

# Luxembourg's New CFC Rules

by Oliver R. Hoor

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In this article, the author analyzes the scope and mechanics of Luxembourg's new controlled foreign company rules and considers problems such as overlap with transfer pricing rules and the risk of double taxation.

Recent Luxembourg tax reform implements the EU anti-tax-avoidance directive (Council Directive 2016/1164 or ATAD) and other base erosion and profit-shifting-related measures into Luxembourg tax law. The ATAD requires EU members to implement several antiabuse provisions, including controlled foreign company (CFC) rules, and allows them leeway in how they choose to implement the CFC rules. This article analyzes Luxembourg's new CFC rules, including concerns such as overlap with transfer pricing rules and the risk of double taxation.

### I. Introduction

Companies that are part of the same group are generally taxed separately because they are separate legal entities. When a Luxembourg parent company has a subsidiary, the subsidiary's profits are taxable only at the parent's level once distributed. Depending on the residence state and the tax treatment of the subsidiary, dividend

income may either be tax exempt (in full or in part) or taxable with a right to credit potential withholding taxes levied at source.<sup>1</sup>

Thus, if a foreign subsidiary is in a low-tax jurisdiction, the taxation of its profits may be deferred through the timing of the distribution. The CFC rules are intended to eliminate (long-term) tax deferrals resulting from the nondistribution of profits by low-taxed subsidiaries.

As part of the work on BEPS action 3, the OECD developed guidance on the design of CFC rules.<sup>2</sup> However, while the OECD provided mere recommendations for countries that intended to adopt those kinds of provisions, the EU included CFC rules as a minimum standard in the ATAD.

### II. Scope of the CFC Rules

The CFC rules apply to all Luxembourg corporate taxpayers, including entities covered by article 159 of the Luxembourg Income Tax Law (LITL) and Luxembourg permanent establishments of nonresident corporate entities.<sup>3</sup>

#### A. Defining CFCs

According to LITL article 164-ter, a CFC is an entity or a PE whose profits are either not subject to or exempt from tax in Luxembourg if two conditions are met. First, the Luxembourg corporate taxpayer by itself or together with its associated enterprises must hold a direct or indirect participation of more than 50 percent of the voting rights, directly or indirectly own more

<sup>1</sup> Luxembourg Income Tax Law (LITL) article 97(1) No. 1 in connection with article 166(1) (Luxembourg participation exemption regime), article 115 No. 15a (50 percent exemption for dividends received from specific subsidiaries when the conditions of the participation exemption regime are not met), or article 134-bis (tax credit).

<sup>2</sup> The final report on BEPS action 3 was released in October 2015.

<sup>3</sup> LITL article 160(1).

than 50 percent of capital, or be entitled to receive more than 50 percent of the profits of the entity (the control test). Second, the actual corporate tax paid by the entity or PE must be lower than the difference between the corporate tax that would have been charged in Luxembourg and the actual corporate tax paid on the entity or PE's profits — in other words, the actual tax paid must be less than 50 percent of the tax that would have been due in Luxembourg (the low-tax test). Given that Luxembourg's corporate income tax (CIT) rate is 18 percent, the CFC rule will apply only if the taxation of the entity or PE's profits is lower than 9 percent<sup>4</sup> on a comparable taxable basis.<sup>5</sup>

When analyzing whether the low-tax criterion is fulfilled for a direct or indirect subsidiary, LITL article 164-ter (1) No. 2 specifies that profits attributable to PEs that are not subject to or are exempt from tax in the subsidiary's residence state should be disregarded.<sup>6</sup> It follows that only the tax treatment of profits attributable to the subsidiary in its state of residence is relevant for the low-tax test.

Last but not least, when assessing the actual tax paid by the entity or PE, only taxes that are comparable to the Luxembourg CIT are to be considered.

Not all entities or PEs are covered by the CFC rules. Excluded from the scope are entities or PEs with accounting profits of no more than €750,000 or whose accounting profits are no more than 10 percent of their operating costs for the tax period.<sup>7</sup> Those exceptions for CFCs generating insignificant profits are meant to limit the administrative burden on taxpayers and the tax authorities.

<sup>4</sup>That rate should be reduced to 17 percent beginning in 2019 based on a recent announcement from the Luxembourg government. If the rate is reduced, the low-tax criterion would be fulfilled if the CFC profits are taxed at less than 8.5 percent on a comparable basis.

<sup>5</sup>Under the low-tax test, the taxable income of the direct or indirect subsidiary must be determined as if it would be a Luxembourg corporate taxpayer applying Luxembourg tax law. The result of that computation is the comparable taxable basis.

<sup>6</sup>The profits attributable to a foreign PE of a direct or indirect subsidiary are to be disregarded when determining the hypothetical Luxembourg tax liability on the entity's profits.

<sup>7</sup>Those are implementation options provided under the ATAD.

## B. Associated Enterprises

The control test requires analyzing whether the Luxembourg corporate taxpayer by itself or together with its associated enterprises has a minimum direct or indirect participation in the entity.

LITL article 164-ter provides three definitions of the term "associated enterprises."<sup>8</sup> Category 1 includes entities in which a taxpayer directly or indirectly holds a participation of at least 25 percent in terms of voting rights or capital ownership, or is entitled to receive at least 25 percent of an entity's profits. Category 2 includes individuals or entities that directly or indirectly hold a participation in the Luxembourg corporate taxpayer of at least 25 percent in terms of voting rights or capital ownership, or are entitled to receive at least 25 percent of the taxpayer's profits. Category 3 includes entities in which associated enterprises of category 2 directly or indirectly hold voting rights or capital ownership of at least 25 percent, or are entitled to receive at least 25 percent of that entity's profits.

