

Corporate Tax - Cyprus

Importance of substance in recent cases involving Cyprus structures

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Background

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Comment

Background

Cyprus follows the 'substance over form' and 'business purpose test' doctrines, which allow the tax authorities to recategorise an artificial or fictitious transaction or structure. The Assessment and Collection of Taxes Law, which was amended to transpose the EU Mutual Assistance Directive (77/799/EEC) into domestic legislation, contains general anti-avoidance rules, under which the tax authorities may disregard artificial or fictitious transactions and assess the taxpayer on the proper object of tax. The provisions apply to both local and international transactions, for residents and non-residents.

One of the principal objects of Cyprus's rapidly developing body of anti-avoidance legislation is to prevent companies without any significant substance in Cyprus (often referred to as 'brass-plate' companies) from unfairly enjoying the benefits offered by the Cyprus tax regime. For example, where an intermediate holding company is interposed between operating companies and the ultimate holding company, for no purpose other than to obtain savings in withholding taxes, the tax authorities may set aside the structure by applying a general anti-avoidance doctrine. Tax authorities are increasingly looking into the substance of transactions rather than their form, and substance over form issues should be considered carefully in order to minimise the risk of a successful challenge by the tax authorities under the general anti-abuse legislation.

For a holding company to enjoy the advantages provided by Cyprus's business-friendly tax legislation and its extensive network of double tax treaties, it must be able to demonstrate that it is resident in Cyprus for tax purposes. Under Cyprus law, the key test for residency is the locus of management and control. This test has developed through the English courts, whose decisions are followed by Cyprus courts where there is no local precedent. It is generally accepted that the locus of management and control is the place where key strategic decisions are made, rather than where day-to-day management takes place. This will usually be where the directors meet, but each case will be determined on its facts - if management of the company is carried on outside board meetings, it is necessary to look at where and by whom the key decisions are made.

However, tax residence alone is not sufficient - business substance must also be considered. This update outlines the principal established cases in the field of business substance and recent developments that underpin its growing importance, as illustrated by two recent cases involving Cyprus entities in which arrangements that lacked the required degree of business substance failed to achieve their desired results. Both cases also demonstrate the growing sophistication of onshore tax authorities in collecting information and formulating arguments against arrangements that they consider to be artificial.

Substance over form in recent cases

The two recent cases regarding substance over form specifically relate to the use of Cyprus structures and entities to mitigate tax - one is a decision by a Russian court and the other a decision of a UK first-tier tax tribunal.

Russian decision

In *Decision of Russian Federation Ural District* (FAC Φ09-3637/11), issued on June 30 2011, a Russian court decided that a common royalty scheme - which involved a Cyprus company as an intermediary licensing vehicle between a BVI holding company and a Russian operating entity - had no business substance, and concluded that the Cyprus company was interposed merely in order to gain access to unjustified tax benefits.

The decision is highly significant in the context of IP structures, given that Cyprus companies are very commonly used as intermediary sub-licence vehicles in respect of IP rights exploited in Russia and royalty income channelled abroad. Under Article 12 of the Russia-Cyprus Double Tax Treaty, Russia may not impose any withholding tax on royalties paid by Russian licensees to Cyprus, whereas Cyprus only taxes the margin between licensing income paid and received, which can be minimal. Furthermore, royalty payments are normally fully tax-deductible for Russian tax purposes.

UK decision

In a potentially far-reaching recent UK tax case - *Kljun v HMRC* ([2011] UKFTT 371 (TC)) - the first-tier tax tribunal resolved that, when applying the dependent personal services article of a double tax treaty, the key factor is the country of residence of the company that controls and bears the cost of the employee (ie, the economic employer) and not the country of the formal or registered (for contractual purposes) employer.

This case is a striking reminder that the courts will look at the substance of a transaction when determining the tax rules that apply. The Cypriot authorities are likely to adopt the same approach to this issue, since Article 15 of the Cyprus-UK treaty is identical to Article 15 of the UK-Yugoslavia treaty.

Comment

As the cases outlined above demonstrate, the substance over form doctrine is increasingly important in the framework of international taxation. When planning and implementing tax mitigation measures, there are a number of practical precautions that should be taken in order to ensure that the structure is compliant and to minimise the risk of successful challenge.

Careful planning is required to determine the existence (or lack) of substance on a case-by-case basis. The key considerations to be taken into account include:

- the nature of the business and operations of the enterprise concerned;
- the corporate governance and management structure at various levels and the related human capital requirements;
- the commercial nature of the transactions which the company undertakes, and any related legal requirements;
- the target jurisdiction in which the investment is taking place;
- the resources required by the company to carry out its activities and investments;
- whether the business objectives and transactions could be accomplished through simpler schemes than the tax scheme currently proposed;
- the locus of operations; and
- where tax is payable.

Practical measures which will assist in enhancing substance include:

- establishing a real physical presence in Cyprus by setting up a fully resourced and independent office in Cyprus;
- employing people to work for the company in Cyprus and complying with the relevant tax and social insurance obligations;
- opening local bank accounts to settle expenses incurred by the company, including employment costs; and
- maintaining accounting books in Cyprus and ensuring that the company discharges all its statutory corporate and fiscal obligations on time.

Once the above elements are cumulatively observed, the substance of the structure will be greatly enhanced and the overall protection entrenched.

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