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Overview of corporate tax work

Luxembourg continues to be a global leader as a platform for international business, investment funds and cross-border financing. The importance of economic substance and business purpose for Luxembourg structures remains a particular focal point. Notably, in December 2021, the European Commission ("EC") published its proposed directive aimed at curbing the perceived abusive use of so-called "shell" companies with a focus on minimum substance requirements to avoid adverse tax implications such as refusal of EU Directive or double tax treaty benefits.

Transfer pricing requirements continue to expand along with increased enforcement activities by the Luxembourg tax authorities. Accordingly, transfer pricing has become a central focus of risk management for multinational groups with Luxembourg-based cross-border financing and Alternative Investment Funds ("AIFs") utilising Luxembourg special-purpose vehicles for downstream investments.

Significant deals and themes

With respect to AIFs, the Special Limited Partnership ("SCSp") continues to be the favoured investment vehicle and the Reserve Alternative Investment Fund ("RAIF") continues to be the most popular regulatory regime, while Luxembourg Specialised Investment Funds ("SIFs") and Luxembourg investment companies in risk capital (commonly referred to as "SICARs") are less frequently chosen. With a number of improvements being proposed, European Long-Term Investment Funds ("ELTIFs") are likely to become a favoured investment vehicle if the proposed changes are implemented.

Despite a slower first quarter due to market uncertainties, fund finance deals have remained at a very high level over the past 12 months. Recent months have seen, in particular, a frantic demand for new facility arrangements to be put in place within record time. The cross-border real estate finance market remains very dynamic, with a steady volume of deals compared to last year, while the securitisation market benefits already from the most favourable conditions following the recent modernisation of the Luxembourg law on securitisation (with a significant increase in creation or transformation of securitisation vehicles). Should the uncertainty relating to Anti-Tax Avoidance Directive implementation be lifted in the coming months, the perspective for the Luxembourg securitisation market is very positive.

For multinational corporate groups, the level of M&A activity has steadily risen over the past 12 months and the use of Luxembourg "special-purpose acquisition companies" ("SPACs") continues to grow in transaction volume.

As the COVID-19 pandemic seems to be entering into an indefinite reprieve as of summer 2022, COVID-19-related measures are also set to expire, including the allowances for cross-border workers and special exceptions to corporate governance regarding Luxembourg companies.

Key developments affecting corporate tax law and practice

COVID-19 updates

COVID-19 crisis: Exceptional corporate governance measures for Luxembourg companies

The Grand Ducal Decree of 20 March 2020 introduced temporary exceptional measures to maintain and facilitate the effective ongoing governance of Luxembourg companies overruling the normal requirement for physical board and shareholder meetings.

These emergency measures continue to override anything to the contrary in the Luxembourg Company Law Code (Law of 10 August 1915) as well. The emergency measures also authorise electronic signatures for validating corporate governance documents. At the time of writing, these measures are expected to continue in force until 31 December 2022.

Cross-border workers

As at the time of writing, the Luxembourg government has confirmed extensions of the existing "amical" tax agreements for cross-border workers working remotely from their countries of residence without adverse tax implications for French, German and Belgian resident cross-border workers until 30 June 2022. These amical agreements allow cross-border workers to work remotely from Luxembourg's neighbouring countries without the risk of being taxed locally in their country of residence.

DAC6 updates

Since its enactment in 2020, Luxembourg's DAC6 Law is now being applied generally as an integral part of all new Luxembourg transactions. In terms of new developments, it is worth highlighting that on 5 May 2022, the Luxembourg tax authorities published "frequently asked questions" ("FAQs") on DAC6. Notably in these FAQs, the Luxembourg tax authorities have taken the position that for purposes of Hallmark E.3., a cross-border merger or liquidation that involves a transfer of functions, risk, or assets within the same group and which results in a 50% reduction for the following three years in annual EBIT, compared to if the transaction had not taken place, falls within the scope of Hallmark E.3. The FAQs also clarified that EBIT should be understood to mean the result for the year as found in the Luxembourg statutory accounts plus interest and tax expenses, and that the result is simply defined as the difference between income and expenses as found in the profit and loss account.

