Executive summary

On 30 June 2017, the Cyprus Tax Authorities (CTA) issued a Circular (the Circular) revising the transfer pricing framework for companies carrying out intra-group financing activities in Cyprus. The Circular provides additional guidance in terms of substance and transfer pricing requirements in line with the Organisation for Economic Co-operation and Development (OECD) Guidelines, as well as guidance as to the required content of a Transfer Pricing study. The Circular is effective from 1 July 2017 and replaces the Minimum Margin Scheme regime applicable until 30 June 2017 (as announced by the CTA in February 2017 – withdrawal of MMS).

Detailed discussion

Financing activity definition

The Circular defines intra-group financing transactions as all activities of granting loans or advances to related entities remunerated by interest (or should be remunerated by interest) and funding them through public debt issuance, private loans, advances, or bank loans, among others.
Application of the arm’s length principle to intra-group financing transactions

It is required that all intra-group transactions be conducted in compliance with the arm’s length principle (a principle under which transactions are performed at market rates, as would have been performed between unrelated entities). As such, it is necessary to prepare a comparability analysis testing the group transaction with a similar transaction between unrelated entities.

Comparability analysis

This analysis will need to consist of two parts:

1. An identification of the commercial/financial relationship between the related entities and determination of the conditions and economically relevant circumstances applicable to those relations in order to accurately delineate the controlled transaction.

2. A comparison of the accurately delineated conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities.

Part 1 – Identification of commercial/financial relationships between the related entities and determination of the conditions and economically relevant circumstances

A description of the role of each of the entities participating in the controlled transaction is required. As such, it may be appropriate to outline the structure and organization of the group, as well as how those affect the functioning of the said group. This should also include any interdependencies between any functions performed by the entities, the contributions of each controlled entity in generating value and the impact of any contribution to the arm’s length principle remuneration.

In order to accurately delineate such functions, characteristics and terms of the transactions, functions performed, assets used and risks assumed by each entity should be determined. These will need to be compared with similar transactions between unrelated entities.

Substance over form

For this analysis, what matters is not only any formalized written agreement, but the actual conduct of the parties, even if such conduct deviates from any written contractual agreements between the controlled entities.

Functional analysis

The Circular provides extensive details on the approach to be taken in conducting a functional analysis, outlining the importance of identifying the functions performed and assets used to determine the risk related to a financing transaction.

The functions to be analyzed include decision making, and as such, it is necessary to determine the legal rights and obligations of each party when performing said functions.

Examples of such functions include, but are not limited to:

- Initiation of a financing transaction
- Management of financing transaction

Risk analysis and required amount of equity

In line with the OECD Base Erosion and Profit Shifting (BEPS) Action Plan (Actions 8-10), the Circular refers to the importance for group financing companies to have the capacity to accept, manage, and assume risks in order to precisely delineate the controlled financing transaction.

The Circular requires the performance of a comprehensive risk analysis in order to determine the adequate level of equity. In that respect, the Circular refers to the need to estimate – based on the facts and circumstances of each situation – the economically significant specific risks in relation to a financing transaction. If the activity of a group financing company would be comparable to a typical regulated entity, under the European Union (EU) Regulation No. 575/2013 of the European Parliament and the Council of 26 June 2013 on requirements for credit institutions and investment firms and amending EU Regulation No. 648/2012, the use of solvency requirements applicable to such regulated entities should lead to an amount of equity to be considered as sufficient in light of the risks borne by the group financing company. If the activity of a group financing company would be different from a typical regulated entity, other methods (for instance methods based on credit rating analysis) could be used to determine the appropriate level of equity of the group financing company.

A group financing company is considered to control the risk if it meets all three criteria outlined:

- It has the decision-making power to enter into a risk-bearing opportunity
- It has the capacity to address such risks
- It actually performs such decision-making functions
Actual presence
In order to demonstrate that an entity controls and manages the risk and to validate that the management and control are exercised in Cyprus, the financing Company must have an actual presence in Cyprus.

The term actual presence is not officially defined nor regulated and it will need to be evaluated in the context of the actual case under consideration.

Nonetheless, the following actual presence criteria are detailed in the Circular:

- The majority of board Directors members should be Cyprus tax residents
- The majority of the board of Directors meetings must be held in Cyprus and the main management and commercial decisions must be made in Cyprus
- The majority of the shareholders meetings must be held in Cyprus
- The financing company must have qualified personnel controlling and managing the financing transactions

Part 2 - Comparison of the controlled transaction with those of comparable transactions between independent entities and determination of arm's length remuneration
Comparable transactions must be identified in order to assess the arm's length remuneration. The identification process must be transparent, systematic and verifiable.

Transactions without commercial purpose
For transactions having no commercial purpose (i.e., transactions that would not have been concluded by independent parties in comparable conditions), the Circular further mentions that these transactions and their tax consequences should be ignored in order to be compliant with the arms' length principle.

Simplified measures
For group companies exercising a purely intermediary financing activity and meeting the substance requirements listed above, the transactions entered into by such group financing companies will be considered as compliant with the arm's length principle if such group companies obtain a minimum return on the assets financed after tax of at least 2%.

Reliance on the simplified measure needs to be disclosed (when applied) in the tax return of the company and could be subject to exchange of information.

A deviation with the above-described requirement of a 2% minimum return is acceptable when duly justified in a transfer pricing analysis.

Simplified measures are also introduced to determine the arm's length return on equity for a company having a functional profile comparable to certain regulated entities (reference is made to financial institutions). In such a case, a return on equity of 10% would be considered as compliant with the arm's length principle.

Minimum requirements for transfer pricing analysis in the case that approval is requested
The minimum requirements of such an analysis should include:

- A description of the computation of equity allocation required to assume risks
- A description of the group and the inter-linkages between the functions performed by the entities
- The precise scope of the transactions analyzed
- A complete list of the potentially comparable transactions searched
- A rejection matrix for the aforementioned transactions (with rejection justification)
- The final list of comparable transactions selected
- A general description of the market conditions
- A list of all previous transfer pricing agreements concluded with other countries in relation to the transactions
- A list of all previous agreements concluded and being still valid with the entity or entities under analysis
- Projected income statements for the years covered by the request

Advance tax rulings and advance pricing agreements (APAs)
Application for the issuance of tax rulings (including rulings relating to the simplification measures) or an APA are subject to the above minimum requirements for transfer pricing analysis.

Any use by taxpayers of the aforementioned simplification measures and/or issuance of tax rulings or APAs will be subject to the exchange of information rules set under the Directive on Administrative Cooperation.
Implications

The new transfer pricing framework for intra-group financing companies introduced by the new Circular impacts existing and future financing structures in Cyprus.

Taxpayers should consult their local tax advisor to assess the implications of the new Circular on their operations in Cyprus. Determination of the functional profile and comparable market data is required in order to evaluate whether the applied pricing is considered as arm’s length for Cypriot transfer pricing purposes.

EY’s Cyprus Transfer Pricing team has significant experience with local financing transactions.

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