I modelli di Licence Box

An overview the favourable Luxembourg intellectual property tax regime

Jerónimo Chavarría-Pérez
Adv. LL.M. in international taxation
International tax advisor
at Deloitte Luxembourg

Luxembourg as an attractive intellectual property jurisdiction within the EU internal market and for investment from third countries

1. Overview

In 2007, Luxembourg introduced a favorable tax regime applicable to income and capital gains derived from certain IP rights (hereafter IP tax regime). In that respect, Luxembourg continues to prove that it is an international but also a diversified financial center. This article reviews from a direct corporate taxation standpoint some of the most important elements of the IP tax regime, such as the scope, conditions as well as other important domestic and international considerations.

2. Introduction to the Luxembourg IP tax regime

Over the last years the exploitation of IP has played a fundamental role for enterprises, but also for countries' economic growth. In addition, companies seem to manage such assets more actively, *e.g.* by transferring them to attractive jurisdictions.

Within the European Union (hereafter EU) context, the European Council has encouraged Member States to enhance R&D[1] and the European Commission has welcomed tax measures adopted by Member States that promote R&D[2].

In Luxembourg, the level of IP protection is high. Luxembourg is party of various international IP conventions and agreements[3]. In addition, the introduction of the IP tax regime, which aims at promoting R&D and IP activities in Luxembourg[4], has increased the Luxembourg's international competitiveness and stimulated an R&D-oriented culture within the country[5]. This fiscal measure constitutes an incentive providing for a lower taxation of IP income under certain conditions, as described here below.

3. Luxembourg tax aspects

3.1. General Luxembourg tax framework

A resident corporate taxpayer is subject to taxation on its worldwide income; for instance, a company with registered seat and central administration in Luxembourg City and with taxable income of more than EUR 15'000 is subject to tax at a total combined rate of 29.22%[6]. It is also subject to an annual net wealth tax, which is levied at a rate of 0.5% on its worldwide net wealth as at January 1. of each year.

Dividends paid by a corporate taxpayer are in principle subject to withholding tax, typically at a rate of 15%; however, exemptions are available for distributions to qualifying corporate shareholders[7] provided certain threshold and holding period requirements are met. Exemption or reductions are also available under applicable tax treaties. In addition, arm's length interest and royalty payments made by a corporate taxpayer are generally not subject to withholding tax in Luxembourg, except for profit sharing interest and certain artistic and literary royalties.

3.2. Overview of the key elements of the IP tax regime

The IP tax regime was introduced by a law approved on 21 December 2007 and is provided for by article 50*bis* of the Luxembourg income tax law (hereafter Loi de l'impôt sur le revenu or LIR). The Luxembourg tax authorities have subsequently issued Circular LIR no. 50*bis*/1 of 5 March 2009 (hereafter Circular), whereby they express their views on and clarify various points of the IP tax regime.

The IP tax regime provides for an exemption of 80% of the net positive income[8] derived from, and capital gains realized on, qualifying IP rights acquired or created by a Luxembourg taxpayer after 31 December 2007. Therefore, for a corporate taxpayer the combined tax rate mentioned above is reduced to an effective tax rate of 5.84%. IP rights directly acquired from certain (direct) associated company don't qualify for the IP tax regime.

A taxpayer using a self-developed patent for its own business activities benefits from a notional deduction equal to 80% of the net positive income[9] that it would have earned from a third party as consideration for the right to use the patent. The deduction is available from the date the taxpayer applies for the patent protection, rather than from the date of the issuance of a certificate formalizing such a protection. In the case the patent application is refused, the amounts previously deducted pursuant to the IP tax regime must be added up to the taxpayer's taxable income in the fiscal year in which the refusal was notified to the taxpayer.

Further details are outlined here below.

3.2.1.
Qualifying IP and revenue

The IP tax regime applies to net income derived in consideration for the use of, or the right to use, as well as capital gains realized on:

- software copyright,
- patents,
- trademarks,
- designs,
- models and,
- domain names[10].

