



CYPRUS

OUTLINE

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LIST OF ABBREVIATIONS

Agreement	Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments
CIT	Corporate Income Tax
Commissioner	The Commissioner of Income Tax
Directive	Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments between associated companies of different Member States
ECJ	European Court of Justice
ITL	Cyprus Income Tax Law 118(I)/2002
ITL (am)	Cyprus Income Tax Law (amending) 195(I)/2004
Merger Directive	Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States
OECD	Organization for Economic Cooperation and Development
OECD MC	OECD Model Tax Convention 2003
Parent-Subsidiary Directive	Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States
Savings Directive	Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments
SDC	Special Defence Contribution
SDCL	Special Defence Contribution Law 117(I)/2002



LIST OF LEGAL REFERENCES

Laws

- Income Tax Law 118(I)/2002, published on 15 July 2002, took effect on 1 January 2003.
- Income Tax Law (amending) 195(I)/2004, published on 30 April 2004 took effect 1 May 2004.
- Special Defence Contribution Law 117(I)/2002, published 15 July 2002, took effect 1 January 2003.

Circulars

- Circular 2003/8 of 19 May 2003, took effect on 1 January 2003.

PART I. IMPLEMENTATION OF THE DIRECTIVE

1. INTRODUCTION

1.1. GENERAL INFORMATION ON THE IMPLEMENTATION OF THE DIRECTIVE

Cyprus has fulfilled its obligation to implement Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments between associated companies of different Member States (the "Directive") into its national law by way of abolishing Cypriot source taxation on interest income of non-resident legal entities in general and under specific circumstances with regard to royalties.

The exemption from withholding tax granted to non-residents in respect of interest income paid from Cyprus, is provided by the Special Defence Contribution Law N117(I)/2002 (SDCL) which took effect on 1 January 2003.

With regard to the withholding tax exemption on the payment of royalties to a company of another Member State, or a permanent establishment of a company in a Member State situated in another Member State, this is provided in the Income Tax Law (amending) N195(I)/2004 (ITL (am)), which took effect on 1 May 2004. All implementing provisions are laid down in Article 3 of the ITL (am).

1.1.1. Interest

The SDCL specifies that a resident in the Republic is liable to SDC on dividends, interest and rents (Art. 3 (2) of SDCL).

Subparagraph (b) of this paragraph specifies that every person which is a resident in the Republic who receives or is credited with interest is liable to 10% SDC.

The exemption from withholding tax which the legislation grants to non-resident recipients of interest is by making specific reference to residents only with regard to liability to SDC. Therefore, by implication non-residents are not subject to this withholding.

The exemption applies irrespective of the legal form of the recipient of the income (corporate entities with limited liability, partnerships, transparent or hybrid entities), its place of residence (EU Member State or not) or the affiliation to the payer of the income (associated company or not).

1.1.2. Royalties

As far as royalties, the exemption is not general, but applies in certain circumstances.

The ITL which took effect on 1 January 2003 provides that a 10% withholding tax applies on royalty income derived within the Republic by a non-resident person (Art. 21 of the ITL). This does not apply in cases where the royalty is granted for use outside the Republic, in which case the payment is made with no withholding.

However, prior to joining the EU, an amending law ITL (am) was passed, which took effect from 1 May 2004. This exempts from any withholding in Cyprus, royalty income of which the beneficiary is an associated company of the EU or a permanent establishment of such company situated in another Member State (Art. 3 of the ITL (am)).

The term associated company means:

- (i) the first company owns directly at least 25% of the share capital of the second company or

- (ii) the second company owns directly at 25% of the share capital of the first company or
- (iii) a third company owns directly at least 25% of the share capital of both the first and second company.

Therefore, based on the above, the only situation where withholding tax would be imposed on the payment of royalty out of Cyprus is where payment is made to a non-resident outside the EU for rights which have been granted for use within Cyprus.

