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Cyprus Debt Crisis
Implications for Cyprus-India structures

Developments surrounding the Cyprus bail-out and the prevailing uncertainty have prompted investors to revisit Cyprus-India structures.

News reports mention that as part of the EU 10 billion bail-out plan which was accepted on March 25, 2013, Cyprus is required to raise an additional EU 5.8 billion. A significant part of the funding is proposed to be raised by way of a charge on bank deposits in Cyprus, liquidation of the second biggest Cypriot bank, exchange of certain types of deposits for bank shares and further internal restructuring of the Cypriot banking sector. To prevent flight of funds out of Cyprus, certain temporary capital control measures are also reported to have been introduced.

While the European Union and Cyprus Government moot solutions to the ongoing debt crisis, it is advisable that investors using Cyprus structures take certain precautions in the short term.

A. Cyprus-India structure: Rationale

As of January 2013, Cyprus is the 7th largest FDI investor into India with total inflows amounting to around 3.6% of total FDI flows. Several Indian companies have also established subsidiaries and holding companies in Cyprus for their offshore investments.

Apart from certain strategic advantages that Cyprus offers, an important reason for investors choosing Cyprus is the favorable tax treaty between Cyprus and India. Capital gains earned by a resident of Cyprus from sale of Indian securities are not taxable in India. Further, Cyprus does not currently impose capital gains tax which makes it possible to achieve tax neutral exits.

The Cyprus tax treaty also lowers the withholding tax rate on outbound interest payments from India to 10% (from around 42%). Cyprus vehicles have therefore been popularly used for making debt investments into Indian companies, which is quite common in several sectors such as real estate and construction.

Tax relief under the Cyprus treaty is not subject to any ‘limitation of benefits’ clause or ‘substance’ requirements which are present in some of India’s tax treaties (eg: treaties with Singapore and Luxembourg).

In addition to zero capital gains tax, investors have also sought to benefit from Cyprus’ low corporate tax rate of 10%, participation exemption for certain types of dividends, absence of thin capitalization rules, flexible corporate laws, access to wide range of tax treaties and European directives.

India and Cyprus has also entered into a bilateral investment protection agreement with Cyprus which provides a range of benefits to investors of both countries including relief against expropriation, most favored nation status, effective dispute resolution and others.

B. Going forward

Economic and political stability are important factors influencing the choice of investment holding jurisdiction.

In the short term, investors should carefully consider developments in Cyprus before any funds are remitted into Cyprus bank accounts, whether in the nature of capital (including debt and equity) or income (including dividends, interest, capital gains and royalties). Investors may consider deferring any remittances or accruals till there is better clarity on the economic, legal and tax environment in Cyprus. Having said this, please note that we are a law firm licensed to practice Indian law and do not wish to substitute our commercial judgment for that of our clients in this matter.

Based on how Cyprus deals with its economic condition investors may consider whether to continue with Cyprus or choose alternative structures. Investors who wish to restructure may explore various options including transfer of underlying investments, liquidation, migrating companies out of Cyprus through a process of redomiciliation or an outbound merger of the Cyprus company within the limits prescribed under Cypriot corporate law and the EU framework.

Any such restructuring may potentially result in Indian tax implications, and availability of relief under the Cyprus tax treaty has to be carefully examined. In cases where Indian companies restructure interests in Cypriot entities, treaty exemptions would not be available and Indian tax risks have to be carefully addressed. General anti-avoidance rules (“**GAAR**”) in Indian tax law have come into force on April 1, 2013. India’s 2013 Budget proposes to defer the implantation date of GAAR to April 1, 2015. This will also have to be factored in while undertaking any form of restructuring.

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