Double Tax Treaty between the Czech Republic and Cyprus

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The following article examines how Czech businesses can benefit from including a Cyprus holding company in their corporate structure.

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I. Introduction

A new agreement between the Czech Republic and the Republic of Cyprus for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income ("Treaty")[1] entered into force on January 1, 2010 and applies to persons who are residents of one or both of the countries. The Treaty replaced the existing 1980 double taxation treaty between the two countries and it is a reflection of escalating global focus on tax optimising structures. The importance of the Treaty for Czech businesses is underlined also by statistics estimating that every second company active in the Czech Republic was incorporated in Cyprus.[2]

This article will examine in the framework of the Treaty how Czech entrepreneurs can benefit from including a Cyprus holding company in their corporate structures and point out some of the practical issues to be considered.

II. Outline of general provisions

The categories of taxes on income to which the Treaty applies include:

- the tax on income of individuals and legal persons imposed by the Czech Republic, and
- the income tax, corporate income tax, capital gains tax and special contribution for the defence of the Republic (commonly referred to as SDC tax) imposed by Cyprus.

The Treaty ensures that profits of a Cyprus company are taxable only in Cyprus unless the company carries on business in the Czech Republic through a permanent establishment situated in the Czech Republic.

In such cases, the profits of the company which are attributable to that permanent establishment may be taxed in the Czech Republic only. This principle applies vice-versa to Czech companies having a permanent establishment in Cyprus. The tax charge will generally be based on the profits which the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment (Article 7(2) of the Treaty).

In this connection companies need to be aware of the potential adverse consequences of unintended creation of a permanent establishment. The term covers a wide range of possibilities, including fixed places of business such as a factory or office, and a permanent establishment may also arise from the provision of services for periods exceeding in the aggregate six months within any twelve month period.

Particular care needs to be taken regarding the issuing of general powers of attorney. A company from one country will be deemed to have a permanent establishment in the other country if a person acts there on its behalf and habitually concludes contracts in its name (Article 5(5) of the Treaty). It is therefore generally advisable for Cyprus companies with representatives active in the Czech Republic to grant a special power of attorney each time a representative is to act and perform tasks on their behalf there.

III. Cyprus tax residency

The term "resident of a Contracting State" in the context of the Treaty includes any company which, under the laws of that State, is liable to tax therein by reason of its domicile, residence, place of management, place of incorporation or any other similar criterion.

Mere incorporation of a company in Cyprus will not suffice to make it a Cyprus tax resident and eligible to the benefits of Cyprus's favourable tax regime (including a 10 percent tax rate on worldwide income). Under the laws of Cyprus the key test for residence is the locus of management and control. If the company is managed and controlled by its directors in Cyprus and they do not allow anyone else to usurp that management and control (a factual test), then for Cyprus law purposes it will be tax resident in Cyprus. In practice, all strategically important decisions on the affairs of the company should be considered and made at board meetings in Cyprus and the board meetings must be genuine decision-making forums. In practice, a majority of locally resident directors creates a rebuttable presumption of management and control being exercised in Cyprus although this does not in itself constitute sufficient basis for satisfaction of the legal test. On the other hand, having directors all (or most) of who are resident abroad will give rise to a presumption of management and control being exercised abroad. In such a case tax residency may be established abroad or, worse, a dual tax residency status could be established. Directors who reside abroad will have to visit Cyprus to physically attend and participate in an appropriate number of board meetings each year in order to satisfy the test.

It is apparent that substance prevails over form. Cyprus's own rapidly developing body of anti-avoidance legislation is aimed at denying companies without any significant business substance or commercial rationale for existing in Cyprus, (i.e. mere letterbox or brass-plate companies) the benefits available under the island's tax law and double tax treaties. Where an intermediate holding company is superimposed on operating companies merely to obtain savings in withholding taxes, the tax authorities may be able to set aside the structure by applying a general anti-avoidance doctrine.[3]

The same line is followed by the Treaty. The protocol annexed to it provides that the benefits of the Treaty may be withheld from any person or in connection with any transaction, if the dominant purpose of the structure or transaction is to obtain benefits under the Treaty that would not otherwise be available.

