Bloomberg
BNA

TAX PLANNING INTERNATIONAL

EUROPEAN TAX SERVICE

International Information for International Business

VOLUME 18, NUMBER 1 >>> JANUARY 2015

www.bna.com

Cyprus

Philippos Aristotelous
Andreas Neocleous & Co LLC

The past year has been a busy one for tax practitioners in Cyprus, with plenty of new developments, including several new or substantially modified double tax agreements entering into force and a wide-ranging package of tax incentives and other amendments. The main changes are summarized below.

I. Amendments to the Tax Laws

In July 2015 the Cyprus government submitted a package of proposed amendments to the existing tax laws to the House of Representatives, aimed at encouraging economic activity, attracting inward direct investment and simplifying the tax regime in order to make it more attractive, fair, and effective. As a result of parliamentary time constraints the amendments were enacted in two instalments; one in July and the other in December.

A. The July Amendments

1. Amendments to the Income Tax Law[1]

(a). Notional Interest Deduction for new Equity Capital

In order to level the playing field between debt and equity finance, the Income Tax (Amendment) Law[2] introduces a notional interest deduction ("NID") on new equity capital (paid-up share capital and share premium) introduced into companies and permanent establishments of foreign companies after January 1, 2015 for the purpose of financing business assets. The NID will be allowed as a deduction against taxable profit, calculated by applying a reference rate to the new equity. The reference rate is the higher of the 10-year government bond yield of Cyprus or the country in which the assets funded by the new equity are utilized, in each case plus 3 percentage points. The bond yield rates to be used are as at December 31 of the year preceding the year of assessment.

New equity may be contributed in cash or in the form of other assets, in which case the amount of new equity will be the market value of the assets agreed with the tax authorities. No NID is available in respect of capitalization of reserves, revaluation of assets or for companies benefiting from the reorganization exemptions included in the tax laws, and NID may be refused if the tax authorities deem that the transaction concerned has no economic or business purpose. The NID is limited to 80% of the taxable profit before deducting the NID, and no NID will be allowed in the event of losses. Unutilized NID cannot be carried forward to be offset against future years' profits.

(b). Taxation of Widows' Pensions

A further amendment addressed an anomaly in the taxation of widows' pensions, which had been exempt from income tax until the end of 2013. From the beginning of 2014 a special basis of taxation applied under which the first 19,500 euros per year was tax-free and any amount above 19,500 euros was taxed at 20%.

The July amendment gives the taxpayer the option to elect on a year-by-year basis between the special basis described above or to be taxed under the general rules. The amendment is effective from the 2014 tax year onwards.

2. Amendments to the Special Defence Contribution Law[3]

(a). Introduction of a "Non-Domiciled" Regime

Up to and including July 15, 2015, Cyprus-resident individuals, like Cyprus-resident companies, were liable to pay Special Defence Contribution, commonly referred to as SDC tax, on dividends, passive interest and rents received, at rates of 17%, 30% and 3% (applied to 75% of the rent) respectively. Dividends and passive interest (but not rents or active interest) are exempt from personal or corporate income tax.

With effect from July 16, 2015 the Special Defence Contribution (Amendment) Law[4] exempts individuals who are not domiciled in Cyprus for the year of assessment concerned from liability to SDC tax.

Philippos Aristotelous is a partner at Andreas Neocleous & Co LLC

 01/15 Copyright © 2015 by The Bureau of National Affairs, Inc. TPETS ISSN 1754-1646

This article first appeared in the January 2016 issue of "European Tax Service" and is reproduced by kind permission of the publishers.

Coupled with the income tax exemptions applying to such income, individuals who are resident but not domiciled in Cyprus are exempt from Cyprus tax of all forms on dividends and passive interest, regardless of source. Companies are not affected by the change.

For the purposes of determining liability to SDC tax an individual has a domicile in Cyprus if he or she has a domicile of origin in Cyprus as defined in the Wills and Succession Law,[5] which follows the principles of English common law as regards domicile, unless he or she:

- has acquired and maintains a domicile of choice outside Cyprus and was not a tax resident of Cyprus as defined in the Income Tax Law for any period of at least 20 consecutive years prior to the year of assessment, or
- has not been resident in Cyprus for purposes of the Income Tax Law for any of the immediately preceding 20 tax years.

