1 Introduction

Cyprus and Russia are linked with historical, religious and cultural bonds for hundreds of years. Cyprus, upon its independence in 1960 immediately established diplomatic relations with the then USSR and maintains excellent relations with Russia up until today. Trade, commerce and economic activity between the two countries is also very active, leading to the conclusion of a large number of bilateral agreements covering multiple areas (political, economic, commercial, cultural, legal, etc.).

This publication outlines the business landscape between Cyprus and Russia, in the context of the Cyprus-Russia Double Tax Treaty (the “DTT”), the benefits investors stand to gain via the use of Cypriot companies as holding, financing and/or licencing entities and also how the use of a Cyprus International Trust can enhance wealth protection and maintenance.

2 Cyprus – Russia DTT

Following the trend of strengthening of economic ties between the two countries, the protocol to the double taxation agreement between Cyprus and Russia (the “2013 Protocol”) entered into force on 1 January 2013. The 2013 Protocol amended the existing Cyprus-Russia double tax treaty which was in place since the late 1990s (the “1998 DTT”). The 2013 Protocol introduced substantial changes with respect to information exchange and the taxation of capital gains (although the original 4-year transition period for implementation of the new capital gains provisions has been extended – see below). However, it should also be stressed that many favourable features of the 1998 DTT remained, such as the attractive withholding tax rates.

The main features and rates of the 1998 DTT (as amended by the 2013 Protocol) are set out in the table below. Note that these rates are applied for payments made from Russia to Cyprus, where the relevant conditions are met. With respect to payment from Cyprus, in accordance with Cyprus tax legislation, there are no Cyprus withholding taxes on payments of dividend, interest or royalties not used in Cyprus towards non-Cyprus residents.
### Double Tax Treaty Provisions

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>- 5% Withholding Tax (&quot;WHT&quot;) if there is a direct investment in the capital of the Russian entity in excess of €100,000</td>
</tr>
<tr>
<td></td>
<td>- 10% WHT in all other cases.</td>
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<tr>
<td>Interests</td>
<td>- 0% WHT</td>
</tr>
<tr>
<td>Royalties</td>
<td>- 0% WHT</td>
</tr>
<tr>
<td>Capital Gains on shares or</td>
<td>- As a general rule, capital gains from the disposal of shares remain under the exclusive taxing right of the country of residence of the seller. Since Cyprus imposes no tax on disposals of shares unless the gain is derived from real estate in Cyprus, this made Cyprus companies a great vehicle 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 Russian company owning the real estate rather than the property itself.</td>
</tr>
<tr>
<td>other movable property</td>
<td>- The 2013 Protocol changed this and where there is a disposal by a resident of one country of shares of companies in the other company which derive more than 50% of their value from immovable property, then the country in which the real estate is situated will also have the right to tax the gain made. This change is in line with the OECD Model Tax Convention on Income and Capital.</td>
</tr>
<tr>
<td></td>
<td>- The Protocol provided for a 4-year transition period for the implementation of the new provisions regarding capital gains, so the changes were initially planned to be effective as of 1 January 2017. However, the governments of Russia and Cyprus agreed for postponing the application of these changes until similar provisions are introduced in other double tax treaties between Russia and other EU countries.</td>
</tr>
<tr>
<td>Black List</td>
<td>- Simultaneously with the entry into force of the 2013 Protocol, Cyprus was removed from the black list of &quot;States and Territories providing preferential tax treatment and/or not requiring disclosure and furnishing of the information upon conducting of financial transactions (offshore zones)&quot;.</td>
</tr>
<tr>
<td></td>
<td>- The effect of this removal is that Cyprus companies are now eligible to benefit from the participation exemption introduced in Russia in 2008 under which dividends received by Russian shareholders from eligible equity participations in Cypriot subsidiaries are exempt from tax.</td>
</tr>
</tbody>
</table>

### 3 Deoffshorization – Russian CFC Rules

Russian deoffshorization rules (applicable since 1 January 2015) (the “CFC Rules”) introduced the concept of controlled foreign companies (“CFCs”) into Russian tax legislation, in addition to introducing tax residency tests for legal entities.

