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Interest Limitation Rule of Section 11(16) of the Cyprus Income Tax Law: Cyprus Tax Authorities issue Circular clarifying its application

In brief

On 05 July 2023 the Cyprus tax authorities issued Circular 5/2023 (the "**Circular**") clarifying certain aspects regarding the application of the Interest Limitation Rule ("**ILR**") of Section 11(16) of the Cyprus Income Tax Law ("**CITL**").

The aspects being clarified include the scope of the ILR, the application of the ILR on Cyprus Groups, the application of certain exemptions to the ILR, etc.

The Circular also includes practical examples aiming to illustrate the clarifications.

For more information with respect to the ILR refer to our newsletter issued upon the introduction of the ILR in the Cyprus legislation.

In detail

1. Background - Brief outline on how the ILR works

The ILR (applicable as of 1 January 2019) limits the otherwise deductible exceeding borrowing costs ("**EBCs**") of a Cyprus tax resident company/Cyprus Group (as defined below) to 30% of adjusted taxable profit ("**taxable EBITDA**").

The ILR contains an annual EUR 3m safe-harbour threshold ("**Safe Harbour**"). This means that EBCs up to EUR 3m are in any case not restricted by the ILR (the Safe Harbour would apply in cases where 30% of taxable EBITDA is less than EUR 3m). In the case of a Cyprus Group, the EUR 3m applies for the aggregate EBCs of the Cyprus Group and not per taxpayer (explained in detail below).

The taxable EBITDA is computed by adding back to the taxable profit of the year the EBCs, depreciation, amortisation, and deductions in relation to fixed assets and intangible assets.

"EBCs" are defined as the amount of deductible borrowing costs in excess of the amount of taxable interest income/ other taxable income economically equivalent to interest.

"Borrowing costs" are broadly defined and cover interest expenses on all forms of debt, other costs economically equivalent to interest expenses, as well as expenses incurred in connection with the raising of finance, including, for example, payments under profit participating loans, financing-related hedging costs, and guarantee fees.

Consistent with the OECD BEPS Action 4, from which the ILR derives, the annual Cyprus notional interest deduction ("**NID**"), which is calculated on new equity (introduced in Cyprus with effect from 1 January 2015), is not considered as 'borrowing costs' for the purposes of the ILR (described in more detail below).

The ILR applies to EBCs irrespective of whether the financing is with related parties or third parties.

Certain exclusions to the ILR are applicable, namely with respect to loans concluded before 17 June 2016, standalone entities, long-term public infrastructure projects, and entities with a low debt to equity ratio (measured against the debt to equity ratio of their group). EBCs remaining after such exclusions are the EBCs Subject to Restriction ("**EBCSTRs**").

2. Main clarifications provided in the Circular

NID

The NID is not considered as an interest expense (or equivalent) for ILR purposes, nor does it need to be added back for the purposes of determining the taxable EBITDA for ILR purposes.

Borrowing costs and EBCs

- Interest expense and economic equivalents that are granted as corresponding adjustments pursuant to Section 33 of the CITL should be considered as borrowing costs for ILR purposes (and, correspondingly, interest income and economic equivalents that are imposed pursuant to Section 33 of the CITL should be considered as interest income for ILR purposes);
- Any finance expense recognised solely for the purpose of IFRS 16 (when this does not relate to a finance lease for the lessor) should not be considered as a borrowing cost for ILR purposes;
- Non deductible borrowing costs should not be taken into consideration when determining EBCs;

  (Relevant example is found in Part VII, paragraph 30(vii)(a), of the Circular)

- Non taxable interest income, and other economically equivalent incomes, should not be taken into consideration when determining EBCs.

Determination of the taxable EBITDA

As indicated previously, the taxable EBITDA is computed by adding back to the taxable profit of the year the EBCs, depreciation, amortisation, and deductions in relation to fixed assets and intangible assets. With respect to the determination of the taxable EBITDA the Circular clarifies that the following are not taken into account:

- tax losses brought forward;
- group relief of tax losses;
- the taxable profit/loss arising from a long-term public infrastructure project;
- foreign tax credits that may have been claimed against the Cyprus tax liability.

Conversely, any taxable income/loss which arises from activities financed by loans concluded before 17 June 2016 (i.e. loans benefitting from the grandfathering provisions of the ILR) will be taken into account for the purposes of determining the taxable EBITDA.

Furthermore, the Circular clarifies that "deductions in relation to fixed assets and intangible assets" include, amongst others:

- balancing deduction;
- capital allowances;
- capital allowances related to R&D;
- capital allowances related to rights/benefits of patents and IP rights.

