Cyprus - Substance and Physical Presence

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Cyprus as an attractive jurisdiction for its tax regime – Perception in the recent past

Cyprus' strategic location, developed legal system, competitive corporate tax rate of 12.5%, personal tax incentives, well-educated local workforce and business-friendly environment make Cyprus an ideal country for this purpose.

In addition to the Corporation Tax rate, which is the lowest in the European Union and is a flat rate irrespective of type and level of income (this is not usually the case in other traditional financial centres), Cyprus offers the following main advantages to offer commercial companies:

- its membership of the European Union which, in combination with its strategic geographical position, makes Cyprus a gateway to the booming manufacturing countries such as China and India via which they may enter the EU and vice versa for European and other countries to expand their operations to the Far East;
- the absence of any Withholding Tax for payments of dividends to non-Cyprus residents, irrespective of the country in which the shareholder is based and irrespective of the legal form of that shareholder;
- the island's excellent telecommunications and other infrastructure which, together with the business-friendly time zone, eliminate the barrier of distance in carrying out commercial activities from Cyprus;
- the country's well-educated, skilled and multilingual workforce, which means that there is an abundance of talent available to service the needs of such structures;
- the extensive network of double tax treaties that Cyprus has signed with countries from every part of the world with beneficial provisions relating not only to corporate but also to personal taxation;
- the high quality of professional advisers which can provide a sound background of support services, such as banking, audit, and legal.

Thanks to these and many other advantages, operating through Cyprus and using appropriate tax planning/structuring to mitigate Cyprus tax (sometimes to effective levels well below 12.5%) is a far better strategy nowadays than trading through an offshore company registered in a tax haven.

In addition, a comprehensive network of double taxation treaties has been integral to Cyprus's success as a financial centre. Cyprus has concluded tax treaties with more than 55 countries, whereas even more treaties are under negotiation, or awaiting ratification.

Most of the Treaties follow the Organisation for Economic Co-operation and Development (OECD) model and their objective is that of reducing or eliminating the double taxation payments imposed by the Contracting states on cross border transactions.

Foreign investors have the opportunity to facilitate investments and trading through Cyprus, with a country that Cyprus has a treaty with, allowing for a reduction or elimination of the withholding taxes. It is also undeniable that Cyprus maintains a very competitive tax regime for dividends, gains from the sale of shares and margins on back-to-back loans and much more.

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When is a Company considered to be tax resident in Cyprus

The taxation of companies is based on residence. All companies that are tax residents in Cyprus are taxed on their worldwide income accrued or arising from sources both within and outside Cyprus. Non-resident companies are taxed in Cyprus only on income derived from a permanent establishment or immovable property in Cyprus. A company is resident of Cyprus if it is managed and controlled in Cyprus (the place where the key management and commercial decisions that are necessary for the conduct of the entity's business).

Perception in the recent past

In the recent past, most Cyprus companies could successfully claim double taxation benefits under the relevant DTT just by the fact that they were incorporated in Cyprus. In practice, the Cyprus Company would simply apply for a tax residence certificate from the Cyprus Tax Authorities which they would then present to the foreign tax authority. Based on this tax residence certificate, the foreign tax authority would allow the Cyprus Company to claim DTT benefits on receipt of dividends/interest/royalties from the foreign entity.

OECD and Base Erosion and Profit Shifting ("BEPS") project

Since the OECD presented their action plan on 'Base Erosion and Profit Shifting (BEPS) the importance of the topic of 'substance' has significantly increased. Under the BEPS initiative the OECD counters harmful tax practices, by introducing tighter regulation of the international tax system as a whole. This has made it clear that establishing appropriate levels of substance in jurisdictions where there has previously been limited presence will become best practice for multinational enterprises. In addition, businesses may look to rationalize the number of entities that they have globally and concentrate certain activities in jurisdictions which are conducive to the establishment of a fully operational business presence. The main purpose of these regulations is to close gaps in international taxation for companies that allegedly avoid taxation or reduce tax burden.

As part of this development, the mere fact that a company is incorporated in Cyprus and pays taxes in Cyprus on its worldwide income (and therefore able to obtain a Tax Residence Certificate from the Cyprus Tax Authorities) is no longer sufficient for a business to guarantee that a Cyprus company can access the full treaty benefits offered through the expanding and favourable DTT network that Cyprus has to offer.

