COSTAS TSIELEPIS & CO
CHARTERED ACCOUNTANTS

COSTAS TSIELEPIS & CO LTD | TAX UPDATE

By ALEXIS TSIELEPIS, Director, Head of Taxation

VOLUME 4, ISSUE 5

DIVIDENDS FOUR-YEAR RULE

"knowledge"

Facts, information and skills acquired through experience or education; the theoretical or practical understanding of a subject.
OXFORD DICTIONARY

AUTHORED: JANUARY 2013 UPDATED: APRIL 2014

ΓΝΩΣΗ

205, 28th October Str., Louloupis Court, 1st Floor, 3035 Limassol, Cyprus I P.O. Box 51631, 3507 Limassol, Cyprus
T: + 357 25 871000 I F: + 357 25 373737 I E: info@tsielepis.com.cy I www.tsielepis.com.cy

DIVIDENDS FOUR-YEAR RULE:

Understanding the four year exception to the exemption rule on Special Defence Contribution for dividends between Cyprus tax-resident companies

1.0 Introduction

A 2012 amendment in the tax legislation has introduced an exception to the exemption afforded to the imposition of Special Defence Contribution (SDC) on dividends between Cyprus tax-resident companies. In order to appreciate the application of this legislative change, a wider understanding of certain provisions of the SDC legislation, including the deemed distribution rules, is required.

The purpose of the present update is to explain this. None of the provisions stated in this tax update apply when the beneficial owner, of the Cyprus tax-resident company, is <u>not</u> a Cyprus tax-resident person (physical or legal).

2.0 Explanation of the legislation before the change

Under deemed distribution rules, a Cyprus company should declare as dividends at least 70% of its after-tax accounting profits within two years from the end of the tax year in which those profits were made. If the company fails to do this, to the extent that such dividends were not declared, then the company will be *deemed* to have declared such dividends, for tax purposes, and the withholding tax rate of 17% (20% between 01.01.2012 - 31.12.2013) will apply to such dividends (the «deemed distribution rules»).

The deemed distribution rules however do not apply when the shareholder is a **non-Cyprus tax-resident** (physical or legal person). They also do not apply when the ultimate shareholder, who indirectly owns the shares through other Cyprus tax resident companies, is **not** a Cyprus tax-resident (see example 4 below). If the shareholding of a non-Cyprus tax resident person is held through a Cyprus tax-resident nominee, the deemed distribution rules still do **not** apply.

In the case that the shareholder is a Cyprus tax-resident physical person, then the deemed distribution rules always apply. They also apply if such shareholding is indirect. Given that actual dividends between Cyprus companies are exempt from the imposition of SDC withholding tax, then a situation may arise where the deemed distribution rules create taxation.

Whereas, if actual dividends had been distributed, the company-to-company exemption would apply and no tax would arise.

As such, care should be taken over the deemed distribution rules in the event that there are two or more Cyprus tax resident companies in a vertical structure, with the ultimate shareholder being a Cyprus tax-resident individual. However, where an actual dividend is issued, so the deemed distribution rules do not apply, each holding company in a vertical structure can delay the imposition of any SDC by up to two years.

Thus, if for example there were three holding companies between the Cyprus tax-resident physical shareholder and the trading entity that generates profits, so long as the deemed distribution rules do not apply, then the tax payer could delay the imposition of SDC, by up to 2 years for each holding company. This “window” of tax planning is what the change of legislation addresses.

3.0 Understanding the change in the legislation

As stated previously, a Cyprus tax-resident company is exempt from SDC with regards to any dividends it receives from another Cyprus-tax resident company.

As of 01.01.2012, the above exemption does not apply to any dividends received indirectly, if four years have passed from the year in which the profits arose, out of which those dividends were declared.

