



TAXATION OF INTANGIBLES: CYPRUS TAX LAW, TAX TREATIES, & EU TAX LAW

PRESENTATION BY
Christos Theophilou
BSc (Econ.), FCA, ADIT,
MSc Tax Law (Oxon),
LLB Law

October 2024

Your global tax partner

Agenda



1. Introduction: International Tax & EU Developments
2. Taxation of Intangible Property
3. Tax planning of Intangible Property
4. Base Case example: Step 1-3
5. Beneficial Ownership, PPT & EU GAAR, Corporate Substance, Special Tax Regimes
6. Transfer Pricing Challenges for Intangibles: Definition
7. IP Box and Transfer Pricing
8. Intangibles under Tax Treaties & Transfer Pricing
9. Base Case example: Step 4 & 5
10. References



Introduction: International Tax and EU Developments

BEPS Action Plan (October 2015)



COHERENCE

- AP2: No hybrid mis-matches
- **AP3: Better CFC rules**
- AP4: Interest deduction limitation rules
- **AP5: No harmful tax practices**

**Digital
Economy AP 1**

SUBSTANCE

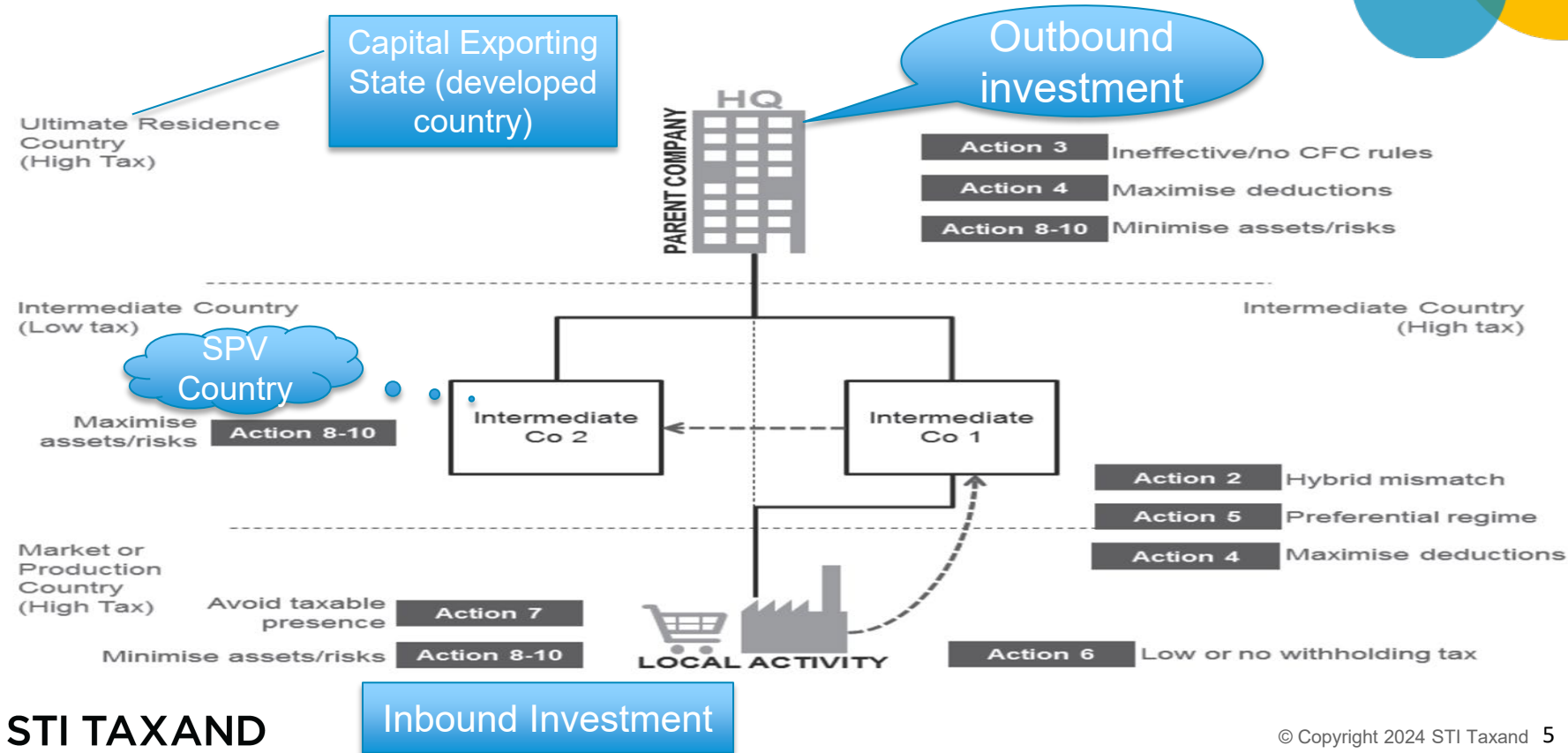
- **AP6: Preventing Tax Treaty abuse**
- AP7: Prevent artificial avoidance of PE
- **AP8: Transfer Pricing of Intangibles**
- AP9: TP/risk and Capital
- AP10: TP high risk transactions

**Multilateral
Instrument AP15**

TRANSPARENCY

- AP11: Methodologies and data analysis
- AP12: Disclosure of rulings
- **AP13: TP Documentation**
- **AP14: Dispute resolution**

