

Intellectual Property (IP) Tax Regime – Old and New

Introduction

In May 2012 Cyprus introduced a package of incentives and tax exemptions relating to investment in IP rights, commonly known as the IP Box Regime (**Old IP Box Regime**). IP projects lend themselves to cross-border tax planning by reason of the mobility of IP rights, which do not consist of physical assets and so can easily be moved between different jurisdictions and tax systems according to prevailing circumstances.

This tax regime provides for favourable tax treatment in relation to income generated from any type of qualifying intellectual property rights, patents and trademarks as well as providing for generous capital allowances for acquisition and development of such rights.

In October 2016, the House of Representatives has voted amendments to the IP Box Regime, introducing a new regime (**New IP Box Regime**) which brings the legislation in Cyprus with regards to the taxation of Royalties, in full compliance with the guidelines and requirements of the OECD BEPS Action 5 and within the new EU rules. This ensures stability in the methodology of calculating taxes on royalties and therefore enables investors to plan accurately for the future.

It is also important to state that the New Law, under some conditions, gives the opportunity for those that were benefiting from the **Old IP Box Regime** to continue to benefit as until the end of June 2021.

The amendments to the IP Box Regime are effective as from 30th of June 2016.

The Old IP Box Regime

In accordance to the **Old IP Box Regime**:

- i) **Royalty Profits:** 80% of **Royalty Profit** generated from **Qualifying IP Rights** will be considered as a deemed expense for corporation tax purposes. The remaining 20% will be subject to the normal corporation tax rate of 12,5%.

For the purpose of determining the "**Royalty Profit**" the law requires the deduction from the resulting royalty income of all expenses incurred wholly and exclusively for the production of royalty income.

- ii) **Sale of a Qualifying IP Right**: The possible profits generated from a future sale of a **Qualifying IP Right** will also enjoy the above favourable tax treatment. In effect 80% of the profit from the sale of the **Qualifying IP Right** will be considered as a deemed expense and only the remaining 20% will be subject to the normal corporation tax rate. This provision is of significant importance as it provides to the owners of the IP Rights a tax efficient exit route for the future.
- iii) **Acquisition/Development Capital Allowances**: The Cyprus IP Holding Company will be able to write off the capital expenditure made on the acquisition or development of such Qualifying IP Rights in the first five years of use. The company will be able to receive capital allowances of 20% straight line, starting from the first year of the use of the asset, as well as the subsequent four years of usage. These capital allowances are considered of course, tax deductible, which makes the tax benefits of the first five years even more attractive. In effect, the tax rate applicable on the Cyprus IP Holding Company can be lower than the maximum effective rate of 2.5% as it can be further reduced by the deduction of the above capital allowances.

In order for a Cyprus IP Holding Company to benefit from the above favourable tax regime it must satisfy certain conditions. These conditions are analysed in more detail below:

1. **Qualifying IP Right**

According to the Tax legislation, any intangible asset that is protected by the following laws of Cyprus will be considered as a Qualifying IP Right for the purposes of the favourable tax regime:

a) **Patent Law**

Patents and Innovations are protected:

- In Cyprus through the Patent's office of the Department of the Registrar of companies and Official Receiver which is the responsible body to examine an application and to issue national patent certificates.
- At European Level, pursuant to the European Patent Certificate issued by the European Patent Office.
- Internationally, by the International Patent Certificate issued by the World Intellectual Property Organisation (WIPO) under the provisions of the Patent Cooperation Treaty of which Cyprus is a signatory.

b) **Trademark Law**

Similarly with Patents, the three aforementioned ways of protection are available and recognised in Cyprus when it comes to trademarks:

- Protection of a Trademark at National level is achieved by registration with the Trademarks' office of the Department of the Registrar of Companies and Official Receiver, under the provisions of Trademarks Law Cap. 268.

- Protection of a Trademark at European level is achieved by virtue of the EU Regulation 207/2009 of 26/02/2009 on the Community Trademark and EU Regulation 6/2002 of 12/12/2001 on the Community Design registration.
- Protection at International level is achieved through the Paris Treaty on the Protocol of Industrial Property as administered by WIPO and by the Madrid Protocol which affords global protection of trademarks, service marks and designs

c) Intellectual Property Law

Copyright is a recognised and protected intellectual property right, even though there is no system of copyright registration in Cyprus as copyright vests in works automatically.

- Protection of Copyrights at National level is achieved by the Intellectual Property Law N.59/1976 (IP Law), according to which following works of intellectual property are protected by copyright:
 - Scientific works;
 - Literary works, including computer programs;
 - Musical works;
 - Artistic works, including photographs of any type;
 - Films;
 - Databases;
 - Sound recordings;
 - Broadcasts and
 - Publications of previously unpublished works.
- At international level, Cyprus is a signatory of the Bern Convention of 1886 (Literary and Artistic Works) as well as the Rome Convention (Performance, Production and Broadcasting). Both Conventions have been transposed into the Cyprus legislation. It follows that, copyright in works which is protected by the said international treaties is automatically recognised and protected in Cyprus.

2. Ownership of the Qualifying IP Rights

In order for a Cyprus IP Holding Company to qualify under the scheme it must be the owner of the Qualifying IP Right. The ownership might come through acquisition of an existing IP Right or through the internal development of the IP Right. It is worth mentioning that the acquisition of an already existing IP right can be done not only with cash but it can also be acquired as a contribution in exchange of shares. For example a Cyprus company can increase its share capital and allot the new shares to the owner of the IP right. The owner of the IP right will contribute the IP Right as a full settlement for the shares allotted, avoiding therefore any cash outflow for the group. In such situations, it is suggested that a valuation of the Qualifying IP Right is obtained from a qualified valuer, in order to be able to justify, when and if required, the amount of capital allowances calculated on the value of the IP Right as explained in Section B.3 above.