(Relevant example is found in Part VII, paragraph 30(i)(b), of the Circular)

Grandfathering of loans concluded before 17 June 2016

The Circular clarifies that the grandfathering of the relevant loans (i.e. exclusion of the borrowing cost from the ILR) does not apply to any borrowing cost relating to any amendments made to such loans from 17 June 2016 onwards.

The Circular provides examples of amendments made post 16 June 2016 (provided that such amendment was not already provided for in the loan agreement that was in force on 16 June 2016) which affect the applicability of the grandfathering provision; these examples are amendments to the:

- duration of the loan;
- interest rate or method of calculation of the interest of a loan;
- loan amount;
- contracting parties if the liability to settle the loan is assigned to a Cyprus tax resident person which is not a member of the Cyprus Group to which the initial borrower belonged on 16 June 2016; amendments to the contracting parties as a result of a "qualifying reorganisation" do not affect the application of the grandfathering provision (to the extent that all other relevant loan terms remain unchanged).

In case of amendments, the Circular clarifies that the grandfathering provision is only applicable to the part of the borrowing cost which is based on the loan terms that were applicable as at 16 June 2016.

The Circular provides clarifications with respect to the interaction of the grandfathering provisions with back to back arrangements. Where borrowing costs of a back to back arrangement with related parties are not subject to restriction due to the grandfathering provisions, then, correspondingly, any interest income relating to the back to back arrangement with related parties should not be taken into account for calculating the EBCSTRs. If the intermediate entity and its borrower are not members of the same group for group relief purposes, then the intermediate entity can take the margin realised from this back to back arrangement into consideration (as interest income or interest income equivalent) when calculating its EBCSTRs. See also section 3 "EBCs and Cyprus Groups" below for the comparable treatment in a Cyprus Group situation.

(Relevant examples are found in Part VII, paragraphs 29 and 30(v) & (vi), of the Circular)

Carry forward of EBCSTRs and of Unused Interest Capacity ("UIC")

- EBCSTRs not deductible in a tax year due to the application of the ILR, and
- UIC (i.e. where the amount of 30% of taxable EBITDA is in excess of the EBCSTRs for a tax year)

may be carried forward to future tax years.

EBCSTRs carry forward

The Circular provides for a number of clarifications which are summarised below:

- **Carry forward period:** EBCSTRs to be carried forward can be carried forward for a 5-year period. This 5-year carry forward is in line with Cyprus' 5-year tax loss carry forward rule. For example, EBCSTRs carried forward from 2019 can be used up to and including tax year 2024 (EBCSTRs carried forward are subject to the provisions of Section 11(16) of the CITL).

  (Relevant examples are found in Part VII, paragraph 26, of the Circular)

- **Use of EBCSTRs brought forward against UIC of the current year:** EBCSTRs brought forward are used against UIC of the current year on a first in first out basis (FIFO).

  (Relevant examples are found in Part VII, paragraph 27(i), of the Circular)

- **Allocation of EBCSTRs carried forward by Cyprus Group members:** The Circular indicates that EBCSTRs carried forward are a characteristic of each individual member of a Cyprus Group (defined below) and, thus, in case a member leaves the Cyprus Group, then that member can take with it the EBCSTRs that it was carrying forward.

  (Relevant examples are found in Part VII, paragraph 27(i), of the Circular)

- **Tax losses generated as a result of using EBCSTRs brought forward:** In case that EBCSTRs carried forward are utilised during a subsequent tax year and this results in tax losses being generated in that subsequent year, then such tax losses will be able to be:
  - offset against other taxable income of the relevant taxpayer; or
  - transferred to other companies of the Cyprus Group pursuant to the Cyprus group relief provisions; or
  - carried forward for a period of 5 years.

- **EBCSTRs carried forward of a person leaving a Cyprus Group and becoming a standalone entity:** Any EBCSTRs being carried forward will be fully deductible at the time that the person becomes a standalone entity, provided that the 5-year period from the year that the EBCSTRs were generated has not expired.

UIC carry forward

The UIC does not take into consideration the Safe Harbour amount and is subject to the normal ILR restrictions applied to interest capacities.

The Circular provides for a number of clarifications which are summarised below:

- **Carry forward period:** UIC to be carried forward can be carried forward for a 5-year period. For example, UIC carried forward from 2019 can be used up to and including tax year 2024.

