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Upcoming enhancement of the Transfer Pricing regime in Cyprus

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Introduction

With the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) action plans published in 2015 having reached an advanced stage of implementation around the world, the tax and Transfer Pricing (TP) landscape in Cyprus has seen numerous changes in recent years with further major developments which are expected shortly.

The sweeping changes taking place at an international level and their impact on the Cyprus TP environment started to become evident with the implementation of country-by-country reporting (CbCR) in 2016, for Cypriot tax resident companies and permanent establishments which are part of Multinational Enterprise (MNE) Groups with annual consolidated group revenue exceeding EUR 750 million.

In addition, the issuance of a Circular in 2017 by the Cyprus Tax Department (CTD) on the TP requirements for intra group back-to-back financing arrangements based on OECD principles, was a significant event which highlighted the message to many taxpayers that TP was here to stay and would grow in importance.

Moreover, the interposing of the provisions of the European Union (EU) Anti-Tax Avoidance Directive (ATAD) into local legislation, with effect for some of the rules from 2019 and for the remaining ones from 2020, was a major development in the Cyprus tax system. Whilst the ATAD does not contain an explicit provision on TP and is focused on other more direct measures to limit tax base erosion, TP is inextricably intertwined in the application of parts of the ATAD, such as the Controlled Foreign Company (CFC) and interest limitation rules.

Against this backdrop of rapid changes, in this article we examine the current TP environment in Cyprus and how this has evolved in recent years. We also discuss how the TP regime in Cyprus will be enhanced with the expected completion of the implementation of the three-tiered global standard for TP documentation requirements as recommended by BEPS Action 13. Furthermore, as Cyprus is an EU Member State, we discuss how the Cyprus TP environment is expected to be further transformed by the various initiatives being undertaken globally by the OECD/G20 and the drive by the EU for Member States to implement many of the resulting measures in a consistent manner.

The TP environment in Cyprus

The arm's length principle in Cyprus
The arm's length principle has existed in the Cyprus tax legislation for many years. It was established in the legislation that resulted from the major tax reform of 2003 under Section 33 of the Income Tax Law, prior to the accession of Cyprus to the EU in 2004. The arm's length principle, as stated in Section 33, closely follows the concept and wording in Article 9 of the OECD Model Tax Convention.

TP developments in recent years
In 2015, an amendment to the law, refined Section 33 to provide for corresponding adjustments in the case of a transaction between two Cypriot resident corporate taxpayers (including Cypriot permanent establishments), i.e. where the Commissioner increases the profits of one party, a corresponding deduction is granted to the other party.

Subsequently, within the context of Cyprus' commitment to the various initiatives around tax transparency and exchange of information, on 1 November 2016 Cyprus signed the Multilateral Competent Authority Agreement on the automatic exchange of country-by-country reports. This development occurred following Cyprus' signing of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters in 2014, which was jointly developed by the OECD and the Council of Europe. Cyprus thereafter introduced CbCR requirements as of 2016, by interposing the relevant EU Directive on CbCR into its domestic legislative framework.

Further developments occurred in the first half of 2017 with a Circular issued, which stated that in cases where the benefits of the Cyprus Intellectual Property (IP) regime (which provides for an 80% deduction on qualifying profits from qualifying assets under an OECD compliant nexus approach) are being claimed on embedded IP income, a TP study needs to be prepared based on the OECD TP Guidelines to support the amount of embedded income that is considered to qualify for the IP regime.

Intra-group financing activities
Later the same year, Interpretative Circular 3 was issued by the CTD on 30 June 2017 with respect to intra-group back-to-back financing arrangements. This was the development that brought TP into the limelight for many Cypriot resident corporate taxpayers, belonging to both international and domestic groups, as well as for professional advisers in Cyprus. Given the significant number of companies in Cyprus that undertake financing activities, issuing this Circular elevated the importance of TP in Cyprus to an unprecedented level. The practical impact of this Circular was that it replaced the acceptable minimum margins on back-to-back financing that the Commissioner had agreed with the Institute of Certified Public Accountants of Cyprus in 2011.

The abolishment of the agreed minimum margins and their replacement with a Circular based on the OECD endorsed TP principles, was a reflection of the winds of change that had been sweeping across the world in terms of resetting the international tax landscape. This was evident by the fact that a similar Circular on intra-group financing transactions had been issued by the Luxembourg tax authorities a few months earlier, the contents of which were along very similar lines to the one issued by the CTD.