BEPS ACTION PLAN EXAMPLE

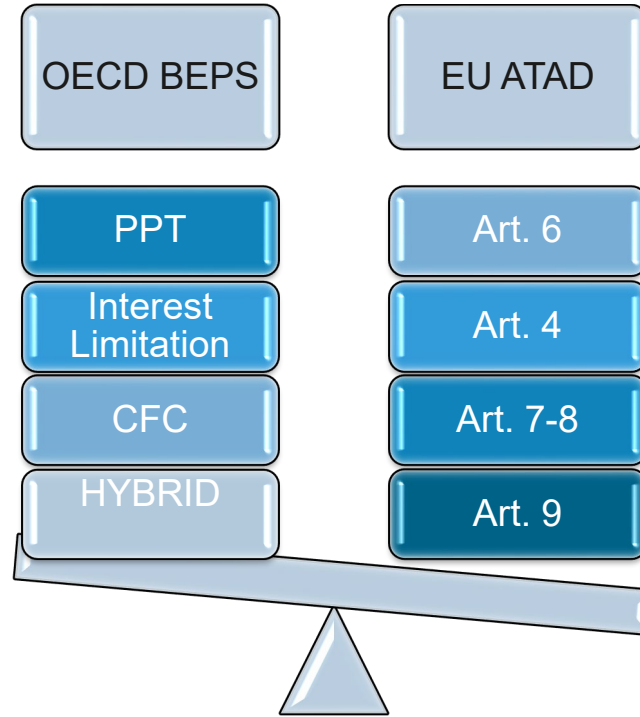


EU BEPS

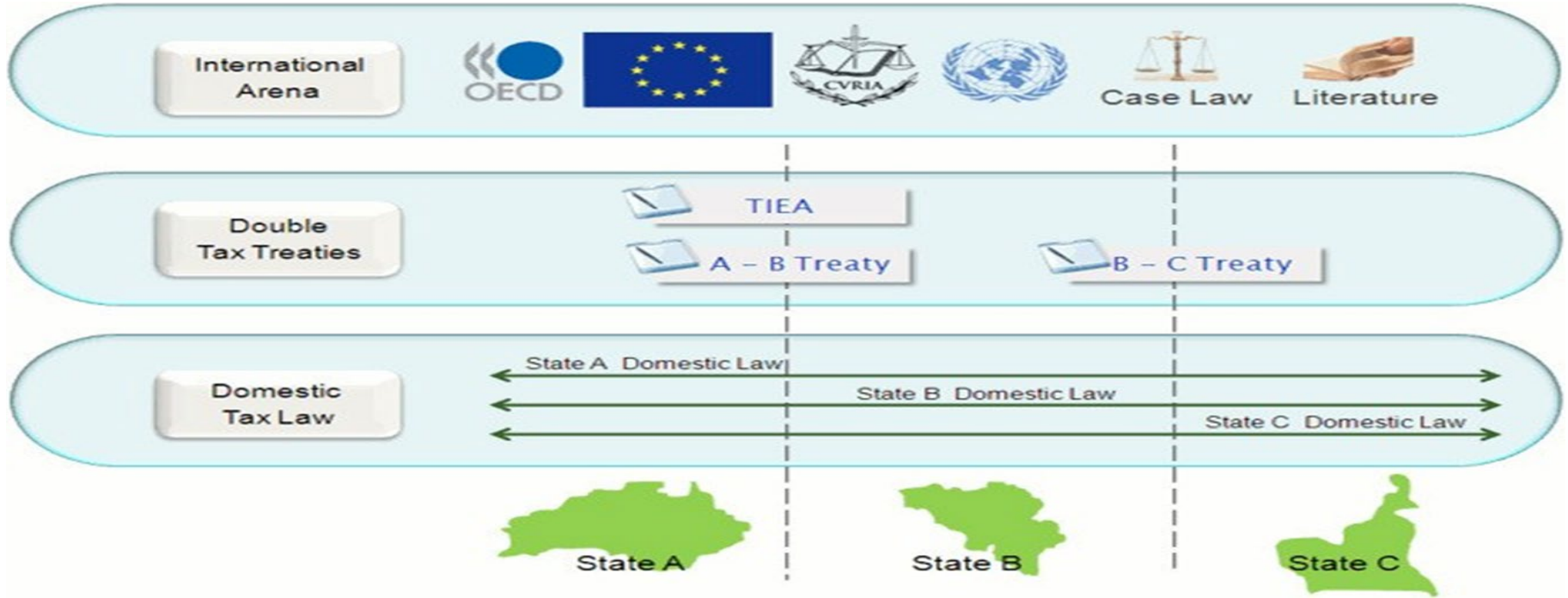


<u>OECD BEPS Actions</u>	<u>EU Coverage</u>
Action 1: Digital Economy	EC VAT Action Plan EC Proposals on taxation of digital economy
Action 2: Hybrids	Parent-Subsidiary Directive Anti-Tax Avoidance Directive
Action 3:CFC	Anti-Tax Avoidance Directive
Action 4: Interest Limitation	Anti-Tax Avoidance Directive
Action 5: Rulings	Directive on Administrative Cooperation -EOI
Action 6: Treaty Abuse	ATAP Recommendation
Action 7: PE	ATAP Recommendation
Actions 8-10: TP	JTPF to follow up
Action 11: BEPS Data	NA
Action12: Mandatory Disclosure Rules	Directive on Administrative Cooperation -EOI
Action 13: CBCR	Directive on Administrative Cooperation -EOI
Action 14: Dispute Resolution	Directive on Double Taxation Dispute Resolution
Action 15: MLI	NA

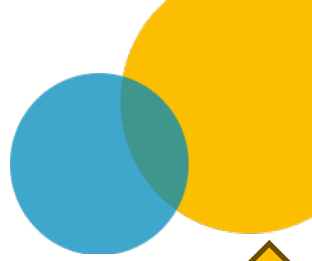
EU Anti-Tax Avoidance Directive (ATAD)



Conceptual map of factors influencing the international tax environment*



Ιεράρχηση Κανόνων Δικαίου



EU Law (Article 1A of the Constitution)

The Constitution is the supreme law of the Republic of Cyprus (Article 179 of the Constitution)

International Conventions such as Tax Treaties (Article 169 of the Constitution)

Laws, Primary Legislation (i.e. Legislation passed by the House of Representatives & colonial legislation)

Common law and equity principles

Secondary Legislation: Regulatory Administrative Acts (Κανονιστικές Διοικητικές Πράξεις ΚΔΠ)

Tax Circulars?

Taxation of Intangible Property

Definition for Intangibles: Cyprus Income Tax Law Vs. OECD Model



Cyprus Income Tax Law Article 21

- The gross amount of ***any intellectual property rights, premium, compensation or other income*** derived from sources within the Republic by any person not being resident in the Republic, who is not engaged in any business in the Republic, in consideration for the use of, or for the privilege of using, ***any copyright, patent, design, secret process or formula, trade mark, know-how or any other like property or in consideration of technical assistance***, shall be charged to tax at the rate of ten cent in the pound:

VS

2017 OECD Model Tax Convention Article 12



- The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Definition for Royalties: UN Model Vs. OECD Model



2021 UN Model Tax Convention



Article 12

- The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

- **Article 12A Fees for technical services**

VS

2017 OECD Model Tax Convention



Article 12

- The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Definition for Intangibles: EU Interest & Royalties Vs. OECD Model



EU Interest & Royalties Directive

Article 2(b)

- The term 'royalties' means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films **and software**, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, **industrial, commercial or scientific equipment** shall be regarded as royalties.

VS

2017 OECD Model Tax Convention

Article 12



- The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

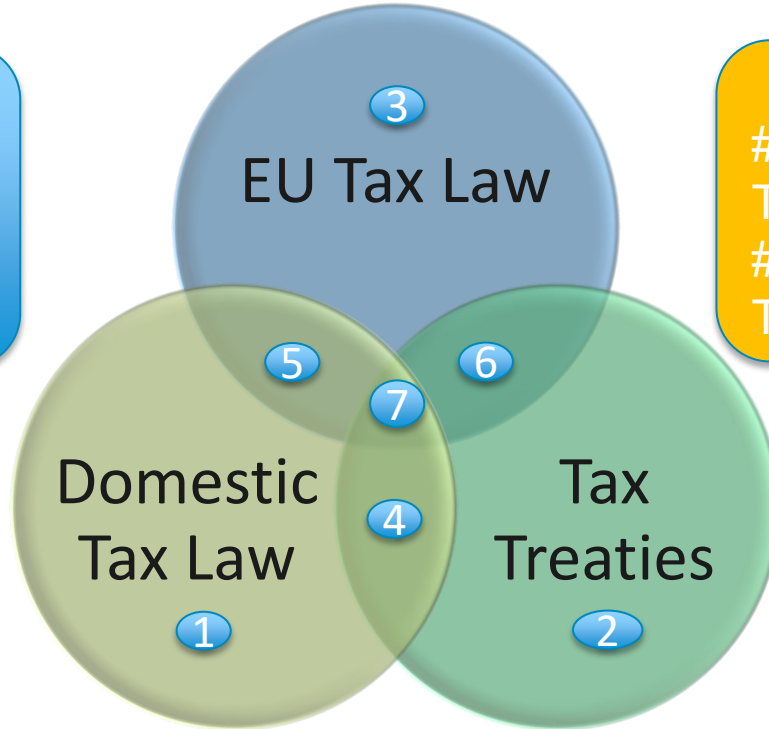
Overlapping between Domestic Tax Law, Tax Treaties and EU Tax Law



Overlap between:

#4 Domestic Law & Tax Treaties

#5 Domestic Law & EU Tax Law



Overlap between:

#6 Tax Treaties and EU Tax Law

#7 Domestic Law, Tax Treaties & EU Tax Law

Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG vs IAS 38



Transfer
pricing



IAS 38

- ❖ Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances
- ❖ Patents; Know-how and trade secret; Trademark, trade names and brand; Rights under contracts and government licences; Licences and similar limited rights in intangibles; and Goodwill and ongoing concern value.
- ❖ Specific local market advantages, group synergies and assembled workforce are not classified as intangibles.

VS

- ❖ An identifiable non-monetary asset without physical substance, controlled by the entity and held for use in the production or supply of goods or services, for rental to others, or for administration purposes.
- ❖ IAS 38 may require that intangible development be recorded as an expense and not capitalized and shown as an asset on the balance sheet. Yet, for TP purposes, there may be a valuable IP asset.

Definitions: Practical Issues to Consider (1)

Accounting

IAS 38



VS

Tax



Article 12
Royalties

Article 9
Associated
Enterprises

Article 7
Business
Profits

Article 13
Capital Gains

Definitions: Practical Issues to Consider (2)



- ❖ **Wider In Scope:** IP catalogue of the domestic law can be wider in scope of the Tax Treaty
- ❖ **Conflicts of qualification/classification/characterisation:** Tax treaty provides for an autonomous definition of the term “royalties” whereas **domestic tax laws** typically do not provide their own definitions of intellectual property (IP) items, instead relying on explicit or implicit references to domestic private IP law.
- ❖ **Use (renting out) vs Sale:** Article 12 of the OECD Model addresses the transfer of the “use or right to use” IP, covering IP rentals. IP sale, however, falls under Article 13 Capital Gains of the OECD Model (an exception is tax treaties following the pre 2016 US Model).