It also applies to self-developed patents. On the contrary, technical assistance income does not qualify for the application of the IP tax regime.

According to the Circular, in order to benefit from the IP tax regime, income generated by these IP rights must qualify as royalties within the meaning of article 12, paragraph 2 OECD Model[11]. Therefore, this proviso of the OECD Model, together with the Commentary thereto, provides great guidance for the purpose of application of the IP tax regime.

As mentioned earlier, capital gains realized on alienation of these IP rights are also covered; however, they have to be reduced by an amount equal to 80% of the corresponding net negative income of the year of the alienation as well as of the previous years (claw back rule). The net negative income previously activated in the taxpayer's balance sheet (described below) is not taken into account for these purposes.

Under the IP tax regime, a Luxembourg corporate taxpayer must have acquired or created the IP rights; therefore, it must be the owner of the said rights. In the event of a split of ownership, the Circular confirms that for the purposes of the IP tax regime the ownership of IP rights is to be allocated to the party having the economic benefits and control over the said assets[12]. Put it differently, it is not required for the economic owner of the IP also to have the legal ownership, or to be the creator thereof.

3.2.2.
Conditions

The application of the IP tax regime, except for in the case of self-developed patents, is subject to the following conditions: *(i)* the IP rights must be acquired or created after 31 December 2007; *(ii)* all expenses in direct economic relation with the IP rights must be booked (or, as commonly mentioned in practice, *"activated"*) in the taxpayer's tax balance sheet as assets and affect the taxable result in the first year in which the IP tax regime is applied; *(iii)* the IP rights must not be acquired from an *"associated company"*. For the purpose of the IP tax regime, the term *"associated company"* means:

a) a company holding a direct participation of at least 10% in the capital of the company wishing to apply the IP tax regime; or
b) a company in which the company wishing to apply the IP tax regime holds directly a participation of at least 10%; or
c) a company whose capital is directly held, for at least 10%, by another company that in turn holds a direct participation of at least 10% in the capital of the company wishing to apply the regime.

3.2.2.1.
Key date

As regards the acquisition of the IP rights, it suffices to look at the date established in the sales agreement, if any exists.

Other ways of acquiring the IP could be, for example, mergers, demergers, etc., where roll-over provisions may provide for deferral of taxation of capital gains, which would typically entail that historic values and historic acquisition dates remains valid at the *"new owner's"* level. If the taxpayer decides to carry out any of these transactions by applying such provisions and the historic acquisition date dates before 31 December 2007, then the IP tax regime cannot apply.

Similarly, the allocation of IP rights to a Luxembourg permanent establishment, the migration of a company to Luxembourg and the change of status of a company from exempt to ordinarily taxed do not result in a new acquisition date for the purposes of the IP tax regime and the historic acquisition dates prevail.

With regard to the creation of IP rights, the relevant date for patents is the date of the application for protection, rather than the date of the issuance of the certificate formalizing the protection. Similarly, with reference to domain names, the key date is the date of application for registration. Since software copyrights are not always registered, the relevant date is when they begin to be commercialized. In this respect, the Circular provides for some indications on the possible items of evidence of the key date, namely, detailed accounts showing the moment in which the company started deriving income from these IP rights, as well as a detailed management plan. With regard to trademarks, designs and models, the relevant date is, in principle, the date of application for registration. However, since the commercialization of these IP rights often start before their registration, the relevant date is intended to be the date when they begin to be commercialized**[13]**.

3.2.2.2.
Activation of expenses

Expenses and tax losses incurred before the application of the IP tax regime are in principle neutralized in the tax profit and loss accounts at the time the regime is applied. However, the taxpayer is allowed, from the same moment, to deduct such expenses and amortize such losses year by year in direct proportion to the IP rights' lifetime.

3.2.2.3.
Associated company

This condition has to be looked at, and complied with, right before the acquisition. For example, the contribution by a shareholder of IP rights to a Luxembourg corporate taxpayer upon its incorporation is acceptable.

