The Cyprus Patent Box: A new beginning or an end?

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Intellectual Property (IP) is progressively becoming one of the most important assets for multinational and global corporations, especially given the significance of a 'brand'. Choosing the appropriate tax jurisdiction for the development, holding and exploitation of IP assets is very important for businesses in order to achieve IP protection and reduction of tax leakages.

Currently, the Cyprus IP tax regime provides for an 80% exemption on the income derived from the exploitation of the IP as well as on any profit relating to the disposal of such IP.

Intangible assets are those defined in the amended Patent Rights, Trademarks and Intellectual Property laws.

The net profit is calculated after deducting from the royalty income all direct expenses associated with the production of such income.

The rate of capital allowances of such IP was set at 20% on the cost of acquisition/development of such IP.

Example

Cost of IP: €1.000.000
Royalty income: €700.000
Direct costs: €300.000
Other administration expenses (not directly related to IP): €25.000

Tax computation	**€**
Royalty income	700.000
Direct costs	(300.000)
Capital allowances	(200.000)
Gross profit	200.000
80% exemption	(160.000)
Other administration expenses	(25.000)
Taxable profit	15.000
Tax at 12,5%	1.875
Effective Tax Rate	0,27 %

Action 5

In an effort to respond to the critics of the international competition in nexus-free patent boxes, the Organization for Economic Co-operation and Development (OECD) in conjunction with the G20 published a detailed report, the Action 5 of the Base Erosion and Profit Shifting (hereinafter “BEPS”) Action Plan.

Based on this detailed report, on 30 December 2015 the Cyprus Ministry of Finance announced an amendment to the current IP tax regime, which should be finalized and enforced by the end of June 2016 at the latest.

It is expected that the said amendment will include OECD’s recommendations contained in Action 5 as well as the Conclusions of the ECOFIN Council adopted on 8 December 2015.

The approach of Action 5 is based on the substantial activity requirement i.e. it requires the existence of a direct nexus between the income receiving benefits and the activity contributing to that income.

What does it mean?

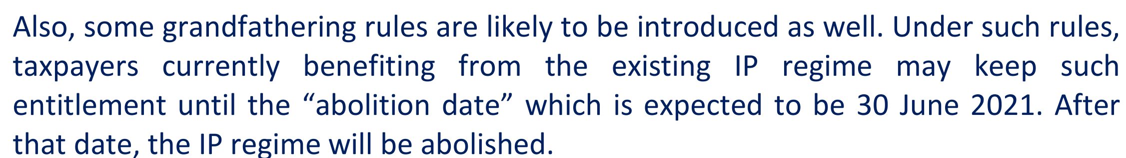
This means that benefits (i.e. the reduced tax rate) can only apply to income arising from IP where the actual R&D activity will be undertaken by the taxpayer itself. It may also be accepted that taxpayers that outsourced a portion of the R&D activity to a third party may still enjoy the benefits of the reduced tax rate. Capital contribution or expenditure on substantial R&D activity by someone other than the taxpayer will mean that income arising from that activity will not qualify for the benefits.

One parameter of the modified nexus approach is that taxpayers may have to track and trace R&D expenditure. This is expected to be a complicated exercise, especially where the IP will be transferred from the existing IP regime, which does not require tracking, to the new IP regime.

Another parameter of Action 5 is that there should be no new entrants to the existing IP tax regime after the date that a new regime consistent with the modified nexus approach takes effect and no later than 30 June 2016.

“New entrants” are expected to include both new taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the regime.

It is further anticipated that new entrants are expected to be only those that fully meet all substantive requirements of the new IP regime and have been officially approved by the tax authorities, if required. Therefore, new entrants may not include taxpayers that have only applied for the new IP regime (i.e. through a ruling).



Also, some grandfathering rules are likely to be introduced as well. Under such rules, taxpayers currently benefiting from the existing IP regime may keep such entitlement until the "abolition date" which is expected to be 30 June 2021. After that date, the IP regime will be abolished.

Guidance on the definition of qualifying IP is also likely to be included either in the amendment provisions of the tax law or through a Circular to be issued by the Commissioner of Taxation. Under the modified nexus approach the only IP assets that could qualify for benefits under an IP regime are patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes, where such processes are relevant. It is further noted that the modified nexus approach explicitly excludes from receiving tax benefits marketing-related IP assets such as trademarks. However, it is not yet clear whether Trademarks will indeed be excluded from the updated Cyprus IP tax regime.

Action Plan

Based on the above, at the time of writing this article, there is limited time for new IP players to benefit from the current IP regime, since it (and all similar foreign regimes) will be closed to new entrants from 30 June 2016. Taxpayers already enjoying the tax benefits offered by the current IP regime may still benefit from it until mid-2021.

It is, therefore, recommended that taxpayers with IP assets or income emanating from such assets to consider the option of entering and benefiting from the favorable Cypriot IP regime while the window of opportunity is still open, and that 'new entrants' seek specialized tax advice in order to effectively plan for the future.