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Luxembourg
Research, innovation and intellectual property in Luxembourg

While most famous as a leading finance centre, Luxembourg is becoming more active in the field of research and development (R&D). The recent establishment of the National Research Fund is a perfect example of this trend.

Luxembourg has also become increasingly attractive in the field of IP exploitation.

In order to afford strong legal protection to intellectual property, Luxembourg has signed various international treaties assuring the legal protection of IP rights, including the World Intellectual Property Organisation (WIPO) Convention, the Bern Convention, the Patent Cooperation Treaty, the Paris Convention, the Patent Law Treaty and the Madrid Agreement and Protocol.

The high quality of protection that Luxembourg can offer to IP owners is supplemented by a dedicated tax regime for income and capital gains resulting from intellectual property, which is considered one of the most interesting in Europe.

The Finance Bill 2008, which was passed on December 21 2007 and came into force on January 1 2008, established an 80% exemption for such income and gains in the hands of Luxembourg resident companies and Luxembourg permanent establishments of non-resident companies.

In addition, on March 5 2009 the Luxembourg tax authorities published a circular on the Luxembourg IP regime designed to provide guidance on interpreting this partial exemption regime.

As per January 1 2009, the IP regime was completed with a full exemption from net wealth tax, levied annually at a rate of 0.5%, for net wealth contained in IP rights.

Objectives of the law

The aim of these tax provisions is to encourage and develop originality and invention in Luxembourg and to promote R&D.

Such measures are therefore in line with the European strategy, as expressed in the Guidelines for Growth and Jobs issued by the European Commission on April 12 2005 – in particular, Guideline 12 recommending increased and improved investment in R&D. They further underline the Luxembourg government's intention to attract IP groups to Luxembourg.

The 80% exemption is intended to encourage international groups to manage their intellectual property through a Luxembourg fully taxable company or permanent establishment.

Eligible entities

The regime applies to:

- fully taxable corporate entities that are resident in Luxembourg;
- permanent establishments of corporate entities established in an EU member state, as referred to in Annex II of EU Directive 90/435/EEC; and
- permanent establishments of corporations resident in a country with which Luxembourg has concluded a double tax treaty (currently there are 52 such treaties and this number is growing).

Qualifying IP rights

National and international laws and conventions recognise the product of a person's mental efforts as their intellectual property. IP rights provide a means of protecting some of the intangible assets of companies. Statutory IP rights may be divided into industrial property (patents, trademark, designs and models) and copyright.

The 80% exemption applies to net income derived from the use, exploitation and/or disposal of the rights in the following.

Software copyrights

Software copyrights are regulated by the Law on Copyrights, Related Rights and Databases (April 18 2001). Luxembourg has also ratified the Bern Convention, under which artistic works, including software, are protected in every member state of the convention from the moment of their creation without any administrative formalities.

Patents

Any patent application, irrespective of the jurisdiction in which it is filed, can qualify for the tax exemption. The exemption can be enjoyed from the filing date of the patent application, thereby alleviating the consequences of the prosecution period, which is usually several years until grant. The tax exemption provision assumes that a filed patent application will result in a granted patent. If a patent application is refused, the initial deduction must be reintegrated into the tax base for the financial year in which the taxpayer is notified of this negative decision.

Utility models, short-term patents and supplementary protection certificates are treated identically to patents for the purpose of the tax exemption.

Patent protection in Luxembourg can be obtained through three different procedures:

- a Luxembourg patent, granted by the Luxembourg Ministry of Economy and Foreign Trade;
- a European patent, granted by the European Patent Office (EPO); or
- an international patent application, filed in accordance with the Patent Cooperation Treaty administrated by WIPO, followed by a national entry in Luxembourg or a regional entry with the EPO.

National patent examinations in Luxembourg are purely formal, as is the case in other small countries (eg, Belgium and the Netherlands). This means that, provided that it does not claim subject matter that is excluded from patentability (eg, discoveries or theories), a patent application will be automatically granted 18 months after the filing or priority date, irrespective of the relevance of the prior art cited and the merits of the invention.

Trademarks, designs and models

Any trademark, design or model registered in any jurisdiction can fall under the scope of the tax exemption. The exemption can be enjoyed from the filing date of the application.

