

LUXEMBOURG

OUTLINE

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PART II. THE AGREEMENT.....XV

ANNEX XVI

LIST OF ABBREVIATIONS

Agreement	Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments
Directive	Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payment made between associated companies of different Member States
ISF	<i>Impôt sur la fortune</i> (Luxembourg Net Wealth Tax Code)
LIR	<i>L'impôt sur le revenu</i> (Luxembourg Income Tax Code)
Merger Directive	Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States
OECD	Organization for Economic Cooperation and Development
OECD MC	OECD Model Tax Convention 2003
Parent-Subsidiary Directive	Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States
Savings Directive	Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments
StAnpG	<i>Steueranpassungsgesetz</i> (Tax Adaptation Law)



LIST OF LEGAL REFERENCES

Laws

- Law 5232 of 9 July 2004 to modify certain provisions of the income tax law of 4 December 1967 and to modify the law on the valuation of goods and securities of 16 October 1934, Memorial A of 9 July 2004, 1878.
- Law of 21 June 2005 on the ratification of various Savings Agreements, Memorial A of 22 June 2005.

Decree

- Grand Decree of 21 December 2004 to modify the Grand Decree of 26 May 1979 on the application of Art. 134bis (3)(f).

Parliamentary Documents

- Projet de loi, no. 5232, Chambre Des Deputes, Session Ordinaire 2003-2004.

PART I. IMPLEMENTATION OF THE DIRECTIVE

1. INTRODUCTION

1.1. GENERAL INFORMATION ON THE IMPLEMENTATION OF THE DIRECTIVE

The Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payment made between associated companies of different Member States (the "Directive") was implemented into Luxembourg legislation by law of 9 July 2004 and a decree of 21 December 2004, which applies retroactively as from 1 January 2004 (Law of 9 July to modify certain provisions of the income tax law of 4 December 1967, as amended, and to modify the law on the valuation of goods and securities of 16 October 1934, as amended, and a Decree of 21 December 2004 modifying the decree of 26 May 1979 on the application of the withholding taxes (Art. 134bis (3), letter f LIR)).

The implementation of the Directive was only required to a limited extent since under Luxembourg domestic law no withholding tax was levied on most types of interest. Royalties were subject to a 10% withholding tax but this withholding tax was abolished when implementing the Directive. The exemption now applies to any person, resident or non-resident, individual or a company.

This abolition was based on the following arguments:

- most beneficial owners of royalties are resident in another EU Member State;
- it furthers the development of new technologies; and
- the abolition is a line with the policy laid down in Art. 12 of the OECD MC that royalties should be taxable in the state of residence.

Articles 152 and 156(7) LIR were amended to provide for this exemption. Pursuant to the abolition of the withholding tax on royalties, also the net wealth tax was amended, providing for an exemption for royalties (Art. 77 ISF). In this context, it must be noted that on 19 October 2005 a bill was presented to parliament, which, inter alia, provides for an abolition of the net wealth tax for individuals.

A withholding tax is only levied on interest on profit participations received by moneylenders, interest received for arrears and interest obligations, which next to a fixed interest entitle the beneficiary to a variable interest compensation depending on the distributed profits and interest on mortgage debts inscribed in the Luxembourg mortgage register.

1.2. TAX TREATMENT OF INTEREST AND ROYALTY PAYMENTS UNDER GENERAL TAX LAW

1.2.1. Domestic rules

a. Tax treatment at the level of the paying company

Deduction of interest and royalty payments

In general, interest payments on loans, bonds, debentures and other debts of the company are fully deductible as normal business expenses. Particular legal provisions, however, deny the deduction of interest in a number of situations.

Interest relating to derived exempt income is not deductible to the extent of the exempt income derived during the same year (Art. 45(2) LIR). For example, interest paid during a year on a loan contracted to acquire a shareholding that qualifies for the participation exemption is only deductible to the extent it exceeds the amount of the exempt dividends derived from this shareholding during the same year.

Royalty payments are fully deductible as normal business expenses, provided that they do not constitute a hidden profit distribution or are in conflict with the arm's length principle.

The deduction of interest and royalties can be denied under a general anti-abuse provision, which provides that legal forms and "construction possibilities" in civil law may not be abused for the purpose of tax avoidance (Art. 6 StAnpG). If the legal form or the construction surrounding a transaction is not appropriate in terms of its substance, tax will be assessed in accordance with the substance of the transaction as if it had been concluded in the appropriate legal form.

