Introduction

On 16 June 2020, an amending Income Tax Law ("**ITL**") was published in the Official Gazette of the Republic of Cyprus with respect to the application of the provisions of the Notional Interest Deduction ("**NID**") on new share capital contributed into a company after 1 January 2015.

The revised NID provisions enhance the tax benefits for Cyprus companies which finance their operations through new equity, and offer additional clarity and certainty for Taxpayers. These amendments are considered to be in line with the recommendations of the European Commission and it is expected that they will positively facilitate towards the finalisation of the review of the Cyprus NID regime by the EU Code of Conduct Group.

The key amendments performed on the NID rules effectively provide for:

- The calculation of the NID Reference rate, which, as of *1st January 2020*, needs to be based solely on the interest rate of the 10-year government bond yield of the country in which the new equity is invested (the Cyprus' 10-year government bond yield will cease to be used as comparison as from the effective date noted above), increased by 5% (instead of 3% applicable up to 31st December 2019).
- A revised definition of 'new equity', which, as of *1st January 2021*, no longer includes any equity derived directly or indirectly from reserves that existed on 31 December 2014 regardless of whether or not it is related to new assets used in the business.

Other amendments include:

- A clarification that the NID is applied, as of *1st January 2015*, under the matching principle between new equity and derived net taxable income on every income stream separately.
- A clarification that the NID is restricted, as of *1st January 2015*, in the event of a net allowable loss resulting from the introduction of new equity, which was already been applied in practice as it had been communicated by the Cyprus Tax Authorities ("**CTA**") in a relevant circular issued in 2016.

Our newsletter aims to provide some colour around the applicability of the new NID rules, outline the main benefits of the Cyprus NID regime, and highlight the tax structuring opportunities which can be exploited by Cyprus entities during the planning of financing their business.

Background

In brief, the NID adjustment which can be inserted within the tax computation is equal to the amount of the new equity multiplied by the relevant 'reference interest rate', and is subject to an annual cap of 80% of the taxable income arising from the new equity.

NID = New equity x Reference interest rate (capped at 80% of taxable profit)

It is clarified that the maximum NID that can be claimed is the lowest of:

a) 80% taxable profit resulting from the use of the new capital for each business asset or for each group of business assets or for each line of activity; OR

b) 80% of the taxable profit that resulted from the use of the new capital on an aggregated basis.

Furthermore, NID is restricted to 80% of company's taxable income of the year, as calculated before the inclusion of the NID in the tax computation. Any amount restricted cannot be carried forward.

It is also noted that Taxpayers can elect not to claim the NID or claim part of it for each tax year.

Key Provisions amended

The revised ITL introduces primarily the amendments which are summarised below.

Reference Interest Rate

Effective up to 31 December 2019	Effective as from 1 January 2020
The NID Reference interest rate is calculated on the basis of the 10-year government bond yield of the country in which the "new equity" is invested or of the Republic of Cyprus (as at 31st December of the year preceding the tax year the NID is claimed, published annually), whichever is the highest, increased by 3% (as a form of premium). Until 31 December 2019, the *minimum* NID Reference interest rate which can be applied is the 10-year government bond yield of Cyprus as at 31 December of the year preceding the tax year plus 3%.	The NID Reference interest rate is calculated solely on the basis of the yield of the 10-year government bond (as at 31 December of the year preceding the tax year the NID is claimed) of the country where the new equity is employed/invested plus 5%, and there is no minimum Reference interest rate. Where the country in which the new equity is employed/invested does not have an issued 10-year government bond as at 31 December of the relevant year, the NID Reference interest rate will be based on the Cyprus' 10-year government bond yield plus 5%.

The NID reference interest rates that shall be applicable for 2020, based on the country where the new capital is invested, is presented at the end of this newsletter for illustration purposes.

New Equity

Effective up to 31 December 2020	Effective as from 1 January 2021
Represents equity introduced into the business on or after 1 January 2015 and includes issued fully paid share capital and share premium but does not include amounts which have been capitalised and resulted from a revaluation of movable or immovable property or retained earnings (prior to 31 December 2014). The definition of new equity excludes equity created from the capitalisation of reserves existing on 31 December 2014 (pre-existing reserves), unless the equity created from the pre-existing reserves is invested in the business assets earning taxable income which did not exist on 31 December 2014.	As of 1 January 2021, it will no longer be possible to claim NID on equity created from the capitalisation of reserves existing on 31 December 2014 regardless of whether or not such equity is funding new assets used in the business.

