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IP Structuring Through Cyprus Newsletter– 10.12.2019

1. Cyprus IP Box Regime

We note that Cyprus has an IP Box regime, whereby any income relating to IP (e.g. royalty income, profits from sale of IP) is allowed an <u>80% deemed deduction</u> in arriving at the taxable income of the IP holding company. If utilized in full, then this can reduce the effective tax rate of a company to as low as 2.5%.

However, recent amendments in international taxation following the OECD's BEPS Action Plan, have been transposed into the Cyprus tax legislation in a bid to avoid being 'blacklisted' as a jurisdiction. Specifically, the so-called 'Nexus' approach to IPs aims to align the tax benefits arising as a result of owning an IP, with the expenditure and activities which took place in order to develop this IP. To this respect, the Nexus Fraction has been introduced (which many countries are adopting as it is an OECD recommendation), by which specific incomes and expenses are entered into a formula, which calculates how much of the IP income is eligible for the 80% deduction.

Without going into the details of the formula, one item which appears to be relevant to most IP businesses, is the outsourcing of R&D activities to foreign related companies. The key point here is whether the R&D suppliers are related or not, as the Nexus formula excludes any R&D costs relating to the outsourcing of R&D activities to related companies. In this respect, if a company is experiencing high levels of R&D costs outsourced to related companies, this will reduce the effectiveness of the Cyprus IP Box, as such expenses would be restricted through the Nexus fraction.

2. Cyprus NID Regime

The IP box and Nexus application are not the only incentives applicable to IP structuring, as there are numerous other rules and regulations which come into play. One key example is the Notional Interest Deduction (NID) provisions of the Cyprus tax legislation. This regime can also substantially reduce a company's effective corporate tax rate in Cyprus by using the IP, without any Nexus restrictions. Furthermore, NID has been approved as a genuine, non-abusive tax planning incentive by the OECD, so is unlikely to be removed from the Cyprus Tax System anytime soon.

The Cyprus NID regime was introduced in 2015, in order to promote the investing in equity (as opposed to debt financing) of Cyprus companies, though the law allows for an in-kind capital contribution which may take the form of an IP.

NID is calculated by multiplying the New Capital by the Reference Interest Rate (RIR), time apportioned in the instance where the New Equity was introduced part-way during the year.

The RIR is the yield of the 10-year governmental bond of the country in which the new equity is invested (as at 31/12 of the previous year), plus 3%. In the instance where the Cyprus government bond yield is higher than that of the country in which the capital is invested, then the Cyprus RIR will be used instead. We note that NID will not be available for loss making companies, and is capped at 80% of the profits emanating from the new equity (through a matching process) in each relevant tax year.

Finally, based on industry insight we understand that there is likely to be an amendment made to the NID regime, but affecting only the RIR to be used. This has resulted from a recent OECD review aimed at determining whether the measure is abusive, and the new provisions are expected to be announced sometime during 2020. No official word has been released yet, however it is expected that the RIR will now be the interest rate of the 10-year government bond of the country in which the funds are invested, plus 5% (instead of 3%). Furthermore, there will be no possibility of choosing the Cyprus RIR in the instance where the foreign one is lower, though practically we anticipate that this will make the scheme even more favourable.

3. Recommendation

In this respect, we recommend that businesses holding high value IPs and wishing to obtain tax benefits from these IPs, who would otherwise lose much of the benefit from the IP Box due to the Nexus fraction restrictions, can benefit from the NID regime instead. Therefore, Cyprus remains one of the strongest jurisdictions within the EU to hold IPs, even though the actual tax regime used is not the IP Box Regime.

This structure would be fully compliant with the Cyprus Tax Legislation, though we do stress that there might be implications arising upon the transfer of the IP to the Cyprus company from abroad. For example, exit taxes may apply, or a gain may be charged in the home jurisdiction from which the IP will be transferred. This will typically be a one-off charge upon the exit of the IP from its home jurisdiction, after which the tax benefits described above should continue to be applicable indefinitely. For this purpose, we strongly recommend that you also seek advice from local advisors with country-specific expertise within the jurisdiction/s where the business' assets and operations are currently located and IP held.