In any event, an individual will be deemed to be domiciled in Cyprus if he or she has been a tax resident for 17 or more of the 20 tax years immediately preceding the year of assessment.

The SDC Amendment Law inserts a new article into the SDC Law allowing the tax authorities to disregard transfers of assets from any person domiciled in Cyprus to a spouse or relative within the third degree of kindred who is not domiciled in Cyprus, providing a specific anti-avoidance provision against domiciled individuals transferring assets to related non-domiciled persons in order to take advantage of the changes.

(b). SDC Tax Anti-avoidance

The SDC Amendment Law also introduces a new anti-avoidance measure to deal with a common device used to reduce or postpone the payment of SDC tax. It inserts a new article into the SDC Law enabling the tax authorities to disregard the interposition of a company without any real business or economic purpose between an individual and a company making profits, if this has been done with the principal objective of reducing or deferring the payment of SDC tax.

3. Amendments to the Capital Gains Tax Law

Capital gains tax in Cyprus is charged only on disposals of immovable property situated in Cyprus and of shares in unlisted companies to the extent that their value derives from such property.[6] In order to stimulate the real estate market the Capital Gains Tax (Amendment) (No 2) Law[7] introduces a further exemption for immovable property acquired between July 16, 2015 and December 31, 2016, provided that the property was acquired on an arm's length basis and not under the foreclosure provisions of the Transfer and Mortgage of Immovable Properties Law. Any gain on the disposal of the property will be exempt from capital gains tax, irrespective of the date of disposal.

As an added incentive, the normal transfer fee payable to the Department of Lands and Surveys on acquisition of immovable property will be discounted to 50% of the standard rate until December 31, 2016, provided that the property was acquired on an arm's length basis and not under the foreclosure provisions of the Transfer and Mortgage of Immovable Properties Law. Alternatively, if VAT is payable on the purchase of the property, no transfer fee is payable at all, provided that the sale agreement is deposited with the Land Registry by December 31, 2016.

B. The December Amendments

1. Amendments to the Income Tax Law

(a). Offshore Activities

The definition of the term "Republic of Cyprus" has been amended to explicitly include the territorial sea, the contiguous zone, the exclusive economic zone and the continental shelf of Cyprus, and the definition of the term "permanent establishment" has been amended to include all activities pertaining to the exploration and exploitation of the seabed in the exclusive economic zone.

The gross income earned from sources within Cyprus by a person who is not tax resident of Cyprus or who does not have a permanent establishment in Cyprus in consideration for providing ancillary services related to such exploration or exploitation activities is subject to tax at the rate of 5%. If the payment is made by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus, but the cost is borne by an associated person in Cyprus, the Cyprus-resident associate is responsible for withholding this tax and paying it to the Cyprus tax authorities by the end of the following month.

All these changes are effective from January 1, 2016.

(b). Tax Neutrality of Foreign Exchange Gains and Losses

With retrospective effect from January 1, 2015 profits and losses arising from movements in currency exchange rates will be disregarded for tax purposes apart from gains or losses arising from trading in foreign currencies or foreign currency derivatives. Entities trading in foreign currencies or foreign currency derivatives may irrevocably elect to be taxed on the basis of only realized profits or losses.

These changes apply retrospectively from January 1, 2015.

(c). Implementation of the 2015 Amendments to the EU Parent-Subsidiary Directive

In order to incorporate the 2015 amendments to the EU Parent-Subsidiary Directive into domestic tax law anti-avoidance provisions have been introduced for hybrid instruments and artificial transactions for dividends.

Dividends received by Cyprus-resident companies from abroad will no longer be exempt from corporate income tax if the payment of the dividend is a tax-deductible expense for the company paying the dividend under the laws of the country in which it is resident. In addition, there is no longer any exemption from corporate income tax for dividends received under an arrangement that has been put in place with

This article first appeared in the January 2016 issue of "European Tax Service" and is reproduced by kind permission of the publishers.

the main purpose of obtaining a tax advantage and that is not based on valid commercial reasons reflecting the underlying economic reality.

