Tax Incentives for Innovative SME's

Introduction

The Cyprus' House of Representatives, at the end of 2016, approved the introduction of revised tax incentives for investment in innovative businesses.

The tax incentives aim to support start-ups in developing innovative products and services and strengthen the Cypriot entrepreneurial ecosystem. The new incentives are effective from 1 January 2017.

Tax incentive provided to qualifying investors

According to the new provisions, a "qualifying investor" that makes a "risk-finance investment" in an "innovative small and medium-sized enterprise (SME)" may deduct the costs of the investment from his/her taxable income, subject to the following limitations:

- **Percentage limit**: The tax deduction is limited to 50% of the investor's taxable income in the year in which the investment is made, as calculated before allowing this deduction but after allowing deductions for life insurance premiums and contributions to provident and other approved funds (as per Article 14 of the ITL).

- **Annual limit:** The total deductible amount may not exceed EUR 150,000 per year.

- **Carryforward**: The remaining investment cost not claimed as tax deductible may be carried forward and deducted from the taxable income of the subsequent five years, subject to the restrictions.

A qualifying investor

A qualifying investor is an individual that is deemed to be independent from the enterprise. An investor is deemed to be independent, if he/she is not an existing shareholder of the enterprise, unless he/she was one of the founders of the enterprise upon its incorporation.

A risk-finance investment

A risk-finance investment is an "equity investment" or a "quasi-equity investment" or a "loan", or a combination thereof, and includes finance leases and guarantees. A risk finance investment may be the initial investment in the enterprise or a "follow-on investment". The above terms are explicitly defined in the law.

Other requirements for follow-on investments to qualify for the deduction

For a follow-on investment to qualify for the tax deduction, the following conditions must be satisfied:

- The total amount of risk finance investment may not exceed EUR 15 million;

- The possibility of a follow-on investment must have been foreseen in the original business plan submitted to the authorities; and

- The enterprise receiving the follow-on investment may not be linked with another undertaking as outlined in Article 21(6)(c) of the EU state aid rules (Regulation 651/2014).

The approved means of making a risk-finance investment

A qualifying investor can invest either directly in the innovative SME or indirectly via an "investment fund" or an "alternative trading platform". Both terms are explicitly defined in the law.

Minimum period for holding the investment?

A qualifying investor needs to hold his/her investment for a minimum period of three years, otherwise the Commissioner of Taxation may disallow the tax deduction.

An innovative SME

According to the definition provided in Article 9A of the ITL, a SME will qualify as an innovative SME if it meets the following requirements:

- It operates in the Republic of Cyprus; and

- At the time of the investment, it is an unlisted SME (unless it is listed on an alternative trading platform) that has a business plan for its risk-finance investment and fulfills at least one of the following conditions:

    - It has not been operating in any market; or o It has been operating in any market for less than seven years following its first commercial sale; or

    - It requires an initial risk-finance investment which, based on a business plan prepared in advance of a new product offering or the entering of a new geographical market, is higher than 50% of its average annual turnover in the preceding five years; and

- It has been approved by the Cyprus Ministry of Finance or other authority as a qualifying innovative SME.

A business will automatically lose its innovative SME status, if at any time, the total amount of risk-finance investment received exceeds EUR 15 million.

The process for obtaining approval as a qualifying innovative SME

To be approved as an innovative SME, the company must submit an application to the authorities, along with a statement from an independent auditor confirming that the R&D expenses (which may also include any capitalized R&D expenses) represent at least 10% of the total operating expenses of the enterprise in at least one of the three tax years preceding the tax year in which the investment was made; or, in the case of a start-up enterprise without any financial history, based on the audited financial statements or in the absence of audited financial statements, in accordance with a business plan that the authorities are entitled to request.

The Ministry of Finance is expected to issue additional guidelines with regards to the application procedure.

Effective period of the tax incentive

The tax incentive is available to qualifying investors for a three-year period beginning on 1 January 2017, unless a new law is passed before the end of that period that extends the application of the incentive.

Important considerations

The Commissioner of Taxation may refuse a tax deduction in case where actions have been taken to abuse the provisions of the law.

The tax incentive is in line with EU rules on state aid

The tax incentive is in line with EU rules on state aid as outlined in EU Regulations 651/2014.

Tax incentive granted to qualifying businesses

According to the revised Article 9(d) of the ITL, qualifying expenditure incurred by an innovative SME may be deducted from taxable income equally in the year incurred and in the following five years (i.e. over a total of six years).

Type of expenditure that qualifies for the deduction

Expenditure,

- incurred for scientific research including for research and development (R&D), as recognized by International Accounting Standards,
- incurred by a person conducting an innovative SME
- which are not eligible for capital allowances as per Article 10 of the ITL

* The information provided above is purely a courtesy guideline and should not be constituted as advise.

Please contact us for an updated profile. Specialist advise may be sought.