Luxembourg has no general thin capitalization rules. Nevertheless, interest payments may be regarded as hidden profit distributions if the lending company is a shareholder of the borrowing company. In practice, the tax administration applies a debt to equity ratio of 85:15 for the holding of participations.

b. Tax treatment at the level of the beneficiary company

Interest or royalty income derived by resident companies is subject to corporate income tax under standard rules (Art. 14 LIR). As a general rule, interest and royalties paid to resident companies are not subject to withholding tax.

Luxembourg does not levy a withholding tax on outbound interest and royalties.

c. Transfer pricing

Luxembourg tax law does not contain transfer pricing provisions, but the arm's length principle applies to transactions between related parties. If the arm's length principle is not met the profits will be readjusted, unless the company making the transfer proves that the transaction was based on sound business reasons, for example to protect a market position.

In case of an adjustment a hidden profit distribution is deemed to be made, which is defined as an advantage granted, whether directly or indirectly, to a person due to his position as a shareholder or an interested person, e.g. a sister company (Art. 164(3) LIR). The following transactions may, inter alia, be classified as hidden profit distributions (Art. 164(3) LIR):

- increased or reduced buying or selling prices;
- loans made to shareholders either free of interest or at an unreasonably low rate of interest, or loans given without the intention of repayment;
- loans from shareholders at an unreasonably high rate of interest; and
- loans to shareholders at an unreasonably low rate of interest.

The distributing company may not deduct the amount of the hidden distribution from its taxable income. If any advantage is granted at a too low price, the difference between the arm's length price and the price charged is added to the taxable income. The reintegration of the transferred amount to the taxable base is made by reference to the data provided by the reassessed company or, if no data are available by reference to comparable market transactions.

d. Constructive dividend distribution rules

Payments made by a Luxembourg company or a Luxembourg permanent establishment of a foreign company to another resident or non-resident related company, which are not at arm's length, may be treated as a constructive distribution. This means that the distribution is subject to dividend withholding tax of 20%, unless reduced under any relevant tax treaty or unless the requirements of the EC Parent-Subsidiary Directive are met (Art. 149(1) LIR). Under Luxembourg tax treaties the withholding tax on dividends is normally 15%. If the distributing company has not withheld the 20% tax on an amount distributed, it is deemed to have borne the tax. In such a case, the rate of the withholding tax is increased to 25% (Art. 148 LIR). The application of this higher rate can be avoided if the distributing company subsequently obtains from the shareholder a reimbursement of the 20% withholding tax that should have been withheld.

The Luxembourg company receiving the hidden distribution must include the advantage in its taxable income. Any tax withheld is deductible against final income tax. However, an adjustment at the recipient level will not be made if the hidden profit distribution was received in connection with shares for which the participation exemption applies.

1.2.2. Treaties

Prior to the implementation of the Directive, interest flows to a non-resident company were generally exempt as Luxembourg did not levy a withholding tax on interest. The tax treatment of royalties was dependent on the tax treaty between Luxembourg and the treaty country. The law on the implementation of the Directive generally abolished the 10% withholding tax on royalties.

Luxembourg has a tax treaty with all EU Member States except Cyprus, Estonia, Latvia and Lithuania (see Annex). In 2004 tax treaties were signed with Latvia and Lithuania, but those treaties are not yet ratified. All tax treaties cover interest and royalty payments. The list of treaties set out in the Annex is mainly for the purpose of indicating the rates of the withholding taxes that Luxembourg would, in principle, be free to impose, pursuant to those treaties, on outbound interests and royalties.

a. Interest

The withholding tax rate on interest under the treaties with the other EU Member States varies from 5% to 15%. However, the treaties with the Czech Republic, Denmark, Finland, Germany, Hungary, Ireland, Malta, Slovak Republic, Sweden and United Kingdom provide for exclusive taxation in the state of residence.

Interest from profit sharing bonds is classified as a dividend under the treaty with the Netherlands.

Avoidance of double taxation is achieved via a credit method.

b. Royalties

The withholding tax rate on interest under the treaties with the other EU Member States varies from 5% to 10%. Avoidance of double taxation is achieved via a credit method.

2. SCOPE

2.1. PAYMENTS

2.1.1. Concept of interest

a. Definition

Luxembourg tax law defines various categories of interest subject to income tax and corporate income tax in Art. 97(3)-(5) LIR, which include:

- interest on bonds and similar values including profit shares and repayment premiums;
- interest on debt claims secured by registration in the mortgage register; and
- interest on debt-claims such as loans, funds, contributions, deposits, and current accounts.

