

TAXATION OF INTEREST: CYPRUS TAX LAW, TAX TREATIES & EU TAX LAW

PRESENTATION BY
Christos Theophilou
BSc (Econ.), FCA, ADIT,
MSc Tax Law (Oxon),
LLB Law

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AGENDA

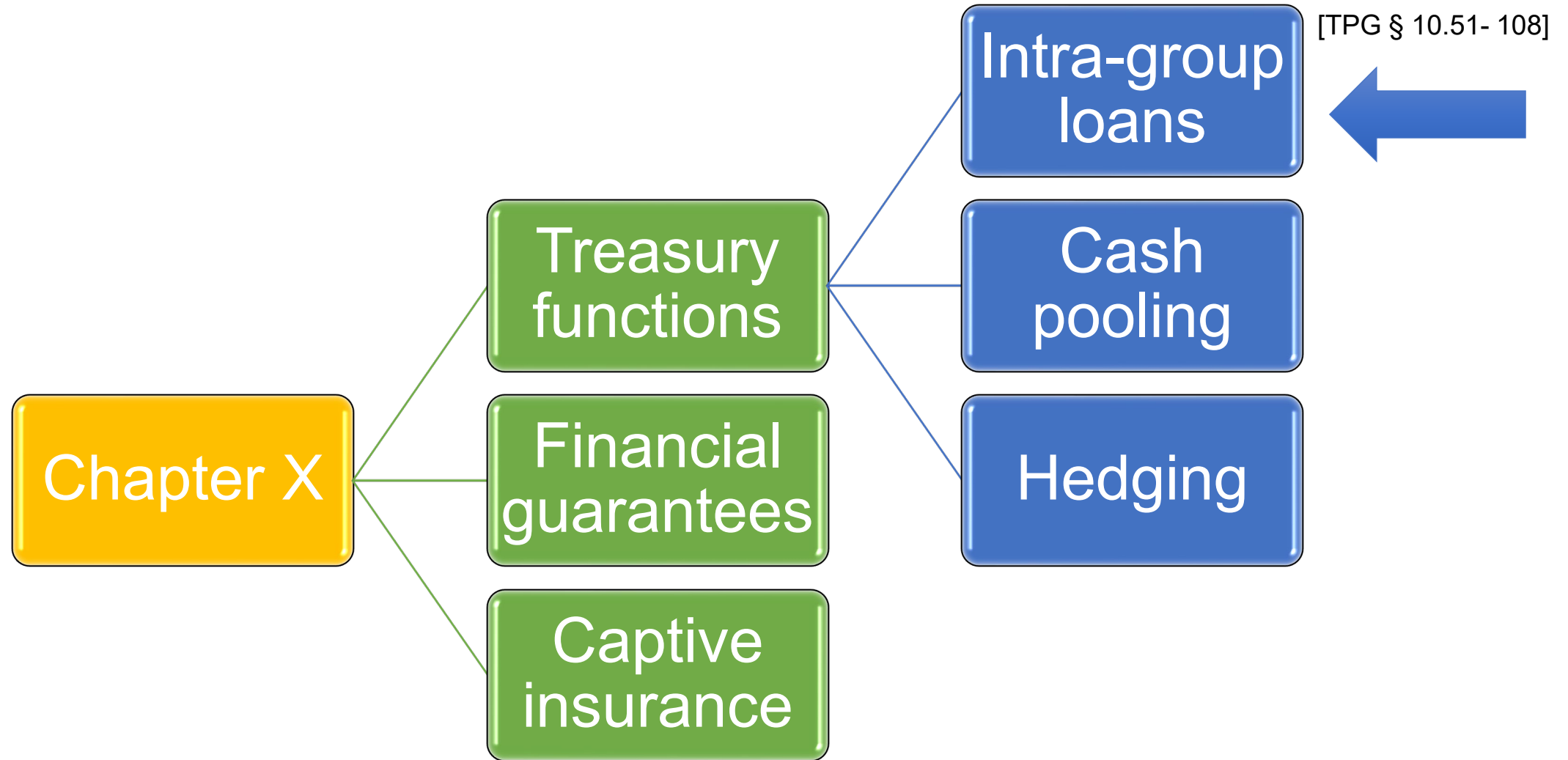
1. Introduction: International Tax & EU Developments
2. Taxation of Interest
3. Base Case Finance Company Structure: Step 1-3
4. Beneficial Ownership, PPT & EU GAAR, Corporate Substance, Special Tax Regimes, Hybrids
5. Interest under Tax Treaties & Transfer Pricing
6. Base Case: Step 4 & 5
7. References



INTRODUCTION: INTERNATIONAL TAX AND EU DEVELOPMENTS



2022 OECD TPG CHAPTER X: TRANSFER PRICING ASPECTS OF FINANCIAL TRANSACTIONS



BEPS ACTION PLAN (OCTOBER 2015)

COHERENCE

- AP2: No hybrid mis-matches
- **AP3: Better CFC rules**
- AP4: Interest deduction limitation rules
- **AP5: No harmful tax practices**

**Digital
Economy AP 1**

SUBSTANCE

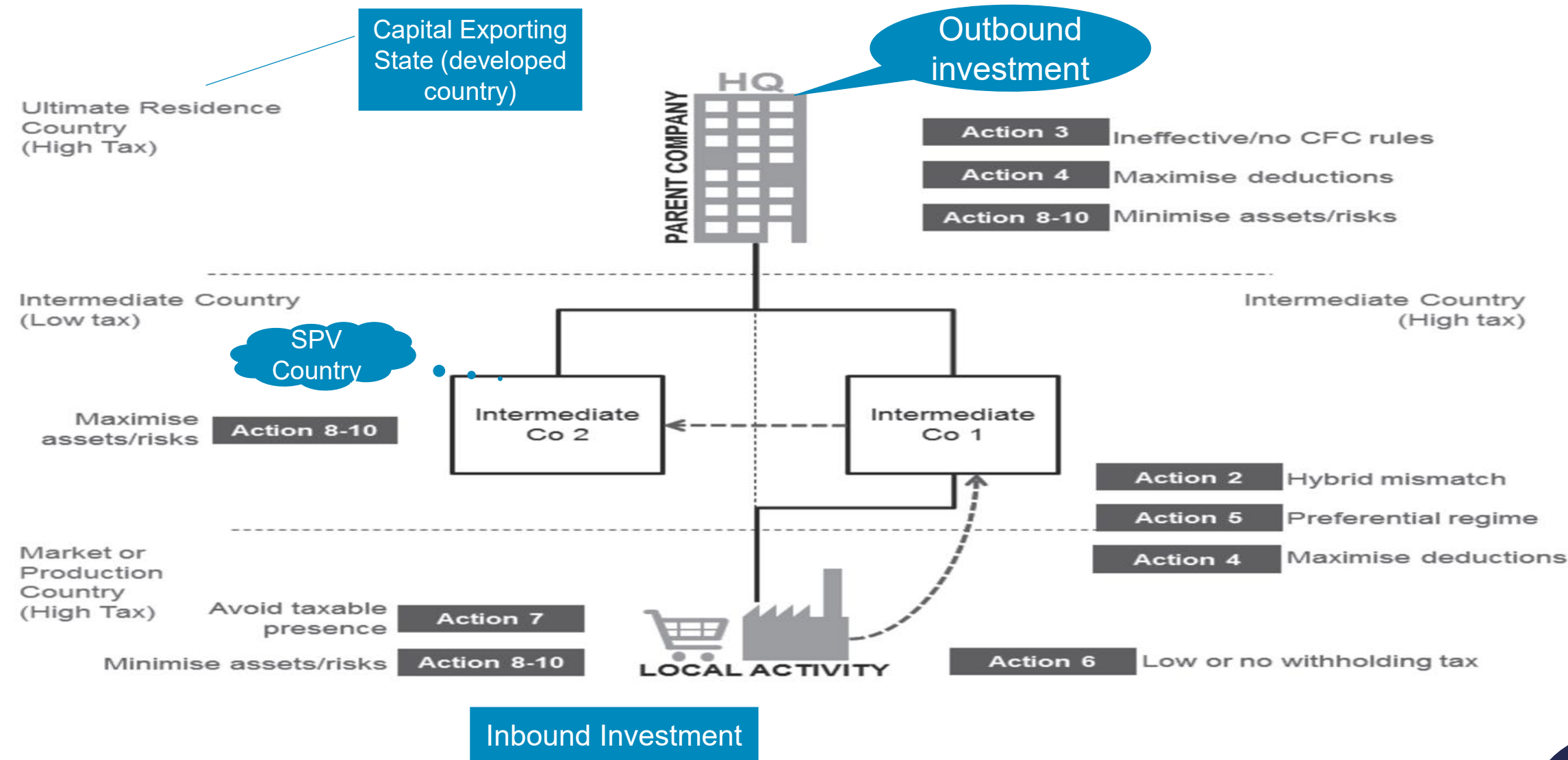
- **AP6: Preventing Tax Treaty abuse**
- AP7: Prevent artificial avoidance of PE
- **AP8: Transfer Pricing of Intangibles**
- AP9: TP/risk and Capital
- AP10: TP high risk transactions

**Multilateral
Instrument AP15**

TRANSPARENCY

- AP11: Methodologies and data analysis
- AP12: Disclosure of rulings
- **AP13: TP Documentation**
- **AP14: Dispute resolution**

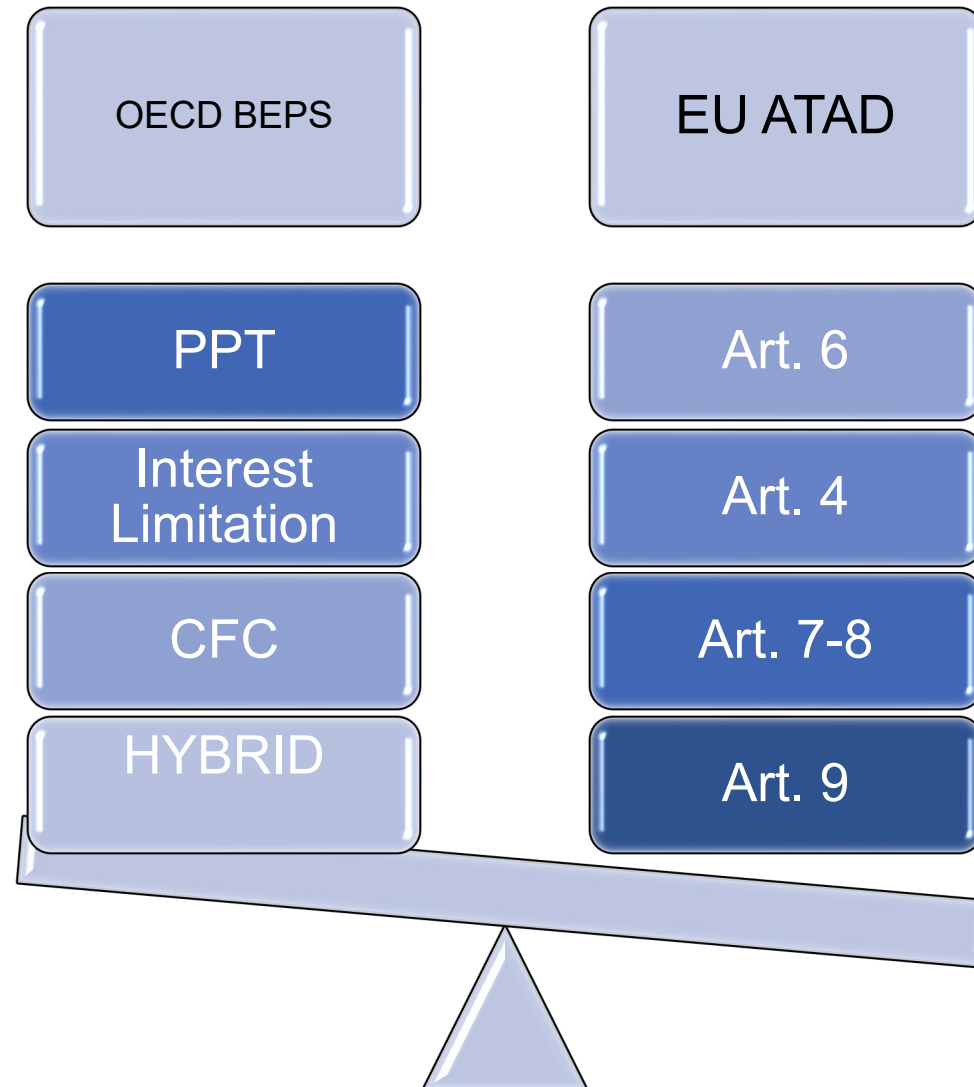
BEPS ACTION PLAN EXAMPLE



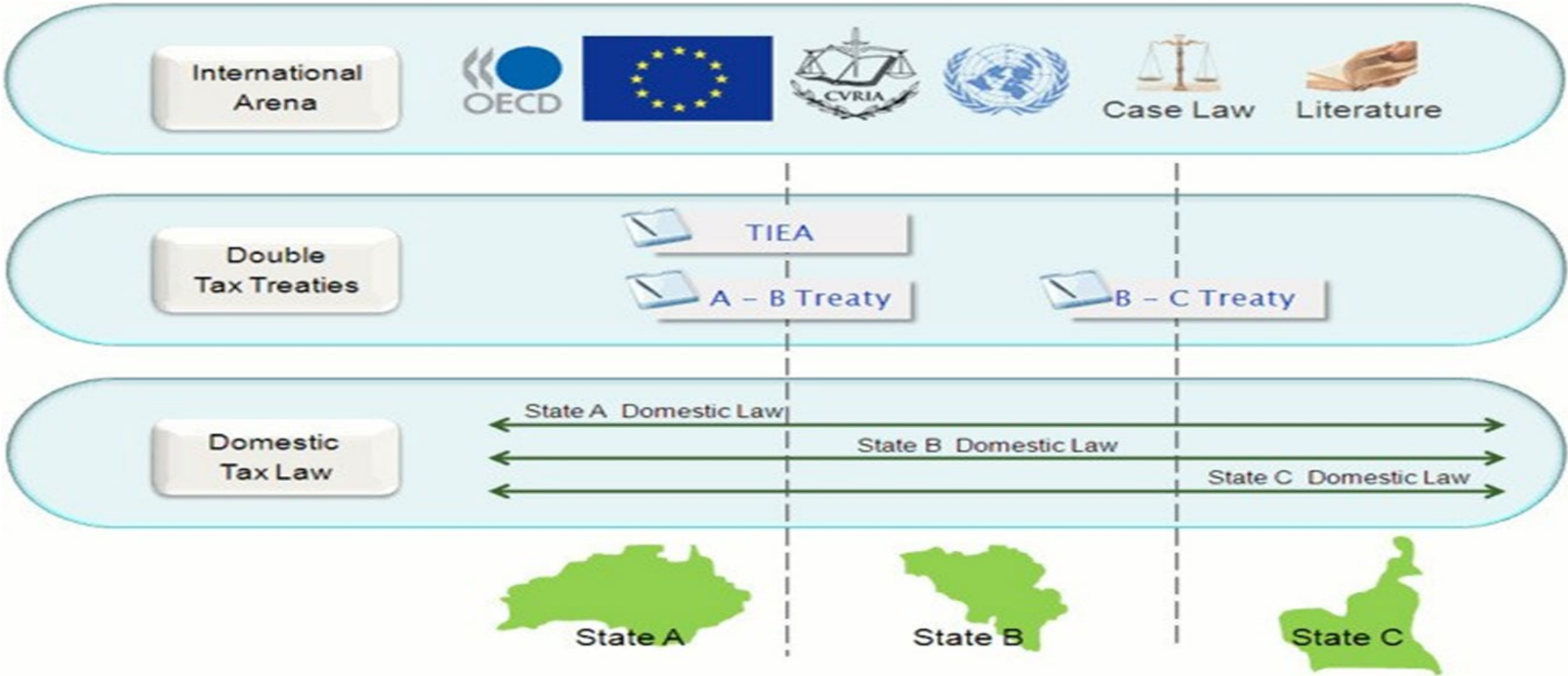
EU BEPS

<u>OECD BEPS Actions</u>	<u>EU Coverage</u>
Action 1: Digital Economy	EC VAT Action Plan EC Proposals on taxation of digital economy
Action 2: Hybrids	Parent-Subsidiary Directive Anti-Tax Avoidance Directive
Action 3:CFC	Anti-Tax Avoidance Directive
Action 4: Interest Limitation	Anti-Tax Avoidance Directive
Action 5: Rulings	Directive on Administrative Cooperation -EOI
Action 6: Treaty Abuse	ATAP Recommendation
Action 7: PE	ATAP Recommendation
Actions 8-10: TP	JTPF to follow up
Action 11: BEPS Data	NA
Action12: Mandatory Disclosure Rules	Directive on Administrative Cooperation -EOI
Action 13: CBCR	Directive on Administrative Cooperation -EOI
Action 14: Dispute Resolution	Directive on Double Taxation Dispute Resolution
Action 15: MLI	NA

EU ANTI-TAX AVOIDANCE DIRECTIVE (ATAD)



CONCEPTUAL MAP OF FACTORS INFLUENCING THE INTERNATIONAL TAX ENVIRONMENT*



ΙΕΡΑΡΧΗΣΗ ΚΑΝΟΝΩΝ ΔΙΚΑΙΟΥ

EU Law (Article 1A of the Constitution)

The Constitution is the supreme law of the Republic of Cyprus (Article 179 of the Constitution)

International Conventions such as Tax Treaties (Article 169 of the Constitution)

Laws, Primary Legislation (i.e. Legislation passed by the House of Representatives & colonial legislation)

Common law and equity principles

Secondary Legislation: Regulatory Administrative Acts (Κανονιστικές Διοικητικές Πράξεις ΚΔΠ)

Tax Circulars?

