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Luxembourg

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Overview of corporate tax work over the last year

Types of corporate tax work

Over the past 12 months, Luxembourg corporate tax work has experienced a high focus in the alternative fund sector, cross-border financing (particularly with securitisation vehicles), and a moderate level of M&A activity involving multinational groups.

The Luxembourg tax authorities ("LTA") continue to focus on transfer pricing documentation and economic substance, so it is now more important than ever to have solid transfer pricing documentation and robust economic substance in Luxembourg structures.

Significant deals and themes

Alternative investment funds

The Luxembourg financial services sector is currently dominated by growth in the alternative investment fund ("AIF") sector. These alternative funds tend to be either tax transparent or exempt, and have thus proved to be highly tax-efficient investment vehicles. We summarise below the latest developments in this domain.

With respect to AIFs, the Special Limited Partnership ("SCSp") continues to be the favoured investment vehicle, and the Reserve Alternative Investment Fund ("RAIF") also continues to be the most popular funds regime, while Specialised Investment Funds ("SIFs") are used less frequently. With a number of recently implemented improvements on both the investment side (increased flexibility) and the investor side (more effective use of the "retail-distribution" passport and allowance for efficient and effective access by retail investors), European Long-Term Investment Funds ("ELTIFs") offer another interesting option for fund promoters.

In addition, the proposed changes to the Alternative Investment Fund Managers Directive ("AIFMD"), currently in the European Union ("EU") parliamentary process and touching mainly on certain aspects of delegation, marketing, debt fund structuring and reporting, will change the AIF/AIFM landscape in Europe somewhat.

Finally, Luxembourg has launched the parliamentary process in relation to a variety of improvements to fund laws, including the RAIF law and the SIF law but also the law of 17 December 2010 on undertakings for collective investment ("2010 Law") and others. The proposed changes will enhance flexibility (e.g., regarding the definition of "well-informed investors" under the SIF law and the RAIF law or the legal form that may be chosen for an investment company with variable capital ("SICAV") under part II of the 2010 Law) and address topics that have been identified as potentially cumbersome. It is expected that these changes will come into force before the summer break.

M&A

For multinational corporate groups, the level of M&A activity has remained fairly constant; however, the use of Luxembourg "special-purpose acquisition companies" ("SPACs") has seen a decline since our last update in 2022.

Finance sector

Luxembourg domestic law generally imposes no withholding tax on interest and there is no discussion of this changing in the foreseeable future. In the last 12 months, Luxembourg has continued to be a vital jurisdiction for cross-border financing, through the pro-business regulatory framework, as seen through the increased amount of financing deals summarised further below.

To begin with, the volume of deals in structured finance and securitisation has increased dramatically since the beginning of 2023. It appears that market players are eager to take advantage of the changes implemented last year to the Luxembourg law of 22 March 2004 on securitisations (the law amending the securitisation law was voted on 9 February 2022). There has been a surge in future flow securitisations, and there is a strong interest for transparent securitisation vehicles, particularly when assets are held on a fiduciary basis.

Towards the final quarter of 2022, there was a high level of fund finance activity, which slowed in the first quarter of 2023. However, if we look over the past 12 months, the Luxembourg fund finance practice remained generally strong. Despite market uncertainty relating to the war in Ukraine, changes in inflation and interest rates, the fund finance deal flow has been particularly strong at the outset of the second quarter of 2023. The recent volatility in the USA's regional banking market does not currently appear to have had a meaningful impact on investment funds' appetite for financing from international financial institutions. We continue to see demand for subscription, NAV and hybrid facilities coming from funds based in the USA, Europe, and Asia.

The cross-border real estate finance practice has been negatively affected by the increase in interest rates, causing many transactions and deals to be aborted. Nevertheless, deal flow has started to pick up since the end of the first quarter/beginning of the second quarter in 2023.

Transfer pricing

The LTA continue to place an ever-growing importance on transfer pricing documentation and compliance. Over the past 12 months, the LTA have increased their vigilance that corporate tax payers are complying with transfer pricing documentation requirements.

