

Luxembourg: No Interest and Royalty Deduction for EU Non-Cooperative Tax Jurisdictions

On 28 January 2021, the Luxembourg Parliament approved the new law, which disallows the tax deductibility of interest and royalties payable to related corporate entities located in the EU's list of non-cooperative jurisdictions for tax purposes. The new law will enter into force on 1 March 2021 and apply to interest and royalties accruing as from that date.¹

The Cayman Islands was removed from the list at ECOFIN's last meeting in October 2020 and thus should not be impacted by this new law, given that it is effective from 1 March 2021 onwards.

Background to the New Measure

In March 2020, the Luxembourg Finance Minister submitted the draft legislation (*projet de loi* 1747) to Parliament, which provided for the disallowance of interest and royalty expenses paid to a related corporate entity located in one of the jurisdictions listed in the European Council of Economic and Financial Affairs ("ECOFIN")'s Annex I List of Non-Cooperative Jurisdictions for Tax Purposes ("Annex I Jurisdictions")². For more information on the draft legislation, see our earlier update.³

The Details of the New Law

The law proposes a new section (Article 168.5) to the Luxembourg tax code. This new section will disallow the deduction of interest and royalties accruing for tax purposes, if the following conditions are fulfilled:

- (a) The beneficial owner is an entity ("organism with collective character");
- (b) The entity is a related party; and
- (c) The entity is established in an Annex I Jurisdiction.

Both interest and royalties are broadly defined in the new law. Specific examples of interest mentioned in the new law cover interest payments linked to profitability but exclude any late payment penalties. Likewise, royalties broadly encompass any payment for the use or the right to use a wide spectrum of intellectual property rights such as artistic copyrights, know-how, trade secrets, marketing intangibles and patents.

The new law specifically excludes related party transactions that have valid commercial reasons

¹ [Projet de loi 7547, Chambre des deputes, Session Ordinaire, 2019-2020](#)

² The Economic and Financial Affairs Council's ("ECOFIN") Annex I: EU List of Non-Cooperative Jurisdictions for Tax Purposes, Outcome of Proceedings, 18 February 2020.

³ [Denial of Tax Deduction on Interest and Royalties | March 2020](#)

and reflect economic reality - subject to the taxpayer providing proof.

The new law only applies to "accruals" of interest and royalties and not to actual payments. Such modification was made to avoid any retroactive effect of the law being applied to payments made after the law, but accruing before the law took effect.

Corporate Entities vs. Partnerships

The new law only applies to accruals with respect to related entities that would be considered as tax opaque under Luxembourg tax law such as corporations, private or public companies, certain limited liability companies, mutual assurance associations and non-profit associations.

The law excludes from the scope of application payments to tax transparent entities, such as limited partnerships and thus implies a look through rule for determining beneficial ownership at the level of the limited partners (or equivalent).

For example, payments to a limited partnership located in an Annex I jurisdiction, should not be within the scope of this rule. However, the denial of an interest or royalty deduction might still apply to the pro-rated share of such accrual to a limited partner, which is a related corporate entity in an Annex I Jurisdiction.

Related Party Transactions

"Related entity", as defined in the new law, refers specifically to Luxembourg's tax law on transfer pricing which broadly defines the concept to include the following situations:

- When one enterprise participates directly or indirectly in the control or capital of another enterprise; or

- When the same persons participate, directly or indirectly, in the control or capital of two enterprises; and
- In either case, conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises.

Periodic updating of the Annex I Jurisdictions

For the first year, the new law will only be applicable to those jurisdictions still officially listed on Annex I as of 1 March 2021, but will be applicable for the list of as 1 January for subsequent years. The list currently includes the following jurisdictions: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands, Vanuatu and Seychelles.

ECOFIN should release an updated list during February 2021 (i.e.: before the 1 March 2021 start date of the new law taking effect).

Looking to the future, the list should be updated annually by the Luxembourg government based on future ECOFIN decisions to remove or add jurisdictions to the list, as the case may be, on a rolling basis.

The new law states that if a jurisdiction is removed from the list during the year, the denial of the deductions shall apply as of the date such jurisdiction is removed from the list.

One of Four Measures

Luxembourg enacted this new law in light of recommendations by ECOFIN to implement at least one of four proposed "defensive measures" against jurisdictions in Annex I. ECOFIN has

recommended that each EU Member State adapt its choice of defensive measures as from 1 January 2021. These measures include:

- (a) Non-deductibility of costs paid from an EU resident company to a person located in an Annex I jurisdiction;
- (b) Application of controlled foreign company ("CFC") rules requiring current inclusion of the undistributed profits of subsidiaries located in an Annex I jurisdiction;
- (c) Imposition of higher withholding taxes on payments made to or received in an Annex I jurisdiction; or
- (d) More stringent limitations of any participation exemption benefits with respect to profits distributed from an entity located in an Annex I jurisdiction.

As shown by this new law, Luxembourg has opted for the first measure regarding denial of costs. Currently, there is no proposed legislation or even discussion on Luxembourg expanding any further defensive measures into these other three options.

For advice as to how this law may affect current structures, please liaise with your usual Maples Group contact or:

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