Domestic laws and regulations

Luxembourg 2022 Budget Law

We summarise below some of the new corporate tax measures introduced by the Luxembourg Budget Law for 2022 (n°7878):

- Tax credit for hiring unemployed persons will be extended until 31 December 2023.
- Since 1 January 2021, UK companies are removed from any tax provisions of the Luxembourg Income Tax Law ("LITL") referring to EU Member State companies (i.e. Annex of Article 166 (10) LITL and §60 of the Luxembourg Valuation Law).
- A definition of the concept of "consolidated group for financial accounting purposes", based on the definition provided by Directive (EU) 2017/952 of 29 May 2017 ("ATAD II"), has been introduced for the purpose of Article 164*bis* LITL (tax consolidation) and Article 168*bis* LITL (interest deduction limitation rule).

- Under the Controlled Foreign Company ("CFC") rules, income initially included under the CFC rules in Luxembourg is disregarded for municipal business tax purposes. Conversely, the amount exempted for corporate income tax purposes upon effective distribution or disposal of the CFC should be added back for municipal business tax purposes to ensure tax neutrality.
- Tax rates for direct or indirect tax purposes remain unchanged.

New guidance on tax fraud procedures and fines

On 28 July 2021, the Luxembourg Tax Administration ("LTA") published a circular detailing guidance on procedures and penalties with respect to both civil and criminal tax offences. The circular lists various classes of offences, including "administrative" violations such as incomplete filing of tax returns, tax fraud, and involuntary tax fraud, as well as "criminal" offences such as aggravated tax fraud and intentional tax fraud. The various administrative and criminal punishments range from fines of 5% to 25% of the avoided taxes in the case of incomplete tax return filings, and up to five years in prison and fines of up to EUR 25,000 or 10% of the avoided tax in the case of intentional tax fraud. It also clarifies the procedure and cooperation for ongoing investigations between the LTA and the state prosecutor's office.

Updated third tax circular on the interest limitation rules

On 28 July 2021, the LTA published the third Grand Ducal Circular on interest limitation rules, which contains a new section 6.2 on the requirements for applying the equity escape clause to Luxembourg entities within a fiscally consolidated group. The equity escape clause generally allows the deduction of exceeding borrowing costs (even if in excess of the 30% of EBITDA limitation) provided that the equity over total assets ratio of the Luxembourg entity is equal to or higher than the comparable group ratio and that the Luxembourg entity is a member of a consolidated financial accounting group. It is worth highlighting that most of the other details in the equity escape clause were already provided for in the earlier circular dated 2 June 2018.

New Luxembourg tax circular on loss carry-forwards

On 31 August 2021, the LTA published a Grand Ducal Circular detailing guidance on tax loss carry-forward rules, which replaces the earlier 1991 circular on loss carry-forwards. Under current tax law, loss carry-forwards are generally limited to 17 years, while losses incurred prior to 31 December 2016 generally have no limitation. The circular clarifies the ordering of loss utilisation. For example, losses subject to an indefinite carry-forward, i.e. prior to 31 December 2016, are to be offset before losses limited to the 17-year carry-forward rule. It also details the mechanics for calculating tax losses and elaborates on the other requirements necessary to utilise the loss carry-forwards in future years.

Luxembourg: New one-time tax reporting obligation for investment vehicles

On 20 January 2022, the Luxembourg tax authorities issued a tax circular clarifying the reporting obligations for certain Luxembourg investment vehicles in corporate form. This reporting is part of Luxembourg's new regime that imposes a 20% levy on income and gains derived, directly or indirectly, from real estate located in Luxembourg, effective since 1 January 2021.

All Luxembourg-exempt alternative investment vehicles in corporate form were generally required to file a one-time reporting obligation by 31 May 2022. These vehicles had to file regardless of whether they held, directly or indirectly, Luxembourg real estate during 2020 or 2021. Failure to comply with this one-time reporting obligation triggered possible penalties of up to EUR 10,000.

