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Cyprus

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Overview of corporate tax work

Despite being among the smallest countries in terms of area and population, over the past 40 years Cyprus has developed into one of the world's most important financial and business centres. It has numerous advantages, including a strategic location, a mature and transparent legal system based on common law, world class professional and financial services and a modern, business-friendly tax regime, which offers attractive planning opportunities. Cyprus has close cultural ties with Eastern Europe, based on a common Orthodox religion, and following the break-up of the Soviet Union it rapidly developed into the offshore centre of choice for investment into Russia and the CIS, performing the same role as Singapore does for South East Asia and Hong Kong for China. Entry into the EU in 2004, and the Eurozone in 2008, consolidated Cyprus's position as the main portal for investment between Russia and Eastern Europe on the one hand, and the rest of the world on the other. At the same time, with the rise of the Chinese and Indian economies, Cyprus also widened its geographic horizons to include these countries and the rest of Asia. In addition, in a reversal of the accustomed direction of investment, businesses from the developing economies began to use Cyprus as a point of entry into the European market.

Further possibilities emerged when large gas deposits were discovered in Cyprus's exclusive economic zone in 2011. These may transform Cyprus into a major energy exporter in the medium term, but for now the industry is in the early development stage. It is generally accepted that if the gas reserves are capable of commercial exploitation, it will be at least five years before they have a significant impact. Nevertheless, significant preparatory activity is taking place and many companies, including two of the largest international oilfield services companies, have set up a regional base in Cyprus, creating substantial professional services activity.

The global economic downturn took some time to show its effects in Cyprus but in 2011 the economy sustained a severe blow with the Greek "haircut" causing severe losses and capital shortfalls for the principal local commercial banks, which had substantial holdings of Greek public and private sector debt and significant operations in Greece. The government was forced to underwrite a capital issue by one of the banks which, combined with a long-term failure to control general public spending, made the public finances unsustainable. In the summer of 2012 the then government applied for support from the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) but for more than six months no meaningful negotiations took place, with the "Troika" (the European Central Bank, the European Commission and the International Monetary Fund) representing the potential providers of financial support.

It was only after the election of a new president at the end of February 2013 that negotiations

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began in earnest on a support package. The situation was politically complex, being influenced by sectoral interests and political considerations not only in Cyprus, but also in the rest of Europe, particularly Germany and Holland. A package was effectively imposed on the Cyprus government involving the effective winding-up of the second largest bank on the island and the forced recapitalisation of the largest. Anyone with more than €100,000 in the second largest bank lost all but the first €100,000 and deposits above €100,000 in the largest bank were subject to a "haircut" of around 50 per cent. The two banks concerned dominated the domestic market and there was virtually no-one, and no business, that was unaffected.

Paradoxically, while the bailout had a severe impact on the domestic economy, its impact on the international business sector was much less severe, as most international businesses do not maintain large balances in local banks. Indeed, contrary to predictions that the Cyprus banking crisis would bring about the demise of Cyprus as an international financial sector, investment into Russia via Cyprus increased significantly in 2013, reaching the highest level ever since 2008.

Key developments affecting tax law and practice

The natural starting point for a review of recent developments in Cyprus tax is March 2013, the month of the international bailout. This marked the lowest point in the island's history since the Turkish invasion of 1974 and led many to question whether Cyprus would survive as an international financial centre following the loss of confidence in the banking system consequent upon the "bail-in" of depositors imposed by the Troika. In the ensuing 15 months there have been many developments, which we set out in chronological order below. Given the huge amount of ground to be covered, there is no room for detail and for every change to be included, but readers can find out more at www.neocleous.com.

Increase in the corporate tax rate

In April 2013, as a condition of international financial support, Cyprus was required to increase its corporate tax rate from 10% to 12½%. Even after the increase Cyprus's corporate tax rate is one of the lowest in the EU and the increase has not materially affected most holding companies, since dividend income is not subject to corporate income tax. Furthermore, the other benefits of the Cyprus holding company regime, such as the tax-free flow of dividends through Cyprus and the beneficial exit opportunities offered by Cyprus's favourable national tax legislation and wide network of double tax agreements, remains intact.

Economic citizenship programme

In April 2013 the government announced details of its "economic citizenship" programme, under which individuals with substantial economic interests in Cyprus and their dependants may obtain Cyprus citizenship by naturalisation on an accelerated basis. In order to qualify, applicants must be of good character, with no criminal record, and must own a residence in Cyprus. In addition they must invest €2.5 million or more in Cyprus, or be the owner or a substantial shareholder of a company doing business in Cyprus. Since Cyprus is an EU member, Cyprus citizenship is proving highly attractive to high net worth individuals, as it considerably simplifies international travel and visa requirements for certain countries.

