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Cyprus Tax News

Cyprus completes adoption of ATAD provisions

Following the partial adoption of the EU Anti-Tax Avoidance Directive of 12 July 2016 (ATAD I) in 2019, on 19 June 2020, the Cyprus Parliament voted into law the remaining provisions of ATAD I as well as the provisions of the EU Anti-Tax Avoidance Directive of 29 May 2017 (ATAD II). The law was published in the Official Gazette on 3 July 2020.

The anti-tax avoidance measures which have been transposed into law are the following:

1. Exit taxation rule (ATAD I)
2. Hybrid mismatches (including Reverse hybrid mismatches) rules (ATAD II)

It is noted that these measures are expected to impact companies and groups of companies with **international activities**.

The definitions of the key terms are listed at the end of the alert.

1. EXIT TAXATION

Scope and objective

The exit taxation rule is designed to prevent taxpayers from avoiding tax, by transferring residence, activities or assets out of the country in which economic value has been created. Based on this rule, Cyprus will have the right to tax, subject to the provisions of the Cypriot Income Tax Law (CITL), any unrealised gain created in Cyprus at the time of the exit. The value of such gain should reflect the arm's length principles.

Application date

Exit taxation rule applies as from **1 January 2020.**

Rule

A taxpayer shall be subject to corporate tax on an amount equal to the market value of the transferred assets at the time of exit, less their value for tax purposes, in any of the following circumstances:

a) Transfer of **assets** to the Head Office (HO) or to Permanent Establishment (PE) in another EU member state or in a third country in so far as Cyprus no longer has the right to tax the transferred assets;

b) Transfer of **tax residence** to another EU member state or to a third country, except for those assets which remain effectively connected with a PE in Cyprus and for which Cyprus has the right to tax;

c) Transfer of the **business** carried on in Cyprus by a PE in another EU member state or in a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.

Where the transfer of assets, tax residence or the business carried on by a PE is made from another EU member state into Cyprus, the starting value of the assets for tax purposes shall be the value established by that EU member state at the point of exit, unless this does not reflect the Market Value.

In case the assets are set to revert to Cyprus within a period of 12 months, the above provisions shall not apply to:

- asset transfers related to the financing of securities,
- assets posted as collateral, or
- where the asset transfer takes place to meet prudential capital requirements or for the purpose of liquidity management.

Under certain circumstances and conditions, a taxpayer has the right to defer the exit taxation payment by paying it in instalments over five years.

It is noted that any amount subject to corporate tax in accordance with the above provision, will also be subject to the exemptions and deductions provided by the Income Tax Law. For example, any gain arising from the transfer of securities may be subject to the exemption provided in the law.

2. HYBRID MISMATCHES

Definition of a hybrid mismatch

A hybrid mismatch is the consequence of differences in the tax treatment of a payment (financial instrument[1]) or an entity, under the laws of two or more jurisdictions.

Scope and objective

The objective of the hybrid mismatches rules adopted by the EU Commission is to neutralise the tax effects of hybrid mismatch arrangements. Due to the cross-border nature of these mismatches, the adoption of common measures within the EU aims to achieve a higher degree of anti-tax avoidance protection for the EU market.

The new measures have a broad scope to cover mismatches arising both between EU member states and between an EU member state and a third country (i.e. a non-EU country).

Application dates

1 January 2020: Hybrid mismatches rule

1 January 2022: Reverse hybrid mismatches rule

Effect of a hybrid mismatch

A **hybrid** mismatch usually has the following tax effect:

- Double deduction[2] (i.e. same deduction in two jurisdictions); or

- Deduction with no inclusion[3] (i.e. deduction of the income in one jurisdiction without inclusion in the tax base of the other)

Types of arrangements

The new provisions only apply where there is sufficient "connection" between the parties. This includes mismatches that arise between (i) taxpayer and its associated enterprises[4] (ii) associated enterprises (iii) a head office and a PE (iv) two or more PEs of the same entity and (v) mismatches resulting from a structured arrangement involving a taxpayer.

The implementation rules address the following types of arrangements:

(a) A payment under a **financial instrument** that gives rise to a *deduction without inclusion* and:

  (i) the payment is not included in the jurisdiction of the payee within reasonable time; and
  (ii) the mismatch is attributable to differences in the characterisation of the instrument/payment.

(b) A payment to a hybrid entity[5] that gives rise to a deduction without inclusion and that mismatch results from **differences in the allocation of payments** made to the hybrid entity.

(c) A payment to an entity with one or more PEs that gives rise to a *deduction without inclusion* and that mismatch results from differences in the allocation of payments between the **head office** and the **PE** or between two or more PEs of the same company;

(d) A payment that gives rise to a *deduction without inclusion* as a result of a payment to a **disregarded PE**[6];

(e) A payment by a hybrid entity that gives rise to a *deduction without inclusion* and that mismatch results from the fact that the **payment is disregarded** under the laws of the **payee jurisdiction**;

(f) A **deemed** payment between a head office and a PE or between two or more PEs that gives rise to a *deduction without inclusion* and that mismatch results from the fact that the **payment is disregarded** under the laws of the **payee jurisdiction** (unless the deduction is offset against **dual-inclusion income**[7], as defined above); or

(g) Situations with double deduction outcomes, unless the deduction is offset against dual inclusion of income.

Neutralising measures

The Directive provides for two corrective mechanisms to neutralise the effects of hybrid mismatch arrangements:

- **The Primary Rule** provides that if there is a deduction without inclusion of the income, the payer will be denied a deduction of the payment; and
- **The Secondary Rule** provides that if the payment is deductible at the level of the payer, the income will be included at the level of the recipient.

