ADIT

Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 2.03 – CYPRUS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Prior to the branch disposal

The benefit that will arise to the Cyprus branch as a result of the waiver of the principal amount due to USA SEC Inc. will not constitute taxable income for the Cyprus branch.

Any amount of interest expense waived and which has been claimed by the branch as a tax deductible expense but has not been actually paid, will not be tax deductible. As such, the said expense must form part of the taxable income of the branch for the tax years concerned.

The amount of interest expense waived, which has been claimed by the branch as a tax deductible expense and which has been actually paid, must be apportioned to the tax exempt activities of the branch (the holding of investments) and the taxable activities (the provision of financing to SEC BVI) on a pro rata basis.

The amount of interest expense which is attributed to activities which do not generate taxable income will not be tax deductible.

Up until 30/6/2017, the amount of interest expense attributed to activities which generate taxable income will be tax deductible to the extent that the minimum profit margin of 0.25% is not reduced.

As from 1/7/2017, the profit margin on the back-to-back financing arrangement must be examined in the light of Interpretive Tax Circular 3, dated 30/6/2017 and an appropriate Transfer Pricing Study must be prepared by a transfer pricing expert.

The branch, in its present status, cannot claim the group loss relief provisions of Article

13(4) of the Income Tax law.

However, if the branch elects to be taxed as a Cyprus tax resident company, in accordance with the provisions of Article 5(4) of the Income Tax Law, then it may surrender its tax losses for use against the taxable profits of Cyprus SEC Holdings Ltd, as the two will constitute "group companies" for the purposes of the group loss relief provisions of the Law, given that both, the Cyprus branch and Cyprus SEC Holdings Ltd are at least 75% owned by Cayman SEC Holdings Ltd (subject to the anti-abuse provisions of Article 13(8)(d) of the same Law.

Subject to the above s.5(4) election, the branch loss that can be surrendered in any tax year is the current year tax loss. As such, the branch tax loss of €620,000 may be surrendered against the taxable income of Cyprus SEC Holdings Ltd of €1,980,000.

Branch disposal

The disposal of the branch constitutes a disposal of business. Due to the financial, economic and commercial distress of the branch, it is not expected that the disposal will result in taxable trading goodwill residue. Hence, the branch disposal is not expected to trigger any income tax implications.

The disposal of the office premises of the branch will trigger capital gains tax implications, as the immovable is situated in Cyprus.

The capital gains tax burden is computed as follows:

	€	€
Disposal price		500,000
Less: Cost	350,000	
Indexation allowance (225.57/88.16 @350,000 minus 350,000)	545,525	
		895,525
Capital loss		-395,525
Capital gains tax		NIL

Total

Note: For simplicity's sake, balancing adjustments are not accounted for. Credit was however granted accordingly.

Question 2

In accordance with Article 2 of the Income Tax Law (N118(I) of 2002, as amended) Mr Abdul is considered to be a resident of Cyprus for income tax purposes in tax year 2018, since he lived therein for at least 60 days and he did not reside in any other country more than 183 days, he maintained a rented house in Cyprus and he also exercised an employment in Cyprus which was maintained till 31st December. Therefore, for the tax year 2018 he is subject to income tax in respect of worldwide income earned, subject to any relevant exemptions stipulated by the Law for all Cyprus tax residents.

Concerning Mr Abdul's salaried remuneration (as an executive director), he is entitled to claim the 50% exemption stipulated by Article 9(23) of the Income Tax Law, for 10 years beginning from the year of commencement of employment in Cyprus, i.e. from tax year 2018, irrespective of whether he is considered to be resident in Cyprus for tax purposes during the said 10 year period, given that:

- He was not resident in Cyprus for tax purposes in any 3 out of the 5 tax years prior to the year of commencement of employment in Cyprus, including the tax year prior to the year of commencement of employment, (i.e. the year 2017 and any 2 out of tax years 2013-2016).

- His salaried remuneration for the first year of employment in Cyprus, ie 2018, exceeds €100,000.

