THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 2.03 – CYPRUS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Sidetrack Ltd

The amount of the Loan waived by the company prior to its assignment to Sidetrack Treasury Ltd, amounting to €4 million will constitute a non-tax deductible loss for the company, in accordance with the provisions of Article 11 of the Income Tax Law.

The loss incurred by the company as a result of the transfer of the shares held in Sidetrack Treasury Ltd to Finance Company Ltd will constitute a non-tax deductible loss for the company, in accordance with the provisions of Article 8(22) of the Income Tax Law.

The interest expense incurred by the company in order to acquire the rights to the Loan from EUB shall constitute a tax deductible expense, subject to the following restrictions:

If the terms of the loan obtained from the French group company are not based on arm's length principles, the provisions of Article 33 of the Income Tax Law will apply and the tax deductible amount will be restricted to the arm's length based amount.

If Sidetrack Ltd owns assets not used in the business, the interest expense will be tax deductible to the extent of the amount that is not directly, or indirectly attributed to the said non-business assets, in accordance with the relevant provisions of Article 11(15) of the Income Tax Law and Tax Circular 2010/8 dated 7/6/2010.

The tax deduction will further be restricted in accordance with the provisions of Article 11(16) of the Income Tax Law.

Finance Company Ltd

The in kind liquidation proceeds (Loan Receivable) to be received by the company as a result of the liquidation of the its subsidiary Sidetrack Treasury Ltd do not constitute taxable income for the purposes of the Income Tax Law, nor for the purposes of the Special Contribution for the Defence of the Republic Law.

Any dividends to be received by the company from Sidetrack Treasury Ltd prior to the latter's liquidation, shall be exempt from income tax in accordance with the provisions of Article 8(20) of the Income Tax Law, and shall also be exempt from special contribution for the defence, in accordance with the provisions of Article 3(2)(a) of the Special Contribution for the Defence of the Republic Law, since Sidetrack Treasury Ltd is a trading company.

The company shall be eligible to claim Notional Interest Deduction (NID) in respect of the new equity to be issued to Sidetrack Ltd, which qualifies as "new capital", in accordance with the provisions of Article 9B of the Income Tax Law and Tax Circular 2016/10, dated 18/7/2016, subject to the following:

1. The NID will be available for as long as the new capital remains in place and the assets in which the funds obtained from the share issue produce and continue to produce taxable income.

2. The amount of NID is equivalent to the lower of:

    - "new capital" multiplied by the "reference rate", and
    - 80% of the taxable income produced by the assets in which the new capital is invested.

3. The NID shall be reduced by an amount equivalent to the interest expense claimed by Sidetrack Ltd, since the amount contributed by the latter to Finance Company Ltd, being the Loan Receivable, was financed by a loan.

The amount of the Loan outstanding which is to be written off by the company, will constitute a non-tax deductible loss for the company, in accordance with the provisions of Article 11 of the Income Tax Law.

Alternatively, if the outstanding amount of the Loan is settled by way of issue of shares by Sidetrack Medical Ukraine, any gain, to be realised by Finance Company Ltd upon settlement, effectively this representing interest income, shall be subject to income tax and shall be exempt from special contribution for the defence, on the basis that it represents income generated from or closely related to the trading activities of the company.

Question 2

Part 1

The property-holding arrangement described, and as for long as the immovable property which is located in Portugal, is held by Santafe Ltd solely for the personal use and enjoyment of Mr Sheffield and his family and not for the purpose of carrying on any business that falls within the scope of the provisions of Article 5(1)(a) of the Income Tax Law, will not trigger any income tax implications for Santafe Ltd.

Likewise, any expenses to be incurred by the company, including the cost for outsourcing the services described, will not constitute tax deductible expenses for the company.

The company will not be entitled to claim any wear and tear allowances either, in respect of the property, nor it will be entitled to claim Notional Interest Deduction (NID), in respect of the shares to be issued to Mr Damien.

Given that the shareholder of Santafe Ltd, Mr Sheffield, is a non-Cyprus tax resident and non-Cyprus domiciled individual, the company shall not be subject to the deemed dividend distribution provisions of the Special Contribution for the Defence of the Republic Law.

