

THE CYPRUS FINANCE COMPANY



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Throughout the world the barriers to capital movements are fast disappearing. Tax differences have become a very significant factor in commercial decisions, and therefore investment structures which have the least tax leakage are preferred by investors. During the last decade various European Countries have introduced finance company regimes and nowadays it is very difficult for a multinational group to select the right jurisdiction in which to establish their finance company.

Despite being one of the world's smallest countries, Cyprus has developed into one of the world's major financial and business centres. It has gained this enviable position through its attractive tax system, transparent legal system, world-class professional and banking services and superior global telecommunications capabilities. Cyprus's accession to the EU on 1 May 2004 has come to add to the country's impressive advantages. Cyprus has also adopted the Euro as its official currency as from 1st of January 2008.

Using a Cyprus company as a finance company, though being a good choice, was not always advisable and proper. The main reason for this was the uncertainty on interest margins.

However, in late 2008 it has been agreed between the Association of Certified Public Accountants of Cyprus and the Inland Revenue authorities, that the tax authorities will accept very low interest margins. In addition to this as from the 1/1/2011 the Cyprus tax authorities are willing to issue pre-tax rulings confirming the acceptance of pre-approved interest margins. This latter development has created excellent opportunities for tax professionals to prefer Cyprus as the primary location to establish their finance company within the European Union.



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Tax considerations may not be the decisive factor in choosing to set up a finance company in a particular jurisdiction. There are instances where the non-tax considerations may outweigh the tax considerations of an international group, in choosing the location of its finance company.

Some non-tax considerations may include among others:

- Company law requirements
- Political stability and stable economic infrastructure
- Availability of human resources
- Telecommunication capabilities
- Set-up and other administration costs
- Spoken language and time zone

This publication aims to discuss only the major tax considerations that an international group should take into account, in choosing the location of its finance company.



TAX CONSIDERATIONS

The major tax considerations that a multinational group should take into account, in choosing a suitable finance company jurisdiction should include the following:

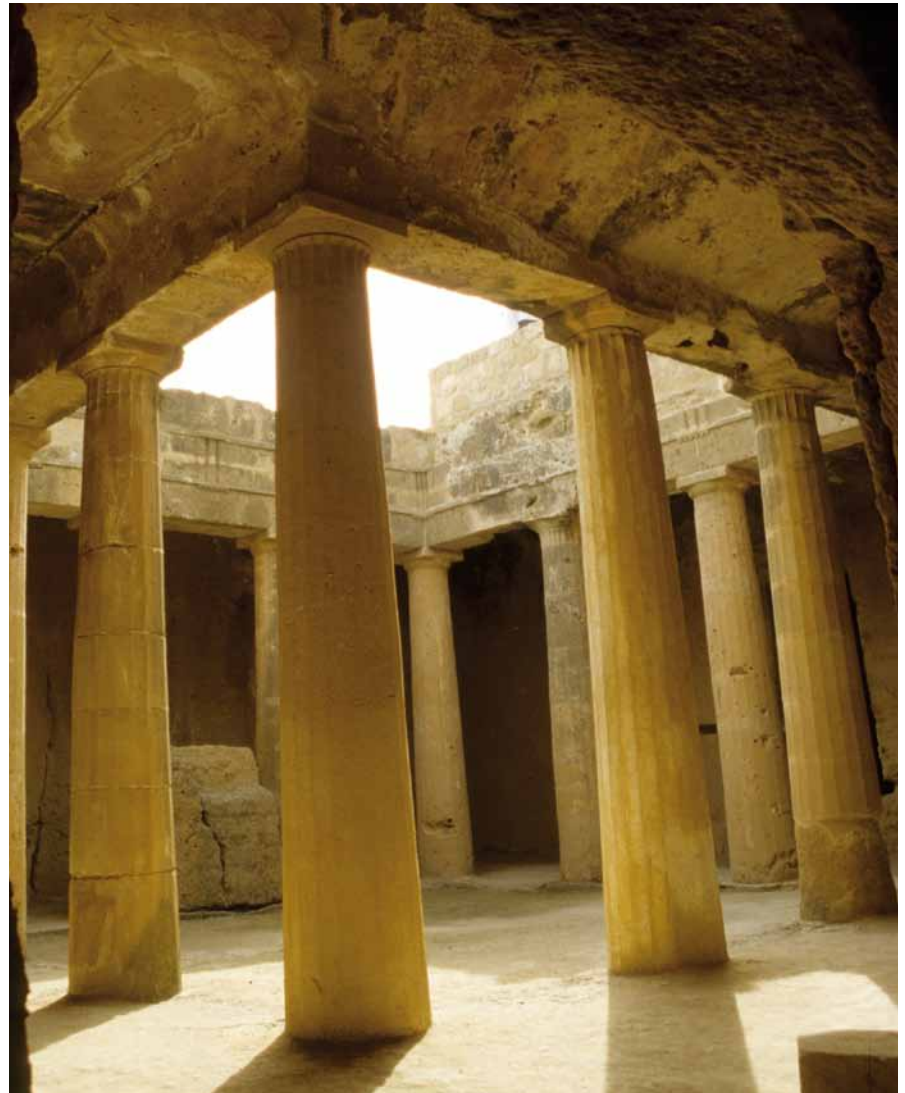
- Tax regime with regards to withholding taxes on outward interest payments
- Tax regime with regards to the tax deduction of interest payments
- Tax regime with regards to the tax treatment of interest receivable
- Double Tax Treaties
- Tax regime with regards to the margin required by the tax authorities and the availability of pre-transaction rulings
- Tax on liquidation of the finance company
- Other significant provisions
 - The existence or not of CFC rules (controlled foreign companies)
 - Thin Capitalisation
 - Loss relief
 - Reorganisation Rules

