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The new double taxation agreement between Cyprus and Ukraine

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Cyprus and Ukraine have finalised a new tax treaty, replacing an agreement dating back to the Soviet era which had found itself criticised for enabling abuse by Ukrainian businesses. The following article takes us through the new treaty.

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Most of the new states which emerged from the break-up of the Soviet Union adopted the Cyprus-USSR double taxation agreement which had previously applied to them. Over the intervening years new agreements have been negotiated between Cyprus and many of the states concerned, with the Cyprus-USSR agreement now continuing to apply to only a handful of countries.

Ukraine is the latest country to conclude its own agreement with Cyprus. The issue had been a source of contention in Ukraine for several years, with populist politicians claiming that the Cyprus-USSR agreement was excessively generous and was abused by Ukrainian businesses to evade their obligations, rather than for legitimate tax mitigation. In 2010 the World Bank recommended that Ukraine 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 to Ukrainian businesses would be lost as a result of the renegotiation. These fears have proved to be unfounded, and the new Cyprus-Ukraine agreement, which was signed on November 8, 2012, is taxpayer-friendly and maintains Cyprus's status as among the most beneficial 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. It is unlikely that the requisite notifications will be exchanged before the end of 2012, so the new agreement is likely to enter into force some time during 2013 and apply to tax years beginning after 31 December 2013. Until then the Cyprus-USSR agreement will remain in effect.

The new agreement closely follows the 2010 OECD Model Tax Convention and the wording of certain articles, such as that relating to permanent establishments, is different from that of the Cyprus-USSR treaty, which dates back to 1982. However, most provisions are substantially unchanged in their effect. The principal changes are described below.

I. Immovable property

In line with the OECD Model the definition of immovable property includes property ancillary to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting 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.

The Cyprus-USSR agreement provided that income from immovable property belonging to a resident of one contracting state and situated in the other would be liable to taxation only in the country where the property was located. The new agreement is more ambiguous, providing that such income "may" be taxed in the country in which the property is located but not ruling 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, and so appears to exclude gains from the disposal of property.

II. Dividends, interest and royalties

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

Article 10 of the new agreement provides that the maximum rate of withholding tax on dividends will be limited to 5% if the beneficial owner is a 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 not satisfying these criteria the maximum rate of withholding tax will be 15%.

Article 11 restricts the maximum rate of withholding tax on interest to 2%. Any withholding tax paid in Ukraine will be credited against the recipient's corporate income tax liability in Cyprus, so there is no additional tax cost resulting from the change.

Article 12 provides for a maximum rate of withholding tax of 5% on royalties in respect of copyright of scientific work, patents, trademarks, secret formulas, processes or industrial, commercial or scientific know-how; and 10% on royalties in respect of literary or artistic work, 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 the recipient to the beneficial owner, is in line with the latest OECD Model Convention and is designed to forestall artificial avoidance schemes.

III. 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 wording.

IV. Exchange of information

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

- 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 by 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 any person who may hold the information requested, if known.
- A declaration that the provision of such information is in accordance with the legislation and the 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 according to the terms of its ordinary administrative practices.
- 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.

V. What has not changed – taxation of gains on shares

There were fears that a number of benefits would be lost as a result of the renegotiation. One of the great benefits of the Cyprus-USSR treaty is its highly favourable provisions regarding capital gains on disposal of shares in property-rich companies. Movable property, including shares, is taxable only in the country of residence of the owner, and 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 to be disposed of tax-free.

The OECD Model Agreement 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 into the new agreement. However, this fear has proved to be unfounded. Gains on disposals of movable property 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.

VI. Some preliminary conclusions

The loss of the zero withholding taxes on dividends, interest and royalties was inevitable. The new maximum rates are modest and Cyprus remains among Ukraine's most favoured treaty partners in this regard.

The continuation of the very favourable arrangements for taxation of property-rich companies is excellent news and gives Cyprus a huge 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, and 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 exchange of information are dealt with exclusively by the International Tax Relations Unit ("ITRU") of the Department of Inland Revenue. Exchange of information may only take place via the ITRU: direct informal exchange of information between tax officers bypassing the competent authority is prohibited. A request must be much more than a brief email containing the name and identifying 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 even before they request the information. As a final safeguard, Cyprus's Assessment and Collection of Taxes Law requires the written consent of the Attorney General to be obtained before any information is released to an overseas tax authority.

In summary, the new agreement remains very beneficial and Cyprus is unlikely to be displaced as the predominant portal for international investment to and from Ukraine once it takes effect.

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NOTES

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