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a closer look

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Taxation Of International Shipping Activities: Cyprus

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The Cyprus ship registry ranks tenth worldwide, with 1,857 ocean-going vessels and an aggregate gross tonnage of more than 21 million tonnes. Cyprus is also one of the world's most important ship-management centers, with a total of around 60 ship-management companies employing almost 40,000 seafarers and accounting for a fifth of the global third-party ship-management market.

Together with the island's strategic location, Cyprus's favorable tax treatment of shipping activities has been a major factor in its development as an international shipping center. Tax incentives and exemptions are available to both residents and non-residents of Cyprus, and Cyprus's extensive network of double taxation agreements facilitates effective international planning. Virtually all the double taxation agreements provide that shipping profits are taxable only in the place of residence or effective management, irrespective of whether or not a permanent establishment exists in the other treaty country.

Since Cyprus joined the EU in 2004, Cyprus resident shipping and ship management companies had enjoyed the most benevolent shipping taxation regime in Europe, with significant exemptions



and the option for ship management companies to choose between a preferential corporate income tax rate of 4.25 percent or a tonnage tax regime.

A new tonnage tax system for Cyprus resident shipping and ship management companies was approved by the European Commission in March 2010 as compatible with the relevant guidelines on State Aid to Maritime Transport. It was enacted into law in May 2010 in the form of the Merchant Shipping (Fees and Taxing Provisions) Law of 2010 ("the Tonnage Tax Law"), and took effect retrospectively from January 1, 2010. The tonnage tax system exempts qualifying shipping and ship-management activities of qualifying vessels from income tax and any other form of Cyprus tax. In addition:

- No tax is payable either on profits from the operation of Cyprus-registered vessels, or on dividends received from a ship owning company;
- No capital gains tax is payable on the sale or transfer of a Cyprus-registered vessel or the shares of a ship owning company;
- No stamp duty is payable on ship mortgage deeds or other security documents;

- Emoluments of seamen employed on board Cyprus-registered vessels are exempt from tax;
- No estate duty or inheritance tax is levied following the death of a shareholder.
- EUR0.136688 for each additional tonne up to 10,000;
- EUR0.068344 per gross tonne above 10,000 tonnes.

This is the first simplified tonnage tax system to be approved for an EU Member State with an open registry. It extends the favorable benefits applicable to owners of Cyprus flag vessels and ship managers to owners of foreign flag vessels and charterers. It also extends the tax benefits that previously only covered profits from the operation of vessels in shipping activities, to cover profits on the sale of vessels, interest earned on funds used other than for investment purposes and dividends paid directly or indirectly from shipping related profits.

Following enactment of the Tonnage Tax Law, section 19 of the Income Tax Laws of 2002-2010, which gave ship managers the option on a year by year basis of paying corporate income tax at a reduced rate of 4.25 percent on net earnings instead of tonnage tax, has been repealed by the Income Tax (Amendment) Law of 2010 (Law 41 (I) of 2010).

Registration Fees

For passenger vessels the registration fee is EUR0.256290 for each gross tonne, subject to a minimum fee of EUR427.

Fees for the registration of all other vessels are calculated on the basis of gross tonnage, as follows:

- EUR0.170860 per gross tonne up to 5,000 tonnes;

The minimum registration fee is EUR213 and the maximum is EUR5,125.

Eligibility

Qualifying Persons, Activities And Vessels

In order to be eligible for the tonnage tax regime, a "qualifying person" must be carrying out "qualifying activities" in relation to "qualifying vessels."

Qualifying persons are tax-resident owners or charterers (bareboat, demise, time and voyage) of Cyprus ships, of Community ships or of fleets of ships comprising Community and non-Community ships, and ship managers providing technical or crewing services or both. Ship managers are required to maintain a functioning office in Cyprus staffed by a sufficient number of appropriately qualified personnel. At least 51 percent of onshore personnel must be citizens of the European Economic Area ("EEA") (comprising the EU together with Iceland, Liechtenstein and Norway) and at least two-thirds of the total tonnage under management must be managed within the EEA.

