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WORKING PAPER

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MEETING DOCUMENT

From:	General Secretariat of the Council
To:	Code of Conduct Group (Business Taxation)
Subject:	(Draft) Progress Report by the Code of Conduct Group (Business Taxation) to the ECOFIN Council of December 2018 - Annex: Cyprus's notional interest deduction regime (CY020)

Delegations will find attached a document in view of the meeting of the Code of Conduct Group (Business Taxation) on 15 November 2018.

Cyprus's notional interest deduction regime (CY020)

I/ AGREED DESCRIPTION

The following description was agreed by the Code of Conduct Group on 12 April 2018:

1. Name of the regime:

Deduction on new capital (referred to below as the notional interest deduction – NID).

2. Year of introduction / entry into force:

The NID provisions apply as from 1 January 2015 (i.e. from the start of the 2015 tax year in Cyprus).

3. Please attach (or provide a link to) the relevant legislation which introduced/amended your NID regime and any administrative guidance providing clarifications (if in a language other than English, please provide a translation):

The NID provisions are contained in Section 9B of the Cyprus income tax law (CIT law) 118(I)/2002, as amended, attached as Appendix I. An unofficial translation, prepared by a local third party, in the English language is also attached in Appendix II.

A circular was issued by the Cyprus Tax Authority (CTA) on 18 July 2016 (Circular 2016/10, the Circular) on the interpretation and tax practice of the NID provisions (i.e. of Section 9B of the CIT law). The Circular is addressed to the CTA assessing staff and is publicly available, attached as Appendix III. An unofficial translation, prepared by a local third party, in the English language is attached in Appendix IV.

4. Please describe the scope of entities that can claim a NID deduction (companies based in your country / treatment of PE of foreign companies):

The NID deduction is available to:

- Cyprus tax resident companies, and
- Cyprus permanent establishments (PEs) of non-Cyprus tax resident companies which carry on business.

Further to the above, note that NID deduction is available without any restriction in terms of residency of shareholders (resident or non-resident shareholders) or in terms of business sector.

5. NID formula:

The NID is an annual deduction which is calculated as: the **Reference interest Rate (RIR) * New Capital (NC)**, which belongs to the company and is used for the carrying on of the company's activities (Basic calculation). The CIT law provides thereon, for a cap on the NID deduction, and further, for no NID deduction in case of tax losses (refer to 6 below).

This calculation is performed for each asset financed by NC.

5.1. Reference Rate: please describe the formula to determine the deductible interest rate; provide the applicable rates for the previous years (since entry into force):

The RIR is fixed for each tax year and is the 10-year Government bond rate of return (on 31 December of the immediately prior tax year) of the State in which the NC is invested by the business plus 3% premium.

As a minimum, the lowest rate that the RIR may be is the Cyprus 10-year Government bond rate of return (on 31 December of the year immediately prior to tax year) plus 3% premium.

For the purposes of determining the RIR the NC is deemed to have been invested in the State in which it was directly invested by the business.

The RIR is based on the yield on bonds in the official currency of the relevant State of investment. Where, however, the asset is denominated in a currency other than the official currency of the relevant State of investment (e.g. an investment is made in an asset located in State A denominated in the currency of State B) and the relevant State of investment has issued bonds in that other currency (e.g. State A has issued Government bonds denominated in B-currency) then the RIR will be based on the yield on bonds in that other currency.

Rates are publicly announced by the CTA for certain States in which the NC is invested. Based on the relevant CTA announcements the RIR since introduction of the NID provisions are attached in Appendix V.

In case where a taxpayer needs the RIR for a State not included in the announcements already published, such taxpayer may request the CTA to provide it. The RIR for these States will then be publicly announced on the CTA website.

Debt bias and financing neutrality are in practice more effectively addressed through a rate which is closer to the market interest rate on a company's long-term debt rather than through a single rate applicable to all cases. This position is also supported by academic papers including papers of the European Commission¹²³⁴.

The market interest rate on a company's long-term debt reflects the risk environment of the company. In this respect the Cyprus NID does not take a single general rate for all cases, rather it reflects the risk environment in which the entity operates.

If the Cyprus tax resident entity (or the Cyprus PE) operates solely in Cyprus, then the Cyprus related risk environment needs to be considered.

Where the Cyprus tax resident entity (or the Cyprus PE) invests directly in another jurisdiction it is exposed to the risk environment of both jurisdictions.

¹ Refer for example to the Institute of Fiscal Studies, Mirrlees review, Dimensions of Tax Design, Chapter 10, Box 10.2.

² We understand that such an approach is also recognised by the European Commission in its staff working document on the CCCTB (SWD(2016) 341 final), refer, for example to page 49 footnote 81 where it is stated that "...full financing neutrality for the ACE and the AGI is achieved only if the rate equals the market interest rate".

³ Further, the ZEW in its project for the European Commission TAXUD/2013/CC/120, Final Report 2016, notes on page B-24 "...full financing neutrality is achieved only for the case that the notional interest rate equals the interest rate on debt capital".

⁴ The OECD in its 2007 paper, Fundamental Reform of Corporate Income Tax, notes on page 126 "The neutrality properties of the ACE system also depend on the choice of the imputed return on equity. In order to tax the return on equity and debt-financed investment in a similar way, the imputed return should equal the interest rate that the corporation pays on its debt-financed investment. More precisely, the imputed return should equal the interest rate that corporations would have to pay if they would finance marginal (new) investment with debt instead of equity...".