Interest limitation rules extended to EU-regulated Luxembourg SSPEs

On 9 March 2022, the Luxembourg Parliament published a draft law, which proposes to revoke an exemption available for EU-regulated Luxembourg securitisation special-purpose entities ("SSPEs") from Luxembourg's interest limitation rules ("ILRs"). The draft law is expected to enter into force as of 1 January 2023. Once enacted, these Luxembourg SSPEs will be subject to the ILRs and may be at risk of increasing their Luxembourg corporate tax exposure, in light of potential deductibility limitations on payments made to investors. The draft law stems from a formal notice letter sent by the EC in 2020 advising Luxembourg to remove the ILR exemption applicable to SSPEs.

Luxembourg tax authorities release new circular on defensive measures against the EU list of non-cooperative tax jurisdictions

On 31 May 2022, the LTA issued a Grand Ducal Circular providing further guidance on the application of the "defensive measure" law, which disallows the tax deductibility of interest and royalties payable to related corporate entities located in the EU's list of non-cooperative jurisdictions for tax purposes. The circular clarifies the definitions of interest and royalties for purposes of applying the defensive measure. Interest is to be interpreted quite broadly and can include interest of any nature, including in arrears (e.g. from original issue discount paid at maturity), while the definition of royalties is aligned with the right to use or exploit any type of intellectual property ("IP") (also broadly defined). The circular clarifies that the disallowance of deductibility is based on when such deduction accrues and not on actual payment, which means that such interest and royalties accrue before the enactment of the defensive measure. The EU's list of non-cooperative jurisdictions for tax purposes is generally updated bi-annually and currently includes American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, the US Virgin Islands and Vanuatu.

<u>Domestic cases and litigation</u>

Luxembourg court upholds variable interest charge on profit participating loan

On 13 July 2021, the Luxembourg Tribunal overturned an assessment by the Luxembourg tax authorities that recharacterised a portion of the profit-linked variable interest on a profit participating loan ("PPL"), issued by a Luxembourg company, as dividends and subject to 15% withholding tax. Previously, the LTA had entered into a binding Luxembourg tax ruling with the Luxembourg company, which provided that the profit-linked interest would be respected provided such interest was at arm's length pursuant to transfer pricing principles. The LTA issued an assessment recharacterising a part of the variable profits as a hidden dividend, especially, they argued, when taking into account that the terms of PPL resulted in substantially all the profits of the Luxembourg company being paid out and leaving only *de minimis* profits for equity holders. Based on these arguments, the LTA denied a portion of the profit-linked interest expense and imposed a 15% withholding tax on dividends on such amount. The Luxembourg company, however, produced a fixed interest rate benchmark study that demonstrated that the annual variable interest rates at the heart of the controversy were still within the benchmark study's ranges and thus within the terms and conditions of the Luxembourg tax ruling.

The court sided with the Luxembourg taxpayer that the PPL's profit-linked interest payments were still within the range of the fixed interest rate benchmark study and thus compliant with the terms and conditions of the Luxembourg tax ruling. The case is especially relevant today as it affirms that the variable yield on a PPL can be equated from a transfer pricing point of view to a range of fixed interest rates and underlines the growing importance that the LTA places on robust transfer pricing documentation.

Luxembourg court rules on additional paid-in capital (Account 115) regarding Luxembourg's participation exemption

On 31 March 2022, the Luxembourg Administrative Court ruled that additional paid-in capital, commonly referred to as "Account 115" under Luxembourg GAAP nomenclature, is not taken into account for purposes of calculating the minimum holding requirements of EUR 1.2 million as one of the requirements for Luxembourg's domestic withholding tax on dividends exemption. In the case at hand, the Account 115 amounts in question related to subsequent contributions by the shareholder that were not part of the initial costs in acquiring the shares under dispute.

