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From:	General Secretariat of the Council
To:	Delegations
Subject:	Code of Conduct Group (Business Taxation): standstill review process – Luxembourg's draft law relating to the tax regime for intellectual property

Delegations will find attached the description and assessment of Luxembourg's draft law relating to the tax regime for intellectual property (LU017), which were endorsed by the ECOFIN Council on 22 June 2018.

ANNEX

Agreed description of Luxembourg's draft law relating to the tax regime for intellectual property (LU017)

The Code of Conduct Group agreed on 14 February 2018 to use the following two documents as the "agreed description" of the LU017 regime[1]:

1. The questionnaire covering the proposed legislation filled in by Luxembourg for the purposes of providing a description of the regime to the Code of Conduct Group as well as to the OECD Forum on Harmful Tax Practices (FHTP). The same questionnaire has been used for the previously examined patent boxes.

2. An amendment to Art. 50ter of the draft law which clarifies the definition of 'qualifying expenditure' incurred by a foreign permanent establishment.

[1] General overview of all regimes examined by the Code of Conduct Group (business taxation) since its creation in 1998: see doc. 9639/18.

Questionnaire:

Country			Country name
1. Please provide below the basic information about your regime	a. Name of the regime		Luxembourg IP regime (article 50ter of the Luxembourg income tax law ("LITL")
	b. Year of introduction/relevant legislation	Year	Foreseen as from tax year 2018.
		Please attach to this template (or provide a link to) the legislation which introduces your new IP regime (if in a language other than English or French, please provide a translation).)	The draft law is in the process of being submitted to Parliament. We will provide you with the link to the website of the Luxembourg Parliament concerning the official legislative document as soon as it has become available.
	c. Benefits under your regime (e.g. a reduced rate or a deduction, an exception, or some other reduction in the taxable base)		Exemption of 80% of the net qualifying income derived from the qualifying IP asset after application of the nexus ratio.
	d. Effective tax rate under your regime		5,2%
	e. Statutory rate in your jurisdiction that would apply in the absence of the regime		For a company established in the municipality of Luxembourg – applicable statutory combined income tax rate (corporate income tax, including a solidarity surcharge of 7% and municipal business tax) of 26.01% as from tax year 2018.
	f. Stated purpose of your regime		Recognising that IP represents an important driver of growth and employment, the new IP regime is aimed at stimulating R&D activity in Luxembourg in order to foster innovation. Innovation represents a key element in the strategy of the Luxembourg Government to strengthen sustainable growth.
2. Please describe the scope of qualifying taxpayers under your regime.			Qualifying taxpayers are taxpayers (who have developed a qualifying IP asset) subject to LITL who apply for the regime in their yearly tax return.
3. What types of IP assets can qualify for benefits under your regime?			• Patents ;

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<table>
<tr><th colspan="3">Country</th><th>Country name</th></tr>
<tr><td colspan="3"></td><td>Utility models;
Supplementary protection certificates;
Prorogations of Supplementary protection certificates;
Plant breeders’ rights;
Orphan drug designations;
Copyrighted software.</td></tr>
<tr><td rowspan="4">4. Third category of IP assets</td><td rowspan="4">a. Are you planning on allowing the third category of IP assets described in paragraph 37 of the Action 5 Report to qualify for benefits?</td><td>Yes/no</td><td>No</td></tr>
<tr><td>(i) Please describe how you will limit the taxpayers benefiting from the third category.</td><td></td></tr>
<tr><td>(ii) Please describe what IP assets will qualify under this category, and the reason why they will fit with the specific requirements in paragraph 37 of the Action 5 Report.</td><td></td></tr>
<tr><td>(iii) Please describe the transparent certification process (undertaken by a competent government agency that is independent from the tax administration) under your regime.</td><td></td></tr>
</table>

