Cyprus

Tax Newsletter

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Cyprus adopts legislation implementing EU Anti-Tax Avoidance Directive

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Executive summary

On 5 April 2019, the Cypriot House of Representatives adopted the law (the Law) implementing the provisions of the European Union (EU) Anti-Tax Avoidance Directive (the ATAD of Directive). The Law will come into force once it is published in the *Official Gazette of the Republic,* which is expected to take place within two weeks from the enactment date. Notwithstanding the date of publication in the *Official Gazette*, the provisions of the Law apply as of 1 January 2019 (i.e. from 2019 tax year onwards).

The Law introduces controlled foreign corporation (CFC) rules, a limitation to interest deductibility provision as well as a general anti-abuse rule.

The final content of the Law has been the result of intensive discussions and consultation with various stakeholders (including the EU Fiscalis Committee set up to assist Member States) which lasted almost a year. The ATAD implementation process is not, however, entirely completed as the provisions of the Directive with respect to exit taxation rules, as well as the provisions of the amending Directive[1] with respect to anti-hybrid rules, will be transposed into the Cypriot domestic law during 2019 and will be effective as from 1 January 2020.

The tax authorities are expected to issue tax circulars providing clarity as to the practical application of the CFC and interest limitation rules.

This Alert summarizes the various provisions of the Law.
On 19 March 2019, the Cypriot Ministry of Finance (MoF) circulated a draft bill (the Bill) to transpose the European Union (EU) Directive 2018/822/EU of 25 May 2018 on the mandatory disclosure and exchange of cross-border tax arrangements (referred to as DAC6 or the Directive) into Cypriot national legislation. The Bill will amend the existing Cypriot law on Administrative Cooperation in the field of Taxation.

The Bill is subject to the MoF's public consultation procedure and public comments on the proposed draft text are requested by 19 April 2019. The Cypriot draft legislation will then be subject to the formal legislative process and is expected to be enacted into law by the end of 2019.

Official guidance is expected to be issued by the Cypriot tax authorities to provide clarification on the interpretation of specific terms and provisions of the Cypriot Mandatory Disclosure Rules (MDR) legislation. The guidance notes will be issued after the enactment of the law.

The key highlights of the Bill are as summarized below.

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Detailed discussion

CFC rules

The relevant CFC article in the ATAD allows Member States to choose between two options. The first option is generally applicable to passive income of a CFC (option A) while the second option is applicable to income arising from "non-genuine arrangements" (option B), also referred to as the significant people functions approach. Cyprus adopted option B.

The CFC rules apply to both Cypriot tax resident companies and non-Cypriot tax resident companies which have a permanent establishment (PE) in Cyprus.

CFC definition

The definition of a CFC follows the wording of the ATAD. As per the Law, a non-Cypriot tax resident company, or a foreign PE of a Cypriot tax resident company whose profits are not subject to or exempt from (Corporate) Income Tax in Cyprus, shall be treated as a CFC if the following conditions are met:

a) A Cypriot tax resident company, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in a non-Cypriot tax resident company. The threshold is determined in terms of participation in the share capital, voting rights or the entitlement to profits of the foreign company.
b) The actual tax suffered by the non-Cypriot tax resident company or the foreign PE is lower than 50% of the tax that would have been imposed on that company or foreign PE had its profits been taxable in Cyprus.

It may be relevant to note the following:

i) The definition of associated enterprises is generally based on a 25% direct or indirect participation (same definition as the one added for the purpose of applying the new interest limitation rules, see section below).
ii) The computation of the hypothetical Cypriot tax is made in accordance with the provisions of the Cypriot Income Tax Law.

Income to be included (CFC inclusion)

In the event it is determined that a foreign entity is a CFC, the tax base of the Cypriot controlling taxpayer shall include any *non-distributed income* arising from *non-genuine arrangements* which have been put in place for the essential purpose of obtaining a tax advantage under the Cypriot Income Tax Law.

An arrangement or series thereof shall be regarded as non-genuine to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all or part of its income if it were not controlled by the Cypriot company which carries out the significant people functions which are relevant to those assets and risks that substantially contribute to the generation of the income of the CFC. Therefore, the allocation of income (or loss) is restricted to the amounts generated through assets and risks which are linked to the significant people functions carried out by the Cypriot controlling entity.

