

## CYPRUS

## Taxand Cyprus



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## Cyprus and Germany sign protocol to amend tax treaty

**Christos Theophilou and Niki Antoniou of Taxand Cyprus discuss the amendments to the Cyprus and Germany tax treaty.**

**O**n February 19 2021, a new protocol was signed (protocol), amending the existing tax treaty between Cyprus and Germany (the treaty). Following a decision of the Minister of the Council dated October 23 2019, the signed protocol was published in the Official Gazette of Cyprus in accordance with the provisions of Article 169.3 of the Cyprus Constitution.

### Changes to the tax treaty

The new protocol introduces, among others, the OECD BEPS minimum standards dealing with treaty shopping and other amendments that have been bilaterally agreed upon.

### Incorporation of the preamble

As part of the BEPS package, Action 6 sets out one of the four BEPS minimum standards, dealing with treaty shopping. Specifically, according to the OECD BEPS project, it requires jurisdictions to include two components in their tax agreements: an express statement on non-taxation (generally in the preamble) and one of three methods of addressing treaty shopping (see below Article 27).

In compliance with Action 6, specific wording of the preamble is incorporated within the treaty, stating that the treaty “intends to eliminate double taxation with respect to the taxes covered by this Agreement without creating opportunities for non-taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third States)”.

### New Article 7: business profits

New Article 7 dealing with the business profits attributable to the permanent establishments has been added. The new Article 7 is based on the 2010 OECD Report on the attribution of profits to a permanent establishment (AOA) and has

significant differences compared to the pre-2010 version of the OECD Model Article 7.

Consequently, the profits attributable in each contracting state for the permanent establishments must be made, taking into account the functions performed, assets used, and risks assumed. As a result, the attribution of profits to permanent establishments is approximated with the transfer pricing (TP) approach applicable to associated enterprises under the treaty.

The new Article 7 further clarifies that if an adjustment regarding the permanent establishment profits is not agreed upon by the parties, the contracting states shall endeavour to eliminate any double taxation based on the mutual agreement procedure.

The AOA and the 2017 OECD Commentaries to Article 7 provide that the new Article 7 follows a two-step approach.

The first step deals with a functional and factual analysis of the PE in order to identify the ‘Significant People Functions’ (SPF) (or ‘Key Entrepreneurial Risk Taking’ (KERT) functions for financial institutions) of the permanent establishment, determine assets employed and risk assumed on the basis of the SPF/KERT, and on the basis of the assets used, draw a notional balance sheet with ‘interest-bearing’ and ‘free’ capital for the permanent establishment.

As second step, and on that basis, profits are attributed to the permanent establishment under the new AOA, using the OECD Transfer Pricing Guidelines, to be applied ‘by analogy’, taking into account as referred above the functions performed, assets used, and risks assumed.

### Article 25: exchange of information

Subparagraph 5.4 of paragraph 5 of the protocol to the treaty was deleted from the treaty. This paragraph obliged contracting states to provide information regarding personal data upon request of the other state (using its own domestic gathering resources), in cases where the requested contracting state does not need such information for its own tax purposes.

### New Article 27: entitlement to benefits

A new paragraph has been inserted in Article 27 that deals with the application of the agreement in special cases. More specifically, the treaty implements the Principal Purpose Test (PPT), which is, among others, one of the mechanisms used to attack treaty shopping arrangements in response to the BEPS Action 6.

By the addition of the PPT clause in Article 27 it is made clear that no benefit would be granted to the taxpayer under

this agreement, “if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless the taxpayer establishes that granting that benefit was in accordance with the object and purpose of the tax treaty”.

As a result, taxpayers should be in a position to establish that such benefits are in accordance with the object and purpose of the treaty and there is no tax avoidance, tax evasion nor treaty shopping.

### Entry into force

The publication of the protocol in the Official Gazette of Cyprus means that Cyprus has ratified the protocol. Provided that both parties ratify the protocol by the end of 2021, the treaty amendments should be effective as of January 1 2022.

### Key takeaways

The introduction of BEPS minimum standards on the tax treaty between Cyprus and Germany enhances both competent tax authorities’ ability to challenge treaty shopping, tax avoidance, or transactions that lack economic substance.

Thus, taxpayers should seek to carefully examine the alignment of economic substance with profit allocation, as well as the overall business purposes for their transactions to address such tax risks.

Further, the new wording of the Business Income Article 7 amends the allocation rules of such business profits between the head office and the PE increasingly aligned with TP rules. Consequently, current TP documentation and support for the allocation of profits between head offices and permanent establishments are highly recommended to avoid double or multiple taxation situations.

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