
Cyprus signs the OECD/G20 BEPS project “Multilateral Convention” and the EU adopts ATAD II

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In brief

On 7 June 2017 Cyprus co-signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the “MLI”) along with 66 other signatories covering 68 territories. The MLI was developed under Action 15 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project.

Once ratified by Cyprus and by the co-signatories the MLI will update the bilateral double tax treaties (DTTs) of Cyprus which are covered by the MLI. Notably the MLI will incorporate in the relevant Cyprus DTTs a Principal Purpose Test (PPT). Under the PPT a bilateral DTT benefit shall not be granted, under conditions, if obtaining that benefit was one of the principal purposes of an arrangement or transaction. This measure is designed to tackle “treaty shopping” and puts a strong emphasis on ensuring that operations are supported by appropriate substance and reflect a principal commercial rationale. It is possible that the MLI will be effective for a particular bilateral DTT of Cyprus as from 1 January 2018, however, as from 1 January 2019 is more likely.

Further, on 7 June 2017 the EU published in its Official Journal a Council Directive regarding hybrid mismatches (ATAD II) amending the so-called Anti-Tax Avoidance Directive (ATAD I). Cyprus will now need to transpose the provisions of the ATAD II into local domestic law, at the latest by the relevant deadlines as set out in the ATAD II (the earliest of such deadlines is to transpose by 31 December 2019, with effect from 1 January 2020).

In detail

MLI

Background to the MLI

The October 2015 OECD/G20 Action 15 Report “Developing a Multilateral Instrument to Modify Bilateral Tax Treaties” concluded that a multilateral instrument (MLI) to enable countries to swiftly modify their bilateral DTTs in line with the BEPS project outcomes was desirable and feasible.

An ad hoc group of over 100 interested territories was established to develop the MLI, the text of which was agreed in November 2016.

Territories have been able to sign up to the MLI since 1 January 2017, with a formal signing ceremony taking place on 7 June 2017 in Paris. On 7 June 2017, 68 territories signed the MLI and another 9 have committed to signing. More territories are expected to join over time and the

OECD has said it will probably organize another official event before the end of 2017.

The MLI supplements and ‘modifies’ the bilateral DTTs that it covers with a series of BEPS-related provisions. A bilateral DTT is covered by the MLI if both parties to the bilateral DTT are signatories to the MLI and if both choose to list the bilateral DTT as a covered DTT under the MLI.

A territory has various choices to make under the MLI (in addition to choosing which existing bilateral DTTs it wants to be covered under the MLI) regarding which provisions to opt in or out of, in whole or in part. Nevertheless, certain minimum standards of the BEPS project reflected in the MLI are generally obligatory.

The level of impact of the MLI on any particular existing DTT typically depends on the parties to the DTT making 'matching' decisions under the MLI, although there are limited instances where the MLI allows asymmetrical choices.

Cyprus' MLI position

The 28-page provisional list of notifications and reservations made by Cyprus on signing the MLI constitutes Cyprus' "MLI Position" – which was published by the OECD on June 7, 2017 and remains subject to confirmation by Cyprus upon Cyprus' ratification of the MLI.

The main points to highlight from Cyprus' MLI Position are:

- Cyprus has included all of its bilateral DTTs to be covered under the MLI except for the recently signed DTT with Luxembourg (which already incorporates the relevant BEPS project minimum standards). These DTTs are not automatically covered under the MLI. As we note above, in order for a bilateral DTT to be 'modified' by the MLI both parties to the DTT must sign the MLI and both must list the relevant bilateral DTT. So, for example, while Cyprus has listed its DTT with the United States (US) in its MLI Position, that DTT

will not be covered under the MLI unless the US subsequently signs the MLI and lists the Cyprus – US DTT as covered.

- As regards the key minimum standard under BEPS Action 6, Cyprus' approach is to adopt the PPT. The PPT provides that a DTT benefit shall not be granted, if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that DTT benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTT. This measure is designed to tackle "treaty shopping" and puts a strong emphasis on ensuring that operations are supported by appropriate substance and reflect a principal commercial rationale.

Cyprus has not opted for the restrictive provisions of the Simplified Limitation on Benefits (SLOB) and, based on the options of Cyprus, a SLOB will not apply to Cyprus' DTTs under the MLI (even in cases where the other party to the bilateral DTT has opted for a SLOB).

- Concerning the minimum standard under BEPS Action 14 on Mutual Agreement Procedures (MAP), Cyprus' approach is to follow the improved procedures as set out in the MLI and accordingly update the bilateral DTTs of Cyprus covered by the

MLI to the extent that they require updating.

