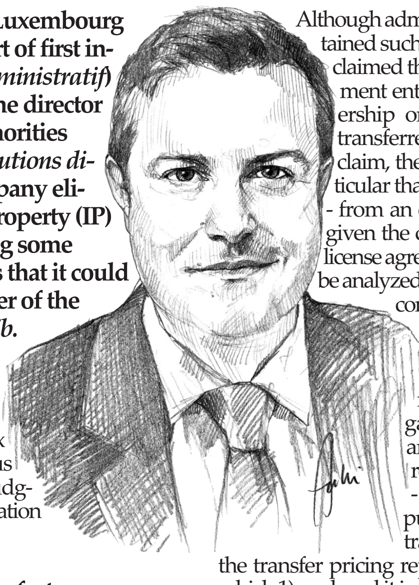
Tax controversy series

Administrative court judgment on economic appreciation



On 26 July 2023, the Luxembourg administrative court of first instance (*Tribunal administratif*) confirmed the decision of the director of the Luxembourg tax authorities (*Administration des contributions directes* – LTA) to deny a company eligibility to the intellectual property (IP) exemption regime regarding some trademarks, on the grounds that it could not be regarded as the owner of the trademarks in question (*Trib. administratif, 26 juillet 2023, n° 45706 et n°46555*).

In this second article of our tax controversy series, we will focus on what the key focus of this judgment is for us: economic appreciation and ownership.

Summary of the facts

The complainants are two Luxembourg-based companies (hereafter referred to as "Company 1" or the "Licensee", and "Company 2") that have been members of the same fiscal unity according to article 164bis of the Luxembourg income tax law ("LITL") since 27 April 2015 – one being the integrating parent company (Company 2) of the other (Company 1).

On 9 December 2015, the integrated company entered into an agreement with an affiliated US company (the "Licensor") and was granted the right to use a trademark. The agreement also provided the Luxembourg company with the right to sub-license the trademark to other companies that were also members of the same group and based in the European Union.

On 7 June 2018, the tax office informed Company 1 about its intent to disregard the tax return submitted for 2016 as it disagreed with the tax treatment applied to the trademark licensing agreement (i.e., 80 percent tax exemption based on the old article 50bis LITL).

From the tax office's point of view, Company 1 is not the owner of the trademarks. Despite the taxpayer's objections sent on 5 July 2018, the tax office confirmed its decision to disregard the tax return. On 20 September 2018, Company 1 met with the tax office but did not succeed in convincing it to reconsider its position.

On 3 April 2019, the tax office issued the final tax assessments for Company 1 for 2016 (relating to corporate income tax and municipal business tax) and 2017 (relating to net wealth tax). It also issued the final tax assessment for Company 2 for the year 2016 (relating to corporate income tax and municipal business tax). Both complainants reissued their comments on 10 April 2019, but the tax office stood by its decision.

Subsequently, on 5 July 2019, Company 1 and Company 2 decided to file an administrative claim (*réclamation*) to the director of the LTA regarding the tax assessments issued in April 2019. Furthermore, on 23 August 2019, Company 1 filed another administrative claim to the director of the LTA regarding the letter sent by the LTA on 21 May 2019 in which it denied its eligibility for the IP exemption regime.

Context of the decision

The court decision is quite detailed with many interesting angles to examine. For instance, the court had to take a stance on whether, in the context of a fiscal unity, the integrated member (which is not liable to corporate income tax and municipal business tax) has no legal interest in bringing an action (*intérêt pour agir*).

The court also referred to article 59 of the amended law of 21 June 1999 regulating the procedure before the administrative courts. It serves as a reminder that the procedure attributes to the taxpayer the burden of proof of the facts releasing them from a tax obligation or reducing the applicable tax rate. On this basis, in the case at hand, in order to benefit from the favorable tax conditions provided for in article 50bis LITL, it was up to the plaintiff to establish that it meets the conditions of application provided for therein, and in particular the status of economic owner of the IP rights in dispute.

However, the most interesting aspect of this judgment is likely the determination of who shall be considered the owner of the trademarks, and the considerations around the notion of legal owner and economic owner. We will focus in this article on that angle.

Decision of the administrative court

Behind the litigation on whether the complainant should qualify for the IP exemption regime, the main question that arose from this case was whether the Licensee could be regarded as the economic owner of the trademark under discussion. Indeed, it was clear – and not debated by the taxpayer – that the Licensor had retained the legal ownership on the trademarks.

Although admitting that the Licensor had retained such legal ownership, the Licensee claimed that, based on the license agreement entered into, the economic ownership on the trademarks had been transferred to them. In support of this claim, the complainants argued in particular that:

- from an economic point of view (and given the characteristics of the disputed license agreement), the transaction should be analyzed as a transfer of the trademarks concerned.
- the Licensor treated the transaction as a transfer of the trademarks in their US tax return, where it indicated a gain corresponding to the amount of the single payment received from the Licensee.
- the classification of the disputed license agreement as a transfer is further confirmed by the transfer pricing report relating to said contract, which 1) analyzed it in the light of US transfer pricing rules and the principles of the Organisation for Economic Co-operation and Development (OECD) guidelines on transfer pricing and 2) specified in particular that the Licensee bears the risks linked to a) the lack of notoriety or the loss of good reputation of the trademarks concerned, b) legal proceedings in the event of misuse of said trademarks, and c) the market (e.g., competition, drop in demand, economic slowdown and risk of default).
- the Licensor abandoned the right to license to a third party or to exercise itself the same rights as those granted to the Licensee, while specifying that the Licensee concluded, during the months following the conclusion of the disputed license contract, seven sublicense contracts.
- An IP expert opinion concluded that the Licensor only retained the legal ownership of the trademarks concerned, the economic ownership of which would however have been transferred to the Licensee, in particular on the basis of the very long duration of the license agreement (25 years renewable), reflecting the intention of the parties to commit definitively.
- the director of the LTA would have carried out, in this case, only a literal application of the clauses of the disputed license agreement without taking into consideration the fundamental principle of the economic assessment of legal operations.

