

## THE NEW CYPRUS IP BOX REGIME

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On 14 October 2016, the House of Representatives enacted into law amendments to the Income Tax Law (ITL) which provide for:

- (a) the gradual phase out of the current IP regime, and
- (b) the introduction of a new IP regime that is fully aligned with the parameters of the relevant OECD recommendations of Action 5 plan on fighting base erosion and profit shifting (BEPS) as well as the new EU rules on the subject.

### **Phase out of the current IP regime (Grandfathering provisions)**

The legislation includes transitional provisions for persons who have entered the existing Cyprus IP box regime, enabling them to continue claiming the benefits of the legislation up to 30 June 2021 for qualified intellectual property rights which:

- (a) Were acquired before 2 January 2016;
- (b) Were acquired directly or indirectly from a related person during the period 2 January 2016 to 30 June 2016 but at the time of acquisition these intellectual property rights were enjoying the benefits of the Cyprus or other IP box regime;
- (c) Were acquired from an unrelated person or have been internally developed during the period from 2 January 2016 to 30 June 2016.

There are transitional provisions to continue to apply the IP box provisions for acquisitions from related parties made during the period 2 January 2016 to 30 June 2016 only up to 31 December 2016 which do not fall under the above categories. The conditions are that the intangible assets qualifying are those which at 30 June 2016 either generated income or their development has been completed.

Under the existing IP Regime (which was introduced in Cyprus in 2012), an 80% exemption is applied on the Net Profits arising from the exploitation of intangible assets as these are defined in (a) The Patents Law, (b) The Trade Marks Law and (c) the Intellectual Property Rights Law. Specifically, the exemption is applied on the result deriving from the deduction from the IP income generated of all the directly related expenses linked to it and the deduction of a 20% capital allowances.

In connection with the Cyprus' Corporation Tax, the existing IP regime allowed for an effective taxation of maximum 2.5%.

## The New Cyprus IP Box Regime

The amendments to the Income Tax Law do not provide for a change to the current effective tax rate of 2.5% as provided under the current IP regime, but rather focus on the application of a “nexus approach” for calculating the amount of income, expenditure and profits on which the 80% tax exemption is calculated (qualifying income/expenditure/profits) and the definition of the IP assets qualifying for the new IP regime (qualifying assets). Finally the new legislation provides guidelines for maintaining accounting records.

### QUALIFYING ASSETS

Qualified intangible assets are intellectual property assets acquired, developed or exploited by a person in advancement of his business and which is the result of research and development activities and includes intangible assets for which only economic ownership exists. Specifically qualifying intangible assets **include**:

- (a) Patents
- (b) Computer software
- (c) Other IP assets which are legally protected and they fall under one of the following:
  - a. Non-obvious, useful and unique, utilized in the business of a person for the generation of taxable income which does not exceed annual gross revenues of € 7.500.000 (€50.000.000 for taxpayers forming part of a Group) and which are certified as such by an appropriate authority in Cyprus or abroad. For the purposes of the above calculation, an average of 5 years is used.
  - b. Utility models, intellectual property assets which provide protection to plants and genetic material, orphan drug designations and extensions of protections for patents,

but **exclude** trademarks, image rights, brands, business names and other relevant intellectual property rights used to market products and services.

### QUALIFYING PROFITS

The qualifying profits are calculated based on the so called **Nexus approach**, according to which **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 patent box regime. Under the nexus approach, the profits that are eligible to the IP regime depend on the R&D expenditure incurred on the development of the qualifying asset.**

The following formula, which is the one used under BEPS, has been introduced to determine the **qualifying profits** that can benefit from the new Cyprus IP regime:

$$\text{Overall income from IP Assets} \times \frac{\text{Qualified Expenditure for developing IP Asset}}{\text{Overall expenditure incurred to develop IP Asset}}$$

Under the new Cyprus IP regime, 80% of the qualifying profits as these are calculated using the above formulae, are deemed to be a tax 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.

#### ***Overall Income:***

The gross profit derived from the qualifying assets, being the gross income generated less any directly related expenses.

Gains on the disposal of a qualifying asset do not fall within the scope of the definition of overall income and are fully exempt from income tax.

#### ***Qualifying Expenditure***

The sum of all the research and development costs incurred exclusively for the development of the qualifying asset in any tax year, which are also directly related to that asset.

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

- Wages and salaries
- Direct costs
- General expenses relating to installations used for research and development
- Expenses for supplies related to research and development activities
- Costs associated with research and development that has been outsourced to non-related persons

In addition, an 'uplift expenditure' is included to the above qualifying expenditure costs which is defined as the lower of:

- the 30% of the qualifying expenditure, and
- the total acquisition cost of the qualifying asset plus any R&D costs outsourced to related parties.

The below expenditures are not considered as qualified expenditure:

- Cost for the acquisition of intangible assets
- Interest paid or payable
- Costs relating to the acquisition or construction of immovable property

- Amounts paid or payable directly or indirectly to a related person to contact research and development activities, regardless of whether these amounts relate to cost sharing agreement
- Costs which cannot be proved directly connected to a specific illegible intangible asset.

For the purposes of calculating the nexus fraction:

- Direct costs include all the expenditure incurred directly or indirectly, wholly and exclusively, for the production of the overall income.
- Any corresponding transfer pricing adjustment which is derived from the development or sale of a qualified asset is treated as a direct expense.
- Notional interest on equity contributed to finance the development of the qualifying intangible asset, is considered as an indirect expense for the purposes of calculating the profit.

### *Overall Expenditures*

The sum of any expenditure falling within the qualifying expenditure definition above, and the total acquisition cost of the qualified assets and any R&D costs outsourced to related parties incurred in any tax year.

### *Qualifying taxpayers*

Qualifying tax payers include a Cyprus tax resident person, a permanent establishment (PE) of a non-tax resident persons as well as a foreign PE which is subject to tax in Cyprus.

## **FOREIGN PERMANENT ESTABLISHMENT (PE)**

Amending provisions have been introduced to ensure that the taxpayer can elect whether a foreign PE is taxable in Cyprus, so that the PE can be classified as a qualifying taxpayer.

Under the modified nexus regime, foreign PEs of Cyprus tax resident companies engaged in R&D activities and which have been elected by the taxpayer as taxable in Cyprus, give rise to “qualified expenditure”. It should be noted that such an election is irrevocable. In the instance where the profits of the foreign PEs are taxed abroad, a unilateral tax credit relief will be afforded in Cyprus, up to the amount of the tax payable in Cyprus on such profits.

## **OTHER AMENDMENTS RELATING TO INTANGIBLE ASSETS**

The amendments also introduce capital allowances for all intangible assets (excluding goodwill and assets qualifying for the existing IP regime). In accordance with these amendments, the capital costs of the assets will be tax deductible (as a capital

allowance) and will be spread over the useful economic life of the asset, as determined by generally acceptable accounting principles (with a maximum useful life of 20 years).