

Luxembourg's Tax Regime Applicable to Directors' Fees

Following the Issuance of a New VAT Circular: A Critical Analysis

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On 30 September 2016, the Luxembourg VAT authorities released the long-awaited Circular on the VAT treatment applicable to directors' fees. The Circular determines that directors' services constitute an economic activity and indicates the director's status as a VAT taxable person, irrespective of whether this activity is exercised by an individual or by a company. Directors' services are therefore subject to Luxembourg VAT when invoiced by a Luxembourg established director to a Luxembourg company. This article analyses the direct tax and VAT treatment of directors' fees and considers the appropriateness of the current regime against the backdrop of the developments in the international tax arena.

1. Introduction

Luxembourg is a financial centre and a prime location for the structuring of cross-border investments and business activities via Luxembourg companies. For such structuring to be efficient in Luxembourg and abroad, it is crucial to equip the Luxembourg entities with an appropriate level of substance. The importance of substance has only become more important over the last years when the topic of (international) taxation has been at the top of the agenda of the G20 and the OECD which has been working since 2013 on its Base Erosion and Profit Shifting ("BEPS") Project.

Substance is relevant for the application of both domestic tax law and tax treaties. More precisely, substance is crucial for managing tax residency and to avoid the situation whereby a corporate structure is (partially) disregarded under foreign anti-abuse provisions (for example, on the grounds of abuse of law or substance-over-form arguments). Another means to challenge a corporate structure is the beneficial ownership concept that is employed under tax treaties and, in some cases, under domestic tax law to avoid tax treaty or directive shopping.

Luxembourg (professional) resident directors are an essential element for reinforcing the substance in Luxembourg. This can significantly reduce the risk of potential challenges by foreign tax authorities. It follows that companies will likely need more Luxembourg directorship in the future to manage their business activities in Luxembourg. However, as analysed in this article, the overall direct and indirect tax treatment of directors' fees at the level of the company and the directors has a punitive character and should be reconsidered by the Luxembourg legislator.

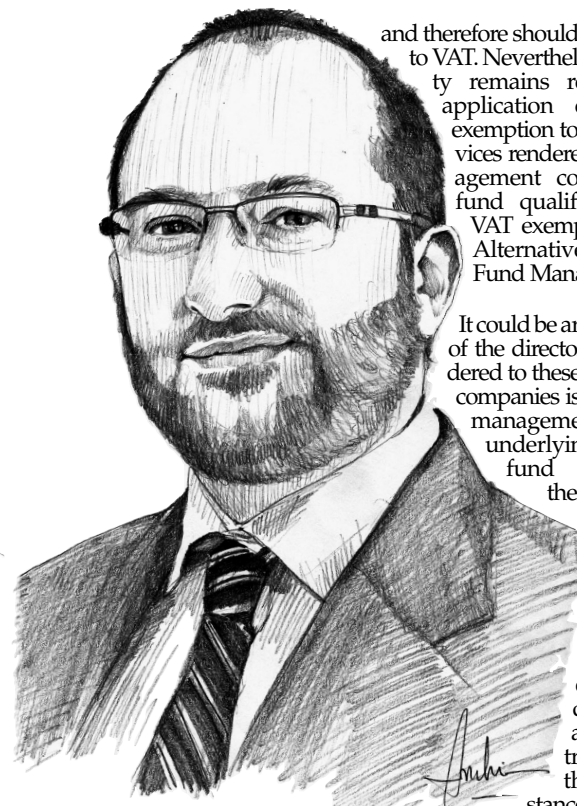
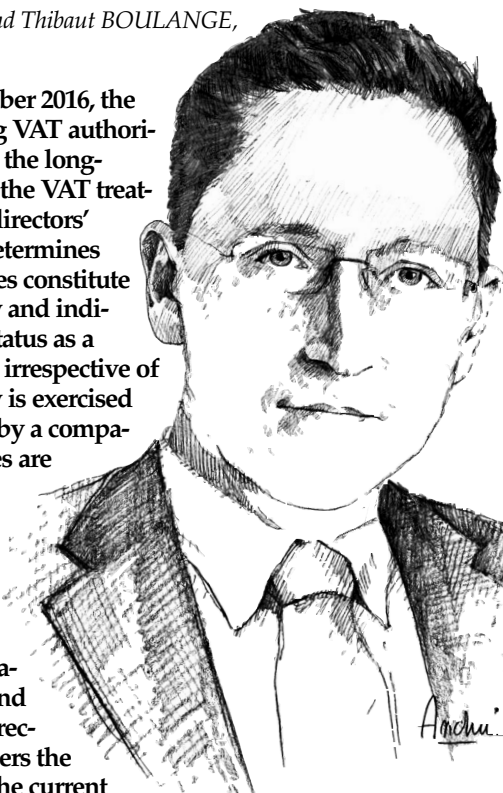
2. Luxembourg VAT Treatment of Directors' Fees

2.1. Opening Comments

In recent months, the future Luxembourg VAT treatment applicable to directors' fees has been subject to debate and to comments in numerous press articles. Until now, no specific guidance had been published by the Luxembourg Indirect Tax authorities ("Administration de l'Enregistrement et des Domaines") on the VAT treatment applicable to these fees; the practice was quite fluctuating and unpredictable.

