

## SPECIMEN QUESTION 1 (SECTION A)

Assume that today's date is 3 January 2007.

Duncan, an Irishman aged 55, has lived in London for many years. He has recently visited your office.

During your meeting with Duncan, you ascertained the following:

1. In April 2006 Duncan took up residence in Cyprus with his wife. He plans to live with his wife in Cyprus for a number of years. Duncan and his wife do not have any children.
2. Duncan's wife has no property in her own name. Her only income is from a trust set up by her late parents in London. Annual income from the trust is circa £22,000 and income tax of circa £4,000 is deducted at source by the trustee.
3. Duncan is the owner of the following capital assets :-

Description	Acquisition cost (£)	Acquisition date	Year of construction	Cost of construction (£)
Freehold shop in London	250,000	March 1983	1959	30,000
House in London as main residence	95,000	August 1980	1947	15,000
House in Ireland – inherited from his father	N/A	July 1984	1908	N/A
House in Nicosia				
- land	60,000	May 2006	N/A	N/A
- building	250,000	May 2006	2005	250,000
Shares on the London Stock Exchange	800,000	1979 to 2005	N/A	N/A
Land in Pomos village	360,000	May 2006	N/A	N/A

4. Duncan is a higher rate income tax payer.

5. Duncan is planning to sell all his capital assets in the UK and invest most of his money in immovable property in Cyprus, during the year 2007, as follows:

- (i) Develop the Pomos land into eight villas. The cost of construction is estimated at £600,000 (VAT exclusive). Four of the villas will be sold at an estimated price of

£200,000 (VAT exclusive) each and the rest will be rented out at an estimated annual rental of £9,600 each. All the villas will be of the same area and market value. You may assume that this piece of land may be divided into eight independent land plots before its development into villas.

- (ii) Acquire an industrial plot of land in the Dali industrial zone for £500,000. This will be leased out on a 21-year lease at an annual rental of £30,000. The lessee will build a factory on this land at his/her own cost. The cost of construction is estimated at £200,000 (VAT exclusive) (which is equal to the value of the owner's benefit) and at the end of the lease period, legal ownership and the right of occupancy of the building will belong to the landowner for no further consideration.
- (iii) Acquire three adjacent plots of agricultural land in Ayios Theodoros village for £1,000,000. This land is expected to be converted into a tourist zone property within the next ten years. Duncan expects that within this ten year period, he will be able to sell all three plots to a single investor involved in the tourist industry in Cyprus, at a price of £2,500,000.
- (iv) Acquire a plot of land in the Oroklini tourist area for £550,000. The price includes £50,000 for the goodwill of planning permission for thirty-two tourist apartments. Duncan is to develop the land at an estimated cost of £1,800,000 (VAT exclusive) and engage in the business of renting out apartments himself. He will obtain a bank loan for seven years for the purposes of the construction, at an annual interest rate of 7.75%. Duncan estimates that the annual profit, after bank loan interest but before tax, from running this business will be £50,000 (net of capital allowances) on average. He anticipates that he will sell the business as a going concern after seven years at a price of £3,200,000 (comprising £200,000 for trading goodwill, £2,900,000 for the premises and £100,000 for net current assets).
- (v) Demolish his house in Ireland and employ a local contractor to erect on his behalf, a block of six flats. Duncan estimates that the cost of construction will be £300,000 (VAT exclusive). Three of the flats will be sold for £130,000 (VAT exclusive) each, and the other three flats will be rented out at an annual rental of £12,000 each. The house in Ireland is currently unoccupied.

For the purposes of answering this question you should assume that Irish tax law is in principle the same as Cyprus tax law with respect to income, capital gains and value added tax.

**Required:**

**Write a letter to Duncan advising him on the following:**

**(a) (i) The income and/or capital gains tax and special defence contribution implications in respect of the five activities ((i) to (iv)) described above, if they are each undertaken in Duncan's own name. (10 marks)**

**(ii) Whether or not tax savings can be made in respect of the five activities by structuring them in a different way. Your answer should include relevant computations of the tax payable and/or tax savings achievable in each case. (16 marks)**

Note: You may assume that the annual increase of the retail price index (RPI) is 4%, ignoring the effect of compounding.

