

Question 1

Part 1

The several income streams of Giovanni and Lena, after they take up tax residence in Cyprus will be as follows:

Giovanni

Since the pension income pertains to work performed outside of Cyprus and prior to his becoming Cypriot tax resident he may elect to be taxed on this income at a flat rate of 5% with an exemption of an amount of €3,420. Nonetheless, Giovanni also has the option to elect to be taxed according to the general income tax scaling rates (i.e. 20-35%) which provide for an exempt amount of €19,500. This is usually more beneficial in case the beneficiary has pension income lower than the €19,500 threshold. Nonetheless, in the case of Giovanni, since his pension income is higher, it is more beneficial for him to be taxed at the special tax rate of 5% with the exempt amount of €3,420.

As per the interest from the foreign Government bonds (German and Italian), this would not be subject to income tax in Cyprus, but will be subject to special defence contribution at a rate of 30%. This income may not qualify for the lower rate provided by the law (3%) as this only captures Cyprus Government bonds. Any tax withheld abroad on this income may be credited against the special defence contribution which would be due on these amounts. Nonetheless, the tax credited may not exceed the amount of tax which would be due on the relevant income as taxed in Cyprus (gross) at the rate deriving if the relevant income was multiplied by the total amount of tax due on the income of the beneficiary / the total income of the beneficiary.

Dividends income will be exempt from income tax in Cyprus but would be subject to the special defence contribution at 17%. The foreign tax withheld thereon may be credited against this tax, with the same rules and limitations as mentioned above regarding interest income.

The rental from the house in Sicily will not be taxable in Cyprus, as it may not be considered being rent for trading purposes, pursuant to the badges of trade which may be considered applicable, as they have been formed under UK and Cyprus jurisprudence. Namely, the badges of trade to be examined upon considering whether a transaction is of capital or trading nature are the following:

- The nature of the transaction;
- the duration of ownership;
- the circumstances under which the transaction takes place;
- the way the acquisition of the asset was financed;
- the motive;
- the knowledge of the owner;
- how often similar transactions are performed;
- the supplementary work;
- how the asset was acquired; and
- how the proceeds of the sale will be used.

In view of the above, the relevant income will be considered of capital nature and will not be subject to income tax in Cyprus which would be allowed for a 20% deduction as well as capital allowances at 4% annually). Nonetheless, it will be subject to special defence contribution at 3% on the 75% of the rental income.

Lena

Lena's state pension will be taxed in the same way as mentioned above for Giovanni. Nonetheless, for Lena it will be more beneficial to apply the ordinary income tax on this income, since she has low overall income and thus most of her income would fall under the exemption of €19,500. The rental from flats in Cyprus would be considered taxable income for Lena and will be subject to income tax at the personal income tax scale (i.e. €19,500 exempt, €19,501-€28,000 at 20%, €28,001-€36,300 at 25%, €36,300-€60,000 at 30% and excess of €60,000 at 35%).

Nonetheless, an allowance is allowed from the taxable amount of 20%, i.e. in this case the allowance would amount to €3,000, leaving a taxable amount of €12,000, and capital allowances would be deductible for wear and tear at 4% per year until the property reaches 33 years, which we understand is the case since it was built in 1980, thus no such allowance will be available for Lena. Thus the rental taxable income for Lena will be €12,000, which along with the €10,000 of pension will amount to €22,000, thus resulting to a tax of €500 ((€22,000 – €19,500) x 20%).

Lena will also be liable for 3% special defence contribution on 75% of the rental income, which would amount to €337.50.

Lena will also be liable for immovable property tax on the flats in Cyprus, which will be calculated as follows:

€40,000 at 6%
€40,001-€120,000 at 8%
€120,001-€170,000 at 9%
€170,001-€300,000 at 11%
€300,001-€500,000 at 13%
€500,001-€800,000 at 15%
€800,001-€3,000,000 at 17%
exceeding €3,000,000 at 19%.

Thus is calculated on the value of the property as at 1/1/1980 as adjusted for inflation based on the index issued by the Ministry of Finance.

Part 2

Assuming the residence is taken up in Cyprus, the following implications will arise from the option considered by Giovanni and Lena:

- The sale of the bonds and shares will not be subject to tax in Cyprus as they are tax exempt.
- The sale of the immovable property in Cyprus will be subject to capital gains tax at 20%. The tax basis will be calculated as the difference between the value of the property as at 1/1/1980 (the donation of 2000 will be disregarded as it was not taxable) as adjusted for inflation based on the index issued by the Ministry of Finance. Upon sale there must be a balancing statement on the capital allowances which have been calculated until the sale of the property. Nonetheless, as in this case no capital allowances will have been allowed no such need would arise. Land transfer fees will also be due.
- The sale of the house in Italy will not be subject to capital gains tax as it is not Cypriot immovable property.

Question 2

Part 1

The disposal of the shares in E Ltd by A Ltd will not be subject to tax in Cyprus.

