

# Cyprus' new rules for intra-group back-to-back financing arrangements

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Cyprus' Tax Department has issued on the 30<sup>th</sup> of June 2017 an expository Circular in relation to the update Tax Treatment of intra-group back-to-back financing arrangements, with effect as from the 1<sup>st</sup> of July 2017. The Circular applies to all existing and future transactions. Tax rulings issued before the 1<sup>st</sup> of July 2017 will no longer be valid for tax periods as from the 1<sup>st</sup> of July 2017.

The Circular is applicable to Companies that carry out group financing transactions and are Cypriot tax resident companies or are non-Cypriot tax resident companies and have a permanent establishment in Cyprus and the financing activities are attributable to the permanent establishment.

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

The application of arm's length principle (Section 33 of the Income Tax Law) to intra group financing transactions is quite significant since the latter have to correspond to the price which would have been accepted by independent entities in comparable circumstances, taking into account the economic nature of the transaction.

In order to determine whether transactions between independent entities are comparable to transactions between related entities, a comparability analysis needs to be carried out. The first part of this comparability analysis relates to the delineation of the controlled transaction, namely the identification of commercial or financial relationship between related entities and determination of the conditions and economically relevant circumstances attaching to those relations. The second part relates to the determination of the arm's length remuneration and is about the comparison of the delineated conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities.

In analyzing the first part of the comparability analysis ("delineation of the controlled transaction"), it is important to determine its characteristics (terms and functions, assets used, risks assumed by related entities).

## **CONTRACTUAL TERMS:**

It should be noted that the actual conduct of the parties needs to be considered rather than what was contractually agreed between them (Substance over Form).

### **FUNCTIONAL ANALYSIS:**

The scope of the functional analysis is to recognize 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. Companies conducting intra-group financing transactions can perform functions such as:

- Origination of transaction (i.e. commercialization of a transaction, negotiation, identification of the refinancing structure related to the financing activity and evaluation of the compliance with the contractual commitments prior to the final closing);
- Managing the transaction (i.e. managing the financing transaction and credit risk monitoring).

### **ANALYSIS OF RISKS:**

A group financing entity is considered to assume the risk if it has the financial capacity to manage the risk and to bear its financial consequences if the risk materializes. The financial capacity to assume the risk can be defined as the access to funding necessary in order to take on or avoid the risk, to pay for the risk mitigation actions, and finally to bear its consequences if the risks materializes.

Control of the risk by the financial entity happens if the financial entity (a) has the decision making power to enter into a risk bearing commercial relationship, (b) has the ability to address such risks and (c) in order a group financing entity to be able to justify the risk of control and validate that its management and control is exercised in Cyprus, it is necessary to have actual presence in Cyprus. Actual presence takes into account, but is not limited to the following:

- The number of Cyprus tax resident Directors;
- The number of Board meetings held in Cyprus and whether the main management and commercial decisions are taken in Cyprus;
- The number of shareholders' meetings taking place in Cyprus.

In addition, qualified personnel are essential in the group financing entity in order to control the transactions performed. Any functions that may not have a significant impact on risk control can be outsourced provided that the financing entity maintains control and adequately supervises the risk and function outsourced.

In regards to the second part of the comparability analysis (“determination of arm’s length remuneration”), it should be noted that in order to be determined, it is vital to compare the transaction with comparable transactions in the open market.

### ***SIMPLIFICATION MEASURES***

When a group financing company which meets the criteria and pursues a purely intermediary activity grants loans or advances to related entities which are refinanced by loans or advances granted by related entities, it is considered that, for the sake of simplification, the transactions are deemed to comply with the arm’s length principle if the analysed entity receives a minimum return of 2% after-tax on assets. The percentage of 2% will be regularly reviewed by the Tax Department based on relevant market analysis.

Entities should reveal the use of the said measures to the Tax Department in order to benefit from the simplification measure. They should do that by their tax return of the corresponding fiscal year.

### ***MINIMUM REQUIREMENTS FOR TRANSFER PRICING ANALYSIS***

These are included in the Circular under paragraph 29 and 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 participating in the controlled transactions and the rest of the group, together with a description of the value creation in the broad sense within the group by the entities participating in the transactions;
- The precise scope of the transactions analyzed;
- Complete list of the searched potentially comparable transactions;
- A rejection matrix for rejected potentially comparable transactions together with justifications of such rejections;
- The final list of comparable transactions which have been selected and used to determine the arm’s length price applied in the intra-group transactions accurately delineated;
- A general description of market conditions;
- A list of all previous agreements on TP concluded with other countries in relation to the transactions in question;

- A list of all the previous agreements concluded with the 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.

A transfer pricing analysis should be prepared by an expert of a Transfer Pricing and should include the minimum requirements of the Circular as mentioned above. In addition, it should be submitted to the CTD by a person who has a license to act as an auditor of a company according to the Cyprus Company Law and is required to carry an assurance control confirming the quality of the transfer pricing analysis.

### **TAX RULINGS**

The issuance of tax rulings including rulings related to simplification measures or Advanced Pricing Arrangements are subject to the exchange of information rules set under the Directive on Administration Cooperation (Council Directive 2011/16/EU as amended by Council Directive (EU) 2015/2376).

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