CYPRUS FIDUCIARY ASSOCIATION

CYFA 2022 Seminar #2:

“Recent direct tax developments & the Draft EU UNSHELL Directive”

Tuesday, 08th & Thursday 10th March, 2022
Speaker: Mr Andreas Papagavriel

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TOPICS OF DISCUSSION

1. KEY RECENT TAX DEVELOPMENTS MADE AND EXPECTED TO BE MADE IN CYPRUS

2. KEY RECENT INTERNATIONAL TAX DEVELOPMENTS MADE AND EXPECTED TO BE MADE

3. IMPORTANCE OF SUBSTANCE FROM A TAX PERSPECTIVE

4. ANALYSIS OF THE PROVISIONS OF DRAFT EU COUNCIL DIRECTIVE LAYING DOWN THE RULES TO PREVENT THE MISUSE OF SHELL ENTITIES FOR TAX PURPOSES

KEY RECENT TAX DEVELOPMENTS MADE AND EXPECTED TO BE MADE IN CYPRUS

INCORPORATION TEST FOR RESIDENCE AS OF 31 DECEMBER 2022

INCORPORATION TEST FOR RESIDENCE AS OF 31 DECEMBER 2022

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<u>Importance of tax residency</u>

1. It will determine the state which has taxing rights over the profits of the Company
2. It will determine the entitlement of tax treaty benefits under a bilateral double tax treaty

<u>A company can be considered tax resident in the respective country by reason of:</u>

1. Incorporation (USA and Sweden)
2. Place of effective management and control (Singapore)
3. Jointly incorporation and place of effective management (Germany, France, Canada, China, UK)

INCORPORATION TEST FOR RESIDENCE AS OF 31 DECEMBER 2022

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Tax residency in Cyprus

1. Under the current provisions of the Cypriot tax legislation, a company is considered to be tax resident of Cyprus if its management and control is exercised from Cyprus.

2. Further to the recent amendment made to the Law, as of 31 December 2022, any company incorporated or registered in Cyprus whose management and control is exercised outside Cyprus will still be considered as tax resident of Cyprus, unless this company is considered as tax resident in any other state.

3. The existing corporate tax residency 'management and control' test will continue to apply, so that a company that has its management and control in Cyprus will continue to be considered as a tax resident of Cyprus.

WHT ON PAYMENTS TO BLACKLISTED JURISDICTIONS

WHT ON PAYMENTS TO BLACKLISTED JURISDICTIONS

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1. Further to recent amendments made to the Income Tax Law and the Special Defence Contribution Law, Cyprus will apply withholding tax (“WHT”) on certain outbound payments of dividends, interest and royalties, in the cases where the recipient is a Company which is tax resident in an EU blacklisted jurisdiction (or incorporated in such jurisdiction but is not considered as tax resident anywhere).

2. The provisions are only applicable to payments made by Companies and are summarized below:

   - Dividends → 17% provided that there is more than 50% participation/entitlement to profits by the receiving company, with the exception of dividends paid by Cypriot tax resident companies listed on a recognized stock exchange.

   - Interest → 30% with the exception of interest relating to securities listed on a recognized stock exchange.

   - Royalties → 10% irrespective of whether the asset for which the royalty is paid is for use in Cyprus or abroad.

3. The Law will enter into force on 31 December 2022.

4. There is also an intention to apply WHT on outbound payments made to low tax jurisdictions (expected to come into force by the end of 2024).

ALLOWANCE FOR EMPLOYMENT IN CYPRUS – PROPOSED/DRAFT LEGISLATION

ALLOWANCE FOR EMPLOYMENT IN CYPRUS

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Current provisions of the Law – Articles 8(21) and 8(23) of Income Tax Law

1. An **exemption of 20% or €8.550** (whichever is lower) from income tax is granted on the remuneration from any employment exercised in Cyprus by an individual who was resident outside Cyprus prior to the commencement of his/her employment, for a maximum period of 5 years starting from the year following the year of employment (available for employments commencing until the end of 2025).

2. An **exemption of 50%** from income tax is granted on the remuneration from any employment exercised in Cyprus by an individual who was resident outside Cyprus prior to the commencement of his/her employment (subject to conditions), for a maximum period of ten years, provided that the remuneration exceeds the amount of €100.000 per annum.

ALLOWANCE FOR EMPLOYMENT IN CYPRUS

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<u>Proposed amendments to the Law expected to enter into force during 2022</u>

1. Based on the draft legislation, the existing provisions will not be applicable from 2022 onwards (subject to transitional provisions discussed in the next slide).

2. The proposed amendments to the Law provide for an exemption of 50% from income tax to individuals who are non-domiciled in Cyprus and become employed in Cyprus, subject to the following conditions:

   - Their remuneration from employment in Cyprus must be at least €55.000 per annum.
   - The exemption is granted for a period of 10 years starting from the year of employment (effective from the year 2022).
   - The exemption will not be granted to individuals that were Cypriot tax resident in the year preceding the year of employment or during any three (3) of the five (5) years preceding the year of employment.
   - The exemption will not be granted for an employment exercised in a company in which the individual (or his/her related persons) own directly/indirectly more than 10% participation OR an employment exercised in a company with which the individual is related based on the provisions of Article 33 of the ITL.
   - The exemption will not be granted to athletes.

ALLOWANCE FOR EMPLOYMENT IN CYPRUS

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3. The following transitional provisions are included in the proposed amendments to the Law:

   - The individuals who are **domiciled in Cyprus** and are currently claiming the exemption of 20% or 50% based on the provisions of Articles 8(21) and 8(23) of the ITL will continue to claim the exemption for the remaining years.

   - The individuals who are **non-domiciled in Cyprus** and are currently claiming the exemption of 50% based on the provisions of Article 8(23) of the ITL will be eligible to claim the exemption for a period of 17 years (i.e. instead of 10 years) starting from the year of employment.

   - The individuals who are **non-domiciled in Cyprus** and are currently claiming the exemption of 20% based on the provisions of Article 8(21) of the ITL will be eligible to claim the exemption of 50% for a period of 17 years starting from the year 2022 (i.e. entry into force of the new provisions) in case their remuneration was at least €55.000 per annum during the year of commencement of their employment.

TRANSFER PRICING – PROPOSED/DRAFT LEGISLATION

TRANSFER PRICING – PROPOSED LEGISLATION

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Current transfer pricing provisions in Cyprus

1. Currently, in Cyprus, there is no transfer pricing legislation in place.

2. Any adjustments between related parties can only be made under the provisions of **Article 33 of the ITL** which gives the right to the tax authorities to adjust the profits of a Cypriot tax resident company in the cases where the transactions between related parties are not based on market pricing/conditions (i.e. are not at arm's length).

3. In addition, there is also an **interpretative circular (No 3, dd 30.06.2017)** that was issued by the Cyprus Tax Department governing the transfer pricing provisions in the cases of intra-group back to back financing arrangements.

4. Based on the provisions of the aforementioned circular, the companies which are involved with intra-group back to back financing arrangements must prepare a transfer pricing study in order to derive the market pricing that they should charge for the aforementioned activities OR alternatively they must follow a 'safe harbour rule' (i.e. simplification procedure) subject to certain conditions.

TRANSFER PRICING – PROPOSED LEGISLATION

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Introduction of transfer pricing documentation requirements in Cyprus (expected within 2022)

- The proposed/draft transfer pricing legislation was sent to the House of Representatives in June 2021 and it is expected that it will be presented to the plenary for voting in the first half of 2022.
- The draft legislation consists of the following:
  - Amendment to Article 33 of the ITL to provide a definition for related parties and allow the issuance of Advance Pricing Agreements.
  - Amendment to the ITL to introduce regulations for maintaining a Master Documentation File and Local Documentation File.
  - Amendment to the Assessment and Collection of Taxes Law to provide for administrative penalties in case of non-compliance.

TRANSFER PRICING – PROPOSED LEGISLATION

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- Based on the draft legislation, the requirements for transfer pricing documentation will cover:
  - transactions of Cyprus tax resident companies;
  - transactions between Cyprus permanent establishments of non-tax resident companies and their head office or related companies of the head office established outside Cyprus;
  - transactions between Cyprus tax resident companies and their foreign permanent establishments.
- The Transfer Pricing Documentation will include the Basic Documentation File (Master File) and the Cyprus Documentation File (Local File).
- Exemption from the obligation to keep a Cyprus Documentation File if the transactions with related parties do not exceed (cumulatively per category) the amount of €750.000 per tax year.
- The definition of related parties will be based on a participation/entitlement to profits of 25% (i.e. a person holds more than 25% shareholding in the company or the same persons own more than 25% in two or more companies).

