Corporate Tax - Cyprus

Recent developments in Cyprus-India double tax avoidance agreement

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Introduction

Over the past three months there has been a great deal of discussion and speculation following the Indian government's decision to declare Cyprus a 'notified jurisdiction' with effect from November 1 2013, for allegedly failing to exchange information effectively with the Indian tax authorities. Notified jurisdiction status has meant that transactions carried out by Indian taxpayers with entities based in Cyprus would potentially come under increased scrutiny from the Indian tax authorities, and that withholding tax might be imposed on payments by Indian taxpayers to recipients in Cyprus, which would subsequently have to be reclaimed.

While the difficulties now appear close to resolution, it is unfortunate that there was not greater consultation by the Indian authorities before the decision was made to classify Cyprus as a notified jurisdiction, as this caused considerable uncertainty for taxpayers and their advisers.

Double tax avoidance agreement

India and Cyprus concluded the current double tax avoidance agreement in 1994. The agreement includes particularly favourable provisions regarding the taxation of interest income and capital gains on disposals of investments. As a result, and due to its other attractions as a holding company jurisdiction, Cyprus has become one of the most attractive locations through which to route investment into India. A significant amount of inward investment into India has been made through Cyprus entities since 1994, making Cyprus the seventh largest source of foreign direct investment into the Indian economy. The development of commercial and economic relations between the two countries in turn led to enhanced cooperation in areas such as education, trade and tourism.

Negotiations

In order to resolve the current dispute, a delegation from Cyprus visited India in November 2013 for consultations on the effective exchange of information and the renegotiation of the double tax avoidance agreement. As a result, India agreed to withdraw the notification suspending tax benefits for investments from Cyprus, provided that the new agreement adopted Article 26 of the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention relating to exchange of information. Cyprus also agreed to establish efficient channels of communication with India in order to deal with requests for information efficiently and promptly. On this basis, it was agreed that the declaration of Cyprus as a notified jurisdictional area under Section 94A of the Indian Income Tax Act 1961 would be withdrawn with retrospective effect from November 1 2013.

In order to facilitate information exchange, the Indian government also decided to establish an income tax overseas unit, similar to those already in operation in Mauritius and Singapore, as part of its multi-pronged strategy to combat money laundering and tax evasion. The units in Mauritius and Singapore have generally been viewed as successful in facilitating cooperation and consultation between the respective tax authorities, and it is expected that similar benefits will result in the case of Cyprus.

It appears that both nations are keen to resolve their differences on this issue and that matters are now moving towards a satisfactory resolution. The new Indian high commissioner to Cyprus, who formally took up his appointment in early February 2014, has informed the local media in Cyprus that a technical delegation from India is expected to visit Cyprus in March to "tie up loose ends and sign a new treaty" on double taxation.

Comment

Although the primary impact of the penalties imposed in November fell on Cyprus, such penalties also had an adverse effect on India by creating uncertainty in the minds of investors. As the Indian government recognises, India will need significant foreign direct investment over the next few years in order to develop its economy. As a vibrant and successful jurisdiction, Cyprus can contribute to attracting foreign investors into the Indian economy and can be a portal for Indian outward investment. It has already achieved a measure of success in this regard.

It is clear that India will benefit by working with a treaty partner that is a well-regulated EU member state that is on the OECD white list and has a tax system that conforms to EU law and the EU code of conduct. These are significant factors in appealing to global investors. It is therefore hoped that the recent turbulence in relations will prove to be a one-off incident and a new agreement can be agreed in the near future, and that a mutually beneficial relationship can be established that recognises the tax authorities' legitimate rights to obtain information, while at the same time protecting taxpayers against abuse of the authorities' powers.

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