EU ATAD: Cyprus implements Exit Taxation and Hybrid Mismatches rules

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Introduction

The transposition of the first stage of the Anti-Tax Avoidance Directive (ATAD) into the Cyprus tax legislation occurred on 5 April 2019, by incorporation into the Income Tax Law of rules regarding interest limitation, controlled foreign companies, and a general anti-abuse rule. Refer to Information Sheet 140 for more details.

On 19 June 2020 the Cyprus Parliament approved further amendments to the Income Tax Law, implementing the remaining provisions of the ATAD, namely exit taxation rules and hybrid mismatches rules (including reverse hybrid mismatches).

The amendments came into force on 3 July 2020 upon publication in the Official Gazette of the Cyprus Republic with effect as of 1 January 2020, with the exception of reverse hybrid mismatches rules which will come into effect as of 1 January 2022.

Exit taxation

The purpose of exit taxation is to prevent tax avoidance by corporate taxpayers who move their tax residency, assets or business activities, out of the country in which economic value has been created. This is accomplished by granting to that country the right to tax the economic value of any capital gain created in its territory at the time of exit, albeit that such gain has not been realised upon exit.

The rule (Section 33B of the Income Tax Law)

A Cypriot corporate taxpayer [either a Cypriot tax resident company or a Cypriot permanent establishment (PE) of a non-Cypriot tax resident company] shall be subject to tax as per the provisions of the Income Tax Law at an amount equal to the **market value** of the transferred assets at the time of exit less their value for tax purposes.

For exit taxation purposes, "**market value**" is defined as the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction.

Exit tax shall apply in the following cases, where:

- A Cypriot company transfers assets from its head office in Cyprus to its foreign PE (either 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;
- A non-Cypriot company with a Cypriot PE transfers assets from its Cypriot PE to its head office or to another foreign PE, in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer;
- A Cypriot company transfers its tax residence outside of Cyprus and becomes tax resident in another jurisdiction. Any assets that remain effectively connected with a PE in Cyprus - and for which Cyprus retains the right to tax - are excluded from the exit taxation provisions;

- A non-Cypriot company with a Cypriot PE transfers the business carried out by the Cypriot PE to another jurisdiction, in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.

Transfers from another EU Member State into Cyprus

In cases 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 transferred assets for tax purposes shall be equal to the value established by that other Member State, unless this does not reflect the market value of the transferred assets.

Exemptions

In case where the exit taxation provisions apply, the profit to be added to the taxable income of the corporate taxpayer is subject to the provisions of the Income Tax Law, including any relevant exemptions and deductions, depending on the nature of the profit. For instance, the transfer of qualifying titles (shares, bonds, debentures etc) would be exempt from the provisions of exit taxation, on the basis that any profit from disposal of such titles is exempt from taxation in any case.

Further, for assets that are transferred outside Cyprus and are set to revert to Cyprus within a period of 12 months, the exit taxation provisions do not apply to transfers relating to the financing of securities, assets posted as collateral, or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

Deferral of payment of tax

When corporation tax arises as a result of the exit taxation provisions, the taxpayer may opt – under certain circumstances – to defer the payment and to settle the outstanding tax via instalments over a period of five years.

Such deferral is possible in cases of transfers to EU Member States, or transfers to third countries that are party to the European Economic Area (EEA) Agreement and have concluded an agreement with Cyprus (or with the EU) on the mutual assistance for the recovery of tax claims.

In case where the taxpayer opts for payment via instalments, the outstanding tax is subject to interest. Furthermore, if there is a demonstrable and actual risk of non-recovery, the taxpayer may be required to provide a guarantee as a condition for deferring the payment of the tax.

Finally, in case where certain future events occur, or if the taxpayer fails to honour its obligations regarding the payment of the instalments, the deferral of payment may be discontinued with the due tax becoming immediately recoverable.

Hybrid mismatches

In a nutshell, a hybrid mismatch occurs from discrepancies in the tax treatment of a transaction or an entity under the laws of two or more jurisdictions. The aim of hybrid mismatches provisions is to neutralise the tax effects of any such hybrid mismatch arrangements.

The hybrid mismatch provisions incorporated in the Cyprus Income Tax Law apply to Cypriot tax resident companies, as well as to foreign companies that have a permanent establishment (PE) in Cyprus. Moreover, there needs to be a sufficient 'connection' between the parties involved. This includes hybrid mismatches arising between:

- Associated enterprises*;
- A taxpayer and an associated enterprise;
- A head office and its PE, or two or more PE's of the same company; or
- Under a structured arrangement involving a hybrid mismatch, where the mismatch outcome is priced into the terms of the arrangement.

** For the purposes of the Directive, an "associated enterprise" is defined as:*

(i) an entity in which the taxpayer holds, directly or indirectly, at least 50% of voting, capital or profit interest, or

(ii) an individual or entity that holds, directly or indirectly, at least 50% of voting, capital or interest in the taxpayer

The 50% threshold becomes 25% in case where the hybrid mismatch involves a payment under a financial instrument.

The definition of associated enterprise also 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 a significant influence in the management, or an enterprise that has a significant influence in the management of the taxpayer.

