CYPRUS INVESTMENT FUNDS ASSOCIATION

TAX REFORM RECOMMENDATION

OCTOBER 2024

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1 Introduction

The Cyprus Investment Funds Association (CIFA) was established in February 2013 and registered as an Association in April of the same year under the Associations and Foundations Law of 1972, with the purpose and aspiration to become the collective voice and the reference point for all professionals and legal entities, offering services or engaged in the Investment Funds Industry in Cyprus.

CIFA's overarching objective is to support the growth and development of the Cyprus investment fund industry. To realize this locally, CIFA represents the industry in economic missions spearheaded by the government and/or regulatory authorities, orchestrates fund conferences, events, and seminars, and engages with the media to amplify its reach and influence. On the international stage, CIFA raises awareness and promotes the Cypriot fund industry through active involvement with global industry associations and by participating in key industry conferences.

Integral to these efforts is the continuous monitoring of the Cypriot tax framework, ensuring it remains competitive by benchmarking it against other renowned fund domiciles and that existing tax practices do not hinder the competitiveness of Cyprus as an investment funds hub.

CIFA is committed to providing insightful recommendations aimed at enhancing the tax efficiency of the local fund landscape. These suggestions are designed to refine the tax environment, thereby making Cyprus an even more attractive and strategic choice for fund managers and investors worldwide.

Against the backdrop of the overall comprehensive tax reform in Cyprus, it is imperative to address the taxation of investment funds, specifically Alternative Investment Funds (AIFs) and Undertakings for Collective Investment in Transferable Securities (UCITS) as well as the taxation of Fund Managers and any other vehicles of the investment funds ecosystem. Given the significant role these funds play in the Cypriot economy, their taxation should be a central aspect of the overall tax reform agenda.

2 Setting the scene

Currently, Cyprus does not maintain a specific tax regime for investment funds. Investment funds and fund managers, are subject to the general applicable tax rules. A number of tax related provisions are included in the AIF Law (reference) providing for exemption from transactional tax implications (i.e. Stamp Duty) but there is no separate system of taxation governing investment funds.

At the moment, the tax implications associated with the operation of funds in Cyprus, is in line with the rules that applies for other persons, depending on their legal form and classification.

At the same time, fund managers and other ‘’identified staff’’ may be subject to Cyprus tax at the flat rate of 8%, with a minimum tax liability of EUR 10,000 per annum in relation to the variable remuneration such persons receive and is effectively connected with the carried interest received by the employing entity. This special mode of taxation is available for a period of ten years in total, subject to the annual election of the individual, and is not added to any other income.

2.1 Corporate funds

It is well established that for a corporate fund vehicle to be considered tax efficient, it must have the capacity to achieve a 'tax neutral' outcome for investors, meaning that there should be little to no local tax implications. It is recognized that, with the exception of gains from Cypriot real estate, capital gains are not subject to tax in Cyprus. Therefore, the emphasis for these fund types should be on how income is taxed, including the Special Defence Contribution (SDC) including also the current rules on the deemed dividend distribution.

As a result, Cyprus is in a disadvantageous position when compared to a number of EU fund domicile jurisdictions. The current Cyprus corporate taxation regime allows for the exemption of any realised/unrealised gains on bonds, as it gives specific exemption for such tax-qualifying titles, whilst taxing interest income, but with the potential use of Notional Interest Deduction which may reduce the effective tax rate ("ETR") down to as low as 2,5%. In case any withholding tax is suffered upon distribution, Cyprus avails foreign tax credits that reduce further the ETR applicable at the level of the Cypriot corporate fund.

It is important to note that, in comparison to other well-known fund domiciles such as Ireland, Luxembourg, and Malta[1], Cyprus finds itself in a less competitive position regarding corporate vehicles when it comes to the taxation of income from debt instruments. To address this, targeted reforms are necessary to enhance the tax framework and bolster Cyprus's appeal as a domicile for funds with the specific investment strategy.

By implementing such changes, Cyprus can improve its standing in the international fund management community and attract a broader spectrum of investors.

2.2 Non-corporate tax transparent funds

Fund structures that operate with transparency often employ a combination of corporate entities, such as feeder and/or holding companies beneath the fund. These purposes may include allowing for the reinvestment of earnings before taxes, preventing the taxation of trading income for certain tax-exempt investors, and leveraging tax treaties that are in place. Fund managers typically prefer to consolidate their operations within a single jurisdiction, and therefore Cyprus's capability to offer this should be further enhanced.