Regulation of providers of corporate and fiduciary services

The Law Regulating Companies Providing Administrative Services and Related Matters of 2012 ("the ASP Law"), enacted in December 2012, transposed the Third Money Laundering Directive into national law. It regulates the provision of company and trust management

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services and establishes a framework for the licensing and supervision of service providers, offering security to clients and strengthening confidence in the sector. The ASP Law provides that relevant services may be offered only by persons or legal entities that hold a licence from the Cyprus Securities and Exchange Commission ("CySEC"), or who are specifically exempted from the licensing requirement (principally, registered lawyers and accountants, who are regulated by their respective professional bodies).

Establishment of registers for trusts established in Cyprus

In September 2013 the ASP Law and the International Trusts Law of 1992 to 2012 were amended to create a register of trusts established in Cyprus. Each of the supervisory bodies for the purposes of the ASP Law (CySEC, the Cyprus Bar Association and the Institute of Certified Public Accountants of Cyprus) is required to maintain a register of trusts established by service providers they regulate containing the following information:

- the name of the trust;
- the name and full address of every trustee at all relevant times;
- the date of establishment of the trust;
- the date of any change in the law governing the trust to or from Cyprus law; and
- the date of termination of the trust.

For trusts created after 9 September 2013 service providers are obliged to provide the information to the supervisory body within 15 days of establishment of the trust; for trusts in existence at the time the law took effect, six months (to 9 March 2014) was allowed.

Service providers establishing trusts are now required to obtain documentary evidence of identity of the settlor, the trustees, the beneficiaries (or information on the class of beneficiaries including the beneficiaries to whom any distributions have been made pursuant to the trust) and others associated with the trust, as well as information on the activities of the trust, and keep this information available for inspection by the relevant supervisory body on request.

These changes will enhance Cyprus's reputation and position as a fully transparent and attractive trust jurisdiction with a legal infrastructure which entrenches jurisdictional and asset protection for trusts whilst fully complying with all applicable EU and domestic anti-money laundering laws and regulations. Nevertheless, as the registers of trusts are not open for public inspection, confidentiality is not prejudiced.

OECD Global Forum on Transparency and Exchange of Information for Tax Purposes

Towards the end of 2013 there was considerable publicity in the financial media regarding the fact that the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes had assessed Cyprus, together with the British Virgin Islands, Luxembourg and Seychelles, as non-compliant with international information exchange standards. It is important to put this issue into a proper context.

Compliance with international information exchange standards is assessed in two phases. The Phase One assessment focuses on whether the requisite legal and institutional infrastructure and procedures are in place for effective information exchange to be possible. Phase Two focuses on the practical implementation of the procedures. Only countries that have satisfactorily passed the Phase One assessment can go forward to Phase Two. Cyprus underwent the Phase One assessment in 2011 and the Phase Two assessment was concluded in March 2013, at the peak of the banking crisis. The respective reports were published on 5 April 2012 and 22 November 2013.

Cyprus is one of only 50 jurisdictions that have undergone a Phase Two assessment. A

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further 50 jurisdictions have undergone only a Phase One assessment. More than half (29 of the 50) have been found to lack at least one essential element and in more than a quarter (14 of the 50), the deficiencies are sufficiently serious to prevent admission to the second phase until they have been dealt with.

The Phase Two assessment evaluates compliance against 10 criteria. Cyprus was found to be fully compliant in five of these, largely compliant (that is, showing only minor failings) in one, partially compliant in two and non-compliant in two. Although steps had already been taken to deal with the deficiencies, no credit was given for these in the assessment. Austria, Jamaica and Mauritius, which achieved full compliance in fewer areas than Cyprus, were nevertheless spared from inclusion in the list of non-compliant jurisdictions.

While the current rating is undoubtedly a disappointment, it does not affect the effectiveness of Cyprus holding and financing structures and it has to be viewed in the context that only 18 of the 50 jurisdictions assessed were found to be fully compliant. Several internationally significant finance centres fell short of full compliance, including the Channel Islands, Germany, Hong Kong, Malta, the Netherlands, Singapore, the UK and the USA. No doubt, following the banking crisis and the allegations of laxity in the Cyprus regulatory environment that preceded it, there was a general reluctance to give Cyprus the benefit of the doubt, and the Cyprus authorities' contention is that the non-compliant rating is unduly harsh and does not reflect the situation as it is today. The government has announced that the tax authorities are working with the accounting and legal professions and all other relevant bodies in order to rectify all the reported deficiencies, and that it is confident that significant improvements will be noted at the next review, which is due to take place in 2014.

