Chartered
Institute of
Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 2.03 – CYPRUS OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

- You should answer **FOUR** out of the seven questions.
- Each question carries equal marks.
- Start each answer on a new sheet of paper. If you are using the on-screen method to complete your exam, you must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.
- All workings should be made to the nearest month and Euro unless the question requires otherwise.
- Marks are specifically allocated for presentation.

1. Giovanni has lived his entire life in Italy. He is married to Lena, who was born in Cyprus but who has lived in Italy with Giovanni for the previous forty years. Both Giovanni and Lena recently retired and are seriously considering taking up residence in Cyprus, due to the higher tax rates applicable to income and capital in Italy.

Giovanni's and Lena's annual income streams are as follows:

Giovanni	€
State pension	20,000
Private pension	60,000
Interest: Italian Government bonds*	400,000
Interest: German Government bonds**	200,000
Dividends: Russian public listed***	50,000
Rental from house in Sicily after tax	12,000
Lena	
State pension	10,000
Rental from flats in Cyprus	15,000

*Gross amount (withholding tax at source of 10%)
**Gross amount (withholding tax at source of 15%)
***Gross amount (withholding tax at source of 15%)

The Italian and German bonds have a market value of €16 million, are electronically traded, and were all inherited from the estate of Giovanni's father.

The Russian shares were acquired by Giovanni at a cost of €200,000 and have a market value of €800,000.

Lena's flats in Cyprus were initially purchased by her parents before 1 January 1980 and were donated to her in 2000.

Giovanni's and Lena's incomes are remitted to their bank accounts in Italy and Switzerland. They plan to open a bank account in Cyprus to remit €40,000 annually, to cover their living expenses, once they relocate to the island.

Cyprus has Double Taxation Agreements with Italy, Germany and Russia, identical to the OECD Model Tax Convention.

1) **You are required to advise Giovanni and Lena of the respective tax treatment of each of their income streams if they were to take up residence in Cyprus. Your response should refer to all possible elections and reliefs available, and reference must be made to Income Tax, Special Defence Contribution, and Immovable Property Tax.** (17)

2) Giovanni's financial adviser has brought to his attention a programme of trading in financial instruments with high expected profits. If Giovanni decides to embark on such a programme, he will sell all his bonds and shares to raise the necessary funds. Giovanni is also considering selling his house in Italy. Lena is also considering selling her flats in Cyprus.

   Advise Giovanni of the Cyprus Income Tax, Special Defence Contribution and Capital Gains Tax implications of this option, assuming that residence is taken up in Cyprus. (8)

Total (25)

2. A Ltd is an international business company, which was registered in Cyprus ten years ago. Its shares are all held by another Cyprus-registered company, B Ltd. The principal activity of A Ltd is the organisation of high level conferences in Africa, Latin America and Asia relating to the energy sector.

In recent months, the owners of the group have been in negotiations with CD plc, a publicly listed company in Frankfurt, for the sale of the company's principal activity. The parties agreed that the value of the operation is anywhere between €20 million and €25 million, depending on performance over the next two years of operation. Accordingly, they have now reached an agreement to act as follows:

1) A new company, E Ltd, is to be formed in State B, an EU member state. 75% of shares in E Ltd will be held by CD plc; the remaining 25% will be held by A Ltd.

2) Put options will be issued by E Ltd to A Ltd, under which A Ltd may dispose of its shares in E Ltd after two years in return for cash, with the result that E Ltd will eventually be 100% owned by CD plc.

3) CD plc will pay €10 million into E Ltd, in consideration for its 75% shareholding, issued at a premium.

4) A Ltd will transfer its principal activity into E Ltd in consideration for its 25% shareholding (issued at par) and will receive €10 million from E Ltd.

5) Over the next two years, all of E Ltd's profits will be distributed to its shareholders.

6) In E Ltd's books, the principal activity of A Ltd will be capitalized as an intangible asset. This asset will be amortised in accordance with international, generally acceptable accounting principles (GAAP). The amortisation cost will reduce the profits available for distribution and, as it is a non-cash item, will create cash surpluses in E Ltd. These cash surpluses will be advanced to the company's shareholders (A Ltd and CD plc) in the form of an interest bearing loan.

7) On the expiration of the two year period, the final consideration for the acquisition of A Ltd's principal activity will be finally determined. At this point in time the following will take place:

   a) A Ltd will exercise its put options to sell its shareholding in E Ltd in exchange for cash.

   b) The loans granted by E Ltd to A Ltd, including interest charged, will be written off in part consideration of the transfer of the shares of A Ltd to CD plc.

