TRANSFER PRICING DEVELOPMENTS IN CYPRUS

PRESENTATION BY TAXAND CYPRUS

4 MARCH 2021

Your global tax partner

OVERVIEW

1. Setting the scene and relevance of Transfer Pricing for tax planning
2. Recent Transfer Pricing developments in Cyprus
3. Update on Transfer Pricing Financial Transactions focusing on intra-group loans
4. Importance of Transfer Pricing substance

RECENT TRANSFER PRICING DEVELOPMENTS IN CYPRUS

DEMIS IOANNOU

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LEGAL BASIS (1)

Period: 2002-2016

- In Cypriot domestic tax law, the arm's length principle is enshrined in Section 33 of the Cypriot Income Tax Law which in brief, allows reported earnings to be adjusted if the prices differ from those which would have applied between two independent enterprises for comparable transactions in comparable circumstances.

- Section 33, adopts the arm's length principle as found in Article 9 of the OECD Mode Tax Convention on Income and on Capital which constitutes the international agreed standard by OECD members that must be used to establish transfer pricing between related companies. As of December 2016, there have been no detailed transfer pricing rules in Cyprus.

LEGAL BASIS (2)

Period: 2017 until today

- On 30 June 2017, the Cypriot tax authorities issued a tax circular to provide detailed transfer pricing requirements on intra-group financing transactions. In substance, the circular determines whether the remuneration agreed, given the economic substance of the transaction and other factors, complies with the arm's length principle.

RECENT TP DEVELOPMENTS IN CYPRUS

- Intention of the Cyprus government to introduce detailed TPG in 2021.
- Such rules are expected to be aligned with the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
- The tax circular is expected to be repealed.

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UPDATE ON TRANSFER PRICING FINANCIAL TRANSACTIONS FOCUSING ON INTRA-GROUP LOANS

COSTAS SAVVA

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INTRA-GROUP LOANS

General considerations on determining the arm's length interest rate of intra-group loans

- Both the lender's and borrower's perspectives should be taken into account, acknowledging that these perspectives may not align in every case (10.51.)
- A thorough credit assessment of the potential borrower including analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet (10.54.)
- The same commercial considerations such as creditworthiness, credit risk and economic circumstances are relevant (10.55.)

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INTRA-GROUP LOANS

- Credit risk for the lender is the potential that the borrower will fail to meet its payment obligations in accordance with the terms of the loan (10.57.)
- The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge (10.62.)
- The credit rating of an MNE is effectively a form of relative ranking of the creditworthiness in comparison to other borrowers. A lower credit rating will indicate a greater risk of default and be expected to result in a higher rate of return for lenders (10.64.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Comparable uncontrolled price method (CUP method)
  - The arm's length interest rate for a tested loan can be benchmarked against publicly available with sufficiently similar terms and conditions and other comparability factors (10.91.)
  - In the search for comparability data, a comparable is not necessarily restricted to a stand-alone entity (10.92.)
  - Arm’s length interest rates can also be based on the return of realistic alternatives to intra-group loans i.e. bond issuances, loans, deposits, convertible debentures, commercial papers, etc. (10.93.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Loan fees and charges

  - Independent commercial lenders will sometimes charge fees as part of the terms and conditions of the loan (arrangement fees or commitment fees). If such charges are seen in a loan between associated enterprises, they should be evaluated in the same way as any other intra-group transaction(10.96.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Cost of funds

  - The cost of funds will reflect the borrowing costs incurred by the lender in raising the funds to lend. To this would be added the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin, which will generally include the lender’s incremental cost of the equity required to support the loan (10.97.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Credit default swaps

  - Credit default swaps reflect the credit risk linked to an underlying financial asset. In the absence of information regarding the underlying asset that could be used as a comparable transaction, taxpayers and tax administrations may use the spreads of credit default swaps to calculate the risk premium associated to intra-group loans (10.101.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Economic modelling

