

Beyond Cyprus

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Until recently, choosing a tax-efficient international structure for Ukraine (be it a holding, financing or licensing structure) was a relatively easy thing to do. Indeed, Cyprus was (and still is) offering a quite attractive domestic tax regime, with a modest corporate income tax rate and impressive list of tax exemptions. Virtually non-existent withholding tax added to the tax attractiveness of Cyprus, making the profit repatriation exercise less burdensome than in many other countries.

In addition to the advantageous domestic tax rules (which were already very tempting per se) Cyprus was safely enjoying an amazing double tax treaty of 1982 (concluded with the now-defunct USSR and inherited by Ukraine). The treaty provides for quite a number of catching tax benefits (exemption from withholding tax in Ukraine of dividend, interest and royalty income payable to Cypriot residents can be mentioned).

According to Ukrainian statistics, Cyprus was one of the top direct investors in Ukraine (it is actually the largest direct investor in the country). Cyprus owes this top position to its tax appeal, which was irresistible to investors in Ukraine.

New treaty negotiations and especially the attempts of the Ukrainian government to arrange for the unilateral denunciation of the treaty have however clouded the tax idyll between Ukraine and Cyprus.

The draft treaty Ukraine proposes to sign is much less favourable for Cypriot investors. The draft provides for withholding tax on dividends, interest and royalty (however, reduced rates will be available as follows: dividends – 5% in the case of participations of at least 25%; interest – 10%; royalty – 10%). The draft also provides that gains from the alienation of shares may be taxed in Ukraine if more than 50% of the value of the shares is derived directly or indirectly from immovable property located in Ukraine.

The timing of the new treaty entering into force is a tricky issue. According to the draft treaty, it enters into force after the ratification instruments have been exchanged. Immediately upon such an exchange the old (Cyprus-USSR) treaty ceases to be effective. However, the new treaty provisions will become applicable as of January 1 of the year following the year when the new treaty enters into force. There is a risk, therefore, that the old treaty might be terminated before the new one is applicable and there would be a period when no treaty protection is available at all.

Obviously, a unilateral denunciation of the old treaty by Ukraine would cause a similar effect (no treaty protection for some time).

What if the “old” Cypriot treaty ceases to exist?

The draft treaty, if signed and ratified by both sides, could materially affect the structuring of inbound investment in Ukraine. Even though the domestic Cypriot tax rules would remain quite attractive, the tax lure of Cyprus will not be that obvious and irresistible in the absence of such an important differentiating factor as an advantageous double tax treaty.

For many businesses, additional Ukrainian withholding tax could be devastating. Indeed, it will be fairly difficult to count on the offset of the additional taxes payable in Ukraine against the tax liability in Cyprus, for these latter are likely to be insufficient to absorb the large amount of taxes to be levied in Ukraine (at rates ranging from 5 to 15% of gross amount of income payable).

Logically, those businesses will be forced to look for (re)structuring opportunities through other jurisdictions.

Criteria to choose an alternative to a Cyprus-based structure

A number of tests would have to be applied to choose an appropriate replacement for the existing structure.

A simple test would be to compare the tax and other relevant rules in the jurisdiction under consideration with those of Cyprus and choose the one which is the most similar to Cyprus.

Seriously speaking, the basic tax tests would de minimis include considering the following issues:

- WHT in the country the income originates from. Ideally there should be no or reduced WHT. Normally this is achieved through availability of an advantageous double tax treaty.
- Beneficial ownership (substance) requirements (in both the country of income payer and the country of income recipient). Check how strict or, instead, liberal those requirements are.
- Taxation of income at the recipient's level: are there any exemptions or reduced tax rates available in respect of that income in the country of recipient's residence?
- Subsequent repatriation from the country of income recipient's residence, inter alia:
 - What repatriation opportunities exist
 - What is the taxation of a chosen method of repatriation (will there be WHT or other taxes applicable, etc.).

The above are just some generally relevant issues. Additional considerations would have to be taken into account to address specifics of a particular structure (financing, holding, licensing, trading, shared services, and so on).

