Branch Reporters
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Summary and conclusions

Luxembourg's market conditions reflect its position as a major financial centre. The banking, investment funds and insurance sectors are particularly strongly represented. Most foreign investment passes through to target jurisdictions, whereas Luxembourg is used as a platform for the holding and financing of investments. Private equity houses and landed property investors are important players in the market.

As regards the tax treatment of debt constituting a liability for a Luxembourg taxpayer, interest charges (interest accrued or paid) are generally tax deductible, with certain limitations. As a general rule, interest payments are not subject to a withholding tax (WHT). There are, however, some exceptions. First, interest on bonds which is calculated by a reference to the global net distributable profits of the issuer, as well as interest paid to a silent partner, is subject to a WHT. Secondly, a WHT is included in the European Union (EU) Savings Directive, as implemented into Luxembourg law, as well as by a Luxembourg domestic law introducing a WHT on interest on savings.

Interest income realized by a Luxembourg taxpayer is subject to income tax at an aggregate rate of 28.80 per cent for 2011 (for Luxembourg City). If a specific transaction involves a related party, the arm's length principle should be observed. Recent transfer pricing regulations have also been introduced in respect of intra-group financing activities.

As regards inbound equity investment, certain factors should be considered. There is no proportional capital duty at present (only a nominal fixed registration duty). A debt to equity ratio of 85:15 should generally be followed in respect of holding activities. A certain minimum substance should be maintained. In the case of a dividend distribution, a WHT of 15 per cent will apply as a rule. How-

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ever, there are numerous exceptions to this, resulting from the implementation of the EU Parent and Subsidiary Directive, but also from broader solutions introduced into the Luxembourg legislation independently from the EU context.

Income realized on equity investments carried out by Luxembourg taxpayers is generally subject to income tax at an aggregate rate of 28.80 per cent for 2011 (for Luxembourg City). However, the participation exemption regime is applicable in numerous cases, leading to an exemption of the income.

In respect of Luxembourg's treaty policy, the OECD model convention is generally followed. The domestic WHT rate on dividends of 15 per cent is often reduced by a tax treaty for a corporate shareholder holding at least 25 per cent of the capital or voting rights in the Luxembourg entity.

The classification of an instrument as debt or equity for tax purposes is governed by the substance over form principle (referred to in the Luxembourg tax doctrine as the *Wirtschaftliche Betrachtungsweise* principle). The debt and equity features of a given instrument will need to be considered, without one specific feature being predominant by itself. Equity features include, for instance, voting rights, participation in the profit of the issuer, right to liquidation proceeds, subordination, etc. Debt features include, for instance, fixed and relatively short term, a fixed and regular return, no voting rights, no participation in liquidation proceeds, etc. The accounting treatment is used as guidance in practice, even though the substance over form principle will prevail. As regards hybrid instruments, Luxembourg will follow its own principles, without regard to the classification performed by the other country. The tax authorities play an important role in the classification of financial instruments as equity or debt. Their role is twofold: they carry out a classification during the process of evaluation of the tax returns filed by the taxpayer, by issuing a tax assessment; and they also may agree to discuss the tax treatment of specific instruments in advance.

Unlike many countries, Luxembourg has not adopted any legislation providing for a limitation of benefits of the classification of a specific instrument as one type or another. There are no earnings stripping or similar rules in Luxembourg.

As results from the above, the ideal situation for Luxembourg holding and financing companies is to have equity interest in subsidiaries, and to finance these participations with debt. The market has come up with numerous solutions to address this objective by using specific instruments. Such instruments contain both debt and equity features and each time an analysis needs to be made in view of their classification as debt or equity. They include: profit participating loans (or profit sharing loans), interest free loans, redeemable convertible bonds or convertible preferred equity certificates, *Genussscheine* and *Genussrechte*, mandatory redeemable preference shares and preferred equity share certificates. There also exist instruments designed for a specific sector (e.g. instruments derived from Islamic finance, real estate certificates, or global depository receipts). Finally, derivatives are being used which cannot simply be qualified as debt or equity, but rather require a thorough analysis of the various components of the instruments when the remuneration from them is assessed (e.g. a total return swap, a silent partnership or repurchase agreements).

As regards structural approaches intended to eliminate the consequences of the debt–equity distinction, no such global solutions have been adopted or are planned in Luxembourg.

Luxembourg has experienced a progressive reduction of the corporate income tax (CIT) rate in recent years. Also, a trend to reduce the taxation of equity investment (inbound and outbound) was reflected in an abolition of a proportional capital duty as from 2009, as well as a gradual extension of the participation exemption regime. Despite this, debt investment continues to remain more attractive for tax purposes, due to the tax deductibility of interest and the general absence of a WHT on interest payments. The creativity of the financial market when it comes to inventing new instruments and solutions is a reflection of this preference. It may be expected to continue, unless the tax policy dramatically changes.

1. Overview of regulatory and market conditions

Market conditions in Luxembourg reflect its position as a major financial centre. The financial sector is a pillar of the national economy, representing around 30 per cent of the country's GDP. The banking, investment funds and insurance sectors are particularly strongly represented. Luxembourg is also frequently used as a holding and financing jurisdiction.

