



New tax regime for intellectual property rights

On 4th August 2017, the **bill no. 7163** regarding the **new tax regime for IP rights** has been introduced in accordance with the previous announcement that had been made by the prime minister during the month of April. If the bill is passed, the announced measures would enter **into force on 1st January 2018**. This regime is directly based on the so-called « modified nexus approach », outlined in action n°5 of the BEPS project of the OECD, according to which an exemption is directly linked to the substance of the R&D activity.

Like the previous regime, an **exemption of 80% of the net eligible income** (in particular, royalties and capital gains upon disposal) related to a **patent or copyrighted software** is provided. Unlike the previous regime, **brands, designs and models as well as domain names** are **excluded**.

However, due to the provisions of the BEPS plan, this 80% exemption would only be granted after the application of a **ratio** i.e., development costs directly linked to the IP rights / total costs, that would be used as an indicator of the substance of the activity in the country. Acquisition costs of the IP right or of the right to use said right, real estate costs and financing costs are not considered as costs directly linked to the development of an IP right.

The bill has been drafted in a way that allows Luxembourg to preserve its competitiveness by introducing an **effective tax rate of 5.2%** for eligible income while complying with the current international and European principles in tax matters.

Like the previous regime, eligible IP rights will be **exempt from net wealth tax**.

Eligible IP rights

Based on the newly introduced article 50 ter I.T.L., these rights should have been **constituted, developed or improved after 31 December 2007** in the framework of research and development activities. This

regime is limited to the following assets:

- **inventions protected** in accordance to domestic and international provisions in force under:
 - patents;
 - utility models;
 - supplementary protection certificates related to patents on pharmaceutical and on phytopharmaceutical products;
 - supplementary protection certificate extensions for pediatric medicine;
 - plant variety certificates;
 - orphan drug designations.
- **software protected by copyright** in accordance to domestic and international provisions in force.

Marketing-related IP rights such as brands, designs, models and domain names are thus excluded.

Eligible taxpayers

Individuals and **companies resident** in Luxembourg as well as Luxembourg permanent establishments of companies located in the EEA (European Union, Iceland, Liechtenstein and Norway) are eligible to the new regime.

Eligible income

- **royalties**;
- **capital gains** on the disposal of IP rights;
- **IP income embedded** in the sale price of products or services, directly related to an eligible asset;
- **judicial indemnities** related to eligible assets.

Eligible expenses

These expenses must be **directly linked** to the constitution, development or improvement of eligible IP rights in the context of research and development activities:

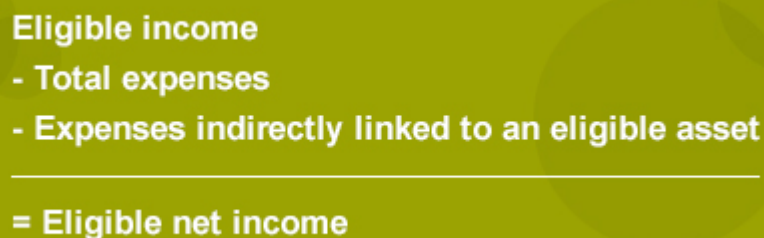
- either carried on by the taxpayer himself;
- or carried on by a permanent establishment of the taxpayer located in the EEA, operational at the moment of the realization of the eligible income, if not already benefitting from a similar regime in its country;
- or paid by the taxpayer to a third-party undertaking;
- or paid by the taxpayer to an affiliated undertaking (in the sense of article 56 I.T.L.), provided that said affiliated undertaking transfers the amounts received to a third-party undertaking without realizing a profit margin.

Acquisition costs of the IP right itself or of the right to use said right, interests and financing costs, real estate costs as well as other costs not directly linked to an eligible asset would thus be considered as non-eligible expenses.

Computation of the adjusted net taxable basis: guidelines

In principle, eligible net income should be determined for **each eligible asset on an individual basis**. As an exception, the computation could be performed for a product or service or for a class of products or services in the presence of several eligible assets when the research and development activity is so complex that it renders an individual follow-up impossible (under conditions).

- *Step 1: Determination of the net eligible income*


$$\begin{array}{l} \text{Eligible income} \\ - \text{Total expenses} \\ - \text{Expenses indirectly linked to an eligible asset} \\ \hline = \text{Eligible \u net income} \end{array}$$

- *Step 2: Determination of the adjusted net eligible income*

The adjustments provided by the bill would be used to **offset negative net income of previous years** – linked to the deduction / depreciation of R&D expenses in the absence of income – with the positive net income for each asset on an individual basis, through a mechanism similar to the carry forward of tax losses.

The computation of the adjustments to perform would be different based on the accounting treatment of expenses. Said expenses may either be booked in the profit and loss account (expenses deductible from the profit of the company) or be activated. **The tax benefit granted would nevertheless be identical** irrespective of the method that has been chosen.

- *Step 3: Determination of the adjusted and compensated net eligible income*

The compensation mechanism would be used to **offset negative net income linked to an eligible asset with positive net income linked to another eligible asset**.

A compensation could thus only happen when a taxpayer holds several eligible assets including both assets generating positive adjusted net eligible income and assets incurring negative adjusted net eligible income. Moreover, this compensation should be performed in a specific order and could never lead to the creation of a loss.

An additional compensation mechanism would also be introduced for eligible assets not generating any income.

- *Step 4: Determination of the prorated adjusted and compensated eligible income*

The biggest development regarding the new regime consists in the introduction of a **prorate** whose purpose is to ensure that the proportion of income benefiting the regime corresponds to the proportion of eligible expenses compared to the total expenses. The eligible expenses will act as an **indicator ensuring that the taxpayer indeed carried on research and development activities and thus has a proper level of economic substance in Luxembourg**.

The 30% markup on eligible expenses has been introduced to reflect the significant participation of some taxpayers to the development / improvement of the IP right even when said IP right has been acquired or

if R&D activities have been sub-contracted.

The prorate would thus be computed as follows:

$$\frac{\text{Sum of eligible expenses increased up to 30\% of its amount } (\leq \text{to the sum of total expenses})}{\text{Sum of total expenses}}$$

The partial exemption of 80% would then be applied on the amount resulting from this last computation.

Other conditions

Any taxpayer willing to benefit from the regime should be able to **track its total expenses**, its eligible expenses and its eligible income and should also be able to demonstrate the **link between said expenses and income** for each asset on an individual basis.

An exception to this principle is nevertheless provided in the presence of numerous eligible assets when the research and development activity is so complex that the monitoring of each eligible asset is impossible to perform (under condition).

In any case, the total eligible expenses and the total eligible income should be determined in accordance with the so-called **arm's length principle** laid down in articles 56 and 56 bis I.T.L.

The administration would have the right to request the taxpayer to provide any document allowing to conclusively evidence the respect of these provisions. In this respect, the commentary attached to the provisions of the bill mentions "**extensive obligations of documentation**" ("*obligations de documentation étendues*").

Coexistence of two tax regimes

The new regime will enter into force in 2018. As a reminder, **the former IP regime of article 50bis I.T.L.** was repealed and a **grandfathering period** has been provided to allow taxpayers to continue to benefit from said regime – under conditions – until **30 June 2021** for corporate income tax and municipal business tax purposes and until 1st January 2021 for net wealth tax purposes.

The old and the new regime will therefore coexist as from 1st January 2018 until the end of the grandfathering period.

Both regimes are nevertheless not cumulative. **A taxpayer eligible to both regimes will have to irrevocably opt for one of them.**



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