Definitions: Practical Issues to Consider (3)



- ❖ **Use vs Rendering Services:** Technical Assistance e.g. article 21 of the Cyprus Income Tax Law or Article 12A Fees for Technical Services of the 2021 UN Model or Article 7 Business Profits of the OECD Model
- ❖ **Royalty vs Business Income:** Sale or provision of software generates business income and therefore falls under Article 7 Business Profits of the OECD Model, while granting even limited copyright results in Royalty Income (i.e. Article 12 of the OECD Model). Therefore, the payment should be split into these components (mixed transactions).
- ❖ Practical example Boulez US case Law: US Tax Court (USTC), 16 Oct. 1984, Boulez v. Commissioner, 83 T.C. 584

Tax Issues to Consider (1)



❖ Taxation of Residents:

- ❖ CFC Rules typically cover royalty income
- ❖ Royalty Income taxed under normal rules or under IP Box;
- ❖ Royalty Expenses from the perspective of the IP Owner (i.e. **Licensor**):
 - ❖ Capital Allowances;
 - ❖ R&D tax incentives (e.g. accelerated depreciation, super deductions or tax credits)

Tax Issues to Consider (2)



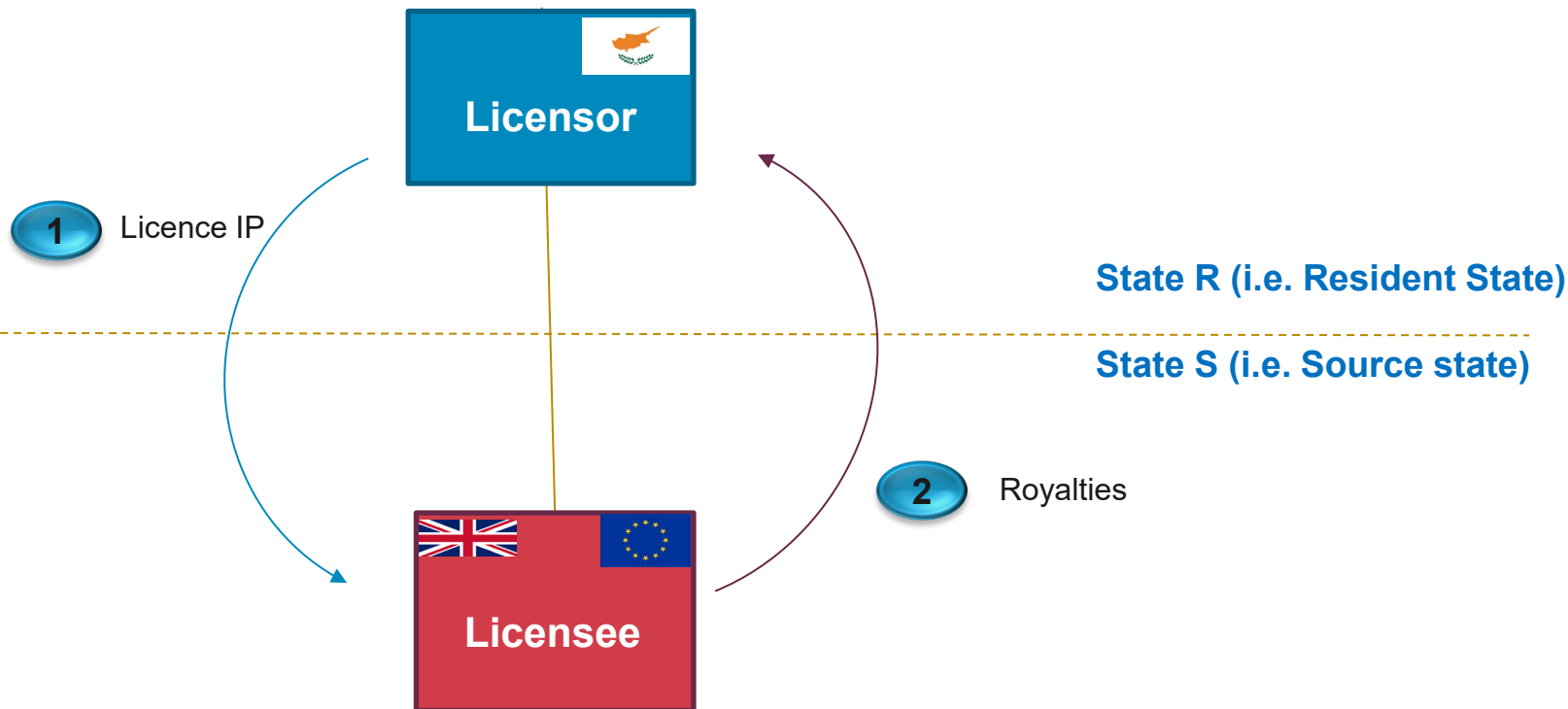
❖ Taxation of Residents:

- ❖ Royalty Expenses from the perspective of the **Licensee**:
 - ❖ Royalty Payments are fully deductible (Transfer pricing issues for disallowing excessive royalties)
 - ❖ Modified nexus approach: IP Box benefits on royalty income only if the related research expenses were incurred within the country
 - ❖ Linking Rules: Subject to tax Rules on Low taxed Royalties (i.e. Special Tax Regime such as IP Box)
 - ❖ Beneficial Owner
 - ❖ Principal Purpose Test
 - ❖ Mixed Contracts

❖ Taxation of Non-Residents: Source Rules for Royalties:

- ❖ Pay rule;
- ❖ Use rule; or
- ❖ UK special source rule WHT on UK-registered patents, regardless to where the patent is actually used

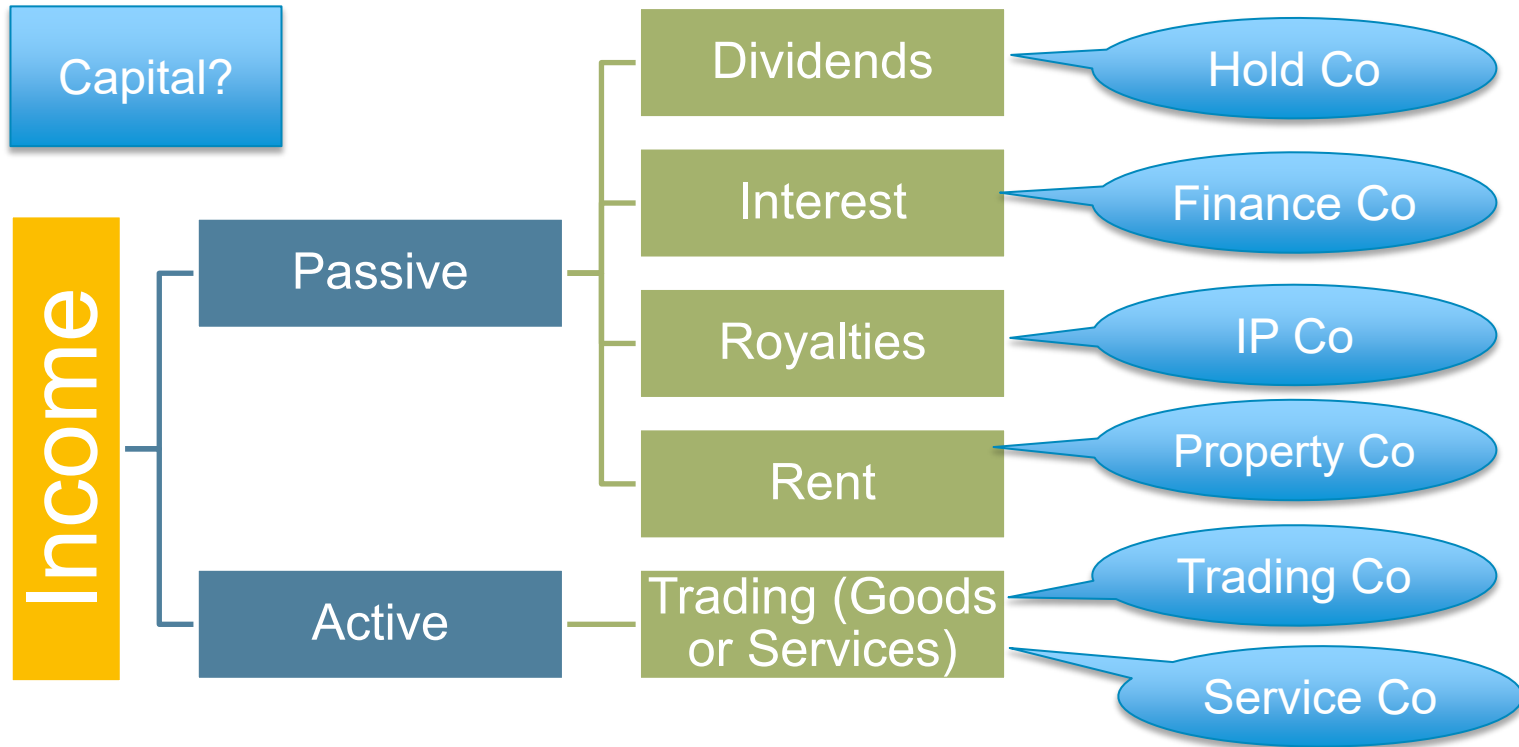
IP Company Structure: Tax Issues To Consider: Practical Example





