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The Cyprus Tax Reform

DIE STEUERREFORM IN ZYPERN

Im Juni und Juli 2002 wurde in Zypern die Steuerreform verabschiedet. Die steuerlichen Voraussetzungen für den EU-Beitritt Zyperns wurden dadurch geschaffen. Wolfgang *Gassner* war wesentlich an der Vorbereitung dieser Steuerreform beteiligt. Er schildert die Highlights.

I. Introduction

In June of 2001, I had the pleasure to lecture at a seminar in Nicosia on my ideas on the Cyprus tax reform. This lecture was published by this journal.[1]) The tax reform having been enacted by 17 pieces of legislation in June/July 2002,[2]) I have the pleasure of giving a report on the progress achieved and to express some thoughts for additional measures still necessary to benefit best from the new tax legislation.

The Cyprus Tax Reform of 2002 was one of the major challenges in the negotiations with the European Union and one of the major legal projects in connection with the accession. The international business sector and its preferential tax treatment seemed to be the most crucial issue. But, looking into the problem of adaptation to the Acquis Communautaire in more details, the tax reform proved to be much more complex. A new regime for the international business companies was only one of many issues. The whole income tax system had to undergo a change. This involved difficult issues of European law, of legal techniques to be used in rewriting the legislation and transposing Directives into Cyprus legislation. Decisions on social, economic and political directions of the reform had to be taken. And not to forget the budget implications. One of the most difficult issues was to assess, or better to say to estimate, the effects on the revenues. The work on the tax reform ended all up in the enactment of 17 pieces of tax legislation, before the House of Representatives left for its summer recess.

To make the tax reform a success is now a challenge to the tax administration, the professionals and above all to the businesses. They have to adapt to this tax reform, which is a substantial one in many respects, taking the shift of revenues in the budget, the new features of the tax legislation and the new opportunities for business in Cyprus into account.

I can only give you a short overview on the Cyprus Tax Reform. I will comment on the background and principles of this tax reform, on the new concepts introduced into the tax legislation, will highlight the tax rules on reorganizations and express some thoughts on the implementation and on future measures. Future measures which are necessary to further develop the Cyprus tax legislation into an effective instrument of tax competition within Europe and in the global arena.

II. The Background and Principles of the Cyprus Tax Reform

1. The Drivers for a Substantial Tax Reform

Any major tax reform needs effective drivers. The most effective driver for a substantial tax reform in Cyprus was the increase of revenues from VAT and excise duties. The

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1) Need and Principles for a Tax Reform in Cyprus, SWI 2001, 354.

2) See *Savvides*, Tax Reform 2002, Cyprus Offshore Report July 2002, Special Issue – Issue 06/02-48, page 2 et seq.

minimum general tax rate for VAT in the European Union is 15%. Cyprus had to raise its tax rate in several steps substantially. VAT and excise duties will double their revenues compared to 2000 in the process of harmonization. Substantial additional revenues are thus available to finance the tax reform.

Altogether the taxes on consumption will take a much bigger share in the cake of Cyprus revenues than before. In order to maintain economic and social stability the taxes on income had to be reduced to avoid effective double taxation of income to be used for consumption and of consumption itself. Grants had to be provided for from a social policy point of view to give relief from additional taxes on consumption to low or no income earners and to families etc.

A strong driver was of course EU law. The Cyprus tax legislation contravened European law in many respects. The complex rules on the personal scope of the income and corporation tax based on the principles of territoriality, the many preferential treatments of taxpayers in respect of allowances, deductions, incentives and rates were in conflict with the basic freedoms and the state aid rules of the EC Treaty. The tax reform had to abolish such rules.

The tax reform had also to satisfy the European Union in respect of the Code of Conduct for Business Taxation and the OECD with its campaign against Harmful Tax Competition. Both institutions listed various tax measures intended to attract foreign business like Cyprus has, as harmful. Ring-fencing the International Business Companies and providing them with preferential treatment was not viable any more.

