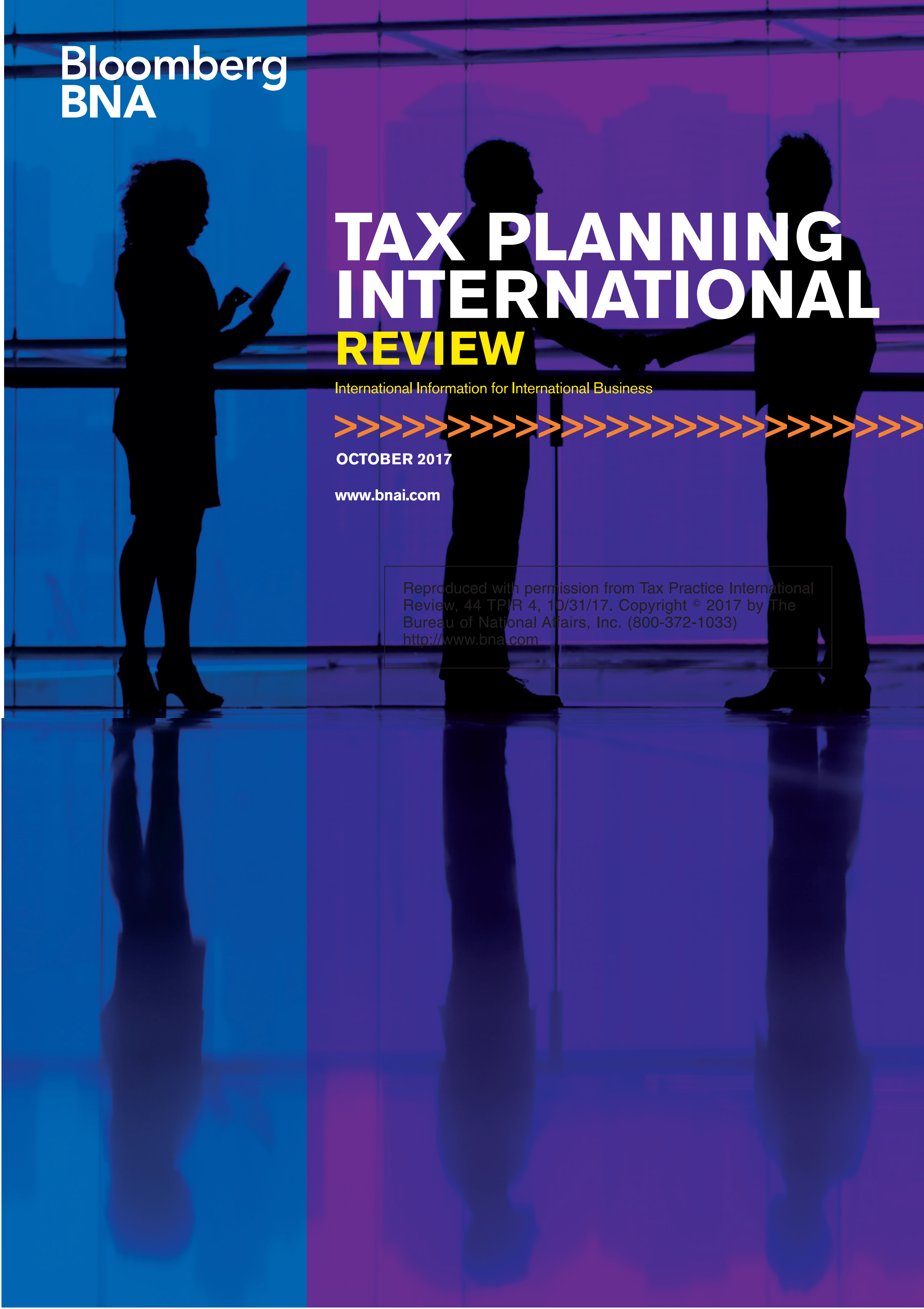

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The New Luxembourg IP Tax Regime: Opportunities for the Post-BEPS Era

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Luxembourg's new IP regime has been introduced in a draft law recently released. As from January 1, 2018, income derived from patents and copyrighted software will benefit from an attractive tax regime that is consistent with the modified nexus approach.