The Law provides the following measures with regards to the treatment of hybrid mismatch outcomes:

1. Double deduction (DD)

To the extent that a hybrid mismatch results in a *double deduction,* the deduction shall be denied in Cyprus under the **primary rule**, if Cyprus is the investor jurisdiction.

Where Cyprus is the payer jurisdiction, the deduction shall be denied in Cyprus if it is not denied by the investor jurisdiction.

A double deduction shall be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax period.

2. Deduction without inclusion (D/NI)

To the extent that a hybrid mismatch results in a *deduction without inclusion,* the deduction shall be denied in Cyprus under the **primary rule**, if Cyprus is the payer jurisdiction.

If Cyprus is the payee jurisdiction and the deduction is not denied in the payer jurisdiction, the amount of the payment will be included in Cyprus under the **secondary rule**, up to the amount that would otherwise give rise to a mismatch outcome.

This rule will not apply in cases **b), c), d),** and **f)**, as described under the 'types of arrangements' section above.

In accordance with the law, certain hybrid mismatches that arise from payment of interest under a financial instrument are exempt from the scope of the new rules until 31 December 2022, subject to conditions.

Furthermore, the notional interest deduction granted on new equity under article 9B of the ITL, as well as similar deductions granted by other jurisdictions, are outside the scope of the above rules.

Imported mismatch

Cyprus shall deny the deduction for any payment to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction between associated enterprises or entered into as part of a structured arrangement.

This rule should not apply to the extent that one of the jurisdictions involved in the transaction has made an equivalent adjustment in respect of such hybrid mismatch.

Disregarded Permanent Establishment (PE)

To the extent that a hybrid mismatch involves disregarded PE income, which is not subject to tax in Cyprus, the Cyprus taxpayer will have to include in its net income, the income that would otherwise be attributed to the disregarded PE.

This applies unless the income from the PE is exempt from tax under a double taxation treaty entered into by Cyprus with a third country.

Hybrid transfer[8]

Where a hybrid transfer is designed to produce a relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved, Cyprus will have to limit the benefit of such relief in proportion to the net taxable income regarding such payment.

The hybrid transfer rules is expected to target sale and purchase transactions as well as stock lending transactions.

Tax residency mismatches

The new law targets tax residency mismatches whereby payments, expenses or losses are deductible in two jurisdictions because a taxpayer is resident for tax purposes in two or more jurisdictions.

In this case, Cyprus shall deny the deduction for such payments, expenses or losses except if they relate to dual-inclusion income.

Such payments, expenses or losses will remain tax deductible in Cyprus if the other jurisdiction is an EU member state with which Cyprus has concluded a double taxation treaty under which the taxpayer is deemed to be a Cyprus resident.

Reverse hybrid mismatches

A reverse hybrid is an entity that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. non-transparent/opaque) under the laws of the jurisdiction of the investor.

The income of a reverse hybrid therefore may be neither taxable in its establishment jurisdiction (as the income is deemed to be allocated to the investor) nor in the residence state of the investor (where the income of the opaque entity is generally not included in the taxable income of the investor). As a result, a deduction with no inclusion mismatch may arise.

Based on the new provisions, the reverse hybrid mismatch rule will impact transparent companies registered in Cyprus (e.g. partnerships) that are viewed as taxable persons by one or more non-resident associated entities holding directly or indirectly at least 50% of the voting rights, capital ownership or profit interest in the hybrid entity. The corrective action will be for Cyprus to regard such hybrid entity as a *resident of Cyprus* and tax its income accordingly.

This provision does not apply to a collective investment vehicle which means "an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in Cyprus".

Way Forward

ATAD I and ATAD II was a major change in the direct EU taxation, which has a significant effect on the tax base of EU businesses.

ATAD II should largely affect *groups and multinationals* that will need to focus on ensuring that the deductibility of payments is appropriately considered in light of the new rules. These rules are expected to have a significant impact on intragroup transactions and in particular financing and intellectual property type arrangements.

Affected taxpayers should begin evaluating the prospective effects of the implementation of the Directive on their business operations as soon as possible to ensure operations are compliant and sustainable.

KEY TERMS

1. ***"Financial instrument"*** *means any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer;*

2. ***"Double deduction"*** *means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment, the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated;*

3. ***"Deduction without inclusion"*** *means the deduction of a payment or deemed payment between the head office and permanent establishment or between two or more permanent establishments in any jurisdiction in which that payment or deemed payment is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction. The payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction;*

4. ***"Associated enterprise"*** *means:*
   (i) an entity in which the taxpayer holds, directly or indirectly, a 50% or greater voting, capital or profit interest, or
   (ii) An individual or entity that holds, directly or indirectly, a 50% or greater voting, capital or profit interest in the taxpayer.

If an individual or entity holds, directly or indirectly, a 50% or greater interest in a taxpayer and one or more entities, all the entities concerned including the taxpayer, also will be treated as associated enterprises. Where the hybrid mismatch involves a payment made under a financial instrument the 50% threshold will be decreased to 25%.

The definition of associated enterprise includes an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has significant managerial influence or an enterprise that has a significant managerial influence over the taxpayer;

5. ***"Hybrid entity"*** *means any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;*

6. ***"Disregarded Permanent Establishment"*** *means any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction and is not treated as giving rise to a permanent establishment under the laws of the other jurisdiction;*

7. ***"Dual inclusion income"*** means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen;

8. ***"Hybrid transfer"*** *means any arrangement to transfer a financial instrument where the underlying return on the transferred financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to that arrangement.*

Get in touch

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