Luxembourg is the second largest investment fund centre in the world. According to statistics, on 31 August 2011 3,799 investment funds were registered with the *Commission de Surveillance du Secteur Financier* (CSSF), the Luxembourg financial market regulator, and their assets under management amounted in all to 2,085 billion euro. New types of investment vehicle benefiting from lighter regulation have recently been introduced to meet the needs of investors. They include the specialized investment fund (SIF),[1] the venture capital investment fund (SICAR)[2] and the securitization vehicle (SV).[3]

Luxembourg also remains a major banking centre. On 31 August 2011, there were 143 banks from 25 countries registered with the CSSF. Luxembourg is generally ranked among the world's top ten private banking and financial centres.

Another important feature of the Luxembourg market is its role as an intermediary jurisdiction. Most foreign investment passes through to target jurisdictions, whereas Luxembourg is used as a platform for the holding and financing of investments, as well as the management of intellectual property or treasury functions. As a result, private equity houses and landed property investors are important players in the market. Various fund regimes and unregulated structures are frequently used. Finally, multinational groups use Luxembourg as a holding jurisdiction for investments both in and outside Europe.

As Luxembourg is a member of the European Union (EU), its legal and regulatory environment is largely determined by the numerous EU directives and regulations that have been adopted within the framework of the Financial Services Action Plan. The objective of this legislation is twofold: to deliver a robust, competitive

1 See the Law of 13 February 2007 relating to specialized investment funds.
2 See the Law of 15 June 2004 relating to the investment company in risk capital.
3 See the Law of 22 March 2004 on securitization.

legal framework for the financial centre, while guaranteeing optimal protection for investors. The players in the financial centre must also observe the EU legal measures relating to the fight against money laundering and the financing of terrorism, while respecting stringent rules with regard to financial privacy.

These market and regulatory conditions create specific needs in terms of the structuring of financing instruments to be issued or held by Luxembourg entities. There will generally be a preference for a Luxembourg company to hold equity instruments, while issuing debt instruments. This approach is often tax driven, and the reasons for it are outlined below.

Luxembourg civil and commercial law offers significant flexibility as to the types of instruments that may be issued. Thus an instrument may often be devised to suit the particular requirements of investors. Instruments must not be contrary to the public order provisions in national legislation, but they are not treated differently from other contractual arrangements. Examples of frequently issued instruments include subordinated notes, convertible notes, preferred stock with a fixed return, perpetual notes and notes whose value is contingent on the value of publicly traded property. Notes for which the interest is contingent on the issuer's profits may also be issued, bearing in mind the relevant tax issues (which are outlined in section 3). The classification of a given instrument as debt or equity for tax purposes will in principle depend on the economic substance of the arrangement, and thus on the terms and conditions of the instrument (this subject is addressed in greater detail in section 3).

2. Summary of key tax principles in the subject jurisdiction

The way to finance an investment mainly depends on (a) the tax treatment of the debt, as well as (b) that of the equity; (c) the withholding tax rates and the tax treaty policy adopted by Luxembourg are also carefully analysed for (d) the election of the most efficient structure, as well as other considerations.

2.1. Tax treatment of debt

The tax treatment of a debt instrument depends on whether it is booked as a liability or as an asset for the taxpayer resident in Luxembourg.

2.1.1. Liability in Luxembourg

If the debt instrument is recorded as a liability in the accounts of the taxpayer, two main tax consequences should be taken into consideration:

- on the one hand, the deduction of the interest charge accrued or paid on the debt instrument from the taxable basis of the taxpayer for income tax (composed of municipal business tax (MBT) and corporate income tax (CIT)) purposes, as well as the deduction of the debt instrument (included the related interest accrued but not paid) from the taxable basis of the taxpayer for net worth tax (NWT) purposes, and

- on the other hand, interest payments (in most of the cases) are not subject to a withholding tax (WHT).

With respect to the deduction of the interest charge from the income tax basis, the principle is that "tax follows accounting" (article 40 of the Luxembourg Income Tax Law (LITL)). According to this principle, as long as the taxpayer uses Luxembourg generally accepted accounting principles (GAAP), the interest deductible accounting wise should also be deductible for income tax purposes.

In particular cases, however, the following exceptions may apply preventing the deduction of interest for the income tax basis.

Some specific limitations related to the context of the interest charges provided by article 48 LITL may apply. Among other examples, the interest paid as a consideration for the funds put at the disposal of a company as quasi-capital (as opposed to debt) is not deductible for income tax purposes. Also, more importantly, the interest paid in the frame of a transaction not exclusively related to the business of the taxpayer should not be tax deductible.

According to the arm's length principle, a transaction involving related parties might lead to the recharacterization of the interest payment into hidden dividend distribution that would not be deductible for income tax purposes. This principle is embedded in several LITL provisions such as article 56 LITL, as well as article 164(3) LITL specifically related to hidden dividend distribution.

Article 164(3) LITL indeed indicates that hidden dividend distributions belong to the taxable basis of the Luxembourg distributing entity, which means that in the case of an interest payment recharacterized into a hidden dividend distribution, the amount to be paid will have to be reintegrated in the taxable basis of the entity. The article defines a hidden dividend distribution as the receipt of any direct or indirect advantage by a partner from the entity for which he is a partner, which he would not have received if he had not been a partner of such an entity.