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On August 4, 2017, the text of the draft law introducing the new Luxembourg Intellectual Property ("IP") regime was released. The new IP regime is consistent with the modified nexus approach that has been agreed between the OECD and G-20 member countries as part of the work on Action 5 of the Base Erosion and Profit Shifting ("BEPS") Project. This article provides an overview of the modified nexus approach and Luxembourg's new IP regime.

Introduction

In an effort to become the prime location for Europe's envisioned knowledge-based economy, in 2008 Luxembourg implemented a first IP regime providing for an 80 percent tax exemption applicable to royalty income and capital gains deriving from a broad range of IP rights generated by Luxembourg taxpayers.

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In 2013, the OECD BEPS Action Plan identified preferential tax regimes including, in particular, IP and patent box regimes as a key pressure area. Indeed, Action 5 of the BEPS Project called for proposals to develop rules to counter harmful tax regimes more effectively, taking into account such factors as transparency and substance.

In September 2014, the OECD released a deliverable regarding Action 5 that proposed the application of a "nexus approach" that would align research and development ("R&D") expenditure with the granting of benefits: on the basis of this model, Germany and the U.K. issued a joint statement proposing a "modified nexus approach" in November 2014. Under the modified nexus approach, which has been adopted in the Final Report on Action 5, the benefits provided by patent boxes are linked to the qualifying R&D expenditure incurred by the taxpayer itself.

In accordance with the consensus reached under Action 5, Luxembourg repealed its former IP regime as of June 30, 2016 with a five-year grandfathering period, ending on June 30, 2021, for IP assets that previously benefited from the IP regime. As from January 1, 2018, income derived from patents and copyrighted software will benefit from an attractive tax regime that is consistent with the modified nexus approach and, therefore, fit for the post-BEPS era. While the draft law released by the Luxembourg legislator may still evolve and change during the legislative process, the main traits of the new regime should not change.

The Modified Nexus Approach

The nexus approach provides that IP income can only benefit from an IP regime to the extent that the taxpayer has incurred R&D expenses in creating IP on its own. The nexus approach is named as such since it establishes a "nexus" between the R&D expenditures incurred by the taxpayer, the IP income and the benefit that can be obtained under the IP regime. As is shown in the formula below, the proportion of R&D expenditure is the proxy to calculate how much IP income can benefit from the IP regime.

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Net qualifying income from IP asset} = \text{Income receiving tax benefits}$$

According to the Final Report on Action 5, jurisdictions are permitted to treat the tax benefit calculated under this formula as a rebuttable presumption, which may be reversed if the taxpayers provide sufficient evidence to demonstrate a direct link between their expenditure and the IP income and prove that more income should be permitted to benefit from the IP regime. However, countries should limit the application of this rebuttable presumption under strict conditions to cases with exceptional circumstances.

As the nexus approach raised some serious concerns, Germany and the U.K. made a proposal that modified the nexus approach previously proposed by the OECD. In February 2015, the OECD approved the modified nexus approach, the result of which was also included in the Final Report on BEPS Action 5 as released on October 5, 2015.

The proposal made by Germany and the U.K. modified the original nexus approach in the following two areas:

- Under the modified nexus approach, jurisdictions are allowed to permit taxpayers to apply a 30 percent "up-lift" to "compensate" for the exclusion of costs incurred by related parties or for the acquisition of IP rights. The purpose of the up-lift is to ensure that the modified nexus approach does not unfairly penalize taxpayers for acquiring IP or outsourcing R&D activities to related parties.

