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ITS Alert



New Protocol to the Russia-Switzerland Double Tax Treaty signed

Following the recent negotiations concerning the double tax treaties with Cyprus and Luxembourg, the Russia-Switzerland double tax treaty (the "Treaty") has been amended by way of introduction of a new Protocol with an Annex.

On 21 September 2011 the Russian Prime Minister signed Government Regulation No. 1624-r approving a new protocol to the Russia-Switzerland Treaty (the "Protocol"). The Protocol was signed by the Swiss Federal Council and the Russian government on 24 September. The text is available at the official website¹ of the Swiss Federal Tax Administration. It is unclear at the moment whether the wording of the Protocol will be amended prior to the initiation of the ratification phase.

One of the most remarkable developments is the elimination of withholding tax on interest paid to the resident of the other contracting state that is the beneficial owner of income. This is to be introduced by a new Article 11 based on the OECD model. Under the current text of the Treaty the general withholding tax rate applicable to interest is 10%. A reduced rate of 5% applies only to bank loans,

¹ English version - <http://www.news.admin.ch/NSBSubscriber/message/attachments/24400.pdf>;

Russian version - <http://www.news.admin.ch/NSBSubscriber/message/attachments/24405.pdf>

and exemption from taxation at source is restricted to interest paid in connection with certain sales on credit. This amendment should remove the principle tax obstacle to cross-border debt financing for corporates. Currently Switzerland is rarely used as a jurisdiction for providing corporate intra-group loan financing, unlike other EU locations with more beneficial tax treaties such as Cyprus, Luxembourg and the Netherlands.

Another interesting amendment is the inclusion of a tie-breaker rule in Article 4 for determining the place of effective management (the "PoEM") of a company in cases of a dual-residence conflict. According to the new criterion set out in an Annex to the Protocol agreed by the parties, the PoEM is deemed to be situated where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. It is also specified that all relevant circumstances should be taken into consideration in determining this place and that while an entity may have more than one place of management it may have only one PoEM at any time. The amendment is currently of little practical value because Russian domestic tax law does not recognize corporate residence based on PoEM, but rather based on registration only. Therefore a dual residence conflict can occur only if a Russian registered company has a place of effective management in Switzerland (a situation unlikely to arise in practice). However, should Russia change its domestic residency rules (the Ministry of Finance has been saying for some years that this is one of the planned changes to tax policy), such treaty provisions will become highly relevant.

By and large, the provisions of the Protocol are similar to those recently introduced to Russia's tax treaties with Cyprus and Luxembourg, and inter alia include:

- a) a new definition of "dividends" to include distributions from mutual investment funds (Article 10);
- b) a clear statement on "thin capitalization rules" introduced by the Annex to the Protocol stating that the provisions of Articles 10 and 11 should not prevent the

application of thin capitalization rules set out in the domestic legislation of contracting states (this goes in line with the recent policy trend not only in Russia but also in Europe to combat perceived tax avoidance schemes through aggressive intra-group debt financing);

- c) the allocation of taxing rights on capital gains derived from the sale of shares of property-rich companies to the source state (Article 13), whereas under the current text such gains are taxed solely in the state of residence of the recipient;
- d) the introduction of a new standard information exchange provision in a new Article 25(a) following the recent OECD model article for exchange of information on tax matters²; and
- e) a new anti-conduit provision introduced by a new Article 25(b), which gives a right to competent authorities to restrict the application treaty benefits in certain "flow-through" situations.

Unlike the new protocols to Russian Treaties with Cyprus and Luxembourg which extend the definition of income from immovable property to cover distributions by real estate investment funds, Article 6 of the Treaty with Switzerland is left unchanged. This in principle means that distributions from "real estate mutual funds" should not be covered by Article 6, but rather under the revised article 10 (see further below).

The revised Article 10 will abolish withholding tax on dividends paid to pension funds, political subdivisions, local authorities, the Central Bank of Russia or the Swiss National Bank. No changes are envisaged with regard to the withholding tax rates (currently, 5%/15%) on dividends paid within corporate groups or the de-minimis investment threshold.

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http://www.oecd.org/document/53/0,3746,en_2649_33747_33614197_1_1_1_1,00.html

The definition of dividends is extended to include not only distributions from mutual investment funds but also payments on units of real estate/mutual investment funds deriving more than 50 per cent of their income from shares. If payments are made on units deriving less than 50 per cent of their income from shares then they would fall under the definition of interest. It is noteworthy that the definition of interest was also amended to exclude charges for late payment, which is in line with the OECD model.

Unlike the Russia-Cyprus protocol, the revised Article 13 "Capital gains" specifies that the new provision would be applicable to sale of shares in a company *directly or indirectly* deriving more than 50% of its assets' value from immovable property. At the same time, the accompanying carve-out clause for listed shares and, most importantly, companies holding immovable property in which their business is conducted (i.e. mining, agricultural, hotel businesses etc.), means that the new rules would mainly target gains on disposals of shares in property-rich companies held as mere passive investments. It is noteworthy that unlike the Russia-Cyprus Treaty the implementation of these changes is not postponed and would come into effect along with other changes to the Protocol on 1 January of the year following the year of its entry into force.

As in the case of the Russia-Switzerland Treaty, the Protocol establishes a formal framework for information exchange requests to be followed by the tax authorities, defining a list of information to be provided with a request (e.g. identifying the person, tax purpose of the request etc.).

It is noteworthy that the above-mentioned "anti-conduit" provisions against treaty-shopping represent something entirely new in relation to Russian tax treaties. A "conduit arrangement" is defined as a transaction or a series of transactions structured in such a way that a company registered in a Contracting State receives income from a company resident in the other Contracting State and pays it (directly or indirectly, wholly or partially) to a company not resident in the

same Contracting state, which would not be entitled to the same benefits if income were paid to it directly. Article 25(b) restricts the application of Articles 10, 11 and 12 to any dividend, interest or royalty paid under or as part of a conduit arrangement. When the above rules should apply is subject to agreement by the competent authorities of Russia and Switzerland under the Mutual agreement procedure on a case-by-case basis. The above provision seems to be a rather restricted implementation of the "beneficial ownership" concept that is currently being revised by OECD.

Similarly to the new protocol to Russia's Treaty with Luxembourg, the requirement for a certificate of residence to be subject to legalization procedure or to be certified by an apostille is being abolished.

The practical implications of the changes to the Treaty with Switzerland are generally positive for taxpayers, mainly, due to the reduction of the WHT rate on interest and more favourable changes to Article 13 than those to be introduced by the Russia-Luxembourg and Russia-Cyprus protocols. On the other hand, in the light of the new provisions introduced by Article 25(a, b) to the Treaty particular attention should be paid to creating sufficient substance in Swiss companies which may wish to rely on benefits envisaged in the Treaty.

Although the ratification of the Protocol may take time from both sides, we expect developments soon given the importance of the proposed changes. We will keep you informed on the status of the Protocol.

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