**(b) The value added tax (VAT) implications in respect of each of the five activities ((i) to (v)) described above. (5 marks)**

**(c) Whether or not it would be possible to reduce Duncan's/the buyers' exposure to VAT and the buyers' exposure to land transfer fees, in respect of the Pomos development (activity (i) above). Your answer should include an illustration of the savings that might be made and give details of any anti-avoidance regulations that might need to be considered. (7 marks)**

**Additional marks will be awarded for the appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)**

**(40 marks)**

## ANSWER TO SPECIMEN QUESTION 1

DUNCAN

A N Accountant  
Nicosia  
Cyprus

4 January 2007

Mr Duncan X  
Nicosia  
Cyprus

Dear Duncan

### **Re: Your proposed business and investment transactions**

Further to our recent meeting regarding the above, I have set out below explanations of the various tax issues affecting the five proposed activities.

#### **(a) (i) Income/capital gains/special defence contribution implications if the transactions are undertaken in your own name.**

##### 1. Pomos village development

The profit on the sale of the four villas of £320,000 ((£200,000 x 4) - (£360,000 + 600,000) x 1/2) will be subject to income tax, as this is a trading activity.

The annual rental of £38,400 (4 x £9,600, less 20%) less capital allowances on the construction cost) will be subject to income tax, and the gross rental, less 25% will also be subject to special defence contribution at 3%

##### 2. Dali industrial land

The annual rental of £30,000 will be subject to income tax. The 20% deduction is not given against land rental income. The annual rental of £30,000, less 25% will also be subject to special defence contribution at 3%.

You will also have an assessable benefit spread evenly over the lease period due to the construction of the factory, as ownership of the building will come to you at the end of the lease period. This annual assessable benefit, which is deemed as income will be £200,000/21 years less capital allowances based on the benefit of £200,000, but this will not be subject to special defence contribution. The 20% deduction is not allowed in this case as this sum is not considered as rental income [*Income tax circular 2007/3 dated 19/01/2007*]

#### 3 Plots in Ayios Theodoros

This transaction if taken in isolation could be considered of a capital nature (although transactions in isolation may be assessed as of a trading nature) and the expected gain of £2,500,000 less the indexed cost, will be subject to capital gains tax.

However, considering all of your other transactions in immovable property in Cyprus, the possibility that the Commissioner will deem this transaction as one of a trading nature increases dramatically. The profit (without indexation) is, therefore, likely to be assessed to income tax.

#### 4. Land in Oroklini

This is clearly a trading activity. The £50,000 annual profits will be subject to income tax. In the year of sale, the trading goodwill of £200,000 will also be subject to income tax.

The gain on the sale of the business premises after taking into account the effect of seven years of capital allowances at 3% and indexation, will be subject to capital gains tax, as this is clearly a capital transaction.

#### 5. House in Ireland

As you are a resident of Cyprus, you are taxed on your worldwide income in Cyprus. Thus, the profit from the sale of the three flats, which is of a trading nature, will be subject to income tax in Cyprus on £240,000 (£130,000 x 3 - £300,000/2) less the original cost of acquisition of the house to Duncan's father. The annual rental income from the other three flats of £36,000 (3 x £12,000) less 20%, less capital allowances will also be subject to income tax in Cyprus. The gross rental income, less 25%, will also be subject to special defence contribution of 3%.

Both the profit from the sale and the rents will most probably also be taxed in

Ireland as it is income arising from immovables situated in Ireland. However, any tax paid in Ireland will be credited against the income tax payable in Cyprus and in the case of the rents, the special defence contribution.

**(a) (ii) Potential tax savings available**

You are a higher rate taxpayer (i.e. taxed at 30%) and so is your wife, because of the trust income of £22,000. There is therefore no valid tax reason for you to register any part of your property in your wife's name.

You should, however, consider using a limited company(ies) for those planned transactions, which are classed as of a trading nature, as the effective tax rate of a company is 19.45% (10% corporation tax plus 9.45% special defence contribution on deemed distributions of 70% of after tax accounting profits (70% x 90% x 15%)).

If a company is used for the Pomos development, instead of the development being undertaken in your own name, the tax saving on the sale of the villas will be £33,760 (w1). In addition, there will be an annual tax saving of £798 (w1) on the rental income

Similarly, in the case of the land in Dali, an annual tax saving of £3,326 (w2) can be obtained.

