THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 2.03 – CYPRUS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Dr Zaoui did not spend more than 183 days in Cyprus during 2022 and so prima facie he is not a Cyprus tax resident for year 2022.

However, he did not spend more than 183 days in any single country and assuming the 183-day rule application in France, he was also not tax-resident of France or any other country for that matter.

As Dr Zaoui spent more than 60 days in Cyprus and as (cumulatively) he maintains a permanent home in Cyprus and was also employed in Cyprus, then he could be treated as a tax resident of Cyprus for year 2022 and taxed on his worldwide income in Cyprus.

Part 2

Pension income from France

Per Art.18 OECD MC the residence State (Cyprus) has exclusive taxing rights.

Dr Zaoui's income is assessable only in Cyprus. He will be entitled to a tax refund from the France tax authorities for tax withheld at source.

Foreign pension income is taxed under special mode in Cyprus if taxpayer so elects.

Such income is not aggregated with other income and taxed at rates of 0% and 5% if election is made.

As his income is substantial during 2022, he is advised to make the election for taxation of his foreign pension income.

Outside scope of SDC as non-domiciled but within scope of GeSY.

Rental income from Germany

Subject to income tax.

Not subject to SDC as Dr Zaoui is not Cyprus domiciled but subject to GeSY.

Tax paid in Germany will be relieved against Cyprus tax liabilities on the ordinary credit method (Art.23(b) OECD MC)

Salaried income from Cyprus

Subject to income tax and GeSY in Cyprus. Employer has to deduct PAYE.

Gain on sale of veterinary practice in Paris (Goodwill)

Gain treated as trading goodwill.

Forms part of Dr Zaoui's taxable income in Cyprus as it arose during 2022.

However, it arose from a PE overseas. Taxed in France and exempt from Cyprus tax per s.36 Law 118/2002

Exempt from SDC but subject to GeSY (as non-domiciled).

Bank deposit interest (Germany)

Specifically exempt from income tax in Cyprus.

Not subject to SDC @ 30% in Cyprus as Dr Zaoui is a non-domiciled but subject to GeSY.

Bank deposit interest (Cyprus)

Specifically exempt from income tax in Cyprus.

Not subject to SDC @ 30% in Cyprus as Dr Zaoui is a non-dom, but subject to GeSY.

Dividends from EU listed companies

Specifically exempt from income tax in Cyprus.

Not subject to SDC @ 17% in Cyprus as Dr Zaoui is a non-dom, but subject to GeSY.

Tax withheld in EU source States may be possible to be refunded per their local tax law.

Income from French tourist apartments

Characterised as business income.

As business income arising from an overseas PE, it will be exempt from Cyprus income tax per s.36 Law 118/2002.

As business income, outside SDC scope but subject to GeSY (as non-domiciled).

Gain from trade in European listed shares and bonds

Exempt from both income and capital gains tax as these financial instruments are included in the list of the ‘titles’ definition.

Exempt from SDC but subject to GeSY contributions.

GeSY contributions are capped to an assessable income of €180,000 p.a.

Question 2

Part 1

Mr Lux is related to his company LuxCo SA (re: >25% shareholding) and both Mr Lux and LuxCo SA are related to CypCo Ltd (re: >25% shareholding in CypCo Ltd) and all previous 3 parties are related to Mr Costas (re: >25% shareholding in CypCo).

Mr Lux, LuxCo SA, CypCo Ltd and Mr Costas are related to CypManCo Ltd (re: >25% in CypManCo Ltd) and Ms Aishen (re: >25% in CypManCo Ltd).

Mr Lux and LuxCo SA are also related to GregCo AE (re: >25% shareholding in GreCo AE) and EngCo Ltd (re: >25% shareholding in EngCo Ltd).

Therefore, due to the fact that LuxCo SA is related to CypManCo Ltd, GreCo AE and EngCo Ltd, then CypManCo Ltd is also indirectly related to GreCo AE and EngCo Ltd as these three companies are all under indirect common control of Mr Lux, Mr Costas and Ms Aishen.

Part 2

The loan advanced from LuxCo SA to CypCo Ltd is a controlled transaction as these two parties are related.

Also, the fact that CypCo Ltd advanced a loan to its related party CypManCo Ltd, also a controlled transaction, creates a back-to back loan relationship.