We note that Cyprus has made full reservations (opt-outs) as regards the following articles of the MLI:

- Article 3 – Transparent entities
- Article 4 – Dual resident entities
- Article 5 – Methods for elimination of double taxation
- Article 8 – Dividend transfer transactions
- Article 9 – Capital gains from the alienation of shares/interests of entities deriving their value principally from immovable property
- Article 10 – Permanent establishments (PE) situated in third jurisdictions
- Article 11 – "Saving clause"
- Articles 12-15 – "PE related provisions"
- Articles 18-26 – "Arbitration"

We note that these articles will not apply to Cyprus bilateral DTTs due to Cyprus' full reservation even in cases where the other party to the bilateral DTT has opted for them.

Timing

The timing of when the MLI provisions will take effect for a particular bilateral DTT will depend upon how quickly Cyprus and the other treaty partner carry out the necessary domestic procedures to ratify the MLI and the relevant choices. It is possible that the MLI will be effective for a particular bilateral DTT of Cyprus as from 1 January 2018, however, as from 1 January 2019 is more likely.

ATAD II

On 7 June 2017 the EU published in its Official Journal a Council Directive

regarding hybrid mismatches (ATAD II) amending the so-called Anti-Tax Avoidance Directive (ATAD I).

The terms and concepts contained in ATAD II are very similar to those in the OECD's BEPS Action 2 recommendation. Explicit mention is made in the preamble of ATAD II to the explanations and examples contained in the OECD recommendation which should be used "as a source of interpretation" insofar as they are consistent with EU law.

The ATAD II has a broader anti-hybrid scope than ATAD I had as it also covers hybrid mismatches with third countries and more categories of mismatches.

Key provisions of ATAD II

- **Hybrid mismatch definition:** ATAD II extends the hybrid mismatch definition of ATAD I, which covered situations of double deduction or deduction without inclusion resulting from hybrid entities or hybrid financial instruments, to include mismatches resulting from arrangements involving PEs, hybrid transfers, imported mismatches, reverse hybrid entities, tax residency mismatches.

Mismatches that pertain to hybrid entities are only covered where one of the associated enterprises has effective control over the other associated enterprises.

Deduction without inclusion arising due to the tax (exempt) status of a payee or the fact that an instrument is held subject to the terms of a special regime is not to be treated as a hybrid mismatch.

- **Double deduction:** to the extent that a hybrid mismatch results in double

deduction, the deduction shall be denied in the investor Member State (MS) or, as a secondary rule, in the payer MS.

Nevertheless, any deduction shall be eligible for off-setting against dual inclusion income now or in the future.

- **Deduction without inclusion:** to the extent that a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer MS or, as a secondary rule, the amount of the payment shall be included as taxable income in the payee MS.

- **Imported mismatch:** An imported mismatch arises where an entity (the payee) sets off a hybrid mismatch payment against an otherwise taxable receipt arising on a payment from the payer.

The mismatch is "imported" into the payer jurisdiction and the payer is denied a deduction for the payment.

The taxpayer MS shall deny a deduction to the extent a hybrid mismatch is imported.

- **Disregarded PE income:** the MS in which the taxpayer is tax resident shall require income inclusion to the extent a hybrid mismatch involves disregarded PE income, unless a double tax treaty concluded with a third country requires exemption of the income.

- **Hybrid transfer:** to the extent a hybrid transfer is designed to produce withholding tax relief to more than one of the parties involved, the taxpayer MS shall limit the relief in proportion to the net taxable income regarding the payment.

- **Reverse hybrid:** a hybrid entity shall be regarded as a resident of the MS of incorporation or establishment and taxed on its income to the extent this income is not otherwise taxed.

This rule shall not apply to collective investment vehicles.

- **Tax residency mismatches:** to the extent dual (or more) tax residency results in double deduction, the taxpayer MS shall deny deduction insofar as the duplicate deduction is set-off in the other jurisdiction against non-dual-inclusion income.

If both jurisdictions are MSs, the loser State under the residency tie-breaker rule of the relevant double tax treaty shall deny the deduction.

- **Options for exclusion:** MSs may e.g. under certain conditions and temporarily exclude hybrid mismatches resulting from intra-group instruments issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements (e.g. regulatory hybrid capital).

Next steps

MSs, including Cyprus, will need to transpose the provisions of ATAD II by 31 December 2019 and apply them per 1 January 2020. This applies to both mismatches between MSs and between MSs and third countries. By way of derogation, the reverse hybrid entity rule will need to be transposed by 31 December 2021 and applied per 1 January 2022. Payments to reverse hybrids will however not be deductible anymore from 1 January 2020.

Let's talk

For a deeper discussion of how this development might affect you or your business, please contact:

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