



TAXATION OF INTEREST, DIVIDENDS AND CAPITAL GAINS IN CYPRUS

LAWS AND DECREES

The Income Tax (Amendment) Law of 2005

The Special Contribution for Defence (Amendment) Law of 2004

The Assessment and Collection of Taxes (Amendment) Law of 2005

The Capital Gains Tax (Amendment) Law of 2002

The Stamp Duty (Amendment) Law of 2002



TAXATION OF INTEREST

Interest receivable by a **group financing company** is considered to be business income and is not subject to the 10% defence contribution.

- **Interest not accruing from ordinary business activities** is subject to a 10% defence contribution as a final tax. 50% of such income is subject to corporation tax at a rate of 10%; **IE., A TOTAL OF 15% EFFECTIVE TAX RATE**
- **However, interest derived from ordinary business activities, including interest deemed to be closely connected with business activities (Group Finance Companies), is not treated as interest but as business profits** and is therefore not subject to the defence contribution. Such interest is fully subject to corporation tax at the general rate, without entitlement to the 50% exemption applicable to interest subject to the defence contribution, **IE., A TOTAL OF 10% EFFECTIVE TAX RATE**
- The concepts "interest derived from ordinary business activities" and "interest closely connected with business activities" are defined in Circular 2003/8, issued by the Commissioner of Income Tax. Accordingly, the former means (a) interest income of banking businesses, including all banking units, cooperatives and businesses having as a primary object the provision of loans, e.g. the Housing Finance Corporation; and (b) interest income of financing businesses offering hire-purchase, leasing and other financing arrangements. The latter means (a) interest income from trade debtors; (b) interest income of insurance companies; (c) interest income on commercial (current) bank accounts; and **(d) interest income of companies that act as a vehicle for the purpose of financing group companies (e.g. a holding company, a subsidiary company or an associated company that borrows money and subsequently lends these to other group companies). All other cases that do not fall under the above categories should be submitted in writing to the Commissioner of Income Tax for his consideration.**

Other points to note for Cyprus re: Group Finance Companies:

- Absence (under a Double Tax Treaty or the Interest and Royalty Directive) of interest withholding tax.
- Low overall tax burden.
- Possibility of deducting interest expenses from taxable income.
- Absence of thin capitalization rules or their inapplicability in the case of "back to back" financing.



- Absence of interest withholding tax in connection with interest paid on loan financing, irrespective of jurisdiction or the absence of a DTT (even for interest payments to offshore jurisdictions).
- Reasonable level of "margin" required by tax authorities.
- Low expense level for professional / financial fees.

Limitations to deduction of financing charges

Legal limitations

There are no debt/equity restrictions in Cyprus and a company may therefore be financed in any proportion of debt-to-equity.

Abuse of law concept

Under a general provision in Sec. 33 of the Assessment and Collection of Taxes Law, any artificial and/or fictitious transactions may be disregarded. Accordingly, the Commissioner of Income Tax may disregard any such transaction and assess tax on the person concerned.

This provision applies to any transaction, whether local or international, and to residents and non-residents.

Thin capitalization

There are no specific thin capitalization rules in Cyprus.

General principle on deductibility of interest

The general principle of Cyprus tax legislation, which also applies to interest, is that for an expense to be allowed as a deduction it must have been incurred wholly and exclusively for the production of income.

Consequently, interest paid on borrowings used for the trading activities of an entity or for the acquisition of "trading" fixed assets is allowed as a deduction. Interest paid by a holding company on the acquisition of a 100% subsidiary is deemed as trading in nature. Interest paid on the acquisition of "non-trading" fixed assets is not allowed as a deduction.

The following fixed assets are considered by the Commissioner of Income Tax as being "non-trading":



- investments in shares/bonds etc. (unless these represent stock);
- saloon cars; and
- land (unless this represents stock).

