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Luxembourg Tax Update

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1 The 2017 Tax Reform

The Luxembourg Parliament adopted the Tax Reform Law on 14 December 2016, aiming at increasing companies’ competitiveness and bringing more stability and predictability in tax matters.

Although the Tax Reform Law introduced mainly changes in the personal income tax regime, a few measures concern corporate tax, the most important of which are the following.

a. Reduction of income tax rates

The corporate income tax rate decreases to 19% for tax year 2017 and to 18% as from 2018. This leads to an aggregate income tax (corporate income tax plus municipal business tax) of 27.08% (in 2017) and thereafter of 26.01% (as from 2018), for companies in Luxembourg city.

Regarding small companies with a taxable profit under EUR 25,000, a reduced rate of 15% will apply (whereas a 20% rate applied until 31 December 2016 on profits under EUR 15,000). Taxable profits ranging from EUR 25,000 to EUR 30,000 will suffer a flat tax of EUR 3,750 plus 39% (to be decreased to 33% as from tax year 2018) of the income over EUR 25,000.

b. Limitation of tax losses carried forward

As from tax year 2017, tax losses can be carried forward for a period of maximum 17 years. Tax losses incurred before 1 January 2017 can still be carried forward indefinitely in time. Furthermore, the law provides for a FIFO system (first-in, first-out), meaning that the oldest losses are used first to offset taxable income in any future year.

c. Increase of the minimum tax

The Tax Reform also increases the minimum net wealth tax to EUR 4,815, for companies with financial assets of a value exceeding EUR 350,000 and which represent more than 90% of their total balance sheet.

d. New sanctions

Finally, the Tax Reform has strengthened the administrative and criminal sanctions in all tax matters. A fine of minimum 5% and up to 25% of the taxes avoided or unfairly reimbursed is now applied in case of incomplete or inaccurate information deliberately provided in the tax returns or in case of deliberate absence of filing of a tax return, while the penalty applied by tax

authorities to compel taxpayers to comply with their filing obligations can now reach EUR 25,000. Further, the law now distinguishes three different levels of tax fraud: simple fraud, aggravated fraud and tax swindle. The different offences give rise to the application of a scale of monetary sanctions and both the aggravated fraud and the tax swindle are also criminally sanctioned.

2 Revisit of the transfer pricing framework

a. A new legal provision

Luxembourg seized the opportunity of the 2017 budget law adopted on 23 December 2016 to introduce a new Article *56bis* in the income tax law ("**ITL**"), the provisions of which are directly inspired by the revision of the OECD Transfer Pricing Guidelines (the "**OECD Guidelines**") published in Actions 8-10 of the final reports of the OECD BEPS project.

This new article sets out the principles and the methodology to be applied as from 1 January 2017 by related entities carrying out intra-group transactions (i.e. so called "*controlled transactions*"), when determining the at arm's length prices of such controlled transactions within the meaning of article 9 of the OECD Model Convention.

Based on the OECD Guidelines, article 56*bis* ITL states that the core principle to determine an at arm's length remuneration for controlled transactions between related parties consists of a **comparability analysis,** which relies on the two following pillars:

i. analysing the commercial or financial relations between related parties and determining the economic conditions and economically significant circumstances attached to these relations in order to precisely delimit the controlled transaction; and

ii. comparing the conditions and economically significant circumstances of the controlled transaction, in a precise manner, with a comparable uncontrolled transaction.

The introduction of this new article seems to be a mere confirmation by Luxembourg that it adheres to the at arm's length principle as laid down in the OECD guidelines, which are already followed by the administrative practice and the Courts of Luxembourg, was it not that it also prompted the Luxembourg Tax Authorities ("**LTA**") to revisit its circular on intra-group financing.

b. Adoption of a new transfer pricing circular for intra-group financing activity

Hence, further to the introduction of new Article 56*bis* in the Luxembourg ITL, the LTA issued a new administrative circular L.I.R. n°56/1 – 56*bis*/1 on 27 December 2016 (the "**Circular**") prepared in cooperation with the DG Competition of the European Commission. The Circular has to be read and understood against the background of the Fiat Finance State aid case, in which the previous circulars on intra-group financing are at the heart of the dispute.

