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Luxembourg Tax Alert

New BEPS-compliant IP regime open opportunities

8 August 2017

ESMA's Yesterday, the Luxembourg Parliament published the draft law submitted by the Minister of Finance on 4 August on its website, which is intended to replace the so-called "IP Box" regime. The new article 50ter of the Luxembourg Income Tax Law (LITL), which would provide for an 80 percent exemption on revenues derived from the commercialization of certain Intellectual Property (IP) rights, as well as a 100 percent exemption of these rights from Net Wealth Tax, would be applicable as from fiscal year 2018.

Context

As part of the OECD/G20 BEPS Action Plan, consensus was reached on the modified nexus approach in order to evaluate whether IP regimes meet the substantial activity requirement of Action 5. Under this approach, the benefits of an IP regime are conditional and proportional to the Research and Development (R&D) costs incurred by the taxpayer.

Like several other countries, Luxembourg had to repeal its preferential regime because it was not in line with the requirements of BEPS Action 5 report. Because Innovation and R&D activities have become a priority in the country's diversification process, Luxembourg needed to replace it with a new regime in order to remain competitive. The key characteristics of the draft law are hereafter summarized.

Qualifying Assets

The scope of qualifying assets will be more limited that the one included in the IP Box, as marketing-related IPs cannot benefit from the preferential regime under the nexus approach, and would include the following rights:

1. Patents and functionally equivalent IP rights that are legally protected by utility models, extensions of patent protection for certain drugs and phytopharmaceutical products, plant breeder's rights, and orphan drug designations
2. Copyrighted software

Such IP assets should have been constituted, developed, or improved after 31 December 2007.

Qualifying Net Income

The income qualifying for the new regime would include:

- Income derived from the use or the concession of the use of qualifying IP rights.
- IP income embedded in the sale price of products or services directly related to the eligible IP asset. The principles of article 56bis LITL would be used to separate income unrelated to the IP (e.g. marketing and manufacturing returns).
- Capital gains realized upon sale of the qualifying IP rights.
- Indemnities based on an arbitral or judiciary decision directly linked to a breach of a qualifying IP right.

The regime will apply on a net income basis, meaning that expenses in relation with the qualifying IP asset have to be deducted from the gross qualifying income.

An important modification compared to the previous regime is that the exemption would apply only when the global net income derived from the qualifying IP asset exceeds the global expenditures linked with the said qualifying IP rights. This means that if net losses have been suffered during previous tax years on the eligible IP rights, such losses must be taken into account during the first year the taxpayer would be in a net positive income situation. The draft law foresees two methods to adjust previous losses depending on whether such costs have been capitalized or not from an accounting perspective.

As preconized by the OECD and the EU, this mechanism is intended to ensure that net losses incurred in relation with the preferential IP regime would not offset other income taxable at standard rates on a permanent basis.

The Nexus ratio

The nexus ratio, the cornerstone of the new regime, would then determine the proportion of the qualifying net income entitled to the benefits as dependent on the ratio of qualifying expenditures and overall expenditures.

Qualifying expenditures would include all R&D expenditures incurred by the taxpayer for the constitution, development, or improvement of qualifying IP rights. They would not include real estate costs, interest and financial charges, costs of acquisition of the IP, and costs that cannot directly be linked to the eligible IP asset.

The following expenditures would also qualify:

- R&D expenditures incurred by a permanent establishment located in a EEA country provided that the permanent establishment is still operational at the time the eligible income is derived and does not benefit from a similar IP regime in its country of establishment
- R&D expenditures outsourced to an unrelated partly in the sense of article 56 LITL (including when outsourcing is channeled through a related partly but only if the latter does not mark-up the outsourcing costs)

- Expenditures for general and speculative R&D or expenditures for unsuccessful R&D that can be linked or pro-rated across qualifying IP assets to the extent duly documented by the taxpayer

Overall expenditures are the sum of qualifying expenditures, IP acquisition costs, and outsourcing costs to related parties. The principles of article 56bis LITL would be applicable to determine the amount of IP acquisition costs and outsourcing costs to related parties.

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

Finally, a 30 percent uplift would apply to qualifying expenditures up to the amount of overall expenditures (i.e., ratio cannot exceed 1).

Documentation requirements

The new regime requires taxpayers to track income and expenditures in order to determine the nexus ratio and the net eligible income per type of qualifying IP asset. Taxpayers are required to provide evidence of this to the tax administration.

When the taxpayer is engaged in a sufficiently complex IP-related business and that tracking per individual asset would be unrealistic and based on arbitrary judgment, he would be allowed to use a product-based approach, where expenditures and income would be tracked and traced to products or services, or families of products or services, arising from qualifying IP assets. These groupings would include all the IP assets that arise from overlapping expenditures and contribute to overlapping streams of income. Taxpayers using this approach are required to produce documentation justifying and evidencing the appropriateness of this approach with reference to objective and verifiable information.

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

Conclusion

The text incorporates the requirements of BEPS Action 5 and aligns the IP regime to the new international standards. It also contains certain provisions intended to deal with the coexistence of the new regime with the provisions of article 50bis LITL which remains applicable until 30 June 2021.

There is no doubt that this new IP regime will be beneficial for the country’s economic diversification objectives and now need to be reviewed by the Parliament and approved in parallel by the international bodies (OECD and EU).

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Designed and produced by MarCom at Deloitte Luxembourg