Effect of hybrid mismatches

In general, hybrid mismatches usually have the following effects:

- A **double deduction**, i.e. a deduction of the same payment in both the jurisdiction in which the payment has its source (payer jurisdiction) and in another jurisdiction (investor jurisdiction), or
- A **deduction without inclusion**, i.e. a deduction of a payment in one jurisdiction, without a corresponding inclusion for tax purposes of income in the recipient's jurisdiction.

Neutralisation of hybrid mismatches

The hybrid mismatches rules attempt to neutralise the above effects. With effect as from **1 January 2020**, Section 11 of the amended Cyprus Income Tax Law provides for the following:

To the extent that a hybrid mismatch results in a **double deduction:**

a) where the investor is Cypriot tax resident, the deduction shall be denied in Cyprus; and

b) where the payer is Cypriot tax resident, and where the deduction is not denied by the foreign investor's jurisdiction, the deduction shall be denied in Cyprus.

Noting that any denied deduction shall be eligible to be set off against dual inclusion income, whether arising in the current or in a subsequent tax year.

To the extent that a hybrid mismatch results in a **deduction without inclusion**:

a) where the payer is Cypriot tax resident, the deduction shall be denied in Cyprus; and

b) where the payer is foreign, and where the deduction is not denied in the foreign payer's jurisdiction, the amount of the payment (that would otherwise give rise to a mismatch outcome) shall be included in the taxable income of the Cypriot tax resident recipient.

In cases of **imported mismatches,** Cyprus shall deny a deduction for any payment by a Cypriot taxpayer, to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction (or series of transactions) between associated enterprises or entered into as part of a structured arrangement. The rule does not apply in case where one of the jurisdictions involved in the transaction has made an equivalent adjustment in respect of such hybrid mismatch.

To the extent that a hybrid mismatch involves **disregarded PE income** (with disregarded PE being defined as any arrangement treated as giving rise to a PE under the laws of the head office jurisdiction but not under the laws of the other jurisdiction), with such income not being subject to tax in Cyprus, the Cypriot taxpayer will be required to include in its taxable base the income that would otherwise be attributed to the disregarded PE. The rule does not apply if the income from the PE is exempt from tax under a double tax treaty entered into by Cyprus with a third country.

Exemptions

As mentioned above, in cases of deduction without inclusion where Cyprus is the recipient jurisdiction and the payment is not denied at the level of the foreign payer, the rule is that the amount of the payment shall be included in the taxable base of the Cypriot recipient. Notwithstanding this, Cyprus has opted to exclude certain hybrid instruments from this rule (with such exclusion being allowed by the Directive); namely payments to **hybrid entities***, or payments to involving PEs and hybridity [refer to parts (b), (c), (d) and (f) of section *'Types of hybrid mismatches'* below for the specific hybrid instruments that are excluded].

****** *A 'hybrid entity' is defined as 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.*

Moreover, a temporary exemption applies up to 31 December 2022 in cases of 'deduction without inclusion' where, under certain conditions, hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise, where the financial instrument has conversion, bail-in or write-down features, or where it has been issued with the sole purpose of satisfying loss-absorbing capacity requirements.

Further, the notional interest deduction (NID) on new equity as per Section 9B of the Income Tax Law falls outside the scope of the hybrid mismatch rules.

Types of hybrid mismatches

The hybrid mismatch rules address the following types of arrangements:

a) a payment under a financial instrument gives rise to a deduction without inclusion outcome and:

   (i) such payment is not included to the income within a reasonable period of time; and

   (ii) the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it.

b) a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity;

c) a payment to an entity with one or more PEs gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and PE or between two or more PEs of the same entity under the laws of the jurisdictions where the entity operates;

d) a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded PE;

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

f) a deemed payment between the head office and PE or between two or more PEs gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction; or

g) a double deduction outcome occurs.

Reverse hybrid mismatches

A reverse hybrid entity is an entity which is treated as transparent and is not considered to be taxable in its jurisdiction of incorporation or establishment, but is considered as a taxable entity under the laws of the investor's jurisdiction. Such cases could potentially give rise to deduction with no inclusion, where the income of the reverse hybrid entity may be exempt from tax in its jurisdiction of establishment, as well as in the jurisdictions of the investors (of account of the fact that they are not treated as transparent).

To counter this, the law provides that, under certain conditions, a reverse hybrid entity incorporated or established in Cyprus shall be considered as a company incorporated in Cyprus and its income will be subject to tax in Cyprus (Corporate Tax and/or Defence Tax as the case may be), to the extent that such income is not otherwise taxed under the laws of Cyprus or of any other jurisdiction.

The above does not apply to collective investment vehicles, under certain conditions.

The reverse hybrid provision enters into effect as from **1 January 2022**.

Tax residency mismatches

In cases where a Cyprus tax resident entity obtains a double deduction on account of it being considered tax resident in one or more additional jurisdictions, then, regardless of any other provisions of the Income Tax Law, Cyprus shall deny the relevant deduction, to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income.

In case where the other jurisdiction is also an EU Member State, then it will be necessary to refer to the tie-breaker provisions of the relevant double tax treaty between Cyprus and the other Member State. The country where the taxpayer is not deemed to be tax resident according to the tie-breaker rules shall deny the relevant deduction.

NOTES:

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.