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Taxation Of Cyprus International Trusts

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The International Trusts Law Of 1992-2012

The 1992 International Trusts Law gave Cyprus a "state of the art" international trusts regime, allowing non-residents to establish Cyprus-resident trusts with excellent tax mitigation and asset protection features. In the ensuing years, Cyprus international trusts proved to be extremely popular with residents of Russia and Central and Eastern Europe, allowing them to hold their newly-accumulated wealth through a jurisdiction offering stability and reliability, providing flexibility in terms of financial management and freedom from forced heirship provisions at home. Over the years a number of other jurisdictions followed Cyprus in introducing laws enabling the establishment of international trusts and by the end of the first decade of the current century the Cyprus international trusts regime was beginning to look somewhat dated. While the basic structure provided by the International Trusts Law was still sound, it lacked features available in other jurisdictions that had arrived on the scene after 1992 and needed updating in order to adapt it to the needs of investors today and in the coming years.

In March 2012 the enactment of the International Trust (Amending) Law of 2012 brought the Cyprus



international trust firmly into the twenty-first century and restored Cyprus to the premier league of trust jurisdictions. The amendments strengthen the already formidable asset-protection benefits of Cyprus international trusts, widen trustees' investment powers to those of an absolute owner, provide greater flexibility and control for settlors and remove limits on the duration of trusts. Today, Cyprus international trusts provide an extremely effective and flexible wealth-holding structure with formidable asset protection features, and are likely to attract high net worth individuals from around the world.

Under the 1992 law, in order to prevent tax avoidance, permanent residents of Cyprus were prohibited from establishing international trusts. The concept of permanent residence was not defined in the 1992 law or elsewhere. It was not clear whether settlors could relocate to Cyprus after establishing a Cyprus International Trust, and the resultant uncertainty undoubtedly discouraged many of them from doing so. Furthermore, residents of Cyprus could not be beneficiaries of international trusts, and international trusts were not allowed to own immovable property in Cyprus.

Following Cyprus's entry into the EU these restrictions were considered to be inconsistent with the freedom of movement of people within the internal market and they were abolished as part of the 2012 amendments. Now the only stipulation is that the settlor may not be a Cyprus tax resident for the year preceding the year in which the trust was established.

The New Tax Regime For International Trusts

As a general rule Cyprus trusts are transparent in tax terms. The trustee is responsible for discharging the beneficiaries' tax liabilities on their behalf, but the income of the trust is not assessed on the trustee.

Since neither settlors nor beneficiaries of international trusts could be Cyprus residents the 1992 law had no requirement for detailed tax provisions. There was merely an all-embracing clause exempting income earned from sources outside Cyprus from Cyprus tax. Now that beneficiaries may be resident in Cyprus it has become necessary to include more detailed provisions. Nevertheless, these are relatively straightforward.

The amending law of 2012 introduces a uniform tax regime applicable to all persons on the basis of the tax residency test. Income and profits of an international trust which are earned or deemed to be earned from sources within and outside Cyprus are subject to every form of taxation imposed in Cyprus in the case of a beneficiary who is resident there. In the case of a non-resident beneficiary only Cyprus-source income and profits are subject to Cyprus tax.

These provisions ensure that there will be no discriminatory taxation or undue tax advantage available to anyone. Beneficiaries who are Cyprus tax residents will be subject to Cyprus tax on their worldwide income in the same way as any other Cyprus tax residents and non-resident beneficiaries will be subject to Cyprus tax only on Cyprus-source income.

The application of these provisions is clear and straightforward when all the beneficiaries of the trust concerned are non-resident or (no doubt less frequently) resident in Cyprus. Where there is a mixture of resident and non-resident beneficiaries it will be necessary to apportion the various forms and sources of income between them. The Inland Revenue Department has announced that it will issue guidance in due course on the application of the new provisions regarding the tax treatment of the various forms of trust structure that may be established under the new regime and that the tax laws will be amended if necessary.

Application Of The New Provisions

In the meantime, preliminary discussions have taken place between the Inland Revenue Department, the Institute of Certified Public Accountants of Cyprus and other interested parties, and the following principles have been agreed:

- The trustee will be the person responsible for the payment of any taxes due, as is the case under existing tax legislation.
- The trustee will be responsible for maintaining and collating all the relevant information concerning the trust and its beneficiaries. The trustee will also be responsible for compliance with anti-money

laundering legislation and for providing information to the Inland Revenue Department. This is analogous to the arrangements for international business companies held through nominees such as fiduciary service providers.