In the case of Ayios Theodoros, if the gain is assessed to capital gains tax it is distinctly more advantageous to undertake the transaction in your own name, and not in the name of a company, as this will result in tax savings of £159,500 (w3). Additionally, if this transaction is the only transaction of the company, then the whole of the after tax profits of the company will be subject to special defence contribution at 15% resulting in a further £67,500 (£1,500,000 x 30% at 15%) being payable in this case

However, as stated above, the possibility of the gain being treated as trading income is considerably higher than of it being treated as a capital gain. Therefore, I advise that you use a limited company in this case also, as this will give you a tax advantage of between 6.5% (30% - 23.5%) and 11.55% (30% - 19.45%) on the profit (without indexation in this situation) of £1.5 million.

The Oroklini project should also be carried out in the name of a company, instead of in your own name, as this gives a total tax advantage of £26,225. (w4)

It should further be noted that if instead of the company selling its business and premises, the company's shares are transferred to the buyer, additional tax savings can be obtained in terms of the trading goodwill not being taxed (as there is no profit on the sale of goodwill by a company (tax effect of £20,000 (w4)); and there will not be any special defence contribution at 15% on the distribution of the last five years' undistributed profits (tax effect £41,250 (w4)), as the company will not be wound up.

Nor will there be special defence contribution at 15% on the accounting profits created by the capital gains due to the transfer of the business premises (tax saving of £36,450 (w5)).

It will, therefore, pay you to carry out this project in the name of a separate company, whose shares will be sold on the expiration of seven years as you anticipate.

In conclusion, out of the four transactions involving Cyprus, transactions 1, 2 and 3 could be undertaken in the name of a single company and transaction 4 should be undertaken in the name of a separate company.

With regards to the Irish transaction, the Cyprus tax considerations are exactly the same as for transaction 1 (Pomos development). However, as we do not have specific knowledge of the Irish tax system or tax rates, it is not possible to give you any definite advice in this case and further advice should be sought from an Irish tax consultant.

**(b) Value added tax (VAT) implications of the transactions**

The VAT position in respect of the five transactions if carried out as proposed will be as follows:

The activity of developing and selling the four Pomos villas will be within the scope of VAT, and be taxed at the standard rate of 15%. Input VAT on the cost of construction will be deductible from the output VAT imposed on the sales of the villas.

Rental income is generally exempt from VAT and this exemption will apply to the rental income from both the Pomos and Dali properties.

The VAT incurred on the construction of the Dali industrial building will still constitute valid input VAT, which will be available for deduction from the output VAT of the lessee.

The Ayios Theodoros disposal is a transaction in land, which is also currently exempt from VAT.

The Oroklini project involves the generation of rental income from tourist apartments. Such income is considered to be income from the carrying on of a business, and so will be within the scope of VAT, but is taxed at the reduced rate of 8%. The subsequent sale of this business as a going concern, will, however be an exempt transaction for VAT purposes.

The project in Ireland is essentially identical to the Pomos project, so if the VAT law applicable in Ireland in relation to transactions in land is in principle the same as Cypriot VAT law, the VAT implications will be exactly the same as stated above for the Pomos project, but at the applicable Irish VAT rates. However, again I would advise you to obtain further advice from an Irish VAT consultant.

**(c) Possibility of reducing your/the buyers' exposure to VAT and land transfer fees with regards to the Pomos project.**

As previously stated, VAT will be imposed on the gross sales value of the villas. Land transfer fees will also be charged on this gross value.

However, as it is possible to split the land into eight plots before development commences, and if you can both sell the land to the buyer(s) at its market value and contract with the land buyer(s) to construct a villa for him/her, then VAT could be avoided, as the transaction would then constitute a sale of land, which as stated above is currently exempt from VAT. Further, in this case, the land transfer fees will only be assessable on the value of the land, instead of on the value of the property as a whole once the villas are finished.

The benefit which might be obtained can be illustrated as follows:

Assuming that the value of each plot of land when you come to sell it, will be £60,000, the VAT 'saving' per villa will be £21,000 (£140,000 at 15%) and the 'saving' per villa in terms of land transfer fees will be £12,400 ((£230,000 -

100,000) at 8% + (£100,000 - 60,000) at 5%). In other words, the buyer will pay £33,400 (£21,000 +12,400) less if the transaction is structured in this manner.

However, you should be aware that anti-avoidance rules apply in this area, and the VAT authorities may well deem the two transactions (of selling the land and undertaking the development) as a single connected transaction. The factors taken into account by the VAT authorities when examining such cases are the following:

- the timing of the contracts;
- the way of declaring the transactions at either the land registry office or the income tax office;
- the reason for the existence of separate contracts; and
- whether or not the development was undertaken by the same party as the party which sells the land.

