



Cyprus tax reform in full swing

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The Cyprus House of Representatives approved earlier this month most of a batch of tax reform bills, aimed at streamlining the island's tax system and encouraging investments.

The changes bring about a new status of a “non-domicile”, introduced to attract business executives and high net-worth individuals to Cyprus, exempting such persons from paying certain tax obligations, and thus reducing their overall effective tax rate.

At the same time, a reduction of transfer fees on real estate transactions by 50% until the end of 2016 applies.

Another provision exempts from capital gains tax the sale of land with or without a building on it, provided the property was acquired between the entry into force of the law (16 July 2015) and 31 December 2016.

There is also a notional interest deduction on fresh capital for businesses.

A number of submitted bills, which were expected to also be approved together with the above, have been deferred by the House for the session after the summer holidays, pending further scrutiny and examination.

What's in the Box?

1. Non-Domicile Status - Special Defence Contribution


The most important change is that of the legislation governing Special Defence Contribution (SDC). It is a change that affects physical persons only, and not legal persons. In order to appreciate this change, the SDC legislation must first be explained.

1.1 Understanding the SDC Legislation

SDC firstly only applies to Cyprus tax resident persons, either physical persons or legal persons.

Secondly, it only applies to three types of income, being:

- dividend income,
- interest income, and
- rental income.



SDC legislation should be seen as running 'parallel' to the income tax legislation. In Cyprus, both companies and physical persons are taxed under the same legislation, being the income tax legislation as there is no separate corporation tax legislation as in some other jurisdictions.

As such, dividend income and interest income are exempt from the income tax law and are therefore only taxed under SDC. Given that SDC only applies to Cyprus tax resident persons, this means that Cyprus imposes no tax on interest and dividend income where the beneficiary is a non-Cyprus tax resident person.

It is noted that interest income which is closely related to the business of a company is considered as business income, taxed under income tax /corporation tax rates.

Where SDC applies, gross dividend income is currently taxed at a flat rate of 17%, and gross interest income is taxed at a flat rate of 30%. A Cyprus tax resident person is taxed on worldwide income which means where SDC applies, it applies to dividend and or interest income arising from anywhere in the world, and not just from Cyprus.

With regard to rental income, the SDC is *in addition* to the tax imposed under the income tax law, although the SDC amount is normally insignificant compared to the income. The SDC on rental income is fixed at 3% of the gross rental income, reduced by 25%. That is to say the SDC on rental income is 3% of 75% of the gross rental income.

1.2 Understanding Residency

In order to understand whether SDC applies, it is important to understand residency, given that SDC does not apply to non-Cyprus tax residents.

For physical persons

A Cyprus tax resident *physical* person is any person who is physically present in Cyprus *for more than* 183 days in a calendar year. It does not matter the purpose of being in Cyprus, nor is it a condition that a Cyprus tax resident person owns or rents accommodation in Cyprus. It is literally based on the number of days without any further conditions.

In calculating the days:

- the day of departure is considered a day outside of Cyprus,
- the day of arrival is considered a day in Cyprus,
- arriving in Cyprus and departing on the same day is considered a day in Cyprus, and
- departing from Cyprus and arriving on the same day is considered a day outside of Cyprus.

For legal persons

Although the change in the SDC legislation applies to physical persons only, for the purpose of completeness an explanation of the residency criteria for legal entities is provided below.

A company is tax resident in Cyprus if it is *managed and controlled* from Cyprus. It is irrelevant where the company was incorporated. If the *effective management and control of the company is carried out* from Cyprus, then the company is Cyprus tax resident. The term *managed and controlled* is not explained in any Law in Cyprus. There is a definition that is derived from case law. Management and control is taken to mean:

- where the majority of directors reside,
- where the board meetings of the company are held,
- where the general policy of the company is formulated.

None of the above criteria is conclusive on its own. Moreover the co-existence of all three is essential. In examining this matter, the company will need to show that the board meetings and in general the decisions are taken from Cyprus, and that things such as the minutes of these meetings support this view.

1.3 The change in the law

A new concept is inserted in the SDC legislation, that of *domicile*. By the nature of this term, it is clear that it only applies to the case of physical persons.

The SDC legislation then clarifies that the SDC will only apply to a person who is a Cyprus tax resident (as defined above) *and at the same time* is domiciled in Cyprus. The table below summarizes when SDC applies under the new rules:

Does SDC apply?	<i>Cyprus tax-resident</i>	<i>Non Cyprus tax-resident</i>
<i>Domiciled in Cyprus</i>	YES	NO
<i>Non domiciled in Cyprus</i>	NO	NO


1.4 Definition of ‘domicile’

The SDC law defines the term domicile with reference to the Will and Succession Law, Cap 195, as amended. Before examining the definition of domicile in the SDC legislation, it is important to explain the definition contained in this other law.