In the meantime, any dividends received within the two years' period of ownerships by A Ltd will not be subject to tax in Cyprus, nor will they be subject to 17% special defence contribution, unless E Ltd. more than 50% of the latter's income is investment income and it is established in a jurisdiction which has a significantly lower tax rate than Cyprus. By significantly lower is considered less than 50% of the corporate income tax rate, i.e. less than 6.25%. Since E Ltd will be established in an EU country and Cyprus currently has the lowest corporate income tax rate in the EU, this would not be the case.

The trading goodwill which could arise from the sale of by Company A, Cypriot tax resident, would be taxable in Cyprus at the corporate income tax rate of 12.5%. This transaction may not fall under the reorganisation regime of sections 26-30 of the Cyprus income tax law (implementing the EU merger Directive) which provides for significant tax benefits (no taxation of trading goodwill and no balancing statements, no stamp duty, no mortgage fees, no property transfer fees etc.), since in order for it to apply the transferred activity must be considered a going-concern (i.e. self-standing business) which may probably be the case, A Ltd should acquire shares in the receiving entity (E Ltd) in exchange for the transfer of activity of at least 50% or in excess of it and in case there is also a cash remuneration this may not exceed 10% of the value of the activity. Since the value has been determined at between €20,000,000 and €25,000,000, and A Ltd will receive €10,000,000 in cash and 25% participation in E Ltd, the two latter conditions are not met. Thus the transaction may not fall under the re-organisation beneficial regime.

Interest paid by A Ltd to E Ltd for the interest bearing loan which will be granted to it will need to be at arm's length in pursuance to section 33 of the case they are considered to be affiliate entities (this does not only depend on participation but also on voting rights and whether one company has control over the other through BoD members, etc.), otherwise it may be adjusted and not be allowed. Moreover, the deductibility of the interest expense will depend on how this loan has been used by A Ltd and whether it has been fully used on taxable business activity or not.

Part 2

State B, in which E Ltd is established is both an EU member state and a jurisdiction with which Cyprus has in place a double tax treaty. In this respect, both the parent- subsidiary Directive could be applicable, which provides for an exemption from dividends withholding tax, if its conditions are met and the double tax treaty, whichever is more beneficial for A Ltd (the beneficiary).

The conditions for the application of the merger Directive are that both entities should be EU tax residents, that both entities have one of the legal forms provided in the list included in Appendix I of the Directive and that A Ltd has a participation of at least 10% for at least two consecutive years. Thus, based on the above, it seems that in the case at hand the conditions for application of the parent- subsidiary Directive would be met. It should be noted though that an anti-avoidance clause has been included in the parent subsidiary Directive and that some countries provide for an exemption from the beginning of the two years period, provided that the two years' holding is guaranteed (usually also a bank guarantee is required) while others provide that the withholding is performed and the tax is refunded upon completion of the two year period.

On the other hand, in case of application of the double tax treaty which follows the OECD model convention (art.10) dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state may be taxed in that other state. However, according to par. 2 of the same art. such dividends may be taxed in the contracting state of which the company paying the dividends is resident and according to the laws of that state, but if the beneficial owner of the dividends is a resident of the other contracting state the tax is capped at the percentage provided in the DTT.

In this respect, it is possible that under the double tax treaty there may be some withholding performed in State B and no full exemption would be provided, which would render the application of the parent subsidiary Directive more beneficial. Nonetheless, for it to apply the shares must be transferred at least one day after the two years' holding period has lapsed.

It should be noted that the article of the DTT on dividends also provides for a "beneficial ownership" limitation, thus in case it is considered that the recipient is not the beneficial owner of the dividends, application of the DTT provisions may be denied. There is not specific determination of the beneficial owner term but it is considered that the crucial element should be the freedom which the recipient of the dividends has on deciding how to use the dividends received.

Part 3

No difference would arise in case of this alternative.

Question 3

Part 1

Den Ltd is examining two options:

Option 1

To establish a 100% subsidiary, Cypco Ltd, and register the patent in the name of its Cypriot subsidiary. In this case, no tax would be due on the patent, since it will firstly be registered in its own name. It could be the case that this option could be considered contribution in kind by the shareholder, but given that the patent will only be registered by the Cypriot entity it may not be considered transfer of a right and its value may not easily be determined.

Nonetheless, in such case since Cypco will have no costs for the registration of the patent or for its development it will not be able to compute any capital allowances in the future.

Option 2

In case the patent is registered by Den Ltd and then sold to Cypco at cost. Cypco will be able to either consider the relevant cost as a deductible expense or capitalise it (depending on the nature of the right). Since in the case at hand the right acquired will be a patent, the relevant cost would most probably be capitalised and be subject to annual capital allowances at 20%.

It should be noted that since the sale will be performed between related entities, pursuant to section 33 of the Cyprus tax law it should be performed at arm's length.

Part 2

Under the first alternative, under which Den Ltd will perform the production and Cypco will undertake its distribution Cypco will be taxed at the corporate tax rate of 12.5% for the income from this distribution, while the production of the product will completely be undertaken by Den Ltd. The transactions should be at arm's length.

