

# Enhancing substance in Cyprus



## Introduction

The international tax landscape is changing worldwide. It is becoming increasingly clear that it is not a matter of moving from one jurisdiction to another: the initiatives undertaken by the G20 and the OECD are global in their reach and wide in their scope.

It is important to remain ahead of the developments and be well prepared for the challenges that lie ahead.

Substance in Cyprus is vital in order to:

- support Cyprus tax residency status
- avoid creating a taxable presence in another jurisdiction
- support transfer pricing challenges
- defend beneficial ownership challenges (as mentioned below)
- address increased anti-avoidance and anti-abuse provisions
- exchange information transparently and confidently

## Beneficial ownership of income as an anti-avoidance provision

The concept of the “beneficial ownership of income” has been introduced in the OECD-model treaty as an anti-avoidance measure in order to eliminate the avoidance of (withholding) taxes in specially structured transactions.

The beneficial owner is the recipient of the income that has the actual right to use, enjoy and dispose the income, without being constrained by a contractual or legal obligation to pass on the payment received. In transactions where the recipient of income is not the beneficial owner but acts simply as an intermediary that has an obligation to pass on the income to another person, the benefits of a double tax treaty between the intermediary company and the state of the payer company (i.e. lower withholding tax rates) may be denied.

In a number of double tax treaties concluded by Cyprus the provisions of the treaty are only granted if the recipient of the interest is the beneficial owner of the income. Such a treaty which has recently entered into force is the treaty with Ukraine.

A number of other double tax treaties concluded by Cyprus, including the treaty with Russia, do not include a beneficial ownership of income provision.

However, recently Russian courts are increasingly applying the “**look-through**” approach and disregard the intermediary company that, in their view, is simply created with the purpose to avoid tax without being the beneficial owner of the income, even in the case of treaties of Russia with countries such as Cyprus, Luxembourg and the Netherlands, where the treaties do not include beneficial ownership of income provisions

## Consequences of having no Substance.

Foreign structure found to lack substance could face considerably higher tax burden as well as investigations by the tax authorities.

Contrariwise, the expression “Substance” does not normally appear in the actual text of Double Tax Treaties or any of the local legislations, thus the concept of Substance in a particular location can be open for interpretation – however at the same time the reason the foreign companies cannot afford to miscalculate.

Consequently, there are practical standards that can be followed to achieve the same.

## Substance defined in Cyprus

The typical definition of an entity having economic Substance is that a transaction or entity located in low tax jurisdiction (like Cyprus) must have an economic purpose and relevant infrastructure besides being created 'artificially' and only for the purpose of reducing tax liability.

Various steps can be taken to achieve this. This could be accomplished for example through ensuring that all entities (including holding companies) have real physical presence in Cyprus, with independent local offices and staff administering the day-to-day management of the company.

Further to the definition of Substance (especially economic substance), the matter is open to interpretation and also largely lie to the interpretation of the authorities of the respective country.

We have prepared the description of the main factors that can be examined in search of Substance. The authorities normally will seek to find out whether the foreign entity located in low-tax jurisdiction has:

- Its own (rented or owned) office space / premises / physical address;
- Qualified and knowledgeable directors and managers who are located and employed in Cyprus;
- Other employee/s with relevant experience residing in Cyprus;
- Employer status of the company and registration with the Cyprus department of Social Insurance where directors and/or other staff are employed (not only nominated);
- Its accounting records maintained in Cyprus and the accounting work performed by local accountants;
- Operative local bank accounts, with local resident signatories/counter-signatories;
- Relevant assets located in Cyprus (i.e. staff, equipment and all other necessities which are normally required for doing business);
- The substantial involvement of local staff in the operations of the entity;
- An independent local email address and/or website;
- An independent telephone and fax line.

With the above noted, it is increasingly important to make sure that the substance of a Cyprus company is sufficient for foreign purposes.

Another country is free to impose its own substance rules (e.g. as a result of local CFC rules). In such case, the obligation will lie on the Cyprus company (including its foreign beneficiaries) to demonstrate to the foreign authorities that the company is performing a real business from Cyprus.

## Maintaining a Physical Office and Substance in Cyprus

A concern often raised for maintaining a physical office is usually that costs for setting up a Cyprus company will increase significantly. However, it is to be also noted that these costs can be minimized in various ways and that the substance will secure the clients from additional tax burden.

## Substance requirements under the new rules for intra group back to back financing arrangements in order to meet simplification measures

In order to justify the risk control and to further validate that the management and control are exercised in Cyprus it is imperative that the group financing company must have an actual presence in Cyprus.

In this regard the following will be taken into account:

- the number of the members of the board of directors who are tax resident of Cyprus
- the number of meetings of the board of directors taking place in Cyprus and
- the availability of qualified personnel to control the transactions performed.

Nonetheless the group financing company may subcontract functions which do not have a significant impact on risk control.

## Substance requirements for “active” holding companies

Under the Multilateral Instrument provisions, for a tax resident to be entitled to treaty benefits, it must be engaged in the “active conduct of a business”.

Such an active conduct shall **not** include:

- Operating as a holding company
- Providing overall supervision or administration of a group of companies
- Providing group financing (including cash pooling)
- Managing investments unless carried out by a bank, Insurance companies or registered security dealer in the ordinary course of its business

Holding companies should optimally perform the following functions within a group:

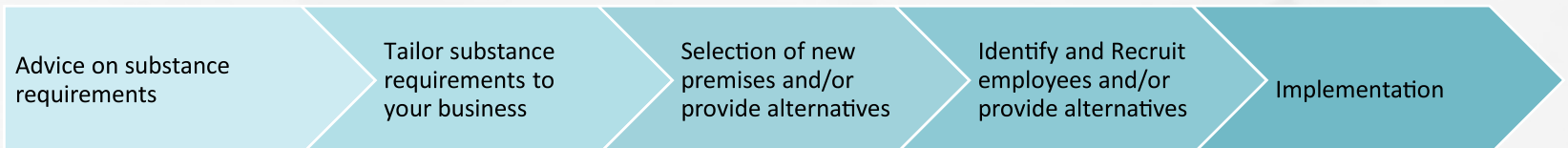
- Asset ownership / participation interest in operating & non-operating group companies.
- Accumulation of capital and shareholder value.
- Consolidation of business segments (incl. consolidated IFRS financial statements).
- Asset protection / mitigation of risks.
- Receiving dividends from operating companies.
- Distribution of profits to shareholders.
- Reinvestment of capital into new projects.

# How CFA can help?

CFA specialists can assist you with the following services:

- Diagnostics of the tax risks arising in the existing structure
- Recommendations on the actions required to deal with these risks including aligning the following:
  - Split of functions and risks between foreign jurisdiction and Cyprus
  - Supporting of the desired functions and risks in the foreign jurisdiction and Cyprus with the corresponding substance in terms of decision-makers/employees' location and documentation structure
- Assistance in the implementation of substance recommendations following the diagnostic review
- Assistance in preparing a comprehensive corporate governance framework
- Setting-up an office and hiring employees in Cyprus (including assistance in drafting employment contracts, obtaining work permits and optimization of taxation and social security liabilities with respect to the employees)
- Organization of decision-making process in relation to operational and strategic matters
- Providing support in relation to administrative issues (assistance in accounting functions, tax compliance, audit) of the Cypriot companies

## Let's Talk



For a deeper discussion of how the above might affect you or your business, please contact:

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.