TAX HEAVEN FOR IP OWNERS

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Luxembourg is an attractive jurisdiction for both intellectual property (IP) management and taxation, because it has a long-established tradition of being business-friendly, especially for R&D-driven companies. Enterprises can benefit from a stable legal and political system, government support for research projects, private equity seed funding, high educational standards, a multilingual population, international IP management firms, and favourable tax legislation.

Tax exemption for IP

Based on the goals of the EU to make Europe a competitive location for investments in R&D and IP, Luxembourg has introduced a special tax regime for income and capital gains that are generated from IP, which became effective on January 1, 2008. This tax law, which was incorporated as Article 50bis LIR and later specified by a Luxembourg tax authority circular in March 2009, provides for an 80 percent income tax exemption on the positive net income that arises from the commercialisation of certain IP rights. Given that there is a combined tax rate for companies that are taxable under corporate income tax (income tax and municipal business tax) of 28.8 percent in the city of Luxembourg, this results in an overall tax rate of only 5.76 percent. Additionally, eligible IP assets are exempt from net worth tax. This makes Luxembourg one of the most attractive locations for IP holdings in Europe. Despite the fact that this tax regime was introduced in 2008 and many foreign firms have already transferred their IP assets to Luxembourg or are evaluating the possibility, news of this opportunity is spreading slowly.

Eligible intangibles

The tax law is applicable to copyrights in software, patents, trademarks and designs within the meaning of the Organisation for Economic Co-operation and Development (OECD) model tax convention on income and capital (Article 12, paragraph 2). However, the Luxembourg tax law is more restrictive as it excludes copyrights in artistic and scientific works, plans, secret formulas and processes, as well as information concerning industrial, commercial and scientific experiences. On the other hand, domain names are considered to be eligible for tax exemption. These intangibles and others grant their owner an exclusive right to exploit that can be personally exercised or commercialised by transfer or licensing to third parties. Neither the actual legal owner nor the registered owner is of interest for taxation purposes. It is only the economic beneficiary of an IP right that is of interest.

Basic conditions

Certain conditions have to be met for the favourable taxation to apply. First, the IP right must have been established or acquired after December 31, 2007. For patents, registered trademarks, designs and domain names, an application filing date is material for determining a creation date. For copyrights in software, the creation date is considered to be the date when all necessary programming works were finalised and the program was ready for commercialisation. Further developments of the software cannot be taken into consideration, unless they are marketed independently. The Benelux Office for Intellectual Property (BOIP) offers to file a so-called i-Depot. This is a means of obtaining an officially recognised date stamp that proves the existence of an idea, concept, plan or composition, as lodged with BOIP on a certain day. In the context of partial tax exemption for income generated from IP, tax authorities follow a pragmatic approach and refer to the i-Depot as a possible way of proving the date that a piece of software was created (the software's source code must be filed on a disk at the office). An IP right that was created before 2008 falls under this tax regime if it was acquired by a taxable entity after 2007; the term acquisition includes contributions in kind. In all cases, the burden of proof relating to a date of creation or acquisition rests on the taxpayer.

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> IAS 38.21 ALLOWS AN INTANGIBLE ASSET TO BE RECOGNISED IF IT IS PROBABLE THAT THE EXPECTED FUTURE ECONOMIC BENEFITS THAT ARE ATTRIBUTABLE TO THE ASSET WILL FLOW TO THE ENTITY, AND THE COST OF THE ASSET CAN BE MEASURED RELIABLY.

Second, the IP right must be recorded on the third party's balance sheet with its acquisition price and expenditures, amortisations and deductions for depreciations that are directly related to the creation of the asset. The accounted value has to be amortised over its useful life. This is in accordance with IAS 38.21, a financial reporting standard. This allows an intangible asset to be recognised if it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and the cost of the asset can be measured reliably.

Third, IP may not be acquired from an affiliated company. The objective of this constraint is to avoid an IP right benefiting from tax exemption within the same group of companies more than once. The tax law defines an affiliated company as a company that holds or is held by a direct participation of at least 10 percent of the share capital (parent company/subsidiary), or a third company that holds at least 10 percent of the licensee or purchaser as well as the licensor or seller (sister companies). The holding of a participation through a tax-transparent entity is to be treated as a direct holding in proportion to the part that is held in the transparent entity. Interestingly, these anti-abuse provisions do not restrict the sale or licensing of IP assets to an indirectly associated company (grandparent company). Furthermore, there is no limitation regarding the acquisition or licensing of IP assets from a shareholder who is a physical person. The relevant date for the evaluation of the affiliation is solely the moment of the transfer or licensing of the intangibles.

Qualifying income and IP evaluation

A taxable basis is the positive net income defined as the gross revenue that is generated from an IP asset, minus disbursements that must be in direct economic relation with this income, including amortisations and deductions for depreciations. Costs that are related to research do not have this direct link. If a patent application is rejected, previously accounted deductions must be added to the taxable net profit. Foreign withholding tax that is paid on revenues that relate to exploiting IP can only be deducted at a 20 percent level if the foreign net revenues

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are positive, but they can be deducted completely if the foreign net revenues are negative. A taxable person or entity that has constituted a patent or other IP asset and uses it (only) internally is entitled to make a deduction that corresponds to 80 percent of the positive net income that could have been realised if the IP right had been licensed to a third party at market price.

Hence, a fictive remuneration may be taken as a basis. The valuation of the fictive income that derives from royalties, the excess value that is generated through divestiture, and the financial value of the created IP or granted licences, may be conducted according to any generally accepted method. However, it has to be stressed that the arm's-length principle applies without exception. The legislator recognises the fact that IP asset valuation is a complex and costly procedure. Therefore, the law provides for a simplified valuation method that is applicable to micro, small or medium-sized enterprises. It is accepted that such taxable entities may record an estimated excess value of 110 percent of the costs that are related to the creation and the transfer of an intangible asset (cost-plus pricing). Micro, small and medium-sized enterprises are defined as entities that employ fewer than 250 people and that have a gross profit on sales that is no higher than €50 million, or the balance sheet total is €43 million or less. The economic downturn may offer new opportunities to re-value IP assets at a lower level and to transfer them to a company that is taxable in Luxembourg.

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Richard Brunner's practice involves international trademark and domain name portfolio management services, as well as copyright, commercial and corporate law. He has been counselling enterprises and associations on international IP prosecution and enforcement matters for more than 10 years. His track record shows stewardship of trademark-outsourcing projects of multinational corporations. He is the author of numerous publications on copyright law and IP outsourcing.

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