Cyprus: The New Intellectual Property (IP) Tax Regime in Cyprus

On 14 October 2016, the House of Representatives passed amendments to the Income Tax Law in order to align the current Cyprus IP tax legislation with the provisions of Action 5 of the OECD's Base Erosion and Profit Shifting (BEPS) project. The amendments apply retroactively, as from 1 July 2016.

The revised legislation includes certain transitional provisions for IP assets that have already qualified under the existing IP box regime. In such cases, taxpayers will continue to benefit from the existing IP regime for a maximum of five years, after which date the new IP tax regime shall apply.

Under the new regime, **80% of qualifying profits generated from qualifying assets will be deemed to be tax deductible.** Cyprus IP companies can achieve **an effective tax rate up to 2,5% on qualifying profits earned from exploiting qualifying IP**.

"Qualifying intangible asset" means an asset which was acquired, developed or exploited by a person in furtherance of his business, (excluding intellectual property associated with marketing) and which is the result of research and development activities and includes intangible assets for which only economic ownership exists.

These assets are:

a) Patents as defined in the Patents Law
b) Computer Software
c) Other IP assets which are legally protected and they fall under one of the following:
   - utility models, intellectual property assets which provide protection to plants and genetic material, orphan drug designations and extensions of protections for patents
   - nonobvious, useful, and novel, where the person which utilizes them in furtherance of a business does not generate annual gross revenues exceeding Euro 7.500.000 (in case of a group of companies not exceeding Euro 50.000.000), which are certified as such by an Appropriate Authority in Cyprus or abroad

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Qualifying intangible assets specifically exclude:

a) Trademarks
b) Business Name
c) Brands
d) Image Rights
e) Other intellectual property rights used for the marketing of products and/or services.

Qualifying profits are calculated based on the "nexus approach". More specifically, the level of profits eligible for the 80% tax exemption will depend on the level of R&D expenditure carried out by the taxpayer to develop the qualifying asset. The qualifying profits are calculated based on the following fraction that captures this:

$$\textbf{QP = OI multiplied by } \frac{(QE + UE)}{OE}$$

Whereby:

QP: Qualifying Profit
OI: Overall Income
QE: Qualifying Expenditure
UE: Uplift Expentiture
OE: Overall Expenditure

In detail:

Overall Income (OI): is defined as the gross income derived from qualifying intangible assets during the tax year less any direct costs incurred for generating the income.

Cyprus: The New Intellectual Property (IP) Tax Regime in Cyprus

Gross income including, but is not limited to the following in relation to the qualifying asset:

a) Royalties or any other amounts relating to the use of qualifying assets
b) Any amount for the grant of a license for the exploitation of the qualifying assets;
c) Any amount relating to the insurance or compensation of the qualifying assets
d) Trading income from the disposal of the qualifying asset;
e) Embedded income on qualifying assets, which is derived from the sale of goods, the provision of services or use of any processes that are directly related to the qualifying assets. Capital gains arising from the disposal of a qualifying asset under the new IP regime are not included in qualifying profits and are fully exempt from income tax.

Direct costs refer to:

a) All generally allowable costs incurred wholly and exclusively for the generation of gross incomes
b) Amortisation of the cost of the assets (over the life of IP, with a max of 20 years)
c) Notional Interest Deduction (NID) associated with the qualifying asset

Capital gains arising from the disposal of a qualifying asset under the new IP regime are not included in qualifying profits and are fully exempt from income tax.

Qualifying Expenditure (QE) is the total of all research and development (R&D) costs incurred directly related to the qualifying asset during the tax year and exclusively for the development, improvement or creation of qualifying intangible asset.

Cyprus: The New Intellectual Property (IP) Tax Regime in Cyprus

Qualifying expenditure including, but is not limited to:

a) Wages and salaries
b) Direct costs
c) General expenses relating to installations used for research and development
d) Commissions relating to research and development
e) Research and development costs outsourced to non-related parties

Qualifying expenditure does not include:

a) The acquisition cost of a specific intangible assets
b) Interest paid or payable
c) Cost for acquisition or construction of immovable property
d) Amounts paid or payable directly or indirectly to a related person to conduct R&D activities, regardless of whether such amounts relate to cost sharing agreements
e) Costs that cannot by directly linked to the qualifying asset.

Any expenditure for R&D that has been outsourced to non-related parties, any expenses of a general nature for R&D which cannot be allocated to the qualifying expenditure of a specific qualifying intangible asset, can be apportioned pro rata to the qualifying intangible asset.

Uplift Expenditure (UE): is added to the qualifying expenditure, which will be equal to the lower of:

a) 30% of QE or
b) The total costs of acquiring the qualifying asset plus the cost of outsourcing to related parties of any research and development

The purposes of the up-lift is to ensure that the nexus approach does not penalise taxpayers excessively for acquiring IP or outsourcing R&D activities to related parties.

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Overall Expenditure (OE): relating to qualified intangible assets is defined as the sum of:

a) The qualifying expenditure and
b) The total cost of acquiring the qualifying asset plus the cost of outsourcing to related parties of any research and development costs outsourced to related parties incurred in any tax year.

Calculation of taxable profit

80% of the overall profit derived from the qualifying intangible asset is treated as deductible expense. Every year the taxpayer may elect not to claim the whole or part of this allowance.
In the case of a resulting loss, only 20% of the loss can be surrendered to other group companies or be carried forward to subsequent years.
Qualifying taxpayers that are eligible for the IP regime include Cyprus tax resident persons, permanent establishments (PEs) of non- resident person and foreign PEs that are subject to tax in Cyprus.
Persons claiming benefit from the new intellectual property provisions are obliged to maintain proper books and recodes, as well as proper, full documented books of incomes and expenses for each intangible asset.

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Illustration – Application of New IP Box – "Nexus Approach":

A company has acquired a qualified asset on the 1st of January 2017 (after the 1st July 2016).

You are provided with the following information:

Cost of acquisition	€ 500,000
Royalty income associated with qualifying intangible	€ 2,800,000
Research and development cost outsourced to non-related parties	€ 500,000
Research and development cost outsourced to related parties	€ 300,000
Generally directly associated allowable expenses linked with income	€ 150,000
Wages and salaries linked to R&D	€ 200,000
Amortisation	5 years

Solution:

Overall Income is: **€ 2,550,000**

Qualifying Expenditure *is:* **€ 700,000**

Uplift Expenditure is: **€ 210,000**

Overall Expenditure is: **€ 1,500,000**

⇨ QP = OI multiplied by $\frac{(QE + UE)}{OE}$ = **€ 1,547,000**

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- ⇨ *A 80% deemed deduction is granted to* Qualifying *Profits is € 1,237,600*

As a result of the above, the taxable profit will be decreased by €1,237,600 as "deemed deduction".

CALCULATION OF CORPORARION TAX

Net Profit	*€ 1,550,000*
less Deemed Deduction (80% on Qualified Profits)	*(€ 1,237,600)*
Taxable income	*€ 312,400*
12.50%	*39,050.00*
Effective Tax Rate:	**3%**