Question 1

Part 1

Based on the definition provided in the Cyprus Income Tax Law, as regards patent royalties, the initial license fee to be received by PS SAS would fall under the definition of royalty income. Cyprus does not in principle charge any withholding tax on royalty payments made from Cyprus residents to foreign beneficiaries, unless the royalties are exercised within Cyprus. In this respect a 10% withholding tax applies to the royalty payments, based on the domestic law provisions of Cyprus. In the case at hand, however, taking into account that the rate of withholding tax on royalty payments between Cyprus and Frelandia is nil, no withholding tax would apply in Cyprus.To be noted also that an exemption from the payment of withholding tax on royalty payments is also provided in the Interest Royalty Directive of the EU, to the extent that the paying and the receiving entity are related parties (minimum shareholding 25% for at least 2 consecutive years). However, the provisions of the EU Directive do not seem to apply in the case at issue.

Part 2

The same as above applies to the annual support fee to be invoiced to Cyprus entities, subject to the condition mentioned above (exercise of royalties within Cyprus). In this respect, a 10% withholding tax would in principle apply on the payment of the fee, based on Cyprus law provisions, being however, reduced to nil, as there is no withholding tax on royalty payments between Cyprus and Frelandia.

Part 3

In case the initial license fee and the annual support fee were to be invoiced by a Cyprus subsidiary, then no withholding tax would apply, as the Cyprus law does not provide for withholding tax on payments between Cyprus tax residents. The same would also apply in case a Cyprus branch were to be set up.

Part 4

In case the initial license fee and the annual support fee were to be invoiced by a Cyprus subsidiary the royalty income to be received would fall under the IP box regime provided in the Cyprus tax legislation. In this respect the annual profits of the Cyprus subsidiary would be reduced by any direct expenses incurred (e.g cost of development), which if capitalized would be subject to capital allowances at the rate of 20% per year. To be noted that the direct expenses include also any notional interest deduction, in case of new equity to be injected in the Cyprus subsidiary either in the form of paid up share capital/share premium in cash or in assets in kind (at market value). Following the deduction of the above direct expenses/capital allowances, a statutory deduction of 80% is granted by the Cyprus legislation and the remaining profits are taxed at the applicable corporate rate of 12,5%. In case of IP losses, only 20% of the losses can be carried forward and the remaining amount is lost.

The profits of the Cyrpus branch would be also taxed in the same manner and would be also taxed in Frelandia, taking a credit for the tax paid in Cyprus. In case the branch would incur losses these would be aggregated with the profits of the foreign head office, thus leading to a tax saving equal to the amount of losses at the corporate tax rate of Frelandia (35%).

As regards withholding taxes on the payment of royalties to the Cyprus entity the relevant tax treatment would be defined in the local jurisdictions of the countries paying the royalties, subject to the provisions of the relevant Double Tax Agreement and the EU Interest Royalty Directive, which could reduce or even eliminate the tax payable.

Part 5

If the Cyprus operations are financed by equity by PS SAS then the income to be received would be dividends, distributed by Cyprus to Frelandia.

If the operations were to be financed by loan received by a bank in Frelandia and then redirected to the Cyprus Company, the back to back loan arrangements provisions would apply. A margin should be charged on the loan to be granted by PS SAS to the Cyprus company (currently at the rate of 0,35%) which margin would be taxable at the level of PS SAS. Interest expense would be payable by the Cyprus company, which would be deductible only on the basis that it is used to finance its business assets. No withholding tax would apply on the interest payment by Cyprus to Frelandia.

In case the Cyprus Company would receive a loan directly from a Cypriot bank the interest expense would also be deductible to the extent that it is used to finance its business assets.

Part 6

In case of the sale of business by the Cypriot company (trading goodwill), any gains/profits (following the deduction of any related costs) would be subject to tax, as this is trading income.

The profits arising from the transfer of shares would be exempt from corporate income tax, as well as from capital gains tax, to the extent that no immovable property is situated in Cyprus.

Question 2

Part 1

Sections 26-30 of the Cyprus Income Tax Law explicitly prescribe the different methods of reorganizations schemes qualifying for tax benefits, in line with the EU Merger Directive.

