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March 28, 2013

The latest developments in the Cyprus banking sector

The measures taken in Cyprus are unprecedented in the context of European bail-outs and it remains to be seen whether the draconian measures implemented by the European authorities will alleviate the island's economic distress.



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I. The crisis

There is some way to go before the financial crisis in Cyprus is resolved; but now that the terms of the agreement between the Eurogroup and Cyprus are now clearer, it is a suitable time to take stock of the current situation as it affects owners of Cyprus corporate, trust and other structures and account holders with Cyprus banks.

With large holdings of Greek public and private sector debt and significant operations in Greece, the principal Cyprus banks suffered severe losses and asset write-downs as a result of the Greek financial crisis, particularly the “haircut” imposed by the Eurogroup in 2011. The Cyprus government was forced to underwrite a capital issue by one of the banks, which made the public finances unsustainable. In the summer of 2012, the government of the day applied for support from the European Financial Stability Facility and the European Stability Mechanism. For a variety of reasons, the application had not been resolved by the time of the February 2013 presidential elections, and the new government appointed in March made this a priority.

II. Events leading to the rescue plan

An initial political agreement was reached with the Eurogroup of finance ministers on March 16, which included a so-called solidarity levy or “bail-in” of bank depositors, which was to apply without exception to all deposits held with credit institutions in Cyprus, including the Cyprus branches and subsidiaries of overseas banks. This levy was subject to the approval of the Cypriot parliament.

In order to ensure the stability of the banking system, the European Central Bank issued an order on the same day, temporarily suspending all banking transactions in Cyprus, including internet banking facilities. This suspension remains in force for the time being. The Central Bank of Cyprus also declared several bank holidays, meaning that banks in Cyprus have remained closed since March 15.

On March 19, the Cyprus parliament rejected the “bail-in” proposal without a single vote being cast in favour of it. Following the rejection, discussions and negotiations continued between the Cypriot government and regulatory authorities on the one hand and the “troika” (the European Commission, the European Central Bank and the International Monetary Fund) representing the potential providers of financial support on the other. In addition, negotiations took place with the Russian government regarding possible financial assistance, but these were inconclusive.

On March 23, 2013, the Cyprus parliament enacted a law empowering the government to impose restrictions on capital movements on individuals and businesses operating accounts with credit institutions in Cyprus. These restrictions may be activated by the relevant authorities only “in cases of emergency and following consultation with the relevant European authorities and the International Monetary Fund (“IMF”).

III. Details of the agreement

On March 24, the Cyprus government presented its new proposals to the “troika” ahead of the Eurogroup meeting, which was scheduled to take place later that day. Following protracted negotiations, a new political agreement was reached with the Eurogroup on a general framework of financial support for Cyprus. The main points of the agreement are as follows.

- Cyprus Popular Bank, commonly known as Laiki Bank, will immediately enter into a resolution process and will be

restructured into a “bad” bank and a “good” bank. All unimpaired assets will be transferred to the “good” bank, together with all customer credit balances of less than EUR 100,000, and the first EUR 100,000 of larger balances. For larger balances, the first EUR 100,000 will be transferred to the “good” bank and any excess will remain frozen in the “bad” bank, along with all non-performing assets. Following realisation of those assets depositors should receive a partial payment on their frozen deposit.

- The Laiki “good” bank will be merged with Bank of Cyprus to create a new bank.
- Bank of Cyprus customers' credit balances of less than EUR 100,000 and the first EUR 100,000 of larger credit balances will be unaffected. A proportion of any excess over EUR 100,000 will be converted into shares in the new bank, so as to achieve a capital ratio of 9 per cent. The required proportion will only be determined as the process progresses — preliminary estimates are in the order of 40 per cent.

IV. What is the cut-off date for determining the quantum of deposits?

The cut-off date for determination of deposits is expected to be March 15, when accounts were initially frozen, with funds credited to accounts after that date being freely available, subject to any restrictions on capital movements under the new law referred to above. However, there has been no official announcement on this.

It is important to note that the bank restructuring affects only the holders of deposits in excess of EUR 100,000 with Laiki Bank and Bank of Cyprus. The first EUR 100,000 of any deposit is safe, but a proportion of any excess over EUR 100,000 is likely to be lost, in the case of Laiki, or converted into equity in the bank, in the case of Bank of Cyprus. In principle, customers of Laiki Bank should be able to obtain relief for their loss against future profits or against profits of other companies in the same group. At this stage, the tax authorities have not issued any guidance on this matter, and is likely to be announced in due course.

V. Can the persons affected challenge these measures?

The authors have considered whether it would be possible to challenge the measures put in place, and on the basis of current information have concluded that any challenge would be fruitless, particularly as this is an unprecedented development. However, the situation may change if any new information comes in that may make it possible to challenge the drastic measures.

VI. What next?

No restructuring of deposits is intended for other banks operating in Cyprus. Following the agreement, banks in Cyprus are now expected to reopen on March 28. It is widely expected that capital restrictions within the framework described above will be in place by that time. Given the possibility of introduction of capital controls, it would be prudent to keep banking arrangements under constant review in order to minimise the risk of any adverse effect. It should be noted that there is no requirement for Cyprus companies, entities or trusts to open or maintain bank accounts in Cyprus, and the recent changes do not detract from the favourable Cyprus holding company regime and the advantages offered by other Cyprus structures.

The proposed increase in Cyprus's corporate tax rate from 10 percent to 12.5 percent, which has been agreed with the Eurogroup should not materially affect most holding companies; and the other benefits of the Cyprus holding company regime such as the tax free flow of dividends through Cyprus and the beneficial exit opportunities offered by Cyprus's favourable national tax legislation, particularly the exemption of capital gains on shares from tax, and its wide network of double tax treaties remain intact. Furthermore, even after the increase in the corporate tax rate, Cyprus has by far the most attractive regime for intellectual property taxation in the EU, with an effective tax rate of less than 2.5 per cent.

This article is intended to give a general overview of the current situation, which is developing rapidly.

For More Information

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