For owners or charterers of Cyprus ships the tonnage tax scheme is mandatory. Other owners or charterers and ship managers may opt for taxation based on

profits or tonnage tax, but, having opted for the tonnage tax scheme, they must remain within it for ten years unless the vessel is sold, or a charter or management agreement is terminated. For a fleet to qualify for the scheme, at least 60 percent of its tonnage should comprise Community ships. If this requirement is not met, the non-Community vessels may still qualify if certain criteria are met, but surcharges may be payable.

For owners and charterers, qualifying activities are maritime transport of goods or people between Cyprus ports and foreign ports or offshore installations, or between foreign ports or offshore installations, including towage, dredging and cable laying. For ship managers, qualifying activities are the provision of services under a written agreement to a ship owner or bareboat charterer in relation to crew management, technical management or both.

A qualifying vessel is any seagoing vessel certified under applicable international or national rules and regulations and registered in the ship register of any member of the International Maritime Organization or the International Labour Organization recognised by Cyprus. Vessels which transport humanitarian aid are included in the definition, but the following vessels are excluded:

- fishing and fish factory vessels;
- vessels used primarily for sport or recreation;
- vessels constructed exclusively for inland waterway navigation;
- harbor, estuary and river ferries and tug boats;
- fixed offshore installations which are not used for maritime transport;

- non self-propelled floating cranes;
- non-ocean going tug boats;
- stationary vessels employed for hotel and/or catering operations (floating hotels or restaurants);
- vessels employed mainly as casinos or gambling facilities.

Ship Owners

As noted above, the tonnage tax system is mandatory for owners of Cyprus flag ships. Owners of EEA (EU plus Iceland, Liechtenstein and Norway) flag ships or third country flag ships may opt to be taxed under the tonnage tax system.

Owners of third country flag ships must comply with certain requirements to qualify for taxation under the new regime. These include a "flag-share" requirement, stipulating that at least 60 percent of their fleet in tonnage terms should be comprised of EEA flag ships and that this share must be maintained for the whole of the three-year period following the exercise of the option, and a requirement that the commercial and strategic management of the fleet should be carried out from within the EEA. If this requirement is not satisfied the non-Community vessels may still qualify if certain criteria are met, but surcharges may be payable.

An owner opting for the tonnage tax system must remain in it for 10 years. Early withdrawal will render the owner liable to pay the difference between the amount of tax paid under the tonnage tax system and the amount that would have been paid as corporation tax in respect of the same period. In addition, the ship owner will forfeit the right to

participate in the tonnage tax scheme for 10 years from the date the option was first exercised.

The tonnage tax system covers profits from shipping operations, dividends paid directly or indirectly out of such profits, profits on the sale of the ship or interests in it and interest earned on funds used as working capital or for the financing, operation or maintenance of the ship.

Charterers

A charterer under any form of charter agreement may opt for taxation under the tonnage tax system. Charterers of third country flag ships must comply with the flag-share requirement described above. Where the charterer opts for a tonnage-tax basis, the total tonnage taxed may not exceed 75 percent of the total tonnage of ships chartered or operated for more than three consecutive years. The eligibility percentage increases to 90 percent if the ships chartered are registered in the EEA or their crew and technical management are carried out from within the EEA.

The provisions outlined above for ship owners regarding minimum time spent in the tonnage tax system, penalties for early withdrawal and revenues covered by the system apply *mutatis mutandis* to charterers.

Ship Managers

Ship managers providing crew or technical ship management services are eligible to participate in the tonnage tax system subject to the following conditions:

- The ship manager must maintain a fully functional office in Cyprus with an adequate number of qualified personnel, a majority of whom should be EEA citizens;
- At least two thirds of the ship manager's management activity must be carried out from the territory of the EEA;
- At least 60 percent of the fleet under management should be carrying an EEA flag; and
- All ships and crew under management must comply with international standards and EU requirements relating to maritime security, safety, training and certification of seafarers, protection of the environment, on-board working conditions and the like.