TAXATION OF INTEREST



DEFINITION FOR INTEREST: INCOME TAX LAW VS. OECD MODEL



Income Tax Law Article 5(1)(c)

- ❖ (c) any dividend, interest or discount;
- ❖ The terms “dividend”, “interest” or “discount” **are not defined**
- ❖ **Concerns Payments Received (i.e. income)**

VS



2017 OECD Model Tax Convention Article 11

- ❖ The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

DEFINITION FOR INTEREST: SDCL VS. OECD MODEL (INCOME)



Special Contribution for the Defence of the Republic Law of 2002 (SDCL) 3(2)(b)

- ❖ (b) every person who is resident in the Republic, who receives or is credited with an amount of interest, except interest falling within the provisions of paragraph (c), at a rate of thirty per cent (17%) on the interest received or credited:
- ❖ The term “interest” is **not defined**
- ❖ **Concerns Payments Received (i.e. income)**

VS



2017 OECD Model Tax Convention Article 11

- ❖ The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

DEFINITION FOR INTEREST: SDCL VS. OECD MODEL (EXPENSES)



SDCL 3(2)(b) first reservation

- ❖ Provided that, notwithstanding of the other provisions of this paragraph, this paragraph applies to **any company that is not a resident of the Republic** and is **resident in another jurisdiction**, which is included in a list of third country jurisdictions that have been assessed by the member states collectively as **non-cooperative for tax purposes** or incorporated or registered in such jurisdiction and is not tax resident in another state not included in the said list and **receives or is credited** with an amount of interest earned **from sources within the Republic** and the said amount is **not paid by an individual**.
- ❖ It is further provided that the above reservation does not apply in the case where the interest received or credited to a non-resident company of the Republic is paid in respect of **securities listed on any recognized stock exchange**.
- ❖ **Concerns Payments Made (i.e. expenses)**

VS



2017 OECD Model Tax Convention Article 11

- ❖ The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

DEFINITION FOR INTEREST: EU IRD VS. OECD MODEL



EU Interest & Royalties Directive Article 2(a)

❖ The term “interest” means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest;

VS



2017 OECD Model Tax Convention Article 11

❖ The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from **government** securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

DEFINITION FOR INTEREST: UN MODEL VS. OECD MODEL



2021 Model Tax Convention Article 11

- ❖ The term “interest” as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article

VS



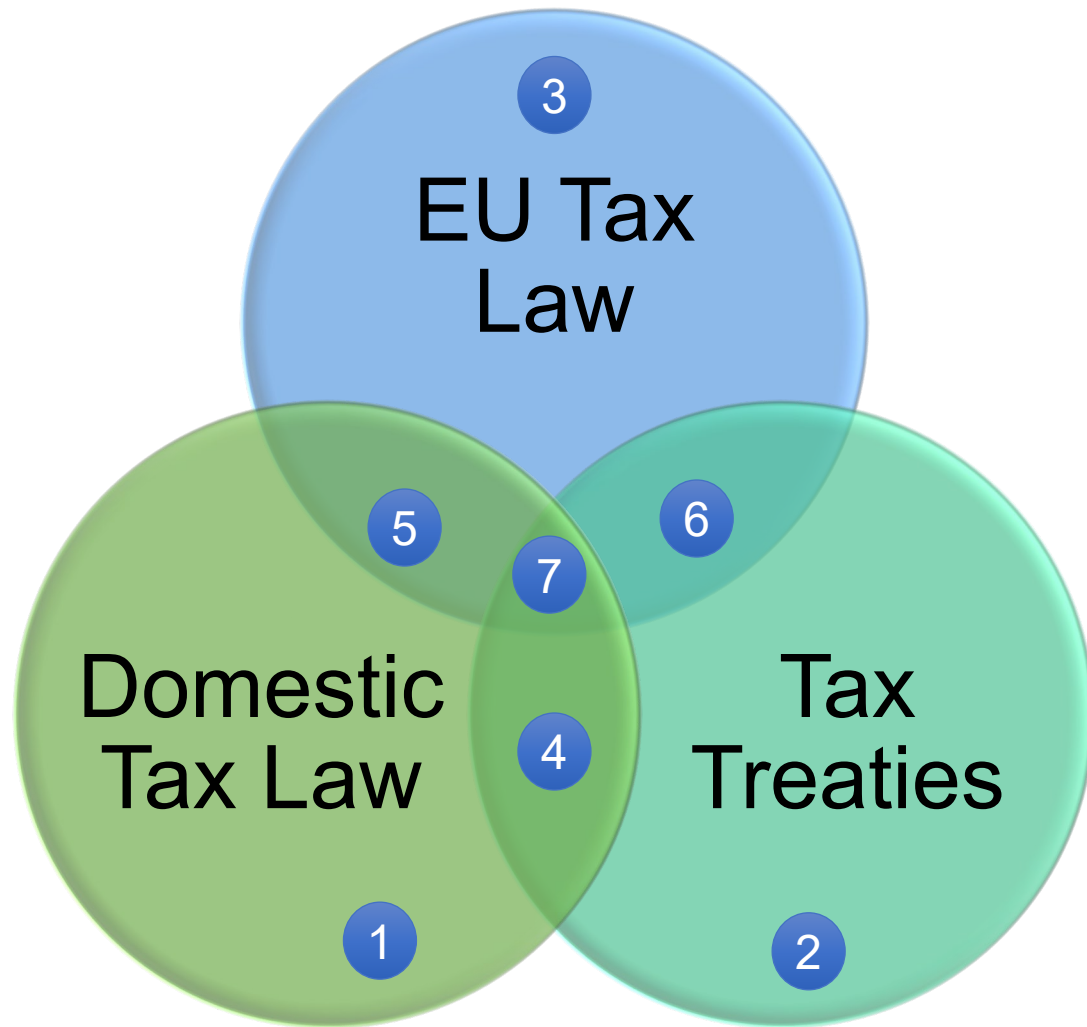
2017 OECD Model Tax Convention Article 11

- ❖ The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

DO THE FOLLOWING AMOUNTS QUALIFY AS INTEREST?

- ☐ Amounts received in lieu of or in satisfaction of interest?
- ☐ Commitment, legal, accounting and other similar costs of borrowing money?
- ☐ Guarantee fees paid to a Guarantor? (OECD TPG Chapter X Section D)?
- ☐ Rights to participate in the profits of the borrower (Is this a Dividend?)
- ☐ Premiums or Discounts? Discounts see Article 5(1)(c) of the ITL
- ☐ Gains on disposal or redemption of debt security?
- ☐ Annuities relating to employment or pensions?

OVERLAPPING BETWEEN DOMESTIC TAX LAW, TAX TREATIES AND EU TAX LAW



- 1 Domestic Law
- 2 Tax Treaties
- 3 EU Law
- 4 Overlap between Domestic Law & Tax Treaties
- 5 Overlap between Domestic Law & EU Tax Law
- 6 Overlap between Tax Treaties & EU Tax Law
- 7 Overlap Between Domestic Law, Tax Treaties & EU Tax Law

ARTICLE 11: INTERACTION WITH OTHER ARTICLES



ARTICLE 11 OECD MTC: INTERACTION WITH OTHER ARTICLES



Article 11 Interest

Article 6 Immovable Property

Mixed payment
e.g. Finance Lease

Article 7 Business profits

Interest attributable to a PE

Article 11(4)

Article 9 Associated Enterprises

TP Adjustment

Management, Control or Capital

Article (11)(6) deny Treaty Benefit

Special Relationship

A11(6)
Wider in Scope

Article 10 Dividends

Debt or Equity or Hybrid Instrument

Article 13 Capital Gains

Disposal or Realisation of Debt instrument

Article 24 Non-Discrimination

A24(3)

PEs of non-resident enterprises

DEFINITIONS: PRACTICAL ISSUES TO CONSIDER

- ❖ **Business vs Investment:** Countries may include investment interest income in a category dealing with income from capital and business interest in a category dealing with income from business (e.g. taxed under ITL or SDC Law).
- ❖ **Conflicts of qualification/classification/characterisation:** Tax treaty or EU IRD provides for an autonomous definition of the term “interest” whereas **domestic tax laws** typically do not provide their own definitions of the term “interest”.
- ❖ Characterization of corporate securities as debt or equity and the payments on those securities as interest or dividends, respectively
- ❖ **Sale of Rights to interest:** Right to receive future payments of interest that are not yet receivable is sold separately from the principal amount of the debt (so-called “stripped interest” obligations)
- ❖ **Sale of obligations with accrued interest** (i.e. unpaid interest): Converting interest income into capital gains)

Timing of Inclusion of Interest Income (or Expense).

Received
(or Paid)?

Becomes
Receivable (or
Payable)

Accrues
(or Accrual)

Market-to-
Market Method
(i.e. fair value
accounting)

- ❖ Cyprus ITL article 5: Income **accruing** or **arising**
- ❖ SDCL article 2(b): **receives** or is **credited** with an amount of interest

TAX ISSUES TO CONSIDER (1)

❖ Taxation of Resident Lenders:

- ❖ CFC Rules typically cover interest income
- ❖ Interest Income taxed under normal rules or eligible for the NID;

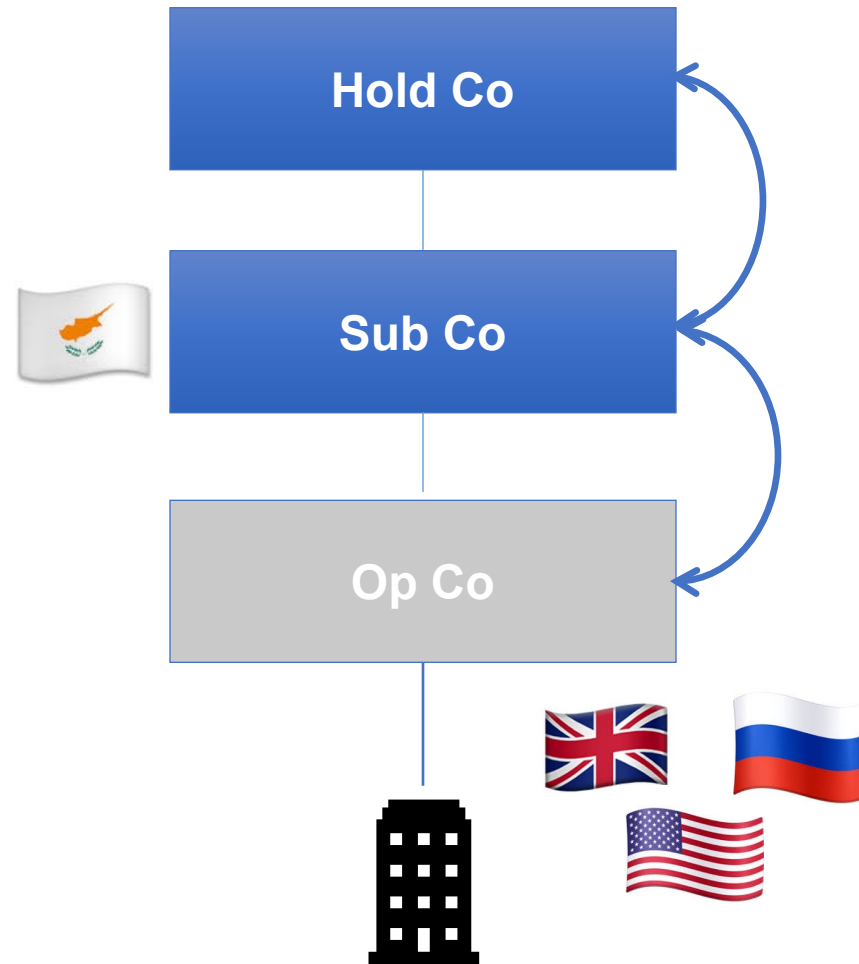
❖ Taxation of Resident Borrowers for payments made to Non-Resident Lenders: Source Rules for Interest:

- ❖ Pay rule; or
- ❖ Use rule; or
- ❖ Assets Location/Mortgage; or
- ❖ Governing Law.