Under Luxembourg's domestic withholding tax on dividends exemption regime, one of the requirements is that the corporate shareholder of the distributing Luxembourg company must own at least 10% of the issued share capital or have an acquisition value of EUR 1.2 million in such company. In the case at hand, the corporate shareholder held under 10% of the Luxembourg company's share capital and so was relying on the EUR 1.2 million acquisition value condition being fulfilled. However, the bulk of the value of the corporate shareholder's contributions totalling EUR 1.2 million had been allocated to the Luxembourg company's Account 115 rather than the issuance of shares.

The Luxembourg court upheld the lower Tribunal's earlier decision siding with the LTA that for purposes of acquisition costs, the portion of the EUR 1.2 million allocated against Account 115 could not be taken into account for calculating this minimum threshold. Notably, the court elaborated that only expenses related to the increases in shares could be taken into account and the contributions by the corporate shareholder to the Account 115 neither provided new shares nor increased the value of the shares held by the corporate shareholder.

This case highlights the importance now that taxpayers who had been relying on Account 115 to meet minimum acquisition values (e.g. EUR 1.2 million for withholding tax on dividends and dividends received exemption, as well as the EUR 6 million on capital gains exemption) should revaluate their position to assure that such minimum amounts are properly reallocated to actual shares or possibly also share premium. Conversely, arguments may still be possible that Account 115 issued as part of the initial share acquisition could still be taken into account for "acquisition cost" purposes, unlike the case at hand where the Account 115 contributions in question occurred after the shares had been acquired by the corporate shareholder.

Luxembourg court rules that MRPS are equity for Luxembourg tax purposes (hybrid instruments)

On 31 March 2022, a Luxembourg court rendered another decision related to mandatory redeemable preferred shares ("MRPS") where the Luxembourg tax authorities refused their debt qualification for income and net wealth tax purposes. The court applied a "substance over form" approach in determining whether the MRPS were equity or debt for Luxembourg tax purposes. The court cited multiple factual reasons why the MRPS should have equity and not the debt treatment sought by the taxpayer, including that the overwhelming characteristics of the MRPS were equity-like, that the MRPS subscriber and the sole shareholder were the same person, and that the MRPS arose out of equity accounts pursuant to a recapitulation giving rise to new equity instruments. The court also concluded in favour of the equity as the taxpayer had failed to demonstrate that the MRPS were issued for any other reason besides pure tax purposes.

This case, which focused on the hybrid analysis (debt *vs* equity) of the MRPS, demonstrates that use of hybrid instruments may increasingly become the focus of tax litigation and scrutiny by the Luxembourg tax authorities.

Tax treaty updates

New protocol to amend the UK-Luxembourg double tax treaty

On 7 June 2022, the UK and Luxembourg signed a new protocol amending the existing double tax treaty ("New Lux-UK Treaty"), which contains a substantial number of changes to the existing double tax treaty and will impact real estate investments and withholding tax rates.

The New Lux-UK Treaty allows UK (or, if applicable, Luxembourg) taxation rights on the sale of shares (or similar equity rights) on entities that derive more than 50% of their value directly or indirectly from real estate in the jurisdiction in which the real estate is located. In practice, this means that Luxembourg residents disposing of a UK "real estate-rich" entity will be potentially subject to UK capital gains under UK domestic law, if applicable. Prior to the new protocol, Luxembourg residents were protected from such potential UK non-resident capital gains.

The New Lux-UK Treaty will generally introduce a new 0% withholding tax (compared to the actual 5%) for dividends paid from Luxembourg to a UK shareholder (the UK does not levy withholding tax on dividends) who is the beneficial owner of those dividends. This measure is particularly interesting in light of Brexit, which removed UK companies from benefitting from the withholding tax on dividends exemption pursuant to the EU's Parent Subsidiary Directive. However, the zero rate may not be applicable to certain dividends or other distributions derived from UK real estate, which is generally applied at a 15% rate (some exceptions apply including pension funds).

The New Lux-UK Treaty's rate for withholding tax on royalties is now reduced to 0% (down from the actual 5%) and the withholding tax rate on interest remains unchanged at 0% as well.

