New IP tax regime in Luxembourg – in effect from 1 January 2018

23 March 2018

In brief

On 22 March 2018, the Luxembourg Government voted to approve the legislative measures necessary to bring Luxembourg’s new Intellectual Property (“IP”) regime into force with effect from 1 January 2018 (subject to confirmation by the Luxembourg Conseil d’Etat that no second hearing is required). The measures were originally set out in Bill No. 7163, published in August 2017, and have not since been amended significantly.

An 80% tax exemption on eligible net income for qualifying IP rights is available.

The new regime seeks to promote R&D activity in Luxembourg.

The new regime is fully consistent with all 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 thus adopts the “nexus approach”, to ensure that only activities with enough substance can qualify for beneficial treatment. This approach is also in line with positions taken by the EU’s Code of Conduct Group on business taxation, which monitors IP regimes operating in EU Member States. The new regime takes effect from the 2018 tax year, and comprises article 50ter of Luxembourg’s Income Tax Law (“LITL”). The previous article 50bis LITL IP regime was closed to new entrant IP with effect from 30 June 2016, although previously-qualifying IP can continue to benefit from the old regime during its “sunset” period, running until 30 June 2021.

In detail

The “nexus approach”

Under the new regime, eligible net income from qualifying IP assets benefits from an 80% exemption from income taxes. Consequently, a corporate taxpayer based in Luxembourg Ville with eligible net income will be taxed on such income at an overall (i.e. 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 levels of these exemptions are consistent with those given under the previous regime. However, the scope of the new regime, and the way in which income that is to benefit from the exemption is to be computed, are both markedly different. The “nexus approach” focuses on establishing a direct connection between expenditures, the IP assets and the income that can benefit from the beneficial regime.

In applying the new regime, each IP asset must be looked at separately, and income and expenditure linked to each asset thus needs to be identified. The only exception to this approach is when a closely linked family of products or services are involved, and it would be so complex as to make it impossible to adopt an asset-by-asset approach. The detailed analysis below must be read on the basis that an asset-by-asset approach is being taken.
The new regime is open to Luxembourg resident companies, to Luxembourg permanent establishments of foreign companies, and to individuals. The main general features of the new regime are summarised below.

**Eligible assets**

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

1. Inventions protected under patents, utility models, and other IP rights that are functionally equivalent to patents. More specifically, these comprise supplementary protection certificates for a patents on pharmaceutical or phyto-pharmaceutical products, extensions to supplementary protection certificates to paediatric medicines, plant variety certificates, and orphan drug designations.

2. Software protected by copyright under national or international norms.

Market-related IP, such as a trademark, is not eligible.

To be eligible, the IP asset need to have been constituted, developed or improved after 31 December 2007, as part of the [R&D activities](#) of the taxpayer **carried out by the taxpayer itself**. Such activities may be conducted in Luxembourg, or through a foreign permanent establishment so long as this is located within the European Economic Area (“EEA”) and does not benefit from a similar IP regime in its country of location. The existence of a foreign R&D permanent establishment must be declared annually in the tax return.

**Eligible expenditure**

Eligible expenditure is solely that which is necessary for R&D activity directly connected to the eligible IP asset. Expenditure 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 permanent establishment, for the expenditure to continue to be counted as eligible, the R&D activity at the permanent establishment must still be operational when eligible income is realised.

If outsourced, the counterparty to which the R&D activity is outsourced must either be **not a related party** (as defined by Luxembourg’s 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 on to unrelated parties. Consequently, many intra-group contract research arrangements will not give rise to eligible expenditure, because the service is paid for on a cost-plus basis. Cost contribution arrangements will also need to be examined with great care.

The legislation explicitly excludes from the scope of eligible expenditure:

1. **“Acquisition costs”** - the costs (directly linked to the IP asset being created or developed and reflected in the value of that IP asset) of buying or accessing other IP assets, or rights to research.

2. Any financing costs.

3. Any property-related costs.

4. Any other costs not directly linked to a specific eligible IP asset. As an exception to this rule, if the taxpayer has documentary proof, and can show a link between the costs (or a proportionate share of them) and the eligible IP, such costs can be regarded as eligible expenditure.

In identifying eligible IP expenditure, expenditure is to be recognised in full as it is incurred, irrespective of any accounting or tax treatment being applied for other purposes (e.g. capitalisation of costs).
**Eligible income**

In determining **gross eligible income**, the taxpayer can take into consideration the fees earned for the use (or concession for use) of the eligible IP asset. However, the taxpayer can also include:

1. income directly linked to the eligible IP asset but which is incorporated into the sale price of products or services (i.e. “embedded” income);
2. capital gains realised upon disposal of the eligible IP asset; and
3. any indemnity amounts receivable in the context of an arbitrated or judicial decision concerning an eligible IP asset.

**Total expenditure** linked to the IP asset must also be computed. This comprises:

1. Eligible expenditure, as specified above; plus
2. The “acquisition costs”, also as specified above; plus
3. Necessary R&D expenditure directly linked to the IP asset being created or developed, payable to any related party (and not counting as qualifying expenditure)

Consistent with the approach to be taken when identifying qualifying expenditure, all expenditure is to be recognised in full as it is incurred, irrespective of any accounting or tax treatment being applied for any other purposes.

**Net eligible income** must then be determined. This is 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 the **net eligible income** as identified above, to arrive at the amount of **adjusted net eligible income** to which the 80% exemption applies.

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

However, in establishing the “nexus ratio”, and as envisaged by the Action 5 2015 Final Report, a **30% “up-lift**” can be applied to the figure arrived at for **eligible expenditure**. This augmentation of the eligible IP expenditure figure however cannot take this figure above the total amount of overall expenditure – in other words the nexus ratio cannot exceed 1. The purpose of this adjustment is to avoid unduly penalising taxpayers for acquiring IP developed by other parties in order to pursue their own R&D, or for outsourcing some R&D activity to other group companies, recognising that in such situations the taxpayer could still be creating value.

The “nexus ratio” multiplier is thus defined as **Eligible expenditure x 130% capped at 1.00. Total expenditure**

The calculation outlined above is somewhat simplified, as the legislation requires the two expenditure figures used in the calculation of the nexus ratio to be determined by reference to expenditure not just attributable to the period in which the net eligible income arises, but also to expenditure in **all previous periods**. Several of the more complex situations that can arise (e.g. when expenditure has been capitalised) have been analysed by way of examples set out in the explanatory text that accompanied Bill No. 7163, and thus reference to the Bill may continue to be useful even after the legislation has been enacted.
Other requirements

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

- 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 Luxembourg IP regime (article 50bis LITL) (“the former IP regime”) granted an 80% exemption from tax on the net income derived, or deemed to be derived, from a wide variety of types of IP asset. In conformity with both decisions made by the EU’s Code of Conduct Group for Business Taxation in 2014, and the conclusions and timeline set out in the OECD/G20 BEPS Project Action 5 2015 Final Report, the former IP regime was repealed by the law of 18 December 2015.

This was with effect as from 1 July 2016 for corporate income tax/municipal business tax, and as from 1 January 2017 for net wealth tax.

Taxpayers owning IP assets at 31 December 2015 that benefited from the former IP regime can however continue to be able to benefit from the former regime during a transitional period lasting until 30 June 2021.

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

- They have been developed, or acquired from unrelated parties, before 1 July 2016; or

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

In relation to IP income that can still benefit from the transitional rules under the former IP regime and which may also qualify under the new regime, the legislation gives the taxpayer the right to elect for the regime it prefers to benefit from. Any such election then applies from the year in which it is made, and is irrevocable.