



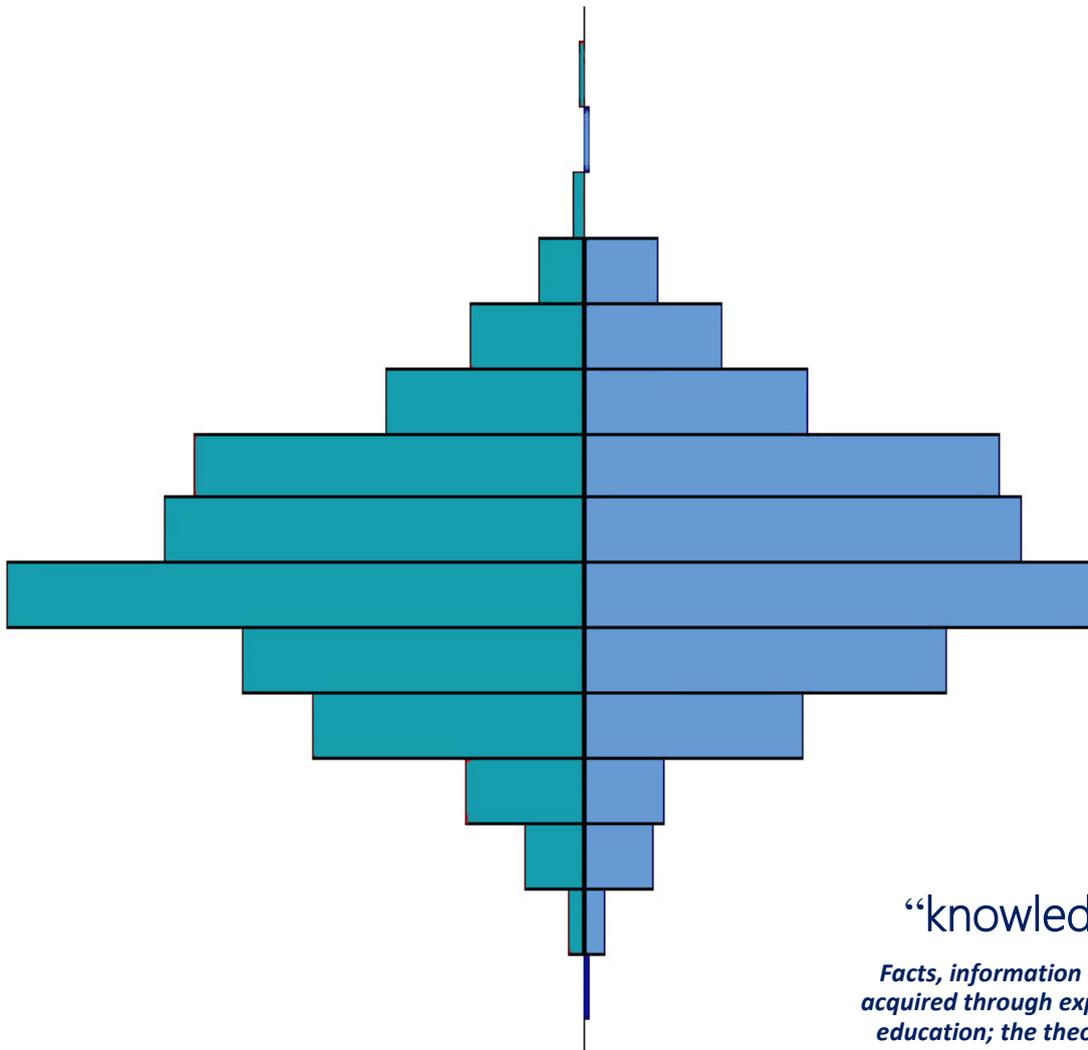
**COSTAS TSIELEPIS & CO LTD**

**TAX UPDATE**

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# BACK-TO-BACK LOANS



“knowledge”

*Facts, information and skills  
acquired through experience or  
education; the theoretical or  
practical understanding of a  
subject.*

OXFORD DICTIONARY

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**ΓΝΩΣΗ**

# Back-to-Back Loans

## 1.0 Introduction

The topic of today's third update for 2014 is the use of back-to-back loans in Cyprus.

Back-to-back loans between related companies is a scheme that allows funding between related parties to take place through Cyprus with the ability to keep as taxable profits in Cyprus only the difference between the borrowing rate and the lending rate.

The provision of loans by Cyprus companies is governed by Article 33 of the Income Tax Law, which provides that all transactions undertaken by Cyprus companies, including financing and loan arrangements, must always be at arm's length terms. This means that the interest rate to be imposed on a loan granted by a Cyprus company will depend on the prevailing market conditions at the time the loan is provided.

Cyprus offers a special regime for back-to-back loan arrangements, which results in a very favorable effective tax rate. This update, which was originally issued on 5 October 2012, explains this special regime and examines the various changes in tax legislation that affect it.

## 2.0 Taxation of back-to-back loans

Following lengthy discussions and representations between the private sector and the Inland Revenue Department of 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 ITO's final decision was outlined in a long-awaited official tax advice letter to the Institute of Certified Public Accountants of Cyprus (ICPAC) in July 2011.

In practice, the ITO fully implemented ICPAC's representations thus officially accepting thin/small spreads for pure back-to-back loan transactions as being at arm's length. As long as the outlined criteria for back-to-back loans are met, the profit margins detailed below will apply.