TRANSFER PRICING – PROPOSED LEGISLATION

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- The Transfer Pricing Documentation File must be prepared within twelve (12) months from the year–end and accompanied by the Summary Information Table which in turn must be prepared and submitted electronically to the Tax Department within nine (9) months from the year–end.
- The Transfer Pricing File must be submitted to the Tax Department within 60 days from such request by the Tax Department.
- The details of what the two Files should include will be described in a notification to be issued by the Tax Department.
- There will be a possibility to issue Advanced Pricing Agreements for approval of the method(s) used, the comparison or reference data and related adjustments, the critical assumptions made for the operational profile or the pricing of transactions.
- The proposed legislation also includes certain provisions for penalties relating to the non-timely submission of the information requested or the filing of incorrect information.

KEY RECENT INTERNATIONAL TAX DEVELOPMENTS MADE AND EXPECTED TO BE MADE

DAC6 – REPORTABLE CROSS-BORDER ARRANGEMENTS

DAC 6 – GENERAL OVERVIEW

What is DAC 6

1. DAC 6 is the EU Council Directive 2018/822 which was adopted by the Economic and Financial Affairs Council on 25th May 2018 in order to amend the Council Directive 2011/16/EU on administrative cooperation in the field of taxation.

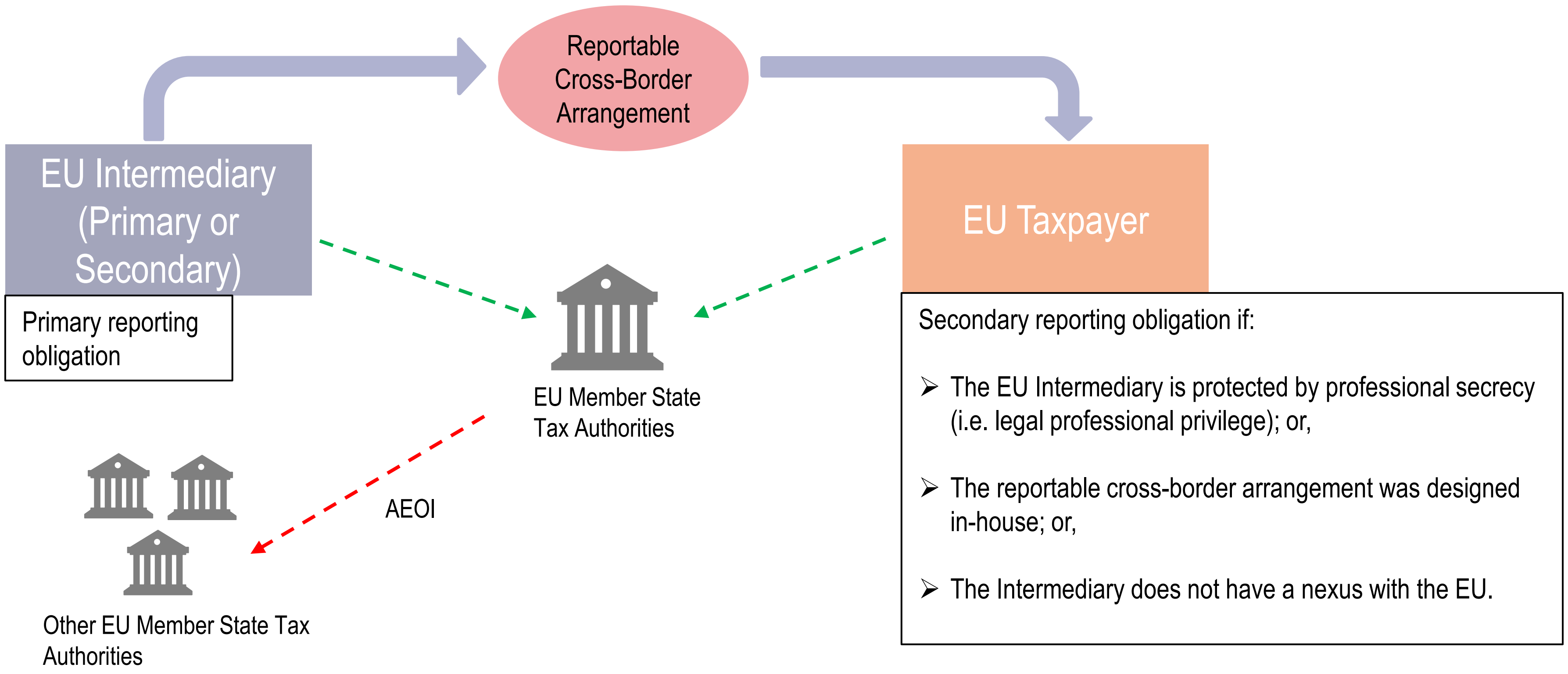
2. DAC6 relates to the mandatory automatic exchange of information of certain cross-border arrangements and was introduced by the Council in order to improve transparency by requiring intermediaries (or taxpayers) to provide information regarding potential aggressive tax planning arrangements to EU Member States.

3. The 'cross border arrangements' that are considered reportable are those that meet certain criteria (i.e. Hallmarks) which indicate that aggressive tax planning may have taken place.

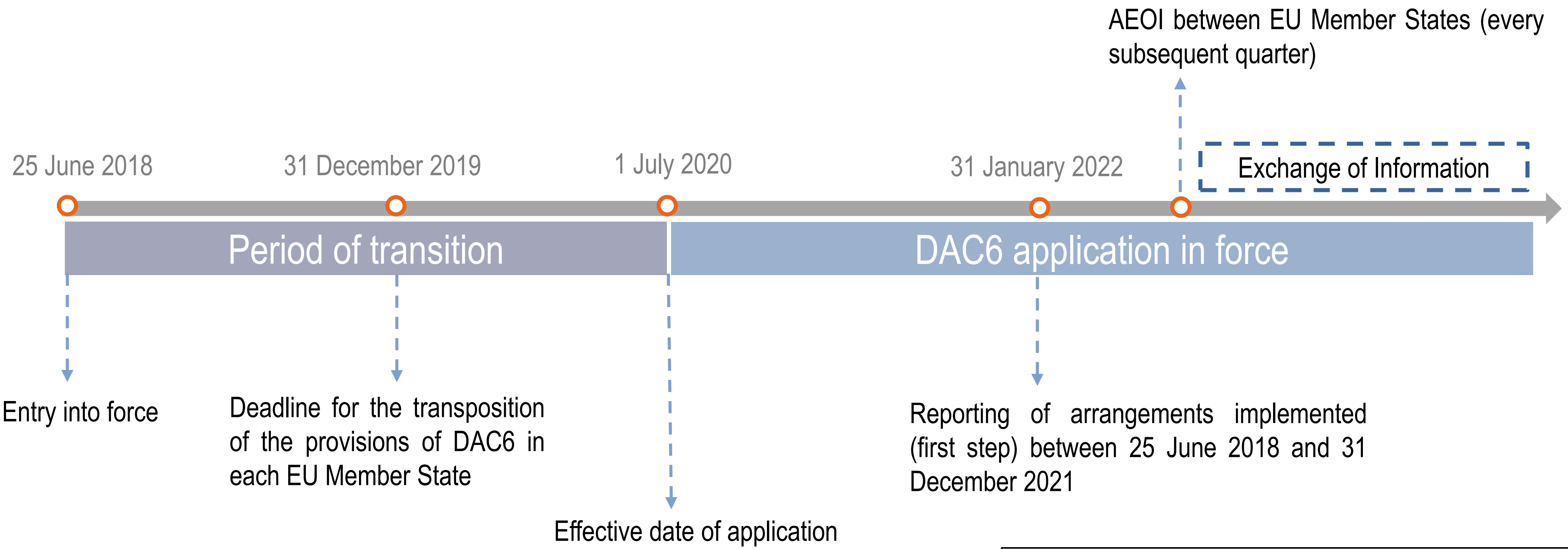
4. The objective of the Council is to provide to EU Member States with valuable information as regards to potential aggressive tax planning arrangements that may be followed by taxpayers, in order to undertake targeted tax audits and close potential loopholes.

5. The provisions of DAC 6 apply to all kind of direct taxes. Indirect taxes such as VAT, customs, excise duties and social security contributions are excluded.