A particular area of attention by the LTA is verifying that the economic substance described in transfer pricing documentation is also to be found in the actual facts of the personnel, risks, assets, and functions of the Luxembourg corporate tax payer's structure and operations.

Tax disputes

The LTA have increased their information requests and field audits with a particular focus on transfer pricing, economic substance, and beneficial ownership. Luxembourg tax litigation has also seen an increased rise, with an enhanced focus on taxpayers who had weakly supported tax structures, lack of robust economic substance, and ill-prepared transfer pricing documentation.

Key developments affecting corporate tax law and practice

Domestic – cases and legislation

Luxembourg Administrative Court rules on alphabet shares

On 27 January 2023, the Luxembourg Administrative Court issued a long-awaited decision

addressing "alphabet shares". The Court confirmed that a repurchase of a class of shares could constitute a "partial liquidation" if relevant conditions were fulfilled and thus treated as a capital gain if the fair market value of the shares repurchased was greater than their issue value. However, the Court opined further that any excess repurchase price above their fair market value could also constitute a hidden dividend and thus be potentially subject to 15% withholding tax on dividends. The case involved a class of "alphabet shares" issued and repurchased by a Luxembourg resident company with a sole Cayman Islands shareholder (Luxembourg Case Number 42432).

The LTA had included in their line of arguments that the alphabet shares in this instance was an abuse of law, citing the absence of differences in the various classes, the timing of the implementation, and the fact that the company had only one shareholder. As such, the LTA's position was that the entire transaction should be treated as a dividend distribution and subject to 15% withholding tax. However, the Court did not address the LTA's abuse of law argument, but rather focused, as mentioned above, on whether the redemption of the class of shares caused a capital gain to the shareholder and limited any hidden dividend treatment to the amount repaid, which was above the fair market value of the shares redeemed.

One key takeaway from this case is that the potential challenge of abuse of law remains somewhat uncertain and therefore, as a matter of prudence, there should be credible economic reasons supporting the use of alphabet shares in Luxembourg structures and planning.

European – CJEU cases and EU law developments

ATAD 3: the Proposed Unshell Directive

As reported in last year's update, the European Commission ("EC") published a draft of the proposed Unshell Directive ("Proposed Unshell Directive") intended to prevent the misuse of "shell" entities for aggressive tax planning purposes within the EU. However, since the Proposed Unshell Directive's first draft was published, there has been a fairly robust discussion on its scope and mechanics both at the practitioner and policymaker levels. As of the writing of this update, there is still widespread anticipation of a long-awaited updated draft that is still yet to be published.

In summary, the Proposed Unshell Directive is aimed at entities that do not maintain sufficient substance within the EU and are thus perceived as likely to give rise to aggressive tax planning and perceived tax treaty abuses. Under the proposal, EU entities that do not satisfy minimum substance requirements would be potentially subject to denials of a tax residency certificate, the inability to benefit from EU tax directives or tax treaties, as well as additional penalising taxes for falling in the category of a "shell company". For a detailed discussion of the Proposed Unshell Directive, please see our chapter in *GLI – Corporate Tax 2022*.

One important development over the past 12 months is that, on 17 January 2023, the European Parliament ("EP") published recommended amendments ("EP Recommendations") to the EC's original version of the Proposed Unshell Directive. While EP Recommendations are not binding on the EC to adapt them, they are still indicative of potential changes that we can anticipate being added into the updated draft, which is expected to be published sometime this year.

The EP Recommendations included modifying the three gateway criteria for assessing whether an entity, located within the EU, falls within the scope of the Proposed Unshell Directive as follows (EP amendments are bolded for your reference):

1. the entity derives more than **65%** (down from the original proposal of 75%) of its income from sources defined as "relevant income". Relevant income includes typical "passive" income such as dividends, bonds and interest;

2. the entity is engaged in cross-border activity such that more than **55%** (down from the original proposal of 60%) of its assets or income is earned or paid out of cross-border transactions; and
3. in the preceding two years, the entity has outsourced the administration of its day-to-day operations and decision-making on significant **functions "to outsourced third parties"** (thus implying that such services performed by group entities are acceptable).

