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EU Anti-Tax Avoidance Directive

(ATAD I and ATAD II)

Cyprus House of Representatives adopted on 19th June 2020 the law to implement the directive (EU Anti-Tax Avoidance Directive (ATAD EU 2016/1164) that will be applied retrospectively as of 1st January 2020 with the exception of reverse hybrids which will be applicable as from 1st January 2022.

A. EXIT TAXATION (ATAD I) - *Applied retrospectively as of 1st January 2020*

A Cyprus company or the permanent establishment in Cyprus of a non-Cyprus company shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, in any of the following circumstances:

1. The Cyprus tax resident company transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far Cyprus no longer has the right to tax the transferred assets due to the transfer;

2. A permanent establishment in Cyprus of a non-Cypriot company transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far Cyprus no longer has the right to tax the transferred assets due to the transfer.

3. A Cyprus tax resident company transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;

4. A permanent establishment in Cyprus of a non-Cypriot company transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment 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 permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

''Market value'' is 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.

The exit taxation provisions are not applicable in the case of assets which are expected to return in Cyprus within a period of 12 months provided these assets relate to the financing of securities, assets provided as collateral or when the transfer of assets is made to meet prudential capital requirements or for the purposes of liquidity management.

In accordance with ATAD I, a taxpayer has the right to defer the payment of an exit tax by paying it in instalments over five years (subject to certain conditions).

If a taxpayer defers the payment, interest may be charged in accordance with the legislation of the Member State of the taxpayer or of the permanent establishment, as the case may be.

If there is a demonstrable and actual risk of non-recovery, taxpayers may also be required to provide a guarantee as a condition for deferring the payment.

B. HYBRID MISMATCHES (ATAD II) - *Applied retrospectively as of 1st January 2020*

Hybrid mismatch arrangements are arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries.

Hybrid mismatches rules provide that:

To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.

To the extent that a hybrid mismatch results in a deduction without inclusion, Cyprus shall deny the deduction of such payment. And if a resident of Cyprus is the recipient of the payment Cyprus will tax the payment and neutralise the hybridity.

It is clear that the rules are typically limited to mismatches as a result of hybridity and do not impact the allocation of taxing rights under tax treaties.

Hybrid mismatches are considered as abusive and covered by the provisions of EU Tax Avoidance Directive when they arise :

a. Between associated enterprises
b. Between a taxpayer and associated enterprise.
c. Between a Head Office and its foreign PE

d. Between 2 or more PEs of the same company
e. Under a structured arrangement. (A structured arrangement is an arrangement involving a hybrid mismatch, where the mismatch is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch. This will not apply if the taxpayer or an associated enterprise reasonably could not have been expected to be aware of the hybrid mismatch and neither the taxpayer nor the associated enterprise benefited from the advantage resulting from the hybrid mismatch.) :

Cyprus Law strictly follows, but does not go beyond, ATAD II's mandatory "***minimum standards"*** aiming to address these hybrid mismatches. In addition, Cyprus decided to ***opt in for all possible exceptions provided for by ATAD II***

<u>If a hybrid mismatch results in:</u>

i. ***Double Deduction (DD)***: a double deduction, any Cyprus-resident recipient will be denied the deduction, if a deduction is given to an overseas resident.
ii. ***Deduction Without Inclusion (DWI)***: a deduction without inclusion, if the Cyprus resident party is the payer, the deduction will be denied, and if the Cyprus-resident party is the recipient and a deduction is given to the overseas payer, the recipient will be taxed.

The National Interest Deduction does not give rise to hybridity issues.
Hybrid mismatch rules apply to both Cypriot tax resident companies and foreign companies with a PE in Cyprus and applies the following hybrid mismatch arrangements

A. Hybrid Financial Instrument Mismatches

Situations where the qualification of a financial instrument or the payment made under it differs between two jurisdictions (e.g. the instrument is considered as debt in the payer jurisdiction and as equity in the payee jurisdiction)

Based on the Anti-Tax Avoidance Directive in case of a hybrid financial instrument mismatch between two Member States leading to a deduction without an inclusion, the Member State of the payer should deny the deduction of the payment. A hybrid financial instrument mismatch between a Cyprus and a third country should be addressed depending on the jurisdiction of the payer.

If Cyprus is the jurisdiction of the payer, Cyprus should deny the deduction of the payment from the taxable base to the extent of the mismatch. If the jurisdiction of the payer is a third country, Cyprus should require the payment to be included in the taxable base to the extent of the mismatch.

B. Hybrid Entity Mismatch

An entity can be transparent or non-transparent for tax purposes. If an entity is transparent for tax purposes, for example in case of a partnership, the entity itself is not subject to tax, but the proportionate share of the items of income, gain and expenditure derived and incurred by the partnership is allocated to the partners as taxable income.

