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Practical Application Of The New Cyprus Notional Interest Deduction

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As reported in a July 2015 issue of *Global Tax Weekly*,¹ Law 116(I) of 2015 amending the Income Tax Law of 2002 introduced a notional interest deduction ("NID") on new equity capital (paid-up share capital and share premium) injected into companies and permanent establishments of foreign companies on or after January 1, 2015, for the purpose of financing business assets and operations.

The Fundamentals Of The NID

The NID is a deduction from taxable profit, calculated by applying a reference rate to the new equity. The reference rate is the higher of the ten-year government bond yield of Cyprus or the country in which the assets funded by the new equity are employed, with an uplift of three percentage points. The bond yield rates to be used are those applying on December 31 of the year preceding the year of assessment.

The NID is limited to 80 percent of the taxable profit before deducting the NID. No NID is available unless there is a taxable profit and unutilized NID cannot be carried forward to be offset against future years' profits.

The NID is a continuing deduction. It is available not only in the year the capital injection is made, but also for all subsequent tax years as long as the new capital remains in place.

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.

NID Rates For 2015 And 2016

Earlier this year the tax authorities announced the ten-year government bond rates at December 31, 2014, on which the NID for the 2015 tax year will be based, for Cyprus, Germany, India, Romania, and Russia. They subsequently announced the corresponding rates at December 31, 2015, on which the notional interest deduction on capital introduced in 2016 will be based, for these countries and for the Czech Republic, Latvia, Poland, Ukraine, and the United Arab Emirates. After applying the three percentage points uplift, the NID rates for capital introduced in 2015 range from 3.54 percent for Germany, to 16.73 percent for Russia. Including the uplift, the NID rate for capital used to finance assets in Cyprus (and in any country with a lower rate) is 8.037 percent.

With the tax return deadline for 2015 on the horizon, the tax department has issued a circular explaining how the provisions for NID are to be applied in practice. The guidance sets out the legal basis for the NID, explains the underlying concepts, definitions and basic principles of calculating NID, and their application in practice, and provides worked examples illustrating various hypothetical scenarios.

Sample Calculations

A simple example will help illustrate the principles. Assume that a new company is established on March 31, 2015, with an initial capital of EUR20m (USD22.3m), fully paid in cash. Its pre-tax profit for the nine months ended December 31, 2015, is EUR400,000, and for the year 2016 it is EUR2m.

For 2015, the maximum NID is nine-twelfths (because the capital was in place for only nine months of the year) of 8.037 percent (the NID rate for Cyprus) applied to the new capital of EUR20m, giving a result of EUR1,205,550. It is then necessary to consider whether the 80 percent ceiling on profits applies. As profits for the period are only EUR400,000, the NID is limited to 80 percent of this, namely EUR320,000, and the company's taxable profit is reduced to EUR80,000.

For 2016, there is no time-apportionment because the capital is in place throughout the year. The maximum NID is 6.685 percent (the Cyprus rate for 2016) of EUR20m, namely EUR1,337,000. This is less than 80 percent of the pre-tax profit, so there is no cap on NID. The unused NID from 2015 cannot be used to bring the NID up to 80 percent of pre-tax profit. NID is therefore

EUR1,337,000, reducing taxable profit for the year to EUR663,000. Assuming that the company remains profitable, and the capital is not reduced, NID will continue to be available at the ruling rates for the years concerned.

Clarification Of Practical Issues

The circular also clarifies a number of issues which had not previously been considered in detail, and these are outlined below.

New share capital issued by way of capitalization of realized reserves which were created after January 1, 2015, is eligible for NID, but capitalization of reserves created prior to that date is not, unless the reserves are related to new assets or activities which generate taxable income. Issue of share capital by conversion of loans payable and other debts or amounts due to shareholders, or by conversion of non-repayable capital injections (non-reciprocal capital contribution) also qualifies for NID.

Capital of a permanent establishment of an overseas company is to be calculated as the average of the balance of the financing of the permanent establishment for its general operating activities for the year of assessment, without taking account of any balances arising from current accounts between the company and the permanent establishment arising from commercial or short-term financial transactions. For companies incorporated overseas, NID will be allowed only to the extent that the legal status of the company's capital is equivalent to that under Cyprus law.

In the example earlier, the capital was the company's general operating capital and the limit on NID was calculated by reference to overall results. If new capital is injected for the purpose of financing a specific project or specific assets, the limit is to be calculated by reference to the income stream from the project or assets concerned according to the "matching" principle of accounting, using the same methodology and practice as that used to calculate allowable interest and expenses set out in Circulars 2008/14 and 2010/8. In the event of a capital reduction, the same principles are to be applied.

The same principles and methodology should also be applied in order to apportion any adjustments made by the tax authorities under Article 33 of the Assessment and Collection of Taxes Law of 1978 after examination of tax returns, such as adjustment of profits or losses on transactions between related parties.

Where new capital is provided by converting a loan to equity, the new equity will be deemed to finance the same assets as were funded by the loan.

If the new capital derives from new capital introduced into another company or permanent establishment, only one of the companies or permanent establishments may claim NID, except to the extent that the reinvestment of the new capital creates new separate taxable income. Similarly, if the new capital derives from loans on which a tax deduction is claimed for interest, the NID will be reduced by the amount of interest allowed as a deduction.

If a company transfers its tax residence to Cyprus after January 1, 2015, its total paid-up share capital and share premium at the date of transfer will be treated as new capital for calculation of NID. In the case of companies registered overseas, NID will be allowed only to the extent that the legal status of the company's capital is equivalent to that under Cyprus law.

No NID is available in respect of new share capital arising from the capitalization of pre-existing reserves unless the taxpayer can demonstrate that the old reserves were previously invested in specific assets which were not used in an activity that produced taxable income, and that they have subsequently been converted into new assets used for the purpose of producing taxable income.

If new capital is introduced in kind, in the form of assets, an independent valuation or equivalent evidence (*e.g.*, market reports if there is an active open market for the type of assets concerned) will be required to substantiate the value attributed to the assets.

Reorganizations and restructurings are exempt from tax in Cyprus, and they are also disregarded for the purpose of calculating NID. NID will be allowed on any new capital of the recipient company only to the extent that the transferring company was entitled to NID on the assets or operations transferred, and that the transferring company's entitlement to NID ceased as a result of the reorganization.

As an overriding principle, no NID will be allowed if, in the opinion of the tax authorities, the main purpose of the underlying transactions was to reduce the liability to tax and there was no substantial economic or commercial purpose.

Conclusion

The NID goes a long way towards redressing the balance between equity finance and debt finance, and removing any tax incentive to use unstable financing structures. It will not be relevant for

holding companies, since dividends are exempt from tax in any case, but, as the example above shows, it can lead to a significant reduction in taxable profits for trading companies. It should therefore act as an incentive for Cyprus companies to invest in income-generating projects, with consequent benefits for employment and general economic activity.

ENDNOTES

¹ *Global Tax Weekly*, Issue No. 141, July 23, 2015.