1.2. TAX TREATMENT OF INTEREST AND ROYALTY PAYMENTS UNDER GENERAL TAX LAW

1.2.1. Domestic rules

a. Tax treatment at the level of the paying company

Interest and royalties are generally treated as a deductible expense in computing the company's income, provided that they are wholly and exclusively incurred for the production of income. No thin capitalization rules or legislation exist in Cyprus.

b. Tax treatment at the level of the beneficiary company

Interest and royalty payments to a Cyprus company

Interest income which arises from the ordinary carrying on of the business is taxed in Cyprus at the CIT rate of 10%. The same applies to interest income which is closely connected to the ordinary carrying on of the business of a company.

In the absence of a definition of what constitutes such income, in the ITL or SDCL, a circular issued by the Commissioner (2003/18) provides an explanation as to what constitutes such income:

- A. The following is considered as interest income accruing "from the ordinary carrying on of the business".
 - 1. Interest income of banking businesses. The category includes all banking units, co-operatives and business having as a primary object the provisions of loans like the Housing Finance Corporation.
 - 2. Interest income of financing businesses offering hire purchase, leasing and other financing arrangements.
- B. The following is considered as "Interest income closely connected with the ordinary carrying on of a business".
 - 1. Interest from trade debtors e.g. of businesses engaged in trading of land and buildings or land development as well as businesses involved in trading of motor vehicles or other vehicles or machinery;
 - 2. Interest income of insurance companies;
 - 3. Interest income on commercial bank accounts (current); and

4. Interest income of companies which act as a vehicle for the purpose of financing group companies. As example would be a holding company, a subsidiary company or an associated company which borrows money and subsequently lends these to other group companies.

If interest income is neither considered to arise in the ordinary course of business nor is closely connected to the ordinary course of business, it is 50% exempt from income tax. In addition, in such a case, the whole amount is subject to defence tax at 10%.

As far as royalties received by a Cypriot company, these are taxed at the CIT rate of 10% after the deduction of all expenses wholly and exclusively incurred for the production of income, including royalties paid.

In both cases of interest and royalty income, credit is granted in Cyprus for foreign tax suffered under domestic law, if a treaty exists under Art. 35 of the ITL and if no treaty exists under Art. 36 of the ITL.

Cross-border interest and royalty payments

Interest paid from Cyprus to non-residents is exempt from Cypriot withholding tax pursuant to the provisions of SDCL (see 1.1.1. Interest above).

Royalties paid from Cyprus to non-residents are treated for taxation purposed in the way described in 1.1.2. Royalties, above.

c. Transfer pricing

No transfer pricing legislation is in place but the arm's length principle applies to transactions between related parties (Art. 33 ITL 118(I)/2002).

Where transactions take place between related parties at terms different than those between third parties, the Commissioner may deem income in the hands of the Cypriot entity and tax it accordingly at the applicable CIT rate.

For the purposes of this article, related with respect to companies means

- one company in the Republic participates directly or indirectly in the management or control or capital of another company, or
- the same persons participating directly or indirectly in the management, control or capital of two or more companies.

1.2.2. Treaties

Cyprus has tax treaties with most of the EU Member States (see Annex).

The relevance of the tax treaties with regard to interest and royalty payments arising in Cyprus currently is very limited since Cyprus, in most cases, has given up the right to tax these types of income under its domestic law. The table would be relevant for royalty payments to which a withholding does apply in Cyprus as explained in 1.1.2. Royalties above.

2. SCOPE

2.1. PAYMENTS

2.1.1. Concept of interest

a. Definition

There is no specific definition of interest under Cyprus law for tax law purposes. However, the Commissioner has the right to interpret such term using definitions provided in other sources, such as the International Accounting standards, the OECD guidelines, the Banking Law and decided court cases.

The Circular 2003/8, issued by the Commissioner on 19 May 2003 does indirectly specify what is regarded as interest for tax purposes, which includes:

- interest on bank accounts;
- interest on hire-purchase, leasing and other financing arrangements;
- interest charged against debtors; and
- interest from bonds.