3. Use of the Qualifying IP Right

The Cyprus IP Holding Company should use the Qualifying IP Right for the production of taxable income. This means that the IP Right should be licensed to other parties in exchange for royalty income.

Grandfathering Rules

As stated above, the amendments to the Law provide that persons will continue to benefit from the **Old IP Box Regime** until the 30th of June 2021 provided that the Qualifying IP:

- a. Was acquired/qualified in the **Old IP Box Regime** before 2 January 2016.
- b. Was acquired directly or indirectly from a related person during the period from 2nd of January 2016 until 30th of June 2016 and which asset:
 - At the time of acquisition qualified or was already benefiting under the IP Box Regime or under similar scheme of another member state, or,
 - Was not acquired with main or one of the purpose the avoiding of taxes
- c. Was acquired from unrelated person or developed during the period from 2nd January 2016 until 30th of June 2016.

A **Qualifying IP Right** that was acquired directly or indirectly from a related person during the period from 2nd of January 2016 until 30th of June 2016 and does not meet the above grandfathering rules, will continue to benefit from the **Old IP Box Regime** a shorter transition period until 31st of December 2016.

The New IP Box Regime

Based on the **New IP Box Regime**, which is fully compliant with international developments relating to the tax treatment of IP income and recommendations under the OECD's BEPS project, the arrangements for assets developed after 1st July 2016 comply with the modified nexus approach, as a consequence 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 in the **New IP Box Regime**. 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. Further explanations are given below:

1. Qualifying Persons

Qualifying Persons include Cyprus tax resident companies and individuals, tax resident permanent establishments (PEs) of non-tax resident persons and foreign permanent establishments (PEs) 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.

2. Qualifying Assets

Qualifying Assets ("QA") are those acquired, developed or exploited by a person in the course of its business and that relates to IP, are a result of R&D expenditure and for which the person is the economic owner, excluding any IP relating to marketing (trade names, brands, trademarks, image rights).

Qualifying Assets include patents as defined in the Patent Law (as explained in **Old IP Box Regime** above), computer programs, utility models and all assets as defined in Intellectual Property Law (as explained in **Old IP Box Regime** above), 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.

In comparison to the **Old IP Box Regime**, 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**.

3. Qualifying Profits

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

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

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 ("OI") 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 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 QA.

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

Qualifying expenditure ("QE") relating to a qualifying asset is the sum of all R&D expenditure incurred in any tax year wholly and exclusively for the development, enhancement or creation of a qualifying asset and that is directly related to that asset. 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 expenditure associated with R&D activities; and
- R&D expenditure outsourced to unrelated parties.

Qualifying expenditure does not include:

- The acquisition cost of a specific intangible asset;
- Interest paid or payable;
- Expenditure relating to the acquisition or construction of immovable property that has been paid or is payable directly or indirectly to a related person carrying out R&D, regardless of whether the amounts relate to a cost sharing agreement;
- Costs that cannot be shown to be directly associated with a specific qualified asset.

Expenditure for the assignment of R&D activities to unrelated persons, as well as the expenditure of general and theoretical nature for R&D, that cannot be allocated to the qualifying expenditure of a specific qualified asset with which they have a direct connection, may be allocated proportionately to the qualified assets or products. Qualifying expenditure is included in the nexus fraction in the year in which the expenditure was incurred, regardless of its accounting or tax treatment.

Uplift expenditure ("UE") of a qualified asset is the lower of:

- i) The total acquisition cost of the qualifying asset plus any R&D costs outsourced to related parties, and
- ii) 30% of the Qualifying Expenditure

Overall expenditure ("OE") of a qualifying asset is the sum of:

- i) Qualifying Expenditure, and
- ii) The total acquisition cost of the qualifying asset 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 that arises from the development or sale of a qualifying asset is treated as a direct expense; and
- Any notional interest deduction under Article 9B of the Income Tax Law which is attributable to a qualifying asset, is considered as an indirect expense for the purposes of calculating the Qualifying Profit.

The taxpayer may choose to forego all or part of the deduction and, where the calculation of Qualifying Profits results in a loss, only 20% of the loss may be carried forward or group relieved under the Income Tax Law.

4. Other changes relating to intangible assets

The amendments to the ITL also include the introduction of capital allowances for all intangible assets (except goodwill and assets qualifying for the **Old IP Box Regime**). As a result, the capital costs of such intangible assets will be tax deductible and will be spread over the useful economic life of the asset, as determined by generally acceptable accounting principles (up to a maximum useful life of 20 years). Upon the disposal of such an intangible asset, a balancing statement will need to be prepared with any balancing addition/charge being subject to income tax and any balancing deduction/allowance being tax deductible. The taxpayer has the option not to claim capital allowances for such intangible assets in a particular tax year.

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).

Other Points

1. Where the intangible asset qualifies for both the **Old IP Box Regime** and the **New IP Box Regime**, the **Old IP Box Regime** will apply until that Regime is fully phased out.
2. Cyprus is signatory to the following international conventions relevant to IP:
 - European Community Trademarks
 - Convention Establishing the World Intellectual Property Organisation (WIPO)
 - WIPO
 - The Madrid Agreement Concerning the International Registration of Marks (the Madrid Agreement) and Protocol to the Madrid Agreement
 - The Patent Cooperation Treaty
 - Berne Convention for the Protection of Literary and Artistic Works
 - Paris Convention for the Protection of Industrial Property
 - Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of Their Phonograms
 - WIPO Performance and Phonograms Treaty
 - Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations
 - Trademark Law Treaty
 - WIPO Beijing Treaty on Audiovisual Performances

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