Key Benefits from utilising the Cyprus NID regime

- ✓ Low or no withholding tax on interest payments made by foreign entities to a Cyprus company due to the favourable Cyprus double tax treaty network or EU directives;
- ✓ Deductibility of interest expenses in the borrowing company (subject to applicability of thin capitalisation rules);
- ✓ No withholding tax on dividend payments from Cyprus;
- ✓ When properly structured, a Cyprus company can achieve an effective corporation tax rate of 2,5% (or even less) instead of 12,5%.

Tax Structuring Opportunities

Debt has traditionally been a tax efficient way of financing business operations. However, tax developments are such that businesses financing their operations through back to back debt, may be subject to certain risks and challenges.

The Cyprus NID regime is directed towards reducing the discrepancy in the tax treatment between debt and equity financing, as it enhances the tax benefits of financing business operations through equity and offers a tax efficient alternative to debt financing.

It also provides a potential solution to beneficial ownership of income issues that are increasingly the subject of double tax treaty anti-avoidance provisions.

A Cyprus tax resident company / Cyprus permanent establishment of non-Cyprus tax resident company can take advantage of the tax incentive offered by the NID regime in a number of different ways taking always into account the relevant anti-abuse provisions. The recent amendments to the NID rules are of interest as follows:

- Companies should review their calculations for their 2020 annual NID amount in order to assess whether their annual NID amount is impacted by the amendments within the framework of the upcoming 31 July 2020 deadline for the submission of the 2020 provisional corporate income tax return and payment of the first instalment of 2020 provisional corporate income tax.
- Those companies that did not follow the original policy intent of "matching" as set out in the relevant CTA Circular and did not cap their annual NID amount on the basis of the "matching" concept may need to consider how their filing positions of prior years may be impacted. Such companies should have declared this non-compliance with the relevant Circular upon submission of their corporate income tax return to the CTA.
- Those companies which have pre-existing reserves invested in the business assets earning taxable income which did not exist on 31 December 2014, may wish to proceed with their capitalisation before 31 December 2020 to enable them to take advantage of the NID regime.

Taxpayers seeking to benefit from the NID regime must be able to substantiate the application and use of new equity to appropriately apply the relevant rules, such as fittingly supporting the market value of new capital contributions in kind.

How we can help

We remain at your disposal for any further information / assistance in respect of the above, including:

- reviewing and advising on the implications resulting from the amended NID provisions;
- discussing with you the relevant tax implications upon issuing new equity and/or restructuring existing financing arrangements;
- performing a business/asset valuation exercise which can be utilised by the Cyprus company when new capital is contributed in kind.

The revised NID Reference Rates for 2020 are as follows (countries marked with * have a negative interest):

Country	Interest rate of 10-year government bond yield	NID Reference Rate 2020 (New)
Abu Dhabi	2,514	7,514
Argentina	10,253	15,253
Armenia	8,064	13,064
Austria	0,016	5,016
Belarus (US$)	5,350	10,350
Belgium	0,086	5,086
Bulgaria	0,257	5,257
Canada	1,699	6,699
China	3,130	8,130
Croatia	0,621	5,621
Cyprus	0,536	5,536
Czech Republic	1,569	6,569
Dubai (US$)	3,160	8,160
Egypt	13,518	18,518
Egypt (US$)	6,382	11,382
Finland	0,043	5,043
France	0,115	5,115
Germany	-0,210*	4,79
Greece	1,431	6,431
Hong Kong	1,699	6,699
Hungary	2,017	7,017
India	6,557	11,557
Ireland	0,120	5,120
Isle of Man	1,712	6,712
Israel	0,960	5,960
Israel (US$)	2,520	7,520
Italy	1,404	6,404
Kazakhstan (€)	0,996	5,996
Kazakhstan (US$)	2,566	7,566
Kenya	12,180	17,180
Latvia	0,136	5,136
Lithuania	0,169	5,169
Luxembourg	-0,087*	4,913
Morocco	2,420	7,420
Mauritius	4,260	9,260
Netherlands	-0,060*	4,94
Nigeria	11,563	16,563
Norway	1,540	6,540
Poland	2,109	7,109
Romania	4,398	9,398
Russia	6,270	11,270
Russia (US$)	2,605	7,605
Saudi Arabia	2,839	7,839
Serbia	2,778	7,778
Singapore	1,730	6,730
Slovakia	0,192	5,192
Slovenia	0,267	5,267
South Africa	9,018	14,018
Spain	0,463	5,463
Sweden	0,145	5,145
Switzerland	-0,454*	4,546
Taiwan	0,670	5,670
U.S.A.	1,919	6,919
Ukraine (US$)	6,504	11,504
United Kingdom	0,817	5,817
Vietnam	3,459	8,459

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