3 Framework for the proposed reforms

The current tax framework for the investment funds sector in Cyprus requires modernization to keep pace with international standards and to enhance the attractiveness of Cyprus as a fund domicile. The reforms should be designed to encourage foreign fund managers and investors to contribute to the local economy, while simultaneously streamlining the process for local investors to participate in these funds.

Moreover, any tax efficient rules relating to the taxation of fund managers should be preserved and their practical implementation should be made seamless. The physical presence of fund managers in Cyprus can serve as a catalyst for the jurisdiction to become a preferred location for funds, fostering a thriving funds industry and contributing to the broader economy.

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[1] Overview of taxation of interest in different EU fund domicile jurisdictions.

For foreign fund managers and investors, the reform should introduce competitive but acceptable tax incentives that align with global best practices. This could include tax neutrality for certain fund structures or reduced withholding taxes on dividends and interest payments to non-resident investors. By doing so, Cyprus can position itself as a leading jurisdiction for international fund management and investment.

Conversely, for local investors, the reform should aim to dismantle existing barriers that deter them from utilizing investment funds. This could involve simplifying the tax reporting requirements, offering tax deductions for investments in local funds, or providing clearer guidelines on the tax treatment of fund returns. Such measures would not only foster a more vibrant domestic investment culture but also support the growth of the local fund industry.

In conclusion, the tax reform for investment funds in Cyprus should be crafted with a dual focus: to entice foreign investment and to empower local investors. By doing so, Cyprus can secure its place as a competitive hub for investment funds, ultimately contributing to broader economic prosperity.

In the next section we outline in greater detail our recommendations for the update of the Cypriot tax framework in relation to the investment funds sector.

4 Executive Summary

Our recommendations in relation to the amendment of the current taxation rules and practices relating to the investment funds industry, within the context of the overall tax reform can be summarized as follows:

- Abolition of the Deemed Dividend Distribution rules (DDD) or a reduced rate of DDD subject to the application of an anti-avoidance rule;

- Exemption from the application of the upcoming defensive measures of payments to designated investment funds;

- Abolition of the Capital Gains Tax for real estate funds. Alternatively, current practices that hinder the investment in real estate funds should be removed. The entry of new investors in real estate funds should not be considered as taxable event for Capital Gains Tax purposes;

- Introduction of direct tax incentives relating to the investment in ESG/Green funds that will stimulate investment into funds that produce environmentally positive impacts and can also reduce the disadvantage of Cypriot funds when it comes to the taxation of interest income when such income is generated by ESG/Green funds;

- Preservation of the special means of taxation for individual fund managers and other identified staff;

- Introduction of a parallel Net Asset Value (''NAV'') system of taxation for common funds.

5 Special Defence Contribution – Optimizing the rules for the investment fund industry

5.1 Background

Issues of deemed dividend distribution may be of increasing importance in the event where the Fund attracts investment from an increased number Cyprus tax resident and domiciled individuals. It is an essential cornerstone of business that building sustainable frameworks also includes the maintenance of a healthy local base (i.e. including local investment). In this context, deemed dividend distribution cannot go unnoticed.

Even in the absence of an ability to distribute dividends (whether because of a lock-up period the investment strategy and policy of the Fund ,or otherwise) , at least 70% of the accounting profits of the Fund that are deemed to account to Cyprus tax resident individual investors and UBOs will be deemed as distributed at the expiry of the two year period from the end of the year to which the profits relate and will be subject to Special Contribution for the Defence at the rate of 17%. However, in the determination of the DDD to be paid, accounting profits corresponding to units already redeemed cannot be ignored, as the redemption of a fund unit constitutes a disposal of title and not a distribution of dividend (or even, equivalent for dividend distribution).

5.2 Inequality between investors

In more detail, the redemption of the unit by the Investor will be treated as a disposal of the unit and exempt from income tax. At the same time the redemption will not be treated as a reduction of capital for the purposes of the Special Contribution for the Defence Law. As such, the amounts paid to the Investor, if such investor is a Cyprus tax resident and domiciled individual that are in excess of the investor's subscription amount will not be deemed as distributed dividends and will thus not be deemed as reducing the accounting profits of the year on which deemed dividends distribution will apply. As a result, the Cyprus tax resident and individual investor redeeming the unit, will not be deemed as having received a dividend, and the profits of the Fund on which deemed dividend distribution would be imposed two years later, will not be reduced by the redemption. Hence, a Cyprus tax resident investor that redeems its units, is put in a better position than the Cyprus tax resident investor that does not and enters into a long-term investment with the Fund. This is a discrepancy which needs to be addressed.

