Effective Management of the Cyprus Limited Company

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In spite of the vagaries of interpreting statistics at first blush, the website of the Cyprus Registrar of Companies leaves the visitor in little doubt that 2007 was a record year for corporate formations. As a result of the residency basis of taxation, many of these will pay tax in Cyprus, notwithstanding the fact that they have foreign owners and international affairs. But how does a Cypriot company determine the extent of its tax liabilities at home and elsewhere?

Lifting the veil of business uncertainty is an integral part of business tax planning. In a commercial world that is awash with postulates, many of which do not stand up to scrutiny in one way or another, it pays dividends to ask the question whether or not a widely held precept is true or not.

This article reviews the meaning of governing terms such as central management and control, effective management and permanent establishment and considers how they are applied to the taxation of Cypriot companies.

Legal Sources

Understanding the priority of legal sources is as important as the sources themselves. Cyprus, which has been an independent since 1960, is a constitutional republic. The Republic's supreme law is the constitution. Article 169(3) states that the mutually observed bilateral international treaty has superior force to any municipal law in the event of disagreement. Swiftly after independence, the legislature laid down appropriate rules for the administration of the justice system that took the form of the Courts of Justice Law of 1960. Article 29 of this law directed the courts to follow the constitution and constitutionally consistent statutes but where there were no statutory provisions, the English common law and equity (prior to independence) would be applied. In addition, English authorities handed down after independence may not be binding but they are nevertheless regarded as persuasive.

Treaty Override

The clearly hierarchical character of the Republic's legal sources informs the practitioner that double tax conventions (mutually upheld) override any provisions under municipal or common law. So, as a first step, a company's activity has to be placed within the context of any prevailing tax treaty. In the absence or irrelevance of any treaty, corporate residency is determined using the legal authorities of central management and control.[1]

OECD Model Tax Convention

Found in Article 4 under the heading of 'Residence', the OECD's model tax treaty explains that a company can only be resident in one of the contracting states and not both at the same time. This "tie breaker" arrangement is determinable upon the identification of the "place of effective management". There is no definition of this term in the model, but Article 3 states that each State is to apply its own meaning although where different meanings exist within a State's laws, those of taxation law are to prevail. Clearly there could be a difference of opinion between the contracting states, however, there is machinery for negotiation and agreement to be found in Article 25.

There is significant body of legal authority concerning the test of central management and control, going way back to the De Beers case[2] at the beginning of the 20th century. But uncovering legal precedents that define the term "place of effective management" has not been quite so easy, owing perhaps to the fact that the growth of the double tax treaty is a more recent phenomenon. Thankfully, the recent English appeal case of Wood[3] did provide us with a British interpretation.

The Wood Case

The case itself looked closely at a corporate structure utilising the special purpose vehicle (SPV). The client was based in the North West of England and had been advised by his local office of a firm of international accountants. One SPV company was based in Holland. The court was asked to consider questions as regards the location of that company's central management and control and place of effective management. Rather helpfully for us, the judge pointed out that the company's corporate managing director was in Holland; the statutory books were kept in their office and the corporate correspondence was sent and processed there. The relationship between the company and the advisory accountant was regulated assiduously and in accordance with a letter of engagement. The judge's conclusion was: the place of effective management was in Holland and the offices of the client and his accountant, both of which were in England, did not conflict or contradict this. Moreover, from the judge's analysis the place of effective management is concerned with the place of day-to-day and routine management. This contrasts starkly with central management and control which is concerned with the meeting place of the directors where the real strategic decisions of the business are taken. This does not mean that directors can afford to simply go through the motions. Not at all, where directors just stand aside in order to do another's bidding, the central management and control is likely to be located in the hands of a shadow director or beneficial shareholder.[4]

Under Cypriot law the English case of Wood would be considered to be persuasive as it was an English case handed down after Cyprus became independent. But practically speaking, these English cases are of great importance given the fact that few international trust and corporate cases

come before the Cypriot bench. Therefore, practitioners can take heart from the markers of the Wood decision and might indeed model their structures upon the lessons of the English judgment.

Permanent Establishment

Having located the place of effective management, it is essential to review all of the locations of branches, offices, factories and warehouses, etc. that could be regarded as a permanent establishment (PE). Otherwise, there might be contingent tax claims from other overseas tax authorities.

Article 5 defines permanent establishment as a "fixed place of business through which the business of the enterprise is wholly or partly carried on." In circumstances where a PE gives rise to branch profits, these would be taxable according to the law of the state in which the branch is situated (Article 7).

The model treaty gives details of several important exemptions that are not regarded as a permanent establishment. The most important and popular of these is the wholly-owned subsidiary company. Being able to delegate authority to managers of businesses situated outside of Cyprus is a valuable facility but its use and application has to be considered carefully.

Moreover, in each case, it is important to check the applicable treaty[5] where all or any of these exemptions are listed and, furthermore, to consider all or any of a treaty's provisions in the light of the enterprise's business plans.

De Beers Case

An illustration might be helpful. The 1906 legal authority of *De Beers Consolidated Mines and Howe* is the seminal case of central management and control. The case was heard in the House of Lords where Lord Loreburn stated that the tax residence of a company lies where its real business is carried on, being where the "central management and control actually abides".

The factual circumstances were as follows:

- The company was registered in South Africa where the day-to-day activities were organised.
- The majority of the board lived in the United Kingdom (UK) but some of the board lived in South Africa.
- Board meetings were held in both countries but the major decisions of policy were made at the meetings in London.

Flowing from Loreburn's dicta, the central management and control of De Beers was held to be in the UK because the strategic decision making was carried out in London. However, following the Wood case, one could conceive of De Beer's central management and control being situated in London and its effective management in South Africa. If there were a double tax convention in place the outcome would have been reversed!

It is also apparent that De Beers may have had a permanent establishment in South Africa, the profits of which would have been taxable there.

Conclusion

Corporate residence for tax purposes turns upon either the place of effective management or central management and control. Although the former has precedence, owing to the concept of "treaty override", central management and control is still relevant as the default test where there is no extant double taxation convention. The recent English case of Wood and Holden has helped clarify the application of the OECD's terms under English law and insofar as the English dicta would be upheld in the Cypriot courts, corporate practitioners have a definite steer as to how they should position themselves when advising their clients.

END NOTES:

1. *Law 118/2002.*
2. *De Beers Consolidated Mines and Howe 1906.*
3. *Wood and Holden (Inspector and Taxes) 2005.*
4. *Unit Construction Co Ltd and Bullock 1960.*
5. *The Cypus-USA (1986) Double Taxation Convention does not contain this exemption for subsidiaries.*