Bloomberg BNA

TAX PLANNING INTERNATIONAL

EUROPEAN TAX SERVICE

International Information for International Business

JANUARY 2017

www.bna.com

Reproduced with permission from BNAI European Tax Service Monthly Digest, 19 ETS 16, 1/31/17. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Cyprus: Taxation Landscape 2016

Phillipos Aristotelous
Andreas Neocleous & Co LLC, Cyprus

Compared with the previous year, which saw the introduction of significant new incentives, including exemption of investment income of non-domiciled individuals and a notional interest deduction on new equity capital, 2016 has seen fewer changes to the Cyprus tax system. Nevertheless, tax professionals in Cyprus have several new developments to keep themselves busy into the new year, including a reformed intellectual property box regime, new incentives for investment into small- and medium-sized enterprises, and new double taxation agreements.

I. Reform of the Intellectual Property Box Regime

In January 2016, the Ministry of Finance announced that the Cyprus intellectual property ("IP") box regime would be amended to bring it into line with the "modified nexus" approach, which allows taxpayers to benefit from an intellectual property taxation regime only to the extent that they can show material relevant activity, including a clear connection between the rights which create the IP income and the activity which contributes to that income.

In October 2016, the Cyprus Parliament passed Law 118(I) of 2016, which amends the Income Tax Law to bring its provisions on taxation of income from the use or sale of intangible assets into line with the "modified nexus" approach. Regulations issued under the law, which will have retrospective effect from July 1, 2016, provide detailed guidance on the calculations and application of the new IP box regime.

A. Transitional Arrangements for IP Assets Developed up to June 30, 2016

Phillipos Aristotelous is a Partner at Andreas Neocleous & Co LLC, Cyprus

The existing IP box regime, which was introduced in 2012, provides for 80 percent tax exemption of income from the use of a wide range of intangible assets, including not only patents but also trademarks and other forms of IP. Coupled with Cyprus's low corporate income tax of 12.5 percent, it gives an effective tax rate on such income of 2.5 percent or less. Unlike many other countries' IP regimes, it allows bought-in IP to benefit as well as internally developed IP.

Taxpayers already benefiting from the existing scheme may continue to claim the same benefits on all assets within the scheme at June 30, 2016 until June 30, 2021, subject to certain conditions regarding assets acquired from related parties between January 2, 2016 and June 30, 2016. Assets acquired in this period from a related party will qualify for benefits only until the end of the 2016 tax year, unless at the time of their acquisition they were already benefiting under the Cyprus IP box regime or under a similar scheme in another country.

B. New Arrangements for IP Assets Developed after June 30, 2016

The arrangements for assets developed from July 1, 2016, follow the modified nexus approach. Qualifying assets are restricted to patents, software and other IP assets which are legally protected. IP rights used to

01/17 Copyright © 2017 by The Bureau of National Affairs, Inc. TPETS ISSN 1754-1646

market products and services, such as business names, brands, trademarks and image rights, are excluded. Relief is linked to the cost incurred by the taxpayer in developing the IP through its research and development ("R&D") activities. Costs of purchase of intangible assets, interest, costs relating to the acquisition or construction of immovable property, and amounts paid or payable directly or indirectly to a related person, are excluded from the definition of qualifying expenditure.

As is the case under the existing scheme, 80 percent of the overall profit derived from the qualifying intangible asset is treated as deductible expense, preserving the effective tax rate of less than 2.5 percent on such income.

C. Other Amendments

The new law introduces capital allowances for all intangible assets other than goodwill and assets qualifying for the existing IP box regime. The capital cost of the assets will be tax deductible, spread over the useful life of the asset in accordance with generally acceptable accounting principles, with a maximum useful life of 20 years, and a balancing allowance or a balancing charge on disposal of the asset.

In addition, relief under Articles 35 and 36 of the Income Tax Law in relation to relief from double taxation will not be allowed if the taxpayer has chosen to claim losses in accordance with Article 13(9).

II. New Tax Relief for Investors in Small- and Medium-sized Innovative Enterprises

The Income Tax (Amendment) (No. 2) Law of 2016 (Law 135(I) of 2016)) introduces new tax relief for investors in qualifying small- and medium-sized innovative enterprises. It adds a new section 9A to the Income Tax Law of 2002 allowing independent investors in such enterprises to deduct the cost of the investment from their taxable income for the year in which the investment is made. The deduction is limited to 50 percent of taxable income for the year or 150,000 euros, whichever is less. Any cost above the 50 percent limit may be carried forward for deduction against taxable income of subsequent years, subject to a 50 percent limit, for a maximum of five years. In order to qualify for relief, the investor must retain the investment for at least three years.

The new provisions took effect on January 1, 2017 and will expire on January 1, 2020 unless they are extended before then.

III. Double Taxation Agreements

A. Deferral of the New Provisions Regarding Shares in Companies Holding Immovable Property in Russia

In the final days of 2016 the Ministry of Finance announced that the Russian Government had agreed to defer the introduction of new provisions allowing for source-based taxation of capital gains on shares in "property-rich" Russian companies, which were due to take effect on January 1, 2017.

Under the 1998 double taxation agreement ("DTA") between Cyprus and Russia, gains on disposals of shares are taxable only in the country of residence of the person disposing of the shares. Since Cyprus does not impose any capital gains tax on disposals of shares in companies unless they own immovable property in Cyprus, this makes Cyprus a very advantageous location for holding shares in Russian companies.

The Protocol to the 1998 DTA, which was signed in 2010, changed the basis of taxation of property-rich companies. It allows gains on disposal of shares in companies which derive their value principally from immovable property in Russia to be subject to tax in Russia after a transitional period, which was due to expire at the end of 2016. Shares in other companies were not affected.

