Luxembourg’s new IP tax regime applies as of January 1, 2018

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In brief
The Luxembourg government on March 22, 2018, approved the legislative measures necessary to bring Luxembourg’s new intellectual property (IP) regime into force effective retroactively to January 1, 2018, subject to confirmation by the Luxembourg Conseil d’Etat that a second hearing is not required. The measures were introduced in Bill No. 7163, published in August 2017, and since then have not been amended significantly. The new regime provides an 80% tax exemption on eligible net income for qualifying IP rights.

In detail
The new regime, which seeks to promote R&D activity in Luxembourg, is consistent with the recommendations made by the OECD’s Forum on Harmful Tax Practices, including those set out in the OECD/G20 BEPS Project Action 5 Final Report published in October 2015. The new regime adopts the ‘nexus approach’ intended to ensure that only activities with sufficient substance can qualify for beneficial treatment. This approach also is in line with positions taken by the EU’s Code of Conduct Group on business taxation, which monitors IP regimes in EU Member States.

The new regime takes effect for the 2018 tax year and comprises article 50ter of Luxembourg’s Income Tax Law (LITL). The IP regime under previous article 50bis LITL was closed to new IP June 30, 2016. IP qualifying for the previous regime can continue to benefit from the old regime during the ‘sunset’ period ending June 30, 2021.

The ‘nexus approach’
A corporate taxpayer based in Luxembourg Ville will have its eligible net income taxed at an overall (corporate income taxes plus municipal business tax) effective tax rate of 5.202% in the 2018 tax year. IP assets qualifying for the new regime also benefit from a full exemption from Luxembourg’s net wealth tax.

The exemption levels are consistent with those under the previous regime. However, both the scope of the new regime, and the way in which the exemption is computed, are different. The nexus approach focuses on establishing a direct connection among expenditures, the IP assets, and the income that can benefit from the regime.

Taxpayers must look at each IP asset separately, and must identify the income and expenditure linked to each asset. The only exception to this approach applies when a closely linked family of products or services is involved and it would be too complex to adopt an asset-by-asset approach. The detailed analysis below is based on the asset-by-asset approach.

The new regime is open to Luxembourg-resident companies, Luxembourg permanent establishments...
(PEs) of foreign companies, and individuals. The new regime’s main features are summarized below.

**Eligible assets**

Two main groups of IP assets are eligible to benefit from the new regime:

- inventions protected under patents, utility models, and other IP rights that are functionally equivalent to patents, specifically supplementary protection certificates for patents on pharmaceutical or phyto-pharmaceutical products, extensions of supplementary protection certificates to pediatric medicines, plant variety certificates, and orphan drug designations
- software protected by copyright under national or international norms.

Market-related IP, such as trademarks, is not eligible.

To be eligible, the IP asset must have been constituted, developed, or improved after December 31, 2007, as part of the taxpayer’s R&D activities. Such activities may be conducted in Luxembourg or through a foreign PE, so long as the PE is located within the European Economic Area (EEA) and does not benefit from a similar IP regime where it is located. The taxpayer must declare the foreign R&D PE in its annual tax return.

**Eligible expenditure**

Eligible expenditures are what is necessary for R&D activity directly connected to the eligible IP asset. Expenditures must be incurred within the framework of an R&D activity, which can be undertaken either by the taxpayer itself or outsourced.

If the taxpayer R&D activity is conducted by the taxpayer itself through an EEA PE, for the expenditure to continue to be eligible, the R&D activity at the PE still must be operational when the eligible income is realized.

If the activity is outsourced, the counterparty must either not be a related party as defined under Luxembourg transfer pricing legislation, or if it is, must perform the activity on a pure cost (i.e., no mark-up) basis and pay all expenses to unrelated parties.

**Observation:** Consequently, many intra-group contract research arrangements will not give rise to eligible expenditures because the service is paid for on a cost-plus basis. Taxpayers also will need to examine carefully all cost contribution arrangements.

The legislation explicitly provides that the following are not eligible expenditures:

- ‘acquisition costs,’ which are the costs of buying or accessing IP assets or rights to research that are directly linked to the creation or development of the IP asset and reflected in the IP asset’s value
- financing costs
- property-related costs
- other costs not directly linked to a specific eligible IP asset, unless the taxpayer can prove a link between the costs, or a proportionate share of them, and the eligible IP

Eligible IP expenditures are to be recognized in full when incurred, regardless of any accounting or tax treatment applied for other purposes, such as capitalization of costs.

