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Minimum TP Documentation requirements and Simplification Measures for persons that are exempt from the obligation to maintain a Cyprus Local File

In brief

The Cyprus Tax Department (“CTD”) issued a new Circular providing guidance **to persons that are exempt from the obligation to prepare a Cyprus Local File**, for maintaining minimum Transfer Pricing (“TP”) documentation to support the arm’s length nature of their related party transactions (“Controlled Transactions”). In addition, the Circular introduces optional Simplification Measures applicable to such persons, for certain types of Controlled Transactions (financing and low value adding services). The guidance and Simplification Measures apply as from 1 January 2022.

In detail

Scope

The Circular applies to Cyprus tax resident persons or permanent establishments in Cyprus of non-Cyprus tax resident persons which are exempt from the obligation to maintain a Cyprus Local File, based on the provisions of Article 33 (9) (a) of the Income Tax Law as amended, for their Controlled Transactions that cumulatively per category do not exceed or would not exceed, based on the arm’s length principle, the value of €750,000 p.a..

It is clarified that the provisions of the Circular **do not apply** for transactions which should be included in a Cyprus Local File (i.e. Controlled Transactions that exceed in aggregate per category of transaction p.a., the above mentioned €750,000 threshold).



¹ Circular 6/2023 dated 6 July 2023

² As per Article 33 (9) (a) of the Income Tax Law (N.118(I)/2022 as amended)

Minimum Transfer Pricing (“TP”) Documentation requirements

According to the provisions of Article 33 of the Cyprus income tax legislation, transactions between related parties should be performed on an arm’s length basis, otherwise, the CTD may adjust the taxable income of the relevant person, to include (and tax accordingly) any additional profit/income that should have been realised had the transactions been performed on an arm’s length basis.

In this respect, persons that engage in related party transactions should maintain the following **Minimum TP Documentation**, to support the arm’s length nature of any of their Controlled Transactions that are not required to be documented in a Cyprus Local File:

1. Brief functional analysis (functions, assets, risks)
2. Description of the functional profile of the entity, based on the results of the functional analysis
3. Reasoning for selection of the most appropriate TP method
4. Determination of the arm’s length price(s) supported by relevant benchmarking results using internal or external comparables (as applicable) or any other relevant economic analysis compliant with the OECD TP Guidelines³ (e.g., the use of valuation models for financial guarantees).

The Minimum TP Documentation should be submitted to the CTD upon request (within 60 days).

Simplification Measures for certain types of Controlled Transactions

Persons that are exempt from the obligation to prepare a Cyprus Local File for Controlled Transactions, may **elect to apply the Simplification Measures** for the pricing of the following types of Controlled Transactions:

- a. Financing granted to related parties financed by borrowings
- b. Financing granted to related parties financed by equity
- c. Financing obtained from related parties to the extent it is used in the business
- d. Low Value Adding Services (“LVAS”) (received or provided).

It is important to note, that the above Simplification Measures cannot be applied, if the (arm’s length) value of all the financial transactions (for application of measures (a)-(c)) or all services transactions (for application of measure (d)) of the taxable person exceed €750,000 p.a. in aggregate per category.

Furthermore, the Simplification Measures cannot be applied if reliable internal comparables (i.e., comparable transactions with unrelated parties) can be used to determine the arm’s length price of the Controlled Transactions.

The Simplification Measures are described in more detail below.

a) Financing granted to related parties financed by borrowings

This measure relates to loans or cash advances granted to related persons that bear (or should bear) interest, which are financed by financial instruments such as bonds, loans from affiliated companies or related persons including interest-free loans from the shareholders, cash advances and loans from credit institutions. Any eligible business⁴ that performs functions for the origination and management of the above-mentioned financing transactions, regardless of whether it has the financial capacity to assume related risks, may elect to apply this simplification measure.



³ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the OECD in 2022 (the “OECD TP Guidelines”), which should be observed by multinational enterprises and tax authorities in order to ensure the application of the arm’s length principle on the pricing of transactions between related parties

⁴ If the business is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions

Such financing transactions (financed by borrowings) are considered to comply with the arm's length principle if **a minimum pre-tax net return (margin) of 2.5% p.a. on the average outstanding receivable balances (comprising the principal financing amount plus unpaid accrued interest) is earned by the lender.**

Persons that elect to apply the above simplified measure need to maintain the following supporting documentation:

1. Brief functional analysis and description of the functional profile of the parties involved.
2. Description of the loans for which the simplification measure is applied (dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, details of any amendments to the loan agreements, etc.).
3. Description of the reasons justifying that the financing granted to related parties has been financed by financial instruments.
4. Workings and reconciliations to document how the simplified return has been applied in the income tax computation of the relevant person.

b) Financing granted to related parties financed by equity

This measure relates to loans or cash advances granted to related persons, that bear (or should bear) interest, that are financed by equity (proceeds from the issuance of share capital and share premium, non-reciprocal capital contributions, or retained earnings). Lenders that grant equity financed loans to related parties, are deemed to have the financial capacity to assume the risks associated with such loans.

Such financing transactions (financed by equity) are considered to comply with the arm's length principle, if **the interest rate⁶ applied (to each transaction) by the eligible lender⁵ is at least equal to the ten-year government bond yield rate of the jurisdiction in which each borrower operates, increased by 3.5%.** The said interest rate should be applied on each average outstanding receivable balance (comprising the principal amount plus unpaid accrued interest) and updated annually as may be appropriate.

