

Setting up in Cyprus: Tax Residence

The international tax landscape has evolved over the past years so that the deciding factors for tax allocation no longer comprise a *situs* of incorporation or majority of directors' test but a close diagnosis of substance and untainted decision-making so that taxing rights are accorded where the strings are really being pulled. Cyprus itself adheres to the "substance over form" doctrine whereby the tax authorities will examine a transaction or series of transactions and may result in a finding that such transaction or series of transactions is fictitious or artificial, with no real business purpose, and should be set aside, assessing the taxpayer on what they consider to be the true object of tax. The relevant anti-avoidance article which the tax authorities are making increased use of is found in the Assessment and Collection of Taxes Law, which transposes the EU Mutual Assistance Directive (77/799/EEC) into domestic legislation and applies to both local and cross-border transactions, for residents and non-residents alike. Distinct from the Cyprus tax litmus test, international tax authorities also have a growing appetite to claim taxing rights and challenge cross-border transactions, particularly where a tax benefit is perceived to be derived by a project participating resident, director or shareholder, over whom they claim jurisdiction, whether by way of residence or domicile. The volume of such challenges is expected to increase even further when the concerted global efforts on automatic exchange of information begin to be processed and to yield results, delivering on their promise of transparency from host-to-home jurisdictions.

Challenges are of course, already rife, the UK and Russia both very alert to claiming taxing jurisdiction. In the case of *Kljun v HMRC* [2011] STI 2405 the distinction between the "contractual employer" and the "economic employer" of a Croatian employee, employed by a Cyprus company and subcontracted by the Cyprus company to a UK company, was pivotal in allocating taxing rights. The Croatian employee sought tax relief under the UK-Yugoslavia double tax treaty for the PAYE deducted by his UK employer, and it was decided that the economic employer (in the UK) rather than the contractual employer (in Cyprus) was the relevant employer for whose benefit the services were actually being rendered and therefore treaty relief was rejected. Likewise in the Eastern Value Partners Limited case (Decision of the Moscow Arbitration Court No A40-607SS/1220-388 of 29 August 2012, upheld by the Decision of the 9th Circuit Arbitration Court of Appeals No 09An-33421.2012-AK) a cross-border debt financing structure in which the Russian branch of Eastern Value Partners Limited received a loan from an interposed Cyprus creditor (ultimate lender was a BVI company) and did not withhold tax when paying interest income courtesy of the Cyprus-Russia double tax treaty was challenged on the basis that the ultimate recipient of the interest income was a BVI company with no double tax treaty with Russia. The tax office argued that the headline withholding tax rate on interest of 20 per cent should apply – on the particular facts the borrower succeeded in convincing the court that the beneficial ownership article interpretation permitted the interposition and succeeded in retaining the nil withholding tax but with new legislation brought by the deoffshorization initiatives, it is likely that the same arguments would not hold sway again.

The benefits of Cyprus taxation

One of the main drivers for setting up in Cyprus is tax. All companies tax resident of Cyprus are taxed on all their income accrued or derived from all sources in Cyprus and abroad. A non-Cyprus tax resident company is taxed on income accrued or derived from a business activity which is carried out through a permanent establishment in Cyprus and on Cyprus source income (such as rental income). A company is considered a resident of Cyprus if it is managed and controlled from Cyprus. Some of the tax advantages offered by the Cyprus regime include:

- 12.5 per cent corporate tax rate

- Broad network of double tax treaties
- Unilateral tax credit on any tax paid abroad on the same income, irrespective of the existence of a double tax treaty
- Profit from sale of shares and titles is exempt from taxation
- No capital gains tax other than on the disposal of immoveable property situated in Cyprus or shares representing immoveable property based in Cyprus
- Payment of dividends and interest to non-Cyprus tax residents are exempted from withholding tax
- Notional Interest deduction on new capital introduced as from 1 January 2015 in the form of paid up share capital or share premium of a Cyprus company is eligible for an annual notional interest deduction which is calculated as a percentage of interest on the new equity
- Transfers of assets and liabilities between companies can be effected without tax consequences within the framework of a reorganization. (mergers and demergers, divisions, exchange of shares)

Aside from corporate taxation, the Cyprus government is also stepping-up efforts on individual taxation to entice corporate managers to relocate to Cyprus and create substance for the companies they manage on the ground. Significantly, for high earning individuals (income over €100,000 per annum) moving to Cyprus, a 50 per cent deduction will apply for the first ten years. For employments commencing as from 1 January 2015, this exemption is applicable only where the individual was not resident in Cyprus prior to their employment and provided that the individual was not a Cyprus tax resident for at least three out of the five years preceding the year of employment. For employees who do not meet this threshold, remuneration from any office or employment exercised in Cyprus by an individual who was not resident of Cyprus before the commencement of their employment, for a period of five years will be eligible for a 20 per cent exemption of income subject to maximum of €8,550 annually.