In that regard, the term "entity" includes corporate and transparent entities, irrespective of whether they are tax resident in Luxembourg or abroad.<sup>9</sup>

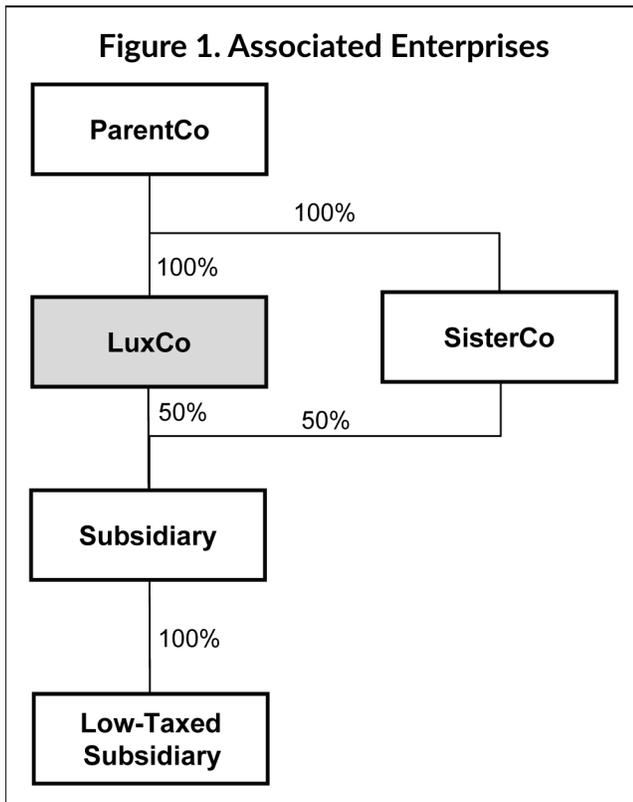
*Example.* A Luxembourg company (LuxCo) owns a 50 percent participation in a subsidiary that holds a participation in a company that is tax resident in a low-tax jurisdiction (low-taxed subsidiary). A sister company of LuxCo that is held by the common shareholder (the parent) owns the remaining 50 percent in the subsidiary.

The parent, sister, subsidiary, and low-taxed subsidiary are all associated enterprises of LuxCo. Hence, LuxCo (together with its associated enterprises) is deemed to own 100 percent of the shares

<sup>8</sup>The LITL definition is much broader than that under article 9 of the OECD model tax convention.

<sup>9</sup>Here, LITL article 164-ter (2) refers to entities covered by LITL articles 159 (Luxembourg corporate taxpayers), 160 (nonresident corporate taxpayers), and 175 (entities that are transparent for Luxembourg tax purposes).

in low-taxed subsidiary, which technically makes it a CFC of LuxCo. (See Figure 1.)



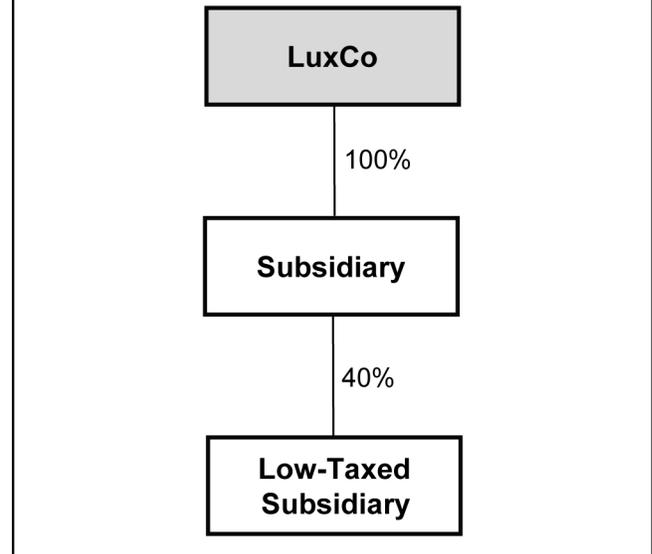
When determining the percentage of indirect participation, the shareholding percentages through the chain must be multiplied with each other.

*Example.* LuxCo owns a 100 percent participation in a subsidiary that in turn holds a 40 percent participation in a company that satisfies the low-tax test (low-taxed subsidiary).

LuxCo is deemed to own a participation of 40 percent in the low-taxed subsidiary (100 percent \* 0.40 = 40%). It follows that the low-taxed subsidiary is not a CFC of LuxCo. (See Figure 2.)

It is interesting to note that the definition of associated enterprises within the meaning of LITL article 164-ter is much broader than the concept of associated enterprises within the meaning of article 9 of the OECD model.

**Figure 2. Indirect Participations In a Low-Taxed Subsidiary**



### C. Nondistributed Profits

LITL article 164-ter applies only if a CFC does not distribute its profits during the accounting period in which the profits are realized. Hence, when a CFC distributes its profits before year-end, the CFC rules do not apply.<sup>10</sup>

For indirect CFCs that are held via one or more intermediary companies, profits should be deemed to be distributed only if the Luxembourg parent receives a dividend. In contrast, the distribution of profits by a CFC to an intermediary company should not be considered a distribution under the Luxembourg CFC rules.

Profits are commonly distributed after the end of the accounting period in which the profits have been realized once the financial statements have been prepared. The distribution of profits before the end of the accounting period entails numerous complexities, such as the preparation of interim accounts (potentially subject to external audit) and the organization of an additional board meeting for making the decision on the distribution. Further, the CFC might not even be in a position to pay a dividend in the absence of cash, given that income (for example, interest

<sup>10</sup>The repayment of capital or share premium should not be considered a distribution in this respect.

income or royalties) might be accrued but not be paid.

The administrative burdens and costs linked to the distribution of profits before year-end will be even more substantial for indirect CFCs that should distribute profits through a chain of companies to the Luxembourg parent.

#### D. Non-Genuine Arrangements

LITL article 164-ter is a specific antiabuse rule under which the nondistributed profits<sup>11</sup> of an entity or PE that qualifies as a CFC are taxable in Luxembourg if they arise from non-genuine arrangements whose essential purposes are obtaining a tax advantage.

Further, an arrangement or a series thereof will be regarded as non-genuine if the entity or PE would not own the assets or would not have undertaken the risks that generated all or part of its income if it were not controlled by a Luxembourg corporate taxpayer when the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the CFC's income.

Accordingly, the CFC rules should not apply if a Luxembourg corporate taxpayer does not perform the significant people functions that are relevant to the CFC's assets and risks. However, even the very fact that a Luxembourg company is performing functions or services for a CFC's benefit cannot, on its own, lead to the conclusion that an arrangement or a series thereof is non-genuine.

The definition of non-genuine arrangements in LITL article 164-ter is not very clear, so the interpretation of that concept might be informed by the definition of non-genuine arrangements under the ATAD's general antiabuse rule.<sup>12</sup> The ATAD states that an arrangement or series thereof

will be considered non-genuine if it is not put into place for valid commercial reasons that reflect economic reality.

