

TAX UPDATE JULY 2017 **(Transfer pricing rules)**

The Cyprus Tax Department (CTD) has informed the Institute of Certified Public Accountants in Cyprus (ICPAC) of their intention to abolish the practice of accepting pre-agreed minimum set profit margins of 0,125% - 0,35% on intra-group and related party financing arrangements that were in the form of back-to-back loans.

It is being reminded that in accordance with Article 33 of the Cyprus Income Tax Law, all transactions between related parties must, for tax purposes, be made on an arm's length basis. The CTD has the right to impose tax adjustments to make up for any deviation from the arm's length principle (usually made in the form of a notional interest income). In the case of back-to-back loans between related parties, the CTD has, by way of practice, accepted such thin spreads / minimum profit margins without challenging the arm's length applicability.

This current practice, which had been agreed between the CTD and ICPAC during July 2011, is abolished as from 1 July 2017. It is further noted that any tax rulings issued prior July 1st 2017 on transactions within the scope of this circular will no longer be valid for tax periods as from 1st July 2017.

On the way forward, intra-group financing arrangements and their interest rates / profit spreads should be supported by a transfer pricing study, based on the relevant OECD guidelines. This will be required both for the purposes of issuing tax rulings as well as for corporate tax assessments.

The driving force behind this decision is the intention to align the Cyprus tax treatment of such arrangements with Action Points 8 – 10 (transfer pricing) of the OECD BEPS Action Plan.

The transfer pricing rules are followed the relevant OECD transfer pricing guidelines.

The new tax treatment is applicable for companies which meet the following criteria:

- Carry out Intra- group financing transactions.
- Are Cyprus tax resident companies or are non-Cypriot tax resident companies which have a permanent establishment in Cyprus and the financing activities are attributable to the permanent establishment.

The term “intra-group financing transaction” refers to any activity consisting 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.

1. Application of arm's length principle to intra group financing transactions

It is necessary to determine for each intra-group financing transaction conducted, same as with all types of intra-group transactions, whether the agreed remuneration complies with the arm's length principle (as set out in Article 9 of the OECD Model Tax Convention on Income and on Capital) i.e. whether it corresponds to the price which would have been accepted by independent entities in comparable circumstances, taking into account the economic nature of the transaction.

2. Comparability Analysis (transfer pricing study)

An appropriate comparability analysis (transfer pricing report) must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related entities. The comparability analysis should consist of two parts:

Identification of commercial or financial relationship between related entities and determination of the conditions and economically relevant circumstances attaching to those relations.

Comparison of the as accurately delineated conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities.

3. Substance requirements

In order to justify the risk control and to further validate that the management and control are exercised in Cyprus it is imperative that the group financing company must have an actual presence in Cyprus. In this regard the following will be taken into account:

- the number of the members of the board of directors who are tax resident of Cyprus
- the number of meetings of the board of directors taking place in Cyprus and the availability of qualified personnel to control the transactions performed. Nonetheless the group financing company may subcontract functions which do not have a significant impact on risk control.

4. Simplification measures

When a Cypriot tax resident group financing company pursues a purely intermediary activity, grants loans or advances to related companies, which are refinanced by loans or advances obtained from related companies, it is considered that for sake of simplification, the transactions are deemed to comply with the arm's length principle, if the company receives a minimum after tax return of 2% on the assets. 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.

In order to benefit from this simplification measure, entities should:

- satisfy the minimum substance requirements mentioned in section 3
- 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 in exceptional cases it is duly justified by an appropriate transfer pricing analysis.

this minimum return percentage cannot be used, without a transfer pricing analysis, to determine arm's length remuneration for intra-group financing transactions different from those covered by the circular.

5. Minimum requirements for transfer pricing analysis

The minimum requirements for the transfer pricing analysis are those that are set out in paragraph 29 of the relevant circular.

The Transfer Pricing Analysis should be prepared by a Transfer Pricing Expert.

It must be submitted to the Cyprus Tax Department by a person who has licence to act as auditor of a company in Cyprus, who is required to carry an assurance control of the transfer pricing analysis.

With the above in mind, it is strongly recommended that such existing intra-group financing arrangements are carefully reviewed in order to assess the potential impact of the upcoming changes and to take corrective action, if required. For new transactions of this type, companies should consider having a transfer pricing study in place.

Loan restructuring opportunity:

The relatively recently introduced provision for allowing a tax benefit through a Notional Interest Deduction (NID) on new equity continues to attract great interest by international tax advisors. This provision, apart from reducing the effective tax of the Cyprus company by up to 80%, can also tackle the topical tax issue of being the 'beneficial owner of income', especially in the cases of loans granted by the Cyprus company. Note that in the case of loans eligible for NID, the resulting Cyprus tax charge can be as low or even lower than in the case of using thin spreads.

