



Cyprus Tax News

Amendments to the Income Tax Law for the adoption of rules against tax avoidance practices

On 5 April 2019, the House of Representatives voted into law the provisions of the European Council Directive for the adoption of rules against tax avoidance practices that directly affect the functioning of the internal market (known as Anti-Tax Avoidance Directive – ATAD).

The Directive stems from the action plan against Base Erosion and Profit Shifting (BEPS), which is the result of the initiative of the G20 and the member countries of the Organization for Economic Co-operation and Development (OECD) to combat tax evasion through the transfer of profits to countries with preferential tax regimes.

The anti-tax avoidance measures provided by the Directive are the below:

1. Interest limitation rule
2. General anti-abuse rule
3. Controlled Foreign Company rule
4. Exit taxation
5. Rule to tackle hybrid mismatches.

These measures are included in the Directive published on 12 July 2016 (known as **ATAD I**), while the provisions on hybrid mismatches are extend in a second Directive adopted on 29 May 2017 (known as **ATAD II**).

Application dates

1 January 2019: Interest limitation rule, general anti-abuse rule and controlled foreign companies rule.

1 January 2020: Exit taxation and rule to tackle hybrid mismatches (reverse hybrid rules shall apply by 1 January 2022).

The provisions voted into law that apply as from 1 January 2019 are analyzed below. It is expected that by the end of 2019 the provisions that apply as from 1 January 2020 will also be transposed into law.

In addition, we note that related tax Circulars which will analyse in detail the practical application of the below rules are expected to be issued by the Tax Department.

The definitions of the *relevant terms* are listed at the end of this alert.



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1. **Interest limitation rule**

The interest limitation rule aims to discourage group of companies from providing financing facilities to companies based in high-tax jurisdictions through subsidiaries based in low-tax jurisdictions. The rule focuses on limiting the deduction of 'inflated' interest arising from the above practices.

Rule

The interest limitation rule provides that the *excess borrowing cost (EBC)*^{1,2} which exceeds 30% of **taxable** income before interest, tax, deductions and additions (EBITDA), is not deductible for the purpose of calculating the taxable income of a company. Losses brought forward are not taken into account for the calculation of the EBITDA.

By derogation from the above rule, the EBC is deducted up to the amount of €3.000.000 per fiscal year, per company or Cypriot group, as the case may be.

Where the company is a member of a Cypriot group, the interest limitation rule is applied at the level of the Cyprus Group, as this is defined in the Income Tax Law (75% participation group), including permanent establishments in Cyprus.

Instructions concerning the allocation of the interest deductibility per company belonging to a Cypriot group are expected to be issued in a relevant tax Circular of the Tax Department.

Exclusions from the interest limitation rule

The interest limitation rule does not apply to:

- *financial undertakings*³
- *standalone entities*⁴

- loans used to fund long-term public infrastructure projects where the project operator, borrowing costs, assets and income are all in the European Union.
- loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans.

Equity escape clause

Where the company is a member of a consolidated group for financial accounting purposes, it may choose for each tax year to fully deduct the amount of the EBC if it is able to demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group.

The ratio is considered to be equal to the equivalent ratio of the group, if it is equal to or at most lower by 2% of the group ratio.

Carry forward of EBC and unused interest capacity

- The amount of EBC which cannot be deducted in the year in which it was incurred, can be carried forward and be deducted from the taxable income of the entity for the next 5 years.
- The unused interest capacity (the difference between 30% of EBITDA and EBC), which cannot be deducted in the current tax year can be carried forward and used for the next 5 years. It is clarified that for the calculation of the unused interest capacity the €3.000.000 threshold mentioned above is not taken into consideration.

Reorganizations

In case of a reorganization, any accumulated EBC and unused interest capacity will be transferred to the transferee company in accordance with the relevant provisions of the legislation regarding the reorganization of companies.

2. General anti-abuse rule

The general anti-abuse rule (GAAR) aims to tackle abusive tax practices that have not yet been dealt with through specific provisions.

Rule

The rule provides that for the purposes of calculating the corporate tax liability, an arrangement or a series of arrangements which are non-genuine and have as a main purpose the obtaining a tax advantage, are ignored.

Non-genuine arrangements are arrangements which are not put into place for valid commercial reasons that reflect economic reality.