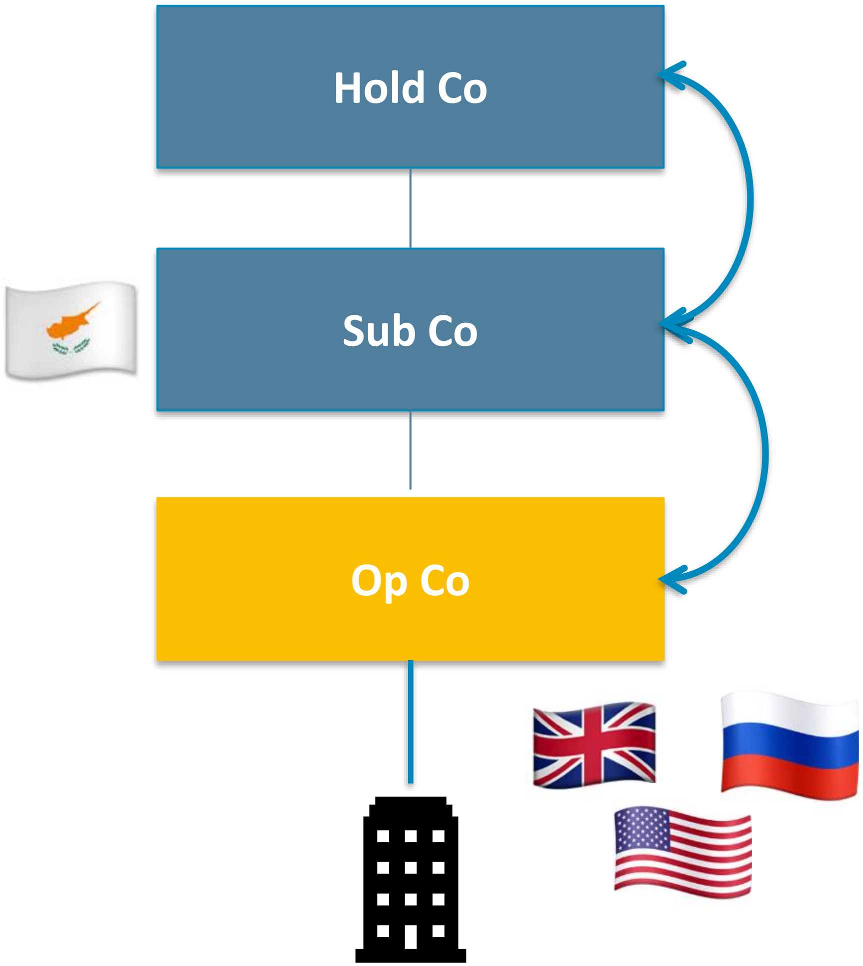
  - Economic models calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan – e.g. default risk, liquidity risk, expected inflation or maturity. In some instances, economic models would also include elements to compensate the lender's operational expenses(10.105.)

DIFFERENT APPROACHES TO PRICING INTRA-GROUP LOANS

- Bank opinions

  - In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a "bankability" opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise. (10.107.)

BACK-TO-BACK ARRANGEMENTS



EXPECTED LOSS METHOD

- The expected loss model is considered to be more in line with the economics of lending businesses. A notion is similar to current financial institutions regulations such as Basel III.

- The arm's length principle for a financing company

    - asks a market-related interest rate (also known as risk remuneration)

    - and a proof that the group's financing company has the financial capacity to assume the loan's credit risk, and that it can support the financial consequences of the risk if it occurs. This financial capacity is referred to as the "equity-at-risk."

EXPECTED LOSS METHOD

- The valuation of expected loss method would estimate the value of the loan on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default.

- Three factors are relevant in analysing expected loss:
  - Probability of default
  - Exposure at default
  - Loss given default

- The loan could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).

EXPECTED LOSS METHOD

- The expected loss on a portfolio of loans represents the loss that must be accepted and priced, due to the nature of the loan activity.

- As a formula, we calculate expected loss as follows:
  - Expected Loss (EL) = Probability of Default (PD) x Loss Given Default (LGD) x Exposure at Default (EAD)

- EL equals multiplying the chance of default by what is lost in the case of default and the exposure at the default.

- Expected loss tends to be considered as a percentage of loss, on which the exposure is applied to create an absolute number.

