GLOBAL LEGAL INSIGHTS

Corporate Tax

First Edition

Contributing Editor: William Watson
Published by Global Legal Group

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Cyprus

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Overview of corporate tax work

Despite being among the smallest countries in terms of area and population, Cyprus has become one of the world's most important financial and business centres. It has numerous advantages, including a strategic location, a mature and transparent legal system based on common law, world class professional and financial services and a modern, business-friendly tax regime, which offers attractive planning opportunities. Cyprus has close cultural ties with Eastern Europe, based on a common Orthodox religion, and following the break-up of the Soviet Union it rapidly developed into the offshore centre of choice for investment into Russia and the CIS, performing the same role as Singapore does for south-east Asia and Hong Kong for China. Entry into the EU in 2004, and the eurozone in 2008, consolidated Cyprus's position as the main portal for investment between Russia and Eastern Europe on the one hand, and the rest of the world on the other. At the same time, with the rise of the Chinese and Indian economies, Cyprus also widened its geographic horizons to include these countries and the rest of Asia.

Things changed again with the discovery in 2011 of large gas deposits offshore of Cyprus, which are likely to transform Cyprus into a major energy exporter in the medium term. While the industry is currently in the early development stage, it has already been the source of several significant assignments for us.

Cyprus's role in most major commercial transactions continues to be as a portal for cross-border finance and investment. Traditionally, the main direction of these flows has been from the developed "western" economies into Central and Eastern Europe, but China, India and the Middle East are continuing to grow in importance. In addition, in a reversal of the accustomed direction of investment, businesses from the developing economies are using Cyprus as a point of entry into the European market.

In the summer of 2012, as a result of the "knock-on" effect of the 2011 Greek debt 'haircut' on the local economy, the Cyprus government applied for assistance from European financial stability funds, and a final support package is close to being agreed. This has not significantly affected confidence, and a large number of substantial transactions have taken place in and through Cyprus in the past year.

Significant deals and highlights illustrating aspects of corporate tax

In 2006, Cyprus introduced a legal framework for the incorporation of European Public Limited Companies, commonly known as SEs, and many companies have immigrated to Cyprus and re-formed as Cyprus SEs since then.

One recent example is Petrolia, an oil exploration and services company which owns and charters drilling vessels for offshore, deepwater oil and gas exploration and development drilling worldwide. Petrolia was initially based in Norway, and is listed on the Oslo Stock Exchange. In 2012, Petrolia relocated its head offices to Cyprus by means of a cross-border merger with a Cyprus public company, Petrolia Cyprus, formed for the purpose. The merger had the twofold purpose of moving the company closer to key markets, while also ensuring that it will be appropriately positioned in respect of future growth, which is expected to take place outside Norway. On completion of the merger, Petrolia was wound up without going into liquidation and transferred all its assets and liabilities to Petrolia Cyprus, which adopted the form of a European Public Limited Company registered in the Republic of Cyprus. This was the first cross-border merger in Cyprus involving a listed company. It was completed on 26 October 2012, and trading in the shares of the new company on the Oslo Stock Exchange began on the following business day.

Key developments affecting tax law and practice

The best starting point for a review of recent developments in Cyprus tax is August 2011, when the first "austerity" measures were introduced by the government of the day in order to rebalance the public sector finances. In the ensuing year-and-a-half there have been many further changes, which we set out in chronological order below. Given the huge amount of ground to be covered, there is no room for detail and for every change to be included, but readers can find out more at www.neocleous.com.

August 2011 – the arrival of austerity

In August 2011, the rate of Special Defence Contribution (commonly referred to as SDC tax) on interest received was increased from 10% to 15%, and the rate of SDC tax on dividends received by Cyprus-resident individuals was increased from 15% to 17%. These changes had little impact on companies, because most interest received by companies is subject to corporate income tax rather than SDC tax, and companies are generally exempt from SDC tax on dividends received. While the increase did apply to deemed-dividend distributions by companies, foreign-owned companies are unaffected since the deemed-dividend provisions do not apply to shares held by non-residents.

At the same time, an annual charge of €350 on companies registered in Cyprus was introduced. The charge is payable to the Registrar of Companies no later than 30 June each year.

