UPDATE ON TAX DEVELOPMENTS IN LUXEMBOURG

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This update provides a snapshot of several Luxembourg tax matters which are relevant for any Luxembourg resident corporate income taxpayer engaged in holding and financing activities.

Luxembourg Tax Residency

- Pursuant to Luxembourg income tax law, a Luxembourg company is considered as tax resident in Luxembourg to the extent that it has its statutory seat or its central administration in Luxembourg.

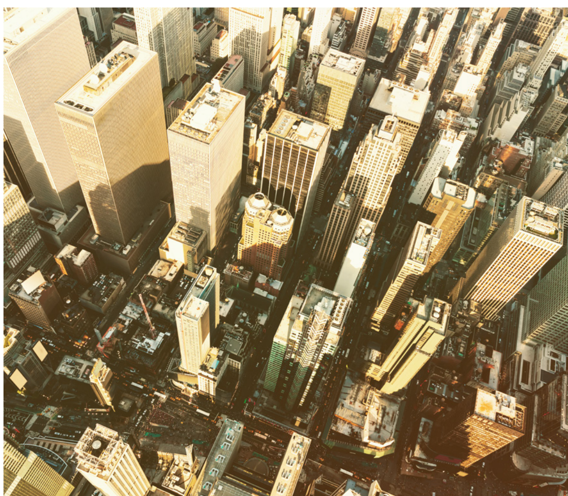
- Please note however that from an international tax perspective, other jurisdictions may impose further substance requirements to grant the benefit of a DTT, EU Directives or a specific exemption under domestic tax law.

- Luxembourg entities must have sufficient substance in Luxembourg (and be able to demonstrate this substance) to be entitled to benefit from any applicable double tax treaty or EU Directive by ensuring tax residency in Luxembourg is not challenged by a foreign tax authority.

- In order to manage Luxembourg substance a number of factors will need to be considered such as the place of management, capital structure and the location of day-to-day business activities.

Corporate Income Tax/Municipal Business Tax

- A Luxembourg resident corporate income taxpayer ("Luxco") will be tax resident in Luxembourg, and will be subject to Corporate Income Tax ("CIT") and Municipal Business Tax ("MBT") in Luxembourg on worldwide income unless certain items benefit from an exemption under domestic law or DTTs.



- The Luxembourg overall income tax rate is 27.08% for 2017, i.e. (i) 19% CIT, (ii) 7% contribution to the unemployment fund computed based on CIT due and (iii) 6.75% MBT rate for companies whose statutory seat is located in Luxembourg city (after an allowance of €17.5k granted for MBT purposes only).

Shareholding activity

Participation exemption

- In principle, income derived by a Luxembourg company from its subsidiaries is fully subject to tax in Luxembourg at the overall standard tax rate (i.e. 27.08% for 2017) unless the Luxembourg participation exemption regime applies.

- In summary, at the date the dividend /liquidation proceeds are paid, or at the date the shares are disposed of, the Luxembourg company must hold or commit itself to hold a direct and continuous shareholding in its fully taxable subsidiary for at least 12 months. This shareholding must represent at least 10% of the capital of the subsidiary or its acquisition price must amount to at least €1.2m for dividends and liquidation proceeds exemption (and €6m for the capital gains exemption).

- The Law of 18 December 2015 implemented the Directive 2014 / 86 / EU on anti-hybrid instruments and Directive 2015 / 121 / EU on the European general anti-abuse rule ("GAAR") amending the parent-subsidiary Directive 2011 / 96 / EU into the Luxembourg Income Tax Law ("LITL").

- The GAAR should target:
  - double non-taxation situations resulting in a mismatch of tax treatment applicable to an income distribution between two Member States;

  - any abuse of the Parent Subsidiary Directive and in particular, where an arrangement or a series of arrangements is / are
  (i) put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purposes of the above

mentioned Directive and
(ii) is / are not genuine having regard to all relevant facts and circumstances. Such arrangement or a series of arrangements shall be regarded as not genuine to the extent that they have not been put in place for valid commercial reasons reflecting economic reality.