The Luxembourg domestic definition of interest includes the categories mentioned in Art. 2 (a) of the Directive. Furthermore, the law on the implementation of the Directive provided that mortgage interest paid to non-residents is no longer subject to tax.

b. Exclusion of hybrid financial arrangements (Art. 4(1) b-d))

Interest on certain profit-participating bonds and on securities, which next to a fixed interest compensation provide for a profit-linked interest compensation, continues to be subject to a 20% dividend withholding tax (Art. 146 (1)(3) LIR), which is authorized by Art. 4 (1) b) of the Directive.

c. Exclusion of interest reclassified as a profit distribution or conflicting arm's length (Art. 4(1)(a) and Art. 4(2)).

Non-deductible interest is treated as a constructive distribution under the transfer pricing rules (see Introduction, 1.2.1. *c. Transfer pricing*). Disallowed interest is re-characterized as a dividend and subject to the 20% dividend withholding tax. This rate may be reduced under the applicable tax treaty. The dividend may be reduced or exempt under any applicable tax treaty or if the requirements of the Parent-Subsidiary Directive are met, as the case may be.

2.1.2. Concept of royalties

a. Definition

Luxembourg tax law mentions various categories of royalties in Art. 98(3) LIR. The definition includes a consideration for the use or the right to use any copyright of literary, artistic or scientific work, including cinematographic films, patents, design or model, trade mark, secret formula or process or another similar right, the use or the right to use industrial, commercial or scientific equipment and information concerning industrial, commercial or scientific experience.

This definition is similar to the definition of Art. 2(b) of the Directive except for the fact that software payments are not covered.

b. Classification of revenue from leasing and software

Under Luxembourg domestic law income from leasing and software is treated as business income or royalties. However, it is not part of the domestic definition of royalties. This fact is irrelevant as Luxembourg does not levy a withholding tax on royalties.

c. Exclusion of interest as profit distribution or conflicting arm's length (Art. 4(1)(a) and Art. 4(2).

Excessive royalties that conflict the arm's length principle fall under the general Luxembourg transfer pricing rules (see Introduction, 1.2.1. *c. Transfer pricing*). In certain cases excessive royalties may be reclassified as a constructive dividend (see Introduction 1.2.1. *d. Constructive dividend rules*).

2.2. COMPANIES

2.2.1. Types of companies benefiting from implementing provisions (Art. 3(a)(i))

a. Types of entities

Luxembourg does not levy tax on interest or royalties paid to non-resident entities irrespective of the legal or corporate form of both the payer and the recipient of the income. The exemption from withholding tax is available to a broader list of entities than the one contained in the Annex to the Directive.

b. Hybrid entities

The issues related to application of exemption in situations involving hybrid entities do not arise in Luxembourg. The legal form of a paying or recipient company has no relevance because of the general character of the exemption.

2.2.2. Residence requirement (Art. 3(a)(ii))

a. Implementation of the requirement

For the purposes of the withholding tax exemption under Luxembourg law, the residence of the recipient has no relevance, as any non-resident benefits from the exemption on interest and royalty income.

b. Application of the requirement in dual residence cases

Dual residency or dual source issues do not arise in Luxembourg in application of the exemption from withholding tax with respect to interest and royalty payments. The residence of the recipient company has no relevance because of the general character of the exemption. For the same reason, the Luxembourg corporate income tax law does not address the question of the source.

2.2.3. Subject-to-tax requirement (Art. 3(a)(iii))

a. General

Luxembourg does not levy tax on interest or royalties paid to non-resident entities irrespective of whether the recipient is subject to tax.

b. Proof to demonstrate compliance with the subject-to tax requirement

No relevance in the context of Luxembourg law.

c. Application of the requirement to hybrid entities

No relevance in the context of Luxembourg law.

2.2.4. Associated company (Art. 3(b))

Luxembourg does not levy tax on interest or royalties paid to non-resident entities irrespective of the affiliation of the recipient to the payer.

2.2.5. Beneficial ownership (Art. 1(4))

No relevance in the context of Luxembourg law.

2.3. PERMANENT ESTABLISHMENTS

2.3.1. Definition (Art. 3(c))

The definition of permanent establishment under Luxembourg domestic law does not have relevance with respect to the exemption of interest and royalty income derived from Luxembourg by non-resident corporate entities.

2.3.2. Application of source rules (Art. 1(2))

No relevance in the context of Luxembourg law.

'2.3.3. Tax-deductible expense' requirement (Art. 1(3))

No relevance in the context of Luxembourg law.

2.3.4. Beneficial ownership (Art. 1(5))

No relevance in the context of Luxembourg law.

2.3.5. Permanent establishment in a third country (Art. 1(8))

No relevance in the context of Luxembourg law.

3. PROCEDURE

There are no procedural requirements to be fulfilled in order to benefit from the general withholding tax exemption under Luxembourg law. The exemption is applied at source and there is no need to request a refund.

3.1. MINIMUM HOLDING PERIOD (ART. 1(10))

3.1.1. General

No holding period required.