Domicile as per the Will and Succession Law

According to this law, every person has at any given time either:

- i. the domicile received by him/her at birth (*‘domicile of origin’*), or
- ii. the domicile (not being the same as the domicile of origin) acquired or retained by him/her by his/her own act (*‘domicile of choice’*).



Under (i) above, the *domicile of origin* of a legitimate child is that of the father's, or in the case of an illegitimate child, that of the mother's.

Under (ii) above, a person may acquire a *domicile of choice* by establishing his/her home at any place in Cyprus with the intention of permanent or indefinite residence.

The domicile of origin prevails and is retained until a domicile of choice is in fact acquired. Once a domicile of choice has been acquired, it will be retained until it is abandoned, in which case either a new domicile of choice will be acquired, or the domicile of origin is resumed.

Definition of domicile under SDC

The amended SDC law provides that a person is domiciled in Cyprus if that person's *domicile of origin* (see above) is Cyprus. There are however two exemptions to this, the exemptions being from the starting point that the person *does* have a domicile of origin in Cyprus:

- a. the first is where the person has not been a tax-resident in Cyprus for a period of 20 consecutive years, before the 16 July 2015, the date when the law came into force. In this case he/she will not be considered to be domiciled in Cyprus, even though he/she has a domicile of origin in Cyprus.

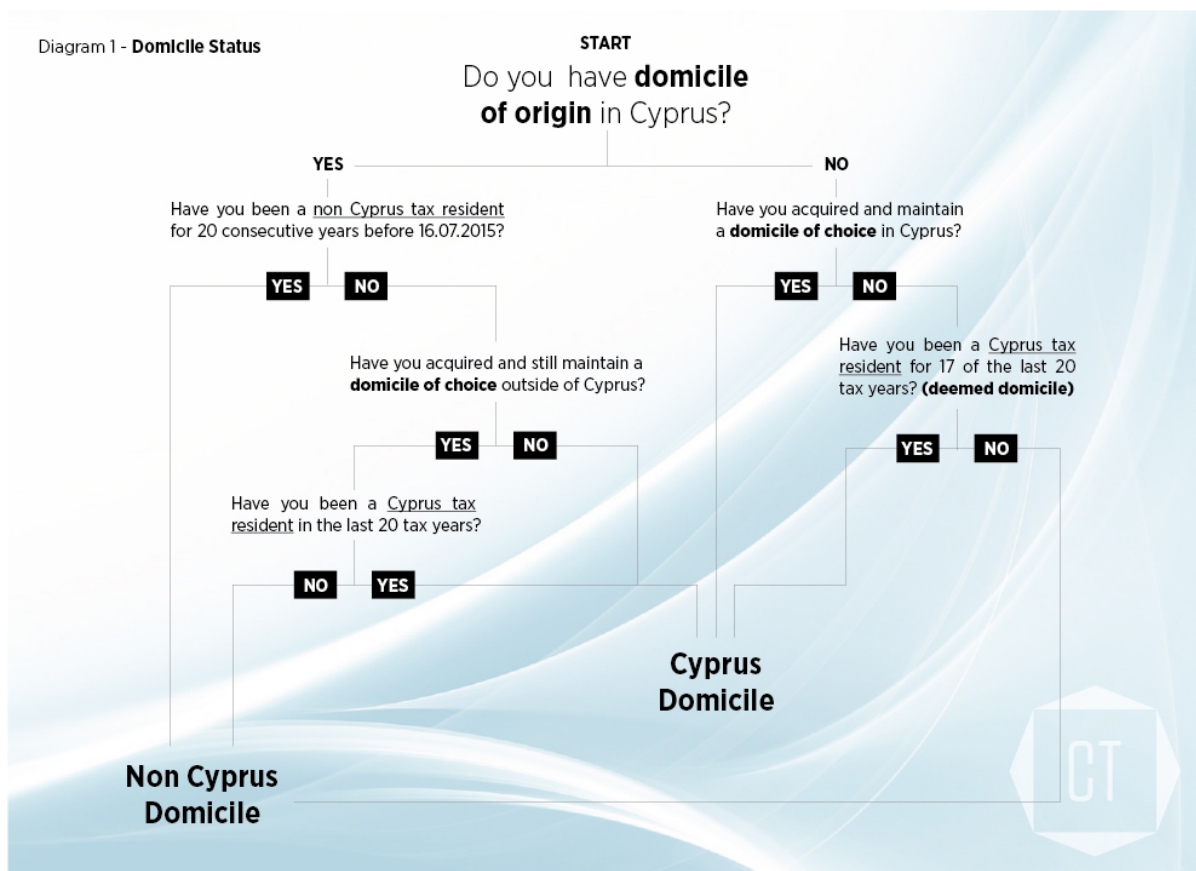
The exemption *only* applies if the years are consecutive, meaning that if the person was a tax resident even for one year in the last 20 years, the exemption does not apply.