With effect from January 1, 2016 such dividends will be taxed as normal business income subject to income tax and will be exempt from Special Contribution for Defence.

(d). Exemption of Income from First Employment in Cyprus

Individuals becoming tax resident and taking up employment in Cyprus were previously entitled to an exemption of 20% of their annual income from employment in Cyprus for the first three years of residence. The exemption was limited to 8,550 euros per annum. With effect from the 2015 tax year onward, the exemption is extended to five years, but it will be available only until the year 2020.

In 2012 a further exemption was introduced, exempting 50% of the first five years' income from employment in Cyprus of a person who was not previously resident in Cyprus, provided the income from employment in Cyprus exceeds 100,000 euros per annum. The period of five years has now been extended to ten years. In respect of employments that started on or after 1 January 2015, the exemption is not available to anyone who was resident in Cyprus in any three of the five tax years preceding the year in which the employment in Cyprus began, or to anyone who was resident in Cyprus in the year preceding the year in which the employment began.

The exemption is available in respect of any tax year in which income from employment exceeds 100,000 euros per annum, irrespective of whether the income falls below that amount in any year, provided that when the employment started the income exceeded 100,000 euros and the tax authorities are satisfied that the variations in the annual income are not made for the purpose of obtaining this tax benefit.

It has now been made clear that the two exemptions are mutually exclusive, and that only one of them can be claimed by a particular taxpayer.

(e). Losses under the Intellectual Property Box Regime

Cyprus's IP box regime allows an 80% deduction from the net profit generated by the use or disposal of IP rights. If a loss is made from such activities, only 20% of the resulting loss can be offset against income from other sources or carried forward to be offset against income of subsequent tax years.

This amendment applies retrospectively to all tax years from 2012 onwards.

(f). Increased Writing-Down Allowances for Capital Expenditure

The increased tax writing-down allowances of 20% on expenditure on plant and machinery and 7% on new industrial and hotel buildings will be extended until December 31, 2016.

(g). Geographic Extension of Group Loss Relief

Previously group loss relief was available only for losses incurred by Cyprus tax resident companies. In order to align domestic loss relief provisions with the decision of the European Court of Justice in the *Marks & Spencer* case, the law has been amended so that a subsidiary company which is tax resident in another EU member state can surrender its taxable losses to another group member company tax resident in Cyprus, provided the subsidiary has exhausted all means of surrendering or carrying forward the losses in its member state of residence or to any intermediate holding company.

The amount of taxable losses must be calculated on the basis of the Cyprus tax laws.

In order to determine whether two companies are members of a group the law has also been amended to allow the interposition of holding companies established in another EU Member State, in a state with which Cyprus has concluded a double tax treaty or in a state which has signed the OECD multilateral convention for exchange of information.

These changes apply to 2015 and later tax years.

(h). Anti-avoidance Provisions for Reorganizations

Corporate reorganizations are exempt from all forms of tax in Cyprus. The Income Tax Law has now been amended by adding a new Article 29A, allowing the tax authorities to withhold the exemption if they have sufficient reason to conclude that the reorganization is not based on valid commercial or financial considerations and that the main purpose or one of the main purposes of the reorganization is the reduction, avoidance or deferment of payment of taxes. Any such decision is open to objection and appeal in accordance with the provisions of articles 20 and 20A of the Assessment and Collection of Taxes Law.

The tax authorities will also have the right to impose conditions on the number of shares which can be issued as part of any reorganization and the minimum period for which such shares should be held (up to a limit of three years). These restrictions do not apply in the case of publicly listed companies and transfers of shares on death.

The changes take effect from January 1, 2016.

