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Ukraine and the Cyprus Bailout: Time to Find a New Haven for Direct Foreign Investments?

Islands are typically susceptible to various natural disasters, and over the centuries island dwellers have developed various means to cope with all sorts of calamities. But the shockwaves from the Eurozone crisis may have been more than most of the 860,000 inhabitants of the island of Cyprus — as well as the vast majority of the nearly 320,000 companies registered there — could have anticipated or done much to prepare for.

For weeks now many have watched events unfold in Cyprus as the country reached out for a lifeline in the form of a bailout by the Eurogroup. But perhaps — other than the Cypriots themselves — none were as nervous as Russian and Ukrainian businesses. Estimates placed Russian deposits in Cypriot banks at over $30 billion, with estimates of Ukrainian deposits varying from as low as $1 billion to as high as $25 billion.

The announcement of the bailout may mean that those businesses, not prescient enough to join the other holders of just over $900 million in deposits withdrawn from the Cypriot banking system in the days leading up to the announcement, may ultimately face significant losses. But will this be enough to end this island's appeal as an offshore financial center for Ukrainian businesses? Or will Ukrainian businesses as well as other international investors continue to utilize Cyprus as a base from which to invest into, and take profits out of, Ukraine?

Why Cyprus?

Cyprus has long been a destination favored by businesses investing into Ukraine due primarily to the favorable double tax treaty in place between Cyprus and the USSR since 1983. After the break-up of the Soviet Union, Ukraine, as a former republic, succeeded to the terms of this treaty. Although a number of former republics, such as Russia, have since entered into new, less favorable, treaties (and Ukraine has signed a new treaty that awaits ratification), the benefits provided by the USSR/Ukraine-Cyprus treaty for investors into Ukraine remain unmatched, with no withholding tax charged on dividends, interest or royalty payments from Ukraine to Cyprus, and capital gains not taxed in Ukraine.

In the years following the dissolution of the Soviet Union, Ukrainian businesses turned to tax havens such as Cyprus for a variety of reasons, including fear over the impact that the lack of a stable rule of law, instability of the Ukrainian banking system, high taxes, hyperinflation, lack of convertibility of the Ukrainian hryvnia and selective government support of business might have on their businesses. Cyprus, with its favorable tax regime, common-law based traditions and off-shore services (such as trusts to preserve anonymity of beneficial owners) became viewed as a close and attractive jurisdiction to funnel profits from Ukrainian businesses and to eventually reinvest into Ukraine, with tax optimization (and in some cases tax avoidance) often being the overriding goal.

As Ukraine began to become more integrated into the world economy and levels of foreign investment into Ukraine grew, Ukrainian businessmen were joined by legitimate foreign investors lured by the beneficial tax rules, with the result that Cyprus became the largest source of foreign investment into the Ukrainian economy, representing nearly 30% of all FDI to date. Statistics indicate that in 2012, nearly $4 billion dollars were invested into Ukraine through Cyprus, accounting for nearly 65% of total FDI in Ukraine that year. Cyprus, coincidentally, also became one of the largest destinations for Ukrainian investment abroad.

Trouble in Tax Paradise…

The troubles in Cyprus can be traced back to March 2012, when two of the largest Cypriot banks — Bank of Cyprus (BoC) and Cyprus Popular Bank (Laiki) — suffered significant losses from the haircut they took on their holdings of Greek bonds as part of that country's bailout. These losses greatly contributed to the current financial problems of Cyprus and eventually forced it into bailout negotiations.

Restructuring of two largest banks

On March 25, 2013, Cyprus and the Eurogroup reached an agreement on the key elements of a €10 billion bailout package under the condition that the depositors of BoC and Laiki share a portion of each bank's losses. Laiki will be resolved, and will transfer deposits below €100,000 to BoC. The rest of its deposits will remain with Laiki and can only be recovered (if at all) once the bank is liquidated. Deposits in BoC which exceed €100,000 will be set off against any loans of that depositor, and the positive residual amount will be subject to the following measures:

- a 37.5% "haircut" on the deposits in exchange for shares of BoC;
- a 22.5% freeze on the deposits until an independent valuation is completed. Thereafter, this amount will also be, either partially or entirely, converted into shares of BoC;
- a 30% temporary freeze on the deposits, which is expected to be removed shortly; and
- the remaining 10% was unfrozen on April 2, 2013.