**CFC Rules**

A CFC is a foreign company or structure (including tax structures) that is: (i) not a Russian tax resident; and (ii) is controlled by individuals or legal entities that are Russian tax residents.

The main effect of the CFC Rules is that the profits of CFCs that fall within the perimeter of such rules are taxed in Russia, if such profits exceed RUB 10 million. CFC income is subject to a 20% tax rate if the CFC is controlled by a legal entity and a tax rate of 13% if it is controlled by an individual. Russian
tax will be imposed only on the profits of CFCs determined in periods starting in 2015. The profit amount can be reduced by the dividends paid out of the CFC’s profits.

A controlling party of a CFC means an individual or legal entity with a direct or indirect interest in the CFC (for individuals — jointly with spouses and minor children) of: (i) over 25%; or (ii) over 10%, if total participatory interest of all Russian tax residents in the CFC is over 50%.

There are a number of exemptions from the CFC Rules, with the main exemptions being:

- a foreign company resident of a treaty country with exchange of information which has an “effective” tax rate which exceeds 75% of the “average weighted” Russian tax rate (this is 15% of effective tax rate in most instances);
- companies whose active income is over 80% of their overall income;
- family structures (i.e. discretionary irrevocable trusts); and
- foreign companies that are held through a Russian public company.

**Tax Residency Test**

Under the new Russian tax rules, foreign organisations managed from Russia may be recognised and deemed as Russian tax residents, meaning that their worldwide income will be taxed in Russia. A company incorporated overseas is to be regarded as tax resident in Russia if: (i) it is tax resident in Russia under an international taxation agreement; or (ii) its place of effective management is in Russia.

The rules set out the following criteria which, if met, the overseas company will be deemed to be effectively managed in Russia:

*Main criteria*

- more than 50% of the meetings of the board of directors (or other executive management body) are held in Russia;
- the executive body regularly conducts its activities in Russia; and
- the key officers predominantly manage the company (regarding its day-to-day activities) from Russia

*Additional criteria*

- accounting is maintained in Russia;
- records are maintained in Russia; and
- HR management is performed in Russia.

It is therefore highly recommended for international structures of Russian beneficiaries and organisations to be reviewed with the above in mind, potentially with a view of enhancing ‘substance’ and ‘management and control' of their overseas entities, including in Cyprus.
4 Features of Cyprus Tax System Enhancing Tax Benefits of DTTs

Cyprus tax legislation provides for numerous tax advantages that greatly enhance the tax efficiency of structures at the Cyprus level. In addition, Cyprus’ tax and legal systems are in compliance with EU and OECD requirements, which means that Cyprus is included in the ‘White List’ of international cooperative jurisdictions. Key features of the Cyprus tax system are the following:

- Corporation tax rate of 12.5% (one of the lowest in the EU);
- Inbound dividends (i.e. from subsidiaries of Cypriot companies) are tax exempt;
- Cyprus Income Tax Law provides for the following:
  - Outbound dividends (i.e. declared by Cypriot companies) are not subject to any withholding taxes and totally tax exempt if paid to a non-Cypriot shareholder (otherwise subject to Special Defence Contribution (“SDC”));
  - 0% withholding tax on interest paid by Cypriot company; and
  - 0% withholding tax on royalties;
- No tax on gains from the sale of shares in Cypriot companies (unless they relate to immovable property in Cyprus);
- Full implementation of EU Directives, resulting in acquiring the tax benefits granted to intra-community transactions; and
- No inheritance tax.

5 CRS (Common Reporting Standard)

In the new world we are living in of globalisation and exchange of information, 96 separate tax jurisdictions (55 early adopters and 41 late adopters) have decided to proceed with the exchange of information with respect to the beneficial owners’ bank accounts balances (and the ones of the entities beneficially owned by him that are classified as ‘passive’ entities) from 1st January 2016 and 1st January 2017 respectively and with reporting dates 31st March 2017 and 31st March 2018 respectively.

Russia, like Cyprus, is part of CRS reporting so with respect to beneficial owners having bank accounts in Cyprus, information will be exchanged to the Russian tax office in case entities holding such accounts as classified as ‘passive’.

It is strongly advisable to closely monitor any changes in the CRS Reporting standards in order to be able to swiftly reach and consider the structures already in place with a view to maintain tax efficiency.

