INFORMATION SHEET No.140

Cyprus implements the EU Anti-Tax Avoidance Directive

May 2019

Introduction

The Anti-Tax Avoidance Directive (ATAD), which was adopted by the EU Council on 12 July 2016, is effectively the action taken by the Council in response to the recommendations of the Base Erosion and Profit Shifting (BEPS) Action Plan of the OECD. The main objective of the ATAD is to ensure that tax is paid where the profits and value are generated.

Member States are obliged to transpose the ATAD into their local legislation. Towards this end, on 5 April 2019 the Cyprus House of Representatives approved amendments to the Income Tax Law ('the Law'), through which three of the five anti-tax avoidance measures of the ATAD were incorporated into the Law, as follows:

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

The amendments of the Law came into force on 25 April 2019 upon publication in the Official Gazette of the Cyprus Republic, with retroactive effect from 1 January 2019.

The remaining two measures, expected to be transposed into law sometime during 2019 with retroactive effect from 1 January 2020, are as follows:

1. Exit taxation provisions
2. Hybrid mismatch rules

It is expected that the Cyprus Tax Department will issue relevant tax circulars through which it will provide guidance and clarifications on the practical application of the above rules.

Interest limitation rule

A fairly common tax planning practice is for companies based in low tax jurisdictions to provide financing to related companies based in high tax jurisdictions. The interest expense at the level of the borrowing entities (which effectively reduces the overall tax liability) could, under circumstances, be considered as 'artificial' interest.

The purpose of the interest limitation rule is to discourage the practice of shifting profits and erosion of companies' tax bases through the practice of excessive interest payments.

The rule

In essence, the interest limitation rule provides that the "**exceeding borrowing costs**" (EBCs) will be tax deductible in the tax year in which they are incurred only up to **30% of the taxpayer's EBITDA** (earnings before interest, tax, depreciation and amortization), subject to a **de-minimis EBC threshold of €3,000,000.**

EBCs are defined as the amount by which the 'deductible borrowing costs' of a company exceed the 'taxable interest revenues' and other economically equivalent taxable revenues of the company. It is further clarified that the term 'deductible borrowing costs' include not just interest expenses on all forms of debt, but also any other costs economically equivalent to interest, as well as any expenses incurred for the raising of finance.

For the purpose of calculating a company's **EBITDA**, any income that is exempt from taxation, as well as any tax losses brought forward from previous years, are not taken into consideration.

Moreover, the interest limitation rule applies to both Cypriot tax resident companies as well as to non-Cypriot tax resident entities with a permanent establishment in Cyprus.

In case where a company is part of a group for Cyprus tax purposes (i.e. 75% participation), then the interest limitation rule - as well as the €3,000,000 threshold - applies for the Cyprus group as a whole. Otherwise, the rule will apply for the company itself.

Exemptions

Apart from the €3,000,000 de-minimis threshold, the revised legislation provides for certain exemptions where the interest limitation rule does NOT apply, as follows:

- **Standalone entities**: These are defined as entities that are not part of a consolidated group for financial reporting purposes and have no interest in associated companies (25% minimum participation) or permanent establishments.
- **Financial undertakings**: These include (but are not limited to) credit institutions, insurance and reinsurance companies, occupational retirement pension funds, social security pension schemes, alternative investments fund (AIF) managed by an AIFM, UCITS etc.
- **Grandfathering**: Interest on loans that were concluded prior to 17 June 2016 is excluded for the purpose of calculating the EBCs. It is noted that the exclusion shall not extend to any subsequent modifications of such loans.
- **Long-term public infrastructure projects**: The interest on loans used for the funding of such projects in the EU, which are considered to be in the general public interest, is also excluded for the purpose of calculating the EBCs. Notwithstanding this, it is noted that any income arising from such projects is not included for the purpose of calculating the company's EBITDA.

Carry forward provision

In case where a company has EBCs that, as a result of the interest limitation rule, cannot be deducted during the tax year in which they were incurred, the company may carry forward such EBCs and utilize them over the next five years, subject of course to the provisions of the interest limitation rule.

In addition, the company may carry forward any unused interest capacity (i.e. the amount by which 30% of tax-adjusted EBITDA exceeds the amount of EBCs) for a maximum of five years. It is noted that the non-utilised amount of the €3,000,000 de minimis exception cannot be carried forward.

Equity escape provision

The Law provides for an equity escape provision in cases of consolidated groups of companies, which is basically a comparison between the ratio of equity over total assets of the company in question against the equivalent ratio of the consolidated group.

More specifically, if a company is a member of a consolidated group for financial accounting purposes, then the company may opt, for each tax year, to fully deduct its EBCs, if it can demonstrate that the ratio of its equity over total assets is equal or greater than the equivalent ratio of the group.