Since this condition only relates to companies, a direct acquisition from an individual falls within the scope of the IP tax regime.

The so-called look through approach is applied in the case of a participation held through an entity considered transparent from a Luxembourg tax perspective**[14]**; in this case the participation held through the transparent entity is considered a direct participation held in proportion to the interest in the said tax transparent entity.

Finally, it is worth mentioning that a taxpayer may license or transfer IP rights to any associated party without jeopardizing the benefits of the IP tax regime.

3.2.3.
Valuation

Any valuation method generally accepted in the international arena for IP valuation may be used for the purpose of the IP tax regime. The Circular confirms this approach by making reference to the OECD transfer pricing guidelines (hereafter OECD TP Guidelines) for the purposes of the valuation as well as the corresponding documentation.

For the purposes of computing the capital gain upon the transfer of qualifying IP rights, the estimated realization value has to be determined**[15]**. However, in the case of micro, small, or medium-sized enterprises**[16]**, such value may be assumed to be equal to 110% of the expenses incurred by the alienator.

3.2.4.
Net wealth tax

Pursuant to the law of 19 December 2008, exemption from net wealth tax is provided for by article 60*bis* of the Luxembourg valuation law (hereafter Bewertungsgesetz) as of 2009 for qualifying IP rights to the extent that the conditions established under article 50*bis* LIR are met.

4.
International tax aspects

4.1.
Foreign tax credit

By virtue of the EC Interest and Royalties Directive (hereafter the Directive)**[17]**, as well as of the Luxembourg's extensive tax treaty network (currently, 64 tax treaties are in force and 27 are under negotiation)**[18]**, withholding taxes on royalty payments to Luxembourg corporate taxpayers that in principle could be levied in the source country are in most cases avoided or reduced.

In the event a foreign withholding tax is actually levied, a tax credit is available to resident taxpayers on the basis of Luxembourg domestic law or any applicable tax treaty. Such credit is however granted under certain limitations (*e.g.* with a cup computed by taking into account only the 20% qualifying taxable income) and conditions. The tax credit does not apply for municipal business tax purposes; however, the foreign tax that is not credited can be proportionally deducted for tax purposes.

4.2.
General requirements on the application of the Directive and tax treaties

Generally, in order to benefit from an exemption or a reduction of a withholding tax rate under the Directive or under an applicable tax treaty, a Luxembourg taxpayer must qualify *(i)* as resident and be subject to tax regarding royalty income under the Directive or, under a tax treaty, typically as resident liable to tax, and *(ii)* as the beneficial owner to the royalties. A Luxembourg corporate taxpayer benefiting from the IP tax regime, *i.e.* a normally taxed corporation with registered seat and central administration in Luxembourg, meets the first qualification requirement and royalty income is subject to tax. In the case of tax treaty application, the source country might require further elements, such a certificate of residence; therefore, this point is generally checked on a case-by-case basis. In relation to the second qualification requirement and in view that a Luxembourg taxpayer must have the ownership of the IP rights, generally it should be considered as the beneficial owner of the royalties. In the same vein, the Luxembourg taxpayer should have the freedom as regards what to do with the royalty income, *e.g.* reinvestment, distribution, etc., but it should not be obliged to pay it on**[19]**.

4.3.
Transfer pricing

Particularly in relation to intra-group transactions, acquisition and sales prices as well as royalties should be determined on an arm's length basis and according to market values, taking into account *inter alia* the assets at hand, risks incurred and functions performed. The foregoing should be sufficiently supported by legal and transfer pricing documentation as in this sense the burden of proof lies on the taxpayers.

4.4. European law aspects and State aid

The Council of the Economic and Financial Affairs (ECOFIN, which is composed of the economics and finance ministers of the 28 EU Member States) adopted a resolution on a Code of conduct for business taxation (hereafter Code) on 1. December 1997 and confirmed the establishment of the Code of Conduct Group on 9 March 1998. On 2 December 2008, the IP tax regime has been cleared by the Code of Conduct Group[20]. The Group concluded that there was no need for this measure to be assessed against the Code criteria[21]. Although the Code is not a legally binding instrument, it clearly does have political force.