In brief, Interpretative Circular 3 provides for the application of TP methodology to intra-group back-to-back financing activities based on the arm's length principle, as advocated by the OECD. The Circular applies to intra-group financing activities where loans are granted by a Cypriot tax resident company (or Cypriot permanent establishment) to related parties, financed by financial means and instruments, such as private loans, cash advances, bank loans and debentures.

The Circular includes a description of how taxpayers should conduct their TP analysis of such financing transactions and prepare a "TP Analysis" (effectively a TP study), including undertaking the following:

- Accurate delineation of the financing transaction in question.
- Functional and risk analysis.
- Analysis of the relevant factors that may determine whether a company can be considered to assume the risk related to the financing activity, including inter alia whether it has the financial capacity to undertake the risk.
- Comparability analysis involving a comparison of the accurately delineated controlled transactions with equivalent transactions on the open market.
- Special considerations with respect to entities that may be comparable to regulated financing and treasury companies.

In addition, a simplification measure was introduced for companies engaging in purely intermediary financing activities, borrowing from related entities and on-lending to related entities. Such an entity is deemed, for the sake of simplification, to comply with the arm's length principle if it receives a minimum return of 2% after-tax on assets in relation to its controlled transactions. An entity that fits such a profile, and does not intend to prepare TP documentation, may choose to benchmark its remuneration based on this minimum return on assets. The Circular states that the 2% minimum return, will be regularly reviewed by the CTD based on relevant market analysis. The choice to opt for the simplification measure is indicated on the annual corporate tax return and is subject to exchange of information. In practice, following the subsequent introduction of the EU DAC6 legislation in Cyprus, this is exchangeable under the hallmark relating to unilateral safe harbour rules.

The issuance of the above Circular was pivotal for Cyprus, as this was the first time that detailed principles drawing on OECD Guidelines were articulated in a formal document published by the CTD. Building on the contents of Interpretative Circular 3, the CTD uploaded FAQs on TP matters on its website on 24 January 2022 which provided certain clarifications with respect to the Circular. One key clarification is companies that are eligible and opt for the 2% safe harbour, should have a functional analysis in place to support that they qualify for the simplification measure. It is also clarified that TP studies prepared are not required to be submitted as part of the annual tax filing process but only upon request by the CTD. A summary of the key clarifications can be found in our relevant tax alert.

