

The Intellectual Property (IP) box regime in Cyprus

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Introduction

On 14 October 2016, the House of Representatives passed amendments to the Income Tax Law in order to align the 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 included certain transitional provisions for IP assets that had already qualified under the previous IP box regime. In such cases, taxpayers continued to benefit from the existing IP regime for a maximum of five years, after which date the new IP tax regime applies.

Cyprus IP box regime tax benefit:

In essence, the Cyprus IP box regime offer a tax benefit of up to 80% on qualifying IP profit, by way of notional expense deduction.

Transitional arrangements (expired on 30 July 2021)

With a view to protect the owners of IP assets that had already qualified under the previous Cyprus IP regime, transitional provisions had been introduced in the legislation. According to these, taxpayers benefiting from the previous IP regime continued to apply its provisions, subject to certain conditions, until 30 June 2021 when the transitional provisions expired.

Provisions of the Cyprus IP box regime

The IP box regime complies with the provisions of the modified '**nexus approach**', whereby for an intangible asset to qualify for the benefits of the regime, there needs to be a direct link between the qualifying income and the own qualifying expenses contributing to that income.

In brief, an amount equal to 80% of the **qualifying profits** earned from **qualifying intangible assets** will be allowed as a tax deductible expense.

A. Qualifying intangible assets

As per the amended legislation, "qualifying intangible asset" is defined as an asset which was acquired, developed or exploited by a person within the course of carrying out his business (with the exception of intellectual property related to marketing), which is the result of research and development (R&D) activities, and which includes intangible assets for which only economic ownership exists.

Qualifying intangible assets comprise of:

- (a) patents, as defined in the Patents Law
- (b) computer software
- (c) other IP assets which are legally protected and fall within one of the following categories:
 - utility models, intellectual property assets which provide protection to plants and genetic material, orphan drug designations and extensions of protections for patents
 - non-obvious, useful and novel, where the person utilizing them in furtherance of a

business does not generate annual gross revenues in excess of €7,500,000 from all intangible assets (€50,000,000 in case of a group of companies), which are certified as such by an appropriate authority, in Cyprus or abroad

The definition of qualifying intangible assets **specifically excludes** business names, brands, trademarks, image rights and other intellectual property rights used for the marketing of products and services.

B. Qualifying profit

Qualifying profit (QP) is defined as the proportion of the overall income (OI) derived from the qualifying asset, corresponding to the fraction of the qualifying expenditure (QE) plus the uplift expenditure (UE) over the overall expenditure (OE) incurred for the qualifying intangible asset.

The amount of qualifying profit can be derived through the application of the following formula:

$$QP = OI \times \frac{QE + UE}{OE}$$

The relevant terms are explained in the next section.

Tax benefit:

For the purpose of calculating the taxable profit, **80% of the qualifying profit** derived from qualifying intangible assets **is treated as a deductible expense**. For each tax year, the taxpayer may elect to waive this allowance, either in part or in whole.

By the same token, in case where a loss is incurred, only 20% of this loss can be surrendered to other group companies or be carried forward to subsequent years.

C. RELEVANT TERMS EXPLAINED

(a) Overall Income (OI)

Overall income is defined as the gross income earned from qualifying intangible assets during the tax year, minus any direct costs incurred for generating the income.

Overall income includes, but is not limited to:

- royalties or other amounts resulting from the use of qualifying intangible assets
- license income for the operation of qualifying intangible assets
- any amount received from insurance or as compensation in relation to qualifying intangible assets
- income from the disposal of qualifying intangible assets, excluding profits of a capital nature
- embedded income of qualifying intangible assets arising from the sale of products or services, or from the use of procedures that are directly related to the assets

For the purpose of calculating overall income, direct costs include:

- all costs incurred, either directly or indirectly, wholly and exclusively for the purpose of earning the income from qualifying intangible assets
- the amortization of the cost of the assets

- notional interest on equity contributed to finance the development of the assets (being a notional interest tax deduction allowed by Cyprus tax provisions)

(b) Qualifying Expenditure (QE)

Qualifying expenditure for qualifying intangible assets is defined as the sum of all R&D costs incurred during any given tax year wholly and exclusively for the development, improvement or creation of qualifying intangible assets, and which costs are directly related to such assets.

Qualifying expenditure includes, but is not limited to:

- wages and salaries
- direct costs
- general expenses relating to installations used for R&D
- commission expenses associated with R&D activities
- costs associated with R&D that has been outsourced to non-related persons

However, qualifying expenditure does not include:

- costs for acquisition of intangible assets
- interest paid or payable
- costs for acquisition or construction of immovable property
- 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
- costs which cannot be proved directly connected to a specific qualifying intangible asset

Any expenditure for R&D that has been outsourced to non-related parties, as well as 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 assets.