Further, DDD also applies to vehicles that cannot, by virtue of their accumulation class, or as part of their investment strategy distribute dividends as their prospectus provides that any income generated by the investments (e.g dividends or interest payments) is reinvested back into the fund instead of being distributed to investors. Investors in this way capitalize on compounded growth over time and upon redemption, realize the accrued value of their investment growth. By imposing DDD on accumulation classes, reinvestment into the Fund is being penalised. It should be borne in mind that the accumulation nature of Funds cannot be overseen as such structures are not meant to be used as Private.

In attempting to create a level-playing field, and on the basis of widely accepted principles as to need for maintaining neutrality for funds (i.e. investment fund being treated as a separate taxpayer — should not be faced with an additional layer of tax being imposed on any income or gains by the intermediary vehicle, it is also essential to aim for a tax neutral treatment between resident and non-resident investors and to ensure that the overall final tax burden on the basket of various types of investments is about the same, irrespective of the vehicle used for the investment.

With the Deemed Dividend Distribution provisions causing the discrepancy outlined hereinabove, the imposition of accounting profit of units redeemed impacts the NAV position of the Fund, potentially also impacting the NAV value attributed to the investors (including non-resident investors) on redemption, especially the investors subscribing into the units before the DDD liability is formed. Any DDD liability on profits attributed to redeemed units formed after the entering of an investor into the Fund, impacts the NAV value attributed on redemption to the investors. Hence, the redemption price of non-resident investors may be impacted for a tax liability that only impacts and should only impact Cyprus tax resident investors.

Therefore, in order to safeguard tax neutrality for funds to the extent possible we consider that the Tax Reform should aim to strive tax neutrality for the non-resident investors as regards DDD impact on NAV.

5.3 Access to trading platforms

DDD also impacts the ability of Cypriot funds to be traded on several private market platforms and asset holders including central securities depositaries (e.g. Clearstream, Thomson 1) as such major platforms that are onboarding Cyprus funds would not accept transferring the DDD liability to the investors and would refuse onboarding such funds unless access is restricted to Cypriot investors; legally that would not be possible as it would violate the non-discrimination principle.

Though it is understood that issues concerning DDD might be of lesser importance due to its application only to Cyprus tax resident and domiciled individuals, nevertheless we recognise that it does create practical issues and inequalities for funds as outlined hereinabove.

5.4 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would recommend that Deemed Dividend Distribution is abolished for the affected funds (i.e. funds with a corporate nature) on the basis of non-discrimination and the unfair treatment between resident and non-resident investors. Predominantly, we would support an overall abolishment of DDD provisions; should however not this be possible, we would advocate for a different treatment for the asset management industry always subject to the satisfaction of EU State aid and harmful tax practices notions. Most certainly, we would strongly advocate in favour of DDD disapplication in respect of Funds with accumulation class (i.e.forbidden to distribute dividends and operating only on redemption).

Alternatively, we would advocate in favour of a reduced rate for DDD exposure for the fund industry with temporal anti-avoidance clause (i.e. impose a lesser rate for DDD and raising it up to the dividend distribution rate should the funds distribute dividends within a certain period or fail to meet other anti-avoidance provisions); this would not solve the issue of onboarding into market trader platforms but it may help to lessen the tax liability imposed on funds as a result of DDD.

6 Exemption for investment fund structures in relation to upcoming defensive measures - withholding taxes

6.1 Background

It is well established that investment funds have investors from different jurisdictions with varying tax rules at the investor jurisdiction level. As mentioned above, from a tax perspective, an investment fund aims to be tax-neutral by not creating additional tax liabilities for investors beyond what they would incur if they invested directly.

As part of its Recovery and Resilience Facility (RRF) plan, Cyprus has committed to introducing defensive measures on passive income streams such as interest, royalties, and dividends. Such measures may take the form of an imposition of withholding tax or the absence of a tax deduction (for interest and royalties). Understandably, this move is aimed at strengthening the country's tax framework and aligning it with international efforts to combat tax evasion and avoidance.