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Country			Country name
		(iv) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information.	
5. What income will qualify for benefits? Please describe how you are ensuring that the amount of income is not equal to the gross income from IP assets.			Qualifying income derived from the qualifying intellectual property assets includes: • Royalties; • Embedded royalties; • Proceeds from the sale of a qualifying intellectual property asset; • Income derived within the framework of a legal or arbitration proceedings. IP expenditures are calculated by applying the ordinary domestic tax law provisions. They will therefore include both direct and indirect expenses related to the qualifying IP asset. The net qualifying income of each qualifying intellectual property asset is calculated by deducting first the expenditures of the year related to the qualifying income. Then the losses of previous periods related to the qualifying asset are deducted. Net qualifying income can only benefit from the reduced tax rate in as far as it exceeds the cost price of the qualifying IP asset as well as any other former losses related to the qualifying IP asset.
6. Embedded IP income	a. Does your regime allow embedded IP income to qualify for benefits?	Yes/No	Yes
	b. If yes, please describe how you are ensuring that non-IP income (e.g. marketing and manufacturing returns) does not also qualify for benefits.		The tax relief is available in respect of the part of the sales price of a product or service which is directly related to the qualifying IP asset. Such part will be determined in accordance with international transfer pricing rules (in line with the revised OECD Transfer Pricing Guidelines

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Country			Country name
			(Action 8-10 of the BEPS Action Plan)), which are laid down in Article 56bis LITL. It should be noted as well that the definition of "qualifying IP asset" excludes marketing-related IP assets from the scope of the regime.
7. Tracking and tracing	a. Have you designed tracking and tracing requirements to ensure that income that is not from qualifying IP assets or that is not qualifying IP income does not qualify for benefits?	Yes/No	Yes
	b. If yes, please describe your regime's tracking and tracing requirements.		The taxpayer shall establish documents which demonstrate that qualifying expenditures, overall expenditures and qualifying income are tracked, and which show the link between such expenditures and such income. Documents are on a per qualifying IP asset basis, unless the taxpayer has several IP assets and demonstrates that he is engaged in such a complex R&D activity that tracking to individual IP assets would be impossible, in which case the taxpayer can track and trace to products, services, or to families of products or services arising from qualifying IP assets. In that specific case, the taxpayer will have to hold at the disposal of the tax authority documentation demonstrating the complexity of its R&D activity and providing justification for using the approach tracking to products, services, or families of products or services arising from qualifying IP assets. The taxpayer shall also prepare documentation substantiating that prices are equivalent to arm's length prices. Failure to have the necessary documentation available results in the taxpayer not qualifying for the tax relief.
8. Please explain how losses associated with the IP income will be treated under your regime. The explanation should include how your			Losses associated with a qualifying IP asset are deductible at the ordinary tax rate, but have to be recaptured according to a system of

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Country			Country name
regime ensures that the requirement under footnote 14 to paragraph 47 of the Action 5 Report is met.			deduction of previous losses relating to an IP asset (or to a product, service, or family of products or services arising from qualifying IP assets) from subsequent net qualifying IP income of such assets. This system is foreseen by article 50ter (2) - (4) LITL. The initial benefit of offsetting IP losses against income taxed at the ordinary rate is annulled later on by ensuring that these losses are deducted from later net qualifying IP income. Only net qualifying IP income exceeding these previous losses can qualify for the tax relief under article 50ter LITL, with the rest being taxed at the ordinary rate, cancelling out the initial benefit of offsetting the losses against income taxed at the ordinary rate. Thus, net qualifying IP income from the qualifying IP asset will not qualify for the tax relief as long as it does not exceed development costs or other losses related to the qualifying IP asset. Furthermore, if the taxpayer has more than one qualifying IP asset, the Luxembourg regime also provides that losses relating to a qualifying IP asset will be deducted from any net qualifying IP income, regardless of which qualifying IP asset generated such income.
9. If you are not a Member State of the European Union, have you designed your regime to be consistent with footnotes 16 and 19 on page 42 of the Action 5 Report? If you answered YES to this question, skip to Question 12. If you answered NO to this question or are a Member State of the European Union, proceed to Questions 10 and 11, and skip Questions 12.		Yes/No	N/A
10. Related-party outsourcing	a. Does your regime limit benefits based on outsourcing to	Yes/No	Yes

