Luxembourg and the EU Blacklist:

Why transactions with non-cooperative tax jurisdictions should be monitored by Luxembourg taxpayers?

*By Petya DIMITROVA & Steve IDRISSOU, ATOZ Tax Advisers**

On 28 January 2016, the European Commission presented an anti-tax-avoidance package for fairer, simpler and more effective corporate taxation in the European Union ("EU"). The key proposal of that package was the set-up of a process to list the non-cooperative tax jurisdictions ("Blacklist" or "Blacklisted Jurisdiction(s)") which refuse to play fair. On 5 December 2017, the EU Council released its first Blacklist. Since then, the Blacklist has already been updated 13 times. The latest update was published in the Official Journal ("OJ") of the EU on 26 February 2021 and includes the following jurisdictions: American Samoa, Anguilla, Dominica, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands and Vanuatu.

In January 2021 however, the members of the European Parliament adopted a resolution requesting that the system currently used to draw up the Blacklist is changed, labelling it as «confusing and ineffective». The proposals made by the European Parliament include notably that all jurisdictions with a 0% corporate tax rate or with no taxes on companies' profits should be automatically placed on the Blacklist. The EU Parliament also proposed to widen the criteria to judge if a country's tax system is fair or not by also including tax practices and not only the level of tax rates. EU member states should also be screened to see if they display any characteristics of a tax haven and be regarded as tax havens too as the case may be.

More recently, on 18 May 2021, the European Commission released a communication to the attention of the European Parliament and the Council on "Business taxation for the 21st Century". To motivate third countries to join the international agreement on Pillar 2 (i.e. set of rules which the OECD Inclusive Framework is working on to get a minimum effective taxation of profits generated by multinational enterprises), the European Commission commits to propose to introduce Pillar 2 in the criteria used for assessing third countries in the EU listing process of non-cooperative countries. Even though no international consensus has been reached yet, G7 countries have already agreed on a 15% minimum effective taxation under Pillar 2. That would mean that countries with an effective tax rate lower than 15% may be included in the Blacklist.

Based on these recent proposals of the European Parliament and the European Commission, it could be expected that the Blacklist will be extended to several non-EU jurisdictions, such as the Cayman Islands, Jersey, Guernsey, Bahamas etc., and potentially to some EU jurisdictions.

Since the release of the first Blacklist, Luxembourg has been adopting administrative and legislative measures whose application is directly impacted by the subsequent updates of the Blacklist. The listing of a jurisdiction as non-cooperative may also have an impact on the reporting obligations applicable according to the Luxembourg Law of 25 March 2020 implementing Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements ("DAC6 Law").

This article gives an overview of the Luxembourg (A) defensive administrative measures, and (B) defensive legislative measure adopted by Luxembourg related to transactions involving blacklisted jurisdictions, as well as (C) DAC 6 reporting requirements for arrangements concluded with associated entities located in Blacklisted Jurisdictions and the impact that the various updates of the list may have on these measures.

A. Defensive administrative measures

On 7 May 2018, the Luxembourg tax authorities ("Tax Authorities") issued the circular L.G. – A n°64 ("Circular") implementing enhanced control measures applicable to certain transactions and taxpayers. These measures are applicable as from fiscal year 2018.

1. Scope of the measures

Based on the Circular, the Tax Authorities apply enhanced monitoring if a collective undertaking has used structures or arrangements involving Blacklisted Jurisdictions. Hence, in application of the Circular there should be no automatic adverse tax consequences for a Luxembourg taxpayer entering into transactions with a resident located in a Blacklisted Jurisdiction. In order for that monitoring to be effective, collective undertakings are required to indicate in their tax returns whether or not they entered into transactions with associated enterprises located in Blacklisted Jurisdictions (e.g. line G2350 of the form 500 for the year 2020).

If a collective undertaking entered into such transaction, it should then keep at the disposal of the Tax Authorities the details of that transaction, in particular the total amount and the statement of income/expenses and claims/debts related to that transaction. The information should be provided to the Tax Authorities upon request.

In absence of specific indications, based on the electronic tax forms made available by the Tax Authorities, the Circular should only apply to collective undertakings which are obliged to file corporate tax returns (i.e. form 500) in Luxembourg. Hence, Luxembourg taxable resident companies (within the meaning of article 159 of the Luxembourg income tax law ("ITL")) and Luxembourg permanent establishments of non-resident companies should be in the scope of the Circular. Conversely, individuals, Luxembourg tax transparent entities and tax-exempt entities should not be in the scope of the Circular.

