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Non-deductibility of interest and royalties paid to group entities located in blacklisted countries

On 30 March 2020, the Luxembourg government published bill No. 7547, amending article 168(4) of the income tax law (ITL).

This proposal has been made in light of the European Union Council's conclusions issued on 5 December 2017 whose purpose was the adoption of defensive measures against non-cooperative countries.

Based on the text of the bill, as from 1st January 2021, interest and royalties paid or due will not be tax deductible when the following conditions are cumulatively met:

- Only payments made between associated enterprises pursuant to art. 56 ITL are covered by this measure.
- The beneficiary must be located in a blacklisted jurisdiction. Please note that only the beneficial owner of the payments must be considered as beneficiary for this purpose (look-through approach).

  The backlist should be published before 1st January 2021 and updated once a year in the Luxembourg Budget Law (based on the list published in the EU Official Journal).

  New additions to the list would be taken into account as from the 1st January of the following year. Any withdrawals would be taken into account as from the publication date of the list in the Official Journal of the EU.

  For the time being, and since 27 February 2020, this EU blacklist includes 12 jurisdictions: American Samoa, Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Trinidad and Tobago, Vanuatu and the US Virgin Islands.
- The beneficiary is a "collective undertaking" within the meaning of art. 159 ITL (i.e. joint-stock companies/corporate bodies).

Interest and royalty payments will however remain deductible if the operation is supported by valid commercial reasons reflecting the economic reality and to the extent that, based on the relevant facts and circumstances, these reasons can be considered as real and offering a sufficient economic advantage beyond the potential tax advantage obtained through the operation.

PKF comment

Multinational groups should verify whether any interest or royalty payments involve entities located in non-cooperative jurisdictions (not only as the recipient of the payment but also as a beneficial owner of the income). In that case, it would be recommended to consider alternative options taking into account the fact that similar measures could also exist in other EU Member States.

It is also worth noting that the bill has not yet been approved by the Luxembourg Parliament.

Upcoming modification of withholding tax rates on dividends and interest between Luxembourg and Russia

In April 2020, an official letter was addressed to the Luxembourg Ministry of Finance upon request of Russian president Vladimir Putin.

In this letter, Russia expressed its intent to renegotiate the current withholding tax rates applied on dividends and interest currently provided for by the double tax treaty concluded between Luxembourg and Russia.

The Russian Ministry of finance requested the following amendments to be implemented as from 1st January 2021:

- An increase of the withholding tax rate applied on dividends from 5% (subject to conditions) to 15% (art. 10 of the treaty); and
- An increase of the withholding tax rate applied on interest from 0% (subject to conditions) to 15% (art. 11 of the treaty).

The purpose of this modification is to avoid “treaty shopping” in situations where Luxembourg conduit companies are used, as an intermediary, to access preferential withholding tax rates.

The double tax treaty in force between Luxembourg and Russia is not the only one to be impacted by a change in withholding tax rates as similar correspondence has been received from Cyprus and Malta.

PKF comment

Multinational groups should verify whether any dividend or interest payments are made between Luxembourg and Russia to determine the impact of this change on their structures.

Upcoming changes for securitisation vehicles

On 14 May 2020, the European Commission sent letters of formal notice to Luxembourg, as part of its infringement procedure, to request the following amendments to be made to existing Luxembourg tax law:

- The inclusion of securitisation vehicles governed by EU Regulation No. 2017/2402 into the scope of the Luxembourg interest limitation rules (which are part of the so-called "ATAD I" measures).

  Pursuant to art. 168bis, para. 1, 7), (j), ITL, said securitisation vehicles are currently not subject to the rules related to the limitation of interest deductions. They were excluded as "financial undertakings" which, in the opinion of the Commission, goes beyond the permitted exclusions. However, credit institutions, insurance and reinsurance companies, AIF and UCITS should remain out of the scope of the interest limitation rules.

  It is worth noting that Portugal received the same type of notice.

- Taxation of Luxembourg and foreign securitisation vehicles should be aligned. A more onerous taxation is currently applied on foreign entities having their statutory seat in another EU Member State and carrying out taxable operations in Luxembourg, which is not in line with the EU freedom of establishment.

PKF comment

Securitisation vehicles in Luxembourg should expect new developments in this respect within the next few months as Luxembourg will likely align its legislation with the views of the European Commission.

Possible switch from a vertical to a horizontal tax unity regime in Luxembourg

On 14 May 2020 (case C-749/18, B and Others v ACD), the European Court of Justice (ECJ) ruled that the Luxembourg tax unity regime is contrary to the EU freedom of establishment due to the existing distinction between "vertical" and "horizontal" tax consolidation regimes.

Indeed, based on current legislation, a group may opt either:

- for a "vertical" tax unity: integration between the integrating Luxembourg parent company and its Luxembourg subsidiaries; or
- for a "horizontal" tax unity: integration between Luxembourg sister companies (held by a non-resident and non-integrating parent company). Taxable income is then consolidated at the level of a Luxembourg integrating (top) subsidiary.

In the case at hand, a vertical tax unity was already in place between the Luxembourg parent company, LuxCo A (which was held by a French company) and several Luxembourg subsidiaries.

LuxCo B and C, although not held by LuxCo A, were indirectly owned by the same French company and wanted to become part of the existing tax unity regime. The envisaged tax unity would thus have been constituted by Luxembourg sister companies A, B and C (and potentially their Luxembourg subsidiaries) while LuxCo A would have remained the integrating company for the group, thus creating a horizontal tax unity.

The tax authorities, however, refused the request of the group to switch from a vertical to a horizontal tax unity. Indeed, based on article 164bis ITL, a company may not be part of more than one tax consolidated group at a time.

The horizontal tax unity could nevertheless have been established but it would have required the prior dissolution of the vertical tax unity.

However, a fiscal unity in Luxembourg must remain in place for at least 5 consecutive years (at the level of each participating entity). If not, a modification of the previous tax assessments is automatically performed by the tax authorities. Hence, the dissolution would have entailed adverse tax consequences (with retroactive effect) for the group.

PKF comment

The ECJ ruled in favour of a more flexible approach to the tax consolidation regime in Luxembourg. Further developments are thus expected on this regime in future, assuming that the Luxembourg legislator decides to amend current tax law taking into account the comments made by the ECJ in this ruling.

For further information or advice regarding recent events or any advice with respect to Luxembourg taxation, please contact Aurélie Moline at aurelie.moline@pkf.lu or call +352 39 58 42 82.