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Taxation of Cyprus international trusts

Philippos Aristotelous and Stavros Supashis
Andreas Neocleous & Co LLC, Cyprus

Cyprus international trusts have long provided stability and reliability for non-residents and today attract high-net-worth individuals from around the world. This article looks at the features which have enabled Cyprus to maintain its formidable reputation.

I. International trusts law

The enactment of Cyprus' International Trusts Law in 1992 allowed non-residents to establish Cyprus-resident trusts with excellent tax mitigation and asset protection features, creating a "state of the art" international trusts regime, enabling them to hold their wealth through a jurisdiction offering stability and reliability, providing flexibility in terms of financial management. Cyprus international trusts also provided a means of circumventing forced heirship provisions that apply in many countries and regaining testamentary freedom. Cyprus international trusts proved to be extremely popular with residents of Russia and Central and Eastern Europe, enabling Russian and Eastern European businessmen to hold their newly-accumulated wealth in an international safe haven.

Over the years a number of other jurisdictions followed Cyprus's example, introducing new, innovative features with their trusts laws, and by the end of the first decade of the current century the Cyprus international trusts regime was beginning to look somewhat dated. While the basic structure provided by the International Trusts Law was still sound, it lacked features available in other jurisdictions that had arrived on the scene after 1992 and needed updating in order to adapt it to the needs of investors today and in future years.

The enactment of the International Trust (Amending) Law of 2012 brought the Cyprus international trust firmly into the twenty-first century and restored Cyprus to the premier league of trust jurisdictions. The amendments made by the new law strengthen the asset-protection benefits of Cyprus international trusts, widen trustees' investment powers to those of

an absolute owner, provide greater flexibility and control for settlors and remove limits on the duration of trusts. Today, Cyprus international trusts provide an extremely effective and flexible wealth-holding structure with formidable asset protection features, and are likely to attract high net worth individuals from around the world.

The 1992 International Trusts Law prohibited "permanent residents" of Cyprus from establishing international trusts, in order to prevent tax avoidance. Residents of Cyprus could not be beneficiaries of international trusts, and international trusts were not allowed to own immovable property in Cyprus. However, the concept of permanent residence was not defined, either in the law or elsewhere. It was not clear whether the validity of the trust would be affected by the settlor deciding to relocate to Cyprus after establishing the trust, and the resultant uncertainty undoubtedly discouraged many of them from doing so.

After Cyprus joined the EU in 2004 these restrictions were considered to be inconsistent with the freedom of movement of people within the internal market and they were abolished as part of the 2012 amendments. Now the only stipulation is that the settlor may not be a Cyprus tax resident for the year preceding the year in which the trust was established (there are ways of working around this restriction provided proper structuring takes place prior to the establishment of the trust). This provides a simple, decisive test, as tax residence is clearly defined in the Income Tax Law.

II. The new tax regime for international trusts

As a general rule Cyprus trusts are transparent in tax terms. The income of the trust is not assessed on the

Philippos Aristotelous is a partner and Stavros Supashis is an associate in the Corporate and Commercial Department of Andreas Neocleous & Co LLC, Cyprus

trustee, but the beneficiaries, and the trustee is responsible for discharging the beneficiaries' tax liabilities on their behalf.

Since the 1992 law provided that neither settlors nor beneficiaries of international trusts could be Cyprus residents there was no need for detailed tax provisions in the law, but merely an all-embracing clause exempting income earned from sources outside Cyprus from Cyprus tax. However, now that beneficiaries may be resident in Cyprus it has become necessary to include more detailed provisions. Nevertheless, these are relatively straightforward.

The amending law of 2012 introduces a uniform tax regime applicable to all beneficiaries on the basis of tax residency. Income and profits of an international trust which are earned or deemed to be earned from sources within and outside Cyprus are subject to every form of taxation imposed in Cyprus in the case of a beneficiary who is resident there. In the case of a non-resident beneficiary only Cyprus-source income and profits are subject to Cyprus tax.

These provisions ensure that there is neither discriminatory taxation nor undue tax advantage available to anyone. Beneficiaries who are Cyprus tax residents will be subject to Cyprus tax on their worldwide income in the same way as any other Cyprus tax residents and non-resident beneficiaries will be subject to Cyprus tax only income derived from a source in Cyprus.

If all the beneficiaries are non-resident or (no doubt less frequently) resident in Cyprus, these provisions are very straightforward and easy to apply. However, where there is a combination of resident and non-resident beneficiaries the issue becomes slightly more complex, and it will be necessary to apportion the various forms and sources of income between them. The Inland Revenue will issue guidance in due course on the application of the new provisions regarding the tax treatment of the various forms of trust structure that may be established under the new regime and the tax laws will be amended if necessary.

III. Application of the new provisions

In the meantime, preliminary discussions have taken place between the Inland Revenue, the Institute of Certified Public Accountants of Cyprus and other interested parties, and the following principles have been agreed:

- The trustee will continue to be the person responsible for the payment of any taxes due, as is the case under existing legislation.
- The trustee will be responsible for maintaining and collating all the relevant information concerning the trust and its beneficiaries. The trustee will also be responsible for compliance with anti-money laundering legislation and for providing information to the Inland Revenue. This is analogous to the arrangements for international business companies held through nominees such as fiduciary service providers.
- If any beneficiary is a Cyprus tax resident the trustee will be the person responsible for registering the beneficiary for Cyprus tax purposes if they are not already registered.