Hence, when a Luxembourg taxpayer can establish valid commercial reasons and prove that an arrangement reflects economic reality, the CFC rules should not apply, irrespective of whether the Luxembourg taxpayer performs significant people functions. Instead, the Luxembourg parent company should receive an arm's-length remuneration for the services rendered for the CFC's benefit.

The CFC rules also seem to include a motive test, given that they apply only if an arrangement has been put in place for the essential purpose of obtaining a tax advantage. Again, when a taxpayer can establish valid commercial reasons, an arrangement should not be regarded as existing for the essential purpose of obtaining a tax advantage.

In practice, multinational groups often centralize some functions, such as treasury activities or the management of intangibles, in one entity that renders services to other members of the group. When a multinational group has a Luxembourg investment platform that manages specific functions for the benefit of other group companies, including CFCs, the CFC rules should apply only if a taxpayer cannot establish valid commercial reasons for the arrangement. In those circumstances, the (appropriate) substance of a CFC is an important element when substantiating the commercial rationale of the group structure.

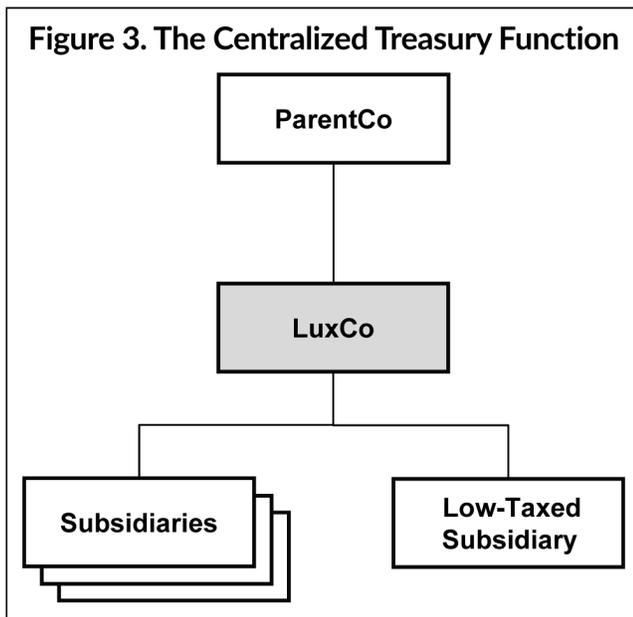
*Example.* A multinational group manages its business activities in Europe via LuxCo, which functions as a European investment platform. LuxCo employs a team that takes care of all treasury functions of the European businesses.

LuxCo has a subsidiary that is subject to low taxation under LITL article 164-ter (1) No. 2. The subsidiary performs several activities, including providing financing to other group companies. As far as the intragroup loans of the CFC are concerned, LuxCo manages the treasury functions in exchange for an arm's-length remuneration. In terms of substance, the CFC has a real presence in its state of residence.

<sup>11</sup>The relevant nondistributed CFC profits are those realized by the CFC during the accounting period (profits carried forward from previous accounting years are disregarded). The CFC income is to be considered in the fiscal year of the Luxembourg corporate taxpayer in which the CFC's financial year ends.

<sup>12</sup>That definition has also been included in the abuse-of-law concept (the 2019 tax reform amended section 6 of Luxembourg's Tax Adaptation Law to be consistent with the ATAD's general antiavoidance or abuse rule). Given that LITL article 164-ter is a specific antiabuse rule, which — like the GAAR — targets non-genuine arrangements, there should be no room for the application of the GAAR when the CFC rules are not applicable (for low-taxed subsidiaries or PEs).

LuxCo owns a 100 percent participation in an entity that qualifies as a CFC. Moreover, the treasury-related functions are centralized at LuxCo's level. However, there are several valid commercial reasons for the CFC, including managing business operations in its residence state, research and development activities, and providing funding to other group companies. Thus, the CFC rules should not apply. (See Figure 3.)



In light of the above, the CFC rules should not apply automatically whenever a Luxembourg corporate taxpayer owns a CFC. Instead, it must be established that a CFC's nondistributed profits arise from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage. In that regard, Luxembourg taxpayers should be able to provide evidence for case-by-case analysis by the Luxembourg tax authorities. (See Figure 4.)

### III. Determining CFC Income and Tax Treatment

The ATAD framework for implementing CFC rules provides a common definition of CFCs but two alternatives for the fundamental scope of the rules: the passive income option and the non-genuine arrangement option.

Luxembourg has chosen the non-genuine arrangement option. Under that option, the

nondistributed profits of an entity or PE that qualifies as a CFC are taxable in Luxembourg if they arise from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage.

When the CFC rules apply, the CFC income is subject to CIT (currently 18 percent). A provision has been included in the municipal business tax law excluding CFC income from the municipal business tax base. Thus, CFC income is included only in the corporate income tax base.