(c) Uplift Expenditure (UE)

An uplift expenditure is added to the qualifying expenditure, which will be equal to the lower of:

- i) 30% of the qualifying expenditure; and
- ii) the total cost of acquisition of the qualifying intangible assets, plus the cost of outsourcing to related parties of any R&D activities in relation to such assets.

(d) Overall Expenditure (OE)

Overall expenditure relating to qualified intangible assets is defined as the sum of:

- i) the qualifying expenditure; and
- ii) the total cost of acquisition of the qualifying assets, plus the cost of outsourcing to related parties of any R&D activities in relation to these assets, incurred during any tax year.

D. Accounting records

Persons claiming benefits under the new regime are obliged to maintain proper books of account, as well as records of income and expenses for each intangible asset.

E. Intangible assets that do not qualify for the IP Box regime

Expenditure for the acquisition of an intangible asset that does not qualify for the IP box regime, and which asset is used in furtherance of the business, can be amortized over the asset's useful life, in accordance with accepted accounting principles, with a maximum period of 20 years.

As from 1 January 2020, taxpayers may elect not to claim capital allowances (or to claim part of them) in a given year. Any unused capital allowances can be carried forward and claimed over the remaining useful life of the asset.

Practical examples

To put things in perspective, we set out some numerical examples illustrating how, under the IP box regime, one would reach the QP stage on which 80% notional deduction would be applied.

The variable factors in the examples are:

- (a) whether the asset was **internally developed** or whether it was **acquired**, and
- (b) whether subsequent R&D costs were outsourced to **related parties** or to **third parties**.

The **scenarios** to be examined are as follows:

1. The asset was created/developed/improved **internally**, with R&D costs being undertaken by the company itself
2. The asset was **acquired**, with subsequent R&D costs for improvements of the asset being were outsourced to **non-related parties**
3. The asset was **acquired**, with subsequent R&D costs for improvements being outsourced to **related parties**

For the purposes of the examples, the following figures are used:

	<u>Scenario 1</u> <u>EUR</u>	<u>Scenario 2</u> <u>EUR</u>	<u>Scenario 3</u> <u>EUR</u>
<i>Overall Income (OI) from qualifying IP (after deduction of direct costs incurred for generating the income)</i>	1,000,000	1,000,000	1,000,000
<u>Overall Expenditure (OE)</u>			
- Cost of acquisition of asset	N/A	300,000	300,000
- R&D costs incurred internally for creation and development of the asset	500,000	N/A	N/A
- R&D costs for improvement of the asset, outsourced to non-related parties	N/A	200,000	N/A
- R&D costs for improvement of the asset, outsourced to related parties	N/A	N/A	200,000
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	<u>500,000</u>	<u>500,000</u>	<u>500,000</u>
<u>Qualifying Expenditure (QE)</u>			
- Internal R&D for creation and development of asset	500,000	N/A	N/A

- R&D for improvement of asset outsourced to non-related parties	N/A	200,000	N/A
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	<u>500,000</u>	<u>200,000</u>	<u>N/A</u>
<u>Uplift expenditure, being the lower of:</u>			
- 30% of the qualifying expenditure, and	150,000	60,000	0
- Total cost of acquisition plus cost of outsourcing R&D to related parties	0	300,000	500,000

Applying the above figures to the formula for calculation of the qualifying profit (QP) and the tax benefit of up to 80% as a notional deduction, we have:

	$QP = OI \times \frac{QE + UE}{OE}$	QP for 80% tax benefit	Tax benefit: 80% of QP as notional deduction
Scenario 1:	$€1,000,000 \times [(\text{€}500,000 + \text{€}0) / \text{€}500,000]$	€1,000,000	€800,000
Scenario 2:	$€1,000,000 \times [(\text{€}200,000 + \text{€}60,000) / \text{€}500,000]$	€520,000	€416,000
Scenario 3:	$€1,000,000 \times [(\text{€}0 + \text{€}0) / \text{€}500,000]$	€0	€0

As a result, the IP tax benefit will be:

Scenario 1:	Taxable profit will be decreased by €800,000 notional expense
Scenario 2:	Taxable profit will be decreased by €416,000 notional expense
Scenario 3:	No notional expense applies

Noting that:

In **scenario 1**, the entire amount of the overall income is considered to be qualifying profit, due to the fact that the development of the asset was carried out internally, and so were the subsequent R&D costs for improvement of the asset (it is noted that if the R&D costs were subcontracted to a third party, they would still have qualified).

On the other hand, in **scenario 2** (asset acquired) the amount of qualified profit is significantly lower, and in the case of **scenario 3** (asset acquired and R&D costs outsourced to related parties), none of the profit qualifies for the regime.

NOTES

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.