For individuals, a 35% income tax rate was introduced for taxable income in excess of €60,000 in respect of 2011 and subsequent years, balanced by a new incentive for individuals taking up residence and employment in Cyprus. For the first three calendar years following the start of their employment, individuals taking up residence and employment in Cyprus are entitled to an annual allowance of the lower of €8,543 or 20% of their remuneration. However, with effect from the 2012 tax year, if income from employment exceeds €100,000 per annum, a 50% deduction is allowed for the first five years of employment.

Autumn and winter 2011 – generally positive

In September 2011, the new double tax agreement between Cyprus and Denmark entered into force, replacing the 1981 agreement between the two countries.

November 2011 marked Cyprus's removal from the so-called blacklist published by the Portuguese tax authorities. Residents of countries on the list are denied certain benefits of the Portuguese tax system and are subject to higher rates of certain taxes. Companies resident in the countries on the list are subject to the Portuguese CFC rules, with significant Portuguese shareholders being liable to Portuguese tax on undistributed profits attributable to them. Decree 292/2011 of the Portuguese Ministry of Finance, published on 8 November 2011, sets out the revised "blacklist" of 81 jurisdictions, which include the Channel Islands, Gibraltar, Hong Kong, the Isle of Man, Qatar, Seychelles and the British and US Virgin Islands.

November 2011 also saw the introduction of a tax amnesty law allowing a partial waiver of interest and penalties on overdue tax, provided that liabilities were settled by 31 March 2012. The period has since been extended.

March 2012 – revitalising the trusts sector

In March 2012, the long-awaited law modernising the International Trusts Law of 1992 was enacted. It addressed a number of perceived deficiencies in the international trusts regime, removed certain restrictions and further strengthened the already-formidable asset-protection defences of Cyprus international trusts, returning Cyprus to the premier league of trust jurisdictions.

May 2012 – the "IP Box" and other incentives

In May 2012, a number of changes were made to the laws relating to income tax and SDC tax, aimed at stimulating the economy and attracting investment from overseas. The changes had retrospective effect from 1 January 2012.

The most important was the introduction of substantial incentives for investment in intellectual property, including the availability of an 80% deduction against revenue from the exploitation of intellectual property rights, including compensation for infringement of rights and revenue from the sale of rights. Combined with other allowances and Cyprus's low corporate tax rate, this results in an effective tax rate of less than 2½% on revenue from intellectual property, by far the lowest rate available in Europe. Furthermore, gains on disposal of intellectual property assets can effectively be fully sheltered from tax.

Another change related to the deductibility of interest incurred in connection with the acquisition of shares in a wholly-owned subsidiary company. With effect from 1 January 2012, such interest will be deductible for tax, regardless of the place of incorporation or residence of the subsidiary and whether it is directly or indirectly held. If any of the subsidiary's assets are not employed in its business, the deductible interest cost will be reduced by the amount referable to the non-business assets.

For all plant and machinery (excluding private saloon cars) acquired during 2012, 2013 and 2014, the annual capital allowance for tax purposes will be doubled to 20% of the cost. For industrial and hotel buildings acquired during these years, the annual capital allowance will increase from 4% of the cost of the asset to 7%. In addition, for the purposes of calculating profits subject to the deemed distribution rules, any capital expenditure incurred on the acquisition of plant and machinery (excluding private saloon cars) and buildings during the years 2012, 2013 and 2014 is deductible from post-tax profits.

The previous group relief rules required companies to be members of a group for the whole of the tax year in order to qualify. For 2012 and subsequent tax years, a subsidiary incorporated by its holding company part-way through a year is deemed to have been a member of the group for the whole year. The provisions of Section 33 of the Income Tax Law regarding arm's length principles will no longer be applied to transactions between a parent company and its wholly-owned direct subsidiary, as long as the conditions for group relief are satisfied.

November 2012 – the new double taxation agreement with Ukraine

Like most of the new states which emerged from the break-up of the Soviet Union, Ukraine adopted the Cyprus-USSR double taxation agreement which had previously applied. This was very favourable, giving exemption from Ukrainian withholding taxes and effective exemption from capital gains tax, even for "property-rich" companies. During the early years of the current century, the double taxation agreement became a source of contention in Ukraine, with populist politicians claiming that the Cyprus-USSR agreement was excessively generous and was abused by Ukrainian businesses to evade their obligations, rather than for legitimate tax mitigation. In 2010, the World Bank recommended Ukraine to eliminate what it described as the preferential tax treaty with Cyprus, and an unsuccessful attempt was made to revoke it in the Ukrainian legislature.

