INFORMATION SHEET No.130

Cyprus Tax Provision: Notional Interest Deduction

February 2025

Introduction

As part of the overall effort to continuously improve and simplify the Cyprus tax system, as well as to remain a highly compliant and attractive jurisdiction, new laws /provisions have been introduced in July 2015. Amongst these, there has been the introduction of the **Notional Interest Deduction ("NID")** for tax purposes.

The main aims for introducing the NID provision is to reduce excessive dependence of Cypriot entities on debt financing, thus strengthening their economic robustness, preserving their competitiveness as well as encouraging the investing of new equity in Cypriot corporate structures.

In fact, this provision offers a powerful way of reducing the taxable base of a Cyprus company whilst at the same time reinforcing the much needed case of being accepted as the 'beneficial owner of income' for the purpose of accessing double tax treaty and EU Directive benefits.

How does NID work?

NID is a notional tax allowable deduction that can be claimed, as from **1st January 2015,** by Cyprus tax resident companies against their taxable income.

As per the provisions of the amended Income Tax Law, companies resident in Cyprus (as well as non-resident entities with a permanent establishment in Cyprus) which carry out business activities, are entitled to claim NID against their taxable income, where this income is generated through the application of new funds contributed to the equity of the company on or after 1st January 2015.

NID is calculated by multiplying the '**new equity'** introduced in the company and used to carry out its activities with a '**reference interest rate'** *(both terms defined in below sections).*

NID can be claimed each year in perpetuity, to the extent that the 'new equity' is not decreased and continues to be used in the business.

The maximum amount of NID that can be claimed is restricted to 80% of the taxable profit generated by the application of the new equity, as calculated before the NID deduction.

This, coupled with the 12,5% corporate tax rate, and depending on the level of capitalisation, provides the opportunity for a reduction of the effective tax rate of the company to as low as 2,5%.

A basic example illustrating the application of NID is provided further down.

Reference interest rate

Up to 31 December 2019, the 'reference interest rate' used to calculate NID was defined as the higher of:

a) the yield of the 10-year government bond (as at 31st December of the year preceding the year of assessment) of the country in which the new equity is invested, increased by 3%, and

b) the yield of the 10-year government bond of the Republic of Cyprus (as at 31st December of the year preceding the year of assessment), increased by 3%.

As of 1 January 2020, the yield of the Cypriot 10-year government bond will no longer be used as a minimum for the purpose of calculating NID. Only the yield of the 10-year government bond of the country in which the new equity is invested will be taken into account, now increased by **5%** (as opposed to 3%).

In case where the country in which the new equity is invested has not issued any government bond up to and including 31 December of the year preceding the year of assessment, then the NID will be calculated with reference to the yield of the 10-year government bond of the Republic of Cyprus as at 31 December of the year preceding the year of assessment (increased by 5%).

Indicatively, the reference interest rates for year 2025 for a number of countries, including Cyprus, as published in the Cyprus Tax Department's webpage, are as follows:

	10-year bond yield as at 31/12/2024	***2025 NID reference rate***
Cyprus	*2,980%*	*7,980%*
China	*2,941%*	*7,941%*
Czech Republic	*4,087%*	*9,087%*
Germany	*2,500%*	*7,500%*
Greece	*3,898%*	*8,898%*
Hong Kong	*2,601%*	*7,601%*
India	*7,027%*	*12,027%*
Italy	*4,002%*	*9,002%*
Latvia	*3,423%*	*8,423%*
Poland	*3,361%*	*8,361%*
Romania	*7,332%*	*12,332%*
Russia	*14,380%*	*19,380%*
Ukraine (USD)	*13,426%*	*18,426%*
United Kingdom	*4,565%*	*9,565%*
United States	*4,572%*	*9,572%*

New equity

"New equity" is defined as issued and fully paid share capital and share premium that is introduced in the business on or after 1st January 2015.

In contrast, "old equity" is defined as equity existing as at 31st December 2014. For the purpose of calculating NID, only equity in excess of old equity is taken into consideration.

New equity may also be introduced **in-kind**, i.e. by providing assets, instead of funds, as consideration for the new shares issued. In such a case, the amount of equity for NID purposes

cannot exceed the market value of the assets in question as at the date of their introduction into the business.

What is excluded:

The definition of new equity for NID purposes does not include any amounts capitalized which were derived from a revaluation of movable or immovable property.

Up to 31 December 2020, any new equity introduced in a company on or after 1st January 2015 which emanates - either directly or indirectly - from reserves existing as at 31st December 2014 is also excluded from the definition of new equity, unless such capital relates to the financing of new assets used in the business, i.e. assets which did not exist prior to 1 January 2015.