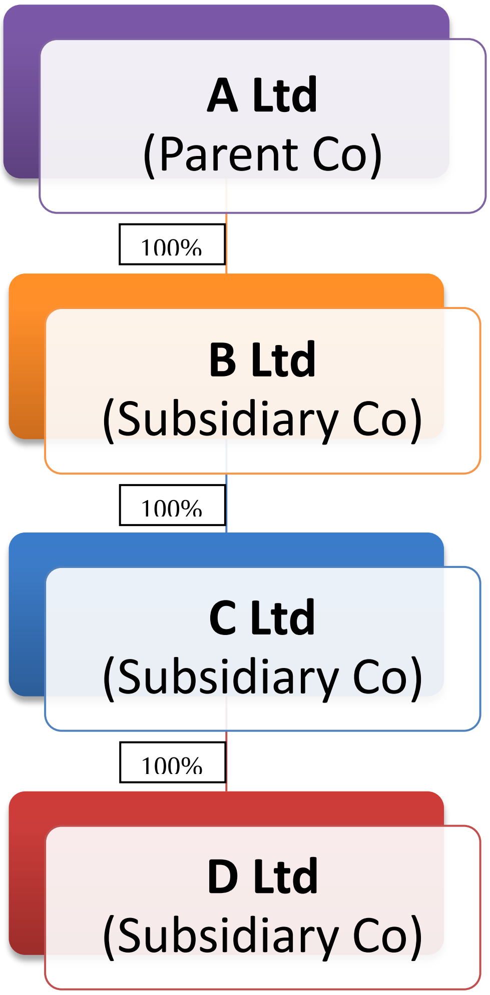
3.1 Application of the legislation

The above measure does not apply in the case that the beneficial owner of the company is not a Cyprus tax-resident person. It applies to any dividends which are distributed from 01.01.2012 onwards, regardless of the year in which the profits arose.

Any dividend declared from income that is derived either directly or indirectly from dividends on which SDC was imposed, is exempt from any further SDC. In other words, once SDC has been imposed on a dividend, then that same amount of money will not attract further SDC if distributed further up the chain in a vertical structure. This is explained also in the examples below.

4.0 Examples

Example 1



Company A Ltd owns 100% of the share capital of company B Ltd, which in turn owns 100% of the share capital of company C Ltd, which in turn owns 100% of the share capital of company D Ltd. Companies A Ltd, B Ltd and C Ltd have no other activity other than the holding of shares. All companies are Cyprus tax-resident.

The shareholder of A Ltd is a Cyprus tax-resident, physical person.

Company D Ltd makes after-tax accounting profits in the year 2012 of €1.000. On 31.12.2014, D Ltd declares an actual dividend to C Ltd, equal to 70% of its accounting profit.

On 31.12.2016, C Ltd declares an actual dividend to B Ltd, equal to 70% of its accounting profit.

On 31.12.2018, B Ltd declares an actual dividend to A Ltd, equal to 70% of its accounting profit.

On 31.12.2020, A Ltd declares an actual dividend equal to 70% of its accounting profit.

Tax Treatment:

In all cases, the dividend is exempt from corporation tax. However it should be investigated whether it is taxable under SDC, especially given the 2012 change in legislation. This is achieved by examining in each instance firstly whether the exemption for dividends between Cyprus companies applies, and secondly whether the deemed distribution rules apply.

31.12.2014: D Ltd declares a dividend to C Ltd, equal to €1.000 x 70% = €700. The dividend is not subject to SDC given that this is an actual dividend between two Cyprus tax-resident companies, within 2 years from the date that the profit is made. Thus the exemption for dividends between Cyprus companies applies, and the deemed distribution rules do not apply.

31.12.2016: C Ltd declares a dividend to B Ltd, equal to €700 x 70% = €490. The dividend is not subject to SDC given that:

- it is an actual dividend between two Cyprus tax-resident companies,
- the dividend is given within 4 years from the end of the year in which the profits arose (which was 2012), out of which that dividend income was derived, (thus the exemption applies), and
- C Ltd declares 70% of its dividend income received from D Ltd, within 2 years from the end of the year in which it receives the dividend (thus the deemed distribution rules do not apply).

31.12.2018: B Ltd declares a dividend to A Ltd, equal to €490 x 70% = €343. In this case, B Ltd should withhold, and pay to the Income Tax Office (ITO), SDC at a rate of 17% (given that the 20% rate was valid only until 31.12.2013). That is to say it will withhold €343 x 17% = €58,31. The net dividend that A Ltd will receive will thus be €284,69. The reason that SDC applies is because A Ltd receives indirectly a dividend for which 4 years have passed, from the end of the year in which the profits arose (being 2012), out of which the dividend was derived - this is the application of the new legislative change. Had the amendment in the legislation not been made, no SDC would arise on this dividend.

31.12.2020: A Ltd declares a dividend to its shareholder, amounting to €284,69 x 70% = €199,28. No SDC arises on this dividend given that it derives indirectly from dividend which has been subject to SDC already (being the dividend from B Ltd to A Ltd).