DAC 6 – GENERAL OVERVIEW



DAC 6 – TIMELINE FOR CYPRUS



After 1st January 2022, the arrangements must be reported within 30 days from the day after the arrangement is made available for implementation **or** is ready for implementation **or** from the day that the first step has been implemented **or** from the day that aid, assistance or advice has been provided.

DAC 6 – REPORTING OBLIGATION

What is not considered as a reportable transaction

- The provision of compliance services in relation to historic data, that is not part of the implementation, e.g. assistance with the completion of a tax return for a client who has previously entered into a reportable transaction, would not result to the person providing the service being an intermediary.
- Similarly, an auditor would not qualify as an intermediary if during the review of the accounting entries comes across reportable transactions.
- The provision of an opinion on whether a transaction is reportable would not itself create a reporting obligation, as the definition of the Intermediary would not be satisfied.
- A person will not be considered as a Secondary Intermediary, if they did not know, and could not reasonably be expected to know, that they were providing aid, advice or assistance with respect to a reportable cross-border arrangement or had little or no knowledge or understanding of what the arrangement actually entails.

DAC 6 – REPORTABLE INFORMATION

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Information to be reported

The following information should be reported to the Tax Authorities in the cases of a “reportable cross-border arrangement”:

- Identification of the intermediaries and the relevant taxpayers
- Details of the hallmarks in which the arrangement falls
- Summary of the arrangement
- Date of implementation of the first step of the arrangement
- Details of the local legislation that the arrangement is based on
- Value of the arrangement
- Identification of the EU Member States impacted by the arrangement
- Identification of any person in an EU Member State to be affected by the arrangement

DAC 6 - HALLMARKS

Main benefit test – i.e. if it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage

A – Generic hallmarks

1. **Confidentiality:** Relevant taxpayer undertakes to comply with a condition of confidentiality (i.e. not to disclose how the arrangement could secure a tax advantage with other intermediaries or the tax authorities).
2. **Success fee:** Intermediary is entitled to a fixed percentage fee by reference to the tax advantage.
3. **Standardized documentation:** Structure is available to more than one taxpayer without a need to be substantially customized for implementation.

B – Specific hallmarks

1. Acquisition of **loss-making company**, discontinuing its main activity and using its losses in order to reduce tax liability.
2. **Conversion of income** into **capital, gifts, or other types of revenue** which are taxed at a lower level or exempt from tax.
3. **Circular transactions** resulting in the **round-tripping of funds**, using entities without any other primary commercial activity or transactions that offset/cancel each other.

C – Specific hallmarks related to cross-border transactions

1. **Deductible cross-border payments** between associated enterprises in the cases where:
   b. (i) The tax jurisdiction of the recipient does not impose any tax (or tax rate is almost zero); or,
   c. The payment benefits from a full exemption from tax in the jurisdiction of the recipient; or,
   d. The payment benefits from a preferential tax regime in the jurisdiction of the recipient.

DAC 6 - HALLMARKS

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Not linked to the main benefit test

C – Specific hallmarks related to cross-border transactions	E – Specific hallmarks related to transfer pricing
1. **Deductible cross-border payments** between associated enterprises in the cases where: a. The recipient is not tax resident in any jurisdiction. b. (ii) The jurisdiction of the recipient is included in a list of third-country jurisdictions which have been assessed as non-cooperative (by EU or OECD). 2. **Deductions for the same depreciation** on an asset claimed in **more than one jurisdiction.** 3. **Relief from double taxation** for the same item of income/capital claimed in **more than one jurisdiction.** 4. **Transfer of assets** where there is a **material difference in the amount being treated as payable** for the assets in the jurisdictions involved.	1. An arrangement which involves the use of **unilateral safe harbour rules.** 2. An arrangement involving the **transfer of hard-to-value intangibles** for which no reliable comparable exists and for which the projection of future cash flows or income expected to be derived from the transaction or the assumptions used are highly uncertain. 3. An arrangement involving an **intra-group cross-border transfer of functions, risks or assets**, in the cases where the projected annual EBIT of the transferor during the 3 years after the transfer are less than 50% of the projected annual EBIT of such transferor if the transfer had not been made.

DAC 6 - HALLMARKS

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Not linked to the main benefit test

D – Specific hallmarks related to AEOI and beneficial ownership

1. An arrangement undermining the reporting obligation on the automatic exchange of financial account information (i.e. CRS) with:
    a. The use of an account, product or investment that is not a financial account but has similar features (i.e. certain derivatives).
    b. The transfer of financial accounts or assets to (or the use of) jurisdictions that are not bound by the AEOI with the jurisdiction of residency of the relevant taxpayer.
    c. The reclassification of income/capital into products/payments that are not subject to AEOI.
    d. The transfer or conversion of a financial account/institution/assets to a financial institution/account/assets not subject to AEOI (i.e. splitting up of accounts to remain under the CRS threshold).
    e. The use of legal entities, arrangements or structures that eliminate the reporting of account holders or controlling persons under CRS (i.e. not informing the financial institution about changes in the beneficiaries of a trust).
    f. The use of arrangements that undermine or exploit weaknesses in the due diligence procedures used by financial institutions in order to comply with their obligations to report financial account information, including the use of jurisdictions with weak AML regimes or transparency requirements (i.e. citizenship/residence by investment schemes).
2. An arrangement involving a non-transparent legal/beneficial ownership chain with the use of persons, legal arrangements or structures:
    a. That do not carry a substantive economic activity or substance; and
    b. Are incorporated/managed/resident/controlled/established in a jurisdiction other than the jurisdiction of residence of the beneficial owners; and
    c. Their beneficial owners are unidentifiable.

DAC 7 – REPORTING OBLIGATION FOR DIGITAL PLATFORM OPERATORS

DAC 7 - OVERVIEW

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What is DAC 7

- DAC7 introduces reporting obligations for EU and non-EU Digital Platform Operators (“DPOs”) that connect certain ‘Reportable Sellers’ to buyers.
- DAC7 **only covers the intermediation services** provided by DPOs and therefore it does not apply in the cases of e-shops where sellers own their own products/services.
- DPOs have the option to register in only one Member State (also applicable to DPOs located outside EU).
- The objective is to provide information to EU Member States in order to conduct accurate income tax and VAT assessments for ‘Reportable Sellers’.
- The information is reportable by 31 January of the year following the calendar year in which the seller is identified as a ‘Reportable Seller’ and the first information should be reported for 2023 (the fist reporting should therefore take place by 31 January 2024).

DAC 7 – KEY DEFINITIONS

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Key Definitions

- ‘Reportable Seller’ – a platform user (individual or entity) that carries out a ‘Relevant Activity’ and is resident in an EU Member State OR rents out immovable property located in an EU Member State.
- ‘Relevant Activity’ – Any activity (domestic or cross-border) carried out for a consideration and being any of the following:
  - Rental of immovable property (i.e. residential, holiday, commercial)
  - Personal services (i.e. time or task-based work such as freelancing)
  - Sale of goods (i.e. new or used, B2B or B2C)
  - Rental of any mode of transport (i.e. cars)

DAC 7 – KEY DEFINITIONS

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Key Definitions

- The following **platforms** are outside the scope of DAC7:
  - Platforms exclusively allowing users the processing of payments in relation to a ‘Relevant Activity’.
  - Platforms exclusively allowing users to list/advertise a ‘Relevant Activity’.
  - Platforms exclusively redirecting/transferring users elsewhere.
- The following **entities** are outside the scope of DAC7:
  - Governmental entities.
  - Listed entities.
  - Entities for which the DPO facilitated more than 2.000 relevant activities in a calendar year, relating to the **rental of immovable property** units located at the same street address, owned by the same owner and offered for rent on a platform by the same seller.
  - Entities for which the DPO facilitated less than 30 relevant activities in a calendar year, relating to the **sale of goods** for which the total consideration did not exceed €2.000.

OECD PILLAR 2 MODEL RULES

OECD Pillar 2 Model Rules

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Background:

- Building on the BEPS project, the OECD developed a Two-Pillar solution focused on addressing the tax challenges arising from the digitalisation of the economy.
- The Two-Pillar solution establishes a new framework for international tax with the objective to ensure that MNEs will be subject to a minimum tax rate of 15% and that the profits of the largest and most profitable MNEs will be re-allocated to countries worldwide.
- **Pillar One** aims to ensure a fairer distribution of profits ant taxing rights among countries with respect to the largest MNEs (turnover >€20bn), via the introduction of new nexus and profit allocation rules. Under Pillar One, it is expected that more than US$125bn of profit will be reallocated to market jurisdictions.
- **Pillar Two** puts a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax rate at the rate of 15% (the GloBE rules). It is expected that Pillar Two will generate US$150bn in new tax revenues globally.
- As of 8 October 2021, 136 out of the 140 members/jurisdictions of the OECD/G20 Inclusive Framework agreed to the statement and joined the Two-Pillar solution. Cyprus also supported the statement (although we are not a member of the Inclusive Framework).

