

# Is “Substance” The New Buzzword?

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It seems that one of the latest buzzwords in the field of international tax planning is “substance”. The term “substance” is frequently used to indicate real/physical presence of legal entities in their country of tax residence, as opposed to the use of the so called “shell” or “conduit” companies for obtaining certain tax, or double tax treaty, benefits.

But what does “substance” really entail?

Is it enough to merely rent or have available some sort of office space (sometimes shared with other entities), or is the employment of personnel also required? And when we are considering the employment of personnel, is the existence of secretarial or administrative staff sufficient, or does higher ranking managerial staff need to be employed as well?

The Cyprus Income Tax Law does not provide a detailed or solid definition of what constitutes tax residency in relation to legal entities. General practice and caselaw looks at the “management and control” of a company. As matters currently stand, the criteria for a company to qualify as a Cyprus tax resident are quite general and include the place of residence of the board of directors, the place where the board meetings are held and where the general policy of the company is formulated. Nonetheless, are these prerequisites enough? Someone could argue that in case of the existence of a dispute between the tax authorities of two separate states, the mere presence of the above-mentioned criteria could not prevail in the absence of *real* presence.

The tie breaker rule, as included in the OECD model tax convention, is the “effective management and control” test, which concerns the place where key management and commercial decisions that are necessary for the conduct of the company’s business, are in substance, made. This tie breaker test will look at the quality and appropriateness of directors, the commercial rationale of the existence of the company in the relevant jurisdiction (commercial substance), the flow of funds, the physical presence (if necessary), economic viability and the lever of risk assumed or controlled by the entity.

It is important to note that the most significant element is the quality of the directors (or as we may put it the “mind” of the company). Therefore, the existence of the actual decision makers in the country of residence plays a decisive role in determining the tax residency of the corporate entity. It could be said that physical presence is not always necessary – especially in cases of holding companies, where the important feature would be the ability of the directors to decide where to invest, to assume and control the risk of taking on the actual investment and to follow up on the investments made by the company properly.

Cyprus is amongst the jurisdictions where the establishment of real presence (fully fledged offices) can confer a number of benefits on the business of the company as a whole. There are a lot of incentives available for managers and higher officers wishing to re-locate and properly be appointed on the board of a Cyprus company. Apart from obtaining the tax resident non-domiciled status (conferring exemptions from the Special Defence Contribution tax), expatriate relief is also available, whereby 50% of the gross emoluments are allowed to be deducted from taxable income for individuals that were not tax residents of Cyprus prior to the commencement of their

employment in Cyprus. This deduction applies when income exceeds EUR 100,000 per annum and is available for a period of ten (10) years, commencing from the date of employment. Expatriate relief at 20% is also available for employees with emoluments less than EUR 100,000, however this will only be available by the year 2020. In addition, the availability of suitable office spaces for rent, the reasonable cost of living in comparison with other European countries, the high-level infrastructure and the quality of life offered, are additional factors that render Cyprus an appealing head office destination.

Thus, “substance” is important but what constitutes substance for a company should be determined on a case by case basis and in accordance with the actual business and operations of such company. Entities incorporated in the Republic of Cyprus can benefit out of the incentives provided by the relevant laws and regulations and can properly structure their group in a way that would not jeopardise the Cyprus tax residency of the company. The importance behind any corporate structuring is the ability to evidence genuine economic reasons for doing so. The era of letter-box companies is far behind us.