Implementation of the EU Anti-Tax Avoidance Directive by Cyprus

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FOREWORD

On 5 April 2019, Cyprus' House of Representatives, voted into Law the provisions of the EU Anti-Tax Avoidance Directive. The Directive was published on 12 July 2016. The Income Tax Law has been amended on 25 April 2019, upon publication in the Official Gazette of the Republic, with the incorporation of three measures:

- Interest limitation rule
- Controlled Foreign Company (CFC) rule
- General Anti-Abuse rule (GAAR)

The three measures above will have retroactive effect as from 1 January 2019.

However, the Anti-Tax Avoidance implementation measures are not limited to the above. On 24 May 2017, a second Directive was published in respect of exit taxation rules and hybrid mismatch rules. The applicable date of the two measures above is 1 January 2020. The provisions of this Directive have not yet been implemented in Cyprus Income Tax Law but is expected to be transposed into it during 2019.

A brief summary of the provisions is laid in the following pages.

Interest Limitation Rule

This rule targets groups of companies which provide financing arrangements to companies in high tax jurisdictions through companies in low tax jurisdictions. This practice is very common and aims in reducing the overall tax liability of the group. The rule aims to minimize the excessive interest expenses from being used as vehicles to shift profits.

The rule applies to both Cyprus Tax resident companies and foreign companies which maintain permanent establishment in Cyprus.

Provisions
Exceeding Borrowing Costs (EBC), will only be allowed for tax deductibility purposes for up to 30% of the taxpayer's **tax-adjusted** EBITDA. However, the Directive allows for a de-minimis exception per company/group, by which ECB up to €3,000,000 can be deducted.

"Exceeding Borrowing Costs" is the definition given to the excessive amount of borrowing costs over interest income and other economically equivalent taxable revenues.

Furthermore, the term **"borrowing costs"** is defined as the interest expenses on all forms of debt and any other costs economically equivalent to interest, as well as any expenses incurred in relation to the raising of finance.

Application on local group level
In any case where a company is part of a Cyprus group, as defined in the relevant section of the Income Tax Law, the interest limitation rules apply to the whole group. In case where a company is not part of a group, the rule will apply to the company itself. This clearly means in case of a group, the €3,000,000 threshold will be available for the group as a whole and in the case of the company this will be available to the company alone. It is also noted that exceeding borrowing costs and tax adjusted EBITDA shall also be adjusted to the group level.

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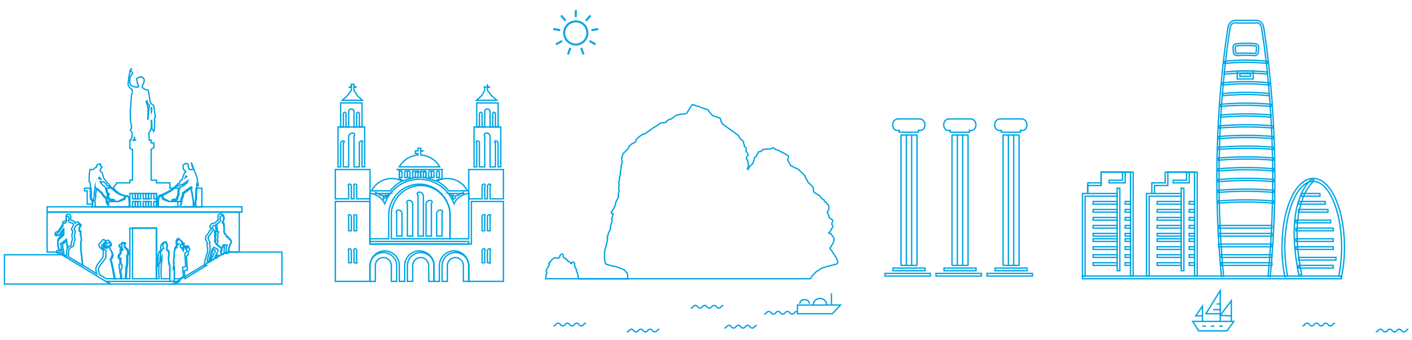
[1] EU Directive 2016/1164 of 12 July 2016. Specifies rules against tax avoidance practices that impact the sound functioning of the internal market

[2] EU Directive 2017/952 of 29 May 2017. Amending the EU Directive 2016/1164 with regards to exit taxation rules and tackling hybrid mismatches.



Rule exemptions

- Loans prior to 17 June 2016 – the Law incorporates a grandfathering clause providing for exemption of Exceeding Borrowing Costs definition for loans concluded prior to 17 June 2016. It is noted that subsequent amendments to the initial loans are not subject to this exemption.

