Cyprus Authorities' tax circular for intra-group financing transactions

Issue N-13-2017, 3 July 2017

In brief

On 30 June 2017 the Cyprus Tax Authorities (the CTA) issued a circular (the Circular) providing guidance for the tax treatment of intra-group financing transactions (IGFTs). The Circular - effective as from 1 July 2017 - closely follows the application of the arm's length principle of the OECD Transfer Pricing (TP) Guidelines. It applies for all relevant existing and future IGFTs. No grandfathering provisions have been provided for existing IGFTs.

The Circular requires the carrying out of a comparability analysis for the purpose of describing (delineating) the IGFT and determining the applicable arm's length remuneration. Of particular note in the comparability analysis are the requirements for (i) sufficient equity level and (ii) adequate substance in Cyprus, relating to the IGFTs.

Under certain conditions taxpayers carrying out a purely intermediary intra-group financing activity may opt for a Simplification Measure (resulting in a minimum 2% after-tax return on assets).

Understanding in detail the Circular's requirements and their impact on existing and new structures is important so as to facilitate adapting to these requirements as soon as possible, given their effective date of 1 July 2017. This Tax Insight covers the key elements of the Circular.

In detail

The Circular tackles the tax treatment of Cyprus tax resident entities and permanent establishments situated in Cyprus that engage in IGFTs - that is the activity of granting loans or cash advances to related companies that are (or should be) remunerated by interest and are financed by financial means and instruments, such as debentures, private loans, cash advances and bank loans.

The Circular - effective as from 1 July 2017 - applies to all relevant existing and future IGFTs. No grandfathering provisions have been provided for existing transactions, and therefore rulings previously issued on transactions within the scope of the Circular are no longer valid for tax periods as from 1 July 2017.

Application of the arm's length principle to IGFTs

The Circular clarifies that, in line with Section 33 of the

Cyprus Income Tax Law, the remuneration arising from IGFTs should comply with the arm's length principle and correspond to the price that would have been accepted by independent parties in comparable transactions carried out in the open market in comparable circumstances.

The Circular requires a comparability analysis to be performed for the purpose of:

- Accurate description (delineation) of the transaction.
- Determination of the arm's length remuneration.

Accurate delineation of the transaction

The Circular states that in order to accurately delineate an IGFT it is necessary to determine its characteristics, such as its terms and functions, the assets used and the risks assumed by the related entities.

(i) Substance over form

Under the Circular, the economic reality of the transaction and the actual conduct of the parties prevail over any written contractual terms.

(ii) Functional analysis

The purpose of the functional analysis is to identify the economically substantial activities, responsibilities and functions, the assets used or provided in the context of the IGFT.

The Circular provides a non-exhaustive list of functions that can be performed by companies conducting IGFTs covering the origination and management of the transaction.

The identification of the functions performed and the assets used is essential to understand the risks related to the financing transaction.

(iii) Risk analysis

The capacity to assume and control the risks are economically significant characteristics, which must be identified to accurately delineate the IGFT:

(a) Equity level

The taxpayer is generally considered to assume the risks if it has sufficient equity level as this indicates its financial capacity to manage the risks and bear the financial consequences if they materialise.

Where the taxpayer has a profile comparable to a regulated financing and treasury business (as defined in the Circular) and its equity level respects the applicable regulated solvency criteria, then the taxpayer is deemed to have sufficient equity to assume the risks. Otherwise, the minimum equity level required so as to assume the risks will be determined using other applicable credit risk analysis methods.

(b) Substance requirements

A taxpayer controls the risks when it has, and actually exercises, the decision-making capabilities to enter into such risk bearing transactions and to monitor the risks.

To justify such control of risks, the taxpayer must have an actual presence in Cyprus and the qualified personnel. In order to determine an actual presence in Cyprus the following criteria, inter alia, will be taken into account:

- the number of Cyprus tax resident directors
- the number of Board of Directors' meetings held in Cyprus
- the main management and commercial decisions taken in Cyprus
- the number of shareholders' meetings held in Cyprus

Functions that do not have a significant impact on risk control, as well as daily activities of risk mitigation, may be outsourced provided that the taxpayer maintains overall control of the risk as prescribed in the Circular.

Determination of the arm's length remuneration

Once the transaction has been accurately delineated then the arm's length remuneration is determined by identifying comparable transactions observed in the open market at the time of undertaking the transactions and considering the remuneration that would have been agreed on the open market (with relevant comparability adjustments in line with internationally recognised standards, where required).

The Circular notes that in case the taxpayer performs similar functions to those performed by regulated financing and treasury businesses (as defined in the Circular) a return on equity of 10% after-tax is observed in the open market. This percentage will be regularly reviewed by the CTA.

Transactions without commercial rationale

Related party transactions that cannot be observed in the open market and are also devoid of any commercial rationale must be disregarded, along with their associated tax consequences, to ensure full compliance with the arm's length principle.

Simplification Measure for pure intermediary entities

The Simplification Measure may be followed, at the option of the taxpayer, where a taxpayer meets the substance requirements (as set out above) and pursues a purely intermediary activity of granting financing to related parties which is financed by related party loans/advances.

Under the Simplification Measure transactions are deemed to comply with the arm's length principle if at least a 2% return after-tax on assets is received. This percentage will be regularly reviewed by the CTA.

We understand that for the Simplification Measure, no TP analysis is required. However, a deviation from the minimum return of 2% is only accepted exceptionally and provided that it is justified by an appropriate TP analysis.

Taxpayers opting for the Simplification Measure are required to disclose this on their annual tax return.

Exchange of information

Use of the Simplification Measure, as well as tax rulings (or advance pricing arrangements), will be subject to the exchange of information rules set under the EU Directive on Administrative Cooperation.

TP report requirements

The Circular prescribes the required content of a TP report and provides that such reports should be prepared by a TP expert. It is expected that the

TP report is submitted to the CTA by a licenced company auditor who is required to carry out an assurance control confirming its quality.

The takeaway

It is important to perform an assessment of the impact of the Circular on the taxpayer's existing and future structures and consider what actions need to be taken:

- Identify whether the financing structures fall within the scope of the Circular.
- Analyse the impact of the requirements for substance and equity at risk (on the financing structures falling within the scope of the Circular) taking into account the functional and risk profile of the financing structure.
- Examine whether the remuneration from the financing structures satisfies the arm's length considerations.
- Ensure that an appropriate TP policy and relevant TP documentation are in place.

Let's talk

For a deeper discussion of how this development might affect you or your business, please contact:

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