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Audit – Tax – Advisory

Cyprus enacts legislation adopting EU Anti-Tax Avoidance Directive

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Introduction

On 5 April 2019, the House of Representatives has enacted a legislation (the "**Law**") by virtue of which Cyprus adopted the provisions of the European Union ("**EU**") Anti-Tax Avoidance Directive (the "**Directive**" / "**ATAD**"), which lays down rules against tax avoidance practices that directly affect the functioning of the internal market.

The Directive stems from the action plan against Base Erosion and Profit Shifting ("**BEPS**"), which is the result of the initiative of the G20 and the member countries of the Organization for Economic Co-operation and Development ("**OECD**") to combat tax evasion through the transfer of profits to countries with preferential tax regimes.

The anti-tax avoidance measures provided by the ATAD are the following:

1. The Interest limitation rule;
2. The General anti-abuse rule ("**GAAR**");
3. The Controlled Foreign Company ("**CFC**") rule;
4. The Exit taxation rule; and
5. The rule to tackle hybrid mismatches.

These measures are included in the Directive published on 12 July 2016 (known as ATAD I), while the provisions on hybrid mismatches are extended in a second Directive adopted on 29 May 2017 (known as ATAD II).

For Cyprus, the ATAD implementation process is not, however, entirely complete as the provisions of the Directive with respect to exit taxation rules, as well as the provisions of the amending Directive with respect to anti-hybrid rules, is expected to be transposed into the Cypriot domestic law during 2019 and will be effective as from 1 January 2020.

The key provisions of the Law that apply as from 1 January 2019 are analysed in this alert. Furthermore, the Cyprus Tax Authorities ("**CTA**") are expected to issue tax circulars/guidance providing clarity as to the practical application of the relevant rules.

The Interest limitation rule

Overview

The Law introduces an interest limitation rule whereby the deductibility of taxpayers' borrowing costs is limited to 30% of the taxable EBITDA (Earnings (taxable profits) before Interest, Tax, Depreciation and Amortisation).

It is important to note that the current rules regarding tax deductibility of interest expense have not changed. Moreover, the new interest limitation rule applies to all corporate taxpayers (same as for the CFC rule), i.e. to both Cypriot tax resident companies and non-Cypriot tax resident companies which have a Permanent Establishment in Cyprus.

The interest limitation rule aims to discourage group of companies 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.

The Interest limitation rule (continued)

Scope and application

The interest limitation rule provides that the excess borrowing cost which exceeds 30% of taxable EBITDA is not deductible for the purpose of calculating the taxable income of a company. Losses brought forward are not taken into account for the calculation of the EBITDA.

By derogation from the above rule, the Law provides that any exceeding borrowing costs up to €3 million (per tax year, per company or Cypriot group, as the case may be) are not subject to the limitation (de minimis exception as allowed under the Directive).

The relevant key terms defined in the Law are the following:

"*borrowing costs*" are defined as interest expenses on all forms of debt, other costs economically equivalent to interest, as well as expenses incurred in relation with the raising of finance.

"*exceeding borrowing costs*" are defined as the excess of borrowing costs over interest income and other economically equivalent taxable revenues.

Based on the logic of the Directive, no distinction is made on the creditor type and hence the limitation equally applies to both intra-group (related) and third-party loans.

Where the company is a member of a Cypriot group, the interest limitation rule is applied at the level of the Cyprus Group, as this is defined in the Income Tax Law (75% participation group), including permanent establishments in Cyprus. On the other hand, where the company is not part of a Cypriot group, the rules will apply to the entity itself. The application of the rules on an aggregated (group) basis is not optional. In the case of a Cypriot group, the de minimis exception of €3 million is available to the entire group and not to each of its constituent entities.

Guidance from the CTA is anticipated as regards the allocation of the interest deductibility per company belonging to a Cypriot group.

Exclusions

The interest limitation rule does not apply to stand-alone entities and financial undertakings, as well as to the following types of loans:

- 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.

"*stand-alone entity*" is defined as an entity which is not part of a consolidated group for financial accounting purposes and which has no associated enterprise or Permanent Establishment in Cyprus. The terms consolidated group for financial accounting purposes and associated enterprise are defined in the Law in a similar manner as defined in the Directive.

"*financial undertaking*" is defined 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 Interest limitation rule (continued)

Equity escape provisions

Where a company is a member of a consolidated group for financial accounting purposes, it may deduct in each tax year its exceeding borrowing costs in full, provided it can demonstrate that its equity to total assets ratio is equal to or higher than the equivalent ratio of its consolidated group for financial reporting purposes (i.e. that is no more than 2% lower than the equivalent group ratio). To this end, 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.