Russia will be reporting for the first time on 31st March 2018 based on the bank balances as at 31st December 2017. Cyprus has already reported on this on 31st March 2017 based on bank balances on 31st December 2016.
6 Inward investments to Russia via the use of Cyprus holding companies

A non-Cypriot owner can be a Russian tax resident where he will receive dividends back to Russia or can leave profits to accumulate at the Cyprus level, or indeed may choose to become a non-domicile resident and enjoy the numerous tax advantages afforded by such status (see below for more information).

7 Outward / international investments from Russia via Cyprus holding companies

The above diagram outlines an efficient use of Cypriot holding companies for Russian investors investing outside of Russia. The use a Cypriot holding company effectively grants access to jurisdictions where Russia does not have a DTT. Cyprus therefore can be considered as a ‘gateway’ of international investments by Russian investors.
Use of Cypriot companies in back-to-back financing structures

Traditionally Cyprus companies have been utilised as finance investment vehicles for intra-group financing structures leading to efficient accumulation of interest income.

The existing typical structure

The typical structure would be for a Cypriot company to be (i) a subsidiary of a foreign company incorporated in a zero / very low corporate income tax jurisdiction (e.g. Seychelles, BVI) and (ii) the parent of the Russian operating / investment company. A loan from the parent offshore company was passed to the Cypriot company and then on to the Russian company with respective interest received.

The new transfer pricing rules

On 30 June 2017, the Cyprus tax authorities issued a circular (the "Circular") revising the transfer pricing framework for companies carrying out intra-group financing activities in Cyprus. The Circular is effective from 1 July 2017 and replaces the minimum margin scheme which was introduced back in 2011 (the minimum margin scheme provided guidance as to the minimum margin / spread the Cyprus tax authorities accepted for back-to-back loans, with acceptable net financing margins ranging from 0.125% to 0.35% per annum, depending on the amount under the loans).

The new Circular provides guidance in terms of substance and transfer pricing requirements to back-to-back financing transactions in line with the OECD Guidelines, as well as for guidance on the required content of a transfer pricing study substantiating the arm’s length level of the financing margin earned by a Cypriot company.

The Circular provides that all intra-group financing transactions be conducted in compliance with the arm’s length principle. To prove that the arm’s length principle is met, it is necessary to prepare a comparability analysis testing the group transaction against similar transactions between unrelated entities. Such analysis need to consist of two parts:

- **Part 1**: identification of commercial/financial relationships between the related entities and determination of the conditions and economically relevant circumstances; and
- **Part 2**: comparison of the controlled transaction with those of comparable transactions between independent entities and determination of arm’s length remuneration.

However, a simplified process may be followed for group companies exercising a purely intermediary financing activity given that the transactions entered into by such group financing companies will be considered as compliant with the arm’s length principle if such group companies obtain a minimum return on the assets financed after tax of at least 2%. To be eligible to simplified measures Cypriot companies of the group must have sufficient level of actual presence in Cyprus. Simplified measures are also available to certain regulated entities (financial institutions). A return on equity of 10% would be considered as compliant with the arm’s length principle for the eligible regulated entities.

The transfer pricing analysis should be prepared by a transfer pricing expert (usually a suitably trained auditor). It is very important for Russian business groups with Cyprus-based financing companies to assess the implications of the new Circular on their intercompany transactions and financial structures in Cyprus and/or consider alternative financing structures via Cyprus.
Back-to-back financing – is it beneficial now as a structuring tool?

Given the implementation of the Common Reporting Standards and Automatic Exchange of Information, the passive nature of interest income effectively negates the benefits gained via the use of back-to-back structures for most beneficial owners. This is also true for Russia so such structures may be effectively shifted into either using the non-domicile tax residency or via the notional interest deduction rules (see further details for both, below).

An investor can keep all the benefits of using this structure if he/she considers relocating to Cyprus, becoming a Cyprus tax resident and utilising the tax advantages gained by the recently adopted non-dom regime, which include:

- 0% tax on passive interest income;
- 0% tax on rental income;
- 0% on dividends income;
- 50% exemption on employment income in case this is over €100,000;
- 100% exemption on the entire amount gained from the disposal of titles such as shares, bonds, debentures, futures, options and others; and
- no Capital Gains Tax on the sale of immovable property situated out of Cyprus.