The loans advanced by CypManCo Ltd to Mr Costas (indirect shareholder with effective control of 28% (40% x 70%) and Ms Aishen are loans advanced to shareholders and any deemed interest arising due to favorable annual interest rate (of less than 9% - in this case only 3% p.a. is charged) will be assessed as a Benefit in Kind on Mr Costas and Ms Aishen personal income, also attracting Social Security and GeSY contributions.

Loans advanced to CypS1 Ltd and CypS2 Ltd are not controlled transactions as these companies are unrelated to the remaining parties who are related between them (less than 25% shareholding).

Part 3

In relation to Notes 3 and 4, the controlled price at which CypManCo Ltd sold to related party GreCo AE of €5 per unit is less than the €6.50 per unit which was charged to unrelated parties in the Greek Market. Therefore, CypManCo Ltd charged its related party a discounted price of €1.50 per unit or 30% (1.50 / 5) less mark-up which represents a 2.5 million x 30% = €750,000, this latter amount being a reasonable taxable profits adjustment.

In relation to Notes 5 and 6, the controlled price at which CypManCo Ltd sold to related party EngCo Ltd of €7 per unit is less than the €8.50 per unit which was charged to unrelated parties in the English Market. Therefore, CypManCo Ltd charged its related party a discounted price of €1.50 per unit or 21.43% (1.50 / 7) less mark-up which represents a 22.5 million x 21.43% = €4,821,429, this latter amount being a reasonable taxable profits adjustment.

Part 4

Although CypCo Ltd advanced loans to unrelated parties (CypS1 Ltd and CypS2 Ltd), and one could argue that the annual interest rates of 7% and 6% could be deemed as comparable uncontrolled prices, this is not entirely correct for the following reasons:

- Interest rates charged to the two unrelated parties are different and there are other factors that affect the arm's length 'price'.
- A loan interest rate includes certain premiums which relate to certain risks affecting the borrower such as operational, default/gearing and control risks for which no data is provided in the question.
- The actual amounts of the loans advanced to related and unrelated parties differ significantly between them, which constitutes another factor why it is impossible to measure total risk and therefore the required premium on the loan.
- The duration of the loans is not specified in the question, which constitutes another factor why it is impossible to measure total risk and therefore the required premium on the loan.

Safe harbour rules are as follows:

- Back-to-back loans: 2.5% pre-tax margin on loans receivable balance including interest.
- If financing is used in purely for trading activities purposes of the borrower: 1.5% + 10-year Sovereign bond yield
- If financing is from equity capital of the lender: 3.5% + 10-year Sovereign bond yield.

PART B

Question 3

Part 1

The calculation of taxable profits or benefits of an owner of a ship or aircraft, are based on a proportion of the sales of services in the Republic (in respect of fares or freight for passengers, goods or mail shipped in Cyprus).

The proportion is based on a certificate by the taxing authority of the country in which the principal place of business of the owner of a ship or aircraft is situated.

The certificate must state:

- that the owner of a ship or aircraft has furnished, to the satisfaction of that authority, an account of the whole of his business; and
- the ratio of the profits or benefits for the relevant accounting period to the gross income of the owner of a ship or aircraft for that period, as computed according to the income tax law of that country, after deducting interest on any monies borrowed and employed in acquiring the profits or benefits.

If the profits or benefits of an owner of a ship or aircraft have been computed on any basis other than the ratio of the profits or benefits, shown by a certificate as explained above, at any time within 2 years from the end of the year of assessment the owner of a ship or aircraft is entitled to such revision as may be necessary to give effect to the said certificate and to have any tax paid in excess refunded.

Profits or benefits arising from the business of operating ships or aircraft carried on by a person who is not resident in the Republic, shall be exempted from tax, provided that the Minister of Finance is satisfied that an equivalent exemption from income tax is granted by the country in which such person is resident to persons resident in the Republic.

As from tax year 2010, on coming into force of the Merchant Shipping (Fees and Taxing Provisions) Law of 2010, Law 44(I)/10 eligible ship owners of Cyprus ships continue to be exempt from income tax in respect of their Cyprus ship profits, as well as dividends paid directly or indirectly out of those profits.