Lastly, it is worth highlighting that the New Lux-UK Treaty contains a standard "principal purpose test" ("PPT") consistent with the OECD's Multilateral Instrument ("MLI") for purposes of anti-abuse for treaty shopping.

Other tax treaty developments

As of 31 May 2021, Luxembourg's tax treaty network has expanded to include 85 double tax treaties in force. Notably, since July 2021, the following new tax treaties and protocols have come into force: Belgium; Botswana; and Kuwait. Additionally, the following tax treaties have been signed since our last update in June 2021 but are not yet in force: Cabo Verde; Colombia; Ethiopia; and Rwanda.

OECD and EU developments

OECD Model GloBE Rules and the EC's proposed directive on GloBE Rules

On 20 December 2021, the OECD published its long-awaited rules regarding the OECD's Pillar 2, which are aimed at assuring that multinational enterprises ("MNEs") will be globally subject to a minimum 15% tax rate as from 2023 ("GloBE Rules"). Two days later on 22 December 2021, the EC also published a proposal for a directive applying the OECD GloBE Rules for EU Member States ("Proposed GloBE Directive"). The GloBE Rules are part of the OECD/G20 Inclusive Framework on BEPS, which currently has 141 participating countries. The EC's proposed GloBE Rules are quite similar to the OECD version, with some changes focusing particularly on compatibility with EU law.

On 12 March 2022, an amended draft of the Proposed GloBE Directive was published, which contained several amendments to the GloBE Rules and, in particular, delayed the proposed directive by one year from the original date to 31 December 2023 for implementation of the IIR and 31 December 2024 for the UTPR (as defined and elaborated on further below).

Generally speaking, the GloBE Rules provide for a coordinated system of taxation aimed at large MNE Groups to pay a minimum level of tax on income derived from every jurisdiction in which they operate. The rules create a "top-up tax" to be applied on profits on a jurisdictional basis whenever the effective tax rate ("ETR") is below the minimum 15% rate.

The GloBE Rules are aimed at MNEs that had at least EUR 750 million in annual revenue in at least two of the preceding four years. The OECD defines an MNE Group as when there is at least one group entity or permanent establishment located in a different jurisdiction than the "Ultimate Parent Entity" and which is taken into account in the consolidated accounts of the Ultimate Parent Entity. The EC's proposal follows the same definition of an MNE Group but expands the definition to include purely "large-scale domestic groups" in order to comply with the EU fundamental freedom of establishment.

The GloBE Rules' principal enforcement is by applying a top-up tax via the Income Inclusion Rule ("IIR") and the Undertaxed Payment Rule ("UTPR"). The IIR imposes a top-up tax on the Parent Entity with respect to the low-taxed income of group entities (referred to as "Constituent Entities"). The IIR is generally applied on a top-down basis with the aim of imposing the IIR at the top of the MNE Group, which would normally be the Ultimate Parent Entity, but can also be applied to "Intermediate Parent Entities" as well as "Partially Owned Parent Entities".

The UTPR acts as a backstop to the IIR when an entity with low-taxed income is not brought into the IIR going up the ownership chain, such as, for example, when the Ultimate Parent Entity is located in a low-tax jurisdiction with no IIR in its local tax laws. The UTPR requires an adjustment at the lower group entity's level (such as denial of deduction) that results in an increase in the tax liability of the subsidiary to achieve the minimum 15% tax rate.

The EC's proposal also references the Subject to Tax Rule ("STTR"), which is a treaty-based rule enabling source jurisdictions to impose taxation on certain related party payments that are subject to below the minimum tax rate. However, the EC's proposal does not address the STTR as this is for jurisdictions to implement individually.

Both the OECD and the EC's GloBE Rules provide exemptions for the following "excluded entities" (non-exhaustive list): government entities; international organisations; non-profit organisations; investment entities; and real estate investment vehicles that are the Ultimate Parent Entities within an MNE.