Provided:

- His annual salaried remuneration is maintained over €100,000 throughout the years for which the exemption applies, irrespective of whether the said remuneration may fall below €100,000 in any tax year following the year 2018, subject to the satisfaction of the Commissioner of Taxation that any subsequent increase/decrease of the remuneration is not part of scheme put in place in order to denote the taxpayer eligible to claim the particular exemption.

- Since he has income as an executive director, the fees earned relating to his participation on the board of directors of the Cyprus company also form part of the income that is eligible for the exemption.

Dividend income is subject to income tax in accordance with Article 5(1)(c) of the Income Tax Law and is exempt in accordance with Article 5(20) of the same Law.

Interest income earned is subject to income tax in accordance with Article 5(1)(c) of the Income Tax Law and is exempt in accordance with Article 5(19) of the same Law. Given the facts and circumstances surrounding the generation of the particular income, the latter does not seem to be generated in the ordinary course of business of Mr Abdul nor it is considered to be related to his ordinary course of business, hence the said income is eligible for the exemption stipulated by the Law.

As the said interest income is not subject to income tax, the foreign tax withheld at source cannot be relieved at the stage of imposing income tax.

Computation of the taxable income of Mr Abdul for tax year 2018

	€	€
Salaried income (as an executive director)		150,000
Fees (as a non-executive director)		10,000
		160,000
Less: 50% exemption		(80,000)
		80,000
Dividend income	30,000	
Less: amount exempted	(30,000)	-
Interest income	90,000	
Less: amount exempted	(90,000)	-
Taxable Income		80,000

Given that Mr Abdul has a Qatari domicile of origin and that he did not reside in Cyprus during the last 17 years prior to tax year 2018, he is not subject to special defence contribution. As such any foreign tax withheld at source in respect of interest income remains unrelieved.

PART B

Question 3

Part 1
Section 9B deemed interest deduction is calculated on the basis of the 'relevant applicable interest rate' which is taken as the relevant Government 10-year bonds yield plus 3%. The 'relevant Government' is either the Government of the Republic of Cyprus, or the Government of the State in which the new capital has been invested for business purposes.

The relevant interest rate (as determined above) is multiplied by the new Capital injected in the CypCo but is limited to 80% of the taxable income of CypCo.

Part 2

The Austrian company assigns usage of the IP right to CypCo at a fixed annual fee

This fee will be tax deductible from CypCo taxable base at a marginal tax rate of 12.5% but taxable at the Austrian marginal tax rate in the hands of AusCo.

If this fee is paid by CypCo every year, then any required capital injection in CypCo must be in cash.

Russian partners inject cash in CypCo for their part of share capital.

Austrian side assigns usage of the IP rights to CypCo at a fixed annual fee for 10 years but forfeits its receipt in exchange for share capital issued by CypCo to AusCo

In this case, the AusCo tax position in Austria is as in 1 above.

CypCo will not be granted any deductions for IP royalties as it will not be paying any. It will however be entitled to the section 9B deduction in respect of the value of the forfeiture.

Russian partners inject cash in CypCo for their part of share capital.

Austrian side assigns usage of the IP right to CypCo at a fixed annual fee. Russian partners do not inject cash

This fee will be tax deductible from CypCo taxable base at a marginal tax rate of 12.5% but taxable at the Austrian marginal tax rate in the hands of AusCo. If this fee is paid by CypCo every year, then any capital injection in CypCo must be in cash. Russian partners perform an increase in share capital of existing company RusCo and exchange their shares for shares in the CypCo, instead of injecting cash.

RusCo becomes in this case, a controlling or non-controlling subsidiary of CypCo.

Austrian side assigns usage of the IP rights to CypCo at a fixed annual fee for 10 years but forfeits its receipt in exchange for share capital issued by CypCo to AusCo. Russian partners do not inject cash

In this case, the AusCo tax position in Austria is as in 1 above.

CypCo will not be granted any deductions for IP royalties as it will not be paying any. It will however be entitled to the section 9B deduction in respect of the value of the forfeiture.

Russian partners perform an increase in share capital of existing company RusCo and exchange their shares for shares in the CypCo, instead of injecting cash.