According to the Motor Vehicle and Road Transport Law of 1972 and the Regulations of 1984 a "saloon car" is any motor vehicle which is not used in public transport (e.g. bus, taxi), not used for the transportation of goods (e.g. van or truck) and not used for driving lessons.

Buildings that do not generate income, e.g. flats which are not rented or are used by the directors, are also considered non-trading fixed assets.

There are no specific provisions in Cyprus's treaty network relating to the deductibility of interest and thin capitalization.

Other limitations

As explained above there are no rules which relate specifically to debt-to-equity situations but to general rules which apply irrespective of the capitalization base. An overview is provided below of the general rules that apply irrespective of the capitalization base:

- exchange controls. There are no exchange controls following the accession of Cyprus to the European Union;
- deemed dividend rules. Interest payments cannot be deemed to represent dividends; and intra-group balances.
- amounts due between group companies which are not of a trading nature in a strict sense (i.e. as a result of sales and purchases between them) are expected to carry an interest charge at the market rate of interest. If not, the Commissioner of Income Tax has the authority to charge notional interest at the market interest rate under the **arm's length principle**.

Planning opportunities: tax-efficient interest repatriation

Interest paid by a Cyprus company to non-residents is not subject to withholding tax. This rule applies to all interest payments made to non-residents irrespective of whether or not these are intra-group payments.

Fiscal consolidation/group treatment

No fiscal consolidation regime exists under Cyprus law. However, companies of the same group can use the group relief provisions for offsetting losses.



Two companies are considered to be a group for group relief purposes if:

- one company is a 75% subsidiary of the other; or
- both companies are 75% subsidiaries of a third company.

A company is considered to be 75% controlled by another company if at least 75% of the ordinary share capital with voting rights is held directly or indirectly and the holding company is entitled to not lower than 75% of the subsidiary's:

- distributable profits; and
- assets of the subsidiary that would have been available for distribution to the shareholders on liquidation.

Offsetting of losses between group companies will be granted only where the surrendering company and the claimant company are part of the same group for the whole of the tax year.

If a payment for group relief occurs (i.e. a payment is made by the claimant company to the surrendering company for the amount of tax losses surrendered by way of group relief), such a payment:

- shall not be regarded, in any way, as a distribution; and
- shall be ignored in computing the taxable profits or losses of either company.



TAXATION OF DIVIDENDS

Dividends received by a holding company from its subsidiaries

The tax treatment of dividend income received by domestic shareholders will depend on the country of residence of the payer. If the dividend is received from a company residing in an EU country and the relevant conditions are satisfied, then the dividend will be received by the domestic shareholder gross, free of withholding tax based on the principles of the Parent-Subsidiary Directive.

If on the other hand, the dividend is received from a company residing in a non-EU country then the rate of withholding tax will depend on whether a double taxation treaty between Cyprus and the country of residence of the payer exists. If not, then the domestic rate of the source country will apply.

Dividend income in the hands of domestic shareholders will be taxed depending on whether the recipient is a corporate or an individual shareholder

Following the introduction of the Income Tax Law 118(I)/2002 as amended (effective from 1 January 2003), dividend income is taxed in a completely new way in Cyprus. **Generally, dividends are exempt from tax in Cyprus, except when received by a Cypriot tax resident individual.**

Dividends from Foreign companies (EU or non-EU companies)

No income tax arises on dividend income, and an exemption from special contribution for defence is in place, subject to conditions. The exemption from income tax applies with no conditions, whereas the exemption from the special contribution for defence applies subject to certain conditions (details below). We note here however that these conditions are such that practically in almost 100% of cases would not apply unless one is a Cypriot tax resident individual (not the case of international clients).