The approach of the Cyprus NID is consistent in all cases in reflecting the risk environment of a company. In all cases, the NID rate is calculated by reference to the higher risk environment that the Cyprus tax resident entity (or the Cyprus PE) is exposed to (therefore, effectively the Cyprus risk environment rate serves as a minimum).

5.2. Equity: is your regime stock-based or an incremental regime?

For the NID regime equity is Capital introduced in the business on or after 1 January 2015 i.e. incremental, refer to 5.3 below.

5.3. Equity: please define the equity on which the interest can be deducted:

Relevant equity is NC. NC is Capital introduced to the business on or after 1 January 2015. Capital is share capital and share premium from the issue of shares to the extent that these have been fully paid.

Old capital (OC) is capital (i.e. paid-up share capital and share premium) which existed as at 31 December 2014.

6. Limitations applicable to the amount of notional interest deduction:

6.1: Does your legislation provide for a maximum amount of taxable income against which the NID can be claimed? If so, please describe the mechanism and state the lowest effective tax rate that can be achieved by using the maximum amount of NID:

The CIT law provides for a cap on the NID deduction and, further, for no NID deduction in case of tax losses.

For the cap:

- the annual NID deduction cannot exceed 80% of taxable income as determined prior to the application of the NID provisions. Any NID in excess of the cap is lost i.e. it is not available to carry forward or otherwise use, as there are no specific provisions for the utilisation of the excess amount. Given that the cap is based on taxable income no NID is available on tax exempt income e.g. the holding of an equity participation financed out of NC gives rise to tax exempt income and thus no NID deduction.

- the relevant taxable income is that income generated from those assets financed by NC and this must be monitored by the company.

- firstly, each asset that is financed by NC should be identified through a tracing/matching method. Where tracing/matching is not possible allocations are required. The 80% cap is then calculated based on the taxable income derived from each asset (or group of assets/ activity if necessary) financed by NC separately. Such cap is compared with the NID calculated for each asset under the Basic calculation set out at 5. The deduction for each asset is then determined as the lower of these two amounts. A preliminary total deduction for NID for the company is then derived from the sum of these amounts which have been established for each asset.

- secondly, a second 80% calculation is then made on the total taxable income derived from all assets financed by NC. If this amount is lower than the total deduction for NID derived under the

first step above, this lower amount is used. The amount calculated under the second step would only be lower than the amount calculated under the first step in cases where tax losses are generated from one or more of the assets financed by NC. For a numerical example refer to Example 2 of the Circular.

- taxable profits/losses generated by assets not financed by NC are not considered for the purposes of the above calculations, in line with the fact that only NC is considered for NID purposes.

The lowest effective tax rate that may be achieved with a maximum possible NID deduction is 2,5% i.e. $12,5\% \text{ CIT rate} \times (100\% \text{ taxable income} - 80\% \text{ taxable income} / \text{maximum NID deduction})$.

6.2: Can the NID create losses? If so, please describe how those losses can be used by the taxpayers (carry-back, carry-forward, time and amount limitations):

The NID cannot create losses.

7. Please describe the treatment of distributions made out of profits relieved from tax through a NID claim:

Distributions made out of profits relieved from tax through a NID claim are treated the same way as distributions made out of profits not relieved from tax through a NID claim.

8. Please describe any limitations of scope in your legislation (exclusion of some specific assets, participations, treatment of foreign PE of a domestic company):

As indicated at 4 above the NID deduction is available without any restriction in terms of residency of shareholders (resident or non-resident shareholders) or in terms of business sector. It is available to Cyprus tax resident companies (including those with foreign PEs) as well as Cyprus PEs of non-Cyprus tax resident companies.

Limitations on the NID deduction as regards taxable income and losses are set out in 6 above.

Anti-abuse measures are discussed in 9 below.

9. Do you have specific anti-abuse provisions in your legislation that may apply in the following fields (if so, please explain the measure):

Specific anti-abuse measures include the below as well as the anti-abuse measures set out in 9.1-9.8:

i. Cannot cascade NC

In case NC of a Cyprus tax resident company (or Cyprus PE of a non-Cyprus tax resident company) is derived directly or indirectly from NC of another Cyprus tax resident company (or Cyprus PE of a non-Cyprus tax resident company), the NID is available in one of those businesses only, except where the reinvestment of the NC creates new separate taxable income.

ii. Transactions without substantial economic or trading purpose

NID is denied in cases where the CTA view that actions or transactions have been carried out without any substantial economic or trading purpose.

iii. NC does not include Capital deriving from revaluations

NC does not include Capital deriving from the revaluation of movable or immovable assets.

iv. NC does not include Capital deriving from reserves existing as at 31 December 2014 but are not related to new assets used in the business

NC does not include Capital deriving from the company's reserves that existed as at 31 December 2014 (i.e. immediately prior to the introduction of the NID) but are not related to new assets used in the business.

v. NC is the amount in excess of the OC

NC of a company is the net increase over the amount of OC.

9.1: Intra-group loans and loans involving associated enterprises;

The amount of the NID deduction is reduced by 'shareholder's' deductible interest expense. This measure provides that where NC is directly or indirectly financed out of loans obtained by another company, for which interest deduction is granted under the CIT law, the NID shall be reduced by the amount of interest deducted in that other company. For a numerical example refer to Example 7 of the Circular.

