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Cyprus: The Day After

The sun will still shine bright

By Pavlos Aristodemou

Introduction

Cyprus has been in the spotlight recently due to the negotiations with what has become known as the troika (the International Monetary Fund, the European Central Bank and the European Commission) regarding terms of financial aid. It is not the first time that a member of the Eurozone has sought to negotiate with the troika for financial aid. Ireland, Greece and Spain all came before Cyprus but the therapy was very different in the case of Cyprus.

The problem on each occasion related to the size of public debt and the size of the banking sector in relation to the country's gross domestic product. In other countries, a "bail-out" procedure was followed whereas in the case of Cyprus, a "bail-in" procedure was imposed. In other words, in the former instances funds were provided from the troika to the government and banks without the depositors' participation whereas in the case of Cyprus the depositors participated.

Media coverage of the Cyprus banking crisis focused on certain facets that raised concern regarding the future of the jurisdiction for business. This included the bail-in itself, the amount of funds deposited by international depositors in Cypriot banks (especially Russian depositors) and the size of the package *vis-à-vis* the size of the Cypriot economy.

The purpose of this article is to look objectively at the changes that are to be introduced to Cyprus following the final agreement between Cyprus and the troika and consider specifically whether these changes are likely to affect corporate structuring involving Cyprus and banking in and outside Cyprus using a Cyprus corporate vehicle.

Corporate structuring involving Cyprus

One may suggest that recent events in Cyprus amount to confiscation or nationalisation of funds and wealth. Is that true, though? A look into the actual situation evidences that such statements are far from accurate.

The resolution measures related to banks were imposed following the passing of the Resolution of Credit and other Institutions Law 13(I)/2013 which is standalone legislation. Cyprus has in the past transposed into domestic law the provisions of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions (the "Directive"). Whilst many people may not be aware of it, EU member states have already transposed the provisions of the Directive into domestic law which one may argue shares a great deal of similarities subject to measures such as bail-in which could be legally challenged. That leads us to the next question which is very crucial:

Does the passing of the Resolution Law and or any laws related to the financial arrangement between Cyprus and the troika put at risk the right to own shares in private companies or other Cypriot vehicles, or impose any sort of risk on property held in private companies? Is there a way the Cypriot government could confiscate the shares of individuals?

The answer is a clear and fully justified, "No". One must not confuse the resolution of banks and proposed measures related to cutting public deficit with possible confiscation and/or nationalisation of property that is privately owned. One must not confuse a situation of the rescue of a bank which would otherwise be in liquidation with ownership in private companies and private assets.

In other words, it is important to realise that the two banks that constitute the largest part of the banking sector of Cyprus ended up in such financial difficulty that, had the European Central Bank not supported them, their immediate involuntary liquidation would likely have followed.

To avoid that, the troika negotiated with the Cyprus government to reach an agreement where the resolution of the banks would consist of *inter alia* a bail-in, unlike a bail-out, which would mean indirect funding through a facility provided to the government for re-capitalisation of banks.

That is most probably the source of confusion as it relates to confiscation of funds. To a certain extent that was justified by the initial decision of the Eurogroup, which suggested a bail-in by depositors in all banks. A closer look however would suggest that that approach would have been unconstitutional and against the relevant article of the European Convention on Human Rights. The Cyprus parliament rejected the passing of such a bill sending a clear message that it would respect peoples' fundamental rights. It was a strong message that a problem in specific banks cannot be made a problem of depositors in financially robust institutions.

It is therefore evident that the measures related to the resolutions of banks should not and must not be confused with corporate structuring via Cyprus. One may look to Ireland as an example: while banks went down, it by no means meant the end of corporate structuring. I would dare say, the contrary happened.

The main drivers of international corporate structuring

Taxation is usually the main driver for the set up of international structures. In particular when people decide their group's corporate structures the following are a few points considered:

Corporate tax

While corporate tax will be increased from 10 per cent to 12.5 per cent, Cyprus will continue to have one of the most

attractive corporate tax rates in the EU on par with that of Ireland and Malta. It is important to note that in Cyprus corporate tax exempts taxation of securities (including shares, units in funds redeemable shares, GDRs, etc).

Treatment of taxation on dividends

Cyprus has an extremely favourable regime on the participation exemption of dividends which remains unchanged based on the agreement between the troika and the government of Cyprus. In particular, irrespective of the percentage of participation in a subsidiary and the holding period, the dividends will be exempt from taxation. Dividends will only be taxed if the subsidiaries (directly or indirectly) have engaged in more than 50 per cent passive activities or have paid effective tax of less than 5 per cent. In other words, the test is such that it allows for exemption from taxation of dividends in most cases. (That does not apply however to Cyprus residents who are subject to a 20 per cent special contribution for defence tax.)