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Country			Country name
	related parties?		
	b. If yes, please explain how your regime limits benefits based on outsourcing to related parties.		The net qualifying income derived from the qualifying IP asset shall be multiplied by a ratio (the nexus ratio), where related party outsourcing expenditures as part of the overall expenditures on the qualifying asset will be put in the denominator (and not in the numerator). In doing so, related party outsourcing expenditures will reduce the net qualifying income derived from the qualifying IP, in line with BEPS action 5 report. Related parties are defined with reference to article 56 LITL. Under article 56 LITL, two enterprises are deemed to be related when one enterprise participates, directly or indirectly, in the management, control or share capital of the other, or if the same persons participate, directly or indirectly, in the management, control or share capital of both enterprises.
11. Acquisitions of an IP asset	a. Does your regime limit benefits based on acquisitions?	Yes/No	Yes
	b. If yes, please explain how your regime limits benefits based on acquisitions. Following this question, please proceed to Question 13.		The net qualifying income derived from the qualifying IP asset shall be multiplied by a ratio (the nexus ratio), where acquisition costs of any acquired IP as part of the overall expenditures on the qualifying asset will be put in the denominator (and not in the numerator).
12. Related-party outsourcing and acquisition of an IP asset in line with footnotes 16 and 19 on page 42 of that Action 5 report	a. Does your regime limit benefits based on the location of the R&D activities in the case of related-party outsourcing and acquisitions?	Yes/No	N/A
	b. If yes, please explain how your regime limits benefits based on the location of R&D activities.		N/A

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Country			Country name
13. Rebuttable presumption	a. Does your regime treat the nexus ratio as a rebuttable presumption?	Yes/No	No
	b. If yes, please answer to the following questions (i) through (iii)	(i) Please describe how departures from the application of the nexus ratio will be limited to the exceptional circumstances described in paragraph 48 of the Action 5 Report.	/
		(ii) Please provide examples of situations where your jurisdiction expects taxpayers to rebut the presumption.	/
		(iii) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information.	/

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Amendment to be made to article 50*ter*, paragraph 1, point 3 L.I.R.

3. "qualifying expenditure" means the sum of the expenditure required for research and development activities directly related to the creation, development or improvement of a qualifying asset, including expenditure incurred by a permanent establishment, but attributed to the taxpayer according to a convention for the avoidance of double taxation, provided that this permanent establishment~~it~~ is located in a State party to the Agreement on the European Economic Area (EEA) other than Luxembourg, is operational at the time of realisation of the qualifying income and does not benefit from a similar tax regime for intellectual property in the State in which it is situated, and which is incurred by the taxpayer for research and development activities carried out by the taxpayer himself or is paid by the taxpayer:
   (a) to an entity that is not a related undertaking; or
   (b) to a related undertaking in so far as that undertaking pays the remuneration obtained without margin to an entity which is not a related undertaking.

   The following shall not constitute qualifying expenditure:
   (i) acquisition costs;
   (ii) interest and financing costs;
   (iii) real estate costs;
   (iv) other costs that are not directly related to a qualifying asset.

   By way of exception to point (iv) above, expenditure incurred for general or speculative research and development or expenditure on research and development which has not led directly to the creation of a qualifying asset may nevertheless be taken into account as qualifying expenditure provided that the taxpayer establishes a link between that expenditure and a specific qualifying asset or proves that there is a proportionate distribution of such expenditure between the qualifying assets in respect of principle and of the amount of such distribution, on the basis of supporting documents.

   Qualifying expenditure is to be taken into account at the time it is incurred, irrespective of its accounting or tax treatment;

Commentary

Paragraph 1, point 3 of article 50*ter* L.I.R., that article 1, point 1 of the bill of law n° 7163 suggests to implement with effect as from the tax year 2018, defines the qualifying expenditure.