A tax incentive or measure introduced by a Member State must comply with EU law. After more than five years of the introduction of the IP tax regime, the European Commission has not started an official assessment with respect to this regime in the light of State aid rules[22]. Currently the general view in Luxembourg is that the IP tax regime is unlikely to constitute illegal State aid on the basis of the following.

In order for a measure to qualify as State aid, the following cumulative conditions have to be met:

- it has to affect intra-EU trade,
- it has to be granted out of State resources,
- it has to distort or threaten to distort competition, and
- it has to confer a selective economic advantage to undertakings.

In the case at hand, the selectivity test is the most important one and arguably the most difficult to apply.

In this context, the European Commission authorized a Spanish corporate tax credit regime of 50% for various IP rights in 2008[23]. According to the Commission, the tax credit would be available to all companies, irrespective of their size or sector, there would be no restriction concerning the location of the eligible activities, and that the public administration has no discretion in applying the measure as the criteria are objective and defined *ex ante* in the implementing regulation. The Commission also concluded that the regime would provide an incentive for companies to invest in R&D.

As regards the IP tax regime, irrespective of the size of an enterprise, its location throughout the country and the sector to which it belongs, it is available in general to resident corporate taxpayers as well as resident individuals with independent activities. In addition, the application of the IP tax regime is not subject to an approval or the discretion of the Luxembourg tax authorities as the article 50*bis* LIR *ex ante* and the Circular provides for sufficient guidance. Last but not least it stimulates R&D, which has been encouraged by the European Council and Commission, *e.g. via* the Lisbon Strategy, and it favors the country's economy. Therefore, it follows from the foregoing that the IP tax regime should not be considered as a selective measure and thus should not be considered illegal State aid.

5. Conclusion

The IP tax regime has several attractive aspects, for example, a low effective tax rate; the fact that tax efficient structuring is possible for international groups, including foreign tax credit, if need be, and exit; although it could be extended to other IP rights, many are already covered; the conditions are not too restrictive; the economic ownership of the IP rights suffices, which reduces legal costs and formalities and can be a relevant commercial aspect for foreign groups; and, it has been cleared by the Code of Conduct Group and it is unlikely to constitute illegal State aid.

Elenco delle fonti fotografiche:
http://cbshouston.files.wordpress.com/2012/04/luxembourg.jpg?w=620 [05.10.2013]

http://i.dailymail.co.uk/i/pix/2012/12/09/article-2245412-0015CAB600000258-6_634x325.jpg [05.10.2013]

http://im.ft-static.com/content/images/04205b73-7385-43da-88c2-87aea1a90c60.img [05.10.2013]

