Tax Department issues clarifications on Notional Interest Deduction

8 September 2016 – **The Cyprus Tax Department has published a number of clarifications on the application of Notional Interest Deduction (NID).**

NID allows Cyprus companies to reduce their tax liability to as low as 2,5% from the normal 12,5% through deducting deemed interest expense on new capital introduced and used for business purposes.

The clarifications relating to the application of Article 9B of the Income Tax Law 118(I)/2002, as amended, on NID, were published on 26 July 2016, through Circular No. 2016/10, dated 18 July 2016, (hereinafter "the Circular").

The NID provision was introduced back in July 2015, effective as from 1 January 2015, and provides that companies (including permanent establishments of foreign companies) are entitled to a NID on the new equity introduced in the company and used for business purposes. The NID is equal to the "reference interest rate" multiplied by the "new equity" that is introduced and used by a company in the carrying on of its business activities. The NID cannot exceed 80% of the taxable profit for the tax year before applying the NID.

Background

As from 1 January 2015 a notional tax deduction is allowed following the application of the NID to the amount of new equity injected to Cyprus tax resident companies and used for business purposes.

The NID is deductible in a similar manner as for actual interest expense (i.e. only if it is used to finance most types of business assets). NID is deducted following the determination of a company's taxable profit.

As the NID is a 'notional' deduction there is no need for any expense being booked or any exchange of funds to take place in order for the NID to apply.

The objective of the NID is to reduce corporate debt by increasing the attractiveness of equity creating a tax lowering effect. The introduction of the NID makes even more attractive the Cyprus tax system as the effective tax rate can be reduced from 12,5% to as low as 2,5%.

New equity

New equity for the purposes of the NID means equity contributed as from 1 January 2015 in the form of paid-up share capital or share premium (ordinary shares, preference shares and redeemable preference shares). In order for the NID to apply, the subscription price paid for the issue of shares must either be by cash or in kind. If consideration is in kind, it cannot exceed the market value of the assets contributed (a transfer pricing study may also need to be submitted confirming the value of the assets contributed).

The Circular also provides an analysis of what constitutes New Equity for the application of the NID regime referring to specific scenarios such as the capitalisation of realized reserves and the introduction of new equity in the form of assets. The Circular further analyses what constitutes "equity" of a permanent establishment.

According to Circular 2016/10 the term "new equity" also includes:

- Unpaid share capital on which actual or deemed interest is imposed subject to corporation tax is considered as new equity which has been fully paid for the purposes of the Circular.
- Issue of shares relating to the capitalization of realizable reserves which were created after 1/1/2015.
- Issue of shares relating to the capitalization of realizable reserves which existed on 31/12/2014 and that can be proved that those are associated to assets generating taxable income.
- Capitalisation of loans payable, shareholders credit balances, or other liabilities through the issue of shares.
- Issue of shares relating to a non-reciprocal capital contribution.
- New equity relating to a Cyprus permanent establishment represents the average balance for the finance of the permanent establishment's operations for the specific tax year and does not include any balances between the head office and the permanent establishment which were incurred from trading or temporary financial transactions.

Reference interest rate

The NID rate (reference rate) is the yield on the 10-year government bonds (as at 31 December the year preceding the tax year the NID is claimed) of the country where the funds are invested for business purposes plus a 3% premium.

The NID rate is subject to a minimum amount which is the yield of the 10-year Cyprus Government bond plus a 3% premium.

The reference rates are determined by the Ministry of Finance based on the yield of the 10-year government bond of the respective states.

Based on the relevant announcements made by the Cyprus Tax Authorities, the **minimum** NID rates (which also include the 3% premium) to be used for the tax years 2015 and 2016 are 8,037% and 6,685%, respectively.

80% Restriction

It should be noted that NID granted on new equity cannot exceed 80% of the taxable profit of the company emanating from the assets which were financed by the new equity for the year preceding the deduction. If the company has made a tax loss, then the NID will not be available.

The "matching" principle

The Circular also introduces the ''matching'' principle which should be used when calculating the maximum NID that can be claimed.

This means that the 80% restriction should be applied by reference to the taxable profits that are generated from assets/activities that are financed by the new equity on which the NID is calculated.

Therefore, taxpayers should be able to determine the assets/activities that are financed by the new equity as well as the taxable profits generated from such activities.

The Circular provides that the new equity should be allocated as follows:

(a) New equity should be allocated between the various assets/activities of the taxpayer under the following order of priority:

- Matching concept i.e. direct matching of new equity with specific assets/activities;
- Allocation of new equity first to non-business assets and assets not generating taxable income;
- Pro-rata apportionment to the remaining assets/activities of the taxpayer.

(b) Taxable profits should be allocated between the various assets/activities that are financed by new equity, in accordance with the Cyprus tax legislation.

The NID is then restricted to the 80% of the taxable profits associated to the relevant asset/activity.

The overall NID is further restricted to the 80% of the taxpayer's total taxable profits associated from all assets/activities that are financed by the new equity (taking also into consideration any tax losses).

Anti-abuse provisions

Several anti-avoidance and anti-abuse provisions have been introduced in order to restrict any abuse of the application of the NID.

It is noted that the NID will not be granted by the Commissioner of Taxation if the taxpayer fails to properly complete the relevant section of the income tax return.

In addition if the taxpayer fails to substantiate the relevant NID calculations or if he/she fails to respond to the Commissioner of Taxation request to submit the relevant supporting documentation / calculations on the NID within the statutory deadlines, no NID will be provided.

Also the Commissioner may not grant the NID, if in his judgment actions/transactions have taken place without substantial economic or commercial purpose or the new equity on which the NID is claimed emanates from equity that existed prior to 1 January 2015 and is presented as new equity through actions/transactions with related parties, with the aim of claiming the NID.

For any additional information or for assistance with Notional Interest Deduction, please feel free to contact our Tax Department.