



Cyprus Tax News

New rules for taxation of intra-group financing arrangements

On 30 June 2017, the Cyprus Tax Department (“CTD”) issued a Circular with respect to the new rules for the taxation of intra-group financing arrangements which apply from 1 July 2017. The new Circular provides for the application of transfer pricing methodology to such activities based on the arm’s length principle as advocated by the OECD.

As mentioned in our Tax Alert of 6 March 2017, the CTD announced earlier this year that the application of the pre-agreed minimum profit margins (of 0.125% to 0.35%) for “back to back loans” will be terminated as at 30 June 2017. The new framework laid out in the Circular will apply to these and certain other financing arrangements going forward.

We analyze below the main provisions of the Circular:

1. Scope of applicability

The Circular applies to intra-group financing activities where loans are granted by a company (“financing company”) to related parties, financed by financial means and instruments, such as private loans, cash advances, bank loans and debentures.

The Circular provides that two companies are considered to be related if they fall within the scope of Section 33 of the Income Tax Law.

2. Transfer pricing requirements

A financing company will be required to determine its remuneration on the basis of transfer pricing principles. This would involve the company identifying each commercial and financial relationship with related parties (“controlled transactions”) and determining the economically significant conditions and circumstances relating to such transactions.

The actual conduct of the parties should be taken into account if this differs from what was contractually agreed. An analysis is required of the functions performed, assets used and risks assumed by the financing company.

An underlying principle of the risk analysis is that a financing company bearing risks must have the financial capacity to manage those risks and bear the financial consequences if the risks assumed actually materialize. In this respect, the company is expected to determine, using relevant methodology, the appropriate level of equity that would be needed to assume the risks¹.

Note 1: Where the financing company is comparable to entities subject to the EU regulation on prudential requirements for credit institutions and investment firms, and it has an equity level that complies with the solvency criteria laid out in this regulation, it is deemed to have a sufficient level of equity to bear the financial consequences of its risks.

Furthermore, an appropriate comparability analysis must be carried out in order to determine whether the remuneration resulting from the transactions between the related parties are comparable to transactions between independent parties under similar circumstances on the open market². In this way, the company can benchmark its remuneration against that generated by comparable transactions and circumstances between unrelated parties.

The comparability analysis should involve a process of identifying comparable transactions in a transparent, systematic and verifiable manner using appropriate sources of information.

Note 2: The Circular indicates that in the case of companies performing functions similar to those of regulated financing and treasury companies, a return on equity of 10% after-tax can be observed in the market and can be considered as reflecting an arm's length remuneration at the time of publication of the Circular. This percentage will be regularly reviewed by the Tax Department based on relevant market analyses.

3. Substance requirements

The Circular stipulates that financing companies must have an actual presence in Cyprus and have the qualified personnel to control the risks and transactions entered into. A financing company is considered to control the risk if it has the decision making power to enter into a risk-bearing commercial relationship, if it has the ability to address such risks, and it actually performs such decision-making functions.

The actual presence criteria take into account the number of the members of the board of Directors that are Cyprus tax residents and the number of board of Directors' meetings as well as shareholders' meetings held in Cyprus.

The daily activities of risk mitigation may be outsourced as long as the company has the capability to take, and actually makes, the key decisions with respect to the outsourcing.

4. Transactions without commercial rationale

Transactions that cannot be observed on the open market and are devoid of any commercial rationale must be disregarded to ensure full compliance with the arm's length principle.

5. Simplification regime

A financing company which meets the substance requirement mentioned above and is engaged in purely intermediary financing activities, borrowing from related entities and on-lending to related entities, will be deemed for the sake of simplification to comply with the arm's length principle if it receives in relation to its controlled transactions a minimum return of 2% after-tax on assets.

An entity which fits such a profile and which does not intend to prepare transfer pricing documentation may choose to benchmark its remuneration based on this minimum return on assets approach. The 2% percentage mentioned above will be regularly reviewed by the Tax Department based on relevant market analyses.

Tax returns will be amended to include a relevant field to be filled in by such entities in order to benefit from this simplification measure.

It is noted that a deviation from this minimum return is only allowed in exceptional cases, where it is duly justified by an appropriate transfer pricing analysis.

6. Minimum Requirements

Besides the principles mentioned above, the Circular provides for some minimum requirements for a transfer pricing analysis:

- a description of the computation of equity allocation required to assume the risks,
- a description of the group and the inter-linkages between the functions performed by the entities participating in the controlled transactions and the rest of the group, together with a description of the value creation within the group by the entities participating in the transactions,
- the precise scope of the transactions analysed,
- a list of the searched potentially comparable transactions,
- a rejection matrix for rejected potentially comparable transactions with justifications,
- the final list of comparable transactions which have been selected and used to determine the arm's length price applied to the intra-group transactions accurately delineated,

- a general description of market conditions,
- a list of all previous agreements on transfer pricing concluded with other countries in relation to the transactions in question,
- a list of all the previous agreements concluded with entities under analysis which are still in effect at the time of the submission of the request,
- a projection of the income statements for the years covered by the request.

The Circular also states that it is expected that the transfer pricing analysis will be submitted to the Tax Department by auditors, who are required to carry out an assurance control in order to confirm the quality of the transfer pricing analysis.

7. Rulings and exchange of information

The issuance of tax rulings related to intra-group finance arrangements or Advanced Pricing Arrangements, as well as the use by a taxpayer of the simplification measure, will be subject to the exchange of information rules set under the Directive on Administrative Cooperation.

8. Entry into force

The Circular applies from the 1st of July 2017, for all existing and future transactions. Any rulings issued prior to this date will no longer be valid for periods from 1st of July 2017 onwards.

If the intra-group financing transactions had been supported by a Transfer Pricing study and are still ongoing after the above date, the study will need to comply with the provisions of the Circular.

DELOITTE COMMENTS

- Financing companies will either need to undertake the required transfer pricing analysis or alternatively, if eligible, use the simplification regime.
- The Circular provides for the minimum requirements for a transfer pricing analysis which is expected to be submitted to the CTD by a licensed auditor providing an assurance on the quality of the transfer pricing analysis.
- A review of the substance and qualified personnel that a financing company has in Cyprus will be required to assess if these are at an adequate level to exercise control over the risk arising from the financing activity. Taking action in these areas should assist companies in mitigating any beneficial ownership risks in relation to the income in other jurisdictions.

- Conversely, not aligning with these requirements of the Circular and not having sufficient commercial rationale where appropriate may expose the financing company to beneficial ownership risks in other jurisdictions. It is noted that the consequences in Cyprus of this are not analysed in the Circular. It will be interesting to monitor developments in this area.

Deloitte can assist clients with understanding the potential impact of the Circular on their financing arrangements and where appropriate assist with the preparation and submission of the relevant transfer pricing study and ruling/APA where considered necessary.



Get in touch

Nicosia Offices	infonicosia@deloitte.com	tel: +357 22360300
Limassol Offices	infolimassol@deloitte.com	tel: +357 25868686
Larnaca Offices	infolarnaca@deloitte.com	tel: +357 24819494

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