It turned out that the wording of the bill of law may lead to confusion by allowing to consider as qualifying expenditure the research and development expenditure incurred by a permanent establishment located in a State party to the Agreement on the European Economic Area (EEA) other than Luxembourg and which is attributed to the said permanent establishment, while the said expenditure should only be considered as qualifying expenditure if it is attributed to the taxpayer (i.e. to the head office) and if it is furthermore directly related to the creation, development or improvement of a qualifying asset imputed to the taxpayer. However, such a reading was not intended and would furthermore be contrary to the provision included in the footnote number 4 relating to paragraph 33 of Chapter 4 of the Final Report on Action 5. The said note specifies that "*Jurisdictions with IP regimes should ensure that the same IP asset is not allocated to both the head office and the foreign PE (e.g. because they apply the authorised OECD approach (AOA)).*"

As the definition of qualifying expenditure included in the bill of law in its current version may lead to misinterpretations which would not be in line with the framework outlined by the OECD in the Final Report on Action 5, it is important to amend article 1 of the said bill of law in order to clarify that the research and development expenditure incurred by a permanent establishment located in another EEA State are only considered as qualifying expenditure of the taxpayer provided that, subject to the other conditions, the said expenditure is attributed to him on the basis of a convention for the avoidance of double taxation in force between the other EEA State on the territory of which the permanent establishment is located and Luxembourg and are directly related to the creation, development or improvement of a qualifying asset that is imputed to him. This is the case if the taxpayer exercises and controls all the key functions linked to research and development activities (i.e. the functions related to the development, enhancement, maintenance, protection and exploitation) carried out by the permanent establishment and that generated this expenditure, and if the taxpayer assumes all the risks related to these functions.

ASSESSMENT BY THE

CODE OF CONDUCT GROUP (BUSINESS TAXATION)

The following assessment was agreed by the Code of Conduct Group on 12 April 2018:

	1a	**1b**	**2a**	**2b**	**3**	**4**	**5**
LU – Luxembourg IP regime	X	?	X	?	X	?	X

In accordance with the 24 November 2016 report of the Code of Conduct Group to the Council, the following draft assessment has been prepared with regard to paragraphs 1 to 5 of the Code, based on the OECD description (hereafter referred to as "agreed description") provided by the Luxembourg authorities and subsequent clarifications from the latter. The measure was assessed against all Code criteria and on the basis of the modified nexus approach.

Explanation

Significantly lower level of taxation:

"Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code"

The new Luxembourg IP regime ("IP regime") was adopted on 22 March 2018.

The IP regime provides for an exemption of 80% of the net qualifying income derived from the qualifying IP asset after application of the nexus ratio.

The IP regime generally results in an effective tax rate of 5.2% compared to the Luxembourg company ordinary tax rate of 26.01% as from tax year 2018 (corporate income tax, including a solidarity surcharge of 7% and municipal business tax for companies established in the municipality of Luxembourg).

This rate is significantly lower than the rate generally applying. **The IP regime is therefore potentially harmful within the meaning of paragraph A of the Code.**

Criterion 1: "whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents"
Criterion 1 contains two elements. The first element is whether the measure is exclusively available to non-residents or transactions with non-residents (criterion 1a). The second element is whether it is only or mainly used by non-residents or for transactions with non-residents (criterion 1b). 1a) Criterion 1a concerns the *de jure* application of the measure. The IP regime is available to any resident or any non-resident taxpayer who carries on a business through a permanent establishment in Luxembourg and who fulfils the conditions of a qualifying taxpayer (by having developed a qualifying IP asset). **We have therefore proposed a cross ("X") for this criteria.** 1b) Criterion 1b is used to complement the assessment under criterion 1a which only looks at the literal interpretation of the measure. It takes account of the *de facto* effect of the measure. Where the majority of taxpayers (or counterparties to transactions) benefitting from the measure are in fact non-residents the measure will fall foul of criterion 1b. In light of the recent introduction of the IP regime, it is unlikely that statistical or impact data is either available at this stage, or representative enough to reflect the comprehensive effects of the newly IP regime. Moreover, the agreed description in the format used[2] lacks such data. This horizontal issue concerned almost all assessments on new IP regimes adopted by Member States following the modified nexus approach. Our suggestion in this respect was that the group reserves the possibility of a potentially different outcome of a future assessment based on information that is more complete. **We have therefore proposed a question mark ("?") for this criterion.**

[2] For this particular exercise, the Member State's reply to the OECD questionnaire for FHTP.