#### A. Determining CFC Income

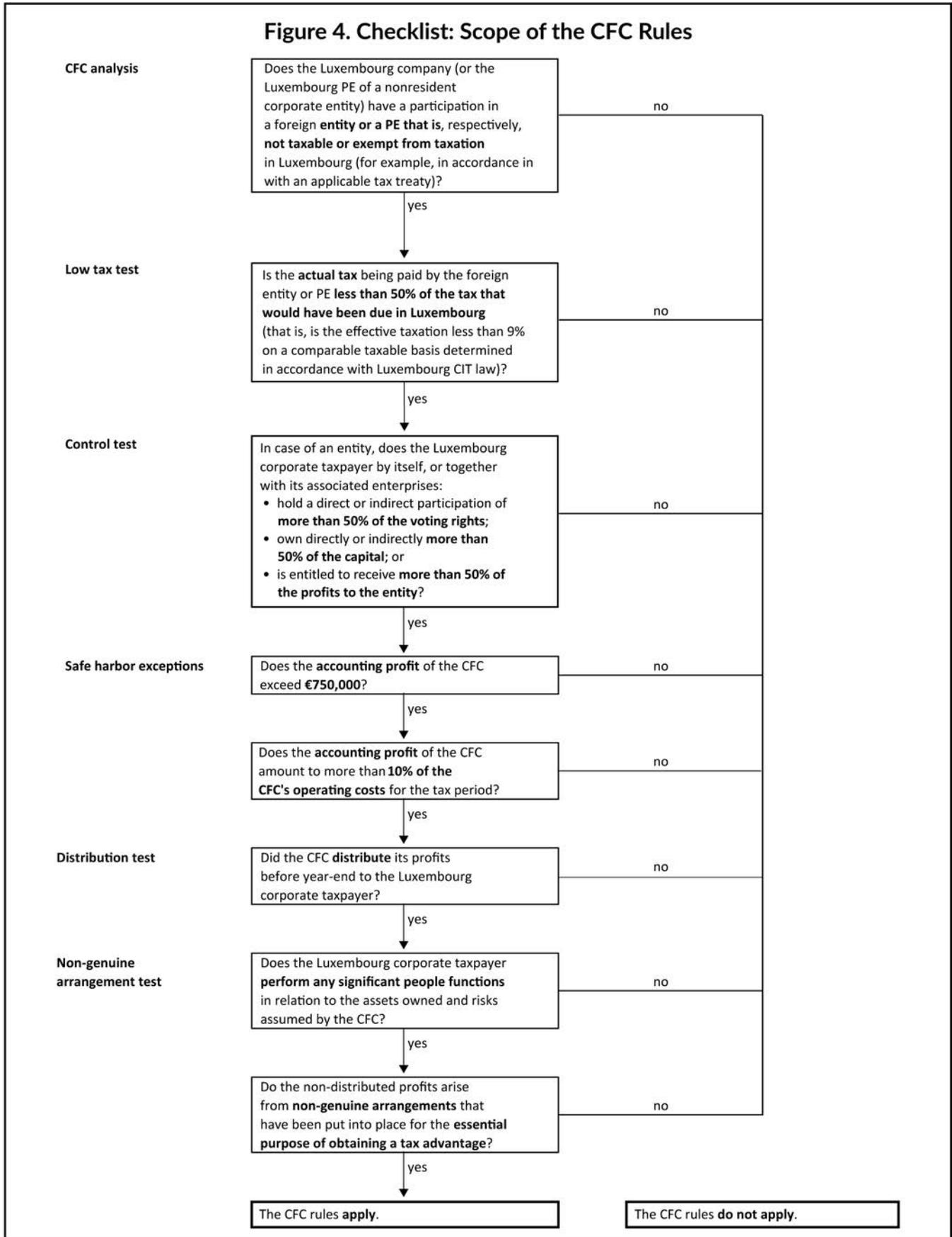
According to LITL article 164-ter, a CFC's profits should generally be included in the tax base of a Luxembourg corporate taxpayer if that taxpayer manages the CFC's activities that generate those profits — that is, the significant people functions for the assets owned and risks assumed by the CFC. Conversely, when a Luxembourg parent does not carry out any significant people functions for a CFC's activities, no CFC income should be included in its CIT base.

When a Luxembourg corporate taxpayer is involved in the management of the activities performed by a CFC, the CFC income to be included in the CIT base should be limited to amounts generated through assets and risks linked to significant people functions carried out by the Luxembourg taxpayer. In those circumstances, the attribution of CFC income shall be calculated in accordance with the arm's-length principle of LITL articles 56 and 56-bis.

There is overlap between the CFC rules and Luxembourg transfer pricing rules. However, if applying the arm's-length principle already results in including the CFC income in the Luxembourg parent's CIT base, the CFC rules should not apply.<sup>13</sup>

For a CFC PE, the concept of significant people functions is the basis for attributing

<sup>13</sup> Luxembourg transfer pricing rules are to be applied in the ordinary course of determining the taxable income of a Luxembourg corporate taxpayer (before the potential application of antiabuse rules) and therefore take precedence over the CFC rules.



profits.<sup>14</sup> When a Luxembourg company has a foreign PE, profits linked to assets and risks managed by the Luxembourg head office should be taxable in Luxembourg and cannot benefit from a tax exemption under an applicable tax treaty.<sup>15</sup> As long as the arm's-length principle is properly applied, the CFC rules should generally not apply to CFC PEs.

*Example.* LuxCo has a PE in a jurisdiction with which Luxembourg has concluded a tax treaty. The PE satisfies the low-tax criterion of LITL article 164-ter (1) No. 2, which technically makes it a CFC PE. According to the treaty, profits attributable to the PE are exempt from taxation in Luxembourg.

The profits realized through the activities carried out by the PE amount to €2 million. Forty percent of those profits are linked to significant people functions performed by the Luxembourg head office; thus, 40 percent should be attributable, at arm's length, to the head office. The income should be subject to CIT and municipal business tax.<sup>16</sup> Because the CFC rules apply only to profits attributable to the significant people functions performed by the Luxembourg head office, they do not apply here.

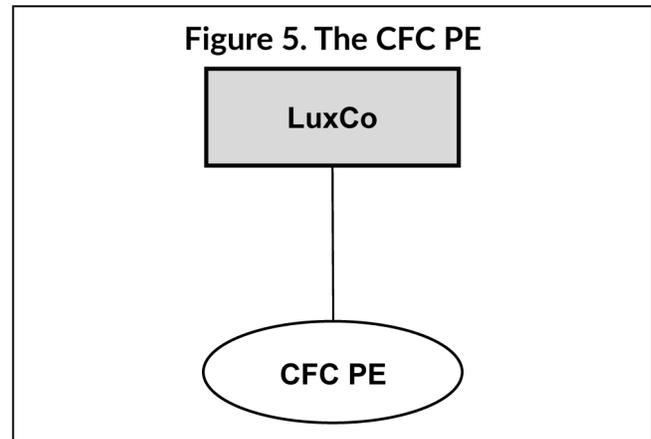
As a variation, all significant people functions are performed at the PE level. Thus, Luxembourg transfer pricing and CFC rules would not result in the inclusion of any profits at the head office level. (See Figure 5.)

When a Luxembourg parent company performs significant people functions for the benefit of a CFC entity, it should realize an arm's-length remuneration for the services rendered.

<sup>14</sup> See Oliver R. Hoor, "The Tax Treatment of Permanent Establishments," 54(7) *Eur. Tax'n* 287 (July 2014); and *The OECD Model Tax Convention: A Comprehensive Technical Analysis* 121 (2015). See also guidance in OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (July 22, 2010).