The debate on whether directors' fees are subject to VAT, benefit from a VAT exemption or do not fall within the scope of the VAT has been on-going for several years in various Member States. In this respect and under threat of an infringement proceeding from the European Commission, the Netherlands amended its VAT practice in 2011 to ensure that directors are treated as VAT taxable persons regardless of the number of mandates held. However, major differences to the VAT treatment of directors' fees amongst EU Member States continue to exist. In this context, the Luxembourg VAT authorities released the long-awaited Circular n°781 on the VAT treatment applicable to directors' fees and published on their website a list of "Frequently asked questions" on 30 September. This Circular provides an overview of the Luxembourg VAT treatment applicable to directors' fees.

Simply put, the Circular confirms that directors' services do constitute an economic activity and



indicates the director's status as a VAT taxable person, irrespective of whether this activity is exercised by an individual or by a company.

2.2. VAT treatment of Luxembourg Independent Directors

One of the main confirmations provided by the Circular is that director mandates exercised independently by a Luxembourg individual or by a Luxembourg company constitute an economic activity falling within the scope of the VAT. Luxembourg directors at the board of a company are consequently considered as VAT taxable persons ("assujettis").

2.2.1. Practical consequences at the level of the Luxembourg directors

Directors established in Luxembourg will be required to register for VAT purposes as from 1 January 2017. The Circular confirms that the strict observance of these rules is required as from 1 January 2017 as well.

As a general rule, directors' services will therefore be subject to Luxembourg VAT at the rate of 17% when invoiced by a Luxembourg director to a Luxembourg company. It should be noted that withholding tax applied on fees invoiced by the director is part of the taxable basis subject to VAT.

If we consider the gross remuneration of the director's mandate amounts to EUR 100,000.00, the withholding tax would amount to EUR 20,000.00 (20% of the gross amount) and the Luxembourg VAT would amount to EUR 20,400.00 (EUR 120,000.00 x 17%).

Directors will have to issue VAT compliant invoices and to submit VAT returns. The filing periodicity will be based on the annual turnover of the director (periodical and/or annual VAT returns). Directors will be liable to pay the VAT charged on the services rendered to the Luxembourg Treasury, after deduction of the amount of input VAT borne within the framework of their activity.

2.2.2. Exceptions: small enterprise scheme and «honorary» directors

Provided, in particular, that the annual turnover of a director does not exceed a threshold of EUR 30,000.00 (as from 1 January 2017), the Circular specifies that the small enterprise scheme would be applicable to that director. In such a case, no VAT would be applicable on the services rendered by the directors but, as a consequence, no VAT deduction right would be recognised. A VAT registration is nevertheless required in such a case.

Furthermore, «honorary» director services would benefit from a specific VAT exemption already in force in the current Luxembourg VAT Law. According to the Circular, «honorary» directors are those which only receive an indemnity considered as a defrayal. No additional detail is provided by the Circular in order to determine the scope of the notion of «defrayal».

2.2.3. Exception: VAT exemption for the management of investment funds

Surprisingly, no guidelines are given by the Circular on the application of the VAT exemption foreseen for the management of investment funds (article 44, § 1, d. of the Luxembourg VAT Law). There exist, however significant arguments to consider that director services at the board of regulated funds should be covered by this VAT exemption

and therefore should not be subject to VAT. Nevertheless, uncertainty remains regarding the application of the VAT exemption to directors' services rendered to the management company of a fund qualifying for the VAT exemption or to an Alternative Investment Fund Manager.

It could be argued that part of the director services rendered to these management companies is related to the management of the underlying qualifying fund and should therefore benefit from the VAT exemption. A case-by-case approach would be recommended in order to determine the adequate VAT treatment in these circumstances.

2.3. VAT treatment of Luxembourg Dependent Directors - Employees

The circular also reaffirms that directors acting within the framework of an employment contract are not independent and are therefore not considered as VAT taxable persons. An employee sitting at the board of a company on behalf of his or her employer is not acting independently and should not be considered as a VAT taxable person. In such a case, the employer will be considered as supplying the director services and the VAT obligations will arise at the employer level.

2.4. VAT treatment of Foreign Independent Directors

When the director is established outside of Luxembourg, a distinction has to be made based on the VAT status of the Luxembourg company receiving the director services.

If the Luxembourg company is a VAT taxable person, VAT will be declared under the reverse charge mechanism (B2B VAT rule). Luxembourg companies performing only VAT exempt activities (e.g. EU financing activities) could potentially be required to register for VAT purposes if they receive directors' services from non-Luxembourg directors.