Criterion 2:

“whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base”

As regards criterion 2 the division between criteria 2a and 2b is done in the same way as in the case of criterion 1 (i.e. *de jure* interpretation and *de facto* analysis). In general, a measure is caught by criterion 2 if the advantages are ring-fenced from the domestic market so that they do not affect the national tax base. In most cases, the evaluation against criterion 2 follows closely that of criterion 1.

2a) What has been written under criterion 1a applies analogously to criterion 2a.

There are no rules preventing domestic taxpayers from benefiting from the IP regime nor to exclude domestic transactions from the benefit of the IP regime.

We have therefore proposed a cross (“X”) for this criteria.

2b) On the basis of the explanations provided above and the marking under criterion 1b, the evaluation of criterion 2b follows the same reasoning.

In light of the recent introduction of the IP regime, it is unlikely that statistical or impact data is either available at this stage, or representative enough to reflect the comprehensive effects of the newly IP regime. Moreover, the agreed description in the format used[3] lacks such data.

This horizontal issue concerned almost all assessments on new IP regimes adopted by Member States following the modified nexus approach. Our suggestion in this respect was that the group reserves the possibility of a potentially different outcome of a future assessment based on information that is more complete.

We have therefore proposed a question mark ("?") for this criterion.

[3] For this particular exercise, the Member State's reply to the OECD questionnaire for FHTP.

Criterion 3: "whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages"
In November 2014, the Group agreed, in co-ordination with developments at the OECD, on the modified nexus approach as the appropriate method to ensure that patent boxes require sufficient substance. Therefore, under this agreed approach, criterion 3 for the Code has to be interpreted in line with the modified nexus approach. The key elements of the modified nexus approach are: Scope (qualifying IP assets), Nexus ratio, Tracking and tracing, Rebuttable presumption and Treatment of losses. **1. Scope**: *Under the modified nexus approach, the only IP assets that can qualify should be patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes where such processes are relevant. IP assets that are functionally equivalent to patents are (i) patents defined broadly (utility models, IP assets that grant protection to plants and genetic material, orphan drug designations, and extensions of patent protection), (ii) copyrighted software*[4] *and (iii) 3rd category of assets that share features of patents (non-obvious, useful and novel), are substantially similar to the IP assets of the first two categories, and are certified as such in a transparent certification process by a government agency that is independent from the tax administration*[5]. The Luxembourg IP regime can benefit to: 1) Patents; 2) Utility models; 3) Supplementary protection certificates; 4) Prorogations of supplementary protection certificates; 5) Plant breeder's rights;

4 Other copyrighted assets may not be included.

5 This category should be limited to taxpayers that have no more than EUR 50 million in global group-wide turnover and that do not themselves earn more than EUR 7.5 million per year in gross revenues from all IP assets.

6) Orphan drug designations;

7) Copyrighted software.

The definition of qualifying IP asset excludes marketing-related IP assets from the scope of the regime.

The Luxembourg IP regime does not provide for a third category of assets.

The scope of the Luxembourg IP regime appears to be in line with the modified nexus approach.

2. Nexus ratio:

The tax advantage granted under the Luxembourg IP regime is an exemption of 80% of the taxable base. It is calculated by multiplying by 80% the income qualifying for the regime as calculated under the modified nexus formula: [QE (+30% uplift) / OE x OI].

- Qualifying Expenditure: the sum of the expenditure required for R&D activities directly related to the creation, development or improvement of a qualifying asset. Qualifying expenditure includes expenditure incurred by a permanent establishment but attributed to the taxpayer according to a convention for the avoidance of double taxation, provided that this permanent establishment (i) is located in a State party to the EEA other than Luxembourg, (ii) is operational at the time of realisation of the qualifying income and (iii) does not benefit from a similar tax regime for IP in the State in which it is situated. Qualifying expenditure include R&D activities incurred by the taxpayer himself or paid by the taxpayer to an unrelated party or through a related party without margin to an unrelated party.

Acquisition costs, interest and financing costs, real estate costs and other costs not directly related to a qualifying asset are expressly excluded.

