PUBLICATION SHEET No. 2 18 May 2018

# Notional Interest Deduction (NID) - A tax incentive for equity financing and debt restructurings

## Introduction

Debt has traditionally been a tax efficient way of financing business operations, especially in Cyprus where the back to back debt financing was broadly used. Cyprus introduced a new tax incentive, the so called, "Notional Interest Deduction" or "NID". The NID enhances the tax benefits of financing business operations through equity and offers a tax efficient alternative to debt financing.

## Legal Framework

On 16 July 2015, the Cyprus Income Tax Law of 2002 was amended, with the introduction of Article 9B, titled, "deduction on new equity". According to this new Article, with effect from 1 January 2015, Cyprus tax resident companies and Cyprus permanent establishments (PEs) of non-tax resident/foreign companies are entitled to a Notional Interest Deduction (NID) upon the introduction of **New Equity** employed/injected into Cyprus resident companies, provided that the **New Equity funds are used in the Production of Taxable Income**. As the provisions of Article 9B of the Income Tax Law (ITL) are broad, on 18 July 2016, the Cyprus Tax Authorities issued Circular 2016/10, providing clarifications regarding the application of the law as well as practical examples with regards to the calculation of the NID. Below, we summarize the main provisions of Article 9B of the ITL as well as details of the relevant Circular.

## Purpose and Scope of Notional Interest Deduction (NDI)

The main aims for introducing the NID provision are:

- To reduce the discrepancy in the tax treatment between debt and equity financing, and in specific alignment of the tax treatment of equity finance with tax treatment of debt finance. Before the introduction of the NID, remuneration for debt financing was generally tax deductible while equity financing was not.
- To reduce excessive dependence of Cypriot entities on debt financing, thus strengthening their economic robustness, preserving their competitiveness.
- Promotion of capital-intensive investments in Cyprus. Through the introduction of the NID, Cypriot companies can be used as financing, central procurement and factoring centers of international groups.
- As an additional support for small and medium-sized businesses

In other words, the advantages that NID offers are:

- It can be applied with other incentives provided for in Cypriot legislation (e.g. intellectual property regime)
- It has similar benefits to debt financing
- Companies can maintain tax benefits while increasing their financial robustness

The parties which can benefit from the introduction of the NID are:

- Cyprus tax resident companies and
- The Cyprus permanent establishments of non-Cyprus tax resident companies.

## Notional Interest Deduction (NDI) calculation

The NID is effectively a notional interest tax deductible expense that arises upon the introduction of New Equity employed in the Production of Taxable Income by a Cyprus company, or an overseas company with a Cyprus PE. The fact that it is a notional expense, this means that no accounting entries are triggered in relation to the NID, i.e. it does not affect the accounting profit or loss of the Company, but it only affects the Corporation Tax Computation performed and consequently the Taxable Profit or Loss.

The NID is calculated by multiplying the **"New Equity"** introduced in the Company and used to carry out its activities, with a **"Reference Interest Rate"**, and it is subject to a cap equal to 80% of the taxable profit (as calculated prior to the NID). As corporate profits are subject to income tax at the rate of 12,5%, a taxpayer claiming NID can achieve an effective tax rate of up to 2,5% (=20% x 12,5%).

## Terms

1) "New Equity"

**"New Equity"** is defined as equity introduced in a company as from 1 January 2015 in the form of issued and paid-up share capital and share premium. New Equity includes shares of any class, including ordinary, preference, redeemable and convertible shares, paid either in cash or in-kind (explained below). The Circular clarifies that unpaid share capital, in respect of which a corresponding claim has been recognized which gives rise or is deemed to give rise to interest which is subject to income tax, shall be considered as paid-up capital for the purposes of Article 9B of the ITL.