The protection of trademarks, designs and models in Luxembourg is regulated by the Benelux IP Convention. The exclusive right to a trademark in Luxembourg is acquired upon the first deposit of the trademark with the Benelux Office of Intellectual Property.

Along with Benelux protection, trademarks, designs and models may be protected in Luxembourg in accordance with the EU Community Trademark Regulation and Design Regulation.

Domain names

Domain names are not protected by law in Luxembourg. Case law considers domain names to be a user right.

Eligible income

Income derived from the exploitation of IP rights

Article 50*bis al* 1 of the Corporate Income Tax Law provides for a tax exemption of 80% for all net income (defined as the difference between the gross revenue and any expenses directly connected to such revenue, including amortisations and potential write-offs) earned by a taxpayer in consideration for the use of qualifying IP rights.

Negative IP net income remains fully tax deductible.

The circular specifies that in order to qualify for the IP regime, an item of income must be a royalty in the sense of Article 12(2) of the Organisation for Economic Cooperation and Development Model Tax Convention on Income and Capital.

Development of IP rights for own activities

According to the law, a Luxembourg resident company which has registered an IP right and which uses it for the benefit of its own activity is entitled to a deduction of 80% of the net consideration that a third party would have paid for using the IP right had it been licensed to such third party.

The aim of this provision is to encourage research activities in Luxembourg and to promote the protection of R&D through patents. The deduction is granted from the date of application for protection of the IP right. If the application is refused, the initial deduction must be reintegrated into the tax base for the financial year in which the taxpayer is notified of this negative decision.

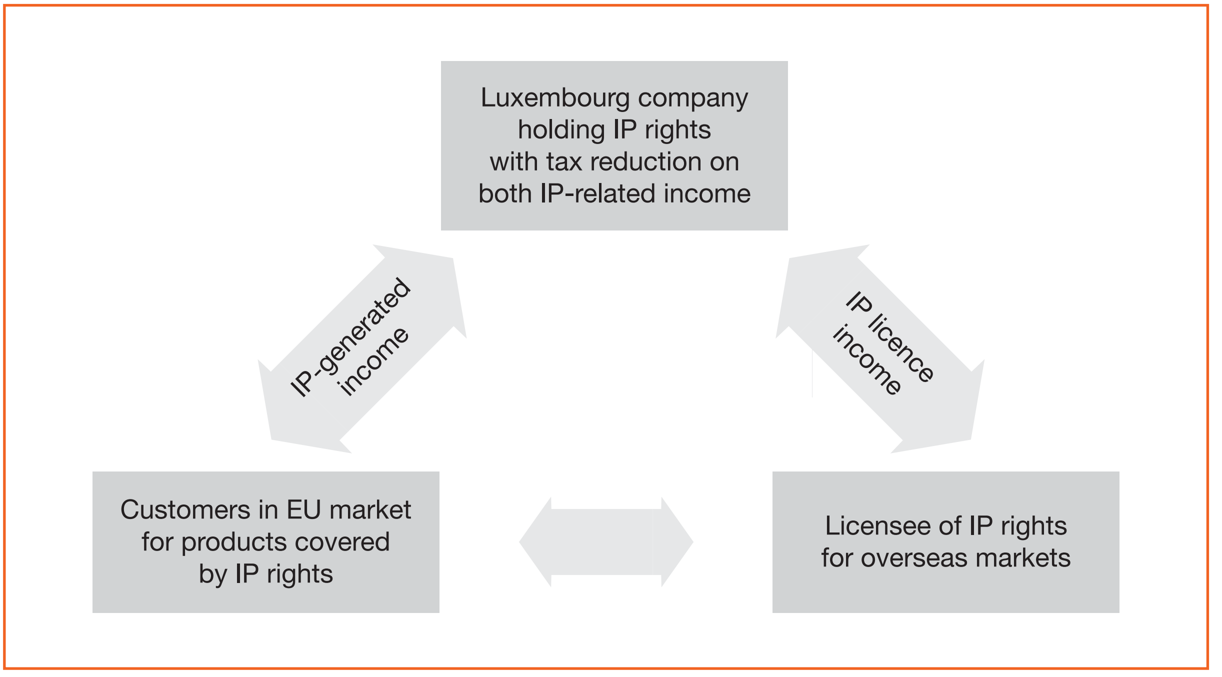
Acquisition and licensing of IP rights

A Luxembourg resident company need not necessarily create or register IP rights to fall under the scope of the tax regime; it can also acquire some or all of its IP rights. It need not necessarily exploit all IP rights itself; some or all of them can be licensed to third parties, such as foreign companies.