OECD Pillar 2 Model Rules

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Overview of the rules:

- The Pillar Two Model Rules (GloBE rules) were released by the OECD on 20 December 2021.
- The GloBE rules released under Pillar Two consist of the following:

    a. The **Income Inclusion Rule (IIR)** → Primary Rule: A top-up tax imposed at the level of the ultimate parent entity (UPE) of the group in the cases of low-taxed constituent group entities with an effective tax rate below 15%.

    b. The **Undertaxed Payment Rule (UTPR)** → Secondary Rule (serves as a backstop to the IIR): Limiting/denying tax deductions or requiring equivalent adjustments in the cases of low-taxed constituent group entities with an effective tax rate below 15% that are not subject to IIR.

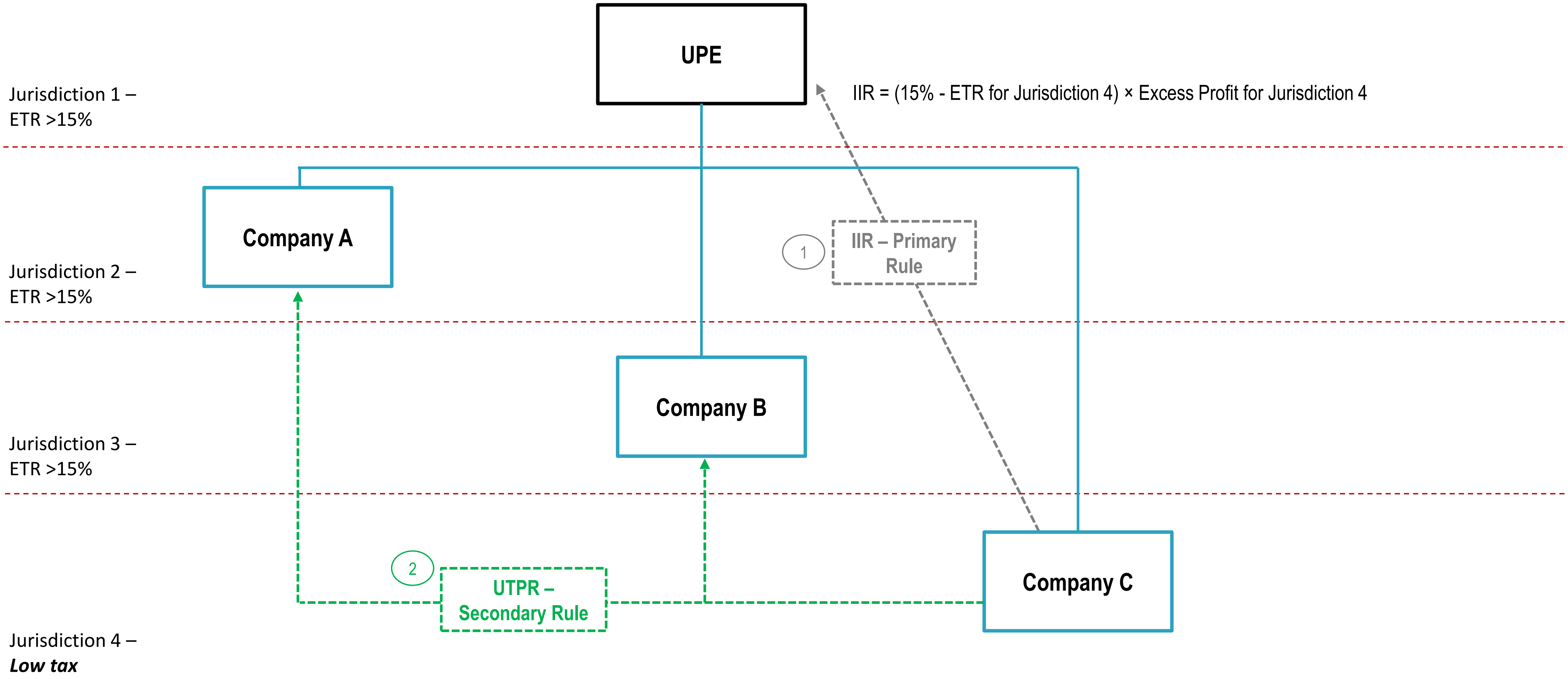
- There is also another rule which is part of Pillar Two and is referred to as the **Subject to Tax Rule (STTR).** STTR is a treaty-based provision that will enable developing countries to impose withholding tax on certain payments (i.e. interest, royalties and other payments based on mobile features) that are not subject to a nominal rate of at least 9%. Future guidance for STTR is expected to be issued within 2022 along with a multilateral instrument for its implementation.
- Ambitious timeframe – expected that the IIR will come into effect in 2023 and the UTPR in 2024.

OECD Pillar 2 Model Rules

Scope of the IIR and UTPR (GloBE rules):

- Applicable to MNEs with annual consolidated group revenue exceeding €750m in at least two of the last four years preceding the tested year.
- Certain entities such as governmental entities, non-profit organizations, pension funds and investment funds/real estate investment vehicles that are UPEs are excluded from the GloBE rules.
- The below steps need to be followed in order to apply the GloBE rules:
    1. Calculate the effective tax rate (ETR) for all constituent entities located in the same jurisdiction.
    2. Determine the top-up tax that will be imposed at the level of the UPE via IIR **or** at the level of the constituent entities via UTPR (if the low-taxed income is not subject to IIR).
    3. Apply/impose the IIR or UTPR.

OECD Pillar 2 Model Rules



OECD Pillar 2 Model Rules

$$\textbf{Jurisdictional ETR} = \frac{\text{Adjusted Covered Taxes for Jurisdiction}}{\text{Net GloBE Income for Jurisdiction}}$$

Net GloBE Income

- The Net GloBE Income is the financial accounting net income in the jurisdiction (before consolidation adjustments – subject to a five-year election).
- Certain items such as dividends, equity gains/losses, unrealized FX gains/losses etc. are excluded from the calculation.

Adjusted Covered Taxes

- The Adjusted Covered Taxes are the current taxes relating to the financial year under consideration, subject to certain adjustments (i.e. temporary differences etc.).

OECD Pillar 2 Model Rules

$$\textbf{Jurisdictional Top-up Tax} = (15\% - \text{Jurisdictional ETR}) \times \overbrace{(\text{Net GloBE Income for Jurisdiction} - \text{Substance-based carve out})}^{\textit{Excess Profit}} - \text{Domestic Top-up Tax}$$

If a qualified domestic minimum top-up tax applies

De minimis exclusion

Exclusion of a Jurisdiction where:

- Average GloBE Revenue <€10M and Average GloBE Income <€1M.

The average is computed on a 3-year basis taking into consideration the current year and the preceding two years.

Substance-based carve out

- Exclusion from the top-up rules for an amount corresponding to 5% of the carrying value of eligible tangible assets **and** 5% of the payroll costs for eligible employees.

- There are transitional provisions in order to apply a rate of 8% and 10% respectively, decreasing each year for 10 years in order to arrive at the 5% rate by 2033.

OECD Pillar 2 Model Rules

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Jurisdictional Top-up Tax

IIR – Primary Rule

Imposed at the level of the UPE via a top-down approach for constituent entities that do not meet the minimum ETR of 15%.

UTPR – Secondary Rule

Allocated among all other Jurisdictions that have introduced the GloBE rules based on a *predetermined formula.*

$$\left(50\% \times \frac{\text{Total value of Tangible Assets in Jurisdiction}}{\text{Total Value of Tangible Assets in all UTPR Jurisdictions}}\right) + \left(50\% \times \frac{\text{Number of Employees in Jurisdiction}}{\text{Number of Employees in all UTPR Jurisdictions}}\right)$$

OECD Pillar 2 Model Rules

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Practical Example 1

Jurisdiction 1 –
ETR >15%

UPE

IIR = **95** (4)

Jurisdiction 2 –
ETR >15%

Company A

Jurisdiction 3 –
ETR >15%

Company B

Jurisdiction 4 –
Low tax

Company C

<u>Facts</u> (1)
- Adjusted Covered Taxes = 200
- Net Globe Income = 2.000
- Carrying Value of Tangible Assets = 1.000
- Payroll Cost = 200

<u>Effective Tax Rate</u> (2)
200 ÷ 2.000 = **10%**

<u>Substance Based Carve Out Amount</u>
(1.000 × 8%) + (200 × 10%) = **100**

<u>Jurisdictional Top-up Tax</u> (3)
(15% - 10%) × (2.000 – 100) = **95**

<u>Assumption that:</u> Jurisdiction 1 adopted the rules and applies IIR; The de-minimis exclusion does not apply.