The concept of interest is sufficiently broad to cover the concept under the Directive.

b. Exclusion of hybrid financial arrangements (Art. 4(1) b-d))

Cyprus has not used the option to exclude payments under financial arrangements listed in Art. 4(1), b), c), d) of the Directive.

c. Exclusion of interest reclassified as profit distribution or conflicting arm's length (Art. 4(1) a) and Art. 4(2))

Cyprus has not used the option to deny exemptions to interest as per Art. 4(1) (a).

As for interest conflicting arm's length, Cypriot tax law requires that transactions between related parties be carried out on an arm's length basis (i.e. the fair value on normal commercial terms). For the concept of related parties see 1.2.1. *c. Transfer pricing*. Application of arm's length standard may result in denying the deduction at the level of the payer but does not affect the exemption on outbound interest.

2.1.2. Concept of royalties

a. Definition

According to Art. 21 of the ITL the concept of royalties includes payments of any kind received as a consideration for the use of, or the right to use, any copyright, patent, design secret process or formula trade mark, know how or any other like property or in consideration of technical assistance.

The definition does not explicitly mention cinematograph films, software, information concerning industrial, commercial or scientific experience and industrial, commercial or scientific equipment listed in Art. 2 (b) of the Directive.

However, Art. 22 of the ITL specifies that payments to non-residents in relation to cinematographic films are subject to a 5% withholding in Cyprus. Article 4 of the ITL (am) has amended this provision

by abolishing this withholding when the payment is made to an associated company of an EU Member State or a permanent establishment of such associated company situated in another Member State.

Payments for the use of software, information concerning industrial, commercial or scientific experience as well as for the right to use industrial, commercial or scientific equipment within Cyprus fall within the scope of concept of royalties under Art. 21 ITL as payments for the use of "other like property".

b. Classification of revenue from leasing and software

The definition of royalties under Art. 21 of the ITL does not explicitly include payments for the use or the right to use software or leasing, i.e. use of, or the right to use, industrial, commercial or scientific equipment. As mentioned previously, the definition of royalties under Art. 21 ITL treats these payments as payments for the use of "other like property" (see 2.1.2. *a. Definition* above). There is no further guidance with respect to tax treatment of these types of royalty payments.

c. Exclusion of royalties reclassified as profit distribution or conflicting arm's length (Art. 4(1) a) and Art. 4(2))

Cyprus does not apply these provisions, apart of arm's length principle (see 2.1.1. *c. Exclusion of interest reclassified as profit distribution or conflicting arm's length*).

2.2. COMPANIES

2.2.1. Types of companies benefiting from implementing provisions (Art. 3(a)(i))

a. Types of entities

The exemption from withholding tax on interest and royalty income of non-residents derived from Cyprus applies irrespective of the legal or corporate form of both the payer and the recipient of the income.

In relation to royalties paid for rights granted for use within Cyprus (see 1.1.2. Royalties), the exemption only applies to companies listed in the Annex to the Directive in respect of the payer and recipient of income.

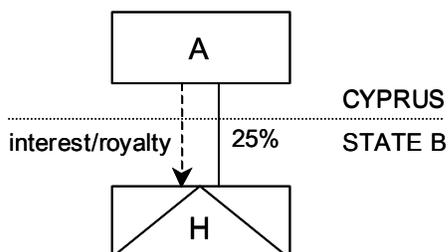
b. Hybrid entities

The issue of tax treatment of payments in situations involving hybrid entities has no specific relevance in the context of Cyprus for the reasons explained above in relation to interest and to royalties with exception for royalties paid for the use of rights within Cyprus (see 1.1.2. Royalties above). As a confirmation, three hypothetical situations are briefly discussed below:

- Case 1: a Cyprus company pays interest and royalties to a hybrid entity H located in Member State B;
- Case 2: a Cyprus hybrid entity H pays interest and royalties to a company in Member State A;
- Case 3: a Cyprus company pays interest and royalties to a company through a hybrid entity H, the latter two located in Member State A.