It is, therefore, imperative that care should be taken to avoid contravening the above in order that the two transactions are not deemed by the VAT authorities as a single transaction.

I trust that I have addressed all tax issues arising from our recent meeting, but should you require any further information please do not hesitate to contact me.

Yours truly,

AN Accountant

## Workings re part (a)(ii)

### 1. Pomos Development

	£
Profit from the sale of villas (from part (a)(i))	<u>320,000</u>
Income tax on Duncan at 30%	96,000
Effective tax if a company is used at 19.45%	<u>(62,240)</u>
Tax saving if a company is used	<u>33,760</u>
Gross annual rental income (from part (a)(i))	<u>38,400</u>
If the villas are in Duncan's name	
Gross rents less 20%	30,720
Less: capital allowances (£600,000/2 at 3%)	<u>(9,000)</u>
Taxable income	<u>21,720</u>
Income tax at 30%	<u>6,516</u>
If the villas are in the name of a company	
Taxable income (£38,400 less £9,000)	<u>29,400</u>
Effective tax at 19.45%	<u>5,718</u>
Annual tax saving if a company is used	<u>798</u>

### 2. Land in Dali

	£
Annual rental income	30,000
Part of assessable benefit (200,000/21)	9,524
Less: capital allowances (£200,000 at 4%)	<u>(8,000)</u>
Taxable income	<u>31,524</u>
Duncan's income tax at 30%	9,457
Effective company tax at 19.45%	<u>(6,131)</u>
Annual tax saving if a company is used	3,326

### 3. Land in Ayios Theodoros (assuming assessed as a capital gain)

	£
<u>Capital gains on Duncan</u>	
Sales price	2,500,000
Less: indexed cost (£1,000,000 x 140% (4% x 10 years + 100%))	<u>(1,400,000)</u>
Capital gains	1,100,000

Less: lifetime exemption	(10,000)
Taxable capital gains	<u>1,090,000</u>
Capital gains tax at 20%	<u>218,000</u>
<u>Effective tax on a company</u>	
Capital gains tax (£1,100,000 at 20%)	<u>220,000</u>
Special defence contribution re: deemed distribution (£1,500,000 x 70% at 15%)	<u>157,500</u>
	<u>677,500</u>
Tax saving if in Duncan's name	159,500

#### 4. Oroklini apartments

	£
Annual business income	<u>50,000</u>
Duncan's income tax at 30%	15,000
Company's effective tax at 19.45%	(9,725)
Annual tax saving if a company is used	<u>5,275</u>
<u>Sale of business and premises after 7 years</u>	
<u>If in Duncan's name</u>	
Trading goodwill (£200,000 at 30%)	<u>60,000</u>
<u>If in company's name, business sold and company wound up</u>	
Trading goodwill £200,000 at 10% corporation tax	20,000
Special defence contribution on undistributed profits of last 5 years (5 years at 30% x £50,000 plus £200,000) at 15%	<u>41,250</u>
	61,250
less: annual tax savings (£5,275 x 7)	(36,925)
add: additional tax re: capital gain (w.5)	<u>9,450</u>
	<u>33,775</u>
Tax benefit of using a company	<u>26,225</u>

#### 5. Capital gain on the sale of the Oroklini apartments

Sales price	2,900,000
Less: indexed cost (£2,350,000 x 128% (4% x 7 years +100%))	(3,008,000)
less: capital allowances (£1,800,000 x 7 years at 3%)	<u>378,000</u>
Capital gains	<u>270,000</u>
Duncan's capital gains at 20%	<u>54,000</u>

Company's corporation tax at 10%	27,000
Special defence contribution on deemed distribution	
(£270,000 – 27,000) at 15%	<u>36,450</u>
Total company tax cost	<u>63,450</u>
Additional tax if in company's name	<u>9,450</u>