Foreign dividends are exempt from the special contribution for defence provided that the parent company owns at least 1% of the share capital of the subsidiary.
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Special Contribution for Defence Law 117(1)/2002 and more specifically Art. 3(2)(a) of this Law provides for circumstances under which dividend income from abroad **will not be subject to the tax exemption** under the special contribution for defence law. A company will not be exempt from the special



contribution for defence **ONLY if the following two conditions are satisfied simultaneously:**

A. The overseas company paying the dividend engages directly or indirectly in more than 50% activities which give rise to investment income {Dividends are not considered investment income if they are derived, directly or indirectly, from trading subsidiaries}; and

B. the foreign tax burden on the foreign company is significantly lower than the Cyprus tax burden. Significantly lower is interpreted to mean 50% lower, that is a tax rate of 7.5 %. Investment income is considered to be any income other than trading income. (The term "significantly lower" for the purpose of this section means lower than 50% of the tax rate for dividends in Cyprus, which is 15%). The Cyprus tax authorities' interpretation of "trading income" is fairly broad.

Where dividends are not exempt, a credit for any overseas tax withheld abroad is available unilaterally.

Further, a credit for underlying corporate taxes on dividends is provided under some tax treaties. A credit is also granted for profits tax paid by the direct subsidiary located in other EU Member States **or by lower-tier subsidiaries**.

Dividends paid by a holding company to its shareholders

The new Income Tax Law introduced the abolishment of the withholding tax on dividends, paid by all types of companies from 2003 onwards.

Withholding tax - Non-resident shareholders (individuals or companies)

In accordance with the Income Tax Law, where applicable, any withholding tax is dealt with under the Special Contribution for Defence Law.

As already explained no withholding tax applies to payments of dividends to non-residents, whether the recipient is a body corporate or a private taxpayer.



TAXATION OF CAPITAL GAINS

Capital gains realized by a holding company on disposal of shares in its subsidiaries

Full exemption on gains from disposal of securities

The new law that came into force on 1 January 2003 introduced full exemption from tax (capital gains and income tax) on gains from the disposal of "securities", whether the gain is considered to be of a capital or revenue nature.

"Securities" means shares, debentures, government bonds, founder's shares or other securities of companies or other legal persons which have been incorporated in Cyprus or abroad and options thereon. The definition of "securities" covers shares in both domestic and foreign companies.

This exemption enables a holding company to dispose of the shares in a subsidiary with no adverse tax implications being triggered in Cyprus.

Capital gains tax

Capital gains tax is payable only if the company whose shares are being sold is not listed on a recognized stock exchange and owns immovable property situated in Cyprus

Capital losses

A capital loss is calculated in exactly the same way as a capital gain (see above). This can be set off against capital gains arising in the year of assessment. Any unutilized capital losses can be carried forward indefinitely and can be set off against future capital gains arising out of the disposal of any capital asset. Capital losses cannot be set off against trading profits.

Capital gains realized by shareholders (individual or corporate shareholders) on disposal of shares in a holding company



No capital gains tax arises on the disposal of shares both of companies listed on a recognized stock exchange and private companies, except where the latter own immovable property situated in Cyprus.

Corporation tax and related issues

No income tax or other taxes are payable on dissolution – liquidation of a Cyprus company.



CFC LEGISLATION AND TAX HAVEN COMPANIES

Cyprus does not have CFC rules as such. Only one provision contained within the Special Contribution for Defence Law 117(1)/2002 and more specifically Art. 3(2)(a) of this Law provides for circumstances under which dividend income from abroad will not be subject to the tax exemption under the special contribution for defence law.

Foreign dividend income is exempt from income tax without conditions. It is also exempt from the special contribution for defence provided that the parent company owns at least 1% of the share capital of the subsidiary.

A company is not exempt from the special contribution for defence if the following two conditions are satisfied simultaneously:

- the overseas company paying the dividend engages directly or indirectly in more than 50% activities which give rise to investment income; and
- the foreign tax burden on the foreign company is significantly lower than the Cyprus tax burden.

Significantly lower is interpreted to mean 50% lower, that is a tax rate of 5%. Investment income is considered to be any income other than trade income.