The new system of taxation of intellectual property rights in Cyprus

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The growth measures introduced in May 2012 included a package of incentives and tax exemptions relating to income from intellectual property rights, aimed at stimulating investment in research and development. A number of other countries, including Luxembourg, the Netherlands, Ireland and the United Kingdom have already introduced such schemes, which have come to be known as an intellectual property box ("IP box").

Intellectual property projects lend themselves to cross-border planning by reason of the mobility of intellectual property rights, which are intangible and can therefore be easily migrated between different jurisdictions and tax systems according to prevailing circumstances and developments in different jurisdictions. By introducing an IP box Cyprus hopes to consolidate its position as a hub for the cross-border holding and exploitation of intellectual property rights.

The amendments to the Income Tax Laws are effective from 1 January 2012 and apply to all expenditure for the acquisition or development of intangible assets incurred by a person carrying on a business, including the rights set out in the Patent Law of 1998 as amended, the Intellectual Property Rights Law of 1976 as amended and the Trademarks Law, Cap. 268 as amended. The amendments effectively apply to all categories of intellectual property.

The main features of the new IP box are as follows:

FIVE YEAR AMORTISATION PERIOD

The cost of acquisition or development of an IP right may be capitalised and amortised on a straight line basis over five years, giving an annual writing down allowance of 20 per cent.

This is a considerable acceleration compared with the previous amortisation regime, in which rates were determined by reference to the estimated useful life of the underlying asset. For example, if a patent had a validity of 20 years its useful life would be deemed to be 20 years and the annual writing down allowance would be 5 per cent.

The acceleration of writing down allowances will result in substantial cash flow benefits by reason of the deferral of tax liabilities, especially where the value of the IP asset is substantial.

80 PER CENT EXEMPTION OF PROFITS FROM EXPLOITATION OF IP RIGHTS

Four-fifths of the profit earned from the use of intangible assets (including any compensation for improper use) is disregarded for tax purposes.

Since any dividend income generated paid to non-resident shareholders is exempt from Cyprus tax of any description a Cyprus company can be used to generate royalties under licensing or similar arrangements with third parties and distribute profits to its shareholders by way of dividends with minimal tax leakage.

80 PER CENT EXEMPTION OF PROFITS ON DISPOSAL OF IP RIGHTS

Four-fifths of any profit resulting from the disposal of relevant intangible assets is disregarded for tax purposes.

While this may be a useful exemption in certain circumstances, in most cases a more beneficial result from the taxpayer's viewpoint can be achieved by holding the assets concerned in a separate company and disposing of the shares in that company, rather than the assets themselves. This option would result in full exemption of the gain, as well as stamp duty savings, since gains on disposals of qualifying securities (which includes shares) are exempt from all forms of taxation in Cyprus except to the extent that they derive from the disposal of immovable property located in Cyprus.

OVERALL, AN EFFECTIVE TAX RATE OF LESS THAN TWO PER CENT, THE LOWEST BY FAR IN THE EU

The amount subject to tax under the new rules is calculated by deducting the writing down allowance, the costs (including interest) of financing the acquisition or development of the assets and any other direct expenses from the revenue earned, and dividing the resultant amount by five. Applying the Cyprus corporate income tax rate of 10 per cent produces an effective tax rate of two per cent of the net income. Given that generous deductions are available against gross income, the effective rate should generally be well below two per cent.

This rate compares very favourably with the competition: the United Kingdom's optional new "patent box" regime gives an effective rate of 10 per cent on relevant income. The Irish scheme is more complex, and it is not possible to directly compare rates, but it will generally produce a rate close to the UK rate. The Luxembourg and Netherlands schemes are somewhat better, with effective tax rates of 5.76 per cent and 5 per cent respectively, but they are both considerably less beneficial than Cyprus.

ADVANTAGES AND SAVINGS COMPARED WITH THE PREVIOUS REGIME

Before the introduction of the IP box a Cyprus licensing arrangement would typically be structured as follows:

1. the IP rights would be owned by a company ("the IP owner") incorporated and resident in a zero-tax or low tax jurisdiction;
2. the IP owner would license the use of the IP rights to a Cyprus-resident company ("the intermediary");
3. the intermediary would sub-license the use of the IP rights to end-users, preferably registered and tax resident in a country with a double tax treaty with Cyprus;
4. the royalty fees charged by the IP owner would usually be approximately 90 per cent of the royalty income generated by the intermediary, leaving a 10 per cent margin subject to Cyprus tax.

Following the introduction of the IP box, considerable savings can be achieved by locating the IP owner in Cyprus and having it license the use of the rights direct to the end users, eliminating (or at least reducing) foreign withholding taxes via a double tax agreement or the EU Interest and Royalties directive, which provides a uniform tax regime for royalties paid throughout Europe.

In addition to tax savings, the elimination of a corporate layer in a different jurisdiction will allow considerable savings to be made in administrative and compliance costs.

The new rules will also enhance the degree of legal and jurisdictional protection, given that the legal and corporate governance affairs of the IP structure will be governed by the laws of Cyprus, so ensuring an increased level of legal certainty, asset protection and predictability.

USING A CYPRUS INTERNATIONAL TRUST TO OWN AND FINANCE THE IP OWNER

A Cyprus international trust receiving dividends from a Cyprus-resident IP owner (the ultimate source of which is royalty income generated by the IP owner) will not be subject to any form of taxation in Cyprus. As long as no beneficiary is a Cyprus tax resident the trust can accumulate income which can be converted into capital at the year end without any Cyprus tax consequences for the trust or its beneficiaries.

The Cyprus international trust can also provide interest-bearing finance to the IP owner for the purpose of acquiring the IP assets or for working capital. While the interest paid by the IP owner will be deductible for tax purposes, the interest received by the trust may be exempt from Cyprus tax as long as no beneficiary is a Cyprus tax resident.

As described earlier, it is possible to acquire IP rights for development purposes and subsequently effect a tax free exit by disposing of the shares in the IP owner. This option becomes even more attractive when combined with a Cyprus international trust which holds the shares in the IP owner.

VAT

The acquisition of intellectual property rights from any-

where in the world by a Cyprus company is treated as a service rendered to the company which will create an obligation for it to register for VAT and to account for VAT on services received in accordance with the reverse charge rule. Other things being equal, no registration obligation will be created if the intellectual property right is developed organically rather than being purchased.

If the company charges royalty fees to taxable persons within the European Union area it will also have to register for VIES.

CONCLUSION

The new regime provides very attractive opportunities for structuring the exploitation of IP assets through Cyprus and in particular through the use of Cyprus-resident IP owners, especially in the context of Cyprus's extensive network of double tax treaties under which foreign withholding taxes on royalty income are either eliminated altogether or substantially reduced.

In most cases immediate economic and tax savings can be achieved by transferring intellectual rights currently held by entities located in low or no tax jurisdictions to Cyprus resident companies in order to take advantage of the new exemptions. The transfer of IP rights into a Cyprus company will not give rise to any form of taxation in Cyprus and the new benefits and substantial exemptions will become available as soon as the asset is transferred.

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