ARTICLE NO.4

The Cyprus Holding Company

Effective as of 1 January 2003, Cyprus has introduced a new tax legislation in order to comply with the acquis communautaire of the European Union in light of its forthcoming accession. Its provisions are particularly favourable for the establishment of holding companies in Cyprus. As will be demonstrated in the article below significant tax advantages accrue to companies who choose to structure their holdings via a Cyprus company rather than directly. The new regime is expected not only to boost the popularity of Cyprus as a jurisdiction for holding companies at the expense of traditional rivals such as Denmark and the Benelux but also to complement the holding regimes of these jurisdictions by providing an effective solution for the exit route of dividends from these jurisdictions.

CYPRUS

Cyprus is the third largest island in the Mediterranean after Sicily and Sardinia, and covers an area of 9,251 square kilometers. It is located in the east Mediterranean basin, 75 km. south of Turkey and 380 km. east of Rhodes. Cyprus is a widely-used communication node with the major international airlines offering frequent services to and from the island. Larnaca and Paphos each have an international airport serving the island.

Cyprus has always enjoyed strong political, cultural and historical ties with Europe. The Republic joined the Council of Europe in 1961 and has been an active member since. An Association Agreement was concluded with the then European Economic Community in 1972 which led to a Customs Union Agreement in 1987. In July 1990 the Republic applied for full European Community membership. Procedures have since progressed and it has been decided by the European Council at Copenhagen that the next phase of enlargement will include Cyprus.

Cyprus is a natural choice for international business for a number of reasons. Apart from the tax incentives which will be discussed below, Cyprus has a number of competitive advantages for the foreign investor. First, it is located at strategic cross points and has excellent international connections. The island is serviced by two international airports and more than 1 000 scheduled flights to and from Europe, Africa and the Middle East each week. Cyprus furthermore has excellent telecommunications, a relatively low cost of living, bonded and warehouse facilities and a service-oriented economy which is highly skilled and internationally reputable. Last but certainly not least, Cyprus enjoys an extensive Double Tax Treaty network both with capital exporting countries and emerging markets. All in all Cyprus has to date concluded Double Tax Treaties with 34 countries.

The recent tax changes have only added to the competitive advantages already enjoyed by Cyprus. The rise in taxation brought about by the recently introduced legislation, still retains the tax rate at an attractive European low of 10%, and cancels limitation of benefit articles introduced into certain treaties (such as those with the UK and the US) which under the previous taxing regime, effectively excluded fiscally privileged companies from a number of benefits accruing thereto. The reorganisation rules were introduced to implement the EC Merger Directive and their main effect is that any profits or gains made as a result of a reorganisation are exempt from taxation. Although the aim of the EC Merger Directive is to facilitate cross border mergers within the EU, the Cyprus rules go further in that they are also concerned with wholly internal situations, i.e. reorganisations which have only a domestic element. Furthermore, the new legislation abolishes the five year limit for carrying forward losses, and losses from the year 1997 and onwards can be carried forward and set off against future profits indefinitely. Group Relief rules have also been enacted which provide for group relief of tax losses among companies of the same group.

The above features of the new legislation will not be discussed in the present article but their enactment no doubt influences the choice of jurisdiction when seeking an effective and well regulated place to consolidate your holdings.

HOLDING COMPANIES

Why set up a holding company? In essence, holding companies are set up as an effective means of consolidating ownership of operating subsidiaries. Setting up a holding regime is not always tax driven, but more often than not, businessmen and entrepreneurs will seek the most tax effective means of consolidating such ownership. In this exercise, various considerations are at play. What a prospective client usually looks for in a jurisdiction in which he intends to set up a holding company are the following features:

- Ability to extract dividends from foreign subsidiaries at low or zero rate of foreign withholding tax
- Ability to receive dividends at low or zero local tax
- Ability to distribute such dividends to shareholders at low or zero rate of withholding tax;
- Access to the Parent/Subsidiary Directive whereby tax-paying companies in the European Union are entitled to receive dividends from “subsidiaries” (a company in which at least 25% of the equity is held by the recipient of the dividend) in other EU countries free of withholding tax
- A good network of Double Tax Treaties to fall back on if the conditions of access to the Parent / Subsidiary Directive are not met
- Exemption from capital gains tax on any disposal of the holding in an underlying company

Jurisdictions which provide some or all of the above facilities are considered prime “Holding Company” locations, and traditionally include the Netherlands, Luxembourg, Denmark and Belgium. As from its tax reform however, Cyprus has begun to feature prominently among the most popular “Holding Company” jurisdictions, and this for a number of reasons.

First, we can examine the ability of the Cyprus holding company to extract dividends from its foreign subsidiaries. Cyprus has a good network of double tax treaties which effectively reduce the applicable withholding tax rates, especially with Eastern European countries to which Cyprus is considered the most tax effective stepping stone. As from its accession to the EU, Cyprus also has access to the Parent / Subsidiary Directive which exempts intra EU dividends from any tax when exported from one EU state to another.

1. Second, we can examine the treatment of dividends received in Cyprus. Under the new legislation, dividend income received by a Cyprus resident will not be charged under the

income tax law but under the special defence contribution law at 15%. It is important to note that dividends received from non-resident companies, which is primarily the case for international holding companies, are exempt from this tax if the holding in the paying company is at least 1%.

2. This exemption does not apply if a) more than fifty per cent (50%) of the paying company's activities result directly or indirectly in investment income and b) the foreign tax burden on the income of the company paying the dividends is substantially lower than the Cypriot tax burden.

3. The conjunction "and" implies that both these conditions must be met for the exemption NOT to apply. So for example, if a Cyprus company owns more than 1% of a BVI trading company and the BVI company pays a dividend to the Cyprus company then this dividend will be exempt from the special contribution tax of 15% because although the tax rate of the paying company is substantially lower than the tax burden of the Cyprus company (zero as opposed to ten per cent) it is a trading company so the a) criterion above is met.

4. Furthermore, credit relief for the underlying tax may be given as a credit against the Cyprus tax if provided under the double taxation agreement. As noted above, Cyprus has a rich network of double tax treaties.

5. Third, we can examine the treatment of dividends sent out from Cyprus. There are no withholding taxes on payments to non residents in respect of dividends or interest regardless of the existence or provisions of any double tax treaties. Furthermore, there is no withholding tax on royalties arising from sources outside Cyprus.

6. Fourth, as from its accession to the European Union which was on 1 May 2004, Cyprus has access to the Parent / Subsidiary Directive, which eliminates double taxation on dividends paid by subsidiaries to their parent companies located in another Member State. If minimum holding requirements are not met or if anti avoidance provisions are in place which disable access to the benefits of the Directive then Cyprus companies have a rich network of double tax treaties to fall back on which although do not eliminate, often drastically reduce the applicable withholding tax rates.

7. Fifth, there is no capital gains tax in Cyprus other than on gains accruing from the disposal of immovable property held in Cyprus or shares in companies, the property whereof consists of immovable property held in Cyprus. Moreover, the new legislation specifically exempts from taxation gains accruing from the disposal of shares, securities and debentures.

For more detailed advice on how a Cyprus Holding Company can be used to structure your business, you can contact the author at:

Written by: Peter G. Economides, FCCA
Chairman
TOTALSERVE MANAGEMENT LTD
P.O. Box 54425, 3724 Limassol, Cyprus
Tel. + 357 25866000, Fax. + 357 25866001
services@totalservecy.com / www.totalservecy.com