

TAX update

01/16

AMENDMENTS TO THE TAX LEGISLATION
OF CYPRUS


KINANIS

A. INTRODUCTION

New laws have recently been enacted in Cyprus, effecting important changes to the Income Tax Law and Capital Gains Tax Law.

In addition, a serious change has been effected on the procedure followed by the Income Tax Authorities in issuing tax residency certificates with the aim to secure that the management and control of the tax resident companies is indeed exercised in Cyprus.

The changes are of major importance for the international investor who must seriously consider them for future tax planning.

The summary of the new laws and the new Income Tax procedure as to the issuing of tax residency certificates is herein below analysed.

B. INCOME TAX LAW - CHANGES

1. Profit from foreign exchange differences

Any profit derived from currency exchange differences which is due to the fluctuation of currency exchange rates will be tax exempt. The exemption will not apply for companies engaging in currency trading activities (i.e. Forex Companies).

Any person which is engage in the trading of currency may irrevocably elect that the non - realised currency exchange differences will not be subject to income tax and will not be deducted from the taxable income, if they relate to profits or losses, respectively.

The above change is applicable as from 1st of January 2015.

2. Limitation of loss carried forward on IP activities

The Cyprus IP tax regime provides that 80% of royalty profit (royalty income less related expenses) will be regarded as deemed expense. Therefore, only 20% of the royalty profit will be taxed at 12.5% corporation tax and in this respect the maximum effective tax rate is 2.5%.

The law as existed did not clarify what percentage of losses will be taken into account in case the company had losses instead of profits.

With the new changes the law clarifies that only 20% of the losses can be set off or carried forward and the loss is calculated on the same principles as the profit.

The above changes are considered to be applicable as from 1st of January 2012.

3. Extending the available exemptions of personal income tax for those taking up residency in Cyprus

As the Law existed, non - Cyprus tax resident individuals who were taking up employment in Cyprus were entitled to claim the following:

- a. 20% of their employment income to be exempted from personal income tax for a period of 3 years or EURO 8.550,00 per year which one was the lower;

Or, subject to the applicability of the conditions mentioned below,

- b. 50% of their employment income earned in Cyprus to be exempted from income tax for a period of 5 years, provided that their employment income earned was more than EURO 100.000,00 per year.

The new law extends the period of the first exemption from 3 to 5 years but this exemption will be abolished as from the year 2020 onwards and provided the employment started within or after 2012.

For the second exemption the years of exemption are extended from 5 to 10 years.

Further, the exemption will not be granted to a person who was Cyprus tax resident for any three out of the five years prior to the commencement of his/her employment and also it is not granted to a person who was a tax resident of Cyprus the year before his employment. This provision applies for employments after 1/1/2015.

The exemption will continue to be granted in case their employment income drops below EURO 100.000,00 after the year the exemption was granted, provided that the tax commissioner is satisfied that the increase/decrease was not made for the purpose of obtaining the exemption.

It should be noted that the law now clarifies that no one can be benefited from both exemptions.

The above changes are applicable as from 1st of January 2015.

4. Annual allowances for capital expenditure - extended to 2016

Under the current provisions of the law in the estimation of the taxable income of a person, a particular capital allowance, higher than the standard applicable rates, is granted for plant, machinery, industrial buildings and hotels reducing respectively the taxable income, provided, the capital expenditure for these items was made during the years 2012 - 2014.

The amended law has extended the increased capital allowances offered and for the years 2015 and 2016.

The rates that will continue to apply for 2015 and 2016, will be, for plant and machinery, 20% instead of 10% and for Industrial and Hotel buildings, 7% instead of 4%.

The above change is applicable as from 1st of January 2015.

5. Group relief

Under the current provisions of the law, taxable losses of one Cyprus Company, (the surrendering company), could be surrendered, to another Cyprus company (the claimant company) provided, they were both Cyprus tax resident companies belonging to the same group of companies.

Under the new provisions of the amending law, the surrendering company who will surrender the loss, may be a company which has its base and is tax resident of another member state, provided, it has exhausted all possibilities of setting off the loss or carrying it forward, in the member state of its residence or with any intermediary holding company existing between the surrendering company and the claimant company who will set off / accept the losses. The obligation which existed that both companies surrendering company and claimant must be tax residents of Cyprus has been abolished.