### 2.1 Tax years 2003-2007

For the tax years 2003 until 2007 inclusive (i.e. from 1.1.2003 until 31.12.2007), the minimum profit margin acceptable on back-to-back loans, regardless of the amount of the loan, is 0,3%.

### 2.2 Tax years 2008 onwards

From 1.1.2008 onwards the following profit margins are acceptable by the ITO on back-to-back loans:

1. The case where loans are interest bearing:

Loan amounts	Profit margin
€	%
<50 mln	0,35
≥50 - ≤200 mln	0,25
>200 mln	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 the 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% then the rate which 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 12,5% of €39.063. The effective tax rate is thus 0,60% on the income, as per our above example, and 0,0156% on the capital.

The company can reduce this tax further if it has additional expenses incurred wholly and exclusively for the purpose of generating income.

## 2. 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.

### **2.3 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. In practice, the ITO does not request evidence to see that companies are in fact related. Thus groups of companies using nominee shareholders for each company individually can still benefit from the application of the profit margins.

Our experience is that where a company borrows from a bank in order to lend further to a group company, the above margins will also apply. Generally if the Cyprus company borrows from a third party and lends to an associated company, the provisions will apply where the third party has relevant guarantees from other associated companies.

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. Net Profit Margin: Any expenses (excluding exchange differences) that are directly related and/or correspond to these transactions will be deductible ie it is about the Net Profit Margin. Exchange differences resulting from such types of loans, realized or not, will not be allowed as deductible expenses in case of loss, and will not be taxable in case of profit.

6. 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 6 months.

7. The above mentioned requirements must be adhered to until the loan is either repaid or written off.

8. The above margins apply for every separate loan that the Cyprus tax resident company borrows and provides.

It should be noted that 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 capitalization rules may also apply for the rate at which the Cyprus company borrows although there are no fixed criteria either in the law or as guidance from the ITO. In practice, the focus is on leaving sufficient margins in the Cyprus tax resident company that acts as the group treasurer.

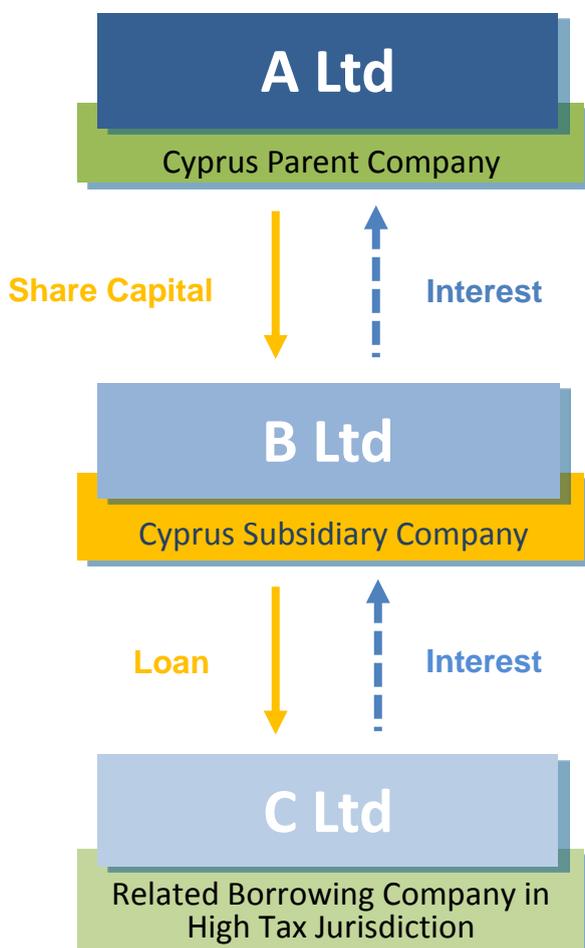
### 3.0 How new legislation relating to 100% subsidiary companies applies to back-to-back loans

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 01.01.2012.

Where a Cyprus company 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 loan is tax deductible. The 100% subsidiary need not be Cyprus tax resident.

This is the case unless the subsidiary has assets which 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 Cyprus tax resident, as shown in the following example:



## Chart Legend

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, C Ltd, within 6 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 regard to offsetting the interest receivable with the interest payable, from 01.01.2012, 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 another Cyprus tax resident 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 12,5%.
- 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 12,5%.

For this purpose, the provisions relating to group relief in the tax legislation were also amended. From 01.01.2012, 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). We stress that this only applies to companies incorporated by their parents and not to subsidiaries that are acquired.

It is worth noting that before the recent amendment to the tax legislation, ie up until 31.12.2011, 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 which are not deemed to be an asset used in the business.

## 4.0 In Conclusion

Advice on the financing methods of your group of companies has become a very important area of tax planning. By implementing the low effective tax rate that the Cyprus tax system can offer and by minimising potential withholding taxes from other tax jurisdictions as well as negotiating the effective rate with Cyprus and foreign tax authorities that can be applied under arm's length principles based on arguments such as the underlying lender's risk, could significantly contribute to minimising tax 'leakage' within a group.

### **Note:**

The tax information contained in this publication is accurate as at the date of its publication. The information in this publication is designed to increase the reader's general awareness of the Cyprus Tax System and is issued as guidance only. It should not be solely relied upon to structure business transactions without expert advice. For professional consultation, please contact the Taxation Department of Costas Tsielepis & Co Ltd.