- Standalone entities are defined as entities that are not part of a consolidated group for financial reporting purposes and which has not associated enterprises or Permanent Establishments.

- Financial institutions: include credit institutions, insurance and reinsurance undertakings, investment firms, occupational retirement pension funds, social insurance pension funds, alternative investment firms (AIF) managed by an AIFM, UCITS funds etc.

- Long term public infrastructure loans: the provisions of the rule exclude loans that are intended for being used to finance projects for the public interest whose operator, borrowing costs, assets and income are all within EU.

Equity escape

The clause allows for a Company being member of a consolidated group for accounting purposes to opt for each tax year to fully deduct its Exceeding Borrowing Costs, if it successfully demonstrates that its equity to total assets ratio is equal or higher than the equivalent of its group.

Such clause can be successful if two crucial conditions are met:

1. The equity to total asset ratio of the company can be considered equal to the group's ratio if it is lower by maximum 2%.
2. All assets and liabilities of the company have to be valued by the same methodology as in the group's financial statements are prepared in accordance to an acceptable financial reporting framework.

Carry forward provisions

Any amount of EBCs which cannot be deducted in the year in which they incurred due to the introduction of the limitation rules, can be carried forward for the next five years.

Any unused interest capacity (this forms the difference between the 30% of the tax adjusted EBITDA and the EBC), can also be carried forward for the next five years.

Reorganizations

The reorganization rules in the Income Tax Law are amended to include provisions for the transfer of unused interest capacity and EBCs to a receiving company, only if the reorganization was conducted in accordance to the relevant legislation of companies' reorganizations.

General Anti-Abuse Rule (GAAR)

The target of this rule is to face tax abusive and non-genuine practices whose main purpose is to obtain tax advantage.

In accordance to this rule, an arrangement or a series of arrangements is not considered genuine if it lacks commercial or economic reasoning. If no commercial reality is proved the rule disregards such arrangements and the tax liability is then calculated pursuant to Income Tax Law.

Controlled Foreign Company (CFC) rule

The CFC rule aims in discouraging taxpayers from shifting profits from high tax jurisdictions to low tax jurisdictions. It basically reattributes the profits from subsidiaries in jurisdictions with more preferential tax regimes, to their parents or controlling parties.

Defining Controlled Foreign Company
A CFC is considered a non-Cyprus tax resident company or a foreign PE of a Cyprus tax resident company whose income is not taxed or is exempt from Cyprus corporate taxation, if the conditions below are met:

- A Cyprus tax resident company, alone or with its associate companies, maintains directly or indirectly a 50% or more participation in the share capital, voting rights, or in the entitlement of the profits of a non-Cyprus tax resident.

- The actual tax burden of the foreign company or PE is lower than 50% of the tax burden it would have been imposed in case the profits of the foreign company or PE were taxed in Cyprus.

How the rule works
It is determined that if the conditions above are satisfied, thus when a foreign entity is considered a CFC, the non-distributed income of the CFC may be included in the tax base of the Cyprus controlling party, if such income arose from non-genuine arrangements whose main purpose was to obtain tax advantage.

"Non distributed income" is the income that has not been distributed to the controlling party of the CFC within the tax year in question or within a 7-month period after the year end.

"Non-genuine arrangements" is an arrangement (transaction) or series of arrangements (series of transactions) which lack of economic or commercial rationale.

Such arrangements can be considered as non-genuine, if it cannot be adequately demonstrated that a CFC could have owned the assets or could have assumed the risks associated to the generation of the income if it were not controlled by the Cyprus controlling party which carries significant functional activities that are related to the generation of this income.

It is therefore concluded that the amount of CFC income (or loss) that shall be included in the Cyprus entity's tax base, shall be restricted to the amount generated through the effective participation of the Cyprus controlling party (assets used and risks assumed for the generation of relevant income). The attribution of income (or loss) is driven by the arm's length principles of Cyprus Income Tax Law and it is restricted to the amount of non-distributed income of the CFC.

Rule exemptions
It is provided that no CFC charge is imposed on the Cyprus entity level if:

a) The accounting profits do no exceed €750,000 and non-trading revenues are not more than €75,000.

b) Accounting profits not exceeding 10% of its operating costs.

Double Taxation avoidance
In cases where the CFC distributes profits to its Cyprus controlling party, the amount of these profits already been distributed in the past and which were already included in the tax base of the Cyprus entity, are exempted from the taxable income of the Cyprus company, during the tax year in question.

Additionally, any foreign tax paid on the income of the CFC can be credited against the Cyprus tax burden when it comes to settle the Cyprus taxes.

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