The Circular, which has entered into force as from 1 January 2017, sets out a new approach purportedly in line with the newly introduced transfer pricing provision of Article 56*bis* ITL in the specific context of intra-group financing activity.

The Circular repeals and replaces the two previous circulars pertaining to intra-group financing activities, namely, circular L.I.R. n°164/2 dated 28 January 2011 and circular L.I.R. n°164/2bis dated 8 April 2011.

Key changes introduced by the Circular are the following.

i. Determination of the equity at risk

The previous rule regarding the determination of the amount of equity at risk that a Luxembourg company should carry when engaging in intra-group financing activities, consisting in the lesser amount of either 1% on the amount on lent or a maximum of EUR 2 million, is abandoned. This rule was one of the points on which the European Commission was the most critical. Indeed, one should admit that the lump-sum approach to the equity at risk was difficult to maintain in light of the OECD guidelines;

Now, as an example, the Circular provides that companies with a risk profile similar to the one of entities that are subject to Regulation EU 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (i.e. EU implementation of the so-called Basel III Agreement – "**Regulated Financing Entity**") and that comply with the equity requirements of said regulation, are deemed to have sufficient equity at risk;

For companies with another risk profile (notably regarding assets used and functions performed), the equity at risk will need to be determined on a case by case basis, through other methodologies, including by means of a credit risk analysis based on balance sheet and market data, as well as other risk factors that are relevant in the context of a financing activity.

ii. Determination of an arm's length remuneration

Since the **comparability analysis** is the core concept of the new legal provisions, when determining the at arm's length remunerations one should precisely compare the controlled transaction with uncontrolled transactions entered into on the free market in the relevant sector of activity. Such is done on the basis of an identification of the significant economic elements of the transaction as well as on the basis of a functional analysis and risk analysis.

The Circular seems to distinguish two main base cases.

- **Intra-group finance companies**

  If the finance company has a profile similar to a Regulated Financing Entity (e.g. banks, credit institutions etc) besides having equity at risk in line with the Basel III Agreement, it could be deemed to earn an at arm's length remuneration if its return is equal to 10% (after tax) of its equity. This rule seems to apply mainly to so-called "*intra-group banks*" of multinational groups developing similar activities as a bank, such as treasury management, cash-pooling, and long- and short-term financing.

- **Finance companies acting as intermediary**

  In case the finance company does not have a profile of an intra-group bank, but rather intervenes as an "*agent*" in a financing transaction, i.e. sources funds to on-lend such funds to affiliated companies, the Circular considers that at an arm's length

remuneration should equal a return of 2% (after tax) on the assets financed (i.e. the on-loan).

However, this determination of the at arm's length remuneration, whether for intra-group finance companies or finance companies acting as intermediary, does not apply if a transfer pricing report is produced, in accordance with the OECD Guidelines and the provisions of the Circular, which determines a different return.

Hence, although the above percentages, which are quite high under current market circumstances, are presented by the Circular as so-called safe harbour rules, to be applied in the absence of a transfer pricing report, they may in our opinion be seen rather as a sanction.

Interesting to note is that companies that do not wish to conduct a proper transfer pricing analysis and therefore wish to apply the above lump-sum determination should opt explicitly for this possibility in their yearly tax return. By doing so, the transaction will automatically be subject to an exchange of information under the different relevant exchange of information instruments entered into by Luxembourg. This approach taken by the Circular tends, in our opinion, to confirm the deterrent effect of the lump-sum percentages and the reliance on those.

From a practical point of view, the Circular clearly aims at incentivising taxpayers to conduct an appropriate transfer pricing study in order to determine the at arm's length remuneration of a mere agent activity, especially in situations where the financing structure implies the involvement of numerous entities. We expect that mere agent entities should produce proper transfer pricing reporting to demonstrate that a remuneration of less than 2% after taxes of the financed assets is at arm's length.

