THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2017

PAPER 2.03 – CYPRUS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Tax residency of physical persons is determined by reference to physical presence according to Cyprus Tax Law.

As Mr Xing was physically present in Cyprus for more than 183, he is deemed as Cyprus tax resident for the 2016 tax year.

The question does not tell us as to how Tigral law determines tax residence of physical persons And therefore Mr Xing could find himself in a dual tax residency position, which means that The tie-breaker rules of Article 4 OECD MC will have to be applied between the Cyprus and Tigral competent authorities in such a case.

According to the tie-breaker rule, if both States consider an individual as their tax resident on the basis of physical presence or any other criterion. The next stage is to examine where the individual's center of vital interests are found.

From the facts of the case, Mr Xing's center of economic interests remains in Tigral, as he is still the managing director and controlling shareholder of a Tigral company. However, his family (personal) ties during 2016 were with Cyprus.

As personal (family) ties were in Cyprus during 2016, on balance Mr Xing will most probably be treated as a Cyprus tax resident.

Assuming that the center of vital interests cannot be easily be agreed between the competent authorities, the final test is that of citizenship.

However Mr Xing is a citizen of both countries and the citizenship test cannot be applied, although Mr Xing is still Tigral domiciled.

Part 2

Capital gain on sale of first private residence (900k-700k=€200K) – specifically exempt as acquisition and disposal took place before the end of year 2016 (s exemption).

Hotel rental income – Rent accruing in 2016 less 20% less annual capital allowances on initial cost of €900,000 @ 4% annually, taxed at standard personal income tax rates.

Hotel's renovation will be treated as a capital expense and not deductible for income tax purposes.

Hotel rental income – specifically exempt from special defense contribution (SDC), as Mr Xing is a non-dom.

Deemed divestment in real estate company (investment of Mr Xing's friend in October 2016). (Value of company in October 2015 was 5m/55% = €9m / Value of company in October 2016 was 2.5/15% = €16.67m / Mr Xing's gain (55%-45%) x (16.67-9)=€766,000 less lifetime exemption of €17.100 will be subject to capital gains tax at 20%.

Dividends and interest received from Xing Aviation Co Plc are specifically exempt from income tax.

Dividends and interest received from Xing Aviation Co Plc will be exempt from SDC, as Mr Xing is a non-dom.

Despite the analysis in part 1 above re: Me Xing's tax residency, Mr Xing's salary is taxable in Tigral, as Mr Xing had spent more than 90 days there during 2016 (Art.6 OECD MC).

As Mr Xing is a Cyprus tax resident, his salary from Xing Aviation Co Ltd, will also be taxable in Cyprus (Worldwide income basis of taxation).

Mr Xing will be able to claim the 90 day rule exemption, as he was employed by a foreign employer abroad.

Therefore 4/12ths of his salary will be exempt from income tax in Cyprus.

Mr Xing will also be able to claim DTR on his Tigral salary on 8/12 of the tax withheld at source from his salary in that country (ordinary credit relief s.23 Law 118/2002).

Question 2

Part 1

As project 1 will last for less than 6 months, assuming that the company will not register a branch in Cyprus, there are no income tax obligations in Cyprus.

The company will however be providing services to Cyprus and will have to register for VAT in Cyprus through a VAT representative and charge and account for VAT.

Part 2

Project 2 will last for more than 6 months and according to Cyprus income tax law, this will constitute a construction Permanent Establishment (PE). As such income attributable to this PE will be taxed in Cyprus at the standard corporate income rate of 12.5%.

However, in accordance with Art 7 of the OECD MC, a construction PE is only formed if the construction exceeds 12 months. As project 2 will last for 11 months only, this provision will override the Cyprus income tax law and therefore the income tax treatment of project 2 will be the same as that of project 1 (assuming that the company will not register a branch in Cyprus) The VAT position of the company is exactly the same as for project 1 above.

Part 3

As project 3 will last for more than 12 months a construction PE will be formed, irrespective of the company registering or not registering a branch in Cyprus. As such income attributable to this PE will be taxed in Cyprus at the standard corporate income rate of 12.5%.