9.2: Cash contributions and contributions in kind;

As noted at 9i above there are cascading restrictions.

Further, where NC is created as a result of a contribution of assets in kind (i.e. not cash) the value of the NC cannot exceed the market value of the assets at the time of their introduction to the business. No NID will be available on such NC if the market value is not documented to the satisfaction of the CTA.

9.3: Transfers of participations;

Due to the 80% cap applicable on the NID deduction the holding of an equity participation will not give rise to a tax deductible amount under the NID provisions. As described at 5 and 6 above the NC should be matched to each asset it is financing and the maximum NID calculated on an asset by asset basis. As the holding of an equity participation does not give rise to taxable income the maximum NID would be nil (i.e. 80%*nil). Accordingly no specific anti-abuse measure is required for transfers of equity participations.

9.4: The re-categorisation of old capital as new capital through liquidations and the creation of start-ups;

NID is denied in cases where the CTA view that actions or transactions carried out with connected persons have as their main purpose the conversion of OC to NC.

9.5: The creation of subsidiaries;

As noted at 9i above there are cascading restrictions.

Additionally, as noted at 9ii above NID is denied in cases where the CTA view that actions or transactions have been carried out without any substantial economic or trading purpose.

Also as noted at 9.4 above, NID is denied in cases where the CTA view that actions or transactions carried out with connected persons have as their main purpose the conversion OC to NC.

9.6: Acquisitions of businesses held by associated enterprises;

As noted at 9ii above NID is denied in cases where the CTA view that actions or transactions have been carried out without any substantial economic or trading purpose.

Further, as noted at 9.4 above, NID is denied in cases where the CTA view that actions or transactions carried out with connected persons have as their main purpose the conversion OC to NC.

9.7: Double-dipping structures combining interest deductibility and deductions under the AGI;

As noted at 9.1, the amount of the NID deduction is reduced by 'shareholder's' deductible interest expense.

9.8: Increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date.

As noted at 9.1, the amount of the NID deduction is reduced by 'shareholder's' deductible interest expense.

10. Do you have a general anti-abuse provision in your legislation?

Yes. As per Section 33 of The Assessment and Collection of Taxes Law 4/78 (A&C law), as amended, where the CTA are of the opinion that in respect of any year of assessment the object of the tax of any person is reduced by any transaction which in the CTA opinion was artificial or fictitious, the CTA may disregard any such transaction and assess the persons concerned on the proper object of tax. As such NID could be denied on the basis of Section 33 of the A&C law. Refer also to 8 and 9 above. Further, Cyprus intends to transpose the GAAR of the Anti-Tax Avoidance Directive with effect as from 1 January 2019.

11. Please describe the administrative procedures to benefit from the NID:

Per the Circular, no NID shall be granted in the case where the company or the permanent establishment fails to duly complete the Income Tax Return with respect to the claim of NID and to declare that it has complied with the Circular.

Furthermore, per the Circular, no NID will be granted in cases where the CTA has requested a detailed calculation of the claimed NID, in which the implementation of the Circular is documented, and the taxpayer does not respond within the specified date prescribed in the notice.

Follow up queries:

12. Do you have any relevant data on the application of the regime?

The Deduction on new capital regime came into force on 1 January 2015 (i.e. from the start of the tax year 2015 in Cyprus). The regime is referred to below as the notional interest deduction – NID.

Data available relates to tax year 2015 (1st January 2015 – 31st December 2015). As the deadline for submission of tax returns for tax years 2016 and 2017 are 31st March 2018 and 31st March 2019 respectively, there is no sufficient representative data relating to those years.

The data for the application of the regime is based on information submitted to date by taxpayers in their 2015 tax returns. The data is as per taxpayers' submissions on a self-assessment basis and not examined by the Cyprus Tax Authority (CTA). For further details refer to question 2 below.

Specifically as regards data, could you provide data that shows the breakdown between foreign beneficiaries of the regime and Cypriot beneficiaries?

In 2015 a total of 119 taxpayers claim a NID with a total deduction of €55m (tax impact €7m = €55m * 12,5%).

From these 119 taxpayers we note that 102 taxpayers were tax resident in Cyprus in tax years 2014 and prior. This indicates that the regime has not affected in a significant way the location of business activity in the Community as the vast of taxpayers claiming NID in 2015 were tax residents of Cyprus prior to the introduction of the NID.

From a high level review of the data available, we estimate that approximately:

- 45% of the number of taxpayers claiming the NID deduction in 2015 are members of Cyprus headed groups;
- 30% of the value of the total 2015 NID deduction is claimed by members of Cyprus headed groups.

Cyprus notes the importance of the fact that Code of Conduct Group's general principles on the assessment of measures (document 16410/08) take into consideration economic factors such as the size and openness of a Member State's economy. Therefore the above estimates should be considered in light of the small size and high degree of openness of the Cyprus economy.

13. Is there any general provision which prevents combining the benefit of the NID with benefits from other regimes?

In terms of other regimes in force in Cyprus there is only the Intellectual Property (IP) regime (i.e. the prior regime for grandfathered IP until 30 June 2021 and the (modified) nexus compliant regime).