<sup>15</sup> Luxembourg generally adopts the exemption method to eliminate the double taxation of business profits.

<sup>16</sup> While income derived through a foreign PE would be excluded from Luxembourg municipal business tax, profits attributable to a Luxembourg head office are subject to it.



Depending on the facts and circumstances, the Luxembourg parent may, at arm's length, even be entitled to (part of) the CFC's profits. However, if the CFC's profits are already included in the Luxembourg company's tax base, the CFC rules do not apply.

It is also important to distinguish between significant people functions performed by a Luxembourg parent for the benefit of a CFC entity and oversight functions performed by the Luxembourg taxpayer in its capacity as shareholder. The latter should not trigger the inclusion of CFC income in the Luxembourg corporate tax base.

Also, the CFC income to be included in the tax base should be computed in proportion to the Luxembourg taxpayer's participation in the CFC. From a timing perspective, the CFC income should be included in the tax period of the Luxembourg corporate taxpayer in which the CFC's tax year ends.

Expenses incurred by the Luxembourg parent should be deductible if they have an economic relationship with the CFC income.

Losses incurred by a CFC are to be disregarded when determining the taxable income of the Luxembourg corporate taxpayer. However, those losses may be carried forward and reduce the CFC income in subsequent fiscal years.<sup>17</sup>

When CFC income must be included in the CIT base, Luxembourg corporate taxpayers may

<sup>17</sup> That rule applies only to losses incurred by a CFC in fiscal 2019 and after.

offset that income with tax losses incurred in the same year or carried forward from previous tax years.<sup>18</sup>

## B. Avoiding Double Taxation

The inclusion of nondistributed CFC income in the CIT base of a Luxembourg corporate taxpayer may result in double taxation. For CFCs owned through a chain of companies that are tax resident in different jurisdictions, it is possible that the same CFC income is included in the tax base of more than one company. Double or multiple taxation can have different causes, such as:

- the CFC rules in different jurisdictions are not coordinated and result in the inclusion of the same CFC income;
- the distribution of CFC profits are taxable at the level of the intermediary company owning the participation in the CFC and still must be included as CFC income at the level of the indirect parent company; or
- transfer pricing adjustments and CFC rules are applied to the same profits.

LITL article 164-ter has several provisions to eliminate the double taxation of CFC income in Luxembourg.

### 1. Profit Distributions

When a CFC distributes profits to a Luxembourg corporate taxpayer, and those distributed profits were included in the taxpayer's CIT base in previous years, the amounts of CFC income previously included in the tax base (in accordance with LITL article 164-ter) should be deducted from the base when calculating the tax due on the distributed profits.<sup>19</sup>

### 2. Sales

When a taxpayer disposes of its participation in a CFC entity or of the business carried out by a CFC PE, any part of the proceeds from the disposal that had previously been included in the tax base (in accordance with LITL article 164-ter) must be deducted from the amount of capital

gains realized by the Luxembourg corporate taxpayer on disposal.

However, that provision applies only if the Luxembourg corporate taxpayer directly owns the CFC. When a CFC is indirectly owned through one or several intermediary companies, it does not apply.

Moreover, a deduction from the CIT base is allowed only if the dividend income or capital gains are taxable in Luxembourg. When a tax exemption applies, no tax adjustments will be made under LITL article 164-ter (4) No. 6 or 7.<sup>20</sup> Dividends paid by a foreign subsidiary may, for example, be exempt under an applicable tax treaty regardless of the tax treatment of that subsidiary.<sup>21</sup>

### 3. CFCs Subject to Taxation

When the CFC entity or PE is subject to taxation in the residence or host state, Luxembourg will allow the Luxembourg corporate taxpayer to deduct from its CIT liability the tax paid by the CFC.<sup>22</sup> The credit to be considered is proportional to the CFC participation held by the Luxembourg parent.<sup>23</sup> When there is no Luxembourg CIT liability to which the tax credit method can be applied, the tax paid by the CFC may still be deducted from the taxable income.<sup>24</sup>

The amount of creditable tax is limited to taxes paid by the CFC itself. In contrast, when a CFC is indirectly held via one or more intermediary companies, the taxes levied on distributed or undistributed CFC income at the intermediaries' level would not be creditable in Luxembourg. Hence, in those circumstances, double and multiple taxation might occur.

<sup>20</sup> Tax treaties concluded by Luxembourg may provide that dividends paid by a foreign subsidiary or capital gains realized on disposal of a participation are exempt from tax in Luxembourg even if the entity fulfills the low-tax criterion in the CFC rules.

<sup>21</sup> As one example, the Luxembourg-Switzerland tax treaty provides for the application of the exemption method for dividends paid by a Swiss company to a Luxembourg parent under specified conditions — that is, a participation of at least 10 percent in the capital of the Swiss company must have been held since the beginning of the accounting year. That exemption does not depend on a particular tax treatment — that is, minimum taxation — of the subsidiary in Switzerland.

<sup>22</sup> The tax credit method is determined under LITL articles 134-bis and 134-ter.

<sup>23</sup> LITL article 164-ter (4) No. 7.

<sup>24</sup> LITL article 13.

<sup>18</sup> LITL article 114. Available tax losses may offset the entire amount of CFC income.

<sup>19</sup> LITL article 164-ter (4) No. 6.

#### IV. CFC Rules in an EU Context

EU subsidiaries or PEs of Luxembourg corporate taxpayers should generally not be subject to low taxation within the meaning of LITL article 164-ter (1) No. 2. However, when an entity or PE falls under Luxembourg's CFC rules, EU law and the jurisprudence of the Court of Justice of the European Union should be considered.

Under the CFC rules, the advantage of investing in a low-tax subsidiary is neutralized because profits are included in the corporate tax base of the Luxembourg parent when the low-taxed subsidiary does not distribute the profits in the accounting period when they are realized. Whether that treatment is compatible with EU law (in particular, the freedom of establishment) has been clarified in a landmark CJEU decision.<sup>25</sup>

According to that decision, all measures that prohibit, impede, or render less attractive the exercise of freedom of establishment must be considered to restrict that freedom. Restrictions are permissible only if they concern situations that are not objectively comparable or are justified by overriding reasons in the public interest recognized by EU law. In those cases, the restriction must also be appropriate for ensuring the attainment of its objective and must not go beyond what is necessary to achieve that.