The allocation/attribution of profits of a CFC and the inclusion into the tax base of a Cypriot taxpayer is made in accordance with the arm's-length principle as this is defined in the Cypriot Income Tax Law. It may be relevant to note that during 2019 Cyprus is expected to adopt broader transfer pricing rules, as well as detailed transfer pricing documentation requirements, which will be vastly based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines and the recommendations of OECD Base Erosion and Profit Shifting (BEPS) Action 13.[i] It may be relevant to note the following:

i) The amount of non-distributed income to be included in the tax base of the Cypriot controlling entity is computed by applying the general tax framework and provisions of the Income Tax Law.

ii) The CFC amount (whether or income or loss) which is to be included in the tax base of a Cypriot controlling entity is calculated based on the percentage of the profits that the Cypriot entity is entitled to receive from a CFC.

<u>De minimis exception</u>

In line with the option given by the Directive, the Law provides that no CFC inclusion should be made of any non-distributed income of a CFC if a CFC has either:

i) Accounting profits that do not exceed €750 000 and non-trading income which is not more than €75 000; or

ii) Accounting profits that do not exceed 10% of its operating costs for the tax year.

<u>No double taxation of the same profits</u>

As required under the Directive, the Law includes provisions aiming to avoid double taxation of the same profits if a CFC distributes profits (or if there is a sale of a CFC) and the resulting dividend income (or profits from the disposal of the CFC) are taxable. In such a situation, the dividend income (or profit from disposal) to be included in the tax base shall be reduced by the amount of the underlying profits that had been previously caught under the CFC rules and included in the tax base as CFC income.

<u>Foreign tax relief</u>

It is possible for the Cypriot controlling entity to claim credit for any overseas tax imposed on the CFC profits which are included in its tax base. The Law does not limit the credit to the tax imposed in the jurisdiction of the CFC.

Interest limitation rules

The relevant article in the ATAD allows Member States to make several options and choices. The following sections outline how such choices and options are reflected in the Law.

As a first remark, it is important to note that the current rules regarding tax deductibility of interest expense have not changed. Moreover, the new interest limitation rules apply to all corporate taxpayers (same as for CFC rules), i.e., to both Cypriot tax resident companies and non-Cypriot tax resident companies which have a PE in Cyprus.

<u>Scope and application of the new rules</u>

Under the new rules, the deductibility of *exceeding borrowing costs* is restricted to 30% of a taxpayer's *tax-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA)*. However, the Law provides that any exceeding borrowing costs up to €3 million (per tax year) are not subject to the limitation (de minimis exception as allowed under the Directive). The relevant terms are defined in the Law.

"*Exceeding borrowing costs*" is defined as the excess of borrowing costs (see definition below) over interest income and other economically equivalent taxable revenues.

The definition of "*borrowing costs*" follows the definition in the Directive: interest expenses on all forms of debt, other costs economically equivalent to interest, as well as expenses incurred in relation with the raising of finance.

Following the logic of the Directive, no distinction is made based on the creditor and hence the limitation equally applies to both intra-group (related) and third-party loans.

The Law provides that the "*tax-adjusted EBITDA*" should be determined by adding to the taxable income of the year the exceeding borrowing costs and the adjusted amounts for deductions, allowances and additions in relation to fixed and intangible assets. Any tax-exempt income shall be excluded from the EBITDA.

Interest limitation rules to be applied at a local group level

If a taxpayer is part of a *Cypriot group*, the interest limitation rules will apply on the group as a whole. On the contrary, if a taxpayer is not part of a Cyprus group, the rules will apply on the entity itself. The application of the rules on an aggregated (group) basis is not optional.

If the rules are to apply on a Cyprus group basis, the de minimis exception of €3 million is available to the entire group and not to each of its constituent entities. Moreover, it would be necessary to aggregate the exceeding borrowing costs and tax-adjusted EBITDA for the entire group.

The Law defines a *Cypriot Group* as made up by all Cypriot tax resident companies, as well as any overseas companies that have a PE in Cyprus, which are considered to be members of a group as defined in section 13 of the Income Tax Law for the purpose of determining a group for loss relief purposes.

