



# Indirect Tax Update

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On 9 January 2018 the Tax Department released the Interpretative Circular 222 aiming to explain the tax treatment of companies that are exclusively involved in the holding of shares in other companies. These Companies are known as 'Holding Companies (HC)'.

The circular, clarifies that HC are not considered taxable persons exercising an economic activity as provided for in Article 3 of the VAT Act and relevant ECJ (Court of Justice of the European Union) settled case law. It should be noted that the mere holding of shares in other enterprises does not constitute an exploitation of any type of tangible asset such as immovable property for the purpose of obtaining income on a continuous basis since the potential dividend results solely from the ownership and not exploitation of the tangible asset.

However, the above tax treatment may be differentiated if it is ascertained that a HC is **directly** or **indirectly** involved in the **management** of the companies in which it acquires shares.

In the above sentence, the words "**directly**" or "**indirectly**" and "**management**" have the following meaning.

**Direct Involvement:** Members of the BoD of the HC are also members of the BoD of the subsidiary.

**Indirect involvement:** Although there is no direct involvement in the BoD, the HC is in a position to influence the subsidiary's decisions in another way e.g. directors of a fully controlled related company are also members of the board of directors of the subsidiary.

**Management or administration:** The management or administration of affiliates has the meaning of managing and coordinating affairs, steering events in a particular direction, organizing and decision making.

Whether a HC can provide the above services, is a matter of the surrounding facts. For example, the HC may either have its own human and technical resources or assign the performance of management services to third parties who have these resources. Irrespective of whether a HC has available own resources or assigns the management and administration function to third parties, the existence of an economic activity is only evidenced if there is a separate consideration for these services.

Therefore, if the HC acquires services from third parties, such as legal, administrative and promotional services, it is not entitled to deduct input tax unless it uses them in the context of supplying taxable goods or services i.e. it charges them to the subsidiary to which it provides management and administration services. It should be noted that charges to the subsidiary must reflect the economic and commercial reality in order to justify the amount of expenses incurred and, consequently, the input tax claimed i.e. avoid artificial arrangements with the sole aim to obtain tax benefit; for example, to charge €1.000 per year, account for €190 output VAT and claim €50.000 input VAT on expenses.

If the HC acquires services that are or will be used by its subsidiaries, input tax is not deductible unless subsequently recharged to the subsidiaries. That is, if the HC acquires services for the benefit of its subsidiaries without re-charging them, it is not entitled to deduct input tax.

However, it should be noted that if such services are received by persons established outside the Republic and are related to the direct and exclusive needs of a subsidiary of the HC established in the Republic, the subsidiary may have an obligation to account for VAT under the reverse charge method. The reason for this treatment is focused on dealing with cases where, for the purpose of avoiding VAT payment, the invoices for the acquisition of service are issued to the

HC, which is not considered to be a taxable person, instead of being issued to the subsidiary for the sole purpose of not accounting for VAT if the activities of the subsidiary do not allow it to deduct VAT.

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## Examples with regards to direct or indirect involvement in a subsidiary

### Direct involvement

#### Example 1

A Cyprus established Company (holding) acquires 80% of the issued capital of another Cyprus established Company (subsidiary). Upon conclusion of the agreement, the parent ensures that at least one member of the board of directors of the subsidiary is appointed by the parent. The subsidiary's board of directors consists of five (5) members.

**Although the parent's involvement in the subsidiary's BoD is direct, it cannot affect the BoD's decisions and therefore the argument that the parent has a direct involvement in the management of the subsidiary cannot be supported.**

#### Example 1 a

The same facts as example 1 except that the parent asked to appoint 3 out of 5 Directors.

**In this case it can be supported that the parent company is directly involved in the management of the subsidiary.**

#### Example 2

A Cyprus established Company (holding) owns 100% of the issued capital of another Cyprus established Company (subsidiary A). The BoD of subsidiary A is appointed by the parent. Subsequently, the parent acquires subsidiary B and appoints the BoD of subsidiary A on the BoD of subsidiary B.

**The parent has direct involvement in the BoD of subsidiary A and direct involvement in subsidiary B.**

### Indirect involvement

#### Example 3

A Cyprus established Company (Holding Co) owns 100% of the issued capital of another Cyprus Co (subsidiary A) and appoints the BoD. Subsidiary A owns 100% of the issued capital of subsidiary B and appoints the BoD.

