Tax update
4 April 2018

New Luxembourg IP Box regime adopted

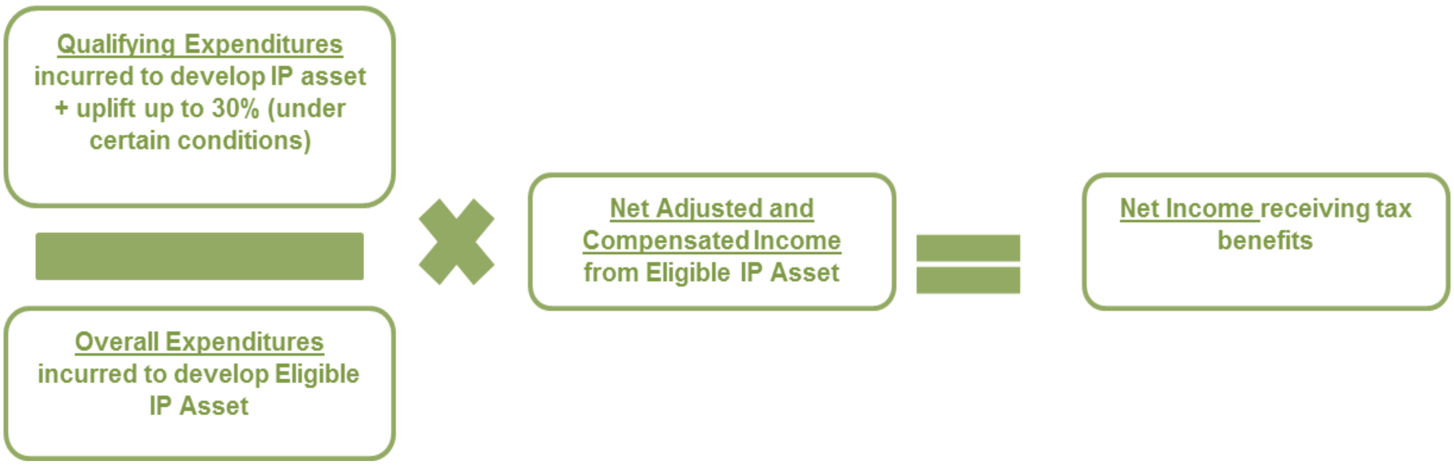
On 22 March 2018 the Luxembourg Parliament (*Chambre des députés*) adopted the new IP Box Law (see our newsflash "Tax changes for 2018 disclosed in the new budget bill" dated 13 October 2017, available at arendt.com/publications). The new IP Box Law replaces the previous IP Box regime which was repealed in 2016 with specific grandfathering provisions.

In line with the recently adopted "BEPS compliant" IP Box regimes in Europe, the IP Box Law introduces a new article 50ter into the Income Tax Law allowing a Luxembourg resident company or individual to benefit from a partial exemption of 80% on the net income ("**Net Income**") derived from eligible IP assets ("**Eligible IP Assets**"). The new IP Box regime thus leads to an effective tax rate of 5.202% (corporate income tax and municipal business tax in Luxembourg City). The Eligible IP Assets furthermore benefit from a total net worth tax exemption.

The adopted IP Box Law remains in line with the Bill of Law (n°7163) which was subject to only one amendment adopted for the sake of compliance with the modified nexus approach of BEPS Action 5. This amendment concerned the definition of qualifying expenditures ("**Qualifying Expenditures**") for the determination of Net Income: Qualifying Expenditures only include those incurred by the permanent establishment of the taxpayer provided that (i) the permanent establishment is located in the European Economic Area and (ii) the expenditures are attributable to the Luxembourg taxpayer by virtue of an applicable double tax treaty. This should be the case when the Luxembourg taxpayer exercises the significant functions and assumes the risks linked with the Research & Development ("**R&D**") activity performed in the permanent establishment.

