BACK TO BACK FINANCIAL ARRANGEMENTS

INTRODUCTION

Back to back financial arrangements are financial arrangements where a Cyprus tax resident company borrows funds from an associated company or a third party (i.e. a bank) and subsequently lend those funds to other related companies.

This brief guide provides a summary of the tax treatment of back-to-back financial arrangements.

TAXATION OF BACK-TO-BACK FINANCIAL ARRANGEMENTS

On 14 July 2011 the Institute of Certified Public Accountants of Cyprus (hereinafter "ICPAC)"has announced that the Inland Revenue Department (hereinafter "IRD") has agreed to certain minimum profit margins that may be applicable to related-party financial arrangements.

The agreed minimum profit margins are presumed to be net, i.e. to be calculated after the deduction of expenses directly related and/or attributable to the financing arrangement entered by a company. Any foreign exchange differences (either realized, or unrealized) should not have any impact on such calculation as they are to be treated as non-deductible in case of foreign exchange loss and non-taxable in case of foreign exchange profit.

The minimum profit margins agreed with the IRD are the following:

1. <u>Tax years 2003–2007</u>

For the tax years 2003 to 2007 inclusive (i.e. from 1 January 2003 until 31 December 2007), the acceptable minimum profit margins on back-to-back financial arrangements, regardless of the amount of the financial arrangement, is 0,3%.

2. <u>Tax years 2008 onwards</u>

From 1 January 2008 onwards the following minimum profit margins are acceptable by the IRD:

a) *<u>Interest bearing loans</u>*

LOAN AMOUNTS PROFIT MARGIN	
Less than € 50 million	0,35%
Between € 50 and 200 million	0,25%
Above € 200 million	0,125%

For example, a Cyprus tax resident company borrows €20.000.000 and subsequent lends the funds to other group companies. If the borrowing interest rate is set at 2,5% the minimum interest rate that the Cyprus tax resident company could charge is 2,85%.

b) *Interest free loans*

In the case where the back-to-back financial arrangement – i.e. both the loan receivable and the loan payable – is interest free, a minimum profit margin of 0,35% should be earned and be taxed by the Cyprus tax resident company.

CONDITIONS

The minimum profit margins are applicable only if the below conditions are met:

1. The ultimate beneficial owner of the company involved in a back to back financial arrangement must not be a Cyprus tax resident.

2. The Cyprus tax resident company receives an interest free/interest bearing loan from a related company or a third party, 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.

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. For example, if the payable loan is waived, then the Cyprus company will be taxed on interest at market rates on the receivable loan. If the receivable loan is waived, the payable interest on the payable loan will not be tax deductible.

5. The loan granted by the Cyprus company must be subsequently lent within 6 months from the date it borrowed the funds.

6. The minimum profit margins apply only until the loans are either repaid or written off.

7. The minimum profit margins apply for each separate loan that the Cyprus tax resident company borrows and provides.

If a loan does not meet the conditions of a back-to-back loan, then the interest rate to be charged by the Cyprus lending company should be the market interest rate.