The imposition of withholding taxes will serve as a mechanism to ensure that income generated within Cyprus and paid to non-resident entities is appropriately taxed at source. This measure is particularly significant in the context of cross-border transactions where the recipient of such income may be subject to a lower tax rate or benefit from preferential tax regimes in their jurisdiction.

When a fund imposes withholding taxes on distributions such as dividends, interest, or royalties, it can potentially impact the tax neutrality of the investment, particularly for non-resident investors. Tax neutrality is a principle where an investment vehicle, like a fund, is structured in such a way that investors are not subject to additional layers of tax that they would not incur if they invested directly, as mentioned above.

6.2 The call for exclusions from the application of the rules for investment funds

Regulated investment fund structures do not pose risk for tax evasion, as they operate within a framework that promotes compliance, transparency, and accountability. Moreover, the principle of tax neutrality, does not lead investors to plan their tax affairs through investment funds.

On the other hand, a catch-all provision for the imposition of defensive measures to persons that are resident of a ‘’low-tax’’ jurisdiction deteriorates the tax position of the fund itself and of its investors.

6.3 Widely held investment funds

It may be the case that a Cypriot investment fund (corporate form) or a Cypriot company shall be making a dividend payment to a Partnership investment fund of a location that is to be designated as a low-tax jurisdiction. For Cypriot tax purposes, the general rule is that a partnership vehicle shall be treated as tax transparent. Therefore, the foreign investment fund should be considered as tax transparent, while the ownership of the fund is dispersed amongst numerous investors, tax residents in various jurisdictions.

The Cypriot payor is likely to be unaware of the residency of each and every investor and as such it may be impractical to seek to apply any defensive measures.

It should also be remembered that the defensive measures are essentially aimed to prevent double non-taxation through payment to associated entities. Where widely held investment funds are involved, the payees are unlikely to be associated with the payor.

As such, defensive measures, either through the imposition of withholding tax or through denying the available deduction, should not apply in relation to investment funds.

6.4 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would recommend that a number of exemptions should apply in relation to the upcoming rules for defensive measures for payments to ‘’low-tax’’ jurisdictions that are expected to be introduced by the end of the year.

Such exemptions should indicatively include:

- payments made to companies which have a transferable security admitted on a recognized stock exchange

- payments made to companies which are “regulated financial entities”,

- payments made to “qualifying investment funds”.

- payments to “recognised pension funds” (this term is also included in Cyprus’s model treaty)

For “qualifying investments funds”, the exemption should apply if the fund is subject to investor-protection regulation. This should be the case even if such payments are made via an intermediary company(ies) registered or resident in a low tax jurisdiction provided that such entity is at least 75% or more directly held by a “qualifying investment fund”.

The above is consistent with the recent approach adopted by OECD in July 2023 upon release of the STTR model treaty provisions where they excluded the following recipients from the scope of withholding taxes:

• An individual

• A recognised pension fund

• A specified non-profit organization

• A State (or a political subdivision or local authority), a central bank, or an agency or entity established by, or any other person wholly or almost wholly owned by a State (or a political subdivision or local authority), provided its principal purpose is to fulfil a government function and it does not carry on a trade or business

• An international organization

- An investment fund that meets specified conditions
- An entity that is subject to a single level of taxation and meets specified conditions
- An entity that is wholly or almost wholly owned by an excluded recipient that meets specified conditions

7 Legislative framework and application of the Capital Gains rules in relation to investment funds

7.1 Introduction

The operation of Real Estate investment funds unequivocally stimulates investment in the real estate sector while providing benefits to investors and the broader economy. While the ways in which the Real Estate funds can contribute positively to the Cypriot economy lie outside the scope of this letter, we will elaborate on the current tax rules and practices that currently hinder the investment into real estate funds, with subsequent suggestions to remove such obstacles.

7.2 Alignment with Income Tax Law

In line with the proposals put forward by other professional bodies and organizations, it is suggested, as part of the overall tax reform, to consider the abolition of the capital gains tax on immovable property and extend the scope of application of the income tax law to gains arising from the disposal of real estate (directly or indirectly). Such an amendment will be a welcoming development for investment funds investing in real estate in Cyprus.

It will enhance certainty to funds and investors alike and will also enhance the tax efficiencies involved.

7.3 Re-visiting certain practices

As part of the overall tax reform, will be necessary to revisit and clarify certain current practices that hinder the investment into real estate investment funds investing in Cyprus based immovable property and in particular the tax treatment of the investment/subscription in funds who invest in Cypriot real estate.