- **Use of UIC brought forward against EBCSTRs of the current year:** UIC brought forward is used against EBCSTRs of the current year on a first in first out basis (FIFO).

- **UIC is a Cyprus Group characteristic:** the Circular clarifies that UIC carried forward is a characteristic of the Cyprus Group *(relevant examples are found in Part VII, paragraph 27(ii), of the Circular)* rather than a characteristic of each individual member of a Cyprus Group. In this respect, the Circular clarifies the following:
  a. As a general rule, if an entity leaves the Cyprus Group the UIC remains with the Cyprus Group;
  b. As a general rule, if due to the exit of entities a Cyprus Group ceases to exist, the UIC should be allocated between the members of the dissolved Cyprus Group fairly and logically, on the basis of the specific facts and circumstances; the allocation must be approved by the Tax Commissioner, and if no approval is obtained then the UIC is considered as lost;
  c. As a general rule, in case of a new member entering a Cyprus Group (whether due to a "qualifying reorganisation" or due to another reason), then any UIC of the new member of the Cyprus Group will be assumed by the new Cyprus Group; the UIC is subject to the 5-year restriction and the restrictions imposed in the CITL relating to changes of ownership and reduction of activities of an entity;
  d. The Circular indicates that, notwithstanding the general rules outlined above, each case should be assessed on its own merits, and for each of (a)-(c) above the approval of the Tax Commissioner is needed.

Equity Escape Rule ("EER")

The EER is an annual election which is based on the level of equity of the Cyprus tax resident company/Cyprus Group as compared to the level of equity of the Cyprus tax resident company's/Cyprus Group's consolidated group for accounting purposes (on a worldwide basis).

In cases where the ratio of 'equity/total assets' is higher at the level of the Cyprus tax resident company/Cyprus Group (or even up to 2% lower) as compared to its consolidated group for accounting purposes (on a worldwide basis), the ILR, in effect, does not apply for that tax year.

With respect to the EER the Circular clarifies that:

a. For a Cyprus tax resident company to be considered a member of a consolidated group for accounting purposes, it must be consolidated on a line by line basis (i.e. if consolidated on an equity accounting basis it cannot elect for the EER);
b. In case the EER exemption is claimed for the year, then:
   (i) no UIC is created with respect to that year;
   (ii) the 5-year period in which EBCSTRs and UIC can be carried forward is not suspended (in other words, the year during which an EER election is applied counts towards the relevant 5-year period).

Step 1 Definition of consolidated group for accounting purposes	Step 2 Determination of the consolidated financial statements of the consolidated group for accounting purposes	Step 3 Determination of the financial statements of a Cyprus tax resident company (or Cyprus Group)	Step 4 Adjustments to the balance sheet of a Cyprus tax resident company (or Cyprus Group) in order to ascertain its equity and assets	Step 5 Calculation of the equity to assets percentage
a. The ultimate parent entity ("**UPE**") where the Cyprus tax resident company/ Cyprus Group is/are consolidated must be identified. b. UPE is the entity which is not fully consolidated by any other entity. c. If there are multiple consolidations, what is relevant is the last top level. d. UPE can only be an entity (not an individual). e. Steps 2-4 are irrelevant if the Cyprus Group is also the consolidated group for accounting purposes.	a. Consolidated financial statements must be prepared in accordance with IFRS, or the national accounting standard, or an accounting standard which is acceptable by the Tax Commissioner. b. An accounting standard will be considered as acceptable by the Tax Commissioner if it is acceptable by stock market authorities listed on the list of members of the International Organisation of Securities Commissions (IOSCO). c. The Circular describes what needs to be undertaken in case there is no obligation for preparation of consolidated financial statements. d. The relevant consolidated financial statements are those that coincide with the relevant tax year (the Circular also covers cases of non-coincidence).	a. If the financial statements of a Cyprus tax resident company (or Cyprus Group) were prepared on the basis of a different accounting standard than the consolidated financial statements of the consolidated group for accounting purposes, then financial statements (quality reviewed by an independent expert) will need to be prepared. b. The Circular describes what needs to be undertaken in case there is no obligation for preparation of consolidated financial statements by a Cyprus Group. c. The relevant financial statements of a Cyprus tax resident company (or Cyprus Group) are those that coincide with the relevant tax year (the Circular also covers cases of non-coincidence).	The Circular clarifies that the equity and assets of a Cyprus tax resident company (or Cyprus Group) have to be recorded using the same method as for the consolidated group for accounting purposes. In this respect, the Circular provides some examples of adjustments that need to be undertaken. With respect to "equity" the Circular indicates that this is meant to include shares (whether ordinary, preference, redeemable or convertible) of any class, provided that such shares are considered as equity for accounting purposes. Equity also includes share premium, revaluation reserves, P&L reserves, etc.	a. The Circular indicates that financial institutions, as defined in Section 2 of the CITL, should be excluded from the calculation of the equity/asset ratio for the purposes of the ILR. b. When applying the ILR on a Cyprus Group, the Cyprus Group should be considered as one entity, and, thus, if the test is met then the ILR will apply to all members of the Cyprus Group. c. If the Cyprus Group is the same as the consolidated group for accounting purposes the conditions of the EER are considered as met.

