



## Cyprus: Taxation of Interest

Cyprus has been attractive over the past few years for its favorable tax legislation which has led a big number of entrepreneurs to move their businesses in Cyprus. Cyprus has at the moment the lowest corporate tax rate in Europe (10%) and a number of Double Tax Treaties enabling the avoidance of the International Double Taxation when the same profits of a legal person or of an individual are taxed in two or more countries. As a result of the Double Taxation Treaties International Businesses are traded with stability and certainty. This is also the main reason why the Treaties constitute an important tool for International Tax Planning and give important advantage to the countries which sign such Treaties.

One of the main issues that have been under a lot of debate with the existing tax legislation in Cyprus, is the taxation of interest received. The reason for this is the fact that interest received is distinguished between interest received from trading activities and interest received from non trading activities.

Interest received is taxed either in accordance with Article 8(19) of the Income Tax Law No.118(I)/2002 or in accordance with Article 3(2)(b)(i) of the Special Contribution for the Defence of the Republic Law No.117(I)/2002. The question that arises is which interest is taxed in accordance to the Income Tax Law and which interest is taxed in accordance to the Special Contribution for the Defence Tax Law?

### 1. Article 8(19) of N118(I)/2002 of the Income Tax Law

- (a) All the interest received by a physical person is exempted from income tax.
- (b) 50% of the interest received by a legal person is exempted from income tax.

On 22 October 2009 the Cyprus Parliament has voted for the amendment of this law with retrospective effect as from 1st of January 2009. According to the amended law the interest received both by physical persons and legal entities is exempted from income tax.

However any interest earned by a person from the usual activities of business, including interest which is closely connected to the usual activities of business, is not deemed to be interest but income from trading activities and it is therefore taxed at Income Tax law.

## 2. Article 3(2)(b) of N117(I)/2002 of the Special Contribution for Defence of the Republic Law

Any person resident of Cyprus who receives or is credited with interest, with the exemption of few specific circumstances as mentioned in the Law, is liable to the payment of Special Contribution for Defence at 10% on the amount of interest received.

With reservation to the above articles any interest received by a person during the normal course of it's business, including interest which is closely related to the normal course of business, is not considered interest but income from trading activities.

### ***For better application of the above provisions the following are clarified:***

#### *A. Interest earned in "the usual activities of business" is considered to be the interest derived by:*

1. Banking Enterprises. This category includes all the banks and co operatives and businesses that have as their main purpose the provision of loans, such as the Housing Finance Corporation.
2. Businesses that provide finance via hire purchase or leasing or other types of financing (finance companies).

#### *B. Interest which is "closely connected to the usual activities of business" is considered to be interest derived from:*

1. trade debtors, e.g. relating to businesses whose normal trading activity is the buying and selling of land or relating to the business of sale of cars or other vehicles.
2. insurance companies
3. retail banking accounts (current accounts) and
4. companies that act as an agent via which companies of a group are financed. For example a company, parent or subsidiary or associate company borrows money and then lends such money to other companies in the group.

*C. It is noted that interest described in the following cases, which do not fall within the categories already mentioned, is not deemed to be interest earned from the usual activities of the business nor interest closely relate to the usual activities of business, therefore it is subject to Special Contribution for the defence.*

1. interest derived from the provision of loans by a company to third parties.
2. interest from deposits or bonds.

## Example 1

Company X grants a loan of €500.000 on 1/1/2008 to company Y. Company X and Y are not related in any way and the main activity of Co. X is the trading of furniture. The rate of interest charged is 5% per annum. The company had taxable loss during the year of €15.000 excluding the interest received.

Suppose that interest charged in the year 2008 is €22.000.

Special Contribution for Defence Tax for Co. X

€		
Interest received		22.000
Defence Tax due	(€22.000*10%)	2.200

Note: There is no Corporation Tax as the interest is not considered trading income and the company had taxable loss for the year.

## Example 2

As above with the only difference that company X is a holding company of Y and borrowed the amount of €500.000 from another company.

Corporation Tax for Co. X

€
Taxable loss for the year (15.000)
Add: Interest received 22.000
Taxable profit 7.000

Corporation tax for the year (7.000@10%)
700

Note: There is no Special Contribution for Defence because the interest is considered trading income.

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