The EP Recommendations also amended the minimum substance requirements as follows for EU entities to avoid the abovementioned negative consequences of being characterised as a "shell company":

1. it has its own premises, or premises for its exclusive use, in the Member State **or the premises is shared with entities of the same group**;
2. it has at least one own and active bank account **or e-money account** in the EU **through which the relevant income is received**; and
3. the EP Recommendations delete the following criteria from qualifying directors under the safe harbour minimum substance requirements:
   - The director would have been disqualified had he/she been employed by a company that is not an associated enterprise or if the same individual was also a director for another company that was not an associated enterprise.
   - The director would have been required to actively and independently use their director authorisation on a regular basis.

The recommendation to remove the two criteria above has been widely welcomed amongst Luxembourg tax practitioners as both requirements were viewed as overly broad and vague.

It is not entirely clear when the Proposed Unshell Directive will be in its final form and when a deadline will be set for its transcription by EU Member States. As of the writing of this update, the general consensus is that its enactment date will not occur before 2025 at the earliest.

The Proposed Unshell Directive once (if ever) implemented could have a substantial impact in Luxembourg, including on holding companies, financing companies, securitisation vehicles (unregulated) and other Luxembourg special-purpose vehicles ("SPVs") with a cross-border focus. Notably, the level of economic substance for such entities may need to be reinforced to avoid falling into the negative consequences found in the current draft. Conversely, Luxembourg fund vehicles, which are most often tax transparent or tax exempt anyway, should not be impacted by this proposed directive.

EU Member States unanimously adopted Pillar 2 GloBE Rules for minimum corporate income tax

On 15 December 2022, EU Member States unanimously adopted their version of the OECD's Global Anti-Base Erosion Model Rules ("GloBE Rules") mainly aimed at large multinational enterprises ("MNEs"). In summary, the GloBE Rules will impose a global minimum corporate tax of 15% on MNEs that have annual turnover of at least EUR 750 million.

The GloBE Rules' principal enforcement mechanisms consist of two rules: the Income Inclusion Rule ("IIR"); and the Undertaxed Payment Rule ("UTPR"). The IIR generally imposes a top-up tax on the Parent Entity with respect to the low-taxed income of group entities (referred to as "Constituent Entities"). The UTPR acts as a backstop to the IIR when an entity with low-taxed income is not brought into the IIR going up the ownership chain; for example, when the Ultimate Parent Entity is located in a low-tax jurisdiction with no IIR in its local tax laws.

EU Member States are required to transpose the directive by 31 December 2023 with respect to the IIR becoming effective for tax years beginning after this date, while the UTPR will normally only apply for tax years beginning after 31 December 2024.

In Luxembourg, the GloBE Rules will have a limited impact. Most MNEs with annual revenue of EUR 750 million or more will generally only have Luxembourg holding and financing companies here. As we highlighted in our 2022 update, the GloBE Rules provide carve-outs for group holding companies benefitting from participation exemptions, by excluding dividends and equity gains of group subsidiaries from the accounting profits for purposes of calculating whether the Constituent Entity has a low tax rate. Accordingly, Luxembourg holding companies benefitting from the participation exemption should generally not be impacted. Similarly, Luxembourg companies engaged in cross-border intragroup financing should not be impacted by the GloBE Rules (although other anti-abuse mechanisms and transfer pricing will continue to be applicable).

Please see our update from 2022 for a more comprehensive review of the GloBE Rules.

Italian court case affirms that a Luxembourg SICAV is eligible to receive a reimbursement for the withholding tax that was imposed on dividends

On 7 February 2022, the provincial tax court of Pescara in Italy rendered a decision affirming that a SICAV, a type of Undertaking for Collective Investment in Transferable Securities ("UCITS") based in Luxembourg, is eligible to receive a reimbursement for the withholding tax that was imposed on dividends distributed by companies in Italy. The SICAV had requested reimbursements for the withholding tax that was levied on dividends received during the period of 2014 to 2016. The SICAV argued that the imposition of withholding tax on Luxembourg UCITS SICAVs was discriminatory since Italian UCITS SICAVs were exempted from withholding tax under Italian law, and that such discrimination contravened the freedom of movement of capital under the EU Treaty. The Italian tax court concurred with the claimant's position, citing previous Court of Justice of the European Union ("CJEU") cases on discriminatory tax treatment based on tax residence.

