

## Cyprus adopts legislation implementing exit taxation and hybrid mismatch rules

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### Executive summary

On 19 June 2020, the Cypriot House of Representatives adopted the law to implement the provisions of the European Union (EU) Anti-Tax Avoidance Directive<sup>1</sup> (ATAD I) with respect to exit taxation rules, as well as, the provisions of the amending Directive<sup>2</sup> (ATAD II) with respect to hybrid mismatch rules (the Law). The Law will come into force once it is published in the *Official Gazette* of the Republic, which is expected to take place within two weeks from the enactment date. Notwithstanding the date of publication in the *Official Gazette*, the provisions regarding exit taxation rules and hybrid mismatches rules will apply retroactively as of 1 January 2020 (with the exception of reverse hybrids which will be effective as of 1 January 2022).

This Alert summarizes the various provisions of the Law.

### Detailed discussion

#### Exit taxation rules

##### Scope of application

A company which is tax resident in Cyprus or a non-Cypriot tax resident company which has a permanent establishment (PE) in Cyprus, will 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 cases:

- a) A Cypriot tax resident company transfers asset(s) from its head office in Cyprus to its PE in another 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) A non-Cypriot tax resident company with a PE in Cyprus transfers assets from its PE in Cyprus to its head office or another PE in another 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 Cypriot tax resident company transfers its tax residence from Cyprus to another Member State or to a third country, except for those assets which remain effectively connected with a PE in Cyprus.
- d) A non-Cypriot tax resident company with a PE in Cyprus transfers the business carried on by its PE from Cyprus to another 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.

If a company tax resident in a Member State transfers into Cyprus its assets or its tax residence or its activities carried out through a foreign PE, the starting value of the transferred assets for tax purposes must be equal to the value as determined by the Member State at the point of exit, unless this does not reflect the market value of the transferred assets.

In addition, 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.

### Payment deferral of the exit tax

In accordance with ATAD I, a taxpayer has the right to defer the payment of an exit tax by paying it in installments over five years provided certain conditions are met.

### Hybrid mismatch rules

#### Scope and definitions

Broadly speaking, the purpose of the anti-hybrid mismatch rules of ATAD II is to ensure that deductions or credits are only taken in one jurisdiction and that there are no situations of deductions of a payment in one country without taxation of the corresponding income in the other country concerned. The rules are typically limited to mismatches as a result of hybridity and do not impact the allocation of taxing rights under a tax treaty.

The 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.

Under the Law, the hybrid mismatch rules apply to both Cypriot tax resident companies and foreign companies with a PE in Cyprus and covers the following hybrid mismatch arrangements:

- ▶ *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).
- ▶ *Hybrid entity mismatches*: Situations where an entity is qualified as opaque under the laws of one jurisdiction (i.e., a taxable entity under the laws of that jurisdiction) and qualified as transparent by another jurisdiction (i.e., the partners of the entity are taxable on their share of profit under the laws of that other jurisdiction).
- ▶ *Hybrid transfers*: Situations where the laws of two jurisdictions differ on whether the transferor or the transferee of a financial instrument has the ownership of the payments on the underlying asset.
- ▶ *Hybrid PE mismatches*: Situations where the business activities in a jurisdiction are treated as being carried on through a PE by one jurisdiction while those activities are not treated as being carried on through a PE in the other jurisdiction.
- ▶ *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.
- ▶ *Tax residency mismatches*: Situations where a taxpayer is resident for tax purposes in two or more jurisdictions.

A hybrid mismatch will be limited to situations arising: (i) between associated enterprises (as defined); (ii) between a taxpayer and an associated enterprise; (iii) between a head office and its PE; (iv) between two or more PEs of the same company; or (v) under a structured arrangement (as defined).

The definition of **associated enterprises** is based on a 25% direct or indirect participation (same definition as the one added for the purpose of applying the new interest limitation rules introduced by ATAD I). However, the 25% minimum participation threshold will apply only in the situation of hybrid mismatches arising from a hybrid financial instrument, while a 50% threshold will apply for all other mismatches, including mismatches resulting from the hybrid nature of entities. In addition, the concept of “acting together” is introduced, which leads to aggregating the voting rights or capital ownership that different persons hold in the same entity if they are considered as “acting together.”

