

Cyprus provides guidance on minimum TP documentation for persons exempt from the Local File requirement

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In brief

The Cyprus Tax Department (CTD) issued on July 6 a new Circular providing transfer pricing (TP) guidance to persons that are exempt from the obligation to prepare a Cyprus Local File, with respect to maintaining minimum TP documentation to support the arm's-length nature of their related-party transactions (Controlled Transactions). In addition, the Circular introduces optional simplification measures applicable to relevant taxpayers, for certain types of Controlled Transactions (financing and low value adding services). The guidance and simplification measures are effective for tax years starting from January 1, 2022.

Actions to consider: Cyprus companies that are exempt from the obligation to prepare a Cyprus Local File should consider the minimum TP documentation requirements and the various simplification measures available depending on respective fact patterns.

In detail

Minimum TP documentation requirements and simplification measures for persons exempt from the obligation to maintain a Cyprus Local File

Scope

The provisions of the Circular apply to Cyprus tax resident persons or permanent establishments in Cyprus of non-Cyprus tax resident persons that are exempt from the obligation to maintain a Cyprus Local File, based on the provisions of Article 33 (9)(a) of the Income Tax Law as amended, for their Controlled Transactions that cumulatively per category do not exceed or would not exceed, based on the arm's-length principle, the value of €750,000 p.a.

Minimum TP documentation requirements

According to the provisions of Article 33 of the Cyprus income tax legislation, transactions between related parties should be priced on an arm's-length basis; otherwise the CTD may adjust the taxable income of the relevant person

to include (and tax accordingly) any additional profit/income that should have been realized had the transactions been priced on an arm's-length basis.

In this respect, persons that engage in related-party transactions should maintain the following minimum TP documentation to support the arm's-length nature of any Controlled Transactions that are not required to be documented in a Cyprus Local File:

- Brief functional analysis (functions, assets, risks)
- Description of the functional profile of the entity, based on the results of the functional analysis
- Reasoning for selection of the most appropriate TP method
- Determination of the arm's-length price(s) supported by relevant benchmarking results using internal or external comparables (as applicable) or any other relevant economic analysis compliant with the OECD TP Guidelines (e.g., the use of valuation models for financial guarantees).

The minimum TP documentation should be submitted to the CTD upon request (within 60 days).

Simplification measures for certain types of Controlled Transactions

Persons that are exempt from the obligation to prepare a Cyprus Local File for Controlled Transactions may elect to apply the simplification measures for the pricing of the following types of Controlled Transactions:

- a. Financing granted to related parties financed by borrowings
- b. Financing granted to related parties financed by equity
- c. Financing obtained from related parties to the extent it is used in the business
- d. Low value adding services (LVAS) (received or provided).

Note: Controlled Transactions (a - c) above are subcategories of the financing transactions category; (d) is a subcategory of the services transactions category.

Note: The above simplification measures cannot be applied if the (arm's-length) value of all the financial transactions (for application of measures (a - c)) or all services transactions (for application of measure (d)) of the taxable person exceed €750,000 p.a. in aggregate per category.

Furthermore, the simplification measures cannot be applied if reliable internal comparables (i.e., comparable transactions with unrelated parties) can be used to determine the arm's-length price of the Controlled Transactions.

The simplification measures are described in more detail below.

Financing granted to related parties financed by borrowings

This measure relates to loans or cash advances granted to related persons that bear (or should bear) interest, which are financed by financial instruments such as bonds, loans from affiliated companies or related persons, including interest-free loans from the shareholders, cash advances, and loans from credit institutions. Any eligible business (i.e., if the business is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions) that performs functions for the origination and management of the above-mentioned financing transactions, regardless of whether it has the financial capacity to assume related risks, may elect to apply this simplification measure.

Such financing transactions (financed by borrowings) are considered to comply with the arm's-length principle if a minimum pre-tax net return (margin) of 2.5% p.a. on the average outstanding receivable balances (comprising the principal financing amount plus unpaid accrued interest) is earned by the lender.

Persons that elect to apply the above simplified measure must maintain the following supporting documentation:

- Brief functional analysis and description of the functional profile of the parties involved
- Description of the loans for which the simplification measure is applied (dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, and details of any amendments to the loan agreements, etc.)
- Description of the reasons justifying that the financing granted to related parties has been financed by financial instruments
- Workings and reconciliations to document how the simplified return has been applied in the income tax computation of the relevant person.

Financing granted to related parties financed by equity

This measure relates to loans or cash advances granted to related persons — that bear (or should bear) interest — that are financed by equity (i.e., proceeds from the issuance of share capital and share premium, nonreciprocal capital contributions, or retained earnings). Lenders that grant equity-financed loans to related parties are deemed to have the financial capacity to assume the risks associated with such loans.

Such financing transactions (i.e., financed by equity) are considered to comply with the arm's-length principle, if the interest rate applied to each transaction by the eligible lender (i.e., if the lender is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions) is at least equal to the 10-year government bond yield rate (as at the 31 December of the year prior to the relevant tax year) of the jurisdiction in which each borrower operates, increased by 3.5%. The said interest rate should be applied on each average outstanding receivable balance (comprising the principal amount plus unpaid accrued interest) and updated annually as may be appropriate. Note: If this yield rate is negative, then it should be deemed to be zero.