In addition to the above exemptions, non-domicile rules have been introduced, whereby an individual who is a tax resident of Cyprus under the provisions of the Income Tax Law (183 days rule) but is not-domiciled in Cyprus, will be exempt from the provisions of the Special Contribution for the Defence Law (which imposes tax on interest, rents and dividends) despite the fact that they may be Cyprus tax residents and/or the income is derived from sources within Cyprus. In a nutshell, to qualify as a non-domiciled resident of Cyprus an individual must be born to a non-Cyprus domiciled father and not have been a Cyprus tax resident for at least 17 out of the last 20 years prior to the year in which such individual applies for non-dom status. The tax advantages which accrue to non-domiciled persons residing in Cyprus are that they will not be subject to the otherwise applicable SCD on dividend income at 17 per cent, interest income at 30 per cent and rental income at 3 per cent.

How to establish Cyprus corporate tax residence

Cyprus looks to management and control as the primary test for tax residency but, even if tax residency is established in Cyprus from a local perspective, if there is no business purpose and no substance to the decision making process here, home jurisdictions will be increasingly likely to challenge the host jurisdiction for taxing rights. We have seen that such challenges are rapidly increasing so corporates acting in cross border situations are attaching increased worth to securing certainty and a pre-determined tax position so as to arrange their

affairs as efficiently as possible. How can challenges be minimised? Below is a list of non-exhaustive indicators that we recommend.

By appointing qualified directors.

The ability of a Director to apply independent judgment and steer a business to profit can be deduced only from such Director's qualifications and experience. It is no longer sufficient for satisfying management and control purposes to appoint any person with a Cyprus tax residence to sit on a board and turn the stakes in favour of Cyprus tax residence. A Director must have both the freedom and acumen to decide, inter alia, independently, how to use capital or assets or the yields therefrom, what and when to make available to the shareholders by way of dividends, to intervene constructively to safeguard the position of the company from potential pitfalls and dangers, and to propose constructive solutions to tangible problems that the company may face such as deadlock or potential creditor claims.

By staffing a physical office in Cyprus.

The Cyprus tax resident company ought to have qualified personnel at its disposal in an office located in Cyprus, to fulfill and administer the transactions entered into, with telephone lines, facsimile, and a website registered with a Cyprus domain (or access link on international site). Book-keeping and audit of the Cyprus company should be conducted in Cyprus and the operative bank account should be managed from Cyprus.

By having sufficient equity.

Taking into account its assets and operating risks, a Cyprus company should be adequately capitalised to operate on a day-to-day basis. Although the thin capitalization rules in Cyprus are generous, maintaining sufficient equity will bolster substance and ward off claims from other tax authorities. What will qualify as sufficient should be considered on a case by case basis.

By bolstering beneficial ownership.

The Cyprus company should beneficially own the income it receives. Such income must accrue to the company itself and be reported to its bank account and financial statements. Contingent to this requirement, the Cyprus company should bear genuine economic risk in relation to its financing, licensing, rental or leasing transactions and obtain a real benefit therefrom where a profit is derived, with arms' length pay-outs which are commercially justifiable where group structures are concerned.

How Harneys can add value

At Harneys our Directors add real value by offering effective, high-level appointments of individuals with a proven track record in their respective fields and a demonstrated ability to comprehend and implement complex corporate strategies. Directors appointed by Harneys will exercise their duties diligently and responsibly so as to minimise challenges, facilitate treaty access and meet OECD beneficial ownership and substance requirements. Our commitment is to provide few, substantive Directorships, including non-executive Directorships in listed companies, in which we can establish an effective, problem-solving interface with the management, adding breadth of experience, local knowledge and a sound skill set to strengthen the board and steer the company to meet its targets.

Harneys Directors profiles can be found at the following links:

Emily Yiolitis

<http://www.harneys.com/people/profile/emily-yiolitis>

Pavlos Aristodemou

<http://www.harneys.com/people/profile/pavlos-aristodemou>

Demetris Loizides

<http://www.harneys.com/people/profile/demetris-loizides>

Nancy Erotocritou

<http://www.harneys.com/people/profile/nancy-erotocritou>

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