Cyprus Treatment:
- Corporation Tax on income received from intra-group lending: 12.5%
- No thin cap / debt-to-equity restrictions
- No transfer pricing legislation in place, however, loans have to be advanced on an arm’s length basis
- With respect to back-to-back financing, see details on arm’s length requirements above.
Use of Cypriot financing companies in conjunction with Notional Interest Deduction

The implementation of the Notional Interest Deduction ("NID") rule in Cyprus since July 2015 has created a powerful tool to local and international organisations seeking new options to finance their operations. By using NID, businesses have the opportunity to deleverage and realise a new, tax efficient return on new equity, via the deduction of a 'notional' interest expense against their taxable income.

Equity financing in Cyprus can therefore constitute a very useful alternative to debt financing (thus avoiding the use of, now inefficient, offshore financing parents of the Cypriot company). The use of NID can achieve effective tax rates in Cyprus of up to 2.5%.

The NID rate is equal to the higher of:

- 3% plus the yield on the 10-year government bonds (as at 31 December of the year preceding the tax year the NID is claimed) of the country where the funds are deployed (e.g. in Russia); and
- 3% plus the yield on 10-year government bonds of Cyprus.

The NID rule works as follows:

1. qualifying equity is contributed to the Cypriot company;
2. a tax deduction is allowed following the application of the NID rate to the amount of qualifying equity contributed to the Cypriot company (the deduction is made in a similar manner as if it was actual interest expense i.e. only if it is used to finance business assets);
3. NID is deducted following the determination of the taxable profit of the company, which can be up to a maximum of 80% of the taxable profits of the company. This deduction is made annually and in perpetuity.

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**PROPOSED STRUCTURE**

- Principal Company / Investor
- Qualifying Equity
- Loan
- Interest
- Investments

**WORKED EXAMPLE**

For the purposes of the below example, we have assumed that Qualifying Equity of €1,000,000 is contributed to CypCo and that 8.5% NID rate is applicable:

<table>
<thead>
<tr>
<th></th>
<th>No NID</th>
<th>With NID</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable profit</td>
<td>€100,000</td>
<td>€100,000</td>
</tr>
<tr>
<td>NID</td>
<td></td>
<td>€80,000</td>
</tr>
<tr>
<td>Taxable Profit</td>
<td>€100,000</td>
<td>€20,000</td>
</tr>
<tr>
<td>Tax</td>
<td>€12,500</td>
<td>€2,500</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>12.5%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

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1 Qualifying equity is generally equity contributed (in cash or in kind): (i) as from 1 January 2015 in the form of paid up share capital of share premium; or (ii) pre-existing shareholder reserves which are converted into share capital.
10  Cyprus Royalties Company – the IP Box

IP is undoubtedly a very valuable asset of most businesses. Thus, choosing the appropriate regime and location for structuring the exploitation of IP assets is paramount for businesses striving to achieve business development, effective IP protection and maximum tax optimisation.

A Cypriot sub-licensing company may be interjected between the non-resident beneficial entity / non-dom beneficial owner and the licensee company which will actually exercise the rights on the IP. As a result, royalty payments will be made by the licensee to the Cypriot sub-licensing entity.

In Cyprus, the net royalty profits are subject to 12.5% corporation tax and any gains from the sale of shares of the Cypriot royalty company are totally exempt from tax. In addition, under new tax incentives implemented in Cyprus, provided the majority of the actual work for developing the IP takes place in Cyprus:

- 80% of any income (net of any direct expenses) generated from the IP rights is exempt from corporation tax; and
- 80% of profit (net of any direct expenses) generated from the disposal of IP by Cypriot companies is exempt from corporation tax.

Furthermore, royalty payments are exempt from withholding taxes in Cyprus provided that the rights are exercised abroad and not in Cyprus.