Grevandia will have to grant DTR to the company for corporate income tax paid in Cyprus per the OECD MC Art. 23 provisions.

The VAT position of the company is exactly the same as for projects 1 and 2 above.

Part 4

The company may either register a branch (or do not register a branch as the tax effect will be the same as registering a branch) or a subsidiary in Cyprus.

The profits of the Cyprus branch (or construction PE) will be taxed at the standard corporate tax rate of 12.5% in Cyprus.

They will also be taxed at 26% in Grevandia but DTR at 12.5% (Cyprus tax) will be granted. Marginal tax rate will therefore be 26%.

If a Cyprus subsidiary is registered to undertake the project, the project's profits will be taxed at 12.5%.

The Cyprus subsidiary will then pay out dividends to its holding company. There will be no withholding taxes or SDC withheld on these dividends as the company is a non-Cyprus tax resident.
Dividends received by the company will have to be declared in Greece and taxed at 10% in Grevandia.

The total tax rate will therefore be 22.5% (12.5% Cyprus + 10% Grevandia tax), assuming that all profits will be distributed as dividends, which is lower than the 26% total marginal rate if a branch (or construction PE) are operated.

If not all profits are distributed by the Cyprus subsidiary, the total tax rate will be lower. This gives an additional business tool to the company, as it gives it the opportunity of keeping undistributed profits in its subsidiary for future expansion.

The company should therefore register a subsidiary in Cyprus.

Part 5

Irrespective of which project the company engages in, it will have to register as an employer in Cyprus and pay social insurance contributions in respect to its Cypriot resident employees.

The same obligation exists in respect to its Grevandian employees. However, as the company is an EU company and as its employees are presumably also EU citizens, it may ask for an exemption on the basis that its Grevandian employees are not ordinary residents of Cyprus, unless some of them move their families to Cyprus and therefore become ordinary residents of Cyprus.

If the company applies the above exemption, it will have to continue paying social security contributions in Grevandia in respect of its Grevandian employees.

Part 6

If project 1 is undertaken, the company's Grevandian employees will spend less than 183 days in Cyprus and therefore have no obligation for income tax in Cyprus.

If project 2 is undertaken, the company's Grevandian employees will spend more than 183 days in Cyprus and therefore be liable for tax in Cyprus on their worldwide income. They will therefore have an obligation to register for income tax in Cyprus and pay tax on a self-assessment basis.

If project 3 is undertaken, the company's Grevandian employees will have the same obligations as in the case of project 2. However, the company (its branch or its subsidiary), will have to administer income tax deductions at source through the PAYE system.

PART B

Question 3

Part 1

Cyprus does not have specific CFC legislation. The only test as to whether a company is a Cyprus tax resident is the ‘management and control’ test.

According to the ‘management and control’ test (which is not defined by Cyprus tax legislation) it is generally understood that a company is a Cyprus tax resident if:

- The majority of its board of directors are Cyprus tax residents and
- Board meetings take place in Cyprus and
- The company’s strategy is formulated in Cyprus.

In the case of Pear Corp., it is clear that the ‘management and control’ test is not satisfied and as such the company cannot be treated as a Cyprus Tax resident company, irrespective of the fact that its majority owner is a tax resident of Cyprus.

In relation to the company’s operations, the profits attributable to the Cyprus Branch, are subject to Cyprus corporate income tax at the standard rate of 12.5%.

The Teshland branch profits are outside the scope of Cyprus income tax (but may be subject to taxation in Teshland).

In respect of the company’s dividend payments, Andros has an obligation to declare his dividends and account for SDC at 17% by self-assessment.

Aishe’s dividend income is not subject to any form of taxation in Cyprus, as she is not a Cyprus tax resident despite being a Cyprus passport holder.

Part 2

The company’s Cyprus and Teshland branches are taxed on the arising profit basis, whereas at the same time the Urland branch is incurring losses as it has no income attributed to it.