You are required to:

1) Identify the taxable and non-taxable components of the above transactions of A Ltd, in light of Cypriot tax law. (19)

2) Examine the basis on which the tax authorities of State B will tax the dividend payments of E Ltd to A Ltd. You should assume that State B has a Double Tax Agreement in place with Cyprus which is identical to the OECD Model Tax Convention. (4)

3) Explain how your analysis for (1) would differ if the shares in E Ltd, as well as the loans granted by E Ltd, were to be issued in the name of B Ltd rather than A Ltd, acknowledging any tax risks you may have identified in (1). (2)

Total (25)

3. Den Ltd is a Danish registered company. After months of research and development, the company has invented a formula for the production of a new cream to be used for the relief of pain and discomfort for people undergoing tattoos. Den Ltd is ready to register a patent and is considering the options of either setting up a Cyprus subsidiary company (CypCo Ltd) and registering the patent in its name, or alternatively registering the patent in Den Ltd's name and then selling it to CypCo Ltd at cost. Danish tax law is identical to Cyprus tax law regarding the treatment of transactions between related parties.

The owners of Den Ltd are also considering three alternatives relating to the production and distribution of the new cream. The first alternative is for Den Ltd to undertake the production of the cream in Denmark and CypCo Ltd to undertake its distribution elsewhere in Europe through local wholesale distributors in each country. The second alternative is for CypCo Ltd to undertake the production of the cream in facilities to be established in Denmark and also to undertake the distribution of the product elsewhere in Europe, through local wholesale distributors in each country. The third alternative is to assign the production process to an independent company in Denmark and the distribution of the product to be undertaken by CypCo Ltd in Europe through local wholesale distributors in each country.

As the new product is expected to be successful in the Americas and Australasia, Den Ltd decided to grant licenses for its production and distribution to interested independent parties in these regions.

It is also anticipated that small orders will be placed by individual consumers through the CypCo Ltd website, with dispatch to be organised either directly from the production facilities in Denmark or through Cyprus, where a small warehouse may be acquired to serve the local market and perhaps the markets of neighbouring African and Middle Eastern countries.

Cyprus and Denmark have signed a Double Taxation Agreement, identical to the OECD Model Tax Convention.

You are required to:

1) **Explain the tax treatment of the acquisition of the patent by CypCo Ltd.** (6)

2) **Discuss the Cyprus Corporation Tax implications relating to the production facility under each of the three alternatives discussed above.** (8)

3) **Discuss the Cyprus Corporation Tax implications relating to the use of wholesale distributors in different European countries.** (6)

4) **Explain how the income or profits of CypCo Ltd from its trading activities and licensing fees will be taxed in Cyprus.** (5)

Total (25)

4.

1) “The Cyprus income tax provisions, in relation to taxation of employment income, provide for various exemptions and incentives, which may not be fully in line with the OECD Model Convention’s corresponding provisions.”

Critically examine the above statement, in light of the relevant sections of Cyprus Income Tax law and Article 15 of the OECD Model Tax Convention.
(16)

2) Payments by the employer to the employee on termination of his/her employment are either taxable or tax exempt.

Under what circumstances are such termination payments tax exempt? (9)

Total (25)

5.

1) “Cyprus grants Double Taxation Relief (DTR) on the basis of the ordinary credit relief method, which is fully in line with Article 23 of the OECD Model Tax Convention.”

Critically examine the above statement, with reference to sections of the Cyprus Income Tax law and Article 23 of the OECD Model Tax Convention.
(15)

2) Ares is a Cyprus-resident, self-employed civil engineer with offices in Nicosia, Athens and Romania. He also holds 90% of the shares of a company registered in the British Virgin Islands (BVI), which runs civil engineering projects in the Middle East.

Ares’ income for 2015 was as follows:

	€
Nicosia office	30,000
Athens office (€15,000 taxes paid in Greece)	60,000
Romania Office (€3,200 taxes paid in Romania)	20,000
Dividend received from BVI company (no withholding tax)	120,000
Rental income from flats in the UK (€6,400 taxes paid in the UK)	24,000
Consultancy income from South Africa (€2,000 tax withheld at source)	10,000

The Athens office has always been profitable.

The Romanian office commenced operations in 2013. It incurred losses of €6,000 during 2013, and €5,000 during 2014, for which loss relief was claimed under s.13 Law 118/2002.

Personal income tax rates in Cyprus are as follows:

Income (€)	Tax rate (%)
1 – 19,500	0
19,501 – 28,000	20
28,001 – 36,300	25
36,300 – 60,000	30
60,001 +	35

Compute the Cyprus Income Tax and Special Defence Contribution payable by Ares for 2015, assuming all available allowances and reliefs are claimed.
(10)

Total (25)

6. Your client is a Dutch limited liability company (DutchCo BV), engaged in the production of alcoholic beverages. At present, all patent rights are located in the Netherlands and production is handled by means of a tolling arrangement with a UK supplier who manufactures the products, invoices DutchCo BV, and exports the products to a Brazilian distributor. The products are currently distributed only in the Brazilian market, based on a distribution agreement with a Brazilian Limited Liability Partnership (a non-affiliated entity).