EU State Aid update: Luxembourg and Fiat Chrysler

In the matter of *Luxembourg and Fiat Chrysler Finance Europe v. the EC*, the CJEU rendered its decision on 8 November 2022, thus annulling both the EU General Court's judgment and the EC's original decision, alleging that Luxembourg had unlawfully granted State Aid to Fiat. The Court held that the EC's assessment, which relied on a reference system to ascertain whether a selective advantage existed, was erroneous in its logic and conclusions.

Previously, in October 2015, the EC determined that a tax ruling that had been granted to Fiat Chrysler Finance Europe by Luxembourg in 2012, sanctioning specific transfer pricing methodologies used to evaluate the annual taxable profits, configured State Aid. As a result, the EC ordered Luxembourg to recover the unlawful and incompatible aid from Fiat Chrysler Finance Europe. In 2019, the EU General Court rejected challenges made by both Fiat Chrysler Finance Europe and Luxembourg, thus affirming the validity of the EC's decision.

A key takeaway from this case is the importance of transfer pricing in Luxembourg. The LTA have long since emphasised the importance of transfer pricing documentation in Luxembourg, and as mentioned above, the LTA have made transfer pricing documentation requests a frequent focus of information requests and field audits with taxpayers.

Proposed DEBRA Directive

On 11 May 2022, the EC published a draft directive on the "debt-equity bias reduction allowance" ("Proposed DEBRA Directive"), which provides for further interest limitation

rules ("ILRs") in addition to those found in ATAD 1, and also contains certain measures for a notional interest deduction on equity investment in EU tax resident companies.

The Proposed DEBRA Directive's ILRs further limit the tax deductibility of "exceeding borrowing costs" ("ECB") to 85% each year. ECB is generally defined as "interest paid minus interest received" and was a key component of the ILRs introduced by ATAD 1 in 2019. These proposed additional ILRs are intended to co-exist alongside the existing ILRs of ATAD 1.

The Proposed DEBRA Directive also provides a notional interest deduction on equity investment for 10 consecutive tax years. The notional interest is generally calculated by multiplying the net increase in equity investment for a given tax year by the 10-year risk-free interest rate of the currency plus a risk premium of 1% (1.5% for SMEs). The notional interest deduction is subject to various qualifications and limitations, including that the notional interest deduction cannot exceed 30% of the taxpayer's EBITDA for any given year (i.e., to be consistent with ATAD 1's ILRs limiting ECB to 30% of the taxpayers EBITDA on an annual basis).

Since its initial publication in May 2022, there have been no further developments of the Proposed DEBRA Directive in terms of approval by EU Member States, which suggests that it may be a lower priority at the moment. As of the writing of this update, it is unclear whether this proposal will move forward by its expected transposition date in EU Member States by 31 December 2023.

From a Luxembourg tax point of view, the Proposed DEBRA Directive may have limited benefits for taxpayers wishing to take advantage of the notional interest deduction on equity by reducing their debt funding and will need to take into account potential net worth tax exposure on such reduced debt financing (Luxembourg imposes an annual net worth tax generally of 0.5% on the net worth of a Luxembourg tax resident company, and therefore many Luxembourg entities are substantially debt financed, rather than equity, to reduce this annual net worth tax charge).

BEPS

Most of the BEPS-related Luxembourg domestic tax laws have been implemented via the transpositions of ATAD 1 and 2 over the past few years. As mentioned above, the OECD's Pillar 2 GloBE Rules will be transcribed in Luxembourg by the end of 2023. It is also worth highlighting that most of Luxembourg's double tax treaties already apply the OECD's multilateral instrument, including the "principal purpose test" against treaty shopping abuse.