Another exception is provided by article 45(2) LITL. The latter states that should an interest charge be in an economic relationship with tax exempt income (received in the same fiscal year), it should not be deductible for income tax purposes. This general rule is also embedded in article 166(5) LITL in the framework of the Luxembourg participation exemption regime. Also, if a Luxembourg company generates a capital gain from the sale of a participation in another company that qualifies for participation exemption, the finance charges that are connected with the acquisition of this participation in the past years will be "recaptured", i.e. will reduce the amount of exempt gain. This rule is aimed at avoiding an abusive situation, where on the one hand, finance costs are fully deductible, and on the other hand all the gains derived from the relating asset are tax exempt.

The Luxembourg thin capitalization rules may also lead to the tax non-deductibility of interest booked accounting wise and therefore is another factor to be taken into consideration. Indeed, the non-respect of the debt-to-equity ratio of 85:15 applicable to holding activities as required by the Luxembourg practice may trigger the recharacterization of excess interest paid into (hidden) dividends and the consequent reintegration of the latter in the taxable basis of the taxpayer.

Finally, the general principle of "substance over form", which is part of the set of Luxembourg tax regulations, may lead to the recharacterization of interest charges into hidden dividend distribution and to the consequent reintegration of the

latter in the taxable basis of the taxpayer if the economic analysis of the financing instrument leads to an equity qualification of the latter despite its debt qualification from a Luxembourg legal point of view.

With respect to the deduction of the debt instrument (including the related interest accrued but not paid) for NWT purposes, the Luxembourg Valuation Law provides for the same kind of rules. The debt instrument (including the related interest accrued but not paid) should be deductible from the net worth taxable basis of the taxpayer, the so-called unitary value (which corresponds to the net asset value of the taxpayer), unless (and to the extent that) the debt instrument (including the related interest accrued but not paid) finances an exempt asset for net worth tax purposes. As an example, if a Luxembourg corporate taxpayer receives a loan in order to finance the acquisition of a shareholding that qualifies for participation exemption, the debt will not be deductible for the purpose of computing the basis subject to NWT.

As regards a potential WHT on interest payment, the principle is set by article 146 LITL together with article 97 LITL providing that interest payment is in principle not subject to WHT.

Two sets of exceptions are, however, to be taken into consideration. The first one is in article 97(2) and (3) LITL providing that interest on bonds that are computed by reference to the global net distributable profits of the issuer are subject to a WHT, as well as interest paid to a silent partner (*bailleur de fonds*) in proportion to the profit realized.

The second set of exceptions is laid down by the provisions of the Law of 21 June 2005 implementing the EU Savings Directive (EUSD) as well as by those of the Law of 23 December 2005 (*Retenue à la source libératoire sur certains intérêts produits par l'épargne mobilière* or RELIBI). Should the interest payment in question fall into the scope of one those two laws, it will be subject to WHT which is currently 35 per cent for non-residents and 10 per cent for residents.

2.1.2. Asset in Luxembourg

In Luxembourg, interest income is subject to the aggregate income tax rate of 28.80 per cent for the year 2011 and for a tax resident in Luxembourg City. This aggregate income tax rate is composed of the CIT rate amounting to 21 per cent plus the MBT rate amounting to 6.75 per cent to which the unemployment fund surcharge of 1.05 per cent (i.e. 21% × 5%) should be added.

In the case of a transaction involving related parties, the interest income should furthermore comply with the arm's length principle as defined by the OECD.

Furthermore, a recent Luxembourg transfer pricing regulation provides that for intra-group financing activities, i.e. a debt instrument (for Luxembourg tax purposes) on the asset side that is financed by another debt instrument (for Luxembourg tax purposes) on the liability side of the Luxembourg entity, specific requirements as regards the substance, the minimum capitalization as well as the remuneration of the intra-group financing activity have to be met if the taxpayer wishes to have a confirmation from the Luxembourg tax authorities on an acceptable finance margin. *Inter alia*, the receivable (for Luxembourg tax purposes) has to be financed by at least 2 million euro or 1 per cent of capital (the so-called "equity at risk"), at least half of the management of the entity has to be professionally

resident in Luxembourg and an arm's length remuneration of the intra-group financing activity has to be left at the level of the Luxembourg entity (circular letters dated 28 January 2011 and 8 April 2011).

However, no controlled foreign company (CFC)or similar lookthrough rules affect the taxation of the interest income at the level of Luxembourg resident taxpayers. Hence, if a Luxembourg entity holds shares in a subsidiary that makes profits, these profits will not be taxed in Luxembourg as long as the subsidiary does not distribute them to its Luxembourg parent.

Most of the foreign WHT paid on the interest income received by the Luxembourg tax resident is creditable against the amount of CIT (but not against MBT) due on the respective income for Luxembourg tax purposes. Any excess (non-creditable) foreign WHT can be deducted as an expense, but cannot be carried forward as a credit (see articles 13 and 134*bis* LITL).

It is worth mentioning here as well that according to article 22*bis*(2)1 LITL, in the case of a profit generated by the conversion of bonds into shares, the latter can be neutralized (interest accrued during the year of conversion, however, remains taxable, even if capitalized).

2.2. Tax treatment of equity

The tax treatment of equity depends on whether the latter is booked as an equity investment into a Luxembourg entity assuming the international frame of the transaction, or as an asset, i.e. investment of a Luxembourg entity into another entity keeping the same assumption, for the taxpayer tax resident in Luxembourg.

2.2.1. Foreign investment in a Luxembourg entity

Two aspects have to be considered by a foreign investor before investing in the form of equity in a Luxembourg company. The foreign equity investment in the Luxembourg entity should indeed be analysed from the inbound side on the one hand and from the repatriation/exit side on the other hand from a Luxembourg tax perspective.