Currently, the Cypriot tax authorities, consider that the issuance of new shares to new shareholders/investors constitutes a ''disposal'' for the purposes of the Capital Gains Tax.

This practice appears to be discriminatory and punitive to existing investors and this disincentivizes altogether the creation of funds that will be investing in Cypriot real estate.

Given that there is no remuneration or benefit (direct or indirect) to the existing shareholders/investors it should be clarified that the investment by new shareholders/investors to investment funds that invest in Cypriot real estate, should not trigger the application of the capital gains taxation.

7.4 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would recommend that the Capital Gains Tax is to be replaced through the extended scope of application of the Income Tax Law to enhance certainty and promote investment into real estate funds.

Moreover, given unfair treatment towards existing investors and the disincentive created for setting up real estate funds, we would recommend that the investment/subscription into such funds should not be considered as a taxable event for Capital Gains Tax purposes.

8 Incentives relating to the investment in ''Green Funds''

8.1 Introduction

Across the European Union, direct tax incentives for green investment funds and environmentally sustainable projects are indeed utilized. The European Union does encourage member states to align their tax policies with broader EU objectives, such as the European Green Deal and the transition to a climate-neutral economy.

Direct tax incentives for ''green'' investment funds are designed to encourage investment in environmentally sustainable projects and companies. These incentives generally aim to make green investments more attractive to investors by offering tax efficiencies.

8.2 Incentives across other EU jurisdictions

Incentives in general provided for ESG / Green type investments in various jurisdictions are typically in the form of government grants / subsidies and tax related incentives, latter relating to predominantly direct and to a lesser extent indirect (VAT) taxes.

Below we provide an overview of the main direct tax incentives available for ESG/Green type investments across known EU fund domicile jurisdictions, namely, Malta, Luxembourg and Ireland and Netherlands.

Jurisdiction	Type of Incentive	Description
Malta	Tax credits	Under the Green Mobility Scheme Malta provides tax credits to corporates for (a) investing in charging infrastructure for their commercial vehicles and (b) the leasing of clean/or zero-emission vehicles.
Luxembourg	Tax credits	The DET tax credit is provided to corporates for investments and operating expenses connected with Digital and Ecological Transformation
Ireland	Accelerated tax depreciation	Accelerated tax depreciation for investment in certain energy-efficient equipment.
	Corporate tax relief	Direct tax investment by a corporate in shares of a qualifying renewable energy company (solar, wind, hydro, or biomass technology investment).
Netherlands	Corporate tax relief	Additional tax deduction for investment in eligible energy-efficient and environmental assets.

		Energy Investment Allowance (EIA) – Additional tax deduction for certain green investments (as annually published by the Netherlands Enterprise Agency in what is called an 'Energy List').

8.3 Direct tax incentives in relation to the investment funds industry

It is already accepted that the investment funds may significantly contribute to promoting projects and practices with significant environmental impact.

This is stipulated in the Irish Budget discussions that expressly aim to: Introduce tax incentives for Irish investors investing into Irish Funds that prioritise investments in projects or companies with significant positive environmental impacts. Linking tax incentives to actual GHG emission reductions achieved by companies within investment portfolios could be an innovative approach. Funds that successfully drive emissions reductions beyond a certain threshold could be eligible for higher tax benefits [and] … introduce tax breaks or reduced tax rates for funds that focus on high-impact sustainable projects, such as renewable energy, clean technologies, or sustainable agriculture to encourage capital flows into sectors that contribute directly to GHG emission reductions. ”

8.4 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would recommend a number of direct tax incentives applicable for Cypriot investors, investment funds and fund managers alike.

For Cypriot investors, we would recommend the introduction of a tax deduction for (Cyprus) investors (individuals and companies) who invest in ESG / Green funds. Such deduction can be similar to the existing tax provision for qualifying investors (both individuals and companies) who make risk-finance investments in innovative SMEs where they can deduct the cost of such investment from their taxable income (subject to conditions and limitations).

For Cypriot funds, we would recommend the exemption or (additional) deduction for interest income earned by Cyprus (tax opaque) funds investing in green bonds [as the latter are defined under internationally accepted standard(s)].

For Cypriot fund managers, we would recommend the exemption or a reduced rate on management fee income for Cyprus fund management companies managing ESG funds.

9 Preservation of the special means of taxation for individual fund managers

9.1 Introduction

The carried interest regime is a significant aspect the investment funds industry, as it pertains to the method under which that fund managers are remunerated for their services.

