



## NEWSLETTER

### Royalties – Effective Tax Routings

#### 1 Introduction

Royalties are the payment of licence fees or commissions by one individual or entity to another for the use of intellectual property (IP). Intellectual property can take several forms as follow:

- (i) Patents that protect inventions or new processes
- (ii) Trademarks that relate to the names of products and perhaps also their design and packaging
- (iii) Copyright, which attaches to any original creative idea expressed in words or pictures
- (iv) Image rights

The aim is to generate the income arising from these rights in the most tax efficient manner possible.

#### 2 How it works

The client owning the intellectual property donates or sells it to an offshore company.

This is ideally done when the property is still of little value.

The offshore company licences some or all of the rights for the use of the property to an onshore intermediary or agency company created in a jurisdiction offering tax benefits.

The onshore intermediary company then exploits the rights by licensing their use in various countries including EU countries.

Royalty fees pass to the onshore intermediary company, which may be subject to zero or a low withholding rate due to double tax treaty benefits.

The onshore intermediary company retains a fee for the work done in negotiating contracts etc. and will pay tax on this sum.

Finally, the onshore intermediary company remits the balance to the offshore company free of any further withholding taxes.

#### 3 Choosing the intermediary company

When choosing where to set up the intermediary company, it is important to consider several issues. It is important, for example, to study the applicable double tax treaties, the cost for setting up the company and the capital requirements.

##### **Why Cyprus - Tax and other considerations:**

We prefer to use Cyprus for royalty routing structures, because Cyprus offers the following advantages:



- No withholding taxes on payment of royalties when distributed out of Cyprus, provided that the holder is not a Cyprus-resident and the rights are used outside Cyprus.
- Tax is only paid on the licence fee retained by the Cyprus Company.
- Cyprus has a vast worldwide network of double tax treaties, and since 1st May 2004 when Cyprus entered the European Union, the EU directive on interest and royalties applies. The directive can provide for NIL (0%) withholding taxes on royalty payments between EU countries.
- Cyprus corporate tax rates (10%) are among the lowest within the EU.

#### **Other practical considerations**

The ideal candidate for royalty routing is a client who has a new IP right, when there is a little difference between the fiscal book value and the real value of the right and it can be transferred to an offshore company at little value.

Once the intellectual property rights are vested in the offshore company they are then licensed to other, usually onshore, intermediary corporations.

#### **4 Case Study Scenario**

An Austrian software company is developing software for which it intends to register the patent rights. The company registers the patent not under its own name but under the name of a 100% owned offshore company. The offshore company, registered in for example the BVI, then enters into a license agreement with a Cypriot company for the offshore company's European patent rights.

The Cyprus Company now has the exclusive ability to exploit these rights in Europe. The Cypriot company then enters into contracts with European customers, through which it exploits the rights, which it now owns.

- (i) Contract 1 is with an Italian software company for the right to subscribe to the software for which the Cyprus Company holds the right.
- (ii) Contract 2 is with the Austrian Company for the same rights.

The income passes fully to the Cypriot company without withholding taxes in any EU country.

#### **Tax implications**

- The Cypriot Company retains a 5% licence fee and pays tax on this income but it will be able to pass 95% to the offshore company where no further tax will be levied.
- If the Austrian company had negotiated these contracts directly it could have suffered up to 34% income tax on the income.
- Also, the Austrian company will pay the Cyprus Company for the right to utilize the patent. This will be considered as an expense for the Austrian company and consequently the taxable profit will be reduced.
- Further, if the Austrian company sells the rights, any gains will be taxed at 34%. However, if the offshore company sells the rights, the capital gains tax is 0%.



**Illustration:**



**What we can do**

- Advice on royalty structure
- Formation of companies
- Administration
- Nominee and office facilities
- Invoicing and accounting
- Office facilities

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