Corporate Tax - Cyprus

New Cyprus-Ukraine double tax agreement maintains beneficial features

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Introduction

Most of the new states that emerged from the break-up of the Soviet Union adopted the double tax agreement between Cyprus and the Union of Soviet Socialist Republics (USSR), which had previously applied. However, over the intervening years, the majority have negotiated new agreements and the Cyprus-USSR agreement now applies to a handful of countries only.

Ukraine is the latest country to conclude its own agreement with Cyprus. The Cyprus-USSR agreement has been a source of contention in Ukraine for several years, with populist politicians claiming that it was excessively generous and was being abused by Ukrainian businesses to evade their obligations, rather than for legitimate tax mitigation. In 2010 the World Bank urged Ukraine to eliminate what it described as the "preferential" tax treaty with Cyprus. Given the degree of political pressure, there were fears that most of the benefits previously available would be lost as a result of the renegotiation.

These fears have proved to be unfounded. The new Cyprus-Ukraine agreement, which was signed on November 8 2012, is taxpayer friendly and maintains Cyprus's status as among the most favourable of Ukraine's treaty partners. The new agreement will enter into force when both states have exchanged notifications that the necessary ratification procedures have been completed.

Its provisions will apply to tax years beginning from January 1 of the following calendar year. As it is unlikely that the requisite notifications will be exchanged before the end of 2012, the new agreement is expected to enter into force during 2013 and will apply to tax years beginning after December 31 2013. Until then, the Cyprus-USSR agreement will remain in effect.

Principal changes

The new agreement closely follows the 2010 Organisation for Economic Cooperation and Development (OECD) Model Tax Convention and the wording of most articles is different from that of the Cyprus-USSR agreement, which dates back to 1982. However, the substance of most provisions remains the same. The principal changes are outlined below.

Immovable property
In line with the OECD Model Convention, the definition of 'immovable property' now includes:

- property ancillary to immovable property;
- livestock and equipment used in agriculture and forestry;
- rights to which the provisions of general law on landed property apply;
- usufruct of immovable property; and
- rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

Ships, boats and aircraft are excluded from its scope of application.

The Cyprus-USSR agreement provides that income from immovable property belonging to a resident of one contracting state and situated in the other will be liable to taxation only in the country in which the property is located. The new agreement is more ambiguous - it provides that such income "may" be taxed in the country in which the property is located, but does not rule out taxation in the country in which the taxpayer is resident.

The new agreement defines 'income from immovable property' as income from the use or letting of such property; gains from the disposal of property fall outside the definition.

Dividends, interest and royalties
One of the most notable features of the Cyprus-USSR agreement (and one of the principal grounds for criticism) is that it entirely eliminated withholding tax on dividends, interest and royalties. As expected, the new agreement allows for the imposition of withholding tax, but at reduced rates.

Article 10 of the new agreement provides for the imposition of withholding tax on dividends. Withholding tax will be limited to 5% where the beneficial owner:

- is resident in the other contracting state; and
- holds at least 20% of the capital of the company paying the dividend or has invested at least €100,000 in it.

For investments that do not satisfy these criteria, the maximum rate of withholding tax will be 15%.

Article 11 restricts the maximum rate of withholding tax on interest to 2%. The recipient of the dividend will be able to offset any withholding tax paid in Ukraine against its corporate income tax liability in Cyprus, so the change will result in no additional tax cost, merely a small timing difference in cash flow.

Article 12 provides for a maximum rate of withholding tax of:

- 5% on royalties in respect of copyright for scientific works, patents, trademarks, secret formulae, processes or industrial, commercial or scientific know-how; and
- 10% on royalties in respect of literary or artistic works, such as films.

For dividends, interest and royalties, there is a significant conceptual change: the Cyprus-USSR agreement refers to the recipient of the dividends, interest or royalties being a resident of the other contracting state. Under the new agreement, the beneficial owner of the income must be a resident of the other contracting state in order to qualify for the reduced rates of withholding tax. This change in emphasis, from recipient to beneficial owner, is in line with the latest OECD Model Convention and is designed to forestall artificial avoidance schemes.

Elimination of double taxation

Article 21 of the new agreement adopts the credit method of eliminating double taxation on income and the standard OECD Model Convention wording.

Exchange of information

Article 24 of the new agreement reproduces Article 26 of the OECD Model Convention word for word, but is modified by a protocol which requires that in order to demonstrate the foreseeable relevance of the requested information, any request for information be supported by the following details:

- the identity of the person under examination;
- a description of the information requested and the form and manner in which the requesting state wishes to receive it;
- the tax purpose for which the information is sought;
- the reason for believing that the requested information is held in the contracting state to which the request is addressed, or is in the possession or under the control of a person within its jurisdiction;
- the name and address of anyone that may hold the information requested, if known;
- a declaration that the provision of such information is in accordance with the laws and administrative practices of the requesting state, and that where the requested information is found within the jurisdiction of the state in question, the relevant authority may obtain the information according to its laws and the terms of its ordinary administrative practices; and
- a declaration that the contracting state making the request has exhausted all other reasonable means of obtaining the requested information.

Information will be provided only if the contracting state requesting the information has reciprocal provisions for providing information of the same nature.

Provisions remaining unchanged

There were fears that a number of benefits would be lost as a result of the renegotiation. One of the most important benefits allowed by the Cyprus-USSR treaty is its highly favourable treatment of capital gains on the disposal of shares in property-rich companies. Movable property, including shares, is taxable only in the country of residence of the owner. Since Cyprus imposes no tax on disposals of shares, except and to the extent that the gain is derived from real estate in Cyprus, Cyprus companies have become an ideal means of holding real estate in Ukraine, effectively allowing property there to be disposed of tax free.

The OECD Model Convention includes a provision allowing gains from the disposal of property-rich companies to be taxed in the contracting state in which the property is located, and it was widely feared that a provision of this nature would be introduced in the new agreement. However, this fear has proved unfounded. Gains on the disposal of shares, including shares in companies whose assets comprise only real estate, remain taxable only in the contracting state in which the disponor is resident, meaning that Cyprus retains its highly favourable status as a jurisdiction for holding Ukrainian property assets.

Comment

The loss of the zero withholding tax on dividends, interest and royalties was inevitable. The new maximum rates are modest and Cyprus remains among Ukraine's most favourable treaty partners in this regard. The continuation of the favourable arrangements for taxation of property-rich companies gives Cyprus a significant advantage as a jurisdiction in which to hold Ukrainian real estate.

Much of the Ukrainian criticism of the Cyprus-USSR agreement related to the perceived inadequacy of its exchange of information regime. It was feared that the new agreement would give the Ukrainian authorities scope to engage in 'fishing expeditions' based on little more than envy and suspicion. These fears are unfounded.

Cyprus's Assessment and Collection of Taxes Law contains robust safeguards against abuse of any exchange of information provisions. Requests for the exchange of information are dealt with exclusively by the International Tax Relations Unit of the Department of Inland Revenue. The exchange of information may take place only via the unit - direct informal exchange of information between tax officers bypassing the competent authority is prohibited. Furthermore, a request cannot simply be a brief email containing the name and identification information of the individual concerned. Instead, a detailed case must be made, with the criteria set out in a lengthy legal document. In effect, this means that the authorities requesting the information must already have a strong case before they request the information. As a final safeguard, the law requires that the written consent of the attorney general be obtained before any information is released to an overseas tax authority.

The new agreement remains very beneficial and Cyprus is unlikely to be displaced as a leading portal for international investment to and from Ukraine after it takes effect.

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