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INFLUENCE OF NEW TRANSFER PRICING RULES FOR FINANCIAL TRANSACTION IN CYPRUS ON THE BUSINESS ACTIVITY OF THE UKRAINIAN TAXPAYERS

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ВПЛИВ НОВИХ ПРАВИЛ ТРАНСФЕРТНОГО ЦІНОУТВОРЕННЯ ДЛЯ ФІНАНСОВИХ ОПЕРАЦІЙ НА КІПРІ НА БІЗНЕС-ДІЯЛЬНІСТЬ УКРАЇНСЬКИХ ПЛАТНИКІВ ПОДАТКІВ

У статті досліджено вплив нових правил трансфертного ціноутворення на Кіпрі на подальшу бізнес-діяльність українських платників податків. З'ясовано основні відмінності правил трансфертного ціноутворення на Кіпрі та міжнародно визнаних правил. Досліджено сутність трансфертного ціноутворення, категорії контролюваних господарських операцій, аспекти податкового контролю за трансфертним ціноутворенням. У статті розглядається сутність трансфертного ціноутворення та використання даного механізму для ухилення від сплати податків українськими компаніями. Визначено вади чинного механізму трансфертного ціноутворення та проаналізовано перспективи розвитку та поліпшення цього напрямку податкового регулювання.

The article examines the impact of the new transfer pricing rules in Cyprus on the further business activities of the Ukrainian taxpayer. The main differences between the rules of transfer pricing in Cyprus and the internationally recognized rules are revealed.

Ключові слова: трансфертне ціноутворення, позика, функціональний аналіз, «попередньо узгоджена маржа», оподаткування, бенефіціарний власник доходу.

Keywords: transfer pricing loan, functional analysis, pre-agreed minimum profit margin, taxation, beneficial owner.

Formulating the problem. Transfer pricing institute is relatively new for our country and the Republic of Cyprus, but the dynamics of its development holds the tone of auditors, financial directors, accountants and lawyers. Since the end of 2013, when the first norms were introduced, and to date, issues of transfer pricing have undergone changes that tend to be consistent with international standards, the extension of the range of persons subject to its regulation and changes in reporting requirements for the effects of controlled operations

Analysis of recent research and publications. Issues of transfer pricing were investigated in their works by both domestic and foreign scholars: K. Drury [1], S. Golov [2], L. Napadovskaya [3], and others. Transfer pricing is considered by scientists in two aspects. The first is an internal firm, under which transfer pricing is a very effective tool for intra-firm planning and management. The second one is tax, which is largely a consequence of the former. The tax dimension of transfer pricing for the Ukrainian and Cypriot economies is new, and therefore insufficiently researched.

Setting objectives. The purpose of the article is to study the practical impact of the new transfer pricing rules in Cyprus on the further business activities of the Ukrainian taxpayer.

Key material. Starting from 1 July 2017, the "pre-agreed" minimum profit margin (which ranged from 0.125 percent to 0.35 percent) on back-to-back loans is abolished. Back-to-back loan is a loan in which a Cypriot company acts as an intermediary that borrows funds to lend them to another borrower. The new TP rules require that the Cypriot companies perform a transfer pricing analysis, elements of which are already known to the Ukrainian taxpayers, such as the functional and risk analysis, selection of the TP method, benchmarking study, etc. Now the Cypriot taxpayers are required to prepare TP documentation to confirm the arm's length nature of their financial transactions.

TP rules for back-to-back loans used to be quite simple in Cyprus: if the taxpayer applies a pre-agreed margin, he will be fine. Now that the pre-agreed margin has been abolished, the international TP rules (namely, the arm's length principle) apply. At the same time, there remain a number of Cyprus-specific legislative provisions, which may differ from the generally accepted ones. Thus, the Circular 2016/15 issued by the Ministry of Finance clarifies the application of article 33 of the Income Tax Law. Article 33 - as amended in 2015 (L.187(I)/2015) (hereinafter – "Circular") provides for a simplified regime, not requiring the TP analysis and documentation. To apply this regime, a minimum return on assets of 2 percent after-tax is required. In our opinion, this indicator might be quite high for many Cypriot companies.

Circular - provides the definition of the arm's length principle for controlled transactions between associated enterprises. In particular, according to the above-mentioned article, if a taxpayer is resident in Cyprus or if there is a permanent establishment of a non-resident in the Republic then for any deviation from the arm's length price, downward adjustments are also possible. In other words, for intra-group transactions on terms that deviate from similar transactions between independent parties, the tax base may be adjusted in order to reflect an arm's length price.

