Luxembourg

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1. Does your country have a Patent Box regime (or a functionally equivalent preferential IP regime) or is a proposal for one under consideration?

An IP/Patent Box regime was first introduced in Luxembourg for the fiscal year 2008 (**2008 regime**). Following the scrutiny of Patent Boxes and the release of the OECD/G20's BEPS Action 5 Report on Harmful tax practices, Luxembourg abolished the 2008 regime, with the law of December 18, 2015. The 2008 regime was repealed as of July 1, 2016, with a grandfathering period ending on June 30, 2021. On March 22, 2018, Luxembourg voted on a new law[2] implementing a new IP/Patent Box regime (**2018 regime**) in line with the nexus approach advanced by the OECD. The 2018 regime applies retroactive to January 1, 2018.[3]

• What benefits does it offer (e.g., partial exemption or reduced tax rate)?

The 2008 and 2018 regimes provide (i) an exemption for 80% of corporate income tax and municipal business tax for net eligible income, leading to an effective rate of 5.202% (2018 rate) for taxpayers located in Luxembourg city; and (ii) a full exemption from net wealth tax for eligible assets.[4]

• What are the terms of the regime (e.g., definition of intangible property, definition of intangible income, definition of qualifying expenditures, treatment of R&D outsourcing, treatment of acquired IP or acquisition costs, grandfathering provisions for expiring regimes, administrative/ compliance requirements, etc.)?

Eligible taxpayer: The law provides that any Luxembourg resident taxpayer and non-resident taxpayer having a permanent establishment in Luxembourg may benefit from the 2018 regime.

Qualifying intangible assets: The 2018 regime limits eligible assets to inventions protected by patents or functional equivalents[5] and software protected by copyrights. The eligible assets can be either protected under the national law of Luxembourg, or international provisions. In this respect, the main difference between the 2008 and 2018 regimes is that the 2018 regime excludes all marketing related intangible assets such as trademarks or trade names, domain names, and logos. In order to benefit from the 2018 regime, the asset in question must have been established, developed, or improved after December 31, 2007.

Qualifying income: Qualifying income under the 2018 regime comprises any income directly related to an eligible asset. The law lists examples of different types of qualifying income, as follows: (i) income received as remuneration for the use of, or concession of the use of, an eligible asset; (ii) income directly linked to an eligible asset that is included in the sales price of a product or service (i.e., embedded royalties), the amount of which can be determined and is in line with Luxembourg transfer pricing rules; (iii) income realized on the disposal of an eligible asset; and (iv) compensation received in the course of legal proceedings or arbitration derived from the infringement of rights of an eligible asset. It is noteworthy that not all eligible income can benefit from the exemption. Only net eligible income, which is computed as the difference between qualifying income and the expenses directly and indirectly related to an eligible asset incurred during the financial year.

Nexus approach: To implement the nexus approach, the 2018 regime limits the exemption to income directly linked to research and development activities carried out by the taxpayer itself and located in Luxembourg. The nexus approach requires the taxpayer to determine a ratio by comparing the research and development (R&D) expenditures effectively incurred in Luxembourg (i.e., the qualifying expenditures) and the overall expenditures linked to the asset. The net eligible income will then be multiplied by this ratio to determine the income benefiting from the partial exemption.

Qualifying expenditures: R&D expenditures are 'qualifying expenditures' if they are carried out by the taxpayer and to the extent they are required for R&D activities directly related to the constitution, development or improvement of an eligible asset, or the expenditures are paid by the taxpayer to an entity that is

not an associated enterprise, or to an associated enterprise, provided that enterprise in turn pays the remuneration obtained without retaining a margin to an entity that is not an associated enterprise. Certain expenditures, regardless of their link to the eligible assets, are expressly excluded from 'qualifying expenses' such as, acquisition costs, interest and financing costs and real estate related costs.

Treatment of R&D outsourcing& treatment of acquired qualifying assetsand acquisition costs (*see in qualifying expenditures*)

Grandfathering provisions: The 2008 regime was abolished as of July 1, 2016, with a transitional period of five years. Since the New Regime entered into force as from fiscal year 2018, the Old and New regimes coexist (between 2018 and 2021). During the grandfathering period taxpayers already benefiting from the 2008 regime, may continue to do so for qualifying assets developed, acquired, or enhanced before July 1, 2016. The 2008 regime ceases to be available for taxpayers that acquired qualifying assets from a related-party (in the sense of article 56 of the Luxembourg Income Tax Act (LIR) or 9 of the OECD Model Convention – i.e. the arm's length standard) after December 31, 2015 and did not previously benefit from the 2008 regime or from foreign IP/patent box regimes. Taxpayers that could benefit from either regime may elect only one and cannot benefit from both cumulatively. The law introducing the 2018 regime allows taxpayers to choose the regime to be applied during the transitional period by selecting the option on their tax return; however, the choice will be irrevocable for the entire transitional period.