Given that Mr Sheffield and his family members are all non-Cyprus tax resident individuals and given also that the immovable property owned by Santafe Ltd is not located in Cyprus, no benefit in kind considerations shall be triggered, for income tax purposes.

On the same basis, since Mr Sheffield is a non-Cyprus tax resident and non-Cyprus domiciled individual, he shall not be liable to the provisions of the Special Contribution for the Defence of the Republic Law, in the event of any dividend distributions by the company.

Part 2

In the event that Santafe Ltd opts to commercially exploit the property by renting the property out to third or related parties (including Mr Sheffield and his family) and outsources the provision of support personnel to a professional service provider (third party or related party), which will act solely on behalf of Santafe Ltd and will not act in the course of carrying a business as an independent agent, the said service provider shall constitute a permanent establishment abroad, belonging to Santafe Ltd, in accordance with the provisions of Article 2 of the Income Tax Law.

As such, Santafe Ltd may opt so that, the rental income generated from such permanent establishment will be exempt from income tax in accordance with the provisions of Article 36(3) of the Income Tax Law.

Any related expenses to be incurred by Santafel Ltd, wholly and exclusively for the production of its income and other deductions, in accordance with the relevant provisions of the Income Tax Law and relevant Tax Circulars, shall be attributed to the tax exempt permanent establishment in Portugal, on the basis of Tax Circular 2008/14 dated 18/12/2008.

Provided also that the sole activity of the permanent establishment shall be the letting out of the property, the said rental income shall be exempt from the provisions of the Special Contribution for the Defence of the Republic Law.

In the event that, Santafe Ltd opts instead to be taxed in Cyprus in respect of the profits to be generated by the permanent establishment in Portugal, as established in sub-par.(i) above, will be subject to income tax as per the provisions of Article 5(1)(a) of the Income Tax Law, at the rate of 12.5%, as per Appendix II of the Income Tax Law.

Any related expenses to be incurred by the company wholly and exclusively for the production of its income and other deductions, including capital allowances for the use of the property, at the rate of 3%, as per Article 10 of the Income Tax Law, shall be tax deductible.

The company shall also be eligible to claim NID in relation to the issue of shares to Mr Damien (in return for the property contribution to the company), as per Article 9B of the Income Tax Law and Tax Circular 2016/10 dated 18/7/2016.

Santafe Ltd will also be subject to special contribution for the defence at the rate of 3%, in respect to the rental income to be generated, subject to a 25% deemed deduction.

Additionally, the company will be eligible to claim double tax relief in accordance with Article 35 of the Income Tax Law, the provisions of Tax Circular 2011/4 dated 7/12/2011 and the provisions of the Double Tax Agreement between Cyprus and Portugal.

For the purposes of the above, where the service provider or the property tenant is a party related to the company, the terms of the transactions between them must be based on arm's length principles, otherwise the provisions of Article 33 of the Income Tax Law shall be triggered.

Likewise, and where applicable, the funding of the expenses to be effected by Mr Sheffield by means of injecting funds, as a loan provided to the company, must also be based on arm's length principles, otherwise the provisions of Article 33 of the Income Tax Law shall be triggered.

The arm's length based interest expense to be incurred by the company, shall also be tax deductible, subject to the provisions of Article 11(15) of the Income Tax Law and Tax Circular 2010/8 dated 7/6/2010.

If the service provider shall act in the course of carrying a business as an independent agent, the said provider shall not constitute a permanent establishment abroad for Santafe Ltd, in accordance with the provisions of Article 2 of the Income Tax Law.

Part 3

Any gain to be generated by Santafe Ltd upon the future disposal of the immovable property shall be exempt from capital gains tax.

However, if in the light of the badges of trade, the disposal proves to be a transaction that forms part of the ordinary business activities of Santafe Ltd, the company shall be subject to income tax in respect of the said gain, and any respective loss, shall be tax deductible.

For the purposes of computing the gain or loss upon disposal, for income tax purposes, any expenses incurred wholly and exclusively for the production of income shall be tax deductible, as per the relevant provisions of the Income Tax Law and Tax Circulars.

PART B

Question 3

Rationale

The primary concern of the OECD BEPS initiative has been the possibility available to enterprises which are tax resident in high taxing jurisdictions, to create affiliated non-resident low or zero taxed enterprises and route or channel income generated by the said resident enterprises to the non-resident affiliates.