Case 1: Payment to a hybrid entity

A Cypriot company A pays interest and royalties to a hybrid entity H situated in Member State B. Cyprus treats the hybrid entity H as a transparent entity.



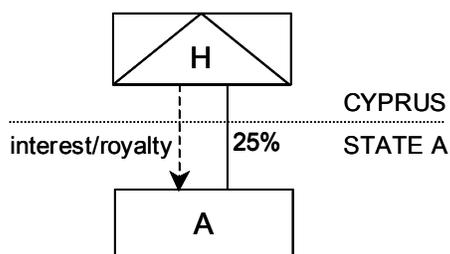
In this case Cyprus may see the interest or royalty to flow through entity H and attribute the income to its members or partners.

Interest paid through the hybrid entity H will be exempt from tax in Cyprus irrespective of the fact whether the partners are individuals or entities.

With respect to royalties paid for use of rights within Cyprus the exemption may be denied if the members of the hybrid entity H do not satisfy the criteria of an associated company of an EU Member State. If the members of the hybrid entity are individuals (or companies) which are residents of third countries, the exemption would not apply. If the members are individuals resident in EU the exemption would still not apply. The exemption would, however, apply if the members are companies resident in EU, subject to the criteria of association being fulfilled.

Case 2: Payment from a hybrid entity

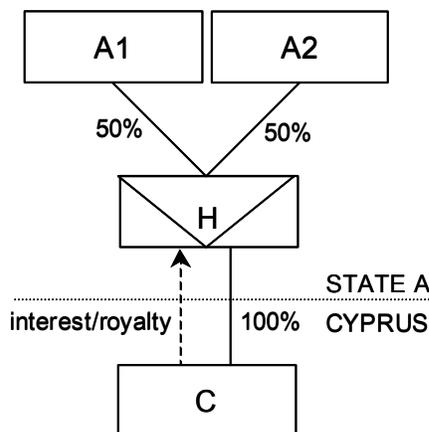
A hybrid entity H in Cyprus (other than a partnership, which will qualify as a company under the ITL) pays interest or royalties to a company A in Member State A.



In the case at hand the hybrid entity H would benefit from the general tax exemption in relation to interest and in relation to royalty. With respect to royalties paid for use of rights within Cyprus the payment would not benefit from the withholding tax exemption. Indeed, only entities listed in the Directive are eligible for its benefits, whether as payer or recipient (see 2.2.1. a. *Other types of entities*, above).

Case 3: Payment through a hybrid entity

Companies A1 and A2 are the members of the hybrid entity H, all located in Member State A. The hybrid entity H holds all the shares in company C, located in Cyprus. Cyprus treats hybrid entity H as a transparent entity. Company A1 grants a loan to the hybrid entity H and the hybrid entity H grants a loan to the company C. Interest flows from the company C to a member A1 through the hybrid entity H.



Cyprus treats A1, which is a corporate entity, as the recipient of the income, therefore, A1 will benefit from the overall withholding tax exemption provided under Cypriot law to non-resident corporate entities.

With respect to royalties paid for use of rights within Cyprus the exemption, the treatment described in Case 1 above applies.

2.2.2. Residence requirement (Art. 3(a)(ii))

a. Implementation of the requirement

For the purposes of the withholding tax exemption under Cypriot law, the residence of the recipient has no relevance, as all non-residents benefit from the general exemption in relation to interest and royalties.

In relation to royalties paid for rights used within Cyprus, the recipient must be an associated company of an EU Member State. Although not specifically mentioned, by implication residency in an EU Member State is required.

b. Application of the requirement in dual residence cases

Dual residency or dual source issues do not arise in Cyprus in application of the exemption from withholding tax with respect to interest and royalty payments. The residence of the recipient company has no relevance because of the general character of the exemption.

2.2.3. Subject-to-tax requirement (Art. 3(a)(iii))

a. General

The entitlement to the overall exemption from Cyprus withholding tax under domestic law does not depend on whether the recipient of the interest or royalty income is subject to tax.

