NEED AND PRINCIPLES FOR A TAX REFORM IN CYPRUS

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The department of Austrian and International Tax Law of the Vienna University of Economics and Business Administration – the second largest research and teaching institution for tax law in Europe has performed research and practical work on the tax aspects of Austria's accession to the European Union. Using its experience from Austria's deal with the European Union, it has prepared a study report to the Cyprus Minister of Finance on "Tax Aspects of Cyprus as an International Business Centre joining the European Union"***. The highlight of this report is, that the international business cannot be dealt with separately but only in connection with a general tax reform. This article summarises the ideas on such a reform.**

I
Need for a Substantial Tax Reform

"An old tax is a good tax", the Scottish philosopher and economist Adam Smith wrote in the Wealth of Nations, published in 1776. This is not true for the Cyprus Income Tax Law. For tax experts it certainly was a beauty when it was first published in 1961 and it became mature in the 70ies when it was used to reposition Cyprus after the Turkish invasion; but it grew old in the 90ies with Cyprus' economic achievements and does not fit any more into the social and economic environment of Cyprus at the beginning of the 21st century.

There is the need for a substantial tax reform in Cyprus. The development of a new tax system which will conform with European Law and with the Acquis Communotaire, which satisfies OECD with its campaign against Harmful Tax Competition and the European Union with its Code of Conduct, is necessary. From a Cyprus point of view a substantial tax reform is necessary also for economic and social reasons and to prepare for Global Tax Competition.

Cyprus is in the process of harmonisation of VAT and excise taxes with the European Union. Starting out with a standard rate of 5%, Cyprus has now three different VAT rates of zero, five and 10%. It will end up with almost no zero rate items, with many more items taxed at the 5% rate and most deliveries and other services taxed at the rate of 15%. Revenues from VAT will increase significantly and a similar rise of excise duty revenues will occur.

** For further information visit the following website: http://fgr.wu-wien.ac.at/INSTITUT/FR/
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Altogether the taxes on consumption will take a much bigger share in the cake of Cyprus revenues than before. The former balance between taxes on income and on consumption will be lost. This certainly creates a problem. In order to safeguard economic and social stability, a substantial tax reform is necessary in my view.

Such a tax reform is also necessary in order to succeed in Global Tax Competition. A number of developed countries have engaged in tax reforms. Almost any tax reform plan nowadays concentrates on a cut of taxes on income, a broadening of the tax base and a reduction of rates to make the tax system transparent, easier to administer and more efficient. Dr. Kirchhof, a leading tax expert in Germany, presented a report to the German Government only a few weeks ago drawn up by a commission of experts. They suggest a reduction of rates from 30-60% to 15-35% and a reduction of the sections of the Income Tax Code from a few hundreds to twentyone. This example shows that the British economist Keynes, who preached an interventionist tax system in his days, is out of date. Interventions by tax measures may be efficient for less developed countries but proved to be inefficient for highly developed economies. In my view this holds also true for Cyprus. In Cyprus everybody has his exemptions, deductions, allowances, special rates or other incentives. This system is, in my view, not efficient any more, if one takes the advanced status of the Cyprus economy into account.

II
Strategies

The most important issue of a tax reform is the strategy to be chosen. The alignment with EU and OECD is undisputed. More difficult is the issue of how to use best the additional revenues from VAT and excise taxes.

In the study performed by the Department of Austrian and International Tax Law of the Vienna University of Economics and Business Administration we propose to invest the money in a tax reform and use it to finance a reduction in taxes on income and to eliminate taxes uncommon in most or many OECD countries. The study proposes to abolish the defence contribution, which seems to be in line with government policy. It also proposes to eliminate stamp duties. Stamp duties are in the eyes of most international businessmen a British disease which spread to all countries of the former British Empire. At least with foreign investors stamp duties such as in Cyprus – and in Austria, where we have inherited it from the Austrian-Hungarian Mannerly and the German Reich – are almost as unpopular as were the duties on tea in New England.

