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The EU Anti-Tax Avoidance Directive in Cyprus Law

1. **The Interest limitation rule**
2. **The Controlled Foreign Company (CFC) rule**
3. **The General Anti-Abuse (GAAR) rule**

What Cyprus Parliament voted on 5 April 2019

The EU Anti-Tax Avoidance Directive (ATAD EU 2016/1164 of July 2016) forms part of a larger anti – tax avoidance package adopted by the EU in response to the OECD's Base Erosion and Profit Shifting (BEPS) action plan to combat tax evasion through the transfer of profits to countries with preferential tax regimes. ATAD lays down minimum standards for EU Member States, requiring them to change their corporate tax laws in certain areas and within specific timelines. These provisions shall apply to all taxpayers (including EU permanent establishments of non-EU Companies) that are subject to corporate tax in EU

The ATAD contains the following five legally binding anti-abuse measures with the purpose to create a minimum level of protection against corporate tax avoidance throughout the EU, while ensuring a fairer and more stable environment for business.

1. Tax deductibility of interest
2. Controlled foreign company rules (CFC)
3. General Anti abuse rules (GAAR)
4. Hybrid mismatches
5. Exit taxation

The interest limitation rule, the CFC rule and GAAR rule are effective as from 01/01/2019, the exit taxation rule and hybrid mismatch rule are effective as from 1/1/2020 while the provisions on reverse hybrid rules shall apply by 01/01/2022.

These measures are included in the Directive published on 12 July 2016 (known as ATAD I) while the provisions on hybrid mismatches are extended in a second directive adopted on 29 May 2017 (known as ATAD II)

The Cyprus Parliament voted on 5 April 2019 the following provisions of the EU Directive with effective date as from 1 January 2019.

1. The Interest limitation rule
2. The Controlled Foreign Company (CFC) rule
3. The General Anti-Abuse (GAAR) rule

The provisions apply to Cyprus corporate income tax taxpayers and more specifically to Cyprus Tax resident companies and Cyprus permanent establishments (PEs) of non-Cyprus tax resident companies.

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The interest limitation rule

The interest limitation rule aims to discourage group of companies from providing financing facilities to companies based in high tax jurisdictions through subsidiaries based in low tax jurisdictions.

The interest limitation rule provides that the excess borrowing cost[1,2] (EBC) which exceeds 30% of the taxable income before interest, tax, depreciation and amortization of tangible/intangible fixed assets (EBITDA) is not deductible for the purpose of calculating the taxable income of a company. The rule contains an annual €3.000.000 safe – harbor threshold which means that EBCs up to and including €3.000.000 is in any case not restricted by this rule.

The 80% Cyprus 'IP Box' deduction on qualifying IP profits is added back to the taxable profit for the purposes of determining the taxable EBITDA.

The interest limitation rule applies on the local group as a whole or if the taxpayer is not part of a Cyprus group[3], the rule applies on the entity itself. The €3 million threshold applies to the entire group and not to each of its constituent entities. Moreover, it would be necessary to aggregate the exceeding borrowing costs and tax adjusted EBITDA for the entire group.

Where the company is a member of a consolidated group for financial accounting purposes, it may deduct its exceeding borrowing costs in full, provided it can demonstrate that its equity to total assets ratio is equal to or higher than the equivalent ratio of the consolidated group and subject to the following conditions

i. The ratio of the taxpayer's equity over its total assets is considered to be equal to the equivalent ratio of the group if the ratio of the taxpayer is lower by up to two percentage points (2%); and
ii. All assets and liabilities are valued using the same method as in the consolidated financial statements prepared in accordance with acceptable accounting standards.

Exclusions from the interest limitation rule

i. Interest on loans that were concluded before 17 June 2016. However, the grandfathering will not apply to any subsequent modifications of such loans.
ii. Interest on loans used to fund long term public infrastructure projects where the operator, borrowing costs, assets and income are all located in the EU. The income earned from such a long-term public infrastructure project is also excluded from the definition of the tax adjusted EBITDA
iii. Standalone entities[4] and
iv. financial undertakings[5]

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Carry forward for Excess Borrowing Cost

EBCs not deductible in a tax year due to the application of the rule may be carry forward to future tax years for up to **five** years.

Additionally, **unused** interest capacity (ie the amount of 30% of taxable EBITDA is in excess of the EBCs for a tax year) that has not been utilized within a tax year may be carried forward for use for the next 5 tax years.

The carry forward provisions are subject to an anti-abuse rule in cases of change in ownership of the company

The General Anti Abuse Rule

This rule aims to tackle abusive tax practices that have not been dealt with through specific provisions.

