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The December 2015 Amendments To The Cyprus Tax Laws

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Introduction

In July 2015, the Cyprus Government submitted a number of draft laws to parliament to implement the new provisions of the EU Parent-Subsidiary Directive, to simplify the tax regime and make it more attractive, fair and effective, with the objectives of stimulating economic activity and attracting inward direct investment.

Certain of the proposals, including the introduction of a non-domiciled regime for Special Contribution for Defence, a notional interest deduction for new equity capital introduced into companies, and a capital gains tax exemption for disposals of immovable property acquired between July 16, 2015 and December 17, 2016, were enacted immediately,¹ but lack of parliamentary time meant that consideration of the other proposed amendments had to be deferred until after the parliamentary recess.

The remaining amendments to the tax laws were enacted by parliament on December 10, 2015, and published in the government gazette on December 31.²



Certain of the changes have retroactive effect and the remainder are effective for the 2016 tax year onwards.

Changes To The Income Tax Law

Offshore Activities

The definition of the term "Republic of Cyprus" has been amended to explicitly include the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf of Cyprus.

The definition of the term "permanent establishment" has been amended to include all activities pertaining to the exploration and exploitation of the seabed in the exclusive economic zone.

The gross income earned from sources within Cyprus by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus in consideration for providing ancillary services related to such exploration or exploitation activities is subject to tax at the rate of 5 percent. If

the payment is made by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus, but the cost is borne by an associated person in Cyprus, the Cyprus-resident associate is responsible for withholding this tax and paying it to the Cyprus tax authorities by the end of the following month.

All these changes are effective from January 1, 2016.

Tax Neutrality Of Foreign Exchange Gains And Losses

With retrospective effect from January 1, 2015, accounting profits and losses arising from currency exchange rate fluctuations will be disregarded for tax purposes. Only gains or losses arising from actual trading in foreign currencies or foreign currency derivatives will be taken into account. Businesses carrying out such activities may irrevocably elect to be taxed on the basis of only realized profits or losses.

Implementation Of The New Provisions Of The EU Parent-Subsidiary Directive

Anti-avoidance provisions have been introduced for hybrid instruments and artificial transactions for dividends.

Dividends received by Cyprus-resident companies from abroad will no longer be exempt from corporate income tax if the payment of the dividend is a tax-deductible expense for the company paying the dividend under the laws of the country in which it is resident. In addition, there is no

longer any exemption from corporate income tax for dividends received under an arrangement that has been put in place with the main purpose of obtaining a tax advantage and that is not based on valid commercial reasons reflecting the underlying economic reality.

With effect from January 1, 2016, such dividends will be taxed as normal business income subject to income tax and will be exempt from the Special Contribution for Defence.

Exemption Of Income From First Employment In Cyprus

Individuals becoming tax-resident and taking up employment in Cyprus were previously entitled to an exemption of 20 percent of their annual income from employment in Cyprus for the first three years of residence. The exemption was limited to EUR8,550 (USD9,280) per annum. With effect from the 2015 tax year onward, the exemption is extended to five years, but it will be available only until the year 2020.

In 2012 a further exemption was introduced, exempting 50 percent of the first five years' income from employment in Cyprus of a person who was not previously resident in Cyprus, provided the income from employment in Cyprus exceeds EUR100,000 per annum. The period of five years has now been extended to ten years. In respect of employments that began on or after January 1, 2015, the exemption is not available to anyone who was resident in Cyprus in any three of the five tax

years preceding the year in which the employment in Cyprus began, or to anyone who was resident in Cyprus in the year preceding the year in which the employment began.

The exemption is available in respect of any tax year in which income from employment exceeds EUR100,000, irrespective of whether the income falls below that amount in any year, provided that when the employment started the income exceeded EUR100,000 and the tax authorities are satisfied that the variations in the annual income are not made for the purpose of obtaining this tax benefit.

It has now been made clear that the two exemptions are mutually exclusive, and that only one of them can be claimed by a particular taxpayer.

Losses Under The Intellectual Property Box Regime

Cyprus's IP box regime allows an 80 percent deduction from the net profit generated by the use or disposal of IP rights. If a loss is made from such activities, only 20 percent of the resulting loss can be offset against income from other sources or carried forward to be offset against income of subsequent tax years.

This amendment applies retrospectively to all tax years from 2012, the year in which the IP box regime was introduced, onwards.

Increased Writing-Down Allowances For Capital Expenditure

The increased tax writing-down allowances introduced in 2013 of 20 percent on expenditure on

plant and machinery and 7 percent on new industrial and hotel buildings will be extended until December 31, 2016.

Group Loss Relief

Previously, group loss relief was available only for losses incurred by Cyprus tax resident companies. In order to align the loss relief provisions with the decision of the European Court of Justice in the *Marks & Spencer* case, the law has been amended so that a subsidiary company which is tax resident in another EU member state can surrender its taxable losses to another group member company that is tax resident in Cyprus, provided the subsidiary has exhausted all means of surrendering or carrying forward the losses in its member state of residence or to any intermediate holding company. The amount of taxable losses that may be surrendered is calculated on the basis of the Cyprus tax laws.