In effect, taxable losses can now be surrendered by a company which is tax resident and has its base, in another EU member state to the place of residence of the claimant company which will be Cyprus.

Such losses when surrendered to a Cyprus company must be calculated on the basis of Cyprus law.

Meaning of Group

As per the provisions of the law two companies are considered as members of the same group if the one is by 75% dependent on the other or both jointly or independently are by 75% dependant of a third company. In determining whether a Group existed it was not possible to establish the 75% link through companies that they were not Cyprus tax residents.

The link can now be established even if that other company is tax resident:

- In another EU member state;
- In jurisdictions where Cyprus has signed a double tax treaty; and
- In a country where Cyprus has signed a treaty for the exchange of information.

The above changes are applicable as from 1st of January 2015.

6. Taxation of Oil and gas activities

The definition of the term “Republic of Cyprus” was amended in order to include the territorial sea and any other area beyond the territorial sea, including the contiguous zone, the exclusive economic zone and the continental shelf of Cyprus.

Further the definition of the “permanent establishment” was also amended in order to include offshore activities for the excavation, investigation or exploitation of the shelf, the underground or the natural resources and the establishment and exploitation of pipelines or other installations to the seabed.

The gross income generated from services relating to oil and gas exploitation offered by a person who is not tax resident in the Republic but the services are offered within the Republic as defined above, is subject to 5% withholding rate on the gross income.

The above change is applicable as from 1st of January 2016.

7. Taxation of dividends

Dividends received by a Cyprus tax resident company or by a non - tax resident company but which has permanent establishment in the Republic, will not be exempted from income tax in Cyprus in case such dividends are tax deductible for the foreign paying company.

For example, in some countries, dividends paid on preference shares or other “hybrid” instruments are considered as interest expense for the foreign paying company and are tax deductible, whilst in Cyprus, are considered as dividends and were exempted from income tax.

In view of the mentioned amendments, in cases where dividends fall within the above provisions will be subject to income tax in Cyprus. In such a case, such dividends will be exempted from Special Defence Tax.

The above change is applicable as from 1st of January 2016.

8. Tax credit on foreign tax paid

In the event where dividends received from another EU member state are taxable in Cyprus with Income Tax, tax credit on taxes paid in that other member state will not be granted in cases where the group structure was set up without valid commercial reasons representing the economic reality.

Therefore, the tax authorities before accepting to grant a tax credit on tax liabilities generated from dividend income received from another member state, will examine the group structure. If the tax authorities do not identify commercial reasons for the setting up of the structure they will not allow the tax credit. In such cases, groups of companies which have real substance in each country will most probably be able to prove that the group structure has commercial reasons.

The above change is applicable as from 1st of January 2016.

9. Anti avoidance provisions for Re-organisation

The new law gives power to the Tax Commissioner not to accept the tax exemptions granted by law on the profit generated from re-organisations.

The tax exemptions apply retrospectively provided the Tax Commissioner, is satisfied that the re-organisation was made with real commercial or financial purpose.

The Tax Commissioner, may not grant the tax exemptions granted by law on the profit generated due to the re-organisation, if according to his opinion the main purpose or one of the purposes of the re-organisation was the avoidance or reduction or postponement of the payment of taxes or the direct or indirect distribution of assets of any business to any person without the payment of tax through its reduction or postponement of the payment of the tax.

In case the tax exemption for the non - payment of taxes is not granted then tax is due on the generated profit due to re-organisation.

The above change is applicable as from 1st of January 2016.

10.Arms' length principle

In case the Tax Commissioner will increase the profits or benefits of one business due to the implementation of the principle of Arms' length, then at the same time it is granted to the other participant of the transaction an analogous reduction which is considered as an expense and the rules as to allowable expenses apply.

The above change is applicable as from 1st of January 2015.

11. Reference Interest rate for Notional Interest Deduction

According to the recent law amendment that took place in July 2015 a company is allowed to claim Notional Interest Deduction (NID) on new equity introduced as from 2015. The NID will equal the multiple of the **"Reference interest rate"** and the **"new equity"**.

"Reference interest rate" is defined as the 10 year government bond yield of the country in which the new equity is invested increased by 3% having however, as a lower limit the 10 year government bond yield of the Republic of Cyprus increased by 3%. The rate used will be the rate as at 31 December of the previous tax year, i.e. for the 2015 tax statements the 31 December 2014 rate will be used.