For the purpose of calculating the corporate tax liability, an arrangement or a series of arrangements which are not genuine and have as a main purpose the obtaining a tax advantage, are ignored.

Non genuine arrangements are arrangements which are not put into place for valid commercial reasons that reflect economic reality

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Controlled Foreign Company (CFC) rule

The CFC rule has the effect of re-attributing the income of a low-taxed controlled foreign subsidiary to its parent and controlling company. The aim is to prevent revenue diversion to subsidiaries which are tax resident in jurisdictions with preferential tax regimes.

A CFC is a low taxed non-Cyprus tax resident company in which the Cyprus CIT taxpayer, alone or together with its associated enterprises, holds a direct or indirect interest of more than 50%.

A CFC is also a low-taxed foreign PE of a Cyprus tax resident company that is exempt from tax in Cyprus (exempt foreign PE)

A non-Cyprus tax resident company (or an exempt foreign PE) is considered as low-taxed if the actual foreign corporate tax paid by the non-Cyprus tax resident company on its profits is lower than 50% of the corporate income tax charge that would have been payable in Cyprus under the Cyprus corporate income tax rules had it been a Cyprus tax resident company.

Exceptions

The CFC rule does not apply to non-Cyprus tax resident companies (or exempt foreign PE)

i. with accounting profits of no more than €750.000 and non-trading income of no more than €75.000; or

ii. of which the accounting profits amount to no more than 10% of their operating costs for the tax period. For the purposes of this exception operating costs do not include the cost of goods sold outside the country where the non-Cyprus tax resident company (or the exempt foreign PE) is tax resident and payments to associated enterprises

Targeted income

When a non-Cyprus tax resident company (or an exempt foreign PE) meets the definition criteria of CFC, the Cyprus CIT taxpayer must include in its taxable profit the non-distributed income of the CFC to the extent that such income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

The non-distributed income of the CFC is defined as the after-tax accounting profit of the CFC, which has not been distributed to the Cyprus CIT taxpayer during the Cyprus tax year in which the CFC profits are included or within the next seven months.

An arrangement or series thereof shall be regarded as non-genuine to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all, or part of, its income If it were not controlled by the Cyprus CIT taxpayer where the significant people functions (SPFs) which are relevant to those assets and risks, are carried out and are instrumental in generating the CFC's income.

The non-distributable income of the CFC included in the taxable profit of the Cyprus CIT taxpayer shall be limited to amounts generated through assets and risks which are linked to the Special People Functions (SPFs) in the Cyprus CIT taxpayer and is calculated based on the arm's length principle.

Income that has previously been included in Cyprus under the CFC rule and is subsequently actually distributed or realized through a disposal of the investment, is exempt from tax in Cyprus.

Any foreign tax paid on the income of the CFC or of the PE is credited against the income tax payable in Cyprus.

The following terms are defined in Law

'Associated Enterprise' means

1. an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights of 25% or more, or is entitled to receive 25% or more of the profits of the entity thereof
2. an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more or is entitled to receive 25% or more of the profits of the entity

   if an individual or entity holds directly or indirectly a participation of 25% or more in a company and in one or more entities, all the entities concerned shall also be regarded as associated enterprise.

[1] The term ***'borrowing costs'*** is broadly defined and covers interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance including for example payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, the finance cost of finance lease payments, the notional interest amount under derivative instruments or hedging arrangements, certain foreign exchange and losses connected with the raising of funds, guarantee fees, arrangement fees and similar costs to borrowing costs.

[2] The term ***'exceeding borrowing costs (EBC)'*** means the amount by which the deductible borrowing costs of the taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives.

[3] The Cyprus Law defines a ***'Cyprus Group'*** as made up by all Cyprus tax resident companies as well as any overseas companies that have a PE in Cyprus, which are considered to be members of a group as defined in article 13 of the Income Tax Law for the purpose of determining group loss relief.

[4] *The* ***Stand-alone entity*** is an entity which is not part of a consolidated group for financial accounting purposes and which has no associated enterprise or PE.

[5] ***'Financial undertaking'*** means credit institutions, insurance companies, reinsurance undertakings, institutions for occupational retirement provisions, pension institutions operating pension schemes as well as any legal entity set up for the purpose of investment of such schemes, Alternative Investment Funds (AIF) or AIF managed by an AIF manager, Undertakings for Collective Investment In Transferable Securities (UCITS), capital counterparties, central securities depositories, Securitization special purpose entity

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