In order to determine whether two companies are members of a group, the law has also been amended to allow the interposition of holding companies established in another EU member state, in a state with which Cyprus has concluded a double tax treaty or in a state which has signed the OECD multilateral convention for exchange of information (Convention On Mutual Administrative Assistance In Tax Matters).

These provisions apply to 2015 and later tax years.

Anti-Avoidance Provisions For Reorganizations

Corporate reorganizations are exempt from all forms of tax in Cyprus. The Income Tax Law has

now been amended to allow the tax authorities to withhold the exemption if they have sufficient reason to conclude that the reorganization is not based on valid commercial or financial considerations and that the main purpose or one of the main purposes of the reorganization is the reduction, avoidance or deferment of payment of taxes. Any such decision is open to objection and appeal in accordance with the Assessment and Collection of Taxes Law.

The tax authorities will also have the right to impose conditions on the number of shares which can be issued as part of any reorganization and the minimum period for which such shares should be held (up to a limit of three years). These restrictions do not apply in the case of publicly listed companies and transfers of shares on death.

These provisions apply with effect from January 1, 2016.

Arm's Length Adjustments

Cyprus does not have specific transfer pricing rules in its domestic legislation, but the arm's length principle is incorporated into the Income Tax Law, allowing the tax authorities to impose additional taxes on profits or benefits arising from related party transactions. Before the current amendment, the only adjustments that could be made were to increase profits, and there was no provision for the corresponding expenses and losses to be compensated.

For 2015 and later tax years, the Income Tax Law as amended allocates the profit arising from

transactions between related parties onto an arm's length basis and, in the event of one party's profit being increased, allows a corresponding deduction for the counterparty to the transaction.

Fees For Issuing Certificates And Advance Rulings

The tax authorities have recently announced new procedures for issuing tax residency certificates and advance tax rulings, and this amendment empowers the Council of Ministers to issue administrative orders setting the fees payable by applicants.

Amendments To Tax-Exempt Income

With retrospective effect from January 1, 2015, local authorities are no longer exempt from taxation on rental income from immovable property.

Changes To The Capital Gains Tax Law

Capital Gains From Sale Of Shares In Property Companies

Prior to the December amendments, capital gains tax was charged only on disposal of immovable property located in Cyprus or on disposal of shares of companies that directly owned such property. It was therefore very straightforward to avoid tax on disposal of the shares in a property-holding company by interposing an intermediate holding company and disposing of the shares in that company, rather than the shares in the property-owning company itself.

The amendment closes this loophole by providing that gains from the disposal of shares in companies

that indirectly own immovable property in Cyprus by directly or indirectly holding shares in a company that owns immovable property located in Cyprus will also be subject to capital gains tax, if the value of the immovable property represents more than 50 percent of the value of the assets of the company whose shares are sold. The taxable gain will be calculated on the basis of the market value of the immovable property.

Trading Gains From Sale Of Shares In Property Companies

If a company's business is dealing in shares of companies, any sale of shares is treated as a transaction of a trading nature, and exempt from income tax under Article 8 of the Income Tax Law, which exempts profit on the sale of shares and other securities. As profits of a trading nature, these gains would not fall within the scope of the Capital Gains Tax Law. This provided a further simple means of gaining complete exemption from tax on disposals of shares in companies owning immovable property located in Cyprus.

The Capital Gains Tax Law has now been amended to close this loophole by providing that trading gains on disposal of shares in property-owning companies fall within the scope of capital gains tax.

Transactions Between Related Parties

In any transaction between related parties, the tax authorities may substitute the market value of the property for the contract price if they consider that the contract price is less than the market value.

Implementation Of The OECD Common Reporting Standard And The "Modified Nexus" Approach On Taxation Of Intellectual Property

Alongside the other reforms, in December 2015 the Ministry of Finance issued a Decree implementing the OECD Common Reporting Standard and the Multilateral Competent Authority Agreement on the Automatic Exchange of Financial Account Information. The Decree requires financial institutions operating in Cyprus to collect and review information from their customers and investors regarding tax residence and to make it available to the tax authorities.

In addition, the Government also announced plans to amend the IP Box regime in line with the "modified nexus" proposal. No details have yet been announced of the proposed changes or of any transitional arrangements, but it is intended that they will take effect by July 1, 2016.

Conclusion

The enactment of the remaining elements of the July tax proposals completes the Government's program of simplifying the tax regime, eliminating loopholes and anomalies, and aligning it with EU directives and case law, and making it more attractive, fair and effective.

ENDNOTES

¹ They are analyzed in detail in *Global Tax Weekly*, Issue 152 dated October 8, 2015.

² The Income Tax (Amendment) (No. 2) Law, 187(I) of 2015, amending the Income Tax Law of 2002; and the Capital Gains Tax (Amendment) (No. 3) Law, 189(I) of 2015, amending the Capital Gains Tax Law of 1980.