Other than BoC and Laiki, no other Cypriot banks, or Cypriot branches of foreign banks, will be affected.

The full text of the announcement of the Eurogroup can be found in the link at the end of this newsletter.

Temporary restriction on bank transactions

All banks in Cyprus were closed on March 25 and 26, 2013. Starting from March 28, relatively strict capital controls have also been put into place by decrees of the Central Bank of Cyprus. Virtually all money transfers out of Cyprus and within Cyprus are now subject to various temporary restrictions.

Initially planned for one week, it is not yet clear when the restrictions - which continue to be revised — will be removed.

In general, companies are now (as of April 10, 2013) allowed to carry out transactions within Cyprus of up to €25,000 daily without restriction, with payments abroad limited to €5,000 per day. Payments above these caps will generally require approval from a special committee, which will take into account a number of factors.

The links to the texts of the Decrees for Temporary Restrictive Measures on Transactions issued by the Central Bank of Cyprus are provided at the end of this newsletter.

Potential tax increase and other measures

Cyprus is expected to implement further fiscal measures, including an increase in the statutory corporate income tax rate from 10% to 12.5%. Cypriot holding companies should not be affected by this measure because their dividend income and capital gains from sales of securities are exempt from this tax.

In addition, Cyprus will increase its "special defense contribution" on interest income from 15% up to 28%. This measure should not have any impact on Cypriot finance companies because their interest income is generally exempt from this tax.

Finally, a number of other measures in the areas of anti-money laundering, fiscal consolidation, structural reforms, and privatization are being developed and are expected to be announced soon.

Time to Find a New Tax Haven?

The measures introduced by the bailout are unprecedented and have already sent shocks throughout the Eurozone. Ukrainian businesses and investors into Ukraine from Cyprus may suffer from losses on deposits, shortages of available cash and/or the capital controls, each of which may impact the continuity of their business transactions and those of their Cypriot business partners and may, potentially, impact upon an already weakened Ukrainian economy.

In addition, Ukrainian exporters may, as a result of the inability of a Cypriot customer to pay for goods or services exported from Ukraine, unintentionally violate the statutory 90-day period established for cross-border settlements (the so-called "90-day rule"). If this were to occur, such that a Cypriot customer were unable to pay for exported goods or services within 90 days after the date that the goods were cleared through customs or that an acceptance act or statement was signed in respect of services, the Ukrainian exporter may face a penalty in the amount of 0.3% of the overdue amount for each day of the delay (but not more than the overdue amount).

Many businesses with holdings in Cyprus now consider whether to continue working through Cyprus or to relocate to another jurisdiction. Despite what some may consider draconian measures of the bailout, Cyprus continues to be one of the most attractive low-tax jurisdictions for legitimate tax planning in respect of Ukraine. It offers beneficial conditions for the placement of holding, finance and IP structures. In particular, dividends received by a Cypriot company and capital gains on the disposal of shares are not taxed in Cyprus provided minimal conditions are met. The recently introduced IP regime in Cyprus provides for an 80% exemption on profits from the exploitation of intellectual property rights. Interest and royalty profits are taxed in Cyprus at a relatively low corporate tax rate of 10%. Also, no withholding tax is paid on dividends, interest and royalties paid from Cyprus to beneficial owners that are not Cypriot residents.