## MARKING SCHEME FOR ANSWER TO SPECIMEN QUESTION 1

### DUNCAN

	Marks
<b>(a) (i) Income/capital gains/SDC if undertaken in own name</b>	
1. Pomos villas	
Treatment of profit on sale	0.5
Treatment of annual rental (incl SDC)	1.5
2. Dali industrial land	
Treatment of annual rental (incl SDC)	1.0
Treatment of assessable benefit (incl SDC)	1.5
3. Plots in Ayios Theodoros	
Treatment of transaction as capital gain	0.5
Treatment of transaction as trading income, with reason	1.0
4. Land in Oroklini	
Treatment of trading profits	0.5
Treatment of the sale of goodwill	0.5
Treatment of the gain on the sale of the premises	1.0
5. House in Ireland	
Treatment of the profit on sale	0.5
Treatment of the rental income (incl SDC)	1.0
Availability of double tax relief	0.5
	<b>10.0</b>
<b>(a)(ii) Potential tax savings</b>	
General points:	
Identify wife as also a higher rate taxpayer, with consequence	1.0
Advise the use of a limited company/companies, with reason	1.0
1. Pomos villas	
Identify the tax saving on the sale using a company, including calculation	1.0
Identify the annual tax saving on the rental income using a company, including calculation	1.0
2. Dali industrial land	
Identify the annual tax saving on the rental income using a company, including calculation	1.0
3. Plots in Ayios Theodoros	
Recommend the use of own name if treated as a capital gain, including calculation of tax saving	2.0

Identify the additional SDC saving from using own name, including calculation	1.0
Recommend the use of a company if treated as trading income, including calculation of the tax saving	1.0
4. Land in Oroklini	
Identify the tax saving on the sale of the business by the company, including calculation	3.5
Identify the additional savings arising if the sale is of shares in the company	1.5
Recommend the use of a separate company re this transaction/conclude generally re use of companies for all Cyprus transactions	1.0
5. House in Ireland	
Identify the position as in principle as for the Pomos development	0.5
Advise obtaining further advice from an Irish tax consultant	0.5
	<b>16.0</b>
<b>(b) VAT implications</b>	
Treatment of the development of the Pomos villas	1.0
Treatment of the rents from the Pornos villas and the Dali industrial land	0.5
Position re the input VAT on the Dali industrial building	0.5
Treatment of the disposal of the plots in Ayios Theodoros	0.5
Treatment of the rents from the Oroklini apartments	1.0
Treatment of the sale of the Oroklini business	0.5
Identify the position re the project in Ireland as in principle as for the Pomos development	0.5
Advise obtaining further advice from an Irish VAT consultant	0.5
	<b>5.0</b>
<b>(c) Possibility of reducing VAT/land transfer fees</b>	
Current position re the treatment of the land transfer fees	0.5
Suggest splitting the transaction, including the consequences (VAT and transfer fees)	2.0
Illustration of the potential benefits	1.0
Identify the benefits as accruing to the buyer	0.5
Explain the anti-avoidance regulations/risk: basic principle	1.0
specific factors	2.0
	<b>7.0</b>
Presentation and format of the letter	1.0
Effectiveness of the communication	1.0
	<b>2.0</b>

TOTAL
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<b>40.0</b>
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## SPECIMEN QUESTION 2 (SECTION B)

Stepan, aged 32 is married and is currently residing in the Slovak Republic (a European Union (EU) member). He recently inherited a large sum of money and he has decided to proceed with investing this inheritance in the following investments:

- A 30% shareholding in a Hungarian company, which owns a hotel in Hungary.
- A 40% shareholding in a Chinese company, which will acquire a shipyard in China.
- A 50% shareholding in a company, which will lease an oil refinery in the Slovak Republic. It is not yet certain where the management and control of this company will be.

You also ascertain the following:

1. Investment 1 above, is considered long-term and is intended to provide a steady dividend income stream.
2. Investment 2 above, will be sold in five years time, realising a substantial gain. No or little dividends are expected from the Chinese company.
3. Investment 3 above, refers to a partnership with a Slovak resident. This company will undertake to refine crude oil mainly bought from ex-Soviet Union countries and charge for this service. It is expected, however, that the company's customers will pay in kind, i.e. in oil and oil products, which will then have to be sold, mainly outside the Slovak Republic to non-EU countries. Stepan will receive a salary as director from this company. Income from a permanent establishment in the Slovak Republic is taxed there.
4. The following tax rates apply:

Country	Withholding tax on dividends	Corporation tax	Capital gains tax
Cyprus	0% / 15% *	10%	20%
Slovak Republic	10%	19%	19%
China	10%	30%	30%
Hungary	10%	20%	25%

\* depending on whether the shareholder is a Cyprus resident or not

5. The Cyprus-China double tax treaty, provides that capital gains arising from the disposition of shares held by a Cyprus resident in a Chinese company will be taxed in

Cyprus, if the shareholding in the Chinese company does not exceed 25%; whereas if the shareholding exceeds 25%, the gains will be taxed in China. No such provision exists in the Slovak-China double tax treaty i.e. capital gains will be taxed in China irrespective of the percentage of shareholding.