According to paragraph 5 of the article 33, in case that a taxpayer's tax base is increased because of TP adjustments a notional expense for the other party in the transaction would be acceptable. The circular clarifies that the implementation of the article 33 (5) may be initiated by the taxpayer. In such a case of a documented TP adjustment, the tax authorities may accept the relevant adjustment and include not only notional revenue but also the corresponding notional expense for enterprises resident in Cyprus or for PEs of non-residents in Cyprus.

On the basis of TP documentation, taxpayers may request or propose relevant adjustment which will better reflect the arms' length principle. As a result, in the event of underestimating of the tax base cause by intra-group transactions, Cypriot enterprises may receive a compensating adjustment for the other party engaged in the said transaction.

The Ukrainian groups that received loans from Cypriot legal entities on 1 July 2017 or later. Consequently, during the TP analysis it is necessary to comprehensively assess the possible risks in all jurisdictions (i.e., both in the Ukraine and Cyprus). For example, the Cypriot tax authorities will obviously not mind above-the-market interest rates on loans granted by the Cypriot companies to the Ukrainian companies; however, in this case it will be difficult for the borrower in the Ukraine to prove that the transaction is at arm's length.

In addition, according to the Circular, in Cyprus (unlike many other countries), only certified auditors have the right to prepare a TP analysis.

Neither the Circular nor other regulations specify which approach should be used for the TP analysis of back-to-back financing to comply with the Cypriot TP rules. Based on the international practice, to which the Circular refers, there are several approaches to the analysis of back-to-back loans. Two main approaches can be distinguished: (i) analysis of the margin and (ii) an analysis of interest rates. With either approach, the company must have access to publicly available databases, which, in general, charge fees. The choice of approach depends on the results of the functional and risk analysis performed. In addition, in some cases, a Cypriot TP analysis will not suit the Ukrainian requirements and it would be necessary to perform a separate TP analysis for Ukraine.

The new Cypriot TP rules introduce an unprecedented approach to the calculation of equity level, required to cover the risks of a Cypriot company. This means that if a Cypriot company is a financial institution or performs similar functions, its equity level is expected to comply with the appropriate EU solvency requirements (criteria) for financial institutions. If the company does not perform functions comparable with those of the regulated financing companies (in our opinion, most Cypriot companies do not), it should propose an alternative model to calculate the equity level that would be sufficient to cover the risks associated with the provision of back-to-back loans.

Importantly, the Cypriot tax authorities have not clarified what method of calculating the required equity level should be applied to non-financial organisations. It is expected that the Cypriot tax authorities will adopt certain amendments in the autumn, regulating the choice of method for required equity level calculation.

The Circular introduces requirements to the Cypriot companies engaged in financial activities in terms of presence and availability of qualified staff that are able to control the transactions performed. The regulator allows using a subcontractor to perform this function, even if it requires daily oversight. On the other hand, the company (its directors and staff) must be able to set objectives for the subcontractor, make decisions on the selection of the subcontractor, assess whether the objectives are properly met and, most importantly, perform these functions themselves.

The Circular does not provide any details on this requirement, but, taking into account current trends in the international taxation and the Ukrainian practice, theoretical risks may soon materialize into practical requirements for the companies in different countries (not only in Cyprus). In Cyprus, we recommend (i) hiring the lacking personnel (financial managers) and reviewing the qualifications of directors (experience, education), (ii) reviewing the rules for meeting of directors and shareholders in Cyprus, (iii) renting a separate office, etc. Necessary to meet the requirements of the Cypriot tax legislation, it can prove important in terms of the Ukrainian legislation, too (to apply the reduced rates of repatriation tax upon payment of interest and meet the requirements to beneficial owners of income).

To be considered a beneficial owner of income in the Ukraine, two criteria must be met: the legal right to receive the income and the actual (unlimited) right of the company to dispose of it. When interest is paid, it is necessary to make sure that the company is not merely a conduit (i.e. a company that has no actual presence) and that the directors have and exercise their right to approve loans and dispose of income from them.

Conclusions. Ukrainian borrowers need to be sure that they will be able to confirm to the Ukrainian authorities the legal and actual right of the Cypriot lender to receive its Ukrainian-sourced income. Ukrainian borrowers need to be sure that they will be able to confirm to the Ukrainian authorities the legal and actual right of the Cypriot lender to receive its Ukrainian-sourced income. Otherwise, Ukrainian companies as tax agents risk significant fines. The new TP rules introduced in Cyprus are largely in line with the generally accepted international TP rules, but at the same time pose a number of specific requirements for the TP analysis. Therefore, it is very important to carefully prepare the TP documentation based on the new rules and requirements mentioned above.

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