The Government of Cyprus has introduced a Notional Interest Deduction as part of a package of measures to encourage inward investment. The following article looks at the provisions in the law.

investment income

The New Cyprus Notional Interest Deduction in Practice

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As part of a package of tax incentives aimed at stimulating investment and economic activity, Law 116(I) of 2015 amending the Income Tax Law 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.

I. NID Basics

The NID is a deduction against taxable profit, calculated by applying a reference rate to the new equity. The reference rate is the higher of the 10-year government bond yield of Cyprus or the country in which the assets funded by the new equity are utilized, in each case plus 3 percentage points. The bond yield rates to be used are as at 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, and no NID will be allowed in the event of losses. Unutilized NID cannot be carried forward to be offset against future years' profits.

The NID is not a one-off allowance that is available only in the year the capital injection is made: it is also available 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.

II. NID Rates for 2015 and 2016

In the early months of 2016 the tax authorities announced the 10-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, followed by revised rates for Russia. Including the three percentage points uplift, the NID rates for capital introduced in 2015 range from 3.54 percent for Germany, to 10.86 percent for India. 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, and explains the underlying concepts, definitions and basic principles of calculating NID and their application in practice, with worked examples illustrating various hypothetical scenarios.

III. 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 10 million euros, fully paid in cash. Its pre-tax profit for the nine months ended December 31, 2015 is 200,000 euros, and for the year 2016 it is 1 million euros.

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 rate for Cyprus) applied to the new capital of 10 million euros, giving a result of 602,775 euros. It is then necessary to consider whether the 80 percent ceiling on profits applies. As profits for the period are only 200,000 euros, the NID is limited to 80 percent of this, namely 160,000 euros. This means that the company's taxable profit is reduced to 40,000 euros.

For 2016 there is no time-apportionment because the capital is in place for the whole year. There is no carry-forward of the "unused" NID from 2015 (i.e. the excess over 160,000 euros that was lost as the result of the 80 percent ceiling). The maximum NID is 6.685 percent (the Cyprus rate for 2016) of 10 million euros, namely 668,500 euros. This is less than 80 percent of the pre-tax profit, so there is no cap on NID. Taxable profit for the year is therefore reduced to 331,500 euros. 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.

IV. 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 and does not include 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.

The 80 percent limit on NID from a particular capital injection is to be calculated by reference to the income stream from the specific assets financed by the injection according to the "matching" concept 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 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 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 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 (for example 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.

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.

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.

V. Conclusion

The NID goes a long way to treating equity finance as favorably as debt finance, and removing any tax incentive to use unstable financing structures. It will not be relevant for holding companies, as 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 knock-on benefits for employment and general economic activity.

For More Information

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