Debt-to-equity ratio

- Based on the Luxembourg tax administrative practice, Luxembourg companies performing shareholding activities must comply with a maximum debt-to-equity ratio of 85:15 in relation to the financing of shares granted or guaranteed by a related party.

Transfer pricing developments

- From 1 January 2017, transfer pricing rules (as set out in article 56bis LITL of 27 December 2016, complemented by the new Transfer Pricing Circular LITL n°56 / 1-56bis / 1 issued by the LTA on 27 December 2017 – the "Lux Financing TP Rules") apply to Luxembourg entities involved in intra-group financing transactions.

- The Lux Financing TP Rules strengthen the Luxembourg transfer pricing regulations and clarify the methodologies (outlined below) available to determine the arm's length price in respect of related party transactions.

- According to the Luxembourg transfer pricing rules:
  - related transaction can be considered arm's length even if different to a transaction between independent parties;

  - Conditions and economic characteristics of related transactions should be comparable to the conditions and economic characteristics of transactions between third parties;

  - Any transfer pricing adjustments should be made on a just and reasonable basis; and

  - Taxpayers should identify the transactions and determine the economically significant characteristics and conditions in order to define the controlled transactions and then compare them to the open market.

- Practically, there are two key aspects for the comparability analysis:
  - Identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attached to those relations so that the controlled transaction is accurately described; and

  - Compare the conditions and the economically significant circumstances of the controlled transaction to those between independent parties.

- The following items should be used to benchmark intragroup transactions:
  - the contractual terms of the transaction;

  - the functions performed by each of the parties to the transaction, considering assets used and risks managed and assumed;

  - the characteristics of the transaction

  - the economic circumstances of the parties and of the market in which the parties operate; and

  - the business strategies pursued by the parties.

- Also, the legislation proposes to introduce a general anti-abuse measure specifically for transfer pricing purposes. In the event that a controlled transaction, or a part of it, does not have a valid business rationale, taxpayers and tax authorities should disregard it to determine the arm's length price.

Financing activity

- Interest income received by Luxco on loans advanced to affiliates will be subject to tax in Luxembourg. However, when each loan will be funded with a corresponding liability at the level of each lender, taxable interest income will be offset by corresponding interest expenses (except for margins remaining taxable).

- As these entities are lending funds to affiliate entities (i.e. entities under a common control), they should be considered as in the scope of the Lux Financing TP Rules applicable to Luxembourg entities involved in intragroup financing transactions.

Transfer Pricing Rules

- Luxembourg entities involved in intragroup financing transactions are subject to specific transfer pricing rules: all back-to-back intra-group financing activities performed by a Luxembourg entity must be made on arm's-length terms, in line with the OECD's general guidelines. New rules are applicable from 1 January 2017.

- Accordingly, they will be required to comply with the provisions of the Lux Financing TP Rules. Please note that the impact of the new Lux Financing TP Rules on certain areas of intra-group financing activity remains to be confirmed and consultation with the LTA in this respect is currently ongoing; however the key elements of the Lux Financing TP Rules are currently expected to be as follows:

Equity at risk

- In principle, Luxembourg entities considered as being in the scope of the Lux Financing TP Rules should be sufficiently equity-funded to hedge transaction risks.
- The Lux Financing TP Rules do not set any specific level of equity required.
- The level of equity required for the purpose of their financing activities should be determined through a credit rating / debt capacity analysis.

Arm's length remuneration

- The Luxembourg entities involved in intragroup financing transactions must derive an arm's length remuneration from their financing activities which would be subject to tax in Luxembourg. The level of equity at risk and risk profile will be taken into account to determine the financing margin to be earned by such companies.
- The level of the remuneration should be supported by transfer pricing documentation to be prepared based on methodologies generally accepted by the LTA.
- The remuneration to be realized for the financing activities usually corresponds to the net interest income of Luxco (i.e. interest income received on receivables reduced by interest expenses incurred on payables). The remuneration could also be offset by operating costs of the company in relation to the financing activity.
- Based our experience and previous confirmations received from the LTA, when a Luxco acts as agent for the purpose of the Lux Financing TP Rules it would not be required to earn any taxable margin on the financing activity.

