Grammaro Accounting Services Ltd

Member of Andreas Sofocleous Group of Companies

Significant amendments to the Cyprus Tax System in the past year

A number of significant amending bills to the Tax Laws of the Cypriot Tax system have been voted by the House of Representatives during 2015.

The changes introduced:

1] Provide incentives for new equity capital and aim to attract foreign investments and high-net worth individuals;

2] Aim at harmonizing Cyprus Tax Laws with the new provisions of the EU Directives;

3] Simplify the Tax regime and eliminate some inconsistencies;

4] Introduce anti-avoidance measures.

Below we summarize the main Tax Law amendments.

The content of this article is intended to provide a general guide to the most important changes. Specialist advice should be sought about your specific circumstances.

[I] Notional interest deduction on new equity

As from 1 January 2015, the Government has introduced the *Notional Interest Deduction (NID)* regime on equity.

NID will be allowed on *"new equity"* funds introduced into a Cyprus Tax Resident company and which funds are used for the operations of the company. Foreign companies that maintain a Permanent establishment in the Republic can also benefit from this provision.

The NID will equal the multiple of *"reference interest rate"* and the *"new equity".*

The definitions of the aforementioned terms under Cyprus Law are:

"Reference interest rate" :The interest rate of the 10 year government bond of the country in which the new equity is invested, plus 3%, having as a lower limit the 10 year government bond yield of the Republic of Cyprus plus 3%. The bond yield is the one applicable as of 31 December of the tax year preceding the relevant tax year.

(10 year government bond of Cyprus as at 31.12.2015 was 5%)

"New equity" : Any equity introduced in the business after 1st January 2015 in the form of both share capital and share premium, provided it is fully paid and used for the operations of the company.

The NID will be limited to 80% of the taxable profit before deducting the NID, and no NID will be allowed in the event of losses.

The deductibility of the deemed interest will be subject to the same rules as actual interest paid (tax deductible only if it relates to assets used in business, based on the actual days, etc.).

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[II] Anti-avoidance provisions

The Commissioner may not authorise the granting of the above exception if it's believed that there is an abuse of the new benefit granted, such as "dressing up" old capital into new capital, claiming notional interest twice on the same funds through the use of multiple companies or where the arrangement introduced lacks valid economic or commercial reasons.

This amendment is effective as of 1 January 2015.

[III] Tax neutrality of foreign exchange gains and losses

Foreign exchange differences, either gains or losses, irrespective of whether they are realized or unrealized will be disregarded for tax purposes. These new provisions do not apply to gains or losses arising from trading in foreign currencies or foreign currency derivatives. Companies trading in foreign currencies or foreign currency derivatives may elect to be taxed on the basis of realised profits or losses and any unrealized foreign exchange differences will be treated as taxable/tax deductible in the year they are realized.

This amendment is effective as of 1 January 2015.

[IV] Hybrid instruments - Dividends

Up to 31 December 2015, dividends received by a Cyprus Tax Resident company were unconditionally exempt from Cyprus Income Tax. In order to align Cyprus Tax Laws with the recent changes to the EU Parent Subsidiary Directive, as of 1 January 2016 dividends received by Cyprus Resident companies from abroad will no longer be exempt from Income Tax if such dividends are a tax -deductible expense for the company paying the dividend.

In addition, there is no longer any exemption from Income Tax for dividends received under an arrangement that has been put in place without any valid commercial reasons and with the main purpose of obtaining a tax benefit.

Furthermore, dividends that are taxed under Income Tax will be exempt from Special Defence Contribution.

This provision is effective as of 1 January 2016.

[V] Group loss relief - Alignment with European Court of Justice (ECJ)

Under the current provisions of Cyprus Law, the group relief provisions are applicable only between Cyprus Tax Resident Companies. From now on, group relief will be available between companies resident in Cyprus and companies resident in other EU member states.

This will however only apply provided the surrendering company has exhausted all possibilities of surrendering the available tax losses in its respective country of residence or in the country where its immediate holding company resides.

Furthermore, in determining whether two companies are members of a group, the recent amendments allow the interposition of holding companies established in another EU country, in any other country with which Cyprus has concluded a double tax treaty or any other country which has signed the OECD multilateral convention for exchange of information.

The above amended group loss relief provisions are effective as of 1 January 2015.