The GloBE Rules provide carve-outs and exceptions for jurisdictions where real economic activities are carried out, and for jurisdictions with revenue below EUR 10 million and average profits less than EUR 1 million and shipping income.

The GloBE Rules should mainly have an impact on large MNE Groups, which have low-taxed subsidiaries or Ultimate Parent Entities. However, the GloBE Rules should not have much impact specifically on holding companies or intragroup financing activities of Constituent Entities within an MNE Group.

Holding companies should generally be outside the risk of being "low tax", as the Pillar 2 rules provide for the exclusion of dividends and equity gains of group subsidiaries from the accounting profits for purposes of calculating the ETR of Constituent Entities. Accordingly, EU-based holding companies benefitting from the participation exemption should generally

not be impacted. Similarly, Constituent Entities engaged in cross-border financing, even within a large MNE Group, should not be impacted by the GloBE Rules (although other anti-abuse mechanisms, such as transfer pricing, will continue to be applicable).

ATAD 3: the Proposed Unshell Directive

On 22 December 2021, the EC published a proposed directive intended to prevent the misuse of so-called "shell" entities for tax purposes. The proposed directive has been described as the "Unshell Directive" ("Proposed Unshell Directive"). The new proposals are aimed at entities that do not maintain sufficient substance within the EU. Entities that do not satisfy minimum substance requirements are subject to additional reporting requirements. In such case, they will be unable to access tax relief and benefits of double tax treaties and EU Directives. Significantly, other EU countries, such as those paying to the entity, or those in which shareholders are resident, may be entitled to impose tax on the income of the entity.

While the initial target date for implementation of the Proposed Unshell Directive is scheduled for 1 January 2024, the European Parliament recently published a Draft Report on the Unshell Directive, which called for a delayed implementation date of 1 January 2025 as well as other proposed changes to the wording of the proposed directive. At the time of writing, it is anticipated that an updated version of this proposed directive is forthcoming; however, whether it will ultimately be approved remains to be seen.

An entity will be within scope if it satisfies each of the three "gateway" tests, which include whether:

1. the entity derives more than 75% of its income from sources defined as "relevant income". Relevant income includes typical "passive" income such as dividends, bonds and interest;
2. the entity is engaged in cross-border activity such that more than 60% of its assets or income is earned or paid out of cross-border transactions; and
3. in the preceding two years, the entity has outsourced the administration of its day-to-day operations and decision-making on significant functions.

Once an entity meets all three gateway tests, it becomes subject to a reporting obligation, which will add to the compliance burden. It will also be subject to automatic exchange of information provisions. The entity is then required to report on certain "substance" characteristics in its tax return to its Member State of residence. The substance requirements that an entity must show are that:

1. it has its own premises, or premises for its exclusive use, in the Member State;
2. it has at least one own and active bank account in the EU; and
3. (i) it has at least one director with the appropriate qualifications and decision-making authority who is not an employee of an unaffiliated entity and does not act as a director of unaffiliated entities and who is resident in or near the Member State of residence of the entity; and/or (ii) the majority of employees of the entity are resident in or near the Member State of residence of the entity.

Certain entities are excluded from the new rules. Excluded entities include (non-exhaustive list): listed companies; AIFs; credit institutions; UCITS; and EU-regulated securitisation vehicles. Once an undertaking is presumed to be a "shell" for the purposes of the directive, and does not rebut such presumption, certain tax consequences can apply, including the denial of the issuance of a tax residency (or tainted residency) certificate, potential fines on the revenue of the shell entity, and denial of EU Directives or otherwise applicable tax treaties with other EU Member States (resulting in potentially higher withholding taxes and other adverse tax consequences).