Exclusion of certain loans

The borrowing costs incurred on the following loans are excluded from the interest limitation rules and should therefore not be taken into account in determining the amount of *exceeding borrowing costs*.

(a) 17 June 2016 loans

In line with the option given by the ATAD, the Law contains a grandfathering clause according to which interest on loans that were concluded before 17 June 2016 is excluded from the borrowing cost definition. However, the grandfathering will not apply to any subsequent modifications of such loans. It is unclear what constitutes a subsequent modification.

(b) Long-term public infrastructure loans

The Law also excludes interest on loans used to fund long-term public infrastructure projects where the operator, borrowing costs, assets and income are all located in the EU. The income earned from such a long-term public infrastructure project is also excluded from the definition of tax-adjusted EBITDA.

Exclusion of stand-alone entities and financial undertakings

As permitted under the Directive, the interest limitation rules do not apply to *stand-alone entities* and *financial undertakings*.

The term *stand-alone entities* is defined in the Law as a taxpayer which is not part of a *consolidated group for financial accounting purposes* and which has no *associated enterprise* or PE. The terms *consolidated group for financial accounting purposes* and *associated enterprise* are defined in the Law in a similar manner as defined in the Directive.

Moreover, the term *financial undertakings* is also defined in the Law to include, inter alia, credit institutions, investment firms, alternative investment fund managers (AIFMs) and management companies of undertakings for collective investment in transferable securities (UCITS), insurance and reinsurance undertakings, alternative investment funds (AIF) managed by an AIFM, UCITS and others.

Equity escape provisions

If a company is a member of a consolidated group for financial accounting purposes, it may deduct its exceeding borrowing costs in full, provided it can demonstrate that its equity to total assets ratio is equal to or higher than the equivalent ratio of its consolidated group for financial reporting purposes (i.e., that is no more than 2% lower than the equivalent group ratio). For these purposes, all assets and liabilities have to be valued using the same method as in the consolidated financial statements drawn up in accordance with acceptable accounting standards.

Carryforward provisions

Any exceeding borrowing costs whose deductibility is restricted due to the application of the new limitation rules (i.e., the amount exceeding 30% of tax-adjusted EBITDA) and any unused interest capacity (i.e., the amount by which 30% of tax-adjusted EBITDA exceeds the amount of exceeding borrowing costs) can be carried forward for the next five years. However, the non-utilized amount of the €3 million de minimis exception is not carried forward.

The Law includes an anti-abuse provision in case a company leaves the group. Under certain conditions, the carryforward amounts of unused interest capacity and exceeding borrowing costs may be forfeited.

Finally, the company reorganization provisions are amended to allow the transfer of unused interest capacity and exceeding borrowing costs from a transferring company to a receiving company if the change of ownership is done in the course of a qualifying company reorganization.

General Anti-Abuse Rule (GAAR)

The new GAAR wording is largely based on the wording of the ATAD. The Law provides that for the purpose of calculating the corporate tax liability, any arrangement or series of arrangements should be disregarded if they have been put in place with the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and which are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than a step or part. An arrangement (or series of arrangements) is not considered as genuine to the extent that it is not implemented for valid commercial reasons which reflect economic reality.

Where arrangements or a series of arrangements are disregarded pursuant to the new GAAR, the tax liability will be calculated in accordance with the provisions of the Income Tax Law.

Remaining ATAD measures

As noted above, exit taxation rules and rules on hybrid mismatches will need to be transposed into Cypriot tax legislation by 1 January 2020. The public consultation process with respect to the implementation of these rules will be launched by the Cypriot Ministry of Finance in the next few weeks.

Implications

The transposition of the Directive into Cypriot domestic law will have a significant impact on corporate taxpayers. The new legislation is complex and constitutes a major change that needs to be considered by all corporate taxpayers regardless of the type of activities they are engaged into. Businesses are therefore encouraged to review, in detail and at an early stage, their structures and arrangements in light of the new rules in an attempt to assess the level of impact and whether there is a need to take any actions.

Endnotes

[i] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

[i] Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third parties.

[i] The OECD BEPS Action 13 report *Transfer Pricing Documentation and Country-by-Country Reporting* and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as revised from time to time.

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