The Circular specifies that the enhanced measures should apply to transactions between associated enterprises within the meaning of article 56 of the ITL. Under this article, enterprises are associated where (i) an enterprise participates directly or indirectly in the management, control or capital of another enterprise or (ii) the same persons participate directly or indirectly in the management, control or capital of an enterprise. Enterprises could therefore be associated even in the absence of a shareholding relationship.

Furthermore, an individual acting in the scope of its business activity and a tax transparent entity should be considered as an enterprise within the meaning of article 56 of the ITL. Hence, transactions between Luxembourg taxable resident companies and such individuals or tax transparent entities located in Blacklisted Jurisdictions should be in the scope of the Circular (to the extent that the parties involved in the transactions are considered as associated enterprises).

The Circular refers to transactions concluded with enterprises located in Blacklisted Jurisdictions instead of referring to the concept of tax residence. However, in certain circumstances, the country of location of an enterprise (e.g. registered address) could be different from the country where the enterprise has its tax residence (e.g. place of effective management). It can be argued that the notion of "location" as indicated in the Circular should be understood as the tax residence of the enterprise.

As a result, the determination of the tax residence of a foreign enterprise should be analysed under the provisions of the relevant tax treaty (if applicable) or the local rules. However, we are of the view that the Tax Authorities may apply an extensive approach and consider that transactions with a foreign associated enterprise having a nexus with a Blacklisted Jurisdiction, either as a result of its place of effective management or due to its registered address, should be in the scope of the Circular.

There is no definition of the transactions under the scope of the Circular. It can be assumed that such definition should be broad and include notably all agreements (e.g. loan, service, licence, etc.) and shareholding relationships (e.g. direct shareholder or subsidiary) with an enterprise located in a Blacklisted Jurisdiction. Consequently, a Luxembourg collective undertaking which is simply held by an associated enterprise located in a Blacklisted Jurisdiction should indicate this transaction in its corporate tax returns (e.g. even if no dividends have been distributed to this shareholder in that year).

Finally, if a Luxembourg taxpayer fails to comply with the reporting measures, the statute of limitations (i.e. right of the Tax Authorities to review and amend a tax return within a certain time period) should be extended from five to ten years.

2. Timing for application

The defensive administrative measures introduced by the Circular are applicable as from fiscal year 2018. Hence, Luxembourg taxpayer closing their 2018 year as from 1 January 2018 should be in the scope of the Circular. We are also of the view that a transaction entered into before fiscal year 2018 and which is still in place as from 2018 should be in the scope of the Circular (i.e. no grandfathering period should apply). The Circular states that the Blacklist as of the end of the year concerned is key for determining whether reporting is required or not. Therefore, as far as the disclosure for the 2020 corporate income tax returns is concerned, reference should be made to the Blacklist in force as of 7 October 2020. It means further that the 2021 tax returns should be prepared based on the update of the Blacklist which was published on 26 February, which is likely to happen in October 2021.

B. Defensive legislative measure

On 5 December 2019, the European Council recommended the member states to apply at least one defensive legislative measure as of 1 January 2021 amongst a pre-defined list of measures. Following this recommendation, Luxembourg introduced the law of 10 February 2021 which denies under certain conditions the corporate income tax deduction of interest and royalty expenses due as from 1 March 2021 to entities located in Blacklisted Jurisdictions ("Law").

1. Scope of the measure

Arm's length interest and royalties due by a Luxembourg corporate taxpayer are in principle deductible from its corporate tax base and are not subject to withholding tax in Luxembourg, irrespective of the country of establishment of the recipient.

Based on article 168–5 of the ITL introduced by the Law, as from 1 March 2021, interest and royalties due to entities located in Blacklisted Jurisdictions are no longer tax deductible, if the following cumulative conditions are met:
- The beneficiary of the interest or royalty is a collective undertaking within the meaning of article 159 of the ITL, thus excluding tax transparent entities and individuals (while the Circular could apply to tax transparent entities and individuals in certain circumstances); if the beneficiary is not the beneficial owner, then the beneficial owner has to be taken into account;
- The beneficiary of the interest or royalty is an associated enterprise within the meaning of article 56 of the ITL; and
- The collective undertaking which is the beneficiary of the interest or royalty is established in a Blacklisted Jurisdiction.

