



REPUBLIC OF CYPRUS  
MINISTRY OF FINANCE



ΤΜΗΜΑ  
ΦΟΡΟΛΟΓΙΑΣ  
TAX DEPARTMENT

Ref. No.: 05.13.001  
Interpretative Circular 3 – Income Tax

June 30<sup>th</sup>, 2017

To all Assessing Staff

### Tax treatment of intra-group back-to-back financing arrangements

#### 1. Definitions

1. This Circular applies to any company carrying out group financing transactions (hereinafter referred to as a group financing company) meaning any entity that conducts intra-group financing transactions. For the purposes of the preceding sentence, the activities related to holding of participations are not taken into consideration. Further, this Circular applies to companies that are Cyprus tax resident, namely companies whose management and control are exercised in Cyprus, as per Section 2 of the Income Tax Law 118(I)/2002 as amended (ITL). It also applies, mutatis mutandis, to companies that are tax resident outside Cyprus and have a permanent establishment in Cyprus as per Section 2 of the ITL and in such case the Circular applies to the extent that it is relevant to the taxation of the Cyprus permanent establishment.

2. For the purposes of this Circular, the term intra-group financing transaction refers to any activity consisting in the granting of loans or cash advances remunerated by interest (or 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 ITL.

#### 2. General information

3. The arm's length principle, as set out in Article 9 of the OECD Model Tax Convention on Income and on Capital, is the international standard adopted by OECD member states used in determining the transfer prices between related undertakings conducting cross-border transactions. To ensure the application of this principle, the OECD has developed regularly updated guidelines to be observed both by multinational enterprises and by tax administrations in the scope of transfer pricing between related entities conducting cross-border transactions.<sup>1</sup>

4. In the national law the arm's length principle is reflected in Section 33 of the ITL 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. Application of arm's length principle to intra-group financing transactions

5. For the purposes of transactions falling within this Circular, 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, i.e. corresponds to the price which would have been accepted by independent entities in

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<sup>1</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

comparable circumstances, taking into account the economic nature of the transaction. An appropriate comparability analysis must be carried out in order to determine whether transactions between independent entities are comparable to transactions between related entities.

### **3.1. Comparability analysis**

6. The comparability analysis referred to in paragraph 5 should consist of two parts:

- I. Identification of commercial or financial relationship between related entities and determination of the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate the controlled transaction;
- II. Comparison of the as accurately delineated conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent entities.

#### **3.1.1. Identification of commercial or financial relations between related entities and determination of economically significant conditions and circumstances**

7. In order to accurately delineate the controlled transactions and to determine the arm's length remuneration in a precise manner, it is necessary to describe the role of each of the entities participating in the controlled transactions, in the context of their commercial or financial relations within the group to which they belong. It might also prove appropriate to understand the structure and organization of the group and the extent to which these aspects affect the functioning of said group. Likewise, it may be useful to understand the interdependencies between the functions performed by the entities participating in the controlled transactions and the rest of the group, the contribution of the related entities to the value creation within the group in the broad sense, and the impact of this contribution on the arm's length remuneration of each of the entities participating in the controlled transactions. Indeed, the economically relevant characteristics of a transaction are associated with the economic circumstances in which the transaction has been conducted.

8. For illustrative purposes, a group financing company may grant loans or advances to related entities for various commercial purposes:

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

9. The list is not exhaustive however it indicates that the economically significant characteristics of a financing transaction are closely linked to the existing commercial relations between related entities and to the economic strategies of the parties.

10. In order to accurately delineate a controlled financing transaction, it is necessary to determine its characteristics, such as its terms and functions, the assets used and the risks assumed by the related entities. The extent to which the comparability factors are economically significant for a particular transaction depends on the extent to which it would be taken into consideration by independent entities assessing the terms of the same transaction, if it were concluded between them.

### **3.1.1.1 Contractual terms**

11. A transaction is the expression of a commercial relation between the parties. For the comparability analysis it is not relevant whether or not the transaction is formalized in writing. The conduct of the parties is essential for the identification and accurate delineation of the controlled transaction. Therefore, even when a contract is formalized in writing, if the actual conduct of the parties differs from what was contractually agreed, it is such actual conduct of the parties that must be taken into account while delineating the transaction.