The merger of the three companies could either be achieved through a merger of the three companies into a new company or through the merger of the three companies and their absorption by Success Ltd (hereinafter "Success"). In this case the three companies on being dissolved without entering into liquidation would transfer all their assets and liabilities either into the new company to be formed or into an existing company, in exchange for the issue of new shares to their shareholders or shares and cash, which could not exceed 10% of the nominal or accounting par value of the shares, in the share capital of the other entity.

In such case, no income tax is due, no capital gains tax, no Special defence Contribution, no stamp duty, no land transfer fees, no mortgage fees, no need for balancing statement. The capital allowances (if any) are continued to be claimed by the receiving entity, the losses of the transferring entity are utilized by the receiving entity as if the merger had not taken place, as well as the depreciation of assets.

Part 2

In case all three companies are merged into Success, the latter would have to increase its share capital and issue new shares to the minority shareholders of Alpha Ltd. Alpha Ltd would be liquidated. In addition, Success would issue new shares to the shareholders of Loss Ltd, i.e. Mr Loris and the minority shareholders, and Loss would be liquidated.

Part 3

The value of the losses could be determined on the basis of the tax saving that could be achieved due to the carry forward right provided as a result of the merger, i.e. value of EUR 13.750 (110.000 x 12,5%).

As mentioned above, the cash payment in the framework of the merger could not exceed 10% of the nominal value (or the accounting par) value of the shares. In case the cash consideration exceeds the above percentage, and in view of the fact that in the case at hand there is immovable property situated in Cyprus, this may give rise to capital gains taxation in Cyprus, to the extent it can be considered that the gains arising from the cash consideration received from the shareholders are related to the immovable property in Cyprus. Moreover, a Special Defence Contribution ("SDC") obligation may arise in respect of the company's dissolution subject to the provisions of the deemed dividend distribution. In particular, in case of a company's dissolution 70% of the accounting profits (net of any taxes) of the 5 years prior to the dissolution are deemed as being distributed to the company' shareholders. To be noted that the SDC obligation arises only to the extent that the ultimate (direct or indirect) shareholder is both Cyprus tax resident and Cyprus domiciled (i.e. either domicile of origin in Cyprus, granted at birth, or Cyprus tax resident for at least 17 years out of the last 20 years immediately prior to the year of tax assessment).

Part 4

Taking into account that the overseas operations are currently loss making and will continue to be for the next 2 years, the form of the branch seems to be tax efficient, in the sense that losses are set off against the profits of the Cypriot head office, subject to the loss recapture rule (i.e. when the branch turns profitable, the losses of the previous year are added back to the profits of the Cyprus company and included in the latter's taxable profits). The profits of an overseas branch are exempt from tax in Cyprus if the activities do not directly or indirectly result more than 50% in investment income and the foreign tax burden is not lower than 6,25%. Said profits are included in the accounting profits of the Cyprus company for deemed distribution purposes. The profits of a subsidiary are taxable in the state of its residence, set off against the subsidiary's losses. The profits of a subsidiary are also taken into account in the accounting profits of the Cyprus company for deemed distribution purposes, however the subsidiary could control the dividend flow, unlike the branch.

Therefore, it would be more efficient to convert the overseas branches into subsidiaries as soon as they become profitable.

To be noted that the tax system of the jurisdiction where the branch/subsidiary is located should be in any case taken into consideration, as regards the corporate income tax rates, any withholding tax obligations on dividend payments, as well as any difference between the tax treatment of branches and the tax treatment of companies.

Finally legal considerations should be taken into account, as any legal claim against the branch would affect also the Cyprus head office, unlike in case of a subsidiary which is a separate legal entity.

Question 3

Part 1 and 2

The capital gain tax exposure of Kyri is as follows per each option:

Option 1: Sale of the shop in Broatania in exchange for the villa plus 200.000 eur in cash

In this case the capital gain would be determined as follows:

Total of the value of the villa (500.000) plus the cash consideration(200.000)
Less indexed acquiition cost of shop (420.000 x 40%) 168.000
Less roll over relief due to the exchange (500.000 - 168.000) 332.000
Capital gain 200.000
Less lifetime exemption for primary residence 84.000
Taxable capital gain 116.000
Capital gain tax 20% 23.200

In addition to the above a balancing statement should be conducted in order for the determination of any tax deductible/taxable item. The acquisition cost of the shop is reduced by the capital allowances claimed and this results to the written down value. If the written down value exceeds the sale proceeds the difference is tax deductible. If the written down value is less than the sale proceeds the difference is taxable.