Practical Example 2

UPE

Jurisdiction 1 –
ETR >15%

Company A

UTPR (5)
40% × 95 = **38**

Facts (4)
- Value of Tangible Assets = 300
- Number of employees = 16

Formula for allocation of Top-up Tax (UTPR)
[50% × (300 ÷ 750)] + [50% × (16 ÷ 40)] = **40%**

Jurisdiction 2 –
ETR >15%

UTPR (5)
60% × 95 = **57**

Company B

Facts (4)
- Value of Tangible Assets = 450
- Number of employees = 24

Formula for allocation of Top-up Tax (UTPR)
[50% × (450 ÷ 750)] + [50% × (24 ÷ 40)] = **60%**

Jurisdiction 3 –
ETR >15%

Facts (1)
- Adjusted Covered Taxes = 200
- Net Globe Income = 2.000
- Carrying Value of Tangible Assets = 1.000
- Payroll Cost = 200

Effective Tax Rate (2)
200 ÷ 2.000 = **10%**

Substance Based Carve Out Amount
(1.000 × 8%) + (200 × 10%) = **100**

Company C

Jurisdictional Top-up Tax (3)
(15% - 10%) × (2.000 – 100) = **95**

Assumptions that: Jurisdiction 1 did not adopt the rules; Jurisdictions 2 and 3 have adopted the rules; The de-minimis exclusion does not apply.

Jurisdiction 4 –
Low tax

OECD Pillar 2 Model Rules

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EU Approach – Draft Directive implementing the GloBE Rules

- The EU has embraced the course of direction of BEPS 2.0 and on 22 December 2021 the European Commission published an EU Directive that effectively establishes a common framework for the implementation of the Pillar Two Model Rules into the local legislation of the EU Member States, subject to certain adjustments to guarantee EU Law compliance.

- The draft EU Directive includes the IIR and the UTPR, like the Pillar Two Model Rules.

- The STTR which is included in Pillar Two is not included in the draft Directive (although this may be introduced by amending the Interest/Royalties Directive in the future).

- There are certain key differences between the Pillar Two Model Rules and the draft EU Directive, some of which are the following:

  - Under the draft EU Directive, the provisions are also applicable to large-scale **purely domestic** groups with combined annual group turnover of at least €750m.

  - Under the draft EU Directive, a Member State may opt to apply a **domestic top-up tax** to constituent entities located in its territory.

  - Under the draft EU Directive, the Member State of a constituent entity applying the IIR, which is usually the jurisdiction of the UPE, would be required to ensure effective taxation at the minimum agreed level not only for foreign subsidiaries, but also for all subsidiaries resident in that Member State.

OTHER IMPORTANT EU DEVELOPMENTS

Other Important EU Developments

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Long-term Initiative – Business in Europe: Framework for Income Taxation (BEFIT)

- BEFIT will provide for common rules for determining the corporate tax base and for the allocation of profits between EU Member States, based on a pre-defined formula.
- BEFIT will replace the pending Common Consolidated Corporate Tax Base (CCCTB) proposal.
- BEFIT would consolidate the profits of the EU entities of MNEs into a single tax base, in order to be allocated to Member States using a formula that will replace the current transfer pricing rules.
- The variables to be included in the formula will be the sales by destination, assets, employees, salaries etc.
- Once the profits are allocated, they will be taxed accordingly in each Member State.

Short-term Initiative – Debt Equity Bias Reduction Allowance (DEBRA)

- The current framework allows for the tax deductibility of interest expenses related to debt financing for corporate income tax purposes, but it doesn't provide for an equivalent deduction of costs related to equity financing.
- The goal is to introduce a mechanism that will place debt and equity financing on equal footing, either by disallowing interest deductions or by creating an allowance for equity (i.e. notional interest deduction).
- The European Commission commits for a legislative proposal for DEBRA within 2022.

IMPORTANCE OF SUBSTANCE FROM A TAX PERSPECTIVE

SUBSTANCE IN CYPRUS FROM A TAX PERSPECTIVE

SUBSTANCE IN CYPRUS FROM A TAX PERSPECTIVE

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- Under the current provisions of the Cypriot tax legislation, a company is considered to be tax resident of Cyprus provided its management and control is exercised in Cyprus.
- There is no definition in the Cypriot tax legislation regarding the term ‘management and control’ and no detailed guidelines have been issued by the Cypriot tax authorities.
- The following conditions are usually taken into consideration in order to determine if a company is managed and controlled from Cyprus and hence if it qualifies as a resident of Cyprus for tax purposes:

1. All strategic (and preferably also day-to-day) management decisions are taken in Cyprus by the directors exercising their duties from Cyprus (i.e. meetings of the board of directors to take place in Cyprus, signing of contracts-agreements-resolutions in Cyprus, administrative functions in Cyprus)
2. The majority of the directors of the company are tax resident in Cyprus and they exercise their office from Cyprus
3. An actual (administrative) office is maintained in Cyprus

SUBSTANCE IN CYPRUS FROM A TAX PERSPECTIVE

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- The following actions/measures indicate substance.
  1. Maintain fully fledged (rented or owned) office space / premises / physical address in Cyprus;
  2. Qualified directors experienced in the relevant sector and remunerated based on market salary who are located and employed in Cyprus;
  3. Other employee(s) with relevant experience residing in Cyprus (either relocating employees from abroad or employing Cypriots);
  4. Employer status of the company and registration with the Cyprus department of Social Insurance when directors and/or other staff are employed;
  5. Accounting records and admin documents maintained in Cyprus;
  6. Operative local bank accounts, with at least one of the signatories to be located in Cyprus;
  7. Actively participate in the local business community / organizations;
  8. Relevant assets located in Cyprus (i.e. staff, equipment and all other necessities which are normally required for doing business);
  9. An independent local email address and/or website and an independent telephone and fax line;

SUBSTANCE REQUIREMENTS INTERNATIONALLY

SUBSTANCE REQUIREMENTS INTERNATIONALLY

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Substance and the Place of Effective Management (“POEM”)

POEM is usually determined by the following:

1. Place where board of directors meeting are held
2. Where the senior executives usually carry on their activities
3. Where the high-level day to day management is carried out
4. Where are the headquarters located
5. Where are the accounting records maintained

The POEM of a Company and the level of physical and economic substance are often taken into consideration along with the concept of ‘beneficial ownership of income’ in order to asses whether a Company is entitled to tax treaty or other benefits.

Substance in the context of exchange of information

Substance is also important in the context of exchange of information (i.e. request of information from foreign tax authorities).

In the case of an investigation by the foreign tax authorities, the following information are usually requested:

1. Tax residency status of the directors.
2. Qualifications and expertise of the directors and the level of their remuneration (request for employment agreements etc.).
3. Whether there is any indemnity in place covering any future financial liabilities for the directors.
4. The place and frequency of the meetings of the company's directors and the minutes of the meetings.
5. Whether the Company has an actual office in Cyprus (i.e. square meters, place etc.) and the equipment acquired by the Company (i.e. any assets in the books etc.).
6. How many employees the Company has and their duties.
7. Details about the Company's bank accounts, who opened these bank accounts and who has authorisation to execute transactions for these bank accounts.

