

## Corporate Tax - Cyprus

### Eligibility for benefits under Cyprus-US double tax convention

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#### Introduction

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#### Comment

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After consideration of the article setting out the limitations on benefits in the double taxation convention between Cyprus and the United States, the US authorities have accepted that a Cyprus-resident holding company qualified for benefits under the Cyprus-US convention, and the reduced rate of tax payable on dividends from qualified foreign corporations, despite not meeting the share ownership requirements stipulated in the convention. The decision is set out in Memorandum 201343019, which was issued by the office of the associate chief counsel of the US Internal Revenue Service on September 10 2013.

#### Qualified dividend income

Under the US Internal Revenue Code, 'qualified dividend income' is taxed at the same rate as net capital gains, a rate significantly below that applicable to other dividends. For example, where a taxpayer would ordinarily pay tax at 39.6% on dividends, the rate on qualifying dividends is only 20%. For taxpayers with a standard rate of 15% or less, no liability to tax on qualified dividends applies.

Qualified dividend income includes dividends received during the taxable year from a 'qualified foreign corporation', which is defined as:

*"any foreign corporation if (I) such corporation is incorporated in a possession of the United States, or (II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program."*

The Cyprus-US convention is among the 57 double tax conventions that satisfy the requirements.

One of the requirements for eligibility is that the dividends have been received from a country whose treaty fulfils the 'treaty test'. In order for the Cyprus company to meet the criteria of this test, it had to be ascertained whether all the requirements of the Cyprus-US convention were met, particularly in regards to residence of the Cyprus company for the purposes of the convention. Furthermore, the limitations on benefits provisions contained in Article 26 of the convention must not have been triggered.

Article 26(1) provides that a resident of Cyprus other than an individual is not entitled to benefits under the convention unless two conditions have been satisfied. First, in the case of a corporation, more than 75% of each class of shares must be beneficially owned, directly or indirectly, by one or more individual residents of Cyprus. Second, the gross income of the corporation must not be used in substantial part, directly or indirectly, to meet the liabilities of persons who are resident in a country other than the United States (and not US citizens) or Cyprus.

However, Article 26(2) (ie, the 'principal purpose test') provides an exception to this rule. It stipulates that benefits under the convention will not be denied even where the two conditions in Article 26(1) are not satisfied if "the establishment, acquisition, and maintenance of the person claiming treaty benefits and the conduct of its operations did not have the obtaining of treaty benefits as a principal purpose". In summary, even if a Cyprus company does not satisfy the shareholder ownership requirement of Article 26(1), it will nevertheless be entitled to benefits under the convention provided that the principal purpose test is satisfied.

The memorandum asserts that in the case in question, the Cyprus company "is being maintained for reasons unrelated to the Treaty" and that consequently "there was no 'principal purpose' of obtaining benefits under the Treaty".

#### Comment

While the memorandum represents a favourable outcome for the taxpayer concerned, it would have been more helpful to practitioners if it had explained the circumstances and reasoning on which this conclusion was based. For example, will a business purpose be sufficient to satisfy the test? Could a Cyprus company formed for the sole purpose of obtaining qualified dividend treatment satisfy the principal purpose test, since this treatment is arguably not a benefit of the convention, but of the code?

The memorandum highlights the existence of this relatively unusual and potentially valuable exemption, which will no doubt be explored further by enterprising practitioners in the years to come.

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