EXPECTED LOSS METHOD

- In simpler terms
  - PD: is based on the credit rating grade of the borrower (based on its financials, industry sector, and country credit risk)
  - LGD: is the fraction of the outstanding loan that is lost if the borrower defaults (collateral / seniority)
  - EAD: is the loan amount outstanding at the time of default (loan and interest re-/payment characteristics)

EXPECTED LOSS METHOD

- Key terms and conditions of the loans to be examined

Characteristics of the Loan	
Amount	Covenants
Interest rate	Currency
Start date	Guarantees
Maturity date	Interest payment frequency
Type of loan	Payment Options (on demand)
Purpose	Security/collateral
conversion	Seniority/Payment rank

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IMPORTANCE OF TRANSFER PRICING SUBSTANCE

CHRISTOS THEOPHILOU

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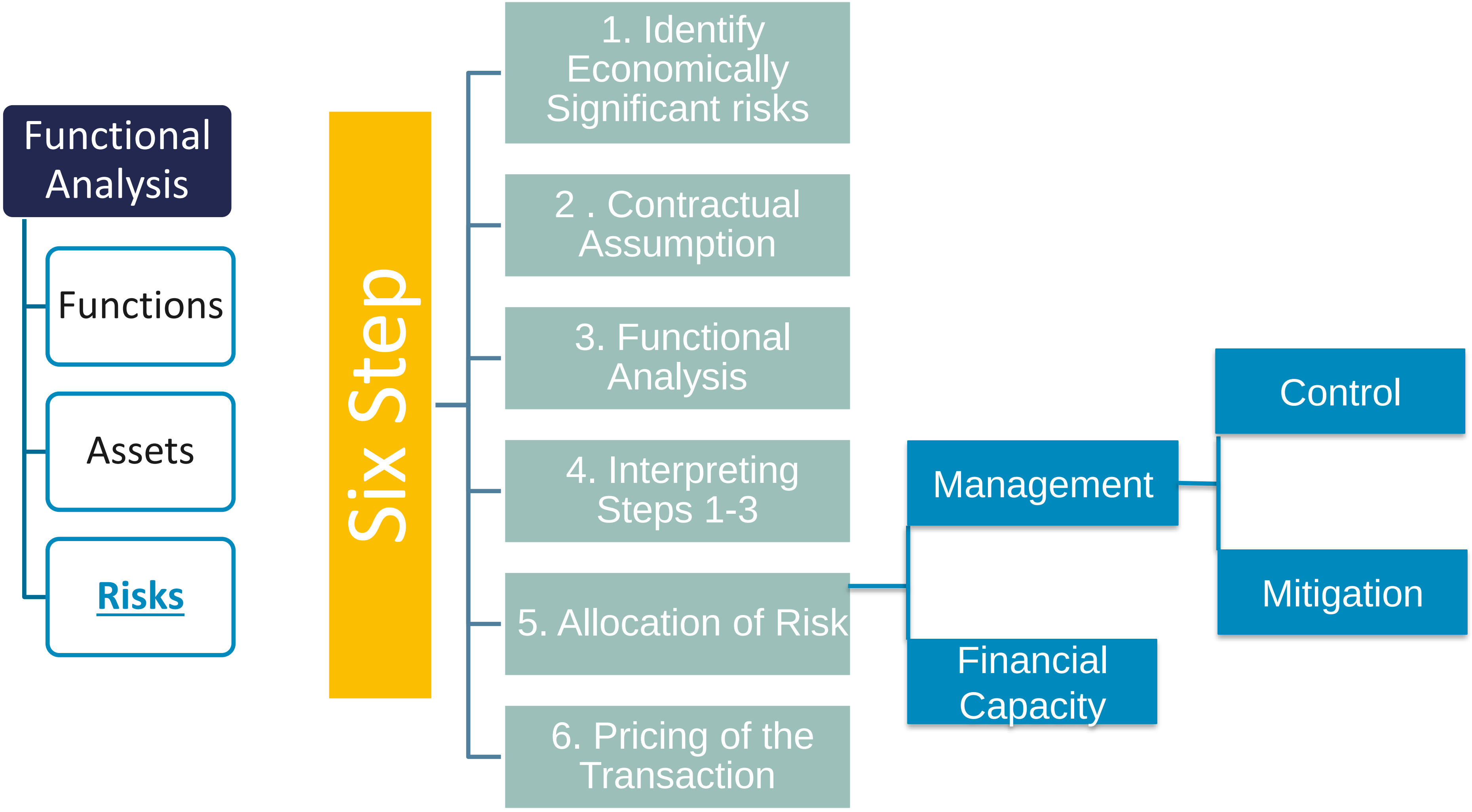
WHAT IS SUBSTANCE?