Any expenses relating directly or indirectly to this activity which is tax exempt as well as a proportion of indirect expenses are deductible from these profits and cannot in any way reduce other income which is taxable at normal rates.

The shipping profits of owners of Community ships are subject to Cyprus income tax like any other business unless they have elected to be subject to tonnage tax under the Merchant Shipping (Fees and Taxing Provisions) Law 44(I)/10. In such case they are exempt from income tax.

Part 2

Ship managers are subject to income tax and/or special defence contribution like any other person who is a Cyprus tax resident.

However, if a qualifying ship manager has opted to be taxed under the tonnage tax system in accordance with the Merchant Shipping (Fees and Taxing Provisions) Law 44(I)/10, such option being subject to remaining in force for at least 10 years, such a ship manager is eligible to tax exemptions (income tax and special defence contribution) in respect of the ship management profits, and in respect of interest income on bank accounts used in paying ship management expenses.

Furthermore, any dividends paid directly or indirectly out of such ship management profits are also exempt from special defence contribution.

Part 3

The gross amount of any royalty, premium, compensation or other income derived from sources within the Republic by any person not being resident in the Republic, who is not engaged in any business in the Republic, in consideration for the use of, or for the privilege of using, any copyright, patent, design, secret process or formula, trade mark, know-how or any other like property or in consideration of technical assistance are subject to tax withholding at 10% at source (but see below).

Royalties paid to non-resident associated companies.

Royalties paid are not subject to withholding tax if the beneficial owner receiving such royalties is an associated company of another EU Member state or a permanent establishment of such company situated in another Member state where such royalties are paid:

- by a company which is resident in the Republic, without considering incomes paid through its permanent establishment situated in a state other than a member state; or
- by a permanent establishment in the Republic of a company which is not a resident in the Republic and where such income represents a tax-deductible expense for such permanent establishment.

The exemption as set out above as well as the film rental exemption applicable to film rentals is in conformity with the Royalties Directive 2003/49/EC of 3.6.2003 and applies to payments made on or after 1.5.2004 by virtue of the Income Tax (Amendment) Law 195(I)/2004.

Royalties arising outside the Republic in respect of rights granted by a Cyprus tax resident person to a non-Cyprus tax resident person for use outside the Republic are not subject to withholding tax, as such royalties are not deemed to be income derived from sources within the Republic.

Income of foreign resident scientists and performing artists

Non-resident scientists, athletes and artists performing in Cyprus are subject to a 10% withholding tax at source on their gross income which include their expenses re-imbursement (if any).

Question 4

Part 1

Derek is not a Cyprus tax resident based on the 183 days rule.

Derek may be Cyprus tax resident on the 60-day rule basis if he did not spend more than 183 days in any other country or he is not treated as tax resident of another country.

As Derek is treated as a Swiss tax resident, he will not be treated as a Cyprus tax resident based on Cyprus tax law provisions and the OECD MC.

Although Derek spent more days in Cyprus (100) than in Switzerland (95), and assuming no other country (i.e. France, Macau and Tahiti) can claim his tax residency, OECD MC Article 4 tie-breaker rule will render Swiss tax residency claim to be superior to Cyprus's tax residency claim as Derek's centre of vital interests (mostly family) are found in Switzerland.

Part 2

Per the analysis in Part 1 above, Derek is not a Cyprus tax resident, and therefore he will be taxed in Cyprus on income from Cyprus sources only.

Cyprus taxable income will therefore consist of:

	€
Salary	80,000
Annual value of house BIK	3,506 (higher of 300K and 320K at 4% x 100 / 365)
House bills BIK	8,640 (9,000 less 360 for exempt internet/TV)
Summer school bills BIK	3,200
Use of car BIK*	3,027 (65,000 x 17% x 100/365))
Repair and upkeep car BIK*	712 (65,000 x 4% x 100/365)
Fuel car benefit BIK*	890 (65,000 x 5% x 100/365)
Total taxable income	99,975

* As the travel from home to work and back is considered private use, all calculated BIK values will be deemed private use.

PART C

Question 5

As from 1 January 2003, "Resident of the Republic", when applied to an individual (at least 60 days as from 1 January 2017 under certain conditions (see below)), means a person who stays in Cyprus for a period or periods exceeding in aggregate 183 days in any tax year.