To be noted that the capital allowances would be claimed on the basis that no capital allowance has been claimed in Broatania.

The readjusted value in case of a future disposal would amount to (500.000 less roll over relief 332.000) 168.000.

Option 2: Acquisition of villa in exchange for the plot in Nicosia

Total value of the villa 500.000
Less indexed cost of plot (200.000 x 40%) 80.000
Less indexed cost of land - based on 01.01.1980 value, as donation is not taken into account and initially acquired before 01.01.1980- (40.000 x 40%) 16.000
Less roll ove relief due to exchange (500.000 - 80.000 - 16.000) 404.000
Capital gain Nil
Capital gain tax nil

In addition to the above a balancing statement should be conducted in order for the determination of any tax deductible/taxable item. See above (the cost of land is not taken into consideration in this case).

The readjusted value in case of a future disposal would amount to (500.000 less roll over relief 404.000) 96.000.

Option 3: Acquisition of villa in exchange for two pieces of agricultural land (Limassol and Nicosia)
Total value of the villa 500.000

Less indexed cost of land Limassol (100.000 x 40%) 40.000
Less indexed cost of land - based on 01.01.1980 value, as donation is not taken into account and initially acquired before 01.01.1980- (40.000 x 40%) 16.000
Less roll over relief due to exchange (500.000 - 40.000 - 16.000) 444.000
Capital gain Nil
Capital gain tax nil

In addition to the above a balancing statement should be conducted in order for the determination of any tax deductible/taxable item. See above (the cost of land is not taken into consideration in this case).

The readjusted value in case of a future disposal would amount to (500.000 less roll over relief 444.000) 56.000.

Finally, as a side note, based on a recent legislative amendment the disposal of immovable property for the period 16.07.2015 until 31.12.2016 is exempt from capital gains tax.

Part 3

Rental income from the rent of the villa would be subject to income tax in Cyprus, even if Kyri returns to Broatania. The gross income, less any deductions, capital allowances claimed and interest on loan received (not the case here though), as well as less the statutory deduction of 20% would be subject to income tax in Cyprus. Any Cyprus tax paid would be credited against his tax liability in Broatania.

The above income would not, however, be subject to SDC, as the latter is imposed only on individuals who are both Cyprus tax residents and Cyprus domiciled. To the extent that Kyri cannot be considered either the one or the other following his moving back to Broatania and taking into account the facts of the case (lived in Broatania for his entire life, where his wife and children reside, and took up residency in Cyprus only for a limited period of time) Kyri would not be subject to SDC on his rental income.

Question 4

Part 1

The conditions for the establishment of a Cyprus International Trust are: a) the settlor should not be a Cyprus tax resident in the year prior to the establishment of the Trust, b) the beneficiaries should not be Cyprus tax residents in the year prior to the establishment of the Trust, and c) any of the trustees should be tax resident in Cyprus for any period during the term of the Trust. In light of the above, to the extent that the settlor/beneficiaries meet the above requirement (i.e. non tax residence in Cyprus) for the year prior to the establishment of the Trust, they could take up residence in Cyprus, following the establishment of the Trust, subject to the above condition.

Part 2

Trusts, in general, are not separate legal entities. For tax purposes they are considered to be transparent, therefore any income is being attributed to the beneficiaries and is taxed in accordance with the applicable provisions. In the case in particular of Cyprus International Trusts, the beneficiaries that are Cyprus tax residents are subject to tax in Cyprus on the basis of their worldwide income, i.e. income from sources within and outside Cyprus, while the beneficiary's non Cyprus tax residents are only taxed on income arising only from sources within Cyprus.

In this respect Cyprus tax resident beneficiaries (individuals) are subject to income tax, being able to claim any allowance or exemption prescribed in the law, SDC on any divend/interest/rental income received (to the extent they can be also considered Cyprus domiciled based on what is being mentioned above), capital gains on the disposal of immovable property in Cyprus or unquoted shares holding directly or indirectly immovable property situated in Cyprus, immovable property tax on any property owned in Cyprus on January 1st each year (calculated on the basis of the 01.01.1980 value, not applicable to owners having properties of less than 12,500 eur value), and stamp duty on the relevant transactions prescribed in the law (unless contract is signed outside Cyprus; the exemption does not apply in case where the contract mentions that the Cyprus courts of law are competent for any dispute arising from the contract).

