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Recent tax developments in Cyprus to attract foreign investment

The Cyprus Government has enacted the following tax legislation to attract and retain foreign investment in Cyprus:

1. The Deemed Dividend Distribution ("DDD") provisions will not apply to Cyprus companies ultimately held by foreign investors; and

2. Related-party financing transactions now have certainty with regard to minimum spreads.

Deemed Distribution Provisions

In order to enhance Cyprus' attractiveness as a financial centre, the Commissioner of Income Tax ("CIT") issued a Circular on September 13, 2011 clarifying that Cyprus-resident companies ultimately held by foreign shareholders will not fall within the DDD provisions.

Under the DDD rules, 70% of the net accounting profits, as adjusted for DDD purposes, retained two years after the end of the tax year during which the profits were derived are deemed to have been distributed to the shareholders of the Cyprus-resident company. In these cases, a Special Defence Contribution ("SDC") applies to the deemed dividend.

As part of this new development, the directors and auditors of Cyprus-resident companies are required to declare that 100% of the Cyprus company's shares are directly and/or indirectly held by foreign residents.

This development eliminates administrative burdens:

- the need for actual dividend distributions in two-tier (or more) Cyprus structures ultimately owned by foreign-resident shareholders. This would have been necessary to manage DDD implications; and
- claiming refunds by the ultimate foreign resident shareholder if SDC had previously been paid on profits distributed as dividends.

Note that where some or all of the ultimate and/or immediate shareholders of a company are resident in Cyprus for tax purposes, the DDD provisions will still apply to the extent that the company does not distribute at least 70% of its profits (as adjusted for DDD purposes) to its immediate shareholder(s) within two years from the end of the year during which such profits are derived.

Related-party financing: certainty in relation to arm's length interest spreads

On July 14, 2011, the Institute of Certified Public Accountants of Cyprus ("ICPAC") announced that the CIT accepted specific minimum spreads for related-party financing transactions.

The parameters detailed below are in line with the provisions of Article 33 of the Income Tax Law concerning arm's length conditions for related-party transactions.

With this development, Cyprus seeks to maintain and attract related party financing transactions.

Minimum acceptable spreads

From fiscal year 2008 onwards, the following minimum spreads will apply to interest-bearing loans:

Amount of loan	Spread
< €50 million	0.35%
€50 million - €200 million	0.25%
> €200 million	0.125%

For non-interest-bearing loans, the spread is 0.35% irrespective of the amount of the loan.

For the Fiscal Years between 2003 and 2007, the minimum spread is 0.30%, irrespective of the loan amount or whether it is interest-bearing.

Calculation of the spread

The minimum acceptable spreads are calculated after the deduction of all expenses directly or indirectly related to the financing transaction (i.e., net spreads).

Any foreign exchange differences (either realized or unrealized) should not be included in the taxable profit calculation of the Cypriot company. That is, foreign exchange gains should not be taxable and foreign exchange losses will not be deductible.

Loans receivables that are written-off cannot be deducted from the taxable profits of the Cypriot company. Likewise, loans payable that are waived will not be included in the Cypriot company's taxable profits.

Application of the above spreads

The above spreads can apply where:

- A Cypriot tax resident company borrows from a related party and uses the funds to on-lend to another related party within a six month period. The funds borrowed and on-lent by the Cypriot company may be interest-free or interest-bearing.
- The Cypriot company obtains one loan in order to finance a number of loans or where the Cypriot company obtains a number of loans in order to finance a single loan.
- The Cypriot company obtains a bank loan (subject to guarantees from another company in the same group) to on-lend to its related parties. Subject to certain conditions, the spread may also apply in cases where credit instruments other than loans are used.

The spreads apply to each separate financing transaction.

This development presents an opportunity for taxpayers to review their financing arrangements and benefit from the certainty offered.

Following this review, taxpayers may wish to apply for written confirmation (ruling) from the CIT for specific financing transactions.

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