Furthermore, the Treaty introduces the term "beneficial ownership", a concept borrowed from the OECD Model Treaty, in the context of Articles 10, 11 and 12. A universally-agreed definition of beneficial ownership has not yet emerged and the exact meaning that should be attributed to the term "beneficial owner" in the new OECD Commentary to the Model Treaty is the subject of considerable debate. Given that the determination of the precise meaning of this term is vital in the context of anti-avoidance provisions and the prevention of treaty abusive exercises, it is important that this uncertainty is resolved as soon as possible.

All these factors underline the importance of thorough tax planning, taking account of all possible eventualities.

IV. Elimination of double taxation

The Treaty provides relief from double taxation by applying the credit method. This means that a resident of one country who derives income which in accordance with the Treaty may be taxed in the other country, may deduct the tax paid in that other country. In other words, liability of Czech tax residents for Czech income tax is reduced by tax paid in Cyprus, so that the taxpayer only pays the higher of the two liabilities and is not taxed twice on the same income. The same applies the other way round for Cyprus tax residents.[4]

There is however a residual possibility of taking into account the income exempted from tax when calculating the amount of tax (Article 21 (2) of the Treaty).

The Treaty also sets out basic rules for exchange of tax information between the competent authorities of the two countries and offers a procedure based on the OECD Model for an amicable solution of potential disputes on taxation (Articles 23 and 24 of the Treaty). It also contains provisions aimed at elimination of tax discrimination against nationals of the other country.

V. Specific tax provisions

A. Dividends (Article 10)

Dividends paid by a Czech-resident company to its Cyprus-resident shareholder may be taxed in Cyprus. In accordance with Cyprus's domestic tax laws, dividends are fully exempt from corporate income tax unless they derive from passive investment subsidiaries situated in jurisdictions whose effective corporate tax rate is 5 percent or less.

However, such dividends may also be taxed in the Czech Republic under its laws but if the beneficial owner of the dividend is a Cyprus-resident company (but not a partnership) that directly holds at least 10 percent of the dividend payer's capital for a continuous period of at least 1 year, the withholding tax will be zero. For companies not satisfying these criteria the tax will be 5 percent of the gross amount of the dividends.

The ability to eliminate withholding tax on dividends (or, at worst, to reduce it to 5 percent) is one of the main advantages of the Treaty for many Czech entrepreneurs, especially when compared with the predecessor treaty which provided for a 10 percent tax, making Cyprus a highly attractive holding company regime.

Tax treatment of dividends further upstream in the corporate structure is also favourable, as dividends paid to a non-resident shareholder (individual or company) by a Cyprus resident are fully exempt from SDC tax. Profits attributable to non-resident shareholders are also exempt from SDC tax under the "deemed distribution" provisions.

B. Royalties (Article 12)

As a general rule, royalties arising in the Czech Republic paid to a Cyprus-resident company or individual may be taxed in Cyprus and vice-versa. On the other hand, income received as remuneration for the right to use the most common forms of intellectual property – including patents, trademarks, designs or computer software, may also be taxed in the country in which they arise under its domestic tax laws. In such cases, however, the rate will not exceed 10 percent of the gross amount of the royalties if the beneficial owner of the royalties is a resident of the other country.[5]

Royalties are deemed to arise in a Contracting State when the payer is a resident of that state or, under certain circumstances, of the Contracting State in which the permanent establishment is situated. Where, by reason of a special relationship between the parties, the amount of the royalties exceeds an arm's length amount, the excess will remain taxable according to the laws of each country.

C. Immovable Property / Capital Gains (Article 6, Article 13)

Income derived by a Cyprus resident company from immovable property situated in the Czech Republic and the use of such property, including letting, may be taxed in the Czech Republic, and vice-versa. Similarly, gains derived by a Cyprus resident company from the alienation of immovable property situated in the Czech Republic may be taxed in the Czech Republic.

Gains arising from the disposal of shares and other interests in companies, partnerships or trusts deriving more than 50 percent of their value from immovable property situated in the Czech Republic (commonly known as "property-rich companies") may also be taxed in the Czech Republic, bringing the Treaty into alignment with the OECD Model Treaty. This issue needs to be carefully considered when Cyprus companies are used for investments in real estate. Gains on all other securities are entirely tax-exempt in Cyprus, making Cyprus companies very effective for holding shares in companies with a good prospect of being sold at a profit.