In an EU context, antiabuse provisions such as CFC rules must be targeted at wholly artificial arrangements that do not reflect economic reality and whose purpose is to unduly obtain a tax advantage. Accordingly, EU members may protect their tax bases via antiabuse rules directed exclusively at those kinds of arrangements.<sup>26</sup> Nevertheless, within the EU, restrictions can only be justified by the need to prevent tax avoidance when a specific antiavoidance rule targets "wholly artificial arrangements"<sup>27</sup> aimed solely at escaping national tax normally due.

<sup>25</sup> *Cadbury Schweppes PLC, Cadbury Schweppes Overseas Ltd. v. Inland Revenue*, C-196/04 (CJEU 2006).

<sup>26</sup> See *id.* at para. 51. See also Eric Robert and Driss Tof, "The Substance Requirement and the Future of Domestic Anti-Abuse Rules within the Internal Market," 51(11) *Eur. Tax'n* 438 (Nov. 2011); and José Calejo Guerra, "Limitation on Benefits Clauses and EU Law," 51(2/3) *Eur. Tax'n* 93 (Feb./Mar. 2011).

<sup>27</sup> See *Cadbury Schweppes*, paras. 51, 55, 57, and 75.

Thus, an abusive situation does not depend solely on the taxpayer's intention to obtain tax advantages (a motive test). It also requires the existence (or absence) of specific objective factors, including an actual establishment in the host state (for example, premises, staff, facilities, and equipment) and genuine economic activity performed by the foreign company.<sup>28</sup>

Regarding the existence of an actual establishment, the CJEU does not seem to require an extensive level of substance. As a rule of thumb, the substance should be appropriate for the activities performed by the company. The notion of genuine economic activity is broad and may include the mere exploitation of assets such as shareholdings, receivables, and intangibles for deriving passive income. The nature of the activity should not be compromised if that passive income is principally sourced outside the entity's host state.<sup>29</sup>

Further, domestic antiabuse provisions cannot require any specific ties or connections between the economic activity assigned to the foreign entity and the territory of that entity's host state.

Therefore, as far as the EU internal market is concerned, the mere fact that a CFC is active in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to put it out of the reach of the CFC rules.

#### V. Critical Review of the CFC Rules

The implementation of CFC rules in Europe and beyond is creating substantial complexity for taxpayers and tax administrations alike. Even the CFC rules implemented by EU members vary significantly despite being based on, or at least consistent with, the ATAD. That could considerably increase compliance costs for taxpayers.

Plus, the overlap with Luxembourg transfer pricing rules, as well as the lack of interaction and coordination with CFC rules and BEPS measures

<sup>28</sup> See *id.* at para. 54-55.

<sup>29</sup> Further, the mere fact that a structure may help to shift income from a high-tax jurisdiction to a low-tax one is not enough to show that the structure is abusive (even if the structure has innovative features). See Robert and Tof, *supra* note 26, at 438.

implemented in other jurisdictions, runs the risk of double and multiple taxation.

### A. Transfer Pricing vs. CFC Rules

Luxembourg adopted the non-genuine arrangement option that requires including a CFC's nondistributed profits in the income of a Luxembourg corporate taxpayer that performs the significant people functions for the assets owned and the risks assumed by the CFC.

The concept of significant people functions originates from OECD guidance regarding the attribution of profits to a PE.<sup>30</sup> As such, it is not self-evident to use this transfer pricing concept as a triggering mechanism in an antiabuse provision. Transfer pricing and CFC rules have a different conceptual core, and they are certainly not complementary.

Depending how EU members implement the CFC rules under the ATAD, those rules risk being used as mechanisms for (secondary) adjustments when transfer pricing rules are inapplicable. That in itself creates a risk of double taxation and changes the character of CFC rules into a methodological supplement of transfer pricing rules.

While CFC income is included on a current basis, transfer pricing adjustments often take place in a subsequent fiscal year — for example, in the course of a tax audit spanning several fiscal years. Hence, when CFC income is included at the level of the Luxembourg parent company and a transfer pricing adjustment is later to the activities performed for the CFC's benefit, double taxation would result.<sup>31</sup>

For CFC PEs, profits should be attributable to the foreign PE only if and to the extent that the significant people functions are performed by employees or managers of the PE. Otherwise, if (part of) those functions are performed by the Luxembourg head office, the head office should receive an arm's-length remuneration for its services or a share in the profits of the PE. In the extreme, the asset allocation and profit attribution to the PE may be challenged in its entirety.

<sup>30</sup> See 2010 OECD report, *supra* note 14.

<sup>31</sup> For example, when an upward adjustment is performed for intragroup services even though the CFC's entire profits have already been included in the Luxembourg corporate taxpayer's CIT base.

Thus, the proper application of the arm's-length principle in attributing a foreign PE's profits should leave no room for applying CFC rules because both transfer pricing and CFC rules rely on the concept of significant people functions for attributing profits attribution and including CFC income, respectively.

For CFC entities, the Luxembourg parent company should receive arm's-length remuneration for services rendered to its subsidiaries. The CFC income to be included in the Luxembourg tax base should be limited to profits attributable to the significant people functions performed by the Luxembourg parent minus remuneration it receives.<sup>32</sup> However, when a Luxembourg taxpayer can present valid commercial reasons for a given group structure and business model, the CFC rules should not apply in the absence of a non-genuine arrangement.

### B. Risk of Double Taxation

Luxembourg's CFC rules entail a risk of double taxation, given that they are not coordinated with CFC rules in other jurisdictions and do not interact with other antiabuse legislation (for example, interest limitation or hybrid mismatch rules).

LITL article 164-ter might even require the inclusion of CFC income when the CFC's actual distribution of profits would benefit from a tax exemption (for example, under an applicable tax treaty), a situation that should in principle not give rise to BEPS concerns.<sup>33</sup> Thus, Luxembourg might tax CFC income even though it exempts dividend payments.

