

**Tax Guide on Financing**
*April 2012*

<b>Introduction</b>
<p>This guidance note outlines the issues and considerations from a Cyprus tax perspective where a Cyprus company is involved in intra group loans and/or related party financing arrangements.</p>
<b>General tax provisions</b>
<p>The Cyprus Income Tax legislation provides that all transactions between related parties shall, <u>for tax purposes</u>, be made at arm's length (i.e. at conditions that would have existed if the parties were unrelated).</p> <p>The application of the arm's length principle to financing / loan arrangements is usually observed though the appropriateness of the interest rate charged by the lender to the borrower. In order to determine whether an interest rate is considered to be at arm's length and as such acceptable from a Cyprus tax perspective, all the facts and circumstances of the loan need to be considered.</p> <p><b>Factors affecting the interest rate</b></p> <p>There are no official guidelines as to what constitutes an interest rate to be considered as at arm's length. In practice, as a very minimum, the Cyprus tax authorities expect that the interest rate charged covers over and above the directly related cost or effective cost of borrowing of the company and is in line with prevailing market rates. In addition, there are other factors that could be taken into account such as currency used, risks involved and the associated terms of the loan (e.g. duration, repayment terms).</p> <p><b>Deviation from the arm's length principle</b></p> <p>Upon potential challenge by the Cyprus tax authorities, it is up to the Cyprus company to demonstrate to the satisfaction of the Cyprus tax authorities that the interest rate charged is at arm's length given the circumstances.</p> <p>Where the Cyprus tax authorities consider that the interest rate charged is not at arm's length, then they are expected to make tax adjustments in such a way to compensate for the deviation from the arm's length principle. Such adjustments are usually in the form of deemed interest income (which is taxable).</p>
<b>Acceptable spreads in case of back-to back loans</b>
<p>In cases of pure back-to-back loan transactions, the Cyprus tax authorities accept thin spreads (small profit margins) without challenging the arm's length principle. The spread for each back-to-back loan transaction can be as low as 0,35% (or even lower) depending on the amounts involved and on the basis that this thin spread is net of any related expenses.</p>
<b>Financing to physical person directors or shareholders</b>
<p>In accordance with a specific Cyprus tax provision, any financial assistance towards a director or direct shareholder of the Cyprus company (and where such persons are <u>physical</u> persons) shall be considered in the hands of such person as a <u>Benefit In Kind</u> of 9% per annum. In case the balance bears actual interest at a rate lower than 9% per annum, the Benefit In Kind shall be calculated as the difference between the actual rate charged and the 9%.</p>

For financial assistance to a corporate director or shareholder, the arm's length provisions shall apply.

#### **Excessive interest**

A specific provision within the Cyprus Criminal Law limits the ability of Cyprus persons (including Cyprus companies) to extend loans at 'excessive' rates (calculated by taking into account the rates provided by the Central Bank of Cyprus). This provision however does not apply in cases of companies providing financing to related parties.

#### **How can we assist you**

For further assistance the Totalserve Tax Department may look into the specifics of particular financing transactions or the whole financing activities of the company and provide you with detailed and customized tax advice, tax report, tax opinion or even assistance with obtaining a Cyprus tax ruling, where necessary.

#### **NOTES:**

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist in this respect. Please do not hesitate to contact us.