BACK-TO-BACK ARRANGEMENTS: TWO LINES OF DEFENSE

Source country (Op Co)
can tax the income (i.e.
interest expense) paid to
non-residents in two
ways:

- 1) Impose a **WHT**; and
- 2) **Denying a deduction**
for payments to non-
residents



TAX ISSUES TO CONSIDER (2)

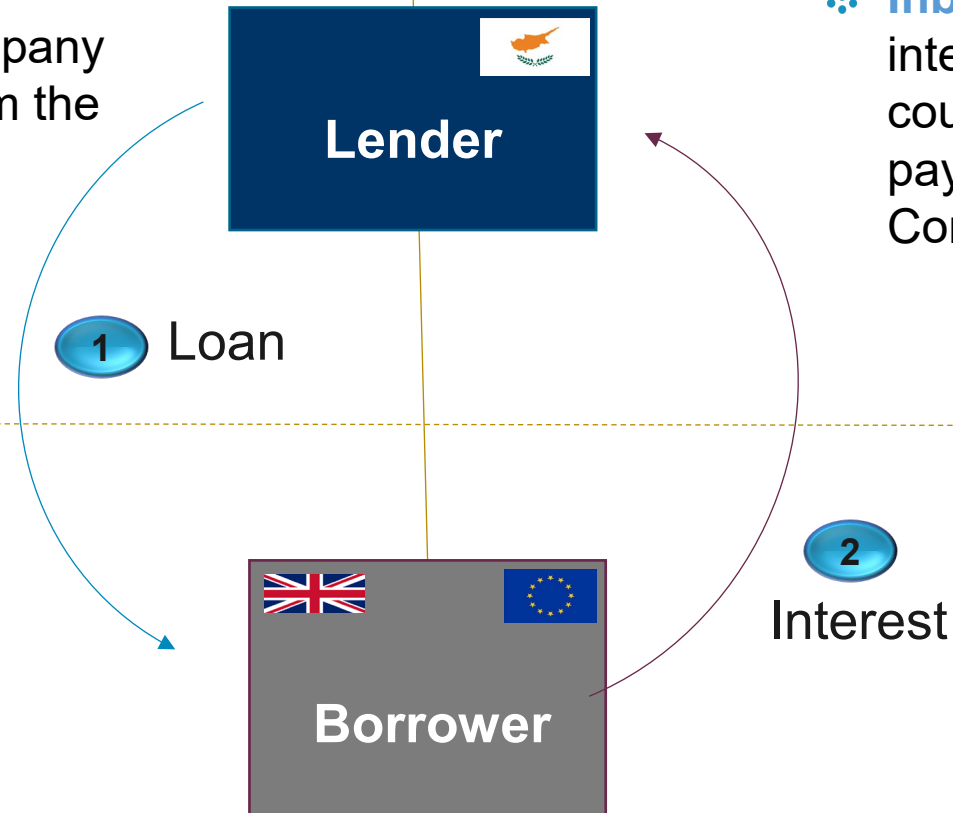
❖ Taxation of Resident Borrowers:

❖ Interest Expenses from the perspective of the **Borrower**:

- ❖ Interest Payments are fully deductible (Transfer pricing issues for disallowing excessive interest)
- ❖ Interest Limitation Rules
- ❖ Linking Rules: Subject to tax Rules on Low taxed Interest income (i.e. Special Tax Regime such as NID)
- ❖ Beneficial Owner
- ❖ Principal Purpose Test
- ❖ Hybrid Rules

FINANCE COMPANY STRUCTURE: “INBOUND” INTEREST

- ❖ **Interest-free** intercompany loans shift income from the lender's country to the borrower's country



- ❖ **Inbound Interest:** Tax Treatment of interest received by residents of a country from non-residents (e.g. payments received by a Cyprus Company)

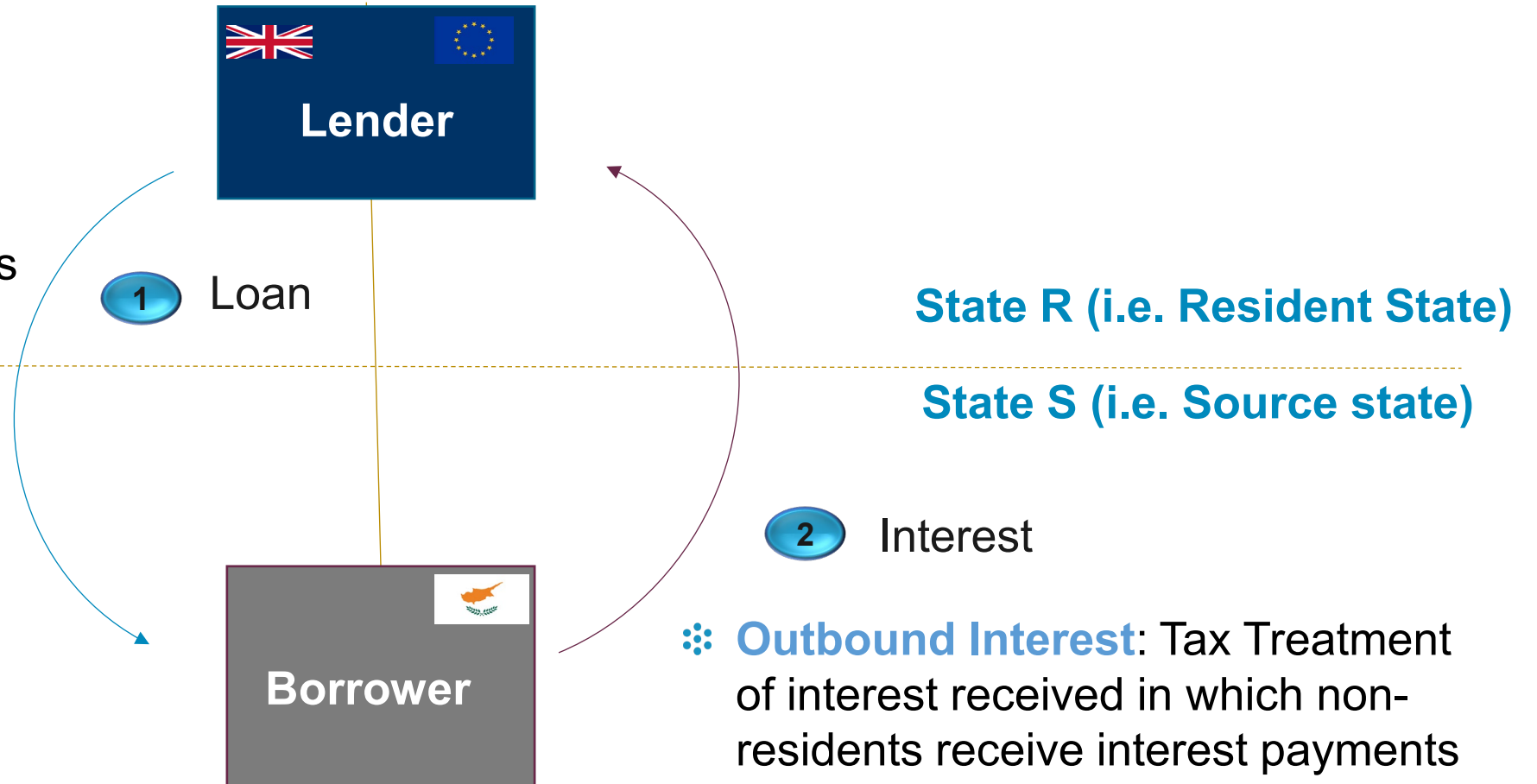
State R (i.e. Resident State)

State S (i.e. Source state)

- ❖ The fundamental **symmetry** between the treatment of cross-border interest income and expenses means that every payment of cross-border interest inevitably raises questions both about whether the **payment is deductible by the payer** and whether the payment is **included in the income of the recipient**.

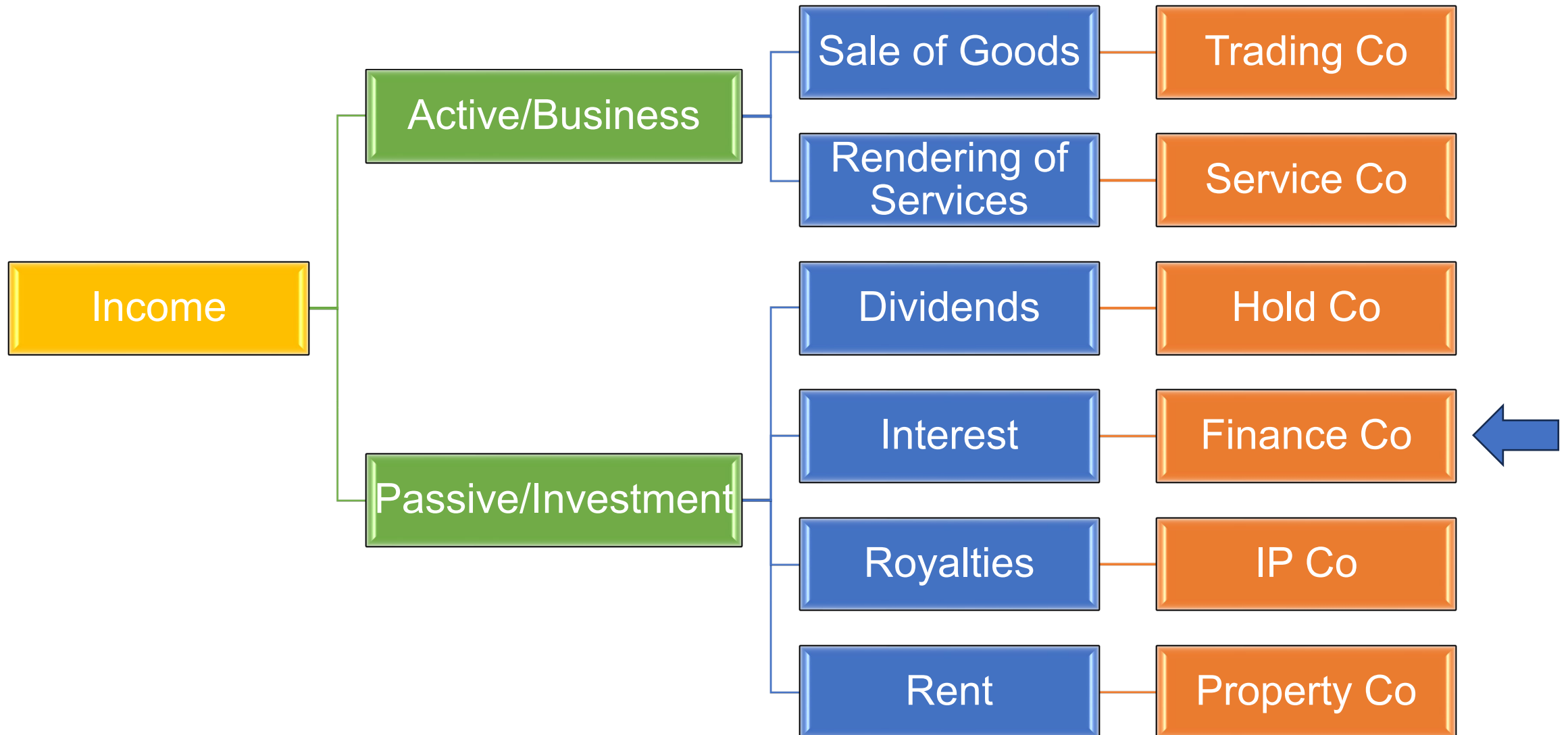
FINANCE COMPANY STRUCTURE: “OUTBOUND” INTEREST

- ❖ **Excessive interest** on intercompany loans shifts income from the borrower's country to the lender's country



- ❖ **Outbound Interest:** Tax Treatment of interest received in which non-residents receive interest payments from residents (e.g. payments made from a Cyprus Company)

INTERNATIONAL TAX PLANNING: TAXABLE INCOME



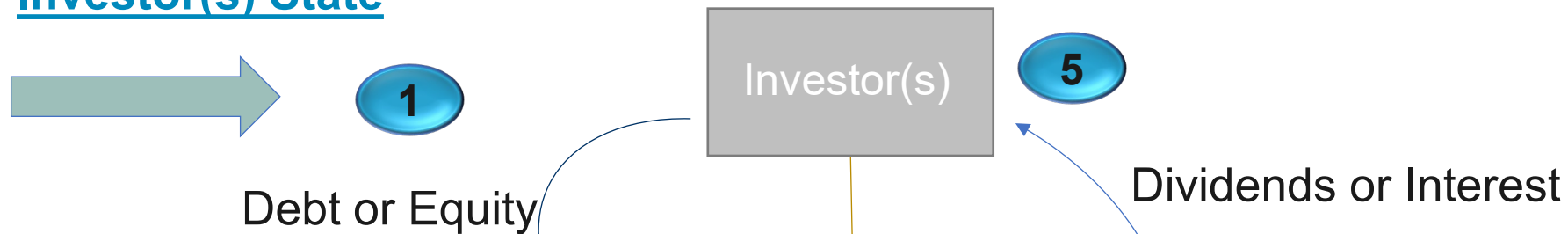
BASE CASE: FINANCE COMPANY STRUCTURE

STEP 1 - 3

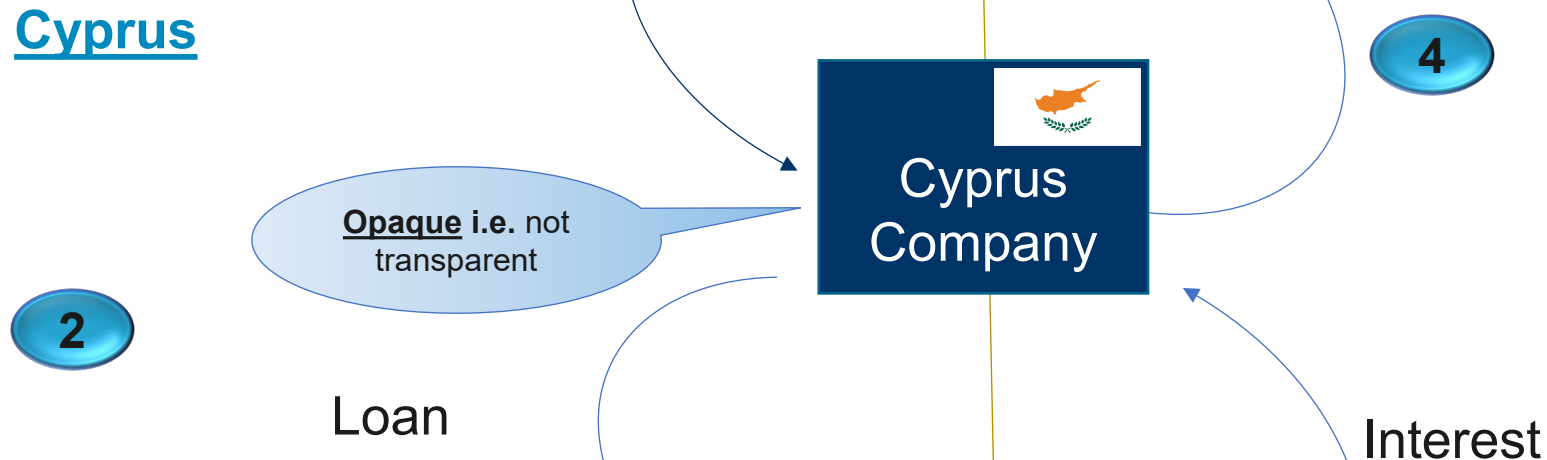


BASE CASE: FINANCE COMPANY STRUCTURE: STEP 1

Investor(s) State



Cyprus



Investment(s) State (i.e. Source state)

FINANCE BY DEBT OR SHARE CAPITAL

STEP 1

- ❖ Cost base (tax value) of assets (e.g. loan) that are thereby brought within the tax jurisdiction of Cyprus.
 - ❖ Issues may arise on the subsequent sale/assignment of such Loans
- ❖ Tax valuation based on the 2022 OECD TPG Chapter X: Transfer pricing aspects of financial transactions

BASE CASE: FINANCE COMPANY STRUCTURE: STEP 3

Investor(s) State

1 Debt or Equity

Cyprus

2

Opaque i.e.
not transparent

Loan

Investment(s) State (i.e. Source state)

Investor(s)

5

Dividends or Interest

4

Cyprus
Company

Interest

3

Operating Co



- No or low/reduced WHT on outbound interest payments
- **EU Interest Royalties Directive** (IRD) 0%
- **Tax Treaty** country in general reduced to 0%, 5%, 10%

TAX IMPLICATIONS AT THE INVESTMENT STATE

STEP 3: Payments made from the non-resident Borrower to the resident Lender (e.g. Cyprus). The Investment State might:

- ❖ Restrict excessive interest payments under local Transfer Pricing Rules
- ❖ Impose withholding tax typically on the gross interest payments
- ❖ Tax Treaty Benefits can be denied on the following anti-avoidance provisions:
 - ❖ Specific Anti-avoidance provisions: **Beneficial Ownership** provision under Article 11(2) of the OECD Model.
 - ❖ General Anti-Abuse Rule (GAAR) and **Principle Purpose Test (PPT)** under Article 29(9) of the OECD Model.
 - ❖ Cyprus company is not considered to be a tax resident
 - ❖ Special Tax Regimes
 - ❖ Hybrid mismatches
- ❖ EU Anti-Abuse provisions

BENEFICIAL OWNERSHIP



SIGNIFICANCE OF “BENEFICIAL OWNERSHIP”

- ❖ OECD Model A10: (Dividends), A11 (Interest), A12 (Royalties)
- ❖ UN Model: A10 (Dividends), A11 (Interest), A12 (Royalties)
- ❖ EU Directives: Parent-Subsidiary, Interest & Royalties
- ❖ US 2016 Model: A10 (Dividends), A11 (Interest), A12 (Royalties), A17 (Pensions),
A21 (Other Income)



OECD MODEL: BENEFICIAL OWNER



Art. 10 DIVIDENDS

(2) ...dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if **the beneficial owner** of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: (a) 5 per cent....; (b) 15 per cent....