[VI] Anti-avoidance provisions for reorganization

According to the amended law, the Commissioner may refuse granting the tax exemptions, if at his discretion, the reorganization was not made based on valid commercial or financial grounds and the main or one of the main purposes of the reorganization is to avoid, reduce or defer the payment of taxes. Such decision can be objected in accordance with the articles of the Assessment and Collection of Taxes Law.

Additionally, following this amendment, the Commissioner has the right to enforce conditions regarding the number of shares which will be issued as a result of the reorganization and the period for which such shares must be held (which cannot exceed three years). The restrictions do not apply to any publicly listed companies and shares transferred on death.

Changes to the arm's length principle

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, providing that additional taxes maybe impose on profits or benefits arising from related party transactions.

The new amended law also provides that when the Commissioner proceeds with an upward adjustment to the taxable profits of a Cyprus resident company (or a Permanent Establishment of a non-Cyprus resident company), then the Commissioner will proceed with a corresponding downward adjustment for the other party involved in the transaction.

These provisions are effective as of 1 January 2015.

[VI] Capital Gains Tax (CGT) Law changes (This provision is effective as of 16 July 2015.)

From the date the amending law comes into force:

Any property acquired (from a non-related party) during the period from 17 July 2015 to 31 December 2016, will be exempted from CGT from a future disposal (both land and buildings).

CGT is imposed on gains from the sale of shares in companies which indirectly participate in a company which owns immovable property in Cyprus (directly or indirectly). This will be applicable only in the case where the value of the immovable property represents more than 50% of the market value of the assets of the company whose shares are sold.

Reduction of transfer fees on real estate transactions

Transfer fees are reduced by 50% for transfers of immovable property until 31 December 2016.

Administrative fees for issuance of Tax Rulings

The Tax Department introduced a new formal procedure for obtaining advance tax rulings. In addition, a fee of €1,000 has been set. This fee is increased to €2.000 in case the taxpayer would like to use an expedite process with a guaranteed response time of 21 working days, provided that all the necessary information is supplied.

Individuals

Introduction of non-domiciled regime

The Special Defence Contribution (SDC) Law is amended so that an individual will be subject to SDC only if he or she is a Tax Resident and domiciled in Cyprus.

Following the introduction of the *"non-domicile"* rule, Cyprus Tax Residents who are not domiciled in Cyprus will effectively not be subject to SDC in Cyprus on any dividends, interest and rental income earned.

An individual is considered to be domiciled in Cyprus if he or she has a domicile of origin unless an individual has:

* Obtained and maintained domicile of choice outside Cyprus, given that such an individual has not been a Tax Resident of Cyprus for a period of 20 consecutive years preceding the tax year, or
* Not been a Tax Resident of Cyprus for a period of 20 consecutive years prior to the introduction of the law.

An individual who has been a Tax Resident of Cyprus for at least 17 years out of the last 20 years preceding the tax year will be considered to be domiciled in Cyprus.

It is expected that the non-domiciled rules will further encourage the relocation of high-net-worth individuals to become Tax Residents in Cyprus.

[VII] Extension of Income Tax exemption for new individual taxpayers (The provision is effective as of 1 January 2015.)

Individuals taking up residency and employment in Cyprus are eligible to claim one of the following tax exemptions regarding Income Tax:

1) 20% of their annual employment income earned in Cyprus, up to a maximum of €8,550 per annum, for the first three years of residence. Following the recent amendments the exemption is extended to five years but applicable only for tax years up to 2020;

2) 50% of their annual employment income earned in Cyprus for the first five years of residence, provided that the individual earns more that €100,000 per annum. The period of five years is now extended to ten years.

Regarding employments that started on or after 1 January 2015, there are additional requirements in order to be eligible for the 50% tax exemption:

1) The employee should not have been a Cyprus Tax Resident for a period of three out of five years prior to the commencement of their employment in Cyprus, and

2) The employee should not have been a Cyprus Tax Resident in the tax year preceding the year in which the employment began.

The 50% tax exemption will be available in respect of any tax year in which the taxpayer's annual employment income exceeds €100,000, regardless of whether the income falls below that amount in any year. This provision shall apply provided that when the employment started the income exceeded €100,000 and the Commissioner is satisfied that the variations in the annual income of the employee are not intended for the purpose of obtaining this tax benefit.