restrictive power. Considering that the ratification of some of the protocol provisions have been delayed, the Russian fiscal authorities should clarify ambiguities

[70] See, for example, Decision of the Ninth Circuit Arbitration Court of Appeals No. 09АП-1 269/2007-АК of 1 October 2007.

found under the DTAs provisions. This may have a profitable impact on tax revenues. Notwithstanding initial concerns caused by the amendments to the Russia Cyprus DTA, it remains one of the most beneficial Russian DTAs. On the other hand, the amendments clearly indicate that the Russian tax authorities are starting to focus on the actual business rationale behind Cypriot structures. In this sense, the protocol provides Russian fiscal authorities with new instruments to confront tax-driven business structures.