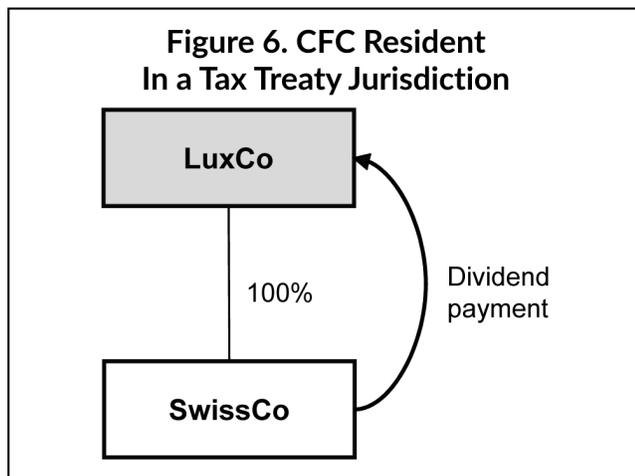
*Example.* LuxCo owns a 100 percent participation in a Swiss subsidiary (SwissCo) that is taxed at 7 percent. Accordingly, the subsidiary is a CFC under LITL article 164-ter (1). However, the Luxembourg-Swiss tax treaty exempts dividend income a Luxembourg company derives from a Swiss subsidiary if the

<sup>32</sup> The remuneration for services a CFC entity pays to a Luxembourg corporate taxpayer reduces the CFC profits that can be included as CFC income.

<sup>33</sup> Dividends a CFC distributes to a Luxembourg corporate taxpayer might benefit from an exemption under an applicable tax treaty.

Luxembourg company held a participation of at least 10 percent since the beginning of the fiscal year (regardless of the Swiss subsidiary's tax status).

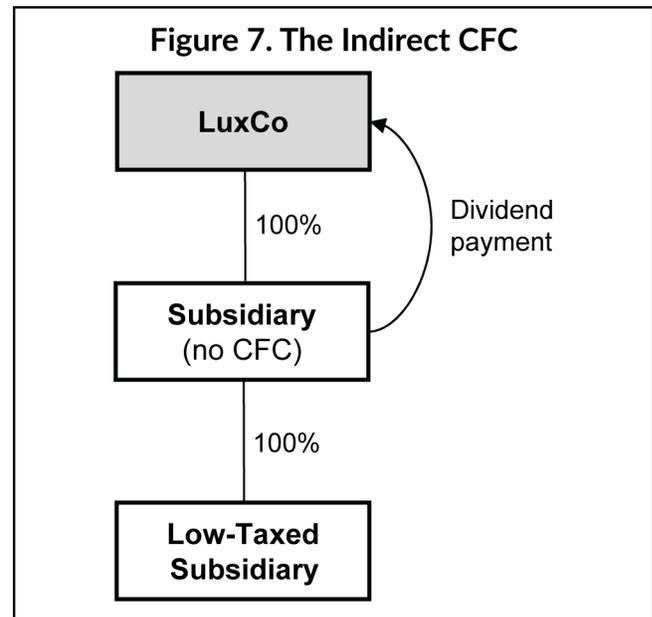
LITL article 164-ter might require the inclusion of CFC income even though the distribution of profits would be tax exempt in Luxembourg. (See Figure 6.)



Likewise, when CFC entities are held indirectly, dividends paid by the CFC through the chain might benefit from an exemption in Luxembourg if the direct subsidiary of the Luxembourg corporate taxpayer qualifies for the Luxembourg participation exemption regime or the dividends are exempt under an applicable tax treaty. Even so, the CFC rules might still require the inclusion of CFC income under those circumstances.

*Example.* LuxCo indirectly owns a 100 percent participation in a company that satisfies the low-tax test. The direct subsidiary is a company that meets the comparable taxation criterion under the Luxembourg participation exemption regime. Accordingly, the income derived from the participation in the direct subsidiary (dividends, capital gains, liquidation proceeds) benefits from a tax exemption.

If the conditions of the CFC rules are met, the CFC's income should be taxed at LuxCo's level even though a distribution of CFC income up the chain would benefit



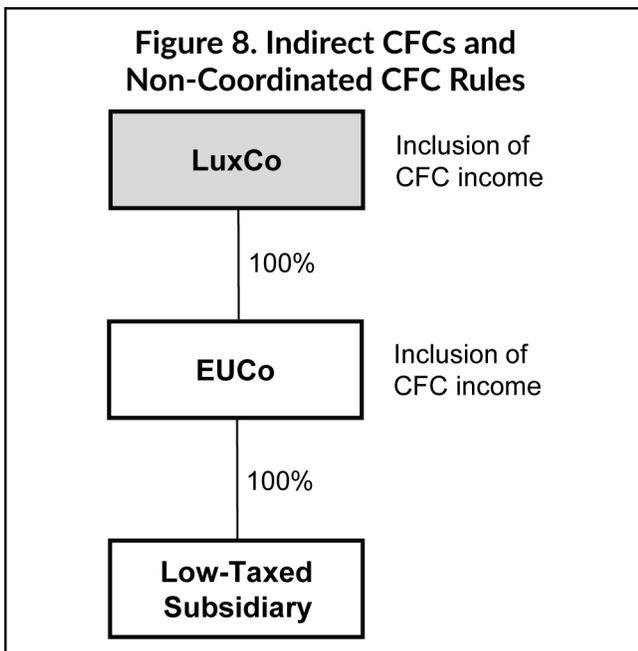
from an exemption under Luxembourg's participation exemption regime. (See Figure 7.)

In a chain of companies, it may be that the same CFC income is included at the level of two or more parent companies. Because jurisdictions' CFC rules generally lack a coordination or priority order, double and multiple taxation could occur.

*Example.* LuxCo owns indirectly a 100 percent participation in a company that satisfies the low-tax test. The direct subsidiary is a company that is tax resident in an EU state (EUCo). The income derived from the participation in EUCo (dividends, capital gains, liquidation proceeds) falls under the Luxembourg participation exemption regime. EUCo's residence state opted for the passive income option when implementing the ATAD CFC rules.

The CFC rules adopted by Luxembourg and EUCo's residence state are not coordinated, so the same CFC income might be included in the CIT base of both LuxCo and EUCo, resulting in double taxation. (See Figure 8.)