**Eligible income**

Gross eligible income includes not only fees earned for the use or concession for use of the eligible IP asset, but also:

- income directly linked to the eligible IP asset but incorporated into the sale price of products or services (i.e., ‘embedded’ income)
- capital gains realized upon disposal of the eligible IP asset
- indemnity amounts receivable in the context of an arbitrated or judicial decision concerning an eligible IP asset.

The taxpayer also must determine its total expenditure linked to the IP asset. This includes:

- eligible expenditure, as specified above
- acquisition costs, as specified above
- necessary R&D expenditures directly linked to the IP asset being created or developed that are payable to any related party but are not included as eligible expenditures.

Consistent with the approach taken when identifying eligible expenditures, all expenditures are recognized when incurred, regardless of any accounting or tax treatment applied for other purposes.

The taxpayer then determines its net eligible income, defined as gross eligible income, less total expenditure, less any other expenditure indirectly linked to the eligible IP asset.

**Application of the ‘nexus ratio’**

As a final step, the new IP regime requires application of a ‘nexus ratio’ multiplier to net eligible income to arrive at the adjusted net eligible...
income to which the 80% exemption applies.

This ‘nexus ratio’ adjustment is in line with the ‘nexus approach’ for IP regimes described in the OECD/G20 BEPS Project Action 5 2015 Final Report. It focuses on the proportion of expenditure directly related to R&D activity as the proxy for substantial activity.

In establishing the ‘nexus ratio,’ and as envisioned by the Action 5 2015 Final Report, a 30% ‘uplift’ can be applied to the figure determined for eligible expenditures. However, this uplift cannot make the nexus ratio higher than 1.0.

**Observation:** The purpose of this adjustment is to avoid penalizing taxpayers for acquiring IP developed by other parties in order to pursue their own R&D, or for outsourcing some R&D activity, recognizing that the taxpayer still could be creating value.

The ‘nexus ratio’ multiplier thus is defined as (Eligible expenditure x 130%) / total expenditure, capped at 1.00.

Note that this calculation is somewhat simplified, as the legislation requires the two expenditure figures used in the nexus ratio calculation to be determined by reference to expenditures attributable not only to the period in which the net eligible income arises, but also to all previous periods.

Several complex situations that can arise, such as when expenditures have been capitalized, have been analyzed in examples set out in Bill No. 7163’s explanatory text.

**Observation:** The Bill’s explanatory text may continue to be useful even though the legislation has been enacted.

**Other requirements**

Taxpayers seeking to benefit from the IP regime need to track individual IP assets (or groups of IP assets if a product/family-based approach is being taken) as well as total expenditures, eligible expenditures, and eligible gross income per IP asset (or asset group), demonstrating the link between income and expenditures.

Expenditures and eligible income should be determined in accordance with the arm’s-length principle.

**Repeal of the previous IP regime and transitional rules**

The previous IP regime granted an 80% tax exemption on the net income derived, or deemed to be derived, from a wide variety of IP assets. In conformity with decisions made by the EU’s Code of Conduct Group for Business Taxation in 2014 and with the conclusions and timeline set out in the OECD/G20 BEPS Project Action 5 2015 Final Report, the previous regime was repealed on December 18, 2015, effective as of July 1, 2016, for corporate income tax/municipal business tax, and January 1, 2017, for net wealth tax.

Taxpayers owning IP assets on December 31, 2015, that benefited from the former IP regime can continue to benefit from that regime until the end of the transitional period on June 30, 2021.

IP assets acquired on or after January 1, 2016, can benefit from the former IP regime through June 30, 2021, provided that:

- they were developed, or acquired from unrelated parties, before July 1, 2016; or
- they were acquired from a related party before July 1, 2016 (including via any tax-neutral transaction), and already had been eligible for the IP regime, or benefited from a foreign country’s IP regime that corresponded to the Luxembourg’s former IP regime, prior to their acquisition.

For IP income that can benefit from the transitional rules under the former IP regime and also may qualify under the new regime, the legislation allows the taxpayer to elect which regime to use. That election applies from the year in which it is made and is irrevocable.

**The takeaway**

The new IP regime takes effect from the 2018 tax year and will coexist with the former IP regime, (in some cases), until June 30, 2021. Under the new IP regime, eligible net income from qualifying IP assets benefits from an 80% exemption from income taxes, while qualifying IP assets benefit from a full exemption from the net wealth tax.

Taxpayers should review their existing IP activities in Luxembourg to confirm whether they can benefit from the former and new IP regimes, as careful analysis of the IP assets and related income and expenses is now required. In some cases, restructuring / refinancing of the Luxembourg IP activities might be necessary. Likewise, substance of the Luxembourg entity performing IP activities should be considered.
Let’s talk

For a deeper discussion of how this might affect your business, please contact:

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