NEWSLETTER: Tax amendments in Cyprus Legislation

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On May 24, 2012, the Cyprus House of Representatives passed a number of tax amendments and incentives designed to further stimulate the growth of the Cyprus economy and reinforce the attractiveness of Cyprus to foreign investors. More particularly, the position of Cyprus as a jurisdiction with a favorable tax regime towards intellectual property holding companies as well as investment holding companies is further enhanced. The amendments related to tax breaks on profits from intellectual property, and to deductions on interest expense (both discussed below), will go into effect when approved by the president and officially published. This is expected to take place soon, possibly in July. The amendments that relate to both the Income Tax Law and the Special Defense Contribution Law took effect retroactively from January 1, 2012 and are the following.

Income Tax Law

Taxation of Profit from Intellectual Property Assets

The Income Tax Law has been amended to provide significant exemptions from the taxation of income arising from use or sale of Intellectual Property (IP) Assets by Cypriot companies. A Cyprus limited liability company that has title to Intellectual Property Assets will usually generate its income in the form of royalties, license fees, etc., or from proceeds from the disposal of such assets.

The definition of intellectual property rights has been amended to coincide with the Patent Rights Law of 1998, the Intellectual Property Law of 1976, and the Law regarding Trademarks. In essence the amendment ensures that the new tax rules apply to the profit from the use or sale of all kinds of Intellectual Property Assets.

Background

Before the amendment came into force any profits from the use of Intellectual Property Assets were taxed under the Corporation Tax at the rate of 10 percent. Any profits from the disposal of those assets might have been taxed under either the Corporation Tax or the Capital Gains Tax. Direct expenses including but not limited to sublicense fees were deductible from income.

Amendment

As from January 1, 2012, 80 percent of the net profit arising from the use or sale of Intellectual Property Assets is exempt from tax.

The 80 percent exemption applies on the net profit after deduction of all direct expenses including amortization. The remaining 20 percent of the profit from the use of IP assets is then taxable at the corporation tax rate of 10 percent.
Amortization of the cost of acquisition of an Intellectual Property Asset is now charged on a straight line basis over a five year period (year of acquisition plus the four following years).

Future Prospects

The amended tax treatment of royalties and other income arising from the use or sale of Intellectual Property Assets is expected to stimulate interest in incorporating Cyprus companies in order to take advantage of the new tax treatment. A Cyprus company could be assigned with the licensing of a specific Intellectual Property Asset to foreign countries with 80 percent of the profit being exempt from taxation in Cyprus; dividends derived from the profits are also exempt from taxation in Cyprus.

Given the extensive network of double tax treaties that Cyprus has in place with many countries both within and outside the EU, this amendment creates significant potential for international businesses with substantial Intellectual Property Assets to incorporate in Cyprus.

Interest Expense Tax Deductibility for Acquisition of Shares in a 100 Percent Subsidiary

Background

Interest expense incurred before January 1, 2012 for the acquisition of subsidiary companies was not entirely tax deductible. Instead, the interest expense equal to the cost of the investment multiplied by the average cost of borrowing of the investing company was taxable (Technical Circular 2010/8 issued by the Inland Revenue issued on July 6, 2010). The taxable interest cannot exceed the interest expense recognized on the income statement.

This limitation on the deductibility of interest expense was effective for seven years (year of acquisition plus six subsequent years).

Amendment

With the new amendment, from January 1, 2012 any interest expense incurred for the direct or indirect acquisition of 100 percent of the share capital of a subsidiary company (irrespective of whether the subsidiary is a Cyprus or foreign tax resident) will be tax deductible to the Cyprus parent company that pays the interest. This tax deduction is available so long as all assets of the subsidiary are used in the business.

When the subsidiary owns assets not used in the business, then the interest expense corresponding to these assets will not be tax deductible.

Future Prospects

The amended taxation rules are expected to enhance the recognition of Cyprus as a favorable jurisdiction for incorporating holding companies that can invest in subsidiaries both within and outside EU.

This amendment is also expected to be useful in cases where previously the acquisition of a subsidiary was financed by a back-to-back loan arrangement and in which the intermediate company was bypassed in taxing the ultimate holding company. With this amendment, investment structuring through Cyprus can be planned so that the effective tax rates are reduced and the intermediary companies are not easily bypassed.

The fact that the interest expense incurred in the process of acquiring a wholly-owned subsidiary is now entirely tax deductible will also create opportunities for groups of companies to apply more efficient tax planning procedures and enjoy the advantage of group relief for the loss created by the deductibility of this interest expense. (According to Cyprus legislation tax, losses may be carried forward indefinitely for offsetting against future taxable profits but also surrendered to another company that is a member in the same tax group—the so-called 75 percent rule).

Accelerated Rates of Capital Allowances for Capital Expenditure

In an effort by the Government to encourage companies to invest in new assets and technologies, as well as to ease the taxation burden, accelerated capital allowances (tax depreciation) for assets acquired during 2012, 2013 and 2014 may be claimed as follows:

- for all machinery and plant: 20 percent per annum [previous rate: 10 percent];
- for industrial and hotel buildings: 7 percent per annum [previous rate: 4 percent].

Group Loss Relief

A Cyprus resident company incorporated by its parent company during a specific year is considered to be a member of the tax group for the entire tax year; group relief may be claimed for the whole year. (Previously a company was considered to be a member of the same tax group for group loss relief purposes only if it belonged to the tax group for a whole tax year.)

This amendment will enable groups of companies to take advantage and surrender taxable losses immediately from a new company of a tax group to another company belonging to the same group and thus avoid significant tax liabilities.

Approved Funds

Contributions made to Pension Funds, Provident Funds or any other Insurance Funds will be treated as deductible in calculating the taxable income of an individual provided that these Funds are approved by the Commissioner of Income Tax.

Special Defense Contribution Law

Profits Subject to Deemed Dividend Distribution

The accounting profit subject to the Deemed Dividend Distribution is now reduced by a deduction for any capital expenditure incurred during 2012, 2013 and 2014 on the acquisition of plant and machinery and buildings.

Previously the capital expenditure was not deductible but only the depreciation expense could be deducted for the purposes of calculating the accounting profit subject to Deemed Dividend Distribution.

Note: The provisions for the Deemed Dividend Distribution do not apply to Cyprus companies that are beneficially owned by non-Cyprus residents.

VAT Legislation

In an effort to further boost the local real estate market, the following legislation has been passed and published on June 8, 2012.

The reduced VAT rate of 5 percent on the construction or acquisition of residential property in Cyprus used as the primary or permanent residence by locals and foreigners now also applies to properties acquired by non-residents for use as vacation residences.

This provision comes into immediate effect following its publication in the official Gazette of the Republic.

Note: The reduced rate of 5 percent applies to the first 200 square meters of residences of total covered area of up to 275 square meters. In the case of families with more than three children the allowable total covered area increases by 15 square meters per additional child beyond the three children. ❑