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Cyprus

George Economides & Constantinos Markou
E & G Economides LLC – Advocates and Legal Consultants

Overview of corporate tax work

Cyprus has traditionally been one of the preferred EU jurisdictions in international tax structuring and is an efficient gateway for business and investments to and from Europe. Despite the past turbulence in the local banking sector, all the elements that constitute the island as an attractive and workable international business centre continue to exist. The domestic tax and legal framework remain unaltered and are continuously further strengthened; whereas at the same time Cyprus concentrates on remaining a fully compliant and transparent jurisdiction as to all related EU and international regulations. At the same time, the exceptionally good double tax treaties that Cyprus has signed with certain non-EU countries, such as Russia, Ukraine and South Africa, have recently been updated, securing Cyprus' position as one of the preferred partners for inbound and outbound investments to and from the said countries.

Two years after the banking crisis and the Troika rescue package coming into play, Cyprus not only survived the test but also managed to surpass all expectations. In the second year of its road to recovery, the island has made great strides and is edging out of recession with a growth-oriented fiscal consolidation package.

The Cyprus banking sector received significant investment from international investors, and through a complete restructuring, foreign and domestic deposits are slowly but steadily growing. The bailout programme is well on track and by 2016 it is projected that economic growth shall reemerge. During the last two years alone, over €2.5bn has been invested in the country via the Citizenship by Investment programme. Company registrations are on the rise, indicating that business activity is picking up, Troika consistently praises the progress of the bailout package implementation, and international rating agencies consistently upgrade the island's economic outlook, while the public and banking sectors are continuously implementing positive reforms.

The Cyprus government reentered international markets with two successful bond issuances, which in both cases were oversubscribed by institutional investors. In extension to the five-year bond of €750m raised in June 2014, Cyprus recently raised €1bn in seven-year bonds, carrying a 4 per cent interest rate, the funds of which will replace previous debt borrowed at much higher rates and provide liquidity and investment to the local economy.

Moreover, dependency on the Greek economy has substantially diminished and, as per the government officials, the risk of a potential Grexit shall not have any noteworthy repercussions on the economy.

A bill for the development of a multi-billion casino resort was recently enacted by the House of Representatives, the materialisation of which is anticipated to attract an additional one million tourists per annum and significantly contribute to the local economy.

The island's prospects in regards to the ongoing exploration for natural gas in its Exclusive Economic Zone are undoubtedly a game-changer, as Cyprus may well become an energy hub in the South Eastern Mediterranean region. The exploration is well under way and the reserves are apparently well above the country's consumption needs, so much of the gas shall be exported to neighbouring countries and possibly to the EU.

On 6 April 2015, the Cyprus government lifted any remaining restrictions on domestic deposits, capital controls and other restrictive measures and limitations relating to international deposits in Cyprus. In light of the positive ongoing restructuring of non-performing loans, the credit rating of Cyprus' major domestic bank was upgraded from all the major international financial credit rating agencies. Finally, the House of Representatives recently enacted a much-anticipated foreclosure law which shall further improve the financial position of local lenders.

Key developments affecting corporate tax law and practice

<u>The Foreign Account Tax Compliance Act ('FATCA')</u>

FATCA is a US law requiring non-US financial institutions with US assets or clients to report to the US government certain information about their client's financial accounts held outside of the United States. The Cyprus government signed the Model 1 Intergovernmental Agreement (IGA) with the United States government on 2 December 2014. Under the Model 1 (IGA), Cyprus financial institutions are required to report to the local tax authorities about their US clients, which in turn will submit such information to the Internal Revenue Service (IRS).

<u>OECD's Convention on Mutual Administrative Assistance in Tax Matters</u>

On 10 July 2014, the Cyprus government signed the Convention on Mutual Administrative Assistance in Tax Matters and its Protocol ('the Convention'). The Convention provides for all possible forms of administrative cooperation in the assessment and collection of taxes, as well as simultaneous tax examinations by the Cyprus tax authorities and the tax authorities of other signatory countries. The business community generally applauded the signature of the Convention as it evidences that Cyprus remains at the forefront of developments as a compliant and reputable jurisdiction.