- As regards timing, countries choosing to have IP regimes had to amend their rules with a view to be consistent with the modified nexus approach no later than June 30, 2016. Moreover, the legislative process to make this change had to commence in 2015. In addition, there is a grandfathering provision that allows taxpayers who have been benefiting from an existing IP regime to continue to do so until June 30, 2021.

However, despite these modifications, the modified nexus approach is not free of controversy. In a European Union ("EU") context, the limitation of an economic activity to a particular territory could run counter to the fundamental freedoms of the EU. This is because, notwithstanding the availability of the 30 percent uplift, it could still disallow most of the R&D expenses incurred in other Member States from benefitting from a domestic IP regime.

In the past, the Court of Justice of the European Union ("CJEU") decided in several cases that regimes which limit benefits such as deductions or tax credits for expenditures to domestic expenditure, instead of extending such benefits to expenditure incurred in other Member States, are not compliant with EU Law (see, for example, CJEU, Decision of July 8, 1999, Case C-254/97, *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA v. Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Peche et de l'Alimentation* and CJEU, Decision of March 10, 2005, Case C-39/04, *Laboratoires Fournier SA v. Direction des vérifications nationales et internationales*). It is difficult to see how the modified nexus approach can be aligned with the requirements set out in relevant CJEU case law. However, the EU Code of Conduct Group completely ignored relevant arguments in the consultation process. It remains to be seen how the CJEU will assess the consistency of IP regimes designed in accordance with the modified nexus approach with the fundamental freedoms.

The New Luxembourg IP Regime

Scope of the IP Regime

Qualifying Taxpayers

The new IP regime will apply to all Luxembourg taxpayers, including individuals and corporate taxpayers. In addition, it will apply to Luxembourg permanent establishments ("PE"s) of foreign companies located in a European Economic Area country (i.e., European Union, Iceland, Liechtenstein and Norway).

Qualifying IP Assets

The scope of qualifying IP assets comprises patents and other IP assets that are functionally equivalent to patents if they are both legally protected and subject to similar approval and registration processes. More precisely, IP rights covered by the new Luxembourg IP regime are:

- patents defined broadly: inventions protected pursuant to domestic and international provisions in force, by a patent, a utility model, a supplementary protection certificate, a patent extension for pediatric medicines, a plant variety protection, orphan drug designations; and
- copyrighted software: software protected by copyright according to the internal and international provisions in force.

The aforementioned IP rights fall within the scope of the new IP regime provided that they are not marketing-related IP assets and were created, developed or enhanced after December 31, 2007 (the former IP regime provided for the same limitation in time) as a result of R&D activities.

Marketing IP assets such as trademarks and domain names are explicitly excluded from the scope of qualifying assets. Hence, the scope of the new IP regime is consistent with the conclusions reached in the Final Report on Action 5 of the BEPS Project.

Determination of Income Receiving Tax Benefits

Qualifying IP Income

Under the modified nexus approach, IP income can only benefit from an IP regime to the extent that the taxpayer has incurred R&D expenses in creating the IP on its own. As a consequence, taxpayers are able to benefit from the IP regime only to the extent that it can be demonstrated that they incurred expenditures such as R&D which gave rise to the IP income.

The net qualifying income from IP assets is the basis against which the expenditures formula applies.

Qualifying IP income comprises income that is derived from the IP asset, including (i) royalties, (ii) capital gains from the sale of an IP asset, (iii) embedded IP income from the sale of products or services (which is directly linked to the IP asset), and (iv) the indemnity received in relation to the qualifying IP asset following a judicial proceeding or an arbitration procedure. Notably, the income considered is net income after deduction of expenditures incurred during the financial year that are allocable to the IP income (from gross IP income earned in the year).

The computation of qualifying IP income should in general be straightforward. However, in case IP income is embedded in the revenue derived from the sale of products, a transfer pricing analysis will be necessary to substantiate the part of the sales price that is attributable to the IP rights.