In order therefore to have a fair balance of profits at each taxable profit center (Cyprus and Teshland branches), the production costs incurred in the Urland branch will have to be reallocated to the other two branches.

This can be achieved by either the Urland branch invoicing the other two branches of the company, or by setting up a subsidiary company in Urland to invoice the Cyprus and Teshland branches.

In either case, invoicing from Urland (Branch or subsidiary) will have to be done at arm’s length per Art. 9 OECD MC and the OECD Transfer Pricing Guidelines.

According to the arm’s length principle, connected parties must invoice between them at a transfer price that is determined if market conditions between unconnected parties were imposed.

If the arm’s-length principle is not observed, tax adjustments may arise (in our case in Urland), and tax likages arise especially in light of the fact that Teshland and Urland are non-EU members and corresponding adjustments to the taxable profits of the Cyprus and the Teshland branches, may not be possible.

Part 3

Pear Corps Cyprus branch has an obligation to register for VAT in Cyprus and submit quarterly returns, as it makes taxable supplies of services.

It also has an obligation to submit recapitulative monthly statements under the VIES system in respect of its sales to EU counterparties.

Sales to EU counterparties who submit a valid VAT number are zero rated.

Sales to EU counterparties who do not provide a valid VAT number, are standard rated and Cyprus VAT at the standard rate will have to be charged and accounted for to the Cyprus VAT/Tax department.

PART C

Question 4

BEPS refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions.

Although Cyprus has been slow in amending its legislation, it has signed the following Multilateral agreements within the framework of the BEPS project:

1. The OECD Multilateral automatic exchange of information agreement or Common Reporting Standard (CRS) for the automatic exchange of tax related information held by its financial institutions (order of the Minister of Finance 477/2015 as replaced by order 161/2016, through which the Cyprus competent authorities will communicate information to 81 participating jurisdictions and
2. The Multilateral Competent Authority Agreement of Country by Country reports (CbC MCAA), on the basis of which, Cyprus competent authorities will be communicating tax related information to the tax jurisdiction of the parent company of a Multinational Group, which addresses Action 13 of the OECD action plan of the BEPS project.

In addition to the above Multilateral Conventions, Cyprus introduced an anti-avoidance provision in s 8(20) of the Income Tax Law 118/2002, which provides for the non-exemption of foreign dividend income in cases where the underlying profits of the remitter company have reduced that company's taxable base. This addresses Action 2 re: to neutralize the effects of hybrid mismatch arrangements.

A number of actions identified in the OECD action plan, evolve around the Controlled Foreign Company (CFC) issues, which is specifically included as action 3. Cyprus does not have any CFC legislation as at 31/12/2016.

The CFC issue also comes in action 4 which addresses base erosion via interest deductions and other financial instruments. In fact, tax practices in Cyprus allowing triangular interest relationships with zero-tax jurisdictions, encourage this type of avoidance schemes. However the 2015 addition of s 9B Law 118/2002, allowing a deemed interest deduction seems to effectively limit the "usefulness" of such triangular loan and interest relationships.

Another aspect of the OECD action plan (actions 8-10 and 13) relates to transfer pricing. Cyprus addresses this issue with just s 33 Law 118/2002, without any further legislation or regulation in relation to this.

Cyprus has made a few steps in relation to harmful tax practices and the prevention of Treaty abuse (actions 5 and 6), in that the Cyprus Tax Department has taken some practical measures, but which only rely on self-certification by a company's directors. Measures will have to be implemented for a more active procedure in examining taxpayers' requests for the issue of tax residency certificates which is in the center of Treaty abuse and harmful tax practices.

Question 5

The concept of “domicile” is defined in the the Wills and Succession Law, CAP. 195, as amended.

Under section 6 of CAP. 195, an individual has at any given time:

(a) a domicile of origin, or
(b) a domicile of choice, or
(c) an incidental domicile of where an individual is found/located.

In the case of a genuine child born during the lifetime of the father, the domicile of origin of the child, is the domicile of the father at the time of the child's birth.

