

Restructuring of back-to-back Loan arrangements

Background

On 30 June 2017, the Inland Revenue in Cyprus issued a tax circular to govern the treatment of back-to-back financing arrangements, effective from 1 July 2017. The circular applies to already existing and/or future transactions.

In case your Company is engaging in such arrangements, kindly be informed of how you might be affected by the main provisions which are as analysed below:

Application of the new law

This circular applies for companies that undertake *intra-group financing transactions*¹ only in the case these are in the form of back-to-back loans. Any other operations (i.e. balances from investment holding operations) do not fall under the provisions of this new tax circular.

Arm's length principle (APL)

The Arm's length principle is the cornerstone of the Cyprus tax legislation and is defined in Section 33 of the Cyprus Income Tax Law (2002).

The APL is used in determining the transfer prices between related undertakings. According to the APL, financing transactions corresponds to the conditions which would have been accepted by independent companies, in comparable situations.

Application of Arm's length principle

In accordance with the provisions of the circular a *Comparability Analysis* (transfer pricing report) needs to be prepared for proving that financing transactions have been performed on arm's length basis.

The aim of the Comparability Analysis is to justify that transactions between related parties are comparable to transactions with independent parties. Thus such analysis should comprise of:

1. Identification of the relationship between the parties and determination of conditions and economic justification as to those conditions;
2. Comparison of conditions and economic circumstances between the transactions of the related parties as compared to similar transactions concluded between unrelated parties;

A *Functional Analysis* will also be required regarding the functions performed, assets used and risks assumed by the Cyprus tax resident financing company (i.e. origination and monitoring of the transactions).

Contents of the transfer pricing analysis

Besides the comparability analysis, the transfer pricing analysis must cover all the following matters:

- ⦿ A description of the computation of equity allocation required to assume the risks;
- ⦿ A description of the group and the inter-linkages between the functions performed by the entities participating in the controlled transactions and the rest of the group;
- ⦿ The precise scope of the transactions analysed;
- ⦿ A complete list of potentially comparable transactions searched;
- ⦿ A rejection matrix for rejected potentially comparable transactions with justifications;
- ⦿ The final list of comparable transactions which have been selected and used to determine the arm's length price applied to the intra-group transaction;
- ⦿ A general description of market conditions;
- ⦿ A list of all previous agreements on transfer pricing concluded with other countries in relation to the transactions in question;
- ⦿ A list of all the previous agreements concluded with the entities under analysis which are still in effect at the time of the submission of the request; and
- ⦿ A projection of the income statement for the years covered by the request.

¹ "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 (as defined in accordance with the provisions of Section 33 of the Cyprus tax legislation), financed via monetary form or through non-monetary means (i.e. debentures/bonds/advances etc.)

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Simplification option – *The alternative route*

Application of the APL with preparation of the Comparability Analysis may prove to be time consuming and costly.

Such detailed analysis can be avoided only when a Cyprus tax resident group financing entity, which pursues a purely intermediary activity, receives a minimum return of *at least 2%*² after tax on the assets.

In such a case, it will be considered that the financing entity complies with the APL thus avoiding the burden of preparing the detailed Transfer Pricing Study. However, a Functional Analysis should be prepared and submitted to the Inland Revenue together with proof that:

- a) the company acts as a purely intermediary company and the risks associated with the transactions analysed are low;
- b) the minimum return of at least 2% after tax on the assets applies; and
- c) The company meets the *criteria of substance* as mentioned in the circular, being:
 - Actual physical presence in Cyprus;
 - Majority of members of the board of directors being Cyprus tax residents;
 - Number of board meetings being held in Cyprus; and
 - Availability of qualified personnel to control the financing transactions.

It is noted that if the Functional Analysis does not prove that the assumed risks are reduced, then a full economic transfer pricing analysis is required.

How we can assist?

VGDA is well positioned to provide you with more details regarding the above developments and whether these apply to your company. Furthermore, our firm can provide you with the following services:

- ⊙ Assistance in analysing your company's financing arrangements, and thereafter assessing and identifying the option which is most suitable to you.
- ⊙ Assistance in obtaining tax rulings/opinions from the Inland Revenue office in Cyprus regarding the applicability of the transfer pricing requirements to your specific case.
- ⊙ If the Comparability Analysis route is selected, we can assist you in preparing the full Transfer Pricing Study, as well as manage its submission and follow-up with the Inland Revenue.
- ⊙ If the Simplicity Option is chosen, we can assist both in the compilation of the documentation needed to prepare the functional analysis, and finding solid solutions for you regarding the fulfilment of the criteria of substance.

We remain at your disposal for any clarifications/ further information required.

² The percentage will be regularly reviewed by the Tax Department based on relevant market analyses.

Nicosia Office

32, John Kennedy Avenue
DADLAW Business Centre, 2nd Floor
1087 Nicosia, Cyprus

Tel.: +357 22 300900
Fax: +357 22 300901

Limassol Office

8, John Kennedy Street
Iris House, 8th Floor
3106 Limassol, Cyprus

Tel.: +357 25 760500
Fax: +357 25 760501

For more information you may contact:

Vasilis Koufaris

Managing Director

Tel. ☎: +357 99 432000

Email ✉: vkoufaris@vgda.com.cy

Antonis Antoniou

Director, Head of Audit

Tel. ☎: +357 99 699664

Email ✉: aantoniou@vgda.com.cy

Constantinos Christodoulou

Director, Head of Advisory

Tel. ☎: +357 99 657028

Email ✉: cchristodoulou@vgda.com.cy

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