In relation to royalties paid for use of rights within Cyprus, the Cypriot law does not require a recipient associated company of an EU Member State to be subject to tax to benefit from the exemption.

b. Proof to demonstrate compliance with the subject-to tax requirement

No relevance in the context of Cypriot law.

c. Application of the requirement to hybrid entities

No relevance in the context of Cypriot law.

2.2.4. Associated company (Art. 3(b))

The overall exemption from withholding tax applies to non-resident entities irrespective of the affiliation of the recipient to the payer in relation to interest.

In relation to royalties paid for the use of rights within Cyprus, the exemption applies to associated companies in the EU, which means:

- (i) the first company owns directly at least 25% of the share capital of the second company; or
- (ii) the second company owns directly at 25% of the share capital of the first company; or
- (iii) a third company owns at directly at least 25% of the share capital of both the first and second company.

The implementing provisions are almost identical to Art. 3 (b) i., ii. and iii. of the Directive. Although not explicitly mentioned, all the companies within the holding must be resident in EU Member States.

2.2.5. Beneficial ownership (Art. 1(4))

Since the overall exemption from withholding tax applies to non-resident entities in general, the question of who is the beneficial owner of the income has no relevance in the context of Cypriot law.

In relation to royalties paid for use of rights within Cyprus, exemption applies only to beneficial owners of royalty income (Art. 21 ITL). There is no further explanation of the term in the law.

2.3. PERMANENT ESTABLISHMENTS

2.3.1. Definition (Art. 3(c))

The implementation legislation has not specifically incorporated the definition of a permanent establishment set out in Art. 3 (c) of the Directive. However, the general definition of a permanent establishment under general Cyprus tax law is similar. The definition of permanent establishment



contained in ITL follows that of the OECD MC and means “a fixed place of business through which the business is wholly or partly carried on and includes a place of management, a branch, an office, factory, workshop, mine oil or gas well, a quarry or any other place of extraction of natural resources, construction, installation or supervisory project exceeding 3 months”.

2.3.2. Application of source rules (Art. 1(2))

No relevance in the context of Cyprus law. The concept of permanent establishment in Cyprus covers the scope of the concept under Art. 5 of the OECD MC.

2.3.3. Tax-deductible expense' requirement (Art. 1(3))

There is no requirement for a payment to be deductible for tax purposes to benefit from the exemption.

2.3.4. Beneficial ownership (Art. 1(5))

There is no requirement of beneficial ownership in respect to permanent establishments.

2.3.5. Permanent establishment in a third country (Art. 1(8))

As for royalties paid for the use of rights within Cyprus, a recipient permanent establishment of an associated company of a Member State must be located in the EU. For interest and royalties used outside Cyprus, the exemption is general and applies to permanent establishments in third countries.

3. PROCEDURE

There are no procedural requirements to be fulfilled in order to benefit from the general withholding tax exemption under Cyprus law. The exemption is applied at source and there is no need to request a refund.

3.1. MINIMUM HOLDING PERIOD (ART. 1(10))

3.1.1. General

No holding period is required.

3.1.2. Relief before the holding period requirement is satisfied

No relevance in the context of Cyprus law.

3.1.3. Appeals

No relevance in the context of Cyprus law.

3.2. ATTESTATION (ART. 1(11) AND 1(13))

No relevance in the context of Cyprus law.

3.3. DECISION ON APPLICATION OF THE RELIEF (ART. 1(12))

No relevance in the context of Cyprus law.

3.4. APPLICATION FOR REFUND (ART. 1(15) AND 1(16))

3.4.1. General

No relevance in the context of Cyprus law, but in case of withholding by mistake an application for refund can be made within 6 years.

3.4.2. Appeals

In case of mistake as explained above, an appeal can be made by the end of the month following the event. If appeal is rejected an application can be made within 45 days to tax tribunal and 75 days to court. Both residents and non-residents follow the same appeal procedure.