In a nutshell, dividends received by holding companies in Cyprus that are managed and controlled from Cyprus will have their dividend fully exempt from taxation if it derives from activities of their subsidiaries which are not passive in nature.

No withholding taxes

The treatment of dividends as examined above along with the non-imposition of withholding taxes on payments out of Cyprus related to dividends, interest or royalties (save 10 per cent if the right is used within Cyprus) makes the Cypriot tax regime extremely attractive. Most of the jurisdictions would have certain anti-abuse provisions and / or a 15 per cent withholding tax rate.

It is important to note that the non-application of withholding tax operates by virtue of the domestic tax rules and not on the basis of double tax treaties. In other words the above would still be applicable in the absence of a double tax treaty and, most importantly, these rules remain unchanged following the agreement of Cyprus with the troika.

It is also important to note that the above makes Cyprus especially favourable for the issue of debt instruments (bonds, debt programmes).

Double tax treaty network

Cyprus has an extensive double tax treaty network, with 45 countries. While other jurisdictions have more (The Netherlands has more than 95 and Luxembourg has more than 60) Cyprus is notable in that it has favourable provisions in tax treaties with key countries such as Russia, Ukraine, India and South Africa.

There has been absolutely no discussion of the amendment of treaties simply because of what happened with the banks as described above. For people who are well aware of how these matters operate, it is easy to realise that a decision to amend or cancel a double tax treaty which is an international treaty and ratified domestically in the countries which are parties to it is not something that may take place overnight. Even if that were the case, any such change would likely take years to come into effect.

Capital gains

No capital gains apply for the sale of securities (ie shares) or real estate situated outside Cyprus. In other words, the Cypriot situation in this regard is as good as it gets.

Legal system

Cyprus follows the common law system and has an attractive companies law regime based on the UK's Companies Law of 1948. One would find no difficulties in arguing that following a legal system and law which is close to the UK system, and based on UK companies law, is a tremendous advantage. Indeed UK law has always been in the forefront of international commerce, trade and financing and the model of Cyprus is not far from that.

It is important to note that no changes are expected on this front. More importantly, a Cyprus company may have its banking activities anywhere in the world provided that its constitutional documents allow for that. It is true to say that most of the high level and high volume transactions which we see involving Cyprus companies featured banking services with leading international triple-A banks.

Taxation on Interest

This may be changed so that interest on deposits will be subject to tax of 30 per cent. That however is unlikely to affect structuring since (i) it does not apply on financing companies (ie financing vehicles within groups) (ii) in relation to holding companies affected, it is only on interest received from deposits and therefore the spread and effective taxation is not expected to be high.

Judiciary

The Cyprus political system is based on the separation of powers, as initially described by Baron Montesquieu, between the executive (in this case the president of Cyprus), the legislature (in this case the Parliament of Cyprus) and the judiciary (in this case the courts of Cyprus).

The judicial system has remained impartial and independent. That is extremely important for parties entrusting their possible disputes to the judgments of Cyprus courts. We do not expect this to change. On the contrary, we expect the courts to stay impartial, objective and rise to the occasion for each case which may be brought before them.

Level of professional services

Cyprus has over the past decades developed a sophisticated legal, audit and consulting services sector due primarily to demand from international clients. As mentioned above the legal and tax systems which are modelled on UK law have made Cyprus a very business-friendly jurisdiction.

Banking

Whilst for a number of years one could refer to a solid banking system in Cyprus, recent events show that that is not now the case. The reasons for this, some of which are now under investigation, are myriad. They include decisions that were taken at the corporate level on investments; the relationship between the banking systems of Cyprus and Greece at the time when the EU debt crisis affected Greece severely; the haircut of the Greek governmental bonds to which Cypriot banks were hugely exposed; and the role of the supervisory bodies.

It is important to note that the banking system, as we will now see it, will be much closer to the average banking system of EU member states *vis-à-vis* the GDP (percentage wise) of EU countries.

Proximity and accessibility

The geographical location of Cyprus at the crossroads of Europe, Africa and Asia and very close to Russia and the CIS countries makes it easy to act as a centre for international business. In addition, many companies may be looking to take advantage of historically low commercial real estate prices in Cyprus.

Conclusion

Cyprus is going through a tough time as far as the banking sector is concerned but there is nothing to suggest that, other than what has been discussed above, international structuring will be affected. On the contrary, recent high value transactions using Cypriot vehicles suggest that international advisors and business leaders continue to give Cyprus a vote of confidence for the reasons outlined above. Cyprus is still going strong.

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