Interest and royalties remain tax deductible if the taxpayer can demonstrate that the operation which the interest or royalties relate to has been put in place for valid economic reasons which reflect economic reality.

Arm's length interest and royalty expenses which are not deductible in application of the Law should remain free of withholding tax in Luxembourg. The non-deduction of the interest and royalties should be limited to the portion attributable to the beneficiary of the interest which is located in a Blacklisted Jurisdiction. The measure is limited to interest and royalties due by a Luxembourg collective undertaking and therefore does not apply to other types of deductible expenses (e.g. service fees, etc.).

Since the interest expenses due to a beneficiary established in a Blacklisted Jurisdiction will not be tax-deductible based on the Law, it will not be taken into account for the application of the measures related to the interest deduction limitation rules introduced under article 168 bis LITL on 1 January 2019.

2. Timing for application

The measure is applicable to interest and royalties due as from 1 March 2021 to entities located in Blacklisted Jurisdictions based on the latest Blacklist available as of 1 March 2021.

Since the latest update of the Blacklist was published on 26 February 2021, the measure currently applies to interest and royalties due to entities located in American Samoa, Anguilla, Dominica, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands and Vanuatu. However, since 2020, the Blacklist is updated twice a year (generally in February and October), so that the scope of application of the measure may evolve another time in the course of 2021 following the next update to take place this year (i.e. in October 2021).

If a country is added or removed from the Blacklist, the effect will be as follows:
- Countries added will be taken into account for interest and royalties due as from 1 January of the following year (i.e. there will be no retroactive nor immediate effect but only an impact as from the following calendar year);
- Countries removed will no longer be taken into account for interest and royalties due as from the date of the publication of the relevant Blacklist in the OJ of the EU (i.e. the removal will have an immediate effect).

C. DAC 6 reporting requirements

In application of the DAC 6 Law, cross-border arrangements which took place after 25 June 2018 and come within the scope of at least one of the hallmarks may need to be reported under the mandatory disclosure regime. The reporting regime limits the number of reportable cross-border arrangements through the adoption of a threshold condition (i.e. the main benefit test ("MBT"). This means that many of the hallmarks only trigger a reporting obligation if an arrangement meets the MBT reducing the risk of excessive or defensive filings.

More specifically, based on the hallmark C.1.b.ii listed in the Appendix of the DAC 6 Law, an arrangement which involves any type of deductible cross-border payments made between associated enterprises where the recipient is resident for tax purposes in a jurisdiction included in a list of third-country jurisdictions which have been assessed by member states collectively (i.e. the Blacklist) or within the framework of the OECD (i.e. as of today, no jurisdictions are listed by the OECD) as being non-cooperative should be automatically reported. The MBT does not apply to this hallmark.

In the absence of further indication in the DAC 6 Law, it is our view that the relevant non-cooperative list (e.g. the Blacklist) to be considered for the analysis of an arrangement should be the one in force at the date of the reporting triggering event(1).

Conclusion

While it is clear today that the European Commission will use the Blacklist to promote the adoption of any anti-tax avoidance good practices, the process and criteria for drawing the EU list of non-cooperative jurisdictions have been assessed at EU level as being inefficient and insufficient to tackle tax avoidance. We are closely monitoring the various proposals to amend the criteria for drawing the list as this could have a significant impact on the number of countries included in the list and therefore on Luxembourg taxpayers. In addition, in certain cases, when assessing whether an entity is "situated" in a Blacklist Jurisdiction, there might be a risk that the Tax Authorities have a different view on the place of tax residence and the place of location of that entity.

Even though the defensive administrative measures and defensive legislative measure introduced by the Circular and the Law apply to the same Blacklist, the scope, timing and effects of these measures are different. Hence, as usual in tax matters, there is no one-fits-all approach, and a careful tailor-made review of any envisaged transactions should be considered before engaging into any corporate implementation steps in order to avoid unnecessary costs and wasting time.

Petya DIMITROVA
Partner, International and Corporate Tax
Petya.Dimitrova@atoz.lu

Steve IDRISSOU
Director, International and Corporate Tax
Steve.Idrissou@atoz.lu

ATOZ Tax Advisers (Taxand Luxembourg)
www.atoz.lu

1) The triggering reporting event is defined as the day after the reportable cross-border arrangement is made available for implementation, or the day after the reportable cross-border arrangement is ready for implementation, or when the first step in the implementation has been made.