A new double taxation agreement between Ukraine and Cyprus was signed on 8 November 2012. Until it takes effect (most likely from the beginning of 2014), the provisions of the double taxation agreement between the USSR and Cyprus, which Ukraine adopted upon independence, will continue to apply.

Given the degree of political pressure that had been brought to bear, there were fears that most of the benefits previously available to Ukrainian businesses would be lost as a result of the renegotiation. In particular, it was feared that the highly favourable provisions regarding capital gains on disposal of shares in property-rich companies would no longer be available. Movable property, including shares, is taxable only in the country of residence of the owner, and since Cyprus imposes no tax on disposals of shares, except and to the extent that the gain is derived from real estate in Cyprus, Cyprus companies have become an ideal means of holding real estate in Ukraine, effectively allowing property to be disposed of tax-free.

The OECD Model Agreement includes a provision allowing gains from the disposal of property-rich companies to be taxed in the contracting state in which the property is located, and it was widely feared that a provision of this nature would be introduced into the new agreement. However, this fear has proved to be unfounded. Gains on disposals of movable property remain taxable only in the contracting state in which the disponor is resident, meaning that Cyprus retains its highly favourable status as a jurisdiction for holding Ukrainian property assets, and is arguably the most beneficial of Ukraine's treaty partners.

December 2012 – regulation of trust and corporate service providers

In December 2012, the law on the Regulation of Fiduciaries, Administration Businesses and Company Directors, which transposes the provisions of Directive 2005/60/EC into national law, was enacted. The first draft law was published in 2006 and several changes were made in the course of a long consultation process, including the shifting of the supervisory responsibility from the Central Bank of Cyprus to the Cyprus Securities and Exchange Commission (CySEC).

The law applies to persons and companies providing relevant fiduciary and other corporate services relating to the administration or management of trusts and companies in or from Cyprus, including directorship and secretarial services provided by a legal person, including acting as an alternate director or secretary, the holding of shares of legal persons in a nominee or trustee capacity, the provision of a registered office, the opening and operating of bank accounts and the ownership of financial assets on behalf of third parties.

The principal objectives of the new law are to regulate the provision of relevant services and impose licensing procedures and effective supervision, offering security to clients and strengthening confidence in the sector.

The new law provides that relevant services may be offered only by persons or legal entities that hold a licence from CySEC or who are specifically exempt from the licensing requirement. Lawyers and accountants who are regulated by their respective regulatory bodies are exempt from the need to obtain a licence.

CySEC will maintain a register of licence holders, and licences may be issued on such terms and conditions as CySEC considers appropriate. In order to obtain a licence, providers of relevant services must comply with certain criteria regarding their professional and academic qualifications, experience and their internal procedures.

2013 – removal from the Russian "blacklist"

On 1 January 2013, the protocol amending the double taxation agreement between Cyprus and Russia entered into force. Most of the changes introduced by the protocol took effect from 1 January 2013 but the new arrangements regarding taxation of "property-rich" companies will not take effect until 1 January 2017.

The long-awaited removal of Cyprus from the so-called Russian tax blacklist also took effect at the beginning of 2013. From that date, companies incorporated in Cyprus will be entitled to the participation exemption introduced by Russia with effect from 1 January 2008, under which dividends received by Russian companies from qualifying participations are exempt from tax. Furthermore, transactions between unrelated Russian and Cyprus companies will no longer be subject to the automatic transfer pricing control scrutiny in Russia that applies to locations included in the "blacklist".

A number of other changes took effect on 1 January 2013. Many of these were of a "housekeeping" nature, relating to record keeping and submission of returns. The most significant are outlined below.

For 2013 and subsequent tax years, trading losses may be brought forward for relief against future trading profits for a maximum of five years. Previously there was no limit on the period for which losses could be carried forward.

For 2013 and subsequent tax years, companies and individuals must submit their provisional self-assessment tax return by 31 July of the tax year, accompanied by a remittance for half the estimated tax payable. The other half must be paid before 31 December. Previously the provisional return had to be submitted by 1 August and estimated tax paid in three instalments.