Tax planning of Intangible Property

International Tax Planning: Taxable Income



Types of Intangibles under OECD TPG



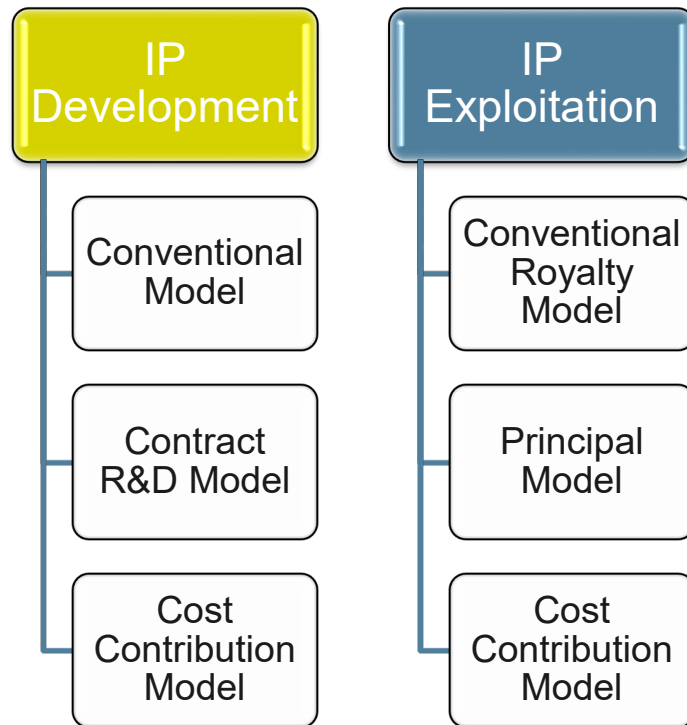
- ❖ Intangibles:
 - ❖ Patents
 - ❖ Know-how and trade secrets
 - ❖ Trademarks, trade names and brands
 - ❖ Rights under contracts and government licenses
 - ❖ Licenses and similar rights
 - ❖ Goodwill and ongoing concern value

- ❖ The following were rejected as intangibles:
 - ❖ Group synergies
 - ❖ Market specific characteristics

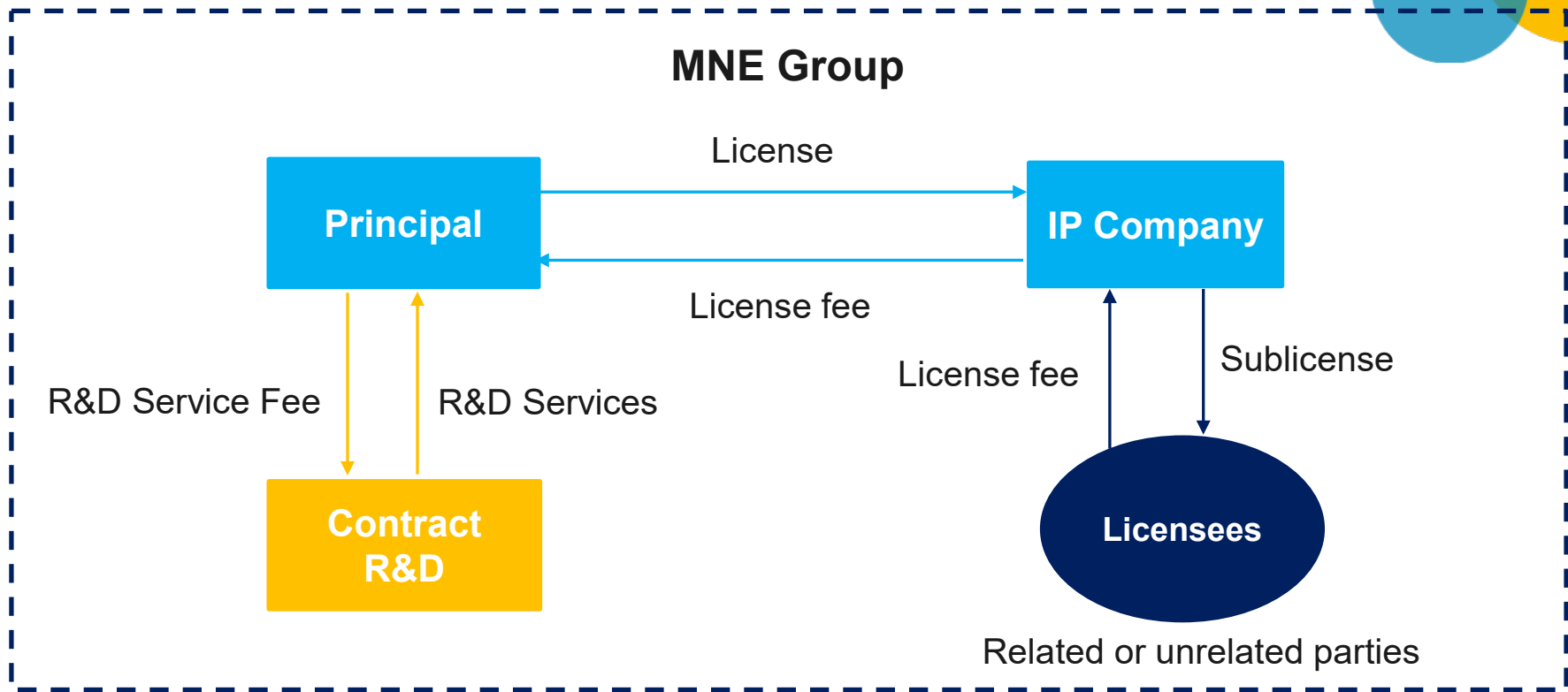
IP Tax Structuring

❖ Businesses often face two crucial considerations when organizing their intellectual property:

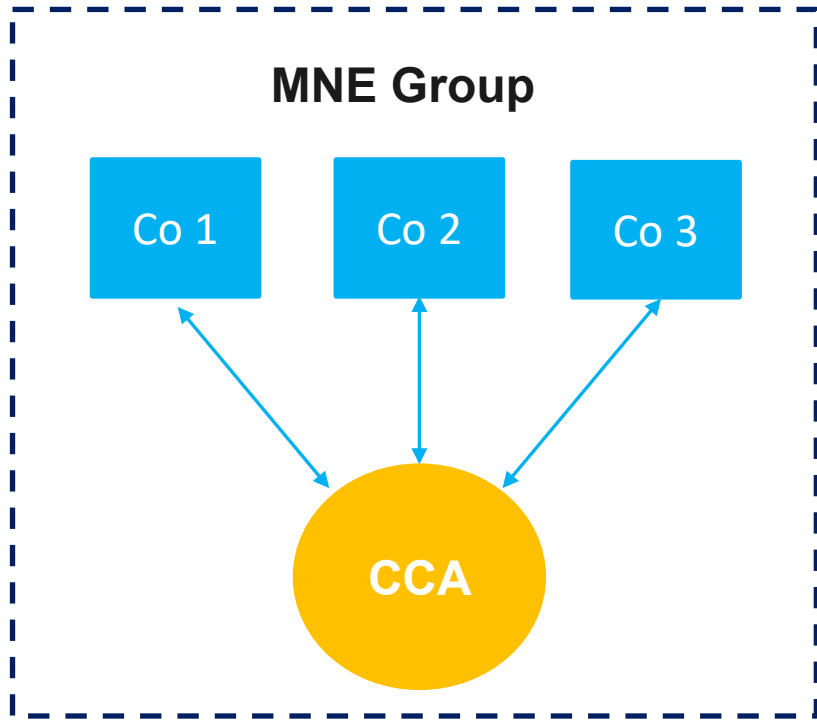
- 1) Determining the location for IP development; and
- 2) deciding where to own the IP for exploitation.



Intangibles: Contract R&D



Intangibles: Cost Contribution Arrangements “CCAs”



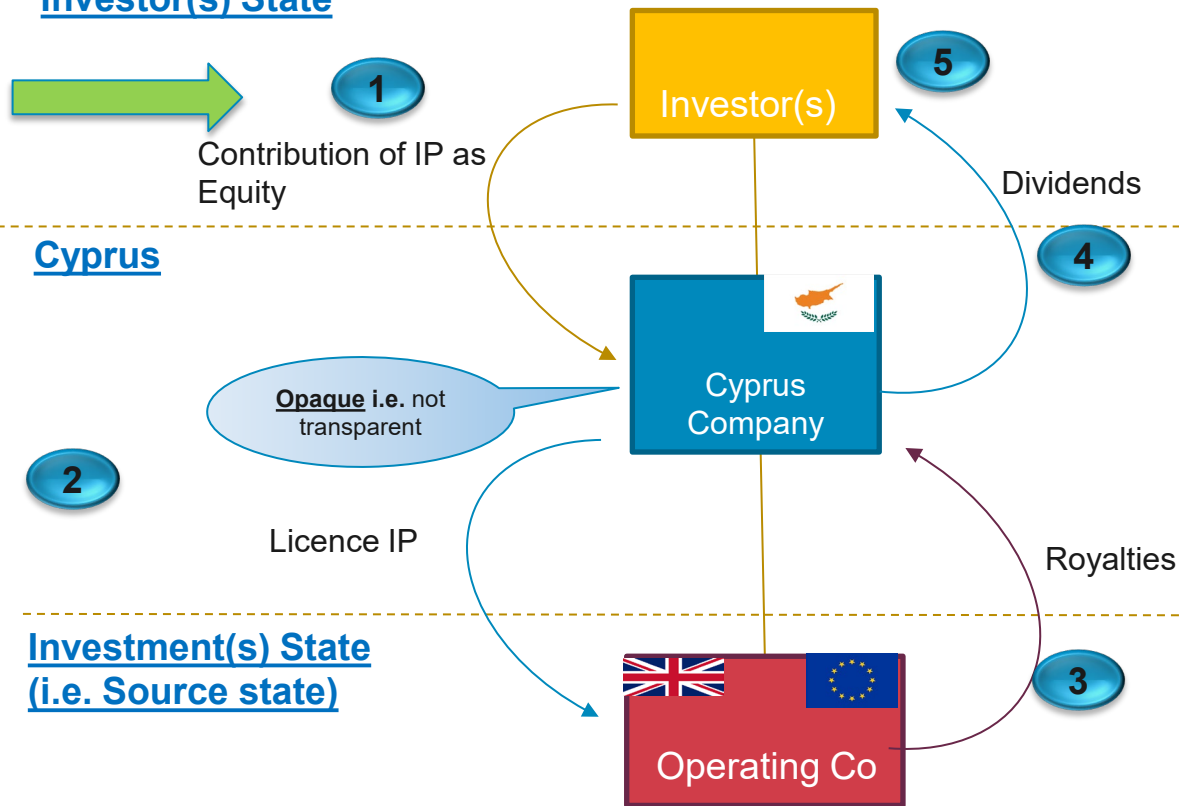
- ❖ Separate legal entity not set up
- ❖ Developments costs shared by participants
- ❖ Cost sharing based on benefits to be received by each
- ❖ May require “buy-in” and “buy-out” payments if participants change

