

Cyprus – an ideal holding company location

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Despite being among the world's smallest countries, Cyprus has developed into a major financial and business centre. It continues to be the largest source of investment into Russia, ahead of Luxemburg, the Netherlands, Germany, Great Britain, the US and France.

Cyprus has always been an excellent location for holding companies for a host of reasons, including 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; and it is on the OECD's 'White List' of compliant tax jurisdictions, issued in April 2009. Since joining the EU in 2004, Cyprus has become the ideal gateway for investment between the EU and the dynamic economies of central and eastern Europe, India and China.

Optimum participation regime

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.

How does Cyprus measure up against these benchmarks?

In brief, the answer is ‘very well indeed’.

- Under Cyprus law all expenses incurred for the production of the associated income are deducted before arriving at taxable income. Cyprus’ corporation tax rate of 10% is the lowest in the EU.
- Dividends received by one Cyprus-resident company from another are exempt from all forms of tax.
- If a Cyprus-resident company owns 1% or more of the share capital of a foreign corporation, any dividends it receives are also exempt from tax, 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 15%. 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 a rate of 10%, 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 tax levied by Cyprus is a 10% (subject to treaty provisions) tax on royalties derived from the use of a right or asset within Cyprus. 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.

Recent developments

The Cyprus government demonstrated its commitment to international standards of transparency and information exchange with the enactment of Law 72(I) of 2008, amending the Assessment and Collection of Taxes Law to allow the domestic tax authorities to disclose information to their overseas counterparts to fulfil their obligations under double taxation agreements. It has since focused on concluding new double tax agreements and modernising existing ones to align them with current best practice. A protocol to the Russia-Cyprus agreement was concluded in April 2009 and a new double tax agreement with the Czech Republic was signed in May.

One of investors' greatest concerns about the protocol to the Russia-Cyprus agreement, namely that the information exchange provisions would facilitate 'fishing expeditions' by the Russian tax authorities, has proved to be unfounded. The protocol contains robust safeguards for taxpayers, requiring enquiries to be specific and based on reasonable, properly documented grounds.

Both revised double taxation agreements continue to provide significant benefits in terms of withholding tax rates. In the case of Russia, the withholding rates applicable to interest and royalties will be zero, and the rate for dividends 5%, subject to a minimum investment level of €100,000.

The new treaty with the Czech Republic reduces the withholding tax on

dividends from 10% to zero, subject to a minimum holding requirement of 10% of the investee's share capital (5% if the minimum holding requirement is not met). It does away with withholding tax on interest, which will be taxed only in the country of residence of the recipient. The withholding tax on industrial licence fees (for the use of patents, know-how, software and similar intellectual property) is increased to 10% (compared with 5% under the 1980 treaty), but the Czech Republic has undertaken that if it concludes a double tax treaty with another EU state providing for a lower rate of withholding tax on licence fees, it will reduce the rate in the Cyprus treaty to match it. Royalties remain tax-exempt in the source country, and are taxed only in the country of residence of the recipient.

Both new agreements preserve the general rule that the right to tax income from the disposal of shares is given to the country of residence of the seller, but modify it in certain specific circumstances in line with the OECD model treaty. In particular, the right to tax capital gains derived on the sale of shares in a property-rich company will be vested in the country where the property is located. Accordingly, gains realised by a resident of one contracting state from the disposal of shares deriving more than 50% of their value from immovable property situated in the other contracting state may be taxed in that other state. While the new arrangements with the Czech Republic

will become effective on 1 January of the year following ratification of the new agreement, the protocol to the Russia-Cyprus agreement provides a four-year grace period. Furthermore, it gives Cyprus ‘most favoured nation’ status by providing that Russia will implement similar provisions in all its double tax agreements, and will amend the protocol to match any more favourable terms it may agree with any other treaty partner.

The verdict

The factors outlined above make Cyprus a highly attractive intermediate holding company jurisdiction, offering the following benefits:

- groups investing outside Cyprus may flow-through income streams, which will generally be tax-exempt in Cyprus and not attract withholding tax as they leave;
- subsidiaries that have scope for significant capital appreciation may be held in Cyprus and sold without any liability to tax on the gain;
- Cyprus’s double tax treaty network and the EU Parent-Subsidiary Directive offer a number of other tax planning opportunities;
- Cyprus offers a favourable exit strategy under Cyprus law, which allows payment of dividend, interest and royalties without payment of withholding tax; and
- Cyprus offers a well-regulated, business-friendly environment with a minimum of unnecessary ‘red tape’.

Cyprus can also be used as the location for the ultimate holding company, for instance in a group that is relocating to a new jurisdiction or on formation of a new publicly-traded corporation with international operations. It is particularly suitable for any fund or investment vehicle, since there is no tax on transactions in securities as defined, even if this is the entity’s main trading activity. As there is no withholding tax on dividends, there is no uncertainty over recovery of tax paid.

Some caveats are required. Cyprus follows the current trend in international tax as regards substance requirements, and the interposition of intermediate holding companies merely to obtain treaty benefits is increasingly subject to scrutiny. Cyprus’s rapidly developing body of anti-avoidance legislation is aimed at preventing ‘brass-plate’ companies without any significant substance in Cyprus from benefiting from the Cyprus tax system merely by incorporation.

Cyprus’s commitment to transparency ensures that it is not stigmatised as a tax haven, and will facilitate the growth of its already extensive network of double tax agreements. It has been removed from Spain’s so-called blacklist of tax havens and the conclusion of the protocol has led to its removal from Russia’s blacklist.

The final choice of a holding company location is a question of balancing tax and non-tax considerations. While no single location can claim first place on every test, Cyprus should always be on the shortlist.

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