2.2.1.1. Luxembourg tax aspects as regards the inbound side of the foreign investment

As from 1 January 2009 no proportional capital duty has been levied in Luxembourg. A fixed registration duty of 75 euro only is due on the incorporation or on the modification of the bylaws of a company having its statutory seat or effective management located in Luxembourg, as well as on the transfer of the statutory seat or effective management of a company to Luxembourg. Some specific rules apply, however, with respect to the contribution of landed property to a company in Luxembourg and the subsequent transfer of shares of such companies.

There is a Luxembourg debt-to-equity ratio of 85:15 applicable to holding activities. This ratio is based on the administrative practice. In some specific cases, however, the minimum equity of 15 per cent can be reduced if the remaining debt is documented by an agreement that has some equity characteristics, or has an interest rate that is clearly lower than the market rate (dilution effect).

2.2.1.2. Luxembourg tax aspects as regards the repatriation/exit side of the foreign investment

The repatriation of profit and/or the exit of a foreign equity investment in a Luxembourg entity is generally carried out through dividend distribution, a partial or full reimbursement of the equity instrument (shares, share premium, etc.) which may generate a WHT, a capital gain, or liquidation proceeds.

The general rules regarding the Luxembourg taxation of dividend distribution are provided by the combination of the articles 146, 97 and 148 LITL. According to these articles, dividend distributions are subject to WHT of 15 per cent.

The LITL provides, however, for an important WHT exemption that is commonly used in corporate structuring. The exemption foreseen in the European Parent–Subsidiary Directive as regards dividend distribution was indeed not only implemented but also enlarged by LITL in its article 147.

The main conditions to be fulfilled in order to benefit from this exemption as regards the holding of the participation in a Luxembourg entity are related to

(a) the status of the foreign beneficiary. It has to be:
- a collective entity listed and covered by the Parent–Subsidiary Directive; or
- a fully taxable resident corporation not listed in article 166 LITL paragraph 10; or
- a permanent establishment of one of the above qualifying entities; or
- a collective entity resident in a treaty country and fully subject to income tax comparable to the Luxembourg corporate income tax as well as a Luxembourg permanent establishment of such a collective entity; or
- a corporation that is resident in and subject to taxation in Switzerland without benefiting from an exemption; or
- a corporation or cooperative company resident in a Member State of the European Economic Area (EEA) other than an EU Member State and fully subject to income tax comparable to Luxembourg corporate income tax; or
- a permanent establishment of a corporation or of a cooperative company resident in an EEA Member State other than an EU Member State.

(b) the status of the Luxembourg subsidiary. It must be:
- a fully taxable resident collective entity listed in article 166 LITL paragraph 10; or
- a fully taxable resident corporation not listed in article 166 LITL paragraph 10.

(c) the size of the participation (at least 10 per cent or an acquisition price of at least 1,200,000 euro to qualify for dividend and liquidation proceeds exemption);

(d) a minimum uninterrupted detention period of at least 12 months on the date the income is allocated or realized for tax purposes (a commitment should satisfy this condition).

It is worth highlighting the broad potential application of the WHT exemption provided by article 147 LITL, potentially opening the exemption to any resident of a country part of the Luxembourg double taxation treaty (DTT) network (more than 69). Indeed, the WHT exemption should apply to any investor being a corporation

fully subject to income tax comparable to that levied in Luxembourg (i.e. minimum income tax of 10.5 per cent as long as the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg) and being a tax resident in a state with which Luxembourg has concluded a DTT or being a local permanent establishment of such an entity.

As regards liquidation proceeds, they are not subject to WHT in Luxembourg regardless of the legal form of the liquidated entity or the quality, residence, or tax status of the shareholder. This fact allows foreign investors to repatriate their equity investment and related profits free of WHT.

Finally, a specific anti-abuse clause (article 97 (3) LITL) may also apply in case of a reduction of share capital of a Luxembourg entity. Under this specific rule, if a Luxembourg entity repays part of its share capital at a point in time where it has substantial available distributable reserves, these reserves may be deemed to be distributed in priority as a (deemed) dividend, and hence, may bear a Luxembourg WHT (unless the shareholder complies with the conditions of the participation exemption).

2.2.2. Investment of a Luxembourg entity into a foreign entity

As regards the investments carried on by a Luxembourg entity in the equity of a foreign entity, article 166 LITL and Grand-Ducal Decree dated 21 December 2001 provide for the so-called participation exemption regime with respect to dividend income, liquidation proceeds and capital gains, for income tax purposes.

The main conditions to be fulfilled in order to benefit from this exemption as regards the holding of the participation into a foreign entity are related to

(a) the status of Luxembourg beneficiary. It has to be:
- a fully taxable resident collective entity listed in article 166 LITL paragraph 10; or
- a fully taxable resident corporation not listed in article 166 LITL paragraph 10; or
- a Luxembourg permanent establishment of either
  - a collective entity that is covered by the Parent–Subsidiary Directive; or
  - a corporation resident in a country with which Luxembourg has signed a tax treaty; or
  - a corporation or a cooperative company that is resident in an EEA country other than a Member State of the European Union.