Art. 11 INTEREST

(2) ...interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if **the beneficial owner** of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest...

Art. 12 ROYALTIES

(1) Royalties arising in a Contracting State and **beneficially owned** by a resident of the other Contracting State shall be taxable only in that other State...

DEFINITION OF THE TERM “BENEFICIAL OWNERSHIP”(1)

- ❖ First time in 1966 protocol to the UK-US DTT (1945).
- ❖ In 1977 included in the 1977 OECD Model (**not an agent or nominee**).
- ❖ **OECD Negative definition:*** Not a **conduit** or **a mere fiduciary** or **administrator** acting on account of the interested parties...
- * OECD 1986 Conduit Companies Report updated the OECD Commentary in 2003

DEFINITION OF THE TERM “BENEFICIAL OWNERSHIP”(2)

- ❖ **OECD Positive definition (2014):*** Full right to **use** and **enjoy** the payment **unconstrained** by a contractual or legal obligation to **pass on it** to another person... Such an obligation will normally derive from relevant legal documents but may also be found to exist on the **basis of facts and circumstances showing that, in substance,.....**
- ❖ Meaning very diverse. OECD fail to provide an express definition, Surprisingly not in BEPS 6 but OECD suggest the use of Principal Purpose Test (PPT)
- * OECD Discussion draft in 2011, revised Discussion draft in 2012 and final draft updated the OECD commentary in 2014.
- ❖ For more details regarding Beneficial Ownership you can find at the following article as published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 1]* [Click here.](#)

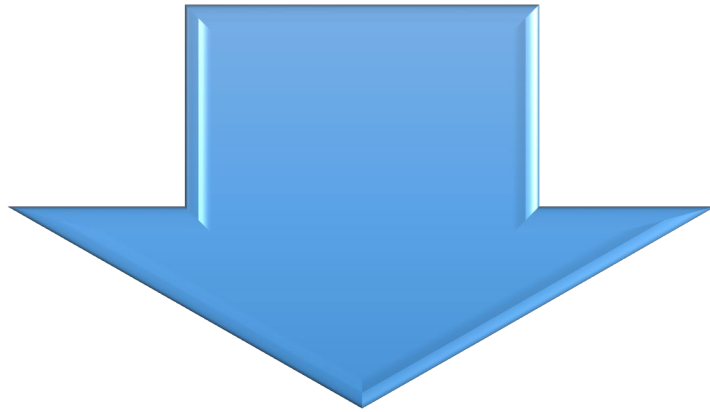
PPT & EU GAAR



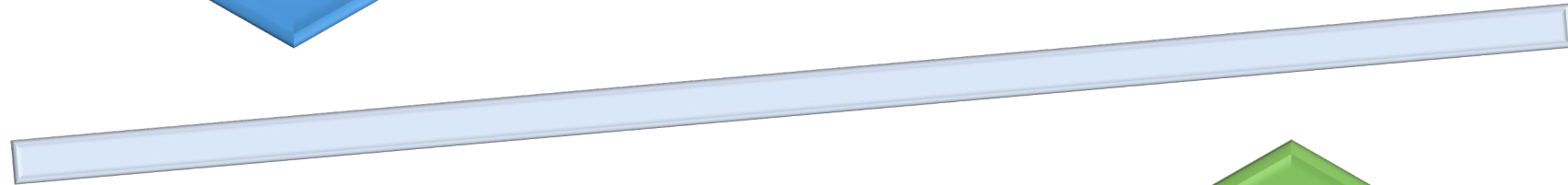
DECONSTRUCTION OF THE PRINCIPAL PURPOSE TEST (PPT)

- ❖ “**Notwithstanding** the other provisions of this Convention,
- ❖ a **benefit** under this Convention shall not be granted in respect of an item of income or capital if it is **reasonable to conclude**, having regard to all relevant facts and circumstances, that obtaining that benefit was **one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit,
- ❖ **unless** it is established that granting that benefit in these circumstances would be **in accordance with the object and purpose** of the relevant provisions of this Convention.”

TWO MAIN ESCAPES FROM BEING CAUGHT BY PPT



Obtaining tax treaty benefit is not a **principal purpose**



Granting of tax treaty benefit is in accordance with **object and purpose** of the relevant provisions of the tax treaty



OBJECT AND PURPOSE OF A TREATY

2017 OECD Model: PREAMBLE TO THE CONVENTION

- ❖ Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,
- ❖ Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for **non-taxation** or **reduced taxation** through **tax evasion** or **avoidance** (including through **treaty-shopping** arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),

BENEFIT IS NOT A PRINCIPAL PURPOSE

2017 OECD Commentary

- ❖ Where an arrangement is **inextricably linked** to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.
- ❖ “[...] removing the obstacles that double taxation presents to the development of economic relations between countries” because “[its] harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known”.
- ❖ For more details regarding the PPT you can find at the following article as published at Bloomberg Tax: INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 2] [Click here.](#)

EU GENERAL ANTI-ABUSE RULE (GAAR): ATAD ARTICLE 6 (1)

- ❖ An arrangement or a series of arrangements shall be ignored if:
 - ❖ put into place for the **main purpose** or **one of the main purposes** of obtaining a tax advantage that defeats the **object or purpose** of the tax law,
 - ❖ **are not genuine** having regard to all relevant facts and circumstances
- ❖ **not genuine means:** to the extent that the arrangement(s) lack valid commercial reasons which reflect economic reality.
- ❖ Article 33A of the Cypriot Income Tax Law

EU GENERAL ANTI-ABUSE RULE (GAAR): ATAD ARTICLE 6 (2)

- ❖ GAAR is a minimum rule because Anti-Tax Avoidance Directive (**ATAD**) shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse
- ❖ For a comparison of the EU GAAR and the PPT, you can find more details in the following article as published at Bloomberg Tax, *OECD's Principal Purpose Test Versus EU's General Anti-abuse Rule* [Click here](#)

EU LAW: ANTI-ABUSE RULES



EU LAW: GENERAL ANTI-ABUSE

- ❖ **General Anti-abuse Principle** of EU law: Danish cases, the ECJ defines the general EU law anti-abuse principle (EU GAAP): It is settled case-law that there is, in EU law, a general legal principle that EU law cannot be relied on for abusive or fraudulent ends.
- ❖ Article 6(1)-(3) of the ATAD (**EU GAAR**)
 - ❖ “for the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.”
 - ❖ “an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.”
 - ❖ “where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law”.

INTEREST AND ROYALTY DIRECTIVE: SPECIFIC ANTI-ABUSE RULE (1)

- ❖ Article 1(1) of the IRD (IRD BO) states:
 - ❖ “interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the **beneficial owner** of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State”.
- ❖ Article 1(4) of the IRD (IRD BO **definition**) states:
 - ❖ “a company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee, or authorised signatory, for some other person.”

INTEREST AND ROYALTY DIRECTIVE: HYBRID FINANCING RULES

- ❖ Article 4(1) of the IRD (Hybrid Financing rules) states:
 - ❖ The source State **shall not be obliged** to ensure the benefits of this Directive in the following cases:
 - ❖ (a) payments which are treated as a **distribution of profits** or as a **repayment of capital** under the law of the source State;
 - ❖ (b) payments from debt-claims which carry a right to **participate in the debtor's profits**;
 - ❖ (c) payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
 - ❖ (d) payments from debt-claims which contain **no provision for repayment** of the principal amount **or** where the repayment is **due more than 50 years** after the date of issue.

INTEREST AND ROYALTY DIRECTIVE: SPECIFIC ANTI-ABUSE RULE (2)

- ❖ Article 5(1) of the IRD (IRD Anti-Abuse [Reservation 1](#)) states:
 - ❖ “This Directive shall not preclude the application of domestic or agreement-based provisions required for the **prevention of fraud or abuse**.”
- ❖ Article 5(2) of the IRD (IRD Anti-Abuse [Reservation 2](#)) states:
 - ❖ “Member States may, in the case of transactions for which the **principal motive or one of the principal motives is tax evasion, tax avoidance or abuse**, withdraw the benefits of this Directive or refuse to apply this Directive.”
- ❖ IRD Council Directive 2003/49/EC of 3 June 2003, as amended on the Council Directive 2013/13/EU of 13 May 2013, [click here](#)

SPECIAL TAX REGIMES



OECD MODEL: PROVISION ON SPECIAL TAX REGIMES

- ❖ Notwithstanding the provisions of [(in the case of **Article 11**): **paragraphs 1 and 2** but subject to the provisions of paragraph 4] [(in the case of Article 12): paragraph 1 but subject to the provisions of paragraph 3] of this Article, **[interest]** [royalties] arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is **connected to the payer** may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a **special tax regime** with respect to the **[interest]** [royalties] in the State of which it is resident.

[OECD Model Commentary on Article 1 paragraphs 85-100]

EU PROVISION ON SPECIAL TAX REGIMES: INTEREST & ROYALTIES DIRECTIVE PROPOSAL (FAILED)

- ❖ 1. **Interest** or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that Member State ... provided that:
 - (a) ...
 - (b) the income deriving from the royalty or interest payments **is subject to an effective tax rate of at least 10% in the Member State of the beneficial owner** ...

- ❖ 1b. Where the condition ... above is not fulfilled, royalty payments arising in a Member State shall however be exempt ... to the extent that
 - the [lower effective tax rate is the result of an *IP box regime compliant with the OECD Nexus Approach*] (I alternative); and
 - the *effective tax rate* is at least equal to X% (II alternative).

[Room Document 2, Working Party on Tax Questions (Direct Taxation), Interest and Royalties Directive (16 Feb. 2016)]

OECD, UN, 2016 US MODEL

- ❖ “Pillar 2” in its Two-Pillar package, the OECD/G20 BEPS Inclusive Framework (IF) has released its own Subject To Tax Rule (STTR) and an accompanying multilateral instrument to implement it into treaties (**Rate is 9%** on gross payments).
- ❖ At its 26th session in March 2023 the UN Tax Committee (UNTC) approved an STTR which will be included in the next edition of the UN Model Convention
- ❖ 2016 US Model Income Tax Convention

CORPORATE SUBSTANCE

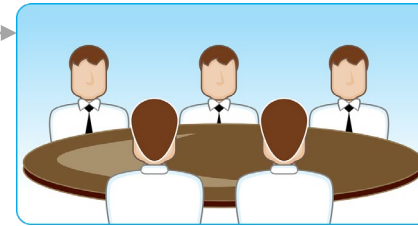
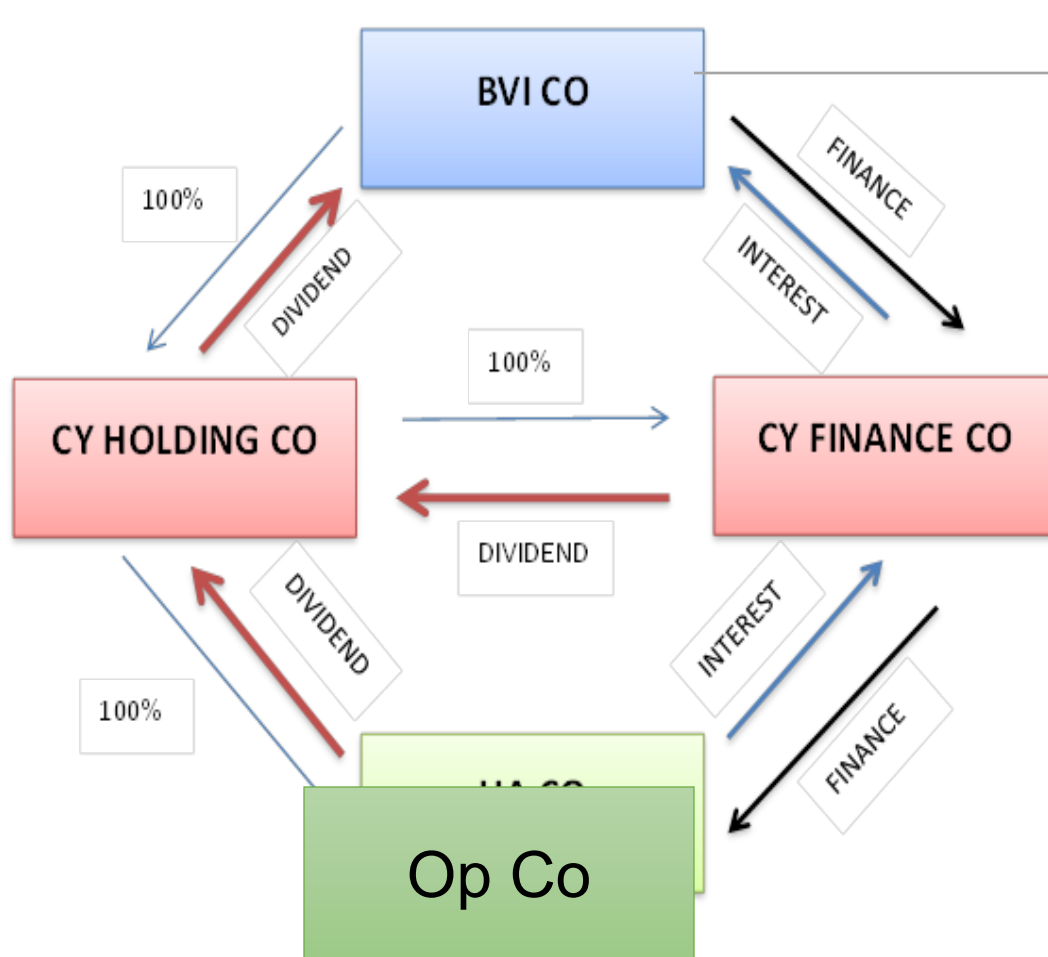


CORPORATE RESIDENCE



For more details about corporate substance post-BEPS you can find in the following article as published in Bloomberg Tax: *INSIGHT: Corporate Residence Post-BEPS and Global Mobility*, [Click here](#)

PRACTICAL ISSUE



Majority of the Board of Directors are Cypriot Tax residents;

→ Under the **M&C test**, BVI Co is probably Cyprus tax resident; **and as a result,**

→ The BVI Co is taxed in Cyprus on its world-wide income wherever arising.