RusCo becomes in this case, a controlling or non-controlling subsidiary of CypCo.

Tax risks

Royalty rates charged by AusCo to CypCo, and by CypCo to RusCo, will need to be at arm's length where the 50% ownership threshold is exceeded and hence the companies are treated as related parties for the purposes of the transfer pricing legislation.

If the 'related party' relationship affects Cyprus and Austria only, any TP adjustments in Austria will be offset by corresponding adjustments in Cyprus.

If the 'related party' relationship affects Cyprus and Russia only, any TP adjustments in Russia will perhaps be offset by same adjustments but in the opposite direction in Cyprus (or perhaps not fully offset as Russia is not an EU member State).

The value of the royalties forfeited and deemed as capital contribution by AusCo to CypCo need to be calculated at arm's length if AusCo and CypCo will be related parties, with similar considerations in case of increase in the share capital of RusCo.

PART C

Question 4

Cyprus tax law specifically provides for tax paid overseas to be credited against Cyprus tax of the same income i.e. source by source basis. (s.35(2)&s.35(3) of Law 118/2002).

Above relief is provided for in all of Cyprus's DTAs but if no DTA in place, this relief is granted unilaterally.

Foreign tax credit cannot exceed Cyprus tax as computed in accordance with Cyprus tax law provisions (ordinary credit).

Foreign income taken in the calculation grossed up with the Foreign tax credit.

Foreign tax credit cannot be deducted as an expense (s.35(5) Law 118/2002).

In cases where Cyprus companies (or a Cyprus PE of a foreign company), receives a dividend from a company from another EU Member State (or from a DTA state with relevant provision) and this dividend is subject to corporate income tax or SDC in Cyprus, credit is also given on tax paid on the underlying profits of the foreign company (s.35(5)(c) Law 118/2002). This underlying relief not available to individuals.

Tax sparing credits also available provided there is a relevant provision in a DTA (s.35(5)(c) Law 118/2002.

Taxpayer has an option for non-credit of foreign tax (s.35(8) Law 118/2002).

Notwithstanding any other provisions in Cyprus tax law, profits from a PE abroad are exempt from taxation in Cyprus (s.36(3) Law 118/2002).

If any relief from losses which were attributed to a foreign PE, was granted under s.13 Law 118/2002, these losses will be taxed under s.36(3) in future years (loss recapture).

S.36(3) exemption does not apply if foreign PE engages more than 50% of its activities in investment/passive income AND the tax burden in that foreign Jurisdiction is substantially lower than Cyprus tax burden, i.e. <6.25% (s.36(4) Law 118/2002).

Therefore Art. 23A OECD MC provisions are fully satisfied.

Question 5

The types of Permanent Establishment, as defined in Cyprus Income tax law are the following:-

A fixed place of business

Through which the business of an enterprise wholly or partly is carried on i.e. there must be a place of business such as premises or, in some cases, machinery or equipment, either owned, rented or shared with another enterprise and in which dependent employees operate.

Examples are a place of management; branch; office; factory laboratory; mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

A building site or construction or installation work or supervisory activities

In connection with these constitute a permanent establishment only if it lasts more than three months .

(Note: The OECD Model Convention provides for 12 months. Various DTAs to which Cyprus is a contracting state provide 6 months or 12 months and some 18 months.)

Dependent Agents (Agency PE)

Where a person - other than an independent agent - acting on behalf of an enterprise, has and habitually exercises, in the Republic, authorization to conclude contracts in the name of the enterprise, such enterprise shall be deemed to have a permanent establishment in the Republic in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to cases of auxiliary or preparatory nature.

Note that an enterprise shall not be deemed to have an Agency PE in the Republic merely because it carries on business in the Republic through a broker, general commission agent or any other independent agent, provided that such persons are acting in the ordinary course of their work.

Also, the fact that a company which is a resident of the Republic controls or is controlled by a company which is not resident in the Republic or carries on business outside the Republic, whether through a PE or otherwise, cannot by itself make one company a permanent establishment of the other.