Nike loses appeal to annul EC investigation into Dutch tax ruling State Aid case

On 14 July 2021, the European Court of Justice ("ECJ") dismissed a motion by Nike to suppress the EC's 2019 investigation into several advance pricing agreements ("APAs") obtained between the Dutch tax authorities and Nike's Dutch subsidiaries involving tax-deductible royalty payments to other Nike entities with minimum economic substance and low-to-zero taxation rates. The EC asserted that the royalties paid on IP rights held by Nike Group Dutch CVs (both Dutch tax-transparent limited partnerships not subject to tax in the Netherlands) constituted unfair State Aid by not reflecting arm's length prices. Pursuant to the APAs, the EC argued that the agreed transfer pricing methodology of the net margin method was inappropriate and resulted in substantially greater tax-deductible royalties than if the more appropriate profit-split method had been applied. Additionally, the EC's argument focused on the fact that both NEON and CN had substantial economic substance including over 1,000 employees and were involved with the development and management of the IP in question, whereas the Nike Dutch CVs had no employees and no economic activity. This case illustrates the EC's focus on APAs and whether, under transfer pricing principles, the positions in these are actually supported by corresponding robust economic substance.

ECJ rules that Belgium's excess profits ruling constitute State Aid

On 16 September 2021, the ECJ overturned the General Court's 2019 findings by ruling that Belgium's excess profits ruling regime constituted illegal State Aid for more than 50 large multinationals benefitting from the regime. Belgium's excess profits regime allowed multinationals to obtain a Belgian tax ruling that the profits earned by the multinational group's Belgian company were in excess of what a standalone entity would make on such activities. The excess profits ruling resulted in exemptions ranging between 50% to 90% of the taxable profits earned by the multinational's Belgian subsidiary.

A particular takeaway from this State Aid case involving the Belgian excess profits regime is to be wary of EU Member State regimes that derive from norms of transfer pricing. In the case of the Belgian excess profits regime, the Belgian tax authorities systematically granted downward adjustments in taxable profits based on transfer pricing (normally tax authorities apply transfer pricing principles to increase, not decrease, taxable profits).

Italian Supreme Court case affirms Luxembourg holding company benefits from withholding tax on interest exemption

On 3 February 2022, the Italian Supreme Court ruled that a Luxembourg holding company engaged in back-to-back intragroup financing benefitted from an applicable Italian withholding tax exemption pursuant to the EU interest and royalty directive, thus overturning the Italian tax authorities' position that the entity was a mere conduit entity and subject to a 12.5% withholding tax rate without the exemption. The court held that the Luxembourg company was the beneficial owner of the interest payments in question pursuant to an application of Article 11 of the OECD's Model Tax Convention and thus entitled to the exemption. The court listed strong economic substance factors for reaching this conclusion, including that the company had existed for over 50 years, had a real operational structure (not a mere "empty box"), had earned over EUR 8 million in profits during the tax year in question, and had the power to dispose of the sums in question (no contractual link of repayment).

Canadian Supreme Court affirms Luxembourg-Canada tax treaty benefits

On 26 November 2021, the Supreme Court of Canada affirmed the availability of benefits under the Luxembourg-Canada tax treaty then in force by overturning the Canadian tax

authorities' position that the treaty was not applicable pursuant to Canada's domestic general anti-avoidance rule applicable to tax treaties. The Canadian tax authorities also cited that the Luxembourg holding company had engaged in treaty shopping and had insufficient economic substance and business purpose (i.e. beyond tax planning). The majority opinion highlighted that the facts arose prior to the implementation of the OECD's MLI and its PPT. If the same case were to arise now, the outcome could be substantially different. The PPT denies a treaty benefit where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction in question was to gain the benefit, unless it is established that granting that benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

The year ahead

As we have already witnessed during 2022, Luxembourg and other EU Member State tax authorities continue to focus their attention on beneficial ownership, economic substance and business purpose with respect to cross-border structures and financing arrangements. Transfer pricing especially continues to be the dominate focus of the Luxembourg's tax authorities tax audits. Prudent international tax planning should therefore include a high-priority focus on such aspects.

DAC6 has now become an integral part of the initial planning of any international corporate, investment or financing structure to assess what mandatory reporting obligations could be applicable.

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Mergers & Acquisitions
Pricing & Reimbursement

GLI GLOBAL LEGAL INSIGHTS