The study also suggests to investigate into the efficiency of municipal taxes. Business taxes are unpopular world-wide among foreign investors. Their administration is costly for cities and even more for townships and villages. If you take the size of Cyprus, a tax system supplementing business taxes by a small share of the municipalities in taxes on income might be more efficient from the point of view of the budget and administration and more transparent for the taxpayer.

III
Taxation of Personal Income

What might be the consequences of the outlined strategies in a reform of the taxation of income of individuals? My department studied the Cyprus budgets for the years 2000 and 2001, the latest Family Budget Survey and various publications and statistics published by the Cyprus Planning Bureau, the Strategic Development Plan 1999-2003, statistics and publications issued by the Central Bank of Cyprus and various commercial banks and data on revenue losses from various exemptions, deductions, allowances and losses. Based on this research work we assume that a 30-40% reduction of the effective income tax burden on individuals should be possible and bring this up for discussion.

How can this be achieved? We recommend a reduction of rates. The zero rate bracket might be doubled and extended to 12,000 CYP. Lower income earners will thus be treated more favourably in exchange for an increase of taxes for consumption. We suggest two tentative rates, a 10% rate, let me say between 12,001-24,000 and a tentative 20% rate for income above 24,001 CYP.

Such a substantial reduction in rates may, of course, not be financed by an increase in revenues from VAT and excise taxes alone. It should also be financed by broadening the tax base. I suggest to consider the elimination of any or almost any of the personal allowances and I recommend to evaluate the various exemptions, deductions and incentives as to their compatibility with EU law, their social and economic effectiveness, taking into account the developed status of the Cyprus economy and their administration costs. This would partly be in compensation of the enlarged zero rate bracket and the lower tax rates and might be accompanied by the introduction of grants to families for their children.

We also recommend consideration on strengthening the taxation at source for Cyprus residents by way of withholding taxes to secure revenue from interest and royalties and final taxation to reduce the member of assessments for income tax and their administration costs. This would partly be in compensation for the enlarged zero rate bracket and the lower tax rates and might be accompanied by the introduction of grants to families for their children.

IV
Taxation of Corporate Profits

A reform of the taxation of corporate profits in Cyprus must conform with EU and OECD requirements. Most important in this respect are:

- the elimination of all explicit incentives for international business to be in line with the OECD campaign against Harmful Tax Competition and the Code of Conduct;
- the elimination of any preferential tax rates being discriminatory according to EU law;
- the introduction of a new regime for the taxation of intercompany dividends, interest and royalties to comply with the Parent-Subsidiary Directive; and
- the introduction of tax rules on reorganisations according to the Merger Directive.

An EU system of taxation of corporate profits is not in existence nor even on the horizon. All systems are open for discussion therefore. We recommend an integration type of taxation for further research and review by experts from the tax authorities, the business community and economists. In such a concept corporation tax and withholding tax on distributions add up to the equivalent of the maximum income tax rate. An integration of corporation and withholding taxes into the income tax burden would thus be achieved for distributed profits.

A new system for Cyprus should provide for a single corporation tax rate. Assuming a marginal income tax rate of 20% we propose a tentative 10% corporation tax rate for further discussion. From distributed profits a 10% dividend tax should be withheld. Corporation tax and withholding tax would add up to the amount of the marginal income tax rate. Intercompany dividends should be exempt from withholding taxes and exempt from corporation tax for the recipient company.

V
Withholding Taxes

The present system of withholding taxes is basically in accordance with EU law and should be maintained. We even suggest to make these withholding taxes more effective for resident individuals. We recommend to consider an extension of the withholding taxes on interest with a rate equal to the marginal income tax rate of for example 20%. All withholding taxes should be final with an optional assessment that the taxpayer may choose if his income tax rate is below the marginal one of, for example 20%. Mandatory assessment should be restricted to cases in which a taxpayer has two or more employments. Otherwise the withholding tax should be final. Taxation of dividends, interest and royalties would thus become more effective with less administration costs for the taxpayer and the Inspector of Taxes. That’s the good news. The bad news is that the banks would have to withhold tax on interest payable to residents, which they seem to dislike worldwide.

