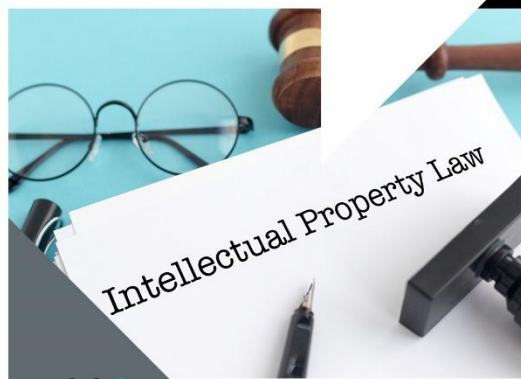




N. XENOFONTOS LLC

The Cyprus IP Box Regime: An Ideal Jurisdiction

INTELLECTUAL PROPERTY




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XENOFONTOSLLC.COM

A. Introduction

Companies owning intangible assets, such as patents, copyrights etc. often require an IP holding vehicle through which they will hold these assets, license them for the generation of royalty income and conduct their business activities.

Choosing the jurisdiction of such an IP holding vehicle requires careful consideration to make sure that there will be satisfactory asset protection, ideal environment for asset development, tax optimisation and flexibility in the legal framework that the structure will function in.

With the introduction of the Cypriot IP Box Regime in 2012 and the amendments that followed in 2016, the island has become one of the major players in the areas of intellectual property.

The benefits that the IP Box Regime can offer an international investor are set out below.

The IP Box Regime

The regime applies on Qualifying IP's that have been developed after the 1st July 2016. Certain conditions must be satisfied for the favourable tax regime to be benefited from.

According to the Regime, 80% of "Qualifying 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%. Thus, the Qualifying profits will have an effective tax rate of as low as 2.5%. The conditions of the IP Box Regime are analysed in more detail below.

Principal Features

80% deduction of profits on disposal of IP rights

Resulting from the disposal of relevant intangible assets is disregarded for tax purposes. This is a generous exemption compared to other regimes.

80% deduction of revenue from exploitation of IP rights

Four-fifths (80%) of the profit earned from the use of intangible assets is deducted for tax purposes. So, only 20% of IP income after deduction of the costs of earning the income, is taken into calculation. Therefore, applying to Cyprus corporate tax rate of 12.5%, which is among the lowest in the EU, provides the effective tax rate of 2.5%.

5-year repayment period

Capital expenditure related to IP acquisition or development may be deducted in the first tax year in which the expense was incurred as well as in the subsequent 4 years. That is, development or acquisition expenses are repaid over a period of 5 years. This in practice can lower the effective tax rate to less than 2%.

I. What is a Qualifying IP?

A qualifying IP means an asset which was acquired, developed, or exploited by a person in the course of his business and it is a result of research and development. It also includes assets for which only economic ownership exist.

Qualifying assets under the regime include:

- Patents as defined in the Patents Law
- Computer software
- Other IP assets which are legally protected, and they fall under one of the following:

Utility Models.

- Nonobvious, useful, and novel where the person utilising does not generate gross revenues over €7,500,000 or in the case of a group not more than € 50,000,000 using a weighted average method of the last 5 years for the calculation of both figures. The IP assets mentioned in this point should be certified by an Appropriate Authority in Cyprus or abroad.

The definition of Qualifying IP specifically excludes business names, brands, trademarks, image rights and other intellectual property rights used for the marketing of products and services.

II. The Nexus fraction

This fraction is used in determining the range of qualifying profits relevant to the deductions on the taxpayer. Important terms in this regard include:

- **Overall income (OI)**

OI is calculated as the gross income minus direct expenditure. This consists of the capital allowances of the assets, royalties received for the use of non-tangible assets, income from the trade of disposable QA, and embedded income originating from the qualifying asset. It does not include capital gains from QA disposal.

- **Qualifying Expenditure (QE)**

QE can be salary/wages, direct costs, general expenditure linked to R & D activities, and R&D expenditure from independent sources. It does not include any expenses of IP acquisition, paid or payable interest, any costs payable to related persons handling R&D, and costs that cannot prove a direct link with specific QA.

Qualifying Expenditure includes but is not limited to the following:

- Wages and Salaries for research and development
- Direct Costs
- General expenses relating to the facilities used for research and development
- Expenses for supplies relating to research and development
- Expenditure relating to research and development which has been outsourced to an unrelated party

But they do not include:

- Cost of acquisition of intangible assets
- Interest paid or payable
- Costs for the acquisition or development of immovable property
- Amounts paid or payable directly or indirectly to a related party to conduct research and development irrespective of whether these amounts relate to a cost sharing agreement
- Cost which cannot be proved that related directly to the Qualifying Asset.

