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Amendments to Cyprus's IP regime

CYPRUS - IP REGIME AMENDED TO INTRODUCE OECD NEXUS APPROACH

Introduction

Changes to Cyprus' intellectual property (IP) regime that were incorporated into the Income Tax Law (ITL) and published in the official gazette on 27 October 2016, provide for the gradual phasing out of the current IP regime and the introduction of a new regime that is in line with the latest international developments on the taxation of IP income and recommendations under action 5 of the OECD's BEPS project. Regulations have been issued that contain detailed guidance on the application of the new IP regime.

Under the current IP regime, 80% of the net profit from the exploitation of IP is exempt from taxation. Net profit is calculated after deducting from the IP income all direct expenses associated with the production of the income, as well as capital allowances at a rate of 20%. Qualifying income includes royalties and gains derived from the disposal of IP; and qualifying assets are defined broadly to include copyrights, patented inventions; trademarks and service marks;

Transition rules applicable for the current IP regime

The main changes to the IP regime include the introduction of transition rules to limit entrants into the regime and ensure that the current regime is phased out by 30 June 2021. The current IP regime will continue to apply until 30 June 2021 with respect to IP that:

- Qualified for the current regime before 2 January 2016;
- Was developed or acquired from a related party during the period 2 January 2016 through 30 June 2016, and the IP qualified for the benefits of the current regime before the acquisition or qualified for a similar regime in another country and the IP was not acquired for the main purpose (or one of the main purposes) of avoiding tax; and
- Was acquired from an unrelated party or was self-developed during the period 2 January 2016 through 30 June 2016.

A shorter transition period will apply to IP developed or acquired from a related party during the period 2 January 2016 through 30 June 2016 that does not fall within the scope of 2); in this case, benefits under the current regime will apply only through 31 December 2016.

New IP regime

The new IP regime is fully compliant with international developments relating to the tax treatment of IP income and recommendations under the OECD's BEPS project. In brief, under the new regime, 80% of **qualifying profits** generated from **qualifying assets** will be deemed to be tax deductible expenses.

Qualifying assets 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 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:

$$OI\ X\ \frac{QE + UE}{OE}$$

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 qualifying assets is defined as the gross profit from the assets (i.e. gross income less any direct expenditure). Overall income includes, but is not limited to:

- Royalties or any other amounts relating to the use of qualifying assets;
- Any amount for the grant of a license for the exploitation of the qualifying assets;
- Any amount relating to the insurance or compensation of the qualifying assets;
- Trading income from the disposal of the qualifying asset; 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 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.

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 includes, but is not limited to:

- Salary and wages;
- 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) 30% of the qualifying expenditure, and (ii) the total acquisition cost of the qualifying asset and any R&D costs outsourced to related parties.

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.

The following applies for purposes of calculating the nexus fraction:

- Direct costs include all expenditure incurred directly or indirectly, wholly and exclusively, for the production of the overall income;
- The deduction granted under a corresponding transfer pricing adjustment as per the ITL that arises from the development or sale of a qualifying asset is treated as a direct expense.
- The deduction granted under the notional interest deduction provision in the ITL, which is attributable to a qualifying asset, is considered an indirect expense for calculating the 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 ITL.

Qualifying taxpayers that are eligible for the IP regime include Cyprus tax resident persons, permanent establishments (PEs) of non-resident persons and foreign PEs that are subject to tax in Cyprus. Amending provisions have been introduced into the ITL to ensure that a taxpayer can elect whether a foreign PE is taxable in Cyprus, so that the PE can be classified as a qualifying taxpayer. Qualifying taxpayers are required to keep track of the relevant income and expenditure to be able to accurately calculate the nexus fraction.

Where the intangible asset qualifies for both the current and the new IP regimes, the current regime will apply until that regime is fully phased out.

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 current IP 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 being subject to income tax and any balancing deduction being tax deductible. The taxpayer has the option not to claim capital allowances for such intangible assets in a particular tax year.

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