Persons that elect to apply the above simplification measure need to maintain the following supporting documentation:

- Brief functional analysis and description of the functional profile of the parties involved
- Description of the loans for which the simplification measure is applied (e.g., dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, and details of any amendments to the loan agreements)
- Description of the reasons justifying that the financing granted to related parties has been financed by equity
- Workings and reconciliations to document how the simplified interest rate has been applied in the income tax computation of the relevant person.

Financing obtained from related parties to the extent it is used in the business

This measure applies to borrowings such as interest-bearing loans, bonds, or cash advances received from related persons to the extent that they are used in the business and the interest expense is deductible under the relevant provisions of the Cyprus income tax legislation.

Such interest-bearing borrowing transactions are considered to comply with the arm's-length principle, if the interest expense of the eligible borrower (i.e., if the borrower is eligible on the basis of being exempt from the preparation of Cyprus Local File for these Controlled Transactions) is calculated at an interest rate that does not exceed the 10-year government bond yield rate of the Republic of Cyprus increased by 1.5%. The interest rate should be applied on the average outstanding payable balances (i.e., comprising the principal amount plus unpaid accrued interest) and updated annually as may be appropriate.

Persons that elect to apply the above simplification measure need to maintain the following supporting documentation:

- Brief functional analysis and description of the functional profile of the parties involved
- Description of the interest-bearing borrowings for which the simplification measure is applied (e.g., dates of conclusion of the loan agreements, loan amount and currency, loan balance at the end of the tax year, repayment date, collaterals, interest rate, and details of any amendments to the loan agreements)
- Description of the reasons justifying that the borrowing transactions qualify for the application of this simplification measure
- Workings and reconciliations to document how the simplified interest rate has been applied in the income tax computation of the relevant person.

Provision or receipt of low value-adding services (LVAS)

This measure applies to Controlled Transactions of provision or receipt of LVAS.

Consistent with the definition in the OECD TP Guidelines (Chapter VII, Section D.1), LVAS are those intra-group services that:

- Are supportive in nature
- Are not part of the core business of the group (i.e., they do not create profit-making activities nor contribute to economically significant activities of the group)
- Do not require the use of, nor lead to the creation of, unique and valuable intangibles
- Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

LVAS generally include the following intra-group services (list is indicative and not exhaustive):

- Bookkeeping, accounting, and auditing services
- Processing and management of accounts receivable and accounts payable
- Human resources activities, such as staffing and recruitment, employee training, remuneration services, and developing and monitoring staff health procedures
- IT services (relating to the IT infrastructure and operation of internal IT systems of the group)
- Internal and external communications and public relations support
- Internal legal services
- Activities with regard to the tax compliance obligations of the group entities
- General services of an administrative or clerical nature.

The pricing of Controlled Transactions that qualify as LVAS generally is determined on a cost plus markup basis, in line with the OECD TP Guidelines.

The pricing of LVAS provided to related parties is considered to comply with the arm's-length principle if the markup applied on the relevant costs is at least 5%. In the case of receipt of LVAS from related parties, the acceptable arm's-length markup applied on relevant costs should not exceed 5%.

Persons that elect to apply the above simplification measure must maintain the following supporting documentation:

- Brief functional analysis and description of the functional profile of the parties involved
- Description of the categories of LVAS provided/received and identity of beneficiaries
- Description of reasons justifying that each category of service qualifies as a LVAS, in the context of the definition described above
- Workings supporting the determination of the relevant cost pool and application of the mark-up, where applicable
- Description of the selected allocation keys and workings showing their application
- Workings and reconciliations to document how the simplified measure has been applied in the income tax computation of the relevant person.

Practical application of the simplification measures

Persons that elect to apply any of the simplification measures described above, should disclose such election to the CTD, by completing electronically the relevant part in their Income Tax Return/Summary Information Table for Controlled Transactions, by the submission deadline for each tax year.

The required documentation supporting the application of any of the simplification measures should be submitted to the CTD upon request within 60 days.

Deviation from the prescribed minimum or maximum returns/rates/markups for the simplification measures must be supported by the preparation of the minimum TP Documentation as described above.

The CTD will not make any downward adjustments if the accounting profit from the Controlled Transactions is higher than the profit resulting from the application of the simplification measures or the results of a transfer pricing study.

Cross-border Controlled Transactions for which the simplification measures are applied may be treated as reportable transactions in accordance with Article 2 (1) and Annex IV, Part II, Label E.1 of the Administrative Cooperation in the Field of Taxation Law of 2012 (205(I)/2012), as amended and in line with the provisions of Regulation 42(2) of K.Δ.Π. 438/2021 (all generally referred to as DAC6 provisions).

Observation: The minimum TP documentation requirements provide for a lighter Cyprus TP documentation framework for taxpayers that are exempt from the obligation to prepare a full-fledged Cyprus Local File. Further, the simplification measures are intended to provide certainty to eligible taxpayers that elect to apply them.

Let's talk

For a deeper discussion of how this new guidance might affect your business, please contact:

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