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New IP regime becomes effective for 2018 calendar year

KPMG Luxembourg Tax Alert 2018

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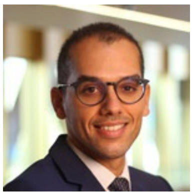

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Yesterday, Luxembourg went the extra mile in the pursuit of promoting innovation by passing the new intellectual property tax regime (the “new IP regime”) into law. The start of its period of effectiveness has been set to 1 January 2018.

The new IP regime makes Luxembourg compliant with the “modified nexus approach” as developed by the OECD in the final BEPS report of Action 5, “Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance.”

This newsletter highlights the key amendments to the initial bill submitted last year. Please refer to our previous Tax Alert 2017-14 for more details.

Foreign R&D permanent establishment

A specific provision on the treatment of R&D expenditures incurred by a foreign permanent establishment of a Luxembourg head office has been added to the text, specifying that such expenditures *are* included in the R&D qualifying expenditures (if directly connected to the eligible IP assets and required for actual R&D activities) for the determination of the nexus ratio, provided that all of the following conditions are met:

- the expenditures are allocated to the head office of the foreign permanent establishment according to the provisions of a double tax treaty;
- the foreign permanent establishment is situated in the European Economic Area (i.e. EU Member States plus Iceland, Liechtenstein, and Norway) and not Luxembourg;
- the foreign permanent establishment is operational at the time the qualifying IP income is generated; and
- the foreign establishment does not benefit from a similar IP regime in the country where it is situated.

In addition, those expenses can only be considered for the purpose of the determination of the nexus ratio if they are directly related to the creation, development, or improvement of a qualifying IP asset allocated to the Luxembourg head office. In other words, the Luxembourg head office should (i) perform and control all significant functions related to the R&D activities (such as development, enhancement, maintenance, protection, and exploitation) carried out by the foreign permanent establishment, which generated the expenses, and (ii) bear all the risks related to those functions.

KPMG Luxembourg comment

As expected, the law takes over most of the bill provisions and aligns the new IP regime to the OECD requirements for taxation where substantial activities are effectively carried out.

This new IP regime is essentially similar to the other IP regimes across Europe with the exception of some specific differences, like the partial exemption of capital gain on disposal of qualifying IP assets or the possibility to consider

R&D expenditures of foreign branches (located in the EEA) as qualifying R&D expenditures, which could be in the Luxembourg regime's favour.

As far as timing is concerned, this new IP regime will coexist with the repealed "old" IP regime, which is still applicable during the grandfathering period (subject to certain conditions), until 30 June 2021.

It's now time for groups to review their strategies with respect to R&D activities, implement the appropriate and efficient tracking of R&D income and expenditures, and prepare supporting documentation (according to transfer pricing guidelines) in order to determine the R&D income benefiting from the 80% exemption.

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