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Changes to the Cyprus "Intellectual Property Box"

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In October 2016 the Cyprus Parliament passed a law amending the Income Tax Law of 2002 fulfilling their commitment to modify the Cyprus IP box in order to conform with the modified nexus approach.

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I. Introduction

In October 2016 the Cyprus Parliament passed a law amending the Income Tax Law of 2002 in order to bring its provisions on taxation of income from the use or sale of intangible assets into line with the "modified nexus" approach.

This approach, which was agreed by G-20 leaders late in 2014 and subsequently adopted by the OECD and the EU, allows taxpayers to benefit from an intellectual property ("IP") taxation regime, commonly known as an IP box, only to the extent that they can demonstrate material relevant activity, including a clear connection between the rights which create the IP income and the activity which contributes to that income.

Countries whose IP regimes were incompatible with the modified nexus approach were required to take steps to amend them. No new entrants to non-compliant IP regimes were permitted after June 30, 2016. However, "grandfathering" arrangements were permitted, allowing taxpayers already in such schemes to continue to benefit from them until June 30, 2021.

The Ministry of Finance announced in January 2016 that it would be taking steps to modify the Cyprus IP box in order to conform with the modified nexus approach. The new law, Law 118(I) of 2016, fulfils this commitment. Regulations issued under the law, which will have retrospective effect from July 1, 2016, provides detailed guidance in the calculations and application of the new regime.

II. Transitional Arrangements for Intellectual Property Assets Developed Prior to June 30, 2016

The original IP box regime, which was introduced in 2012, provides for 80 percent tax exemption of income from and gains on disposal of a wide range of intangible assets. Coupled with Cyprus's low corporate income tax of 12.5 percent, it reduces the effective rate of tax on such income to 2.5 percent or less.

Taxpayers already benefitting from the existing scheme may continue to claim the same benefits until June 30, 2021, subject to restrictions regarding assets acquired between January 2, 2016 and June 30, 2016 from related parties. Such assets will qualify for benefits only until the end of the 2016 tax year, unless at the time of their acquisition they were benefiting under the Cyprus IP box regime or under a similar scheme for intangible assets in another state.

Qualifying income is now extended to include embedded income arising from the sale of products directly related to the IP asset and income derived from intangible assets for which only economic ownership exists. Taxpayers will also be able to opt whether to benefit from the IP box regime on a year-by-year basis.

In addition, any gain arising on the disposal of an IP asset that would qualify under the provisions of the new regime but had not previously benefited will be completely exempt from tax. Prior to this amendment,

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80 percent of any capital gain was exempt. However, in practice, it was possible to achieve full exemption of capital gains on all intangible assets by transferring the ownership of the intangible assets to a company and selling the shares in the company.

III. New Arrangements for Intellectual Property Assets Developed from July 1, 2016

The arrangements for assets developed after July 1, 2016 comply with the modified nexus approach in that the range of qualifying assets and the scope of eligible expenditure are more restricted. Qualifying assets are restricted to patents, software and other IP assets which are legally protected. IP rights used to market products and services, such as business names, brands, trademarks and image rights, do not fall within the definition of qualifying assets. Relief is geared to the cost incurred by the taxpayer in developing the IP through research and development activities. Costs of purchase of intangible assets, interest, costs relating to the acquisition or construction of immovable property and amounts paid or payable directly or indirectly to a related person are excluded from the definition of eligible expenditure.

As was the case under the existing scheme, 80 percent of the overall profit derived from the qualifying intangible asset is treated as deductible expense, preserving the effective tax rate of less than 2.5 percent on such income.

A. Qualifying Persons

Qualifying persons include Cyprus tax resident companies and individuals, tax resident permanent establishments of non-tax resident persons and foreign permanent establishments which are subject to tax in Cyprus. The amending law also allows the taxpayer to elect for a foreign permanent establishment to be taxable in Cyprus so that it can be classified as a qualifying person.

B. Qualifying Assets

Qualifying assets ("QA") are assets acquired, developed or exploited by a taxpayer in the course of its business which relate to IP, result from research and development expenditure and of which the taxpayer is the economic owner, excluding any IP relating to marketing.