SUBSTANCE REQUIREMENTS INTERNATIONALLY

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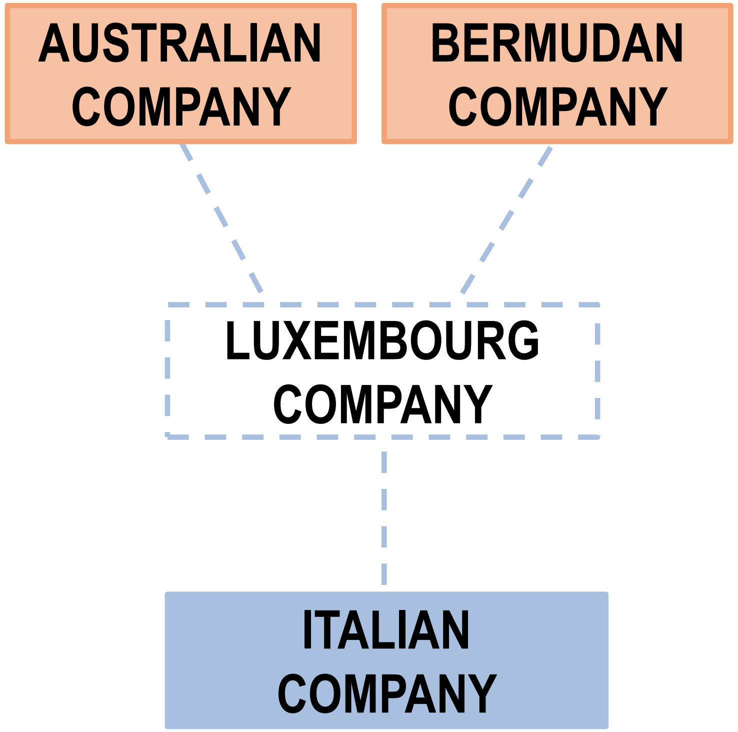
Case Law relating to substance

Decision (Macquarie Group) by the Italian Supreme Court

- Denial of the benefit for reduction of the domestic 26% withholding tax to NIL, when the receiving parent is not subject to tax in its own country by virtue of legislation ”participation exemption.”
- According to the Italian tax authorities, the Luxemburg company (i.e. Malsa), has been incorporated in Luxembourg for the sole purpose of benefitting from the Italy/Luxembourg double tax treaty and the EU Parent/Subsidiary Directive.
- Malsa is not the beneficial owner of the dividends.
- Malsa does not have its POEM in Luxembourg.



SUBSTANCE REQUIREMENTS INTERNATIONALLY

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Malsa appealed against the SCJ by using the following arguments:

- There is no need for an EU parent company to have its POEM in a certain jurisdiction in order to benefit from an EU Directive/Treaty.
- Malsa has obtained a tax residency certificate from Luxembourg and this should be sufficient to prove its POEM in the Country.
- The Court's decision was in conflict with the EU principles of Freedom of Establishment and Free Movement of Capital.
- The group was present in Luxembourg via other group companies, since Luxembourg as a jurisdiction is attractive because of its company and financial laws (i.e. not only for the benefit of using the provisions of the double tax treaty network or the EU Directives).
- The court decision was incorrect since it denied the beneficial owner status from Malsa simply due to the fact that the dividends were tax exempt via the domestic law participation exemption.

SUBSTANCE REQUIREMENTS INTERNATIONALLY

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The Supreme Court rejected the claims under the appeal. Some of their points are depicted below:

- The Italian provision implementing the EU Parent/Subsidiary Directive at that time (subsequently modified) granted the 0% WHT to EU parents owned by shareholders resident in third countries only if such parents demonstrated that they were not holding the Italian participation with the sole or principal purpose of obtaining the benefit.

- Abusive tax practices are to be disallowed not only for the purposes of the EU Parent/Subsidiary Directive but also with respect to treaty benefits.

- The certificates issued by the Luxembourg tax authorities were not sufficient to prove that the POEM of the Company is in the said Country (i.e. Malsa was not able to prove that the Board of Directors had meetings in Luxembourg, it did not produce any minutes of meetings and it did not maintain an actual office in Luxembourg).

- A holding company needs to have a proper nexus with the country where it is tax resident and where its POEM is exercised. Hence, Malsa is simply an SPV for the sole purpose of transferring/channelling dividends to the beneficial owners.

Conclusion: A "business substance" led approach must be followed for the selection of holding and financing locations and entities. Operational change may also be required in the cases of groups with centralized management and control seeking to claim tax treaty benefits via intermediary holding companies located in other jurisdictions.

PROPOSED EU DIRECTIVE ON SHELL COMPANIES

Proposed EU Directive on Shell Companies

Background

- On 22 December 2021, the European Commission (EC) has published the draft Directive laying down the rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU on Administrative Cooperation (also know as DAC).
- The proposed Directive provides indicators of minimum substance requirements for undertakings that engaged in an economic activity and are tax resident in an EU Member State and the tax consequences that kick in for the undertakings that are presumed to be shell entities for the purposes of the Directive.
- The proposed Directive is part of the wider initiative of the EU to tackle low-substance arrangements within EU used for tax avoidance and evasion purposes, via the introduction of specific legislation.
- Currently, the proposed Directive is subject to negotiation between the 27 EU Member States and a unanimous agreement must be reached in order to be adopted.
- Once (and if) adopted, the proposed Directive should be transposed into the national law of Member States by 30 June 2023 and will come into effect as of 1 January 2024.

Proposed EU Directive on Shell Companies

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The "Substance Test"

The proposed Directive lays down a seven-step approach to reflect the logical sequence of each step that is part of the "Substance Test". The seven steps are the following:

1. Identification of the undertakings that should report (also referred to as Gateway Test)
2. Reporting/documenting substance in tax return
3. Presumption of lack of minimum substance and tax abuse (i.e. the entity is qualifying as a shell company)
4. Rebuttal of presumption (i.e. the undertaking has the right make a claim in order to prove that it is not a shell company)
5. Exemption for lack of tax motives (i.e. exempt from the obligations of the Directive on the basis that no tax benefit arises)
6. Consequences (i.e. disallowing tax advantages)
7. Exchange of information with EU Member States

Step 1: Identification of the undertakings that should report – Gateway Test

The first step involves a determination whether the undertaking is lacking substance based on certain gateway criteria. These criteria are the following and they are considered cumulatively:

1. The undertaking engages in activities that are geographically mobile on the basis that 75% of its revenue in the preceding two tax years is 'relevant income' (i.e. predominantly passive income – see next slides).
2. The undertaking engages in cross-border activities on **any of the following** grounds:
   - More than 60% of the book value of its immovable property or movable property held for private purposes with book value >€1m (other than cash, shares or securities) was located outside the Member State in the preceding two tax years; or,
   - At least 60% of the undertaking's 'relevant income' is earned or paid out via cross-border transactions.
3. The undertaking outsourced the administration of day-to-day operations and the decision making of significant functions in the preceding two tax years.

Proposed EU Directive on Shell Companies

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Step 1: Identification of the undertakings that should report – Gateway Test (contd.)

If an undertaking holds assets that can generate any of the income outlined in points (a)-(c) below and the book value of these assets is more than 75% of the total book value of the undertaking's assets, the said undertaking shall be deemed to meet the first gateway test, irrespective of whether it received any income from these assets in the preceding two tax years:

a) Dividends and income from the disposal of shares

b) Income from immovable property

c) Income from movable property (other than cash, shares or securities) held for private purposes and with a book value >€1m

Proposed EU Directive on Shell Companies

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<u>Step 1: Identification of the undertakings that should report – Gateway Test (contd.)</u>

For the purposes of the Directive, *'relevant income'* relates to income falling under any of the following categories:

- Interest or any other income generated from financial assets, including crypto assets.
- Royalties or any other income generated from IP.
- Dividends and income from the disposal of shares.
- Income from financial leasing.
- Income from immovable property.
- Income from movable property (other than cash, shares or securities) held for private purposes and with a book value >€1m.
- Income from insurance, banking and other financial activities.
- Income from services which the undertaking has outsourced to other associated enterprises.

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Step 1: Identification of the undertakings that should report – Gateway Test (contd.)

The **following undertakings** are considered low-risk and therefore are **carved-out explicitly** for the purposes of the Directive:

- Listed companies.
- Regulated financial undertakings (i.e. credit institutions, insurance companies, funds, fund manager, payment institutions etc.).
- Undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also tax resident in the same Member State.
- Undertakings with holding activities that are tax resident in the same Member State as their shareholders or the ultimate parent entity.
- Undertakings with at least five own full-time employees or members of staff exclusively carrying out the activities generating the relevant income.