CYPRUS DOMESTIC LAW FOR CORPORATE RESIDENCE

No detailed guidelines have been issued by the Cypriot Tax Authorities

No jurisprudence from Cyprus courts of what constitutes management and control

Cyprus legal system is mostly based on common law order

Common law jurisprudence is widely followed by Cyprus courts

Higher level of decision-making: De Beers case (1906), Unit Construction Co case (1960), Wood v Holden case (2006)

TAX TREATIES: TIE BREAKER RULE - PLACE OF EFFECTIVE MANAGEMENT CRITERIA (POEM)

meetings of the person's board of directors or equivalent body are usually held;

where the chief executive officer and other senior executives usually carry on their activities;

where the senior day-to-day management of the person is carried on;

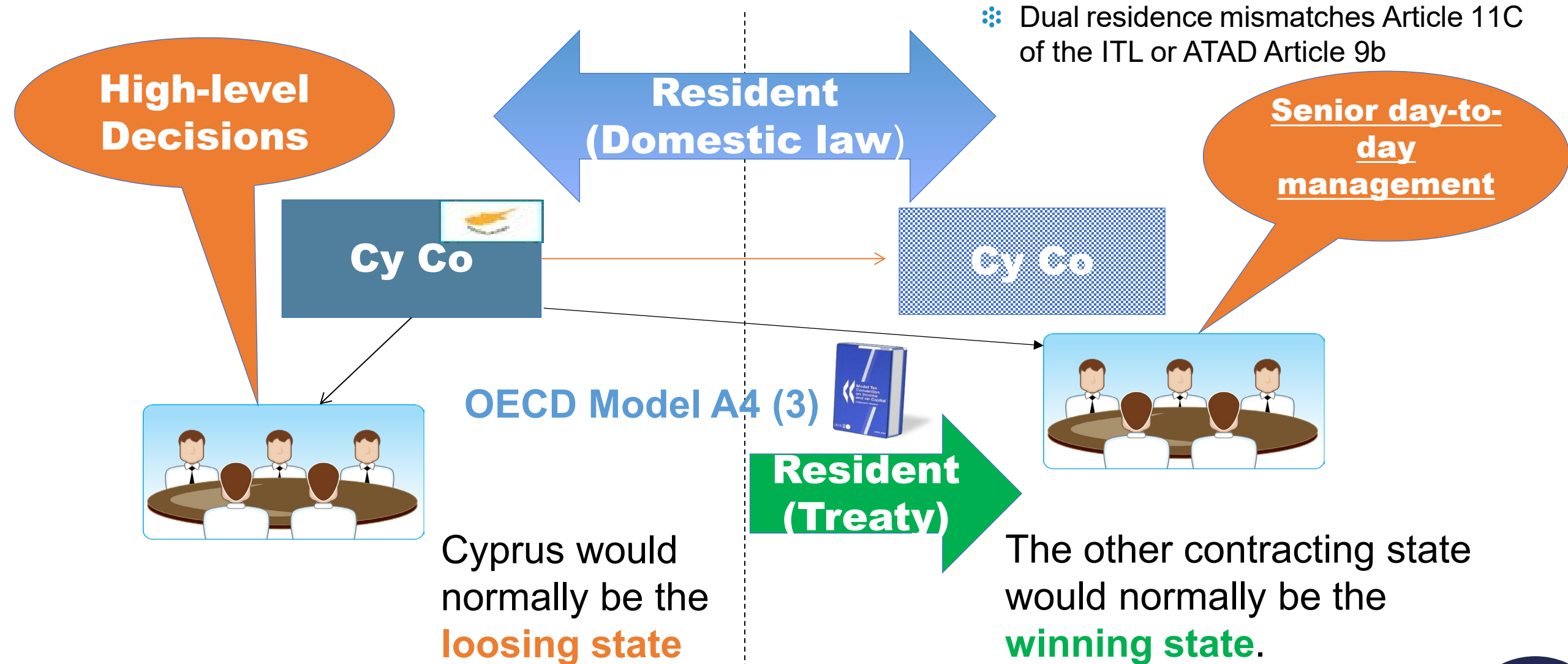
where the person's headquarters are located;

which country's laws govern the legal status of the person; and

where its accounting records are kept.

[OECD Commentary 2014 on Art. 4(3) para. 24]

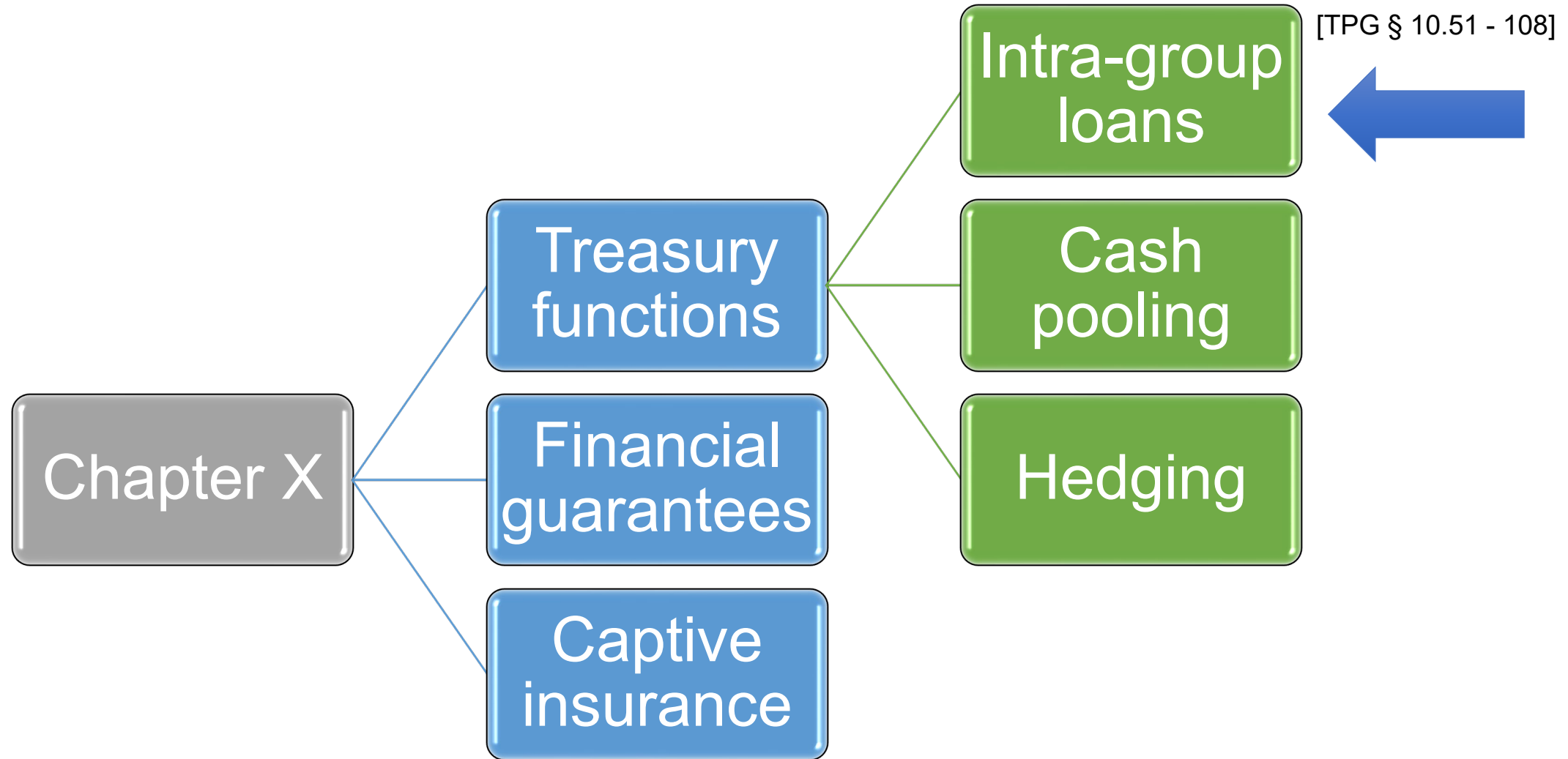
PRACTICAL EXAMPLE: DUAL RESIDENCE CYPRUS COMPANY



TRANSFER PRICING CHALLENGES FOR INTRA-GROUP LOANS



OECD TPG CHAPTER X: TRANSFER PRICING ASPECTS OF FINANCIAL TRANSACTIONS



PURPOSE OF CHAPTER X

Loans

- ❖ Cash rich companies with lack of substance
- ❖ Unusual contractual terms leading to high interest rates

Cash pools

- ❖ High returns to cash pool leaders but little activity
- ❖ Participants leaving balances in the pool long term

Treasury Centres

- ❖ Interest income in treasury centres with limited substance

Captives

- ❖ Typically used to shift profits to low or no tax jurisdictions, but not truly insurers

Guarantees

- ❖ High guarantee fees and enhancement of debt quantum

APPLICATION OF THE ALP—4 STEP APPROACH

Step 1: Identification of the commercial or financial relations



Step 2: Recognition of the accurately delineated controlled transactions



Step 3: Selection of the most appropriate transfer pricing method

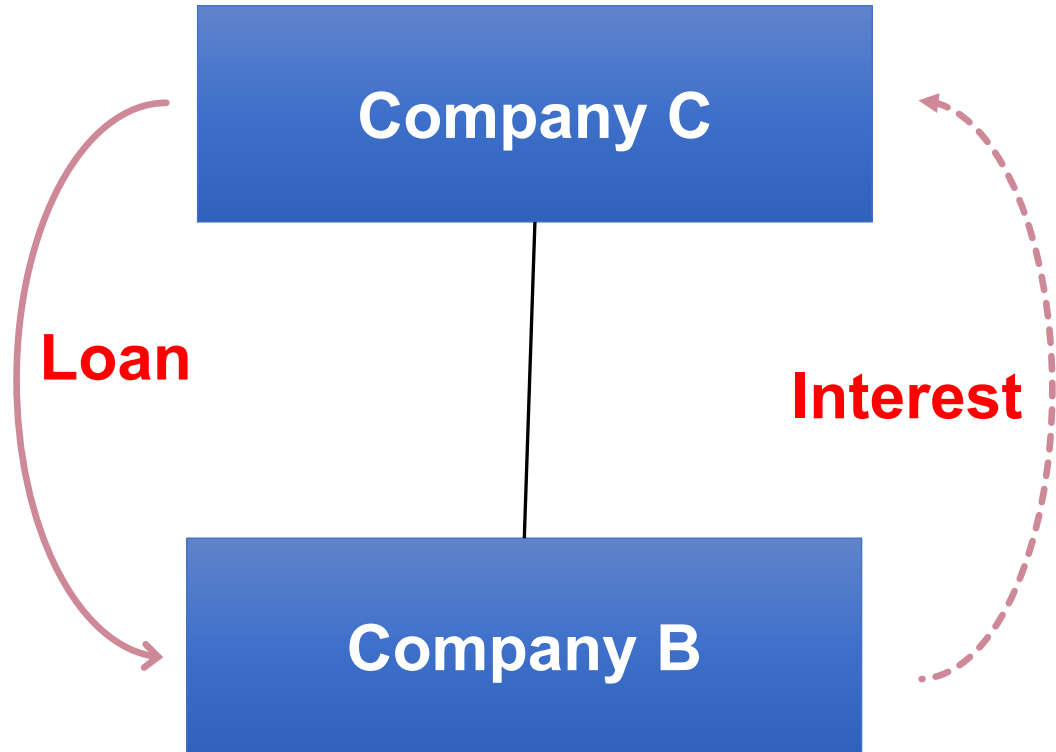


Step 4: Application of the selected transfer pricing method: Economic analysis (Benchmarking)

DETERMINATION OF WHETHER A PURPORTED LOAN SHOULD BE REGARDED AS A LOAN (OR EQUITY)

- ❖ Commentary to Article 9 of the OECD Model Tax Convention notes in paragraph 3(b) that Article 9 is relevant
 - ❖ “**not only** in determining whether the **rate of interest** provided for in a **loan** contract is an arm’s length rate, but **also** whether a prima facie loan can be **regarded** as a **loan or** should be regarded as some other kind of payment, in particular a **contribution to equity** capital”. [TPG §10.05 & §10.10]
- ❖ Guidance on non-recognition (Section D.2 of Chapter I) also be relevant [TPG § 10.06]
- ❖ Accurate delineation of the actual transaction under Chapter I will precede any pricing attempt [TPG § 10.11]
 - ❖ Caveat §C.1. Intra-group loans applies in determining whether interest rate in a loan contract is arm’s length, assuming the transactions are recognized as loans under Chapter I or relevant domestic laws.

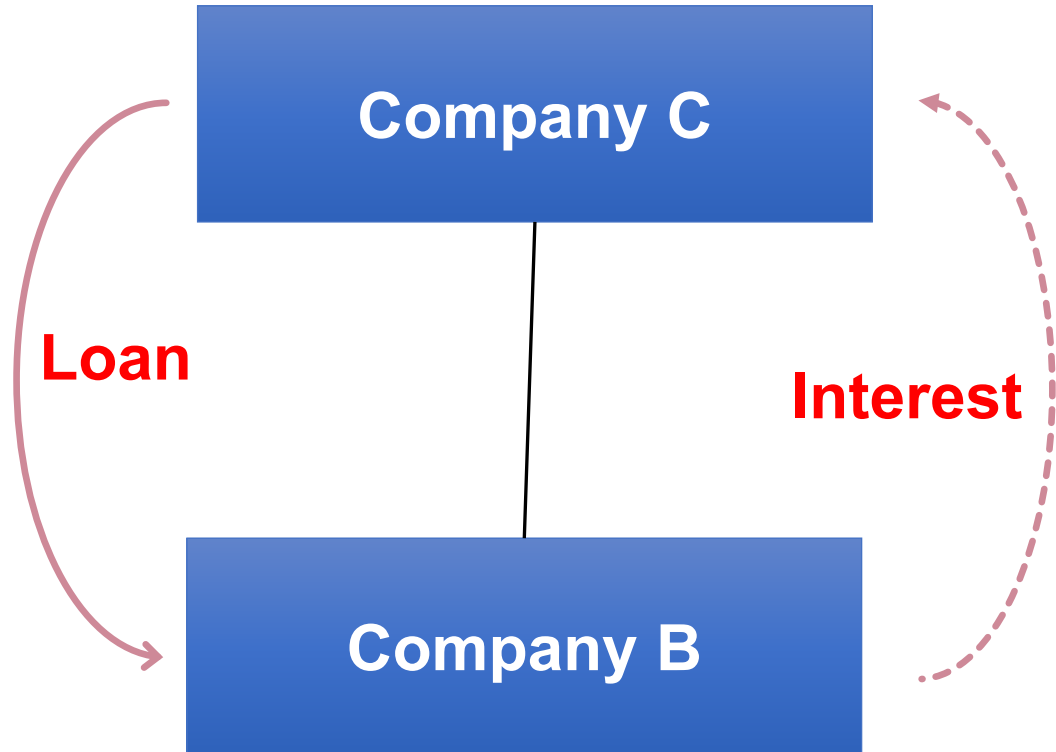
Practical Example: Loan VS Equity Contribution (Facts)



- ❖ Company B, a member of an MNE group, needs additional funding for its business activities.
- ❖ Company C lend money to Company B which is denominated as a loan with a term of 10 years.
- ❖ Projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount.
- ❖ An unrelated party would not be willing to provide such a loan to Company B due to its inability to repay the advance.

