LUXEMBOURG PARLIAMENT PASSED LAW TO LIMIT DEDUCTIBILITY OF PAYMENTS TO NON-COOPERATIVE JURISDICTIONS

On 28 January 2021, the Luxembourg Parliament passed Bill of Law number 7547 (the "Bill"), limiting the deductibility of certain interest and royalties paid to associated enterprises located in so called non-cooperative jurisdictions.

BACKGROUND

Since December 2017, the Council of the European Union provides a list of jurisdictions which do not comply with international tax standards (so called EU Blacklist). With a new guidance in 2019, the Council of the European Union has encouraged EU Member States to take defensive measures and apply administrative and legislative measures towards such jurisdictions.

The Bill followed closely the approach highlighted by the Economic and Financial Affairs Council of the EU (ECOFIN) of 2019 where the EU Finance Ministers iterated the need for a commitment of the EU Member States to lay out binding rules and legislative defensive measures. In the Code of Conduct Group it was agreed on measures (although non-binding) such as (a) withholding tax measures, (b) non-deductibility of costs (e.g. including royalties, interest and concessions on intellectual property assets), (c) controlled foreign company rules, (d) administrative measures (reinforced monitoring of certain transactions, increased audit for tax payers) and (e) limitation of participation exemption on profit distribution.

Luxembourg decided to focus on the non-deductibility of costs measure and leave other already existing measures, such as the disclosure of transactions with associated enterprises in blacklisted countries in the tax declaration or the general absence of withholding tax on interest/royalties untouched.

KEY ELEMENTS OF THE NEW PROVISION

Interest and royalties due to associated enterprises established in any of the non-cooperative jurisdictions would not be deductible under certain conditions. Please refer to our client briefing "Luxembourg publishes draft rules to limit the deductibility of payments to blacklisted countries" for further details.

The following changes should be noticed as most significant compared to the Bill:

- *Change in triggering event*. Compared to the language of the Bill, the new Article 168 Nr. 5 Luxembourg Income Tax Law refers only to interest and royalties "due" (in opposite to the Bill that referred in its initial drafting to interest and royalties "paid or due"). Following remarks by the State Council (*Conseil d'Etat*) as so addressed during the legislative process, the language of the provision has been changed. The State Council noted, that the Bill did not specify when it would be necessary to assess whether interest or royalties in question are not deductible, i.e. at the time of their actual payment, at the time of their accrual or even at both times? This could have lead to situations where interest or royalties due before 2021 (but only paid in or after 2021) would have been considered as non-deductible. Such reasoning would however have given the provision a retroactive effect and likely conducted itself *contra legem* the principles of the General Tax Law (Abgabenordnung).
- *The temporal scope has been clarified*. The new provision provides that only the interest and royalties due are targeted (not those already paid). Therefore, the non-retroactivity of the rule is confirmed.
- *The date of application has been changed*. Due to delay in the legislative process, the new provisions apply as of 01 March 2021.

It is worth noting that the new provision apply subject to the restriction that the concerned taxpayer would be in the position to evidence that the payment of interest or royalties is based on genuine commercial reasons, reflecting economic reality.

THE EU BLACKLIST

As amended on 6 October 2020, the EU Blacklist comprises of the following jurisdictions: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands, Vanuatu, Seychelles.

It is worth noting that the Cayman Islands and Oman have been removed from the list by the last modification.

The list will be subject to update twice a year by the Council of the European Union. Thus, the new provision would apply to countries and territories appearing on the list on the first January of each year. However, in case of withdrawal of a jurisdiction which is published in the Official Journal, the limitation rule ceases to apply. It should be kept in mind that for payments made by a Luxembourg tax payer to entities resident in other jurisdictions, the Luxembourg authorities will continue to apply the general principles (e.g. transfer pricing measures, arm's length principle etc.).

CONCLUSION

With the new provisions, Luxembourg has expressed its commitment to the principles advocated by the Code of Conduct Group. For Luxembourg taxpayers, this new provision may lead to a broadened tax base and therefore, specific attention should be given to interest or royalty payments due to restricted jurisdictions.

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