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Luxembourg Tax Alert

Luxembourg new IP box voted

23 March 2018

On 22 March 2018, the Luxembourg Parliament passed a law replacing the IP box regime that was abolished in 2016. The law voted is in line with the provisions of draft law n°7163 issued in August 2017.

It introduces a new article 50ter into the Income Tax Law (ITL) that provides for an 80 percent exemption on income derived from the commercialization of certain intellectual property (IP) rights, as well as a 100 percent exemption from net wealth tax (NWT).

The new rules will be applicable as from fiscal year 2018.

Background

The proposed legislation is in line with the agreement reached as part of the OECD/G20 BEPS project for patent box regimes, under which preferential IP regimes must comply with the "modified nexus approach" set out in the BEPS final report on action 5, "Agreement on Modified Nexus Approach for IP Regimes." The nexus approach requires substantial economic activities in the benefiting country and that there be a direct link between the income benefiting from preferential treatment and the research and development (R&D) expenditure that contributes to the income. Taxpayers must track and trace expenditure and income to IP assets to justify a claim that expenditure qualifies under the regime.

Luxembourg's regime, like the regimes in several other countries, was not in line with the requirements of the report on action 5 and, therefore, had to be abolished. The regime was abolished as from 1 July 2016 for corporate income tax/municipal business tax purposes, and as from 1 January 2017 for NWT purposes; however, transition rules allow the previous IP regime to be maintained during the period 1 July 2016 through 30 June 2021.

Separately, the government has acknowledged that because innovation and R&D activities are priorities in the country's diversification initiative, Luxembourg needs a new regime to encourage the currently low level of private investment in R&D activities and remain globally competitive.

The key features of the law are summarized below.

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Qualifying assets

The scope of qualifying assets under the draft law is narrower than under the previous IP box, since marketing-related IP cannot benefit from a preferential regime under the nexus approach. Qualifying assets include the following rights:

- Patents (broadly defined) and functionally equivalent rights that are legally protected by utility models, extensions of patent protection for certain drugs and phyto-pharmaceutical products, plant breeder's rights, and orphan drug designations
- Copyrighted software

Such IP assets need to have been created, developed, or improved in the framework of qualifying R&D activity after 31 December 2007.

Qualifying net income

Income qualifying for the new regime include the following:

- Income derived from the use of, or a concession to use, qualifying IP rights (i.e. royalty income)
- IP income embedded in the sales price of products or services directly related to the eligible IP asset. The principles of article 56bis ITL must be used to separate income unrelated to the IP (e.g. marketing and manufacturing returns)
- Capital gains derived from the sale of the qualifying IP rights
- Indemnities based on an arbitration ruling or a court decision directly linked to a breach of a qualifying IP right

The regime applies on a net income basis, meaning that expenses relating to the qualifying IP asset needs to be deducted from the gross qualifying income.

The exemption applies only when the global net income derived from qualifying IP assets exceeds the global expenditure linked to qualifying IP rights. As a result, if net losses were incurred on qualifying IP rights in previous tax years, the losses need to be taken into account in the first year in which the taxpayer has net positive income. The law contains two methods to adjust previous losses, depending on whether the costs were capitalized from an accounting perspective. As required by the OECD and the EU, this mechanism is intended to ensure that net losses incurred in relation to the preferential IP regime would not be able to offset other income taxable at the standard rates on a permanent basis.

Nexus ratio

Under the modified nexus approach, the existence of substantial activity is determined by the presence of qualifying expenditures that are in direct relation with the income derived from the IP rights. Consequently, only revenues that results from prerequisite investment in R&D activities will benefit from the exemption.

The proportion of qualifying net income entitled to the benefits will be determined based on the ratio of qualifying expenditures and overall expenditures (nexus ratio).

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Qualifying expenditures includes four broad categories:

1. R&D expenditure incurred by the taxpayer for the creation, development or improvement of qualifying IP rights. It does not include interest and financing charges, the costs of acquisition of the IP, real estate costs, or costs that cannot be directly linked to the eligible IP asset.

2. Expenditure for general and speculative R&D or expenditure for unsuccessful R&D that can be linked or prorated across qualifying IP assets to the extent documented by the taxpayer.

3. R&D expenditure incurred by a permanent establishment of the taxpayer under the following conditions:

- The permanent establishment must be located in a country within the European Economic Area.
- It must be operating at the time the eligible income is derived.
- It must not benefit from a similar regime in its country of establishment.
- The IP rights and revenues resulting from the R&D activity performed in the foreign jurisdiction must be allocated to Luxembourg based on the relevant double tax treaty. This will be the case when the Luxembourg taxpayer exercises the significant functions and assumes the risks linked with the R&D activity performed in the permanent establishment.

4. R&D expenditure outsourced to an unrelated partly (including when outsourcing is channeled through a related partly but only if the latter does not mark-up the outsourcing costs).

Overall expenditure is defined as the sum of qualifying expenditure, IP acquisition costs, and outsourcing costs to related parties. The principles of article 56bis ITL are applicable to determine the amount of the IP acquisition costs and outsourcing costs to related parties.

The nexus ratio is determined on a cumulative basis and expenditures are included at the time incurred, regardless of the treatment for accounting or tax purposes.

Finally, a 30 percent uplift applies to qualifying expenditure up to the amount of overall expenditure.

Documentation requirements

The new regime requires taxpayers to track income and expenditure to determine the nexus ratio and the net eligible income per type of qualifying IP asset and provide evidence of this to the tax administration.

When a taxpayer is engaged in a sufficiently complex IP-related business and tracking per individual asset would be unrealistic and based on a subjective determination, it is allowed to use a product-based approach, where expenditure and income are tracked and traced to products or services, or families of products or services, arising from qualifying IP assets. These groupings include all IP assets that arise from overlapping expenditure and contribute to overlapping streams of income. Taxpayers using this approach have to produce objective and verifiable documentation that justifies the appropriateness of this approach.

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Finally, in an intragroup context, all transactions have to be properly determined and documented according to the new transfer pricing guidelines deriving from BEPS actions 8-10.

Deloitte Luxembourg comments

Based on the new rules, if a company incurs all of the expenditure to develop a qualifying IP asset, all income derived from the commercialization of that IP would qualify for benefits, leading to an effective tax rate of approximately 5.2 percent.

The law incorporates the requirements of BEPS action 5 and aligns Luxembourg's IP regime with global standards. It also contains provisions intended to deal with the coexistence of the new regime with the transition provisions of article 50bis ITL, which remain applicable until 30 June 2021.

The proposed IP regime is beneficial for Luxembourg's economic diversification objectives and will provide incentives for private R&D investment.

From a legislative process perspective, the Council of State has to provide exemption of a second vote on the law and then, the text will be enacted by the Grand Duke and be published in the Official Journal (Memorial). Following a dedicated provision in the voted law, it will be applicable from fiscal year 2018.

We believe it would be necessary to issue an administrative circular in the best possible delays to clarify certain concepts of the new regime and give application examples of the determination of the nexus ratio.

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