The diagram shows a classic example of the application of the tax reduction regime where a company in Luxembourg has developed and/or acquired IP rights. This company directly exploits the IP rights in its close market and licenses them for the overseas market. Both types of income will enjoy a tax reduction under the regime.

Capital gains arising from alienation of IP rights

Net capital gains arising from the alienation of



qualifying IP rights benefit from a tax exemption of up to 80%.

The reduced basis for taxation of capital gains (ie, 20% of the gain) will be adjusted by 80% of the losses generated from the IP rights over their life (including any depreciation, usual or extraordinary, that has previously been deducted from the taxable income of the taxpayer in the year of alienation or the previous year).

The taxable part of the gain on IP rights may be offset against existing losses, including losses generated on the intellectual property.

Valuation methods

The taxpayer may use general methods available for the valuation of intellectual property to determine the value of its own intellectual property. These methods include:

- market approach – estimating the fair value of an asset based on market prices in actual transactions and on the asking prices of assets currently available for sale;
- cost approach – considering the reproduction or replacement cost as an indicator of value and estimating the value on the basis of the cost of recreating the asset; and
- income approach – estimating fair value based on the cash flow that the asset can be expected to generate over its remaining useful life.

Small and medium-sized enterprises are entitled to use a valuation equal to 110% of the aggregate amount of the expenses incurred in developing the intellectual property.

Restrictions to the exemption

Creation or acquisition date condition

The partial exemption regime applies only to intellectual property created or acquired since the law came into force (ie, January 1 2008).

For transactions eligible for rollover relief, such as mergers and split-ups, the original acquisition date of the intellectual property of the transferring entity qualifies as the acquisition date of the intellectual property for the acquirer, if full rollover relief is applied for.

The circular states that the migration of a company to Luxembourg does not imply that any IP rights held by that company will have an acquisition date equal to the migration date. The original acquisition date is decisive for the acquisition date condition. The same applies when a permanent establishment is created in Luxembourg or a Luxembourg resident company changes from tax-exempt status to normal tax status.

The creation date for patents, trademarks, designs and models is, in each case, the date of application for registration. However, as registration is not required for software copyrights, the date for all necessary work for new software is the creation date.

Year of capitalisation of expenses connected with IP income

Expenses, amortisations and deductions connected with IP income must be capitalised in the tax balance sheet for the first fiscal year when the IP tax exemption is requested.

Related-party rule

Taxable persons that acquire intellectual property from a related company do not benefit from the partial exemption regime.

The notion of a 'related' company is defined restrictively. A company is considered to be related to the taxable person where:

- such company directly owns at least 10% of the share capital of the taxable person;
- the taxable person owns at least 10% of the share capital of such company; or
- a third company, which holds at least 10% of the share capital in the taxable person, holds at least 10% in the share capital of such company.

The taxpayer has the burden of proving that the first and third of these conditions are met.

Crediting foreign withholding tax

Notwithstanding the 80% exemption for royalty income, foreign withholding taxes thereon may be creditable or deductible, although certain limitations may apply.

Conclusion

The new partial exemption regime for IP income makes Luxembourg an ideal jurisdiction in which to locate and develop IP assets from a tax viewpoint.

The combination of the 80% exemption with the standard global corporation tax rate of 28.59% results in an effective 5.72% tax burden on net income deriving from intellectual property – the lowest in the European Union for such income.

In addition, this regime is not a special, discriminatory measure, but is available to any Luxembourg resident company, and may therefore not be considered as 'harmful' in view of the current state aid policy of the European Commission. Combined with the growing network of double tax agreements, this new addition to Luxembourg tax legislation reinforces the country's position as an excellent host for IP hubs.

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Jean-Luc Dascotte qualified as a lawyer in 1995 and gained his masters in tax management in 2001. He joined Wildgen in 2006 and heads the tax department, advising clients across the world on corporate and individual tax planning opportunities involving Luxembourg. Mr Dascotte has specific expertise in corporate financing – including innovative hybrid instruments, M&A transactions, funds structuring, venture capital and private equity vehicles through dedicated SICARs and SPFs, securitisation, tax due diligence and real estate investment.