In its judgment, the court started by reaffirming the principle according to which it should not be bound by the qualifications elected by the parties to carry out a given transaction. Instead, it should go beyond legal forms and analyze the economic reality and the circumstances surrounding this transaction. However, with this principle in mind, the court did not consider that the complainants provided sufficient proof, demonstrating that the economic ownership of the IP rights was transferred to the Licensee under the disputed license agreement.

The court thus pointed out that the disputed license agreement clearly stated that the Licensor was the sole owner of the rights related to the trademarks. "*Licensee recognizes and admits that all rights to the Marks shall be solely and exclusively the property of the Licensor. Licensee shall claim no legal or equitable ownership, interest, right, privilege or title to the Marks […]*"

Moreover, Company 1, as the licensee, was still subject to the Licensor's prior written approval in situations involving the advertising or marketing of the trademark. "*Licensor has the right to approve or disapprove the content and media of all advertising and marketing programs and materials Licensee proposes to use to promote the Marks […]. Licensor has the right to refuse the content and media of all advertising […]*"

The approval of the Licensor was also required in the event of sub-licensing the trademarks. "Licensee shall, and shall ensure that its sublicensees agree to, use the Marks to identify […] Stores only in a manner prescribed by Licensor from time to time"

The Licensor could control the duration of sublicense agreements granted by the Licensee. "Upon expiration of the Terms of this Agreement or upon termination by Licensor or Licensee, Licensor may also terminate the rights granted to sublicensees of Licensee pursuant to any Sublicense Agreements."

Based on its analysis of the provisions of the license agreement, the court concluded that Company 1 could not be considered as the economic owner of the trademarks.

This conclusion was further corroborated in the mind of the court by the review of the sublicense agreements as they were also expressly recognizing the Licensor's as the sole and exclusive owner of the trademark at issue. The judges also pointed out that in the sublicense agreements, Company 1 was not referred to as the owner of the IP rights but merely as the "*holder of exclusive trademark rights*".

On this basis, the court considered that it was absolutely clear (*intention tout à faire claire*) from those agreements that it was never the Licensor's intention to lose control over the IP rights in question.

The court also rejected the complainants' argument according to which the fact that the 25-year term of the contract was automatically renewable was equivalent to a definitive transfer of the disputed trademarks insofar as the agreement specifically provided for a termination clause. The court noted that this type of clause is uncommon in the context of a sale. The court also failed to be convinced by the statement made by the complainants according to which the trademarks in question would have had useful lives shorter than 25 years in the absence of any evidence supporting this view.

Last, and certainly not least, as the complainants relied heavily on § 11 Steueranpassungsgesetz (StAnpG) to try to demonstrate that from an economic standpoint the Licensee should be regarded as the actual owner of the trademark, the judges took that opportunity to clarify the context in which those provisions should be invoked. The court rejected in its entirety (for "lack of relevance"[1]) the developments of the complainants according to which the economic reality would be quite different from that emerging from the license and sublicense contracts, on the basis of the idea that a taxpayer cannot be allowed to use the principle of economic reality to contradict their own unequivocal documents[2]: "*the principle, derived from paragraph 11 StAnpG, aims solely to enable, in tax matters, the tax authorities and the administrative judge to seek and analyze, beyond the legal appearance, the economic reality covered by the legal forms chosen by the parties to carry out a specific transaction, with a view to verifying whether the latter correspond to the real intention of the parties*".[3]

It appears, therefore, that according to the court, the sole purpose of § 11 StAnpG is to enable the tax authorities to go beyond legal forms and appearances by analyzing the economic reality of a given transaction behind the legal forms chosen by the parties, in order to verify whether these correspond to the parties' intentions. In the case at hand, the court considered that the intention of the parties was clear and unequivocal based on the terms of the agreements under scrutiny, meaning that there was no reason to consider that the economic reality should diverge from the legal form chosen.

In light of this, the court ruled that the Licensee did not qualify as the economic owner of the trademarks and, as a result, was not eligible for the partial IP exemption regime.

At a minimum, this decision indicates that for the first instance judge the principle of economic appreciation of § 11 StAnpG can only apply in exceptional situations – where the legal form and appearances are misleading – and that, when the situation is clear, and when the legal documentation is clear ("*pièces non équivoques*"), trying to argue that the economic reality is different or more complex, is worthless.

It is only natural to wonder, however, if there is not more to this decision than meets the eye. The reasoning of the court could indeed be interpreted as suggesting that, from its point of view, the principle of economic appreciation of § 11 StAnpG can only play against the taxpayer, but would not be valid grounds for challenging the position of the LTA. We will be closely monitoring future case law dealing with economic ownership and § 11 StAnpG, and notably the appeal (49388) that has been lodged against this decision.

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1) "*(…) ladite argumentation est à rejeter dans son intégralité pour défaut de pertinence.*"
2) "*(…) qu'il ne saurait être permis à un contribuable de se servir du principe de la réalité économique pour contredire ses propres pièces non équivoques.*"
3) Translation of the French text by the authors: "*le principe, dégagé du paragraphe 11 StAnpG, vise uniquement à permettre, en matière fiscale, aux autorités fiscales et au juge administratif de rechercher et d'analyser, au-delà de l'apparence juridique, la réalité économique recouverte par les formes juridiques choisies par les parties pour réaliser une opération déterminée, en vue de vérifier si ces dernières correspondent à l'intention réelle des parties.*"