THE PAST, PRESENT, AND FUTURE OF LUXEMBOURG SPECIAL PURPOSE COMPANIES

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Amid a global context of widespread budget deficits, it seems that politicians have finally discovered that multinational enterprises, entrepreneurs, and high net worth individuals have recourse to legal frameworks that allow for the tax efficient structuring of investments.

For decades, countries such as the Netherlands, Ireland, Cyprus, and Luxembourg have been well known as jurisdictions of choice for savvy international tax planning. However, even if such structuring is legal, today it appears to be considered immoral or unethical in the eyes of the non-initiated public, who often find it difficult to discern between tax optimization and tax fraud. While the former is legal, the latter is not.

This article addresses the evolution of tax planning through the implementation of Luxembourg special purpose companies ("S.P.V.'s") from its origin to projections for the future in light of ongoing discussions involving the member countries of the Organization for Economic Co-operation and Development ("O.E.C.D.") and others.

1929 LUXEMBOURG HOLDING COMPANIES

The evolution of the contemporary Luxembourg S.P.V. begins with the creation of the 1929 Luxembourg holding companies (the "H29 Companies").

Background

The H29 regime was governed by the Law of 31 July 1929 (the "H29 Law").

The primary purpose of an H29 Company was to hold a portfolio of equities (*e.g.*, shares or bonds) or patents, but it could also grant loans and advances or guarantees to the companies in which it had a direct participation.

An H29 Company enjoyed a preferential tax regime designed to eliminate double taxation of income from a securities portfolio. It was exempt from the following taxes in Luxembourg:

- Corporate income tax,
- Municipal business tax,
- Net wealth tax, and
- V.A.T.

In addition, no withholding tax in Luxembourg was levied on dividends paid by an H29 Company to nonresident shareholders.

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Because of the H29 Law, H29 Companies were excluded from the application of double tax treaties. In today's parlance, the exclusion prevented double non-taxation. H29 Companies were subject only to an annual subscription tax of 0.2% (calculated on the amount of paid-up capital and bonds issued) and the capital duty.

Illegal State Aid – An End to the H29 Companies

In a July 19, 2006 decision, the European Commission determined that "the tax scheme currently in force in Luxembourg in favor of holding companies exempted on the basis of the Law of 31 July 1929 is a state aid scheme incompatible with the common market."[1] The H29 Law was subsequently repealed pursuant to a Luxembourg law dated December 22, 2006.

Consequences

A transitional period was granted through December 31, 2010. As of January 1, 2011, all H29 Companies, in the absence of any restructuring, were automatically considered to be fully taxable companies for Luxembourg tax purposes. Thus, they became liable for corporate income tax and municipal business tax (levied at the aggregate rate of 28.8% for the 2011 fiscal year when established in Luxembourg City), as well as a 0.5% net wealth tax on the net asset value of the company on each January 1. Any dividend distribution became subject to a 15% withholding tax (17.65% on a gross basis) unless reduced by an applicable double tax treaty or exempt under the conditions of the E.U. Parent-Subsidiary Directive, as discussed below.

25 YEARS OF SUCCESS FOR THE S.O.P.A.R.F.I.

Background

In 1990, Luxembourg enacted federal implementation of the E.U. Parent-Subsidiary Directive (the "E.U.P.S.D."),[2] which applies to fully taxable companies resident in Luxembourg.

The E.U.P.S.D. is designed to eliminate tax obstacles in the area of profit distributions between groups of companies operating in the E.U. by:

- Abolishing withholding tax on dividend payments between associated companies in various E.U. Member States and
- Preventing double taxation at the parent company level on the profits of a subsidiary.

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[1] 2006/940/EC: Commission Decision of July 19, 2006 on aid scheme C 3/2006 implemented by Luxembourg for 1929 holding companies and billionaire holding companies.

[2] Council Directive 90/435/EEC of July 23, 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Subject to certain exceptions, all dividends, capital gains, and liquidation proceeds from qualifying participations are exempt from corporate income and municipal business tax in Luxembourg if they are received or realized by a fully taxable Luxembourg company. In the same spirit, dividends paid by a fully taxable Luxembourg company to a qualifying parent company are not subject to Luxembourg withholding tax. Qualifying participations may also be exempt from net wealth tax.

"Subject to certain exceptions, all dividends, capital gains, and liquidation proceeds from qualifying participations are exempt from corporate income and municipal business tax in Luxembourg if they are received or realized by a fully taxable Luxembourg company."