3. Clarifications provided in the Circular relating to the application of the ILR to Cyprus Groups

Entering and leaving a Cyprus Group

The ILR applies to each taxpayer separately unless those taxpayers are part of a Cyprus Group. In such a case, the Cyprus Group will be considered for the purposes of the ILR as a single taxpayer. Consequently, the ILR will be applied on the cumulative position of the Cyprus Group.

A Cyprus Group, which also includes Cyprus Permanent Establishments ("**PEs**") of foreign tax resident companies, is defined by reference to the definition of a "group" for Cyprus group relief purposes (Sections 13(8)(b)-(d) of the CITL).

Entities are considered to be part of a Cyprus Group if they are part of such group for the entire tax year, but a Cyprus Group also includes:

1. a Cyprus tax resident company that is established by its parent company during the tax year, as well as a Cyprus PE of a foreign tax resident company established during the tax year;
2. a person which was dissolved during the tax year (dissolved if a company, or ceased its activities if a Cyprus PE);
3. a person which was Cyprus tax resident, and during the tax year became tax resident of another Member State or a third country with which Cyprus has concluded a bilateral or multilateral treaty for the avoidance of double taxation and/or exchange of information for tax purposes ("**Bilateral or Multilateral Agreement**");
4. a person which was tax resident in another Member State or a third country with which Cyprus has concluded a Bilateral or Multilateral Agreement, and during the tax year became Cyprus tax resident.

Conversely, a person will not be considered as being part of a Cyprus Group if it is an entity which was:

1. Cyprus tax resident, and during the tax year became resident of a third country with which Cyprus has not concluded a Bilateral or Multilateral Agreement;
2. tax resident in a third country with which Cyprus has not concluded a Bilateral or Multilateral Agreement, and during the tax year became Cyprus tax resident.

In such cases, the said person will, in that tax year, need to apportion the annual Safe Harbour over the period that the said person was a tax resident of Cyprus.

Choice between multiple Cyprus Groups

The Circular clarifies that where an entity belongs to more than one Cyprus Groups, the entity must irrevocably elect to be part of only one of those Cyprus Groups (the Circular provides for the possibility to change Cyprus Group subject to the approval of the Tax Commissioner; this possibility is to be applied only in exceptional cases).

The Circular assumes a top down approach with respect to the aforementioned election.

(Relevant examples are found in Part VII, paragraph 33, of the Circular)

EBCs and Cyprus Groups

The EBCs of Cyprus Groups refer to the amount by which the aggregate deductible borrowing costs of the members of the Cyprus Group exceed the aggregate taxable interest income and other economically equivalent taxable income of those members.

If the aggregate taxable interest income and other economically equivalent taxable income of the members exceeds the aggregate deductible borrowing costs of those members, then no ILR issues arise for those members.

(Relevant examples are found in Part VII, paragraph 25, of the Circular)

For the purpose of allocating to each member of the Cyprus Group the restriction imposed on the Cyprus Group by the ILR, the pro rata basis is used (i.e. member EBCSTRs / Cyprus Group EBCSTRs).

(Relevant example is found in Part VII, paragraph 25(i), of the Circular)

With respect to the application of the ILR on a Cyprus Group, the following are clarified:

- Where a grandfathered loan generates interest income for a company which belongs in the same Cyprus Group with the company having the corresponding borrowing cost, then such interest income should not be taken into consideration for determining the EBCSTRs of the Cyprus Group;

- In case a Cyprus tax resident company is an intermediary company in a back to back arrangement, where the borrowing cost of the intermediary is grandfathered, and irrespective of whether the company to which the intermediary company pays the borrowing cost is in the same group for Cyprus group relief purposes as the intermediary company, then:

    - the interest income of the intermediary company should not be taken into consideration for the purposes of determining the Cyprus Group's EBCSTRs; but
    - in case the intermediary company and its borrower (i.e. the company paying interest to the intermediary company) are not members of the same group for Cyprus group relief purposes, then the margin realised by the intermediary company can be taken into consideration for the purposes of determining the Cyprus Group's EBCSTRs.

