The new Cyprus-Iceland double taxation agreement

With less than seven weeks between signature on 13 November 2014 and entry into force on 22 December, the new DTA between Cyprus and Iceland set a new standard for timeliness. Like most of Cyprus's recent double taxation agreements, the DTA closely follows the form of the 2010 OECD Model Convention. Its key features are summarised and explained below.

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TAXES COVERED

The DTA covers the following categories of taxes:

- Cyprus income tax, corporate income tax, special contribution for the Defence of the Republic (SDC tax) and capital gains tax;
- Icelandic state income tax and municipal income tax.

It will also apply also to any identical or substantially similar taxes that are imposed in future in addition to, or in place of, the existing taxes.

RESIDENCE

Article 4 replicates the provisions of the OECD Model. The residence of dual-resident individuals is settled by the closeness of the individual's ties to the respective states or, failing that, by agreement between the two states. Legal persons are resident in the state in which their place of effective management is situated.

PERMANENT ESTABLISHMENT

Article 5 contains the usual list of activities that do not give rise to a permanent establishment, namely storage and display of goods, maintenance of stocks for processing by a third party, maintenance of a purchasing or information-gathering facility or for preparatory or auxiliary purposes.

A building site, a construction, assembly or installation project or a supervisory or consultancy activity connected with it will be deemed to be a permanent establishment only if it lasts for more than twelve months.

If an enterprise has a representative in a contracting state, that has, and habitually exercises, authority to conclude contracts in the name of the enterprise, the enterprise concerned is deemed to have a permanent establishment in respect of any activities which the person undertakes for the enterprise. Taxpayers need to be aware of the potential adverse consequences of unintended creation of a permanent establishment. Particular care needs to be taken regarding the issuing of general powers of attorney.

HYDROCARBON EXPLORATION AND EXPLOITATION

Most of the DTAs that Cyprus has concluded since gas reserves were discovered in its exclusive economic zone in 2008 have included an article dealing with offshore hydrocarbon exploration and exploitation activities, usually requiring a much shorter period (generally three months) than the usual twelve months to trigger the creation of a permanent establishment.

The Cyprus-Iceland DTA does not include a separate article, but instead adds exploration facilities to the standard list of locations giving rise to a permanent establishment. As noted above, it provides that a building site, construction or installation project or any supervisory activities in connection with such site or project constitutes a permanent establishment only if it lasts more than twelve months, but it does not set any minimum duration for exploration activities to constitute a permanent establishment. It is not clear whether this exclusion is intentional or whether exploration activities will be treated in the same way as others.

INCOME FROM IMMOVABLE PROPERTY

Income from immovable property may be taxed in the contracting state where the property is situated.

BUSINESS PROFITS

Profits are taxable only in the contracting state in which the enterprise earning them is resident unless it carries on business in the other contracting state through a permanent establishment there, in which case the profit attributable to the permanent establishment may be taxed in the contracting state in which it is located.

The agreement includes detailed rules for apportionment of profits to permanent establishments, which are to be applied on a consistent basis over time.

INTERNATIONAL TRANSPORT

Profits from the operation of ships (including ancillary equipment such as barges, containers and trailers) or aircraft in international traffic are taxable only in the contracting state in which the enterprise is resident, determined by its place of effective management.

DIVIDENDS

Withholding tax on dividends paid by a company resident in one state to a company (but not a partnership) resident in the other is limited to 5% of the gross dividend as long as the recipient is the beneficial owner of at least 10% of the shares in the company paying the dividend. Otherwise the maximum rate of withholding tax is 10%.

As Cyprus imposes no withholding tax on dividends paid to non-residents, in practice this provision applies only to dividends paid from Iceland to Cyprus.

INTEREST

Interest paid by a resident of one state to a resident of the other is taxable only in the state of residence of the recipient, subject to safeguards against abuse (for example, the exemption does not apply to any excessive interest above interest on an arm's length basis).

ROYALTIES

The maximum withholding tax on royalties is limited to 5%.

CAPITAL GAINS

Gains derived by a resident of one contracting state from the alienation of immovable property situated in the other may be taxed in the contracting state in which the property is situated. Gains on disposal of shares or similar interests in a company or other entity deriving more than 50% of its value from immovable property may also be taxed in the contracting state in which the immovable property is situated. Gains arising from the disposal of immovable or movable property associated with a permanent establishment, or from the disposal of movable property used in connection with the performance of independent personal services, may be taxed in the contracting state in which the permanent establishment is located or the services are performed.

Gains derived from the alienation of all other property (including ships or aircraft operated in international traffic) are taxable only in the contracting state in which the alienator is resident. However, gains from the disposal of shares in a company resident in one contracting state derived by an individual who is resident in the other contracting state but who was a resident of the first-mentioned state in the course of the five years preceding the disposal may be taxed in the first state (the state in which the individual was previously resident).

ELIMINATION OF DOUBLE TAXATION

Elimination of double taxation is achieved by the credit method. The credit is limited to that part of the income tax in the state of residence as computed before the deduction is given that is attributable to income that is subject to tax in the state of residence.

The growing importance of substance over form needs to be taken into account. While there is no explicit limitation of benefits or other anti-abuse provision, 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 in order to obtain the full benefits of the agreement.

MUTUAL AGREEMENT PROCEDURE

The article replicates the corresponding article of the OECD Model, except that there is no facility for unresolved issues to be referred to arbitration. They are therefore to be resolved by the contracting states.

EXCHANGE OF INFORMATION

The exchange of information article reproduces article 26 of the OECD Model Convention verbatim.

The usual Protocol that is included in many of Cyprus's recent agreements, which sets out detailed requirements regarding information exchange, is absent. However, Cyprus's Assessment and Collection of Taxes Law provides the same robust safeguards against abuse of the exchange of information provisions

ENTRY INTO FORCE AND TERMINATION

The agreement entered into force on December 22, 2014 and its provisions are effective in respect of amounts paid or credited on or after January 1 2015 with regard to taxes withheld at source, and in respect of taxable years beginning on or after January 1 2015 with regard to other taxes. Termination of the agreement will require written notice by either contracting state given no later than 30 June in any year from 2019 onwards, whereupon the agreement will cease to have effect from the beginning of the following year.

CONCLUSIONS

The new agreement with Iceland completes Cyprus's double tax treaty coverage of the prosperous Nordic markets. Cyprus and Iceland share many common characteristics: both are islands; both have a relatively small population and a services-based economy, and both are recovering from a painful banking crisis.

The new agreement aims to strengthen their trade and economic relations, in line with the Cyprus government's continuing efforts to update and extend its network of double taxation treaties so as to attract foreign investment and promote Cyprus as an international business hub.■