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Cyprus Tax News- Recent Legislative Amendments on Low-Tax Jurisdictions

Dear Clients, Associates, and Friends

The Cyprus House of Representatives (Parliament) approved three significant legislative amendments ('**Tax Amendments**') to the Cyprus Income Tax Law 2002, the Special Defence Contribution Law of 2002, and the Law of Assessment and Collection of Taxes of 1978. The Tax Amendments in line with its obligations under the EU Recovery and Resilience Plan, and introduce anti base erosion measures ('**Erosion rules'**) when dealing with **low tax jurisdictions** ('**LTJs'**).

The Erosion rules consist of (i) withholding taxes ('**WHT'**) for outbound dividend payments to the LTJs and (ii) deduction denial rules on outbound interest and royalty payments to LTJs.

The Erosion rules will apply as from **1 January 2026.**

Section 1. Income Tax Law (ITL)

- **Overview of the Erosion rules:** The ITL lays down that outbound interest and/or royalty payments (from a Cypriot company) to a company that resides in a LTJs are subject to the Erosion rules, therefore **prohibiting** interest and/or royalty tax deductions by the Cypriot Company when compiling its Cypriot tax computation. In the body of this section, we briefly elaborate on the main provisions of the Erosion rules.

- **Cumulative two-part test**: The outbound interest and/or royalty payment will be monitored by the Erosion rules when <u>cumulatively fulfilling</u> (i) **the low tax test** and (ii) **control/ ownership test**. In brief,

(i) **the low tax test** will generally be satisfied when the recipient of the outbound interest and/or royalty payments is tax resident in a LTJ, and in particular a jurisdiction that applies a 50% lower corporate tax rate than the Cypriot rate (ie lower than 6.25%, based on the 12.5% Cypriot rate).

(ii) **The control/ownership test** which applies to cases where there is a direct or indirect association (between the Cypriot company and the LTJ company), and this exceeds 50% (‘**50% threshold’**). Expanding on this, the 50% threshold is determined by reference to either voting rights or capital or share in profits. Further, the 50% threshold broadly applies to (a) direct associations, or (b) indirect associations (including jointly with other ‘associated/connected companies’) or (c) common ownership (when both the Cypriot company and the recipient are jointly owned).

- **Carve out:** The Erosion rules permit a narrow exclusion allowing tax deductibility for outbound interest in relation to bonds and/or debentures that are listed and traded on recognized exchanges when it is not practical for the Cyprus payer to know the ultimate recipient.

- **Specific anti avoidance rule (‘SAAR’):** The Erosion rules incorporate the SAAR allowing the Commissioner of Taxation to supplement/displace an arrangement or series of arrangement when (i) the main or one of the main purposes is to obtain a tax advantage (e.g., allowing for interest deductibility) that defeats and object and purpose of the applicable tax law and (ii) are not genuine considering all relevant facts and circumstances (e.g. no valid commercial reasons which reflect economic reality). Section 4 below elaborates on the Ministerial Decree concerning the substance indicia for the operation of SAAR (“**Ministerial Decree**”).

Section 2. Amendments to the Special Defence Contribution Law (‘the SDC’)

- **Overview of the Erosion rules:** The SDC lays down that 17% WHT (it is possible that the WHT rate will be reduced as part of a Tax reform currently in the process of Public / Parliamentary consultation) should apply on outbound dividend payments (from a Cypriot company) to a company that resides in LTJs.

  Section A above, elaborates on key provisions for the operation of the Erosion rules under ITL. These key provisions comprise the (i) the cumulative two-part test, (ii) carve out and (iii) the SSAR and they apply equally for the Erosion rules under the SDC. Further, the Erosion rules lay out that a transfer/distribution of assets by way of capital reduction or dissolution may give rise to a ‘deemed dividend’ hence 17% WHT may apply to the difference between the market value of the transferred asset and its book value.

Section 3. Compliance reporting obligations

The Ministerial Decree creates an obligation for a Cypriot company to maintain records for 6 years when paying out dividends, interest or royalty without applying WHT and/or denying the deductibility in accordance with the defensive rules. The records should inter alia stipulate which of the SAAR indicators are satisfied. Such records should be submitted with the Tax Administration when requested. Administrative penalties ranging from Eur 2k to Eur 10k may apply when failing to provide relevant documentation. This obligation is negated/cancelled when the outbound payment is made to a company that:

(i) Is tax resident in Cyprus;
(ii) Is tax resident in EU Member States or EEA;
(iii) Is member to a Multinational Group that is monitored by Pillar 2 rules (either through the respective EU Directive or OECD BEPS);
(iv) Member of a consolidated MNE Group that has no presence in LTJ.

Section 4. The SAAR

The Ministerial Decree lays out 6 substance related indicators that monitor the operation of SAAR. Failure to meet at least 4 out of the 6 substance indictors will give rise to a rebuttable presumption that SAAR allows the Tax Administration to supplement/displace/ignore the arrangement OR series of arrangements. In this situation, the taxpayer should demonstrate valid commercial reasons that reflect the commercial reality persist **or** that obtaining the tax advantage/benefit was not the main or one of the main purposes, to escape SAAR.

The Substance indicators include:

(i) At least one member of the Board of Directors of the recipient Company (a) has the competence and authority to take on decisions in relation to the activities & assets of the company and (b) exercise actively and independently his duties.
(ii) At least one of the members of the Board of Directors tax resides in the jurisdiction where the recipient company is tax resident.
(iii) The recipient company has office space at its disposal for its directors and employees in the jurisdiction where it is tax resident.
(iv) The majority of the meeting of the Board are taken in the jurisdiction where the recipient company is tax resident.
(v) The operation costs (including Directors and employees remuneration) are proportionate to its operations.

(vi) The recipient company does not operate mainly for passing on the entirety of its income realising a marginal profit (if any).

Concluding Remark

The Erosion rules are expected to affect the use and operation of LTJs in their Group structure. Businesses are strongly advised to review their structures accordingly.

Our team of lawyers, advisors and consultants is available to assist you in assessing the impact of these new rules and planning the necessary restructuring steps.