Base Case: IP Company Structure

STEP 1 - 3

Base Case: IP Company Structure

Investor(s) State



Contribution of IP as Equity

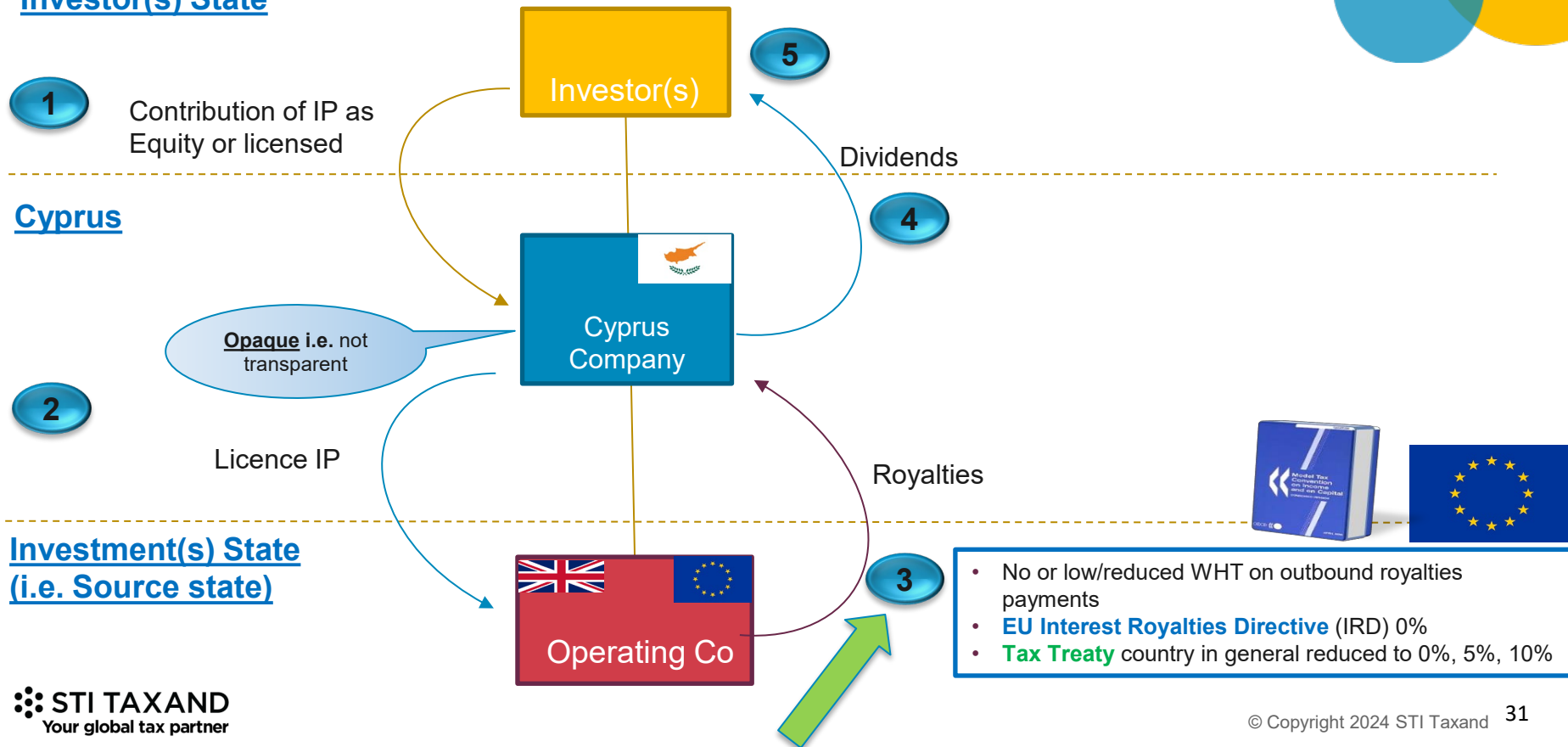


STEP 1

- ❖ Cost base (tax value) of assets that are thereby brought within the tax jurisdiction of Cyprus:
 - ❖ Capital Allowances;
 - ❖ Gain on Sale
- ❖ Tax valuation based on the 2022 OECD TPG Chapter VI Intangibles

Base Case: IP Company Structure

Investor(s) State



Tax Implications at the Investment State



STEP 3: Payments made from the Licensee to the Licensor (e.g. Cyprus). The Investment State might:

- ❖ Restrict excessive royalty payments under local Transfer Pricing Rules
- ❖ Impose withholding tax typically on the gross royalty payments
- ❖ Tax Treaty Benefits can be denied on the following anti-avoidance provisions:
 - ❖ Specific Anti-avoidance provisions: **Beneficial Ownership** provision under Article 12(1) of the OECD Model.
 - ❖ General Anti-Abuse Rule (GAAR): **Principle Purpose Test (PPT)** under Article 29(9) of the OECD Model.
 - ❖ Cyprus company is not considered to be a tax resident
 - ❖ Special Tax Regimes
- ❖ EU Anti-Abuse provisions



Beneficial Ownership

Significance of “Beneficial Ownership”

- ❖ OECD Model A10: (Dividends), A11 (Interest), A12 (Royalties)
- ❖ UN Model: A10 (Dividends), A11 (Interest), A12 (Royalties)
- ❖ EU Directives: Parent-Subsidiary, Interest & Royalties
- ❖ US 2016 Model: A10 (Dividends), A11 (Interest), A12 (Royalties), A17 (Pensions), A21 (Other Income)



OECD Model: Beneficial Owner



Art. 10 DIVIDENDS

(2) ...dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if **the beneficial owner** of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: (a) 5 per cent....; (b) 15 per cent....

Art. 11 INTEREST

(2) ...interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if **the beneficial owner** of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest...

Art. 12 ROYALTIES

(1) Royalties arising in a Contracting State and **beneficially owned** by a resident of the other Contracting State shall be taxable only in that other State...

Definition of the term “Beneficial Ownership”(1)



- ❖ First time in 1966 protocol to the UK-US DTT (1945).
- ❖ In 1977 included in the 1977 OECD Model (**not an agent or nominee**).
- ❖ **OECD Negative definition:*** Not a **conduit** or **a mere fiduciary** or **administrator** acting on account of the interested parties...

* OECD 1986 Conduit Companies Report updated the OECD Commentary in 2003

Definition of the term “Beneficial Ownership”(2)



- ❖ **OECD Positive definition (2014):*** Full right to **use** and **enjoy** the payment **unconstrained** by a contractual or legal obligation to **pass on it** to another person... Such an obligation will normally derive from relevant legal documents but may also be found to exist on the **basis of facts and circumstances** showing **that, in substance,.....**
- ❖ Meaning very diverse. OECD fail to provide an express definition, Surprisingly not in BEPS 6 but OECD suggest the use of Principal Purpose Test (PPT)
- * OECD Discussion draft in 2011, revised Discussion draft in 2012 and final draft updated the OECD commentary in 2014.
- ❖ For more details regarding Beneficial Ownership you can find at the following article as published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 1]* [Click here.](#)



CYPRUS - PPT & EU GAAR

DECONSTRUCTION OF THE PRINCIPAL PURPOSE TEST (PPT)



- ❖ “**Notwithstanding** the other provisions of this Convention,
- ❖ a **benefit** under this Convention shall not be granted in respect of an item of income or capital if it is **reasonable to conclude**, having regard to all relevant facts and circumstances, that obtaining that benefit was **one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit,
- ❖ **unless** it is established that granting that benefit in these circumstances would be **in accordance with the object and purpose** of the relevant provisions of this Convention.”