More recently, a new type of entity has developed known as the Normally Taxable Holding Company, generally called a "S.O.P.A.R.F.I."[3] A S.O.P.A.R.F.I. is an ordinary commercial company established in Luxembourg, governed by the commercial company law of 1915 and fully subject to tax, *i.e.*, it does not benefit from an advantageous tax regime. However, a S.O.P.A.R.F.I. may reduce its tax burden by initially limiting its activity to the holding of participations in Luxembourg or foreign companies and structuring such participations so as to take advantage of the provisions of the E.U.P.S.D.

These provisions apply to all normally taxable companies. Thus, provided the conditions of the E.U.P.S.D. are satisfied, all Luxembourg companies could benefit from the E.U.P.S.D. Moreover, being that a S.O.P.A.R.F.I. is fully subject to tax, like any other commercial company, it also benefits from the provisions of double tax treaties concluded by Luxembourg.

In practice, the scope of activities realized by a S.O.P.A.R.F.I. has been widened, allowing it to (i) perform financing activities, (ii) purchase, sell, or exploit intellectual property ("I.P.") rights, and (iii) acquire shares in real estate companies or own real estate property directly. As a result, Luxembourg has reinforced its position in the international business scene by introducing a series of tax measures favoring inbound and outbound investments. Today, Luxembourg is well known as a go-to jurisdiction for investment management, holding, financing, I.P. activities, and private wealth management.

Rulings

Concurrent with the rise of the S.O.P.A.R.F.I., a new practice was developed in Luxembourg: the granting of tax rulings[4] or advance tax clearances (collectively, "Rulings").

At the beginning, the granting of Rulings was an administrative practice.[5] Its proliferation in Luxembourg can be traced to the migration of Dutch tax advisors in the early 1990's and to the cooperation of the Luxembourg tax authorities, who established a tax office fully dedicated to S.O.P.A.R.F.I.'s and the granting of Rulings.

Today, Rulings practices exist in most European countries.

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3 S.O.P.A.R.F.I. is the French acronym for *Société de Participation Financière*.

4 For the purposes of this article, a ruling may be defined as a confirmation granted by the tax authorities to a taxpayer of how their tax will be calculated.

5 As of January 1, 2015, amendments have been introduced to the General Tax Law that set down a legal framework for advanced tax clearances. See "Advance Tax Agreements ('A.T.A.'s'): Legal Process" below.

Tax Planning: 1990's to July 1, 2013

For more than 20 years, the granting of Rulings was common practice in Luxembourg, and Big 4 accounting firms and specialized law firms developed strong tax planning practices in Luxembourg and attracted talent from all over Europe. A pro-active and business-friendly government, an efficient tax administration, and the neo-liberal politics of the European Union all served to encourage this practice, resulting in a win-win situation for Luxembourg and for multinational companies that desired to invest abroad through a politically and economically stable country in a tax efficient and predictable way. Through the implementation of Luxembourg S.P.V.'s, multinational enterprises, entrepreneurs, and high net worth individuals have been able to reduce global tax burdens, even after leaving an arm's length remuneration in Luxembourg to adequately compensate the Luxembourg S.P.V. for the risks incurred and the functions performed.

All this was (and still is) completely legal, as any structuring through a Luxembourg S.P.V. was done through the application of Luxembourg's double tax treaties, E.U. directives, and Luxembourg law. Specifically, Rulings were granted on the basis of competitive tools provided by applicable legislation and a favorable income tax treaty network, including:

- Luxembourg income tax law[6] and administrative circulars, which include investment tax credits, a fiscal unity regime, an intra-group financing activities regime, an I.P. regime, tax neutral reorganization rules (*e.g.*, share-for-share, merger or division), a Special Limited Partnership regime (as of 2013), a carried interest regime (also as of 2013), and an expatriate regime;
- Specific laws regarding Specialized Investment Funds ("S.I.F.'s"), Specialized Investment in Capital at Risk ("S.I.C.A.R."), Private Assets Management Companies ("S.P.F.'s"), and Securitization Vehicles ("S.V.'s"); and
- Luxembourg's network of more than 70 tax treaties.

However, the political and economic environment that facilitated this practice has been altered by the 2008 "subprime mortgage crisis" and the 2009 "European debt crisis" that plunged the U.S. and the E.U. into recession. National governments became tasked with finding additional financial resources to reduce budget deficits.

THE O.E.C.D. BASE EROSION AND PROFIT SHIFTING ACTION PLAN

Background

At the request of G20 Finance Ministers, in July 2013, the O.E.C.D. launched its Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan.

B.E.P.S. refers to "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no

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6 And resulting from the implementation, into Luxembourg law, of E.U. directives.

economic activity, resulting in little or no overall corporate tax being paid."[7] The main goal of the Action Plan is, in some circumstances, to prevent double non-taxation.

