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Cyprus

INSIGHT: Cyprus Rolls Out Anti-Tax Avoidance Directive

BY ELIAS NEOCLEOUS AND NATASA POLYVIOU

In addition to the implementation of the EU Anti-Tax Avoidance Directive, 2019 will be the first year in which the Cyprus tax authorities have to deal with the new provisions for interest on back-to-back inter-company loans, which took effect on July 1, 2017.

This follows a quiet 2018 for new tax developments in Cyprus. New double taxation agreements were concluded with Saudi Arabia and Andorra, and a revised agreement was concluded with the U.K., and re-revised before the year was out. New or revised agreements with Luxembourg, Mauritius and San Marino, which had been signed in earlier years, entered into force during 2018 and took effect from the beginning of 2019.

Implementation of ATAD

Draft legislation has been published to implement the Anti-Tax Avoidance Directive (″ATAD″) and is expected to be enacted early in the new year, with most provisions taking retrospective effect from the beginning of the 2019 tax year. The main features are as follows.

Borrowing Costs The draft legislation introduces a limit on deductible exceeding borrowing costs, defined in the same way as in ATAD, of 30 percent of taxable EBITDA (profit adjusted for tax purposes before interest, tax, depreciation and amortization) or 3 million euros ($3.4 million), whichever is higher.

Elias Neocleous is Managing Partner and Natasa Polyviou is an Associate at Elias Neocleous & Co LLC, Cyprus

The limit will be applied at the company level unless the company is a member of a group for Cyprus tax purposes, in which case the rule will be applied at the level of the Cyprus group. The rule will not apply to wholly independent companies or financial institutions. Certain public infrastructure projects and their associated income are outside the scope of the rule, together with financial arrangements entered into before June 17, 2016 and not subsequently amended.

The draft law also includes an equity escape rule replicating Article 4.5(a) 26 of ATAD, allowing full deduction of borrowing costs if the local taxpayer's ratio of equity to total assets is not more than two percentage points lower than the equivalent ratio for the group as a whole.

Interest costs disallowed by reason of the rules may be carried forward for up to five years.

CFC Rules The definition of a controlled foreign corporation (″CFC″) is the same as in ATAD, namely an overseas permanent establishment or company directly or indirectly controlled by a locally tax resident company, the corporate profit tax burden of which is less than half of what it would be under the Cyprus tax system.

The draft law adopts the approach set out in Article 7.2(a) of ATAD under which specified categories of income including interest, royalties and dividends receivable by the CFC are to be included as current income in the tax base of the Cyprus parent and taxed in accor-

dance with Cyprus rules, unless the CFC is resident in an EU or European Economic Area ("EEA") country and engages in substantive economic activities.

Exit Taxation The provisions regarding exit taxation replicate Article 5 of ATAD, providing for the taxpayer to be liable for tax at an amount equal to the difference between the market value and the value for tax purposes of assets transferred outside the scope of Cyprus taxation while remaining under the same ownership. The taxpayer may pay the exit tax by installments over five years in the same way as prescribed in paragraph 2 of Article 5 of ATAD, under similar conditions, with very minor modifications regarding provision of security.

The proposed effective date is January 1, 2020, as in the directives.

General Anti-Abuse Rule The draft law adds a new Article 33(6) to the Income Tax Law which reproduces the provisions of Article 6 of ATAD, allowing the tax department to disregard artificial arrangements whose main purposes include obtaining a tax advantage that defeats the object or purpose of the tax laws.

Hybrid Mismatches The draft law includes rules on hybrid mismatches which supplement similar provisions introduced in 2015 to implement the amended EU Parent-Subsidiary Directive.

If a hybrid mismatch results in a double deduction, any Cyprus-resident recipient will be denied the deduction and any Cyprus-resident payer will be denied the deduction, if a deduction is given to an overseas-resident recipient. To the extent that a hybrid mismatch results in a deduction without inclusion, if the Cyprus-resident party is the payer, the deduction will be denied, and if the Cyprus-resident party is the recipient and a deduction is given to the overseas resident payer, the receipt will be included in the recipient's taxable income.

As in the directives, the provisions regarding mismatches of hybrid instruments and tax residence are due to take effect from January 1, 2020, and those relating to reverse hybrid mismatches will take effect on January 1, 2022.

Transfer Pricing for Interest on Related-party Loans In 2017 the tax department announced the introduction of detailed transfer pricing rules for financing transactions undertaken by Cyprus-resident entities with related parties. Companies are treated as related if they meet the conditions set out in Article 33 of the Income Tax Law of 2002.

Under the new rules, which apply from July 1, 2017, intra-group financing transactions will be evaluated to ensure that the agreed remuneration complies with the arm's length principle (that is to say, it corresponds to the price which would have been accepted by independent entities in comparable circumstances, considering the economic nature of the transaction). An appropriate comparability analysis must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related entities.

There is a simplified regime for group financing companies which fulfill a purely intermediary role, granting loans to related entities which are financed by loans from other related entities. This simplified basis is only acceptable for the limited types of transactions specified.

Companies are required to submit their 2017 tax returns by March 31, 2019, and so 2019 will present the first opportunity to see how the tax authorities interpret the new provisions and, in particular, eligibility for the simplified regime.

Planning Points One of the attractions of the Cyprus tax system identified in an international survey of tax professionals was its stability and predictability. Radical change is unlikely during 2019, but practitioners are likely to be fully occupied in ''bedding-in'' the new rules and assessing their impact.

Taxpayers should be reviewing their shareholding, financing and operating arrangements to ensure that they comply with the BEPS principles, particularly those regarding hybrids, CFCs and interest deductions, and ensuring that they can demonstrate the validity of transfer pricing decisions they have adopted.

Elias Neocleous is Managing Partner and Natasa Polyviou is an Associate at Elias Neocleous & Co LLC, Cyprus

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