### **3.1.1.2 Functional analysis**

12. 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 functions assumed in connection with granting loans or cash advances to related entities are substantively comparable to the functions assumed by independent financial institutions subject to the supervision of the Central Bank of Cyprus and/or the Cyprus Securities and Exchange Commission. It should be noted that these functions in case of financing transactions performed by related entities not regulated by rules imposed by the Central Bank of Cyprus and/or the Cyprus Securities and Exchange Commission could differ substantially. The functional analysis focuses on actual activity of the parties and on the competences they deploy. The functions analysed include decision-making, in particular in terms of corporate strategy and risks. In this context, to the extent possible, it is necessary to determine the legal rights and obligations of each party when performing said functions.

13. The following functions (although not an exhaustive list) can be performed by companies conducting intra-group financing transactions:

#### **a) Origination of the transaction**

- Commercialization of a transaction (identification of borrowers, product offering);
- Negotiation (setting of the terms, assessment of the credit risks);
- Identification of the refinancing structure related to the financing activity;
- Evaluation of the compliance with the contractual commitments prior to the final closing (value of guarantees, solvency analysis).

#### **b) Managing the transaction**

- Managing the financing transaction;
- Credit risk monitoring (review of transaction risks and guarantees);
- Managing the financing for the transaction.

14. The identification of functions performed and assets used is necessary in order to identify the risks related to the financing transaction.

### **3.1.1.3 Analysis of risks in financial relations**

15. Financial establishments or other parties engaged in credit-granting activity, before granting credit or providing cash advance, conduct an analysis of risks to which they would be exposed. In particular, they examine the annual accounts of the borrower in order to assess the financial risks of a transaction. To assess the borrower-related risk they verify whether guarantees exist and they analyze the purpose and duration of credit, as well as any

other important factors. On the open market, higher risk generally induces higher remuneration. The ability to manage and the ability to assume risk constitute the economically significant characteristics, which have to be identified in order to accurately delineate the controlled financing transaction.

16. Economically significant risks related to financing transactions, the functions related to or influencing the risk management or impact of risk, as well as the parties which assume such risk, should be assessed based on the facts and circumstances of each individual case. A group financing company is generally considered to assume the risk if it has the financial capacity to manage the risk and to bear its financial consequences if the risk materializes. The financial capacity to assume the risk can be defined as the access to funding necessary in order to take on or avoid the risk, to pay for the risk mitigation actions, and to bear its consequences if the risk occurs.

17. If the comparability analysis under this Circular reveals that a group financing company has a profile comparable to the entities subject to the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (as they may be amended from time to time) and that it has an equity level complying with solvency criteria provided by said regulation, it is deemed that its equity level is high enough to face the financing consequences when the risk occurs. When the comparability analysis reveals significant differences in the functional profile (the assets used and functions performed) of the group financing company as compared to the entities subject to the aforementioned regulation, it is necessary to refer to other methods in order to assess the equity level required to assume the risks, in particular the credit risk analysis methods developed by recognized professionals in this field. Such methods are based on the analysis of the balance sheet components, markets components and other factors important to determine the risks related to financing activity<sup>2</sup>.

18. A group financing company controls the risk if it has the decision-making power to enter into a risk-bearing commercial relationship, if it has the ability to address such risks, and if it actually performs such decision-making functions. A group financing company can outsource the daily activities of risk mitigation. It must however be able to determine the objectives of the outsourced activity, to decide to use the services of a risk mitigating provider, to assess whether the objectives are properly met and, if necessary, to decide to modify or terminate the contract with the service provider, as well as to actually perform these functions.

19. Therefore in order to justify the risk control and to further validate that the management and control are exercised in Cyprus, it is imperative that a group financing company must have an actual presence in Cyprus. In this respect we note that the actual presence criteria take into account, the following:

- The number of board of Directors members of the company that are Cyprus tax residents.
- 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.

Further the group financing company must have the qualified personnel to control the transactions performed. The group financing company may nonetheless subcontract functions that do not have a significant impact on risk control.

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<sup>2</sup> Service providers recognized in regulated or non-regulated financial markets whose objective is the provision of credit risk analyses and the development of scientific models to determine the risk associated to credit activity.

### **3.1.2 Comparison of the controlled and accurately delineated transaction with comparable transactions between independent entities and determination of arm's length remuneration**

20. In order to determine arm's length remuneration, it is necessary to compare the accurately delineated controlled transaction with comparable transactions on the open market.

21. The arm's length remuneration is the remuneration that would have been agreed under comparable conditions on the open market. Therefore, in order to be able to assess the remuneration, it is important to identify comparable transactions. The process of identification of potential comparable transactions must be transparent, systematic and verifiable. The search should be conducted using all sources of information available at the time of the undertaking of the transaction.

