



Brussels, 20 November 2020
(OR. en)

13151/20
ADD 3

FISC 222
ECOFIN 1077

REPORT

From: General Secretariat of the Council
To: Delegations
Subject: Code of Conduct Group (Business Taxation)
- Report to the Council

Measure CY020 – Notional Interest Deduction (Deduction on new capital)

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

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”.

Since the 2020 modifications to the NID regime, the reference interest rate is the “*10-year government bonds yield of the state where the new capital is invested, increased by 5% on 31.12 of the year preceding the tax year.*” In case “*the state where the new capital is invested has not issued any government bonds [...] reference rate is the yield of the government bonds of the Republic increased by 5% on 31.12 of the year preceding the tax year.*” The minimum reference rate is no longer the Cyprus interest rate as was the case before, and can hence be lower or higher than the Cyprus interest rate depending on the respective jurisdiction.

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.

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% ($12.5\% \text{ CIT rate} \times (100\% \text{ taxable} - 80\% \text{ taxable income} / \text{maximum NID deduction})$). 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. **We have therefore proposed a cross ("X") for criterion 1a).**

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 it seems that since then, a small majority of the beneficiaries of the NID regime were tax payers from non-Cyprus groups in the tax years 2015, 2016 and 2017. The following data were provided by the Cyprus Government:

Tax year	Tax payers members of Cyprus groups		Tax payers members of non-Cyprus groups	
2015	66	48.2%	71	51.8%
2016	165	49.6%	168	50.4%
2017	282	48.6%	298	51.4%

However, no sufficient representative data were available for tax year 2018, nor was information provided for tax year 2019. Furthermore, the split up of taxpayers in Cyprus and non-Cyprus groups is unclear and no data were provided concerning the importance of the amounts involved. The statistical information provided up to date 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.

Therefore, as we do not have comprehensive information to determine whether the NID is predominantly used by non-residents in the most recent tax years and regarding the importance of the relevant amounts involved, **we have proposed a question mark ("?") for this criterion 1b).** 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.

As mentioned above, the reference interest rate is determined by the 10-year government bonds yield of the state where the new capital is invested, increased by 5%.

The Cyprus Tax Authority publishes a list of rates for certain countries in which investment is made.¹ 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.

However, this can be justified by the intention to align the reference rate with the market interest rate and the risk environment of the company and to obtain financing neutrality. Furthermore, due to the June 2020 amendments, the Cyprus interest rate is no longer the minimum interest rate and hence, the interest rate for a foreign investment can be lower and the approach is applied consistently.

If no governments bonds have been issued by the state of investment, the reference rate applied is the interest rate of the government bonds of Cyprus increased by 5%. According to the Cyprus

¹ 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.

Government, this solution has been chosen for the ease of administration for Cyprus companies in their NID calculation for the rare cases, in which the other jurisdiction does not issue Government bonds. In this case however, the approach is applied consistently, as the theoretical – since no bonds are issued – interest rate in that country might be higher or lower compared to the Cyprus interest rate.

Consequently, our conclusion is that there does not appear to be a more beneficial treatment for foreign investment and the measure is *de jure* not ring-fenced.

On the basis of the analysis above we **therefore propose a cross (“X”) for criterion 2a)**. Similar to criterion 1b) we propose **a question mark (“?”) for criterion 2b)**.

However, 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 assessment².

²Limitations 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 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.

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.

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 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%*nil taxable profit = 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 - 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%*nil = 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%*nil taxable income = 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.

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.

We would therefore propose a cross (“X”) for criterion 3.

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, and **we have therefore proposed a cross (“X”).**

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. **Since this is the case with respect to this measure, we have proposed a cross (“X”) for criterion 5.**

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”

With respect to the overall evaluation of the Cyprus NID we have suggested a cross (“X”).

We are of the opinion that the June 2020 amendments remedies the *de jure* ring-fencing of criterion 2a compared to the initial 2018 assessment prepared by the Commission Services. Therefore, the regime is not harmful.

However, further monitoring should take place, in order to establish if a high foreign use of the NID regime would appear under criterion 1b and 2b.

We invite the Group to discuss this issue at the next Code of Conduct meeting.