Transfer Pricing

PKE Consultants Limited **Publication Sheet – December 2018**

Transfer Pricing - Group financing Companies

Transfer pricing regulations govern intercompany pricing for goods, services, royalties and loans between companies in a cross-border context. In light of OECD (Organisation for Economic Co-operation and Development) base erosion and profit shifting (BEPS) initiative, multinational Companies may need to establish a transfer pricing policy.

On 30 June 2017, the Cypriot tax authorities issued the Circular 05.13.001 ("the Circular"), complying with Actions 8 to 10 under the OECD BEPS Project. The circular provides a completely new playing field for companies carrying out intra-group back to back financing activities to related companies.

This circular will substitute the so called acceptable profit margin scheme as agreed between the Institute of Certified Public Accountants in Cyprus (ICPAC) and the tax Commissioner in 2011.
The Circular is effective as from 1 July 2017.

The Circular applies to Cyprus tax resident entities and permanent establishments which are involved in back-to-back intra-group financing transactions. The Circular defines intra-group financing transactions as the granting of loans or cash advances to related companies (within the scope of Section 33 of the Cyprus Income Tax Law) that are (or should be) subject to interest and are financed by financial means, such as debentures, private loans, cash advances and bank loans.

Transfer Pricing Study

With effect from 1 July 2017, any Cyprus tax resident company carrying out intra-group-financing transactions must prepare and submit to the Cyprus Tax Authorities a Transfer Pricing study supporting each intra-group financing transaction conducted to determine whether the agreed remuneration complies with the arm's length principle i.e. corresponds to the price which would have been accepted by independent entities in comparable circumstances, taking into consideration the economic nature of the transaction.

The Circular provides for three main Requirements that need to be included in a transfer pricing report; **substance requirement, equity risk requirement and Arm's length compensation**. A group financing company not following the requirements is in breach with the Cypriot tax authorities.
In addition, it provides that the transfer pricing report should be (i) prepared by a transfer pricing expert, and (ii) submitted to the CTA by a person who has a license to act as an auditor of a company according to the Cyprus Companies Law Cap. 113 and is required to carry out an assurance control confirming the quality of the transfer pricing report.

The previously established acceptable profit margins under the back-to-back scheme will be applicable for transactions up to 30 June 2017 inclusive.

Main requirements

a) Substance requirement

The Circular requires companies engaged in intra-group financing activities to have a real substance in Cyprus. The substance requirements (as described in the circular), provide for four main conditions which must all be met:

- the number of board of directors members of the company that are Cyprus tax resident;
- the number of board of directors meetings held in Cyprus and the main management and commercial decisions taken in Cyprus;
- the number of shareholders' meetings taking place in Cyprus;
- the availability of qualified personnel to control the transactions performed.

The meaning of qualified personnel can be interpreted in different ways however it is expected to have the meaning whether a group financing company has an adequate number of employees necessary to manage the financing activities on a daily basis.

The employees may be the company's own employees, or outside staff. Therefore, the day to day management of the company may be still outsourced to well establish Cypriot service providers as long as the directors are capable to supervise the work and their decision making power is not limited.

b) Equity at risk requirement

The circular provides for a new requirement which states that a finance company must bear the risks in relation to its intragroup financing transactions. A finance company's equity at risk must be determined on a case by case basis, being a major change from the old back to back scheme.

Therefore, a finance company should have adequate equity level to assume risks and in particular the credit risks. The circular requires finance companies to be financed with an amount of equity to cover expected losses, should been materialized. The equity should be calculated based on the solvency criteria of regulated financial institutions or if the functional profile differs significantly (proved by the functional analysis) it allows you to refer to other methods as developed by professionals in this field.

The circular does not define the term equity nor provides clarifications of how to use the funds of the equity but given that the purpose is to absorb the risk if materialized, should in principle the funds be easily available in all times.

c) Arm's Length Compensation

The Circular provides that the remuneration arising from back-to-back intra-group financing transactions of the Cypriot group financing companies should determine their arm's length remuneration and should comply with the arm's length principle i.e. correspond to the price that would have been agreed by independent parties in comparable transactions, taking into account the economic nature of the transaction. In this respect, a transfer pricing analysis must be carried out for the purpose of:

> **(1) Identifying the commercial and financial relationship between the related parties and determining the conditions and the economically significant circumstances of the transaction** and the Circular specifies that in order to precisely describe the intra-group financing transaction, it is necessary to determine the characteristics, such as its terms and functions, the assets used and the risks assumed by the related parties. The following matters should be considered and taken into account as part of the analysis: (i) **Contractual Terms/Company Analysis**, (ii) **Functional Analysis** and (iii) **Risk Analysis**.