It is possible to combine the IP regime with the NID regime, however the IP regime and the NID regime are designed in such a way that, in case they interact, they are not both fully claimable on the same income. In case of such interaction, the lowest possible effective tax rate that may be achieved with both the IP regime and NID applied to the same income is 2,1% (as opposed to an effective rate of 0,5% [$12,5\% \times (100\% - 80\%) \times (100\% - 80\%)$] which would have been achieved in the absence of such design). Refer to example 5 of the Circular. The design aims to align the treatment of deductible interest expense on debt financing qualifying IP income as well as respecting the NID cap.

14. With reference to question 8 we understand that the foreign PE of a Cypriot company can benefit from the NID. However, could you please confirm that the capital allocated to a foreign PE of a Cypriot company would be excluded from the NID base?

As described in the answers to points 5 and 6 of the NID questionnaire, the NID base (we understand that NID base refers to capital eligible for the NID i.e. New Capital, NC) should be matched to each asset it is financing and the maximum NID calculated on an asset by asset basis.

Where the NC is financing assets of a foreign PE the NC will be matched with such assets:

- In those cases where the foreign PE profits are exempt from tax in Cyprus then, due to the NID cap (i.e. maximum NID is 80% of matched taxable income), such NC will arrive at **nil** NID deduction.
- In those cases where the foreign PE is taxable in Cyprus such NC will be eligible for a NID deduction.

15. Do you exclude some specific types of assets (such as those not necessary for conducting business, luxury goods for instance)?

Similar to our response to question 4 above, and as we described in the answers to points 5 and 6 of the NID questionnaire, the NC should be matched to each asset it is financing and the maximum NID calculated on an asset by asset basis. As assets not necessary for conducting business and luxury goods do not produce taxable income then NC matched with such assets will arrive at nil NID deduction due to the NID cap (i.e. maximum NID is 80% of matched taxable income where matched taxable income is nil in such cases).

16. Could you please explain further the treatment of distributions made out of profits relieved from tax through a NID claim (question 7 of the questionnaire), perhaps by providing an example?

As described in the answer to point 7 of the NID questionnaire, distributions made out of profits relieved from tax through a NID deduction claim are treated in the same way as distributions made out of profits not relieved from tax through a NID deduction claim.

An example is provided below on the basis of a full distribution of profits by a Cyprus tax resident company to its non-Cyprus tax resident shareholder.

	Company A	Company B
	No NID deduction claim	Maximum possible NID deduction claim
Taxable income prior to NID deduction	€100	€100
NID deduction	-	(€80)
Taxable income after NID deduction	€100	€20
Cyprus income tax (12,5% on €100/€20)	(€12,5)	(€2,5)
Distributable profits (fully distributed)	€87,5	€97,5
Cyprus withholding tax on distribution	€nil	€nil
Cash in hands of the non-resident shareholder	€87,5	€97,5

17. Could you please explain in more detail how the taxation of the NID claim in the hands of a foreign shareholder/partner would work in practice?

Please refer to our response to question 6 above.

18. In your answer to question 9.1 and your example 7 of the circular you explain how the anti-avoidance legislation applies to situations involving intra-group loans involving associated enterprises that carry interest. Can you elaborate as to why this particular anti-abuse approach was chosen instead of applying a simple reduction in the base as used in other NID regimes?

This particular anti-abuse measure is designed to avoid double deduction and we believe that it achieves that.

19. A common tax avoidance scheme involves the use of contributions in kind in these types of regimes. In your answer to 9.2 you indicate that where New Capital (NC) is created as a result of a contribution of assets in kind, the value of the NC cannot exceed the market value of the assets at the time of their introduction to the business. Can you elaborate further how this anti-avoidance provision works in practice?

We note that for the anti-abuse rule referred to in question 9.2 of the NID questionnaire where NC cannot exceed the market value of the asset at the time of introduction to the business the Circular provides that independent valuations are required except in certain cases where the risk of a non-independent valuation being incorrect is low as it may easily be verified (e.g. by referring to an active open market of similar type assets, or by referring to a recent sale of the asset between third parties).

We further note that in addition to the anti-abuse rule referred to in question 9.2 of the NID questionnaire, there are other anti-abuse rules which are also relevant to contributions in kind, in particular:

- As described in the answer to point 9.ii of the NID questionnaire we note that NID is denied in cases where the CTA view that actions or transactions have been carried out without any substantial economic or trading purpose.
- As described in the answer to point 9.4 of the NID questionnaire we note that NID is denied in cases where the CTA view that actions or transactions carried out with connected persons have as their main purpose the conversion of Old Capital (OC) to NC.
- As described in the answer to point 9.1 of the NID questionnaire we note that the amount of the NID deduction is reduced by 'shareholder's' deductible interest expense. This measure provides that where NC is directly or indirectly financed out of loans obtained by another company, for which interest deduction is granted under the CIT law, the NID shall be reduced by the amount of interest deducted in that other company. Refer also to question 8 above.

Additional questions to Cyprus

1. **9.2 (add): Are there anti-abuse rules that prevent a group from changing existing equity to incremental equity e.g., when a parent company makes a cash contribution to its subsidiary or to relocate equity by using equity from other companies in the same group? If yes, does the rules also cover existing equity originating from abroad, when a foreign company makes a cash contribution to its subsidiary resident in Cyprus?**

Yes, anti-abuse rules that may apply in such cases are:

- As described in the answer to point 9.4 of the NID questionnaire, NID is denied in cases where the Cyprus Tax Authority (CTA) view that actions or transactions carried out with connected persons have as their main purpose the conversion of Old Capital (OC) to New Capital (NC). This rule does not target equity originating from abroad.
- As described in the answer to point 9.ii of the NID questionnaire, NID is denied in cases where the CTA view that actions or transactions have been carried out without any substantial economic or trading purpose. This rule may target equity originating from Cyprus or from abroad.
- As described in the answer to point 10 of the NID questionnaire, where the CTA is of the opinion that in respect of any year of assessment the object of the tax of any person is reduced by any transaction which in the CTA's opinion was artificial or fictitious, the CTA may disregard any such transactions and assess the persons concerned on the proper object of tax. In addition, Cyprus intends to transpose the GAAR of the Anti-Tax Avoidance Directive with effect as from 1 January 2019. This rule may target equity originating from Cyprus or from abroad.