The Law also introduces a definition of the concept of **structured arrangement**. This is 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.

It is also relevant to note that the Law explicitly provides that the notional interest deduction as per Section 9B of the Income Tax Law, which is available in relation to new equity capital, as well as other similar deductions provided in other jurisdictions, do not fall within the scope of application of the hybrid mismatch rules.

### Application of the hybrid mismatch rules

The above-mentioned hybrid mismatches trigger tax adjustments only to the extent they give rise to a mismatch outcome, meaning either a double deduction, a deduction or non-taxation without “inclusion” (i.e., taxation), or a double tax credit. Any mismatch outcome that does not result from hybridity does not typically fall in the scope of the anti-hybrid provisions.

The exact rules applicable to a hybrid mismatch giving rise to a mismatch outcome depend on the type of mismatch. Below is a high-level summary of the hybrid mismatch rules:

#### ► **Double deduction**

“Double Deduction” is defined as the hybrid mismatch which leads to a deduction of the same payment, expenses or losses in Cyprus (investor jurisdiction) and in another jurisdiction in which the payment has its source, the expenses are incurred, or the losses are suffered (payer

jurisdiction). In the case of a payment by a hybrid entity or PE, the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated.

To the extent that a hybrid mismatch results in **double deduction**, the deduction will be denied in Cyprus if Cyprus is the investor jurisdiction. Where Cyprus is the payer jurisdiction, the deduction will be denied in Cyprus if it is not denied by the investor jurisdiction.

Any such deduction should be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax year.

#### ► **Deduction without inclusion**

“Deduction without inclusion” is defined as the hybrid mismatch which leads to the deduction of a payment or deemed payment between the head office and the PE or between two or more PEs in any country in which that payment or deemed payment is made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction.

To the extent that a hybrid mismatch results in a **deduction without inclusion** outcome, the deduction will be denied in Cyprus if the payer is a Cypriot tax resident person. Where Cyprus is the payee jurisdiction, and the payer jurisdiction has not denied the deduction, the amount that would otherwise give rise to a mismatch outcome shall be included in the taxable income of the payee who is a Cypriot tax resident person.

### Exceptions

Grandfathering rules are applicable up to 31 December 2022 with regard to hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where certain conditions are met.

In addition, where Cyprus is the payee jurisdiction and the deduction is not denied by the payer jurisdiction (e.g., because its source is in a third country), Cyprus has opted for the possibility not to include the income in the taxable income of the payee who is a Cypriot tax resident person with regard to:

- (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

► **Imported mismatch**

In the case of an imported mismatch, Cyprus will deny the deduction for any payment by a Cypriot tax resident company (or by a PE in Cyprus of a nonresident company) 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.

► **Disregard PE mismatches**

To the extent that a hybrid mismatch involves a PE of a Cypriot tax resident company and such PE is not subject to tax in the jurisdiction where it is situated, it shall be treated as a disregarded PE and as a result, the exemption of profits of such PE should not be applicable in Cyprus. This anti-hybrid rule shall not apply if Cyprus is required to exempt the profits of such PE under a double tax treaty entered into by Cyprus with a third country.

► **Double tax credit**

Where a hybrid transfer gives rise to a double tax credit, Cyprus will limit the benefit of such relief in proportion to the net taxable income regarding the payment derived from a transferred financial instrument.

► **Tax residency mismatch**

To the extent that a deduction for payment, expenses or losses of a taxpayer, which is resident for tax purposes in Cyprus and in one or more jurisdictions, is allowed from the taxable base

in Cyprus and 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. 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.

**Reverse hybrid rules (applicable as from 2022)**

The Law includes provisions with respect to reverse hybrid entities which will be applicable as of 1 January 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 nonresident 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).

## Implications

The ATAD was an unprecedented change in European direct taxation and it has a significant effect on the taxation of businesses operating in the EU. ATAD 2 may have far reaching consequences for taxpayers operating in the EU.

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## Endnotes

1. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
2. Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

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