If the jurisdiction of the payer is Cyprus, the deduction of the payment from the taxable base to the extent of the mismatch will be denied. If the jurisdiction of the payer is a third country, Cyprus should require the payment to be included in the taxable base to the extent of the mismatch.

This provision does not apply to a collective investment vehicle, such as an investment fund or any other multi-shareholder vehicle, holding a diversified portfolio of investments, which is subject to investor-protection regulation in Cyprus.

C. Hybrid Transfers

A hybrid transfer is an arrangement to transfer a financial instrument where the laws of two jurisdictions differ on whether the transferor or the transferee has got the ownership of the payments on the underlying asset.

The hybrid transfer rules recommended in the OECD report are particularly targeted at sale and re-purchase (repo) and securities lending transactions. Hybrid transfers are typically designed in financial centres and derive from complex structures.(e.g. if two companies enter into a sale and repurchase agreement over the shares of a special purpose vehicle (SPV) and one country treats the transaction as a sale and repurchase of the SPV shares while the other country treats the transaction as a loan secured through the SPV shares).

D. Hybrid Permanent Establishment Mismatch Leading to Double Deduction

A hybrid permanent establishment mismatch may lead to a deduction without inclusion, if a payment made by the hybrid permanent establishment to its head office is deducted from the taxable base in the jurisdiction in which the hybrid permanent establishment is situated but is not included in the taxable base in the jurisdiction in which the taxpayer is a resident because the latter jurisdiction does not recognise the permanent establishment. The rules also apply to a hybrid permanent establishment mismatch leading to a deduction without an inclusion.

Cyprus will deny the deduction to the extent that the other jurisdiction(s) allows the duplicate deduction to be set off against income that is not dual inclusion income. However, if both jurisdictions are Member States and there is a double taxation treaty in place between Cyprus and the other Member State according to which the taxpayer is not considered to be a tax resident of Cyprus, the deduction will not be granted in Cyprus. In this case the Cyprus taxpayer will have to include the disregarded income of the foreign PE to its taxable income unless this is exempted under a valid double tax treaty.

E. Imported Mismatches

Situations where the effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches. This includes a deductible payment in a Member State under a non-hybrid instrument that is used to fund expenditure involving a hybrid mismatch.

Cyprus will disallow the deduction of a payment if the income from such payment is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement giving rise to a double deduction. The rule will not apply if one of the jurisdictions involved made an equivalent adjustment to the hybrid mismatched under consideration.

F. Dual Resident Mismatches

A dual resident mismatch may result in a double deduction outcome if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. In case of a dual resident mismatch between Cyprus and a third country, Cyprus should deny the deduction of a payment, but only to the extent that this payment is set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income").

In the event that both jurisdictions are Member States and/or there is a double tax treaty between them and the taxpayer is not considered to be Cyprus tax resident the deduction will not be granted in Cyprus.

G. Reverse Hybrid Rules - Applicable as from 2022

A reverse hybrid entity is an entity incorporated or established in Cyprus that is treated as transparent for Cypriot tax purposes (e.g., partnerships) and one or more non-resident associated enterprises holding in aggregate a, direct or indirect, interest of at least 50% of the voting rights, capital ownership or rights to profit in such entity is/are located in a jurisdiction/jurisdictions that regards the entity as a person subject to tax in Cyprus.

In such case, the hybrid entity is treated as a company resident for tax purposes of Cyprus and its income is subject to (Corporate) Income tax and Special Contribution to the Defense Fund in Cyprus to the extent that such income is not subject to tax in Cyprus or elsewhere.

This provision will not apply, however, to collective investment vehicles provided they meet certain conditions (i.e., widely held, holds a diversified portfolio of securities and is subject to investor protection regulation).

Exceptions

It is understood that the provisions with regard to hybrid mismatches shall not apply to inconsistencies in the treatment of hybrid instruments arising until 31 December 2022 resulting from interest payment on the basis of a financial instrument to a related undertaking, where the following applies cumulatively:

(i) The financial instrument has the characteristics of conversion, rescue by own means or impairment

(ii) The financial instrument has been issued with the sole aim of meeting loss-absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the loss-absorbing capacity requirements of the resident company of the Republic;

In adopting the ATAD provisions Cyprus has opted to adopt the available exemptions where Cyprus is the recipient jurisdiction and the deduction is not denied by the payer jurisdiction (e.g. because its source is in a third country). In this respect, Cyprus will not include in the tax computation of the recipient taxpayer the income deriving from the following payments:

(i) A payment to a hybrid entity when the mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity;

(ii) A payment to an entity with one or more PE when the mismatch outcome is the result of differences in the allocation of payments;

(iii) A payment to a disregarded PE;

(iv) A deemed payment between the head office and PE or between two or more PEs when the mismatch outcome is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

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