It is worth noticing that the lump-sum percentages of 10% and 2% are net, after tax, margins, which in itself do not seem in conformity with the at arm's length principle. It is therefore questionable whether this approach is in conformity with the new article 56*bis* ITL and will be upheld by the Luxembourg Courts. Indeed, there is a large variety of intermediary profiles, ranging from pure pass-through agents (which are purportedly not beneficial owner of the income) to genuine finance transactions, that the Circular does not seem to distinguish in its approach.

Finally, in the context of the comparability study, the Circular seems to put a certain emphasis on the fact that, when analysing the controlled transaction, non-genuine arrangements or transactions lacking economic substance, which would not be found in a third-party relationship, should be disregarded for purposes of determining the at arm's length remuneration. Although not mentioned by the Circular, this could mean that the tax administration will disregard certain commonly used clauses in finance transactions, such as the limited recourse clauses, for the determination of the at arm's length remuneration.

iii. Substance requirements

The substance requirements imposed by the Circular are broadly the same as those set out in the two previous circulars on intra-group financing. However, the Circular now particularly insists on the fact that Luxembourg

companies carrying out intra-group financing activities should have a genuine presence in Luxembourg meaning the capacity to enter into and manage the risk of the transaction via (i) their board, the majority of whom should consist of Luxembourg resident or professionally resident managers and (ii) duly qualified employees to control the transactions, although it accepts that functions which are not significant for the control of the risks can be outsourced.

iv. Advance pricing agreements ("APA") and non-binding effect of existing APA

The Circular confirms that it is still possible for taxpayers who wish to obtain certainty as to the validity of their transfer pricing documentations to ask for advance pricing agreements. However, the requirements in terms of documentation are now more stringent and more complete than they were under the previous regime. This probably will lead to a further increase of the costs of filing an APA.

Finally, the Circular states that, as from January 2017, any APA issued prior to the issue date of the Circular that is not in line with its provisions are no longer valid or binding the LTA, for fiscal years after 2016.

This position, although not surprising, may be questionable. Indeed, according to the law of 19 December 2014, advance tax agreements bind the LTA for a period of 5 years unless there is a change in factual circumstances or if there is a change in the law which is incompatible with the agreement. The question is therefore whether article 56*bis* ITL introduced a change in the law which is incompatible with the APA granted in the past. As stated above, in our opinion, article 56*bis* ITL does not necessarily introduce new rules, but is merely a codification or confirmation of the application of the OECD Guidelines in the Luxembourg ITL, which were already applied before the introduction of the new article 56*bis* ITL.

This being said, we would nevertheless advise taxpayers to review their transfer pricing documentation in light of the rules of the new Circular rather than to rely on a previously obtained APAs.

3 Country by country reporting ("CbCR")

a. Context and purposes of country by country reporting

Luxembourg adopted on 23 December 2016 the law on country by country reporting (the "**CbCR Law**"), implementing the Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.

The CbCR Law applies to information to be reported as from fiscal year 2016 and which will need to be filed before 31 December 2017.

The CbCR Law aims at reinforcing the control of the transfer pricing of multinational enterprise groups ("**MNE Groups**") by the participating jurisdictions (including EU Member States and jurisdictions that are for instance party to the OECD *Multilateral Competent Authority Agreement on the Exchange of CbC Reports* ratified by Luxembourg on 27 January 2016).

b. Scope of CbCR

Ultimate parent entities - as defined within the CbCR Law - of MNE Groups with a **consolidated** group turnover of at least EUR 750 million during the immediately preceding fiscal year, are required to file a country by country report ("**CbC Report**") with the Luxembourg tax authorities ("**LTA**") within 12 months following the last day of the relevant fiscal year.