Prior to the BEPS initiative, Controlled Foreign Companies rules (CFC rules) and other antideferral rules were introduced by many countries to address this issue. However, the CFC rules of many countries did not always counter base erosion and profit shifting in a comprehensive manner; hence the BEPS initiative.

CFC rules have the effect of re-attributing the income of a foreign low-taxed controlled subsidiary to its parent company, and the latter becomes taxable on this attributed income in the state where it is resident for tax purposes. CFC rules may target an entire low-taxed subsidiary, specific categories of income or may be limited to income which has artificially been diverted to the subsidiary.

Where a state limits its CFC rules to income which has been artificially diverted to the subsidiary, effectively targets situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the state of the parent/controller.

CFC rules also extend to the profits of corporate permanent establishments/branches where those profits are not subject to tax or are tax exempt in the country of residence of the corporate head office. However, there is no need to tax under the CFC rules, the profits of permanent establishments/branches which are denied the tax exemption under national rules of the corporate head office, or the profits of the foreign permanent establishments/branches of the CFC which are not taxed in the jurisdiction of the CFC.

For EU tax purposes, in the context of the Anti-Tax Avoidance Directive I (ATAD I), it has been desirable to address such situations both, where the CFC is located within the EU as well as within third countries. Also, in order to comply with EU fundamental freedoms, the income categories have been combined with a substance carve-out, aimed to limit within the EU the impact of the rules to cases where, inter alia, the CFC does not carry on a substantive economic activity or where specific de-minimis rules apply.

While CFC rules in principle lead to inclusions in the residence country of the ultimate parent/corporate head office, they also have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

Cyprus Income Tax Law – Article 36A (applicable as from 1/1/2019)

Cyprus opted to follow “Model B” approach of ATAD I, which aims to tax undistributed income from non-genuine arrangements of a Controlled Foreign Company/Branch (the “CFC”), to the extent of the Cyprus tax resident company’s/corporate head office’s effective % participation interest therein. Losses of the CFC are also included in the tax base of the Cyprus tax resident parent/corporate head office, accordingly.

A CFC is an exempt foreign permanent establishment or a foreign company (in which a Cyprus tax resident company has, directly or indirectly, alone or with associates (as defined by Article 11(16) of the Income Tax Law), more than 50% interest in share capital, voting rights or profits), and whose actual corporate tax burden is lower than 50% of the tax that would have been charged on the company or permanent establishment under the applicable Cyprus corporate tax system.

The permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account.

Undistributed income of a CFC is equivalent to the amount of its accounting profits after tax, as depicted in its financial statements which must be prepared in accordance with accounting principles accepted by the Commissioner of Taxation, and which have not been distributed during the tax year to which they relate or within the 7 months following the said tax year.

Non-genuine arrangements, are those arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

Such arrangements shall be considered to be in place, if in the light of the "significant people functions test", the CFC would not have owned the assets or would not have undertaken the risks which generate all or part of its income, if it were not controlled by the Cyprus company where the significant people functions relevant to the CFC's assets and risks are carried out.

The profits/losses of the CFC that should be included in the tax base of the Cyprus controller, must be based on the arm's length principle, must also be grossed up with any amount of foreign tax paid by the CFC and should be so included, in the tax year of the Cyprus controller in which the relevant tax year of the CFC ends.

In the following cases, the profits of a CFC shall not be subject to the CFC rule:

- the CFC has accounting profits of no more than EUR 750,000 and non-trading income of no more than EUR 75,000; or

- the CFC's accounting profits amount to no more than 10 percent of its operating costs for the tax period. The operating costs do not include the cost of goods sold outside the country in which the CFC is tax resident, nor it includes payments to associated enterprises.

For the purpose of avoiding double taxation, the distributed profits of the CFC or the proceeds from the disposal of the CFC, which are not exempt from tax under the provisions of Article 8 of the Income Tax Law in the tax year of distribution and which have already been taken into account under the CFC rule for the purpose of computing the taxable income of the Cyprus controller in a previous tax year (irrespective of whether they were actually taxed or tax exempt at the time under the provisions of Article 8 of the Income Tax Law), shall not constitute taxable income for the Cyprus tax resident company in the tax year of distribution.