In the following sections, we will consider each of the above tax considerations in detail, relative to locating a holding company in Cyprus.



TAX REGIME WITH REGARDS TO WITHHOLDING TAXES ON OUTWARD INTEREST PAYMENTS

- If a Cyprus finance company is financed in the form of loans by its non-resident parent company, or by its non-resident individual shareholder, it will make the interest payments to the non-resident individual or company gross, without any tax deducted.
- The 0% withholding tax rate applies irrespective of the existence or not of any double tax treaties, or on whether the parent company is located in an offshore jurisdiction or not.



TAX REGIME WITH REGARDS TO THE TAX DEDUCTION OF INTEREST PAYMENTS

- In general, interest payments by a Cypriot company on borrowings are fully tax deductible.
- However, any interest payable by the Cyprus finance company that was not incurred for the purpose of the production of income will not be tax deductible.
- Under normal circumstances, if a Cyprus company pays interest in order to finance its trading activities, such interest is a tax deductible expense. However, if a Cyprus finance company borrows money from a bank at an interest rate of 10%, but advances the money to its subsidiary free of any interest, then this interest payable will not be a tax deductible expense, as it was not incurred for the purpose of the production of income.

TAX TREATMENT OF INTEREST RECEIVABLE

MAIN TRADING ACTIVITY

Interest income derived in the ordinary course of business, or interest income closely connected with the carrying on of a business, is subject to tax normally, at the standard rate of 10%.

The 10% is not on the total amount of interest received but on the net profit (less interest paid, other expenses etc).

Flowchart 1, shows a diagrammatical example showing the relevant tax treatment.

Interest derived from the normal carrying on of a business.

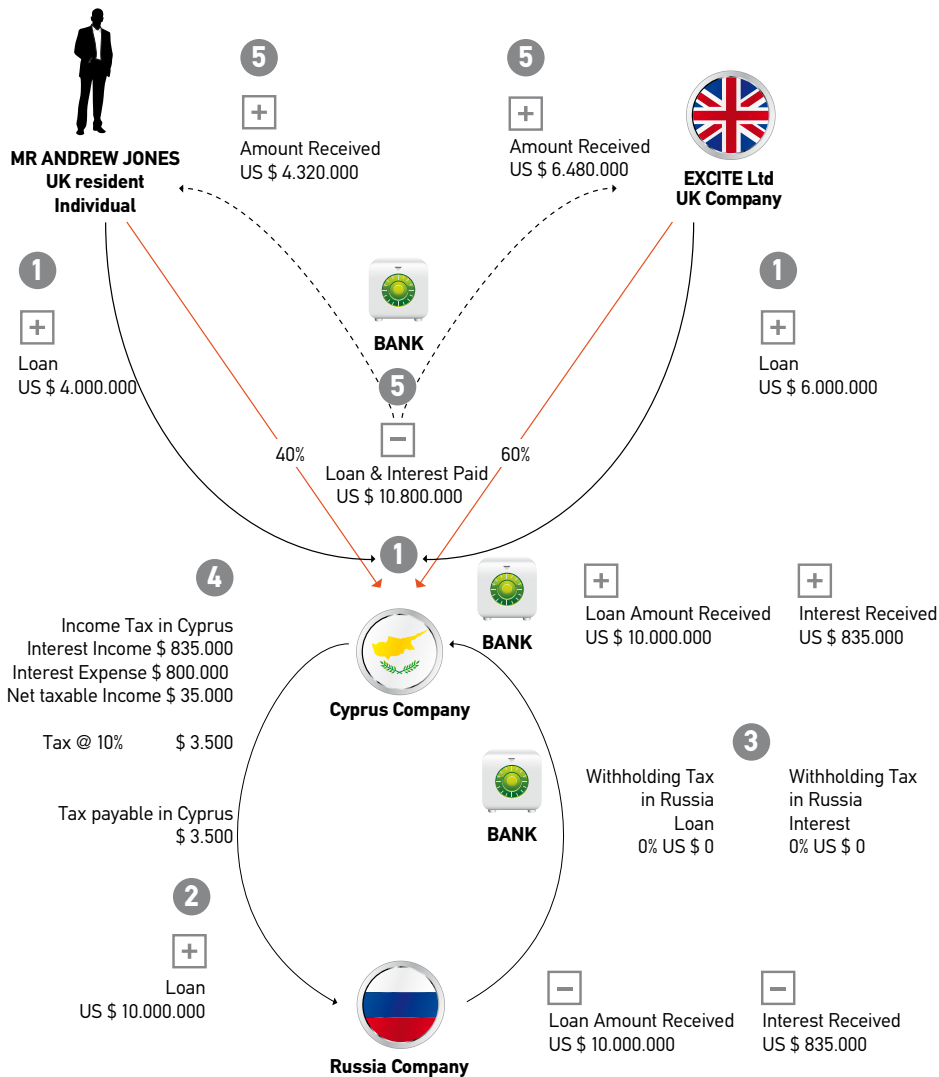
Interest falling into this category can be classified as the interest that is earned by banks, finance companies, hire purchase companies etc.

