

Taxation aspects of the reform of the Cyprus International Trusts Law of 1992

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After years of falling behind, Cyprus has recently updated its law on international trusts to reflect changes in global investment practice. The following article examines the revisions involved from a tax perspective.

I. Background to the reform

When it was enacted in 1992, the Cyprus International Trusts Law gave Cyprus a “state of the art” international trusts regime, with excellent tax mitigation and asset protection features. However, the world has changed considerably in the intervening 20 years and while the basic structure provided by the International Trusts Law remained sound, it required updating to adapt it to the needs of investors today and in the coming years. The enactment in March 2012 of the International Trust (Amending) Law of 2011 brings the Cyprus trusts regime firmly into the 21st century. It strengthens the already formidable asset-protection benefits of Cyprus international trusts, widens trustees’ investment powers to those of an absolute owner, provides greater flexibility and control for settlors and removes limits on the lifetime of trusts. Cyprus international trusts now provide an extremely effective and flexible wealth-holding structure with formidable asset protection features that are likely to attract high net worth individuals from around the world.

When the 1992 law was drafted, the availability of international trusts was restricted to non-resident settlors in order to prevent tax avoidance by Cyprus residents. It was not clear whether settlors could relocate to Cyprus after establishing a Cyprus International Trust, and the resultant uncertainty undoubtedly discouraged many of them from doing so. The amending

law provides only that the settlor may not be a Cyprus tax resident in the year preceding the year of creation of the trust. It also removes the prohibition on resident beneficiaries and on ownership of immovable property in Cyprus, thus avoiding difficulties that might otherwise arise if the settlor or any beneficiary were subsequently to take up residence in Cyprus and ensuring that the Law as amended is fully compliant with EU law regarding the free movement of persons, capital and establishment.

II. The new tax regime for international trusts

Given that the 1992 law contained a blanket prohibition on permanent residents of Cyprus setting up international trusts and on beneficiaries being resident in Cyprus, it did not include any tax provisions apart from an all-embracing clause exempting income earned from sources outside Cyprus from Cyprus tax. Now that beneficiaries may be resident in Cyprus it has become necessary to include more detailed provisions. Nevertheless, these are relatively straightforward.

Section 12 of the Law as amended provides for a uniform tax regime applicable to all persons on the basis of the tax residency test. Income and profits of an international trust which are earned or deemed to be earned from sources within and outside Cyprus are subject to every form of taxation imposed in Cyprus in the case of a beneficiary who is resident there. In the

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case of a non-resident beneficiary only Cyprus-source income and profits are subject to Cyprus tax.

The new provisions ensure that there will be no discriminatory taxation or undue tax advantages open to any person. Any beneficiaries who are Cyprus tax residents will be subject to taxation on their worldwide income in the same way as any other Cyprus tax resident and non-resident beneficiaries will be subject to Cyprus taxation only on any Cyprus-source income.

The application of these provisions is clear in the case of trusts whose beneficiaries are exclusively non-resident or (no doubt less frequently) exclusively resident in Cyprus. In practice, many trusts may have a mixture of resident and non-resident beneficiaries and the apportionment of the various forms and sources of income between them will no doubt be refined in the light of practice.

The Cyprus Inland Revenue Department (IRD) has announced that it will issue guidance in due course on the application of the new provisions regarding the tax treatment of the various forms of trust structure that may be established under the new regime and that the tax laws will be amended if necessary.

III. Application of the new provisions

In the meantime, preliminary discussions have taken place between the Inland Revenue Department, the Institute of Certified Public Accountants of Cyprus and other interested parties, and the following principles have been agreed.

- The trustee will be the person responsible for the payment of any taxes due to the Inland Revenue Department, as is the case under existing tax legislation.
- The trustee will be responsible for maintaining and collating all the relevant information concerning the trust and its beneficiaries. The trustee will also be responsible for compliance with anti-money laundering legislation and for providing information to the Inland Revenue Department. This is analogous to the arrangements for international business companies held through third parties (nominees), such as fiduciary service providers.
- If any beneficiary is a Cyprus tax resident the trustee will be the person responsible for registering the beneficiary for Cyprus tax purposes if they are not already registered.
- Insofar as taxation of the trust and its beneficiaries is concerned, the tax residency status of the beneficiaries will be the determining factor.