Carry forward of exceeding borrowing costs and unused interest capacity

Any exceeding borrowing costs whose deductibility is restricted due to the application of the new interest limitation rule and any unused interest capacity (i.e. the amount by which 30% of tax-adjusted EBITDA exceeds the amount of exceeding borrowing costs) can be carried forward and be deducted from the taxable income of the entity for the next five years.

However, the non-utilized amount of the €3 million de minimis exception is not carried forward.

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.

Reorganisations

In case of a qualifying company reorganisation, any accumulated exceeding borrowing costs and unused interest capacity will be transferred to the transferee company in accordance with the relevant provisions of the legislation regarding the reorganisation of companies.

The General Anti-Abuse rule (“GAAR”)

Overview

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

The GAAR, which is largely based on the wording of the ATAD, aims to tackle abusive tax practices that have not yet been dealt with through specific provisions.

Scope and application

When calculating the corporate tax liability of a company, any arrangement or series of arrangements should be disregarded if they have been put in place with the main purpose (or one of the main purposes) of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and which are not genuine having regard to all relevant facts and circumstances.

Non-genuine arrangements are arrangements which are not put into place for valid commercial reasons that reflect economic reality.

Where arrangements or a series of arrangements are disregarded pursuant to the GAAR, the tax liability will be calculated in accordance with the provisions of the Cyprus Income Tax Law.

The Controlled Foreign Company ("CFC") rule

Overview

The relevant CFC article in the ATAD allows Member States to choose between two options. The first option is generally applicable to passive income of a CFC (option A) while the second option is applicable to income arising from "non-genuine arrangements" (option B), also referred to as the significant people functions approach. Cyprus adopted option B.

The CFC rules apply to both Cypriot tax resident companies and non-Cypriot tax resident companies which have a Permanent Establishment in Cyprus.

The CFC rule has the effect of re-attributing the income of a low-taxed controlled foreign subsidiary to its parent and controlling company. The aim is to prevent revenue diversion to subsidiaries which are tax resident in jurisdictions with preferential tax regimes.

Definition

"*CFC*" is defined as a company or a Permanent Establishment, the profits of which are not subject to tax or are exempt from tax in Cyprus, if the following conditions are met:

a. a Cypriot tax resident company, by itself or together with its associated enterprises holds a direct or indirect participation of more than 50% of the voting rights or of capital, or is entitled to receive more than 50% of the profits in a non-Cypriot tax resident company, and

b. the actual corporate tax paid on the profits by the non-Cypriot tax resident company or the foreign Permanent Establishment is lower than 50% of the tax that would be paid in Cyprus.

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

Scope and application

In the event it is determined that a foreign entity is a CFC, its non-distributed income 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 Cypriot tax resident company, is added to the taxable income of the Cypriot tax resident company.

An arrangement or series thereof shall be regarded 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 company which carries out the significant people functions which are relevant to those assets and risks that substantially contribute to the generation of the income of the CFC. Therefore, the allocation of income (or loss) is restricted to the amounts generated through assets and risks which are linked to the significant people functions carried out by the Cypriot controlling entity. It 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.

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

The Controlled Foreign Company ("CFC") rule (continued)

De minimis exception

The CFC rule is not applied where the company or the foreign Permanent Establishment has:

a. accounting profits of no more than €750.000, and non-trading income of no more than €75.000; or

b. accounting profits of no more than 10% of its operating costs for the tax period.

Avoidance of double taxation

Where the CFC distributes profits to the controlling Cypriot tax resident company (or if there is a sale of a CFC), the resulting dividend income (or profits from the disposal of the CFC) previously included in the tax base of the controlling Cypriot tax resident company in accordance with the current rule, are exempt from tax in Cyprus.

In such a situation, the dividend income (or profit from disposal) to be included in the tax base shall be reduced by the amount of the underlying profits that had been previously caught under the CFC rules and included in the tax base as CFC income.

Foreign tax relief

Any foreign tax paid on the income of the CFC or of the permanent establishment is credited against the income tax payable in the Republic of Cyprus.

How we can help

It is anticipated that the enactment of the Law will have a significant impact on Cypriot tax resident companies and non-Cypriot tax resident companies which have a Permanent Establishment in Cyprus. The Law includes provisions for substantial changes that need to be carefully considered irrespective of the type of activities they are engaged into.

Corporates are therefore urged to pay particular attention in analysing the relevant legislative developments the earliest possible, as well as to review their structures and arrangements taking into consideration the new rules with an aim to assess the level of impact and whether there is a need to take any actions.

VGDA is well positioned to provide you with more details regarding the provisions of the Law and schedule a meeting with a view to discuss how your company is affected.

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