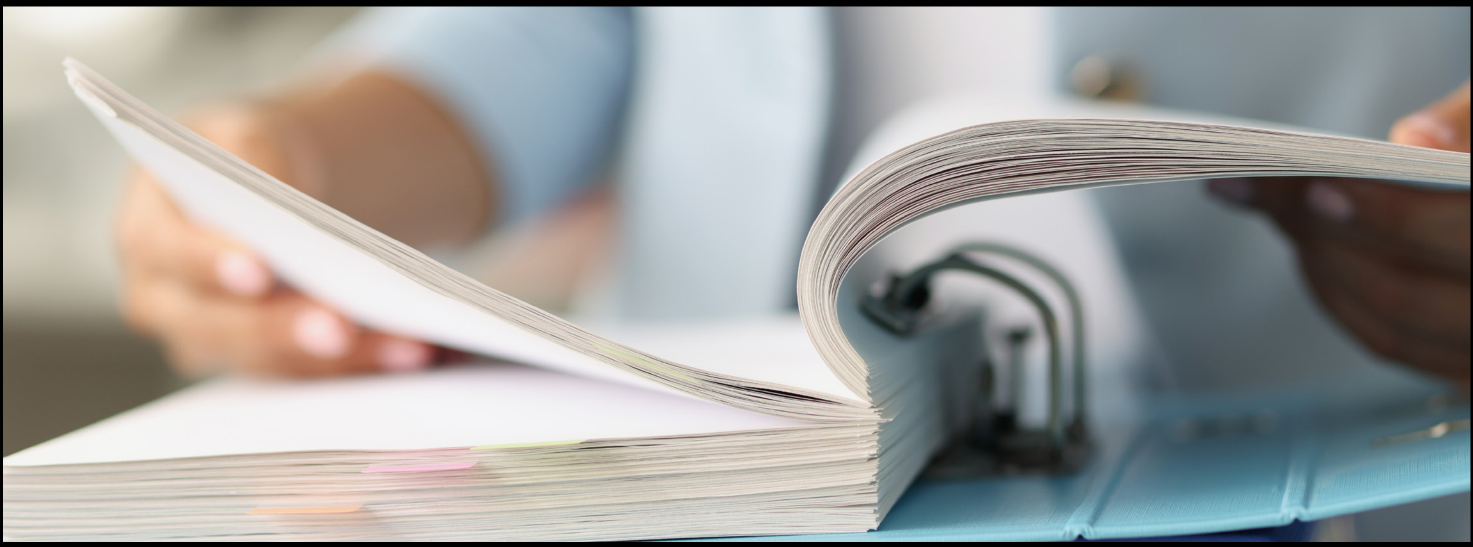
TP audits

The practical approach of the CTD when raising questions on the TP position of a company, has historically been that the CTD would consider TP matters during the course of a normal examination of a company's tax affairs. If the company had a TP study in place, then this could be presented to support its position as part of the overall negotiation with the CTD on the tax liability for the year. The recent focus of the CTD with respect to TP is on intra-group financing transactions falling under Interpretative Circular 3, in respect of which they have been requesting and reviewing TP studies prepared by taxpayers.

Any adjustments, including TP-related ones, are reflected in an assessment issued by the tax authorities within the normal statute of limitations that is six years from the end of the tax year in question. The taxpayer has until the end of the month following the month in which the assessment is issued to object to the assessment. If an agreement is not reached with the CTD then recourse is available to the Tax Tribunal or the courts.

The audit process is expected to undergo changes in the future once the expected detailed TP documentation requirements (described below) are introduced. We anticipate that greater focus will be placed by the CTD on TP matters. It is likely that dedicated TP audits, similar to those seen in other countries, will take place where the CTD will ask questions to understand the taxpayer's business and activities in depth.

In terms of the information available to the CTD, CbCR for companies belonging to larger groups are already available, enabling them to undertake a high-level TP risk assessment. The CTD going forward, will also have at its disposal further sources of information, including Local Files, and in limited cases Master Files, both of which will be introduced under the anticipated new TP regulations.



The expected new TP legislation and regulations

It has been highly anticipated that a new framework for TP compliance is imminently on the horizon and a legislative package has been submitted to the Cyprus House of Representatives last year. This contains a comprehensive framework that will modernize and bring the Cyprus TP regime in line with international standards.

Key aspects of the proposed legislative package, which are publicly available at this time, are described below. Please keep in mind that the package may be subject to change as the draft package passes through the legislative process.

Amendments to the definition of connected parties in Section 33(3) of the Income Tax Law, which introduces a 25% direct or indirect relationship test. Where taxpayers meet the conditions under this 25% relationship test, TP documentation requirements will arise on transactions between such parties, assuming the relevant thresholds have been exceeded.

The TP documentation will need to be maintained in the form of a Local File. In limited cases, a Master File may also be required. The required contents will be identical or closely aligned to the OECD recommendations.

The TP documentation will need to be in place within a timeframe which will be clarified when the regulations are issued. This is expected to be either within 12 months following the end of the tax year or by the deadline for filing the corporate tax return (which is currently 15 months after the year-end). Following this, the TP documentation should be made available to the CTD within 60 days upon request.

The draft Regulations also provide for the following:

- Taxpayers are exempt from maintaining a Local File if the amount of income from each category of intra-group transaction (e.g. goods, services, IP related income, financing) does not exceed (or should not exceed based on the arm's length principle) EUR 750,000 per tax year.

- A taxpayer which is not part of an MNE Group subject to CbCR, is not required to maintain a Master File. Even where the taxpayer is a member of such a large group subject to CbCR, it is exempt from obligation to maintain a Master File if it is not the Ultimate Parent Entity (UPE) or the Surrogate Parent Entity (SPE).

- It is expected that taxpayers will submit a Summary Information Table (SIT) electronically in conjunction with their tax return filing. Effectively the SIT will be a disclosure from providing high level information on intercompany transactions.

- An authorized professional firm should undertake an assurance quality review of the Local File.

- A penalty regime is expected to apply for non-compliance with the new TP documentation and SIT requirements with penalties ranging from EUR 500 to EUR 20,000, depending on the type of violation.

- Under the new TP regime, a process will be put in place for requesting an Advance Pricing Agreement (APA).

The introduction of the new TP regime based on the OECD/G20 BEPS recommendations, will enhance the enforceability of the arm's length principle in the Cyprus tax legislation and affirm the country's position as a jurisdiction with a modern and internationally compliant tax regime. The new rules will provide a clear framework to taxpayers on how they should be documenting their intra-group transactions to support their adherence to the arm's length principle.