<u>New double taxation agreements</u>

Despite the other distractions, the government pressed ahead with its initiative to expand and modernise Cyprus's network of double taxation agreements ("DTAs"). On 1 January 2014 six new DTAs took effect, between Cyprus on the one hand and, respectively, Estonia, Finland, Portugal, Spain, the United Arab Emirates ("UAE") and Ukraine on the other. The first five are entirely new agreements, extending Cyprus's network of DTAs, and the agreement with Ukraine replaces the agreement between Cyprus and the USSR, which had been adopted by Cyprus and Ukraine following the dissolution of the USSR. All the new agreements follow the OECD Model Convention. The DTA with the UAE is Cyprus's first to include an article dealing specifically with taxation of offshore hydrocarbons activities.

The new agreement with Spain was signed on 14 February 2013 and entered into force on 28 May 2014. According to its provisions, the agreement has effect from the beginning of the year following its entry into force. However, the Cyprus tax authorities have indicated that they will allow the benefits included in the new agreement with effect from 1 January 2014.

The new DTAs with Estonia, Finland, Portugal, Spain and the UAE are expected to lead to a substantial expansion of economic ties and reciprocal investment activities between Cyprus and the countries concerned.

The double taxation arrangements between Cyprus and Ukraine had been a source of contention in Ukraine for several years, with populist politicians claiming that the Cyprus-USSR agreement, which Ukraine adopted when it became independent, was excessively generous and was abused by Ukrainian businesses to evade their obligations, rather than for legitimate tax mitigation. In 2010 the World Bank recommended to Ukraine that it should eliminate what it described as the preferential tax treaty with Cyprus.

Given this degree of political pressure, there were fears that most of the benefits previously

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available to Ukrainian businesses would be lost as a result of the renegotiation. These fears proved to be unfounded, and the new Cyprus-Ukraine agreement is taxpayer-friendly and maintains Cyprus's status as among the most beneficial of Ukraine's treaty partners. The revised agreement retains the principal benefit of the DTA it replaced, namely the highly favourable provisions regarding capital gains on disposal of shares in property-rich companies. Gains on movable property, including shares, are taxable only in the country of residence of the disponor of the shares, even when a majority of the assets of the company concerned comprise real estate. By holding real-estate assets in Ukraine in a company owned by a Cyprus-resident company, and by selling the shares in the property-owning company rather than the property itself, gains on real estate in Ukraine can be fully sheltered from tax, since Cyprus imposes no tax on gains on disposals of shares except and to the extent that the gain is derived from real estate in Cyprus. This is in contrast with most of Ukraine's other DTAs, which provide for gains from the disposal of shares in property-rich companies to be taxed in the country in which the property is located. It was widely feared that the new agreement with Cyprus would do the same, but this fear was unfounded. Gains on disposals of movable property remain taxable only in the country in which the disponor is resident, making Cyprus one of the world's most tax-effective jurisdictions for holding Ukrainian property assets.

The government is committed to extending the network of DTAs and modernising existing agreements, while new or revised agreements with Norway, Kuwait and Latvia are awaiting ratification.

Attractions for holding companies

Cyprus has gained a well-deserved reputation as an excellent location for holding companies for a host of reasons that include its transparent legal system, excellent communications and world-class professional and banking services. It has a market economy and no restrictions on capital movements. It is a Member of the EU and its tax system is fully compliant with EU and OECD requirements. It is on the OECD's "White List" of compliant tax jurisdictions, issued in April 2009. Since joining the EU in 2004, Cyprus has established itself as the ideal gateway for investment between the EU and the dynamic economies of Central and Eastern Europe, India and China.

From a tax perspective, four things are required of a holding company structure:

- The ability to extract dividends from subsidiary companies free of withholding tax, either under the subsidiary's domestic tax regime or the EU Parent/Subsidiary Directive, or at a reduced rate of withholding tax under a tax treaty.
- The holding company's domestic tax regime should exempt such dividends from local tax.
- The holding company's domestic tax regime must also allow the holding company to pay dividends without giving rise to any local tax charge. This has generally been the most difficult hurdle to overcome.
- Finally, the holding company's domestic tax regime must permit the holding company to dispose of its investment in the subsidiary without any liability to capital gains tax or its equivalent in the subsidiary territory.

