Tax controversy evolution continues apace in Luxembourg

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Longtime tax observers would probably not include the Grand Duchy of Luxembourg among the tax authorities most likely to audit multinational companies on a regular basis. But after an illegal leak of tax rulings in 2014[1] and resulting international pressure, the government quickly implemented new measures to stamp out accusations of being a tax haven, with more change probably on the horizon.

Luxembourg's tax relationship with the international business community has been debated extensively in recent years. Leaks and peer pressure notwithstanding, Luxembourg has never been listed on the European Union (EU)'s so-called "blacklist" of noncooperative countries for tax purposes, and it has scored a "largely compliant" rating in two peer review rounds by the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum). This puts Luxembourg at the same rank as nearby EU Member States Austria, Belgium and Germany (and also Switzerland, not a member of the EU), as of 25 November 2021 (the latest data available).

How tax enforcement in Luxembourg has evolved

Several key measures are driving Luxembourg's changing environment, but official statistics reflect the shifts more empirically. In 2015, when the Base Erosion and Profit Shifting (BEPS) recommendations were published, taxpayers requested 539 tax rulings from Luxembourg's Inland Revenue (ACD - *Administration des Contributions Directes*), but by 2021, that number fell to 81, a decline of 85%. Similarly, there were 187 requests for Advance Pricing Agreements (APAs) in 2015 but just two in 2021.

What changed over six years? Partly, Luxembourg introduced a more stringent legal framework for tax rulings in 2015, along with a new administrative fee that must be paid with each tax ruling request. Moreover, provisions effective from 2020 mean that tax rulings issued before 1 January 2015 automatically ceased to have effect at the end of tax year 2019.

[1] The so-called Lux Leaks.

It is perhaps unsurprising that these developments, which themselves sit at the heart of Luxembourg's desire to be a leader in tax transparency, have driven an increase in tax controversy. Consider, for example, that:

- In 2021, 79 extended inspections of taxpayers were ongoing at year-end, up from 44 at the end of 2020.
- Approximately 1,600 appeals against tax assessments were filed by taxpayers in 2021, up from around 1,300 in 2020.
- Luxembourg courts handed down more than 190 judgments in tax matters during 2021, compared to approximately 160 in 2020.
- More than 30 judgments concerning call-in warranty of managers or directors for outstanding taxes at the level of the company were handed down in 2021.

Luxembourg's ACD has responded to international peer pressure with words and with actions.

A new approach toward tax and criminal fraud

Two factors make the general shift toward higher levels of tax controversy in Luxembourg more consequential: in 2017, the definition of "tax fraud" was extended, and clearer distinctions between different types of tax offenses and tax fraud were introduced, with different sanctions and penalties established.

In July 2021, the ACD published a Circular[2] setting out new guidance on how the tax authority would apply administrative fines and penalties in tax offense and tax fraud cases (distinguishing between administrative and criminal sanctions) and describing how it would continue to cooperate closely with the Duchy's judiciary.

In addition to specificities related to penalties, the Circular laid out several additional guiding principles, all of which are important to taxpayers. One concerns whether a penalty should be applied at all. By using all available facts at its disposal, the ACD may set the penalty at its sole discretion, but only according to the circumstances of the case and only proportionate to the taxpayer's actions (i.e., including any intent). This is of particular importance to business taxpayers and should give them comfort that they will have every opportunity to discuss and argue the tax treatment of a particular transaction, including in the context of a tax audit, before the ACD even considers whether a penalty (administrative or criminal) is appropriate and applicable.

Within three months of the ACD issuing notification of a penalty, the taxpayer may challenge it via an administrative appeal (*réclamation*). Importantly, the legal provisions referred to in the guidance apply from tax year 2017, meaning penalties could be imposed for any tax declarations filed from 1 January 2017 onward.

As noted, the guidance is split broadly between administrative and criminal penalties.

[2] L.G.-A no 67.

Administrative penalties

The law and guidance distinguish between three types of administrative penalties:

1. Penalties for incomplete or inaccurate tax returns and other tax forms (Art. 166 (3) AO): When signing tax returns or any other tax forms, taxpayers assert that they have provided all information to the best of their knowledge and belief. Under the law, any intentionally incomplete or inaccurate declaration or non-declaration is subject to an administrative penalty amounting to 5% to 25% of the unpaid tax or undue refund. Importantly, whether the taxpayer had the *intention* to file an incomplete or inaccurate tax return must be assessed based on the entirety of the underlying facts and circumstances and compared with the behavior of a *reasonably diligent* taxpayer.

2. Simple tax fraud (Art. 396 (1) AO): Generally speaking, Luxembourg's law covers three types of tax fraud: simple tax fraud, aggravated tax fraud and tax evasion. Simple tax fraud is the least severe of the three and is subject to an administrative penalty. The penalty applies in cases where a person fraudulently (i.e., with intent) obtains an undue tax advantage for his/her own or for somebody else's benefit or causes an undue reduction in tax revenues on purpose. The administrative penalty is 10% to 50% of any avoided taxes or undue refund. Application of the penalty requires that an unjustified tax advantage was granted, or a tax debt created that is lower than the amount that should have been paid under a correct tax calculation. Importantly, the words "or for somebody else's benefit" extend the law to also include professional tax preparers or any other individual who may have prepared a tax return (or form/declaration) on behalf of another party.

3. Unintentional tax fraud (Art. 402 (1) AO): Where a taxpayer, his/her representative or another person assisting with the affairs of a taxpayer negligently (i.e., without intent) causes tax revenues to be reduced or tax advantages to be unduly granted or maintained, he/she is subject to a penalty of 5% to 25% of the avoided tax or undue refund. Contrary to Art. 166 (3) AO and Art. 396 (1) AO above, this provision does not require an intentional act(s) to have occurred. The Circular points out specifically that this provision allows penalties to be levied on representatives, particularly tax advisers that act as intermediaries between taxpayers and the ACD.

