



REPUBLIC OF CYPRUS

Tax Incentives for Investing in Innovative Enterprises

Practical Guide

June 2020

**Ministry of Finance
Deputy Ministry of Research, Innovation & Digital Policy**

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 aiming to exploit business potential, eliminate 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 amendment 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 considered necessary.²

2. Beneficiaries

Eligible are individual investors who 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. Which types of investments are 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 also includes follow-on investments.

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

¹ http://www.cylaw.org/nomoi/arith/2016_1_135.pdf

² Disclaimer:

The Practical Guide "Tax incentives to individuals for investing in innovative enterprises" is an informative driver and aims to inform interested investors and companies through a brief description of the procedure governing tax incentives on the basis of the Income Tax Law. The information in the guide is general and is not exhaustive, does not constitute and may not be considered as a legal advice to any person. The Practical Guide does not substitute a legal text and it cannot be considered as a legal interpretation of the relevant legislation. Only courts have the responsibility for the legal interpretation of laws. Every effort is made to ensure that the information contained in the guide briefly reflects the major provisions of the law, but neither the Ministry of Finance nor the Administrative Reform Unit undertake any responsibility for possible errors or missing details, or for any damage derived directly or indirectly from use the content.

- (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;
- (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 business which receives follow-on investments is not linked to another undertaking other than the financial intermediary or the independent private investor who provide 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” which 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:			
<ul style="list-style-type: none"> • 50% of annual income tax 2017 - €250.000 2018 - €200.000 2019 - €150.000 	(150.000)	(150.000)	(100.000)
<ul style="list-style-type: none"> • Maximum Yearly Discount €150.000 			
Annual Taxable Income subject to tax	350.000	250.000	200.000
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:			
<ul style="list-style-type: none"> • 50% of annual income tax 2017 - €25.000 2018 - €40.000 2019 - €15.000 	(25.000)	(40.000)	(15.000)
<ul style="list-style-type: none"> • Maximum Yearly Discount €150.000 			
Ετήσιο Φορολογητέο Εισόδημα που υπάγεται σε φόρο	25.000	40.000	15.000
Annual Taxable Income subject to tax Remaining investment amount (transferred to 5 years):			
2017 - €100.000 - €25.000	75.000		
2018 - €75.000 - €40.000		35.000	
2019 - €35.000 - €15.000 (Can be transferred in years 2020-2022)			20.000

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) It has a business plan 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.

The classification of an SME as 'innovative' is being evaluated, as follows:

Category A: Existing businesses, with financial history

The company submits a *Certificate from an External Auditor*, certifying that the research and development costs represent at least 10% of its total operating costs. This Certificate must be in accordance with the audited financial statements of the company, which proves the costs for research and development in at least one (1) of the three (3) previous tax years. The categories of expenditure on research and development in the financial statements must be clearly defined. A draft Certificate of External Audit is attached as Annex 2.

Category B: Startups, without financial history

The company submits a Business Plan describing the ability to develop new or clearly improved products, services or processes with high technological or industrial risk, which are characterized as innovative in their field / market. Guidelines for the preparation of the business plan are attached as Annex 3.

Category C: Businesses that meet at least one of the following criteria over the last three years

Businesses that prove that they meet at least one of the following criteria over the last three years, and submit proof for it, will receive a certificate without the need of evaluation:

- The company has secured funding from the SME Instrument (Phase I and / or Phase II), the EIC Pathfinder or the EIC Accelerator programmes of the Horizon 2020 EU Framework Programme, or from the EIC Pathfinder or the EIC Accelerator programmes of the Horizon Europe 2021-27 EU Framework Programme.
- The company has received a Seal of Excellence Seal from the Programs listed above.

- The company has secured funding from the Research and Innovation Foundation's (RIF) PRE-SEED, SEED or INNOVATE Innovation Programs and other corresponding Innovation Programs that will be announced under RIF's National Research and Innovation Framework Programs.
- The company has secured a Startup Visa.

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 or any other Stock Exchange.

Innovative companies can be exercised not only by legal but also by 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 an application (**Annex 1**) to the Deputy Ministry of Research, Innovation and Digital Policy via email (innovative.companies@dmrid.gov.cy).

The Deputy Ministry of Research, Innovation and Digital Policy evaluates the application in the following ways:

Category A: Existing businesses, with financial history

Examination of the Certificate of External Auditors submitted, stating that the company has invested more than 10% of its operating expenses in research and development. If this criterion applies, then the company is considered eligible for a certificate.

It is emphasized that the company and the external auditor are accountable for the accuracy of the information submitted.

Category B: Startups, without financial history

The Business Plan is evaluated by two independent evaluators based on specific criteria (a relevant document is attached as Annex 4).

- In case the Business Plan secures a score of $\geq 21/30$ from both evaluators, then the company is considered eligible for the issuance of a certificate.
- In case the Business Plan secures a score of $\geq 21/30$ by only one evaluator, then the Business Plan is evaluated by a third evaluator. If a score of $\geq 21/30$ is secured by the third evaluator, then the business is considered eligible for certification.

Category C: Businesses that meet at least one of the following criteria over the last three years

After examining and confirming the proof submitted, the company is considered eligible for the issuance of a certificate.

Approval or Rejection of an application

The Deputy Ministry of Research, Innovation and Digital Policy approves or rejects the classification of the business as an innovative small and medium-sized enterprise (SME) within one month of receiving a completed application.

The Deputy Ministry reserves the right to ask the legal representative of the company to provide further clarification / information / explanations about the company.

6. Renewal Process of the ‘Innovative business certificate’

In order to renew the Innovative Business Certificate, the company submits a Certificate from an External Auditor, which certifies that research and development costs account for at least 10% of its operating expenses in at least one of the previous 3 tax years.

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

This tax incentive takes effect from 1 January 2017. This means that any investment, as described in paragraph 3 above, being made to an innovative company after 1 January 2017 and before 30 June 2021 should be declared by the natural person who made the investment in his Income Tax Statement in that year.

In case the investment is made through an approved investment fund, then the shares are considered to have been issued on the date on which the fund closes.

8. 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.

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

The Deputy Ministry of Research, Innovation and Digital Policy will issue a certificate valid for three (3) years to any enterprise that meets the criteria to be characterized as innovative.

The Deputy Ministry of Research, Innovation and Digital Policy 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.

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