The complexity and intransparency of the tax system was another driver for the tax reform. Under the old system almost everybody had his exemptions, deductions, allowances, special rates or other incentives. Such an interventionist tax system is not efficient any more, taking into account the highly developed status of the Cyprus economy and its involvement in the global markets.

A substantial tax reform was also necessary from a tax competition point of view. Countries compete with their tax systems and the attractions they offer for domestic and foreign investments. A number of European and other OECD member countries have engaged in tax reforms recently. 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 more transparent, easier to administer and more efficient.

2. The Government’s Strategy for the Tax Reform

The Government’s strategy for the Tax Reform had to take these aspects into account. In January 2001, in a policy statement “Tax Reform 2001”, the Government made the commitment to the House to submit a tax reform plan. Following various consultations, conferences and the installation of a working party, in November 2001 the Government presented a Policy Statement to the House and a complementary Explanatory Statement to the European Commission which laid out the Government’s strategy for the tax reform.

The major highlights were:

– The tax reform will conform with EU and OECD requirements.
– The additional revenues resulting from increase of VAT and excise taxes will be used for a substantial tax reform and for grants to be introduced.
– Taxes on income will be reduced.
– Attractiveness to international businesses and
– neutrality to the budget should be secured.

III. The General Concepts of the Tax Reform

On this basis general concepts for the tax reform were developed by the working party and the bills drafted accordingly:

1. Taxation of Personal Income

The tax burden on personal income was reduced

- by extending the zero rate bracket from 6.000 to 9.000 CYP in 2002 and to 10.000 CYP in 2004 and
- by lowering the rates substantially. The marginal income tax rate will be reduced from 40 % to 30 % in 2003.

These new rates were partly financed

- by a broadened tax base. This means the abolition of any personal allowances except for contributions to life insurance and to pension and other funds and
- by strengthening taxation at source for residents. The withholding tax on interests was raised to 10 % as the general rate with a refund on application or reduction for low income earners and for certain interest income respectively. The withholding tax on dividends was reduced to 15 %. Both withholding taxes are levied under the defence contribution regime, with final taxation and exemption from income tax.

2. Taxation of Corporate Profits

A new system of taxation was introduced for corporate profits:

- The corporation tax rate for companies will be reduced to 10 %. This rate will be applicable to all companies. Minimum tax and preferential rates were abolished. During a transitional period the international business sector may opt for the present tax regime with the 4.25 % rate. For income over 1 Mio. CYP a 5 % additional charge will be levied in 2003 and 2004.
- The 15 % withholding tax on dividends will be payable only for dividends received by resident individuals. It will be extended to deemed distributions to encounter deferrals of the withholding tax by accumulating profits. A 70 % distribution will be assumed after a watch period of two years if and as far as no effective distribution is resolved.
- Intercompany dividends will be exempt from tax. This will cover domestic and foreign dividends and apply to companies controlled by aliens also. On intercompany dividends no withholding taxes nor corporation tax will be levied therefore. This new regime transposes the Parent-Subsidiary Directive in a very generous way into Cyprus law.
- To characterize this system: It is a classical system with one of the lowest corporation tax rates world-wide and a withholding tax on dividends and deemed distributions payable only on distributions to resident individuals.
- Reorganization rules were introduced which go far beyond the Merger Directive. They provide tax neutrality for reorganizations across the border, for domestic reorganizations and for reorganizations of companies abroad with tax effects in Cyprus. This very liberal regime will support Cyprus and international businesses to adapt their organizations to new needs and to the tax reform. I will come back to the new tax rules on reorganizations in more detail.
- Group relief rules were introduced which enable the set off of losses within a domestic group of companies. These rules follow the British model. They do not extend to foreign group members. In this respect Cyprus is waiting for emerging EU policy to develop a concept for trans-border losses.

- The OECD principle of dealing at arm's length was adopted. Inter-group transactions and transactions between other related partys will be adjusted according to international practice. This will be the basis for the application of the OECD guidelines on transfer pricing.