To benefit from this provision, the following conditions need to be met:

- The ratio of the company's equity over total assets is considered to be equal to the equivalent ratio of the group if the company's ratio is lower by up to two percentage points; and
- All of the company's assets and liabilities are valued using the same method as in the consolidated financial statements drawn up in accordance with International Financial Reporting Standards.

Controlled Foreign Company (CFC) rule

A frequently used tax planning tool is to shift profits from companies based in high-tax jurisdictions to their subsidiaries based in low-tax jurisdictions, thereby reducing the group's overall tax liability. The aim of the CFC rule is to discourage such practice by reattributing the income of the subsidiary to the parent company and to tax such income in the jurisdiction in which the parent company is tax resident.

The rule

In essence, the CFC rule prescribes that the **non-distributed income** of a company that qualifies as a **CFC**, which is derived from **non-genuine arrangements** that have been put in place for the essential purpose of obtaining a tax advantage, **shall be included** in the taxable income of the Cypriot-resident entity that controls the CFC.

It is important to note that the income to be included in the tax base of the Cypriot controlling entity is restricted to the amounts generated through the assets and risks which are linked to the important people roles carried out by the Cypriot entity.

Definitions

Controlled Foreign Company (CFC)

A CFC is defined as a non-Cypriot resident entity ('foreign entity'), or a foreign PE of a Cyprus tax resident entity ('foreign PE') the profits of which are not subject to or are exempt from tax in Cyprus, is considered a CFC when the following conditions are met:

a) A Cypriot resident entity, either by itself or together with its associated enterprises, holds either directly or indirectly more than 50% of the voting rights, or more than 50% of the capital, or is entitled to receive more than 50% of the profits of the foreign entity; and

b) The actual corporate tax paid on the profits of the foreign entity or the foreign PE is lower than 50% of the tax that would have been imposed, if such profits were subject to tax in Cyprus in accordance with the provisions of the Cyprus Income Tax Law.

For the purposes of point (b) above, the permanent establishment of a CFC that is not subject to tax or is exempt from tax in the jurisdiction of the CFC shall not be taken into account.

Non-distributed income

The non-distributed income of the CFC is considered to be the after-tax accounting profit of the CFC which has not been distributed to the controlling Cypriot-resident company during the tax year in which the profit is derived, as well as during the next 7 months from the end of the tax year.

The CFC's income (or loss, as the case may be) that is to be included in the tax base of the Cypriot controlling entity shall be computed according to the percentage of profits that the Cypriot entity is entitled to receive from the CFC.

Non-genuine arrangements

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

Inclusion of CFC income in the Cyprus tax base

The amount of non-distributed income (or loss, as the case may be) of the CFC that is to be included in the tax base of the Cypriot controlling entity shall be limited to amounts generated through assets and risks which are linked to the significant people functions that are carried out by the Cypriot controlling entity.

Moreover, the attribution of the CFC income shall be calculated in accordance with the arm's length principle under the Cyprus Income Tax Law, and is restricted to the amount of the non-attributable income of the CFC.

Finally, the income to be included in the Cyprus tax base shall be calculated in proportion to the Cypriot controlling entity's participation in the CFC.

Exemptions

The CFC rule does not apply where the foreign company or foreign PE has:

- Accounting profits not exceeding €750,000 and non-trading income not exceeding €75,000; **or**
- Accounting profits amounting to no more than 10% of its 'operating costs' for the tax period.

Note: 'operating costs' do not include the cost of goods sold outside the country where the foreign company is resident (or the foreign PE is situated) and payments to associated enterprises.

Avoidance of double taxation

The law contains provisions for avoidance of double taxation in cases where a CFC distributes profits to its Cypriot controlling entity (or where a gain arises on disposal of the CFC), with such profits being taxable at the level of the Cypriot entity. If these profits have already been included in the tax base of the Cypriot entity in prior years, as a result of the CFC rule, then they will be deducted from the taxable income of the Cyprus company during the current tax year, in order to ensure that double taxation of such profits is avoided.

Moreover, any foreign tax paid on the income of a CFC can be claimed as a credit against the Cyprus tax liability, in case where the CFC income in question is included in the tax base of the Cypriot controlling entity.

General Anti-Abuse Rule (GAAR)

In an attempt to tackle any aggressive tax practices that are not addressed by any specific provisions, the ATAD provides for a general anti-abuse rule ('GAAR'). The rule aims at non-genuine arrangements, the main purpose of which is to obtain a tax advantage.

The rule

The GAAR provides that an arrangement or a series of arrangements which are **non-genuine**, and whose main purpose (or one of the main purposes) is to obtain a tax advantage that defeats the object or purpose of the applicable tax law, shall be ignored for the purpose of calculating the corporate tax liability. It is clarified that an arrangement (or series of arrangements) may comprise more than one step or part.

In cases where the GAAR kicks in, then the tax liability shall be calculated in accordance with the provisions of the Cyprus Income Tax Law.

Non-genuine arrangements

For the purposes of the GAAR, an arrangement or a series of arrangements shall be considered as non-genuine, to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

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