(b) the status of the subsidiary. It must be:
- a collective entity listed and covered by the Parent–Subsidiary Directive; or
- a fully taxable resident corporation not listed in article 166 LITL paragraph 10; or
- a non-resident corporation fully subject to income tax comparable to the Luxembourg corporate income tax.

A minimum income tax rate of 10.5 per cent as of 2009 (11 per cent before 2009) generally satisfies this requirement as long as the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg.

The exemption also applies to a participation held in a qualifying company through tax transparent entities.

(c) The minimum participation that qualifies for the exemption is 10 per cent participation; or an acquisition price of at least 1,200,000 euro to qualify for the dividend and liquidation proceeds exemption; or an acquisition price of at least 6,000,000 euro to qualify for the capital gains tax exemption.
(d) There is also a minimum uninterrupted detention period of at least 12 months on the date the income is allocated or realized for tax purposes (a commitment should satisfy this condition).

Here as well the LITL goes further than the requirements set in the European Parent–Subsidiary Directive with respect to the status of the subsidiary, by providing that these rules can benefit to income received from a non-resident (even from a non-EU) subsidiary as long as the latter is a corporation fully subject to income tax comparable to the Luxembourg CIT, i.e. minimum income tax of 10.5 per cent as long as the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg.

Corresponding participation exemption rules are also part of the Luxembourg Valuation Law for NWT purposes. The participation meeting the above-mentioned requirement for article 166 LITL (with the exception of the minimum detention period which is not requested for NWT purposes) should be excluded from the unitary value of the Luxembourg entity and thus exempt from NWT. There are a few specific cases where it may be possible to benefit from participation exemption in Luxembourg on an equity investment made in a foreign entity, despite the fact that the investment generates a return that is considered as a tax deductible charge in the hands of the issuer. This is for example the case for specific investments made in Brazilian limited companies under the "interest on net equity" concept, or for other investments made in Australian limited companies in the form of redeemable preferred shares (RPS).

It is worth mentioning here that Luxembourg benefits from a broad DTT network, more than 69 tax treaties, and more than 93 investment protection treaties.

2.3. Withholding tax rates and tax treaty policy

Luxembourg as a member of the OECD bases most of the DTTs it concludes on the OECD model convention.

An investor located abroad who intends to repatriate its Luxembourg investment and/or the profits realized on the latter will need to carefully consider the taxation of dividend distribution, interest payment, liquidation proceeds as well as the one of realization of capital gain.

2.3.1. Taxation of dividend distribution, liquidation proceeds and capital gains

As regards the taxation of dividend distribution from a Luxembourg entity to an investor located abroad, the general domestic rule (as already described above) provides for a WHT of 15 per cent. However, the latter rate should be reduced (or exempt) in most cases due to the broad DTT network and more particularly the WHT exemption laid down in article 147 LITL (please see above).

The DTTs concluded by Luxembourg provide for two kinds of WHT rates, one for individuals and companies which do not meet a required minimum shareholding

threshold and one for companies which meet the threshold, generally 25 per cent of the capital or the voting power of the paying company, i.e. the Luxembourg entity in the case at hand.

The first one is generally 15 per cent, which highlights the fact that the domestic Luxembourg WHT of 15 per cent on dividend distribution is low in comparison with other international standards, but can be reduced to 10 per cent with countries like, among others, China, Hong Kong or Singapore. The fact that the domestic tax rate of 15 per cent corresponds to the treaty rate of most DTTs (as regards to dividends paid to individuals) avoids administrative formalities and simplifies the life of the authorities: no refund claim is generally necessary.

The second one ranges between 0 per cent and 10 per cent (with one exception of 15 per cent with a few countries such as Brazil), but is generally 5 per cent. For instance, subject to specific conditions, the following rates apply:

- 0 per cent with *inter alia* Bahrain, Barbados, Hong Kong, Qatar, Sweden, Switzerland or USA;
- 5 per cent with *inter alia* Armenia, China, the Czech Republic, Denmark, Estonia, Finland, France, Hungary, Ireland, Japan, Malta, Mexico, Monaco, Norway, Poland, Spain or Turkey;
- 10 per cent with *inter alia* Belgium, India, Korea, Morocco, Russia or Tunisia.

However, in most cases, the dividend distribution should be exempt from WHT according to Luxembourg domestic law, i.e. WHT exemption from article 147 LITL (please see above for further details of the conditions of applicability), which provides that a dividend distribution is exempt from Luxembourg WHT as long as it is made to a corporation fully subject to income tax comparable to that levied in Luxembourg (i.e. minimum income tax of 10.5 per cent provided that the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg) and is a tax resident in a state with which Luxembourg has concluded a DTT.

The same applies to dividends paid by Luxembourg entities to a Luxembourg permanent establishment of a head office located in a jurisdiction that has signed a DTT with Luxembourg.

A specific reference should be made to the DTT between Luxembourg and Switzerland which aims to reproduce the Luxembourg participation exemption regime resulting from the application of the EU Parent–Subsidiary Directive. The WHT on dividends should indeed be reduced to 0 per cent provided that the latter was received by a company tax resident in one of the contracting states from another company resident in the other contracting state, in which a minimum shareholding of at least 25 per cent had been held for at least two years.

The DTT between Luxembourg and the USA provides for another interesting characteristic. Indeed the WHT on dividends paid to pension funds and other type of tax exempt entities is eliminated.

