Tax Flash. Linklaters

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Taxation of interest income – Amendment of the law dated 23 December 2005

On 27 June 2007, the European Commission (the "**Commission**") requested Luxembourg amend its legislation on savings income paid in form of interest to individuals resident in Luxembourg.

The Luxembourg law of 23 December 2005 (the "**Relibi Law**") introduced a 10% withholding tax (the "**10% Withholding Tax**") on interest payments made by Luxembourg paying agents to Luxembourg resident individuals. This 10% Withholding Tax satisfies in full the tax liability on interest for Luxembourg resident individuals receiving the payment in connection with their private wealth.

The Commission considered that the Relibi Law as originally drafted breached the EC Treaty rules since it constituted an obstacle to the free movement of capital and to the freedom to provide services. In particular, Luxembourg resident individuals were not incentivised to invest in other EU Member States if they were taxable at the full rate in Luxembourg on interest payments made by foreign paying agents, while they could enjoy a relatively low tax rate on interest paid by Luxembourg paying agents.

In this context and to comply with the Commission's request, Luxembourg adopted a law on 17 July 2008 (the "**Law**") amending the Relibi Law.

The Law has introduced a 10% tax (the "**10% Tax**") on interest payments made to Luxembourg resident individuals by paying agents located in the European Union, the European Economic Area or in a State or territory which has concluded an international agreement directly related to the EU Savings Directive 2003/48/EC [1].

The interest income falling within the scope of the Law corresponds to the interest income that would be subject to the 10% Withholding Tax under the Relibi Law. However, contrary to the 10% Withholding Tax (which is compulsory under the Relibi Law), the 10% Tax is optional and is limited to interest income received by a Luxembourg resident individual in connection with his/her private wealth. The 10% Tax does not apply to Luxembourg resident individuals receiving interest as business income.

The 10% Tax satisfies in full the tax liability on interest for Luxembourg resident individuals receiving the interest payment in the connection with their private wealth.

The 10% Tax must be declared and paid by the beneficial owner of the interest. A specific tax return has to be filed at the latest by 31 March of the year following the year during which the interest is paid. If the beneficial owner decides to opt for the 10% Tax, the 10% Tax will apply to all relevant interest income received by him/her from foreign paying agents during the tax year.

Withholding tax levied in the country of source (if any) is creditable against the 10% Tax by the application of either the double tax treaties concluded by Luxembourg or article 154 of the Income Tax Law.

If the credit is claimed on the basis of a double tax treaty, the credit will be limited to the amount of Luxembourg tax, i.e., if the foreign withholding tax is higher than 10%, the Luxembourg tax can be reduced by up to 10% without possibly of reimbursement for the excess. However, if the foreign withholding tax has been levied as a result of the application of the EU Savings Directive, the beneficial owner can benefit from a refund corresponding to the difference between the European withholding tax and the 10% Tax.

Reference: Memorial A - N°107, 25 July 2008 - page 1510.

[1] The parliamentary works refer to the dependent and associated territories within the meaning of article 17§ 2 of the EU Savings Directive 2003/48/EC.

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