- **Uplift Expenditure (UE)**

This expenditure is calculated as a less;

- o 30% QE and
- o The total of QA acquisition and any R&D costs from related participants.

- **Overall Expenditure**

This is expenditure relating to the qualifying intangible assets as the total of;

- o QE and
- o The sum of cost acquisition of QA and cost outsourced from related parties of any R&D assets as incurred during any year taxable.

Overall Expenditure means the total capital expenditure either qualifying or not, relating to the creation of the Qualifying IP.

Overall Income (OI)

The term Overall Income refers to the gross income arising from the Qualifying IP in a tax year less the direct costs incurred for the production of this gross income. The term includes but it is not restricted to the following:

- Royalties or other amounts in relation to the use of the Qualifying IP
- Any amount received as license for the use of a Qualifying IP
- Any amount received from insurance or compensation in relation to the Qualifying IP
- Embedded income of the Qualifying IP which income derives from the sale of goods, services or procedures relating directly with the Qualifying asset

Direct costs include:

- All direct or indirect costs incurred in earning the income from the qualifying intangible asset
- The amortization of the cost of the intangible
- Notional Interest Deduction (NID) on equity contributed to finance the development of the qualifying intangible asset

Capital gain derived from the disposal of Qualifying IP are not included in the Overall Income and are fully exempt from tax.

III. Accounting Records

Any person who claims benefit under the IP Box Regime should maintain proper books and records in accordance with the laws in Cyprus.

C. An Ideal Jurisdiction

Considering the global tax trends and requirements as well as the specific requirements of the Cyprus IP Box, the simple set-up of a company in Cyprus will not be adequate in order to enjoy the full benefits that Cyprus has to offer.

Investors who want to create an efficient structure in order to develop the patents or copyrights (i.e. computer software) must create robust building blocks and real economic substance in Cyprus. Therefore, they will need to set up their regional headquarters in Cyprus, relocate specialist from abroad to form a strong board of directors and middle management and/or use the local employment market to find suitable employees. By doing this a whole new window of opportunity is opened for the investors to develop innovation in a welcomed and tax efficient environment.

The Cyprus IP Box in relation to the tax treatment of royalties received from a Qualifying IP as analysed above, is undoubtedly advantageous. However, when taking into consideration the other features of the Cyprus tax, legal and business environment it becomes evident that Cyprus is the ideal IP Holding Jurisdiction.

Example

A typical IP holding structure involves an investor setting up an IP holding company which will develop and be the owner of a Qualifying IP. This company IP will license the Qualifying IP, for example, to CIS Region and European licensees. The investor will need to take into consideration tax, legal and local business environment issues when deciding which jurisdiction to use for the IP Holding such as:

Local Business Environment:

1. The investor should consider hiring local employees.
2. Acquisition /Rental of premises for the execution of the primary activities.
3. Relocation of the directors and other employees from abroad.

Tax issues:

1. withholding tax deducted from the foreign jurisdiction on the incoming royalty income.
2. taxation of the royalty income at the jurisdiction of the IP holding co.
3. withholding tax deductions on payments of dividends to the investor.
4. taxation on profit from sale of the IP Right

Legal issues:

1. The IP asset to be sufficiently protected.
2. Legally permissible to develop the Qualifying IP.

Tax Aspects:

1. Incoming Royalties – Withholding Tax on Foreign Jurisdiction

Whenever a licensee makes a payment of royalty to the licensor (i.e. the IP holding company), the country of residence of the licensee has the right to deduct withholding tax on the amount. This means that instead of the IP holding company receiving the full amount of royalties, it will receive only the net amount after the deduction of withholding taxes.

The investor, therefore, must choose a jurisdiction that will give him the ability to extract incoming royalties from the various jurisdictions with as low as possible withholding tax deduction from their jurisdictions

Cyprus has many means available that will enable the investor to achieve this. Particularly, the investor may seek the benefits obtained from:

- **The Double Tax Treaties**

Cyprus has signed an extensive network of Double Tax Treaties with third countries. This gives the ability to extract royalties from these jurisdictions at reduced rates when compared with the normal withholding tax rates imposed by these jurisdictions in the absence of such treaties.

It is important to note that in order to be able to benefit from the treaties the company should at least meet the following conditions:

i. The Double Tax Treaties apply to natural and legal persons who are tax residents in Cyprus. Hence, it is important that careful tax planning is made to ensure that the effective management and control of the holding company is performed from Cyprus.

ii. Further, it is important that this company be considered as the beneficial owner of the income in order for foreign tax authorities to grant the treaty benefits. Thus, the company should have sufficient economic substance in order to obtain the treaty benefits.

iii. The structure was not set up with principal purpose to obtain treaty benefits.