In view of these new requirements, which could come into effect from 1 January 2022 (the effective date to be confirmed once the final version of the regulations is issued), taxpayers should start planning with respect to their TP practices and methods to be documented under the new rules. Having good quality and robust TP documentation in place should enable audits that may be conducted by the CTD to be concluded in a smoother manner and mitigate the risk of controversy arising due to differences between the position of the tax authorities and the taxpayer.

Further forthcoming changes in the international tax landscape and their impact on TP in Cyprus

There are a number of forthcoming developments at an international level that are expected to further impact the TP landscape and enhance the reputation of Cyprus as having a modern tax system that promotes transparency and compliance. For example, the adoption of the EU Public CbCR Directive, which will need to be interposed by all EU Member States including Cyprus by the middle of 2023 at the latest, will require MNE Groups with annual consolidated group revenues exceeding EUR 750 million, who are either parented in the EU or parented outside the EU but with large EU subsidiaries and branches, to publish the taxes paid (and some other information) in each EU Member State, as well as information on their activities in any countries which are on the “black” and “grey” lists of the EU’s list of non-cooperative jurisdictions for tax purposes. Based on the timelines involved, it is likely that the first reporting will take place by 2024.

There is also an expected EU Directive on the horizon, intended to implement Pillar Two of the Two Pillar Solution to address the tax challenges arising from the digitization of the economy driven by the OECD/G20 as a major part of BEPS. In line with the global agreement reached by the Inclusive Framework on BEPS, the draft Directive is based closely on the OECD model rules and sets the minimum effective tax rate at 15% for the purposes of applying the Anti Global Base Erosion (GloBE) measures.

Some of the provisions of this Pillar Two Directive, such as the income inclusion rule, are expected to come into effect as soon as 1 January 2023 (though this may be delayed following recent discussions in the EU Council), assuming the draft Directive is approved unanimously by EU Member States. Such provisions will then need to be interposed by Cyprus into domestic legislation. Currently, the draft EU Directive refers to the rules applying to companies that are members of a group with a consolidated group revenue of at least EUR 750 million in at least two of the four preceding years, but with some exceptions available subject to specific criteria. The impact of potential TP adjustments, where amounts are not consistent with the arm’s length principle, on the income inclusion calculation for the purposes of the Pillar Two tax base, will inevitably need to be considered when the final legislation is ironed out.

There are also anticipated future developments in terms of a proposed EU Directive (the so called “ATAD 3”) aiming to prevent the misuse of “shell entities” for tax purposes within the EU, which has obvious overlaps with TP issues and the impact on the functional and risk analysis of a Cypriot tax resident company, where for example substance is increased in order to be compliant with the new rules. This proposed Directive is subject to further discussion and, if unanimously voted by the Council of the EU, would be transposed into domestic legislation effective 1 January 2024.

Furthermore, it remains to be seen how the EU will proceed with Pillar One and its consequent impact on the Cyprus tax system, in respect of in-scope MNEs that source revenue from consumers in Cyprus. This Pillar aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational giants (through Amount A) and to reward the baseline marketing and distribution functions in a market jurisdiction (through Amount B). From statements published by the OECD, it is understood that the application of the arm’s length principle to in-country baseline marketing and distribution activities will be simplified and streamlined.

With respect to the Two Pillar Solution, it seems that priority has been given by the EU to the implementation of Pillar Two. How the EU intends to proceed with Pillar One should become clearer later in the year, after the work on the related multilateral convention designed to implement it and the relevant OECD public consultation have sufficiently progressed.

Concluding remarks

There have been significant developments in Cyprus in recent years with respect to the growing importance of TP. These were a precursor to forthcoming major reforms that include, amongst others, the expected introduction of comprehensive new rules to complete the adoption of the three-tiered global standard for TP documentation requirements.

Our TP team in Cyprus has extensive experience in dealing with current TP requirements, as well as a thorough understanding of the upcoming new TP documentation rules. The team can assist by assessing the requirements of each company based on its specific profile, and provide dedicated TP expertise to address the pertinent issues within the context of the changing local and international tax landscape.

Contacts

For further information, please get in touch with our experts listed below.

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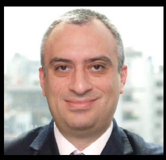

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