Organizational substance requirements

- A Luxco within the scope of the Lux Financing TP Rules would be expected to comply with certain economic and organizational substance requirements reflecting that qualitative Board Meetings are effectively held in Luxembourg reflecting that key and strategic decisions are taking place in Luxembourg, and have qualified personnel (employee(s)) to manage the loans (i.e. payroll costs should appear on the profit and loss account of the company).

- Confirmation of compliance with the Lux Financing TP Rules (including confirmation of the level of the arm's length remuneration) could be obtained from the LTA in the context of an APA process.

- Confirmation issued by the LTA would be valid for a 5-year period (provided that facts and circumstances do not vary).

Withholding tax considerations

Interest

- Interest payments made by the Luxembourg entities will not be subject to WHT, to the extent that the Luxembourg entities comply with the thin capitalization rules described above and the interest is at arm's length.

Dividend

- In principle, dividend distributions by a Luxembourg tax resident entity are subject to a 15% WHT on the gross amount (unless reduced by a double tax treaty or the application of the Luxembourg participation exemption regime).

Net Worth Tax ("NWT")

- Luxembourg resident companies are subject to an annual NWT on their worldwide net worth (unless a double tax treaty or a specific disposition provides otherwise) at a rate of 0.5% for a NWT basis up to €500m and 0.05% for a NWT basis exceeding €500m.

- The net worth is determined on January 1 of each year. The taxable basis is determined roughly as the market value of all the assets (including cash and receivables) less the market value of the liabilities. The assets financed by share capital and retained earnings will thus be taxable.

- The NWT is not due in the year of incorporation but is due in full in the year of liquidation.

- Certain substantial shareholdings may be exempt from NWT. The conditions for the exemption of substantial shareholdings are similar to those applicable to the participation exemption for dividends /liquidation proceeds (but for the holding period).

- The general rule is that debts are deductible. However, debts related to exempt assets are not deductible from the NWT basis to the extent that the value of the debt does not exceed the value of the exempt asset. The excess amount is deductible.

- As from 1 January 2016, Luxembourg companies are subject to a minimum NWT. The minimum NWT would be payable even if the Luxembourg companies have a negative NWT basis.

- Luxembourg companies with a balance sheet comprised of at least 90% of financial items and with a balance sheet amounting at least €350k are subject to a minimum NWT of €4,815 for 2017 (if the total balance sheet amount is lower than €350k, the minimum NWT due is €535).

- Other Luxembourg companies (not subject to the above minimum NWT) will be subject to a progressive minimum NWT of an amount determined based on the amount of total assets on the balance sheet of the relevant entity. The progressive flat tax ranges from €535 to €32.1k.

- This minimum NWT is not an advance payment but could be reduced by CIT due for the previous year.

Chamber of Commerce Contribution

- Entities with a commercial form and with their statutory seat in Luxembourg, as well as individuals carrying out a commercial, industrial or financial activity in Luxembourg and Luxembourg branches of foreign companies which carry out commercial, industrial or financial activities are in principle liable to pay an annual contribution to the Luxembourg Chamber of Commerce ("LCC").

- Companies whose main activities consist in holding participations are excluded from the application of the general system of calculation. These companies are instead subject to an annual €350 lump sum contribution, irrespective of their taxable profits.

Common Reporting Standard

- From 1 January 2016, Luxembourg companies are subject to the new "Common Reporting Standard" ("CRS") in line with the EU Directive 2014 / 107 / EU relating to the mandatory automatic exchange of information in tax matters.

- The CRS rules apply to Luxembourg financial institutions ("FIs") such as banks, certain insurance companies, investment funds, certain non- supervised investment entities and certain insurers, certain corporate service providers and professionals of the financial sector.

- As from 1 January 2016, these entities need to be ready to apply the CRS and start capturing data for CRS reporting. More specifically, Luxembourg FIs have to provide to the LTA authorities reportable information corresponding to the previous calendar year before the 30 June each year (for the first time, on or before 30 June 2017 regarding calendar year 2016).

- Whether the CRS obligation will be applicable to Luxembourg holding companies is still uncertain. This should be properly monitored once the LTA provide further guidance in this respect.

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