With effect from 1 January 2021 this exemption is **abolished**, and new equity will be strictly defined as equity introduced in the business on or after 1 January 2015. Any new capital deriving from reserves existing as at 31 December 2014 will not be eligible for NID, regardless of whether such new capital is related to new assets used in the business.

❖ **PLANNING TIP:**
Capitalization of existing loans obtained by the Cyprus company will qualify as "new equity" for the purposes of NID. This means that capitalizing back-to-back loan arrangements via Cyprus will give access to NID (hence reducing the taxable base of the Cyprus company to similar levels as with the back-to-back arrangement that used thin spreads) AND at the same time reinforce the status of the Cyprus company as being the beneficial owner of the income on the foreign interest it receives on loans granted out.

Important considerations

Restrictions – limitations

The maximum amount of NID that can be claimed in any given year is restricted to 80% of the taxable profit generated via application of the new equity, as calculated before the NID deduction. The 80% restriction applies separately to the taxable profit generated from each individual business asset financed by the new equity.

Moreover, in case where a company is in a tax loss position as a result of the introduction of new equity, NID is not granted in the relevant year. Therefore, NID cannot be used to either create or increase a tax loss. Any unutilized NID cannot be carried forward for use in future years.

NID is deemed by nature to be interest and, as such, may be subject to the same limitations and restrictions as actual interest expense. As such, NID is available as tax deductible, provided that the new equity is used for the financing of business assets which generate taxable income.

Qualified reorganisations

In case of reorganisations that are considered as 'qualifying' under the provisions of the Cyprus tax legislation (and, as such, are tax neutral), NID is calculated on new equity as if the reorganisation had not taken place.

Election

A company may elect whether to claim the whole or part of the amount of the NID available, in any given year. This may be of use by Cyprus tax resident companies that wish to show a certain amount of higher tax paid in Cyprus.

Anti-avoidance provisions

The Cyprus tax legislation has also been amended so as to provide for certain safeguards against possible abuse of the NID provision.

General clause

A general anti-avoidance clause is included in the tax legislation, according to which the Commissioner reserves the right not to allow the granting of NID in cases where, in his judgement, transactions or arrangements have been effected without valid economic substance or commercial reasoning, with the main purpose in mind being to claim NID. Similarly, the Commissioner may also restrict the granting of NID in cases of transactions or arrangements between related persons made in such a way so as to present old equity as new equity, for the purpose of claiming NID.

Specific clauses

The tax legislation also provides for the following:

- In case where new equity of an eligible company is derived – either directly or indirectly - from new equity of another eligible company, the NID on the new equity is available to only one of the two respective entities

- In case of new equity derived – either directly or indirectly – through a loan, on which another eligible company has claimed an interest expense deduction, then the NID is restricted accordingly by the amount of the interest expense claimed by that other company.

Basic example on applying NID against taxable income

A Cyprus resident trading company issues new capital on 1 January 2025, comprising of 1000 shares, with a nominal value of €1 each, at a premium of €999 per share (i.e. total new equity of €1.000.000). The funds are utilized in the business and generate income of €200,000.

We set out below 3 alternative scenarios (with the taxable profit being the varying factor), illustrating the company's eligibility to claim NID.

	Scenario 1	*Scenario 2*	*Scenario 3*
	EUR	***EUR***	***EUR***
Income from application of new equity	*200.000*	*200.000*	*200.000*
Cost of sales	*(60.000)*	*(100.000)*	*(160.000)*
Administrative expenses	*(20.000)*	*(20.000)*	*(50.000)*
Profit/ (loss) before claiming NID	*120.000*	*80.000*	*(10.000)*
NID (see calculation notes below)	*(79.800)*	*(64.000)*	*0*
Profit/ (loss) before tax	*40.200*	*16.000*	*(10.000)*
Corporation tax at 12,5%	*(5.025)*	*(2.000)*	*0*
Profit/ (loss) after tax	*5.175*	*14.000*	*(10.000)*

Calculation notes:
For all three scenarios the NID is calculated as follows: €1.000.000 new equity x (2,980% + 5%) = €79.800
In scenario 1, NID can be claimed in full as it does not exceed 80% of the taxable profit before NID. The effective tax rate is equal to 4,3%
In scenario 2, NID is restricted to 80% of the profit: €80.000 x 80% = €64.000. The effective tax rate is equal to 2,5%
In scenario 3, no NID can be claimed, since the company has incurred a loss from its activities. This tax loss can be carried forward for 5 years or be utilized through group relief.

It can easily be deduced from the above that, in the absence of the NID provision, the corporation tax liability in scenarios 1 and 2 would have been significantly higher:

- *Scenario 1: €120.000 x 12,5% = €15.000 (instead of €5.025)*
- *Scenario 2: €80.000 x 12,5% = €10.000 (instead of €2.000)*

NOTES

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.