(Relevant examples are found in Part VII, paragraph 29(ii) and 30(vi), of the Circular)

For the purpose of establishing the maximum amount of a Cyprus Group's EBCSTRs that can be deducted for tax purposes, the annual EUR 3m safe-harbour is not adjusted on a pro rata basis in cases where at least one member of the Cyprus Group was a Cyprus tax resident for the entire tax year under consideration.

(Relevant example is found in Part VII, paragraph 25(i), of the Circular)

4. Other clarifications provided in the Circular

- **Loan transfers due to qualifying reorganisation:** EBCs arising from a loan transferred within the context of a "qualifying reorganisation" continue to have the same tax treatment they had as if the qualifying reorganisation had not taken place. The same applies to loans transferred to Cyprus from another Member State by virtue of a reorganisation, provided that the Member State from which the loans were transferred opted for the grandfathering of loans entered into prior to 17 June 2016;

- **Entities benefitting from Cyprus IP regime:** For the calculation of taxable EBITDA, the deduction of 80% of eligible profits generated from eligible intangible assets is not taken into account. If a loss arises, the entire loss is taken into account for the determination of taxable EBITDA, without being limited to 20%. In case an EBC is carried forward and is ultimately considered as deductible, then, if this EBC was connected to an asset eligible for the 80% deduction of the IP regime, only 20% of the carried forward EBC will be considered as deductible;

  (Relevant example is found in Part VII, paragraph 30(vii), of the Circular)

- **Entities with controlled foreign companies ("CFCs"):** The undistributed income of non-resident companies, or foreign PEs of Cyprus tax resident companies, which are treated as CFCs, and which is added to the Cyprus taxable income, shall be taken into account for the purposes of applying the ILR;

- **Scheduling of EBCSTRs:** In case the EBCSTRs need to be allocated to specific activities (e.g. for tax credit purposes) then the limitation on such EBCSTRs is also allocated correspondingly;

  (Relevant example is found in Part VII, paragraph 30(vii), of the Circular)

- **Implications of an entity ceasing to be a "standalone entity":** The Circular deals with issues arising when an entity ceases to be "standalone" for ILR purposes (e.g. when EBCs are considered to arise, how the Safe Harbour is applied, whether a standalone company can transfer interest capacity, etc);

- **Reversals of interest payable/receivable of prior years:** As a general rule, gains /losses arising from such reversals should not be considered as interest income/borrowing costs for the purposes of the ILR, and are not adjusted in determining taxable EBITDA;

- **Loans used to finance long-term public infrastructure projects:** The Circular deals with (i) when such a project is considered as "long term", (ii) when such a project is considered as "public", (iii) clarifying the term "public interest", (iv) examples of what is an eligible infrastructure project, (v) whether or not the relevant asset must be recorded in the financial statements or not, (vi) whether the income from such a project needs to be taxable or not, and where, (vii) the importance of the value of the loan vs the value of the project;

  (Relevant example is found in Part VII, paragraph 30(vi), of the Circular)

- **Transfer of tax residency to Cyprus:** It is clarified that when a company transfers its tax residency to Cyprus:
  - any EBCs and UIC that were carried forward by the company prior to it becoming a tax resident of Cyprus cannot be carried forward into Cyprus;
    the exemption from the ILR for loans which were entered into before 17 June 2016 only applies if (i) the company transferred its tax residence from an EU Member State, and (ii) that Member State also provided for an exclusion from the ILR of loans which were entered into before 17 June 2016;
    (Relevant example is found in Part VII, paragraph 29(i)(θ), of the Circular)
  - the annual Safe Harbour threshold is adjusted proportionally for the part of the year the company was Cyprus tax resident (provided that it is not a member of a Cyprus Group);
    (Relevant example is found in Part VII, paragraph 24(v), of the Circular)
  - the above apply by analogy to a transfer of the activities of a PE that a foreign tax resident company maintains outside Cyprus to a PE in Cyprus.

The takeaway

Taxpayers should take into account the clarifications provided in the Circular in order to ensure that their tax affairs are prepared in accordance with the Circular, noting the possibility of submitting, subject to certain conditions, amended tax returns to the Cyprus tax authorities.

Lets talk

For a deeper discussion of how this issue might affect your structures involving Cyprus and how we may assist you in navigating through these clarifications, please contact:

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