RELEVANT TO ACCA QUALIFICATION PAPER P6 (CYP)

Back-to-back loans

Following a number of amendments to Cyprus tax legislation, there have been significant changes to the *Study Guide*. The amendments to legislation are a result of measures to combat tax evasion and to increase government revenue, as well as new incentives to make the tax system more attractive. In a previous article, 'Amendments to the Paper P6 (CYP) syllabus', I listed the main changes and gave a brief description of each. In certain cases, I stated that a technical article will be issued to help explain the change.

This article is the second in a series written for this purpose and expands on points A3(b) and (c) of the aforementioned article. It explains the tax treatment of back-to-back loans as well as an amendment relating to the deductibility of loan interest when the loan is used to purchase shares in a 100% subsidiary of a Cyprus company. Candidates will be expected to be familiar with the provisions stated within this technical article, although no references to circulars or sections of tax legislation are required.

1. TAXATION OF BACK-TO-BACK LOANS

Following discussions between the private sector and the Department of Inland Revenue in Cyprus, conclusions were drawn as to what profit margins would be acceptable to the Cyprus Income Tax Office (ITO) from the use of back-to-back lending. The final decisions have not been issued in an official circular, but were communicated by the ITO in a letter sent to the Institute of Certified Public Accountants of Cyprus (ICPAC). In practice, we have seen the ITO fully implementing its representations and, so long as the criteria for back-to-back loans are met (see below), the profit margins detailed below will apply.

(a) Tax years 2003–2007

For the tax years 2003 until 2007 inclusive (ie from 1 January 2003 until 31 December 2007), the minimum profit margin acceptable on back-to-back loans, regardless of the amount of the loan, is 0,3%.

(b) Tax years 2008 onwards

From 1 January 2008 onwards the following profit margins are acceptable by the ITO on back-to-back loans:

(i) The case where loans are interest bearing:

Loan amounts	**Profit margin**
€	**%**
≤50m	0,35
>50 – <200m	0,25
≥200m	0,125

It does not matter what the actual interest rates are. The important thing for the ITO is the margin. If, for whatever reason, the margin on a back-to-back loan is less than that stated above, a deemed interest receivable amount will be added in the tax computation of the company to apply the above margins.

As an example, if a Cyprus tax resident company borrows **€250.000.000** and lends this amount onwards within the group as a back-to-back loan, then if the rate borrowed was set at 2,5% the rate that could be charged by the Cyprus company as a lender could be 2,625%. This equates to net interest income of €312.500, which results in **tax** at 10% **of €31.250**. **The effective tax rate is thus 0,0125%**. The company can reduce this tax further if it has additional expenses incurred wholly and exclusively for the purpose of generating income.

(ii) The case where loans are interest-free:
In the case where the back-to-back loans – ie both the loan receivable and the loan payable – are provided interest free, then a profit margin of 0,35% is acceptable regardless of the value of the loan.

(c) Requirements for a back-to-back loan relationship to exist and related consequences:

1. The ultimate beneficial owner of the related companies must **not** be a Cyprus tax resident. We stress that the identity of such a person is not disclosed to the ITO in cases where nominee shareholders are used. This requirement exists to state clearly that companies that are *beneficially* owned by Cyprus tax residents cannot benefit from the above profit margins.
2. The Cyprus tax resident company receives an interest free/interest bearing loan from a related company, and uses the amount of this loan to grant an interest free/interest bearing loan to another related company.
3. Where part of a loan has been financed from the company's share capital, the above provisions can only be applied to that part of the loan receivable that was financed by a loan payable. However, see section 2 below regarding 100% subsidiary Cyprus companies.
4. The write off of a loan, either of the loan payable by the Cyprus tax resident company, or its loan receivable, does not create – either directly or indirectly – any tax obligation or tax benefit.
5. Timing – the period of time that can arise between the date the company receives the loan, and the date the company provides the loan, must not exceed six months.
6. The above-mentioned requirements must be adhered to until the loan is either repaid or written off.
7. The above margins apply for every separate loan that the Cyprus tax resident company borrows and provides.

If a loan does not constitute a back-to-back loan, then the interest rate charged by the Cyprus lending company should equate to a **market value rate** for that currency. Thin capitalisation rules may also apply for the rate at which the Cyprus company borrows, although there are no fixed criteria either in the law or from the ITO. In practice, the focus is on leaving sufficient margins in the Cyprus tax resident company that acts as the group treasurer.

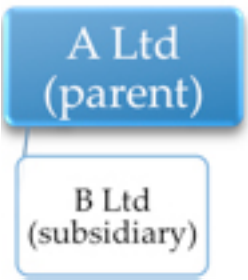
2. HOW NEW LEGISLATION RELATING TO 100% SUBSIDIARY COMPANIES APPLIES TO BACK-TO-BACK LOANS

The following deduction was originally communicated through a circular of the Income Tax Office (Circular 2012/6) but which was later recalled and annulled, and the deduction was explicitly made in the tax law through an amendment. It applies from 1 January 2012 and, thus, forms part of the Paper P6 (CYP) syllabus from the June 2013 exams.

Where a company in Cyprus borrows in order to invest in the share capital of another company which is a 100% subsidiary, either directly or indirectly, then any interest payable on such a loan is tax deductible.

This is the case unless the subsidiary has assets that are not being used in the business. In such a case, the amount of interest payable that will be considered deductible will be restricted based on the cost of those assets not being used in the business.

Overall, this is a very important amendment as it impacts back-to-back loans and tax losses, especially in the case when the subsidiary company is a Cyprus tax resident, as shown in the following example:



A Ltd borrows US$30.000.000 at a rate of 1%, and invests the funds as share capital in a newly incorporated 100% subsidiary, B Ltd. Both A Ltd and B Ltd are Cyprus tax resident companies. B Ltd in turn lends the US$30.000.000 it received from issuing its share capital, to another related company, within six months, at a rate of 1,35%. The two companies do not have other economic activities.

With regards to the back-to-back loan relationship, the margin of 0,35% applied by B Ltd will be acceptable, despite an *indirect* back-to-back loan relationship being present in this case.

With regards to offsetting the interest receivable with the interest payable, from 1 January 2012, this can be done as follows:

- The interest payable in the tax computation of A Ltd will be a tax deductible expense given that it relates to the investment in shares of a

100% subsidiary. As such, A Ltd will have a taxable loss equal to its interest payable.
- The interest receivable in the tax computation of B Ltd will be considered taxable income at the rate of 10%.
- A Ltd and B Ltd can then apply the provisions for group tax relief. As such, the tax losses of A Ltd can be used to offset the taxable income of B Ltd. Thus, the loss of A Ltd will be transferred against the income of B Ltd, leaving in B Ltd only the margin of 0,35%, which will be taxable at 10%.

For this purpose, the provisions relating to group relief in the tax legislation were also amended. From 1 January 2012, where a parent company incorporates a subsidiary company *during* a tax year, the subsidiary will be deemed to be a member of the tax group, for group relief purposes, for the *entire* tax year (previously no group tax relief was available unless the company was physically a member of the group for the entire tax year).

It is worth noting that before the recent amendment to the tax legislation – ie up until 31 December 2011 – the interest payable in A Ltd would have been fully restricted and **not** have been an allowable expense, given that it related to the purchase of shares of a subsidiary that are not deemed to be an asset used in the business.

Written by a member of the Paper P6 examining team