[1] The 2000 Lisbon Strategy was devised and aimed to make, between 2000 and 2010, the EU "*the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*". The Europe 2020 strategy followed in 2010 and aims *inter alia* to invest 3% of GDP in R&D, in particular by improving the conditions for R&D investment by the private sector, and develop a new indicator to track innovation.
[2] In the European Commission press release IP/08/216 on State aid decision No. 480/2007 of 13 February 2008, the Competition Commissioner Neelie Kroes commented: "*I welcome this measure introduced by the Spanish Government, as it aims to create an incentive for companies to invest in R&D for the benefit of the Spanish economy as a whole*".
[3] *Inter alia*, the Bern Convention, the Patent Cooperation Treaty, the Paris Convention, the Patent Law Treaty, the Madrid Agreement and Protocol. Luxembourg is also a party to the European Patent Convention, the Agreement on Trade-Related Aspects of IP Rights and various Benelux IP Conventions.
[4] Rapport de la Commission des Finances et du Budget, Chambre des Deputes, 13 Decembre 2007, parliamentary document 5801, p. 11.
[5] For instance, the law of 5 June 2009 relating to the promotion of research, development and innovation, which is reserved for small and medium size enterprises established in Luxembourg, and Luxinnova, which is the national agency for the promotion of innovation and research.
[6] Tax rate applicable in 2013. It consists of corporate income tax (*impôt sur le revenu des collectivités*) at a rate of 21% and municipal business tax (*impôt commercial communal*) at a rate of 6.75%, as well as 7% solidarity surcharge calculated on the corporate income tax. In addition, as from 1. January 2011 minimum flat taxation rules apply.
[7] It encompasses normally taxed Luxembourg corporations, or entities covered by article 2 of the EC Parent-Subsidiary Directive or permanent establishments thereof, or Swiss resident capital companies subject to corporation tax in Switzerland without benefiting from an exemption, or certain companies resident in treaty countries.
[8] The term "*net income*" is defined in Para. 1, Art. 50*bis* as gross revenue reduced by all expenses having direct economic relation thereto, including amortization and write-offs.
[9] In this case "*net income*" is defined in Para. 2, Art. 50*bis* as the corresponding deemed income, as determined by a generally accepted valuation method, reduced by all expenses having direct economic relation thereto, including amortization and write-offs.
[10] Initially, Art. 50*bis* LIR did not cover domain names. These IP rights were introduced in said article pursuant to the law of 19 December 2008. This measure was also welcomed in Luxembourg.
[11] Not all of the IP rights covered by Art. 12 of the OECD Model are included in the IP tax regime, which may cause practical issues, *e.g.* where on the basis of the legal documentation a company cannot distinguish and separate all existing IP rights and some qualify for the IP tax regime whereas some don't.
[12] The general principle concerning the prevalence and importance of economic ownership is laid down in Art. 11 Loi d'adaptation fiscale or Steueranpassungsgesetz.
[13] Kihn Pierre/Laidebeur Olivier/David Bernard/Bill Jean-Philippe, La propriété intellectuelle au Luxembourg, Promoculture Larcier, 2012, p. 128.
[14] Art. 175 LIR lists the tax transparent entities, namely, limited partnerships (sociétés en commandite simple), general corporate partnerships (*sociétés en nom collectif*), civil company (*sociétés civiles*), economic interest groupings (*groupement d'intérêt économique*) and European economic interest groupings (*groupement européen d'intérêt économique*). To determine whether or not a foreign entity qualifies as transparent for Luxembourg tax purposes, an analysis of all its legal features has to be made and compared with those of a Luxembourg tax transparent entity to establish whether or not they resemble.
[15] Para. 2, Art. 27 LIR provides for the definition of estimated realization value.
[16] For the definition of micro, small and medium sized enterprises, reference is made to Art. 3 of the Règlement Grand Ducal of 16 March 2005.
[17] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
[18] See http://www.impotsdirects.public.lu/conventions/index.html [05.10.2013].
[19] See *e.g.* the U.K. Court of Appeal's decision in Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A., London Branch (2006) EWCA Civ 158 and the Tax Court of Canada's decision in Prevost Car Inc. v. The Queen 2008 TTC 231.
[20] Report from Code of Conduct Group to ECOFIN Council 16084/1/08, p. 4.
[21] The Code was designed to identify measures that unduly affect the location of business activities and competition within the EU and requires Member States to refrain from introducing any new harmful tax measures and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code. The criteria for identifying potentially harmful measures include: an effective level of taxation which is significantly lower than the general level of taxation in the country concerned; tax benefits reserved for non-residents; tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base; granting of tax advantages even in the absence of any real economic activity; the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; and, lack of transparency.
[22] Art. 107 TFEU.
[23] European Commission press release IP/08/216 on State aid decision No. 480/2007 of 13 February 2008. The European Court of Justice's cases concerning Gibraltar and selectivity may also serve as further reference: Jointed Cases C-106/09 P and C-107/09 P.