INFORMATION SHEET 9

Subject:	Substance		
Authored:	April 2015	**Updated:**	------------------------
Company:	Costas Tsielepis & Co Ltd		
Reference:	Double Tax Treaty Benefits		

Introduction

Cyprus maybe renowned for its gorgeous weather and beaches but it is better known in the international business arena for its highly attractive tax and corporate regime.

The island enjoys one of the lowest corporate tax rates in Europe at 12.5% and offers significant tax advantages to companies that choose to structure their holdings via a Cyprus corporate vehicle.

Cyprus maintains an extensive and highly attractive Double Tax Treaty (DTT) network around the world and access to the provisions of relevant EU directives. It also maintains a very competitive tax regime for dividends, gains from the sale of shares and margins on back-to-back loans and much more. It also features an outstanding Trust and Funds regime and Intellectual Property (IP) box as well as practically no withholding taxes on payments to non-Cypriot residents.

Double taxation benefits

In the past, most Cyprus companies could successfully claim double taxation benefits under the relevant DTT just by the fact that they were incorporated in Cyprus. In practice, the Cyprus company would simply apply for a tax residence certificate from the Cyprus Tax Authorities which they would then present to the foreign tax authority. Based on this tax residence certificate, the foreign tax authority would allow the Cyprus company to claim DTT benefits on receipt of dividends/interest/royalties from the foreign entity, typically restricted to the favourable withholding tax rates stipulated within the relevant DTT.

The above was applicable to certain foreign tax jurisdictions, such as Greece and Russia, which had not introduced the concepts of ‘management and control’ and ‘substance’ within their tax legislations.

Substance requirements

Other relatively more sophisticated tax jurisdictions, such as the United Kingdom, Switzerland and Austria, already had substance requirements as a pre-requisite to allowing Cyprus companies to claim treaty benefits. Therefore for the tax authorities in such jurisdictions, which also have DTTs with Cyprus (the Swiss DTT is currently pending ratification by Switzerland), the mere fact that a company is incorporated in Cyprus does not mean than this company is automatically entitled to claim the favourable provisions of the relevant DTT.

Over the past 2-3 years, the pressure on foreign tax authorities to find ways to increase their tax revenue and the global drive for increased transparency and exchange of information amongst tax jurisdictions have meant that most tax jurisdictions, including Greece and Russia, are becoming more sophisticated in their approach when it comes to the treatment of dividends/interest/royalties and generally expenses that are paid to companies in other tax jurisdictions.

Even jurisdictions that had implemented minimal substance requirements are becoming stricter. As part of this development, the mere fact that a company is incorporated in Cyprus and pays taxes in Cyprus on its worldwide income (and therefore able to obtain a Tax Residence Certificate from the Cyprus Tax Authorities) is no longer sufficient for a business to guarantee that a Cyprus company can access the full treaty benefits offered through the expanding and favourable DTT network that Cyprus has to offer.

Most tax jurisdictions will now examine whether the Cyprus company claiming tax benefits has substance, and is not just a shell company set up merely for tax purposes.

What is substance?

Substance can be defined as the various characteristics, notably resources, that demonstrate that the company does indeed have its activities based in the country where it is tax resident, and is not merely a “shell” company formed to avoid paying (usually much higher) tax in the country where the underlying business is based.

Substance can include, but is not necessarily limited to, any of the following:

- use of a fully fledged office as a place of business
- the registration of utilities such as water and electricity in the name of the company
- the payment of local professional rates and taxes
- employment of staff and payment of the relevant payroll taxes
- existence of a telephone number, e-mail and fax in the name of the company
- existence of a company website, company logo and company stationery
- bank statements showing local expenditure (eg. for any of the above)
- the use of local professionals (IT support, courier services etc)
- bank signatories being based in Cyprus
- accounting records and other records such as agreements, contracts, invoices etc being located in Cyprus

Substance is now a very useful tool for foreign tax authorities in determining whether a Cyprus tax resident is entitled to tax benefits under the relevant DTT. A Cyprus company being able to demonstrate that is has substance in Cyprus, as well as management and control in Cyprus, will be in a much stronger position to claim the benefits of DTTs and take advantage of the favourable Cyprus tax regime than one that does not have substance.

It is important to note that foreign tax authorities do not only examine whether a Cyprus company has substance *in Cyprus* and exercises effective management and control from Cyprus. They go beyond that to also look at whether the same Cyprus company maintains 'substance' in their own -foreign- jurisdiction, e.g. maintains a fixed place of business through which it carries out its business, or it is managed and controlled in that jurisdiction, through individuals that undertake the effective decision-making and formulation of the company policy from there.

In the event that they find substance or management and control of the Cyprus company in their own jurisdiction, not only will they not allow the company to enjoy the relevant DTT benefits, but they may also tax all or part of the income of the Cyprus company as income arising in their own jurisdiction.

Setting up fully fledged offices in Cyprus

As a result of the above, the international business industry in Cyprus is now being transformed. Many companies that are Cyprus tax residents but may have had their operations based abroad are now relocating their operations to Cyprus. At the same time, they are closing down any presence they may have had in foreign jurisdictions. Smaller companies that do not require full-time employees are hiring locally part-time employees or managers to take care of the company's day-to-day affairs.

As part of the above changes, there is now an increase in demand for office space, especially fully serviced offices, as well as legal, tax, immigration and advisory services for companies relocating their operations to Cyprus.