

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 2.03 – CYPRUS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Scenario A

There are no income tax considerations as the transaction is outside the income tax scope re: transfer by way of gift to relatives of first degree.

The children will have the actual cost of demolition and construction as their base cost for the future claims of capital allowances to be deducted from rental income.

There are no SDC considerations here as the transaction is outside the SDC scope.

There are no capital gains tax considerations as the transaction is outside the capital gains tax scope re: transfer by way of gift to relatives of first degree.

The children will have the land's 01/01/1980 value, plus the actual cost of demolition and construction as their base cost for potential future disposal of the apartments.

Transaction will be exempt from Land Transfer fees re: transfer to relatives of first degree.

If the children decide to keep some or all of the flats and rent them out, they will each be subject to income tax in Cyprus at the normal rates of 0%-35%.

As the children are non-residents of Cyprus, they will be exempt from SDC (and GeSY).

The children will have an obligation to declare their Cyprus rental income in their country of residence but will be entitled to credit relief for Cyprus income tax suffered on per the provisions of the applicable DTA between Cyprus and Angulia.

Scenario B

There are no income tax considerations as the transaction is outside the income tax scope re: transfer by way of gift to relatives of first degree.

The children will have the actual cost of demolition and construction as their base cost plus a portion of bank loan interest for the future claims of capital allowances to be deducted from rental income.

There are no SDC considerations here as the transaction is outside the SDC scope.

There are no capital gains tax considerations as the transaction is outside the capital gains tax scope re: transfer by way of gift to relatives of first degree.

The children will have the land's 01/01/1980 value, plus the actual cost of demolition and construction, plus the bank loan interest as their base cost for potential future disposal of the apartments.

Transaction will be exempt from Land Transfer fees re: transfer to relatives of first degree.

Scenario C

There are no income tax considerations as the transaction is outside the income tax scope re: transfer by way of gift to relatives of first degree.

There are no capital gains tax considerations as the transaction is outside the capital gains tax scope re: transfer by way of gift to relatives of first degree.

The children will have the property's 01/01/1980 value as their base cost for potential future disposal.

Transaction will be exempt from Land Transfer fees re: transfer to relatives of first degree.

Scenario D

The transfer of the property to a family company by way of gift will be exempt from both income tax and capital gains tax, as the company's shareholders are all members of the same family.

The transfer of the property will however attract Land Transfer Fees which will be refundable in 5 years from the initial transfer provided there have not been any changes in the shareholding of the company.

Note that transfer of shares between shareholders of the same family are not considered as actual transfers of shares.

The costs of demolition and construction will form the basis of calculation of capital allowances that will be deductible as an expense from the company's rental income.

Bank loan interest will form part of the expenses that will be tax deductible from future rental income.

For capital gains tax purposes, the base cost of the apartments will include the 01/01/1980 value of the property, plus the non-depreciated part of the demolition and construction costs.

The net profit of the company per its audited accounts will be taxed at a rate of 12,5%

The company will also be subject to SDC at 3% of the gross rental income, the latter reduced by 25%. i.e. an effective rate of 2,25%.

As all shareholders are non-residents of Cyprus, their dividend payouts will not be subject to any withholding taxes of SDC.

They will however have the obligation to declare these dividends in their country of residence.

The future transfer of shares in the company from parents to children will be exempt from both income tax and capital gains tax.

Question 2

Part 1

Although BCo is incorporated in another jurisdiction, this tax-haven jurisdiction is unlikely to be able to claim tax residency of the company due to its nature i.e. BCo Inc. seems to be managed and controlled in Cyprus and will be treated as a tax resident of Cyprus re: management and control test.

Management and control is not defined in Cyprus tax law but it is taken as meaning, the satisfaction of all of the following criteria:

- Majority of directors resident in Cyprus
- Board meetings take place in Cyprus
- Strategic decisions are taken in Cyprus

The third above criterion may not be satisfied if Chris's country of residence claims tax residency (discussed below).

If the country of incorporation claims the company's residency, the tie-breaker rule in Art 4(3) OECD MC will be applied, according to which the 'place of effective management' of a company is the determining factor.

As the country of incorporation cannot prove the above factor, the company will be treated as a tax resident of Cyprus.

Failing the above tax residency analysis, i.e. the company is not determined as a tax resident of Cyprus, the fact that the company maintains a fully-fledged office in Cyprus, the latter will form a permanent establishment (PE), as it falls within the definition of both s.2 Law 118/2002 and Art 5(2) OECD MC.

As such, profits attributable to this PE, will be taxed in Cyprus.

Analysis of operations

Qatar: BCo Inc. has a factory in this country. This falls within the definition of Art 5(2)(d) OECD MC, but need to examine if this will be excepted from the PE definition by virtue of Art 5(4).