6. Personal income tax rates in the Slovak Republic are considerably higher than the Cyprus personal income tax rates. The basic principle for determining the tax residence of individuals in the Slovak Republic is the same as for determining tax residence in Cyprus.
7. Foreign dividends received by a resident of the Slovak Republic form part of the taxpayers income and are, therefore, subject to personal income tax at the applicable personal income rates.

You recently had a meeting with Stepan at which he informed you of his intended investments and discussed with you the possibilities for the tax-efficient structuring of these three investments through the use of a Cyprus company(ies). He also indicated that he would be willing to take up residence, with his wife in Cyprus, if this would be beneficial to him. Stepan's wife, Natalia has no income sources and holds no investments.

**Required:**

**Based on information provided, write a letter to Stepan advising him on the following:**

**(a) Whether he should take up residence in Cyprus with his wife. (4 marks)**

**(b) If he were to do so, the best way to structure each of his intended investments. (15 marks)**

**Additional marks will be awarded for the appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)**

Note: You should ignore any value added tax (VAT) and social insurance issues.

**(21 marks)**

## ANSWER TO SPECIMEN QUESTION 2

STEPAN

AN Consultant  
Nicosia  
Cyprus

4 June 2007

Mr Stepan Z  
Bratislava  
Slovak Republic

Dear Stepan

**Re: International tax issues**

I refer to our recent meeting in Nicosia, during which you set out your intended investments and requested my advice on how to best structure them in order to minimise your overall tax liabilities.

Regarding your personal tax status, your income will comprise of dividends (investment 1), salary and dividends (investment 3) and capital gains (investment 2).

You are currently a tax resident of the Slovak Republic and you are taxed there on both your salary and dividends, whereas if you were a tax resident of Cyprus, you would only be taxed on your salary, as dividends are exempt from income tax in Cyprus, and only subject to special defence contribution (SDC) at 15%. Further, as personal income tax rates are higher in the Slovak Republic than in Cyprus, the tax payable on your salary will itself be lower here. In addition, as a Cyprus tax resident it is possible for you to avoid paying capital gains tax on your Chinese capital gains (see further below for a fuller analysis). I, therefore,

strongly recommend that you take up residence in Cyprus as soon as possible.

Assuming that you take my advice and become a Cyprus tax resident, I suggest that you should structure your proposed investments, as follows:

### Investment 1

If you acquire this investment in your own name, the dividends received will, as stated above, be exempt from income tax, but be subject to [SDC at 15%](#). The withholding tax of 10% levied in Hungary will, however, be credited against your SDC liability in Cyprus.

If you were to acquire this investment in the name of a Cyprus company, the Cyprus company will still incur the withholding tax of 10% in Hungary, but the dividends received will be corporation tax exempt in Cyprus. However, on payment of a dividend by the Cyprus company to yourself, SDC at 15% will have to be deducted at source. Therefore, the end result will be the same, so I would suggest that in this case you acquire the investment in your own name, and avoid the incorporation costs and annual running costs of a company.

### Investment 2

According to the Cyprus-China double tax treaty, capital gains arising in China on the sale of shares in a Chinese company held by a Cyprus tax resident, will be taxable in Cyprus if the holding in the Chinese company is less than 25%. If the holding is more than 25%, these capital gains will be taxed in China.

As your intention is to acquire 40% of the Chinese company, I suggest that you split this investment into two part holdings, each of less than a 25% shareholding in the Chinese company. Having the investment in the Chinese company split into two parts is crucial to managing to avoid being taxed on any capital gains in China and having them subject to capital gains in Cyprus.

However, you should be aware that this splitting of the investment may be construed as a tax evasion scheme by the Chinese tax authorities and if so, then the whole structure could be ineffective. But, if the scheme can be successfully implemented for Cyprus tax purposes the sale of the shares will be deemed to be a capital transaction, as you intend to hold the investment for 5 years, and as such it will not be subject to income tax in Cyprus. Also, the capital gain will be exempt from capital gains tax in Cyprus, as although the Chinese company is a private company holding immovable property, that immovable property is not situated in Cyprus.