For the record, the main features of the new IP Box are summarised below:

The modified nexus approach



Eligible Assets

The new IP Box covers net income derived from the use (*usage*), or the right to use (*concession d'un usage*) an Eligible IP Asset created, developed or improved within the framework of R&D activities after 31 December 2007. The list of Eligible IP Assets is wider than under the previous regime and includes *inter alia* patents and software protected by copyrights but also various forms of medicinal product rights. However, the exemption is no longer applicable to IP Assets of a commercial nature, excluding intangible assets related to marketing activities, such as trademarks.

Qualifying Expenditures

Qualifying Expenditures are expenditures borne by the taxpayer for the purpose of actual R&D activities and which are directly connected with the creation, development or improvement of an Eligible IP Asset (e.g. wages, direct costs or overhead costs). It also covers payments made by the taxpayer to an unrelated party for the purposes of its R&D activities and directly connected to the creation, development or improvement of an Eligible IP Asset. Acquisition costs, interest and financing costs, real estate costs and other expenses which are not directly linked to the Eligible IP Asset are excluded from the Qualifying Expenditures.

Qualifying Expenditures borne by the taxpayer during the current or preceding financial years may be increased to 30%, provided that this increased amount of the Qualifying Expenditures does not exceed the overall expenses borne by the taxpayer (as defined below) during the current or preceding financial years.

The notion of Qualifying Expenditures plays a crucial role in the new IP Box regime as it serves as an indicator of "substantial activity". It is indeed the proportion of expenditures directly related to R&D activities (*i.e.* the Qualifying Expenditures) that demonstrate the real value added by the taxpayer.

Overall Expenditures

The total expenses ("**Overall Expenditures**") generally include (i) Qualifying Expenditures, (ii) acquisition costs on an Eligible IP Asset including recurrent expenses such as royalties and (iii) expenses necessary for the R&D activities that are directly related to the creation, development or improvement of an Eligible IP Asset and which are paid to a related entity which is carrying out R&D activities for the benefit of the taxpayer.

Net Adjusted and Compensated Income

The net adjusted and compensated income ("**Net Adjusted and Compensated Income**") is based on (i) the income derived from the license from Eligible IP assets, (ii) innovation income embedded in the sales price of the Eligible IP Assets, (iii) capital gain upon the sale of Eligible IP Assets, (iv) payments indemnifying a violation of the IP rights and (v) certain adjustments and compensations.

Indeed, the income deriving from the Eligible IP Assets is subject to certain adjustments and compensations. The purpose thereof is to ensure that the net income from an Eligible IP Asset during a financial year will only benefit from partial exemption when the aggregate net income exceeds the total business expenses (i.e. direct and indirect expenses) with regard to the said Eligible IP Asset. Specific rules are provided for in the event a taxpayer holds more than one Eligible IP Asset.

Net Income

This new IP Box provides that the proportion of the income qualifying for the 80% exemption regime (*i.e.* the Net Adjusted and Compensated Income) is equal to the same proportion as that between Qualifying Expenditures and Overall Expenditures. A taxpayer will thereby only be able to benefit from the 80% exemption on a significant portion of net income from an Eligible IP Asset where the taxpayer has actually undertaken a significant part of the directly related R&D activities.

Our view

The new IP Box is another opportunity in the Luxembourg toolbox. It is fully compliant with the OECD's new nexus approach and is applicable with retroactive effect for the fiscal year closing 2018. Taxpayers may hence make use of the preferential regime as of today. Taxpayers who still benefit from the grandfathering provisions under the former IP Box can either opt to continue to use the old rules or transition to the new tax regime as of the current fiscal year. In any case further guidance is expected from the Luxembourg tax administration, in particular with regard to further clarification of the definition of Eligible Assets.

Our tax partners and your usual contacts at Arendt & Medernach are of course at your disposal to give you further guidance on the structuring possibilities offered by the new Luxembourg IP Box.

For more information, please contact our Tax Team:

Eric Fort
Partner
eric.fort@arendt.com

Alain Goebel
Partner
alain.goebel@arendt.com

Thierry Lesage
Partner
thierry.lesage@arendt.com

Jan Neugebauer
Partner
jan.neugebauer@arendt.com

This document is intended to provide you with general information on the subjects mentioned above.
Under no circumstances shall it constitute legal advice or replace adequate consultation with a legal advisor.