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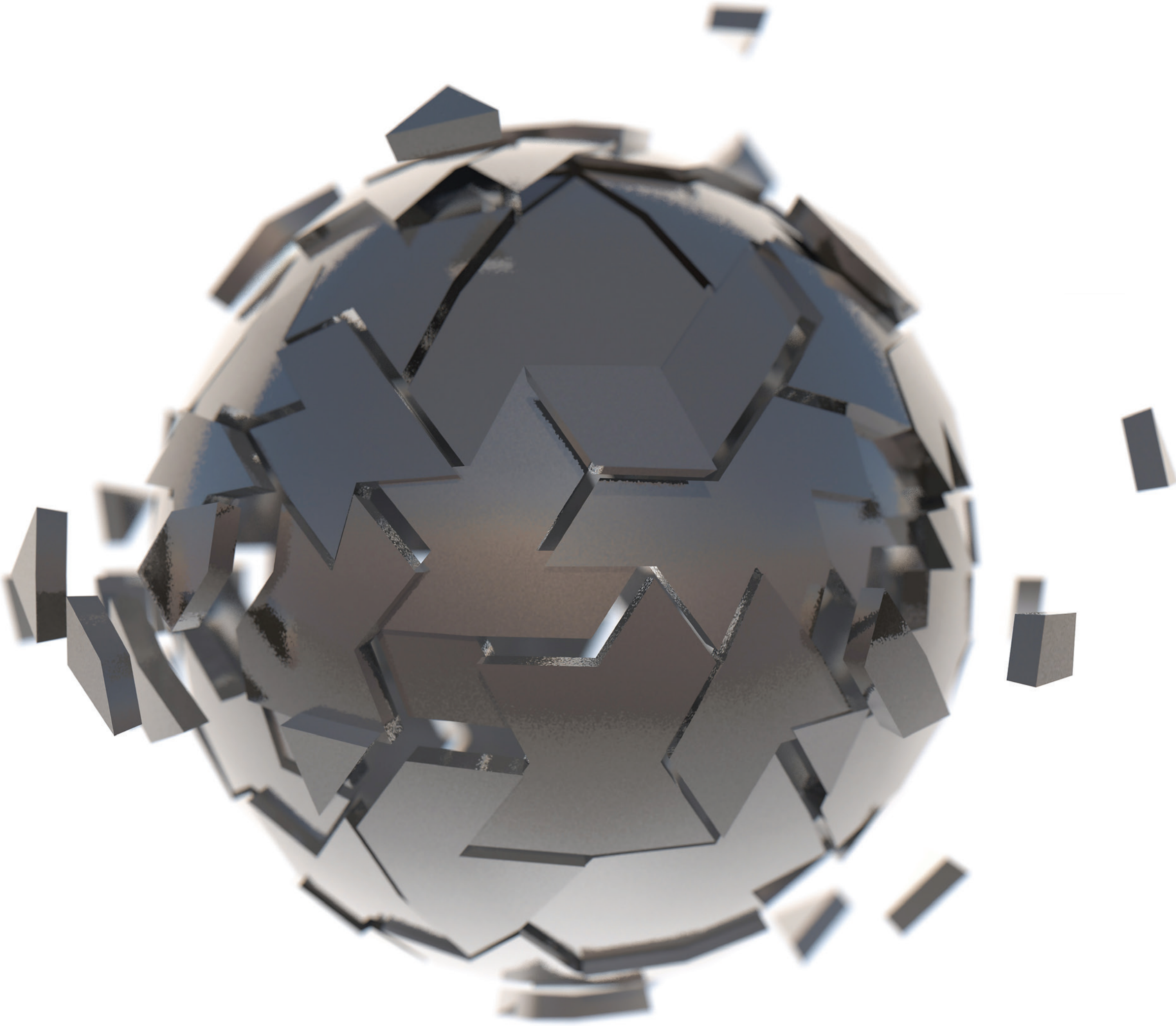

Notional Interest Deduction (NID)

A tax incentive for equity financing and debt restructurings

Tax

BACKGROUND

The Cyprus Income Tax Law (ITL) provides for a notional interest deduction (NID) from the taxable profits of businesses financing their operations through new equity, in a similar manner that companies financing their operations through debt, enjoy an (actual) interest deduction in calculating their taxable profit.

The NID enhances the tax benefits of financing business operations through equity and offers a tax efficient alternative to debt financing.

In November 2020, the EU Code of Conduct Group (Business Taxation) and ECOFIN confirmed that the Cyprus NID regime has been assessed as "not harmful" since its introduction as from 1 January 2015.

LEGAL FRAMEWORK

According to Article 9B, titled, "deduction on new equity", with effect from 1 January 2015, Cyprus tax resident companies and Cyprus permanent establishments (PEs) of non-Cyprus tax resident companies, are entitled to a notional interest deduction (NID) upon the employment of new equity in the production of taxable income.

In 2016, the Cyprus Tax Authorities issued Circular 2016/10, providing clarifications and details regarding the application of the law as well as practical examples of calculating the NID.

NOTIONAL INTEREST DEDUCTION (NID)

The fact that it is notional and thus it is only deductible for the purposes of calculating the taxable profit, means it does not trigger any accounting entries and therefore does not affect the accounting profit.

NID CALCULATION

The NID is equal to the new equity multiplied by the relevant reference rate and it is subject to a cap equal to 80% of the taxable profit (as calculated prior to the NID), arising from the new equity.

NID* = NEW EQUITY X REFERENCE RATE

* *capped to 80% of taxable profit arising from the new equity*

As corporate profits are subject to income tax at the flat rate of 12.5%, a taxpayer claiming NID can achieve an effective tax rate of up to 2.5% (=20% x 12.5%).

