

Luxembourg limits deduction of certain payments made to countries on the EU list of non-cooperative jurisdictions

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Executive summary

On 30 March 2020, a draft law (Draft Law) aimed at disallowing, under certain circumstances, the deduction of interest and royalties paid or owed by Luxembourg corporate taxpayers to associated enterprises that are corporations established in a country listed on the European Union (EU) list of non-cooperative jurisdictions for tax purposes (the EU List), was transmitted to the Luxembourg Parliament. This legislative initiative constitutes a first step by Luxembourg to implement the guidance on further coordination of national defensive measures in the tax area towards non-cooperative jurisdictions, as detailed by the EU Code of Conduct Group for Business Taxation (COCG) in its report and as endorsed by the Council of the EU (ECOFIN) on 5 December 2019.

The new provisions are expected to apply as from 1 January 2021.

Detailed discussion

Background on EU List

The EU published its list of non-cooperative jurisdictions for the first time on 5 December 2017, comprising in Appendix I at that time 17 jurisdictions deemed to have failed to meet the tax transparency, fair taxation and implementation of anti-base erosion and profit shifting measures (BEPS)

criteria established by the European Commission. Since the release of the EU List, there have been multiple changes to its composition based on recommendations made by the COCG. Annex I to the EU List currently includes 12 jurisdictions (American Samoa, the Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the US Virgin Islands and Vanuatu).

On 5 December 2019, the ECOFIN (i.e., the Economic and Financial Affairs Council of the EU, comprising the Ministers of Finance of the EU Member States) endorsed a report on the progress achieved by the COCG, which included in particular a detailed state of play on the EU List. It also includes guidance on further coordination of national defensive measures in the tax area towards non-cooperative jurisdictions (contained in annex 4 of the report). The guidance invited all Member States to apply legislative defensive measures in taxation vis-à-vis the listed jurisdictions as of 1 January 2021, aiming to encourage those jurisdictions' compliance with the Code of Conduct screening criteria on fair taxation and transparency.

This Alert summarizes the provisions of the Draft Law.

Non-deductibility of interest and royalties

The Draft Law would deny, under certain conditions, the deduction by corporate taxpayers of interest or royalties paid or owed.

The Draft Law provides for a specific definition of the concepts of "interest" and "royalties" for the application of the said measure. These definitions are to a large extent aligned with EU legislation, viz. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (the Interest and Royalty Directive), and with the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention.

The term "interest" thus refers to interest and arrears paid or due in relation to receivables of any nature, whether secured by mortgage and whether carrying a right to participate in the debtor's profits, and in particular interest and arrears from bonds or debentures, including premiums and prizes attaching to such securities. Penalty charges for late payment are not regarded as interest for the purpose of this provision.

The term "royalties" as used in the new provision means considerations of any kind paid or owed for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark,

design or model, plan, secret formula or process, and for information concerning industrial, commercial or scientific experience.

For the application of the new rule, there is no distinction to be made with respect to whether the interest or royalties have effectively been paid or are still outstanding.

Paid or owed to related enterprises in an EU listed jurisdiction

The deduction of interest or royalties (as explained above) paid or owed is denied, when the beneficiary of the interest or royalties meets the following conditions cumulatively. Where the beneficiary is not the beneficial owner of the interest/royalty, the criteria need to be assessed in relation to the beneficial owner:

- ▶ The beneficiary of the interest or royalties is a corporate entity as per the definition of Luxembourg Income Tax Law.
- ▶ The beneficiary is a related enterprise under the meaning of the Luxembourg transfer pricing provision of article 56 of the Income Tax Law. The concept of "related enterprise" covers any enterprise participating, directly or indirectly in the management, control or capital of another enterprise, or situations where the same persons participate, directly or indirectly, in the management, control or capital of two enterprises.
- ▶ The beneficiary of the interest or royalties is established in a jurisdiction or territory that is on the EU List.

Application of the safe-harbor rule

Even if the aforementioned conditions are all met, the provision will not apply if the taxpayer proves that the transaction that gives rise to the interest or royalties paid or owed "is used for valid economic reasons which reflect economic reality."

The provision thus recalls the wording of the General Anti-Abuse Rule (GAAR) as codified in paragraph 6 of the Luxembourg Tax Adaptation Law and according to which arrangements that have been put in place for the main purpose or one of the main purposes of obtaining a tax advantage should be ignored if they are not genuine, i.e., if they are not put in place for valid commercial reasons which reflect economic reality.

According to the comments to the draft law, it would not be sufficient to state economic reasons, but such reasons need to be considered "real" and representing an economic

advantage that exceeds a potential tax benefit resulting from the operation. No more details are provided as regards what kind of proof is expected or accepted to sustain that the transaction is effectively justified by valid commercial reasons.

As a result, even if the interest and royalties are paid or owed to a related enterprise established in a jurisdiction or territory that is on the EU List, the amounts paid or owed remain deductible (subject to restrictions as provided by other provisions of the Income Tax Law) if they are incurred or paid in the context of a transaction entered into for valid economic reasons which reflect the economic reality.

Evolution of the EU List

Given that the EU List is constantly evolving, the Draft Law also sets down the criteria for drawing-up the initial version of the EU List and for updating it subsequently.

The Government will propose to Parliament to complete the provision with a (domestic) list, effective 1 January 2021, whose content will be based on the latest version of the EU List as published in the Official Journal of the EU (OJEU) at the time such proposal will be made. This list will apply to interest and royalties paid or owed as from 1 January 2021.

This domestic list will be updated only once a year, again upon proposal to be made by the Government to Parliament, as follows:

- Effective 1 January of the calendar year following the year of the proposal and applicable to interest and royalties paid or owed as from the same date, the list is updated with those countries and territories that are included in Annex I of the EU List (as published in the OJEU) at the date of such proposal.
- Removals from the list at the occasion of subsequent updates of the domestic list are taken into consideration regarding interest or royalties paid or owed as from the date of publication in the OJEU of the EU List enacting the removal of a country or territory from the EU List. The comments to the Draft Law give the following example: a country C, which was on the EU List as at 1 January 2021, is removed from said list with a publication in the OJEU on 12 March 2021. Even if the proposal to update the domestic list was only made in the second half of 2021, the non-deductibility would cease to apply to interest or royalties paid or owed effective 12 March 2021. However, if country C were put back on the EU List as of 4 October 2021, the Luxembourg list would not be updated.

Finally, the comments to the Draft Law highlight that the reporting requirements, as per Circular L.G. - A n°64, in relation to transactions of Luxembourg companies with related enterprises located in jurisdictions that are included in Annex I of the EU List will continue to apply.¹

Endnote

1. See EY Global Tax Alert, [Luxembourg: Reporting implications of revised EU List of non-cooperative jurisdictions for tax purposes](#), 27 February 2020.

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