As to the holding of the investment, one part could be in your name and the other part in your wife's name. Alternatively, the second part of the investment

could be in the name of a Cyprus company, owned by your wife. However, this second option is not the most efficient in tax terms, as, as stated previously, when profits are taken out of the company in the form of dividends these will be subject to SDC at 15%.

### Investment 3

Two distinct activities will be carried out in the case of this investment.

The main activity of refining oil, is carried out physically in the Slovak Republic. Profits arising from this activity will, therefore, be taxed in the Slovak Republic irrespective of the country of residence of the company carrying out this activity. As such, the best option is probably to undertake this activity through a Slovak company.

Any salary you receive from such a company will, however, be taxed in Cyprus, as you are tax resident here and so are taxed on your worldwide income in Cyprus. However, if you spend more than 90 days in the Slovak Republic the Cyprus tax authorities will treat any income relating to your time spent in the Slovak Republic as exempt from income tax in Cyprus, irrespective of whether the employer is a Slovak company or a Cyprus company with a permanent establishment in the Slovak Republic. But, you must ensure that you do not spend more than 183 days in the Slovak Republic, so as not to be classed as resident there, and also ensure that you spend more than 183 days in Cyprus in order to maintain your tax residence status here. Provided, however, that you can spend the appropriate period of time in the Slovak Republic each year, then it will be in your interest to receive a salary from the Slovak company commensurate with your involvement in its activities.

As regards the tax treatment of the dividend payments you receive from the Slovak company, their tax treatment will be the same as the situation regarding the investment in the Hungarian company (see 1 above).

With regards to the secondary activity, of selling oil and oil products, then the trading activity contemplated, of buying oil from the refinery and selling it on elsewhere, is such that it can be located anywhere for tax purposes. Thus, it could be carried out through a Cyprus tax-resident company registered for this purpose, in order to take advantage of the lower corporate tax rates in Cyprus compared to the rate in the Slovak Republic. In effect some of the profit of the Slovak 'refinery' company will be shifted to the 'trading' Cyprus company.

However, some thought needs to be given to the method of taking profits out of

this company. This can be done in the form of salary and/or dividends.

It will be tax efficient to pay yourself a salary at a level that utilises the lower (0% and 20%) income tax rate bands, which is currently £15,000 per annum per person. This is because the total effective tax rate on company profits is 23.5% (10% corporation tax plus 15% SDC on dividend payments), assuming that all the after tax profits will be distributed as dividends. To take further advantage of the lower income tax bands, you should also consider paying a salary to Natalia, if she will have any involvement in the administration of the company. Note however, that any salary should be paid at a market rate appropriate to the duties performed, as any excess amount will be disallowed by the Inland Revenue.

I trust that I have covered all your queries, but should you have any further questions, please do not hesitate to contact me

Yours sincerely

AN Accountant

## MARKING SCHEME FOR ANSWER TO SPECIMEN QUESTION 2

### STEPAN

	Marks
<b>(a) Change of residence</b>	
Correct identification of taxable sources	0.5
Identification of benefits of Cyprus residence re salary and dividends	2.0
Possible benefit of Cyprus residence re capital gains	1.0
Recommend change of residence to Cyprus	0.5
	<b>4.0</b>
<b>(b) Best structure for investments</b>	
Investment 1:	
Explain Cyprus tax position if invest in own name, incl tax credit re overseas tax	1.0
Explain Cyprus tax position if a company is used	1.0
Recommend use own name, with reason	0.5
Investment 2:	
Recommend splitting holding into two parts, with reason	1.0
Warn about possible challenge by Chinese tax authority	0.5
Explain Cyprus tax position	1.5
Identify options for splitting the holding and conclude on better	1.5
Investment 3:	
Oil refining:	
Identify profits as taxable in the Slovak Republic, with reason	0.5
Identify any salary as taxable in Cyprus, with reason	0.5
Identify how salary may be exempted (90 day rule)	1.0
Caution re continued need to satisfy 'right' 183 day rule re residence	1.0
Salary should be at 'commensurate' rate	0.5
Position re dividends as for investment 1	0.5
Oil and oil product trading:	
Identify activity as location neutral	0.5
Recommend use of Cyprus company, with reason	1.0
Recommend taking a salary to make use of lower tax bands, with reasons	1.5
Possibility of salary to wife also	0.5
Caution need for salary to be at appropriate market rate	0.5

	<b>15.0</b>
Presentation and format of the letter	1.0
Effectiveness of the communication	1.0
	<b>2.0</b>
TOTAL	<b>21.0</b>