In addition, the availability of a carried interest serves additional purposes in the industry. Amongs others it aligns the interests of fund managers with those of the investors. Since a manager's compensation is tied to the performance of the fund, they are incentivized to maximize returns. Carried interest may encourage fund managers to focus on long-term gains rather than short-term profits.

Most importantly, the potential for carried interest payouts can attract top talent to the local fund management industry. Skilled managers are essential for identifying investment opportunities and executing strategies that will benefit the investors.

In terms of taxation, carried interest has historically been taxed at a lower rate in many jurisdictions. In Cyprus, as of 2018, special means of taxation apply in relation to fund managers and other ''identified'' staff whose remuneration is effectively connected with the carried interest of an AIF or the performance fee of a UCITS.

9.2 Incentives across other EU jurisdictions

As mentioned above, it is a typical feature of established fund jurisdictions, to provide a special means of taxation for fund managers.

Below we provide an overview of the carried interest rules applying in a number of jurisdictions, namely, Luxembourg, Ireland and the Netherlands.

Jurisdiction	Tax rate for individuals	Description
Luxembourg	0%/22.89%	Luxembourg tax law provides for the special treatment of remuneration structured as a return on the units in the carry-vehicle provided that any gains are realised at least 6 months after acquisition of the units. Where the unitholder holds less than a 10% stake in the carry vehicle, the gains are not subject to tax. Otherwise, the gains are subject to tax at 22.89% (half the progressive rate). In order to fall within the carried interest regime, the carried interest rights, which the entity grants in recognition of the competencies and qualities of the individual as well as the performance of the investments, must be subject to the express condition that the shareholders or other interest holders have already recovered the funds they invested in the fund or in the underlying assets.
Ireland	15%	There is a statutory definition of "carried interest", and there are a number of conditions that must be met for the 12.5%/15% rates to apply.

		The regime applies only for "qualifying venture capital funds" ("QVC Funds"). QVC Funds must meet the following qualifying conditions: 1. They must be structured as a partnership. 2. They must be established for the purposes of making long term (3+ years) investments in "Relevant Investments", which is statutorily defined as "unquoted shares and securities of private trading companies that carry on research and development activities" or "the development of new technological, telecommunication, scientific or business processes". 3. The partners (including the general partner) must be obliged under a legally binding agreement to provide capital sums for investment purposes over a period of time. The regime only applies to the proportion of carried interest that derives from Relevant Investments in EEA states (including Ireland) and the United Kingdom. The carried interest also must not exceed 20% of the total profits of the QVC Fund
Netherlands	24.5%/33% (above EUR 67,000)	24.5% for taxable income up to EUR 67,000 and 33% for taxable income exceeding EUR 67,000 if the carried interest is structured properly through a management company and that company distributes at least 95% of all income derived from the carried interest during a tax year as a dividend to the manager within that same tax year. Where a management holding company is used, each manager needs to hold an interest of at least 5% of (a class of) shares.

9.3 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would strongly advocate for the preservation of the current tax regime for the taxation of carried interest/performance fee at the level of the individual fund managers and other ''identified staff''.

Moreover, additional guidance should be expected as to crystallize a number of features of the special means of taxation. Issues relating to the carrying value of the interest once the individual becomes a Cyprus tax resident are commonly considered by the affected tax managers. In addition, it may be examined to consider the extension of the application of the rules not only to employees, but also to individuals that will have an advisory capacity with the qualifying entities (AIFM, risk/portfolio managers, self-managed funds).

The preservation of the rules, should further contribute to the improvement of the investment funds ecosystem in Cyprus and may attract high-calibre individuals that will contribute not only to the investment funds industry through the establishment and operation of fund management companies and investment fund vehicles but to the broader economy as well.

10 Introduction of a parallel system of NAV taxation for common funds

10.1 Introduction

Currently, in the absence of a specific taxation regime for investment funds in Cyprus, given that common funds are contractual arrangements and do not have a corporate legal form are treated as tax transparent vehicles.

As a result, all profits that may be distributed to a common fund, are flowing through to the unit holders/investors of the fund. Such vehicles do not currently enjoy access to the tax treaties concluded by Cyprus, as they may not be considered as tax residents of Cyprus and they are not issued with a tax residency certificate from the Cypriot tax authorities.