### Proposed Structure

**Cyprus Treatment:**
- Net royalty profits are subject to 12.5% corporation tax
- provided the majority of the actual work for developing the IP takes place in Cyprus:
  - 80% of any income (net of any direct expenses) generated from the IP rights is exempt from corporation tax
  - 80% of profit (net of any direct expenses) generated from the disposal of IP by Cypriot companies is exempt from corporation tax
Cyprus International Trust – a powerful wealth management and preservation tool

Cyprus International Trusts ("CITs") can be created under an enhanced and re-developed legislative framework which was enacted in Cyprus in recent years. They are very powerful and efficient tools for wealth management but also crucially for wealth protection and preservation. For example, the assets settled under a CIT are shielded from interference by actions and events such as divorce, death / inheritance issues and separations. CITs are also exceptionally useful for the purpose of passing down assets for the benefit of future generations and the management of these assets in various, tax-beneficial manners.

There are a number of features of a CIT which make it a highly desirable vehicle for wealth management and wealth preservation:

- the duration of the CIT is not subject to any time limitations;
- the CIT is exempt from estate duty, inheritance tax, income tax, capital gains tax or any other taxes in Cyprus (provided that the CIT assets do not include immovable property in Cyprus);
- the confidentiality of the settlor and beneficiaries is ensured with minimum registration requirements; and
- the safe management of the CIT can be ensured by appointment of ‘protectors’ and ‘enforcers’ appointed under the trust instrument by the settlor. In addition, the settlor may choose to retain the right to revoke/amend the terms of the CIT.

PROPOSED STRUCTURE

Cyprus Treatment:
- No inheritance or estate duty tax
- No withholding taxes on dividends, royalties and interest received in or paid from Cyprus
- No capital gains tax provided no immovable property in Cyprus
- 12.5% corporate income tax on net profits
- after the passing of two years from the date assets are settled under the CIT, no action can be brought against the trustee and the trust assets (i.e. the assets are then considered to be unassailable).

Requirement for setting up a CIT:
- the settlor (i.e. the person setting up the trust) is not a resident of Cyprus during the calendar year prior to the creation of the CIT;
- at least one of the trustees is a resident of Cyprus for the whole duration of the CIT; and
- no beneficiary is a resident of Cyprus during the calendar year prior to the creation of the CIT (but can become subsequently).
In July 2017 the Cyprus Parliament voted for an amendment to the definition of “resident of the Republic” for individuals as such term is defined in Cyprus Income Tax Law. The amendment has a retrospective effect and is effective as of 1 January 2017.

This change is introducing a new, second test for establishing an individual’s tax residency in Cyprus. Previously, the only condition that an individual had to satisfy in order to be deemed as a tax resident, was the requirement of physical presence in Cyprus for an aggregate period of 183 days or more during a tax year. Following the amendment, a new ‘60 day rule’ is introduced which allows individuals who satisfy the below criteria to be considered ‘residents of the Republic’.

**Criteria**

Under the new, additional rule an individual can also acquire tax residency in Cyprus if he/she meets all of the following criteria:

- physical presence in Cyprus for at least 60 days in the tax year;
- no established tax residency in any other jurisdiction in the same tax year;
- no physical presence in any other country for more than 183 aggregate days in the tax year;
- maintain a permanent home in Cyprus either rented or owned; and
- operates any business in Cyprus and/or exercises remunerated employment in Cyprus as an employee and/or holds an office in Cyprus as a director of a company registered in Cyprus during the relevant tax year (if the employment/holding of office/business ceases during the same tax year then the individual may lose the tax residency status under the new regime).

- It is worth noting that the new ‘60 day rule’ does not affect any individuals who are already tax residents in Cyprus under the existing ‘183 day rule’.
13 Conclusion

It is evident that Cyprus offers one of the most attractive tax regimes in the world.

With an extended network of double tax treaties, one of the lowest corporation tax rate in the European Union and a very competitive regime on dividends, interest and royalty payments, Cyprus is an obvious and ideal choice for international group structures and high-net worth individuals.

Cyprus also enjoys a unique geographical location in the south-eastern part of Europe and at the crossroad of three continents thus giving it an unparalleled ability to act as a gateway to and from Europe, the Middle East, Africa and Asia.

The Cyprus-Russia DTT confirms the ever closer cooperation between Cyprus and Russia and the magnified investment opportunities that exist between the two countries.

Kaimakliotis LLC, in cooperation with our dedicated tax advisors, is well placed to provide legal and structuring advice on putting in place new, reviewing existing and if necessary restructuring structures.