3. Taxation of International Business Companies

International business companies will loose their preferential tax treatment. No specific rules and reliefs will be available to them after the transitional period for which they may opt for the present 4.25 % rate. Nor will they have to restrict to offshore business any more. The old system will be supplemented by the general tax system which combines rules favourable to domestic and international business as well. In various situations the new regime will be even more attractive than the old one. The International Business Companies will benefit from the low corporation tax rate, from the abolition of any withholding taxes on dividends and interest payable to non-residents, from the new exemptions for foreign dividends and for profits from permanent establishments abroad, from the options available to offset foreign losses and from the management and control concept used to determine the residence status of companies. Cyprus will thus have one of the best regimes for holding companies, benefiting from the general excellent conditions for resident and for non-resident companies.

IV. The Reorganization Rules

I do not want to go into details of the general concepts I covered and will just elaborate on one subject which is new to Cyprus – the tax rules on reorganizations. They are important from a business perspective, they are interesting from the legal and technical point of view and they offer many opportunities to adapt the legal organization of businesses to the new tax system in Cyprus.

1. Reorganizations Covered

The reorganizations covered by the new rules are defined in Part VI of the Income Tax Law.

- Mergers: in mergers companies are absorbed by another company. This is a concept widely used in civil law and various common law countries.
- Divisions: in divisions companies are split up into two ore more companies. This type of reorganization may be seen as a de-merger.
- Transfer of assets: in such a transaction a company transfers branches of its activities to another company in exchange for shares.
- Exchange of shares: this transaction leads to a combination of companies via share transactions. Such transactions are widely used in Anglo-American countries.

For all of these types of reorganizations Part VI of the Income Tax Law provides relief from corporation tax. The most important measures are:

- Tax neutral rollovers: The balance sheet values of the transferring company are carried forward by the absorbing company. This leads to a deferral of taxes till income arises from the disposition of assets by the absorbing company.
- Carry over of losses: If the transferring company has suffered losses, they may be offset or carried forward by the absorbing company.

In addition to these corporation tax reliefs, the tax reform provides also exemptions from

- Capital Gains Tax and
- Stamp Duties.

Both laws, the Capital Gains Tax Law and the Stamp Duty Law, refer for the application of the exemptions to Part VI of the Income Tax Law.

– A general exemption from VAT applies to transfer of going concerns.

2. The New Reorganization Rules and their Linkage to the Merger Directive

Part VI of the Income Tax Law transposes the Merger Directive into Cyprus Law. The transposition is unique insofar as

– the conditions of the reorganizations listed follow the Merger Directive. The Cyprus legislator took the rules word by word from the Directive.

– All conditions have to be interpreted according to European law, therefore.

– There are no additional conditions set neither taxwise nor by company law.

This technique of close linkage of the Cyprus tax rules on reorganizations to the Merger Directive was used because most reorganizations in Cyprus will involve non-resident companies, non-resident shareholders or assets abroad. Cyprus tax or company law conditions will not be forced on them. They only have to meet the conditions of the Merger Directive, which are the common basis for all member countries, without any additional conditions issued by Cyprus.

However, as far as Cyprus company law is involved, the transactions under the Merger Directive will have to use the legal techniques available under Cyprus company law. Cyprus company law is not very developed in respect of reorganization rules yet, but rather liberal. All the reorganizations listed in Part VI of the Income Tax Law should be viable under Cyprus Company Law, applying the rules on issuance of shares, on the winding up of companies and on arrangements and reconstructions which provide for transfer of assets and winding up without liquidation.

The same technique of close linkage of the new tax rules for reorganizations to the Merger Directive was used for the consequences of a reorganisation. The corporation tax relief rules on rollovers and losses follow exactly the Merger Directive.

3. Wider Range of the Reorganization Rules

However, there are major differences between the new tax rules on reorganizations and the Merger Directive. The new rules go far beyond the Merger Directive in respect of the scope of the new legislation and the exemption from other taxes than corporation tax.