For purposes of calculating the days of stay in Cyprus:

a) the day of departure from Cyprus counts as a day outside Cyprus.
b) the day of arrival in Cyprus counts as a day in Cyprus.
c) the arrival to Cyprus and the departure from Cyprus during in the same day counts as one day in Cyprus; and
d) the departure from Cyprus and return to Cyprus the same day counts as a day outside Cyprus.

In the case of an individual, the tax residence is in Cyprus if during the tax year (1 January to 31 December) such individual cumulatively resides in Cyprus on one or more occasions that exceed 183 days in total and an individual who resides in Cyprus for less than 184 days in a calendar year is not considered to be a tax resident in Cyprus during that year.

As from 1 January 2017 however, i.e. for the year of assessment 2017 and later years, an individual may also be a tax resident of the Republic if he is an individual who does not remain in any other state for one or more periods for more than 183 days in the same year of assessment and who is not a tax resident in any other state for the same year, shall be deemed to be a resident of the Republic in that year of assessment, provided that such individual meets cumulatively the following:

- resides in the Republic for at least 60 days in the year of assessment,
- carries out any business in the Republic and/or is employed in the Republic and/or holds an office in a company resident in the Republic at any time during the year of assessment,
- maintains a permanent residence in the Republic which is owned or rented by such individual.

For the purposes of the above proviso, an individual who cumulatively satisfies the above shall not be considered a resident in the Republic in the year of assessment, if, in that year, such individual terminates the exercise of any business in the Republic and/or his employment in the Republic and/or the holding of an office in a company which is a tax resident in the Republic.

It should be noted that an individual, who is a tax resident in Cyprus according to the rule of the 60-day residence in Cyprus, is obliged to pay the special defense contribution (SDC) under the SDC Law if at the same time he has a residence (domicile) in Cyprus and will also be subject to GeSY contributions.

Question 6

Interest expense is restricted by s.11(15) Law 117/2002, when the credit obtained was for the purpose of acquiring:

a) Private motor vehicles, as determined by the Road Transport Department.
b)
   i) Other assets not used in the business eg. Acquisition of shares in public or private companies, land and buildings, yachts, artworks, and other chattels.
   ii) Securities or titles or shares that generate interest income, such as bonds, do not fall into this category and there is no restriction on interest according to section 11(15). If, however, the issuers of the securities or titles or shares are associated companies, the provisions of section 33 of the Income Tax Law shall apply for the purposes of taxing the interest receivable.
   iii) Acquisition of assets that are used by a foreign branch of a business (the income of which is exempt from tax), interest on loans and other debts that have directly or indirectly been employed in such branch activity, as well as a proportion of interest that has not been allocated directly or indirectly in any branch activity are restricted. Circular 2008/14, 18.12.2008 (loss deduction).
   iv) Interest paid by a person not carrying on any business such as a dormant of a ceased business is not deductible (as not incurred wholly and exclusively for income production).

Calculation of interest restriction

Restriction of interest is made if a business paid interest attributable or deemed attributable to a particular asset, irrespective of whether the business has a loan, or any other interest-bearing debt associated directly or indirectly with the acquisition of the asset.

Allowable interest is limited to the amount borne which corresponds to the principal loan/credit obtained up to the acquisition cost of the related asset multiplied by the percentage of the 'cost of borrowing' of the business.

'Cost of borrowing'

If an interest-bearing loan or other interest-bearing debt has been specifically used for the acquisition of a business asset and the loan or debt completely covers the cost of the asset, the interest rate (plus the related costs) of the loan or debt are tax allowable.

If the loan or part of the loan is repaid before the expiration of seven years, with respect to the part of the cost which corresponds to the part of the loan which has been paid off, unless replaced by a second loan, the weighted average of the interest rates charged on the company on all of its loans and other interest-bearing debts will be considered as the percentage of the 'cost of borrowing'.

In calculating the weighted average, interest free loans can be included, if these were not considered for the purposes of any of the exceptions stipulated in s.11(15), and includes other miscellaneous fees charged by banks or other credit institutions, unless these were of a capital nature.

