



Taxation of cross-border mergers and acquisitions

Cyprus

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Introduction

The Income Tax Law No.118 (I) 2002 introduced major reforms of Cyprus's tax system at the time of Cyprus's accession to the European Union (EU) on 1 May 2004. The law was designed to modernize and harmonize the Cypriot tax system with that of other European countries and ensure full compliance with:

- European Community law (having eliminated provisions in conflict with EU state aid rules)
- the EU Code of Conduct for Business Taxation and the Organisation for Economic Co-operation and Development (OECD) guidelines to eliminate preferential treatment for international businesses
- all EU directives.

As a result, the EU corporate reorganization provisions were incorporated in Cypriot income tax legislation. Several other laws, such as the stamp duty and capital gains laws, were also amended to allow the tax-free implementation of these provisions. The reorganization provisions incorporated in the new tax legislation provide for:

- corporate mergers
- corporate divisions
- transfers of assets
- exchanges of shares.

Recent developments

The tax treatment of cross-border mergers and acquisitions (M&A) has remained mainly unchanged since 2009.

However, in 2015, anti-avoidance provisions were introduced to the M&A provisions that aim to combat abusive use of restructurings as a means to avoid the payment of tax. Under the new provisions, the Tax Department retains the

discretion to deny tax exemptions designed to preserve the tax neutrality of reorganizations if the tax authorities take the view that the reorganization was not carried out for valid commercial reasons that reflect economic reality.

Alternatively, the Tax Department may set conditions for the tax neutrality of a reorganization based on, for example, the number of shares to be issued and a holding during which the shares issued cannot be disposed (maximum period of 3 years).

Recent developments of the Income Tax Law also include (among others):

- a notional interest deduction on new equity, which aims to equalize debt/equity considerations
- alignment of the tax law with EU law (e.g. EU Parent-Subsidiary Directive, EU case law on the treatment of foreign exchange differences and group relief)
- introduction of personal tax allowances for high net worth individuals such as a 50 percent exemption of emoluments over 100,000 euros (EUR).

These amendments complement previous amendments in the tax law, including (among others):

- increase in the corporate income tax rate
- removal of interest deductibility restrictions on equity acquisitions (trading)
- introduction of a time-bar for the carry forward of losses
- introduction of a favorable intellectual property (IP) regime.

Tax rates

Individuals are subject to tax at personal income tax rates as follows:

Up to EUR19,500	0 percent
From EUR19,501 to EUR28,000	20 percent
From EUR28,001 to EUR36,000	25 percent
From EUR36,301 to EUR60,000	30 percent
More than 60,001	35 percent

Companies are subject to tax at the rate of 12.5 percent.

Source: KPMG in Cyprus, 2016

Asset purchase or share purchase

An acquisition in Cyprus usually takes the form of a purchase of the shares of a company, as opposed to its business and assets. There is no capital gains tax on sales of shares or business assets except for capital gains on immovable property in Cyprus and shares in companies the assets of which, directly or indirectly, consist of immovable property in Cyprus.

Gains from sales of shares listed on a recognized stock exchange are exempt from capital gains tax. From a tax perspective, asset acquisitions are likely less attractive for the seller due to the capital gains tax on immovable property situated in Cyprus, the likely recapture of capital allowances (tax depreciation), transfer fees paid on transfer of immovable property, and possible double taxation on extracting the sale proceeds. However, the benefits of asset acquisitions for the purchaser should not be ignored, particularly given that purchased goodwill is tax-deductible. Some of the aspects of each method are discussed later in this report.

Purchase of assets

A purchase of assets (excluding real estate assets) usually results in an increase in the base cost of those assets for capital allowance purposes, although the increase is likely to be taxable to the seller. Historical tax liabilities generally remain with the company and are not transferred with the assets.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is advisable for the purchase agreement to specify the allocations, which are normally acceptable for tax purposes provided they are commercially justifiable.