However, the application of this provision of the Protocol has now been suspended until similar provisions are introduced into Russia's DTAs with other European countries. Until then, disposals of shares in property-rich companies will continue to be taxable only in the country of residence of the person disposing of the shares, in the same way as other shares. The formal terms of the deferral will be set out in an additional Protocol.

B. Entry into Effect of New DTAs with Guernsey and Switzerland

On January 1, 2016, the new DTAs with Guernsey and Switzerland, which were signed in 2014 and entered into force in 2015, took effect. They closely follow the 2010 OECD Model Tax Convention.

C. Entry into Force of DTAs with Bahrain, Georgia and Latvia

Ratification of the DTAs with Bahrain and Georgia, which were signed in 2015, and with Latvia, which was signed in May 2016, was completed during 2016 and the DTAs entered into force on April 26, January 4 and October 27, 2016 respectively. These are the first DTAs between Cyprus and the countries concerned, as neither Georgia nor Latvia adopted the 1982 Cyprus-USSR agreement when they became independent. The new DTAs, which also closely follow the 2010 OECD Model Tax Convention, will take effect from the beginning of 2017.

D. Signature of New DTAs and Protocols

During 2016, in addition to signing the DTA with Latvia referred to above, Cyprus signed new DTAs with Jersey and India. The DTA with Jersey is the first between the two countries: while Jersey is not large in

economic terms it is an important financial center and the DTA will be a valuable addition to Cyprus's extensive treaty network. The new agreement with India, which was signed in November, was ratified very expeditiously and will replace the existing 1994 DTA from with almost immediate effect.

1. Jersey

The DTA will come into force once both parties have ratified it in accordance with their respective domestic legal procedures. It will have effect from the beginning of the following year. The 2004 agreement on taxation of savings income between Cyprus and Jersey will continue in force, but the DTA will be more beneficial to taxpayers once it takes effect.

The new agreement closely follows the 2010 OECD Model Convention, with only minor modifications, and the Protocol to the agreement clarifies the information exchange provisions. Dividends, interest and royalties are taxable only in the state of residence of the recipient. Capital gains on disposal of immovable property may be taxed in the state in which the property is situated; all other gains, including gains on disposal of shares in "property-rich" companies, are taxable only in the state in which the disponor is resident.

The exchange of information article reproduces Article 26 of the OECD Model Convention word for word. However, unusually, the exchange of information provisions will take effect eight taxable years prior to the entry into force of the agreement. A protocol to the DTA provides robust safeguards against abuse of the information exchange provisions by requiring the contracting party that requests information to fulfill specified procedures to demonstrate the foreseeable relevance of the information to the request. No request is to be submitted unless the party making the request has reciprocal procedures and means of obtaining similar information, and every request must be accompanied by the comprehensive details set out in the protocol.

2. India

There had been pressure from India to renegotiate the 1994 agreement between the two countries since the early 2000s, as the Indian authorities considered that the provisions on taxation of capital gains were open to abuse in the form of "round-tripping," a form of tax evasion where money leaving India was recycled back into India in the form of foreign direct investment via a third country. Apparent deadlock in the negotiations over the DTA seems to have been a factor in the Indian authorities designating Cyprus as a notified jurisdictional area under section 94A of the Indian Income Tax Act 1961 in 2013, leading to increased administrative burdens for Cyprus companies operating in India. Following the Indian tax authorities' success in renegotiating the DTAs with Mauritius and Singapore, which contained similar provisions, it was inevitable that the Cyprus DTA would soon follow, and a new agreement was signed on November 18, 2016.

As was widely expected, like India's new agreements with Mauritius and Singapore, the new DTA provides for source-based taxation of gains from the alienation of shares. However, investments undertaken before April 1, 2017 are protected, with taxation rights over gains on the disposal of such shares at any future date remaining solely with the state of residence of the disponor.

Ratification procedures were completed within a month of signature, and the new DTA entered into force on December 14, 2016. It will have effect in Cyprus in respect of tax withheld at source for amounts paid on or after January 1, 2017 and in respect of other taxes for years of assessment beginning on or after January 1, 2017. In India, where the tax year begins on April 1, the agreement will have effect in respect of tax withheld at source for amounts paid on or after April 1, 2017 and in respect of other taxes for years of assessment beginning on or after that date.

Simultaneously with the agreement entering into force on December 14, 2016, the Indian tax authorities rescinded the designation of Cyprus under section 94A of the Income Tax Act 1961 as a notified jurisdictional area. The rescission has retrospective effect from November 1, 2013.

IV. Conclusion

The year 2016 has seen Cyprus's network of double tax agreements continue to grow, and by the beginning of 2017 DTAs with 58 countries will be in effect. The suspension of the new, less beneficial arrangements regarding taxation of capital gains on disposal of property rich companies in Russia, and the signature of the new agreement with India, one of the world's largest and fastest-growing economies, and the restoration of normal tax relations ended the year on a very positive note.

The amendments to the IP box regime secure the existing generous benefits for IP developed before July 1, 2016 until June 30, 2021. While the range of assets and the categories of expenditure qualifying for relief from July 1, 2016 are more restricted than under the previous rules, Cyprus's IP box regime still represents a very attractive option for taxpayers, with an effective tax rate of less than 2.5 percent on qualifying income.

Phillipos Aristotelous is a Partner at Andreas Neocleous & Co LLC, Cyprus

01/17 Copyright © 2017 by The Bureau of National Affairs, Inc. TPETS ISSN 1754-1646