For example, instead of engaging the Cyprus company through a back-to-back loan arrangement, one can take advantage of the NID provisions and grant out a loan through own funds that were introduced in the share capital of the Cyprus company. New financing arrangements are prompted to consider using this method. Existing back-to-back loan arrangements are prompted to consider restructuring these by capitalizing the loans, which would entitle them to receive NID and at the same time help them achieve the beneficial owner of income test on interest received by the borrower.

Notional Interest Deduction (NID)

NID is a notional tax allowable deduction that can be claimed, as from 1 st January 2015, by Cyprus tax resident companies against their taxable income. As per the provisions of the amended Income Tax Law, companies resident in Cyprus (as well as non-resident entities with a permanent establishment in Cyprus) which carry out business activities, are entitled to claim NID against their taxable income, where this income is generated through the application of new funds contributed to the equity of the company on or after 1 st January 2015.

NID is calculated by multiplying the 'new equity' introduced in the company and used to carry out its activities with a 'reference interest rate' (both terms defined in below sections). NID can be claimed each year in perpetuity, to the extent that the 'new equity' is not decreased and continues to be used in the business. The maximum amount of NID that can be claimed is restricted to 80% of the taxable profit generated by the application of the new equity, as calculated before the NID deduction. This, coupled with the 12,5% corporate tax rate, and depending on the level of capitalisation, provides the opportunity for a reduction of the effective tax rate of the company to as low as 2,5%.

The 'reference interest rate' used to calculate NID is defined as the higher of:

- (a) the yield of the 10-year government bond (as at 31st December of the year preceding the year of assessment) of the country in which the new equity is invested, increased by 3%, and
- (b) the yield of the 10-year government bond of the Republic of Cyprus (as at 31st December of the year preceding the year of assessment), increased by 3%.

Basic example on applying NID against taxable income

A Cyprus resident trading company issues new capital comprising of 100 shares, with a nominal value of €1 each, at a premium of €999 per share (i.e. total new equity of €1.000.000). The funds are utilized in the business and generate net income of €200,000.

We set below 3 alternative scenarios (with the taxable profit being the varying factor), illustrating the company's eligibility to claim NID.

	Scenario 1	Scenario 2	Scenario 3
	EUR	EUR	EUR
Income from application of new equity	200,000	200,000	200,000
Expenses	40,000	130,000	210,000
Profit/(loss) before claiming NID	100,000	70,000	(10,000)
NID (see calculation notes below)	<u>(66,850)</u>	<u>(56,000)</u>	<u>0</u>
Profit/(loss) before tax	33,150	14,000	(10,000)
Corporation tax at 12,5%	<u>(4,144)</u>	<u>(1,750)</u>	<u>0</u>
Profit/(loss) after tax	<u>29,006</u>	<u>12,250</u>	<u>(10,000)</u>
Calculations notes:			
For all three scenarios the NID is calculated as follows: €1,000.000 new equity x (3,685% + 3%) = €66,850			
In Scenario 1, NID can be claimed in full as it does not exceed 80% of the taxable profit before NID. The effective tax rate is equal to 4,14%			
In Scenario 2, NID is restricted to 80% of the profit: €70,000 x 80% = €56,000. The effective tax rate is equal to 2,5%			
In Scenario 3, no NID can be claimed, since the company has incurred a loss from its activities. The tax loss can be carried forward for 5 years or be utilized through group relief.			
It can easily be deduced from the above that, in the absence of the NID provision, the corporation tax liability in scenarios 1 and 2 would have been significantly higher:			
<ul style="list-style-type: none"> - Scenario 1: €100,000 x 12,5% = €12,500 (instead of €4,144) - Scenario 2: €70,000 x 12,5% = €8,750 (instead of €1,750) 			

Restrictions – limitations

The maximum amount of NID that can be claimed in any given year is restricted to 80% of the taxable profit generated via application of the new equity, as calculated before the NID deduction. Moreover, in case where a company is in a tax loss position, NID is not granted. Therefore, NID cannot be used to either create or increase a tax loss.

Any unutilized NID cannot be carried forward for use in future years. NID is deemed by nature to be interest and, as such, may be subject to the same limitations and restrictions as actual interest expense.

As such, NID is available as tax deductible, provided that the new equity is used for the financing of business assets which generate taxable income.

Qualified reorganisations: In case of reorganisations that are considered as ‘qualifying’ under the provisions of the Cyprus tax legislation (and, as such, are tax neutral), NID is calculated on new equity as if the reorganisation had not taken place.

Election : A company may elect whether to claim the whole or part of the amount of the NID available, in any given year.

This may be of use by Cyprus tax resident companies that wish to show a certain amount of higher tax paid in Cyprus.

Disclaimer: This publication has been prepared as a general guide and for information purposes only. It is not a substitution for professional advice. One must not rely on it without receiving independent advice based on the particular facts of his/her own case.