

*Large enough to deliver - Small enough to care*

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## **Transfer Pricing**

***The best legal tool to reduce Multinational Enterprises' effective tax rate, increase cash flows and minimize transfer income adjustment risks.***

Transfer pricing (TP) refers to the pricing of contributions (assets, tangible and intangible, services, and funds) transferred within an organization. TP is a key element in tax planning, especially in international tax planning and can be used to shift revenues to countries with preferable tax regimes or to companies that can utilize accumulated losses. From a tax perspective, TP is a powerful and legal tool that can directly affect Multinational Enterprise's (MNE) effective tax rate (ETR). Consequently, most tax administrators, including Inland Revenue Cyprus, focus their audits on the pricing between **related<sup>1</sup> entities**.

TP regulations follow the 'Arms Length Principle', which states that the terms of a transaction between two related parties should be determined according 'market conditions', as if the transaction occurred between two unrelated companies. TP documentation requirements vary from country to country, but most TP regulations are based on the **OECD guidelines<sup>2</sup>**.

Failure to defend a TP policy during a transfer pricing audit might result in income adjustments, often retroactively, and result in double taxation on the same income. Some financial managers and tax consultants consider TP planning as a nuisance and that MNEs should deal with TP only upon tax authorities' request. According to such an approach, MNEs should only adhere to minimum requirements of TP compliance that is required in order to avoid penalties and double taxation. MNEs that follow such an approach miss on one of the most important planning tools within the realm of international taxation. Especially today, when income tax authorities are looking for more ways to increase tax inflows and become very sophisticated in their approach, TP, which is based on acceptable economic models, is one of the last areas that a tax planner could offer sound long term value with full disclosure of related party transactions.

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<sup>1</sup> For the purposes of this article, related with respect to companies means

- one company in the Republic participates directly or indirectly in the management or control or capital of another company, or
- the same persons participating directly or indirectly in the management, control or capital of two or more companies.

<sup>2</sup> Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 2001.

Despite the fact that Cyprus didn't publish TP regulations yet, as a location of many MNE headquarters, tax managers should rely on TP planning to minimize ETR and TP audit risks in their respective markets. TP planning can help increase the benefit of positioning MNE headquarters in Cyprus by shifting most revenues into Cyprus legally and with minimum risks. For example, a large MNE that has its African and Middle East headquarters in Cyprus is being asked to provide supporting documentation for its intercompany pricing by Pakistan, which published transfer pricing regulations.

To summarize, despite the absence of local TP regulation in Cyprus, MNEs with headquarters in Cyprus should consider TP planning as a vital part of their international tax planning.

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