22. It is also necessary to take into account the practice of the concerned comparable sector. In the case of companies performing functions similar to those performed by regulated financing and treasury companies, namely the companies covered by paragraph 17 of section 3.1.1.3., a return on equity of 10% after-tax can be observed in the market and can be considered as reflecting arm's length remuneration for the financing and treasury functions in question, at the time of publication of this circular. This percentage will be regularly reviewed by the Tax Department based on relevant market analyses.

23. Comparability adjustments may be performed based on internationally recognized standards in this field, if it appears necessary for improving the reliability and quality of the comparability analysis.

### **3.1.3 Transactions without commercial rationale**

24. It should be noted that, in the scope of comparability analysis and in the context of the accurate delineation of one or more controlled transactions, it may turn out that such transactions not only cannot be observed in the open market, but are also devoid of any commercial rationale, in a way that independent parties would not have agreed to conclude these transactions under the same conditions. In this case, such transaction or transactions together with the associated tax consequences must be disregarded to ensure full compliance with the arm's length principle.

## **4. Simplification measures**

25. When a group financing company which meets the criteria set out in paragraph 19 of section 3.1.1.3. and pursues a purely intermediary activity, grants loans or advances to related entities which are refinanced by loans or advances granted by related entities<sup>3</sup>, it is considered that, in view of the risks associated with the transactions analysed, for sake of simplification, the transactions are deemed to comply with the arm's length principle if the analysed entity receives in relation to its controlled transactions under analysis, a minimum return of 2% after-tax on assets. This percentage will be regularly reviewed by the Tax Department based on relevant market analyses.

26. 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 this section.

27. In order to benefit from this simplification measure, entities should communicate the use of said measure to the Tax Department by filling in the relevant field in the tax return of the corresponding fiscal year.

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<sup>3</sup> The purely intermediary character of such activity is not affected by the number, amount, nature, maturity or other characteristics of the loans or cash advances in question.

28. A deviation from the minimum return established in the first paragraph of this section is not allowed unless in exceptional cases where such deviation is duly justified by an appropriate transfer pricing analysis.

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

29. The minimum requirements for a transfer pricing analysis<sup>4</sup> in compliance with the principles set out in the previous sections should include:

- 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 in the broad sense within the group by the entities participating in the transactions,
- the precise scope of the transactions analysed,
- a complete list of the searched potentially comparable transactions,
- a rejection matrix for rejected potentially comparable transactions together with justifications of such rejections,
- 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(s) accurately delineated,
- a general description of market conditions,
- a list of all previous agreements on TP concluded with other countries in relation to the transactions in question,
- a list of all the previous agreements concluded with the entity/ies 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.

30. 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 measure described under section 4, 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 2011/16/EU as amended by Council Directive Council Directive (EU) 2015/2376).

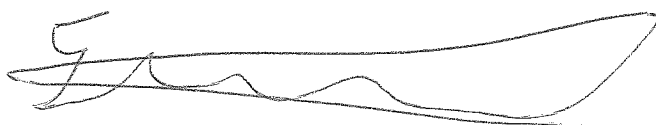
## **6. Entering into force of the circular – non application of existing tax rulings**

31. This Circular applies with effect as from July 1<sup>st</sup> 2017, for all existing and future transactions, irrespective of the date of entering into the relevant transactions and irrespective of any tax rulings issued prior to the said date. It is further noted that any tax

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<sup>4</sup> The Transfer Pricing Analysis should be prepared by a Transfer Pricing Expert. It is expected that the transfer pricing analysis is submitted to the Cyprus Tax Department by a person who has a licence to act as an auditor of a company according to the Cyprus Company Law and is required to carry an assurance control confirming the quality of the transfer pricing analysis.

rulings issued prior to July 1st, 2017 on transactions within the scope of this circular will no longer be valid for tax periods as from 1<sup>st</sup> July 2017. If the intra group financing transactions effected prior to the 1st of July 2017, are still ongoing post the reference date and they were supported by Transfer Pricing study, the said Transfer Pricing study will need to comply with the provisions of this 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 2015/13 and 2016/13 Circulars issued by the Tax Department.



Soteris Markides  
Deputy Tax Commissioner

Cc:

1. Auditor General
2. Permanent Secretary of the Ministry of Finance
3. President of the Tax Tribunal
4. Cyprus Bar Association
5. Institute of Certified Public Accountants of Cyprus (ICPAC)
6. Institute of Approved Accountants of America (CPA)
7. Institute of Approved Accountants of Cyprus
8. Institute of Independent Accountants
9. Cyprus Institute of Internal Auditors
10. The Institute of Financial Accountants
11. Cyprus Fiduciary Association