Income receiving tax benefits under the new IP regime is determined in accordance with the following formula:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Net qualifying income from IP asset} = \text{Income receiving tax benefits}$$

Accordingly, when a company has only one single IP asset and incurs all of the expenditures to develop that asset itself, the nexus approach will allow all of the income from that IP asset to qualify for tax benefits.

Both the qualifying expenditures incurred to develop IP assets and the overall expenditures incurred to develop IP assets have to be taken into account at the time when they are incurred, irrespective of the treatment for accounting or tax purposes.

The draft law further provides for an adjustment and offset mechanism with regard to the net qualifying income. The purpose of the adjustment is to ensure that the net qualifying income incurred by a qualifying IP asset during a financial year only benefits from a partial IP exemption provided that the overall net qualifying income exceeds the operating expenses (i.e., direct and indirect expenses in connection with the asset). Moreover, the offset is applicable when the taxpayer holds more than a qualifying IP asset. In that case, the positive adjusted net qualifying income generated by a qualifying IP asset shall be offset against the negative adjusted income of any other qualifying IP asset. The positive net qualifying income after such adjustment and offset shall benefit from the partial exemption.

Qualifying Expenditures Incurred to Develop IP Assets

Qualifying expenditures are expenditures which are necessary for undertaking R&D activities, directly linked to the creation, the development or the enhancement of a qualifying IP asset and incurred by the taxpayer for undertaking his own R&D activities.

Expenditures which are not directly linked to the qualifying IP assets are not taken into account. It follows that the following expenditures are not considered as qualifying expenditures:

- interest and other costs for financing the IP assets;
- real estate costs;
- acquisition costs; and
- costs not directly related to a qualifying IP asset.

Expenditures for unrelated-party outsourcing performed through a related party are considered as qualifying expenditures, as long as no margin is realized by the related party on its activity linked to the qualifying IP asset.

Qualifying expenditures also include expenditures incurred by a foreign PE, provided that the foreign PE:

- is located in a state which is party to the Agreement on the European Economic Area;
- is operational when the qualifying IP income is realized; and
- does not benefit from a similar IP regime in the country where it is situated.

Finally, when computing the amount of qualifying expenditures, taxpayers are allowed to apply a 30 percent up-lift to expenditures that are included in qualifying expenditures (up to the amount of the taxpayer's overall expenditures). Hence, the up-lift may increase the amount of IP income that benefits from the new IP regime.

In light of the above, if the taxpayer conducts all the R&D activities and develops IP on its own, the beneficial percentage would be 100 percent and all of the income arising from such IP can benefit from the IP regime. If, however, the IP is entirely acquired from a third entity, through purchase or licensing, the acquisition expenditures (for example, purchase fees or royalties) cannot be included in qualifying expenditures but should be included in overall expenditures. Hence, none of the IP income can qualify for the relevant tax benefit.

Between these two extreme scenarios lies a situation in which the taxpayer acquires IP and further develops the IP by itself. The expenses incurred in improving the IP asset after acquisition will be included in both qualifying and overall expenses and, consequently, a proportional part of the IP income can benefit from the IP regime.

Considerations Regarding Outsourcing

In principle, the modified nexus approach requires taxpayers to conduct R&D activities by themselves. However, fees paid to unrelated service providers for R&D activities are included in the qualifying expenses. In contrast, outsourcing fees paid to related parties should not be taken into consideration when determining qualifying expenditures.

The underlying reason for such a distinction under the modified nexus approach is that it has been considered to be unlikely that a company will outsource the fundamental value-creating R&D activities to an unrelated party, while this may be the case when activities are outsourced to a related party. There is a basic presumption that in all cases of outsourcing to related parties, the taxpayer does not conduct substantial activities. However, in practice, many MNEs are outsourcing a large part of their R&D activities to third party service providers, resulting in qualifying expenditures under the new IP regime.