Two rules affect the allocation of the purchase price:

1. The value of the trading stocks must equal the amount they would have realized on the open market.
2. For capital allowance purposes, the purchaser's cost of acquisition and the seller's disposal proceeds must be, in the opinion of the Commissioner of Income Tax, what they would have cost or realized if purchased or sold on the open market.

Goodwill

Where the acquisition price includes goodwill arising from the carrying on of the business, such goodwill is not eligible for capital allowances. However, if the business concern is later resold to another person and the sale price includes trade goodwill, the value of which is taxable to the

seller, the goodwill's original cost to the seller is deducted from the new value of the goodwill sold and any balance is taxable to the seller.

Depreciation

Depreciation of assets charged in the accounts is ignored for tax purposes, but Cypriot tax legislation allows the cost of certain tangible assets (e.g. plant and machinery, furniture and fittings, buildings) to be written off against profits at specified rates by means of capital allowances.

As an incentive, lower rates are provided for wear and tear on certain types of plant and machinery and on industrial and hotel buildings acquired during the tax years 2012–14; after 2014, the lower rates do not apply.

Tax attributes

Tax loss capital allowance pools are not transferred on an asset's acquisition. They remain with the company or are extinguished.

Value added tax

Cyprus's value added tax (VAT) legislation is fully harmonized with the EU's Sixth Directive as of 1 February 2002.

As of 13 January 2014, VAT is levied at the rate of 19 percent (up from 18 percent) on a large number of goods and services. Goods exported from Cyprus to non-EU destinations are subject to a zero VAT rate.

The transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met. The effect of the transfer must put the new owner in possession of a business that can be operated as such. Thus, a sale of assets is not in itself a transfer of a business as a going concern. If land and buildings are being sold, professional advice should be sought.

Sale of shares

The sale of shares is specifically listed as an exempt transaction in the Cyprus VAT legislation (see Schedule Seven, Table B).

Transfer taxes

No stamp duty is levied on instruments transferring ownership of shares.

Transfers of land and buildings in Cyprus are not subject to stamp duty land tax; however, transfer fees on the property's purchase price or market value are paid to the Land Registration Office. Transfer fee rates are:

- 3 percent on the first EUR85,430 of the value
- 5 percent on the next EUR85,430 of the value
- 8 percent thereafter.

Subject to conditions, transfer fees do not apply if the transaction is subject to VAT or the transfer is related to transactions involved in a reorganization scheme.

Further, transfer fees are reduced by 50 percent for any immovable property:

- transferred on or before 31 December 2016, irrespective of the date of the contract's signing or its submission to the Land Registry
- transferred under a contract was signed and submitted to the Land Registry between 2 December 2011 and 31 December 2016, irrespective of the transfer date.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration.

Tax indemnities and warranties

In a purchase of shares, the purchaser takes over the target company together with all its liabilities, including contingent liabilities. Therefore, the purchaser normally requires more extensive indemnities and warranties than in the case of a purchase of assets.

Tax losses

Accumulated, carried forward Cyprus tax losses generated by the target company are transferred along with the company. A company's carried forward loss cannot be set off against the profits of other companies through group relief, but it can be set off against the company's own future profits. Trading losses can be carried forward for up to 5 years from the year to which the profits relate.

Where a Cyprus target company with trading losses is acquired by a company, it may use the losses against its own future trading profits, provided there has been no major change in the nature or conduct of its trade in the period from 3 years before to 3 years after the date of acquisition. If the purchaser intends to substantially change the nature of the target company's business, it may be advisable to wait until at least 3 years have elapsed from the date of acquisition.

Transfer taxes

Stamp duty is payable on the consideration given for shares in a Cyprus company and is calculated on the basis of the consideration stated in the agreement.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign purchaser, and tax considerations often influence the choice. A capital duty applies on the introduction of new capital to a Cyprus company or branch.

Foreign parent company

The foreign purchaser may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This causes no tax problems in Cyprus, because Cyprus does not tax the gains of non-residents disposing of Cyprus shares and does not levy withholding tax on dividends or interest.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign purchaser may structure the acquisition through a Cyprus branch. Cyprus does not impose additional taxes on branch profits remitted to an overseas head office. The branch will be subject to Cyprus tax at the normal corporate rate of 1 percent. If the Cyprus operation is expected to make losses initially, a branch may be advantageous; subject to the tax treatment applicable in the head office's country, a timing benefit could arise due to the ability to consolidate losses with the profits of the head office.

