



## New transfer pricing rules introduced

11 July 2017 - Further to our [Tax Alert No. 47](#) issued on 14 March 2017 relating to the termination of the back-to-back minimum profit margins on intra-group financing arrangements, on 30 June 2017, the Cyprus Commissioner of Taxation issued [Interpretive Circular 3 – Income Tax](#) with respect to the implementation of new rules relating to the taxation of intra-group financing arrangements.

A summary of the contents of the Circular which are applied from 1 July 2017 is can be viewed below.

### Scope

The Circular applies to related party financing arrangements and more specifically where loans are granted by a Cyprus tax resident financing company to related parties, financed by loans, cash advances, bank loans and any other financial instruments. Two companies are considered as related parties if they fall under the scope of Article 33 of the Income Tax Legislation.

### Substance requirements


The Circular specifies that Cyprus tax resident financing companies must have sufficient substance in Cyprus and have qualified employees to control the risks and transactions they are entering into.

To that respect the following will be taken into consideration:

- the number of the directors who are tax resident of Cyprus;
- the number of board meetings taking place in Cyprus; and
- the availability of qualified personnel to control the transactions performed. The daily activities of risk mitigation may be outsourced as long as the Cyprus tax resident financing company can take, and actually make, the key decisions relating to the outsourcing.

### Transfer pricing requirements

A Cyprus tax resident financing company is, from 1 July 2017, required to submit a transfer pricing study as a proof that each financing transaction has been executed on an arm's length basis. This would involve the Cyprus tax resident financing company to identify each financial relationship with related parties and commercially substantiate that the transaction has been entered into based on market conditions. An analysis will also be



required of the functions performed, assets used and risks assumed by the Cyprus tax resident financing company.

A fundamental rule of the risk analysis is that the Cyprus tax resident financing company which will bear the risks should have the monetary ability to manage those risks and suffer the financial costs if the risks assumed actually materialize. In this respect, the Cyprus tax resident financing company is expected to determine, using relevant methodology, the appropriate level of equity that would be needed to assume the risks.

An appropriate comparability analysis must also be carried out in order to determine whether the transactions between related parties are comparable to transactions between independent entities. Based on this comparability study the Cyprus tax resident company can benchmark its remuneration against that generated by comparable transactions and circumstances between unrelated parties.

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

### **Determination of arm's length remuneration**

In order to be able to determine the arm's length remuneration of the delineated transaction, it is necessary to compare the transaction with comparable transactions in the open market.


The Circular mentions that in the case of entities performing functions similar to those performed by regulated financing and treasury entities, a return on equity of 10% after tax can be observed in the market and can be considered as reflecting arm's length remuneration. This percentage will be regularly reviewed by the Cyprus Tax Authorities based on relevant market analyses.

### **Simplification measures**

When a Cyprus tax resident financing company grants loans or other financial assistance to related parties, which are refinanced by loans obtained from other related companies, it is considered that for sake of simplification, the transactions will be deemed to comply with the arm's length principle, if the company receives a minimum after tax return of 2% on the assets.

The 2% percentage mentioned above will be regularly reviewed by the Tax Department based on relevant market analyses.

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.



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.

### **Minimum requirements for transfer pricing analysis**

The minimum requirements for the transfer pricing analysis are those that are set out in paragraph 29 of the relevant Circular.

Those minimum requirements are:

- 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 Transfer Pricing Analysis should be prepared by a Transfer Pricing Expert. It must be submitted to the Commissioner of Taxation by a person who is licensed to act as an auditor of a company in Cyprus, and who is required to carry an assurance control review of the transfer pricing analysis.

### **Exchange of information**

The issuance of advance tax rulings or advanced pricing arrangements, as well as the use by a taxpayer of the simplification measures, will be subject to the exchange of information rules set under the Directive on Administrative Cooperation.



### **Entry into force**

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

As always, The Taxation Department of Costas Tsielepis & Co Ltd is at your disposal should you require any further information or clarifications.