[TPG § 10.13]

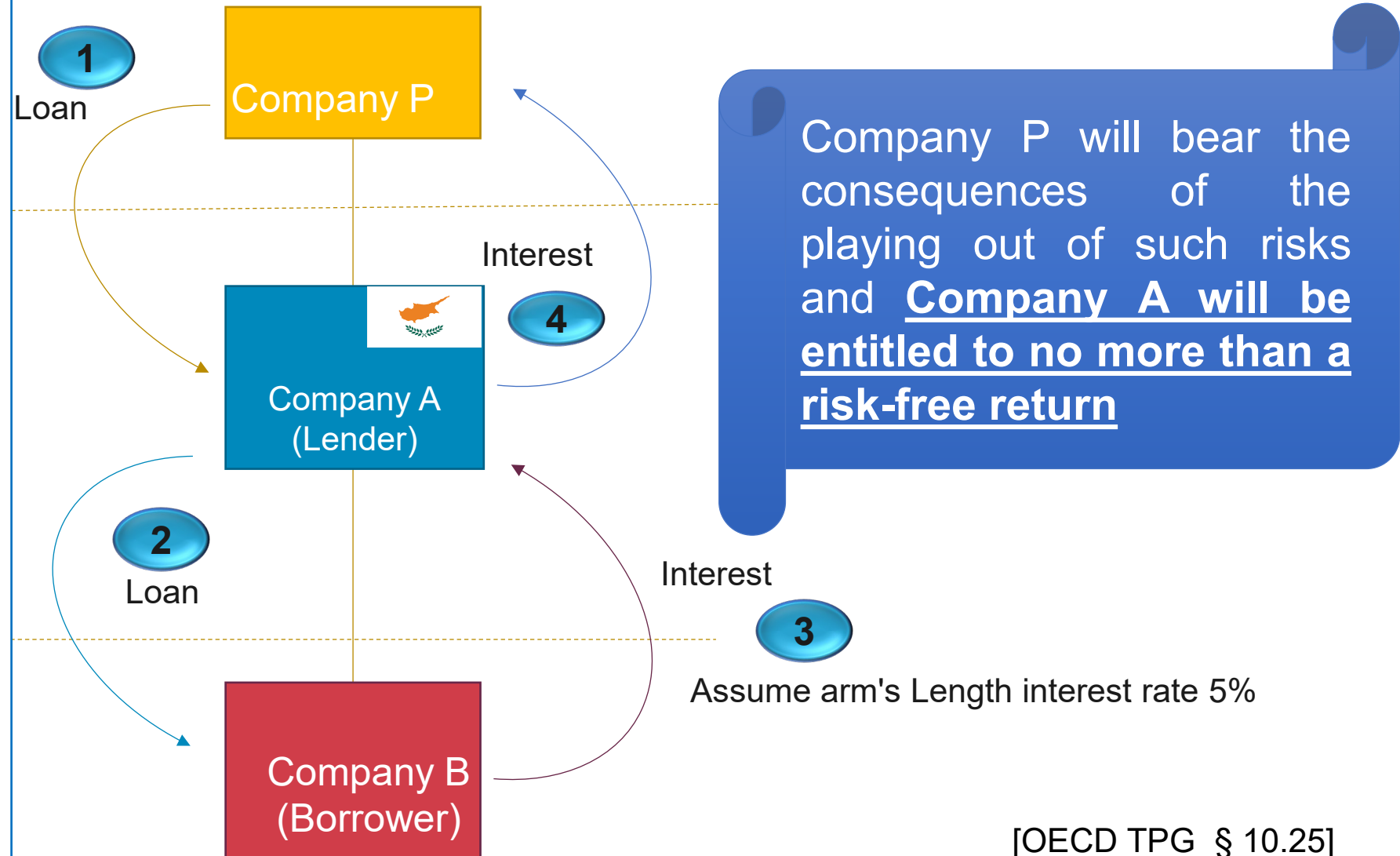
PRACTICAL EXAMPLE: LOAN VS EQUITY CONTRIBUTION



- ✿ Accordingly, the accurately delineated loan amount from Company C to Company B, for transfer pricing purposes, is determined by the maximum amount an unrelated lender would offer and an unrelated borrower would accept, considering the possibility of no loan being made.
- ✿ Consequently, the remainder of Company C's advance to Company B would not be delineated as a loan for the purposes of determining the amount of interest which Company B would have paid at arm's length.

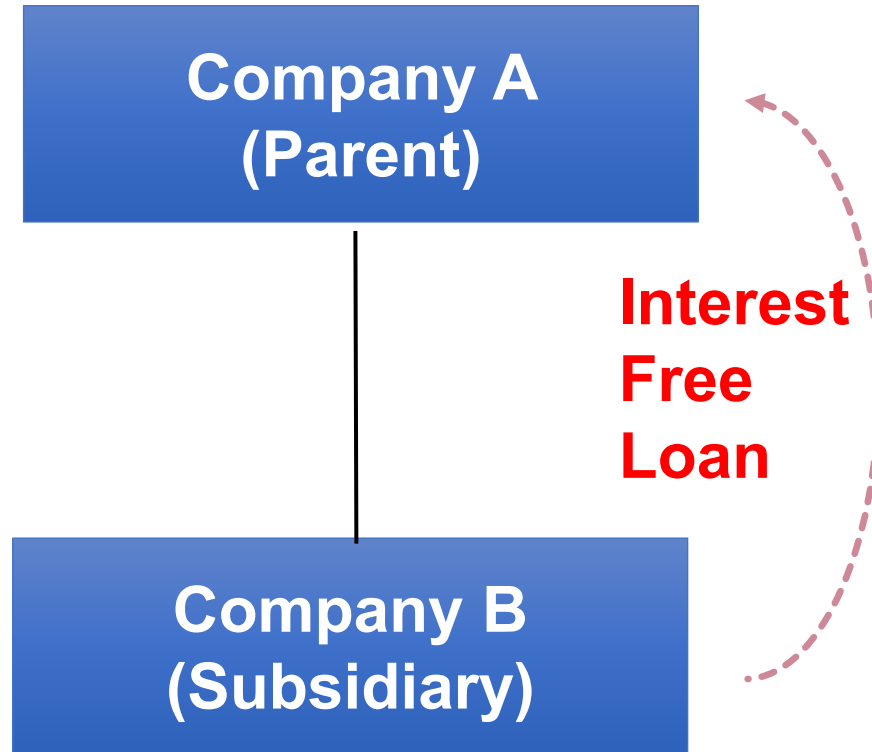
FINANCING COMPANY: RISK-FREE RETURN EXAMPLE

- ❖ Accurate delineation of the actual transaction indicates that **Company A does not exercise control** functions related to the advance of funds
- ❖ **But** that **Company P**, the parent company of the MNE group, is **exercising control over those risks**, and has the **financial capacity** to assume such risks.



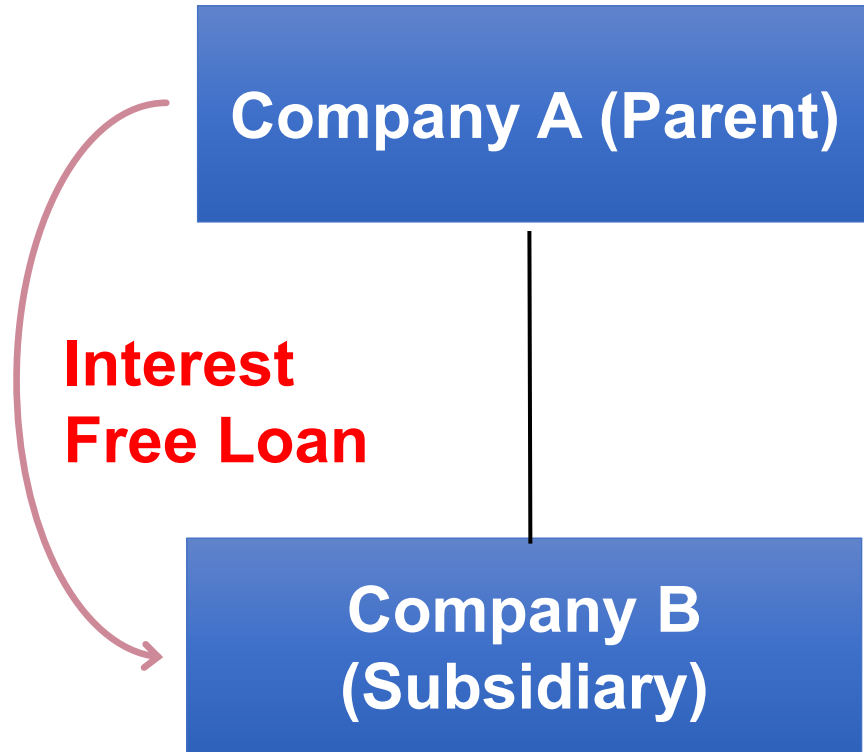
[OECD TPG § 10.25]

Intercompany loan by a subsidiary to its non-resident parent corporation



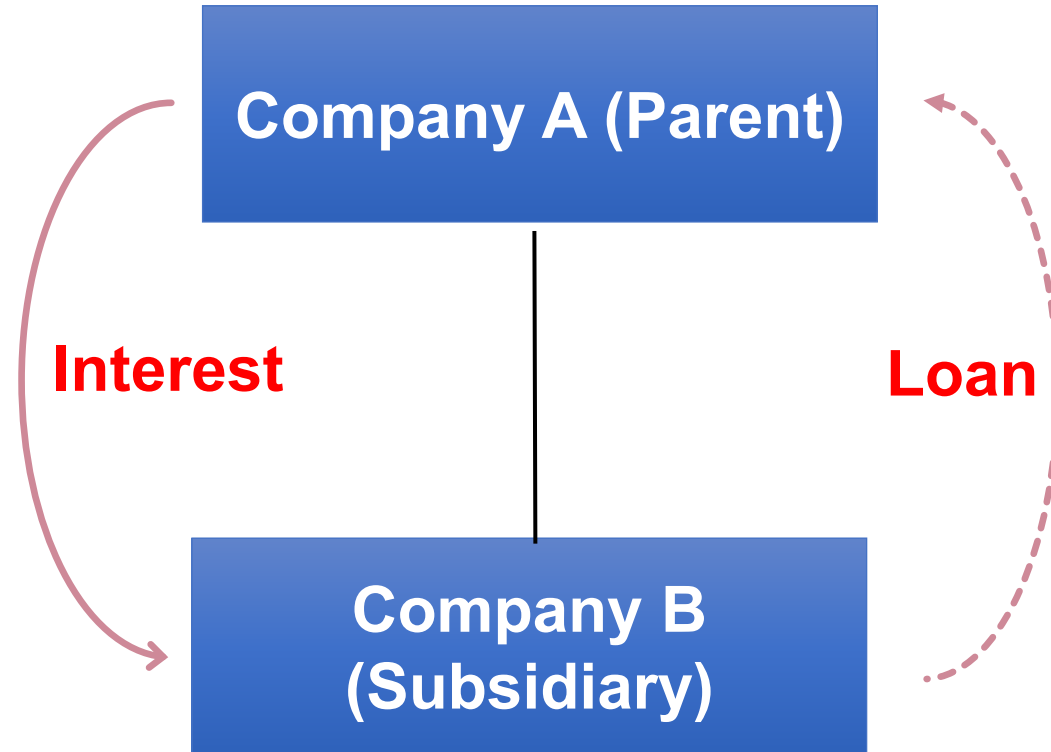
- ❖ Company B, subsidiary of Company A provides **interest free loan**.
- ❖ Might be characterised as **distribution** (dividend)
- ❖ Countries introduce anti-avoidance upstream loan rules

Intercompany loan by a parent to its subsidiary corporation



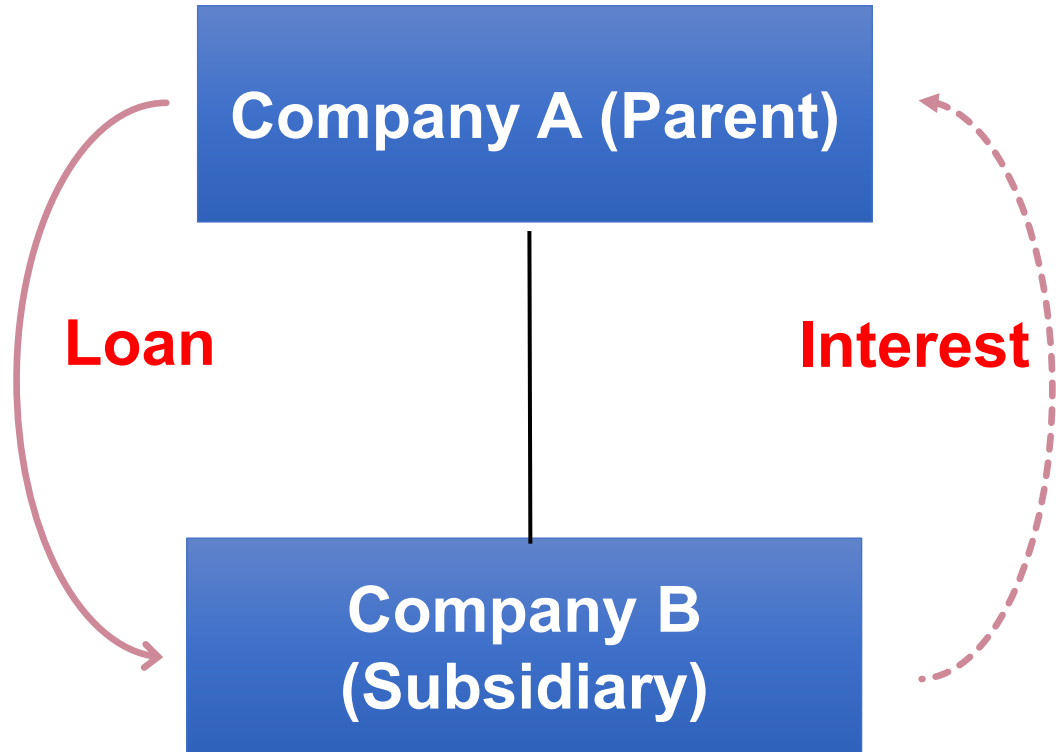
- ❖ Company A, parent of Company B provides **interest free loan**.
- ❖ Might be characterised as **equity** (i.e. contribution to capital)

Excessive Interest: Loan by a Subsidiary to its non-resident Parent



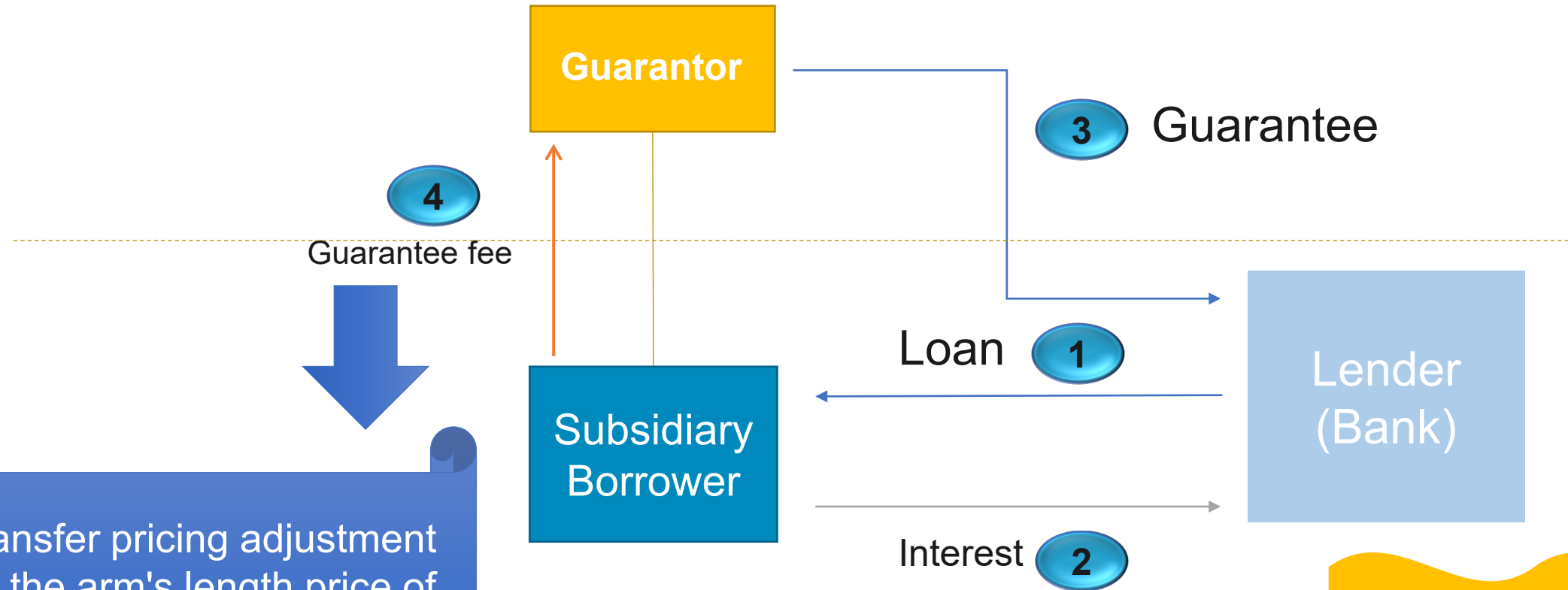
- ❖ Company B, subsidiary of Company A provides a loan to its parent with interest rate in excess of an arm's length rate.
- ❖ The excess could be treated
 - ❖ contribution to the equity capital of the Subsidiary, **or**
 - ❖ interest-free loan by the Parent to the Subsidiary, **or**
 - ❖ partial repayment of the Subsidiary's loan to the Parent.
- ❖ Transfer Pricing adjustments:
 - ❖ **Primary adjustment** Country of the Parent (OECD Model Article 9(1))
 - ❖ **Corresponding adjustment** Country of the Subsidiary (OECD Model Article 9(2))