Expenditure incurred for general or speculative R&D or expenditure on R&D which has not led directly to the creation of a qualifying IP asset may nevertheless be taken into account as qualifying expenditure provided that the taxpayer establishes the link between that expenditure and a specific qualifying asset or proves that there is a proportionate distribution of such expenditure between the qualifying assets. This rule is in line with par. 39 of the Action 5 Report.

- <u>Overall Expenditure</u>: includes qualifying expenditure plus outsourcing to related parties and acquisition costs;

- <u>Overall Income:</u> qualifying income derived from the qualifying IP assets includes royalties, embedded royalties, proceeds from the sale of a qualifying IP asset and income derived within the framework of a legal or arbitration proceeding relating to a qualifying IP asset. The overall income is calculated as a net income by deducting first the direct and indirect expenditures of the year related to the qualifying income Then the losses of previous periods related to the qualifying asset are deducted. Net qualifying income can only benefit from the IP regime in as far as it exceeds the cost price of the qualifying IP asset as well as any other former losses related to the qualifying IP asset.

Regarding embedded royalties, the tax relief is available in respect of the part of the sales price of a product or service, which is directly related to the qualifying IP asset. Such part will be determined in accordance with international transfer pricing rules (in the line with the revised OECD Transfer Pricing Guidelines – Action 8-10 of the BEPS Action Plan).

The nexus ratio of the Luxembourg IP regime appears to be in line with the modified nexus approach.

<u>3. Tracking and tracing:</u>

MS must require companies to track expenditure, IP assets and income. When such tracking would be unrealistic and require arbitrary judgements, MS may allow the application of the nexus approach so that the nexus may be between expenditure, products arising from IP assets and income (product-based approach). It requires tracking of all QE and OE at the level of the product.

The taxpayer shall establish documents, which demonstrate that qualifying expenditures, overall expenditures and overall income are tracked, and which show the link between such expenditure and such income.

Documents are on a per qualifying IP asset basis, unless the taxpayer has several IP assets and demonstrates that he is engaged in such a complex R&D activity that tracking to individual IP assets would be impossible. In such a case, the taxpayer can track and trace to products, services, or to families of products or services arising from qualifying IP assets. In that specific case, the taxpayer will have to hold at the disposal of the tax authority documentation evidencing the complexity of its R&D activity and providing justification for using the approach tracking to products, services or families of products or services arising from qualifying IP assets.

The taxpayer shall also prepare documentation substantiating that prices respect the arm's length principle.

Failure to provide the necessary documentation result in the taxpayer not qualifying for the tax relief.

The tracking and tracing obligations of the Luxembourg IP regime appears to be in line with the modified nexus approach.

4. Rebuttable presumption[6]:

Under the Luxembourg IP regime, the nexus ratio may not be treated as a rebuttable presumption.

5. Treatment of losses[7]:

Losses associated with a qualifying IP asset are deductible at the ordinary tax rate but have to be recaptured according to a system of deduction of previous losses relating to an IP asset (or to a product, service, or family of products or services arising from qualifying IP assets) from subsequent net qualifying IP income of such assets.

The initial benefit of offsetting losses against income taxed at the ordinary rate is cancelled later on by ensuring that these losses are deducted from later net qualifying IP income. Only

[6] Jurisdictions could treat the nexus ratio as a rebuttable presumption but would need to limit to exceptional situations where the ratio could be rebutted to those that meet at minimum the following requirements: the taxpayer should first use the nexus ratio to establish the presumed amount of income that could qualify for benefits; the nexus ratio should (excluding the up-lift) should equal or exceed 25%; the taxpayer should demonstrate that because of exceptional circumstances, the application of the nexus ratio would result in an outcome inconsistent with the nexus approach (burden of proof on the taxpayer).

[7] Note 14 to Action 5 Report: Jurisdictions should also use any tax losses associated with the IP income in a manner that is consistent with domestic legislation and that does not allow the diversion of those losses against income that is taxed at the ordinary rate.

net qualifying IP income exceeding these previous losses can qualify for the tax relief.

Thus, net qualifying IP income from the qualifying IP asset will not qualify for tax relief as long as it does not exceed development costs or other losses related to the qualifying IP asset.

Furthermore, if the taxpayer has more than one qualifying IP asset, losses relating to a qualifying IP asset will be deducted from any net qualifying IP income, regardless of which qualifying IP asset generated such income.

