

INFORMATION SHEET 9

Title:	Substance		
Authored:	April 2015	Updated:	August 2019
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Reference:	Double Tax Treaty Benefits		

Introduction

Cyprus maybe renowned for its gorgeous weather and beaches but it is better known in the international business arena for its highly attractive tax and corporate regime.

The island enjoys one of the lowest corporate tax rates in Europe at 12.5% and offers significant tax advantages to companies that choose to structure their holdings via a Cyprus corporate vehicle.

Cyprus maintains an extensive and highly attractive Double Tax Treaty (DTT) network around the world and access to the provisions of relevant EU directives. It also maintains a very competitive tax regime for dividends, gains from the sale of shares and margins on back-to-back loans and much more. It also features an outstanding Trust and Funds regime and Intellectual Property (IP) box as well as practically no withholding taxes on payments to non-Cypriot residents.

Double taxation benefits

In the past, most Cyprus companies could successfully claim double taxation benefits under the relevant DTT just by the fact that they were incorporated in Cyprus. In practice, the Cyprus company would simply apply for a tax residence certificate from the Cyprus Tax Authorities which they would then present to the foreign tax authority.

Based on this tax residence certificate, the foreign tax authority would allow the Cyprus company to claim DTT benefits on receipt of dividends/interest/royalties from the foreign entity, typically restricted to the favourable withholding tax rates stipulated within the relevant DTT.

The above was applicable to certain foreign tax jurisdictions, such as Greece and Russia, which had not introduced the concepts of 'management and control' and 'substance' within their tax legislations.



Substance requirements

Other relatively more sophisticated tax jurisdictions, such as the United Kingdom, Switzerland and Austria, already had substance requirements as a pre-requisite to allowing Cyprus companies to claim treaty benefits. Therefore, for the tax authorities in such jurisdictions, which also have DTTs with Cyprus (the Swiss DTT is currently pending ratification by Switzerland), the mere fact that a company is incorporated in Cyprus does not mean that this company is automatically entitled to claim the favourable provisions of the relevant DTT.

Over the past 2-3 years, the pressure on foreign tax authorities to find ways to increase their tax revenue and the global drive for increased transparency and exchange of information amongst tax jurisdictions have meant that most tax jurisdictions, including Greece and Russia, are becoming more sophisticated in their approach when it comes to the treatment of dividends/interest/royalties and generally expenses that are paid to companies in other tax jurisdictions.


Even jurisdictions that had implemented minimal substance requirements are becoming stricter. As part of this development, the mere fact that a company is incorporated in Cyprus and pays taxes in Cyprus on its worldwide income (and therefore able to obtain a Tax Residence Certificate from the Cyprus Tax Authorities) is no longer sufficient for a business to guarantee that a Cyprus company can access the full treaty benefits offered through the expanding and favorable DTT network that Cyprus has to offer.


Most tax jurisdictions will now examine whether the Cyprus company claiming tax benefits has substance, and is not just a shell company set up merely for tax purposes.

What is substance?

The starting point in analyzing substance requirements and by far the most important is the make-up/composition of the management of the company, which is typically reflected within the Board of Directors. The appointment of directors requires thorough planning to ensure that the aforementioned risks are addressed. Physical presence of the directors of a company claiming to be Cyprus tax resident, as well as evidence of the major decisions been taken in Cyprus, would serve as a prima-facie safeguard against future challenges.

In determining whether the effective management and control of a company is indeed within a specific country, a tax administration, including the Commissioner of Taxation or court (depending of course on the specific case and the nature of the business of the company in question), would in general consider the following:

- Do the directors possess the appropriate knowledge and the necessary academic qualifications in order to act in their capacity as directors and to take the necessary decisions?
 - Do the directors in fact take those decisions, or do they simply act on behalf or based on the instructions of a third party?
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Deficiencies with respect to the above conditions may result in potential challenges by a foreign tax authority on the grounds that the directors in question were merely acting as “nominee” directors while the actual decisions were made by a third party i.e. the ultimate beneficial owner.

Considering the nature of the business in a case by case separately, we set out hereunder our recommended best practices in empowering substance in Cyprus:

- a) The composition of the Board of Directors should be carefully considered. Having a majority of Cyprus tax resident directors or a dominant Cyprus tax resident director strengthens the company’s substance in Cyprus and, therefore, it may be deemed to be considered a Cyprus tax resident. Having a majority of foreign directors weakens the company’s substance provided that there is no dominant director but may raise challenges by a foreign tax authority.
- b) The company’s directors should possess sufficient technical knowledge and competence to manage the company’s business independently, while their remuneration should correspond to their duties and the scale of the business.

Where technical competence is lacking, the directors could seek (preferably independent) expert assistance. It is acceptable for directors to outsource certain of the duties and to receive specialist advice for decisions. The final decision however should be taken by the directors themselves and appear in the board minutes as such.