- b. the second exemption is where that person, who has a domicile of origin in Cyprus, has acquired, and maintains, a domicile of choice *outside* of Cyprus. If the person, in this case, has also not been a Cyprus tax-resident for any period in the preceding 20 consecutive tax years, then that person will not be considered to be domiciled in Cyprus.

The exemption *only* applies if the person was never Cyprus tax-resident during the last 20 consecutive years, meaning that if the person was a tax resident even for one year in the last 20 years, the exemption does not apply, and the person will still be domiciled in Cyprus, regardless of the non-Cyprus domicile of choice.

The law also provides that any person will be deemed to be domiciled in Cyprus if he/she has been a Cyprus tax-resident in 17 of the last 20 years ('*deemed domicile*').

Diagram 1 – Domicile Status visually explains the above.




1.5 Consequences of non-domicile

Where a person is non-domiciled in Cyprus, but is a Cyprus tax resident, the following consequences arise:

- no Cyprus tax is payable on receipt of dividend income from any company anywhere in the world (although on foreign dividends, the source country may withhold taxes);
- the provisions whereby a Cyprus tax-resident company must declare at least 70% of its after-tax accounting profits within two years (known as the 'deemed distribution rules'), will not apply to that proportion of shareholding beneficially owned by a non-Cyprus domiciled individual;
- no Cyprus tax is payable on receipt of interest income from anywhere in the world (although on foreign interest, the source country may withhold taxes);
- no SDC is payable on rental income.

1.6 Discussion

This is a new concept in the tax legislation and it will be interesting to see whether the Department of Taxation will issue any guidelines. The domicile is principally based on a person's intention, and the facts surrounding that person's lifestyle. Such things as where that person owns a house, what passport does the person hold, where does the person



work and where does that person spend most of his/her time, where do his/her children go to school, in which country does the person have personal bank accounts, what clubs is he/she a member in, where does that person have a registration to vote etc are all factors that may be considered in determining whether a *domicile of choice* arises.

Therefore, in the situation where a person who does not have a domicile of origin in Cyprus, and who also claims not to have a domicile of choice either, but has in the meantime purchased a house in Cyprus, moved his/her family to Cyprus, educates his/her children in Cyprus, applied for and received a Cyprus passport, may be considered by the tax authorities as having the intention to permanently or indefinitely reside in Cyprus, and thus be domiciled in Cyprus by choice. This will require clarifications from the Department of Taxation. Until such clarifications have been made, it would be preferable to clarify any situation through a tax ruling.


Although arguably a small problem, there is one other matter that the law-makers did not 'get right'. In the second exemption discussed in 1.4 (b) above, the wording of the SDC law literary states: "person who has acquired and maintains a domicile of choice outside of Cyprus based on the provisions of the Will and Succession Law." The last part of the sentence, "based on the provisions of the Will and Succession Law" is nonsensical as in fact, there are no provisions in the Will and Succession Law for a person to acquire a domicile of choice outside of Cyprus. The law itself only provides for acquiring a domicile of choice in Cyprus.

1.7 Anti-avoidance provisions

Two provisions have also been inserted in the SDC legislation as anti-avoidance measures.

- i. The first is with regards to dividend distributions between Cyprus companies, which are in most cases exempt of SDC. The new provision states that where a dividend is provided to a company which is not wholly owned by physical persons, and the Commissioner of Taxation judges that the existence of such a company serves no commercial or economic purpose, other than to delay or avoid the payment of SDC, then the Commissioner may deem that the dividend was received by the person(s) who control(s) either directly or indirectly the company, and demand the payment of SDC accordingly, either from such person, or from the company that received the dividend.

This provision is badly thought through and badly worded in my opinion. For structures that have existed for a number of years, it may not be possible to show the commercial reasoning of their existence today, yet this provision applies to them as well. Furthermore, from my experience, the officers working at the Department of Taxation are not always able to understand commercial reasoning and commercial reality.

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- ii. The second is the following: Where a Cyprus domiciled person transfers assets to a non-Cyprus domiciled person, and the two are related up to 3rd degree, and the Commissioner of Taxation judges that the principal purpose of the transfer is to avoid the payment of SDC, then the income that arises from these assets may be subject to SDC, the obligation of which to pay rests on either the person that transferred the assets or the person that received the assets.

