taxnotes® international
Volume 110, Number 17 ■ April 24, 2023

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Reprinted from *Tax Notes International*, April 24, 2023, p. 477

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In this article, Michail explains how non-genuine arrangements and the significant people function principle are important in showing which activities of a subsidiary should be attributed to that entity and which to its controlling parent.

Cyprus transposed the EU anti-tax-avoidance directive (ATAD)[1] into its national tax law, introducing an array of antiavoidance provisions that came into force January 1, 2019. This article expands on the Cypriot controlled foreign corporation law[2] with reference to the "non-genuine arrangement" and the application of the significant people function (SPF) principle.

CFC rules purport to preserve the tax base of the parent entity by preventing the sheltering or diverting of profits to a low-tax subsidiary, mainly those located in low-tax jurisdictions. The rules appear to pierce the corporate veil by including CFCs' profits in the corporate tax base of the parent company. However, the CFC rules should not work as a blanket ban against locating CFCs in low-tax jurisdictions. Demonizing low-tax jurisdictions that accommodate real business activity is counterproductive, raises barriers to foreign trade, and can even create tensions between states.

ATAD I delimits the scope of CFC rules, excluding foreign subsidiaries that:

- carry on substantial economic activity[3] (under the so-called entity/categorical approach); or
- produce non-distributed profits from genuine arrangements[4] (under the transactional approach).

The Court of Justice of the European Union's observations[5] on the fundamental freedoms may also provide guidance on the practical application of ATAD I (including CFC rules).

This article deconstructs the "genuine arrangements" component (as embodied in the Cypriot CFC rules) and in particular the SPF principle.

Overview of Cypriot CFC Rules

The starting point is the cumulative two-prong test[6] that must be met for the foreign subsidiary to be a CFC under Cypriot CFC rules. The two-prong test is made up of the control test and the low-tax test. For the control test, the Cypriot corporate taxpayer (Cypriot parent company) must alone, or with associate[7] companies, hold directly or indirectly at least 50 percent equity participation or voting rights, or be entitled to 50 percent of profits. For the low-tax test, the CFC's profits must be subject to a tax rate

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[1] Council Directive (EU) 2016/1164 of July 12, 2016 (ATAD I).

[2] Income Tax Law, art. 36.A, 118(I)/2002, as amended.

[3] ATAD I, at art. 7.2.a.

[4] ATAD I, at art. 7.2.b.

[5] *Cadbury Schweppes PLC v. Commissioner*, C-196/04 (CJEU 2006).

[6] ATAD I, at art. 36.A.1(a), (b).

[7] The definition of "associates" under article 2(4) of ATAD I has been adopted by the Cypriot CFC rules.