Strategies associated with B.E.P.S. in regard to direct taxation are as follows:

- Elimination of taxation in the market country by avoiding a taxable presence,
- Low or no withholding tax at the source,
- Low or no taxation at the level of the recipient (via low-tax jurisdictions, preferential regimes, and/or hybrid mismatch arrangements) with entitlement to substantial non-routine profits via intra-group arrangements, and
- Eliminating or reducing tax in the country of the ultimate parent.

The B.E.P.S. Action Plan contains 15 specific actions intended "to equip governments with the domestic and international instruments needed to address this challenge."[8] These 15 actions are organized around three main pillars:

1. The coherence of corporate tax at an international level;
2. A realignment of taxation and substance; and
3. Transparency, coupled with certainty and predictability.

Some actions are particularly relevant for Luxembourg, such as:

- Action 6: Preventing the granting of treaty benefits in inappropriate circumstances.
    - The O.E.C.D. recommends the introduction of a Limitation of Benefits ("L.O.B.") clause and/or a "Principal Purpose Test" that would be introduced into all treaties. If the L.O.B. tests and the motive test cannot be met, treaty benefits would be denied.
    - This action item is potentially relevant to the real estate industry, wherein the provisions of a tax treaty may be used to benefit from a capital gains exemption upon disposal of real estate investments via a share deal.
- Action 4: Interest deductions and other financial payments.[9]
    - This action covers best practices in the design of rules to prevent base erosion through the use of interest expense, for example, through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

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7 "About BEPS." OECD: Better Policies for Better Lives. 2015.

8 *Id.*

9 Work to be completed by September 2015.

- Action 2: Neutralizing the effects of hybrid mismatch arrangements.
  - Such arrangements include the tax treatment of certain financial instruments or entities that potentially lead to double non-taxation or a long-term tax deferral.
  - For instance, it is common for U.S. investors to hold financial instruments that qualify as debt in the borrower jurisdiction and as equity from a U.S. tax standpoint (*i.e.*, the subscriber jurisdiction). As a result, the taxation of U.S. investors will be deferred until actual payment is made by the borrower, and even then, the "dividend" payment may be accompanied by an indirect foreign tax credit.
  - The O.E.C.D. proposal provides an exception to this rule in the event that the mismatch is due only to a reasonable timing difference between the recognition of the income and its taxation. However, no standard is prescribed for determining that a timing difference is reasonable.

Beyond Luxembourg, recommendations regarding hybrid mismatches are likely to have a significant impact on the structures and financing of multinational companies, as domestic law is affected on a global basis and extensive coordination will be required. European countries have already amended the E.U.P.S.D. in this respect (see "Amendments to the E.U.P.S.D." below).

The scope of tax benefits from intra-group debt funding likely will be tightened. A number of the proposals will require changes to domestic law. These include limitations on deductibility of interest expense, C.F.C. rules, and anti-abuse treaty provisions.

The impact of the political pressure on tax planning cannot be underestimated – some states have already begun to change domestic tax rules. In Luxembourg, the government is committed to ensuring that the state retains a competitive tax framework while also supporting broader European initiatives towards tax transparency and the O.E.C.D.'s work to combat B.E.P.S.

Direct Implications for Luxembourg – New Rules Already Implemented

E.U. Savings Directive

During the transitional period in Luxembourg that ended on December 31, 2014, the E.U. Savings Directive allowed individuals resident in other E.U. Member States who received interest from a Luxembourg paying agent to opt for exchange of information or application of a 35%[10] withholding tax on interest income. This option no longer exists. From January 1, 2015, Luxembourg automatically exchanges information on interest payments made by a paying agent established in Luxembourg to individuals resident in other E.U. Member States.[11]

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10 Previously, the rate was 15% as of July 1, 2005. It was then raised to 20% in 2008 and 35% as of 2011.

11 Interest paid by a Luxembourg paying agent to a Luxembourg resident individual

Advance Tax Agreements ("A.T.A.'s"): Legal Process

As of January 1, 2015, a formal legal process has superseded the administrative Rulings practice for A.T.A.'s; it is now expressly included in the Luxembourg Tax Law.[12] The aim remains to provide taxpayers with legal certainty regarding the tax treatment of transactions while maintaining uniform and egalitarian treatment for all taxpayers.

Corporate taxpayers[13] who wish to obtain an A.T.A. must now pay an administrative fee in order to compensate for the administrative costs borne by the tax authorities in relation to the A.T.A. process. Depending on the complexity of the request and the workload it requires of the tax authorities, the fee may range anywhere from €3,000 to €10,000.