Further, as from 1.1.2019, any a business' lending cost cannot exceed 30% of the taxable Income Before Interest, Taxes, Compensation and Depreciation (IBITCD), where the IBITCD is determined by adding back the 'excess' lending cost, the adjusted amounts for deductions, allowances and additions regarding fixed assets granted under s.10 Law 117/2002 re: capital allowances, and adjusted amounts for deductions, allowances and additions relating to intangible assets under paragraphs (d), (e), (k) and (l) of subsection (1) of s.9 Law 117/2002, tax losses brought forward under s.13 Law 117/2002, and after deducting any exempt income.

Furthermore, it is possible to carry forward 'excess' lending costs of the year in which incurred in the following five subsequent years of assessment. The excess borrowing cost shall be deducted up to the amount of €3.000,000 per year of assessment, per stand-alone Cyprus company or per Cyprus group.

Question 7

Part 1

In respect of the constructed building, Angelica, Beta Ltd and Cee Ltd have an obligation to register for VAT and apply, collect, and pay VAT over to the government, as all of these parties engage in taxable transactions.

In respect of the building plot, Angelica and Xi Ltd will 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 Angelica to Xi Ltd is deductible from Xi Ltd's VAT liability, as well as input VAT incurred by Xi Ltd for the construction is deductible from Xi Ltd VAT Liability.

In respect of the inherited residential flats which are rented out on long-term rental agreements to families for residential purposes, this type of activity is not commercial, nor is the purpose for which his flats are rented out, and therefore this activity remains outside the scope of VAT.

Part 2

The initial leases of 2017 were outside the scope of VAT, but the new leases of 2023 fall within VAT scope.

This means that for seven years (2016 - 2022) out of the ten years as stipulated by VAT legislation over which input VAT on construction prior to the new VAT provisions came into force, input VAT is irrecoverable.

Therefore, as from year 2023 and for each of the next two years (i.e. three 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 2021 and 2022, were VAT taxable transactions and input VAT incurred for their construction was deductible from Con Ltd VAT liability.

The shops rented out in 2023 fall within the scope of VAT. However, the shops rented out to the dentist and the physiotherapist whose activities are outside the VAT scope, will be outside the scope of VAT.

Therefore, the input VAT of €240.000 will only be partly deductible pro-rata the taxable activity based on floor area and time constraint as follows:

Total floor area = 1,000 for flats + (4 x 50) 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

The €40,000 remaining input VAT is deductible. However, as two of the four shops (all of equal floor space) relate to non-taxable activities, only €40,000 x (2 / 4) = €20,000 will be deductible for ten years equally (leaving €20,000 Input VAT disallowed), starting from year 2023 (i.e. 20,000 / 10 years = €2,000 per year).

Question 8

ABC Holdings Ltd's 2023 Corporation Tax computation is as follows:

	€
Dividends from AB Ltd – exempt	0
Dividends from CD Ltd (re-characterized as interest) 40000/95%	42,105*
Interest from EF Ltd (12,000/75%)	16,000
Branch 1 dividends/profits (exempt s.36 Law 118/2002)	0
Branch 2 dividends/profits (exempt s 36 Law 118/2002)	0
Tourist apartments – Spain (exempt s 36 Law 118/2002)	0
Branch 3 losses (restricted)	(58,105)
Taxable income	0
Corporation Tax liability	0
SDC liability	0

* Application of s8(20) of Law 118/2002

Assumptions

The nature of the company's activities relates to investments and therefore interest income is treated as active income.

Notes

Foreign branch profits are exempt from taxation. Reference to dividends from foreign branches is not applicable.

Tourist apartments in Spain are deemed as a permanent establishment overseas (s.5(s) Law 119/2002 definition) and exempt from taxation per s 36 Law 118/2002.

Tax relief for foreign branch losses may be claimed under s13 Law 2002. The unutilized branch losses of 2023 (80,000-58,105) cannot be carried forward to the year 2024. If in future years Branch 3 turns profitable, the number of losses of €58,105 claimed in 2023 will be taxed in that future year or years (recapture of losses).

If interest from CD Ltd or EF Ltd or both CD Ltd and EF Ltd are treated as passive interest income, they will be exempt from income tax. Hence more of the Branch 3 losses of €80,000 will remain unutilized. Such income will however be subject to SDC at a rate of 17% which is applicable to interest income.