Cyprus adopts intellectual property rights "box"

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In the wake of similar moves by other European jurisdictions, Cyprus has announced plans to introduce an ''IP Box'' to protect investment in R&D. The following article considers the proposals.

The package of measures to promote economic growth adopted by the Cyprus House of Representatives in late May 2012 included the introduction of tax incentives aimed at boosting the island's predominantly service-oriented economy. The most notable of these is a series of incentives and exemptions relating to income from intellectual property rights, commonly known as an intellectual property rights box ("IP Box").

The IP Box concept has already been successfully implemented in other EU member states including Luxembourg, the Netherlands, Ireland and most recently the United Kingdom. The underlying rationale is to stimulate a flow of investments into the research and development sector by providing tax incentives to the private sector. Although the financial benefits of successful investment in R&D generally accrue to the private sector, which funds it, the benefits of successful innovation are enjoyed by the public at large and for this reason states are inclined to encourage investment in R&D.

Intellectual property projects are ideal for cross-border planning by reason of the mobility of intellectual property rights, which do not consist of tangible assets and can therefore be easily migrated between different jurisdictions and tax systems according to prevailing circumstances and developments in different tax jurisdictions. By amending its tax legislation Cyprus hopes to consolidate its position as a hub for the cross-border holding and exploitation of intellectual property rights.

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The amendments to the Income Tax Laws are effective from January 1, 2012 and apply to all expenditure for the acquisition or development of intangible assets incurred by a person carrying on a business, including the rights set out in the Patent Law of 1998 as amended, the Intellectual Property Rights Law of 1976 as amended and the Trademarks Law, Cap. 268 as amended. The amendments effectively apply to all categories of intellectual property.

The main changes are summarised below.

I. Five year amortisation period

Following the amendments, the cost of acquisition or development of an IP right acquired by a Cyprus company ("CyCo") may be capitalised and amortised on a straight line basis over five years, giving an annual writing down allowance of 20 per cent.

This is a considerable improvement on the previous regime, in which amortisation rates were determined by reference to the estimated useful life of the underlying asset. For example, if a patent had a validity of 20 years its useful life would be deemed to be 20 years and the writing down allowance would be 5 per cent per annum.

The acceleration of writing down allowances will result in substantial cash flow benefits by reason of the deferral of tax liabilities, especially where the value of the IP asset is substantial.

II. 80 per cent exemption of profits from exploitation of IP rights

Four-fifths of the profit earned from the use of intangible assets (including any compensation for improper use) is disregarded for tax purposes.

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Furthermore, any dividend income generated out of royalty income earned by a CyCo and paid to its non-resident shareholders is fully exempt from Cyprus tax of any description. As such, there is minimal tax leakage in Cyprus in the context of a structure involving a CyCo generating royalties under licensing or similar arrangements with third parties and subsequently distributing profits in the form of dividends to its shareholders.

III. 80 per cent exemption of profits on disposal of IP rights

Four-fifths of any profit resulting from the disposal of relevant intangible assets is disregarded for tax purposes.

However, in most cases a more beneficial result from the taxpayer's viewpoint can be achieved by holding the assets concerned in a separate company and disposing of the shares in that company, rather than the assets themselves. This option, which is discussed more fully below, would result in full exemption of the gain, as well as stamp duty savings, since gains on disposals of qualifying securities (which includes shares) are exempt from all forms of taxation in Cyprus except to the extent that they derive from the disposal of immovable property located in Cyprus.

> "It is possible to acquire IP rights for development purposes and subsequently effect a tax free exit by disposing of the shares in the IP Owner"

IV. Overall, an effective tax rate of less than two per cent, the lowest by far in the EU

The amount subject to tax under the new rules is calculated after deducting the amortisation of the assets, interest costs of financing the acquisition or development of the assets and any other direct expenses, and dividing the resultant amount by five. Applying the Cyprus corporate income tax rate of 10 per cent, the lowest in the EU, produces an effective tax rate of two per cent of the net income. Given that generous deductions are available against gross income, the effective rate should generally be well below two per cent, as the example at the end of the article shows.

