Philippos Aristotelous

Practical guidance on calculating notional interest deduction

September 16 2016 | Contributed by Andreas Neocleous & Co LLC

Corporate Tax, Cyprus

Introduction

The Tax Department has issued guidance on the application of the provisions introduced in 2015 for a notional interest deduction.**(1)** A notional interest deduction is available for new equity capital introduced into companies and permanent establishments in Cyprus from the beginning of 2015 to finance business assets.**(2)** It is calculated with reference to government bond rates and is limited to 20% of the profit before the notional interest deduction.

The guidance sets out the legal basis for the notional interest deduction and explains the underlying concepts, definitions and basic principles of calculating the deduction and its application in practice, with worked examples illustrating various hypothetical scenarios. The guidance also clarifies a number of issues which had not previously been considered in detail, the most important of which are outlined below.

Guidelines

A permanent establishment's capital will be calculated as the average of the balance of the financing for its operating activities in the assessment year and does not include balances from current accounts between the company and the permanent establishment resulting from commercial or short-term financial transactions.

The 20% limit on a notional interest deduction from a capital injection is calculated by reference to the income stream from the specific assets financed by the injection according to the matching accounting principle, using the same methodology and practice used to calculate allowable interest and expenses.**(3)** The same methodology and practice should also be used to apportion adjustments that the Tax Department makes after the examination of tax returns (eg, the 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 that were funded by the loan.

If the new capital derives from capital introduced into another company or permanent establishment, only one of the companies or permanent establishments can claim a notional interest deduction, except where 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 notional interest deduction 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 the notional interest deduction. In the case of companies registered overseas, a notional interest deduction will be allowed only to the extent that the legal status of the company's capital is equivalent to that under Cyprus law.

No notional interest deduction is available for new share capital arising from the capitalisation of pre-existing reserves, unless the taxpayer can demonstrate that the old reserves:

- were previously invested in specific assets not used in an activity that produced taxable income; and
- 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 (eg, market reports if there is an active open market for the type of asset concerned) will be required to substantiate the value attributed to the assets.

As an overriding principle, no notional interest deduction will be allowed if the tax authorities believe that:

- the main purpose of the underlying transactions was to reduce tax liability; and
- there was no substantial economic or commercial purpose.

For further information on this topic please contact Philippos Aristotelous at Andreas Neocleous & Co LLC by telephone (+357 25 110 000) or email (aristotelous@neocleous.com). The Andreas Neocleous & Co LLC website can be accessed at www.neocleous.com.

Endnotes

(1) Circular 2016/10 dated July 18 2016, Interpretation and tax practice for the new Section 9B of the Income Tax (Amendment) Law of 2015 on notional interest deduction.

(2) For further information please see "Amendment to tax laws".

(3) Set out in Circulars 2008/14 and 2010/8.