On the other hand non Cyprus tax resident beneficiaries would be subject to income tax only on income generated within Cyprus (incl. rental income of immovable property situated in Cyprus acquired by persons both non tax resident and non-domiciled in Cyprus). They would not be however subject to SDC on dividend/interest income. Capital gains tax wouuld be due on the disposal of immovable property in Cyprus or unquoted shares holding directly or indirectly immovable property situtated in Cyprus (subject to the provisions of each applicable Double Tax Treaty- mostly art. 6 and 13 of the OECD Model Convention, if they follow said Convention). Immovable property tax would be also due on any property owned in Cyprus, whereas stamp duty treatment would differ, depending inter alia on the transaction and the place of the signature of the agreement.

Question 5

Introduction

The controlled foreign company (CFC) rules have been a topical issue in the last few years and has certainly been on the OECD's agenda since at least 1998. These rules form an essential part of the BEPS agenda but have also been used by certain countries since the late 60s (e.g. CFC rules were introduced in the US as part of Kennedy's administration). Arguably, strong CFC rules are one of the most efficient anti-avoidance tools that a country can incorporate into its domestic legislation.

Certain countries contain alternatives to CFC rules. For example, the Netherlands adopts general anti-abuse principles (fraus legus) as an alternative to CFC rules and, therefore, has not focused on implementation of domestic CFC rules.

However, it is widely acknowledged that CFC rules form a strong basis of domestic anti-avoidance provisions which, alongside GAAR, TAAR and other anti-avoidance provisions, can help a particular state to prevent avoidance of local taxes.

Outline of the role of CFC rules

The CFC rules are a form of domestic anti-avoidance rules. Broadly, they operate to attribute foreign income (and in some countries - gains) of a non-resident to a member/shareholder who controls the non-resident in question (i.e. in the tax year that income arises to the non-resident, not distributed to its members/shareholder).

The CFC rules seek to prevent avoidance of local tax by transferring, inter alia, income-generating assets offshore. Without effective CFC rules the taxpayer could transfer such assets offshore and, whilst effectively being entitled to such offshore income (economically), is not taxable in its state of residence until distribution of income by the non-resident (thereby affording potentially indefinite deferral of tax or, worse, non-payment of tax at all (e.g. where income is never distributed by the offshore company)). The main role of CFC rules is, therefore, to prevent this form of tax avoidance/evasion.

As an example, (revised) UK CFC legislation was introduced from 1 January 2013 and attributes income (not gains - the UK legislation contains a separate anti-avoidance rule that attributes gains of a non-resident to its 25% shareholders under section 13, Taxation of Chargeable Gains Act 1992) of an offshore entity to a UK resident taxpayer who "controls" (broadly, 50%, but there are special rules where 40% threshold is met) the non-resident. There are:

1. A number of exemptions from a CFC charge under the UK legislation (e.g. where the foreign tax rate is at least 75% of the UK corporate tax rate, which currently is 20% (reducing to 18% by 2020), where the foreign territory is on the list of "approved territories", where the non-resident satisfies the "low profit margin tests" etc);

2. A number of safe harbours (e.g. when certain conditions are satisfied, a CFC charge is not triggered); and

3. A number of gateways (if profits pass through one of gateways, such profits of a non-resident will be subject to a UK CFC charge. Gateways focus on certain income streams of the non-resident and NOT on the entire entity. For example, where there are "significant people

functions" that the non-resident has in the UK in respect of a particular income stream, such income stream may be subject to a UK CFC charge).

<u>CFC being an essential component of the BEPS Action Plan</u>

BEPS Action Plans (first introduced in July 2013) aim to prevent erosion of tax by multinationals who employ different tax-planning techniques to shift profits to a low-tax jurisdiction. Broadly, the aim of OECD's BEPS initiative is to introduce framework for countries to implement rules to prevent "base erosion and profit shifting".
Naturally, CFC rules are key in preventing the erosion of local tax base by various multinationals.

