

Luxembourg

An attractive new tax regime for income deriving from IP rights

Luxembourg is situated within a 300-kilometre radius of the major European markets – and their 100 million consumers – and enjoys a high level of economic prosperity due to the good health of its financial sector and the development of a dynamic IT sector. Luxembourg has built its reputation through the development of groundbreaking investment products supported by powerful IT and communication services.

Thanks to the flexibility and accessibility of government authorities, a favourable tax environment and an excellent logistical network, Luxembourg is the seventh largest financial centre in the world. More than 16,000 holding and finance companies have been established in Luxembourg during the last 10 years.

To enhance the jurisdiction's attractiveness, notably for companies retaining and managing IP rights, the Luxembourg government is promoting research and development (R&D) by allowing companies established under Luxembourg law to pay less tax on income generated from innovations protected by certain IP rights.

These measures are directly in line with the recommendations of the Lisbon European Council of March 2000, which took place amid a sharp reversal of fortune for the global economy, and with the Guidelines for Growth and Jobs (April 12 2005), in particular Guideline 12, which recommended:

- the increase and improvement of R&D investment; and
- government action to attract and develop scientific research in Luxembourg.

The recommendations were implemented in a national plan for innovation and employment, which was unveiled by the Luxembourg government in 2005. The plan established a package of legal measures to increase and improve investment in R&D in order to promote innovation.

Combined with a preferential corporate law framework, in particular the legal provisions relating to parent companies and subsidiaries, the plan will allow Luxembourg to provide integrated and optimum solutions to companies specialising or interested in the management of IP rights.

The new IP Law, which was voted on by Parliament on December 21 2007 and came into force for the 2008 tax year, introduced a new Article 50*bis* to the Income Tax Act and creates an attractive new tax regime for income and capital gains deriving from certain IP rights.

According to the new article, a Luxembourg taxpayer can benefit from an 80 per cent tax exemption for income and capital gains deriving from certain IP rights. Through the new IP tax regime, the Luxembourg government intends to attract industrial companies such as pharmaceutical groups and innovation companies.

Main aspects of the new IP tax regime

The 80 per cent exemption applies to income paid to Luxembourg taxpayers (natural or legal persons or corporate bodies). This income must derive from the exploitation of certain IP rights – that is, from the use, exploitation and/or disposal of copyrights, patents, trademarks and designs and models. However, only copyrights relating to software, plans, formulae or secret processes and other similar rights benefit from the exemption; other copyrights and income deriving from the leasing of industrial, commercial or scientific supplies do not.

The exclusion of non-software copyrights is due to the government's intention to promote R&D and innovative activities by focusing on the technological and industrial aspects of intellectual property.

Article 50*bis*(2) provides for a specific deduction for patents developed internally. The regime is also applicable to taxpayers which develop patents for their own activities. Article 50*bis*(2) provides that such

companies are entitled to a deduction of 80 per cent of the net consideration that a third party would have paid for the right to use the patent if it had been licensed to that third party. Here again, the new IP tax regime applies to both natural and legal persons. Parliament decided to limit the scope of application to patents because they are easily controllable thanks to their public nature and in order to promote the objectives of the new IP tax regime.

From a practical point of view, the exemption is granted from the date of application for protection of the qualifying IP rights. If the application is rejected (eg, if an invention is not considered patentable due to lack of novelty), the initial deduction must be reintegrated into the tax base for the fiscal year in which such decision is notified to the company.

Finally, net capital gains arising from the alienation of software copyrights, patents, trademarks, designs and models also benefit from an 80 per cent tax exemption.

The gain will remain taxable up to the extent of the expenses directly connected to the income, as well as depreciations and write-downs that reduced the tax base in the tax year of the disposal or in any previous tax year.

The new IP tax regime provides that the exemption will not apply if the IP rights are acquired by or from an 'associated company'. A company will be considered 'associated' in three cases:

- where the company directly owns at least 10 per cent of the share capital of the entity eligible for exemption;
- where the entity eligible for exemption directly owns at least 10 per cent of the share capital of such company; or
- where a third company, which directly holds at least 10 per cent of the share capital in the entity eligible for exemption, directly holds at least 10 per cent of the share capital of such company.

Conditions to benefit from the exemption

The new IP tax regime applies provided that the following additional requirements are met:

- Expenses that have a direct economic connection to the qualifying IP rights must be recorded as assets in the balance sheet of the company;
- The new IP tax regime is available only to Luxembourg taxpayers; and
- The IP rights must have been acquired (or created, as the case may be) after December 31 2007 independently from their geographical localisation.

Evaluating the IP rights

A taxpayer that wishes to benefit from the exemption must evaluate the qualifying IP rights. The new IP tax regime gives no accurate indication as to the determination of the income. If the IP rights are used by a third party (eg, through a licence), this determination raises no difficulties. Otherwise, the law provides that if no market value for the IP rights is available, the taxpayer should choose a method recognised by the administration or an internationally recognised method. In either case, the evaluation should preferably be carried out by IP professionals.

Furthermore, small and medium-sized businesses, as defined in the Decree of March 16 2005, are entitled to evaluate the qualifying IP rights which they assign at 110 per cent of the expenses that have reduced their tax base for the tax year of the disposal and of any previous tax year.

Areas of doubt

Some doubts remain, notably concerning the following issues:

- The scope of the new IP tax regime raises some doubts. Domain names are not expressly referred to in the law; however, a bill of October 1 2008 states that these will be expressly covered by the new IP tax regime.
- The law refers to "remuneration for use or the right to exploit". However, it is unclear whether sub-licensing of qualifying IP rights by Luxembourg companies is included within the scope of the new IP tax regime.
- The law does not specify what happens in the case of IP rights already owned by foreign branches of Luxembourg companies before December 31 2007 or where a Luxembourg company acquires IP rights via an indirectly affiliated entity.
- The new IP tax regime includes no provision regarding indirect intra-group acquisitions.

The tax administration is due to publish an administrative circular dealing with these issues. The circular will lay down some methods of implementation and specify the scope of the new IP tax regime – for example, to clarify whether other rights such as supplementary protection certificates for medicinal products are covered. The new IP tax regime should be completed by other similar regulations.

Conclusion

Further questions may be raised, notably regarding the EU rules on state aid as defined by the EC Treaty.

Nevertheless, the new IP tax regime does not concern a specific sector and thus should not be considered by the European Commission as state aid. Moreover, such measures are directly in line with EU strategy as expressed in the Guidelines for Growth and Jobs on April 12 2005, in particular Guideline 12 recommending the increase and improvement of R&D investment. Consequently, the new Luxembourg regime should not be considered to be a form of state aid.

The new IP tax regime is aimed at attracting key industrial and high-tech companies to Luxembourg and encouraging existing companies based in Luxembourg to protect their IP rights more effectively. However, to

maximise the fiscal advantage, a careful drafting of contracts in relation to qualifying IP rights will be required (particularly for assignments and licences).

In addition, in combination with all Luxembourg's assets – notably its good economic health, its preferential legal framework and its various investment tools – the new IP tax regime should help to strengthen Luxembourg's position as a European centre for the establishment of holdings, IT providers or companies for which R&D activities form an important portion of their business. For example, Luxembourg now expects to attract more pharmaceutical groups and companies with strong innovation potential.

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