Where an enterprise from one country has a permanent establishment in the other country, gains from the alienation of movable property forming part of the business property of such permanent establishment may be taxed in that other country. This also applies to gains from the alienation of a permanent establishment, whether alone or with the whole enterprise.

Gains derived by an enterprise from the disposal of business property consisting of ships or aircraft engaged in international transport (including movable property ancillary to their operation) is taxable only in the country in which the place of effective management is situated.

Gains from alienation of any other property are taxable only in the country of which the alienator is a resident.

D. Interest (Article 11)

Interest arising in one country and beneficially owned by a resident of the other will be taxable only in the country of residence of the recipient. A special regime is set out for the cases when a claim in respect of which the interest is paid is effectively connected with a permanent establishment.

Under Cypruś's tax laws interest received by companies in the ordinary course of their business or closely connected to the ordinary course of business, net of costs incurred in earning the interest, is subject to corporate income tax at the rate of 10 percent. Other interest is subject to SDC tax at the rate of 15 percent on the gross amount without any deduction for costs.

Interest is deemed to arise in a Contracting State when the payer is a resident of that state or, under certain circumstances, in the state in which the permanent establishment is situated. Where, by reason of a special relationship between the parties, the amount of the interest exceeds an arm's length amount, the excess will remain taxable according to the laws of each country.

E. Personal services (Article 15, Article 16)

Remuneration received by Czech residents in their capacity as directors of Cyprus-resident companies may be taxed in Cyprus.

Income derived by Czech-resident sportsmen or entertainers who perform their activities in Cyprus may be taxed in Cyprus. This is also the case when the income does not accrue to the sportsman or entertainer himself but to another person, such as a sports club.

VI. Conclusion

Favourable taxation of dividends and interest makes a Cyprus company a favourable option for investment in Czech companies and financing their operations. Withholding tax on dividends paid by a company resident in one country to a shareholder resident in the other country is reduced under the Treaty to zero when the minimum investment condition is satisfied, or to 5 percent in all other cases. It should be noted that any dividends, interest and royalties paid by a Cyprus company to a Czech company are not subject to any taxes in Cyprus in any case under Cyprus's favourable domestic tax laws. If the shares held in a Czech company are sold, the gain will be entirely exempt from tax in Cyprus (with certain exceptions applicable on sales of shares in companies holding immovable property in Cyprus). Interest received by a Cyprus company in the ordinary course of its business will be taxed at the rate of 10 percent after the deduction of costs incurred in earning it. In other cases the interest will be subject to 15 percent SDC tax.

Cyprus companies may also be utilised to structure a low taxed business activity and trade, whether within the European Union or as a gate to or from the rest of the world. Income of Cyprus tax resident companies is taxed at the rate of 10 percent which is approximately half the corporate income tax rate in the Czech Republic.

However, the growing importance of substance over form needs to be taken into account. There are clear signals that artificial structures and transactions which have tax avoidance as their sole purpose will not be tolerated. Careful planning and implementation are essential for Czech businessmen wishing to obtain the full benefits of the Treaty and Cyprus's benign tax regime.

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NOTES

[1] No. 120/2009 of the Collection of International Treaties of the Czech Republic

[2] For example, an article 'Kypr poodhalil vlastníky firem' on www.novinky.cz/ekonomika or an article 'Kypr odhalil majitele kyperských firem' on www.podnikani-krok-za-krokem.webnode.cz

[3] E Neocleous, 'Russian tax cases highlight importance of substance for structures using Cyprus', (2011) 17 Tax Planning International European Tax Service 9. Although this article concerns itself with the "substance over form" rule as applied in Russia, the core issues and questions apply mutatis mutandis in the context of the Czech Treaty as well.

[4] In fact it should be noted that Cyprus went a step further and allows a foreign tax credit even in the absence of an accommodating double tax treaty such as in this case.

[5] To compare, there has been an increase in the withholding tax on royalties - the 1980 double tax treaty provided for 5 percent whereas the Treaty provides for 10 percent. However, the Czech Republic has undertaken in a Protocol to the Treaty that if in the future it concludes a double tax treaty with another EU member state providing for a lower rate for the taxation of royalties, such lower rate will automatically be applicable also under the Treaty.