As regards the taxation of liquidation proceeds, as mentioned above, the Luxembourg domestic law does not provide for a WHT with respect to the latter. Thus it is a common way to repatriate investments. The investor liquidates the Luxembourg investment vehicle and repatriates the funds through the liquidation proceeds, free of Luxembourg WHT.

In certain circumstances, and under the current administrative practice, the repayment (or buy-back) of all the shares held by a specific investor may be treated

as a partial liquidation, and hence may benefit from the absence of WHT similar to the one applicable in the case of a full liquidation.

As regards the taxation of capital gains for a Luxembourg non-resident taxpayer, the latter may be subject to Luxembourg income tax if it falls into the scope of article 156(8)(a) LITL, i.e. if the investor together with his close family has held, directly or indirectly, a participation of at least 10 per cent in the Luxembourg company and has realized the capital gain within six months of the acquisition of the said participation. This domestic law provision is neutralized by most of the tax treaties signed by Luxembourg, which provide for exclusive taxation power to the state of residence of the investor.

2.3.2. Taxation of interest payments

As regards the taxation of interest payments, no WHT is levied on interest payments in Luxembourg according to Luxembourg domestic law, i.e. article 146 together with article 97 LITL as described above.

Article 97(2) and (3) LITL provides, however, for an exception with respect to the profit shares paid to silent partners (*bailleur de fonds*), as well as the variable interest paid on profit participating bonds or other securities, i.e. with respect to interest payments having the economic features of dividend payments (set by reference to the distributable profits of the issuer). These specific interest payments should follow the Luxembourg tax treatment of a dividend distribution, including the exemption as mentioned above.

Also, the EUSD, which was implemented into Luxembourg legislation by the Luxembourg Law of 21 June 2005, provides for another exception. It foresees a withholding tax of 35 per cent from 1 July 2011 on interest payments made by a Luxembourg paying agent to an EU (non-Luxembourg) individual or residual entity unless the latter parties opt for an exemption certificate or for an exchange of information.

A paying agent means any economic operator which pays interest to or secures the payment of interest for the immediate benefit of the beneficial owner, whether the operator is the debtor of the claim which produces the interest or the operator is charged by the debtor or the beneficial owner with paying interest or securing the payment of interest.

Interest payment means any interest paid or credited to an account related to debt claims, notably interest received on bank accounts, income from government securities, income from bonds and debentures, income from bond certificates and interest accrued or capitalized at the sale, refund or redemption of debt claims.

An indirect interest payment through certain investment funds, paid out via dividend or redemption of units, is also potentially within the scope of this interest payment qualification.

As regards domestic transactions the RELIBI law is worth mentioning. This law includes a final WHT of 10 per cent on interest derived from certain transferable securities and paid to Luxembourg resident individuals by Luxembourg paying agents. The WHT applies to interest accrued as from 1 July 2005 and paid after 1 January 2006. An individual is resident in Luxembourg for income tax purposes if he has his fiscal domicile or normal place of residence in Luxembourg (article 2 LITL).

RELIBI is based on the concepts of the EUSD. One notable exception is that investment funds are outside the scope of RELIBI.

Most of the tax treaties provide for a full exemption from WHT on interest, whereas dividends and royalties are generally subject to a 5 to 10 per cent WHT (please see above). This specificity results from a specific request made by Luxembourg given the importance of the financial sector, represented by *inter alia* banks and investment funds, for the Luxembourg economy.

There are also some DTTs with tax sparing clauses, which provide for deemed tax credit in Luxembourg with respect to income received from the contracting state in which the Luxembourg entity invested. For instance such a clause is included in the DTT between Luxembourg and Brazil, as well as those concluded with Spain and Korea.

2.4. Other considerations

Other considerations linked to the rate structure or the tax treatment of business entities may have an impact on the election between a debt or an equity investment to be made by the investor.

2.4.1. Rate structure

The trend with respect to the evolution of the corporate and individual tax rates has been a progressive reduction of the latter over the last 15 years. For instance the CIT rate was 22 per cent for the year 2008 and since the year 2009 has been decreased to 21 per cent. However, despite the trend to reduce the taxation of equity investments, debt investment remains more attractive for Luxembourg tax purposes. Indeed, as a principle, no Luxembourg WHT is levied on interest payments (please see above). Furthermore, interest payments will have the effect of reducing the income tax basis while the debt instrument will reduce the NWT basis.

2.4.2. Considerations relating to the tax treatment of business entities

Considerations that may affect the choice between debt and equity are *inter alia* the tax transparency or opacity of the issuer, the potential benefit from the Luxembourg fiscal unity or any potential benefit generated by the reorganization of a corporate group.

2.4.2.1. Luxembourg tax transparency

As regards Luxembourg tax transparency, article 175 LITL provides for a list of Luxembourg entities that are tax transparent for Luxembourg tax purposes. The list includes partnerships, (European) economic interest groupings, to which branches should be added. From this list it follows that publicly traded entities cannot usually be qualified as tax transparent, since, according to Luxembourg company law, they must generally be public limited companies. It is worth mentioning that there is no optional system such as a "check the box" system available in Luxembourg.

Nevertheless for US tax purposes, only public limited companies (*sociétés anonymes*) are *per se* corporations. Private limited companies (*société à responsabilité limitée*) as well as partnerships limited by shares (*société en commandite par actions*) can generally "check the box" and be treated as transparent for US tax purposes.