Interest closely connected with the normal carrying on of a business.

Interest falling into this category can be classified as the interest that is earned by:

- A company acting as a vehicle to finance other group companies.
- A company that is having trading debtors and is charging interest for late payment.
- A property developer receiving interest in the course of his business by extending the credit period given to his customers.
- An investment company that is earning interest on deposits until good investment opportunities arise.





FLOWCHART 1:
TAX TREATMENT OF INTEREST
(Main Trading Activity)

1 On 1/1/2009 the two shareholders of the Cyprus company gave a loan to the Cyprus company equal to US\$10.000.000. Mr Jones gave US\$4.000.000 and Excite Ltd gave US\$6.000.000. The interest rate on both loans was 8%.

According to the terms of the loan agreement, repayment of the loan amount as well as the interest should be made at the end of 2009.

2 On 1/1/2009, the Cyprus company financed a Russian company, with US\$10.000.000, under a loan agreement bearing an interest rate of 8.35%.

According to the terms of the loan agreement, repayment of the loan amount as well as the interest should be made at the end of 2009.

The double tax treaty between Russia and Cyprus, imposes a withholding tax rate on interest payments from Russia to Cyprus of 0%.

3 On 31/12/2009 the Russian Company pays US\$10.835.000 to the Cyprus company, being the loan amount together with the outstanding interest. Capital amount US\$10.000.000. Interest payment US\$835.000.

4 Cypriot tax rules provide that, any interest income earned by a Cyprus company in the ordinary course of its business, is subject to corporation tax at the rate of 10%.

5 Cypriot tax rules provide no withholding tax on interest payments made to non-residents of Cyprus. On 31/12/09, Mr Jones will receive US\$4.320.000 and Excite Ltd will receive US\$6.480.000, both receipts without any tax deduction in the Cyprus company.

Interest Receivable—Not Main Trading Activity

If interest income is neither considered to arise in the ordinary course of business nor is closely connected to the ordinary course of business, the gross amount of interest is subject to defence tax at 10%.

Flowcharts 2, shows a diagrammatical example showing the relevant tax treatment.

FLOWCHART 2:

TAX TREATMENT OF INTEREST (Not Main Trading Activity)

Scenario:

**The Cyprus Company has trading income of US\$500.000
and trading expenses US\$500.000**

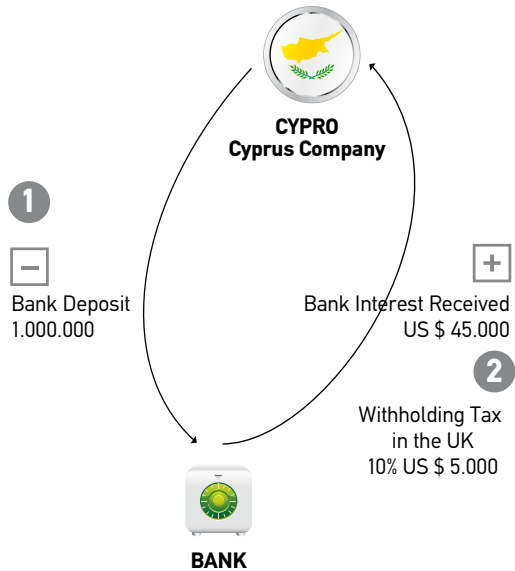
- 1 The Cyprus company's main trading activity is the production and the subsequent sale of hand-held computers.

