Tax News

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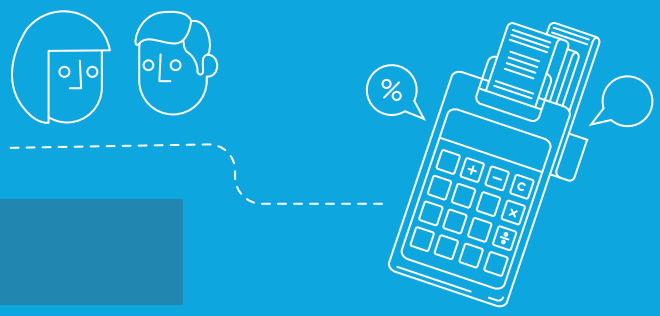

Anti-Tax Avoidance Directive: Implementation into Cyprus Tax Laws

In order to fully adopt the provisions of the EU Anti-Tax Avoidance Directive (ATAD EU 2016/1164) of July 2016, the Cyprus Parliament voted into law the following provisions, which were published in the Official Gazette on 3 July 2020.

- Exit taxation rules
- Hybrid mismatches rules (including reverse hybrid mismatches and tax residency mismatches)

Exit Taxation

Scope of the law

Article 33B of the Income Tax Law, which provides for the exit taxation rules, is to prevent taxpayers from avoiding tax, by transferring their residence, activities or assets out of Cyprus, where 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, taking always under consideration the arm's length principles.

Provisions of the law

In any of the following circumstances, a Cypriot corporate taxpayer (Cyprus tax resident company or a Cyprus Permanent Establishment (PE) of a foreign company), shall be subject to tax on an amount equal to the market value of the transferred assets at the time of exit, less their value for tax purposes:

a. Assets transferred by a Cyprus tax resident company, from its head office in Cyprus to its 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;

b. The Cypriot PE of a non-tax resident company transfers assets from the Cypriot PE to its head office or another 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;

c. A Cyprus company transfers its tax residence to another EU Member State or to a third country, except for those assets which remain effectively connected with a Cypriot PE;

d. The Cypriot PE of a non-tax resident company transfers the business carried on by the PE to another EU Member State or to a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.

In case where a company or a Permanent Establishment tax resident in another EU Member State transfers its assets, residency, or business to Cyprus, the starting value of the transferred items 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 where the assets listed below revert to Cyprus within a period of 12 months, then the above provisions shall not apply:

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

It is noted that such gains shall be taxed taking under consideration exemptions and deductions provided by the Income Tax Law, i.e. gain arising from transfer of securities may be exempted from exit taxation.

Deferral of payments

The Cyprus Assessment and Collection of Taxes Law provides for an option of deferral of the tax by paying it in instalments over a period of five years. This is applicable in the event of intra-EU transfers (including transfers within the European Economic Area where a mutual understanding for tax recovery is in place). Such deferral is subject to interest and the provision of guarantees to leverage non-recovery risks where appropriate and may be discontinued immediately with the tax being deemed payable to the Tax Department, if the provisions of the income tax law are not met.

Application date of the law

The law is entered into force with an effect as of 1st of January 2020.

Hybrid Mismatches

Scope of the law

Article 11B of the Income Tax law, which provides for the hybrid mismatches, 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.

Hybrid mismatch is the consequence of differences in the tax treatment of two or more jurisdictions. European Union have considered the above as abusive to the extent where they arise in the following cases:

- between associated enterprises;
- between a taxpayer and an associated enterprise;
- between a head office and its PE or two or more PEs of the same company; or
- under a structured arrangement (an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch).

The tax effect of a hybrid mismatch usually is:

- A double deduction, which means that in two jurisdictions the same deduction is allowed; or
- A deduction with no inclusion, which means that the deduction of the income in one jurisdiction will not be included in the tax base of the other jurisdiction.

Provisions of the law

In any of the following hybrid mismatch arrangements arises, the rules introduced shall be assessed on both Cyprus tax resident companies and the Non-resident company's PE in Cyprus in the following events:

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 to the income 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 permanent establishments 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 permanent establishment or between two or more permanent establishments 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 permanent establishment;

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 permanent establishment or between two or more permanent establishments 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.

Application of the law

Aiming to neutralise hybridity, the following rules are provided by the ATAD:

- 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.

Regarding the treatment of hybrid mismatch outcome, the following measures are provided by the Law,

a) Double deduction

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.

b) Deduction without inclusion

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 "Provisions of the law" section above

Imported mismatches

Imported mismatches are also caught by hybrid rules under which the deduction for any payment shall be denied, 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 and unless one of the jurisdictions involved in the transaction has made an equivalent adjustment in respect of such hybrid mismatch.

Disregarded 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

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 are expected to target sale and purchase transactions as well as stock lending transactions.

Tax residency mismatches

The rules target tax residency mismatches whereby payments, expenses or losses are deductible in multiple jurisdictions due to the taxpayer being considered a tax resident of those jurisdictions. In the event where such deduction is allowed from the taxable base of the taxpayer in Cyprus and is also allowed as a deduction in the other jurisdiction(s), 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. Even so, the deduction will not be granted in Cyprus in the event where all jurisdictions concerned are EU member states and a double tax treaty is in force between Cyprus and the Member state concerned according to which the taxpayer is not considered to be a Cyprus tax resident.

Reverse hybrid mismatches

A reverse hybrid entity is an entity that is treated as transparent in its jurisdiction of incorporation or establishment (e.g. a partnership where income is considered to flow-through to the partners) but is considered as a taxable entity under the laws of the investor's jurisdiction.

Reverse hybrid entities may give rise to deductions with no inclusions as their income may be exempt in the jurisdiction where they are established as well as in the state of the investor (since the entity is not treated as transparent and there is no flow through approach).

To the extent where the income of a reverse hybrid entity is not otherwise taxed in Cyprus or in any other jurisdiction, the reverse hybrid entity shall, under conditions, be regarded as a Cypriot taxpayer and a Cyprus taxpayer and shall be subject to tax accordingly.

This rule shall not apply to collective investment vehicles that adhere to certain conditions.

Application date of the law

Hybrid mismatches rule is entered into force with an effect as of 1st January 2020, while reverse hybrid mismatches rule will be applicable as from the 1st of January 2022.