The tax authorities issued a circular stating the 10 year government bond yield as at 31/12/2014 for the countries below. These rates can be used in order to determine the **"Reference interest rate"**:

	Bond Yield	Reference Interest Rate
Cyprus	5,04%	8,04%
India	7,97%	10,97%
Russia	13,15%	16,15%
Romania	3,57%	6,57%
Germany	0,27%	3,27%
Ukraine	9,12%	12,12%

It is important to note that the NID granted on new equity cannot exceed 80% of the company's taxable profits

Example

A Cyprus company issued new share capital on 1/1/2015 for EURO 1 million. These funds, received as new share capital, were used by the company in order to provide a loan to a Russian company with interest 5%.

The Notional Interest Deduction will be calculated as follows:

New equity = EURO 1,000,000

Reference interest rate = 13.15% + 3% = 16.15%

NID before restriction = 1,000,000 x 16.15% = EURO 161,500

Interest income/ Taxable income = 1,000,000 x 5% = EURO 50,000

NID restricted at 80% of taxable income = EURO 50,000 x 80% = EURO 40,000

Tax computation

Taxable income - Interest income (€)	50,000
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Less Lower Off

NID before restriction (€)	161,500
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NID restricted at 80% of taxable income (€)	40,000	40,000
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Taxable profits (€)	10,000
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C. CAPITAL GAINS TAX LAW - CHANGES

The current law provided that there will be capital gains tax on the profits from the disposal of immovable property situated in Cyprus or disposal of shares of a company which **directly** owns immovable property situated in Cyprus.

The new amended law provides that in addition to the above there will be capital gains tax on the profits from the disposal of the shares of a company which directly or indirectly participates in a company or companies which possess immovable in the Republic and at least 50% the market value of the shares sold is derived from the immovable property which is situated in the Republic.

The above change is applicable as from 17th of December 2015.

**D. ISSUING OF TAX RESIDENCY CERTIFICATES - NEW PROCEDURE
FOLLOWED BY THE INCOME TAX AUTHORITIES**

Tax authorities have changed their procedure and requirements in order to issue tax residency certificates (TRC) for tax resident companies.

They now request a questionnaire to be completed by the applicant company in which questionnaire the following questions must be replied:

- 1. Is the company incorporated in Cyprus?*
- 2. Is the company tax resident ONLY in Cyprus?*
- 3. Do the majority of Board meetings take place in Cyprus?*
- 4. Does the majority of the Directors exercise control and make key management and commercial decisions necessary for the company's operations and general policies?*
- 5. Are the board of Directors' minutes prepared and kept in Cyprus?*
- 6. Is the majority of the board of Directors tax residents of Cyprus?*
- 7. Do shareholders' meetings take place in Cyprus?*
- 8. Has the company issued a General Power of Attorney?*
- 9. Are the Corporate seal and all statutory books and records maintained in Cyprus?*
- 10. Are corporate filing and reporting functions performed by representatives located in Cyprus?*
- 11. Are agreements relating to the company's business or assets executed or signed in Cyprus?*
- 12. Have all the tax returns that are due, been filed?*
- 13. Have all the self-assessments for the tax years that are due, been paid?*

The authorities now try to investigate whether the tax resident companies have real substance in Cyprus and exercise the management and control from Cyprus.

It is the intention of the authorities, if general powers of attorneys are issued and if contracts are signed outside Cyprus not to grant the requested TRC and not to consider the company as a tax resident company with serious tax repercussions for the company.

Careful consideration must be made so that the action taken by the company will not shift the tax residency of the company outside Cyprus.

E. COMMON REPORTING STANDARD (CRS)

The Ministry of Finance on 31/12/2015 has issued a decree regarding the obligations of the Financial Institutions to follow the provisions and regulations of automatic exchange of information under CRS which is initiated by OECD. The Association of Cyprus Banks has recently issued the following circular explaining the main principles of automatic exchange of information.

“The Common Reporting Standard and its implementation in Cyprus”

What is the Common Reporting Standard (CRS)?

The Standard has been initiated by the Organization for Economic Cooperation and Development (OECD) aiming at improving international tax compliance and preventing tax evasion, through the automatic exchange of information between the countries that implement CRS.