An individual acquires domicile of choice by establishing his/her residence in any place in the Republic of Cyprus with the intention of a lasting or indefinite residence on the island.

The domicile of origin is kept until a domicile of choice is acquired.

Based on the above, a person born outside Cyprus, of a father whose domicile of origin was outside Cyprus retains such domicile of origin of the father. A person whose father had his domicile of origin in Cyprus, retains his domicile in Cyprus.

As from 16.7.2015, for special defence contribution purposes, the term resident individual means a Cyprus tax resident individual as applied for income tax purposes who also has a domicile of origin in Cyprus

A domicile of origin in Cyprus means a domicile under the provisions of CAP. 195, as amended, subject to the following exceptions:

1. An individual who has acquired and maintains a domicile of choice outside Cyprus, provided that he has not been resident in Cyprus, for any period of at least 20 consecutive years before the tax year. In such a case, no SDC is payable on incomes of such person whether arising in Cyprus or outside Cyprus.
2. An individual who was not tax resident in Cyprus for at least 20 consecutive years immediately before 16.7.2015. In such a case, no SDC is payable on incomes of such person whether arising in Cyprus or outside Cyprus.

Regardless of the domicile of origin, any individual resident in Cyprus, for at least 17 of the last 20 years before the tax year, that person will be deemed to have his domicile in Cyprus.

The concept of “domicile” has no bearing on an individual’s income tax status.

Question 6

Part 1

Place of supply is outside the EU and therefore outside the scope of Cyprus VAT. There is no obligation for VAT in Cyprus.

Part 2

Place of supply is the country where the client is established. If client established outside EU, the supply is outside Cyprus VAT scope. If client established in EU, supply is zero rated for Cyprus. VIES system declaration required

Part 3

Place of supply is the EU State in which the exhibition took place. No obligation for VAT declaration in Cyprus.

Part 4

Place of supply will be proportionate to the distance covered in Cyprus and outside Cyprus. Cyprus taxable person will therefore have to charge VAT at the standard rate in proportion to the distance cover.

Part 5

Place of supply is the State in which the building site is situated. No obligation for VAT in Cyprus.

Part 6

Place of supply is the State in which the building site is situated. No obligation for VAT in Cyprus.

Part 7

Place of supply is Italy (EU). No obligation for VAT in Cyprus.

Part 8

Place of supply is Cyprus, as the recipient of the service is situated in Cyprus. Supplier of the service has an obligation to charge VAT at the standard rate and account for it to the Cyprus VAT/Tax department.

Question 7

DGH Holdings Ltd Corporation Tax computation

All figures are in euros.

Dividends from A Ltd – exempt	0
Dividends from B Ltd (re-characterized as interest) 30,000/95%	31.579*
Interest from C Ltd (15,000/75%)	20,000
Branch 1 dividends/profits (exempt s.36 Law 118/2002)	0
Branch 2 dividends/profits (exempt s 36 Law 118/2002)	0
Tourist apartments – Italy (exempt s 36 Law 118/2002)	0
Branch 3 losses	(51.579)
Taxable income	0
Corporation Tax liability	0
SDC liability	0

* Application of new s8(20) of Law 188/2002

Assumptions

The nature of the company's activities relate to investments and therefore interest income is treated as active income.

Notes

- Foreign branch profits are exempt from taxation. Reference to dividends from foreign branches is not applicable.
- Tourist apartments in Italy are deemed as a permanent establishment overseas (s.5(s) Law 119/2002 definition) and exempt from taxation per s 36 Law 118/2002.
- Tax relief for foreign branch losses may be claimed under s13 Law 2002. The unutilized branch losses of 2016 (80,000-51.579), cannot be carried forward to year 2017. If in future years Branch 3 turns profitable, the amount of losses of €51.579 will be taxed in that future year or years (recapture of losses).
- If interest from B Ltd or C Ltd or both B Ltd and C Ltd are treated as passive interest income, they will be exempt from income tax. Hence more of the Branch 3 losses of €80,000 will remain unutilized. Such income will therefore be subject to SDC at a rate of 30% which is applicable to interest income.