10.2 Considerations for introducing an NAV system of taxation

The introduction of a Net Asset Value (NAV) system of taxation for common funds could have a number of potential benefits for the tax attributes of the Cypriot investment fund industry.

1. Simplification of Tax Compliance: A NAV-based tax system could simplify the process of tax compliance for investors and fund managers by taxing the fund itself rather than each individual investor.
2. Attractiveness to Foreign Investors: A clear and straightforward tax regime can make the jurisdiction more attractive to foreign investors and fund managers, who may prefer the predictability and ease of a NAV system over the complexity of a tax-transparent structure.
3. Predictability of Tax Liabilities: Investors in the fund would have greater predictability regarding their tax liabilities, as they would not be directly subject to tax on the underlying investment income, but rather on the performance of the fund as a whole.

The annual percentage of the NAV tax may be in the range of 0,005%-0,01%.

After establishing the percentage of the NAV system, it should be noted that should be made available on an optional basis to common funds.

Different types of funds with different types of strategy may choose different fund vehicles to pursue their respective strategies and asset classes. Therefore, the introduction for such a system of taxation should not apply to all funds as an obligation, but it rather should be on an optional basis as not to remove the necessary flexibility of the Cypriot funds industry.

Given the optionality that will be involved, we fully appreciate that the introduction of such an option should be subject to a number of criteria, which should require the prior clearance by the Cyprus Commissioner of State Aid.

Moreover, any potential introduction of such a measure, in order to avail access of the said common funds to the Cyprus double tax treaty network, it should be accompanied by similar amendments in the existing tax treaty negotiation policy of Cyprus. This will entail the addition of specific clauses in the existing Cyprus double tax treaties. When it comes to prospective treaties, such funds should be added in the definition of tax resident persons, in order for such funds to be eligible to access the relevant treaties.

10.3 Recommendation in the context of the Cyprus Tax Reform

As part of our contribution to the Cyprus Tax Reform discussion, we would strongly advocate for introduction of a parallel system of NAV taxation for common funds on an optional basis, based on a number of well-defined and hardened criteria, on the premise that the introduction of such a rule will be validated from an EU State Aid perspective.

11 Annex 1 – Overview of taxation of interest in other EU fund domicile jurisdictions

Jurisdiction	Taxation of interest income
Ireland	All fiscally opaque structures are further categorized and treated differently on the basis of their assets, specifically if the fund invests in Irish real estate in which case the fund is subject to tax. All fiscally opaque structures not investing in real estate are further categorized and treated in accordance to their investors being resident and subject to tax under gross roll up regime or not residents tax exempt. Ireland does not impose transfer, subscription, net asset or capital taxes on the issue, transfer or redemption of units held by non Irish resident Investors. The tax treatment of regulated funds in Ireland is one of the key reasons for the success of the Irish funds industry. Funds are not subject to any taxes on their income (profits) or gains arising on their underlying investments. Interest income is therefore not subject to tax when generated by Irish regulated funds,
Luxembourg	In Luxemburg structures are categorised first and fiscally treated in accordance to the form of regulation in unregulated structures subject to normal tax and regulated structure subject to funds tax. The regulated structures are further categorised in respect of their fund sub type in that SICARs are generally liable to tax, whereas RAIFS and SIFs are subject to a specific tax as an annual levy. Further distinction is made between RAIF's and SIF's as to the level of levy from 0.05% or 0.01% for RAIF based on other characteristics of the funds. In addition to the categorisation above there is a further categorisation of funds in Luxemburg in accordance to their legal substructure as fiscally opaque and fiscally transparent. An across-the-board tax exception is in place based on the asset class of the fund and funds that primarily invest in assets that represent risk capital (private equity fund) are fully exempted from taxation in Luxembourg.
Malta	Under Maltese Law the taxation of investment funds is determined by the categorization of the fund as either a prescribed or a non-prescribed fund. What distinguishes the two categories is the following: a fund is prescribed if at least 85% of the value of its assets is based within Malta, whereas a non-prescribed fund does not have at least 85% of the value of its assets based in Malta. A prescribed fund must also be acknowledged as such in writing by the Commissioner for Revenue.

	Non-prescribed funds are generally not subject to taxation under Maltese law. The only exception to this rule is if the non-prescribed fund enjoys income deriving from an immovable property situated locally. That income would be subject to taxation under the normal Maltese laws. Thus, a Maltese fund that invests in non-Maltese debt instruments should not be subject to any taxation in Malta.