TWO MAIN ESCAPES FROM BEING CAUGHT BY PPT



Obtaining tax treaty benefit is not a **principal purpose**



Granting of tax treaty benefit is in accordance with **object and purpose** of the relevant provisions of the tax treaty



OBJECT AND PURPOSE OF A TREATY



2017 OECD Model: PREAMBLE TO THE CONVENTION

- ❖ Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,
- ❖ Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for **non-taxation** or **reduced taxation** through **tax evasion** or **avoidance** (including through **treaty-shopping** arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),

BENEFIT IS NOT A PRINCIPAL PURPOSE



2017 OECD Commentary

- ❖ Where an arrangement is **inextricably linked** to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.
- ❖ “[...] removing the obstacles that double taxation presents to the development of economic relations between countries” because “[its] harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known”.
- ❖ For more details regarding the PPT you can find at the following article as published at Bloomberg Tax: INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 2] [Click here.](#)

EU GENERAL ANTI-ABUSE RULE (GAAR): ATAD ARTICLE 6 (1)



- ❖ An arrangement or a series of arrangements shall be ignored if:
 - put into place for the **main purpose** or **one of the main purposes** of obtaining a tax advantage that defeats the **object or purpose** of the tax law,
 - **are not genuine** having regard to all relevant facts and circumstances

- ❖ **not genuine means**: to the extent that the arrangement(s) lack valid commercial reasons which reflect economic reality.

- ❖ Article 33A of the Cypriot Income Tax Law

EU GENERAL ANTI-ABUSE RULE (GAAR): ATAD ARTICLE 6 (2)



- ❖ GAAR is a minimum rule because Anti-Tax Avoidance Directive (**ATAD**) shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse
- ❖ For a comparison of the EU GAAR and the PPT, you can find more details in the following article as published at Bloomberg Tax, *OECD's Principal Purpose Test Versus EU's General Anti-abuse Rule* [Click here](#)



EU law: Anti-Abuse Rules

EU law: General Anti-abuse



- ❖ **General Anti-abuse Principle** of EU law: Danish cases, the ECJ defines the general EU law anti-abuse principle (EU GAAP): It is settled case-law that there is, in EU law, a general legal principle that EU law cannot be relied on for abusive or fraudulent ends.
- ❖ Article 6(1)-(3) of the ATAD (**EU GAAR**)
 - ❖ “for the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.”
 - ❖ “an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.”
 - ❖ “where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law”.

Interest and Royalty Directive: Specific Anti-Abuse Rule (1)



- ❖ Article 1(1) of the IRD (IRD BO) states:
 - ❖ “interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the **beneficial owner** of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State”.
- ❖ Article 1(4) of the IRD (IRD BO **definition**) states:
 - ❖ “a company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee, or authorised signatory, for some other person.”

Interest and Royalty Directive: Specific Anti-Abuse Rule (2)



- ❖ Article 5(1) of the IRD (IRD Anti-Abuse **Reservation 1**) states:
 - ❖ “This Directive shall not preclude the application of domestic or agreement-based provisions required for the **prevention of fraud or abuse**.”
- ❖ Article 5(2) of the IRD (IRD Anti-Abuse **Reservation 2**) states:
 - ❖ “Member States may, in the case of transactions for which the **principal motive or one of the principal motives is tax evasion, tax avoidance or abuse**, withdraw the benefits of this Directive or refuse to apply this Directive.”
- ❖ IRD Council Directive 2003/49/EC of 3 June 2003, as amended on the Council Directive 2013/13/EU of 13 May 2013, [click here](#)



Special Tax Regimes

OECD Model: Provision on Special Tax Regimes



- ❖ Notwithstanding the provisions of [(in the case of Article 11): paragraphs 1 and 2 but subject to the provisions of paragraph 4] [(in the case of *Article 12*): paragraph 1 but subject to the provisions of paragraph 3] of this Article, [interest] [*royalties*] arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is *connected to the payer* may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a *special tax regime* with respect to the [interest] [*royalties*] in the State of which it is resident. [Emphasis Added]

[OECD Model Commentary on Article 1 paragraphs 85-100]

EU Provision on Special Tax Regimes: Interest & Royalties Directive Proposal (failed)



- ❖ 1. Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that Member State ... provided that:
 - (a) ...
 - (b) the income deriving from the royalty or interest payments *is subject to an effective tax rate of at least 10% in the Member State of the beneficial owner* ...
- ❖ 1b. Where the condition ... above is not fulfilled, royalty payments arising in a Member State shall however be exempt ... to the extent that
 - the [lower effective tax rate is the result of an *IP box regime compliant with the OECD Nexus Approach*] (I alternative); and
 - the *effective tax rate* is at least equal to X% (II alternative).

[Room Document 2, Working Party on Tax Questions (Direct Taxation), Interest and Royalties Directive (16 Feb. 2016)]

OECD, UN, 2016 US Model

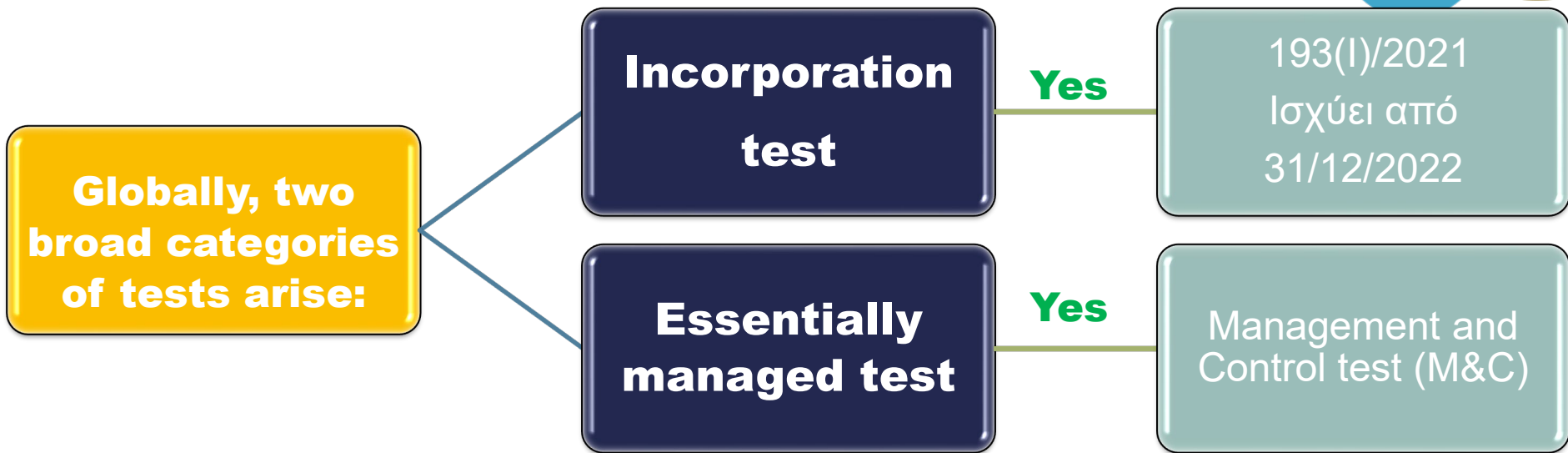


- ❖ “Pillar 2” in its Two-Pillar package, the OECD/G20 BEPS Inclusive Framework (IF) has released its own Subject To Tax Rule (STTR) and an accompanying multilateral instrument to implement it into treaties.
- ❖ At its 26th session in March 2023 the UN Tax Committee (UNTC) approved an STTR which will be included in the next edition of the UN Model Convention
- ❖ 2016 US Model Income Tax Convention



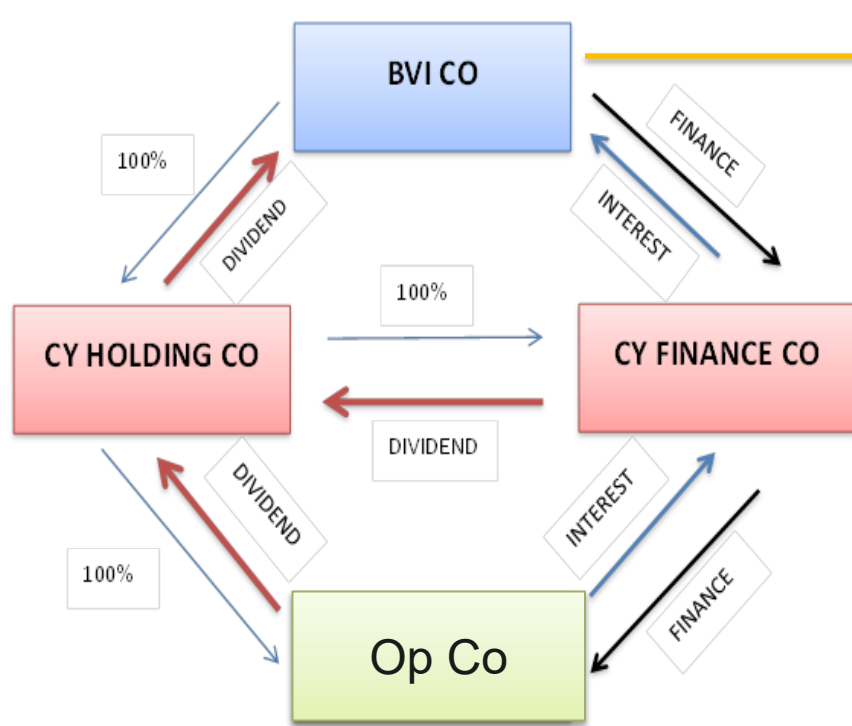
Corporate Substance

CORPORATE RESIDENCE



For more details about corporate substance post-BEPS you can find in the following article as published in Bloomberg Tax: *INSIGHT: Corporate Residence Post-BEPS and Global Mobility*, [Click here](#)

PRACTICAL ISSUE



Majority of the Board
of Directors are
Cypriot Tax residents;

→ Under the **M&C test**, BVI Co is probably Cyprus tax resident; **and as a result**

→ The BVI Co is taxed in Cyprus on its world-wide income wherever arising.