Mandatory Disclosure Rules update

Since our 2022 update, there have been no new developments regarding Mandatory Disclosure Rules in Luxembourg. In practical terms, DAC6 analysis has now become an essential component of all Luxembourg tax planning and transactions in all sectors of international business and investment.

Tax climate in Luxembourg

Luxembourg continues to be a highly attractive jurisdiction for international business and investments. According to the Luxembourg CSSF, Luxembourg has EUR 5.028 trillion of assets under management ("AUM"), which is down from its all-time high of EUR 5.859 trillion at the end of 2021. The reduction of AUM is more a reflection of the downturn in market performance, as the Luxembourg funds industry along with its supporting infrastructure, including tax and legal services, continues to positively grow.

Reflecting Luxembourg's reputation for stability and predictability, there have been very few changes in Luxembourg tax law over the past 12 months.

Luxembourg's holding company regime continues to be a very reliable and tax-efficient regime. The long-term trend of combining holding activities with intragroup financing continues to be widely utilised as well.

Regarding cross-border financing, the Luxembourg securitisation vehicle continues to grow in popularity. Notably, the Luxembourg securitisation fund has seen an increase in utilisation because it is tax transparent and thus generally avoids potential anti-abuse rules such as the IRLs from being potentially applicable.

As mentioned elsewhere in this chapter, the importance of robust economic substance and updated transfer pricing documentation cannot be overemphasised. Luxembourg may be tax efficient and stable but the LTA are very mindful of maintaining Luxembourg's excellent reputation, and compliance with these matters is therefore fundamental.

Developments affecting the attractiveness of Luxembourg for holding companies

Legislative changes affecting holding companies in particular

Luxembourg continues to be a very tax-efficient and reliable jurisdiction for holding companies. While there have been no substantial changes in Luxembourg domestic law particularly impacting holding companies, the potential future impact of the Proposed ATAD 3 Directive (discussed above) could impact holding companies' level of required economic substance.

Other relevant changes

We have summarised below some of the new tax measures introduced by the Luxembourg Budget Law for 2023.

An amendment to Luxembourg's reverse hybrid entity rule clarifies that associated enterprises that benefit from a subjective tax exemption, and for which the absence of taxation of the net income is not due to a difference of classification of the Luxembourg entity or arrangement, are not to be taken into account to calculate the threshold of holding in aggregate of a direct or indirect interest of at least 50% of the voting rights, capital interests or rights to profit in the entity or arrangement for the reverse hybrid entity rule to apply. The updated rule came into effect on 1 January 2022.

Luxembourg decided to entirely exclude fossil gas and nuclear energy investments from the reduced subscription tax rates for sustainable economic activities. This position is contrary to the EC definition, which recently extended certain limited fossil gas and nuclear energy as sustainable economic activities (conditions apply).

An official extension of the deadline for filing income tax returns is now enacted for 31 December of each year. This measure will apply for the first time to 2022 tax returns.

Under the "prime participative" regime, Luxembourg companies can provide a bonus to their employees, 50% of which is exempt from tax, as long as the bonus does not exceed 5% of the net profits of the employer in the relevant year. According to the changes in the 2023 Budget Law, Luxembourg companies in a fiscal unity within the meaning of Article 164*ter* of the Luxembourg income tax law can opt for calculating the 5% limit (of the net profits of the employer in the relevant year) based on the aggregated net profits of all entities within the fiscal unity.

To mitigate the effects of inflation, Luxembourg has reduced its VAT rates for 2023: the standard VAT rate of 17% is reduced to 16%; the intermediate rate of 14% down to 13%; and the reduced rate from 8% to 7%.

Tax rates for direct tax purposes remain unchanged.

Luxembourg tax treaty updates

Over the past 12 months, Luxembourg has continued to expand and improve its double tax treaty network. We have highlighted below the notable updates.

Amendment to the France-Luxembourg Double Tax Treaty increasing remote workday tolerance threshold

Following an amendment to the France-Luxembourg Double Tax Treaty on 7 November 2022, the threshold for authorised remote workdays increased from 29 to 34 days as from 1 January 2023. Accordingly, French tax residents should remain subject to tax in Luxembourg on their salaries earned there, provided that they do not exercise their salaried activity for more than 34 days outside of Luxembourg.