Companies incorporated in Cyprus but not tax-resident there are now required to submit a summary annual tax return so that information is available in the event of a request from an overseas tax authority.

One of the changes to the Assessment and Collection of Taxes Law empowers the Inland Revenue Department to exchange information with any country with which Cyprus has signed a tax information exchange agreement as well as in the context of Council Directive 2011/16/EU of 15 February 2011, which obliges taxation authorities of EU Member States to comply with requests for information on taxation matters received from their counterparts in other Member States within specified time limits, and provides for automatic exchange of information in specified circumstances. Previously, the Inland Revenue Department was not authorised to disclose information to an overseas tax authority except under a double taxation agreement.

Attractions for holding companies

Cyprus has gained a well-deserved reputation as an excellent location for holding companies for a host of reasons that include its transparent legal system, excellent communications and world-class professional and banking services. It has a market economy and no restrictions on capital movements. It is a Member of the EU and its tax system is fully compliant with EU and OECD requirements. It is on the OECD's "White List" of compliant tax jurisdictions, issued in April 2009. Since joining the EU in 2004, Cyprus has established itself as the ideal gateway for investment between the EU and the dynamic economies of Central and Eastern Europe, India and China.

From a tax perspective, four things are required of a holding company structure:

- The ability to extract dividends from subsidiary companies free of withholding tax, either under the subsidiary's domestic tax regime or the EU Parent/Subsidiary Directive, or at a reduced rate of withholding tax under a tax treaty.
- The holding company's domestic tax regime should exempt such dividends from local tax.
- The holding company's domestic tax regime must also allow the holding company to pay dividends without giving rise to any local tax charge. This has generally been the most difficult hurdle to overcome.
- Finally, the holding company's domestic tax regime must permit the holding company to dispose of its investment in the subsidiary without any liability to capital gains tax or its equivalent in the subsidiary territory.

Cyprus measures up against these benchmarks very well indeed.

- Under Cyprus law, all expenses incurred for the production of the associated income are deducted before arriving at taxable income. Cyprus's corporation tax rate of 12½% is among the lowest in the EU.
- Dividends received by one Cyprus-resident company from another are exempt from all forms of tax.
- If a Cyprus-resident company owns 1% or more of the share capital of a foreign corporation, any dividends it receives are also exempt from tax, except in the event that:
  - directly or indirectly, more than 50% of the activities of the paying company result in investment income; and
  - the paying company is subject to tax at a rate substantially lower than the Cyprus rate.
- The profits of a Cyprus company's permanent establishment in another jurisdiction are similarly exempt, subject to the same conditions as for dividends.
- Non-exempt dividend income is subject to defence tax contribution at the rate of 17%. Tax credits are available for taxes paid abroad.
- Interest income that is the result of the main activities of the company, or that is closely connected to those activities, is subject only to corporation tax at the standard rate, like any other "active" trading income. Group finance income is treated as active trading income.
- Mergers, acquisitions and other corporate reorganisations may generally be effected without any tax cost.
- The only withholding tax levied by Cyprus is a 10% (subject to treaty provisions) tax on royalties derived from the use of a right or asset within Cyprus. All other dividend, interest and royalty payments made to non-residents may be made without deduction of tax.

- Furthermore, the tax legislation does not contain any thin capitalisation rules (a debt:equity ratio requirement) and a Cyprus-resident holding company can be primarily financed by debt to capitalise foreign subsidiaries by way of loans rather than equity capital.

The most significant recent developments regarding Cyprus's role as a holding company jurisdiction are the signature of the new double taxation agreement with Ukraine, and the entry into force of the Protocol to the double taxation agreement, with Russia and Cyprus's consequent removal from the Russian tax blacklist. As noted above, given that gains on disposal of shares are taxable only in the country of residence of the disponor under Cyprus's existing double tax agreement with Ukraine, and given that Cyprus levies tax on capital gains only to the extent that they derive from immovable property in Cyprus, holding shares in Ukrainian operating companies, particularly real estate companies, meant that they could be disposed of free of any capital gains tax. These beneficial provisions are maintained under the new double taxation agreement with Ukraine, making Cyprus an ideal jurisdiction for holding Ukrainian assets.