Proposed EU Directive on Shell Companies

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Step 2: Reporting/Documenting substance in tax return

If the undertaking meets the criteria laid down in the first step, it must declare in its tax return whether it meets the following indicators of minimum substance:

a. The undertaking has its own premises or premises for its exclusive use in the Member State.

b. The undertaking has at least one active bank account in the EU.

c. The undertaking fulfils **one of the following** indicators:

   i. One or more of the directors of the undertaking:

      1. Are tax resident in the Member State of the undertaking or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties;

      2. Are qualified and authorised to take decisions in relation to the activities that generate the ‘relevant income’ or in relation to the undertaking’s assets;

      3. Actively and independently use the above authorisation on a regular basis;

      4. Are not employees/directors of an enterprise that is not an associated enterprise.

   ii. The majority of full-time equivalent employees of the undertaking are tax resident in the Member State of the undertaking (or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties) and qualified to carry out the activities that generate the ‘relevant income’.

Proposed EU Directive on Shell Companies

CYPRUS FIDUCIARY ASSOCIATION

Step 2: Reporting/Documenting substance in tax return (contd.)

The information to be reported in the tax return of the undertaking as documentary evidence for the minimum substance indicators shall include the following:

a. Address and type of premises;

b. Amount and type of gross revenue;

c. Amount and type of business expenses;

d. Type of business activities performed to generate the 'relevant income';

e. The number of directors, their qualifications, authorisations and place of tax residency OR the number of full-time employees, their qualifications and place of tax residency;

f. Outsourced business activities;

g. Bank account number, any mandates granted to access the bank account and to use or issue payment instructions and evidence of the account's activity.

Proposed EU Directive on Shell Companies

CYPRUS FIDUCIARY ASSOCIATION

<u>Step 3: Presumption of lack of minimum substance and tax abuse</u>

- Assessment by the Tax Authorities whether the undertaking is a ‘shell’ for the purposes of the Directive based on the documentary evidence provided for the indicators set out in step 2.
- An undertaking that is considered to be at risk for the purposes of the Directive (i.e. based on the Gateway Test in step 1) is presumed not to be a ‘shell’ for the purposes of the Directive, if the required indicators mentioned in step 2 are demonstrated and backed up by documentary evidence.
- However, if the undertaking that crossed the Gateway Test in step 1 lacks at least one of the required indicators mentioned in step 2, it is presumed to be a ‘shell’ for the purposes of the Directive.

Proposed EU Directive on Shell Companies

Step 4: Rebuttal of presumption

- This step involves the right of the undertaking that is presumed to be a ‘shell’ for the purposes of this Directive to prove otherwise (i.e. to prove that it has substance or that it is not misused for tax purposes).
- In order to claim a rebuttal of presumption, an undertaking should produce concrete evidence of the activities it performs to generate the relevant income, such as the following:
    a. The commercial (i.e. non-tax) reasons of setting up and maintaining the undertaking which does not need (some of) the relevant indicators mentioned in step 2.
    b. The resources that it uses to perform its activity (i.e. information about the employees, their qualifications, their experience, their employment contract/terms, their position etc.).
    c. Evidence that the decision making is taking place in the Member State of the undertaking.
- A successful rebuttal by the undertaking (which is certified by the tax authorities of the Member State) will be **valid for the tax year in question** and **can be extended for another five years** (subject to the discretion of the tax authorities of the Member State), provided that the factual and legal circumstances of the undertaking remain the same.

Step 5: Exemption for lack of tax motives

- An undertaking that crossed the ‘gateway’ criteria mentioned in Step 1 and did not meet the required indicators of substance mentioned in Step 2 can **request for an exemption** from the obligations of the Directive, if it can prove that its **existence does not reduce the tax liability of its beneficial owner(s) or the group as a whole** (i.e. it is used for genuine business activities without creating a tax benefit).
- The supporting evidence shall include information about the structure of the group and its activities, in order to allow a comparison between:
    - The amount of overall tax due by the beneficial owner(s) or the group as a whole, taking into consideration the interposition of the undertaking; and,
    - The amount that would be due under the same circumstances in the absence of the undertaking.
- If the exemption is granted by the tax authorities of the Member State, it will be **valid for the tax year in question** and **can be extended for another five years** (subject to the discretion of the tax authorities of the Member State), provided that the factual and legal circumstances of the undertaking, the beneficial owner(s) and the group remain the same.

Step 6: Consequences

If an undertaking will be regarded as a 'shell' entity as a result of the above steps, the following tax consequences kick in, in order to neutralize its tax impact:

Consequences – Member State of the 'shell' entity

1. The Member State of the 'shell' entity should either:
   - Not issue a tax residence certificate to the 'shell' entity; or,
   - Issue the tax residence certificate with a warning statement (i.e. explicit statement that the 'shell' entity is not entitled to the benefits of double tax treaties ("DTT") or the EU Directives).
2. The Member State of the 'shell' entity is free to continue to consider the 'shell' as tax resident in its territory and apply tax on the 'relevant income' and/or assets as per its National Law.

Proposed EU Directive on Shell Companies

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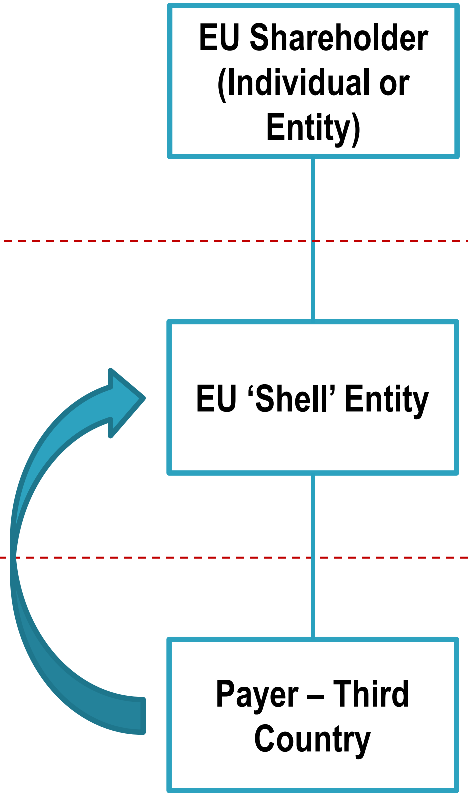
Step 6: Consequences (contd.)

Consequences – Other Member States

1. The other Member States shall disregard any DTT in force with the Member State of the ‘shell’ entity, as well as the provisions of the EU Parent/Subsidiary Directive and the EU Interest/Royalties Directive.
2. This effectively entails that a “look-through” approach will be followed, taking into consideration the shareholders (individuals(!) or entities) of the ‘shell’ entity.
3. The allocation of taxing rights will only affect Member States as it cannot affect third countries.
4. Situations involving third countries will pay due respect to DTT between the Member States and the third countries as regards to the allocation of taxing rights.

Proposed EU Directive on Shell Companies

Step 6: Consequences (contd.)



Will include the payment made by the payer in its taxable income (subject to a double-tax relief for the tax paid at source in accordance with the applicable DTT with the payer's jurisdiction **and** the tax paid by the 'shell' entity).

The entity will continue to be tax resident in the respective Member State and therefore it will have to pay the tax due on the income (if any).

Not bound by the Directive.

However, it may apply domestic tax on the payment **or** WHT based on the DTT in place with the EU Shareholder jurisdiction.

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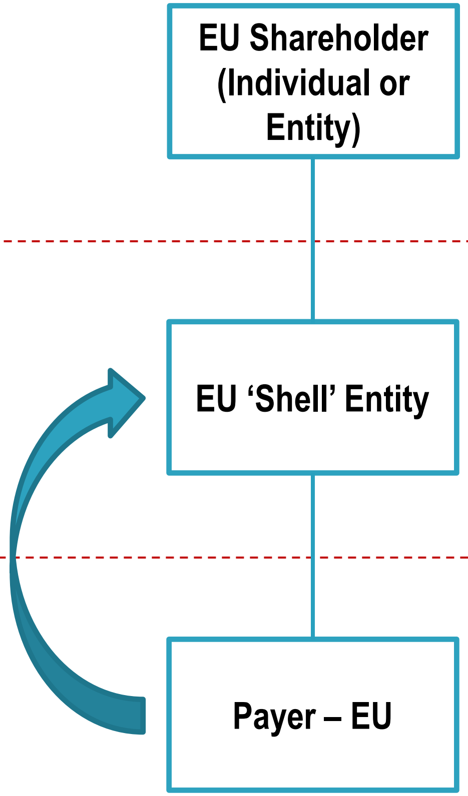
Step 6: Consequences (contd.)