<u>OECD's Base Erosion and Profit Shifting ('BEPS') Action Plan</u>

OECD's BEPS Action Plan has been produced at the request of the G20 and was introduced at the 2013 G20 Finance Ministers' meeting in Moscow. The Action Plan identifies 15 specific actions that will give said governments the domestic and international instruments to prevent corporations from engaging in aggressive tax planning. The Action Plan focuses on five areas, namely on: (1) the digital economy; (2) hybrid mismatch arrangements; (3) strengthening controlled foreign company (CFC) rules; (4) interest deductions and other financial payments; and (5) countering harmful tax practices. Several of the BEPS Actions could have a major impact on domestic legislation if adopted by the Cypriot authorities. The following are the main actions that we consider relevant:

- **Action 4**: Limit base erosion via interest deductions and other financial payments.

  Currently, Cyprus tax legislation does not limit the deductibility of interest payments. Specifically, interest payments to third parties are generally deductible without any restriction, on the basis that the interest expense is incurred wholly and exclusively for the production of own taxable income. Interest payments to related parties are generally deductible without any restriction on the basis that the expense was incurred wholly and exclusively for the production of own taxable income and the interest is paid on an arm's length basis.

- **Action 5**: Counter harmful tax practices more effectively, taking into account transparency and substance.

  Amongst other areas, Action 5 is expected to affect to a great extent the provisions of the existing favourable Cyprus IP Regime. At the moment, Cyprus companies receiving qualifying income (e.g. royalties) from qualifying IPs (Trademarks, Patents and Copyrights) are eligible for an 80% tax deduction of their gross qualifying income. Domestic legislation does not include any substance requirements requiring for example the IP to be developed in Cyprus, which as per the OECD constitutes as harmful tax practice.
- **Action 6**: Prevent treaty abuse.

  OECD envisages introducing a multilateral instrument implementing anti-treaty shopping provisions in the existing double tax treaties of the signatory countries. On the basis that the Cyprus government will sign the multilateral instrument giving into effect of Action 6, the requirements for treaty qualification for Cyprus companies will become much stricter.

Revised Parent Subsidiary Directive

In July 2014, the Council of the European Union amended the EU Parent-Subsidiary Directive (2011/96/EU) and introduced provisions tackling hybrid loan arrangements (e.g. Profit Participating Loans) which benefit from double-non taxation under the Directive. In addition, on January 2015 the Council introduced a general anti-abuse clause to prevent tax avoidance and aggressive tax planning by corporate groups. The anti-abuse clause prevents Member States from granting the benefits of the Directive (mainly the non-application of domestic dividend withholding taxes) to artificial arrangements that have been put into place to obtain a tax advantage without reflecting economic reality. Member States have until 31 December 2015 to introduce the said amendments into national law.

It is anticipated that Cyprus legislation will be amended to reflect the above provisions. With respect to hybrid loans, receipts from other EU Member States shall be taxable, when such payments are treated as tax deductible at the level of the payer company. With respect to the general anti-abuse clause, it is not clear as to how this could affect domestic legislation, as Cyprus does not apply any withholding taxes on outbound payments of dividends to non-residents.

Directors' criminal liability

In June 2014, the Assessment and Collection of Taxes Law was amended, rendering company directors personally liable for any falsified or deliberately misstated tax returns and other documents submitted to the tax authorities as well as any fraudulent omission or delay of payment of any taxes. This criminal liability extends to company executives (e.g. the CEO) and any executive with responsibilities as to the financial management of a company.

Single Tax Department

In July 2014, the government initiated a reform of the public sector, resulting in the merge of the Department of Inland Revenue (Direct Taxes) and the Department of Value Added Tax (Indirect Tax). This measure shall further strengthen the position of the Cyprus tax authorities to serve requests from taxpayers and enhance the collection of due taxes.

Change in the rates of VAT and Special Contribution for Defence

As from 13 January 2014, the standard rate of VAT was increased from 18 to 19% and the reduced rate from 8 to 9%. At the same time, the rate of Special Defence Contribution on dividends paid to Cyprus resident shareholders was decreased from 20 to 17%.

Attractive developments in Cyprus

Cyprus became an EU Member State in 2004 and adopted the Euro in 2008. The legal system is based on English statute and English common law as the UK 1948 Companies Act forms the basis of the Cyprus Company Law. Cyprus has one of the lowest corporate income tax rates in the EU, having a uniform rate of 12.5%. This, in combination with other favourable tax provisions and certain types of income being tax exempt as well as its highly skilled professional services, modern infrastructure, wide variety of investment opportunities, expedient double tax treaties and strategic geographical location, makes the island a preferred international business centre through which foreigners choose to conduct their business.