NEW EQUITY

"New Equity" is equity introduced in a company as from 1 January 2015 in the form of paid-up share capital and share premium.

New equity includes shares of any class, including ordinary, preference, redeemable and convertible shares, paid either in cash or in kind.

The Circular clarifies that unpaid share capital, in respect of which a corresponding claim has been recognised which gives rise or is deemed to give rise to interest which is subject to income tax, shall be considered as paid-up capital for the purposes of Article 9B of the ITL.

Furthermore, the Circular clarifies that the following may qualify as new equity:

- Loans payable and other debt instruments converted into issued share capital;
- Shareholders’ credit balances converted into issued share capital;
- Non-refundable capital contribution converted into issued share capital;
- Realised reserves created after 1 January 2015 converted into issued share capital.

Finally, the Circular provides guidance in determining the level of new equity in a number of cases, including:

- A non-Cyprus tax resident company with a Cyprus PE issuing new equity;
- A non-Cyprus tax resident company transferring its tax residency to Cyprus;
- A non-Cyprus tax resident company with a Cyprus PE transferring its tax residency to Cyprus;
- A Cyprus tax resident company or a PE of a non-Cyprus tax resident company reducing its equity, following the introduction of new equity.

REFERENCE RATE

For tax years up to and including 2019, the reference rate is calculated by adding a 3% premium to the 10-year government bond yield (as at 31 December of the prior tax year) of the country where the funds are employed, subject to a minimum rate, equal to the yield of the 10-year Cyprus government bond, plus a 3% premium.

From tax year 2020 onwards, the reference rate is calculated by adding a 5% premium to the 10-year government bond yield (as at 31 December of the prior tax year) of the country where the funds are employed, with no minimum rate.

Country	Reference rate %			
	31/12/2020	31/12/2019	31/12/2018	31/12/2017
Cyprus	5,136	5,536	5,302	4,881
Czech Republic	6,252	6,569	4,884	4,650
Germany	4,612	4,790	3,284	3,423
Greece	5,190	6,431	7,346	7,073
India	10,865	11,557	10,261	10,571
Latvia	4,820	5,136	4,029	3,715
Poland	6,229	7,109	5,812	6,385
Romania	7,959	9,398	7,811	7,314
Russia	10,910	11,270	11,720	10,590
United Kingdom	5,192	5,817	4,275	4,188

The Reference rate includes the risk premium of 3% as at 31/12/2017 and 31/12/2018 (to be used in 2018 and 2019 respectively) and 5% as at 31/12/2019 and 31/12/2020 (to be used in 2020 and 2021 respectively).

NID CAP CALCULATION

The NID is capped to 80% of the taxable profit, generated from the new equity and calculated before allowing for the NID.

Where a taxpayer invests the new equity in a number of different assets generating taxable income, the Circular introduces a scheduling method for the purpose of calculating the applicable NID cap.

In this respect, taxpayers would need to determine the taxable profits generated from each asset/activity as well as to allocate new equity between the various assets/activities of the taxpayer, as follows:

First, identify new equity that directly financed specific assets (the 'matching concept'). Then allocate any remaining new equity to non-business assets and assets not generating taxable income. Finally, apply a pro-rata allocation to the remaining assets of the taxpayer.

ANTI-ABUSE PROVISIONS

The law provides for a number of specific anti-abuse provisions as well as a general anti-abuse provision.

EXAMPLE

The Circular provides seven practical numerical examples of NID calculations including the following: Cy Co issues new equity amounting to €150m and receives funding of equal value. Cy Co decides to use these funds to purchase three assets in three different countries as follows:

#	NID Calculation	Asset 1 €m	Asset 2 €m	Asset 3 €m	Total €m
1	New equity	50	50	50	150
2	NID [New equity x reference rate]	7.2	6	9	22.2
3	Taxable profit after deducting direct and apportioned indirect expenditure	10	5	12	27
4	NID cap (80% of the taxable profit) [80% x (3)]	8	4	9.6	21.6
5	Deductible NID for each asset [lower of (2) and (4)]	7.2	4	9	20.2
6	Taxable profit [(3) - (5)]				6.8

The maximum NID which may be claimed by Cy Co is the lower of (4) and (5), i.e. €20.2m. It is worth noting that the example assumes that the new equity funding was available for the whole tax year of assessment and that the relevant reference rates for each asset were as follows: asset 1: 14.4%, asset 2: 12%, asset 3: 18%. Furthermore, the example assumes that the taxable profit produced by each asset could be accurately determined.

HOW CAN WE HELP?

A Cyprus company/PE can take advantage of this tax incentive in a number of different ways. We are at your disposal to discuss with you how to best structure the funding of your business from a tax perspective.

Reach out

Pieris Markou
Partner, Tax & Legal Services Leader
Tel: + 357 22 360607
pmarkou@deloitte.com

Antonis Taliotis
Partner, Tax & Legal | Business Tax Services
Tel: + 357 25 868686
ataliotis@deloitte.com

Michael Aris Michaelides
Director, Tax & Legal |Business Tax Services
Tel: + 357 22 360719
mmichaelides@deloitte.com

http://www.deloitte.com/cy

Nicosia
24 Spyrou Kyprianou Avenue
CY-1075 Nicosia, Cyprus
P.O.Box 21675
CY-1512 Nicosia, Cyprus
Tel: +357 22 360300
Fax: +357 22 360400
infonicosia@deloitte.com

Limassol
Maximos Plaza, Tower 1, 3rd floor
213 Arch. Makariou III Avenue
CY-3030 Limassol, Cyprus
P.O.Box 58466
CY-3734 Limassol, Cyprus
Tel: +357 25 868686
Fax: +357 25 868600
infolimassol@deloitte.com