4. FRAUD AND ABUSE (Art. 5)

4.1. MEASURES UNDER ART. 5(1) OF THE DIRECTIVE

4.1.1. Domestic

In addition to the arm's length rules, the Cyprus tax law operates general "substance over form" principle as the means to defeat abusive constructions. However, as the exemption from withholding tax of interest and royalty income (except for royalties used in Cyprus) of non-residents is unconditional and is not restricted to certain types of taxpayers or transactions, this anti-abuse provision is rarely invoked in this respect.

4.1.2. Agreement-based

For the reasons previously mentioned, the issue is not relevant in the context of Cyprus law.

4.2. MEASURES UNDER ART. 5(2) OF THE DIRECTIVE

No specific measures have been introduced under Art. 5 (2) of the Directive.

4.3. COMPARISON WITH SIMILAR MEASURES UNDER PARENT-SUBSIDIARY AND MERGER DIRECTIVES

There are no specific anti-abuse provisions with respect to the Parent-Subsidiary Directive and the Merger Directive under Cyprus law.



5. SUMMARY

Cyprus implemented the Directive by granting exemption from withholding tax on outbound interest and royalty in a much broader scope than that required by the Directive.

No tax is due on interest payments to entities or individuals non-resident in Cyprus. There is also no withholding tax on royalties paid for the use of rights outside Cyprus, irrespective of the form of the recipient of income. Therefore the implementing provisions have an impact only on outbound royalty payments for the rights used within Cyprus.

Scope

There is no specific definition of interest for tax law purposes and the concept is subject to the interpretation by the Commissioner. The definition of royalties does not explicitly mention software, information concerning industrial, commercial or scientific experience as well as payments from leasing. However, the concept of royalties covers these payments as payments for the "other like property" mentioned in the definition of royalties under the ITL.

Exemption of royalties paid for the use of intangibles within Cyprus is granted for associated companies of EU Member States. Cyprus law does not explicitly require the holdings to involve companies resident in EU Member States only but it does by implication. It does not impose a subject-to-tax requirement with respect to companies. The beneficial ownership requirement is not defined in law. The Cyprus law does not incorporate the beneficial ownership requirement with respect to permanent establishment. The non-deductibility of payment has no impact on the application of the exemption.

Procedure

Due to the general character of exemption from withholding tax on interest and royalty payments, there have been no specific procedures introduced to apply the exemption.

Fraud and abuse

Cyprus has not introduced any specific anti-abuse measures and relies on general "substance over form" principle.



PART II. THE AGREEMENT

There have been no specific measures adopted to implement the Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the "Agreement") although Cyprus is bound by the Agreement as a member of EU.

No withholding tax is levied on interest paid to non-residents by virtue of domestic law. The same is true in relation to royalties paid to non-residents for the use of rights outside Cyprus. This treatment equally applies to payments to entities or individuals resident in Switzerland.

If royalties are paid for the use of rights within Cyprus, the paying entity should be entitled to the exemption from withholding tax under the Agreement. However, no guidance has been issued with respect to the concepts of interest and royalties, types of companies benefiting from the exemption as well as procedure for the application of the relief. According to the unofficial information from the Cyprus government, specific measures implementing the Agreement are expected to be adopted in the near future.

ANNEX

Table of the maximum withholding tax rates on interest and royalty payments under the tax treaties between Cyprus and the EU Member States.

EU Member State	Interest (%)	Royalties (%)
Austria	0	0
Belgium	10	0
Czech Republic	10	0/5 <1>
Denmark	0/10	0
France	0/10	0/5 <2>
Germany	10	0/5 <2>
Greece	10	0/5 <2>
Hungary	10	0
Ireland	0	0/5 <2>
Italy	10	0
Malta	10	10
Poland	10	5
Slovak Republic <3>	10	0/5 <1>
Slovenia <4>	10	10
Sweden	10	0
United Kingdom	10	0/5 <2>

- <1> The lower rate applies to copyrights on literary, artistic and scientific works, including film and television royalties.
- <2> The rate is 5% on films, etc.
- <3> The treaty concluded between Cyprus and former Czechoslovakia.
- <4> The treaty concluded between Cyprus and former Yugoslavia.