Cyprus implements EU's Anti-Tax Avoidance Directive

16 April 2019 – **The Cyprus House of Representatives voted into law on 5 April 2019 the provisions of the EU Directive for the adoption of rules against tax avoidance practices.**

The EU Anti-Tax-Avoidance Directive (ATAD) basically aims at preventing multinational companies in particular sheltering their profits in low or no tax jurisdictions (See our Tax Alert No. 83).

The anti-tax avoidance measures provided by the Law are the below:

1. **General Anti-Abuse Rule (GAAR)**
2. **Controlled Foreign Company Rule (CFC)**
3. **Interest Limitation Rule**

The above provisions are applicable as from 1st of January 2019.

It is expected that by the end of 2019 the provisions relating to exit taxation and rules to tackle hybrid mismatches that apply as from 1 January 2020 will also be transposed into law.

The Commissioner of Taxation is expected to issue tax circulars providing clarity and guidance as to the practical application of the CFC and interest limitation rules.

Below is a brief analysis of the relevant provisions of the new voted Laws:

1. General Anti-Abuse Rule (GAAR)

The general anti-abuse rule aims to tackle abusive tax practices that have not yet been dealt with through specific provisions.

The Law provides that for the purposes of calculating the Cyprus corporation tax liability, an arrangement or a series of arrangements which are non-genuine and have as a main purpose the obtaining a tax advantage, should be ignored.

An arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

For example, if a taxpayer, rather than simply sell its product to a business partner would devise a complicated and artificial chain of leases and corporate structures resulting in delivery of the product to the ultimate acquirer without taxation (or with reduced taxation) the Commissioner of Taxation could disregard the whole transactions and take a simple sale transaction as a benchmark.

He could then assess the income received but also take into account the costs which would normally be claimed and, therefore, arrive at an acceptable figure of taxable income and tax to be paid.

A slightly different situation may occur if a taxpayer's operations are solely driven by tax avoidance. In this case, the tax authorities have the right to completely disregard the tax effect of such transactions.

For example, a taxpayer who performs a series of transactions, disposals/acquisitions upon which a tax loss is crystallised and no other external economic benefit is gained, the Commissioner of Taxation could simply disallow any tax reduction due to this tax loss carried forward;

2. Controlled Foreign Companies (CFC)

The CFC Law has the effect of re-attributing the income of a low or zero taxed controlled foreign subsidiary to its parent and controlling company and tax such undistributed income based on the Cyprus Tax Legislation. The aim is to prevent revenue diversion to subsidiaries which are tax resident in jurisdictions with preferential tax regimes i.e. BVI, UAE, Belize, Marshall Islands etc.

A CFC is defined as an entity or a permanent establishment ("PE") whose income is not taxable or exempt in Cyprus if the following two conditions are satisfied:

- the Cypriot tax resident company, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in a foreign company. The threshold is determined in terms of participation in the share capital, voting rights or the entitlement to profits; and

- the actual corporate tax paid on the profits of the company or permanent establishment is lower than 50% of the tax that would be paid in Cyprus (i.e. less than 6,25%).

What will be subject to taxation in Cyprus will be the non-distributed income of the CFC which is derived from non-genuine arrangements that have been put in place for the purpose of obtaining a tax advantage and which are controlled by the controlling Cyprus tax resident company.

An arrangement or a series thereof is regarded as non - genuine to the extent that the CFC would not own the assets which generate all or part of its income or would not have undertaken the risks, if it were not controlled by a taxpayer who carries out the significant people functions which are relevant to those assets and risks, and are instrumental in generating the CFC's income.

Non-distributed income is considered the accounting profit after tax which has not been distributed to the controlling Cyprus tax resident company during the tax year in which the profit is derived.

The Law clarifies that only dividends distributed by the CFC during the same tax year or within the seven months after the end of the year are considered as "distributed" and reduce the amount of the CFC inclusion.

The Law also provides that no CFC inclusion should be made of any non-distributed income of a CFC if a CFC has either:

(a) Accounting profits that do not exceed €750.000 and non-trading income which is not more than €75 000; or
(b) Accounting profits that do not exceed 10% of its operating costs for the tax year.

The income or loss to be included in the tax base of the controlling Cyprus tax resident company shall be calculated in proportion to the company's effective participation in the CFC.

The income or loss shall be limited to amounts generated through assets and risks, which are linked to significant people functions carried out by the controlling company.

The attribution of income shall be calculated in accordance with the arm's length principles and is limited to the amount of the non-distributed income of the CFC. The non-distributed income or loss shall be included in the tax period of the controlling Cyprus tax resident company in which the tax year of the CFC ends.

3. Interest Limitation Rule

The interest limitation rule aims to discourage groups from providing financing facilities to companies based in high-tax jurisdictions through subsidiaries based in low-tax jurisdictions. The rule focuses on limiting the deduction of 'inflated' interest arising from the above practices.

Previously, interest expense was fully deductible, provided that it was based on the arm's-length principle and is not directly or indirectly linked to tax-exempt income. 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). The Law does provide that any exceeding borrowing costs up to €3 million (per tax year) are not subject to the restriction. The latter is a de minimis rule allowing the taxpayer to deduct fully exceeding borrowing costs up to €3 million every year.

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 company 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.

Guidance is expected to be issued by the Commissioner of Taxation relating to the allocation of the interest deductibility per company belonging to a Cypriot group of companies.

The interest limitation rule excludes certain loan arrangements which are listed below:

- loans used to fund long-term public infrastructure projects where the project operator, borrowing costs, assets and income are all in the European Union.
- loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans.

Also the Law provides an exception 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.

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.

The above exemptions are in line with the provisions of the Directive.

Where the company is a member of a consolidated group for financial accounting purposes, it may choose for each tax year to fully deduct the amount of the exceeding borrowing costs if it is able to demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group. The ratio is considered to be equal to the equivalent ratio of the group, if it is equal to or at most lower by 2% of the group ratio. Therefore, 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.

The Law also gives the possibility for a taxpayer to carry forward exceeding borrowing costs for a tax year for the next 5 years.

As a result, if a taxpayer’s exceeding borrowing costs during a given financial year are below 30% of its taxable EBITDA, it may still deduct, in addition to the exceeding borrowing costs of the current financial year, those exceeding borrowing costs that were not deductible in previous financial years (within the limits of the 30% EBITDA limit of the same year).

Furthermore, the newly enacted provisions allow for a five-year carry forward of unused interest capacity, i.e., the amount by which 30% of taxable EBITDA exceeds the amount of exceeding borrowing costs. The unused interest capacity does not take into account the limit of €3 million. The Law includes an anti-abuse provision in case a company leaves the group. Under certain conditions, the carry forward amounts of unused interest capacity and exceeding borrowing costs may be forfeited.

It is strongly recommended that clients shall assess the practical impact of the implementation of the newly voted Laws on their Cyprus structures and a detailed and constructive review of the impact of the implementation of the new provisions is undertaken in order to assess any exposure.

The Department of Taxation of Costas Tsielepis & Co Ltd is at your disposal should you require any further information, clarifications or assistance with the above.