Choice of acquisition funding

A purchaser using a Cyprus acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of debt and equity.

Deductibility of interest

As a general rule, to ascertain a person's chargeable income, all outlays and expenses wholly and exclusively incurred by an individual or company in producing taxable income are deductible, including:

- interest paid on loans used to acquire business assets used in the business
- interest incurred on loans used to acquire, improve or maintain a rental asset (in which case the interest is deductible only against the rental income).

Under Cyprus tax law, interest expenses related to the acquisition of a private motor vehicle (saloon car) or a non-business asset are not tax-deductible. However, after 7 years from the date of purchase of the relevant asset, the tax authorities stop disallowing any interest as they consider the debt on the acquisition of the asset to have been paid.

Following a 2012 amendment, any interest expense related to acquisitions of shares after 1 January 2012 is tax-deductible, provided the acquired company is directly or indirectly wholly acquired (i.e. 100 percent shareholding) and holds assets used in the business. Other interest expense related to non-business assets is not deductible.

Notional interest deduction

For 2015 and later tax years, a deduction is provided on new equity (i.e. introduced into the business on or after 1 January 2015 in exchange for fully paid issued share capital) by way of a notional interest deduction (NID). The NID is calculated on the basis of a reference interest rate on new equity held by the company and used in the business. The reference interest rate is the 10-year government bond yield of the country in which the new equity is invested or of the Republic of Cyprus (as at 31 December of the previous tax year), whichever is the highest, increased by 3 percent. Its deductibility is determined under similar rules applying to the deductibility of interest.

Conditions for eligibility are as follows:

- In calculating the NID, only equity in excess of old equity is taken into account. Any equity introduced into the business on or after 1 January, 2015 is not taken into account if it:
 - results directly or indirectly from reserves existing on 31st December 2014, and
 - does not relate to new assets used in the business.
- Where the new equity of a Cyprus company is derived directly or indirectly from the new equity of another Cyprus company, the NID is granted only to one of those companies so as to avoid duplication.
- In order to safeguard the coherence of the tax base, the NID on new equity is limited to 80 percent of the company's taxable profits prior to deducting the NID.
- No NID is allowed in the event of tax losses.
- The NID is restricted where the new equity is the result of a qualified reorganization.
- The NID may not be provided where the tax authorities consider that the company's transactions and arrangements were undertaken to benefit from the deduction without substantial economic or commercial purpose or where attempts are made to re-characterize old equity as new equity through related-party transactions and other arrangements.
- The claiming of the whole amount of NID is not compulsory; in any given tax year, taxpayers may elect to claim all or only part of the NID available.

Other considerations

Company law and accounting

The Companies Law CAP 113 (as amended; based on the United Kingdom Companies Act 1948) prescribes how Cyprus companies may be formed, operated, reorganized and dissolved. The law governing partnerships in the Partnerships and Business Names Law CAP 116 is also almost identical to that of the United Kingdom.

Cypriot case law has developed significantly since 1960. In the absence of Cypriot case law on particular legal issues, the court looks to UK case law, which is a persuasive, if not binding, authority.

Cypriot companies may be private companies limited by shares, public companies limited by shares, companies limited by guarantee, or branches of overseas companies.

There are no requirements related to the minimum authorized capital of a private limited liability company by shares. Such a company may have as few as one share as issued share capita.

The Companies Law requires companies to prepare complete financial accounts, which in their entirety should conform to International Financial Reporting Standards (IFRS).

The Companies Law allows mergers, reorganizations and cross-border mergers of Cyprus companies with companies having their registered office within EU. Cyprus has fully adopted EU Directive 2005/56 on cross-border merger of limited liability companies. Tax laws incorporate provisions for tax-free corporate reorganizations in line with the EU directive. The various forms of permissible reorganizations are described below.