Another example of double taxation triggered by CFC rules is linked to the lack of interaction and coordination with other BEPS measures such as the anti-hybrid-mismatch (action 2) and

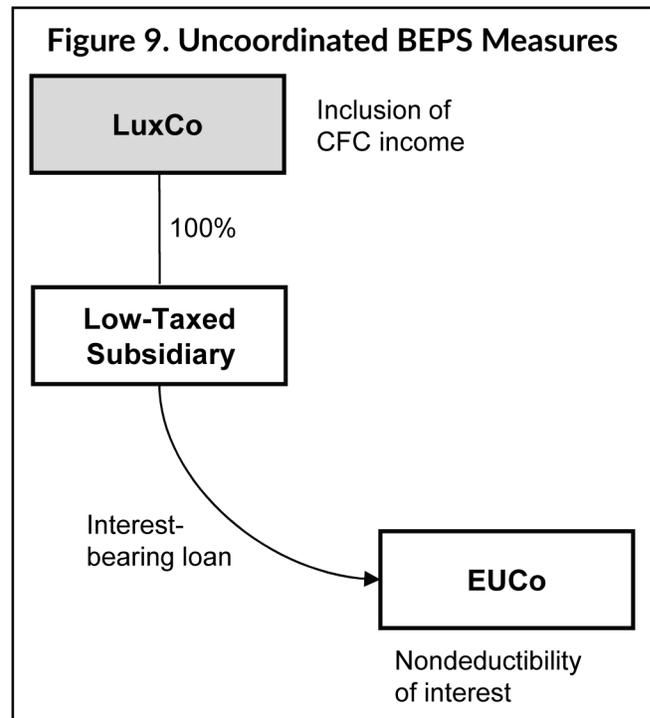


interest limitation rules (action 4). When applicable, both sets of rules result in the nondeductibility of interest expenses although the interest income is generally taxable at the lender's level.

The simultaneous application of CFC rules could result in situations in which interest expenses are not deductible, but interest income must be included as CFC income in the Luxembourg tax base. Ironically, that would be a nondeduction with inclusion outcome under OECD BEPS terminology.

*Example.* LuxCo directly owns a 100 percent participation in a company that satisfies the low-tax test (low-taxed subsidiary). The low-taxed subsidiary grants a loan to a group company that is resident in an EU state (EUCo). EUCo's residence state implemented the ATAD interest limitation rule, restricting deductible interest expenses to 30 percent of EUCo's earnings before interest, taxes, depreciation, and amortization. EUCo's borrowing costs exceed that amount (before the interest expenses charged under the loan granted by the low-taxed subsidiary).

EUCo cannot deduct the interest expenses incurred on the loan granted by the low-taxed subsidiary. At the same time, LuxCo

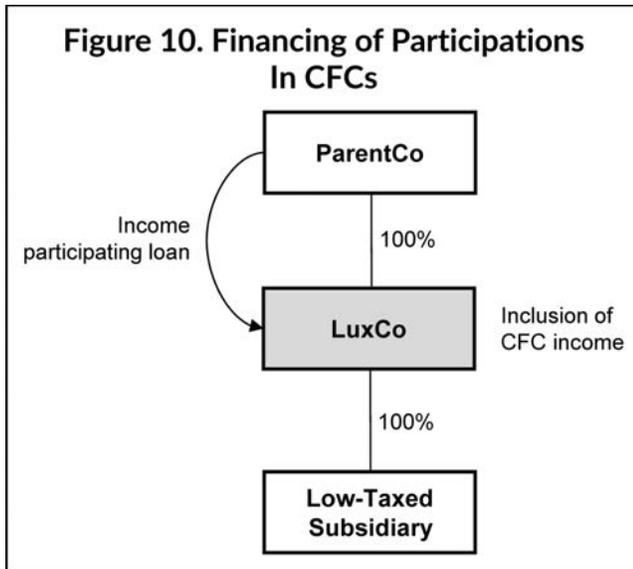


might have to include the low-taxed subsidiary's profits as CFC income in its corporate tax base. Accordingly, uncoordinated BEPS measures applied in Luxembourg and EUCo's residence state could result in double taxation. (See Figure 9.)

Double taxation might also arise in CFC financing. A Luxembourg company may, for example, finance a participation in a CFC entity with a financing instrument that bears variable yield based on the income derived from the participation in the CFC. In those circumstances, interest will accrue only if the CFC actually pays dividends, not when CFC income is included in the Luxembourg taxpayer's CIT base. It follows that CFC income may be fully taxable in the absence of interest expenses related to the financing of the participation.

*Example.* LuxCo owns a 100 percent participation in a company subject to low taxation under LITL article 164-ter. LuxCo finances its participation in that low-taxed subsidiary largely with an income-participating loan that bears variable yield corresponding to 80 percent of the income derived from participation.

Under the CFC rules, the CFC's profits would be included as CFC income in LuxCo's CIT base, whereas no variable yield would accrue under the income-participating loan financing the participation. Thus, the CFC income would be taxable, whereas the corresponding interest expenses would accrue only once the low-taxed subsidiary distributed a dividend. (See Figure 10.)



### C. Tax Treaty Overrides

Because double tax treaties are international agreements that bind the contracting states, the subsequent enactment of domestic legislation to override a treaty constitutes a breach of international law and a state's international obligations.

The commentary to the OECD model tax convention addresses the interaction of CFC rules and tax treaty law. It states that because CFC rules result in a state taxing its own residents, they do not conflict with tax treaties. It also says the same conclusion must be reached for treaties that do not include a provision similar to model article 1(3). Therefore, the application of CFC rules in a tax treaty context is not an illegitimate treaty override.

### VI. Conclusion

When transposing the CFC rules, Luxembourg adopted the ATAD's non-genuine arrangement option. Accordingly, the nondistributed profits of an entity or PE that qualifies as a CFC are taxable in Luxembourg if they arise from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage.

When the CFC rules apply, the CFC income to be included in the Luxembourg CIT base is limited to the profits linked to the significant people functions performed for the CFC's assets and risks. In contrast, when a Luxembourg corporate taxpayer does not perform any people functions for CFC activities, no CFC income should be included in the Luxembourg tax base.

Luxembourg transfer pricing and CFC rules overlap. That and the lack of coordination with other BEPS measures has the potential to create double taxation whenever LITL article 164-ter requires the inclusion of CFC income. Ultimately, Luxembourg corporate taxpayers should carefully screen their group structures to detect potential CFCs and manage the effect of the CFC rules. ■