Art 5(4) OECD MC, stipulates that if the use of facilities in Turkey are solely used:

- a) For storage, display or delivery of goods (not the case here)
- b) To maintain stock solely for the purpose of storage, display or delivery (not the case here)
- c) To maintain stock solely for processing by another enterprise (not the case here)
- d) To purchase goods or collect information for the enterprise (not the case here)
- e) Any other activity of preparatory or auxiliary character
- f) Any combination of the above activities of a preparatory or auxiliary character

The issue to determine here therefore is as to whether the operation of the factory in Qatar is of a purely preparatory or auxiliary purpose.

From the facts of the case, it cannot be inferred that BCo's use of a factory in Turkey is not of a preparatory or auxiliary purpose and as such the company will be treated as having a physical PE in Qatar, irrespective of the fact that sales and receipts are managed and administered from the Cyprus office.

As such profits attributed to the operation in Qatar will be taxed there.

Dubai: Need to examine if distributors deemed as dependent agents in which case, BCo will be treated as having an agency PE in this country per Art 5(5) OECD MC.

The decisive factor in this case, is as to whether these distributors have any authority to negotiate and conclude contracts on behalf of BCo Ltd.

If such authority exists, then they will be treated as dependent agents and accordingly profits attributable to their activities will be taxed in Dubai.

Malta: The warehouse in this country falls within the definition of a physical PE per Art 5(2) OECD MC.

However its activities seem to also fall within the exceptions stipulated by Art 5(4) OECD MC as discussed above.

The warehouse cannot therefore form a PE in Malta and therefore Malta will have no taxing rights in respect of this activity.

In relation to the JV agreement, this will have to be divided in its constituent parts.

The part of the contract (65%) that will be physically carried out in Malta will be deemed as attaching to a physical PE there re: use of premises in Malta and these part of the profits will be taxed in Malta. The remaining part of the contract (35%) will be directly attributable to the Cyprus head office and its attributable profits therefore taxed in Cyprus.

Kazakhstan: Software programmers resident in this Country will not form a PE for the company in this Country, as their services are employed on a freelance basis and do not seem to have any capacity to legally contract on the company's behalf Art 5(5) requirement for agency PE.

Accordingly, Kazakhstan has no taxing rights on the company.

Any Profits attributable to foreign PEs in other Countries will be exempt from taxation in Cyprus (s.36 Law 118/2002)

Part 2

Tax risks faced by Mr C and BCo Inc., depend on the tax residency provisions in the domestic legislation of Mr C's residence State.

Mr C could be treated as a shadow director of BCo Inc. as the Company's board is acting/accustomed to act per Mr C's instructions (Wood V Holden).

Brief analysis of Wood V Holden.

As such, Mr C's residence State may claim BCo's tax residence, as the company is not incorporated in Cyprus and may deem its profits as distributed to Mr C (per CFC provisions).

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

Scenario 1

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

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

Kazakhstan partners need to inject cash in CypCo for their part of share capital.

Scenario 2

In this case, the GerCo tax position in Germany is as in Scenario 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.

Scenario 3

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

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

Scenario 4

In this case, the GerCo tax position in Germany is as in Scenario 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.

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

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

Tax risks

Royalty rates charged by GerCo to CypCo, and by CypCo to KazCo, 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 Germany only, any TP adjustments in Germany will be offset by corresponding adjustments in Cyprus.

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

The value of the royalties forfeited and deemed as capital contribution by GerCo to CypCo need to be calculated at arm's length if GerCo and CypCo will be related parties. Similar considerations apply in case of increase in the share capital of KazCo.

Question 4

Part 1

Dividend income from all companies (Cyprus and overseas) although taxable, is specifically exempt from taxation in Cyprus.

Dividend income also exempt from SDC as Cyprus company holding of shares in overseas companies exceeds 5%.

Cyprus does not impose WHT on outbound dividends paid overseas, nor SDC on dividends paid to non-residents i.e. dividend to RusCo not subject to any WHT or SDC.

Royalty income from BL Ltd is subject to corporate income tax after a deemed deduction of 80% of gross profit.

Although Netherlands should not withhold tax re: EC Interest-Royalty directive, if any such tax was withheld, Cyprus will provide unilateral ordinary credit tax relief for such tax suffered at source.

Interest received from all intercompany loans will be treated as active business income and subject to corporate income tax by reference to HoldCo's activities.

In that case, such interest will be exempt from SDC.

The interest free loan to ME Ltd will attract as deemed interest charge per s.33 Law 118/2002 re: arm's length principle between related parties.

Such deemed interest income will have the same tax treatment by reference to CIT and SDC, as all other intercompany loan interest.

As the group has no unified policy on interest rates charged on intercompany loans, one has to examine each loan relationship separately to determine the arm's length rate.

If the arm's length principle not applied, the Cyprus tax authorities may well deem interest income per art.33 Law 118/2002.