New double tax treaties

As of January 2015, Cyprus' Double Tax Treaty network has been extended with four new treaties coming into effect, namely with Iceland, Lithuania, Norway and Spain.

Iceland: Under the treaty there is a 5% withholding tax on dividends where the beneficial owner is a company holding directly at least 10% of capital of the dividend paying company (in all other cases there is a 10% withholding tax). There is a 0% withholding tax on interest and a 5% withholding tax on royalty payments. Taxing rights on gains from the sale of shares in property rich companies (i.e. shares deriving more than 50% of their value from immovable property) are allocated to the state where the property is situated.

Lithuania: Under the treaty there is 0% withholding tax on dividends where the beneficial owner is a company holding directly at least 10% of capital of the dividend paying company (in all other cases there is a 5% withholding tax). There is 0% withholding tax on interest and 5% withholding tax on royalty payments. Taxing rights on gains from the sale of shares in property rich companies are allocated to the state where the seller is resident.

Norway: Under the treaty there is 0% withholding tax on dividends where the beneficial owner is a company holding directly at least 10% of capital of the dividend paying company (in all other cases there is a 15% withholding tax). There is 0% withholding tax on interest and royalty payments. Taxing rights on gains from the sale of shares in property rich are allocated to the state where the seller is resident.

Spain: Under the treaty there is 0% withholding tax on dividends where the beneficial owner is a company holding directly at least 10% of capital of the dividend paying company (in most other cases there is a 5% withholding tax). There is 0% withholding tax on interest and royalty payments. Taxing rights on gains from the sale of shares in property rich companies are allocated to the state where the property is situated. In the Protocol to the Treaty there is a provision specifying that the treaty shall not prevent a contracting state from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance.

In March 2015, Cyprus concluded and signed a treaty with **Bahrain** which provides for a 0% withholding tax on dividends, interest and royalties. It is expected that the ratification procedures will be completed shortly, and the treaty will be effective as from January 2016.

In April 2015, Cyprus and **South Africa** signed a Protocol to the existing treaty. As per the Protocol, there will be a 5% withholding tax on dividends where the beneficial owner is a company holding directly at least 10% of capital of the dividend paying company (in most other cases there is a 10% withholding tax). There will be no withholding tax on payments of interest and royalties. The Protocol also introduced an updated version of article 26 for the exchange of information, which is in line with the OECD Model Treaty.

In May 2015, Cyprus concluded and signed a treaty with **Georgia** which provides for a 0% withholding tax on dividends, interest and royalties. It is expected that the ratification procedures will be completed shortly, and the treaty will be effective as from January 2016.

During 2014, Cyprus concluded new treaties with **Switzerland** and **Guernsey**. These treaties will enter into force once the ratification procedures have been concluded, which has not been made at the time of writing.

The majority of the treaties concluded by Cyprus follow the OECD Model Treaty which provides clear and consensual rules for the taxation of income and capital. Amongst other benefits, most double tax treaties concluded by Cyprus entail an elimination of double taxation in the Contracting State by way of a tax credit and reduced withholding taxes on dividends, interests and royalties.

<u>Cyprus Alternative Investments Funds (‘AIFs’)</u>

The Cyprus House of Representatives voted on the enactment of the AIF Law in July 2014, in an effort to modernise the local legislative framework on investment fund products in line with EU legislative developments and increase Cyprus competitiveness in the investment funds industry. The AIF Law came into force a few days later following its publication in the Official Gazette, replacing and repealing the International Collective Investment Schemes Law of 1999 (the ‘ICIS Law’). The AIF Law applies to AIFs established in Cyprus and regulates the role and responsibilities of persons engaged in the activity of AIFs such as custodians, directors and asset managers. AIFs are governed by the Alternative Investment Funds Law of 2014 (the ‘AIF Law’) and are authorised and regulated by the Cyprus Securities and Exchange Commission (‘CySEC’).