Transfer Pricing

Given the globalization of transactions and the resulting increased focus on transfer pricing matters,[14] the Luxembourg government is implementing a more solid framework for applying the arm's length principle to associated enterprises.

Article 56 of Luxembourg income tax law now makes an explicit reference to the "arm's length" conditions used between independent businesses as the standard for evaluating the conditions used by related parties. This standard is applied for both resident and nonresident related parties. Based on the new wording of Article 56, profits may be adjusted upwards or downwards for transfer pricing purposes.

"A formal legal process has superseded the administrative Rulings practice.... The aim remains to provide taxpayers with legal certainty regarding the tax treatment of transactions while maintaining uniform and egalitarian treatment."

Disclosure and documentation requirements that are imposed currently on taxpayers in support of individual tax return positions will also apply to transactions between associated enterprises. These rules are in addition to documentation requirements already in place for intra-group financial intermediation activities.

2016 AND BEYOND

Transparency

F.A.T.C.A.

On March 28, 2014, Luxembourg and the U.S. signed an intergovernmental agreement ("I.G.A.") on the implementation of the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in Luxembourg. On the basis of this agreement, U.S. and Luxembourg tax authorities will automatically exchange information regarding the assets of (i) U.S. citizens and (ii) U.S. residents held by financial institutions in Luxembourg. Exchange of information must be operational by September 30, 2015.

remains subject to a final 10% withholding tax.

12 See the new §29a of the General Tax Law, known as the *Abgabenordung*.

13 A.T.A.'s can now be granted for both individuals and corporations.

14 Reference is made to the O.E.C.D. B.E.P.S. Action Plan.

Automatic Exchange of Information for Tax Purposes

On March 12, 2014, Council Directive 2011/16/EU regarding the mandatory and automatic mutual exchange of information in the field of taxation was implemented into Luxembourg law. The law applies to:

- Income from employment,
- Director's fees, and
- Pensions.

On December 9, 2014, the E.U. Council adopted Council Directive 2014/107/EU amending Directive 2011/16/EU of February 15, 2011 on administrative cooperation in the field of taxation. The amended directive extends the scope of the automatic exchange of information for tax purposes among E.U. Member States to interest, dividends, account balances, and sales proceeds from financial assets. It is based on the O.E.C.D.'s Common Reporting Standard and should become effective as of January 1, 2016 for early adopters, with the first exchanges of information between tax authorities scheduled for 2017.

Automatic Exchange of Tax Rulings

According to the European Commission, tax transparency is an essential element in combating corporate tax avoidance.

> Corporate tax avoidance is understood as a situation when certain companies use aggressive tax planning in order to minimize their tax bills. It often entails companies exploiting legal loopholes in tax systems and mismatches between national rules, to artificially shift profits to low or no tax jurisdictions. As such, it goes against the principle that taxation should reflect where the economic activity occurs.[15]

On March 18, 2015, upon the request of Mr. Jean-Claude Juncker,[16] the European Commission presented a package of measures to boost tax transparency. A key element of this package is a proposal to introduce "the automatic exchange of information between member states on their tax rulings."

Amendments to the E.U.P.S.D.

On July 8, 2014, the E.U. Council adopted an amendment to the E.U.P.S.D. to eliminate double non-taxation resulting from mismatches in the tax treatment of profit distributions in various E.U. Member States, in particular, in relation to hybrid financing arrangements. A Member State in which a parent company is tax resident must refrain from taxing profits distributed by qualifying subsidiaries located in another

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15 "Transparency and the Fight against Tax Avoidance." European Commission: Taxation and Customs Union.

16 Mr. Juncker was Luxembourg's Minister for Finance from 1989 to 2009 and Prime Minister from 1995 to 2013. As of November 1, 2014, he is the President of the European Commission.

Member State, but only to the extent that the distributions are not tax deductible in the Member State of the subsidiary. If the profit distributions are tax deductible in the Member State in which the subsidiary is located, then such distributions must be taxed by the Member State of the parent company. The amendment must be implemented into domestic law before January 1, 2016.

On January 27, 2015, the European Council formally adopted a binding general anti-abuse rule ("G.A.A.R.") in the E.U.P.S.D. This amendment is a significant step towards preventing tax avoidance and aggressive tax planning by corporate groups. Member States must implement the amendment into domestic legislation by the end of 2015. Once G.A.A.R. comes into effect, a holding company must have "valid commercial reasons which reflect economic reality" to justify its inclusion in any ownership chain, meaning that a holding company will need real substance.

"Marketing-related I.P., such as trademarks, will no longer benefit from preferential tax regimes."