- If any beneficiary is a Cyprus tax resident the trustee will be the person responsible for registering the beneficiary for Cyprus tax purposes if they are not already registered.
- Insofar as taxation of the trust and its beneficiaries is concerned, the tax residency status of the beneficiaries will be the determining factor.

The Inland Revenue Department will adopt the following approach for the purposes of taxation of trusts under section 12(1):

- If all the beneficiaries are Cyprus tax residents the trust will be treated as a domestic trust and will be subject to every form of taxation in Cyprus on all income, regardless of the source.
- If all the beneficiaries are non-residents the trust will be deemed to be an international trust and will be subject to taxation only on Cyprus-source income.
- In cases where the trust has both resident and non-resident beneficiaries, the tax treatment will be determined by reference to the scope of rights that the respective beneficiaries have in the trust, as set out in the trust instrument.

In the case of a trust with a mixture of non-resident and resident beneficiaries the overall tax treatment of the trust will be determined according to a simple majority test. Where more than 50 percent of

the rights attach to beneficiaries who are resident in Cyprus the trust will be treated as a domestic trust and will be liable to Cyprus tax on worldwide income. Where more than 50 percent of the rights attach to non-resident beneficiaries the trust will be treated as an international trust liable to Cyprus tax only on Cyprus-source income.

However, even in the latter case, any distribution of income to a Cyprus-resident beneficiary will be subject to Cyprus tax and the trustee will be responsible for deducting tax and paying it to the Inland Revenue Department to the extent that the income has not already suffered taxation.

Taxes On Income

To illustrate how the Inland Revenue Department intends to apply the new provisions, consider the case of a trust with five equal beneficiaries, three of which are non-resident and the other two of which are Cyprus-resident. One of the resident beneficiaries is an individual and the other is a company.

The main taxes on income in Cyprus are income tax and Special Contribution for Defence, commonly known as SDC tax. Dividends and passive interest are exempt from income tax, but subject to SDC tax at rates of 20 percent and 30 percent respectively. Rent received is subject to income tax and also to SDC tax at an effective rate of 2.25 percent. Applying the preliminary guidance issued by the Inland Revenue Department, if a dividend is received from a company in Cyprus the trustee should pay SDC tax on the one-fifth of the

dividend attributable to the Cyprus-resident individual (dividends between resident companies are exempt and the portion attributable to non-residents is excluded).

Dividends received from overseas will not be subject to taxation when received, as the trust has a majority of non-resident beneficiaries. When the trustee distributes the income, SDC tax will have to be deducted and paid over to the tax authorities on the amount attributable to the Cyprus-resident beneficiaries.

Similarly, in the case of interest and rents received the trustee will be responsible for paying SDC tax on Cyprus-source interest, and income tax and SDC tax on Cyprus-source rents received. Foreign-source interest will not be subject to any form of taxation on receipt, but if it is distributed to the Cyprus-resident beneficiaries the trustee will be required to deduct SDC tax and pay it over to the tax authorities. For foreign-source rents, income tax and SDC tax will be payable only when and to the extent that the income is distributed to the tax resident beneficiaries. At this stage it is not clear what rate of income tax will be applied to rents and to any other forms of income subject to income tax attributable to individuals. While SDC tax is charged at standard rates and there is a standard rate of corporate income tax, personal income tax is charged at progressive rates according to total income. If, as is generally the case, the trust is to be transparent for tax purposes this will presumably be the individual's marginal rate or rates.

Other taxes

International trusts will be liable to taxes such as VAT and stamp duty on their activities in Cyprus. Section 12(2) of the International Trusts Law as amended provides for a fixed stamp duty of EUR430 on the establishment of an international trust. International trusts will be subject to immovable property tax on property held in Cyprus irrespective of the residence of the beneficiaries. However, the amount of tax payable is unlikely to be material unless the trust has extremely large property holdings.

The only gains subject to capital gains tax are gains on disposals of real estate situated in Cyprus and, to the extent that the gain is derived from the real estate holding, on disposals of shares in companies holding real estate in Cyprus. All international trusts will be liable to tax on such Cyprus-source gains. All other capital gains are exempt from Cyprus tax.

Conclusions

The new tax provisions provide a tax-neutral environment allowing investors to take advantage of Cyprus's benign tax regime, particularly as regards capital gains. While there will no doubt be a "bedding-in" period during which the Inland Revenue Department, taxpayers and their advisers familiarise themselves with the new provisions and work out how to apply them in various situations, the availability of advance rulings from the Inland Revenue Department will eliminate any uncertainty from the taxpayer's point of view.