Qualifying assets include patents as defined in the Patent Law, computer programs, utility models, IP assets which provide protection to plants and genetic material, orphan drug designations and patent extensions, as well as other intangible assets protected by law and certified by a competent authority in Cyprus or overseas as being non-obvious, useful and novel, where the person who exploits these intangible assets in the course of its business does not earn revenue of more than 7.5 million euros per year from them averaged over five years. For a group of companies, the revenue limit is 50 million euros per year.

Trade names, brands, trademarks, image rights and other IP used for the marketing of goods and services do not fall within the scope of qualifying assets.

C. Qualifying Profits

Qualifying profits ("QP") are calculated in accordance with the formula:

$$QP = OI \times (QE + UE) \div OE$$

Where:

- OI is the overall income derived from the QA;
- QE is the qualifying expenditure on the QA;
- UE is the uplift expenditure on the QA; and
- OE is the overall expenditure on the QA.

Overall income derived from the QA is defined as the gross profit from the QA, that is, the gross income less any direct expenditure. The amending law includes the following non-exhaustive list of examples:

- royalties or any other amounts receivable in relation to the use of the QA;
- any amount receivable for the grant of a license to exploit the QA;
- any amount relating to the insurance or compensation of the QA;
- trading income from the disposal of the QA; and
- embedded income derived from the sale of goods, services or use of any processes directly related to the QA.

Capital gains arising from the disposal of a QA are not included in overall income and are wholly exempt from tax.

Qualifying expenditure on a QA is the sum of all research and development expenditure which was incurred, in any tax year, wholly and exclusively for the development, enhancement or creation of the QA and which is directly related to the QA. Qualifying expenditure is included in the calculation of qualifying profits in the year that it is incurred, regardless of the accounting treatment.

Qualifying expenditure includes, but is not limited to:

- wages and salaries;
- direct costs;
- general expenses associated with R&D activities;
- commission expense associated with R&D activities; and
- R&D expenditure outsourced to non-related parties.

The following categories of expenditure are explicitly excluded:

- cost of acquisition of any intangible asset;
- interest;
- expenditure relating to the acquisition or construction of immovable property;
- any amount paid or payable to a related party, regardless of whether it is under a cost sharing agreement; and
- costs which cannot be demonstrated to be directly associated with a specific QA.

The regulations allow expenditure on R&D activities carried out by non-related persons, and expenditure of a pure research nature that cannot be specifically allocated to a QA, to be allocated proportionately to the QAs or products concerned.

Uplift expenditure ("UE") is the total acquisition cost of the QA plus any R&D costs outsourced to related parties, or 30 per cent of the qualifying expenditure, whichever is the lower.

Overall expenditure ("OE") on the QA is the total of qualifying expenditure and the total acquisition cost of the QA and any R&D costs outsourced to related parties incurred in any tax year.

For the purposes of the calculations:

- direct costs include all the expenditure incurred, whether directly or indirectly, wholly and exclusively for the production of the overall income;
- any deduction allowed under Article 33(5) of the Income Tax Law by way of a corresponding transfer pricing adjustment in respect of the development or sale of a QA is treated as a direct expense; and
- any notional interest deduction under Article 9B of the Income Tax Law which is attributable to a QA is considered as an indirect expense for the purposes of calculating the qualifying profit.

IV. Other Amendments

The new law also introduces capital allowances for all intangible assets other than goodwill and assets qualifying for the existing IP regime. The capital cost of the assets will be tax deductible, spread over the useful life of the asset in accordance with generally acceptable accounting principles, with a maximum useful life of 20 years, and a balancing allowance or a balancing charge on disposal of the asset.

In addition, relief under Articles 35 and 36 of the Income Tax Law in relation to relief from double taxation will not be allowed if the taxpayer has chosen to claim losses in accordance with Article 13(9).

V. Conclusion

The transitional arrangements secure the existing generous benefits for IP developed before June 30, 2016 until June 30, 2021. While the range of assets and the categories of expenditure qualifying for relief after July 1, 2016 are more restricted than under the previous rules, Cyprus's IP box still represents a very attractive option for taxpayers, with an effective tax rate of less than 2.5 percent on qualifying income.

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