Overall Expenditures Incurred to Develop IP Assets

The overall expenditures incurred to develop IP assets correspond to the sum of (i) the qualifying expenditures as defined above (but without the 30 percent uplift), (ii) the costs for the acquisition of the qualifying IP assets, as well as (iii) the costs for related-party outsourcing.

Luxembourg Tax Treatment of Qualifying IP Income

(Corporate) Income Tax

Companies that have either their seat or place of central administration (the place of central administration is broadly similar to the place of effective management) in Luxembourg are subject to Luxembourg corporate income tax on their worldwide income at a rate of currently 19 percent which will be reduced to 18 percent in 2018 at the time the new IP regime will enter into force plus a surcharge of 7 percent. However, the Luxembourg IP tax regime provides that net IP income deriving from qualifying IP rights as well as capital gains realized upon their disposal, are tax exempt at 80 percent (Article 50ter (7) LITL, as introduced by the draft law).

Where Luxembourg resident individuals exploit qualifying IP rights, the income derived from IP rights should be taxable as commercial income that is subject to Luxembourg income tax at progressive rates ranging between 0 percent and 42 percent (plus a solidarity surcharge) and municipal business tax. Here, an 80 percent tax exemption may apply in regard to net IP income from qualifying IP assets.

Municipal Business Tax

Luxembourg-resident companies are deemed to be commercial enterprises and therefore subject to municipal business tax (*Gewerbebetrieb kraft Rechtsform*; section 2 (2) No. 2 of the Municipal Business Tax Law ("MBTL"). The municipal business tax rate varies depending on the municipality in which a company is located and in Luxembourg City amounts to 6.75 percent).

The taxable basis for municipal business tax is the commercial income (*Gewerbeertrag*, section 6 (1) MBTL), that is, the taxable income according to the Luxembourg Income Tax Law, adjusted in application of sections 8 and 9 of the MBTL (section 7 MBTL) .

The provisions of the Luxembourg Income Tax Law have direct impact on the taxable basis for municipal business tax purposes, and the 80 percent tax exemption applicable to qualifying IP net income and capital gains is no exception to the rule.

Net Wealth Tax

Luxembourg companies are subject to a 0.5 percent net wealth tax per annum on their unitary value (that is, an adjusted net asset value). In principle, all assets and liabilities are included in the taxable basis for net wealth tax purposes.

Crucially, a full net wealth tax exemption may be available as from January 1, 2018 for qualifying IP rights (section 60ter BewG, as introduced by the draft law). Liabilities in economic connection with qualifying IP rights are, however, not deductible for net wealth tax purposes (section 74 (2) BewG).

As it is recommendable to finance qualifying IP rights with equity (i.e., interest expenses would reduce the net IP income benefiting from the 80 percent tax exemption), the full net wealth tax exemption constitutes a fundamental element of an attractive IP regime.

Conclusion

Innovation is one of the most important elements of promoting long-term economic development. Therefore, the introduction of a new IP regime is positive for Luxembourg taxpayers and the Grand-Duchy alike as the regime should attract new R&D activities to Luxembourg and strengthen existing IP management and development activities.

As from January 1, 2018, a tax exemption of 80 percent applies on income benefiting from the new IP regime. Thus, Luxembourg companies should be subject to an aggregate corporate income tax and municipal business tax rate of 5.2 percent in Luxembourg City (i.e., 26.01 percent standard aggregate tax rate * 20 percent). In addition, qualifying IP assets benefit from a full net wealth tax exemption which makes equity funding more attractive.

While IP regimes implemented by countries participating to the BEPS project will become more and more similar, given that these regimes have to comply with the modified nexus approach, it was important that Luxembourg made the right choices, exhausting all options provided in the Final Report on Action 5. The Luxembourg legislator decided, in particular, to adopt the optional 30 percent up-lift on qualifying expenses. Moreover, even IP income that is embedded in the sales price of products or services may benefit from the IP regime. Ultimately, the new IP regime presents interesting opportunities for the post-BEPS era.

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