3. Controlled Foreign Companies (CFC) Rule

The controlled foreign companies (CFC) rule has the effect of re-attributing the income of a low-taxed controlled foreign subsidiary to its parent and controlling company. The aim is to prevent revenue diversion to subsidiaries which are tax resident in jurisdictions with preferential tax regimes.

Definition of CFC

A company or a permanent establishment, the profits of which are not subject to tax or are exempt from tax in Cyprus, is considered a CFC if the following conditions are met:

(a) a Cyprus tax resident company, by itself or together with its *associated enterprises*⁵ holds a direct or indirect participation of more than 50% of the voting rights or of capital, or is entitled to receive more than 50% of the profits of that company, and;

(b) the actual corporate tax paid on the profits of the company or permanent establishment is lower than 50% of the tax that would be paid in Cyprus.

For the purposes of paragraph (b), the permanent establishment of a CFC which is not subject to tax or is exempt from tax in the jurisdiction of the CFC, shall not be taken into account.

CFC rule

The non-distributed income of a CFC which is derived from non-genuine arrangements that have been put in place for the purpose of obtaining a tax advantage and which are controlled by the controlling Cyprus tax resident company, is added to the taxable income of the Cyprus tax resident company.

Non-distributed income is considered the accounting profit after tax which has not been distributed to the controlling Cyprus tax resident company during the tax year in which the profit is derived, as well as the next 7 months from the end of the tax period.

Exemptions from the CFC rule

The CFC rule is not applied where the company or the foreign permanent establishment has:

(a) accounting profits of no more than €750.000, and non-trading income of no more than €75.000;

or

(b) accounting profits of no more than 10% of its operating costs for the tax period.

Calculation of CFC income

The income or loss to be included in the tax base of the controlling Cyprus tax resident company shall be calculated in proportion to the company's effective participation in the CFC.

The income or loss shall be limited to amounts generated through assets and risks, which are linked to significant people functions carried out by the controlling company. The attribution of income shall be calculated in accordance with the arm's length principles and is limited to the amount of the non-distributed income of the CFC.

The non-distributed income or loss shall be included in the tax period of the controlling Cyprus tax resident company in which the tax year of the CFC ends.

Avoidance of double taxation

Where the CFC distributes profits to the controlling Cyprus tax resident company, the amounts of income previously included in the tax base of the controlling Cyprus tax resident company in accordance with the current rule, are exempt from tax in Cyprus.

Any foreign tax paid on the income of the CFC or of the permanent establishment is credited against the income tax payable in the Republic.

We are at your disposal to discuss whether and how you are affected by the above developments.

RELEVANT TERMS

1. **"Exceeding borrowing cost"** means the amount by which the deductible borrowing costs of a taxpayer exceeds taxable revenue from interest and other economically equivalent taxable revenues.
2. **"Borrowing cost"** means interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance.

It includes:

- *Payments under profit participating loans,*
- *Imputed interest on instruments such as convertible bonds and zero coupon bonds,*
- *Amounts under alternative financing arrangements,*
- *The finance cost element of finance lease payments,*
- *Capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest,*
- *Amounts measured by reference to a funding return under transfer pricing rules where applicable,*

- *Notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings,*
- *Foreign exchange gains and losses on borrowings and instruments connected with the raising of finance,*
- *Guarantee fees for financing arrangements,*
- *Arrangement fees and similar costs related to the borrowing of funds.*

3. "Financial undertaking" means any of the following entities:

- *Credit institutions,*
- *Insurance companies/organisations/undertakings,*
- *Reinsurance undertakings,*
- *Institutions for occupational retirement provisions,*
- *Pension institutions operating pension schemes as well as any legal entity set up for the purpose of investment of such schemes,*
- *Alternative Investment Funds (AIF) or AIF managed by an AIF Manager,*
- *Undertakings for Collective Investment in Transferable Securities (UCITS),*
- *Central counterparties*
- *Central securities depositories*
- *Securitisation special purpose entity (SSPE).*

4. "Standalone entity" means an entity that is not part of a consolidated group for financial accounting purposes and has no associated company or permanent establishment.

5. "Associated enterprise" means:

- an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights of 25% or more, or is entitled to receive 25% or more of the profits of the entity thereof;*
- an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more or is entitled to receive 25% or more of the profits of the entity*

If an individual or entity holds directly or indirectly a participation of 25% or more in a company and in one or more entities, all the entities concerned shall also be regarded as associated enterprises.



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