As for Belgium and Germany, the thresholds remain unchanged at 34 and 19 days, respectively, for residents in those countries and the limit on the amount of days working outside of Luxembourg.

Amended Double Tax Treaty between Luxembourg and the UK

The amended Luxembourg and UK Double Tax Treaty (signed on 7 June 2022) is not expected to enter into force until 2024 due to delays in the ratification procedure.

The new treaty expands taxation rights on capital gains of shares in "land rich" companies located in the respective treaty state. Under the amended treaty, the UK or Luxembourg may tax non-residents on sales of shares of "land rich" companies, being defined as entities deriving more than 50% of their value directly or indirectly from real estate located in the respective jurisdiction. Prior to the amendment, Luxembourg shareholders of such UK land rich companies were only taxable in Luxembourg, but could often benefit from the participation exemption on such disposals.

Another feature of the amended treaty is that Luxembourg investment vehicles set up in corporate form may be entitled to treaty benefits. Such corporate investment vehicles can benefit as residents for purposes of the treaty provided that they are at least 75% owned by "equivalent beneficiaries". An "equivalent beneficiary" is defined as a Luxembourg resident or a resident of another jurisdiction that exchanges administrative information with the UK and who would also be eligible to at least the same tax rate of the respective income received by the Luxembourg vehicle under the relevant tax treaty with the UK. Corporate investment vehicles (SA, SARL, or SA) that are able to benefit include Luxembourg UCITS, UCIs part II, SIFs, and RAIFs.

The amended treaty now provides an exemption from withholding tax on dividends (compared to the prior treaty's 5% and 15% rates), except a 15% withholding tax on dividends will still apply when paid out of investment vehicles, which are indirectly or directly investing into real estate such as a UK REIT.

In addition, the right to tax royalty payments has now been exclusively attributed to the state of residency of its beneficial owner (instead of the 5% withholding tax permitted previously to the source state).

Consistent with all new Luxembourg tax treaties, the new treaty now includes the principal purpose test as found in the OECD's multilateral instrument.

Other treaty updates

Luxembourg continues to be quite active in updating and expanding its double tax treaty network, which currently consists of double tax treaties with 86 jurisdictions. Luxembourg is currently negotiating new double tax treaties with five jurisdictions, including Chile, Egypt, Mali, New Zealand, and Pakistan. There are currently nine jurisdictions that Luxembourg has signed double tax treaties with and awaiting ratification, which are Albania, Argentina, Cape Verde, Ethiopia, Ghana, Kuwait, Kyrgyzstan, Oman, and Rwanda.

The year ahead

Luxembourg continues to be a highly regarded jurisdiction for tax efficiency and stability even in the wake of the recent tsunami of international tax policy reforms (e.g., the OECD BEPS project, ATAD 1 and 2, and DAC6 Mandatory Disclosure Rules, etc.). Luxembourg's tax regime is now fully compliant with all of these new anti-abuse measures yet still proves to be tax efficient and stable.

We anticipate continued substantial growth in AIFs and structured finance (particularly regarding securitisation vehicles) irrespective of how the global economy fares. Likewise, we expect that the LTA will continue their vigilant information requests and field audits focusing on economic substance and transfer pricing documentation. As such, all current as well as future tax planning should have a particular focus on such matters to ensure that Luxembourg tax planning is robust and sustainable.

In the coming year, it is also highly advisable to keep a watchful eye on developments to the Proposed ATAD 3 Directive aiming to curtail perceived abuses of "shell companies". When this directive is implemented, it will have widespread impact on Luxembourg holding companies, finance vehicles, and other Luxembourg tax resident SPVs engaged in cross-border activities (though minimal impact on Luxembourg fund structures).

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James has developed expertise in the mandatory disclosure rules under DAC6, automatic exchange of information regimes (FATCA, CRS), and navigating the international tax landscape in light of the OECD BEPS project (including the GloBE Rules), and the European Union's ever-growing anti-tax abuse measures (ATAD I & II, and the Proposed Unshell Directive).
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