However, a partnership or a branch could be qualified as a permanent establishment and therefore lose tax transparency to become opaque for tax purposes, provided that (and as long as) it had sufficient activities and substance to qualify as a permanent establishment.

If a loan is granted by a Luxembourg company to a Luxembourg transparent entity for tax purposes, the loan should be disregarded, as the investment in the partnership is also disregarded, and the tax treatment would apply "as if" the Luxembourg entity directly held the assets of the partnership.

2.4.2.2. Fiscal unity regime

The LITL in its article 164*bis* provides for a fiscal unity regime with two particularities offering flexibilities and opportunities to foreign investors evolving in an international framework.

In order to benefit from the Luxembourg fiscal unity regime, the main conditions are that the requesting entity should be a Luxembourg tax resident company fully taxable and that the shareholding threshold of at least 95 per cent of the capital of the integrating company should be met.

The two particularities relate respectively to each of the aforementioned main conditions. With respect to the quality of the requesting entity, the head of the Luxembourg fiscal unity can be a permanent establishment of a non-Luxembourg tax resident company (which nevertheless should be fully subject to income tax comparable to that levied in Luxembourg, i.e. minimum income tax of 10.5 per cent provided that the taxable basis is determined according to rules and criteria similar to those applicable in Luxembourg). With respect to the condition related to the shareholding, the threshold of 95 per cent can be met directly or indirectly, which allows the Luxembourg fiscal unity regime to also apply to a chain of entities involving one or more foreign corporations.

2.4.2.3. Reorganization

As regards reorganizations such as cross-border/domestic mergers/demergers or exchange of shares, there is no specific impact on such operations with respect to the presence as well as the ratio of debt or equity (including hybrid instruments) in the balance sheet of the entities at the time of the reorganization.

Article 22*bis* LITL specifically provides for a tax-neutral treatment of spin-offs and share-for-share exchanges provided certain conditions are fulfilled (for example the receiving company must be subject to comparable tax and must hold at least 50 per cent of the shares of the entity that is contributed to it). These rules derive from the EU Merger Directive and from the old practice of *Tauschgutachten*.

3. Classification of debt or equity

With respect to the classification of debt or equity for Luxembourg tax purposes, some general principles have to be followed in the approach to characterization of debt or equity, while the Luxembourg tax authorities play a major role in this classification.

3.1. General approach to characterization

As a general rule, the LITL is governed by the economic approach, which means that a tax qualification is not bound by the pure legal form of a transaction. Indeed the LITL applies the "substance over form principle" which allows the authorities and taxpayers to qualify an instrument of debt or equity according to its fundamental economic nature, and not according to its name or qualification (called in German, *Wirtschaftliche Betrachtungsweise Prinzip*).

For historical reasons, since Luxembourg tax law finds its origin in German tax law, German tax doctrine as well as German tax case law, former or current, still substantially influence the interpretation of Luxembourg tax law. Luxembourg selects the most interesting ideas and analyses given its particular business model in order to build its own tax system.

In order to apply this principle, all the features of an instrument have to be considered together without one being predominant.

For illustration purposes, equity features include *inter alia* voting rights, participation in the profit of the company, right to liquidation proceeds if any, participation in the risk of the company (losses, liquidation), a deep degree of subordination, long maturity or perpetual term (duration of the company), the possibility of the company converting the instrument into equity at its own option unilaterally depending on its own corporate interest or reimbursement in shares of the issuing company. The presence of a stapling clause is also an indication.

For illustration purposes, the debt features include *inter alia* a fixed and relatively short term, fixed and regular return, no voting rights, no entitlement to liquidation proceeds, no participation in the risk of the company (losses and liquidation), and a low degree of subordination.

As regards the characterization of the hybrid instrument, Luxembourg follows its domestic principles, without regard to the characterization operated in the other state.

Article 97(1) LITL includes three kinds of income from capital in its subparagraphs 1, 2 and 3 which have as a common point to be subject to WHT according to article 146 LITL as principle (as mentioned above). A distinction between the first, i.e. dividends, and the two others, i.e. interest on bonds that are computed by reference to the global net distributable profits of the issuer and interest paid to a silent partner (*bailleur de fonds*) in proportion to the profit realized, has, however, to be made. The first falls under the scope of article 164(2) LITL which provides for the non-deductibility of such distribution of income from the taxable basis of the entity, unlike the two others, which are deductible from the taxable basis.

In order to characterize an instrument as equity or debt, accounting aspects need to be considered based on the principle of dependency of the tax balance sheet from the commercial balance sheet (*principe de l'accrochement du bilan fiscal par rapport au bilan commercial*) provided by article 40 LITL which usually applies in respect of values, but in practice is often used as a guidance for classification as well; nevertheless the *Wirtschaftliche Betrachtungsweise Prinzip* prevails. From an indirect tax point of view, in the case where an instrument is treated as a receivable and the Luxembourg entity has more than one interest bearing receivable on its balance sheet, the latter should fall under the scope of the Value Added Tax (VAT) Law, and may need to register for VAT in Luxembourg.

3.2. The role of the tax authorities

The Luxembourg tax authorities obviously plays a major role in the analysis and characterization of an instrument into equity or debt since they have the power to recharacterize an instrument on economic and/or anti-abuse grounds at the time of the tax assessment. The qualification and subsequent tax treatment of any contemplated hybrid instrument can be discussed with the Luxembourg tax authorities. Thus, the risk of requalification at the time of the tax assessment by the Luxembourg tax authorities may be reduced.