- c) Maintaining appropriate documentary evidence, particularly board minutes, is crucial. If a decision is actually made at a board meeting, preferable in Cyprus, then the minutes should evidence that, as well as all relevant facts surrounding the decision. This can help to demonstrate that the decision was actually taken at the meeting held in Cyprus. If a decision was not in reality taken during a board meeting, then any documentary evidence as to who made the decision and where, will again be an important indicator.
 - d) Material decisions should be made, and be seen to be made, by the board as a whole, while unilateral decisions on significant matters should be avoided.
 - e) All major decisions, negotiations and contracts (as well as any preparatory work) should be documented within the minutes of the board meetings, which ideally should be held in Cyprus while full documentation supporting the minutes should be kept on file. Minutes should also be kept for all material matters discussed by the directors.
 - f) Board meetings should be held regularly and at frequent intervals within Cyprus, to establish that the board is operating effectively to manage and control the business. All foreign directors attending the board meetings in Cyprus should retain evidence of their travel, i.e. electronic tickets, boarding passes, hotels, etc.
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- g) Board meetings should be held in Cyprus and preferably not at airports or hotels, but at the permanent premises (if any) of the company.
 - h) It is important that all communications relating to the foreign company should be in terms of giving information about, rather than asking approval for decisions to be taken. While it is acceptable for the directors to request general advice or guidance, they should not receive specific instructions or orders pertaining to the conduct of the company.


In addition to the above, the more practical and the most important aspects in terms of substance, the legal formalities of the company (i.e. the constitution and bylaws governing the company), should also be considered as they may in certain cases serve as secondary evidence of the intention of the parties involved. To this respect, it is important that the above (i.e. vesting all power of management in the board of directors, requiring that all board meetings are held in Cyprus, etc.) are also reflected in the company's constitution/bylaws.

Some other important factors/recommendations that should be considered are:

- a) Establish separate fully-fledged offices in Cyprus. This may also be in a form of leasing/renting different office spaces within a service provider's business premises. The company's letterheads, brochures, websites should include the local address and telephone numbers and not foreign details.
- b) Accounting function should be performed within Cyprus, while books and records of the company should be kept in Cyprus.
- c) Comply with all legal and regulatory requirements in Cyprus and ensure that all statutory filings, i.e. VAT, tax, social insurance filings as well as payments, are up to date.
- d) Ensure that the company's bank accounts (local or foreign) are controlled by Cyprus resident directors/managers (i.e. bank signatories should be based in Cyprus). This is not a key requirement but it does help with substance in the event of enquiries.
- e) The company must not use foreign addresses or telephone numbers in any of their business i.e. website, letterheads, brochures, loan agreements etc.
- f) There should be a dedicated phone and fax line in Cyprus, attended to by non-Cyprus residents (preferably by the company's employees and/or directors).
- g) Hold annual general meetings in Cyprus.

The above, although not exhaustive, are some of the factors that may assist in creating and defending the substance of companies established in a low tax jurisdiction.

It is important to note that foreign tax authorities do not only examine whether a Cyprus company has substance *in Cyprus* and exercises effective management and control from Cyprus. They go beyond that and also consider the following:



- Commercial justification for including a Cyprus entity in the structure, and whether the entity operates as an independent business unit;
- Whether the Cyprus entity has economic substance, such as ownership of sufficient tangible and intangible assets, personnel and offices, and whether it incurs a material amount of expenses to maintain its operations, etc.
- Evidence that the Cyprus company receiving the income does not pass on the income to another nonresident company
- Ability of the Cyprus company's officers to exercise power and authority with respect to the use and disposal of the income received from overseas
- Level of business activities and entrepreneurial risks assumed
- The actual cash flow, which is understood to mean the absence of any transit of funds to a third party

Setting up fully fledged offices in Cyprus

As a result of the above, the international business industry in Cyprus is now being transformed. Many companies that are Cyprus tax residents but may have had their operations based abroad are now relocating their operations to Cyprus. At the same time, they are closing down any presence they may have in foreign jurisdictions. Smaller companies that do not require full-time employees are hiring locally part-time employees or managers to take care of the company's day-to-day affairs.

As part of the above changes, there is now an increase in demand for office space, especially fully serviced offices, as well as legal, tax, immigration and advisory services for companies relocating their operations to Cyprus.

NOTE

The information in this document is intended as a guide only and every reasonable effort was made to ensure the accuracy and timeliness of the information. In no circumstances shall we be legally bound by any information contained in this document, and shall accept no liability in respect of loss caused by reliance on such information.

Our own in-house consultants and our network of associates in Cyprus and worldwide are at your disposal to assist you with the above.