Cyprus measures up against these benchmarks very well indeed.

Under Cyprus law, all expenses incurred for the production of the associated income are deducted before arriving at taxable income. Cyprus's corporation tax rate of 12.5% is among the lowest in the EU.

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Dividends received by one Cyprus-resident company from another are exempt from all forms of tax.

If a Cyprus-resident company receives dividends from a foreign subsidiary, these will be exempt from all taxes in Cyprus, except in the event that:
- directly or indirectly, more than 50% of the activities of the paying company result in investment income; and
- the paying company is subject to tax at a rate substantially lower than the Cyprus rate.

The profits of a Cyprus company's permanent establishment in another jurisdiction are similarly exempt, subject to the same conditions as for dividends.

Non-exempt dividend income is subject to defence tax contribution at the rate of 17%. Tax credits are available for taxes paid abroad.

Interest income that is the result of the main activities of the company, or that is closely connected to those activities, is subject only to corporation tax at the standard rate, like any other "active" trading income. Group finance income is treated as active trading income.

Mergers, acquisitions and other corporate reorganisations may generally be effected without any tax cost.

The only withholding taxes levied by Cyprus relate to royalties derived from the use of a right or asset within Cyprus or the provision of specific services in Cyprus (at a maximum rate of 10%). All other dividend, interest and royalty payments made to non-residents may be made without deduction of tax.

Furthermore, the tax legislation does not contain any thin capitalisation rules (a debt:equity ratio requirement) and a Cyprus-resident holding company can be primarily financed by debt to capitalise foreign subsidiaries by way of loans rather than equity capital.

The most significant recent developments regarding Cyprus's role as a holding company jurisdiction are Cyprus's removal from the Russian tax blacklist following the entry into force of the protocol to the DTA with Russia and the entry into force of the new DTA with Ukraine. As noted above, the new agreement with Ukraine retains the beneficial provisions regarding taxation of gains on disposal of shares in property-rich companies that make Cyprus an ideal jurisdiction for holding Ukrainian assets.

The protocol to the double taxation agreement with Russia introduces a provision allowing gains on the disposal of shares in "property-rich" companies to be taxed in Russia rather than Cyprus, as was previously the case. However, this provision will not take effect until 1 January 2017 and, furthermore, Russia has agreed that, by the time it takes effect, Russia will have introduced similar provisions into its other double taxation agreements. Indeed, such provisions have already been introduced into Russia's double taxation agreements with Switzerland and Luxembourg, and are already in effect, with no grace period.

The limited disadvantage posed by the new arrangements regarding taxation of gains on shares in property-rich companies is balanced by the removal of Cyprus from the so-called Russian tax blacklist, which has already taken effect. From 1 January 2013, companies incorporated in Cyprus will be entitled to the participation exemption which Russia introduced with effect from 1 January 2008, under which dividends received by Russian companies from qualifying participations are exempt from tax. Furthermore, transactions between unrelated Russian and Cyprus companies will no longer be subject to the automatic transfer pricing control scrutiny in Russia that applies to locations included in the "blacklist".

Like most of Cyprus's newer DTAs, both the new Ukraine agreement and the protocol to the DTA with Russia introduce new information-exchange provisions, reflecting the latest OECD

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Model Treaty. However, concerns that these new arrangements would open the floodgates for disclosure of information are alarmist and unfounded. The strong taxpayer safeguards contained in Cyprus's Assessment and Collection of Taxes Law mean that investors should have nothing to fear from the provisions facilitating exchange of information. Requests for exchange of information are dealt with exclusively by a specialist department of the Department of Inland Revenue, and direct informal exchange of information between tax officers is prohibited. Requests for information must be supported by a detailed justification, ruling out speculative enquiries and so-called "fishing expeditions". As a final safeguard, the written consent of the Attorney General is required before any information can be released to an overseas tax authority.

Industry sector focus

The introduction of the "intellectual property box", giving an effective tax rate of less than 2½% on revenue from intellectual property, by far the lowest rate available in Europe and less than half the rate of Cyprus's nearest competitor, has led to great interest in the use of Cyprus as a jurisdiction to hold intellectual property assets, particularly as it is also possible to fully shelter gains on disposal of intellectual property assets from tax. Before the new rules were enacted, it was generally necessary to use a company in a low- or no-tax jurisdiction to hold the IP rights and license them to a Cyprus intermediary licensing vehicle which would sub-license the right to exploit the IP rights to another entity, usually registered and tax-resident in a country with a double tax treaty with Cyprus. Under the new tax regime there is no longer any need for a separate IP owner, giving substantial planning opportunities and savings in tax and administrative costs.