Example 2

As per Example 1, except that D Ltd declares a dividend to C Ltd, equal to 70% of its accounting profits, on 31.12.2015 instead of on 31.12.2014.

Tax Treatment:

31.12.2014: D Ltd has not given an actual dividend within 2 years from the end of the year in which its profits arose. As such, the deemed distribution rules apply. Company D is *deemed*, for tax purposes, to give a dividend equal to 70% of its after-tax accounting profits, ie €1.000 x 70% = €700. This deemed distribution is subject to SDC and D Ltd will have to pay €700 x 17% = €119. This is only for the purposes of the tax declaration. There will be no journal entry for dividend in the accounting records of the company given that no *actual* dividend has been declared.

It is worth noting that had an *actual* dividend been declared on 31.12.2014, it would not have been subject to SDC, as shown in example 1 above.

31.12.2015: D Ltd declares a dividend to C Ltd. No SDC applies to this dividend given that it has already been taxed under the deemed distribution rules. The amount that C Ltd will receive will be €700 -€119 = €581.

31.12.2016: C Ltd declares a dividend to B Ltd amounting to €581 x 70% = €406,70. No SDC applies to this dividend given that it is derived *directly* from a dividend on which SDC has been imposed.

31.12.2018: B Ltd declares a dividend to A Ltd amounting to €406,70 x 70% = €284,69. No SDC applies to this dividend given that it is derived *indirectly* from a dividend on which SDC has been imposed.

31.12.2020: A Ltd declares a dividend to its shareholder amounting to €284,69 x 70% = €199,28. No SDC applies to this dividend given that it is derived *indirectly* from a dividend on which SDC has been imposed.

It is worth noting that the amount that the final shareholder will receive on 31.12.2020 is the same under both examples 1 and 2. The deemed distribution rules resulted in a faster SDC obligation arising, being on 31.12.2014 instead of 31.12.2018.

The SDC that was paid under example 2 is greater than that in example 1. The reason is that each company in the examples declares 70% of its after-tax accounting profit, but in example 2, SDC was applied at D Ltd's level, for which the gross dividend amount declared was largest.

Example 3

As per Example 1 but in addition, on 31.12.2022, D Ltd declares an actual dividend of the remaining undistributed profits from the 2012 year. On the same day, C Ltd declares the same as a dividend to B Ltd, which in turn declares it as a dividend to A Ltd, which in turn declares it as a dividend to its shareholder.

Tax Treatment:

31.12.2022: D Ltd declares the remaining undistributed 2012 profits as a dividend to C Ltd. This amounts to €1.000 - €700 (which were declared as a dividend on 31.12.2014) = €300.

No SDC applies to the dividend. This is because even though 4 years have passed from the year in which the profits arose, the exemption for dividends between Cyprus tax-resident companies still applies, given that the dividend was received directly from the profits which gave rise to those dividends and not indirectly. D Ltd is the one which made the profits from which the dividend was declared, and it is itself declaring the dividend (directly) to C Ltd.

31.12.2022: C Ltd declares a dividend to B Ltd amounting to €300 which it received from D Ltd.

C Ltd should withhold and pay to the ITO, SDC at the rate of 17%, ie withhold and pay €300 x 17% = €51. The dividend that B will receive will thus be €249. The reason that SDC applies is that B Ltd is receiving indirectly dividend, for which 4 years have passed, from the end of the year in which the profits that gave rise to that dividend were made (being 2012). Here we can see the application of the new exception to the SDC exemption rule.

31.12.2022: B Ltd declares a dividend to A Ltd being the €249 it received from C Ltd. A Ltd declares the same amount to its shareholder. In both cases no SDC applies given that the dividend is derived directly and indirectly from a dividend that has already been subjected to SDC.

Example 4

As per Example 1, except that A Ltd's shareholder is not a Cyprus tax-resident person.

In this case, no SDC will apply to any dividend declared in the structure. In addition, deemed distribution rules are also not applicable.

NOTE

The above is issued as guidance only and should not be solely relied upon to structure business transactions without expert advice. Helping to implement the low effective tax rate that the Cyprus tax system can offer, minimising potential withholding taxes from other tax jurisdictions, as well as negotiating with Cyprus and foreign tax authorities, will contribute significantly to minimising tax 'leakage' within a group.

Our experienced team here at Costas Tsielepis & Co, supported by our strong and capable network of associates around the world, are ready to help you plan your business ventures.