As mentioned, CFC rules form part of a country's domestic anti avoidance legislation and, alongside other BEPS initiatives (e.g. to introduce anti-hybrid rules, BEPS Action 2), play an important role in combating aggressive tax avoidance/evasion.

The final BEPS reports (including on CFC - Action 3) were issued on 10 October 2015. Action 3 concludes that countries ought to introduce CFC rules as part of their domestic tax laws and contains certain recommendations in relation to effective CFC rules (i.e. contains a framework for CFC rules). However, the major criticism of Action 3 is that it does not contain a *specific* (as opposed to quite generic) template of CFC rules and therefore countries are left with choice of implementing CFC legislation that they deem fit. This is unlikely to lead to a "uniform implementation of the BEPS measures", which is arguably a major drawback of Action 3 suggestions.

As a side note, the UK has not indicated (as of today) that the abovementioned UK CFC rules will be modified as a result of Action 3.

Lastly, it should be noted that the operation of CFC regimes is not a very new focus for the OECD. For example, in 1986 the OECD issued two reports on base and conduit companies that touch upon domestic CFC provisions. Later on, in May 1996, the OECD was called upon to develop measures to counter the distorting effects of harmful tax competition and the consequences for national tax bases, which resulted in the Harmful Tax Competition Report (1998). This report provides a number of recommendations, one of which concerns CFC or equivalent rules. In particular, the report suggested that countries that do not have such rules consider adopting them and that countries that has such rules ensure that they apply in a fashion consistent with preventing harmful tax practices.

<u>Legal and policy considerations that need to be addressed when designing CFC legislation</u>

It is important that a state considers a number of legal and policy issues when designing (or redesigning) its CFC legislation.

Legal issues

1. CFC rules should not operate in a way that breaches other rules, for example the EU principle of free movement/establishment. In particular, the rules should not unduly restrict local taxpayers from operating in another jurisdiction. This point was recently considered in the Cadbury Schweppes case. In this case the UK CFC rules (old CFC rules) restricted the taxpayers ability to establish subsidiaries in Ireland. The court held that, in principle, CFC rules can restrict freedom of establishment but only when such rules apply to counter tax avoidance. In particular, CFC rules can restrict the freedom of establishment if the taxpayers arrangements are "wholly artificial arrangements". However, in this case it was held that the CFC rules went

beyond countering wholly artificial arrangements and, therefore, constituted an unjustifiable restriction on the EU freedom of establishment.

2. Another issue to consider is the interrelation of local CFC rules with double tax treaties (DTTs) that the country in question has entered into. For example, in the Bitcom case it was held that CFC rules fall outside the scope of DTTs (which is also confirmed in the OECD Commentary. See for example, para 13 on Article 7). To contrast, in the Schneider case the court decided that the application of the French CFC rules was precluded by the operation of Article 7 of the French-Swiss DTT.

3. Some countries (e.g. developing countries) are unlikely to be able to develop and apply in practice comprehensive CFC rules. The OECD's initiative relating to Tax Inspectors without Borders may be used in this regard to assist with implementation of local CFC rules based on other tax inspectors' practical experience.

Policy issues (see also BEPS Action 3 report)

1. One key issue to consider is the need to strike a balance between taxing foreign income and maintaining competitiveness. This means that a country should not impose too strict (or unreasonable) CFC rules that will have an impact on worldwide trade/competition and/or restrict its own competitiveness. In this regard, BEPS Action 3 report recognises two primary types of competitiveness concerns:

   a. Jurisdictions finding themselves at a competitive disadvantage relative to jurisdictions without CFC rules, which means that the taxpayer is more likely to choose to invest via a jurisdiction which has no CFC rules. This may lead to market distortions.

   b. Jurisdictions with robust CFC rules vs jurisdictions with less strict CFC rules

2. Another issue to to ensure that CFC legislation does not create unnecessary burdensome compliance and administrative issues for taxpayers and tax authorities. This is related to the first issues.

3. CFC rules should act as preventative measures (i.e. a deterrendt) and NOT to raise revenue for a particular state. States should recognise that.

4. Base stripping (whether CFC rules in question will focus on the parent company alone, or other companies in the group, thereby having a wider scope)

5. The interrelation between CFC and transfer pricing rules should be considered.