(a) Company analysis

The circular provides guidance on what a transfer pricing analysis should include. It states that the transfer pricing analysis should include an overview of the structure of the organization of the group, the role and functions performed of each entities participating in the controlled transactions and the contribution of the related entities to the value creation within the Group. In addition the circular further states that it is necessary to determine the characteristics of the controlled transaction by describing the terms and functions, assets used and the risks assumed by the related entities. This could be done through a functional analysis.

(b) Functional analysis

The circular at note 13, states that the functions performed by the finance company may be divided into those relating to the origination of the transactions and those relating to the management of the transaction. In our view, regarding the origination of the transaction functions, the most important are the negotiation (decision making whether funds should be transferred and at what terms) and the compliance functions (review agreements, checking for guarantees, resolving legal issues and etc.). In our view, regarding the managing of the transaction functions, all below should be considered important:

- Managing the financing transaction (receive and pay interest, monitoring payments). The Cypriot company should be fully involved in such function.
- Credit-risk monitoring; (analysing the risk of the borrower, the profitability of the loans and the return on the equity invested). This function is very important as the finance company (unlike the previous back to back scheme) will bear all the risks relative to their financial activities. Therefore finance companies should develop risk management policies and have qualified personnel.
- Managing the financing for the transaction; (for example refinancing the loan, sale of the loan, terms to renew or to extend the loan agreements). The Cypriot company should be fully involved in such function.

(c) Risk analysis

It is strongly emphasized in the circular, stating that parties before engaged in granting credit should among other factors need to examine the annual accounts of the borrower, review for any guarantees, the purpose and duration of the credit. According to the circular a finance company should be in the position to manage and bear the risk and must be examined through the functional analysis.

Therefore the finance company is necessary to have the access to funding, necessary to take on or to avoid the risk, to pay the risk mitigations actions and to bear the consequences if the risk occurs. Additionally a group finance company should control its risk by having the decision making power to enter into a risks-bearing commercial relationship, if it has the ability to address the risks and if it actually performs such decision-making makings.

The Circular provides that the ability to assume and manage risk constitutes the economically significant characteristics which must be identified in order to describe precisely the transaction.

An entity is considered to be able to **assume** risk if it has the financial capability to manage the risk and bear the financial consequences in the event that the risk materialises. The Circular, sets out the methodology to be used as part of the risk analysis, including using comparables to credit institutions and investment firms pursuant to EU Regulation, in order to determine the entity's equity levels and whether these are sufficient to enable it to assume the relevant risk.

An entity is considered to be able to **manage** the risk if it has, and actually exercises, the decision making power to enter into risk bearing transactions and if it has the ability to address such risks. In this respect, the Circular provides that entities:

(1) Must have actual presence in Cyprus, which is determined by taking into account the following criteria: the number of Cyprus tax resident directors, the number of the board of directors' meetings held in Cyprus and whether the main management and commercial decisions of the board of directors are taken in Cyprus, the number of shareholders' meetings held in Cyprus, etc.
(2) Must have qualified personnel to control the transactions performed. It is noted that the Circular allows for the outsourcing to third parties of any functions that do not have a significant impact on risk control, including daily activities of risk mitigation, provided that the entity maintains control and supervision of the risk and function outsourced.

(b) Comparing the conditions and economically significant circumstances of the transaction with comparable transactions between independent parties

Once the transaction has been precisely described, then the arm's length remuneration is determined by comparing the transaction with comparable transactions observed between independent parties in the open market.

In order to accurately perform the comparability analysis, the below (not exhaustive) must be examined and performed:

- The role of each of the entities participating in the controlled transactions and their interdependencies between the functions performed
- The structure and organization of the group
- The contractual terms agreed
- A functional analysis that takes into account all economically significant functions, assets used or contributed and the risks assumed by the parties
- The economic rationale behind each transaction
- An analysis of the risks in financial relations including an evaluation of the ability to assume and manage the risks involved in each transaction

The circular provides evidence on how to determine the arms' length remuneration. The return on equity will be one of the approaches for determining the arm's length compensation specifically if you are a regulated financial institution. The circular specifically states that if Cypriot financing companies performing similar functions to those performed by regulated financing companies a return on equity of 10% after tax can be observed in the maker as arms' length remuneration. For any other company, the international recognized standards could be used.

Possibly the arm's length remuneration could be found through an interest benchmarking analysis which analyses the difference between the interest expense and interest income.

<u>**Simplified measures**</u>

The circular provides a simplification measure which is an option to be used which can reduce the burden of preparing a transfer pricing analysis. 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.

However, in our view is expected that in practice, most taxpayers will not opt for the simplification measure because:

a) the minimum return of 2% after tax on the assets, can be regarded as very high and may not represent the arm's length basis of the group financing company;
b) In the circular is stated that taxpayers opting for the simplification measure will be subjected to an exchange of information as set under the council directive 2011/16/EU.
c) For intermediary financing companies that do not comply with the minimum substance requirements, the simplification measure is not applicable without a transfer pricing analysis.

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