Administrative compliance requirements: Application of the 2018 regime (like the 2008 regime) is selected by the taxpayer on its tax return. The new regime imposes strict documentation requirements. The taxpayer must track (i) qualifying expenditures, (ii) overall expenditures and (iii) eligible income per eligible asset in order to establish the link between income and expenses. When tracking per asset is unrealistic, or requires arbitrary judgements, for example in case of commonality of scientific, technological, or engineering challenges, the tracking could then be done per product or service, product line or service line, family of products, or any other justified approach. The taxpayer must establish on the basis of objective and verifiable information that the identification and monitoring is appropriate and compatible with the organization of the R&D activities. Benefits under the 2018 regime will be denied if the taxpayer lacks the required documentation.

2. Assume that a Country A parent company owns an IP affiliate eligible for the patent box regime in Country B. What Country A issues arise from this situation (e.g., CFC legislation, taxation of dividends from the patent box, etc.)

The Luxembourg participation exemption regime in regard to non-EU jurisdictions includes a requirement for the subsidiary to be subject to a comparable tax to that applicable in Luxembourg. A minimum income tax rate of 9% generally satisfies this requirement as long as the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg. Thus, provided that the taxation under the IP/patent box regime in the jurisdiction of the subsidiary (i.e. Country B) is comparable to the Luxembourg IP/patent box regime, the participation exemption should be available.

There are no controlled foreign corporation (CFC) rules in Luxembourg and to date the country has not yet published a proposal to implement the CFC rules in the Anti-Tax Avoidance Directive (2016/1164). Thus, it is still unclear whether Luxembourg will choose: (i) inclusion of non-distributed specific types of income as defined in the ATAD I (Model A); or (ii) inclusion of non-distributed income arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage (Model B). It is expected that Model B will be chosen. CFC rules are expected to be enforced beginning in 2019 and should apply where (i) a Luxembourg company holds a direct participation of more than 50% in a foreign controlled entity and (ii) the controlled entity is subject to an effective tax rate that is less than 50% of the effective tax rate normally applicable in Luxembourg.

3. Assume that a parent company owns an operating subsidiary in Country A and an IP affiliate eligible for the patent box regime in Country B. What are the Country A issues if royalties (or other payments) are paid from Country A to the IP affiliate in Country B? What is the impact if the IP affiliate does not meet the OECD modified nexus approach?

In principle, royalties paid between affiliated parties are tax deductible and not subject to withholding taxes in Luxembourg if they comply with the arm's-length standard. If the royalty payments do not to meet the arm's-length standard: (i) a transfer pricing adjustment may occur and (ii) the payment may be recharacterized as a hidden dividend distribution leading to the denial of the deduction and to Luxembourg withholding tax being levied at a rate of 15%. Regarding the fact that an IP affiliate does not meet the OECD modified nexus approach, currently Luxembourg has no rules addressing this situation and therefore there should be no impact therein.

4. What other R&D tax incentives or benefits does your country offer to attract investment in R&D, e.g., credits, super-deductions, grants, tax holidays, etc.?

- **What are the requirements to be eligible for this tax relief (e.g., revenue thresholds, definition of intangible property, definition of qualifying expenditures, treatment of R&D outsourcing, treatment of acquired IP or acquisition costs, carry-overs, administrative/compliance requirements, etc.)?**

- **Can these incentives be combined with benefits received from a patent box regime (if available) or other incentives?**

Luxembourg offers incentives that are not directly linked to R&D activity, but promote R&D indirectly. Based on article 32(3) of the Income Tax Law (ITL), materials and equipment used exclusively in scientific or technical research activity may qualify for accelerated depreciation at a rate not exceeding four

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times the rate that would be applied for straight-line depreciation and not greater than 40%. The declining balance depreciation method can only be applied if the owner of the qualifying asset is also the user of the asset.

Based on art. 152bis of the ITL, a tax credit of 13% is granted for additional investments in depreciable qualifying tangible fixed assets (*bonification d'impôt pour investissement complémentaire*). The increase in investment over a given tax year is computed as the difference between the current value of all qualifying assets and the reference value allocated to the same type of assets. In addition, an 8% credit is granted for new investments up to 150,000 euro and 2% for investments over that amount (*bonification d'impôt pour investissement global*). Investments in real property, intangible assets, and vehicles (unless specifically allowed by the law) are excluded from the benefit. Investments must be physically operated in Luxembourg or in the European Economic Area in order to be eligible for the incentive. The credit for investment reduces corporate income tax and may be carried forward for 10 years. This tax credit is limited to 10% of the tax due for the financial year.

There are no formal procedural requirements for the tax incentives above. The application is made through the annual tax return; however, additional forms may need to be filed.

There is no overlap between the patent box regime and incentives above except for software acquisition on which taxpayers applying for the investment tax credit will not be able to apply any IP tax regime to the income generated by this software.

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[2] *Cf.* The Law of April 17, 2018 modifying the law of December 4, 1967 as amended concerning the tax regime of intellectual property and modifying the law of October 16, 1934 concerning the valuation of goods and value (*Bewertungsgesetz*) as amended.

[3] Article 50bis ITL.

[4] Liabilities related to the qualifying asset will not be deductible from net wealth tax base.

[5] E.g., utility model, a supplementary protection certificate for patents for medicine or a plant protection product, an extension of a supplementary protection certificate for paediatric medicine, a plant variety certificate, an orphan drug designation.