

**Tax Incentives for Investing in Innovative
Enterprises (Practical Guide)**

February 2017

1. Introduction

The National Policy Statement for the Enhancement of the Entrepreneurial Ecosystem in Cyprus is a joint action involving all actors of the entrepreneurial ecosystem in order to exploit business potential, removing existing barriers and establish a new, growth-oriented, entrepreneurial culture in Cyprus.

One of the major actions in the framework of the the National Policy Statement for the Enhancement of the Entrepreneurial Ecosystem in Cyprus, which was implemented by the Ministry of Finance in cooperation with the Unit of Administrative Reform – Presidency, is the revision of the Income Tax Law in order to create an attractive incentive through tax relief to individuals investing in innovative companies, either directly or through an investment fund.

The new legal framework was approved by the House of Representatives in December 2016 and is effective as from January 1, 2017.¹

This Practical Guide includes some general information for interested companies and investors. It does not contain all detailed rules and will be revised when necessary

2. Beneficiaries

Eligible are individual investors that are 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 establishment. Individuals can carry out their investment either directly or indirectly through an investment fund or through an alternative trading platform for venture capital investment in an innovative small and medium-sized enterprise (SME).

3. What type of investments is eligible?

The incentive is provided for risk-finance investments.

'Risk finance investment' means equity and quasi-equity investments, loans including leases, guarantees or a mix thereof, to eligible undertakings for the purposes of making new investments and includes also follow-on investments.

For the purposes of defining risk finance investments the following definitions are provided in the law:

- (i) "equity investment" means the provision of capital to an undertaking, invested directly or indirectly in return for the ownership of a corresponding share of that undertaking;
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- (ii) "quasi-equity investment" means a type of financing whose return for the holder is predominantly based on the profits or losses of the target enterprise and which are unsecured in the event of default (e.g. hybrid loans, debt convertible into equity etc.)
- (iii) "loan" means an agreement which obliges the lender to make available to the borrower an agreed amount of money for an agreed period of time and under which the borrower is obliged to repay the amount within the agreed period. It may take the form of a loan or another funding instrument including a lease. The refinancing of existing loans shall not be an eligible loan.
- (iv) "follow-on investment" means additional risk finance investment in a company subsequent to one or more previous risk finance investment rounds;

There are special conditions applicable in respect of follow-on investments made in eligible undertakings, including investments made after the 7 year period outlined above in accordance to which, follow-on investments may be eligible if the following cumulative conditions are fulfilled:

- (a) The total amount of risk finance mentioned in paragraph 9 of Article 21 of Regulation (EU) no. 651/2014, is not exceeded;
- (b) The possibility of follow-on investments was foreseen in the original business plan;
- (c) The undertaking receiving follow-on investments has not become linked, with another undertaking other than the financial intermediary or the independent private investor providing risk finance under the measure, unless the new entity fulfils the conditions of the SME definition. "Investing venture capital" means investment in equity and quasi-equity loans, including leasing, guarantees or a combination thereof, to eligible enterprises to make new investments.

According to the new provisions of Article 9A of the Income Tax Law, "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 for 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 aforementioned restrictions.

Examples

(I) Independent Investor, whose annual taxable income is shown below, invests in an innovative enterprise the amount of € 400.000 in year 2017.

The tax benefit is presented below:

Tax Year	2017	2018	2019
	€	€	€
Annual Taxable Income	500.000	400.000	300.000
Discount for investment, lower than: 50% of annual income tax			
2017 - €250.000			
2018 - €200.000	(150.000)	(150.000)	(100.000)
2019 - €150.000			
Maximum Yearly Discount €150.000			
Annual Taxable Income subject to tax	<u>350.000</u>	<u>250.000</u>	<u>200.000</u>
Remaining investment amount (transferred for 5 years):			
2017 - €400.000 - €150.000	250.000		
2018 - €250.000 - €150.000		100.000	
2019 - €100.000 - €100.000			0

(II) Independent Investor, whose annual taxable income is shown below, invests in an innovative enterprise the amount of € 100.000 in year 2017.

