Cyprus closes its IP Box. Or maybe not?

4 November 2016 – **Cyprus seemingly closed its Intellectual Property Box last month in order to fully comply from now on with the relevant OECD recommendations relating to BEPS Action 5. Things though may not be what they seem.**

The Cyprus Parliament voted on 14 October 2016 a number of amendments to the Cyprus IP Box and the relevant regulations have been scheduled to become effective within 30 days, unless amended.

The amendments do not materially affect the existing tax IP regime, which will be valid until the 30th of June 2021, nor do they alter the current effective tax rate of 2,5%. They actually introduce a new IP regime, which is based on the Modified Nexus Approach (see p.3) in calculating the amount of profits which will be subject to the 80% exemption.

The amendments to the Cypriot legislation concentrate on the application of this nexus approach and provide guidance on what constitutes a qualifying IP asset, qualifying income and qualifying expenditure. They further enhance the Cyprus position as a jurisdiction for research and development as businesses may benefit from the preferential regime within the framework agreed internationally.

Old Cyprus IP box closing and transitional rules put in place

The old Cyprus IP Box regime provided for an exemption from taxation of 80% of the gross royalty income following the deduction of all direct costs, such as amortization (over 5 years) and interest expense. In the case of a tax loss, only 20% of the tax loss can be surrendered to other group companies (under the group relief provisions) or be carried forward to subsequent years (subject to the 5 years rule restriction).

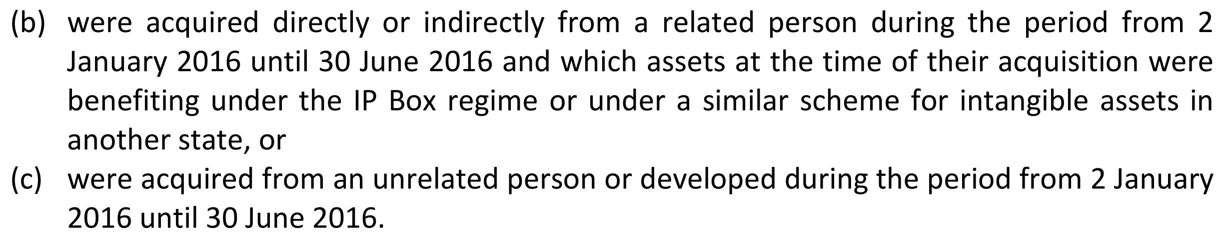
The 80% exemption applies also for any profit arising from the disposal of the IP.

The above provisions related to intangible assets which were defined in the Patents Law, the Trade Marks Law and the Intellectual Property Rights Law.

The amendments provide that the old Cyprus IP box regime closed as from 30 June 2016 (subject to transitional provisions explained below).

Transitional provisions have also been included for taxpayers who have entered the old IP Box regime. More specifically those taxpayers shall be able to continue to benefit from the application of the old IP regime until 30 June 2021, with respect to IPs which:

(a) were acquired before 2 January 2016; or



(b) were acquired directly or indirectly from a related person during the period from 2 January 2016 until 30 June 2016 and which assets at the time of their acquisition were benefiting under the IP Box regime or under a similar scheme for intangible assets in another state, or
(c) were acquired from an unrelated person or developed during the period from 2 January 2016 until 30 June 2016.

For intangible assets which were acquired directly or indirectly from a related person during the period from 2 January 2016 until 30 June 2016 and which do not fall under the above provisions, a transitional period until 31 December 2016 will apply.

The income qualified for the application of the current IP Box regime now includes embedded income and income from intangible assets for which only economic ownership exists.

IMPORTANT: Only intangible assets which as at 30 June 2016 have either generated income or their development has been completed, will qualify for the transitional rules.

New Cyprus IP Box regime

The new Cyprus IP box applies as from 1 July 2016. An 80% deduction is provided for qualifying profits relating to a qualifying IP. Accordingly, in effect, only 20% of the qualifying profits will be taxed at the rate of 12,5%. A taxpayer may elect not to claim all or part of the available 80% deduction for a particular tax year. Qualifying tax losses in the new Cyprus IP box are restricted to 20% of their amount.

(a) Qualifying IP assets

Based on the newly voted provisions qualifying intangible asset means an asset which was acquired, developed or exploited by a person in furtherance of his business, which is the result of research and development activities and includes intangible assets for which only economic ownership exists.

The new provisions restrict qualifying IP assets to patents, computer software, as well as IP assets which are non-obvious, useful and novel and from which the income of a taxpayer does not exceed, in a 5 year period, €7.500.000 per annum (€50.000.000 for taxpayers forming part of a Group). The later should be certified by a competent Cypriot or foreign authority

Further, qualifying IP assets under the nexus approach do not cover trademarks including brands, image rights and other intellectual property rights used for the marketing of products or services.

(b) Qualifying income

Qualifying profits are determined under the OECD BEPS Action 5 nexus approach.

Qualifying income includes, but is not limited to the following:

- royalties or other amounts in connection with the use or license of qualifying intangible assets;
- any amount received from insurance or as compensation in relation to the qualifying intangible asset;
- gains relating to the disposal of qualifying intangible asset;
- embedded income of qualifying intangible asset.

(c) The modified nexus approach and qualifying expenditure

The "modified nexus approach" provides that there should be sufficient substance and an essential nexus between the expenses, the IP assets and the related IP income in order to benefit from a new Cyprus patent box regime.

The following formula has been introduced to determine the qualifying profits that can benefit from an IP regime relating to a qualifying asset:

[(Qualifying expenditure + Up-lift expenditure)/Total expenditure] x Overall IP Income

Qualifying expenditure include among other expenses wages and salaries, general expenses relating to installations used for research and development and expenses for supplies related to research and development activities.

Qualifying expenditure, excludes though the R&D costs of outsourcing to related parties, contrary to the cost of outsourcing to unrelated parties which are considered as part of 'qualifying expenditure", the cost of the acquisition of intangible assets and costs which cannot be directly connected to a specific qualified IP asset.

In addition an up-lift expenditure equal to the lower of

(i) 30% of the eligible costs, or
(ii) the total amount of the cost of acquisition and outsourcing to related parties for research and development in relation to the eligible intangible asset

will be added to the qualifying expenses.

(d) Accounting records

Proper books of account and records of income and expenses must be kept for each intangible asset for which a benefit is claimed under the new regime.

(e) Non-qualifying assets for the IP Box regime

Expenditure of acquiring a non-qualifying intangible asset in accordance with the new rules or which does not qualify for the transitional provisions and the asset is used in furtherance

of the business of the taxpayer can be amortized over the period of its useful life (maximum of 20 years) in accordance with the accepted accounting principles.

Upon sale of this intangible asset, a balancing statement must be prepared. This is the same treatment as when a fixed asset is sold.

Goodwill does not qualify for amortization.

A further update will be provided once the details of the regulations are approved by the Parliament.

The Department of Taxation of Costas Tsielepis & Co Ltd is at your disposal for advice on how to set up your future intellectual property structure in the most tax efficient manner possible.