This rate compares very favourably with Cyprus's main competitors: the United Kingdom's optional new "patent box" regime introduced in the Finance Bill 2012 and applicable from 1 April 1, 2013 (but not fully operational until 2017) gives an effective rate of 10 per cent on relevant income. The Luxembourg and Netherlands schemes are somewhat better, with effective tax rates of 5.76 per cent and 5 per cent respectively, but they are both considerably less beneficial than Cyprus.

V. Advantages and savings compared to the earlier regime

A. Tax and economic advantages

Before the new rules were enacted, a Cyprus licensing arrangement would typically be structured as follows:

1. a company in a low or no tax jurisdiction (the "IP Owner") was established and maintained with the sole purpose of acquiring and owning IP rights;
2. the IP Owner would then license the use of its IP rights to a CyCo which would be set up for the purpose of acting as an intermediary licensing vehicle;
3. CyCo would sub-license the right to exploit the IP rights to another entity, usually registered and tax resident in a country with a double tax treaty with Cyprus;
4. the royalty fees charged by the IP Owner would usually be equal to approximately 90 per cent of the royalty income generated by CyCo leaving a 10 per cent margin subject to Cyprus tax.

Following the introduction of the IP Box, there is no longer a need for a separate IP Owner since CyCo itself can now become the IP Owner with substantial tax savings and planning opportunities.

B. Enhancing legal and jurisdictional protection, eliminating unnecessary costs and red-tape

The new rules will not only result in substantial economic and tax saving opportunities but will also remove unnecessary bureaucracy and reduce administrative and compliance costs. Under the new rules, a CyCo can hold the IP asset and enter into licensing agreements with entities located in jurisdictions accessible to low withholding tax rates, whether via a double tax agreement or the EU Interest and Royalties directive, which provides a uniform tax regime for royalties paid throughout Europe. Cyprus has an ex-

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tensive network of double tax treaties and is also a member of the EU, giving Cyprus resident companies the benefits of the Interest and Royalties directive. Cyprus is therefore an ideal location for the establishment and maintenance of the IP Owner which will generate royalty income that will be substantially exempt from taxation in Cyprus. There will no longer be any need to maintain a structure involving entities in several jurisdictions, with the costs that that entails.

C. From a "Low Tax" to a "No Tax" disposal of the IP asset

While the new rules make it possible to secure 80 per cent exemption of gains on disposal of an intellectual property asset, another option would be to dispose of the shares in the IP Owner rather than the underlying assets. This option would give 100 per cent exemption, since the disposal of securities is free from all forms of tax in Cyprus except to the extent that any gain derives from immovable property situated in Cyprus. There is no minimum holding time or participation percentage threshold to qualify for exemption. Furthermore, no stamp duty would be payable on the transaction itself.

This, combined with the fact that the acquisition or contribution of the IP asset to the share capital of CyCo in the first place can be effected in a tax efficient way without any tax payable in Cyprus, makes such a structure highly attractive from a tax viewpoint.

In summary, it is possible to acquire IP rights for development purposes and subsequently effect a tax free exit by disposing of the shares in the IP Owner. This option becomes even more attractive when combined with a Cyprus International Trust which can act as the shareholder of the IP Owner (see below).

VI. Using a Cyprus International Trust as a shareholder and financier of the CyCo IP Owner

A Cyprus international trust receiving dividends from a CyCo IP Owner (the ultimate source of which is royalty income generated by CyCo) will not be subject to any form of taxation in Cyprus. At the same time, the trust can accumulate income which can be converted into capital at the year end without any Cyprus tax consequences for the trust or the beneficiaries of the trust (to the extent that no beneficiary is a Cyprus tax resident).

The Cyprus International Trust can also provide interest-bearing finance to the IP Owner for the purpose of acquiring the IP Asset or for working capital.

The interest expenses of CyCo under such financing arrangement will be tax exempt in the hands of the trust while being deductible in the hands of CyCo, which optimizes the structure even further from a tax perspective.

VII. The Russian "Monetka" case in the context of the new law

Under the Cyprus-Russia double tax treaty and in particular Article 12(1), royalties paid to Cyprus from Russia do not suffer any form of withholding tax in Russia as long as the double tax treaty requirements are met.