If the above happens, then in accordance with the relevant EU regulations affecting loans with NL Ltd and BL Ltd and the

OECD Transfer Pricing Guidelines (affecting loans with RusCo Ltd), corresponding adjustments will have to be made by the overseas competent authorities in determining the tax base of those overseas entities.

Such adjustments will not be made for HoldCo2 Ltd, as no such provisions exist in Cyprus domestic legislation.

The gain on disposal of shares in HoldCo2 Ltd, will be subject to capital gains tax in Cyprus per the provisions of law 52/1980, as this company owned immovable property situated in Cyprus and it is a private company.

Although NL Ltd is a Cyprus incorporated company it will not be a tax resident of Cyprus, as it is managed and controlled in the Netherlands.

Tax losses of HoldCo2 Ltd cannot be relieved under the group loss relief provisions, as this company did not form a group for the whole tax year.

Part 2

In accordance with the CGT law (52/80), capital gains are subject to tax at 20% if they emanate from the disposal of either immovable property situated in Cyprus, or from the disposal of a private company's shares, whose assets include immovable property situated in Cyprus.

RusCo Ltd's disposal falls within the definition and therefore its capital gains will be prima facie subject to CGT in Cyprus.

However Russia has a DTA with Cyprus and its provisions take precedence over domestic Cyprus legislation

As provided by Art 6, CGT can only be imposed on RusCo Ltd only if the immovable property held by HoldCo2 Ltd accounts for more than 50% of its total balance sheet assets.

This will therefore have to be determined before advising if RusCo Ltd will have in any way, exposure to Cyprus CGT.

Part 3

Option 1. Form a 'money-box' company in a no tax jurisdiction which will hold capital and provide loans to HoldCo Ltd, the latter charging a small margin to the operating companies per the relevant income tax circular or

Option 2. Set up a branch in a zero-tax jurisdiction to which the intercompany financing action will be assigned.

As such, income will be characterized as business income (see analysis in part (a)), which will be eligible for the s.36 Law 118/2002 exception re: income from overseas PE.

In terms of taxation only, Option 2 is preferable.

PART C

Question 5

A Ltd operates from a construction site in Cyprus, which is within the definition of a PE per s.2 Law 118/2002.

However, as the duration is less than 3 months, the definition for a PE will not apply and therefore Cyprus has no taxing rights over A Ltd.

B Ltd operates from a construction site in Cyprus, which is within the definition of a PE per s.2 Law 118/2002.

As the project lasts for more than 3 months, B Ltd's activity will be treated as a PE in Cyprus and profits attributable to it will be taxed in Cyprus.

The fact that the project straddles two tax years (2022&2023), has no effect on the applicability of existence of a PE in Cyprus.

C Ltd will have exactly the same treatment as A Ltd.

As A Ltd, C Ltd and B Ltd are all tax residents of countries with which Cyprus has no DTA in place, it is not possible to determine as to whether they will be eligible for DTR in respect of tax paid in Cyprus. Lorenza is a tax resident of Malta but derives business income from Cyprus (supervising architect activity).

Lorenza is not a tax resident of Cyprus as she spends less than 183 days in any tax year in Cyprus. Also she cannot qualify under the 60-day rule as she is tax resident of Malta.

Lorenza will therefore be subject to tax in Cyprus only if she carries out her activities from a PE in Cyprus, re: construction or services PE.

Her supervising activities of construction projects fall within the definition of a PE per s.2 Law 118/2002.

All 3 projects he supervises in Cyprus could be deemed as having economic and geographical coherence and as in total they exceed 3 months in duration, her activity is treated as arising from a services PE in Cyprus.

However, according to the Cyprus-Malta DTA, the required duration of the activity for a construction PE to exist is 12 months (Art.5(3) OECD MC).

As the DTA takes precedence over domestic law, Lorenza's activity will not be treated as constituting a PE in Cyprus as the 12-month criterion is not satisfied.

Accordingly, Cyprus will not have any taxing rights over Lorenza re: construction PE.

Cyprus may however have taxing rights on Lorenza by reference to a service PE re: her income from B Ltd.

Question 6

Part 1

Andy is a Cyprus tax resident as he spends more than 183 days in Cyprus during 2022 (only 102 overseas).

Therefore Andy is taxable on his worldwide income including salary and daily subsistence allowance received from ECo Ltd.

Andreas will be entitled to the annual 20% deduction on gross salary (capped at 8.550 Euros) for the 3 years commencing 2022 as he returned to Cyprus in 2021 (s.8(21) Income Tax Law 118/2002).

In addition, he may be eligible for the 90-day rule exception re: employed at a Cypriot employer's overseas PE (s36(5) Income Tax Law 118/2002), i.e. he will not be taxed for his salaried income attributable to the 102 days he was overseas.