On 1/1/2009 the Board of directors of the company decided to deposit US\$1.000.000 into a one year fixed deposit with a bank located in the UK. The interest rate on the fixed deposit was agreed at 5%p.a.

Cypriot tax rules provide that, any interest received by a Cypriot holding company which is deemed not to be from or closely related to its ordinary business activities, will be subject to 10% defence contribution tax. Any withholding tax suffered at source, can be set against the 10% tax in Cyprus when received.

Furthermore, Cypriot tax rules provide that the whole interest income is exempt for corporation tax purposes.

- 2 On 31/12/2009, the bank paid the Cyprus company the accrued interest of US\$50.000, less a deduction of 10% withholding tax US\$5.000. The 10% withholding tax is stipulated by the double tax treaty agreement between Cyprus and the UK.
- 3 The company has as much expenses as its other trading income. There is no defence tax payable, because the withholding tax suffered on the interest at source in the UK is set against the 10% defence tax in Cyprus. There is also no income tax payable as the whole interest income is exempt for corporation tax purposes.



3

DEFENCE TAX

Interest Income	US \$ 50.000
Defence tax @10%	US \$ 5.000
Less:	
Tax credit for UK tax (US \$ 5.000)	

DEFENCE TAX PAYABLE NIL

3

INCOME TAX

Interest Income	US \$ 50.000
Trading Income	US \$ 500.000
Less:	
Trading Expenses (US \$ 500.000)	
100% interest deduction (US \$ 50.000)	
Taxable Profit	US \$ 0

INCOME TAX PAYABLE @10% US \$ 0

Cyprus has an extensive double tax treaty network. In most of the cases, incoming interest received by a Cyprus finance company from its foreign subsidiary are either exempt from, or subject to, reduced withholding taxes in the subsidiary's jurisdiction.

Flowchart 3, shows the list of double tax treaties that Cyprus has enacted with third countries, as well as the corresponding rates of withholding tax.

The main purpose of these treaties is the avoidance of double taxation of income earned in any of these countries. Under these agreements, a credit is usually allowed against the tax levied by the country in which the tax payer resides, for taxes levied in the other treaty country, and as a result the tax payer pays no more than the higher of the two rates.

CYPRUS DOUBLE TAX TREATIES - PAID FROM CYPRUS

Dividends

Outward dividends paid by a Cypriot company to non-tax residents of Cyprus, do not suffer any withholding tax in Cyprus.

Interest

Interest payments by a Cypriot company to non-tax residents of Cyprus, are made gross, without any tax deducted.

Royalties

No withholding tax is levied on royalties as long as the right is used outside Cyprus.



RECEIVED IN CYPRUS	DIVIDENDS	ROYALTIES	INTEREST
NON-TREATY COUNTRIES	0	0	0

TREATY COUNTRIES

Armenia	0	0	0
Austria	10	0	0
Belarus	5 ⁽⁴⁾	5	5
Belgium	10 ⁽¹⁾	10 ⁽¹⁴⁾	0
Bulgaria	5 ⁽¹⁷⁾	7 ⁽²²⁾	10 ⁽¹⁸⁾
Canada	15	15 ⁽⁶⁾	10 ⁽¹⁰⁾
China	10	10	10
Czech Republic ⁽²⁶⁾	10	10 ⁽⁷⁾	5 ⁽¹²⁾
Denmark ⁽²⁸⁾	10 ⁽¹⁾	10 ⁽⁸⁾	0
Egypt	15	15	10
France	10 ⁽²⁾	10 ⁽⁸⁾	0 ⁽²³⁾
Germany	10 ⁽¹⁾	10 ⁽⁷⁾	0 ⁽²³⁾
Greece	25 ⁽¹⁹⁾	10	0 ⁽¹¹⁾
Hungary	5 ⁽¹⁾	10 ⁽⁷⁾	0
India	10 ⁽²⁾	10 ⁽⁷⁾	15 ⁽¹³⁾
Ireland	0	0	0 ⁽¹¹⁾
Italy	15	10	0
Kuwait	10	10 ⁽⁷⁾	5 ⁽¹²⁾
Kyrgyzstan ⁽²⁴⁾	0	0	0
Lebanon	5	5 ⁽¹⁴⁾	0