Under the second alternative, under which Cypco will undertake the production of the cream in facilities to be established in Denmark, these facilities will be considered a fixed place of business for the Cypco, i.e. constituting a permanent establishment of Cypco in Denmark, in which case all relevant income should be taxable in Denmark.

In case the production of the cream is assigned to a third party in Denmark, no issue of the transaction being at arm's length will arise as the parties will be independent. It should nonetheless, be considered whether the third party may be considered dependent agent of the Cypco, e.g. in case it has full economic dependence by the Cypco, because in such case it will be considered constituting a permanent establishment of Cypco.

Part 3

The fact that Cypco will use wholesale distributors in different European countries may result to it being considered having branches in all these countries and thus being taxed in these countries for the income generated by these permanent establishments.

Part 4

The income from trading activities will be taxed in Cyprus at the Cypco level at the corporate tax rate of 12.5%, allowing for the deduction of the expenses which are linked to the company's taxable business activity and provided that these expenses are supported by the appropriate tax documents. It should be noted that in case Cypco has foreign branches the income of which is less than 50% from investment activity and which are established in jurisdictions with a tax rate of more than 6.25% their income is not taxed in Cyprus. Nonetheless, the losses from these branches may be used to offset its taxable income, but in case they have future profits, they will be a recapture of the losses relieved and thus this income will be taxable up to the amount of these losses used.

For the income arising from the licensing of the trademarks Cypco will be taxed at 12.5% but there will be an allowance on the taxable basis of 80%, i.e. only 20% of this income will be taxable. Moreover, Cypco will be allowed to deduct from the taxable income annually the capital allowance of 20% on the capitalised value of the trademarks as well as any relevant direct expenses (e.g. loan interest, etc.), as well as the part of common expenses (such as administration costs, etc.) which correspond to this income.

Question 6

Part 1

In order for a company to be considered tax resident in Cyprus its management and control should be in Cyprus. In order to assess whether this is the case, the minimum which would need to be met are the following conditions:

- the majority of BoD members are Cypriot tax residents;
- all the BoD meetings are physically held in Cyprus; and
- the important management decisions are taken in Cyprus.

In this respect, if the Dutchco BV's preferred composition is finally adopted, i.e. all board members to be the Dutch owners of the Dutchco BV who will remain Dutch residents, there could be a high risk that Cypco Ltd. would not be recognised as Cyprus tax resident, but its residency in the Netherlands could be claimed by the Dutch tax authorities, in which case its establishment in the structure would be of no use.

Part 2

The transactions between Cypco and the Dutchco BV as well as between Cypco and Cypco2, which are considered affiliate (since the one is owned 100% by the other) should be at arm's length pursuant to the provisions of section 33 of the Cyprus tax law. It should be noted that for the determination of the arm's length of a transaction Cyprus generally follows the OECD transfer pricing guidelines. In case the transactions are not found to be at arm's length the tax authorities will adjust the relevant income or expense and tax it according to the applicable Cyprus tax law provisions. Namely, in the case at hand, the royalties paid by Cypco to the Dutch BV should be at arm's length otherwise the difference may be disallowed for tax deduction at the level of Cypco (or taxed in the Netherlands for Dutchco BV as the case may be).

Part 3

Pursuant to Cyprus tax law provisions royalties paid by a Cypriot company to a foreign entity for rights which have been used in Cyprus are subject to 10% withholding tax in Cyprus. Nonetheless, pursuant to the interest-royalties EU Directive, which has been incorporated in the Cyprus tax law, royalties payments may be exempt from withholding tax if the beneficiary holds at least 25% participation in the paying entity and this participation is held for at least two consecutive years. In this respect, to the extent that these conditions will apply royalties paid by Cypco to the DutchBVco may be exempt from Cyprus WHT. Moreover, a relief may also be available by the double tax treaty signed between Cyprus and the Netherlands.

Part 4

Cypco Ltd will need to register in Cyprus for VAT purposes since it will presumably exceed the threshold of €15,600 of VATable activity in a 12 month period.

- Cypco Ltd. will sell products to non EU distributors (US, Brazil). These transactions will be exports and as such no Cypriot VAT will need to be charged. Nonetheless, they will qualify for input VAT offsetting right.
- Cypco will also sell to Cypco 2. These sale will be subject to Cypriot VAT at 19%.

- The transaction with the UK entity will be considered an intra-community acquisition thus subject to the reverse charge mechanism, thus Cypco will have to both credit and debit the relevant VAT.
- Royalties charged by the Dutchco will again be considered intra-community receipt of services and be subject to the reverse charge mechanism.

Part 5

Cypco will have to calculate and pay social security contributions for the sales personnel (Cypriot and EU citizens) which will be employed by it. Namely social security contributions are calculated at 7.8% on the gross monthly salary payable by the employer and 7.8% payable by the employee (but withheld by the employer). There is nonetheless a cap of the salaries on which the rate is applied, which is approximately €1,040 per week.

Cypco will not be liable to pay social security contributions for the Dutch Directors.