2. **Under answer 5.1 you argue that "debt bias and financing neutrality are in practice more effectively addressed through a rate which is closer to the market interest rate on a company's long term debt rather than through a single rate applicable to all cases". In this light, could you clarify:**

- a) **Why a +3% premium is added to the basic rate? Could you comment on this sentence from the OECD study you quote in footnote 7: "The necessity to allow for a firm-specific imputed return is reduced if no risk premium is added to the imputed return for the ACE"?**

As the aim is to determine a rate close to the market interest rate on corporate long-term debt a risk premium is added to the yield on government bonds in order to compensate for the additional risk associated with companies over government bond risk. A 3% premium was considered appropriate to reflect such additional risk. We note that the 3% premium is within the range the European Commission used in its simulations (document SWD(2016) 341 final) for the proposed CCTB Directive when considering the proposals for an 'Allowance for growth and investment' (AGI, with the final proposal reflecting a 2% premium). The premium also reflects that the NID is capped to 80% of taxable profits (any NID in excess of the cap is lost), there is no creation of losses/no loss carry forward (which are not, for example, risk features in the proposed CCTB AGI).

Regarding the extract you refer above from the OECD study, we note that the OECD study refers to various possible modelling assumptions including, for example where the

deduction is a “safe” cash flow and also for example where corporations do not differ in their risk premium if they issue debt. Not all modelling assumptions are valid for the Cyprus NID.

- b) **Why a single rate (the Cyprus 10y bond + 3%) is applied when investments are undertaken in different jurisdictions where the country rate is lower than Cyprus', although each of these jurisdictions has its own country rate?**

As described in the answer to point 5.1 of the NID questionnaire, where a Cyprus tax resident entity (or the Cyprus PE) invests directly in another jurisdiction it is exposed to the risk environment of both jurisdictions. As such, the NID rate is calculated by reference to the higher risk environment that the Cyprus tax resident entity (or the Cyprus PE) is exposed to.

- c) **Do you consider that, shall a market-rate rationale apply, a Cyprus company performing a risky investment in another EU Member State might bear a higher risk than a Cyprus company performing a safe investment in a non EU country e.g. Russia?**

If your answer is yes, how do you cater for such a scenario, provided that your basic rule would apply a higher NID rate in the second case?

The NID rules aim to determine a rate close to the market interest rate on corporate long-term debt by adding a 3% risk premium to the yield on government bonds in order to compensate for the additional risk associated with companies over government bond risk. As Government bond yields are available for each State of investment these are taken into account to aim to determine the market interest rate on corporate long-term debt in that jurisdiction. This is a practical design feature of the NID/approach in order to reflect the risk environment in which the business operates without the burden of reviewing all possible elements of a business' risk profile.

- d) **Since you explicitly refer to the risk of the Cyprus company as being the combined risk of the two relevant jurisdictions (Cyprus + the one in which the company invests) why the risk, and related NID rate, is not then calculated as such?**

We do not refer to a “combined risk of the two relevant jurisdictions (Cyprus + the one in which the company invests)” but rather the exposure is to both risk environments such that consistently the NID is calculated by reference to the higher risk environment. Again this is a practical design feature of the NID/approach which does not require the burden of reviewing each businesses' specific risk profile.

3. **Do you have any views on the following points taken from the study you quote in footnote 6 (TAXUD/2013/CC/120, page B-25)? "The rational investor will consider the risk attached to the investment in the firm and the resulting uncertainty of future tax allowances. His discount rate should thus correspond to the interest rate at which the firm can borrow from the capital market. As a consequence, a plausible real-world benchmark to assess to what extent the notional interest deduction, on average, achieves financing neutrality would be some average return on long-term corporate bonds (under full loss-offset it would rather be a risk-free interest rate)"**

The above quoted “plausible real-world benchmark” is indeed what the Cyprus NID aims to achieve. The average return on long-term corporate debt (per State of investment) is determined by taking the yield on long-term Government bond (10-year bonds) plus a premium (3%) to reflect the additional risk of corporates over Government bond risk.

4. How did you arrive at defining 80% of taxable income as an appropriate cap?

Academic models of NID regimes tend not to have caps. Cyprus applies a cap on the NID restricting the deduction to 80% of the taxable income to ensure no excessive deductions and no creation of losses/no loss carry forward. The level of the cap was chosen in order to not deviate too far from the models which allow for 100% deductibility.

5. Can you provide data on the number of cases where the new equity qualifying for NID stemmed from the conversion of an old incoming loan that was used in back-to-back financing transactions?

Data is not available at this stage since taxpayers are not required to file such information in their tax returns submitted to the CTA.