RECEIVED IN CYPRUS	DIVIDENDS	ROYALTIES	INTEREST
Malta	15	10 ⁽⁷⁾	10
Mauritius	0	0	0
Moldova	5 ⁽¹⁷⁾	5	5
Montenegro ⁽²⁵⁾	10	10	10
Norway	0 ⁽³⁾	0	0
Poland	10	10 ⁽⁷⁾	5
Qatar	0	0	5
Romania	10	10 ⁽⁷⁾	5 ⁽¹²⁾
Russia	5 ⁽⁵⁾	0	0
San Marino	0	0	0
Serbia	10	10	10
Seychelles	0	0	5
Singapore	0	10 ⁽²⁰⁾	10
Slovakia ⁽²⁶⁾	10	10 ⁽⁷⁾	5 ⁽¹²⁾
Slovenia ⁽²⁷⁾	5	10	5
South Africa	0	0	0
Sweden	5 ⁽¹⁾	10 ⁽⁷⁾	0
Syria	0 ⁽¹⁾	10 ⁽⁷⁾	10
Tajikistan ⁽²⁴⁾	0	0	0
Thailand	10	10 ⁽¹⁵⁾	5 ⁽¹⁶⁾
Ukraine ⁽²⁴⁾	0	0	0
United Kingdom	15 ⁽²¹⁾	10	0 ⁽²³⁾
United States	5 ⁽²⁾	10 ⁽⁹⁾	0
Uzbekistan ⁽²⁴⁾	0	0	0

NOTES:

1. 15% if received by a company controlling less than 25% of the voting power.
2. 15% if received by a company controlling less than 10% of the voting power.
3. 5% if paid to a company controlling less than 50% of the voting power.
4. This rate applies if the amount invested is over Euro200.000 irrespective of the % of voting power acquired. 10% rate is imposed if received by a company holding at least 25% of the share capital of the paying company. In all other cases the rate is 15%.
5. 10% if received by company, which has invested less than US\$100.000. A protocol was signed on 7 October 2010. Formal ratification is expected to happen before the end of 2010 so that the Protocol could come into effect on 1 January 2011.
6. NIL if paid to the Government or for export guarantee.
7. NIL if paid to the Government of the other State or to a financial institution.
8. NIL if paid to the Government of the other State or in connection with the sale on credit of any industrial, commercial or scientific equipment or any merchandise by one enterprise to another or in relation to any form of loan granted by a bank or is guaranteed from government or other governmental organisation.
9. NIL if paid to the Government of the other State, to a bank or a financial institution.
10. NIL on literary, dramatic, musical or artistic work with the exception of films used for TV programs.
11. 5% on film royalties (except films shown on TV).
12. This rate applies for patents, trademarks, designs or models, plans, secret formulas or processes, or any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.
13. 10% for payments regarding, technical fees, management fees and consultancy fees.
14. NIL if paid to the Government of the other State. There is no withholding tax for interest on deposits with banking institutions.
15. 10% on interest received from financial institutions, or when it relates to sale on credit of industrial, commercial, scientific equipment or merchandise.

16. A 10% on rights regarding industrial, commercial or scientific equipment. A 15% rate applies for patents, trademarks, designs, models, plans, secret formulas or processes.
17. A 10% rate applies if received by a company, which owns less than 25% of the capital.
18. This rate does not apply, where 25% or more of the capital of the Cypriot resident company is owned directly or indirectly by the Bulgarian resident company paying the royalties and the Cyprus company pays less than the normal rate of tax.
19. The treaty provides for 25%, but the Greek Government applies a rate of NIL since it is lower than the treaty rate and it is provided by local legislation.
20. 7% if paid to a bank or similar financial institution. NIL if paid to the government of the other state.
21. This rate applies to Cyprus resident individuals and to Cyprus resident companies controlling less than 10% of the voting rights of a UK resident company.
22. NIL if paid to the government of the other state or is guaranteed by the government.
23. 5% on film royalties, including films used for TV programs.
24. The treaty between the Republic of Cyprus and the United Soviet Socialist Republic still applies.
25. The treaty between the Republic of Cyprus and the Socialist Federal Republic of Yugoslavia still applies.
26. The treaty between the Republic of Cyprus and the Czechoslovak Socialist Republic still applies.
27. A new treaty was signed on 12 October 2010. The treaty is expected to come into effect on 1/1/2011. The rates entered in the table are the new rates. Previous withholding tax rates on dividends and interest was 10%.
28. A new treaty has been signed on 8/10/2010. On the date the new Agreement enters into force, the provisions of the existing Convention between the Government of the Republic of Cyprus and the Government of the Kingdom of Denmark will expire.

A pre-transaction ruling in respect of a particular type of transaction serves to remove taxation uncertainties. Cyprus has recently introduced an advance ruling practice in accordance with OECD recommendations.

The commissioner of Income Tax does provide advance interpretations of the law, when requested, concerning the tax consequences of proposed transactions.

However, he was up until recently reluctant to do so with regards to transfer pricing and margin transactions. As a result the taxation uncertainty with regards to the interest margin could not have been removed completely.

The situation has changed in late 2008 as it has been agreed between the Association of Certified Public Accountants of Cyprus and the Inland Revenue authorities that the tax authorities will accept the below mentioned interest margins.