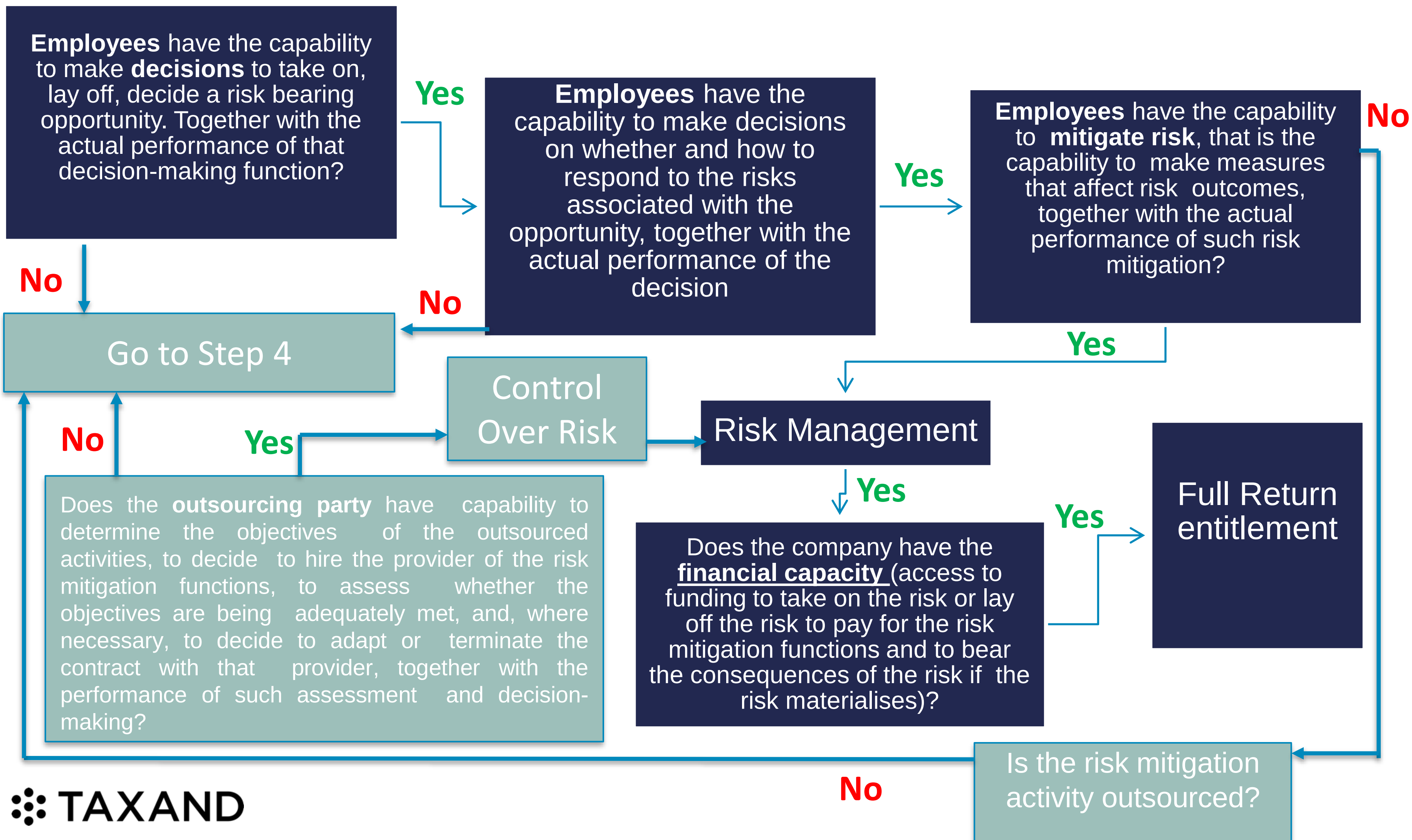
- Very important **but** is not a legally defined term in tax law.
- With respect to Transfer Pricing: certain combination of Function, Assets, Risk:
  - People perform Functions;
  - People create Intangibles; and
  - People manage Risks.
- Tax authorities tend to look on business reality, value chain and key people functions.