Procedural aspects

The Circular sets forth a framework for the ACD to use to help ensure a uniform approach to applying penalties. The ACD may, however, levy an administrative penalty each time the conditions for applying an administrative penalty are met. As noted, the ACD has discretion to set the size of the penalty, which must be justified by its circumstances, and a taxpayer may appeal that decision in front of the tax authority under the same appeal procedure used for tax assessments.

The head of the relevant local tax office must ensure that the circumstances are effectively and explicitly addressed in fairness and expediency as a basis for his or her decision. Importantly, as a penalty always constitutes a discretionary decision, no general rule or exception can be given. The local tax office must set the penalty such that it is, in their view, appropriate to the circumstances and proportionate to the infraction and the taxpayer's capacity to pay. While the tax office has a margin of discretion, the law provides for minimum and maximum amounts that must be strictly respected.

The date on which the decision on a penalty is made also affects the deadline to pay (one month) and by when an appeal must be lodged. The Circular states that in all three cases of administrative penalties, the law refers to the possibility of the taxpayer filing a formal "appeal" (*Anfechtung*) and not a "hierarchical complaint" (*Beschwerde*). The taxpayer is also notified of the available means of appeal at the time they are notified of the penalty.

Criminal tax fraud and penalties

While simple tax fraud constitutes an administrative infraction, Luxembourg's laws foresee two other types of fraud that are criminal offenses: aggravated tax fraud and tax evasion.

The difference between simple tax fraud and aggravated tax fraud is based upon the amount of tax at stake. Fraud is considered to be aggravated if it relates to at least one of the following:

1. An amount of tax exceeding one quarter of the annual tax actually due (but not less than €10,000)
2. An undue refund of tax exceeding one quarter of the annual refund actually due (but not less than €10,000)
3. The amount of annual tax avoided or unduly reimbursed exceeds €200,000

Aggravated tax fraud does not require the systematic (i.e., methodical or organized) use of fraudulent actions to conceal relevant facts from the authorities or to persuade them of incorrect or inaccurate facts. The punishment is one month to three years of imprisonment and a penalty of between €25,000 and an amount representing six times the taxes evaded or unduly reimbursed.

Tax evasion is the most severe infraction under the law, and it is characterized by two elements:

- A fraud involving a significant amount, either in absolute terms or in comparison to the annual tax or refund due
- A fraud committed with the systematic use of fraudulent actions to conceal relevant facts from the ACD, or to persuade it of incorrect facts

The punishment is one month to five years of imprisonment and a penalty that ranges between €25,000 and an amount representing ten times the taxes evaded or the refund(s) wrongfully obtained.

According to the Circular, the thresholds make it possible to objectively quantify when the scale of the fraud is sufficiently material for the sanction to become criminal in nature, describing several such levels:

1. If the fraud relates to an amount of tax avoided or unduly reimbursed of less than €10,000, no aggravated tax fraud is deemed to have occurred. This first level eliminates smaller cases that are considered administrative infractions.
2. A fraud involving amounts of more than a quarter of the annual tax due or of the refund due (but not less than €10,000) constitutes aggravated fraud. This second level is designed to punish fraud that, in absolute amounts, may be considered minor, but is to some extent material compared to the amount of tax due.
3. A fraud involving an amount of annual tax avoided or unduly refunded exceeding €200,000 always constitutes aggravated tax fraud. If said fraud was committed via fraudulent actions, the offense is to be qualified as tax evasion.

Where no amended tax assessment is issued but tax was underreported, the amount of tax avoided results from a comparison between the tax due according to the tax return and the amount of tax as assessed. Where an amended tax assessment has been issued, the amount of tax avoided results from a comparison between the tax payable as per the original tax assessment and the tax payable per the amended tax assessment.

In both cases the head of the competent tax office must transfer the proceedings to the State Prosecutor, who will initiate prosecution.

Call-in warranty measure

Directors or managers of companies should also be aware of the increasing trend toward the ACD making use of the possibility offered by the law to "call in warranty" these individuals to settle the company's outstanding tax debts. According to the law, the legal representatives of a company must satisfy the fiscal obligations incumbent on the company they represent, and in particular, must provide for the payment of taxes out of the funds they manage. In cases where culpable non-fulfillment of said obligations results in a reduction of tax collection or a wrongly granted refund of taxes, the *personal* liability of the legal representative is engaged, and he/she must pay the outstanding amount of tax due. This holds true even if the legal representative is not in direct charge of the day-to-day management of taxes.

Based on case law, the members of the board of directors of a company do not escape their responsibilities because they delegate all or part of them to other persons, but rather they must assume constant supervision of those to whom they delegate such responsibility, since — notwithstanding the existence of a delegate for day-to-day management — board members should also answer for the failure to supervise such a delegate.

Conclusion

Moving forward, taxpayers should closely monitor the pace and scope of tax controversy developments in Luxembourg, and carefully fulfill their tax obligations.

Statistics around the scrutiny of certain tax issues are expected to grow in availability and number as recent cases move through Luxemburg's dispute process — at first administratively within the ACD and then at the levels of the Courts of First and Second Instance, at which point more information will become available publicly.

In particular, the guidance relating to administrative and criminal penalties should be considered in relation to each compliance action, while the call-in warranty measure should place all taxpayers on alert that Luxembourg, among several other tax authorities, may employ different (and indeed novel) techniques to help ensure all taxes are collected.

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