VI
Determination of Chargeable Income from Trade and Business

Income from trade and business is reduced by allowances for wear and tear and by investment allowances. The statutory rates of capital allowances for wear and tear in Cyprus are quite generous. We recommend to review them in respect of incentives and to eliminate such incentives along with the investment allowances.

Consideration should be given to regional incentives for areas suffering most because of the Turkish occupation. Such regional incentives will be justified under European state aid rules.

Export incentives are certainly more sensitive under European law. They may be justifiable by the small home market and by the disadvantages compared with an economy with a better balance between production and services. Such incentives may be acceptable from an European Union policy point of view, at least for a transitional period. Technically, a special export regime might be introduced by a new definition of foreign source income.

VII
International Taxation

This brings me to the reform of international taxation. Nowadays Cyprus applies various methods of relief for foreign source income. The credit method is the general method applied unilaterally and under tax treaties to avoid double taxation. But 90% of the profits or dividends brought into Cyprus from any business carried on outside Cyprus by a company controlled by Cypriots and having an interest of at least 15% in such business are exempt, for example. Also salaries from employment exercised abroad or salaries received from an international business company are exempt or partly exempt. International business companies may deduct foreign income taxes as an expense.

We suggest in general to change from the credit and deduction methods to the exemption method. This would harmonise rules, correspond to the reduction in rates which reduces the effects of the credit method in most cases anyhow and improve competitiveness of Cypriot investments abroad. The change to the exemption method should go hand in hand with a revised definition of foreign source income. The effect should be that many activities which are now taxed at 4.25% applicable only to international business entities will in future be taxed at zero % for all companies, while the domestic income should be taxed at 10% for all companies.

We further suggest to restrict withholding taxes on dividends, interest and royalties to resident individuals. Foreign companies should be exempt. This should be the answer to the Parent-Subsidiary Directive and the EU policy for intercompany interest and royalties and to the EU policy for savings. The benefits of exemption should in our view not be restricted to companies and individuals from the EU so as to avoid different treatment of foreigners.

Mailbox companies are a problem from the treaty shopping point of view and critical under the Harmful Tax Competition Approach. We suggest to limit the treaty benefits to companies with local presence and to encourage certain of the more than 41,000 international business companies without fully fledged offices to open up fully fledged offices which are of much higher value to the Cyprus economy.

VIII
Taxation of International Business

The International Business Sector is of great importance to Cyprus. According to the Strategic Development Plan Cyprus ought to be even upgraded as an International Business Centre. We suggest to achieve this taxwise by a combination of rules resulting from the reform under discussion, which are favourable to domestic and international business as well. There should be no specific rules and reliefs for international business controlled by aliens, but rules which are applied to both foreign and domestic shareholders. Giving up the international business regime should lead to a better linkage of the international and the domestic business sectors.

The Shipping and Ship Management industry should be an exemption to the rule. In many European Countries special rules are applied and it is the policy of the European Union to apply state aid rules to this industry. I therefore suggest, to maintain the regime of tonnage tax and to obtain the confirmation from the European Union.

A critical issue is the exchange of information. With Cyprus' accession to the European Union the Council Directive on Mutual Assistance, which provides inter alia for exchange of information between Member States, will apply to Cyprus. We propose that Cyprus invites all Member States and candidate countries to conclude or renegotiate prior to the accession treaties with an exchange of information clause and to offer the same to all OECD countries. With other countries Cyprus should be very careful to avoid any secrecy problem. We are sure that such a policy will be appreciated by the European Union, OECD and prospective treaty partners.

IX
Conclusion

My conclusion is: Cyprus needs a substantial tax reform and has the best starting position due to the expected increase in revenue from VAT and excise duties. Experts and politicians should do their best to make it a success for both Cyprus and the European Union. I am convinced that through a tax reform Cyprus will be best equipped for Global Tax Competition if an innovative tax policy approach is taken.