In the near future, a third party investor will inject new capital into the Dutch company and distribution is expected to expand into new jurisdictions both within and outside the European Union. DutchCo BV plans to establish a new company in Cyprus (CypCo Ltd) as a 100% owned subsidiary of DutchCo BV, with which all future distribution agreements will be placed. The current distribution agreement with the Brazilian LLP will most probably be dissolved and taken over by CypCo Ltd. A new distribution agreement will subsequently be signed between CypCo Ltd and a new, much larger, US distributor. Distribution of the products in Cyprus will be undertaken by a new Cyprus subsidiary of the Cyprus company (CypCo2 Ltd). The tolling arrangement with the UK supplier will continue. The patent and recipes will remain in the Netherlands. Consequently, CypCo Ltd will pay patent royalties to DutchCo BV.

DutchCo BV wants, to the extent it is possible, to outsource the necessary activities of the Cyprus company to third parties, including bookkeeping and the administration of the distribution agreements. The board of directors of CypCo Ltd will consist of the Dutch owners of DutchCo BV, who are and will remain resident in the Netherlands. To the extent that CypCo Ltd will be engaged in the marketing activities to expand operations and sales to new jurisdictions and regions, the sales personnel (who are Cypriots and EU citizens) shall be employed in Cyprus.

The outcome sought by DutchCo BV is for sales revenues to be directed to Cyprus with a subsequent dividend distribution to the Netherlands. The distribution rights for various jurisdictions will be granted to CypCo Ltd.

Cyprus and the Netherlands have signed a Double Taxation Agreement, which is identical to the OECD Model Tax Convention.

You are required to:

1) Explain the Corporation Tax consequences for CypCo Ltd of DutchCo BV's preferred composition of the company's board of directors. (8)

2) Explain if, and how, transfer pricing rules will apply to the transactions of CypCo Ltd. (3)

3) Explain whether, and why, the patent royalties to be paid to DutchCo BV will be taxable in Cyprus. (5)

4) Explain the VAT treatment of the CypCo Ltd transactions. (6)

5) What are the social security obligations of the Cyprus company (CypCo) in relation to its Dutch directors, and in relation to employees employed in Cyprus? (3)

Total (25)

7. AD Properties Ltd is a Cypriot property development company. The company's shareholders are as follows:

	Shareholding
Alexia	40%
Stelios (Alexia's husband)	25%
Anastasia (Alexia's mother)	25%
Nikos (Alexia's brother)	10%

Nikos is a resident of Malta, but plans to return to Cyprus in the near future.

AD Properties Ltd's balance sheet consists largely of:

1) one commercial and retail complex, with planning permission and development before 1 May 2004, which is rented out; and

2) one plot of land in Nicosia, available for development, both with a cost of €10 million and current market value of €19 million.

The company also has a bank loan to repay.

Alexia and Stelios are the only shareholders working for the company.

The current shareholding resulted from the settlement which followed the death of Achilleas, who previously held 58% of the share capital of the company. Achilleas was Anastasia's husband and the father of Alexia and Nikos.

The company has recently obtained planning permission to develop its available land in Nicosia into offices and shops. Most of the offices and shops will then be sold. Alexia and Stelios decided that they wish to split their interests from Nikos, who also agreed to the split, although Nikos indicated that he would like to be involved in the new development. However, Nikos' wish is strongly resisted by Alexia and Stelios who, as with previous developments, will be responsible for the practical work involved in completing the project. Alexia and Stelios finally agreed to stay out of the prospective Nicosia development which Nikos will proceed with, on his own.

Anastasia indicated that she will be happy to transfer her shares in the company to her children in such a way so as to facilitate a fair split between her children. Anastasia acknowledges that the building currently rented out should belong to Alexia and her husband, as Alexia and Stelios were responsible for its development. Anastasia's stake in the plot of land in Nicosia, which is about to be developed as per the wishes of her children, is to be split between them in equal shares.

Alexia, Stelios and Nikos have recently visited you, seeking your advice regarding the most tax-efficient way of splitting their interests, which as agreed by them will be communicated to their mother for further action.

Note that Alexia and Stelios wish to be involved in other similar land development projects, either on their own or in partnership with others (excluding Nikos).

The following scenarios have been considered:

a) Dissolving the company and registering the two distinct Cyprus assets in Alexia's and Stelios's names, and in Nikos's name, respectively, with an appropriate cash payment between brother and sister after settlement of the loan to achieve asset value equalisation.

b) Proceed with a scheme of re-organisation.

Continued

7. Continuation

You are required to:

1) **Explain the tax implications of a possible dissolution of AD Properties Ltd. Your response should refer to Corporation Tax, Capital Gains Tax, Special Defence Contribution, Value Added Tax, and land transfer fees concerning the immovable properties.** (14)

2) **Explain how the split may be partly accomplished through transfer of assets under a scheme of reorganisation and partly through other means. Your response should include references to the pre-requisites of such a scheme, and the tax liabilities mitigated.** (11)

Total (25)