(j). Arm's Length Adjustments

Cyprus does not have specific transfer pricing rules in its domestic legislation, but the arm's length principle is incorporated into the Income Tax Law, allowing the tax authorities to impose additional taxes on profits or benefits arising from related party transactions. Before the current amendment, the only adjustments that could be made were to increase profits, and there was no provision for the corresponding expenses and losses to be compensated. For the 2015 and later tax years the Income Tax Law as amended allocates the profit arising from transactions between related parties on to an arm's length basis and, in the event of one party's profit being increased, allows a corresponding deduction for the counterparty to the transaction.

(k). Fees for Issuing Certificates and Advance Rulings

The tax authorities have recently announced new procedures for issuing tax residency certificates and advance tax rulings (*see* III. below), and this amendment

This article first appeared in the January 2016 issue of "European Tax Service" and is reproduced by kind permission of the publishers.

empowers the Council of Ministers to issue administrative orders setting the fees payable by applicants.

(l). Amendments to Tax-Exempt Income of Local Authorities

With retrospective effect from January 1, 2015 local authorities are no longer exempt from taxation on rental income from immovable property.

2. Changes to the Capital Gains Tax Law

The following changes have been made to the Capital Gains Tax Law. They will take effect as soon as the amending law is published in the government gazette.

(a). Capital Gains on Disposal of Shares in Property Companies

Prior to the amendment capital gains tax was charged only on disposal of immovable property located in Cyprus or on disposal of shares of companies that directly owned immovable property located in Cyprus. It was therefore very straightforward to avoid tax on disposal of the shares of a property-holding company by interposing an intermediate holding company and disposing of the shares in that company, rather than the property-owning company itself. The amendment closes this loophole by providing that gains from the disposal of shares in companies that indirectly own immovable property in Cyprus by directly or indirectly holding shares in a company that owns immovable property located in Cyprus will also be subject to capital gains tax, if the value of the immovable property represents more than 50% of the value of the assets of the company whose shares are sold. The gain to be taxed will be calculated on the basis of the market value of the immovable property.

(b). Trading Gains from Sale of Shares of Property Companies

If a company's business is dealing in shares of companies, any sale of shares is treated as a transaction of a trading nature, and exempt from income tax under Article 8 of the Income Tax Law, which exempts profit on the sale of shares and other securities. As profits of a trading nature, these gains would not fall within the scope of the Capital Gains Tax Law. This provided a further simple means of gaining complete exemption from tax on disposals of shares in companies owning immovable property located in Cyprus.

The Capital Gains Tax Law has now been amended to close this loophole by providing that trading gains on disposal of shares in property-owning companies are subject to capital gains tax.

(c). Transactions between Related Parties

In any transaction between related persons the tax authorities may substitute the market value of the property for the contract price if they consider that the contract price is less than the market value.

II. Double Taxation Agreements

A. Entry into Force

1. Entry into Effect of new DTAs with Iceland, Lithuania, Norway and Spain

On January 1, 2015 the new or revised DTAs with Iceland, Lithuania, Norway and Spain, all of which had entered into force during 2014, became effective. They all follow the 2010 OECD Model and their detailed provisions are set out and analyzed in an earlier issue of European Tax Service,[8] so they are not repeated here.

2. Entry into Force of DTAs with Guernsey and Switzerland

Ratification of the DTAs with Guernsey and Switzerland, both of which were signed in 2014, was completed and the DTAs entered into force on March 4 and October 15, 2015, respectively. They will take effect from the beginning of 2016.

B. Signature of new DTAs and Protocols

1. Bahrain, Georgia and Iran

During 2015 Cyprus signed new DTAs with Bahrain, Georgia, and Iran, and Protocols to the existing agreements with South Africa and Ukraine. Like all of Cyprus's recent DTAs they closely follow the 2010 OECD Model Tax Convention. Their provisions have been analyzed in detail in previous issues of European Tax Service and so are not repeated here.[9]

The three new DTAs are the first agreements with the countries concerned: unlike many former members of the USSR, Georgia did not adopt the 1982 Cyprus-USSR DTA when it became independent. The new DTA with Iran comes at a particularly opportune time of increased rapprochement between Iran and the West. After years of sanctions, there are immense opportunities for investment into Iran, and the new DTA will provide an excellent conduit.