3.1.2. Relief before the minimum holding period is satisfied

No relevance in the context of Luxembourg law.

3.1.3. Appeals

No relevance in the context of Luxembourg law.

3.2. ATTESTATION (ART. 1(11) AND 1(13))

3.2.1. General

No relevance in the context of Luxembourg law.

3.2.2. Appeals

No relevance in the context of Luxembourg law.

3.3. DECISION ON APPLICATION OF THE RELIEF ART. 1(12)

No relevance in the context of Luxembourg law.

3.4. APPLICATION FOR REFUND (ART. 1(15) AND 1(16))

3.4.1. General

No relevance in the context of Luxembourg law.

3.4.2. Appeals

No relevance in the context of Luxembourg law.

4. FRAUD AND ABUSE (Art. 5)

4.1. MEASURES UNDER ART. 5(1) OF THE DIRECTIVE

4.1.1. Domestic

In addition to the transfer pricing and thin capitalization rules (see Introduction 1.2.1. a. *Thin capitalization* and 1.2.1. c. *Transfer pricing*), Luxembourg applies a general anti-abuse provision to defeat abusive constructions (Art. 6 (StAnpG)). The provision provides that if the legal form or the construction surrounding a transaction is not appropriate in terms of its substance, tax will be assessed as though the substance of the transaction had been concluded in the appropriate legal form (Art. 6 (StAnpG)). This provision will also apply with respect to fraud or abuse of the Directive. However, this provision will be rarely invoked with respect to the application of the exemption from withholding tax as it is unconditional and not restricted to certain taxpayers or transactions.

4.1.2. Agreement-based

No relevance in the context of Luxembourg law.

4.2. MEASURES UNDER ART. 5(2) OF THE DIRECTIVE

No relevance in the context of Luxembourg law.

4.3. COMPARISON WITH SIMILAR MEASURES UNDER PARENT-SUBSIDIARY AND MERGER DIRECTIVES

Luxembourg law does not contain specific anti-abuse provisions with respect to the Parent-Subsidiary Directive and the Merger Directive.

5. SUMMARY

No specific implementation was required in Luxembourg as national law generally complies with the Directive. In most cases no withholding tax on interest payments was levied before 1 January 2004 when the Member States had to implement the Directive. In addition Luxembourg when implementing the Directive abolished the withholding tax on royalties.

The definition of interest and royalties in Luxembourg tax law covers the scope of the relevant concepts set out in Art. 2 of the Directive. Furthermore, both interest and royalties are subject to the transfer pricing and the constructive distribution rules.

Finally, interest from profit-sharing bonds is taxed as a dividend and, therefore, subject to a 20% withholding tax unless reduced or eliminated under any relevant tax treaty or implementing provisions of the Parent-Subsidiary Directive.

PART II. THE AGREEMENT

As Luxembourg does not levy a withholding tax on interest and royalties Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the "Agreement") is not relevant for outbound interest and royalties, but only relevant for outbound dividend payments.

The law of 21 June 2005 on the ratification of various Savings Agreements, published in the Official Gazette of 22 June 2005, clarified to a certain extent the application of the Agreement. The law provides for an extension of Art. 147(2) LIR with a letter f which determines that, based on Art. 15 of the Agreement, no withholding tax will be levied on dividend payments to companies resident in Switzerland. The exemption is granted in accordance with the domestic rules under which outbound dividends are exempt in case of a participation of at least 10% or participation with a value of at least EUR 1.2 million. The provisions of the Agreement are effective from 1 July 2005.

ANNEX

Table of the maximum withholding tax rates on interest and royalty payments under the tax treaties between Luxembourg and the EU Member States.

EU Member State	Interest (%)	Royalties (%)
Austria	0	0/10<1>
Belgium	15	0
Czech Republic	0	0/10<2>
Denmark	0	0
Finland	0	0/5<2>
France	10	0
Germany	0	5
Greece	8	5/7<2>
Hungary	0	0
Ireland	0	0
Italy	10	10
Malta	0	10
Netherlands	0/2.5/15<3>	0
Poland	0/10<4>	10
Portugal	10/15<5>	10
Slovak Republic	0	0/10<2>
Slovenia	5	5
Spain	10	10
Sweden	0	0
United Kingdom	0	5

<1> The higher rate applies if the Austrian company owns more than 50% of the capital in the Luxembourg company.

<2> The lower rate applies to copyright royalties, including films.

<3> Interest on loans secured by mortgages on immovable property is exempt. Interest on profit-sharing bonds is treated as dividends.

<4> The lower rate applies to interest on bank loans and bank deposits.

<5> The lower rate applies to interest paid to a financial institution.