6. Under answer 9 you indicate a list of anti-abuse clauses.

a) Could you provide examples of cases where you made use of the anti-abuse clause and rejected transactions where the measure has been used without economic rationale, just to benefit from the NID?

There are no such examples at this time as the 2015 tax year (first year of the NID) is still under the audit procedures of the CTA (submission deadline for the 2015 tax return was 31 March 2017).

b) Are you going to issue any guidance as to how you will implement the anti-abuse clauses in practice?

The Guidance that has already been issued is included in the CTA Circular dated 18 July 2016 (Circular 2016/10) attached as Cyprus-Appendix III to document WK 1599/2018 INIT (and unofficially translated into English as Cyprus-Appendix IV, document WK 1599/2018 INIT).

7. Under answer 13 you provide aggregate data on the countries of the beneficiaries. Could you provide more details on the 55% of taxpayers, which are members of non-Cyprus headed groups:

a) When were these taxpayers incorporated?

We do not have this precise data. We do note however, and as indicated in the data in response to point 12 of the NID questionnaire (follow up queries) of the 119 taxpayers claiming a NID in 2015 the vast majority (102 taxpayers) were tax resident in Cyprus prior to the introduction of the NID.

b) In which countries do they invest [overview/percentages]?

Data is not available since taxpayers are not required to file such information in their tax returns submitted to the CTA.

c) In which countries does the parent company reside?

Data is not available since taxpayers are not required to file such information in their tax returns submitted to the CTA.

II / FINAL ASSESSMENT

[The following assessment was agreed by the Code of Conduct Group on 15 November 2018:]

Criterion	1a	1b	2a	2b	3	4	5	OA
Notional interest deduction (NID)	X	?	V	?	X	X	X	V

Significantly lower level of taxation: “Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code”

The general tax rate in Cyprus is 12.5%

The *Deduction on New Capital* regime, or notional interest deduction (hereafter, “NID”) applies in Cyprus as from 1 January 2015.

The measure enables Cyprus resident companies and Cyprus PEs of non-Cyprus resident companies to make an annual deduction from their taxable income calculated on the basis of “new capital” (NC). New capital is capital introduced to the business on or after 1 January 2015. Capital is share capital and share premium from the issue of shares to the extent that these have been fully paid.

The Cyprus NID is therefore an incremental regime, and is calculated as a percentage of a company's net equity increase, as follows:

Reference interest rate * *New Capital*.

This is referred to as the “Basic Calculation”.

The reference interest rate is the higher of either: (i) the yield of the 10 year bond of the state in which the new equity is invested plus 3% or (ii) the yield of the 10 year CY government bond plus 3%, on 31 December of the tax year preceding the relevant tax year.

This calculation of the reference interest rate is different from similar regimes in other Member States. It is Cyprus’ view that the debt bias and financing neutrality are more effectively addressed through a rate which is closer to the market interest rate on a company’s long term debt rather than a single rate applicable to all cases. This aspect is mainly relevant for the gateway criterion part of the assessment; however it could also lead to a more beneficial treatment for certain foreign investment

The First Step

The regime requires that each asset financed by NC should be identified through a tracing/matching method. The CY NID deduction cannot exceed 80% of the taxable income from each asset as determined before the application of the NID provisions. The 80% cap is calculated based on the taxable income derived from each asset financed by NC separately. This cap is then compared to the NID calculated for each asset under the Basic calculation above. The deduction for each asset is then determined as the lower of these two amounts.

The Second Step

A second calculation is then made on the total taxable income from all assets financed by NC. If this amount is lower than the total deduction under the first step, this lower amount is used as the deduction.

The lowest effective rate that may be achieved with the maximum deduction is 2.5% (12.5% CIT rate*(100% taxable – 80% taxable income/maximum NID deduction). This reduction of the tax base may lead to a significantly lower level of taxation and this measure is therefore potentially harmful within the meaning of paragraph A of the Code.

Criterion 1: “whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”

Criterion 1 contains two elements. The first element is whether the measure is exclusively available to non-residents or transactions with non-residents (criterion 1a). The second element is whether it is only or mainly used by non-residents or for transactions with non-residents (criterion 1b).

1a) Criterion 1a) concerns the de jure application of the measure. The Cyprus NID applies and is available to all legal entities based in Cyprus without any restriction in terms of shareholding (resident or non-resident shareholders) or in terms of business sector.

1b) Criterion 1b) is used to complement the assessment under criterion 1a) which only looks at the literal interpretation of the measure. It takes account of the de facto effect of the measure. Where the majority of taxpayers (or counterparties to transactions) benefitting from the measure are in fact non-residents the measure will fall foul of criterion 1b).

The CY NID came into force on 1 January 2015 and therefore we only have data relating to the tax year 2015. From a high level review of this data, CY estimates that 45% of the taxpayers are members of Cyprus headed groups. This statistical information is not representative enough to reflect the comprehensive effects on the regime.

This remains a horizontal issue for a number of the NID assessments submitted to the Group. To the extent that our draft assessment is based on currently available information on statistics, we suggest that the group reserves the possibility of a potentially different outcome of a future assessment based on more complete information.

Given the lack of comprehensive data, the Group may wish to monitor the usage of this regime in the future.

Criterion 2: “whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base”

As regards criterion 2 the division between criteria 2a and 2b is made in the same way as in criterion 1 (i.e. de jure interpretation and de facto analysis). In general, a measure is caught by criterion 2 if the advantages are ring-fenced from the domestic market so that they do not affect the national tax base.