Excessive Interest: Loan by a Parent to its non-resident Subsidiary



- ❖ Company A, Parent of Company B provides a loan to its subsidiary with interest rate in excess of an arm's length rate.
- ❖ The excess could be treated as dividends
- ❖ Transfer Pricing adjustments:
 - ❖ **Primary adjustment** Country of the Subsidiary (OECD Model Article 9(1))
 - ❖ **Corresponding adjustment** Country of the Parent (OECD Model Article 9(2))

INTRA-GROUP FINANCIAL GUARANTEES: PRACTICAL EXAMPLE



Transfer pricing adjustment for the arm's length price of a third-party comparable guarantee

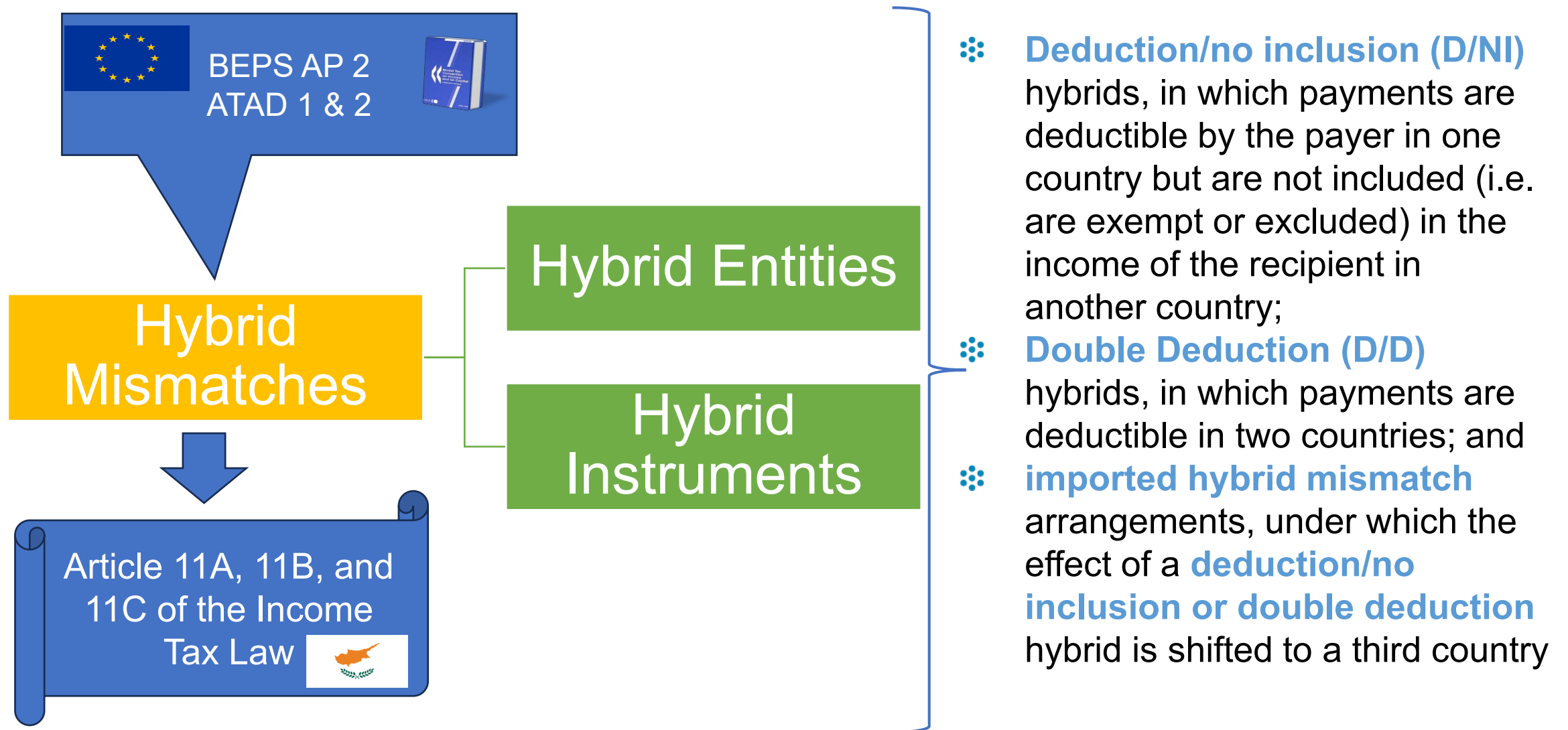
- ❖ Types of explicit financial guarantees:
 - ❖ Downstream guarantee
 - ❖ Cross-guarantee
 - ❖ Upstream guarantee

Performance Guarantees?

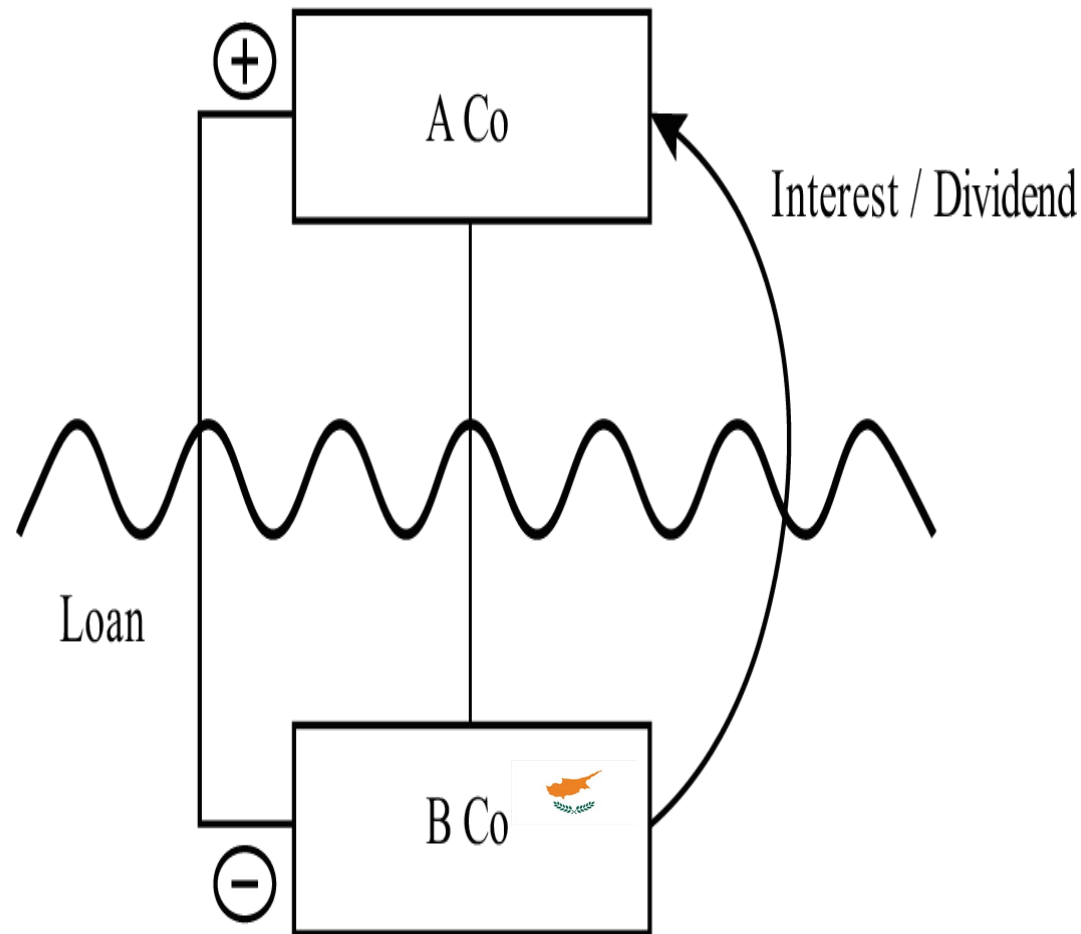
HYBRID MISMATCHES



HYBRID MISMATCHES

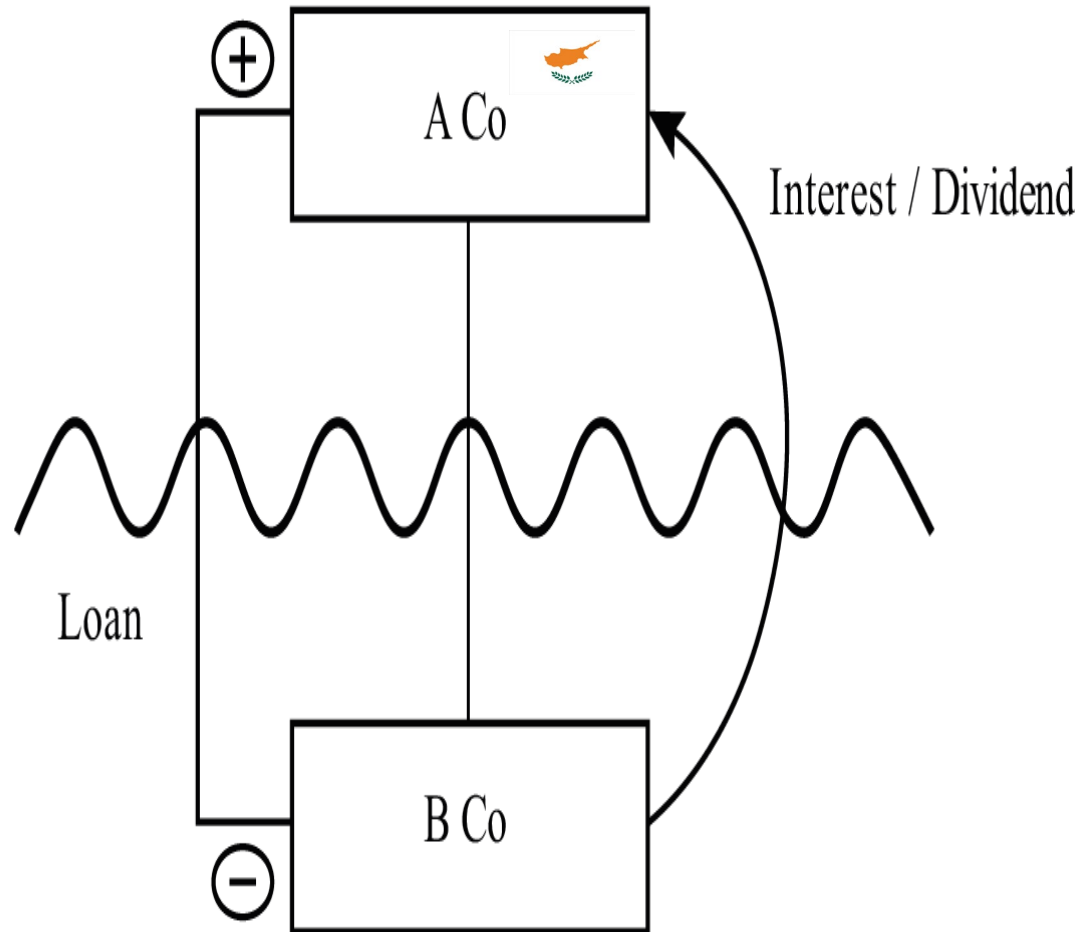


DEDUCTION WITHOUT INCLUSION MISMATCHES (D/NI): PAYER



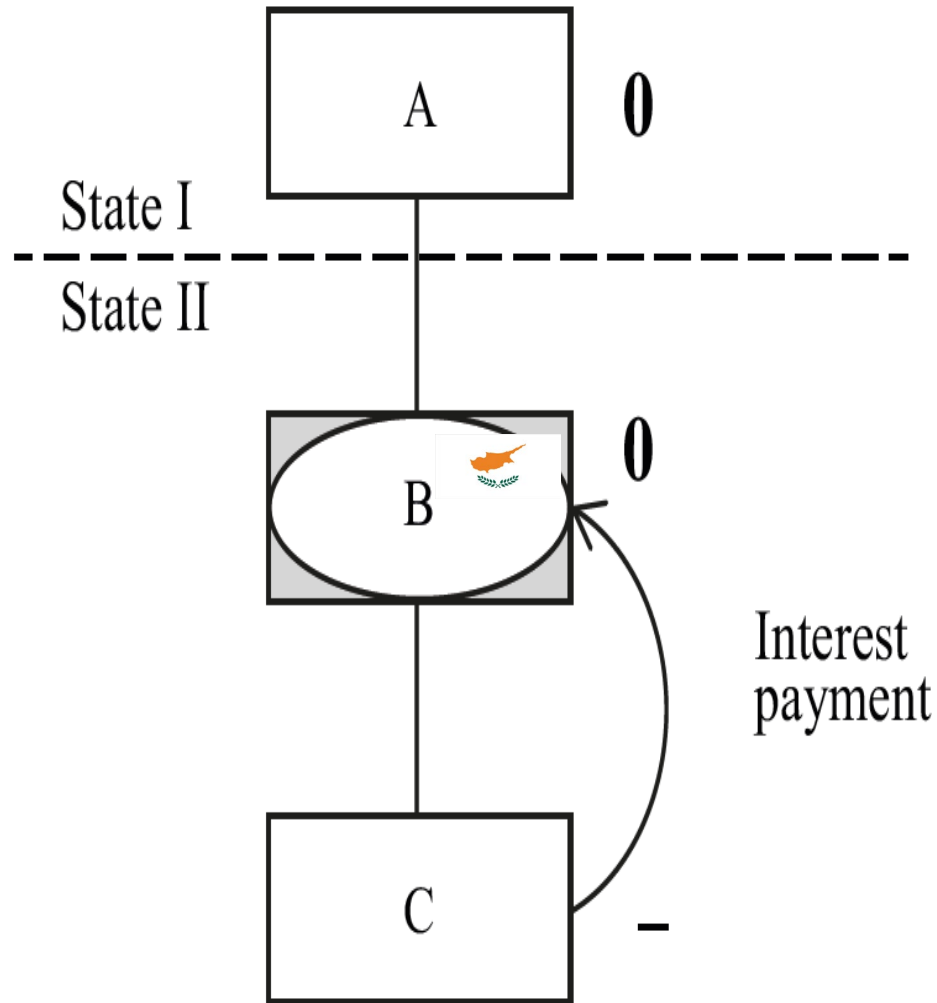
- ❖ Deduction at the level of B Co without inclusion at the level of A Co
- ❖ **Primary Right:** Deduction shall be denied in the payer jurisdiction, the country of B Co, i.e. Cyprus
- ❖ Article 11A(2)(a) of the Cypriot Income Tax Law

DEDUCTION WITHOUT INCLUSION MISMATCHES: RECIPIENT



- ❖ Deduction at the level of B Co without inclusion at the level of A Co Cyprus company:
- ❖ **Primary Right:** Deduction shall be denied in the payer jurisdiction (the country of B Co). If not, a defensive rule is triggered (so called “linking rule”)
- ❖ **Secondary Right (i.e. linking rule):** Denial of dividend exemption for deductible payments and therefore included in income of the Cyprus company and taxed accordingly.
- ❖ Article 11A(2)(b) of the Cypriot Income Tax Law
- ❖ Article 8(20) first reservation takes precedence over Article 11A of the Cypriot Income Tax Law (Linking rule under Parent-Subsidiary Directive)

HYBRID MISMATCH INVOLVING REVERSE HYBRID ENTITY



- ❖ State I considers Cyprus Company B as a taxable person (i.e. opaque) and therefore interest payment is not included.
- ❖ State II (i.e. Cyprus) considers Company B as fiscally transparent (e.g. partnership) and therefore interest payment is not included.
- ❖ Interest payment is deducted by Company C.
- ❖ Company B is a Hybrid Entry
- ❖ Therefore:
 - ❖ Hybrid entity (Company B) must be treated as a resident in Cyprus
 - ❖ Article 11B of the Cypriot Income Tax Law

IMPACT ON THE NOTIONAL INTEREST DEDUCTION & TAX TREATIES

- ❖ The hybrid mismatch rules are inapplicable in cases where a deduction/non-inclusion or double deduction outcome occurs, but this outcome is not caused by a hybrid entity or hybrid instrument. For instance, these rules would not apply in a scenario where one jurisdiction grants a deduction for interest payments made to a non-resident, while the other jurisdiction does not impose tax on that interest.
- ❖ Similarly, the rules would not be relevant if one country allows a deduction for notional income on an equity investment in a domestic corporation by a non-resident, but the other jurisdiction does not tax the notional income.
- ❖ **2017 OECD Model Article 1(2)** reads as follows:
 - ❖ For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

INTEREST INCOME UNDER TAX TREATIES & TRANSFER PRICING



WHEN DOES ARTICLE 11 APPLY?