Therefore this method of dealing with losses appears to be in line with the modified nexus approach.

Therefore, we have proposed a cross ("X") for this criterion.

Criterion 4:

"whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD"

- General transfer pricing rules:

The arm's length principle is enshrined in Luxembourg income tax law (art. 56 and 56bis of LITL) and contains the basic principles to be respected within the framework of a transfer pricing analysis in line with the revised OECD Transfer Pricing Guidelines (Action 8-10 of the OECD BEPS report). Those provisions fully apply in the context of the IP regime.

The arm's length principle is relevant to the following features of a patent box: the reduction of the tax base by a fixed percentage; the calculation of royalty profits; the application of safe harbour rules; the asymmetrical treatment of losses.

- Reduction of the tax base by a fixed percentage: *in principle, reducing a company's arm's length profits by a fixed amount means that the final result does not reflect the arm's length principle. This is a question about the circumstances in which fixed reductions of the tax are acceptable and is therefore part of the overall assessment that the Group needs to make.*

The lower effective tax rate under the Luxembourg IP regime is applied by allowing an exclusion of the tax base equal to 80% of qualifying income. This feature of the IP regime could be understood as a technical measure aimed to achieve the tax benefit, which is ultimately to grant a reduced tax rate to qualifying IP income.

- Calculation of royalty profit (embedded royalties): *where transfer pricing rules exist, the profits that go into a patent box will reflect the arm's length principle because they are just a part of the company's total profit. In principle this applies both to royalties and embedded royalties. If the IP regime covers also the latter category, its identification within the sale price of a product should rely on transfer pricing principles.*

What has been written under criterion 3 above on the same topic applies analogously to criterion 4.

- Safe harbour rules: *adoption of safe harbours is not in accordance with internationally agreed principles; safe harbours are not recommended in the Transfer Pricing Guidelines.*[8]

Luxembourg IP Regime does not seem to provide for such safe harbour rules.

- Asymmetrical treatment of losses: *where the profits from particular IP assets are taxed at a lower rate in a patent box then the losses should be treated in the same way and not deducted outside the box at a higher rate.*

The Luxembourg IP regime has a recapture mechanism. What has been written under criterion 3 above on the same topic applies analogously to criterion 4.

The Code of Conduct Group adopted the new Guidance on the interpretation of the fourth criterion of the Code of Conduct for business taxation at the 22 November 2017 meeting whereas Luxembourg notified its measure on 1 August 2017. Therefore, we propose to treat them as other Member States that previously notified their IP regime by leaving it out of this assessment and **we would therefore propose a question mark ("?") for criterion 4.**

8 *Transfer Pricing Guidelines*, p167.

Criterion 5: “whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”
All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations *etc*. before a measure can be considered transparent. The nexus approach contains commitments to additional transparency in three areas. These concern the third category of qualifying assets, new entrants to existing IP regimes after 6 February 2015 and the rebuttable presumption rule. Commitments regarding new entrants to pre-existing regimes are not subject to the present assessment and are part of a separate monitoring process. The commitments in the 2015 Report cover both the report of certain information to the Forum on Harmful Tax Practices and the spontaneous exchange of information between competent authorities. <u>Third category of qualifying assets</u>: The Luxembourg IP regime does not contain rules relating to the third category of assets. <u>Rebuttable presumption:</u> The Luxembourg IP regime does not treat the nexus ratio as a rebuttable presumption. **We have therefore proposed a cross ("X") for criterion 5.**

Overall assessment:

The Luxembourg IP regime contains no significant deviation from the CoC criteria.

In light of the assessment made under all Code criteria, the Luxembourg IP regime should be considered overall **not harmful** from a CoC point of view.

In principle, reducing a company's arm's length profits by a fixed amount means that the final result does not reflect the arm's length principle. This is a question about the circumstances in which fixed reductions of the tax base are acceptable.

We have given a "?" on this point as it is a horizontal issue that the Group had not yet adopted a position on at the time of notification of this measure. As for other Member States that previously notified their IP regime, we suggest leaving it out of this assessment.