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Luxembourg Tax Alert

Deductions denied for amounts due to certain related parties as from 1 March 2021

29 January 2021

On 28 January 2021, the Luxembourg legislature adopted rules disallowing tax deductions for interest and royalties due to related entities established in a country or territory included in the EU list of non-cooperative jurisdictions for tax purposes (EU list). These rules will be effective as from 1 March 2021.

In line with the European Council's new guidelines issued at the end of 2019 encouraging all EU member states to implement legislative measures designed to impose specific penalties on jurisdictions placed on the EU list, the Luxembourg government introduced legislation in the chamber of deputies at the end of March 2020. Initially, its aim was to deny tax deductions for interest and royalties due to related enterprises established in a country or territory included in the EU list as from 1 January 2021. The revised 1 March 2021 effective date is in line with the principles of legal certainty and legitimate expectations, avoiding any retroactive effect.

The final vote takes into account the various amendments already made during the legislative process and no additional changes are introduced. Below is a summary of the new rules that will apply as from 1 March 2021.

For interest and royalties that are due (including accruals), the deduction disallowance will apply under the following conditions:

- The beneficiary of the interest or royalties is a collective undertaking within the meaning of article 159 of the Luxembourg Income Tax Law (LITL), which excludes "look-through" entities. If the recipient of the payments is not the beneficial owner, the rule will apply to the beneficial owner of the amounts due;
- The collective undertaking is an associated enterprise within the meaning of LITL article 56 (as defined by article 9(1) of the OECD Model Tax Convention), i.e., any direct or indirect participation in the management, control, or capital of the enterprise may cause it to be treated as an associated enterprise; and
- The collective undertaking is established in a country or territory included in the EU list.

However, the expense will be deductible if the taxpayer can demonstrate that the transaction generating the interest or royalties is driven by sound business reasons that reflect economic reality. In this case, though, the expense could be subject, where appropriate, to other tax provisions limiting or denying a deduction (such as the application of the interest limitation rule).

If a Luxembourg company cannot provide economic justification for a particular transaction, the interest or royalties due (including accruals) will not be tax deductible. The legislation states that a Luxembourg company can demonstrate a relevant economic rationale for a transaction, taking into account all facts and circumstances, by presenting a sufficient economic benefit beyond any tax benefit obtained from the transaction.

The law refers to article 2 of the EU interest and royalties directive (Directive 2003/49/CE) for the definition of "interest" and "royalties." Interest is defined as interest and arrears accrued that relate to debt-claims of every kind, even if they are secured by a mortgage or carry a right to participate in the debtor's profits, as well as bonds or debentures, including premiums and prizes attaching to such securities. Penalty charges for late payments are not considered interest under the current rules.

Royalties are defined as payments of any kind accrued as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films and software, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. Royalties also include payments for the use of, or the right to use, industrial, commercial, or scientific equipment.

The rules make direct reference to Annex I of the EU list. They will apply as follows:

- As from 1 March 2021, the new rules will apply to the countries and territories on the latest version of the EU list, as published in the Official Journal of the EU on that date.
    - Currently, there are 12 jurisdictions on the October 2020 EU list: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands, and Vanuatu.
    - As the next review of the EU list is planned for mid-February 2021, the list of concerned countries may differ from the current one.
- As from 1 January of the following year (i.e., as from 1 January 2022 for the first time), the rules will apply to the countries and territories on the latest version of the EU list as of 1 January of that year, as published in the Official Journal of the EU on that date.
- Any withdrawal of countries and territories in subsequent updates will be taken into account as from the date the withdrawal is mentioned in the Official Journal of the EU. This measure aims to ensure that the rules cease to apply to these countries and territories as soon as they are removed from Annex I of the EU list.

Comments

The clarifications brought during the legislative process provides for greater legal certainty to taxpayers regarding the application of the new rules. Interest and royalties that are due (including accruals) as from 1 March 2021 could be affected by the new regime.

For the sake of completeness, based on a 2018 circular, Luxembourg resident companies must indicate in their annual corporate income tax returns if they have entered into transactions with related enterprises located in EU list jurisdictions. The applicable version of the EU list is the one that is available on the date of the Luxembourg company's financial year-end. This means in practice, for instance, that a Luxembourg company closing its fiscal year on 31 December 2020 and having transactions with an entity located in a country on the October 2020 version of the EU list should include the relevant information in its 2020 tax returns.

Your contacts

Bernard David
Partner – Tax Business Leader
Tel : +352 45145 2799
bdavid@deloitte.lu

Eric Centi
Partner – Financial Services Tax Leader
Tel : +352 45145 2162
ecenti@deloitte.lu

Christophe de Sutter
Partner – International Tax Leader
Tel : +352 45145 3503
cdesutter@deloitte.lu

Dany Teillant
Partner – Private Equity Tax Leader
Tel : +352 45145 2246
dteillant@deloitte.lu

Stephane Tilkin
Partner – International Tax
Tel: +352 45145 2307
stilkin@deloitte.lu

Deloitte Luxembourg
20 Boulevard de Kockelscheuer
L-1821 Luxembourg
Grand Duchy of Luxembourg

Tel: +352 451 451
Fax: +352 451 452 401
www.deloitte.lu

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