– The Cyprus tax rules on reorganization apply not only to companies in member countries as listed in the appendix to the Merger Directive but to any body of person, excluding partnerships. The reorganization rules extend therefore eg to cooperatives, semi-governmental organizations etc.

– The Cyprus tax rules are applicable to any comparable companies registered or incorporated abroad. Companies from non-member countries qualify for the rules the same way as companies from member countries.

– The tax rules on reorganizations are further extended to national reorganizations, whilst the Merger Directive is restricted to trans-border reorganizations within the European Union.

– They also apply to reorganizations of foreign companies with assets in Cyprus which is of special importance in situations of the Capital Gains Tax applicable otherwise.

– The reliefs cover also capital gains, which conforms with the Merger Directive, but also stamp duties and VAT, which are not covered by the Merger Directive.

– Under a circular, the conversion of a business run by an individual or a partnership, into a company does not lead to recognition of income. Any accumulated loss may be carried forward by the company according to the new Income Tax Law.

To summarize: Cyprus has one of the best systems of tax rules on reorganizations worldwide. A wide range of reorganizations is covered and the legal technique used by the legislator is appropriate to Cyprus as a small jurisdiction participating in global markets.

V. Outlook

1. The Implementation of the Tax Reform

The tax reform has many ingredients which are necessary to make it a success for Cyprus and its economy. Yet, its success depends widely on its implementation. The greatest challenge to the taxpayers, the tax administration and the professionals will be to administer the old and new legislations parallel for a few years and to keep track of the transitional rules.

To accomplish this, additional resources and training opportunities have to be made available by and for the professionals, the tax administration and the tax experts within the businesses. Training opportunities, seminars and conferences, such as this one at Intercollege, which give room for the exchange of views on the various technical and legal aspects of this tax reform and its opportunities. Such fora for discussion will help to bring to surface major problems still to be solved on an administrative or legislative basis.

An important instrument to support the implementation of the new legislation is a circular on the tax reform. It was the intention of the tax reform to make the tax laws concerned easier to apply. Deductions, allowances, tax incentives and rules on depreciations as well as untimely tax rules were abolished. The drafters of the law did their best to preserve the British influenced legislative practice in order to avoid legal uncertainty as much as possible. Yet, the new features of the legislation, such as the rules on the charge of income, on residence of individuals and companies, on income determination, on losses, on taxation of companies, on reorganizations, on the dealing at arm’s length principle, on interests and dividends and many more, are complicated and pose many questions on how the administration will apply them. To clarify this, the new legislation should be supplemented by a circular, giving answers to general question that arise. This will not only secure legal certainty but will save the taxpayer and the tax administration from unproductive costs for resolving issues at a later stage in tax assessments and tax audits only.

To make best use of the new rules, Cyprus should also introduce a general advance ruling practice. The Cyprus Constitution seems to provide for it anyway but administrative practice denies it reasoning that the constitutional rule does not cover hypothetical situations. But to give you an example from a practical point of view: For taxpayers, like in Cyprus, which are not used to apply reorganization rules, it is very difficult to take advantage of the new favourable rules on reorganizations without prior approval from the tax authorities. OECD and the European Union encourage countries to introduce transparent advance ruling practice and other European countries followed this advice already. A Cyprus advance ruling practice will also have to include the application of tax treaties and transfer pricing. Without reliable advance rulings on international tax issues and transfer pricing, businesses will often encounter effective double taxation of income by two or more countries.

2. The Next Steps in the Tax Reform

The tax reform introduced by the tax package is certainly a great step forward towards a consistent tax system attractive to domestic and international businesses as well. It is amazing in what a short time this work was accomplished. Not many countries will be able to follow this example. Yet, as Rome has not been built in one day, an excellent tax system cannot be introduced in one step only. This holds true for economic, social and technical reasons as well. As international experience shows, a step by step approach is usually necessary to make use of the experiences with a tax reform, to do some fine tuning and to further develop the new features of the tax system and better integrate them into the overall system. I believe it will be necessary for Cyprus too, to further proceed in its tax reform to gain full benefit from it.

