

Transfer pricing with regards to back-to-back loan financing

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The Cyprus Tax Authorities issued a circular revising the transfer pricing framework for Cyprus tax resident Companies or for Companies which are not Cyprus tax residents but have a permanent establishment in Cyprus and carrying out intra-group financing activities in Cyprus.

Definition

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, such as debentures, private loans, cash advances and bank loans. Two companies are considered to be related if they fall within the scope of Section 33 of the Cypriot Income Tax Law.

The Circular is effective from 1 July 2017 and replaces the Minimum Margin scheme which is abolished.

In accordance with the Minimum Margin Scheme, for a Cyprus tax resident company which was engaged in group financing transactions, certain net financing margins (ranging from 0.125% to 0.35% per annum) were considered as an appropriate minimum contribution to the taxable profit of the Cypriot financing company for the purpose of applying the arm's length principle codified in the law.

Application of arm's length principle

It is required that all intra-group financing transactions be conducted in compliance with arm's length principle. In other words, whether the intra-group financing transaction corresponds to the price which would have been accepted by independent entities in comparable circumstances, taking into account the economic nature of the transaction.

Comparability Analysis

An appropriate Comparability analysis must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related parties.

This should consist in two parts:

1. Identification of commercial or financial relationship between related entities and determination of the conditions and economically relevant circumstances relevant to those relations.
2. Comparison of the delineated conditions and economically relevant circumstances, of the controlled transaction with those of comparable transactions between independent entities.

Functional Analysis

The purpose is to identify 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.

The below functions can be performed by Companies conducting intra-group financing transactions.

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

Simplification Measures

When a Cyprus tax resident group financing company, which pursues a purely intermediary financing activity, grant loans or advances to related companies, which are refinanced by loans or advances obtained from related companies, will be considered as compliant with the arm's length principle if such company obtain a minimum return on the assets financed after tax of at least 2%.

This percentage will be regularly reviewed by the Tax Department, based on relevant market analyses. In such case, no transfer pricing study will be required.

The simplification procedures can be used by a group financing company, which meets the criteria for substance (as described in the circular), such as an actual presence in Cyprus, which takes into account (i) the number of the members of the board of directors who are tax resident in Cyprus, (ii) the number of meetings of the board of directors taking place in Cyprus and (iii) the availability of qualified personnel to control the transactions performed.

In order to benefit from this simplification measure, entities should communicate to the Tax Department the use of the simplification procedure, by completing the relevant field in the tax return of the corresponding fiscal year.

It should be noted that any deviation from the minimum return of 2% is not allowed unless it is duly justified by an appropriate transfer pricing analysis.

The minimum requirements of such an analysis should include:

- description of the computation of equity allocation required to assume risks
- description of the group and the inter-linkages between the functions performed by the entities
- The precise scope of the transactions analysed
- complete list of the potentially comparable transactions searched
- rejection matrix for the aforementioned transactions (with rejection justification)
- final list of comparable transactions selected
- general description of the market conditions
- 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

The transfer pricing analysis should be prepared by a Transfer Pricing Expert. It is expected that the transfer pricing analysis is submitted to the Cyprus Tax Department by a person who has a license to act as auditor of a company according to the Cyprus Company Law.

How can dba assist you

Contact us for a detail discussion of how the above amendment might affect your group of Companies.

Contact us

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