Question 6

Part 1

Both Andreas and B Ltd have an obligation to register for VAT and impose, collect and pay VAT over to the government, as they both engage in taxable transactions in respect of the lease and sublease transactions of the newly erected building.

By reference to the leasing of the building plot, both Andreas and X Ltd have an obligation to register for VAT and apply, collect and pay VAT over to the government, as they both engage in taxable transactions.

Input VAT charged by X Ltd to Andreas is deductible from Andreas's VAT liability, as well as input VAT incurred by X Ltd for the construction is deductible from X Ltd VAT liability.

In respect of the inherited flats, as residential renting is not a commercial Andreas' rental income remains outside the VAT scope.

Part 2

The initial leases of 2017 were outside the scope of VAT, but the new leases of 2018 fall within VAT scope.

This means that for two years (2016 and 2017) out of the ten years as stipulated by VAT legislation over which input VAT on construction prior to the new VAT provisions, input VAT is irrecoverable.

Therefore, as from year 2018 and for each of the next seven years (i.e. eight years in total), input VAT relating to construction VAT of €3,000 (€30,000÷10 years) will be deductible.

Part 3

The sale of the ten flats in 2016 and 2017, were VAT taxable transactions and input VAT incurred for their construction was deductible from Con Ltd VAT liability.

The shops rented out in 2018 fall within the scope of VAT, excluding the shops rented out to the dentist and the physiotherapist whose activities are outside the scope of VAT.

Therefore, the input VAT of €240,000 will only be partly deductible pro-rata the taxable activity on the basis of floor area and time constraint as follows:

Total floor are = 1,000 for flats + 4x50 for shops = 1,200 square meters

Input VAT attributable to the flats sold and deductible as relating to a taxable activity = €240,000 x (1,000/1,200) = €200,000

Of the €40,000 remaining part, years 2016 and 2017 are non-qualifying and therefore €40,000 x 2/10 = €8,000* is non-deductible input VAT, leaving €32,000 deductible. However, as two of the four shops (all of equal floor space) relate to non-taxable activities only €32,000 x (2/4) = €16,000 will be deductible for eight years equally (leaving €16,000** disallowed), starting from year 2018 (i.e. 16,000/8 years = €2,000 per year).

Therefore in total input VAT disallowed will be €8,000*+ €16,000 ** = €24,000 in total.

Question 7

In year 2002, Cyprus had undergone a tax reform to harmonize its tax laws in line with EU law in view of its accession to the EU in year 2004.

As a result a new income tax law (118/2002) and a new special defense contribution law (SDC) (117/2002) as well as major reforms in the Capital Gains Tax (CGT) Law 52/1980 and the Stamp Duty Law, Law 19/1963, Land & Surveys Department (Charges and fees) Law CAP.219, came into force as from year 2003

Merger Directive (2009/133/EC)

The scope of this directive is to exempt or defer any tax liabilities which arise in cases of legitimate business re- organizations which may take the form of a merger, division (or partial division), transfer of assets, exchange of shares, or transfer of registered office of a European Company/European Cooperative society, by exempting from taxation such transactions at the time of the re-organisation.

These provisions have certain anti-avoidance restrictions relating to value shifting between shareholders and exit taxes on liquidation, thus safeguarding the tax interests of the exit EU States involved.

The Directive includes provisions for:

- Non imposition of tax in 'qualifying' re-organisation transactions
- A system of deferral of capital gains tax at the time of the re-organisation
- Transfer of tax losses of the 'acquired company' to the 'acquiring company'

The provisions for non-imposition of income tax have been included in ss26-30 of the Cyprus income tax law (Law 118/2002) and this includes the transfer of depreciable assets at tax written down value, as if no transfer took place. This means that a balancing statement is not required i.e. no balancing adjustment made.

The provisions of tax losses transfer are included in s.13 of the same law.

The provision for deferral of capital gains on the transfer of assets is included in Law 119/2002. Transfer of shares or assets are also exempt from Stamp Duty (Law 19/1963) and in the case of immovable property there is an exemption from land transfer fees and Mortgage fees (CAP. 219).