Conditions that apply to the income

- ❖ Interest as **defined** (internal definition) in Art.11(3)
- ❖ Must be **paid**
- ❖ **Source** in one of the contracting states (single sourcing rule)

Conditions that apply to the recipient

- ❖ **Resident** of the other contracting state
- ❖ **Beneficial owner** (treaty anti avoidance provision)

ARTICLE 11 INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.
6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

OECD MODEL ARTICLE 11(6) EXCESSIVE INTEREST: PRACTICAL EXAMPLE



6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

- ❖ The purpose of Article 11 paragraph 6 is to restrict the operation of the provisions concerning the taxation of interest up to the arm's length interest payments.
- ❖ For example, interest **payment amounting EUR 5 million** and the arm's length amount of the interest is **EUR 3 million**, then the excess amount of **EU 2 million** would not be entitled to the tax treaty benefit under Article 11 Interest.



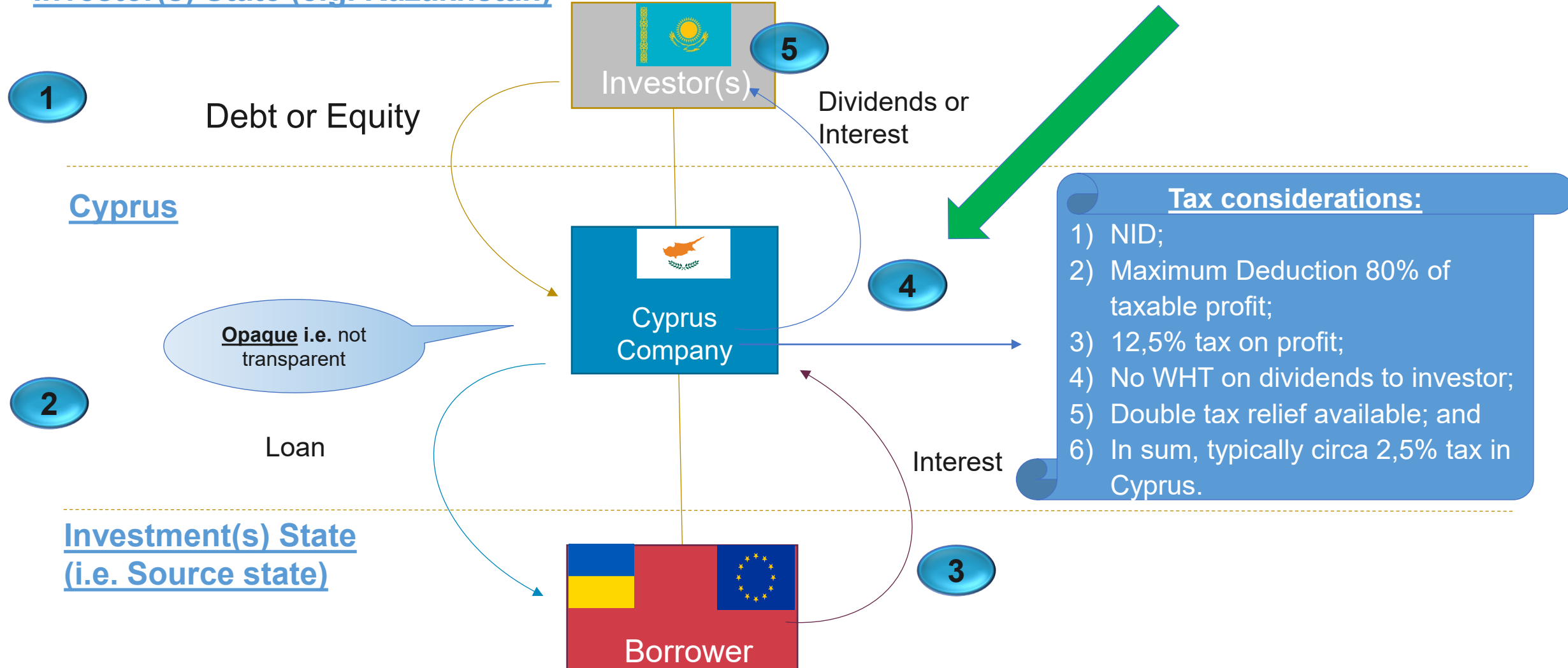
BASE CASE: FINANCE COMPANY STRUCTURE

STEP 4 & 5



BASE CASE: FINANCE COMPANY STRUCTURE: STEP 4

Investor(s) State (e.g. Kazakhstan)



STEP 4: CYPRIOT TAX CONSIDERATIONS

- ❖ NID, Maximum Deduction 80% of taxable profit at 12,5% tax on profit;
- ❖ Normally, no WHT on dividends to investor;
- ❖ Double tax relief available; and
- ❖ In sum, typically circa 2,5% tax in Cyprus.

BASE CASE: FINANCE COMPANY STRUCTURE: STEP 5

Investor(s) State (e.g. Kazakhstan)

1 Debt or Equity

Cyprus

2

Opaque i.e. not transparent

Loan

Investor(s)

5

- Tax implications on both dividend income & capital gains tax on disposal of shares;
- CFC Rules; and
- Double tax relief.

Dividends

4

Cyprus Company

Interest

Investment(s) State (i.e. Source state)

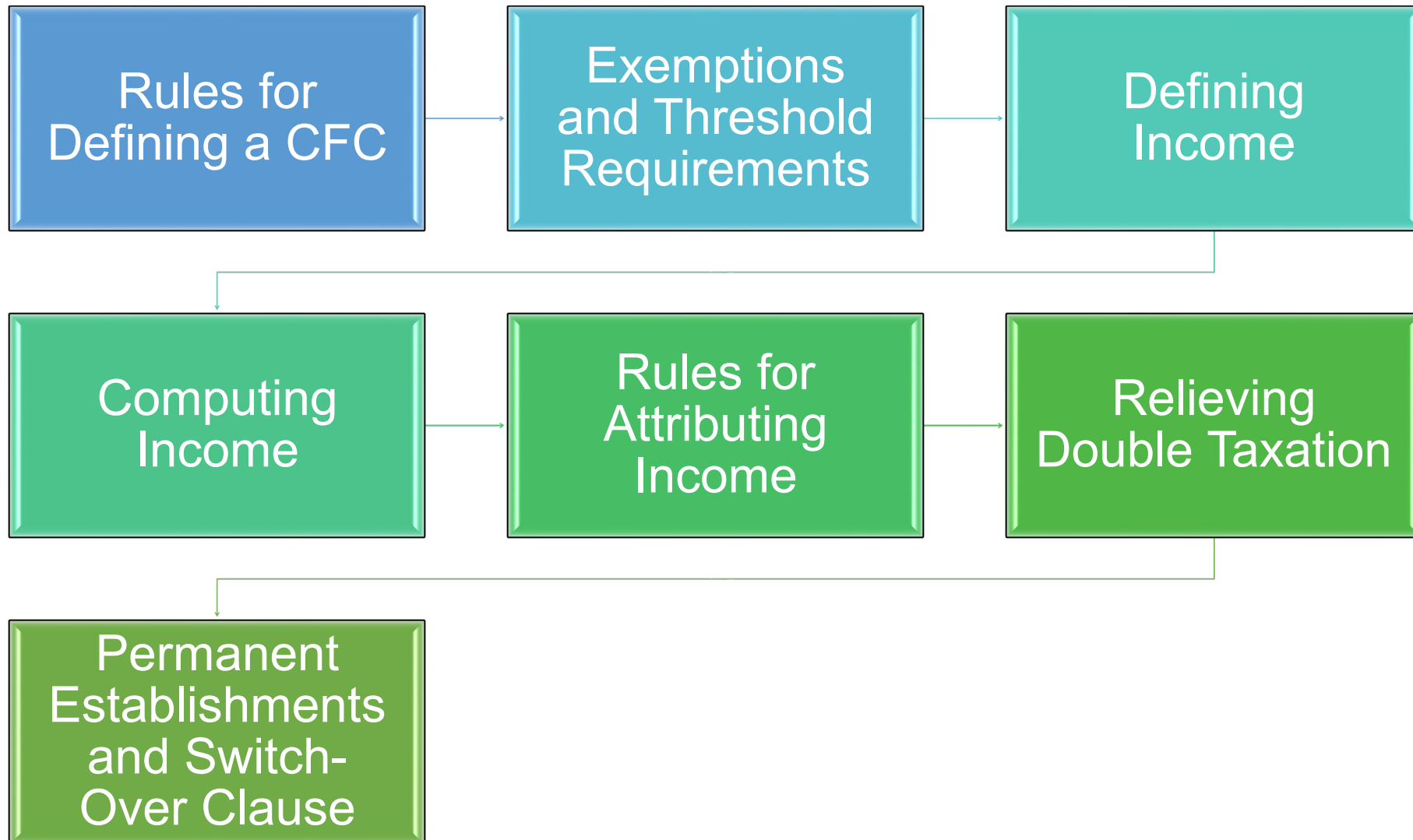
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Operating Co

STEP 5: INVESTORS STATE TAX CONSIDERATIONS

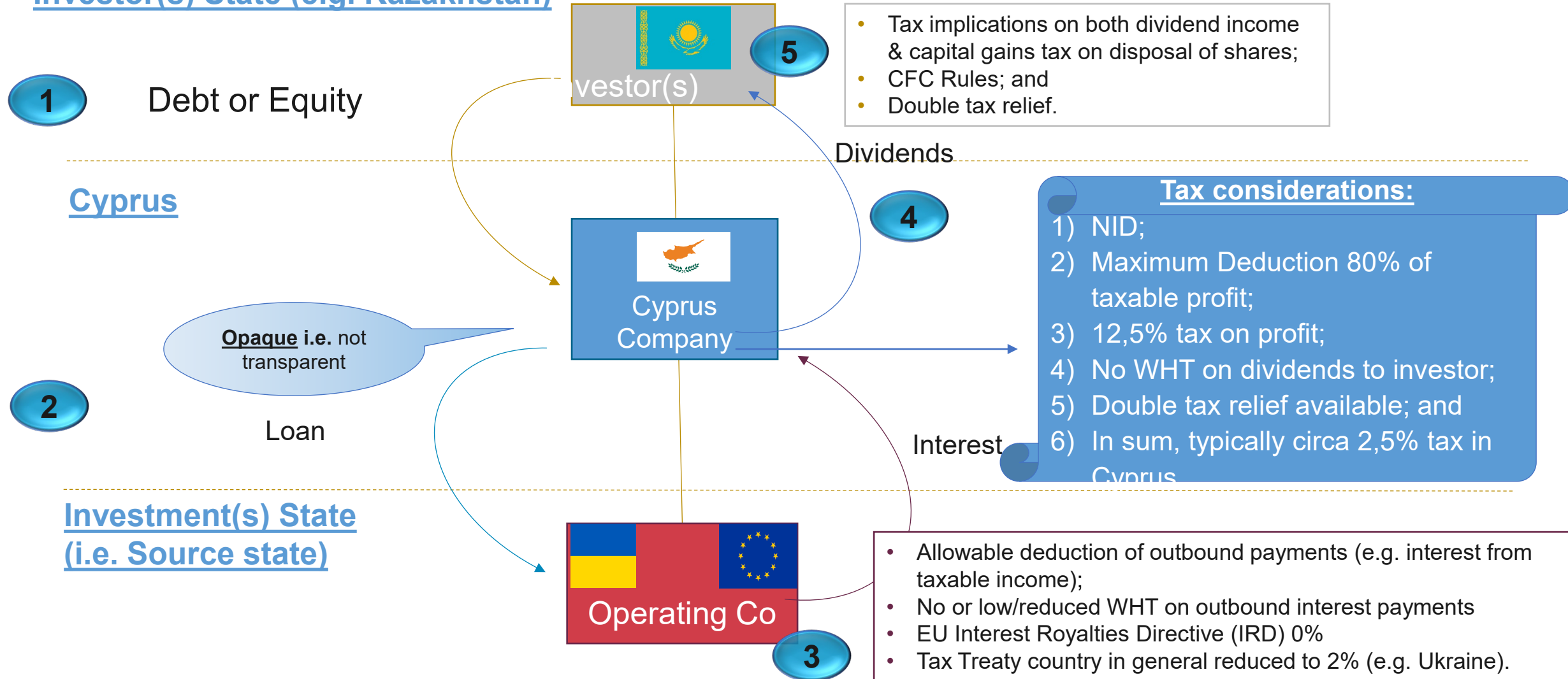
- ❖ Tax implications on both dividend income & capital gains tax on disposal of shares;
- ❖ CFC Rules; and
- ❖ Double tax relief.
- ❖ For more details on how CFC rules, you can find on the following article as published in Bloomberg Tax: *Analysis of Pillar Two Primary Rule IIR – and Comparison With CFC Rules*, [Click here.](#)

CFC RULES BUILDING BLOCKS



BASE CASE: FINANCE COMPANY STRUCTURE

Investor(s) State (e.g. Kazakhstan)



REFERENCES (1)

- ❖ IRD Council Directive 2003/49/EC of 3 June 2003, as amended on the Council Directive 2013/13/EU of 13 May 2013, [click here](#)
- ❖ Model Tax Convention on Income and on Capital: Condensed Version 2017, [click here](#)
- ❖ ATAD Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [click here](#) and ATAD 2 [click here](#)
- ❖ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, [click here](#).
- ❖ OECD/G20 BEPS Project, the 15 actions, [click here](#).
- ❖ EU list of non-cooperative jurisdictions for tax purposes [click here](#)
- ❖ Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report [click here](#)

REFERENCES (2)

- ❖ For more details regarding Beneficial Ownership, you can find the following article published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 1]* [Click here.](#)
- ❖ For more details regarding the PPT you can find in the following article as published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 2]* [Click here.](#)
- ❖ For a comparison of the EU GAAR and the PPT, you can find more details in the following article as published at Bloomberg Tax, *OECD's Principal Purpose Test Versus EU's General Anti-abuse Rule* [Click here](#)
- ❖ For more details about corporate substance post-BEPS you can find in the following article as published in Bloomberg Tax: *INSIGHT: Corporate Residence Post-BEPS and Global Mobility*, [Click here](#)
- ❖ For more details on how CFC rules, you can find in the following article as published in Bloomberg Tax: *Analysis of Pillar Two Primary Rule IIR – and Comparison With CFC Rules*, [Click here.](#)
- ❖ *Debt–Equity Rules Shape Transfer Pricing Risk for Taxpayers*: article as published in Bloomberg Tax [click here](#)

Questions!

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