The Cyprus Finance Company

Current Challenges and the way ahead

Introduction

Cypriot tax resident companies over the years have been used extensively for intra-group financing activities. The main reasons for this were the low corporate tax rate of 12.5%, the availability of double tax treaties with favourable provisions as far as zero or low withholding tax on interest paid on such intercompany loans and the willingness of the Cypriot tax authorities to accept low margins on back to back financing arrangements.

The use of double tax treaties on back to back financing arrangements has recently come under attack by foreign tax jurisdictions that have ignored the provisions of the treaty and such decisions have received support through a number of court decisions.

Furthermore, the Cypriot tax authorities have recently announced that as from July 2017 they will no longer accept low margins and the margins established should be supported by a proper transfer pricing study.

These developments, which are discussed in detail below, seriously threat the use of such financing companies and alternative solutions, should be considered.

Beneficial ownership of income as an anti-avoidance provision

The concept of the "beneficial ownership of income" has been introduced in the OECD-model treaty as an anti-avoidance measure in order to eliminate the avoidance of (withholding) taxes in specially structured transactions.

The beneficial owner is the recipient of the income that has the actual right to use, enjoy and dispose the income, without being constrained by a contractual or legal obligation to pass on the payment received.
In transactions where the recipient of income is not the beneficial owner but acts simply as an intermediary that has an obligation to pass on the income to another person, the benefits of a double tax treaty between the intermediary company and the state of the payer company (i.e. lower withholding tax rates) may be denied.

In a number of double tax treaties concluded by Cyprus the provisions of the treaty are only granted if the recipient of the interest is the beneficial owner of the income. Such a treaty which has recently entered into force is the treaty with Ukraine.

A number of other double tax treaties concluded by Cyprus, including the treaty with Russia, do not include a beneficial ownership of income provision.

However, recently Russian courts are increasingly applying the **"look-through"** approach and disregard the intermediary company that, in their view, is simply created with the purpose to avoid tax without being the beneficial owner of the income, even in the case of treaties of Russia with countries such as Cyprus, Luxembourg and the Netherlands, where the treaties do not include beneficial ownership of income provisions

Withdrawal of the low margin scheme (back to back financing)

Back to back financing regime which allowed related parties and/or connected parties to be taxed at the acceptable margins between 0,125% and 0, 35%, depending on the amount of the loan has been withdrawn on 30 June 2017. As from 1 July 2017, all transactions entered between related parties and/or connected parties should be concluded at an arm's length basis.

Furthermore, the Cyprus Tax Authorities have issued a circular relating to the revised tax treatment of intra-group back to back financing arrangements introducing detailed transfer pricing documentation requirements which should be based on the OECD transfer pricing guidelines.

The new rules for intra-group back-to-back financing arrangements

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 point 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 Circular provides the minimum requirements for the transfer pricing analysis, which needs to be prepared by a transfer pricing expert (e.g. a licensed auditor):

- 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, together with a description of the value creation within the group by the entities participating in the transactions;
- the precise scope of the transactions analysed;
- a list of the searched potentially comparable transactions;
- 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 transactions accurately delineated;
- 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 entities under analysis which are still in effect at the time of the submission of the request;
- a projection of the income statements for the years covered by the request.

6. Exchange of information

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).

7. Entering into force of the 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.

8. Way forward

All affected entities will need to proceed with undertaking the required transfer pricing analysis for each intra-group finance arrangement or alternatively, and subject to conditions, the affected entities may opt to use the simplification regime.

Let's Talk

For a deeper discussion of how the above might affect you or your business, please contact:

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