OVERVIEW OF 2017 OECD TPG: CHAPTER 1

NEW SIX STEP FRAMEWORK FOR PERFORMING A RISK ANALYSIS



SIX STEP ANALYSIS DECISION TREE



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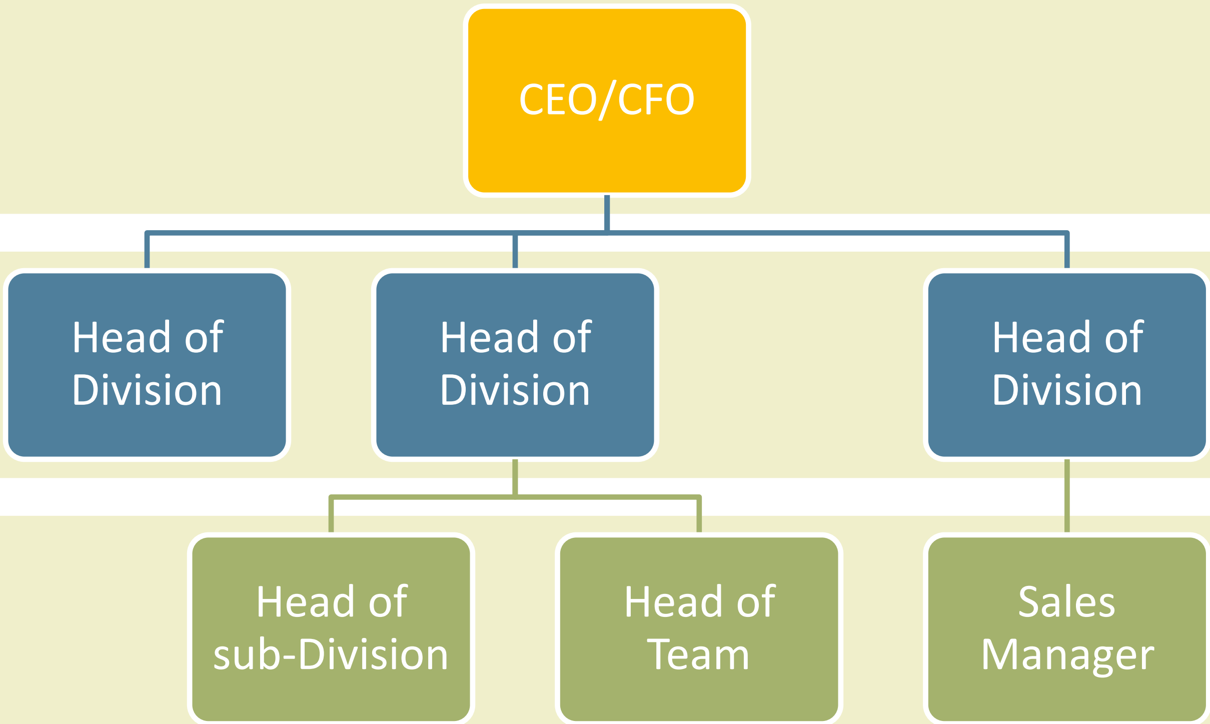
KEY PEOPLE/HIGH-VALUE FUNCTIONS

OVERSIGHT
No direct responsibilities

CONTROLLERS OF RISK
Key people who take strategic asset investment and risk management decisions

MANAGERS OF RISK (MIDDLE MANAGERS)
Key people who make day-to-day risk management decisions

SUPPORT ROUTINE IMPLEMENTATION
Operational Level



SIX-STEP FRAMEWORK FOR ANALYSING TRANSACTIONS INVOLVING INTANGIBLES

1. **Identify the intangibles** used or transferred in the transaction with specificity, and the economically significant risks associated with the **DEMPE** of intangibles

2. Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles

3. Identify the parties performing functions, using assets and managing risks related to the DEMPE of intangibles

4. Confirm consistency between the terms of the contractual arrangements and the conduct of the parties (allocation of risks)

5. Delineate the actual controlled transactions related to the DEMPE of intangibles

6. Determine arm's length prices for transactions consistent with each party's contribution of functions, assets and risks