The fact that the taxpayer can benefit from a higher interest rate from foreign investment means the full advantages of this measure are ring-fenced from the domestic market. The Cyprus Tax Authority publishes a list of rates for certain countries in which investment is made.⁵ The rates for many countries listed, in particular those outside of the Eurozone, are higher than in Cyprus and other Eurozone countries. As a result, investment in such countries can benefit from an increased deduction under this measure. Our conclusion is that there appears to be a more beneficial treatment for foreign investment and the measure is *de jure* ring-fenced.

The Commission services note that there are still advantages available to domestic investment, and there are similar advantages available to some foreign investment. Cyprus justifies the use of different interest rates as reflecting the risk environment of the company. However, this approach is not applied consistently, as the lowest rate allowed is the Cyprus 10-year Government bond rate plus 3% premium. Based on the lists of interest rates published by Cyprus there appears to be ring-fenced advantages to specific foreign investment.

As outlined under criterion 1, the Group may wish to monitor the use of this regime in the future.

Criterion 3: "whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages"

According to the standard practice for the evaluation of the potentially harmful measures against criterion 3, a measure is caught by this criterion if there are no express requirements with regard to real economic activities and notably any requirement with respect to employment obligations.

Such express requirement aims at ensuring that the activities generating the income are undertaken by the taxpayer benefiting from the preferential tax regime.

Notional interest regimes such as the CY Deduction on New Capital are different from other preferential tax regimes in that their tax benefits are not based on income generated or the activity performed but on the policy goal to tackle the debt bias, making it difficult to expect a correlation between income-generating activities and benefits.

Such a regime should nonetheless be properly contained by appropriate anti-abuse measures in order to tackle tax-planning opportunities.

Paragraph L of the Code of Conduct states that: "anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion". In past assessments, the Code Group has taken into account, in the overall assessment of various regimes, the existence of appropriate anti-abuse provisions or countermeasures. In order to avoid tax planning and address abusive situations in applying NID, the below enumerated limitations of the scope and anti-abuse measures have been identified in a previous assessment⁶.

⁵ This can be found in Appendix V of the Cyprus contribution, page 90 of the Compilation of Standardised Questionnaires, room document WK 1599/2018, from 14 February 2018 Code of Conduct meeting.

⁶ Limitations of scope:

- Exclusion of own shares: this exclusion prevents the possibility for a company to increase its equity and simultaneously subscribe the new shares.
- Exclusion of shares held in other resident and non-resident legal persons: this exclusion tackles the possibility to cascade the ACE through chains of equity injection.

The first limitation in scope is that the Cyprus regime is an **incremental regime**. This limits the windfall effect associated with a regime based on the stock of equity.

Exclusion of own shares - this prevents the possibility for a company to increase its equity and simultaneously subscribe the new shares.

The CY NID is structured differently to other similar regimes. The CY NID requires that each asset financed by New Capital (NC) should be matched to the capital. If the asset does not generate taxable income then it will not be possible to benefit from the NID deduction. This should limit the possibility for a company to increase its equity solely to benefit from a NID deduction.

Exclusion of shares held in other resident and non-resident legal persons - this exclusion tackles the possibility to cascade the NID through chains of equity injection. The holding of an equity participation will not give rise to a tax deductible amount under the CY NID provisions. As outlined above the New Capital must be matched with each asset it is financing and the deduction calculated on an asset by asset basis. The holding of an equity participation in Cyprus does not lead to taxable income so the maximum NID available is nil ($80\% \times \text{nil taxable profit} = \text{nil}$).

In addition, according to the agreed CY description, if the New Capital (NC) of a CY resident company (or CY PE of a non-resident company) is derived directly or indirectly from NC of another CY resident company (or CY PE of a non-resident company), the NID is only available in one of those businesses, except where the reinvestment of the NID creates new separate taxable income.

- The application of the allowance may not create nor increase tax losses. Consequently, a negative result due to this deduction does not generate a loss carry forward.

- Assets not necessary for conducting business: this is a classical exclusion in NID systems to avoid benefiting from NID on assets that do not generate taxable income (for instance, luxury goods, artwork, etc.).

- No deduction of NID with regard to capital which is allocated to a foreign permanent establishment. If the foreign PE was a legal person (a subsidiary), the parent company holding its capital would have to exclude those shares from the ACE base.

Anti-abuse rules targeting specifically transactions between related parties: The proposal for an EU Directive on a common consolidated tax base (CCCTB) contains an Allowance for Growth and Investment (AGI). Art. 11(6) of the CCTB reads as follows:

The Commission shall be empowered to adopt delegated acts in accordance with Article 66 to lay down more detailed rules against tax avoidance, and more particularly in the following fields relevant to the AGI:

- (a) intra-group loans and loans involving associated enterprises;
- (b) cash contributions and contributions in kind;
- (c) transfers of participations;
- (d) the re-categorisation of old capital as new capital through liquidations and the creation of start-ups;
- (e) the creation of subsidiaries;
- (f) acquisitions of businesses held by associated enterprises;
- (g) double-dipping structures combining interest deductibility and deductions under the AGI;
- (h) increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date.

The application of the allowance may not create nor increase tax losses - the CY NID cannot create losses.