The Protocol to the double taxation agreement with Russia introduces a provision allowing gains on the disposal of shares in "property-rich" companies to be taxed in Russia rather than Cyprus, as was previously the case. However, this provision will not take effect until 1 January 2017 and, furthermore, Russia has agreed that, by the time it takes effect, Russia will have introduced similar provisions into its other double taxation agreements. Indeed, such provisions have already been introduced into Russia's double taxation agreements with Switzerland and Luxembourg, with no grace period before they take effect.

The limited disadvantage posed by the new arrangements regarding taxation of gains on shares in property-rich companies is balanced by the removal of Cyprus from the so-called Russian tax blacklist, which has already taken effect. From 1 January 2013, companies incorporated in Cyprus will be entitled to the participation exemption which Russia introduced with effect from 1 January 2008, under which dividends received by Russian companies from qualifying participations are exempt from tax. Furthermore, transactions between unrelated Russian and Cyprus companies will no longer be subject to the automatic transfer pricing control scrutiny in Russia that applies to locations included in the "blacklist".

Both the new Ukraine agreement and the Protocol to the double taxation agreement with Russia introduce new information-exchange provisions, reflecting the latest OECD Model Treaty. However, concerns that these new arrangements would open the floodgates for disclosure of information are alarmist and unfounded. The strong taxpayer safeguards contained in Cyprus's Assessment and Collection of Taxes Law mean that investors should have nothing to fear from the provisions facilitating exchange of information. Requests for exchange of information are dealt with exclusively by a specialist department of the Department of Inland Revenue, and direct informal exchange of information between tax officers is prohibited. Requests for information must be supported by a detailed justification, ruling out speculative enquiries and so-called "fishing expeditions". As a final safeguard, the written consent of the Attorney General is required before any information can be released to an overseas tax authority.

Industry sector focus

The introduction of the "intellectual property box", giving an effective tax rate of less than 2½% on revenue from intellectual property, by far the lowest rate available in Europe and less than half the rate of Cyprus's nearest competitor, has led to great interest in the use of Cyprus as a jurisdiction to hold intellectual property assets, particularly as it is also possible to fully shelter gains on disposal of intellectual property assets from tax. Before the new rules were enacted, it was generally necessary to use a company in a low- or no-tax jurisdiction to hold the IP rights and license them to a Cyprus intermediary licensing vehicle which would sub-license the right to exploit the IP rights to another entity, usually registered and tax-resident in a country with a double tax treaty with Cyprus. Under the new tax regime there is no longer any need for a separate IP owner, giving substantial planning opportunities and savings in tax and administrative costs.

Another industry sector in which Cyprus has particular tax benefits is international shipping and shipmanagement. The Merchant Shipping (Fees and Taxing Provisions) Law of 2010 ("the Tonnage

Tax Law"), replaces tax based on profits with a tax based on tonnage for Cyprus-resident shipping and ship-management companies, simplifying and substantially reducing the tax burden. It extends the benefits of the tonnage tax regime and exemptions from income tax, which were previously restricted to owners, operators and managers of Cyprus-flag ships, to owners and charterers of non-Cyprus flag vessels, and widens the range of exempt gains to include profits on the disposal of vessels, interest earned on funds and dividends paid directly or indirectly from shipping-related profits, in addition to profits from shipping operations.

The year ahead

While some of the changes outlined above increase tax rates and costs, the increases are not substantial, and they should not adversely affect Cyprus's competitiveness as an international financial and business centre. Furthermore, the strong taxpayer safeguards contained in the Assessment and Collection of Taxes Law mean that investors should have nothing to fear from the provisions facilitating exchange of information.

On the positive side, the modernisation of the international trusts law, and the introduction in December 2011 of the new regulatory regime for trust and corporate service providers, will put Cyprus back among the world's foremost trust jurisdictions. The introduction of the beneficial tax arrangements for intellectual property, and the removal of Cyprus from the Russian "blacklist", will also have a positive effect.

On balance, while there is no doubt that Cyprus, like much of the rest of the world, faces difficult economic conditions for some time to come, the changes increase its attractiveness as a reputable, well-regulated centre providing a business-friendly environment and incentives for investment and innovation.

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