CYPRUS DOMESTIC LAW FOR CORPORATE RESIDENCE



No detailed guidelines have been issued by the Cypriot Tax Authorities

No jurisprudence from Cyprus courts of what constitutes management and control

Cyprus legal system is mostly based on common law order

Common law jurisprudence is widely followed by Cyprus courts

Higher level of decision-making: De Beers case (1906), Unit Construction Co case (1960), Wood v Holden case (2006)

TAX TREATIES: TIE BREAKER RULE - PLACE OF EFFECTIVE MANAGEMENT CRITERIA (POEM)



meetings of the
person's board of
directors or equivalent
body are usually held;

where the chief executive
officer and other senior
executives usually carry
on their activities;

where the
**senior day-to-day
management**
of the person is carried
on;

[OECD Commentary 2014 on Art. 4(3) para. 24]

where the person's
headquarters are
located;

which country's
laws govern the
legal status of the
person; and

where its
accounting records
are kept.

PRACTICAL EXAMPLE: DUAL RESIDENCE CYPRUS COMPANY

High-level
Decisions

Cy Co

Resident
(Domestic law)

Cy Co

Senior day-
to-day
management

OECD Model A4 (3)

Resident
(Treaty)

Cyprus would
normally be the
loosing state

The other contracting
state would normally be
the **winning state**.



Transfer Pricing Challenges for Intangibles: Definitions

Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG vs IAS 38



Transfer
pricing



- ❖ Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances
- ❖ Patents; Know-how and trade secret; Trademark, trade names and brand; Rights under contracts and government licences; Licences and similar limited rights in intangibles; and Goodwill and ongoing concern value.
- ❖ Specific local market advantages, group synergies and assembled workforce are not classified as intangibles.



IAS 38

- ❖ An identifiable non-monetary asset without physical substance, controlled by the entity and held for use in the production or supply of goods or services, for rental to others, or for administration purposes.
- ❖ IAS 38 may require that intangible development be recorded as an expense and not capitalized and shown as an asset on the balance sheet. Yet, for TP purposes, there may be a valuable IP asset.

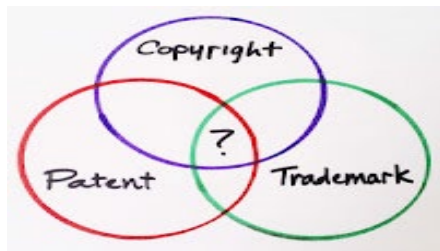
Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG vs IAS 38 Practical Issues



- ❖ Such off-balance-sheet assets might potentially include:
 - ❖ Rights to use industrial assets such as patents, trademarks, trade names, designs or models;
 - ❖ copyrights of literary, artistic or scientific work (including software);
 - ❖ intellectual property such as know-how and trade secrets
 - ❖ customer lists, distribution channels, unique names, symbols or pictures.

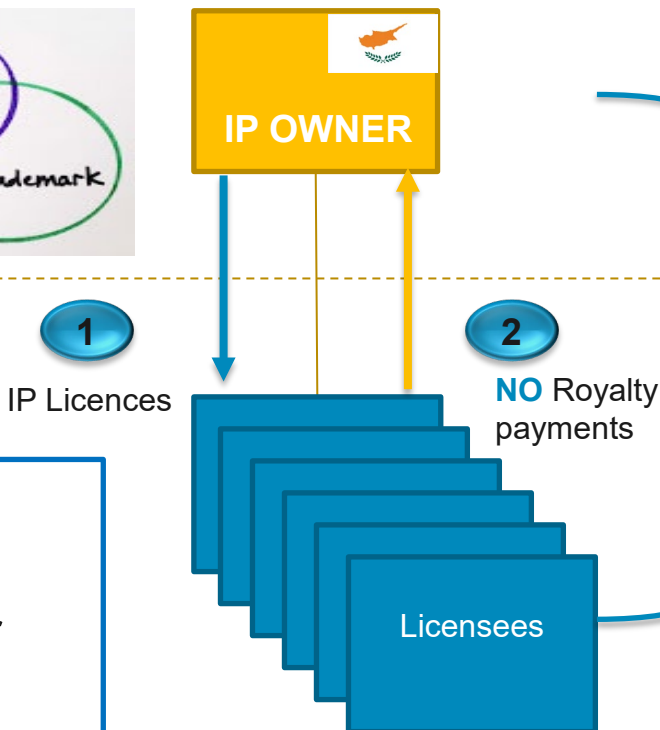
- ❖ Chapter IX: Business Restructurings: Transfer of Intangibles or Transfer of activity (on going concern) such as assembled workforce.

Intangible Asset: Royalty-free agreement



Investment(s) State (i.e. Source state)

- ❖ **Royalty free**
- ❖ Written, oral or implied.



- ❖ Absence of royalties could raise concerns about the arm's length nature of the transaction.
- ❖ Tax authorities would typically adjust the pricing to reflect what would be considered appropriate under the arm's length principle.
- ❖ Could lead to adjustment in taxable income and potential penalties for non-compliance.



Transfer Pricing and IP BOX

Framework for analysing transactions involving intangibles: Six-step process



The allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets [OECD TPG 6.34]

- 1 • **Identify** the **intangibles used** or transferred in the transaction with specificity, and the **economically significant risks** associated with the **Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE)** of intangibles
- 2 • **Identify** the full contractual arrangements, with special emphasis on determining **legal ownership** of intangibles
- 3 • **Identify** the **parties** performing functions, using assets and managing **risks** related to the **DEMPE** of intangibles
- 4 • **Confirm consistency** between the terms of the contractual arrangements and the conduct of the parties (allocation of risks)
- 5 • **Delineate** the **actual** controlled transactions related to the DEMPE of intangibles
- 6 • **Determine** arm's length prices for transactions consistent with each party's contribution of functions, assets and risks

Going forward Legal Ownership becomes less important

How is income allocated between related parties from exploiting the intangible?



The legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed [TPG 6.47].

All members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles [TPG 6.48].

- Which member(s) perform and exercise **control** over **DEMPE**;
- Which member(s) provide **funding** and other assets; and
- Which member(s) **assume the various risks** associated with the intangible.

BEPS Action 5 VS BEPS Action 8-10



Qualifying expenditure incurred to develop the IP Asset & Overall Income from IP Asset

IP BOX: BEPS 5
Nexus Formula

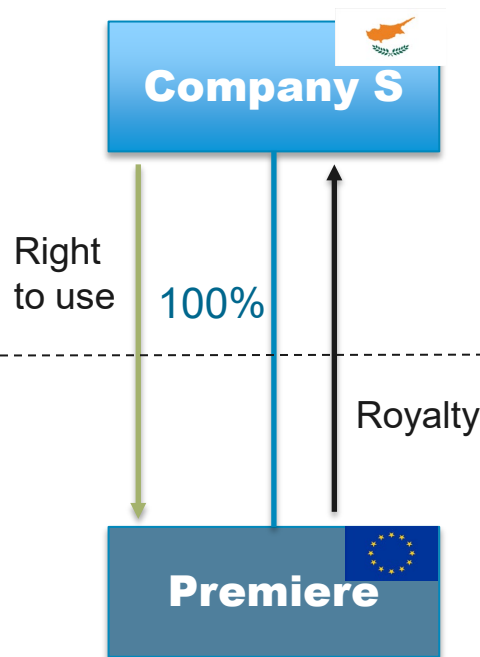
$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$



Development, Enhancement, Maintenance, Protection and Exploitation of intangibles

BEPS Action 8-10
allocation keys
DEMPE

Practical Example: Holding intangible and simply performing a patent administration function is not entitled to intangible related returns



- ❖ Company S employs **three lawyers** to perform its **patent administration** work and has no other employees

- ❖ Company S **does not conduct or control** any of the R&D activities of the Premiere group

- ❖ Premiere **funds R&D** and performs ongoing R&D functions in support of its business operations.
- ❖ Premiere **performs all DEMPE functions** except for patent administration services.
- ❖ Premiere contributes and uses **all assets** associated with the development and exploitation of the intangible, and
- ❖ Premiere **assumes** all or substantially all of the **risks** associated with the intangibles.