What is Substance

Substance can be defined as the various characteristics, notably resources, which demonstrate that the company does indeed have its activities based in the country where it is tax resident, and is not merely a "shell" company formed to avoid paying (usually much higher) tax in the country where the underlying business is based. A strong prove for a company in order to achieve that is managed and controlled in Cyprus, is to show that the majority of directors are residing in Cyprus and the board of directors is holding Meetings in Cyprus.

Minimal substance procedures followed:

- Strategic decisions actually being taken by directors' meetings in Cyprus;
- The board of directors including suitably qualified Cypriot resident individuals;
- Holding of bank accounts in Cyprus;
- Actively acting as a shareholder in lower tier subsidiaries;

More material substance procedures that can be followed:

- The Company has appropriately qualified employees, registered with social insurance and are substantially involved in the operations of the Company
- The Company maintains full documentation of the decision making process
- The administration of the company taking place in Cyprus, as well as the accounting records and other records such as agreements, contracts, invoices etc., are located in Cyprus.
- The Company maintains an office in Cyprus, through which day to day operational functions are exercised;
- The registration of utilities such as water and electricity are in the name of the Company;
- A telephone number, e-mail and fax exist in the name of the company;
- A company has its website, company logo and company stationery;
- Employees and premises must be insured.

A Cyprus company being able to demonstrate that is has substance in Cyprus, as well as management and control in Cyprus, will be in a much stronger position to claim the benefits of DTTs and take advantage of the favourable Cyprus tax regime compared with one that does not have substance.

Today's approach of foreign tax authorities

It is important to note that foreign tax authorities do not only examine whether a Cyprus company has substance in Cyprus and exercises effective management and control from Cyprus. They go beyond that to also investigate at whether the same Cyprus company maintains 'substance' in their own -foreign- jurisdiction, e.g. maintains a Permanent Establishment through which it carries out its business, or it is managed and controlled in that jurisdiction, through individuals that undertake the effective decision-making and formulation of the company policy from there. Undoubtedly, a Company shall be regarded as managed and controlled outside Cyprus if the majority of its directors are non-Cyprus residents and the board of directors does not meet regularly in Cyprus, or even it doesn't have any operational office in Cyprus and generally there is no management of the day to day operations of the company in Cyprus.

It is important to understand that in the event that they find substance or management and control of the Cyprus company in their own jurisdiction, not only they will not allow the company to enjoy the relevant DTT benefits, but they may also tax all or part of the income of the Cyprus company as income arising in their own jurisdiction.

From now on, tax jurisdictions are looking for substance and not just the figment of a tax planner's imagination.

Controlled Foreign Company ("CFC") Rules

The term Controlled Foreign Company has been implemented in the recent years. CFC is a foreign company that:

- Is directly or indirectly controlled by resident taxpayer;
- Earns substantial passive income (interest, rent, dividends, royalties and capital gains); and
- Is subject to substantial lower taxation than in resident state

CFC rules tax the income of controlled foreign subsidiaries in the hands of resident shareholders. For most countries, they are used to prevent shifting of income either from the parent jurisdiction or from the parent and other tax jurisdictions. Some countries which give more importance to the principle of territoriality do not currently apply CFC rules. However, where countries have worldwide tax systems, they may also be concerned about long-term deferral and therefore their rules may have broader policy objectives.

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How PKE Consultants can assist

We assist companies develop value-adding, real solutions using Cyprus as their international business headquarters. We make it a priority to advice all clients of the importance of economic substance and we clearly communicate all risks associated with setting up a legal structure which is designed to achieve specific tax related objectives, e.g. in the case where investors prefer cheap solutions, with no economic substance.

Through our network and affiliates, we can provide a wide range of services that can assist you in the implementation of the strategic objective of increasing business presence in Cyprus:

1. Consulting services regarding the appropriate level of substance;
2. Administration and management services
3. Employee services, i.e. hiring local personnel, dealing with migration formalities and drafting of employment contracts;
4. Rental of office space, with dedicated phone and fax line;
5. Creation of Company website

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PKE Consultants Limited
10 Adamantiou Korai,
2321 Nicosia,
Cyprus

Phone
+357 22 102019

Fax
+357 22 102019

E-mail
info@pkeconsultants.com.cy

Find us at:
www.pkeconsultants.com.cy

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