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Transfer Pricing Legislation in Cyprus Newsletter– 10.12.2019

Old Margin Regime for B2B financing arrangements

Any Cyprus Company engaging in Back to Back (B2B) financing arrangements with related companies up until 30.6.2017, were taxed in Cyprus under the margin or 'Safe Harbour' method. Under this system, a margin of between 0.15-0.35% (spread between borrowing and lending rates) was left to be taxed in Cyprus, depending on the size of the financing.

Introduction of TP provisions for B2B financing arrangements

As the Cyprus tax system is fully aligned with the OECD, it is currently in the process of transposing Transfer Pricing (TP) Legislation into the Cyprus Tax Law, in accordance with the OECD TP Guidelines. The first aspect of TP legislation released, relates only to B2B financing arrangements, as per the circular issued on 30.6.2017. Furthermore, a full set of TP legislation with a much broader scope covering all types of intercompany transactions, is currently being discussed and expected to be in effect as of 1.1.2020, though no official confirmation has yet been announced.

In this respect, we advise that any company involved in B2B financing arrangements, after 1.7.2017, will have two options available to it:

1. Capitalization of loan payable into equity;
2. Preparation of TP Study.

For the avoidance of uncertainty, the Circular defines B2B financing arrangements as any activity of granting interest bearing loans/making advances to related companies (or should be interest bearing), which are funded by debt issuance/private loans/advances from shareholders/bank loans, etc. It is further clarified however, that there is no requirement for a TP study in the case of stand-alone entities under the current legislation.

Furthermore, though there are no thresholds applicable in the current TP provisions covering B2B financing arrangements, there is expected to be a threshold applicable to the full TP legislation once released. This is expected to be the same as for Country-by-Country reporting regulations, which is €750.000.000 at the group level (though there has been no official confirmation of this yet).

Recommendations:

1. Capitalization of Loan Payable into Equity

It is advised that a company may capitalize any loan payable to its foreign shareholders (by converting the loan payable by CypCo into CypCo Share Capital). In such a case, there will be no TP Study requirement under the present TP legislation as it stands, because the arrangement

will no longer be a B2B financing arrangement. However, we note that such arrangements may also require TP studies once the full TP legislation is released. It should be further noted that

where the capitalization of the loan payable was done after 01.7.2017, then there would still be a requirement for a TP study from 1.7.2017 up until the day of capitalization.

Furthermore, a key benefit to this arrangement is the availability of Notional Interest Deduction in Cyprus, which allows for a deduction of up to 80% of taxable income (subject to certain conditions), whilst the increased capital of the Cyprus company will strengthen its beneficial ownership position in the instance where it is challenged by a foreign jurisdiction.

2. **Preparation of TP Study**

Any B2B intercompany financing arrangements will need to be substantiated by a TP study, which may follow one of two methods prescribed by the Circular:

a) Preparation of full TP study;
b) Simplification method.

2.A. Preparation of full TP study:

B2B financing arrangements will now have to be substantiated by a full TP Study, signed by a Cyprus registered auditor. The study should cover the period from 1.7.2017 up until the end of the tax year (31.12.2017), with the old B2B margin scheme being applicable for the first part of the tax year (1.1.2017-30.6.2017). From the 2018 tax year onwards, TP studies will be required for the entire tax year.

The TP study will need to be prepared based on the OECD TP Guidelines, and as a minimum should include the following:

- Determination of commercial and economic relationships of tested parties;
- Comparability Analysis;
- Functional Analysis;
- Outline of contractual terms;
- Risk Assumption.

A TP Study is **not** required for every tax year, but will only need to be replaced in the instance where the circumstances of the arrangement change significantly.

2.B. Simplification Method:

The simplification measure is the only exception to the above, which allows for the circumvention of the requirement for a full TP study, but only in the instance where the tested company generates a Return on Assets (RoA) of at least 2% in Cyprus. However, we note that this method works out to be much more expensive for large levels of B2B financing and as such should be avoided unless the B2B financing levels are very low.

Planning Tip

The election for the simplification measure is advisable only in the instance where the resulting tax liability in Cyprus costs less than the preparation of a full TP report.

It should be noted that the simplification measure is available by election, as the company will need to tick the relevant box within its tax return (TD4) for the relevant tax year. Even if the simplification measure is elected however, an economic analysis will still be required to substantiate that the company is eligible to opt for the simplification measures, applicable only in the instance where the company is not involved in core activities.

The next step

AROSAL is at your disposal to assist with navigating the complexities arising from this new legislation, offering full TP Study services upon request. For any further assistance or clarifications you may require, please contact our office to arrange a meeting and further explore your options.