- Insofar as taxation of the trust and its beneficiaries is concerned, the tax residency status of the beneficiaries will be the determining factor.

The Inland Revenue will adopt the following approach for the purposes of taxation of trusts under section 12(1) of the International Trusts Law as amended:

- If all the beneficiaries are Cyprus tax residents the trust will be treated for tax purposes as a domestic trust and will be subject to every form of taxation in Cyprus on all income, regardless of the source.
- If all the beneficiaries are non-residents the trust will be deemed to be an international trust and will be subject to taxation only on Cyprus-source income.
- In cases where the trust has both resident and non-resident beneficiaries, the tax treatment will be determined by reference to the scope of rights that the respective beneficiaries have in the trust, as set out in the trust instrument.

In the case of a trust with a mixture of non-resident and resident beneficiaries the overall tax treatment of the trust will be determined according to a simple majority test. Where more than 50 percent of the rights attach to beneficiaries who are resident in Cyprus the trust will be treated as a domestic trust and will be liable to Cyprus tax on worldwide income. Where more than 50 percent of the rights attach to non-resident beneficiaries the trust will be treated as an international trust liable to Cyprus tax only on Cyprus-source income.

However, even in the latter case, any distribution of income to a Cyprus-resident beneficiary will be subject to Cyprus tax and the trustee will be responsible for deducting tax and paying it to the Inland Revenue to the extent that the income has not already suffered taxation.

IV. Taxes on income

To illustrate how the Inland Revenue intends to apply the new provisions, consider the case of a trust with five equal beneficiaries. Three are non-resident and the other two are Cyprus-resident. One of the resident beneficiaries is an individual and the other is a company.

The main taxes on income in Cyprus are income tax and Special Contribution for Defence, commonly known as SDC tax. Resident individuals are liable to income tax at progressive rates starting at 20 percent on taxable income above EU€19,500, with a top rate of tax of 35 percent. Companies are liable to corporate income tax at 12.5 percent on taxable income. Dividends and passive interest are exempt from income tax, but subject to SDC tax at rates of 17 percent and 30 percent respectively. Rent received is subject to income tax and also to SDC tax at an effective rate of 2.25 percent. Applying the preliminary guidance issued by the Inland Revenue, if a dividend is received from a company in Cyprus the trustee should pay SDC tax on the one-fifth of the dividend attributable to the Cyprus-resident individual (dividends between resident companies are exempt and the portion attributable to non-residents is excluded).

Dividends received from overseas will not be subject to taxation when received, as the trust has a majority of non-resident beneficiaries. When the trustee distributes the income, SDC tax will have to be deducted and paid over to the tax authorities on the amount attributable to the Cyprus-resident beneficiaries.

Similarly, in the case of interest and rents received the trustee will be responsible for paying SDC tax on Cyprus-source interest, and income tax and SDC tax on Cyprus-source rents received. Foreign-source interest will not be subject to any form of taxation on receipt, but if it is distributed to the Cyprus-resident beneficiaries the trustee will be required to deduct SDC tax and pay it over to the tax authorities. For foreign-source rents, income tax and SDC tax will be payable only when and to the extent that the income is distributed to the tax resident beneficiaries. At this stage it is not clear what rate of income tax will be applied to rents and to any other forms of income subject to income tax attributable to individuals. While SDC tax is charged at standard rates and there is a standard rate of corporate income tax, personal income tax is charged at progressive rates according to total income. If, as is generally the case, the trust is to be transparent for tax purposes the appropriate rate will presumably be the individual's marginal rate or rates.

V. Other taxes

International trusts will be liable to taxes such as VAT and stamp duty on their activities in Cyprus. Section 12(2) of the International Trusts Law as amended provides for a fixed stamp duty of €430 on the establish-

ment of an international trust. International trusts will be subject to immovable property tax on property held in Cyprus irrespective of the residence of the beneficiaries. However, the amount of tax payable is unlikely to be material unless the trust has extremely large property holdings.

The only gains subject to capital gains tax are gains on disposals of real estate situated in Cyprus and, to the extent that the gain is derived from the real estate holding, on disposals of shares in companies holding real estate in Cyprus. All international trusts will be liable to tax on such Cyprus-source gains (although these can be eliminated with proper planning and structuring of the acquisition of the property). All other capital gains are exempt from Cyprus tax.

VI. Conclusions

The new tax provisions provide a tax-neutral environment allowing investors to take advantage of Cyprus's benign tax regime, particularly as regards capital gains. It will no doubt take a few years for the tax authorities, taxpayers and their advisers to familiarise themselves with the new provisions and work out how to apply them in various situations, but in the meantime the availability of advance rulings from the Inland Revenue will eliminate any uncertainty from the taxpayer's point of view.

Philippos Aristotelous is partner and Stavros Supashis is associate in the Corporate and Commercial Department of Andreas Neocleous & Co LLC, Cyprus and can be contacted by email at: aristotelous@neocleous.com and stavros.supashis@neocleous.com.

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