The Inland Revenue Department will adopt the following approach for the purposes of taxation of trusts under section 12(1):

- If all the beneficiaries are Cyprus tax residents the trust will be treated as a domestic trust and will be subject to every form of taxation in Cyprus on all income, wherever it arises.
- If all the beneficiaries are non-residents the trust will be deemed to be an international trust and will be subject to taxation only on Cyprus-source income.
- In cases where the trust has both resident and non-resident beneficiaries, the tax treatment will be determined by reference to the scope of rights that the

respective beneficiaries have in the trust (in accordance with the trust instrument).

In the case of a trust with a mixture of beneficiaries the overall tax treatment of the trust will be determined according to a simple majority test. Where more than 50% of the rights attach to beneficiaries who are resident in Cyprus the trust will be treated as a domestic trust and will be liable to Cyprus tax on worldwide income. Where more than 50% of the rights attach to non-resident beneficiaries it will be treated as an international trust liable to Cyprus tax only on Cyprus-source income.

However, even in the latter case, any distribution of income to a Cyprus-resident beneficiary will be subject to Cyprus tax and the trustee will be responsible for deducting tax and paying it to the Inland Revenue Department to the extent that the income has not already suffered taxation.

IV. Taxes on income

The main taxes on income in Cyprus are income tax and Special Contribution for Defence, commonly referred to as SDC tax. Income tax is payable by corporations at a rate of 10 per cent and by individuals at progressive rates varying with income. Dividends and most interest are exempt from income tax, but subject to SDC tax at rates of 20 per cent and 15 per cent respectively. Rent received is subject to income tax and also to SDC tax at 2.25 per cent.

To illustrate how the Inland Revenue Department intends to apply the new provisions, consider the case of a trust with five beneficiaries, three of which are non-resident and the other two of which are Cyprus-resident. One of the resident beneficiaries is an individual and the other is a company. Applying the preliminary guidance issued by the Inland Revenue Department, if a dividend is received from a company in Cyprus the trustee should pay SDC tax on the one-fifth of the dividend attributable to the Cyprus-resident individual (dividends between resident companies are exempt and the portion attributable to non-residents is excluded).

Dividends received from overseas will not be subject to taxation when received, as the trust has a majority of non-resident beneficiaries. If the trustee subsequently distributes the income, SDC tax will have to be deducted and paid over to the tax authorities on the amount attributable to the Cyprus-resident beneficiaries.

The same treatment will apply to interest and rents received. The trustee will be responsible for paying SDC tax on Cyprus-source interest, and income tax and SDC tax on Cyprus-source rents received. Foreign-source interest will not be subject to any form of taxation on receipt, but if it is distributed to Cyprus resident beneficiaries the trustee will be obliged to deduct SDC tax and pay it over to the tax authorities. Similarly, for rental income earned overseas income tax and SDC tax will be calculated only when and to the extent that the income is distributed to the tax resident beneficiaries. At this stage it is not clear what rate of income tax will be applied. While SDC tax is charged at standard rates, personal income tax is charged at progressive rates according to total income. If, as is generally the case, the trust is to be

transparent for tax purposes this will presumably be the individual's marginal rate or rates.

V. Other taxes

International trusts will be liable to taxes such as VAT and stamp duty on their activities in Cyprus. Section 12(2) of the International Trusts Law as amended provides for a fixed stamp duty of €430 on the establishment of an international trust. International trusts will be subject to immovable property tax on property held in Cyprus irrespective of the residence of the beneficiaries. However, because of the high threshold for immovable property tax it is only material for extremely large property holdings.

Capital gains tax is levied in Cyprus only on disposals of real estate situated in Cyprus and, to the extent that the gain is derived from the real estate holding, on disposals of shares in companies holding real estate in Cyprus. All international trusts will be liable to tax on such Cyprus-source gains.

VI. Conclusions

The recent reforms address a number of perceived deficiencies in the trust regime in Cyprus, bringing it back to the "premier league" of trust jurisdictions internationally and the new tax provisions provide a tax-neutral environment allowing investors to take advantage of Cyprus's benign tax regime, particularly as regards capital gains.

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