- **Relief under the EU Interest and Royalty Directive**

The EU Interest and Royalty Directive provides for the abolition of withholding taxes on interest and royalties paid by a licensee who is resident in one EU member state to a licensor company being resident in another EU member state provided both are within the same group.

With careful tax planning, a Cyprus IP holding company can enjoy the benefits of this EU directive, which grants the ability to receive royalties from all other EU member states with no withholding tax. It therefore opens the European Market to the investor, it reduces the tax leakage and hence, gives flexibility and significant competitive advantage in relation to pricing.

The same conditions as to the tax residency, beneficial owner of the income and the principal purpose test must be met in order to benefit from this directive.

- **Unilateral Tax Credit Relief**

In cases where the Double Tax Treaty network or the Interest and Royalty Directive relief do not provide sufficient protection, it is possible for a Cyprus IP holding company, under the provisions of the Cyprus Tax Law, to claim a Unilateral Tax Credit Relief.

In effect, any tax paid abroad will be credited against any tax that might be payable for the particular income in Cyprus avoiding therefore the double taxation of the specific income. In order to obtain this tax credit, the company must provide sufficient evidence in original proving the payment of overseas taxation on the specific royalty income.

All of the above three tools allow the investor to minimise its tax exposure on withholding taxes paid abroad on the incoming royalties and therefore enhance its overall tax exposure.

2. Taxation of Royalty Income Received – Local Tax

As mentioned above, the Cyprus tax legislation provides that 80% of “Qualifying Profit” generated from such Qualifying IP Rights will be exempt from corporation tax. The remaining 20% will be subject to the normal corporation tax rate of 12.5%.

The above provisions make the maximum effective taxation on royalties to be as low as 2.5% with the ability of further reduction.

3. Outgoing Dividends

Any profits generated by the Cyprus IP holding company can be distributed to its shareholder in the form of dividends.

According to the Cyprus Tax Law, any dividends payable by a company resident in Cyprus to its foreign shareholders (natural or legal persons) or to a Cyprus but non domicile tax resident individual is not subject to any withholding tax in Cyprus.

This is very important as it allows for funds to move to the investor without any additional tax leakage in Cyprus.

4. Taxation on possible sale of the IP Right

Every investor needs to have an exit strategy so as to be able to respond quickly whenever favourable opportunities to dispose the IP Right appear.

Investing through a Cyprus IP holding company will provide the investor with a tax efficient exit route since, as mentioned above, the favourable tax treatment of a maximum effective tax rate of 2.5%, covers also potential profits from any future sale of the IP Right.

To avoid beneficial ownership concerns, the Cyprus IP Holding Company must have a balanced and prudent dividend policy.

Legal Aspects:

1. Adequate Protection of the IP Right

The legislation of Cyprus based on common law and it is in line with European legislation. In this respect, Cyprus meets all the requirements and standards of The World Intellectual Property Organization (WIPO) and the European Union Intellectual Property Office (EUIPO).

Moreover, Cyprus is a signatory to the following International Conventions:

- Bern Convention on the Protection of Literary and Artistic Works.
- Madrid Agreement and Protocol on the Registration of Trademarks at International Level.
- Paris Convention on the Protection of Industrial Property.
- European Community Trademarks.
- Convention Establishing the World Intellectual Property Organisation (“WIPO”).
- The Patent Cooperation Treaty.
- 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 Audio-visual Performances.

2. Legal Permissibility for IP Development

Cyprus is generally opened to new ideas and does not have a lot of restrictions. Further, Cyprus not only does not prohibit any development in new ideas but encourages businesspeople to introduce and develop ideas and invest in innovative products. Moreover, Cyprus offers tax incentives to support businesses in developing innovative products and services which strengthen the Cypriot entrepreneurial ecosystem.

D. Final Comments

Taking into consideration the issues analysed above it is evident that Cyprus is indeed, an ideal IP holding jurisdiction. It allows for proper protection of the IP Rights and it provides for very competitive and efficient tax planning opportunities.

Companies that are engaged in the acquisition and development of IP Rights, should seriously consider the set up for a Cyprus IP holding company as the investment vehicle that will provide them with all the necessary tools to plan and structure their investments and innovations in the most efficient manner.

E. What we can do for you

- Providing tax optimisation advice
- Setting up, consulting and management of IP holding companies
- Advising and drafting IP transactions including financing, acquisitions, sales, and licences
- Registering IP Rights in Cyprus and abroad
- IP rights portfolio management

Connect with us

A: 140 Athalassas Avenue
3rd floor, 2024
Nicosia
Cyprus

T: +357 22 55 27 05
M: +357 99 33 25 32
E: info@xenofontosllc.com
W: www.xenofontosllc.com

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