In addition to this the Cyprus tax authorities as from 1/1/2011 are willing to issue pre-tax rulings confirming the acceptance of pre-approved interest margins.

Flowchart 4, shows a diagrammatical example showing the relevant tax treatment.

LOAN AMOUNT	INTEREST MARGIN
Up to Euro50 million	0,35%
Between Euro 50 million—Euro 200 million	0,25%
In excess of Euro 200 million	0,125%

FLOWCHART 4:

TAX TREATMENT OF INTEREST

(Main Trading Activity)

1 On 1/1/2009 the two shareholders of the Cyprus company gave a loan to the Cyprus company equal to US\$10,000,000. Mr Jones gave US\$4,000,000 and Excite Ltd gave US\$6,000,000. The interest rate on both loans was 8%.

According to the terms of the loan agreement, repayment of the loan amount as well as the interest should be made at the end of 2009.

2 On 1/1/2009, the Cyprus company financed a Russian company, with US\$10,000,000, under a loan agreement bearing an interest rate of 8.35%.

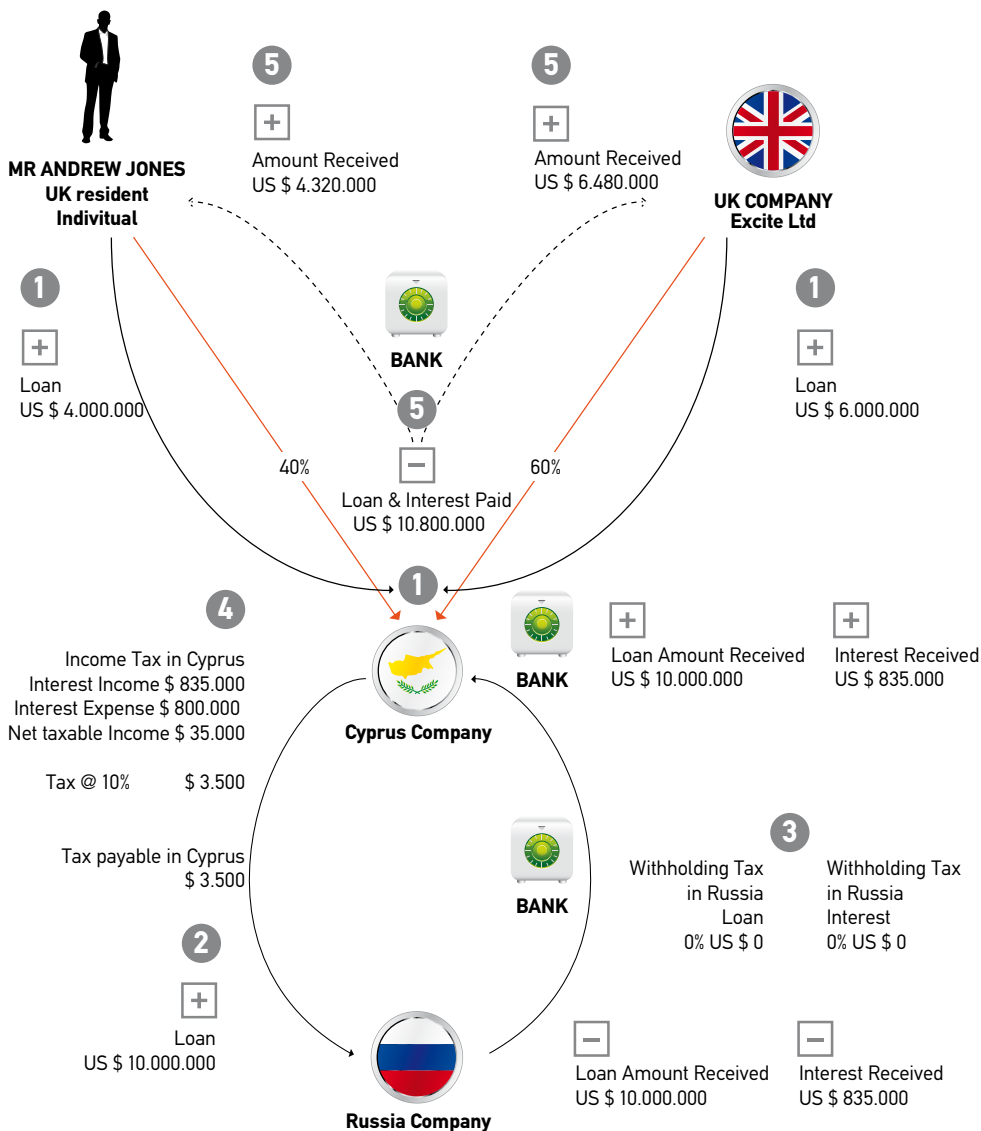
According to the terms of the loan agreement, repayment of the loan amount as well as the interest should be made at the end of 2009.