Assets not necessary for conducting business – As explained in the opening section, the New Capital (NC) must be matched to each asset it is financing and the NID is then calculated on an asset by asset basis using the Basic Calculation. This amount is then compared with the 80% cap and the lower of these two amounts is used as the deduction. The 80% cap is calculated based on the taxable income derived from each asset. Since luxury goods do not generate taxable income, these assets will arrive at nil deduction ($80\% \times \text{nil} = \text{nil}$). Therefore the use of assets not necessary for conducting business would result in a nil NID deduction.

No deduction of NID with regard to capital which is allocated to a foreign permanent establishment - The NID base (referred to as New Capital, NC), must be matched to each asset it is financing and the maximum NID calculated on an asset by asset basis. If the foreign PE is exempt from tax in CY then because of the 80% cap the NC will arrive at nil deduction ($80\% \times \text{nil taxable income} = \text{nil deduction}$). In cases where the foreign PE is taxable in Cyprus then the NC will be eligible for a deduction. Our understanding is that, while Cyprus applies the credit method of double taxation relief, foreign Permanent Establishments are normally exempt from taxation.

The CY NID regime includes **specific anti-abuse measures** that address potentially abusive situations: in particular Section 9B(3)(h) of the Cyprus income tax law. We note that the burden on proof for this anti-abuse section is placed on the taxpayer.

(a) Intra-group loans and loans involving associated enterprises;

Where New Capital is financed from loans obtained by another company, for which interest deduction is granted under the CIT law, the NID will be reduced by the amount of interest deducted in that other company.

There appears to be a risk that in situations where the New Capital is invested in a high interest rate country abroad, the deduction based on a domestic interest rate may not fully neutralise the benefits from the NID based on a much higher foreign interest rate. Therefore double benefits may remain.

In addition there are anti-cascading rules in this regime. If the New Capital (NC) of a CY resident company (or CY PE of a non-resident company) is derived directly or indirectly from NC of another CY resident company (or CY PE of a non-resident company), the NID is only available in one of those businesses, except in a situation where the reinvestment of the NID creates new separate taxable income.

(b) cash contributions and contributions in kind:

There are anti-cascading rules as explained above which would act to prevent the use of cash contributions from a CY resident company (or a CY PE of a non-resident company) to cascade the NID. However, it appears there may be a risk of double dipping or cascading for cash contributions originating from a foreign company.

CY does not have a specific rule preventing contributions in kind. However, where NC is created by contributions in kind, the value of the NC cannot exceed the market value of the assets at the time of their introduction to the business. For example, with this provision a taxpayer cannot claim that the value of NC introduced to the business is €2million when the asset contributed has as its market value at the time of contribution a value of only €1.5 million. In this example, the value of the NC cannot exceed €1.5million. This may work to prevent an artificial increase in the NID base. If the market value is not documented to the satisfaction of the tax authority then no NID is available.

(c) transfers of participations:

Since participations have to be deducted from the NID base, a group could maximise the deduction by placing participations in companies that cannot claim an NID deduction. Similar to the limitation of scope rule relating to the exclusion of shares held in other resident and non-resident legal persons, the holding of an equity participation will not give rise to a tax deductible amount under the CY NID provisions.

(d) the re-categorisation of old capital as new capital through liquidations and the creation of start-ups:

The NID is denied where the tax authority view that actions or transactions carried out with connected persons have as their main purpose the conversion of Old Capital to New Capital, as set out in section 9B(3)(h) of the Cyprus income tax law.

(e) the creation of subsidiaries:

The CY NID is denied in cases where the tax authority view that actions or transactions have been carried out without any substantial economic or trading purpose. In addition the NID is denied where the tax authority view that actions or transactions carried out with connected persons have as their main purpose the conversion of Old Capital to New Capital (section 9B(3)(h) of the Cyprus income tax law).

(f) acquisitions of businesses held by associated enterprises:

The CY NID is denied in cases where the tax authority view that actions or transactions have been carried out without any substantial economic or trading purpose. In addition the NID is denied where the tax authority view that actions or transactions carried out with connected persons have as their main purpose the conversion of Old Capital to New Capital (section 9B(3)(h) of the Cyprus income tax law).

(g) double-dipping structures combining interest deductibility and deductions under the AGI:

As outlined above the amount of the NID deduction is reduced by the shareholder's deductible interest expense to prevent double dipping. This measure appears to mainly work in a domestic context.

(h) increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date.

The anti-abuse rule referred to under (g) also applies to (h).

Finally, Cyprus also has a **General Anti-Abuse Rule (GAAR)**. Section 33 of the Assessment and Collection of Tax Law 4/78 (A&C Law) sets out that where the tax authority are of the opinion that the object of the tax of any person is reduced by any transaction which, in the opinion of the tax authority was artificial or fictitious, the tax authority may disregard any such transaction and assess the persons concerned on the proper object of tax. The GAAR may therefore deny the NID deduction.

Criterion 4: “whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD”

The measures do not contain such elements that would be relevant from the point of view of internationally accepted principles as referred to in criterion 4 of paragraph B of the Code.

Criterion 5: “whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”

No NID will be granted in cases where the taxpayer fails to complete the Income Tax Return with respect to the NID claim, and declared that it has complied with the relevant Circular.

All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations etc. before a measure can be considered transparent.

Overall assessment: “Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community”

The Cyprus NID is considered as overall harmful.

In reaching this assessment we have in particular considered the unique structure of the CY NID that provides for a more advantageous treatment for foreign investment and therefore advantages are ring-fenced from the domestic market.