**The Holding Co has a direct involvement on the BoD of subsidiary A and indirect involvement on the BoD of subsidiary B.**

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## Examples regarding input VAT recovery

### Example 1

A company based in Cyprus draws capital in the form of a loan or issued share capital, either by private placement or by public invitation, in order to acquire the share capital of another company (subsidiary). The intention of the company is to provide management and other kinds of services to the subsidiary. In the process of raising these funds, the company acquires taxable services and incurs input tax.

The funds raised are allocated in full for the purchase of the subsidiary's share capital, which is also registered in the Republic. The purpose of acquiring the subsidiary is the provision of

technical and other kinds of services offered by the parent. Within the context of the acquisition of the subsidiary, it is agreed that the company will appoint people of its confidence on the Board of Directors of the company (direct involvement).

The operations of the subsidiary consist of the development of large tourist projects, whilst the parent company's operation consists of preparation of technical studies and drafting of architectural and civil engineering plans.

Scenarios for examination

(a) The parent company charges the subsidiary for administration and management services as well as for the preparation of technical studies for the development of a tourist village.

(b) The parent company charges the subsidiary only for technical studies for the development of a tourist village.

(c) The parent company does not charge the subsidiary company neither for administration and management services nor for technical studies.

#### **VAT treatment**

**General comment:** Expenses related to the raising of capital are prima facie (see scenario (c)) considered general overheads and if the activities of the parent are all taxable, input tax is fully claimable as credit.

**(a) The parent company charges the subsidiary for administration and management services as well as for the preparation of technical studies for the development of a tourist village.**

Since the parent company's transactions are all taxable transactions, input tax on costs in relation to the raising of capital is fully claimable.

**(b) The parent company charges the subsidiary only for the preparation of technical studies for the development of a tourist village.**

Since the parent company's transactions are all taxable transactions, input tax on costs in relation to the raising of capital is fully claimable.

It is noted that although the services are not those of administration and management but those of technical services, we are of the opinion that it does not affect the right to claim input tax taking into account the fact that the exclusive purpose of acquiring the subsidiary was to provide these services. This position is confirmed by the wording of circular 221 on page 2, third paragraph which refers to administrative, financial, commercial and technical services.

It is expected that the Tax Department will confirm whether it is absolutely necessary to provide management services to allow all input tax to be claimed or whether it should be apportioned on the grounds that the costs also concern the investment in the subsidiary

**(c) The parent company does not charge the subsidiary company neither for administration and management services nor for the preparation of technical studies.**

In this case, if there is no charge to the subsidiary, the parent, even though it has human and technical resources or assigns work to third parties, is not considered to be carrying out an economic activity and is therefore not entitled to claim any input tax.

In addition, the fact that the parent provides management and administration services to the subsidiary in the form of participating on the board of directors cannot be assumed that any dividends distributed by the subsidiary to the parent are treated as consideration for the provision of the above services. A different interpretation will be in conflict with a number of Judgments by the ECJ.

\* The wording of the circular leads to the conclusion that dividends may, under certain conditions, constitute a consideration for the provision of management services. This position is against a number of judgments of the ECJ and therefore requires further clarification from the VAT Office.

## Example 2

The same facts as in example 1 above except that the parent company, other than supplying technical services, also performs exempt transactions and invests in other companies to which it does not provide any services.

Since the costs relating to raising capital are considered to be general overheads, input tax should be apportioned according to the normal rules.

## Example 3

A parent company that does not engage in any other economic activity purchases legal and promotional services from third parties for the exclusive benefit of its subsidiaries. Some of the services are acquired by persons established outside the Republic and some by persons established within the Republic. These services are not charged to subsidiaries.

The parent company is not entitled to register, account for output VAT and claim input VAT accordingly for these services. However, the subsidiaries may be required to register and account for VAT as the services acquired by the parent company are for the exclusive use of the subsidiaries.

If the parent company is registered for VAT purposes, it will be required to account for VAT on services acquired from outside the Republic and will not be able to claim the resulting input tax, either for services acquired outside or within the Republic.

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