

## **Update on the Tax Treatment of intra-group back-to-back Financing Agreements**

Further to the recent amendments introduced in Cyprus as to the Tax Treatment of intra-group back-to-back Financing Agreement, as of the end of June 2017 the Tax Department in Cyprus has released its Circular as to its interpretation of these new provisions. A brief summary of the interpretation to be followed by the Tax Department is indicated below.

### **1. Main Definitions**

The new provisions are applicable for companies which meet the following criteria:

- Companies which carry out group financing transactions. It is worth noting that the activities related to investment holdings are not taken into consideration.
- Companies which are Cypriot tax resident companies (i.e. their management and control is exercised in Cyprus), 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 definition of “*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. It is noted that a group financing company may grant loans and other credit facilities to related companies for various commercial reasons, such as:

- financing of fixed assets;
- financing of current assets;
- long term strategic financing; and
- other types of financing.

### **2. The “at Arm’s Length” Principle**

With regards to all transactions falling within this Tax Circular, it is necessary to determine for each intra-group financing transaction conducted, 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). In other words, whether the intragroup 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.

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Under Cyprus Law, the arm's length principle is included in Section 33 of the Income Tax Law, which allows adjusting the reported profits as described therein in case the transfer prices differ from prices that would have been agreed between independent entities.

### **3. Comparability Analysis**

Under the new provisions, an appropriate comparability analysis must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related entities.

The comparability analysis has to 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 defined conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities.

### **4. Functional Analysis**

The purpose of the functional analysis 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 following functions can be performed by companies conducting intra-group financing transactions:

- Origination of the transaction, ie (i) commercialization of a 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;
- Managing the transaction, ie (i) managing the financing transaction, (ii) credit risk monitoring and (iii) managing the financing of the transaction.

### **5. Simplification**

When a Cypriot tax resident group financing company, which 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, in view of the risks associated with the transactions analyzed, for sake of simplification, the transactions are deemed to comply with the arm's length principle, if the company receives in relation to its controlled transactions under analysis, a minimum after tax return 2% on the assets.

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This percentage will be regularly reviewed by the Tax Department, based on relevant market analyses.

It should be noted, that this minimum return percentage on assets funded by purely intermediary group finance companies with reduced functions 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 relevant Tax Circular.

The simplification procedures can only 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 of 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.

The group financing company may subcontract functions which do not have a significant impact on risk control. 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. A deviation from the minimum return of 2% is not allowed unless it is duly justified by an appropriate transfer pricing analysis.

#### **6. Minimum Requirements for Transfer Pricing Analysis**

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

The issuance of tax rulings (including rulings related to simplification measures) or Advanced Pricing Arrangements, as well as the use by a taxpayer of the simplification measures, whether applied following the issuance of a ruling or not, are subject to the exchange of information rules set under the Directive on Administrative Cooperation (Council Directive (EU) 2011/16 as amended by Council Directive Council Directive (EU) 2015/2376).

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**7. Entry into force for the Tax Circular**

The new circular applies with effect as from 1 July 2017, for existing and future transactions, irrespective of the date of entering into the relevant transactions and irrespective any tax rulings issued prior to the said date.

Any tax rulings issued prior to 1 July 2017 on transactions within the scope of the relevant circular will no longer be valid for tax periods as from 1 July 2017.

If the intra - group financing transactions effected prior to 1 July 2017 are still ongoing post the reference date and they were supported by a transfer pricing study, the said transfer pricing study will need to comply with the provisions of the relevant circular, which will be verified by the Tax Commissioner.

All tax ruling requests, irrespectively of the date they have been submitted, must comply with the Circulars Nos. 2015/13 and 2016/13 issued by the Tax Department, which relate to the issuing of tax rulings by the Tax Department.

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