The double tax treaty between Russia and Cyprus, imposes a withholding tax rate on interest payments from Russia to Cyprus of 0%.

3 On 31/12/2009 the Russian Company pays US\$10,835,000 to the Cyprus company, being the loan amount together with the outstanding interest. Capital amount US\$10,000,000. Interest payment US\$835,000.

4 Cypriot tax rules provide that, any interest income earned by a Cyprus company in the ordinary course of its business, is subject to corporation tax at the rate of 10%.

5 Cypriot tax rules provide no withholding tax on interest payments made to non-residents of Cyprus. On 31/12/09, Mr Jones will receive US\$4,320,000 and Excite Ltd will receive US\$6,480,000, both receipts without any tax deduction in the Cyprus company, corporation tax purposes.



Non-resident shareholders

In case of the liquidation of a Cyprus resident company, irrespective of the method of liquidation, there are no taxes to be paid on the distribution of assets to non-resident shareholders, whether this is in the form of dividends, proceeds from liquidation etc.

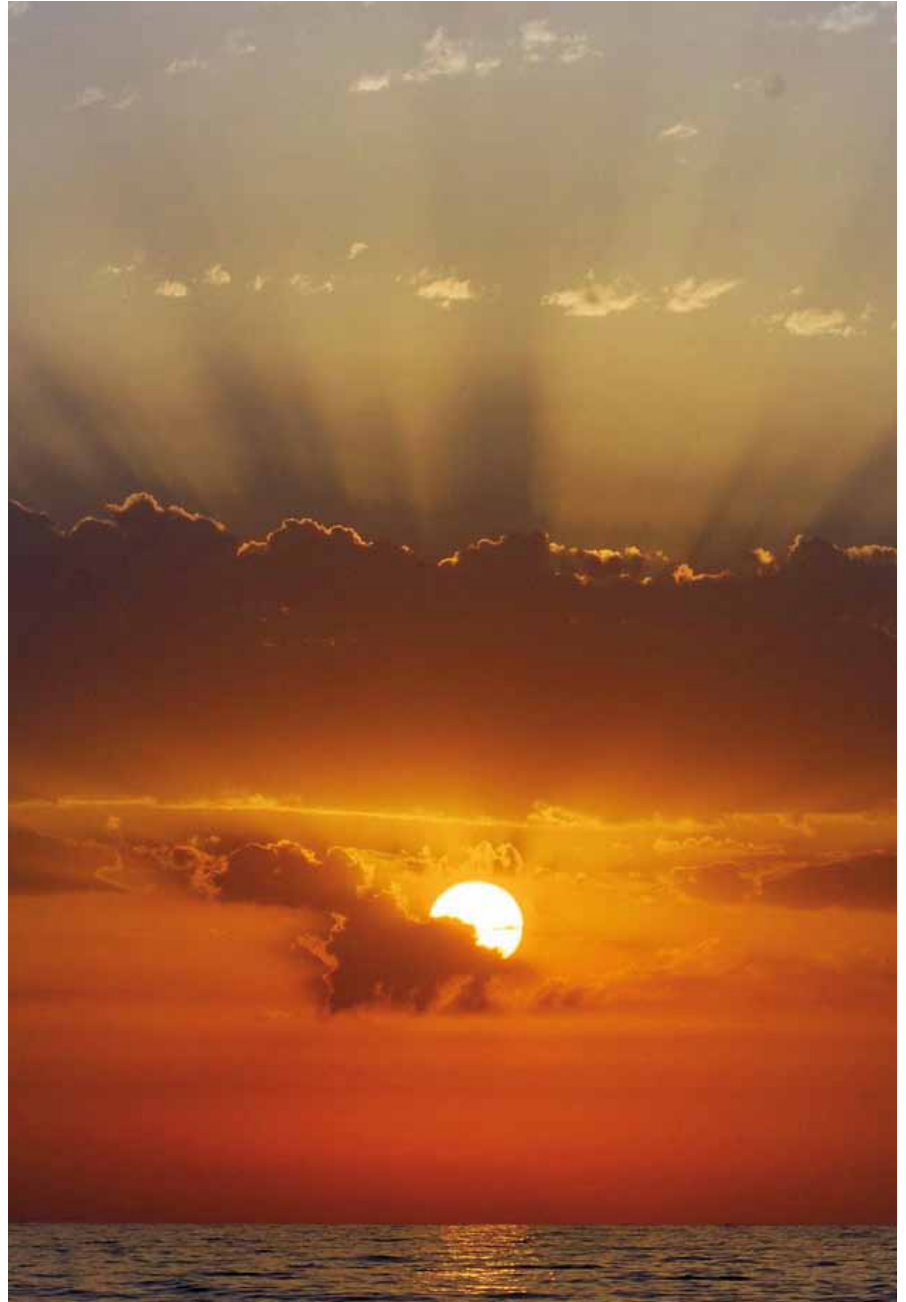
There is one exemption to the above rule. If the Cyprus company owns immovable property situated in Cyprus then the disposal of the Cyprus situated property can result in Capital Gains Tax.

