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RELEVANT TO ACCA QUALIFICATION PAPER P6 (CYP)

Understanding the four-year rule for dividends between Cyprus tax resident companies

Following a number of amendments to Cyprus tax legislation, there have been significant changes to the *Study Guide*. The amendments to legislation are a result of measures to combat tax evasion and to increase government revenue, as well as new incentives to make the tax system more attractive. In a previous article, 'Amendments to the Paper P6 (CYP) syllabus', I listed the main changes and gave a brief description of each. In certain cases, I stated that a technical article will be issued to help explain the change.

This is the fourth, and final, article in a series written for this purpose, and expands on point B(2) of the aforementioned article. It explains the tax treatment of the four year rule which, when applied, does not allow for the exemption from the imposition of special defence contribution (SDC) on dividends between Cyprus tax-resident companies. In order to appreciate the application of this legislative change, a wider understanding of certain provisions of the SDC legislation, including the deemed distribution rules, is required. Candidates will be expected to be familiar with the provisions stated within this technical article.

Explanation of the legislation before the change

Under the deemed distribution rules, a Cyprus company should declare as dividends at least 70% of its after-tax accounting profits within two years from the end the tax year in which those profits arose. If the company fails to do this, to the extent that such dividends were not declared, then the company will be deemed, for tax purposes, to have declared such dividends, and the withholding tax rate of 20% (17% from 1 January 2014) will apply to such dividends (the 'deemed distribution rules').

The deemed distribution rules, however, do not apply when the direct shareholder is a non-Cyprus tax-resident physical or legal persons. They also do not apply when the ultimate shareholder, who indirectly owns the shares through other Cyprus tax resident companies, is not Cyprus tax-resident (see Example 4 below).

In the case that the shareholder is a Cyprus tax-resident physical person, then the deemed distribution rules always apply. They also apply if such shareholding is indirect. Given that actual dividends between Cyprus companies are exempt from the imposition of SDC withholding tax, then a situation may arise where the deemed distribution rules create taxation, whereas if actual dividends had been distributed, the company-to-company exemption would apply and no tax would arise.

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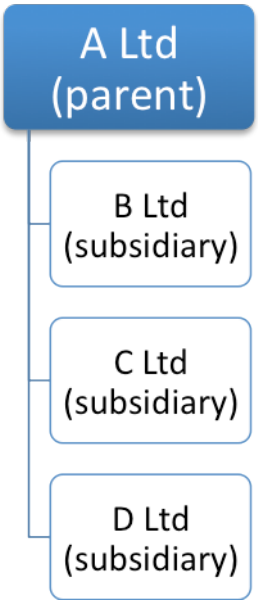
As such care should be taken over the deemed distribution rules in the event that there are two or more Cyprus tax resident companies in a vertical structure, with the ultimate shareholder being a Cyprus tax-resident individual. However, where an actual dividend is issued, so that the deemed distribution rules do not apply, then each holding company in a vertical structure can delay the imposition of any SDC by up to two years. Thus if, for example, there were three holding companies between the Cyprus tax-resident physical shareholder and the trading entity that generates profits, so long as the deemed distribution rules do not apply, then the tax payer could delay the imposition of SDC, by up to two years for each holding company. This 'window' of tax planning is what the change of legislation addresses.

Understanding the change in the legislation
As stated previously, a Cyprus tax-resident company is exempt from SDC with regards to any dividends it receives from another Cyprus-tax resident company.

As of 1 January 2012, the above exemption does not apply to any dividends received **indirectly**, if four years have passed from the end of the year in which the profits arose, out of which those dividends were declared.

Application of the legislation
The above measure does not apply in the case that the beneficial owner of the company is not a Cyprus tax-resident person.

The above measure applies to any profits that arise from 1 January 2012 onwards.



Any dividend declared from income that is derived either directly or indirectly from dividends on which SDC was imposed, is exempt from any further SDC.

Examples

Example 1
Company A Ltd owns 100% of the share capital of company B Ltd, which in turn owns 100% of the share capital of company C Ltd, which in turn owns 100% of the share capital of company D Ltd. Companies A Ltd, B Ltd and C Ltd have no other activity other than the holding of shares. All companies are Cyprus tax-resident.

The shareholder of A Ltd is a Cyprus tax-resident, physical person.

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Company D Ltd makes after-tax accounting profits in the year 2012 of €1.000. On 31 December 2014, D Ltd declares an actual dividend to C Ltd, equal to 70% of its accounting profit.

On 31 December 2016, C Ltd declares an actual dividend to B Ltd, equal to 70% of its accounting profit.

On 31 December 2018, B Ltd declares an actual dividend to A Ltd, equal to 70% of its accounting profit.

On 31 December 2020, A Ltd declares an actual dividend equal to 70% of its accounting profit.

Tax treatment:
In all cases, the dividend is exempt from corporation tax. However, it should be investigated whether it is taxable under SDC, especially given the 2012 change in legislation. This is achieved by examining in each instance whether, firstly, the exemption for dividends between Cyprus companies applies, and secondly whether the deemed distribution rules apply.

31 December 2014: D Ltd declares a dividend to C Ltd, equal to €1.000 x 70% = €700. The dividend is not subject to SDC given that this is an actual dividend between two Cyprus tax-resident companies, within two years from the date that the profit is made. Thus, the exemption for dividends between Cyprus companies applies, and the deemed distribution rules do not apply.