As noted above, the currently effective USSR/Ukraine-Cyprus double tax treaty is unique and provides an exemption from Ukrainian withholding tax on dividends, royalties and interest paid to Cyprus, as well as on capital gains, including gains from disposal of shares in Ukrainian real estate companies. In November 2012, Ukraine and Cyprus concluded a new double tax treaty which has not yet been ratified or officially published. According to news sources, dividends, interest and royalties will become taxable at increased rates of, respectively, 5%, 2% and 5/10%. Also, the new treaty will introduce a beneficial ownership concept and will facilitate the exchange of information between the authorities of the two countries. If the new treaty is ratified in 2013, its provisions will apply starting from January 1, 2014. But even with the anticipated increase of withholding tax rates on income paid from Ukraine to Cyprus under the new treaty, such rates will, when the treaty takes effect, nonetheless be low and competitive with the rates under Ukraine's other double tax treaties.

Nevertheless, the bailout measures may not necessarily solve all of Cyprus's problems and may ultimately lead to cash outflows from the Cypriot banking system. Because Cyprus will need to find money to repay the Eurogroup in the near future, it may once again face financial difficulties. This may push Cyprus to increase its tax rates even further, which may cause even more investors to relocate to other jurisdictions.

Whether or not companies will relocate from Cyprus may ultimately depend upon their appetite for risk. Many companies have mitigated the effects of the bailout by opening bank accounts in other jurisdictions (Switzerland, Latvia, Malta, etc.), many of which are now positioning themselves as "safer" alternatives to Cyprus. Businesses are also considering relocating to other jurisdictions often used for tax-efficient structuring of Ukrainian investments, such as the Netherlands, Switzerland, Austria, Sweden, and the UK. The double tax treaties between Ukraine and these countries provide for attractive withholding tax rates on Ukrainian source income: 0% and 5% — for dividend distribution, 0% and 2% — for interest payments, and 0% — for payments of certain types of royalties.

Also, these jurisdictions offer an attractive investment climate with beneficial tax incentives. For example, Dutch holding companies can potentially enjoy full exemption from taxation of capital gains and dividends received from a qualifying shareholding under application of the Dutch participation exemption. A Dutch cooperative, a widely used vehicle for holding and financing activities, enjoys exemption from the Dutch withholding tax for its outbound dividends. All Dutch corporations apply no withholding tax to outbound interest and royalty payments in accordance with domestic legislation provided certain conditions are met. On the other hand, many of these alternative jurisdictions are more demanding regarding substance issues and typically require higher maintenance costs than Cyprus.

The viability of Cyprus as Ukraine's largest source of FDI and as a premier offshore financial center may be weakened by other concerns. Both the United States and the EU have begun to considerably clamp down on low-tax or tax-free zones, requiring that countries not only more tightly control their banking sectors, making them more transparent and less susceptible to money laundering, but also reduce the size of those sectors relative to their economies (the Cypriot banking sector represents roughly 700% of its total economic output, compared to the United States at 91% of GDP). Even countries in the former Soviet Union are beginning to — at least publicly— shun offshore havens, with Russia recently launching a highly publicized "de-offshorization" campaign.

In addition, substance over form, general anti-abuse and anti-avoidance rules are becoming more important in the world economy as countries face more fiscal pressures at home. Ukrainian tax authorities now pay more attention to beneficial ownership requirements, Ukrainian courts apply the business purpose doctrine to transactions, and the Ukrainian government is preparing new transfer pricing legislation in line with recent world practice. Given this, low-tax or tax-free zones such as Cyprus may be losing their appeal for Ukrainian investors.

Ultimately, perhaps, Ukraine itself will benefit from more money being forced back into Ukraine. But in order to truly take advantage of this unique position caused by the misfortunes of its largest investor, the Ukrainian government may need to remedy those concerns that initially forced its business community to seek havens elsewhere and undertake the various reforms that the EU and others have long been advocating.

The full text of the announcement of the Eurogroup is available by clicking here.

The full texts of the Decrees for Temporary Restrictive Measures on Transactions issued by the Central Bank of Cyprus can be found by clicking on the links to the Decrees below:

– The first Decree as of March 28, 2013.
– The second Decree as of March 29, 2013.
– The third Decree as of April 2, 2013.
– The fourth Decree as of April 3, 2013.
– The fifth Decree as of April 5, 2013.

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Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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