To the extent the Luxembourg company is not a VAT taxable person (e.g. passive holding company), the place of taxation is deemed to be located where the director has established his business (i.e. outside Luxembourg - B2C rule). Depending on the VAT treatment applicable to directors' fees in the country of establishment of the director, invoices with foreign VAT or without any VAT could be received by the Luxembourg company. Indeed, the VAT treatment applicable to directors' fees differs from one Member State to another.

3. Luxembourg Direct Tax Treatment of Directors' Fees

3.1. Opening comments

From a direct tax perspective, the tax treatment of the directors' fees has to be analysed at both the level of the company paying the fees and at the level of the directors. Here, a different tax treatment applies to (i) directors' fees paid for the day-to-day management function and (ii) directors' fees paid for directorship functions (i.e. functions other than the day-to-day management of the company's business activities). Moreover, the tax treatment of resident and non-resident directors varies.

3.2. Directors' fees paid for the day-to-day management function

Where a director carries out a day-to-day management function, the fees paid are considered to be income from employment which can be deducted as a cost by the company. At the level of the directors, the income is taxable as income from dependent activities at a progressive rate ranging between 0% and 45.78% (including solidarity surcharge).⁽¹⁾ Hence, the income is taxable at the level of the director at his individual tax rate (depending on his income situation) whereas at the level of the company the taxable income which is subject to 29.22% corporate income tax and municipal business tax (to be decreased to 27.11% in 2017 and 26.08% in 2018) is reduced accordingly.

Moreover, such income is subject to social security contributions.

3.3. Directors' fees paid for directorship functions

The tax treatment of directors' fees paid for directorship functions is more complex than that of fees paid for the day-to-day management of the company. When determining the taxable income of a Luxembourg company, directors' fees which are not paid for the day-to-day management of the company are non-deductible for Luxembourg tax purposes.⁽²⁾ Accordingly, the amount of such directors' fees increases the taxable income of the company which is subject to tax at an aggregate rate of 29.22%. At the level of the directors, the fees paid for directorship functions are classified as income from self-employment.⁽³⁾ A withholding tax of 20% is levied on the gross amount of these directors' fees (25% if the withholding tax is borne by the company paying the fees).⁽⁴⁾

The withholding tax is the final tax for non-resident beneficiaries if their Luxembourg-source professional income is limited to directors' fees that do not exceed EUR 100,000 per fiscal year (unless the non-resident director opts for being taxed by assessment). Otherwise, the directors' fees will be subject to income tax at the individual tax rate of the director which can be as much as 45.78% (including solidarity surcharge; here, the worldwide income of the non-resident director would be considered when determining the tax rate).

In case of Luxembourg resident directors, the 20% withholding tax is an advance for the income tax which is assessed in the director's income tax return. Thus, Luxembourg resident directors should be subject to income tax at a progressive rate of up to 45.78% with a tax credit being granted for the withholding tax levied by the company. In addition, those fees might be subject to social security contributions in Luxembourg at an aggregate rate of ca. 25%.

Conclusion

The tax regime applicable to directors' fees paid for directorship functions is all in all very unattractive.

First, those directors' fees are non-deductible at the level of the company paying the fees. Second, at the level of a Luxembourg (professional) resident director the fees should be subject to income tax at a progressive rate ranging between 0% and 45.78% (including solidarity surcharge). Third, the directors' fees might be subject to social security contributions in Luxembourg at an aggregate rate of ca. 25%. Fourth, the new VAT Circular clarifies that directors' fees are on top subject to VAT (including VAT on the withholding tax levied by the company on behalf of the director) which is generally a cost for businesses (as many companies don't have a full VAT deduction right).

It follows that the overall percentage of tax levied by Luxembourg on directors' fees paid for directorship functions can be as much as 100% - 115% of the amounts of fees paid to the directors (adding the tax costs at the level of the company and the director).⁽⁵⁾ Given the importance of Luxembourg resident directors for providing robust substance in the current international tax environment, the Luxembourg Ministry of Finance should reflect on this punitive tax treatment. Allowing directors' fees as a deductible expense for Luxembourg companies could restore the balance and make the engagement of Luxembourg resident directors less costly for international businesses and investors.

The unfavourable tax treatment comes in addition to other tax law and bankruptcy law changes according to which directors may be directly liable for any reporting errors or late payments of VAT debts of their respective companies, regardless of any proof of fault on the side of the directors.⁽⁶⁾ In other words, improvements are necessary in many respects to improve the overall tax treatment of directors' fees and to limit the personal liability risks of independent director to cases of fraud. To be continued.

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1) Article 10 No. 4 in connection with 95 (6) of the Luxembourg Income Tax Law ("LITL").
2) Article 168 No. 3 of the LITL.
3) Article 91 (1) No. 2 of the LITL.
4) Article 152, Chapter 2, (1), (3) of the LITL.
5) 29.22% of tax at the level of the company (due to the non-deductibility of directors' fees), between 0% and 45% of income tax at the level of the director and 17% of VAT.
6) See http://www.ila.lu/ila/documents/LettreMinJusticeUEL_ILA27.10.2016_16297.pdf with a letter sent on 27 October 2016 by the ILA and UEL to Luxembourg government representatives.