
Cyprus issues guidance on notional interest deduction

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In brief

Since 2015, Cyprus tax law has provided for a tax deduction on new corporate equity through the notional interest deduction (NID) regime, in an effort to further align the tax treatment of equity and debt financing.

In July 2016, the Cyprus tax authorities (CTA) issued Circular 2016/10 (the Circular) to further clarify the definition of relevant terms and provide guidance on the NID's practical application.

In summary, the Circular provides:

- further guidance on the definitions of 'new equity' and 'NID interest rate'
 - the introduction of scheduling for the purpose of applying the 80% limitation
 - further guidance on relevant anti-avoidance provisions and
 - practical numerical examples for application of the NID.
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In detail

Existing framework

Since January 1, 2015, Cyprus resident companies and Cyprus permanent establishments (PEs) of non-resident companies have been entitled to an annual tax deduction, the NID, on new corporate equity, subject to certain conditions.

To calculate the NID, taxpayers multiply 'New equity' by the NID interest rate (limited to 80% of taxable income).

The Circular provides guidance on the definition of relevant terms and sets out

practical numerical examples for applying the NID.

'New equity'

Under current law, the NID is calculated on equity issued from January 1, 2015, in the form of paid-up share capital and share premiums ('new equity'). It is available during the period that the new equity is outstanding.

The Circular clarifies that new equity includes shares of any class, including ordinary, preferred, redeemable, and convertible shares, paid in cash or in kind.

There is also further guidance on determining the amount of new equity in the cases of:

- non-Cyprus incorporated companies that are Cyprus tax residents
- companies transferring their tax residency to Cyprus
- PEs in Cyprus or abroad,
- capitalization of reserves,
- capitalization of loans and other credit balances, including shareholders' credit balances and non-

reciprocal capital contributions, and

- reductions of equity.

NID interest rate

Under current law, the NID interest rate is the yield on 10-year government bonds on December 31 of the prior tax year of the country where the funds are employed, plus a 3% premium, subject to a minimum amount equal to the yield of the 10-year Cyprus government bond on the same date, plus a 3% premium.

The Circular provides further guidance on how to calculate the relevant bond yield.

According to the Circular, the CTA annually will publish on its website the NID interest rates for selected jurisdictions.

The Circular also includes a procedure for taxpayers to request confirmation of the applicable NID interest rate for any jurisdiction that is not on the published list.

80% limitation

Under current law, the NID is limited to 80% of taxable income.

The Circular introduces scheduling for purposes of calculating the applicable limitation. The limitation will be applied with reference to the taxable

income generated from the assets and activities financed by the new equity on which the NID is calculated.

Taxpayers should be able to determine the assets and activities that are financed by new equity, as well as the taxable income generated from such activities, as described below:

- a) New equity should be allocated between the taxpayer's various assets and activities in the following order:
 - direct matching of new equity with specific assets and activities, known as the 'matching concept',
 - priority allocation of new equity to non-business assets and assets not generating taxable income,
 - pro rata allocation to the taxpayer's remaining assets and activities.
- b) Taxable income should be allocated between the various assets and activities that are financed by new equity, in accordance with the Cyprus tax framework.

The NID then is limited to 80% of taxable income derived from the relevant asset or activity.

The overall NID also is limited to 80% of total net taxable income derived from all assets and activities that are

financed by new equity, taking any tax losses into account.

Anti-avoidance provisions

The Circular provides further clarity and practical numerical examples on specific anti-avoidance provisions in the current law.

The Circular discusses several of the following key anti-avoidance provisions:

- determining the market value of contributions in kind
- capitalization of pre-2015 reserves
- new equity resulting from the new equity of another Cyprus taxpayer
- new equity resulting from funds on which another Cyprus taxpayer obtains interest deductions and
- new equity issued during tax-qualifying reorganizations.

Finally, the Circular re-emphasizes the general anti-avoidance provision for non-commercial transactions stipulated in the current law.

The takeaway

Taxpayers seeking to benefit from the NID provisions must be able to substantiate the application and use of new equity to appropriately apply the provisions in the Circular.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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