The actual collection/receipt of profits by the Cyprus controller, which related to profits of the CFC which were included in the taxable income of the former in a previous tax year, under the CFC rule, and irrespective of whether they were exempt from tax under the provisions of Article 8 of the Income Tax Law at the time, will not constitute to be dividend income for the purposes of the Special Contribution for the Defence of the Republic Law.

Likewise, any foreign tax paid by the CFC in respect of the income which is subject to tax in Cyprus under the CFC rule, is allowed as a credit against the tax paid in Cyprus, subject to the relevant provisions of the Income Tax Law.

PART C

Question 4

Income tax implications

In accordance with Article 2 of the Income Tax Law, Mr Zubyk is considered to be resident in Cyprus for the year 2020, given that, during 2020:

- He has resided in Cyprus for at least 60 days;
- He was not tax resident in any other state, neither he resided in any other state for a period or more which in aggregate they exceed 183 days;
- He has been employed as a CEO by the Cyprus tax resident company Astir Ltd, without cessation of the employment prior to the end of 2020 and till now; and
- He maintained a permanent private residence in Cyprus.

As a Cyprus tax resident individual, Mr Zubyk shall be subject to income tax in respect of his worldwide income, in accordance with Article 5(1) of the Income Tax Law.

In accordance with Article 2 of the Income Tax Law, the business activities carried on by Mr Zubyk through the "Individual Entrepreneurship (Bulgarian IE), constitutes a permanent establishment (PE) in Bulgaria, given that:

- The relevant activities are carried on through a fixed place of business; and
- The activities attributed to the PE are not of an ancillary/supportive nature, relative to the nature of the business of the PE.

Given also that, the PE does not engage, directly or indirectly, more than 50% in activities which lead to investment income, as per Article 36(4) of the Income Tax Law, Mr Zubyk may opt to be exempt from income tax in respect of his share of profits generated by the PE, in accordance with Article 36(3) of the Income Tax Law.

Any income earned by him in the form of interest shall be exempt from income tax, provided that, if assessed in the light of the badges of trade, it proves that it does not constitute trading income, that is, income which is generated from or is considered to be closely connected with the ordinary course of trade of Mr Zubyk.

Any foreign exchange differences to be incurred upon the conversion of BGN funds into US dollars, shall be treated as tax neutral for income tax purposes, in accordance with Article 8(24) of the Income Tax Law, on the basis that Mr Zubyk does not engage in the trading of foreign currencies.

Special contribution for the defence implications

Given that Mr Zubyk's domicile of origin is not Cyprus and that he was for at least 20 consecutive years prior to 2020 a non-Cyprus tax resident individual, any income earned by him in the form of interest (that is, it does not prove to be generated from nor is considered to be closely connected with the ordinary course of trade of Mr Zubyk as assessed in the light of the badges of trade), shall be exempt from special contribution for the defence.

In the event that Mr Zubyk shall maintain a Cyprus tax residency status for tax year 2020 and subsequent tax years, he shall be eligible to claim a non-Cyprus domicile status for the tax years 2020-2036 inclusive, he shall be exempt from special contribution for the defence throughout these years, in respect of the above mentioned interest income.

Question 5

Part 1

Given that Mr Versuse is a Cyprus tax resident individual, he shall be subject to income tax in respect of his worldwide income, in accordance with Article 5(1) of the Income Tax Law.

The annual remuneration earned by Mr Versuse shall be liable to income tax, subject to a 50% exemption, as stipulated by Article 8(23) of the Income Tax Law, given that:

- his total annual gross remuneration exceeds €100,000;
- he was tax resident outside Cyprus prior to the commencement of employment in Cyprus; and
- he wasn't tax resident in Cyprus in any 3 out of the 5 tax years prior to the commencement of employment in Cyprus.

Any gain to be generated or loss to be incurred by Mr Versuse if he exercises the "put option" in 2021, will not be taxable or tax deductible respectively, since the underlying assets of the put option is shares, which constitute qualifying "titles", as per Article 2 and Article 8(22) of the Income Tax Law.