On May 17, 2012 the Federal Arbitrazh Court of the Urals District in Russia issued its long awaited ruling in Trading House "Monetka", a high profile intellectual property case in Russia with a substantial Cyprus tax element which attracted a good deal of attention.

> "As from January 1, 2012 the Cyprus company can act as the owner of the trademark and the royalties can be paid direct to the owner"

The facts of the case are as follows. Element-Trade LLC, a company incorporated and resident in Russia, exploited the trademark MONETKA and paid royalties to a Cyprus company acting as an intermediary licensing vehicle. The Cyprus company paid the royalties it received to the ultimate owner of the trademark, a British Virgin Islands company.

The Russian tax authorities contended that this structure was introduced purely for the purpose of avoiding withholding taxes on royalties paid from Russia to a company in the British Virgin Islands, which is on the Russian Ministry of Finance's blacklist of tax havens, by routing the royalties through Cyprus.

The decision of the court was in favour of the taxpayer, but nevertheless the case is a wake up call for taxpayers to take note that the Russian tax authorities are becoming increasingly methodical in preparing and proving their claims and that they are particularly intolerant of structures which lack substance.

The recent changes in Cyprus remove one area of vulnerability from the taxpayer's point of view, namely the need for a British Virgin Islands company and an

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intermediate "conduit". As from January 1, 2012 the Cyprus company can act as the owner of the trademark and the royalties can be paid direct to the owner. This greatly enhances the infrastructural substance of the structure and reduces the risk of a successful challenge by the tax authorities. Management substance issues will also have to be taken into account so as to ensure that double tax treaty relief will remain intact.

VIII. VAT dimension

The acquisition of intellectual property rights from anywhere in the world by a Cyprus company is treated as a service rendered to the company which will create an obligation for it to register for VAT and to account for VAT on services received in accordance with the reverse charge rule. Other things being equal, no registration obligation will be created if the intellectual property right is developed organically rather than being purchased.

If the company charges royalty fees to taxable persons within the European Union area it will also have to register for VIES.

IX. Conclusion

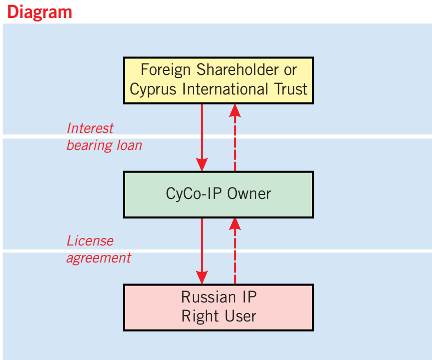
In most cases immediate economic and tax savings can be accomplished by transferring intellectual rights currently held by entities located in low or no tax jurisdictions to Cyprus resident companies in order to take advantage of the new exemptions. The transfer of IP rights into a Cyprus company will not attract any form of taxation in Cyprus and the new benefits and substantial exemptions will become available as soon as the asset is transferred.

The new regime provides very attractive opportunities for structuring the exploitation of IP assets through Cyprus and in particular through the use of Cyprus-resident IP Owners, especially in the context of Cyprus's extensive network of double tax treaties under which the withholding tax rate on royalty income is either eliminated altogether or substantially reduced.

EXAMPLE
Interest expense: USD100
Royalty income: USD1,000
IP acquisition cost: USD1,500
- Fully deductible interest costs
- Dividends paid by CyCo to its shareholder fully tax exempt- No withholding tax on interest payments to foreign shareholder
- Five year amortisation (20 percent allowance per year)
- Royalty income: 80 percent exempt
- No Russian withholding tax on royalty payments to Cyprus (Cyprus-Russia Double Tax Treaty)

Calculation of CyCo's taxable base for Year 1:
Royalty income USD1000 – USD300 (20 percent Amortisation) =**USD700**
Minus interest expense of USD100 = **USD600**
Minus 80 percent deduction: USD600 – 80 percent (USD480) = **USD120**
Calculation of CyCo's tax obligation for Year 1:
10 percent corporate tax on USD120 = **USD12.00**
Effective tax rate for Year 1

Diagram



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