Corporate Tax - Cyprus

Implications of anti-avoidance amendments to EU Parent-Subsidiary Directive

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Background

Cyprus transposed the EU Parent-Subsidiary Directive(1) into domestic legislation when it updated its tax laws in preparation for EU membership in 2004. The Income Tax Law and the Special Contribution for the Defence of the Republic Law provide a liberal system of double taxation avoidance, which also extends to non-EU countries, as the tax laws treat all non-residents of Cyprus in the same way.

The EU Council of Economic and Finance Ministers (ECOFIN) announced in June 2014 that it had reached political agreement for the modification of the directive in order to stem what it sees as over-aggressive tax avoidance techniques. Draft legislation has yet to be published, but it is prudent for users of Cyprus holding and finance structures to review their current arrangements now in order to understand the potential impact of any proposed measures and to plan accordingly.

The directive was introduced in order to prevent double taxation of groups of companies resident in different member states by exempting dividends and other profit distributions paid by a subsidiary company to its parent from withholding taxes and eliminating double taxation of such income at the level of the parent company, with a view to establishing a level playing field in the internal market and promoting fair competition and productivity.

However, differences between national tax systems were exploited by the use of aggressive tax-planning techniques such as hybrid loan arrangements in order to artificially create double non-taxation. The resultant loss of tax revenue, combined with the distortion of competition within the single market created by use of such techniques, motivated national governments to agree on concerted action at the EU level to close the loopholes.

Hybrid loan arrangements are financial instruments with characteristics of both debt (loans) and equity (issuance of shares). Unintended double non-taxation is a consequence of the different qualifications given by EU member states to such arrangements, where interest paid on the instrument is treated as a tax-deductible expense in the member state of the issuer and the revenue received by the holder of the instrument is treated as a tax-exempt distribution of profits in the member state of the holder.

Proposed amendments

The commission proposes to change the tax treatment of hybrid loan arrangements to require that if an instrument gives rise to a deductible expense in the payer's state of residence, the receipt of the income is taxable in the recipient's state of residence. The European Council has requested that the wording of the directive be changed to make this clear.

The commission also proposes the adoption of comprehensive general anti-abuse rules (GAAR), adapted to the specifics of the directive in line with the principles set out in its recommendation of December 6 2012 on aggressive tax planning.

ECOFIN announced that the amendments will be adopted at a forthcoming European Council session after the text is finalised. Member states will be required to make the requisite amendments to national legislation before the end of 2015 so that companies are assessed to tax based clearly on their real economic substance and the commerciality of their transactions, and the effect of artificial or fictitious transactions or structures is eliminated.

Implications for Cyprus structures

The beneficial features of Cyprus tax legislation – especially the wide participation exemption regime and the absence of withholding taxes on interest and dividend payments – mean that most Cyprus

structures do not rely on the use of hybrid instruments. Therefore, in most cases the proposed changes to the directive should have no effect. The minority of structures involving Cyprus entities that use such arrangements should be reviewed at an early stage so that action can be taken as soon as practicable to minimise any adverse impact.

As far as the introduction of GAAR is concerned, Cyprus follows the 'substance over form' and 'business purpose test' doctrines. The Assessment and Collection of Taxes Law, which was amended to transpose the EU Mutual Assistance Directive[2] into domestic legislation, already contains general anti-abuse rules, under which the tax authorities may disregard artificial or fictitious transactions and structures that they consider to be in place solely for the purpose of obtaining a tax benefit and assess the taxpayer on the proper object of tax. The provisions apply to both local and international transactions, for residents and non-residents.

In any international structure it is important to consider the anti-avoidance rules of the other countries concerned and their tax authorities' approach to international structures. The Organisation for Economic Cooperation and Development and the UN Committee of Experts on International Cooperation in Tax Matters have long regarded 'treaty shopping', especially by use of conduit arrangements, as improper and – with tax authorities around the world becoming increasingly aggressive – it is prudent to guard against challenges that the structure is in place merely to obtain treaty benefits. One way of doing this is to ensure that any holding or finance structure has as much economic substance as possible – for example, by giving a holding company an additional function, such as that of a regional administrative and marketing headquarters.

In recent years a number of companies have not only strengthened their claim to Cyprus tax residence, but also enjoyed operational and economic benefits by locating regional administrative and headquarters functions in Cyprus, taking advantage of Cyprus's strategic location, EU membership, low costs and high quality of life. This may be worth considering and could even bring benefits from the proposed changes.

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Endnotes

[1] 2011/96/EU

[2] 77/799/EEC

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