

Denial of Tax Deduction on Interest and Royalties to EU Non-Cooperative Tax Jurisdictions

On 30 March 2020, a draft law¹ was submitted to the Luxembourg Parliament that will disallow the tax deductibility of interest and royalties paid to related entities located in the EU's list of Non-Cooperative Jurisdictions for Tax Purposes. The new law is proposed to enter into force as of 1 January 2021.

The Cayman Islands is expected to be removed from the list at ECOFIN's next meeting in October 2020 and thus should not be impacted by this draft law, given its 2021 effective date.

The New Proposed Luxembourg Measure

The Luxembourg Finance Minister, Pierre Gramegna, submitted draft legislation (*projet de loi 1747*) to Parliament that provides for the disallowance of interest and or royalty expenses paid to a related person located in one of the countries listed on the European Council of Economic and Financial Affairs ("ECOFIN")'s Annex I List of Non-Cooperative Jurisdictions for Tax Purposes ("Annex I Jurisdictions").²

The Details of the Draft Law

The draft law proposes a new section (Article 168.5) to be added to the Luxembourg tax code. This new section will disallow the

deduction of interest and royalties for tax purposes if the following conditions are fulfilled:

- (a) the beneficial owner is an entity ("organism with collective character");
- (b) the entity is a related party; and
- (c) the entity is established in an Annex I Jurisdiction.

Both interest and royalties are broadly defined in the draft law. Interest includes any payments regarding all types of debt. Specific examples mentioned in the draft law include late payment penalties and interest payments linked to profitability. Likewise, royalties broadly encompass any payment for the use or the right to use a wide spectrum of intellectual property rights such as artistic copyrights, know-how, trade secrets, marketing intangibles, and patents.

The draft law specifically excludes related party transactions that have valid commercial reasons and reflect economic reality - subject to the taxpayer providing proof.

Corporate Entities vs. Partnerships

The draft law only applies to payments to related entities that include such legal forms as corporations, limited liability companies, mutual

¹<https://www.chd.lu/wps/portal/public/Accueil/TravailALaChambre/Recherche/RoleDesAffaires?action=doDocpaDetails&backto=/wps/portal/public/Accueil/Actualite&id=7547>

² The Economic and Financial Affairs Council ("ECOFIN")'s Annex I: EU List of Non-Cooperative Jurisdictions for Tax Purposes, Outcome of Proceedings, 18 February 2020.

assurance associations, and non-profit associations.

The draft law excludes from the scope of application payments to tax transparent entities, such as limited partnerships, and thus implies a look through rule for determining beneficial ownership with respect to payments to transparent entities.

For example, payments to a limited partnership, located in an Annex I jurisdiction should not be within the scope of this rule. However, the denial of an interest or royalty deduction might still apply to the pro-rated share of such payment to a limited partner, which is a related corporate entity in an Annex I Jurisdiction.

Related Party Transactions

'Related entity', as defined in the draft law, refers specifically to Luxembourg's tax law on transfer pricing which broadly defines the concept to include the following situations:

- (a) when one enterprise participates directly or indirectly in the control or capital of another enterprise;
- (b) when the same persons participate, directly or indirectly, in the control or capital of two enterprises; or
- (c) when two enterprises have transactions or relationships that are not consistent with those of independent enterprises.

Periodic Updating of the Annex I Jurisdictions

The draft law should be applicable only to those jurisdictions still officially listed on Annex I as of 1 January 2021. The current list is expected to be updated at the next ECOFIN meeting in October 2020. Looking to the future, the list should be updated annually by the Luxembourg government based on future ECOFIN decisions to remove or add jurisdictions to the list, as the case may be, on a rolling basis.

Impact on Transactions with the Cayman Islands

The draft law is only expected to enter into force in 2021 and thus should not impact any interest or royalties paid to Cayman Islands corporate entities. We highlight that the Cayman Islands expects to be assessed as fully compliant and removed from the list of Annex I Jurisdictions when ECOFIN next reviews the list in October 2020.

By way of background, on 18 February 2020, the ECOFIN resolved to move the Cayman Islands to the Annex I as it "...does not have appropriate measures in place relating to economic substance in the area of collective investment vehicles..."³

However, the Cayman Islands Government's statement, in response pointed out that; (i) the jurisdiction passed the necessary investment funds legislation on 31 January 2020, which came into force on 7 February 2020, (ii) the Cayman Islands has been fully co-operative with the EU's requests and (iii) the Cayman Islands remains fully committed to co-operating with the EU and will continue to constructively engage with them with the view to being delisted as soon as possible.

One of Four Measures

Luxembourg is proposing this draft law in light of recommendations by the ECOFIN to implement at least one of four proposed so-called 'defensive measures' against jurisdictions in Annex I. The ECOFIN has recommended that each EU Member State adapt its choice of defensive measures as from 1 January 2021. These measures include:

- (a) non-deductibility of costs paid from an EU resident company to a person in an Annex I jurisdiction;
- (b) application of controlled foreign company ("CFC") rules requiring current inclusion of the undistributed

³ <https://maples.com/en/Knowledge-Centre/Industry-Updates/2020/02/Cayman-Islands-and-the-EU-List-of-Non-Cooperative-Tax-Jurisdictions>

profits of subsidiaries located in an Annex I jurisdiction;

- (c) imposition of higher withholding taxes on payments received in an Annex I jurisdiction; or
- (d) more stringent limitations of any participation exemption benefits with respect to profits distributed from an entity located in an Annex I jurisdiction.

Luxembourg has opted for the first measure regarding denial of costs.

For advice as to how this law may affect current structures with Luxembourg and the Cayman Islands, please liaise with your usual Maples Group contact or:

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