AIFs formed as investment companies are subject to tax like any other Cyprus resident company. A company is considered to be tax resident in Cyprus if its management and control is exercised in Cyprus. When combined with the various favourable tax provisions and related factors, Cyprus becomes one of the most attractive and competitive tax jurisdictions worldwide. Some of the main favourable provisions and factors are: no tax on gain from disposal of shares and other qualifying titles; dividend income is tax exempt (subject to very easy-to-meet conditions); no CFC rules and no thin capitalisation rules; a unilateral tax credit relief mechanism; no withholding taxes on any payments made from Cyprus to non-Cyprus resident persons (such payments include dividends, interest and royalties); and access to benefits of the Cyprus double tax treaty network and relevant EU Directives.

<u>New VAT Leasing Scheme for Aircraft</u>

On March 2015, the Cyprus VAT Department published guidelines on the application of the Cyprus VAT Leasing Scheme for Aircraft. By entering into the scheme upon leasing an aircraft, the cost and administrative burden of VAT is reduced by a substantial level. At the same time, there is no longer a need to maintain detailed records, known as log books, for the duration of the aircraft’s use within EU airspace. By application of the scheme, the relevant VAT charge is calculated depending on the aircraft size/type and duration of use within EU airspace. In general, the conditions for the application of the scheme are easy to be met. The Aircraft Leasing Scheme follows the respective Yacht Leasing Scheme, which was successfully introduced in 2012.

<u>Innovative business</u>

As of 25 July 2014, the costs incurred for the purchase of shares in an innovative business are treated as tax deductible expenses. The term “innovative business” means a business:

(a) which can demonstrate, through a comprehensive study performed by a qualified expert, that it may in the near future develop new or substantially improved products, services or processes in relation to highly improved products services or market operations and which pose the risk of technological or industrial failure; or

(b) of which its research and development expenses represent at least 10% of its total operational expenses in at least one out of the three last years prior to the granting of the deduction, or, in the case of a business which is currently in the start-up phase and has no financial history, to the audit of the current tax year, as certified by an external auditor.

This provision aims to foster the development of innovative local businesses and aid the development of local start-ups.

Industry sector focus

Holding company regime

In general, for pure holding companies there are no Cyprus taxes on the flow of income through Cyprus, and at the same time there is a real tax saving by achieving eliminated or significantly reduced foreign withholding taxes. This is achieved by access to the EU Directives and the beneficial Cyprus double tax treaty network, especially with certain non-EU countries.

Foreign dividends are generally exempt from Cyprus taxes. This exemption does not apply if the foreign dividends derive directly or indirectly from passive operations and the foreign company paying the dividends suffers tax which is significantly lower than the equivalent Cyprus corporate income tax rate of 12.5%. In the rare cases where this exemption does not apply, gross dividends are taxed at the rate of 17% under the Special Defence Contribution Law.

Domestic dividends from other Cyprus resident companies are generally exempt.

Any foreign tax (e.g. withholding tax) on foreign income may be credited against the Cyprus tax resulting from the same income. In the rare cases where a dividend is taxable, underlying tax credit is also allowed unilaterally if the dividend is received from another EU Member State or by application of the provisions of a relevant double tax treaty, if received from a third country.

Similarly, the profits of a foreign Permanent Establishment of a Cyprus company are exempt from corporate income tax. This exemption does not apply if the foreign profits derive directly or indirectly from passive operations and the foreign Permanent Establishment suffers tax which is significantly lower than the equivalent Cyprus corporate income tax rate of 12.5%.

Profit from sale of shares (and other qualifying titles) is specifically exempt from tax on the basis that it does not involve immovable property situated in Cyprus. Qualifying titles include ordinary and preference shares, founder's shares, options on titles, debentures, bonds, short positions on titles, futures/forwards on titles, swaps on titles, depositary receipts on titles, rights of claims on bonds and debentures, index participations resulting in titles, repurchase agreements or repo agreements on titles and units in open-end or closed-end collective investment schemes.

Active interest (including financing interest) is taxed at a rate of 12.5% after deduction of tax allowable expenses. For back-to-back financing transactions small (thin) spreads are possible and accepted. Passive interest (e.g. bank deposit interest) is taxed at the rate of 30% under Special Defence Contribution on the gross amount.

Anti-avoidance provisions: Cyprus legislation does not include any thin capitalisation rules restricting the deductibility of interest expense on loans/financing arrangements for the acquisition of business assets. In addition, any interest expense incurred for the direct or indirect 100% acquisition of shares in an underlying subsidiary is tax deductible provided that the assets of the subsidiary are business assets. Moreover, domestic legislation does not provide for any Controlled Foreign Company rules.