In the event Mr Versuse opts to cancel the Agreement in 2021 in return for the stipulated compensation, in the light of the information provided, the said cancellation shall constitute to be a transaction of a capital nature, therefore no income tax implications shall arise (the amount of the compensation paid shall not be a tax deductible expense for Mr Versuse).

Part 2

Given that in 2021, Mr Versuse shall be a Cyprus tax resident individual and given also that he is a Cyprus domiciled individual too, the coupon interest income earned as a result of investing in corporate bonds, shall be subject to special contribution for the defence at the rate of 3%.

Question 6

Part 1

The shares held in Leslic Ltd constitute "property" for the purposes of Article 2 of the Capital Gains Tax Law, since Leslic Ltd owns immovable property in Cyprus. As such, the transfer of the said shares by Asamic Ltd to Zevodiac Real Estate Investment Fund Ltd, shall constitute a "disposal of property", in accordance with Article 10 of the Capital Gains Tax Law and capital gains tax implications might arise, depending on the amounts involved.

Capital gains tax shall be imposed on the capital gain that will arise, which must be computed as the difference between the sale price/transfer value of shares transferred and the value of the immovable property owned by Leslic Ltd as at the date of the share transfer, and after allowing for an indexation allowance (representing the increase in the value of the property between the date of its acquisition and the date of the share transfer) as well as relevant tax deductible expenses, if any.

However, if the share transfer is carried out through a reorganisation procedure which falls within the scope of Article 10(i) of the Capital Gains Tax Law, no capital gains tax implications shall arise.

This reorganisation procedure should entail the transfer of shares held by Asamic Ltd in Leslic Ltd, to Zevodiac Real Estate Investment Fund Ltd, in exchange for the issue of shares by the latter company to Asamic Ltd. If the settlement consideration shall also include cash, the cash consideration must not exceed 10% of the nominal value of the shares transferred (in the absence of a nominal value, the accounting value of shares transferred may be used instead).

Part 2

The entrance of new investors in Zevodiac Real Estate Investment Fund Ltd, whilst the latter is not listed on a recognised Stock Exchange market, will constitute a "disposal of property", in accordance with Article 10 of the Capital Gains Tax Law, since the shareholdings of the existing Participating Shareholders, shall be "diluted" upon the entrance of new investors in the Fund. The "dilution" shall occur on the basis that the shares held by the existing Participating Shareholders constitute "property" for the purposes of Article 2 of the Capital Gains Tax Law (since the Participating Shareholders hold indirectly the shares of Leslic Ltd which owns immovable property in Cyprus). Therefore, capital gains tax implications might arise, depending on the relevant amounts involved.

For the purposes of computing the relevant capital gain or loss, there shall be taken into account, inter alia, the value of the immovable property in Cyprus owned by Leslic Ltd, at the date of the "dilution" of the shareholdings of the existing Participating Shareholders.

Question 7

Part 1

Non-EU NEPs with no fixed business establishment in Cyprus and who supply goods or services to non-VAT registered persons who are resident of Cyprus, and for which such transactions have as place of supply the Republic or relate to immovable property situated in Cyprus, have an obligation to register, charge and account for VAT in Cyprus either directly or by appointing a representative and VAT representative.

EU VAT registered NEPs in their countries of establishment are not affected by these new provisions as:

- In the case of selling goods to Cyprus resident consumers the distance selling provisions are applied;
- In the case of provision of services, VAT is charged in the country of establishment of the EU Trader; and
- In the case of selling goods/supplying services to Cyprus VAT-registered traders (B2B), where the latter account for VAT under the reverse-charge provisions.

The VAT registration procedure is the same as for everybody else in Cyprus, through submission of forms TD2001 and TD1101 or, in case of supply of electronic services to consumers only, through the MOSS platform

Part 2

Examples include:

- Services relating to immovable property situated in Cyprus including services supplied by builders, carpenters, plumbers, architects, land agents, cleaning and security services;
- Goods transport and related services when transport commences in Cyprus;
- Cultural, sports, scientific, recreational and similar services and organization of such services;
- Movable property valuations where the property is situated in Cyprus;
- Supply of restaurant and food services;
- Rental of movable property whose actual use/exploitation is within Cyprus; and
- The supply of goods for establishment and assembly in Cyprus.