I.P. Tax Regime

In February 2015, the O.E.C.D. and G20 countries released the "Action 5: Agreement on the Modified Nexus Approach for I.P. Regimes," which requires a "nexus" between favorable tax treatment of I.P. income and the exercise of substantial economic activity undertaken for the development of that I.P. in the same jurisdiction (the "Modified Nexus Approach"). Consequently, marketing-related I.P., such as trademarks, will no longer benefit from preferential tax regimes. Further guidance will be produced regarding the exact scope of I.P. assets that do not benefit from patent protection, such as copyrighted software or innovations from technical development or technical scientific research.

All existing I.P. regimes will be closed to new entrants following the introduction of a new preferential regime compliant with the Modified Nexus Approach or, if one is not introduced, after June 30, 2016. Member States may apply grandfathering clauses until June 30, 2021.

The above provisions will impact the Luxembourg I.P. regime, as the current regime must be aligned with the Modified Nexus Approach. The legislative process to replace or amend the current I.P. regime is slated to begin by the end of 2015.

Luxembourg Tax Reform

The Luxembourg government has committed itself to overhauling the current Luxembourg tax regime by 2017. In the intervening time, final reports will be issued under the B.E.P.S. Action Plan and some countries will adapt domestic fiscal legislation to comply with O.E.C.D. and G20 recommendations.

Although the government has not provided specific details, the market is expecting that the standard aggregate corporate income tax rate will be reduced to between 15% and 20% (compared to the 29.22% rate today in Luxembourg City) in order to compete with other E.U. jurisdictions (*e.g.*, the Netherlands and the U.K.). However, should the tax rate be reduced, a broader taxable basis will be required in order to maintain a balanced budget. The expectation of the government is that multinational enterprises have become comfortable in Luxembourg and that as long as the tax burden is comparatively low, Luxembourg will remain an attractive financial and headquarters location.

CONCLUSION

The rules of the game have changed, and as a result, multinational enterprises, entrepreneurs, high net worth individuals, and tax advisors must all adapt the way they globally structure their investments and wealth. Those who wish to follow historic tax plans will encounter the fate of the dinosaurs – the plans and the groups wishing to follow them will become extinct.

There is a trend toward full transparency regarding various types of income received by taxpayers. However, beyond mere words no reliable assurance exists that such private and sensitive information will be absolutely protected by receiving governments.

Substance will surely play a key role. Substance in this context refers to real offices, having computers and phones, where competent human resources are employed to carry on business, as demonstrated by regular correspondence and telephone records. The days of part-time employees having limited credentials and working a few hours each week are over. Facilities must be matched by individuals who possess highly-valued skills and are empowered to make decisions at the level of the Luxembourg S.P.V. However, no clear definition of the required substance is provided for sectors, such as real estate and accounting consolidation centers, where the need for management on a day-to-day basis by highly skilled executives is not required by the business.

On the other hand, innovation, new technologies, and economic globalization have changed the way corporations operate and invest. Through the internet, it is now possible to manage a business from any location, and an owner is no longer required to be sitting in an office in order to be effective. For many organizations, the flexibility afforded by the internet and remote management is the factor that allows a business to flourish.

Although a final report has been issued under the B.E.P.S. Action Plan with regard to the digital economy, it does not reach firm conclusions or recommendations. However, it seems that at least within the E.U., paper-only, mailbox-type entities will no longer be tolerated. This could be an opportunity for Luxembourg to diversify its economy by attracting new talents and developing new activities. In other words, this could be the chance Luxembourg needs to begin providing less "back-office" services and more added-value services similar to those provided by the most important global financial centers.

Since the A.I.F.M. Directive[17] was implemented in Luxembourg, the funds industry has been very active and the assets managed in the country have reached record

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[17] Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

highs. Many large U.S. companies and Chinese banks have already transferred European headquarters to Luxembourg, and if more asset managers and private equity houses follow, the benefits for Luxembourg will be considerable. In our view, this trend will strengthen in the coming years. Luxembourg's business-friendly government and strong relations with the private sector should enable it to implement attractive measures for business that are in line with international standards.

Until national governments implement the final B.E.P.S. Action Plan, it is difficult to assess the future role of Luxembourg S.P.V.'s. However, it is certain that substance, transfer pricing, and the utilization of double tax treaty networks must be carefully monitored and kept in line with economic reality by taking into consideration other national and international factors such as C.F.C. rules, general anti-avoidance rules, and other similar provisions.

"The rules of the game have changed, and as a result, multinational enterprises, entrepreneurs, high net worth individuals, and tax advisors must all adapt the way they globally structure their investments and wealth."