2. South Africa

The Protocol to the DTA with South Africa, which was signed on April 1, 2015 and which will take effect from the beginning of 2016, implements a commitment in the original DTA to reconsider the provisions relating to taxation of dividends in the event of any change in domestic tax law. South Africa introduced taxation of dividends at shareholder level in 2012 and the main purpose of the new Protocol is to implement this change. The new Protocol also updates the definition of residence and the information exchange provisions. Importantly, it does not change the existing, highly beneficial, arrangements regarding taxation of capital gains.

3. Ukraine

Unlike Georgia, Ukraine adopted the 1982 Cyprus-USSR DTA on independence. This was highly beneficial to Ukrainian businesses and when a new DTA was

This article first appeared in the January 2016 issue of "European Tax Service" and is reproduced by kind permission of the publishers.

concluded in 2012 most people expected the benefits to be significantly reduced. These expectations were not realized, and the new DTA, which took effect from the beginning of 2014 was very taxpayer-friendly, particularly regarding taxation of gains on shares in property-rich companies, which can be fully sheltered from tax. The DTA was the target of attacks from populist politicians in the Ukrainian legislature from the beginning, and at one stage the Ukrainian government began to take steps to denounce it. The new Protocol waters down the benefits provided by the DTA, particularly regarding capital gains on shares in "property-rich" companies and withholding taxes on dividends, but not for a considerable time. The earliest date on which the Protocol can enter into force is January 1, 2019.

According to the Cyprus Ministry of Finance a "most favored nation" clause has been agreed for the taxes on interest, dividends, royalties and capital gains, ensuring that Cyprus is treated no less favorably than any other of Ukraine's DTA counterparties in the future.

Subject to ratification by both countries the new Protocol provides a basis for the existing DTA to continue until at least January 1, 2019, the earliest date on which the Protocol may enter into force. The Protocol provides slightly reduced benefits compared with the current DTA, but the "most favored nation" provision means that they will be at least as attractive as under any other of Ukraine's DTAs.

III. Improvements to the Tax Rulings Procedure

An important change for tax professionals was the issuing by the tax authorities of a circular, formalizing the procedures for obtaining advance tax rulings and setting out the terms on which they are binding. The new procedures took effect on October 1, 2015. A recent survey of tax professionals carried out by KPMG found that one of the key factors in assessing the merits of competing jurisdictions is the degree of predictability and reliability they provide. Advance tax rulings are a key element in giving taxpayers and their advisers the assurance they desire, and the clarification and formalization of the advance rulings procedure is highly beneficial.

IV. Revision of OECD Global Forum Rating to "Largely Compliant"

Another positive development towards the end of the year was the decision by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes to revise its Phase 2 rating for Cyprus. Following the initial Phase 2 assessment carried out in mid-2013 Cyprus was assessed as "non-compliant" in two of the ten areas assessed, and was given an overall "non-compliant" rating, despite having achieved a satisfactory rating in more areas than other countries which escaped a "non-compliant" rating.

In October 2015 meeting the Global Forum considered a supplementary Phase 2 report for Cyprus, concluded that it had satisfactorily resolved all the deficiencies and assigned it a "largely compliant" rating overall.

Philippos Aristotelous is a partner at Andreas Neocleous & Co LLC. He can be contacted at aristotelous@neocleous.com
http://www.neocleous.com

NOTES

[1] Law 118(I) of 2002.
[2] The Income Tax (Amendment) Law, 116(I) of 2015.
[3] Law 117(I) of 2002.
[4] Law 119(I) of 2015.
[5] Cap. 195.
[6] Under the Capital Gains Tax Law, number 52 of 1980.
[7] Law number 117(I) of 2015.
[8] *See ETS* , vol. 17, no. 5, p. 16.
[9] *See*, among others, ETS vol 17, no 4, p 30 and ETS vol 17, no 8, p 21.

01/15 Copyright © 2015 by The Bureau of National Affairs, Inc. TPETS ISSN 1754-1646

This article first appeared in the January 2016 issue of "European Tax Service" and is reproduced by kind permission of the publishers.