LUXEMBOURG PROPOSES NEW IP REGIME

On 4 August 2017, the Luxembourg government has filed the bill of law N° 7163/00 proposing a new Intellectual Properties ("**IP**") regime, which aims to be compliant with the "modified nexus approach" foreseen by Action 5 of the BEPS report (the "**Bill**"). Under the nexus approach, an IP derived income may be partially exempt on the condition that it is linked with qualifying expenditures.

The new IP regime will be applicable as from 2018 tax year (if enacted) and will replace the former IP regime which has been repealed.

Under the former regime, royalties, capital gains and damages for breach realised on qualifying IP (i.e. patents, trademarks, software, copyrights, domain names, designs, and models) benefited from an 80% exemption on the net IP income for CIT and MBT purposes and 100% for NWT purposes.

The former IP regime

Since the law of 21 December 2007, Luxembourg has offered a beneficial tax regime for IP derived income based on article 50bis of the Luxembourg Income Tax Law ("**LITL**"). This regime was repealed by the law of 18 December 2015, its effects starting from 1 July 2016 for Corporate Income Tax ("**CIT**") and Municipal Business Tax ("**MBT**") purposes and 1 January 2017 for Net Wealth Tax ("**NWT**") purposes on grounds that it was not aligned with the so-called "modified nexus approach".

Although this regime was repealed, the law of 18 December 2015 foresees a grandfathering clause allowing Luxembourg taxpayers which benefited from the regime to continue to do so until 30 June 2021 in the following situations:

- ✓ The IP rights were developed or acquired from unrelated parties before 1 July 2016;
- ✓ The IP rights were acquired from a related party before 1 July 2016 and were already eligible for the previous IP regime (or benefited from a similar regime in a foreign country), and
- ✓ The IP rights were acquired (including under any tax neutral transaction) from any related party before 31 December 2015.

<u>The new IP regime</u>

The Bill introduces a new article 50ter in the LITL allowing an 80% exemption of CIT and MBT for net qualifying income derived from eligible IP assets. The eligible assets will continue to be fully exempt from NWT.

Note that in the case where an IP asset is eligible for the new IP regime and the former IP regime (due to the grandfathering clause), the taxpayer has the choice to apply the regime of its choice. However, its choice is irrevocable and applicable for all its IP assets.

<u>Eligible IP assets</u>

Eligible assets are segregated in two main groups, as follows:

- ✓ Inventions protected by national or international provisions:
    - patents;
    - utility models;
    - certain supplementary protection certificates;
    - patent extension for paediatric medicines;
    - plant breeder's rights; and
    - orphan drug designations.
- ✓ Software protected by copyright pursuant to national or international provisions.

The eligible assets must have been created, developed, or further improved after 31 December 2007.

The application scope has been extended to plant breeder's rights and orphan drug designations. However, unlike to the former regime, marketing IP (i.e. trademarks, domain names and designs) will no longer be eligible for the tax benefits.

<u>Calculation of the income receiving tax benefits</u>

The new IP regime will benefit to taxpayers able to demonstrate that they incur R&D expenditures. As a consequence, a nexus ratio will apply to ensure that the proportion of qualifying income is the same as the one existing between qualifying expenditures and overall expenditures. Therefore, the income receiving tax benefits shall be calculated as follows:

Qualifying expenditures / Overall expenditures x Adjusted net qualifying income = Income receiving partial exemption for CIT and MBT

If a company incurs all of its expenditures to develop a single eligible asset, the nexus ratio should allow 100% of the Adjusted net qualifying income as income receiving tax benefits.

Note that for the purpose of the nexus ratio, the cumulative amount of qualifying expenditures and overall expenditures must be taken into account.

Adjusted net qualifying income

Qualifying income includes:

- royalties;
- embedded IP income from the sale of products or services;
- capital gains; and
- indemnity received through judicial or arbitral procedures.

The net qualifying income from an eligible asset realised for a given tax year is the positive amount between (i) the qualifying income and (ii) the overall expenditures and the expenses indirectly linked with the IP incurred during this given year.

This net qualifying income realised for a given tax year may be adjusted and offset.

The adjustment of the net qualifying income allows the net qualifying income to benefit from the exemption only in the case where the net qualifying income exceeds the operating expenses incurred during the given tax year (i.e. expenses linked directly or indirectly with the asset).

The offset applies in the case where the taxpayer owns more than one eligible asset and implies that the positive net adjusted qualifying income derived from an eligible asset shall be offset with the negative net adjusted qualifying income derived from another eligible asset.

Only the positive net qualifying income after offset and adjustment may benefit from the exemption foreseen by the new IP regime.

Qualifying expenditures

Qualifying expenditures include 3 types of expenses:

- necessary expenditures for performing R&D activities, incurred by the taxpayer;
- outsourcing costs for R&D carried out by unrelated parties; and
- outsourcing costs carried out by related parties, but only under the condition that the related party outsources to an unrelated party and no margin is retained by the related party.

The related parties are all companies which fall within the scope of article 56 LITL (referring to domestic transfer pricing regulations).

R&D activities do not have to be carried out within Luxembourg (otherwise it would be contrary to the EU fundamental freedoms).

Those R&D expenditures may be incurred by a permanent establishment (“PE”) located in a country party to European Economic Area agreement, as long as the PE is operational when the qualifying IP income is perceived and does not benefit from a similar IP regime in the country where it is located.

Qualifying expenditures do not include acquisition costs, financing costs, real estate costs and costs not directly related to an eligible asset.

To remain competitive and to ensure that the new IP regime does not penalise taxpayers excessively for acquiring IP or outsourcing R&D activities to related parties, the new IP regime provides for the opportunity to apply a 30% uplift to the qualifying expenditures. However this 30% uplift is limited to the overall expenditures incurred.

Overall expenditures

Overall expenditures are the sum of:

- qualifying expenditures (excluding the 30% uplift described above);
- acquisition costs; and
- outsourcing costs incurred by a related party.

Acquisition costs may also include licence fees. Unlike the eligible assets, acquisition costs include all IPs (eligible or not).

Qualifying and overall expenditures must be taken into account when occurred no matter the tax or accounting treatment.

Other requirements

The taxpayers are supposed to be able to demonstrate a link between the costs and the income for which an exemption is requested. This link should be evidenced for each IP separately.

Moreover, overall expenditures and qualifying income must be recognized using the arm's length principle foreseen by domestic transfer pricing regulations (articles 56 and 56bis LITL).

Conclusion

With the new IP regime, the sole acquisition of a qualifying IP right is no longer sufficient to benefit from the IP regime. Moreover, marketing related IPs will no longer be eligible assets.

The former regime was a strong tax incentive for companies to transfer their IP assets in Luxembourg. However, as there was no link between the exempt income and R&D activities, it failed to attract R&D activities to Luxembourg.

The new IP regime aims to preserve Luxembourg's tax attractiveness and complies with the recommendation provided by Action 5 of the BEPS report on harmful tax practices.

While all the countries participating in the BEPS project should apply a similar IP regime in the future, Luxembourg makes the choice to adopt the optional 30% uplift to the qualifying expenditures as proposed in the BEPS report, which clearly demonstrates the desire to remain a competitive country.

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