Practitioners Welcome Cyprus-India Tax Treaty Renegotiation

by Stephanie Soong Johnston

Cyprus's December 3 announcement that it will renegotiate its tax treaty with India to improve information exchange should lead to the resolution of a serious conflict between the two countries and reduce taxpayer uncertainty, Cypriot and Indian practitioners told Tax Analysts.

In a statement following a November 26-28 meeting between Cypriot and Indian officials, the Cyprus government said the parties agreed to adopt provisions under article 26 of the OECD model tax convention relating to exchange of information. They also agreed to improve communication and improve efforts in "processing requests and responses in a swift and effective manner," according to the statement.

The Cyprus government said that a new treaty will be finalized soon but did not offer a timeline.

Once the treaty is amended, India will retroactively rescind its November 1 decision to designate Cyprus as a "notified jurisdictional area" under section 94A of the Indian Income Tax Act, 1961. At the time, India cited a lack of cooperation on information exchange requests under article 28 of the 1994 Cyprus-India tax treaty; the notification effectively acted as a treaty override. (Prior coverage.)

According to Samira Varanasi of Nishith Desai Associates, Cyprus was the first of India's treaty partners to be notified as a noncooperative jurisdiction, highlighting the Indian tax authority's focus on fiscal transparency.

The notification caused widespread unease as taxpayers faced consequences, including withholding tax rates increasing to 30 percent on payments by Indian taxpayers to Cyprus-based recipients and more stringent rules for transfer pricing.

"Therefore, the recent consultations between Cyprus and India with the intention to renegotiate the tax treaty and to rescind the notification of Cyprus as a noncooperative jurisdiction effective retrospectively have been welcomed by industry players," Varanasi told Tax Analysts.

The renegotiations end speculation over the tax and regulatory implications of transactions taking place within the time frame of Cyprus's notification status, according to Emily Yiolitis of Harneys.

Yiolitis noted that this is not the first time that Cyprus has encountered information exchange struggles with a treaty partner. In 2008, Russia amended its tax code to penalize the repatriation of dividends from foreign subsidiaries located in jurisdictions on Russia's "uncooperative territories" list. "Cyprus was included in this blacklist of 53 countries, on the grounds that it did not respond in a satisfactory manner to requests for information from the Russian tax authorities," Yiolitis said.

Russia and Cyprus eventually signed a protocol to their treaty, "including a replica of article 26 of the OECD treaty, which amended the existing 1998 treaty and removed Cyprus from the Russian blacklist, enabling dividends received by Russian companies from Cyprus subsidiaries to qualify for the Russian dividend participation exemption," Yiolitis added.

Cyprus's notification from India came shortly after the OECD's Global Forum on Transparency and Exchange of Information on November 22 published compliance ratings for how well 50 jurisdictions adhered to the forum's information exchange standard. Cyprus, Luxembourg, the British Virgin Islands, and the Seychelles were rated as noncompliant. (Prior coverage.)

"The areas in which Cyprus was deemed noncompliant concern the availability of historic accounting records and the use of compulsory powers to obtain information," Yiolitis said, adding that legislation requiring those records to be available had not passed when the forum assessed Cyprus. "For the use of powers the assessment is widely criticized as harsh, but authorities are nevertheless working towards increased staffing and diligence to change perceptions," she said.

Cyprus seems to be working to rehabilitate its reputation for lacking effective information exchange. "No doubt, following the banking crisis and the allegations of laxity in the Cyprus regulatory environment that preceded it, the government has taken serious steps so as to address all perceived deficiencies, including in respect of the application of exchange of information, in the context of double taxation treaties as well as in general," said Philippos Aristotelous of Andreas Neocleous & Co. LLC.

Aristotelous noted that Cyprus has announced that its tax authorities are collaborating with accountants and lawyers to correct reported deficiencies and that the government expects to make significant improvement to its information exchange capacity during 2014. He added that the government wants to support the business services sector as the Cyprus economy recovers because other sectors, such as the gas industry, are unlikely to contribute much.

"The government is willing to do whatever it takes in offering a competitive and fully transparent tax and business environment, but not to the extent that other, more influential countries perceive this as a threat to their interests," Aristotelous said.

The Future of India-Cyprus Relations

The treaty with Cyprus is important to India. Partly because Cyprus is a common law jurisdiction whose proximity to Europe makes it an ideal gateway to India, it is seventh in direct foreign investment in India, accounting for about 4 percent of total FDI inflows, according to Varanasi.

"Cyprus had long been an attractive jurisdiction for structuring debt instruments, primarily because it imposed a withholding tax rate of just 10 percent on payments from India to Cyprus, as opposed to the domestic withholding tax rate of about 42 percent," Varanasi said. Cyprus has no withholding tax on outbound interest payments, making it a valuable intermediary holding company destination for nonresident investors into India-based debt funds, she added. India's treaties with Mauritius, Singapore, and the Netherlands lack a similar benefit on interest.

Similarly, Cyprus sees its tax treaty with India as one of its most significant as India continues to attract large foreign investments, according to Aristotelous.

Ravishankar Raghavan of Majmudar & Partners noted that both countries had initiated tax treaty renegotiations several years ago. One proposal was to allow only a company's residence country to tax stock sales, but Raghavan said that Cyprus is unlikely to accept that proposal in the current negotiations.

"Further, it could be difficult for Cyprus to do so as long as other treaties exist which give taxing rights only to the country of residence of the seller," Raghavan said. "Any amendment in this regard is likely to significantly affect the structuring of both inbound as well as outbound investments. In my view, it is likely that a limitation of benefit clause, which is an antiabuse provision, will be introduced in the context of capital gains."

Varanasi speculated that the outcome of the Cyprus-India tax treaty renegotiations will have little effect on India's other tax treaties. "Going forward, the relations between the two countries are likely to depend on the outcomes of this renegotiation process," she said. "However, it is also important to keep in mind that the Indian economic and political relations with countries such as Mauritius and Singapore have historically been much stronger than those with Cyprus, which may have also influenced the unilateral move. This move by India may therefore not be indicative of what is likely to happen with all other treaty partners."

For Aristotelous, however, more effective exchange of information provisions would help Cyprus because it gives the country a chance to improve its image. "If other partners of Cyprus are encouraged to renegotiate the current double tax treaties so as to adopt more effective exchange of information provisions, we believe this would be to Cyprus's benefit as it would remove any doubt regarding Cyprus's commitment to full transparency," he said. "Cyprus professionals do not promote or advocate tax evasion or avoidance and taxpayers should always be warned that the old times of full confidentiality are long gone."