In addition, crew managers must have fully implemented the 2006 Maritime Labour Convention and technical managers must have ISM Code certification.

The provisions outlined above for ship owners regarding minimum time spent in the tonnage tax system, penalties for early withdrawal and revenues covered by the system apply *mutatis mutandis* to ship managers.

Tax Exemption

The Tonnage Tax Law replaces taxes based on profits with a tax calculated on the net tonnage of the vessels concerned.

For owners and charterers the tax exemption covers profits from the use of a qualifying vessel, dividends paid out of those profits at all levels of distribution

and interest income relating to the financing, maintenance or use of a qualifying vessel and the related working capital, excluding interest on capital used for investments. Profits from the disposal of a qualifying vessel or any share or interest in it and profits from the disposal of shares in a shipowning company are also exempt from tax. In order to qualify for the exemption at least 25 percent of the net tonnage of vessels subject to tonnage tax must be owned or bareboat chartered. The percentage can be reduced but not for more than three consecutive years. The qualifying percentage is reduced to 10 percent if all the vessels of the charterer are registered or managed in the EEA.

Ship managers may elect to pay tonnage tax at one-quarter of the rates applicable to shipowners and charterers, in which case profits earned from the provision of technical and crewing services are exempt from tax in respect of qualifying vessels, together with dividends paid out of those profits at all levels of distribution.

Profits from commercial management are not covered by the tonnage tax scheme and remain taxable under corporation tax.

Tonnage Tax Rates

The Tonnage Tax Law replaces taxes based on profits with a tax calculated on the net tonnage of the vessels concerned.

Tonnage tax is charged at progressive rates on net tonnage. The rates charged to owners and charterers are as follows:

Tonnage	Rate per tonne
First 1,000 tonnes	EUR0.3650
Next 9,000 tonnes	EUR0.3103
Next 15,000 tonnes	EUR0.2008
Next 15,000 tonnes	EUR0.1278
Each tonne above 40,000	EUR0.0730

Rate Per Tonne

A sample calculation of the annual tonnage tax for a vessel of 50,000 net tonnes is set out below:

Tonnage	EUR
1,000 tonnes @EUR0.3650	365.00
9,000 tonnes @EUR0.3103	2,792.70
15,000 tonnes@EUR0.2008	3,012.00
15,000 tonnes@EUR0.1278	1,917.00
10,000 tonnes @EUR0.0730	730.00

As noted above, rates for ship managers are one quarter of those applicable to owners and charterers.

Reduction Of Tonnage Tax

Sections 11 and 12 of the Tonnage Tax Law provide for a reduction and refund of the tonnage tax by 75 percent in the event that a vessel is laid up for more than three consecutive months, or rendered inoperative for more than three consecutive months due to judicial arrest, act of piracy, armed robbery or force majeure.

"Ring-Fencing" Provisions

Part VII of the Tonnage Tax law contains "ring-fencing" provisions to prevent exemption being gained in respect of ineligible activities. Separate accounts must be maintained in respect of qualifying and non-qualifying activities, and transactions

with related parties who are not in the tonnage tax system must be made at arm's length.

The tonnage tax system is administered by the Department of Merchant Shipping and taxpayers within its scope receive an annual certificate, a copy of which is sent to the income tax authorities.

The Department of Merchant Shipping maintains records of all Cyprus flag vessels and their owners which are not deemed to carry out a qualifying activity, and of all ship managers, shipowners or

charterers of foreign flag vessels who do not carry out a qualifying activity or have not opted for the tonnage tax system.

Conclusion

The Tonnage Tax Law gives Cyprus the most attractive shipping taxation regime in the EU, offering both simplicity and substantial tax savings in full conformity with EU norms. It is still relatively new, and is continuing to evolve. Up to date advice is therefore essential before entering into any transaction.