Resident Shareholders

If a Cyprus company is liquidated, the total of the profits of the last five years before the liquidation which have not been distributed, or have not been deemed to have been distributed, shall be deemed on liquidation to be distributed and the shareholders shall be deemed to receive such dividends.

This deemed distribution is subject to 15% special defence contribution.

This provision does not apply in the case of liquidation of a company for the purposes of reorganisation.



CONTROLLED FOREIGN COMPANIES (CFC) RULES

- Countries such as Germany, UK, France, Denmark have CFC legislation. Under their CFC rules, income and sometimes capital gains of a subsidiary or sub-subsidiary company may be appropriated to the parent company.
- Cyprus does not have in its legislation CFC rules as strict as those in the above countries. As a result, no income is appropriated to the parent company even if the income arises in a tax haven company.

THIN CAPITALISATION

- Most of the European countries, with some exceptions (such as Austria and Ireland), have thin capitalisation rules, such as rules imposing minimum debt to equity ratio requirements. Under these rules, if a company is thinly capitalised, part of the interest deduction may be disallowed and treated as a dividend distribution.
- Cyprus tax legislation does not contain thin capitalisation provisions.
- There is however an indirect debt to equity restriction. Under normal circumstances, if a Cyprus company pays interest in order to finance its trading activities, such interest is a tax deductible expense. However, if a Cyprus company borrows money from a bank at an interest rate of 10%, but advances the money to its subsidiary free of any interest, then this interest payable will not be a tax deductible expense, as it was not incurred for the purpose of the production of income.

LOSS RELIEF

- When a loss is not wholly set-off against income from other sources in the same year, it can be carried forward and set-off against future profits of the company.
- The loss is automatically set-off against the first available profits of the company.
- There is no time limit for claiming loss relief.
- Losses can only be carried forward. No carry-back

of losses is allowed. This provision is applicable for all losses incurred from the 1997 tax year and onwards.

- In case there is any change in the ownership of the shares of a company and a substantial change in the nature of the business of the company, within any three year period from the year of the loss, then the loss cannot be carried forward to the following years.

Group Loss Relief

Definition of a group:

Two companies shall be deemed to be members of a group for loss relief purposes if:

- One is by 75% a subsidiary of the other, OR
- Each one separately is a 75% subsidiary of a third company

The 75% refers to 75% of the

- Voting ordinary shares
- Profits available for distribution
- Assets that would have been available to members on a winding up

REORGANISATION RULES

- Cyprus has adopted and has included in its legislation with sections 26-30 of the Income Tax Law, the EU Merger Directive on the common system of taxation applicable to different types of mergers.
- Therefore, where a transaction falls into the definition of a "reorganisation", it is exempt from corporation tax, capital gains tax and transfer fees. Transfers of assets and liabilities between companies can be effected without any adverse tax consequences within the framework of a reorganisation.
- Reorganisations include:
 - mergers
 - demergers
 - partial divisions
 - transfer of assets
 - exchange of shares
 - transfer of registered office

PRE-TRANSACTION RULINGS

- A pre-transaction ruling in respect of a particular type of transaction serves to remove taxation uncertainties.
- Cyprus has recently introduced an advance ruling practice in accordance with OECD recommendations. The commissioner of Income Tax does provide advance interpretations of the law, when requested, concerning the tax consequences of proposed transactions.

- The Cyprus finance company is becoming increasingly popular as a group financing company.
- The country's attractiveness as a finance company location, in our opinion, lies in the fact that there is tax certainty over the tax payable by the Cyprus finance company as the interest rate margins (spread) have been standardised and have been pre-agreed with the Cyprus tax authorities.
- The very small interest margins in combination with the lowest tax rate in Europe (10% on net profits) can reduce significantly the overall tax burden.
- Other significant benefits are:
 - Interest payments to non-resident individuals or companies are made gross, without any tax deducted.
 - Interest payments on borrowings are fully deductible.
 - The extensive double tax treaty network of Cyprus can in most instances reduce the withholding tax on interest payments to nil.
 - The non-existent thin capitalisation rules of Cyprus and the very narrow in scope CFC conditions can in some cases be significantly important.
 - The exit strategy benefits that exist on the liquidation of a Cyprus company, owned by non-residents. There are no taxes to be paid on the distribution of the assets to the non-resident shareholders.
 - The low set-up, administrative and maintenance costs can sometimes play significant importance.



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