



TAXATION OF INTRA GROUP FINANCING

On 30 June 2017 the Cyprus Tax Department has issued a Circular containing the new framework regarding the taxation of intra-group back to back financing arrangements.

The Circular contains guidance in terms of substance and transfer pricing requirements in line with OECD guidelines and the required content of a transfer pricing study.

Furthermore, the Circular requires that arm's length principles are applied on all intra-group back to back financing arrangements with effect as from 1 July 2017, thus replacing the Minimum Margin scheme applicable until 30 June 2017.

Intra-group financing activities as defined in the Circular refers to any activities consisting in the granting of loans or cash advances remunerated (or should be remunerated) by interest to related companies, financed by financial means and instruments, such as debentures, private loans, cash advances and bank loans. Two companies are considered to be related if they fall within the scope of Section 33 of the Cyprus Income Tax Law.

APPLICATION OF ARM'S LENGTH PRINCIPLE

All intra-group financing transactions are to be conducted in compliance with the arm's length principle (i.e. corresponds to the price which would have been accepted by independent entities in comparable circumstances, taking into account the economic nature of the transaction. For this purpose an appropriate comparability analysis must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related entities.

The Comparability analysis should consist of 2 parts:

- 1) Identification of commercial or financial relations between related entities and determination of economically significant conditions and circumstances
- 2) Comparison of the conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities to determine arm's length remuneration

Part 1 – Identification of commercial or financial relations and determination of economically significant conditions and circumstances

To accurately delineate the controlled transactions it is necessary to describe the role of each of the entities participating in the transaction in the context of their commercial or financial relations within the group to which they belong. Likewise it will be useful to understand the contribution of the related entities to the value creation within the group and the impact of this contribution on the arm's length remuneration of each of the entities participating in the controlled transactions.

In order to accurately delineate a controlled financing transaction it is necessary to determine its characteristics, such as its terms and functions, the assets used and the risks assumed by the related entities. These will need to be compared with similar transactions between unrelated entities.



Contractual terms – Substance over Form

To accurately delineate a transaction, the actual conduct of the parties should be taken into account and not what was contractually agreed (and formalised in writing) between the parties

Functional analysis

A functional analysis should be carried out to identify the economically significant activities, responsibilities and functions, the assets used or contributed and the risks assumed by the parties in the context of the transaction.

Risk analysis

Any parties involved in financing activities before granting credit or providing cash advances, conduct an analysis of risk to which they would be exposed. In particular, they examine the annual accounts of the borrower in order to assess the financial risks of a transaction.

To assess the borrower related risk they verify whether guarantees exist and they analyse the purpose and duration of credit as well as any other factors. On the open market higher risk generally induces higher remuneration.

A financing company controls 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 if it actually performs such decision making functions.

In order for a financing company to justify the risk control and to further validate that the management and control are exercised in Cyprus, it is imperative to have an actual presence in Cyprus. In this respect the circular specifies certain criteria that are considered, among others, when establishing the presence of a Company:

- The number of board of directors members that are Cyprus tax residents
- The number of board of directors meetings held in Cyprus and the main management and commercial decisions taken in Cyprus
- The number of shareholders meetings taking place in Cyprus
- The financing company has qualified personnel controlling and managing the financing transactions

Part 2 - Comparison of the conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities to determine arm's length remuneration

In order to determine the arm's length remuneration, it is necessary to compare the delineated controlled transaction with comparable transactions on the open market.

Transactions without commercial substance

In the case of transactions that would not have been concluded by independent parties in comparable positions (i.e. no commercial purpose), the Circular mentions that such transactions with the associated tax consequences shall be disregarded to ensure full compliance with the arm's length principle.



SIMPLIFIED MEASURES

When a group financing entity has actual presence in Cyprus as described in the criteria above, and conducts a purely intermediary financing activity, grants loans or advances to related entities which are refinanced by loans or advances granted by related entities, it is considered that, in view of the risks associated with the transactions analysed, for simplification purposes the transactions are deemed to comply with the arm's length principle if the analysed entity received in relation to its controlled transactions a minimum return of 2% after tax on assets. This % will be regularly reviewed by Tax Department based on relevant market analyses.

A deviation from the above requirement of 2% minimum return is acceptable only when duly justified by an appropriate transfer pricing analysis.

In order to benefit from this simplification measure, entities should communicate the use of said measure to the Tax Department by filling in the relevant field in the tax return of the corresponding fiscal year.

MINIMUM REQUIREMENTS OF TRANSFER PRICING ANALYSIS

A transfer pricing analysis should be carried out by a transfer pricing expert. It is expected the transfer pricing analysis is submitted to Tax Department by a person who has a license to act as an auditor of a company according to Cyprus Company Law and is required to carry an assurance control confirming the quality of the transfer pricing analysis.

The minimum requirements of a transfer pricing analysis include:

- 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
- The precise scope of the transactions analysed
- A complete list of the searched potentially comparable transactions
- A rejection matrix for the aforementioned comparable transactions with justification of such rejections
- The final list of comparable transactions selected and used to determine the arm's length price
- A general description of market conditions
- A list of all previous agreements on transfer price concluded with other countries in relation to the transactions in question
- A list of all previous agreements concluded with the entity/ies 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

ENTERING INTO FORCE

The new rules apply with effect from 1 July 2017 for all existing and future transactions, irrespective of the date of entering into the relevant transactions. Tax rulings issued prior to June 2017 will no longer be valid