There are no withholding taxes on outbound payments to non-residents in respect of dividends, interest and royalties used outside of Cyprus.

Cyprus IP Regime

In 2014, the European Commission initiated an investigation to determine whether certain European IP Regimes grant a selective advantage to a specific group of companies (e.g. IP companies) in breach of the EU state aid rules. The investigation determined that indeed some of the existing EU IP Regimes are in breach of the above rules and they should be substantially revised or closed down. Having considered the output of the investigation, the OECD proposed revised rules for the application of preferential IP Regimes in line with EU legislation.

In December 2015, the ECOFIN Ministers effectively endorsed the OECD proposal and, as a result, all EU countries should close down their existing IP Regimes to new entrants before June 2016. Companies that qualify under the existing Regimes should be able to have access to the existing benefits until 2021, but new entrants (i.e. joining an IP Regime after June 2016) should follow the new IP Regime rules.

From a Cyprus perspective, there have been no governmental announcements with respect to the above. However, we do expect that the government shall follow the recommendations of the OECD and revise domestic legislation accordingly. As per the above, Cyprus companies with qualifying IPs acquired before June 2016 should enjoy the provisions of the existing Regime up to 2021. Even in the case that the current IP regime is substantially restricted, Cyprus is still an attractive proposition for IP companies mainly due to Cyprus' low tax rate, absence of withholding taxes on outbound payments and access to EU Directives and double tax treaty-related benefits.

The year ahead

New draft bills

Cyprus continues to enhance its competitiveness as an attractive international business centre. As at the time of writing this publication, there is a number of pending bills introducing certain new attractive elements. These include:

- Cyprus Foundations, which are of a similar nature to foundations existing in other EU and non-EU jurisdictions, so as to complement and offer an alternative vehicle to the already successful Cyprus International Trusts.
- The concept of non-domiciled residents ('non-doms'). This would be of great interest to foreign HNWIs, who choose to move their tax residency in Cyprus and be liable to Cyprus tax only on any income earned or remitted in Cyprus, as opposed to their worldwide income.
- Notional Interest Deduction. This tax deduction shall be calculated by multiplying the qualifying equity of the Cyprus Company with a specific interest rate. As of today there have been no clarifications on the terms qualifying equity or the rate of interest, but we generally expect that equity will include at least the share capital, share premium and retained earnings of the Cyprus Company. With respect to the interest rate, it is expected that it will be tied to the Cyprus government bonds yield, though there are concerns that the rate should reflect the characteristics of the market where the funds are put into use (in case of financing overseas operations or subsidiaries).

Regulatory environment

In relation to the global initiatives towards fiscal transparency and tax evasion, Cyprus shall continue to implement various international, EU and OECD guidelines, thereby being in the forefront as a compliant and reputable jurisdiction.

George Economides
Tel: +357 25 866 480 / Email: george.economides@economideslegal.com
George focuses in tax, intellectual property, corporate and commercial law. He graduated from the University of Westminster and having completed his Bachelor's degree, he joined the tax practice of a Cyprus major accountancy firm. He was later admitted to the Cyprus Bar Association and is currently a partner with E & G Economides LLC, a dynamic and rapidly expanding Cyprus law firm. He is a member of the Cyprus Bar Association and the Individual Tax and Private Client Committee of the International Bar Association.

Constantinos Markou
Tel: +357 25 866 480 / Email: constantinos.markou@totalserve.eu
Constantinos specialises in taxation and international tax planning, and is a senior tax consultant. He is a Chartered Certified Accountant and holds an Advanced Diploma in International Taxation (ADIT) from the UK's Chartered Institute of Taxation (CIOT). He is a member of the Institute of Certified Public Accountants of Cyprus (ICPAC) and the Chartered Institute for Securities and Investments (CISI) in the UK. Furthermore, Constantinos is a former member and secretary of the Tax and VAT committee of the Cyprus Fiduciary Association, as well as a member of CISI's national council in Cyprus.

E & G Economides LLC – Advocates and Legal Consultants

17, Gr. Xenopoulou Street, 3106, P.O. Box 58043, 3730 Limassol, Cyprus
Tel: +357 25 866 480 / Fax: +357 25 866 481 / URL: http://www.economideslegal.com

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