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Luxembourg Tax Alert

Luxembourg Circular on Controlled Foreign Company published

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On 4 March 2020, the Luxembourg tax authorities issued a Circular n°164ter/1 ("Circular") clarifying article 164ter of the Luxembourg Income tax law ("LITL") on Controlled Foreign Company ("CFC") rules. This provision was introduced by the law dated 21 December 2018 whose main purpose was to implement ATAD1 into Luxembourg domestic tax law.

This provision contains Luxembourg's first-ever CFC rules implemented in line with articles 7 and 8 of the ATAD 1. These rules are applicable as from fiscal years starting on or after 1 January 2019.

Article 164ter LITL defines a CFC as a foreign collective undertaking or a foreign permanent establishment ("PE"), the income of which is not taxable or is exempt in Luxembourg if the following criteria are fulfilled:

- In the case of a foreign collective undertaking, the Luxembourg taxpayer, alone or together with associated enterprises, directly or indirectly (i) holds more than 50% of voting rights; or (ii) holds more than 50% of the capital; or (iii) is entitled to receive more than 50% of profits of the foreign collective undertaking; and
- The actual corporate income tax paid by the foreign collective undertaking or the foreign PE on its income is lower than the difference between the Corporate Income Tax that would have been paid on the same profits applying LITL and the actual Corporate Income Tax paid in the CFC state.

The rules do not apply to a CFC whose profit registered in the commercial balance sheet does not exceed EUR 750,000 or does not exceed 10% of its operating costs within the tax period (excluding the costs of goods sold outside the CFC's state of residence, as well as payments to associated enterprises).

The Circular provides some clarification and guidelines on the application of CFC rules, which are summarized below:

Scope of CFC rules

The Circular confirms that foreign PEs of Luxembourg resident collective entities are considered within the scope of CFC rules. It further clarifies that a foreign transparent entity (according to article 175 LITL) that constitutes a PE of a Luxembourg entity is also scoped by CFC rules.

The Circular confirms that the notion of “control” over a CFC is to be understood from both a legal and economic perspective. As such, when assessing the 50% threshold, the voting rights or the capital held by a Luxembourg company in a foreign entity are taken into account as well as the rights to profits. In case these rights differ, the criteria with the highest control will prevail. For instance, when a Luxembourg entity holds 40% of the share capital of a foreign entity but 60% of its voting rights, the 60% threshold of the voting rights is the criteria that will be considered.

The Circular also confirms that the direct and indirect control must be added up to determine whether the control threshold of 50% is reached.

In order to be considered a CFC, the Circular clarifies that “control” needs to be established at any point in time during the concerned fiscal year of the Luxembourg taxpayer.

Effective taxation test at the level of the CFC

The Circular provides clarity on how to compare the effective taxation of the CFC to the Luxembourg Corporate Income Tax that would have been due by the CFC under Luxembourg tax rules.

The Circular states that the effective tax paid by the CFC corresponds to the tax due and effectively paid. As such, should the CFC benefit from a tax refund in the future, the effective tax paid by the CFC is decreased.

If requested, the Luxembourg taxpayer will have to provide to the Luxembourg tax authorities with evidence of the taxes assessed and paid by the CFC (e.g. tax slips, evidence of tax payments or any supporting documentation issued by CFC's state of residence).

If the taxable income of the CFC is computed in a foreign currency, the actual tax liability assessed and paid by the CFC will be converted at the exchange rate applicable to the closing date of the taxpayer (not the CFC) and published by the European Central Bank.

When comparing the Effective Tax Rate (“ETR”) of the CFC, the tax base of the CFC will be computed based on the provisions already contained in LITL. This includes the treatment of tax losses of the CFC. As such, tax losses brought forward by the CFC should be considered and treated under the rules applicable to tax losses under Luxembourg law (including 17-year carry forward limitation since fiscal year 2017).

The Circular explains that foreign PEs of a CFC should be disregarded for the ETR test when the income of such PEs is exempt in the country of residence of the CFC. On the opposite, if the income generated by the foreign PEs is to be included in the taxable income of the CFC, the taxes assessed and paid by the foreign PEs are to be included in the taxes assessed and paid by the CFC for the ETR test.

The Circular clarifies that only Corporate Income Tax should be taken into account when assessing the ETR of the CFC, thus excluding the employment fund surcharge and Municipal Business Tax.

It should be noted that, even if not expressly mentioned, the methodology detailed in the Circular provides the taxpayers with guidance on how to interpret the "subject-to-tax" test applicable to non-EU subsidiaries under the Luxembourg participation exemption regime (Art 166 LITL).

CFC income inclusion

CFC provisions are per se anti-abuse provisions. Art 164ter, paragraph 3 LITL defines financial arrangements as non-genuine when a CFC would not own the assets that are the source of all or part of its revenue, nor would have taken the associated risks, if it was not controlled by a taxpayer where the functions related to these assets and risks are performed and play a key role in the CFC's revenue creation ("significant people functions").

Such analysis limits the application of the CFC tax regime to entities which, on the basis of assets owned, functions performed and risks assumed, were not able to generate the disputed income themselves. It should be noted that the rules relating to CFCs only apply after the determination of transfer prices on the basis of Art 56 and 56bis LITL.

The Circular does not provide any instruction on how to identify the "Significant People Functions" but stresses that – for each fiscal year - the Luxembourg taxpayers will have to provide upon request of the Luxembourg tax authorities an analysis of the significant people functions playing a key role in creating the CFC's revenue.

The Circular confirms that the CFC income inclusion is limited to pro-rata temporis participation in the CFC's that are directly or indirectly held by the sole Luxembourg taxpayer.

Expenses of the CFC that are economically linked to the CFC income are to be deducted from the net CFC income basis.

Losses of CFC's shall not be included negatively in the taxpayer taxable basis but can be rolled over for any future CFC income inclusion.

The Circular also reiterates the application of the anti-abuse provisions under Luxembourg tax law (§6 StAnpG) to the CFC regime. As such, any non-genuine arrangement (not defined in the Circular) with the main purpose of getting the Luxembourg taxpayer outside the scope of CFC rules will be considered abusive and as such disregarded by the Luxembourg tax authorities.

Even though the Circular provides some implementation guidelines and useful examples, more clarity on some key concepts such as the interaction of CFC rules with double tax treaties, transfer pricing rules or other tax rules (e.g. interest limitation), and Significant People Functions that allow to capture CFC income would be welcome.

With regards to the administrative burden, we are still awaiting the 2019 tax return form that shall define the scope of the annual reporting obligations for these rules. In the meantime the taxpayers shall continue to review their structures in the light of these rules and get prepared to sustain their position going forward.

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