The tax benefit is presented below:

Tax Year	2017	2018	2019
	€	€	€
Annual Taxable Income	50.000	80.000	30.000
Discount for investment, lower than: 50% of annual income tax			
2017 - €25.000			
2018 - €40.000	(25.000)	(20.000)	(15.000)
2019 - €15.000			
Maximum Yearly Discount €150.000			
Annual Taxable Income subject to tax	<u>350.000</u>	<u>250.000</u>	<u>200.000</u>
Remaining investment amount (transferred to 5 years):			
2017 - €100.000 - €25.000	75.000		
2018 - €75.000 - €20.000		55.000	
2019 - €55.000 - €15.000			40.000
(Can be transferred			

in years 2020-2022)

4. Definition of an innovative SME

A small and medium-sized enterprise (SME) qualifies as 'innovative SME' if:

- (a) Its operations are carried out in the Republic of Cyprus and
- (b) At the time of the investment it is an unlisted SME having a business plan (prerequisite only if it has no financial records) for its risk finance investment and fulfils at least one of the following conditions:
 - (i) It does not operate in any market; or
 - (ii) It has not been operating in any market for more than 7 years (this restriction does not, under certain conditions, apply for follow-on investments) following their first commercial sale; or
 - (iii) It requires an initial risk finance investment which, based on a business plan prepared in view of entering a new product or geographical market, is higher than 50% of their average annual turnover in the preceding 5 years.

It is noted that:

- the term **market** includes all products or services where interested enterprises engaged in the supply of products or services that may be regarded as interchangeable or substitutable by the consumer because of their price and the use they are intended for.
- the term **geographical market** includes the area in which the interested enterprises engaged in the supply of products or services and the competition conditions are sufficiently homogeneous and also this area can be distinguished from neighboring areas because in these areas the conditions of competition vary significantly.

To qualify as innovative, an enterprise should:

- (a) acquire a statement provided by an **independent auditor** confirming that the research and development expenditure (that may also include capitalized costs) represent at least 10% of its total operating costs-
 - (i) In at least one of the three (3) years preceding the granting of the aid or,
 - (ii) In the case of a startup enterprise without any financial history, in the audit of its current fiscal period.

In the absence of audited financial statement, with regard to startups, the MoF approval may be provided on the basis of a business plan. A template of a business plan is provided in **Annex 1**.

Other provisions:

- A business will automatically cease to be considered an innovative SME if at any time, the total amount of risk finance exceeds EUR15 million (Commission Regulation (EU) No.651/2014 of 17 June 2014).
- The innovative SME should not be listed on the Cyprus Stock Exchange or another

Innovative companies can be exercised not only by legal but from natural persons (as private enterprises), or partnerships.

Reference to the state aid rules may provide for the exclusion of the business as an innovative SME.

5. Process for obtaining certification for innovative SME

To acquire a certificate as an innovative SME, the company must submit to the Ministry of Finance via email (innovative.companies@mof.gov.cy), an application form (**Annex 2**).

The Ministry of Finance shall assess the application and it will either approve or reject it. In the case of approval a certificate will be issued characterizing the enterprise as an "innovative small and medium-sized enterprise (SME)" within one month from the date the application was submitted. In case of rejection of the application also the decision should be issued within one month from the date the application was submitted.

The MoF reserves the right to arrange a meeting, using electronic means, with the legal representative of the company for further clarifications / explanations regarding the enterprise.

6. What is the effective period of the tax incentive?

This tax incentive is available 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.

7. Are there any exclusion clauses?

The rules provide for exclusion clauses that may restrict the deductibility of the expense if:

(i) the investor does not maintain the investment for a minimum period of 3 years; or

(ii) the tax authorities consider that actions have taken place that exceed the maximum ceilings set by the rules.

8. How will qualifying investors know that an enterprise is innovative?

The MoF will issue a certificate valid for three (3) years to any enterprise that meets the criteria to be characterized as an innovative.

The MoF will also maintain a Register of all relevant innovative enterprises.

Further to this practical note investors and interested enterprises are advised to also consult:

- (i) The text of the Cyprus Income Tax Law as amended
- (ii) The Circulars and/or Regulations that may be issued by the Ministry of Finance with regard to the approval procedure
- (iii) Commission Regulation (EU) No. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the TFEU.

For more information please contact:

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