QUESTIONS & ANSWERS

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COUNTRY PROFILE - EUROPE

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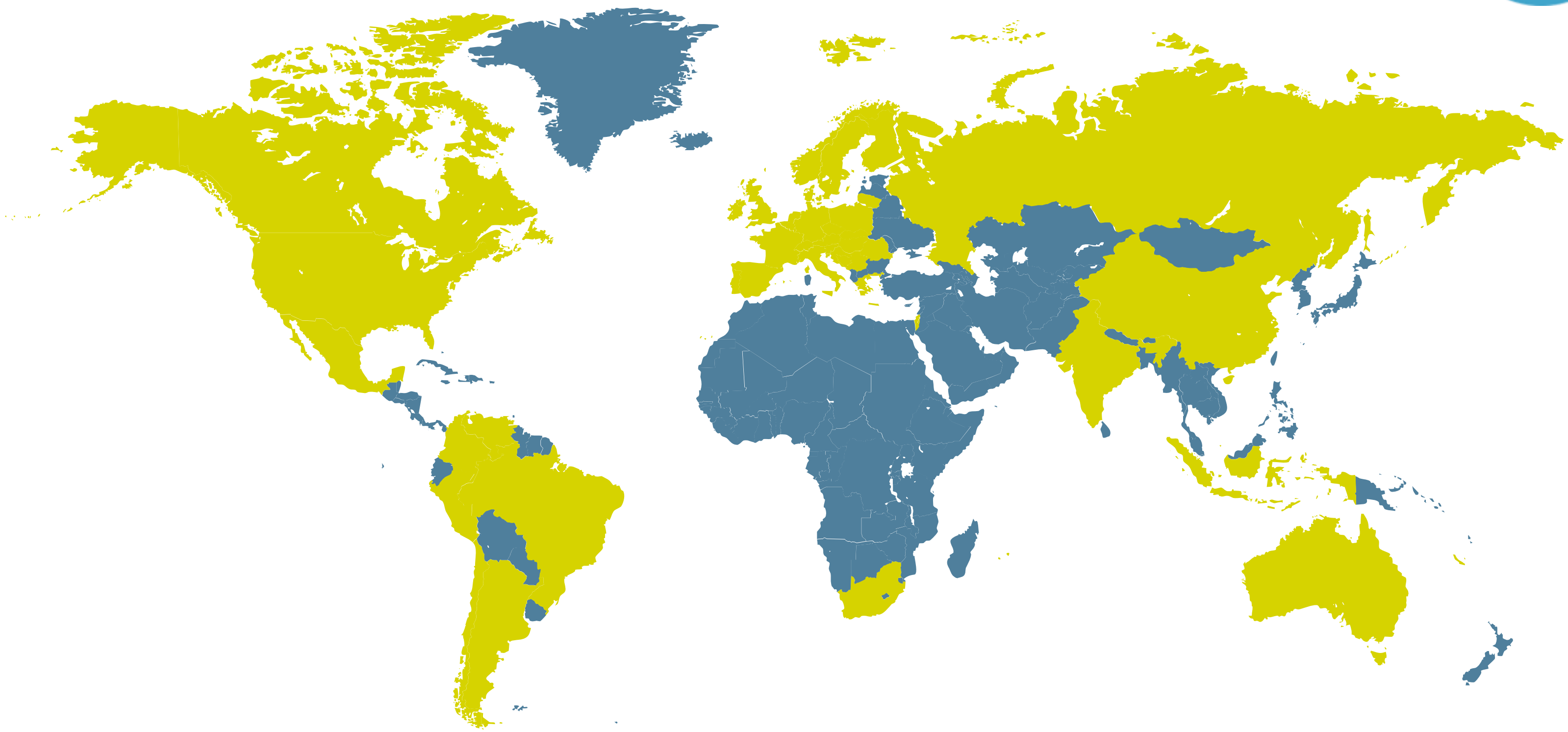
Their tax department specialises in international taxation and delivers a full advisory service across all aspects of corporate tax, individual tax, value added tax and customs, tax litigation, tax accounting, advance tax rulings, tax audits and tax compliance. They also advise their corporate clients on mergers, spin-offs, acquisitions (including due diligence), pre- and post-acquisition restructuring, reorganisations, (distressed) debt restructurings, joint ventures, structured finance, private equity, domestic and cross-border tax-planning and employee incentives.

GLOBAL COVERAGE



Argentina	Cyprus	Ireland	Netherlands	Singapore
Australia	Czech Republic	Israel	Norway	Slovakia
Austria	Denmark	Italy	Peru	Slovenia
Belgium	Finland	Japan	Philippines	South Africa
Brazil	France	Korea	Poland	Spain
Canada	Germany	Luxembourg	Portugal	Sweden
Chile	Greece	Malaysia	Puerto Rico	Switzerland
China	Hungary	Malta	Romania	UK
Colombia	India	Mauritius	Russia	USA
Croatia	Indonesia	Mexico	Serbia	Venezuela

ABOUT TAXAND

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