OECD Conclusion

S is entitled to an arm's length price for the patent administration services and is **not entitled to any intangible related returns**



Intangibles under Tax Treaties & Transfer Pricing

OECD Model Article 12: Royalties



1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.
2. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

What conditions need to be present for Art. 12 to apply?

- ❖ Royalties
- ❖ Mixed contracts
- ❖ Beneficially owned
- ❖ Arising
- ❖ Special relationship

OECD Model Article 12(4) Excessive Royalties: Practical example



4. Where, by reason of a **special relationship** between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, **exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship**, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the **excess part of the payments shall remain taxable according to the laws of each Contracting State**, due regard being had to the other provisions of this Convention.

❖ The purpose of Article 12 paragraph 4 is to restrict the operation of the provisions concerning the taxation of royalties up to the arm's length royalty payments.



❖ For example, royalty **payment amounting EUR 5 million** and the arms length amount of the royalty is **EUR 3 million**, then the excess amount of **EU 2 million** would not be entitled to the tax treaty benefit under Article 12 Royalties.

Base Case: IP Company Structure

STEP 4 & 5

Base Case: IP Company Structure



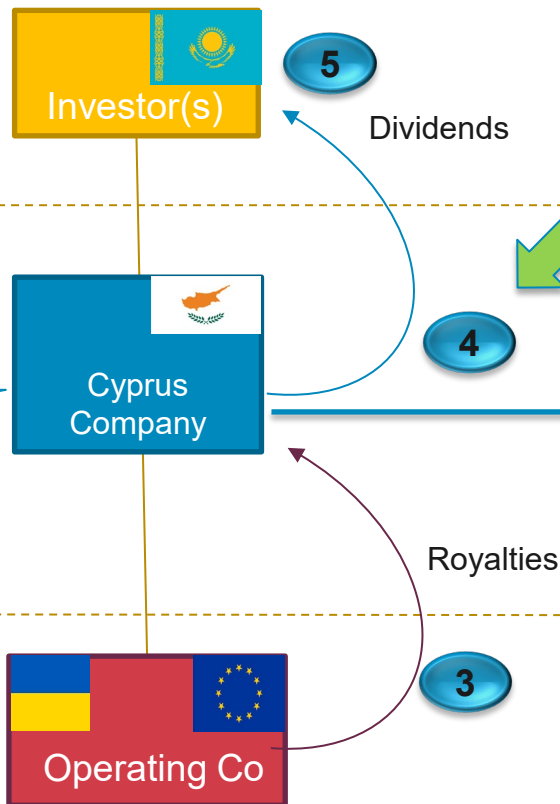
Investor(s) State (e.g. Kazakhstan)

- 1 Sell of IP financed by an interest-bearing loan or contribution of the IP.
Or licensed

Cyprus

- 2 **Opaque** i.e. not transparent
Licence IP

Investment(s) State (i.e. Source state)



Tax considerations:

- 1) IP BoX;
- 2) Maximum Deduction 80% of taxable profit;
- 3) 12,5% tax on profit;
- 4) No WHT on dividends to investor;
- 5) Double tax relief available; and
- 6) In sum, typically circa 2,5% tax in Cyprus.

STEP 4: Cypriot Tax Considerations



- ❖ NID and IP BOX, Maximum Deduction 80% of taxable profit at 12,5% tax on profit;
- ❖ Normally, no WHT on dividends to investor;
- ❖ Double tax relief available; and
- ❖ In sum, typically circa 2,5% tax in Cyprus.
- ❖ For more details on the future of the IP Box, you can find at the following article as published at IBFD: *Patent Boxes: The Rise, the Change or the Fall?* [Click here](#).

Base Case: IP Company Structure



Investor(s) State (e.g. Kazakhstan)

1

Sell of IP financed by an interest-bearing loan or contribution of the IP.
Or licensed



5

- Tax implications on both dividend income & capital gains tax on disposal of shares;
- CFC Rules; and
- Double tax relief.

Dividends

Cyprus

2

Opaque i.e. not transparent

Licence IP



4

Royalties

Investment(s) State (i.e. Source state)

3



STEP 5: Investors State Tax Considerations



- ❖ Tax implications on both dividend income & capital gains tax on disposal of shares;
- ❖ CFC Rules; and
- ❖ Double tax relief.
- ❖ For more details on how CFC rules, you can find on the following article as published in Bloomberg Tax: *Analysis of Pillar Two Primary Rule IIR – and Comparison With CFC Rules*, [Click here](#).

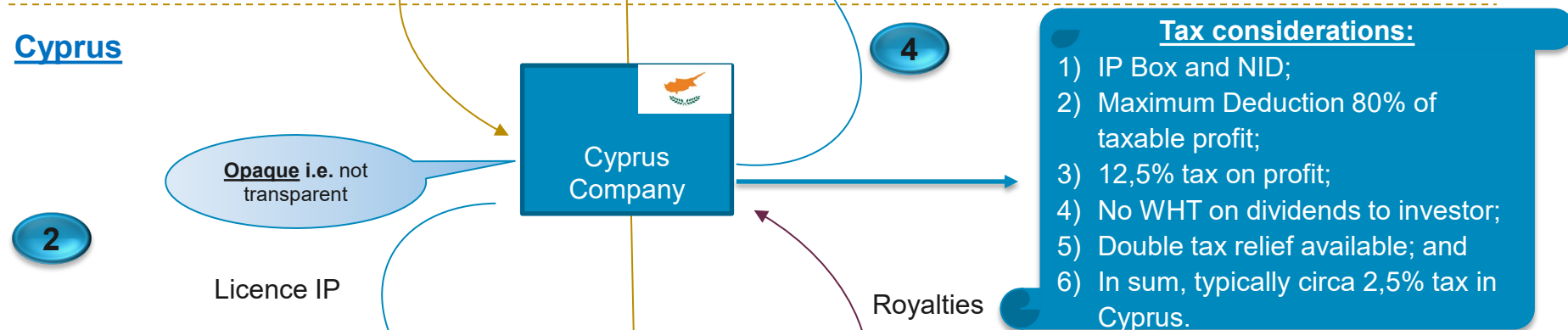
Base Case: IP Company Structure



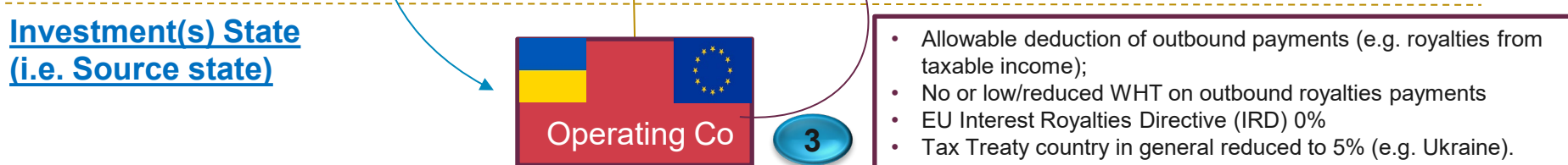
Investor(s) State (e.g. Kazakhstan)



Cyprus



Investment(s) State (i.e. Source state)



References (1)



- ❖ IRD Council Directive 2003/49/EC of 3 June 2003, as amended on the Council Directive 2013/13/EU of 13 May 2013, [click here](#)
- ❖ Model Tax Convention on Income and on Capital: Condensed Version 2017, [click here](#)
- ❖ ATAD Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [click here](#).
- ❖ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, [click here](#).
- ❖ OECD/G20 BEPS Project, the 15 actions, [click here](#).
- ❖ Ο περί Διπλωμάτων Ευρεσιτεχνίας Νόμος του 1998 (16(I)/1998), [click here](#)

References (2)



- ❖ For more details regarding Beneficial Ownership, you can find the following article published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 1]* [Click here.](#)
- ❖ For more details regarding the PPT you can find in the following article as published at Bloomberg Tax: *INSIGHT: Treaty Shopping—Is the New Principal Purpose Test a Game Changer? [PART 2]* [Click here.](#)
- ❖ For a comparison of the EU GAAR and the PPT, you can find more details in the following article as published at Bloomberg Tax, *OECD's Principal Purpose Test Versus EU's General Anti-abuse Rule* [Click here](#)
- ❖ For more details about corporate substance post-BEPS you can find in the following article as published in Bloomberg Tax: *INSIGHT: Corporate Residence Post-BEPS and Global Mobility*, [Click here](#)
- ❖ For more details on the future of the IP Box, you can find in the following article as published at IBFD: *Patent Boxes: The Rise, the Change or the Fall?* [Click here.](#)
- ❖ For more details on how CFC rules, you can find in the following article as published in Bloomberg Tax: *Analysis of Pillar Two Primary Rule IIR – and Comparison With CFC Rules*, [Click here.](#)

Questions!



Thank you for your attention!

(Nothing in this presentation purports to give any advice on the feasibility of the mentioned concepts.)