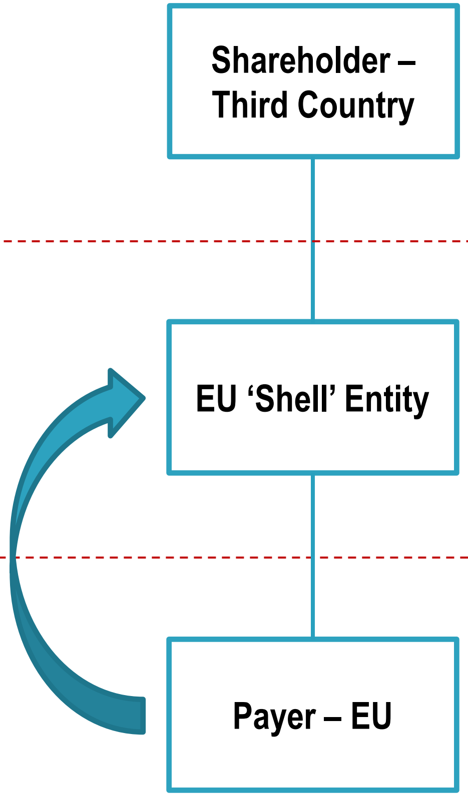


Will include the payment made by the payer in its taxable income (subject to a double-tax relief for the tax paid by the 'shell' entity).

The entity will continue to be tax resident in the respective Member State and therefore it will have to pay the tax due on the income (if any).

No right to tax the payment.

Step 6: Consequences (contd.)



Not bound by the Directive.

However, it may provide a double-tax relief for the WHT paid in the jurisdiction of the payer, if there is a DTT in place with the said jurisdiction.

The entity will continue to be tax resident in the respective Member State and therefore it will have to pay the tax due on the income (if any).

Will apply WHT based on the DTT in place with the Third Country Shareholder jurisdiction **or** based on local legislation if there is no DTT in place.

Proposed EU Directive on Shell Companies

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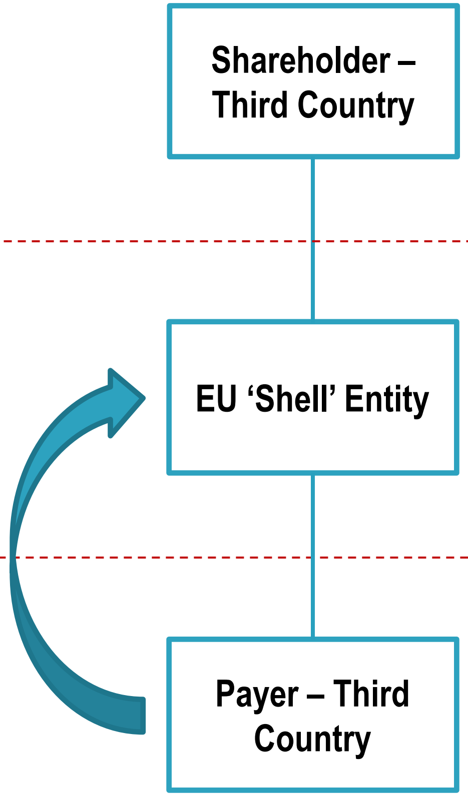
Step 6: Consequences (contd.)



Not bound by the Directive.

However, it may provide a double-tax relief for the WHT paid in the jurisdiction of the payer, if there is a DTT in place with the said jurisdiction.

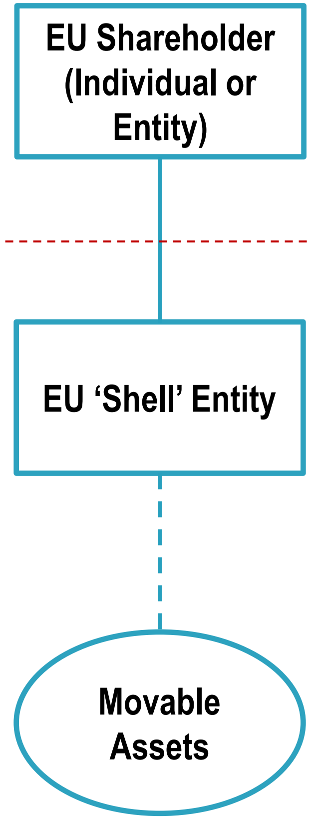
The entity will continue to be tax resident in the respective Member State and therefore it will have to pay the tax due on the income (if any).

Not bound by the Directive.

However, it may apply domestic tax on the payment **or** WHT based on the DTT in place with the Third Country Shareholder jurisdiction, if it wishes to look-through the EU 'shell' entity.

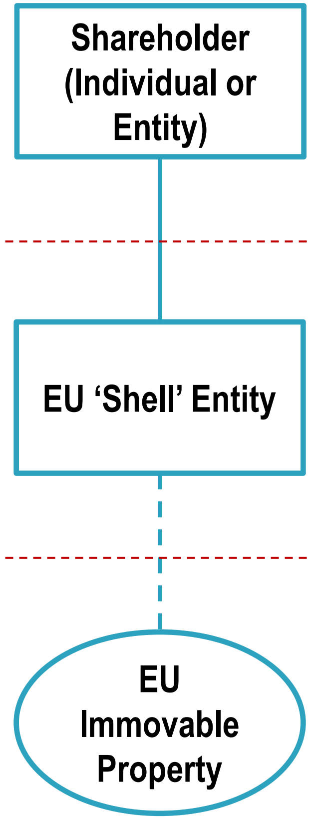
Proposed EU Directive on Shell Companies

Step 6: Consequences (contd.)



Shall tax the property (i.e. assets) in accordance with local legislation, as if it owned the property directly (without prejudice to any DTT in force with the jurisdiction where the property is situated).

Step 6: Consequences (contd.)



Shall tax the immovable property in accordance with local legislation, as if it was owned directly by the shareholder (without prejudice to any DTT in force with the jurisdiction of the shareholder).

Proposed EU Directive on Shell Companies

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Step 7: Exchange of information with EU Member States

- The Directive proposes that all Member States shall have access to information on EU 'shell' entities at any time, without the need to request such information.
- The information will be exchanged by the Member States from **step 1** (i.e. Gateway test), even in the cases where the entity meets the required indicators included in step 2.
- In addition to the information that will be exchanged for step 1, the Member States will also need to exchange information for **steps 4 and 5** (i.e. rebuttal of presumption or exemption from the obligations of the Directive). This will ensure that the Member States are aware of the discretion exercised and the reasons behind each assessment in a timely manner.
- Member States will be able to request the Member State of the undertaking to perform **tax audits** where they have grounds to suspect that the undertaking might be lacking minimal substance for the purposes of the Directive.
- The information will be exchanged automatically through a **central directory within 30 days** from the time that the tax authorities of each Member State has such information. This means:
  - Within 30 days from receiving the tax return.
  - Within 30 days from certifying that an undertaking has rebutted the presumption for lack of minimum substance or from when an exemption is granted.
  - Within 30 days from the conclusion of an audit to an undertaking at risk, if the outcome of such audit has an impact on the information already exchanged or that should have been exchanged for the undertaking.

Proposed EU Directive on Shell Companies

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Step 7: Exchange of information with EU Member States (contd.)

The information to be exchanged for each undertaking shall include the following:

- TIN and VAT number (if available).
- Identification shareholders and beneficial owner(s).
- Identification of other Member States likely to be concerned by the reporting.
- Identification of any person in other Member States likely to be affected by the reporting.
- The declaration provided by the undertaking to the tax authorities in accordance with step 2.
- A summary of evidence provided by the undertaking to the tax authorities in accordance with step 2.
- Certification that the undertaking has rebutted the presumption or is exempt from reporting (if applicable) and associated evidence considered.
- Audit report in case an audit was conducted.

The penalties for non-compliance will be at the discretion of each Member State but the proposed Directive provides that the penalties shall include at a minimum an administrative pecuniary sanction of at least 5% of the undertaking's turnover.

Proposed EU Directive on Shell Companies

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Key issues

- Increased administrative burden for the tax authorities, the taxpayers and the tax advisors.
- Substance of associated/group entities not taken into consideration → the substance test should ideally be performed at a group level.
- ‘Discrimination’ against EU entities (i.e. the draft Directive does not capture shell entities located in third countries) → this may have a negative impact on the competitiveness of EU and it may benefit other non-EU jurisdictions (i.e. UK, Singapore, UAE etc.).
- The lack of definitions and the broad coverage of the draft Directive are likely to give rise to interpretational issues (i.e. ‘grey areas’).
- There are only a few exemptions and only one de-minimis threshold (i.e. the valuable assets held for private purposes which are subject to the threshold of €1m).

Thank you.

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