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Cyprus, Not WTO, May Modernize Russia

By Daniel Klein

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There have been thousands of articles written and endless airtime given to Russia's World Trade Organization accession after 18 years of negotiations. There is a prevalent misconception that it is a done deal, that Russia is now a member of the WTO. But there is still a final stage that requires the Russian government to ratify the WTO treaty. That has yet to happen — and indeed may not happen. Moreover, Russia may try to claw back certain concessions it made, from intellectual property provisions to import tariffs.

Even if Russia ratifies WTO membership by the deadline in August, the immediate and most dramatic effects will only relate to intellectual property issues. The overall impact on business will not be that significant for some time because most import tariffs will only come down gradually. While businesses may see some differences, the average consumer will likely not notice any tangible differences for several years.

The real news for Russian businesses for 2012 is not the WTO but all the changes that are in motion relating to the country's newly ratified Cyprus-Russia Treaty — something that will allow the tax authorities to obtain information about Cyprus companies that have Russian subsidiaries, branches or representative offices in Cyprus, coupled with new laws designed to prevent money laundering.

In short, Russia's "Cyprus Era" may be coming to an end.

The main driver of Cyprus' economy is the service sector, and these new changes will not be welcome in a contracting economy that is saddled with high debt and high unemployment. While many businesses have been preparing for this long-negotiated new treaty, many did not believe that it would come into force. But it was finally ratified in February this year.

According to Alexei Spirikhin of Alinga, a Russian tax consultancy firm: "It is almost as if the continued procrastination and delays associated with the multidecade WTO negotiations has numbed the business community with respect to international treaties. Many businesses have been trained to not pay attention to unsigned laws and proposed treaties."

The Cyprus-Russia Treaty will come into force in two phases: the first in January and the second four years later. Phase One will give the tax authorities the right to obtain complete information about company structures in Cyprus that involve Russian entities. Russia will require companies to withhold 20 percent of their profits in Russia and pay that to the government prior to transferring the remaining 80 percent to Cyprus. Real estate-orientated Russian companies with Cypriot structures have been particularly singled out by the new treaty. As a result of these increased tax burdens, there is speculation that Russian office rents could rise as a result of this tax increase.

Phase Two will impose capital gains on the transfer of shares of Cypriot companies to be paid again to the Russian tax authorities. One of the possible outcomes of the treaty will be that tax residency will move from where the holding structure is to where the company actually conducts its business, meaning that companies will be subject to higher Russian corporate income taxes.

There are hundreds of thousands of Russian companies that use a Cypriot offshore structure, almost as many as the country's population. Cyprus until now has been synonymous with Russian business, and many companies have used Cypriot structures either to legitimately reduce their tax burden or to manage corporate governance risks.

It is this disclosure requirement that is necessary to remove Cyprus from Russia's so-called blacklist. Once Phase One of the treaty comes into place and the threat that disclosure becomes an option for the Russian tax authorities investigating Cypriot structures, many gray-scheme companies will then try to find new jurisdictions for offshore structuring.

It sounds easy, and many experts suggest that there are other jurisdictions that will offer the same benefits as Cyprus once did. But in parallel with this new treaty the Russian government has recently introduced a whole swathe of tough new anti-money laundering regulations and anti-corruption measures.

One in particular requires companies that supply goods or services to Russian state entities to provide complete personal financial information relating to all eventual beneficiaries or ultimate owners of these governmental suppliers. As a result, Cyprus will likely not be the first place that Russian companies go to set up an offshore structure. Those companies that really have something to hide may opt for less respectable tax havens since any money transfers from Russia to blacklisted countries are now very heavily scrutinized.

In sum, the one thing that is certain about these new regulations is that there is a lot of uncertainty out there. Even the real tax experts seem to be at odds on how to interpret many aspects of the new treaty. If the experts don't understand the real impact of the treaty, one can just imagine the confusion in the business community.

In any case, it is clear that the doors have been closing fast for companies that use gray schemes. Finally, in 2012 life has become much more difficult for Russian companies that want to send their doubtful money abroad. For almost two decades, everyone has been speculating about how WTO accession would modernize Russia. While it is true that Russia may modernize post-WTO accession, the reality is that it might be the 800,000-inhabitant island state of Cyprus that may be the real trigger of that modernization.

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