The Circular clarifies that New Equity may also be introduced in-kind and the following may qualify as new equity:

- Loans payable and other debt instruments converted into issued share capital;
- Shareholders' credit balances converted into issued share capital;
- Non-refundable capital contribution converted into issued share capital;
- Realized reserves created after 1 January 2015 converted into issued share capital;

***In such a case, the amount of equity for NID purposes cannot exceed the market value of the assets in question as at the date of their introduction into the business.***

**Realized reserves existing on 31 December 2014** ("old equity") that are converted into issued share capital, **may only qualify as New Equity**, to the extent that it can be substantiated that the old equity was previously employed in assets which were not used in taxable activities and upon conversion it was employed in taxable activities. Finally, the Circular provides guidance in determining the level of new equity in a number of cases including:

- A non-Cyprus tax resident company with a Cyprus PE issuing new equity;
- A non-Cyprus tax resident company transferring its tax residency to Cyprus;
- A non-Cyprus tax resident company with a Cyprus PE transferring its tax residency to Cyprus;
- A Cyprus tax resident company or a PE of a non-Cyprus tax resident company reducing its equity, following the introduction of new equity.

<u>Planning Tip:</u> Capitalization of existing loans obtained by the Cyprus Company will qualify as "New Equity" for the purposes of NID. This means that capitalizing back-to-back loan arrangements via Cyprus will give access to NID (hence reducing the taxable base of the Cyprus company to similar levels as with the back-to-back arrangement that used thin spreads) AND at the same time reinforce the status of the Cyprus company as being the beneficial owner of the income on the foreign interest it receives on loans granted out.

<u>What is excluded:</u>

The definition of New Equity for NID purposes does not include any amounts capitalized which were derived from a revaluation of movable or immovable property. Moreover, any new equity introduced in a Company on or after 1st January 2015 which emanates - either directly or indirectly - from reserves existing as at 31st December 2014 but does not relate to the financing of new assets used in the business, is also excluded.

<u>Restrictions – limitations</u>

**NID Cap**: The NID is capped to 80% of the taxable profit, generated from the new equity and calculated before allowing for the NID.

**Different Assets generating taxable income**: Where a taxpayer invests the new equity in a number of different assets generating taxable income, the Circular introduces a scheduling method for the purpose of calculating the applicable NID cap. In this respect, taxpayers would need to be able to allocate new equity between the various assets/activities of the taxpayer as follows as well as to be able to determine the taxable profits generated from each asset/activity. First, identify new equity that directly financed specific assets (the 'matching concept'). Then allocate any remaining new equity to non-business assets and assets not generating taxable income. Finally, apply a pro-rata allocation to the remaining assets of the taxpayer (Refer to Example shown in *Appendix 1* at the end of the Publication).

**Tax Loss Position**: In case where a Company is in a tax loss position, NID is not granted. Therefore, NID cannot be used to either create or increase a tax loss. Any unutilized NID cannot be carried forward for use in future years.

**Financing of business assets which generate taxable income**: NID is available as tax deductible, provided that the new equity is used for the financing of business assets which generate taxable income.

**Qualified re-organizations**

In case of re-organizations that are considered as 'qualifying' under the provisions of the Cyprus tax legislation (and, as such, are tax neutral), NID is calculated on new equity as if the re-organization had not taken place.

**Election**

A company may elect whether to claim the whole or part of the amount of the NID available, in any given year. This may be of use by Cyprus tax resident companies that wish to show a certain amount of higher tax paid in Cyprus.

## 2) "Reference Interest Rate"

The Reference Interest Rate is defined as **the higher of**:

a) The yield of the 10-year government bond (as at 31st December of the prior tax year) of the country in which the new equity is invested, plus a 3% premium, and
b) The yield of the 10-year government bond of the Republic of Cyprus (as at 31st December of the prior tax year), plus a 3% premium.

The Tax Department publishes the 10- year government bond yields for selected countries on an annual basis through which one can derive the relevant reference rate. In the absence of published guidance on behalf of the Tax Department, the relevant yield should be obtained from Bloomberg (Reference Interest Rates for 2015, 2016, 2017 and 2018 can be found in *Appendix 2* at the end of this Publication).

## Anti-Abuse Provisions

The Cyprus tax legislation has also been amended so as to provide for certain safeguards against possible abuse of the NID provision, according to which the Commissioner reserves the right not to allow the granting of NID in cases where, in his judgement, transactions or arrangements have been effected without valid economic substance or commercial reasoning, with the main purpose in mind being to claim NID. Similarly, the Commissioner may also restrict the granting of NID in cases of transactions or arrangements between related persons made in such a way so as to present old equity as new equity, for the purpose of claiming NID.