Luxembourg tax resident entities may also be appointed to (under the so-called "surrogate mechanism" or under the so-called "secondary mechanism") file a CbC Report with the LTA in case the jurisdiction of tax residence of a non-Luxembourg ultimate parent entity of an MNE Group does not apply or does not apply in an effective manner the CbC rules.

In Luxembourg, the CbC Report will mandatorily and exclusively be filed through an online platform that is expected to be set up soon by the LTA, but is not available at the moment.

c. Content of the report

The CbC Report must contain, for each jurisdiction in which the MNE Group carries out its activities, inter alia information pertaining to the entities composing the MNE Group and their jurisdictions of incorporation and of tax residency, aggregate information regarding the turnover, accounting profit before tax, income tax paid, income tax due, equity, undistributed income, number of employees and tangible assets except cash.

d. Potential sanctions and status notification

Sanctions of up to EUR 250,000 may apply to MNE Group entities required to file a CbC Report with the LTA failing to comply with their obligations, or to declare their status within the MNE Group they belong to, i.e. whether they are an ultimate parent entity, a surrogated entity, or an entity subject to the secondary mechanism, the so-called "**Status Notification**".

e. Timing for Status Notification

As a rule, the Status Notification should be made by the Luxembourg resident entity member of an MNE Group on the last day of the relevant fiscal year at the latest.

Because of the recent introduction of these new provisions into Luxembourg law, the LTA posted on their website in a FAQ section, that for fiscal year 2016, such notification may be made until 31 March 2017 without incurring the risk of a fine.

Further, the LTA is expected to publish additional guidance and clarification shortly *via* its online FAQ section.

Considering the short deadline, it is recommended that taxpayers review the CbCR status of their entities in Luxembourg as soon as possible so as to timely file their Status Notification which has to be done for every Luxembourg entity subject to CbCR rules.

f. What about investment entities/funds?

Regarding the particular sector of investment funds, the OECD *Guidance on the Implementation of Country-by-Country Reporting* published in December

2016 specifies that there is no general reporting exemption for investment funds and that it is recommended to follow the accounting consolidation rules applicable to the investment entity in its jurisdiction.

Most regulated investment vehicles such as risk capital companies (“**SICAR**”) or Specialised Investment Funds (“**SIF**”) and Reserved Alternative Investment Funds (“**RAIF**”) are expressly exempted from the obligation to consolidate their investment subsidiaries. Hence these should not be subject to CbCR.

Unregulated private equity investment entities may under Luxembourg accounting rules, be exempt from the obligation to consolidate their investment subsidiaries in their commercial accounts provided that they comply with certain conditions, as laid down in the Opinion of the Commission for Accounting Standards (the “**Opinion**”) (Avis CNC 2-1 of 18 December 2009). The Opinion is itself based on Article 317 (3) c) of the Law of 10 August 1915 on Commercial Companies (the “**Company Law**”), which states that “*an enterprise does not need to be consolidated if: […] c) the shares or interests of this enterprise are held exclusively with the aim of a future sale.*” The conditions mentioned in the Opinion are those characterising a venture capital/private equity enterprise. The opinion further states that article 317 (3) c) of the Company Law can be invoked by any Luxembourg company, thereby not ruling out other investment entities. We therefore submit that other unregulated entities, such as real estate funds or debt funds, could invoke the same exemption if they have an investment policy similar to venture capital/private equity funds and if they should meet the same conditions.

The impact of CbC reporting obligations may therefore in practice be limited on the private equity and investment fund sector. This should however be assessed in a case by case analysis.

This being said, Luxembourg investment funds or companies may be invested in by a Luxembourg holding company which itself is in the head of an MNE Group and which will thus be subject for its group to the CbCR rules. Since, in practice, many acquisitions by investment entities/funds have been structured through a so-called Luxembourg top holding company, it will need to be analysed whether such a company needs to consolidate its subsidiaries and hence file the CbCR as the head of the MNE Group or can, in accordance with the opinion of the Commission for Accounting Standards, avail itself of the consolidation exemption as a company acting exclusively on behalf of the investment entity/fund meeting the conditions of the exemption.

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