31 December 2016: C Ltd declares a dividend to B Ltd, equal to €700 x 70% = €490. The dividend is not subject to SDC given that:

- it is an actual dividend between two Cyprus tax-resident companies
- the dividend is given within four years from the end of the year in which the profits arose (which was 2012), out of which the dividend was derived, (thus the exemption applies), and
- C Ltd declares 70% of its dividend income received from D Ltd, within two years from the end of the year in which it receives the dividend (thus the deemed distribution rules do not apply).

31 December 2018: B Ltd declares a dividend to A Ltd, equal to €490 x 70% = €343. In this case, B Ltd should withhold, and pay to the Income Tax Office (ITO), SDC at a rate of 17% (given that the 20% rate is valid only until 31 December 2013) – that is to say it will withhold €343 x 17% = €58,31. The net dividend that A Ltd will receive will thus be €284,69. The reason SDC applies is that A Ltd receives indirectly a dividend for which four years have passed, from the end of the year in which the profits arose (being 2012), out of which the dividend was derived – this is the application of the new legislative change. Had

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the amendment in the legislation not been made, no SDC would arise on this dividend.

31 December 2020: A Ltd declares a dividend to its shareholder, amounting to €284,69 x 70% = €199,28. No SDC arises on this dividend given that it derives indirectly from a dividend, which has been subject to SDC already (being the dividend from B Ltd to A Ltd).

Example 2
As per Example 1, except that D Ltd declares a dividend to C Ltd, equal to 70% of its accounting profits, on 31 December 2015 instead of on 31 December 2014.

Tax treatment:
31 December 2014: D Ltd has not given an actual dividend within two years from the end of the year in which its profits arose. As such, the deemed distribution rules apply. Company D is deemed, for tax purposes, to give a dividend equal to 70% of its after-tax accounting profits – ie €1.000 x 70% = €700. This deemed distribution is subject to SDC and D Ltd will have to pay €700 x 17% = €119. This is only for the purposes of the tax declaration. There will be no journal entry for dividend in the accounting records of the company given that no actual dividend has been declared.

It is worth noting that had an actual dividend been declared on 31 December 2014, it would not have been subject to SDC, as shown in Example 1 above.

31 December 2015: D Ltd declares a dividend to C Ltd. No SDC applies to this dividend given that it has already been taxed under the deemed distribution rules. The amount that C Ltd will receive will be €700 – €119 = €581.

31 December 2016: C Ltd declares a dividend to B Ltd amounting to €581 x 70% = €406,70. No SDC applies to this dividend given that it is derived directly from a dividend on which SDC has been imposed.

31 December 2018: B Ltd declares a dividend to A Ltd amounting to €406,70 x 70% = €284,69. No SDC applies to this dividend given that it is derived indirectly from a dividend on which SDC has been imposed.

31 December 2020: A Ltd declares a dividend to its shareholder amounting to €284,69 x 70% = €199,28. No SDC applies to this dividend given that it is derived indirectly from a dividend on which SDC has been imposed.

It is worth noting that the amount that the final shareholder will receive on 31 December 2010 is the same under both Examples 1 and 2. The deemed

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distribution rules resulted in a faster SDC obligation arising, being on 31 December 2014 instead of 31 December 2018.

The SDC that was paid under Example 2 is greater than that in Example 1. The reason is that each company in the example declares 70% of its after-tax accounting profit, and as such, in Example 2, SDC was applied at D Ltd's level, for which the gross dividend amount declared was largest.

Example 3
As per Example 1, in addition, on 31 December 2022, D Ltd declares an actual dividend of the remaining undistributed profits from 2012. On the same day, C Ltd declares the same as a dividend to B Ltd, which in turn declares it as a dividend to A Ltd, which in turn declares it as a dividend to its sharehdoler.

Tax treatment:
31 December 2022: D Ltd declares the remaining undistributed 2012 profits as a dividend to C Ltd. This amounts to €1.000 – €700 (which were declared as a dividend on 31 December 2014) = €300.

No SDC applies to the dividend. This is because even though four years have passed from the year in which the profits arose, the exemption for dividends between Cyprus tax-resident companies still applies, given that the dividend was received **directly** from the profits which gave rise to those dividends and not indirectly. D Ltd is the one that made the profits from which the dividend was declared, and it is itself declaring the dividend (directly) to C Ltd.

31 December 2022: C Ltd declares a dividend to B Ltd amounting to €300 which it received from D Ltd.

C Ltd should withhold and pay to the ITO, SDC at the rate of 17% – ie withhold and pay €300 x 17% = €51. The dividend that B will receive will thus be €249. The reason that SDC applies is that B Ltd is receiving indirectly a dividend, for which four years have passed, from the end of the year in which the profits that gave rise to that dividend were made (being 2012). Here we can see the application of the new exception to the SDC exemption rule.

31 December 2022: B Ltd declares a dividend to A Ltd being the €249 it received from C Ltd. A Ltd declares the same amount to its shareholder. In both cases, no SDC applies given that the dividend is derived directly and indirectly from a dividend that has already been subjected to SDC.

Example 4
As per Example 1, except that A Ltd's shareholder is not a Cyprus tax-resident person.

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In this case, no SDC will apply to any dividend declared in the structure. In addition, the deemed distribution rules are also not applicable.

Written by a member of the Paper P6 examining team

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