1.8 Date of commencement

The above change is effective as from 16 July 2015.

2. Income / Corporation tax

A new provision has been inserted in the income tax legislation to provide a notional interest deduction on new capital used in the business.

2.1 Specific provisions

Eligible persons

The notional interest deduction applies to Cyprus tax resident companies, or to Cyprus permanent establishments of foreign companies, that carry out a business activity.

New Capital

‘Capital’ is defined as issued and fully paid up shares and share premium.


‘New capital’ is defined as capital that has been introduced into the business on or after the 1st January 2015. It will not include amounts capitalised and as a result of the revaluation of movable or immovable property. It will also not include capital, derived directly or indirectly from reserves that existed as at 31 December 2014, if not linked to new assets used in the business.

Where the new capital is provided in kind, e.g. by providing assets to the company issuing shares rather than by providing funds, then the value of the capital for the purposes of the notional interest deduction cannot exceed the market value of those assets on the date of their introduction in the business, and no notional deduction will be provided if such value cannot be justifiably documented.

‘Old capital’ is defined as the capital that existed as at 31 December 2014.

Notional interest rate

The notional interest is defined as being the rate of yield of the 10-year government bond of the country in which the investment is made, increased by 3%. In any case, this will not be



less than the 10-year bond yield of the Government of Cyprus, as at 31 December of the preceding tax year, increased by 3%.

Deduction afforded

A notional interest deduction is afforded to new capital used by eligible persons in their business.

The deduction is afforded in the tax year in which the new capital is used in the business.

It notional interest is deemed to be interest by nature and as such may itself be restricted in the usual way. For example, interest on a loan used to purchase assets not used in the business is restricted. Where new capital is used for this purpose, the notional interest deduction will also be restricted.

Limitations

The above deduction is subject to the following limitations:

- the notional interest deduction cannot exceed 80% of the taxable income arising before the deduction – where an approved reorganisation scheme is used, which does not result in taxable profit, the notional interest deduction is calculated as if the reorganisation scheme never took place;
- no notional interest deduction is available in the case of a taxable loss;
- only the value of the new capital which is greater than that of the old capital will be taken into account;
- where new capital is received by an eligible person, from new capital received by another eligible person, then only one of these persons can claim the notional interest deduction on this new capital;
- where new capital is provided directly or indirectly through the form of a loan, on which an interest deduction is provided, then the interest deduction is restricted by the notional interest deduction afforded to the other business.

The Commissioner of Taxation may reject the notional deduction where he judges that the transactions were such whereby old capital was presented as new capital, or fictitious transactions were created merely for the purpose of obtaining the deduction.

Election

An eligible person can elect whether to take advantage of the notional interest deduction, either in whole or in part. Such election can be made every tax year.

2.2 Date of commencement

The above change enters into force from the tax year 2015.

3. Capital Gains Tax

The capital gains tax legislation was amended in order to provide an exemption on the future sale of a property, whether land, or land and buildings, if purchased within a certain timeframe. This should promote the investment in immovable property in Cyprus. In order to benefit from this, the sale should be subject to capital gains tax, i.e. be considered a capital disposal, and not be considered a trading disposal, which would result in income tax or corporation tax, and where no similar exemption exists.

3.1 Specifics of the Exemption

The requirements for the exemption from capital gains tax to apply, are as follows:

- i. the property should be purchased between the date when the new law enters into force, i.e. 16 July 2015, and 31 December 2016;
- ii. the property was acquired through a purchase and not through an exchange or a gift;
- iii. the purchase price was at market value;
- iv. the seller was independent of the buyer (i.e. the two are not related parties);

It does not matter when the property will be sold.

Properties however that were obtained as a result of a default of the owner on his/her mortgage will not be afforded the exemption. This last provision will not allow the properties that are auctioned by credit institutions as a result of repossession to benefit from the exemption, which in most cases would be purchased at a price significantly less than their market value. The attempt is to promote the sale of property transactions between independent parties and breathe fresh air into this suffering industry.

3.2 Date of commencement

The above change entered into force as of 16 July 2015.

4. Land and Surveys (Fees) - Land Transfer Fees

The amendment to the legislation provides for a reduction of 50% of the land transfer fees for *any* application lodged with the relevant District Land Office to effect a transfer, before 31 December 2016. The same limitation applies as in the capital gains tax law, i.e. that this exemption will not be available to properties that were obtained as a result of a default of the owner on his/her mortgage. It is immaterial when the property was purchased.

The above change entered into force as of 16 July 2015.