The Netherlands – an example of a holding structure

Let's imagine there is a Ukrainian operating company ("Ukrainian OpCo") 100% owned by a Dutch holding company ("Dutch HoldCo"). Dutch HoldCo is owned by Dutch COOP Company ("Dutch Coop") which in turn will be owned by an ultimate holding company ("Top HoldCo") located somewhere on the islands (where taxation is acceptably light).

What tax benefits does such a structure offer on the Ukrainian side?

- Exemption from dividend taxation in Ukraine

The Netherlands-Ukraine double tax treaty exempts dividend payments from taxation in Ukraine if the following conditions are met:

- a) A dividend recipient (Dutch HoldCo) is a beneficial owner of dividends, and
- b) It holds directly at least 50 percent of the capital of the company paying the dividends, and
- c) An investment of at least US\$300,000 or its equivalent in the national currencies of the Contracting States has been made in the capital of the company paying the dividends.

The Ukrainian tax authorities have recently expressed their view on how the above requirements should be understood (letter of the State Tax Administration of Ukraine of 31.10.2008 #22302/7/12-0117). Not surprisingly the authorities' interpretation is unduly restrictive (to put it mildly).

- Exemption from dividend and capital gain taxation

Netherlands-Ukraine double tax treaty exempts from withholding tax in Ukraine gains derived by Dutch HoldCo from the alienation of shares in Ukrainian OpCo, unless the value of such shares is derived principally from immovable property situated in Ukraine. However, the term "immovable property" does not include property used by such company only in its industrial, commercial or agricultural activities or in the conduct of professional services. Thus, there could be a wide range of situations where taxation of capital gain would be avoided.

Tax benefits on the Dutch side

The dividends received by Dutch HoldCo from the Ukrainian OpCo could be exempt from the Dutch corporate income tax under the participation exemption regime provided that certain conditions are met.

The main conditions of the Dutch participation exemption are as follows:

- a) The taxpayer holds at least 5% of the nominal paid-up share capital of a foreign subsidiary
- b) The subsidiary must have a capital wholly or partly divided into shares (this test should normally be met in the case of a Ukrainian limited liability company)
- c) The subsidiary may not be qualified as a low taxed portfolio investment.

The definition of whether a subsidiary is "portfolio participation," as well as how the effective tax burden is determined, are not discussed here.

Capital gains realized by Dutch HoldCo from sale of shares in Ukrainian project companies should be exempt from taxation in the Netherlands on the same conditions as dividends.

Generally, obtaining an advance tax ruling on the applicability of the participation exemption is recommended in each particular case.

Dutch Cooperative

The Dutch Coop is an association incorporated by a notarial deed and is a legal entity. The Dutch Coop is subject to Dutch corporate income tax on its worldwide income as a domestic taxpayer. The Dutch Coop may form a fiscal unity with Dutch HoldCo. In this case any transaction between the two entities, including the repatriation of dividends from Dutch HoldCo to Dutch Coop, should be disregarded for corporate income tax purposes and should not be subject to tax (during the existence of the fiscal unity).

The Dutch Coop should not, based on Dutch dividend tax legislation, be obliged to withhold dividend withholding taxes. Principal criteria in this case are how the by-laws of the Dutch Coop are formulated. Again, it is recommended that the above conclusion be confirmed by an advance tax ruling on a case-by-case basis.

Capital gains realized by the Dutch Coop from sale of Dutch HoldCo's shares may be exempt from taxation under the participation exemption regime rules. An important point however is that the feasibility of the Dutch Coop structure may be affected by the Dutch substantial participation regime rules. This issue requires a separate discussion. Practically, it is strongly recommended to obtain an advance tax ruling to confirm that the substantial interest regime is not applicable in each particular case.

Perpetual attractiveness of Cyprus

The risk of losing an advantageous double tax treaty with Cyprus should stimulate businesses structured through Cyprus to look for alternative jurisdictions (at least as a back up option). Indeed, having Cyprus interacting with Ukraine directly may become substantially less efficient taxwise if the existing treaty is gone.

However, this would not by any means exhaust the tax planning potential of Cyprus.

Postscript: Immediately after this article was completed (17 December 2008), the media covered the failure of another attempt by Parliament to denounce the old treaty with Cyprus.