The most important measures concern the full integration of taxation of interests and dividends into the income tax system. The new legislation provides for lower tax burdens on corporate profits – the combined corporation tax and dividend withholding tax – and on interests as compared to other income such as from emoluments or trade and business. This gives opportunity for tax planning to reduce income tax to the lower rates under the corporation tax and the defence contribution. Another tax reform step should be devoted to narrow the gaps between the different effective tax rates on different types of income, therefore. A fair balance has to be found between equity and effectiveness of the tax system. The principle of equity is said to support the traditional progressive income tax while effectiveness supports rather low and flat rates.

A problem not solved sufficiently yet, is the taxation of capital gains within the Income Tax Law. The new legislation taxes only goodwill resulting from the disposition of a going concern business and capital gains resulting from the disposition of real property. Otherwise recovery only of depreciations and income resulting from the disposition of patents and patent rights or royalties are taxable. However, the taxability of such elements of capital gain may be avoided by various tax planning techniques, such as using the new reorganization rules for example, turning the business into a company and performing a tax free share deal instead of a partly taxable asset deal. In another step of a tax reform, a system of taxing or not taxing of capital gains should be decided upon, therefore, making complicated techniques of tax structuring unnecessary.

3. The European Dimension of the Tax Reform

Let me once more refer to the European dimension of this tax reform. It had to comply with the Acquis Communautaire, which means the European law and includes also soft law such as the Code of Conduct. This was achieved as the European Commission confirmed in their Progress Reports. A minor issue is still on the table, the Cyprus stamp duties. The stamp duties are a problem from a legal and technical point of view, from their practical impacts on business transactions and in respect of effective collection. They seem to contravene European law in many respects as the Sandoz decision of the European Court of Justice on the Austrian stamp duties seems to indicate. The law should be abolished at accession date at the latest or supplemented by a duty on capital payments to companies. Such a duty might be construed in a way which is conform with European law.

Last October the Commission issued the Report “Company Taxation in the Internal Market” on business taxation. This report contains options, on how to develop business taxation within the European Union. The European Commission has issued a Communication on the policy it intends to follow in this respect. The Commission proposes a two track policy. Short term measures should remove the tax obstacles most burdensome to companies engaged in trans-border business within the European Union. In the long term, a consolidated tax base should be provided for such companies.

The Internal Market Report and the Communication were available in draft and final form during the work on the tax reform. The tax reform took best advantage therefore of the recommendations on short term measures by adapting the tax system to the case law of the European Court of Justice, by taking account of latest developments in doctrine on European tax law, by transposing the Parent-Subsidiary Directive and the Merger Directive in a very broad way, by adopting the OECD dealing at arm's length concept and by introducing a liberal regime on domestic and foreign losses. Cyprus will be in a pole position when the Commission comes up with proposals for specific measures, therefore.

In the long term the Commission wants to introduce taxation on a (consolidated) common basis for companies and groups of companies within Europe. Several systems for such taxation have been put on the discussion table ranging from Home State Taxation to a Single European Tax Base. Under the Home State Taxation concept a group of companies should be assessed in the state of the parent company only and the tax base shared by the involved countries. Under the Single European Tax base concept, a uniform tax base should be codified by European law. The Cyprus tax reform could of course not introduce any of these models unilaterally. There will be a long discussion and decision taking process necessary within the European Union before a final decision will be taken. However, Cyprus prepared its position best for this process by the introduction of the 10 % corporation tax rate. This low rate will make any change in the determination of the tax base much easier.

VI. Conclusion

The Cyprus Tax Reform is exciting. It reduces the tax burden on income, introduces new concepts into the tax legislation – much more than I would have ever thought possible – and prepares Cyprus for tax competition and for alignment with emerging European tax policy. However, with the new legislation the tax reform has not come to its end. It has to be implemented and further developed to be of most benefit to Cyprus. I wish it the best success!