The decisive factor for the 90-day rule exception is as to whether his employer will be treated as having an overseas PE.

If EngiCo Ltd activities overseas are treated as PE, Andreas's income attributable to the 102 days overseas, will be exempted from Cyprus income tax.

If EngiCo Ltd activities, not an overseas PE, no exemption available.

Part 2

ECo Ltd is a tax resident of Cyprus and will only be subject to tax in an overseas State if it operates through an overseas PE there.

ECo Ltd operates construction contracts of 6-12 months duration.

In accordance with the Art 5(3) definition, a project must exceed 12 months in duration.

It is not specified in the question if there are one or more construction contracts per jurisdiction.

Even if Eco Ltd may engage on 6-month contracts, it may well engage in two or more per jurisdiction, in which case, the 12 month requirement will be satisfied (economic and geographical coherence).

If ECo Ltd, is treated as having a construction PE in any foreign State, then:

- Andy's salary and subsistence will be deductible against profits attributable to the specific PE
- ECo Ltd profits to the extent that these are attributable to the overseas construction PE will be exempt from corporate income tax per s.36(3) Law 118/2002.

If ECo Ltd is not treated as having a PE in the foreign State, its profits will be aggregated with its other profits, and Andreas's salary etc will be tax deductible from its total profits.

Losses of an overseas PE may be aggregated with profits of the head office .

If in future years the specific PE realizes profits, such trading losses are recaptured ss.13&36(3) Income Tax Law 118/2002.

Question 7Income tax computation

Taxed under special mode:	
UK pension income	70,000
Income tax: 3,400 @ 0%	0
66,600 @ 5%	3,330
Tax payable	3,330*
Taxed under normal tax rates	
Rental income UK	24,000
Rental income Cyprus	9,000
	33,000
Less: 20% deduction	6,600
	26,400
Trading goodwill	300,000
BDI UK	5,000
BDI Cyprus	2,857 (2,000 x 100 / 70)
UK Dividends	50,000
Greek tourist rental	7,000 (12,000 - 5,000)
Total income	391,257
Less: deductions/exemptions	
s.36: Trading goodwill	300,000
Greek tourist income	7,000
BDI	7,857
Dividends	50,000
Total deductions	364,857
Taxable income	26,400
Tax liability	
19,500 @ 0%	0
6,900 @ 20%	1,380
	1,380.00
Less: UK tax paid (rental income DTR ($19,200/26,400 * 1,380$))	(1,003.64)
	376.36
Total income tax due for 2022	3,706.36

*The UK tax withheld at source will have to be claimed back from the UK Tax Authorities. Foreign pension more beneficial taxed under special tax mode at 5%

SDC liability computation

Rental income (UK and Cyprus)	33,000
Less: 25% deduction	8,250
Taxable	24,750
SDC @ 3%	742.50
Less: UK tax paid	(742.50)
SDC due in Cyprus	0
BDI (UK and Cyprus)	7,857
SDC @ 30%	2,357.10
Less: SDC deducted at source	857.00
DTR for UK tax paid	1,000.00
SDC balance payable	500.10
UK Dividends	50,000

Module 2.03 – Cyprus option (June 2023)

SDC @ 17%	8,500
Less: DTR – UK tax paid	7,500
SDC balance payable	1,000.00
Total net SDC payable in 2013	2,242.60

GeSY Computation

Total Income (see above IT computation)	391,257
Less: Trading Income (Trading Goodwill)	(300,000)
Non-Trading income: 91,257 @ 2.65%	2,418.31
Trading Income balance (180,000 cap less 91,257): 88,743 @ 4%	3,549.72
Total GeSY liability	5,968.03

Question 8

Transaction 1

Place of supply is that other EU country in which the branch is situated, as the recipient of the service is situated in that other EU State.

Supplier of the service will charge 0% VAT and account on his VIES (Monthly recapitulative statement)

Transaction 2

Place of supply is the State in which the building site is situated.

No obligation for VAT in Cyprus.

Transaction 3

Place of supply will be proportionate to the distance covered in Cyprus and outside Cyprus.

Cyprus taxable person will therefore have to charge VAT at the standard rate in proportion to the distance covered.

Transaction 4

Place of supply is Cyprus.

English fund will be charged VAT at the reduced rate of 5% which will be accounted for as output VAT by the Cyprus team.

Transaction 5

Place of supply is the State in which the building site is situated i.e. Cyprus.

Service provider will charge Cyprus VAT and account for it as output VAT on his VAT return.

Transaction 6

Place of supply is Cyprus.

Insurance company will have to register on the basis of reverse-charge taxable person and account for VAT on the reverse charge basis, as Insurance companies are VAT exempt parties, input VAT will be a cost.

Transaction 7

Place of supply is Cyprus.

VAT accounted for under the reverse-charge provisions in Cyprus.