CRS has been implemented at the European Union level through the Directive that relates to the mandatory automatic exchange of information in the field of taxation (Directive 2014/107/EU). Relations with countries that are non-EU members are defined through multilateral agreements.

CRS requires the financial institutions that are in countries which implement CRS, to submit information on financial accounts that are held, directly or indirectly, by account holders who are tax residents of countries which implement CRS.

Is the Common Reporting Standard applicable in Cyprus?

The Standard implementation in Cyprus is based on the following:

- 1. Cyprus, as a European Union Member State, must implement Directive 2014/107/EU in its national legislation. As a result, the authorized credit institutions and other financial institutions in Cyprus are required to collect information and submit it to the relevant tax authorities (in the case of Cyprus, to the Tax Department) that will in turn forward annually the information on an automatic basis, to the tax authorities of the countries of tax residence of each account holder, provided the account holders are tax residents of countries that implement CRS (excluding Cyprus).*
- 2. In addition, the Republic of Cyprus has co-signed on 29 October 2014, together with other countries / participating jurisdictions, a Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (published in the official Government Gazette on 18 December 2015).*
- 3. A relevant Decree is expected to be issued by the Minister of Finance.*

Who is within the scope of the Common Reporting Standard?

The Common Reporting Standard is applied by all authorized credit institutions and other financial institutions who are located in countries that apply CRS. CRS applies to both individuals and entities.

For the purpose of identifying tax residence, the financial institutions are required to obtain from the direct and indirect account holders, self-certifications which include the country(ies) of tax residence and the tax identification number(s).

What does the Common Reporting Standard mean for the customers of member banks of the Association?

For new customers as from 1 January 2016, the member banks of the Association are required to ask and receive information relating to the country(ies) of tax residence and, for non-Cyprus tax residents, relating to the tax identification number(s). Without the self-certification with the basic required information, the financial institution cannot open an account.

For pre-existing customers, member banks of the Association may contact the persons affected by CRS, to collect a self-certification form which will determine their residence(s) for tax purposes and provide their tax identification number(s). Without a self-certification, the financial institutions are obliged to consider the account holder as a reportable person. As a consequence, financial institutions will report to the Tax Department the information they already have for the undocumented accounts.

Subsequently the member banks will submit to the Tax Department the information of account holders who are tax residents of other countries that implement CRS. The tax Department will in turn forward the information to the foreign tax authorities.

The first reporting will occur in 2017 and will cover the year 2016.

Financial institutions will be subject to penalties for failure to comply, as determined by the relevant legislation.

The Association of Cyprus Banks and its members are unable to provide tax advice. If further information is required, please contact your tax advisor. Useful guidance may also be found at the OECD CRS portal: <http://www.oecd.org/tax/automatic-exchange/>

Our office will revert with more details on this matter.

F. CONCLUSION

Cyprus aims to maintain and improve its position as an international business place. With the changes above we believe that great incentives are given to international investors especially to those that wish to relocate and create substance for their companies in Cyprus.

Cyprus will continue to improve its position as an international business centre and further incentives are believed to come in the near future.

G. DISCLAIMER

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Our Firm

Kinanis LLC, a law and consulting firm, is one of the leading and largest business law firms in Cyprus and advises for over 30 years the international investor and private clients on all aspects of law, tax and accounting.

Kinanis LLC absorbed the business of its shareholders which are in the legal and consulting profession since 1983, with local and international dimensions.

Experience and practice over the years brought forward the need for transformation from a traditional law firm to a more innovative multidisciplinary firm providing a full range of services combining law and accounting with the extensive expertise in corporate and tax advice to ensure that our clients will obtain the best possible spherical advice adopting the principle as to the services offered “All in one place”, so that the client will find a quick, correct and efficient solution to its daily legal, accounting and tax issues in a trustworthy environment.

This combination of legal, accounting and tax services through our well qualified personnel and our involvement and participation in international transactions over the years, have established our firm as one of the key players in the field. Our involvement in international financial transactions has also provided us with the extensive expertise in representing groups, corporations, funds as well as the private client.

The firm is staffed with around 80 young, energetic and ambitious professionals, including lawyers, accountants and administrators who provide prompt, efficient and high quality services and who are capable of meeting the current demanding challenges of the local and international business environment.

We always look to give solutions in a simple and as possible quick way focusing on the needs of each client trying to anticipate the issues before becoming a problem.

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