Another industry sector in which Cyprus has particular tax benefits is international shipping and ship management. The Merchant Shipping (Fees and Taxing Provisions) Law of 2010 ("the Tonnage Tax Law"), replaces tax based on profits with a tax based on tonnage for Cyprus-resident shipping and ship-management companies, simplifying and substantially reducing the tax burden. It extends the benefits of the tonnage tax regime and exemptions from income tax, which were previously restricted to owners, operators and managers of Cyprus-flag ships, to owners and charterers of non-Cyprus flag vessels, and widens the range of exempt gains to include profits on the disposal of vessels, interest earned on funds and dividends paid directly or indirectly from shipping-related profits, in addition to profits from shipping operations.

The year ahead

During the year ahead it should become clear whether, and if so to what extent, the "de-offshoring" initiative launched by Russian President Vladimir Putin in 2013 will affect Cyprus. Numerous Russian companies, including many state-owned companies and household names such as Gazprom and Aeroflot, use Cyprus-based holding and finance structures for outward investments. In recent years Cyprus has widened its horizons and has attracted substantial volumes of business from the developing economies of Africa, Asia and South America, but nevertheless Russia remains a key market for Cyprus holding, finance and other structures.

The Russian government intends to have a new law in place from the beginning of 2015 regulating controlled foreign companies ("CFCs") and countering abuse of offshore structures. A draft law was published for consultation in March 2014 and a revised draft followed in May 2014. No doubt the law will undergo much fine-tuning during the

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legislative process, but its key provisions, and their potential relevance to companies using Cyprus (or indeed other intermediary jurisdictions such as the Netherlands, Luxembourg, Malta, Singapore and Switzerland) as a route for investment into and out of Russia, merit consideration now, in order to ensure that the benefits of these structures are preserved.

Any consideration of the potential impact of the proposed new law on Cyprus holding structures, or indeed structures involving any country with which Russia has a double taxation agreement in force, must take into account the fact that the internal laws of a country cannot override its obligations under international agreements. Double taxation agreements allocate taxing rights between the contracting states concerned and have inherent rules of interpretation which cannot be overridden by any domestic law of any state. Any new legislation will therefore have effect only to the extent that it is consistent with Russia's existing double taxation agreements, unless Russia is prepared to terminate them, which seems highly unlikely, given the potential impact of such an action.

Subject to this general comment, the crucial question for users of Cyprus structures is whether Cyprus will fall within the scope of the CFC legislation. Given that there is a newly-updated double taxation agreement in place between Cyprus and Russia that includes effective information exchange and anti-abuse provisions, it is arguable that it would be illogical to introduce new, contradictory measures. The latest revised draft law introduces a minimum effective tax rate as a qualification for "whitelisting" but, until the final rate is established, it is not clear whether Cyprus will be required to adjust its corporate tax rate in order to comply. Indeed, the new law could represent an opportunity for Cyprus, as a well-regulated, transparent jurisdiction that provides investors with security and a level playing field, as long as the arrangements comply with substance and business purpose requirements.

A year after the bail-out, it is clear that reports of Cyprus's demise as an international financial centre were premature. Indeed, as noted earlier, investment into Russia via Cyprus increased significantly in 2013, reaching the highest level ever since the onset of the global financial crisis in 2008. The targets for economic reform agreed with international lenders are being met or exceeded, and while there is serious unemployment in the economy as a whole, and particularly in the construction industry, the international services sector has held up well and is likely to be one of the drivers of recovery.

It is also clear that a great deal of the bad press that Cyprus received in the early months of 2013, alleging laxity in application of its anti-money laundering legislation, was unjustified. An audit carried out by Deloitte and Moneyval, the Council of Europe's anti-money laundering body, found that Cyprus has robust legislation and that it is applied consistently and systematically, with no higher level of exceptions than would be expected anywhere.

Certain of the reforms outlined above, made at the behest of Cyprus's international creditors, will improve regulation and keep out undesirable practices, and so help to enhance Cyprus's reputation for transparency and reliability, and its attractiveness to reputable investors. The government and the business services sector are committed to offering a competitive tax and business environment of the highest standards of probity. While there are undoubtedly challenges ahead, progress to date is highly encouraging. On balance, while there is no doubt that Cyprus, like much of the rest of the world, faces difficult economic conditions for some time to come, the changes increase its attractiveness as a reputable, well-regulated centre providing a business-friendly environment and incentives for investment and innovation.

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