Persons that elect to apply the above simplification measure need to maintain the following supporting documentation:

1. Brief functional analysis and description of the functional profile of the parties involved
2. Description of the loans for which the simplification measure is applied (dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, details of any amendments to the loan agreements, etc.).
3. Description of the reasons justifying that the financing granted to related parties has been financed by equity
4. Workings and reconciliations to document how the simplified interest rate has been applied in the income tax computation of the relevant person.

c) Financing obtained from related parties to the extent it is used in the business

This measure applies to borrowings such as interest-bearing loans, bonds or cash advances received from related persons to the extent that they are used in the business and the interest expense is deductible under the relevant provisions of the Cyprus income tax legislation.

Such interest-bearing borrowing transactions are considered to comply with the arm's length principle, if the interest expense of the eligible borrower⁷ is calculated at an **interest rate that does not exceed the ten-year government bond yield⁴ of the Republic of Cyprus increased by 1.5%.** The said interest rate should be applied on the average outstanding payable balances (comprising the principal amount plus unpaid accrued interest) and updated annually as may be appropriate.



⁵ If the lender is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions

⁶ As at the 31 December of the year prior to the relevant tax year. If this yield rate is negative then it should be deemed to be zero

⁷ If the borrower is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions

Persons that elect to apply the above simplification measure need to maintain the following supporting documentation:

1. Brief functional analysis and description of the functional profile of the parties involved.
2. Description of the interest-bearing borrowings for which the simplification measure is applied (dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, details of any amendments to the loan agreements, etc.).
3. Description of the reasons justifying that the borrowing transactions qualify for the application of this simplification measure.
4. Workings and reconciliations to document how the simplified interest rate has been applied in the income tax computation of the relevant person.

d) Provision or receipt of Low Value-Adding Services (“LVAS”)

This measure applies to Controlled Transactions of provision or receipt of LVAS.

As described in the OECD TP Guidelines⁸ LVAS are those intra-group services which:

- Are supportive in nature.
- Are not part of the core business of the group (i.e., they do not create profit-making activities nor contribute to economically significant activities of the group).
- Do not require the use of nor lead to the creation of unique and valuable intangibles.
- Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

LVAS generally include the following intra-group services⁹ (list is indicative and not exhaustive):

- Bookkeeping, accounting, and auditing services
- Processing and management of accounts receivable and accounts payable
- Human resources activities, such as staffing and recruitment, employee training, remuneration services, developing and monitoring staff health procedures
- IT services (relating to the IT infrastructure and operation of internal IT systems of the group)
- Internal and external communications and public relations support
- Internal legal services
- Activities with regard to the tax compliance obligations of the group entities
- General services of an administrative or clerical nature.

The pricing of Controlled Transactions that qualify as LVAS is generally determined on a cost + mark-up basis (in line with the OECD TP Guidelines¹⁰).

The pricing of LVAS **provided** to related parties is considered to comply with the arm's length principle, if the **mark-up applied on the relevant costs is at least 5%**. In the case of **receipt** of LVAS from related parties, the acceptable arm's length **mark-up applied on relevant costs should not exceed 5%**.

Persons that elect to apply the above simplification measure need to maintain the following supporting documentation:

1. Brief functional analysis and description of the functional profile of the parties involved.
2. Description of the categories of LVAS provided/received and identity of beneficiaries.
3. Description of reasons justifying that each category of service qualifies as a LVAS, in the context of the definition described above.
4. Workings supporting the determination of the relevant cost pool and application of the mark-up (where applicable)
5. Description of the selected allocation keys and workings showing their application.
6. Workings and reconciliations to document how the simplified measure has been applied in the income tax computation of the relevant person.



⁸ Para 7.45 of the OECD TP Guidelines

⁹ Examples provided in para 7.49 of the OECD TP Guidelines

¹⁰ Para 7.56-7.62 of the OECD TP Guidelines

Practical application of the Simplification Measures (a) – (d) described above

The persons that elect to apply any of the Simplification Measures described above, should disclose such election to the CTD, by completing electronically the relevant part in their Income Tax Return / Summary Information Table for Controlled Transactions, by the deadline of submission of the Income Tax Return /Summary Information Table for each tax year.

The required documentation supporting the application of any of the Simplification Measures should be submitted to the CTD upon request (within 60 days).

Deviation from the prescribed minimum or maximum returns/rates/mark-ups for the Simplification Measures will need to be supported by the preparation of the Minimum TP Documentation as described above.

The CTD will not make any downward adjustments if the accounting profit from the Controlled Transactions is higher than the profit resulting from the application of the Simplification Measures or the results of a transfer pricing study.

Cross-border Controlled Transactions for which the Simplification Measures are applied should be treated as reportable transactions in accordance with Article 2 (1) and Annex IV, Part II, Label E.1 of the Administrative Cooperation in the Field of Taxation Law of 2012 (205(I)/2012), as amended and in line with the provisions of Regulation 42(2) of Κ.Δ.Π. 438/2021 (all generally referred to as DAC6 provisions).

The takeaway

We will be happy to assist in navigating through the changes, determining how they apply to you and what steps you need to take to ensure compliance.

Lets talk

For a deeper discussion of how this issue might affect your business, please contact:

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