Merger

- One or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company in exchange for the issuance of shares to their shareholders representing the capital of the other company, and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.
- Two or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to a new company that they form in exchange for the issuance of shares to their shareholders representing the capital of that new company and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

- A company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the shares representing its capital.

Division

A 'division' is defined as an operation whereby a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to two or more existing or new companies in exchange for the pro rata issuance of shares to its shareholders representing the capital of the companies receiving the assets and liabilities and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

Partial division

A 'partial division' is defined as an operation whereby a company, without being dissolved, transfers one or more branches of activity to one or more existing or new companies, leaving at least one branch of activity in the transferring company, in exchange for the pro rata issuance of securities to its shareholders representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10 percent of the nominal value or, in the absence of a nominal value, of the accounting par value of those securities.

Transfer of assets

A 'transfer of assets' is defined as an operation whereby a company transfers, without being dissolved, all or one or more branches of its activity to another company in exchange for the transfer of shares representing the capital of the company receiving the transfer.

Exchange of shares

An 'exchange of shares' is defined as an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company, in exchange for the issue to the shareholders of the latter company, in exchange for their shares, shares representing the capital of the former company and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

Group relief/consolidation

Two companies are deemed to be members of a group if:

- one is a 75 percent-owned subsidiary of the other
- each is a 75 percent-owned subsidiary of a third company.

The tax legislation includes detailed rules for determining whether a company is considered a 75 percent-owned subsidiary of another company.

The set-off of losses is only allowed where the surrendering and claimant companies are members of the same group for the whole year of assessment.

For purposes of corporation tax, losses within the group companies can offset the total chargeable corporate income in the corresponding year of assessment only. In computing the loss that may be surrendered, carried forward losses are not taken into account.

Transfer pricing

If an intercompany balance arises between the purchaser and the target following an acquisition, failure to charge interest on the balance may cause transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target company and arm's length interest is not charged, the Cypriot tax authorities could invoke the provision of the Income Tax Law to impute interest on the balance.

Foreign investments of a local target company

Dividends received from abroad by a Cyprus tax-resident company are exempt from corporate income tax, provided that the dividends are not tax-deductible in the jurisdiction of the foreign paying company.

Further dividends distributed to a Cyprus tax resident company from a company abroad are also exempt from Special Defense Contribution where one of two conditions are met:

- The company paying the dividend does not engage more than 50 percent directly or indirectly in activities that lead to passive income (non-trading income).
- The foreign tax burden on the income of the company paying the dividend is not substantially lower than the tax burden in Cyprus.

If the above conditions are not satisfied, then the dividends are taxed at the rate of 17 percent.

Where the dividends are subject to tax, credit is provided for the same income. Credit is not available where an arrangement was put into place for the main purpose of obtaining a tax advantage and is not genuine, having regard to all relevant facts and circumstances. An arrangement is regarded as not genuine to the extent that it is not put into place for valid commercial reasons that reflect economic reality.

Comparison of asset and share purchases

Advantages of asset purchase

- The purchase price (or a proportion not including goodwill) can be depreciated for tax purposes.
- A step-up in the cost base for capital gains tax purposes (where applicable) is obtained.
- No previous liabilities of the company are inherited.
- Possible to acquire only part of a business.
- Greater flexibility in funding options.

Disadvantages of asset purchases

- Additional legal formalities may apply, such as notification of suppliers and change of name.
- Where only assets are purchased, the initial price is higher.
- Tax losses are not acquired.
- Complications may result from rules on the allocation of the purchase price on the purchase of an enterprise.

Advantages of share purchases

- Attractive to sellers since it is exempt from corporate taxation.
- It may be possible to use tax losses, subject to conditions.
- Contracts with suppliers, employees, etc., automatically transfer.
- There is no real estate transfer tax.

Disadvantages of share purchases

- Possible restrictions on interest deductibility where the enabling conditions are not met.
- Buyer inherits all undisclosed liabilities of the target company.
- Higher tax liability will apply on the future disposal of assets due to the lower cost base.

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