**Specific clauses**

The tax legislation also provides for the following:

- In case where new equity of an eligible company is derived – either directly or indirectly - from new equity of another eligible company, the NID on the new equity is available to only one of the two respective entities

- In case of new equity derived – either directly or indirectly – through a loan, on which another eligible company has claimed an interest expense deduction, then the NID is restricted accordingly by the amount of the interest expense claimed by that other company.

## Disclaimer

## Appendix 1 - Example

The Circular provides seven practical numerical examples of NID calculations including the following: Cyprus Co issues new equity amounting to €150m and received funding of equal value. Cyprus Co decides to use these funds to purchase three assets in three different countries as follows:

| # | NID Calculation | Asset 1 €m | Asset 2 €m | Asset 3 €m | Total €m |
|---|---|---|---|---|---|
| 1 | New Equity | 50 | 50 | 50 | 150 |
| 2 | NID [New equity x reference rate] | 7,2 | 6 | 9 | 22,2 |
| 3 | Taxable profit after deducting direct and apportioned indirect expenditure | 10 | 5 | 12 | 27 |
| 4 | NID cap (80% of the taxable profit) [80% x (3)] | 8 | 4 | 9,6 | 21,6 |
| 5 | Deductible NID for each asset [lower of (2) and (4)] | 7,2 | 4 | 9 | 20,2 |
| 6 | Taxable profit [(3) - (5)] | | | | 6,8 |

The maximum NID which may be claimed by Cyprus Co is the lower of (4) and (5), i.e. €20.2m. It is worth noting that the example assumes that the new equity funding was available for the whole tax year of assessment and that the relevant reference rates for each asset were as follows: asset 1: 14.4%, asset 2: 12%, asset 3: 18%.Furthermore, the example assumes that the taxable profit produced by each asset could be accurately determined.

## Appendix 2 – Reference Interest Rates 2015, 2016, 2017 and 2018

| Country | Ref. Int. Rate % for 2018 | Ref. Int. Rate % for 2017 | Ref. Int. Rate % for 2016 | Ref. Int. Rate % for 2015 |
|---|---|---|---|---|
| Austria | 4,881 (3,563*) | | | |
| Canada | 5,079 | | | |
| China | 7,268 | | | |
| Croatia | 5,453 | | | |
| Cyprus | 4,881 | 6,489 | 6,685 | 8,037 |
| Czech Republic | 4,881 (4,650*) | 6,489 (3,414*) | 6,685 (3,499*) | 8,037 (*) |
| France | 4,881 (3,780*) | | | |
| Germany | 4,881 (3,423*) | 6,489 (3,204*) | 6,685 (3,568*) | 8,037 (3,540*) |
| Greece | 7,073 | | | |
| Hungary | 5,031 | | | |
| India | 10,571 | 9,878 | 10,758 | 10,860 |
| Ireland | 4,881 (3,811*) | | | |
| Latvia | 4,881 (3,715*) | 6,489 (3,894*) | 6,685 (4,104*) | 8,037 (*) |
| Luxembourg | 4,881 (3,637*) | | | |
| Netherlands | 4,881 (3,501*) | | | |
| Norway | 4,881 (4,579*) | | | |
| Poland | 6,385 | 6,627 | 6,685 (5,937*) | 8,037 (*) |
| Romania | 7,314 | 6,748 | 6,703 | 8,037 (6,570*) |
| Russia | 10,590 | 11,380 | 12,570 | 16,730 |
| Russia (denom. in USD) | 6,822 | 7,409 | | |
| Serbia | 8,968 | | | |
| Slovakia | 4,881 (3,815*) | | | |
| Slovenia | 4,881 (3,843*) | | | |
| South Africa | 11,780 | | | |
| Spain | 4,881 (4,558*) | | | |
| Sweden | 4,881 (3,540*) | | | |
| Ukraine | | 11,705 | 12,622 | 8,037 (*) |
| United Arab Emirates | | 6,489 (6,326*) | 10,490 | 8,037 (*) |
| United Kingdom | 4,881 (4,188*) | 6,489 (4,326*) | | |
| USA | 5,406 | | | |

* The Cyprus NID interest rate is used as it is the maximum.

__Note__: In respect of countries not mentioned in the announcement, taxpayers may apply to the CTD for the determination of the appropriate NID Reference rate enclosing the interest yields of the 10-year government bonds for the countries concerned as identified on the basis of the Bloomberg Index, or in the absence thereof, their estimation of the applicable rate.