Tax Circular provides guidance on the Notional Interest Deduction provisions

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In brief

In accordance with our Newsletter N-3-2015, dated 17 July 2015, in an effort to further align the tax treatment of equity finance with debt finance, as from 2015 the Cyprus tax legislation provides a tax allowable deduction on new corporate equity by means of a notional interest deduction ('NID').

In July 2016 the Tax Department issued Circular 2016/10 in regards to NID, aiming to provide further clarity on the definition of relevant terms and guidance on practical application.

In summary, the Circular provides the following:

- further guidance on the definitions of 'new equity' and 'NID interest rate';
- the introduction of scheduling for the purpose of applying the 80% cap;
- further guidance on relevant anti-avoidance provisions; and
- practical numerical examples for the application of NID.

We set out in more detail below the main provisions of the Circular.

In detail

Existing framework

In accordance with legislation effective from 1 January 2015, Cyprus tax resident companies and Cyprus permanent establishments of non-tax resident companies could be entitled to an annual tax deduction on new corporate equity by means of a notional interest deduction ('NID').

The NID is calculated as follows:

New Equity x NID rate

(capped at 80% of taxable income)

The Circular provides guidance on the definition of relevant terms and sets out practical numerical examples for the application of NID.

New Equity

As per the legislation, the NID is calculated on 'new equity' i.e. equity introduced as from 1 January 2015 in the form of paid-up share capital and share premium, and it is available for the period during which the new equity is in issue.

The Circular clarifies that new equity includes shares of any class, including ordinary, preference, redeemable and convertible shares, paid in cash or in kind.

There is also further guidance on determining the level of new equity, for example in the cases of:

- non-Cyprus incorporated companies that are Cyprus tax resident;
- companies transferring their tax residency to Cyprus;
- permanent establishments (in Cyprus or abroad);
- capitalisation of reserves;
- capitalisation of loans and other credit balances, including shareholders' credit balances and non-reciprocal capital contributions;
- reductions of equity.

NID interest rate

As per the legislation, the NID interest rate is the yield on 10-year government bonds (as at 31 December of the prior tax year) of the country where the funds are employed, plus a 3% premium, subject to a minimum amount which is the yield on the 10-year Cyprus government bond plus a 3% premium.

The Circular provides further guidance on how the relevant bond yield is arrived at.

Moreover, as per the Circular, the Cyprus tax authorities shall publish on their website on an annual basis the NID interest rates for selected jurisdictions.

A procedure is also prescribed for taxpayers to request from the Cyprus tax authorities to confirm the applicable NID interest rate for any jurisdiction which is not included on the published list.

80% Cap

As per the legislation, the NID is capped at 80% of taxable profits.

The Circular introduces **scheduling** for the purpose of calculating the applicable cap. This means that the cap should be applied by reference to the taxable profits that are generated from assets/activities that are financed by the new equity on which the NID is calculated.

In this respect, taxpayers should be able to determine the assets/activities that are financed by new equity as well as the taxable profits generated from such activities, as described further below:
(a) New equity should be allocated between the various assets/activities of the taxpayer under the following order of priority:

- Direct matching of new equity with specific assets/activities (the **'matching concept'**);
- Priority allocation of new equity to non-business assets and assets not generating taxable income;
- Pro-rata allocation to the remaining assets/activities of the taxpayer.

(b) Taxable profits should be allocated between the various assets/activities that are financed by new equity, in accordance with the Cyprus tax framework.

The NID is then capped at 80% of the taxable profits derived from the relevant asset/activity.

The overall NID is also capped at 80% of the total net taxable profits derived from all assets/activities that are financed by new equity (also taking into account any tax losses).

Anti-avoidance provisions

The Circular provides further clarity and practical numerical examples on a number of specific anti-avoidance provisions stipulated in the legislation.

We set out below key specific anti-avoidance provisions dealt with by the Circular:

- Determining the market value of contributions in kind;
- Capitalisation of pre-2015 reserves;
- New equity emanating from the new equity of another Cyprus taxpayer;
- New equity emanating from funds on which another Cyprus taxpayer obtains tax allowable interest deductions; and
- New equity issued during tax-qualifying reorganisations.

Finally, the Circular re-emphasizes the general anti-avoidance provision for non-commercial transactions that is stipulated in the legislation.

The takeaway

The Circular provides additional guidance and sets out practical numerical examples in regards to the application of NID.

Taxpayers seeking to benefit from the NID provisions must be able to substantiate the application / use of new equity in order for the provisions of the Circular to be applied accordingly.

Let's talk

For an in-depth discussion of how the NID provisions might affect you or your business, please contact:

Theo C Parperis
Partner
Head of Tax & Legal
theo.parperis@cy.pwc.com

Marios S Andreou
Partner
In charge of Tax Advisory
marios.andreou@cy.pwc.com

Nicos P Chimarides
Partner
In charge of Corporate Compliance
nicos.chimarides@cy.pwc.com

Eftychios G Eftychiou
Partner
Head of Tax Technical Committee
eftychios.eftychiou@cy.pwc.com

Or your usual PwC contact

PwC Cyprus
PwC Central
43 Demostheni Severi Avenue
CY-1080 Nicosia, Cyprus
P O Box 21612
CY-1591 Nicosia, Cyprus

www.pwc.com.cy