The authorities will take into account not only the technical characteristics of the instrument, but also the overall context (relationship between parties, etc.).

4. Targeted government approaches to address issues raised by classification rules

Luxembourg legislation does not provide for any specific rules aiming at limiting some benefits of classification as a debt instrument or as an equity instrument. Thin capitalization rules may, however, interact with the classification of an instrument of debt or equity.

4.1. Targeted rules

Contrary to other countries, and subject to previous comments on "substance over form" and "abusive use of legal form" concepts, Luxembourg has not adopted specific legislation providing for limitation of some of the benefits of classification as one type of instrument or another. Also, there are no CFC or earnings stripping or similar rules in Luxembourg.

Possible discussion between the Luxembourg authorities and the taxpayers can lead to a clarification of legislation and prevention of any potential abuses. This is a pragmatic approach for both the taxpayer and the tax authorities.

4.2. Interaction of thin capitalization rules with reclassification

The interconnection between classification of an instrument and thin capitalization rules in Luxembourg has a precise impact since (as described above in sec-

tion 2), thin capitalization rules can only affect the deductibility or not of the interest paid as well as the subjection of the latter to WHT (there is no impact on the classification of the instrument itself but only on the interest related to the latter), i.e. requalification of the interest payment into dividend distribution.

5. Financial market responses to tax and other constraints on achieving desired goals

In a jurisdiction such as Luxembourg where holding and financing activities are predominant, one of the main goals desired from a tax perspective is to achieve low taxation for income derived from investments, whether active or passive, and to facilitate repatriation to foreign investors free of WHT. In this respect, the ideal situation for Luxembourg holding and financing companies is obviously to have equity interest in subsidiaries, and to finance these participations with debt. In such cases the income and gains derived from qualifying subsidiaries could benefit from the Luxembourg participation exemption regime, while interest payments to foreign investors of the Luxembourg holding company could usually be made free of WHT. Debt financing and interest payments may also be preferred to dividend distribution as being more flexible from a legal perspective, since they avoid formalities and the obligation of having retained earnings to repatriate as cash to foreign investors.

Most of the instruments described below are frequently used to achieve these objectives. To some extent these instruments contain both debt and equity features, and a case-by-case analysis will always have to be performed in light of the rules given in section 2, in order to qualify the relevant instrument in tax terms. It should be stressed that these instruments are usually used in intra-group situations, where the distinction between equity and debt is less relevant from a business point of view.

The second and third parts of the list below also include more sophisticated instruments designed for a specific sector, or derivatives which cannot simply be qualified as debt or equity, but rather require a thorough analysis of the various components of the instruments when their remuneration is assessed. A legal equity owner who uses these instruments may become a financing party from a tax perspective, while the legal owner of a receivable under an agreement may be seen as a shareholder for tax purposes.

5.1. Standard financing instruments containing debt and equity features

5.1.1. Profit participating loan/income sharing loan

A profit participating loan (PPL) or income sharing loan is a loan whose interest tracks the company's profits or the income derived from a specific asset. A PPL is often used as an extraction mechanism, since it may in some instances lead to a higher repatriation capacity than a standard fixed interest loan. Whether the instrument qualifies as debt and the deductibility/absence of WHT on the interest will

have to be analysed in the light of the limitations referred to in section 2.1, but the profit-sharing feature may not be an obstacle to qualifying the instrument as debt. Depending on the domestic tax rules of the lender's country, the PPL may also be used as a hybrid instrument where the lender benefits from the most favourable tax regime because the PPL is considered as equity.

5.1.2. Interest free loans (IFLs)

For tax and legal reasons, IFLs are often used as quasi-equity in intra-group financing. From a tax perspective, an IFL granted to a Luxembourg entity by a parent company to its subsidiary will in principle still be considered as a debt and be deductible from the entity's net wealth. From a legal perspective, the repayment of an IFL is easier than a capital reduction. Although the instrument is not really sophisticated, it raises some questions regarding the risk of deemed interest imputation (informal capital contribution for the advantage granted to the affiliate), and regarding the valuation of the instrument (repayment on demand will be preferred, since it minimizes the risk of having to discount the instrument).

5.1.3. Redeemable convertible bonds or convertible preferred equity certificates

The aim of (partly) financing an investment by issuing redeemable convertible bonds or convertible preferred equity certificates (CPECs) is to enable a Luxembourg company to make distributions of future earnings as interest, which is not subject to withholding tax. The use of CPECs is sometimes preferred to bonds because CPECs are considered as equity in some foreign jurisdictions such as the USA. CPECs and bonds are generally long term (more than 10 years), subordinated and convertible into shares.

5.1.4. Genussscheine/Genussrechte

The German *Genussscheine* designates an instrument giving a right to a participation in the annual profits or to the liquidation proceeds. The main difference between these types of instrument and shares is that shares give both ownership and other rights (voting rights, the right to obtain information, etc.), whereas *Genussrechte* (rights derived from *Genussscheine*) only give ownership rights. Depending on their exact features, these instruments may also be treated as debt or as equity for the issuer.

5.1.5. Mandatory redeemable preferred shares and preferred equity share certificates

Mandatory redeemable preferred shares (MRPSs) form part of the share capital and are stated in the articles of association. However, they are in principle short term (generally 10 years), are preferred to the company's ordinary shares and bear a fixed coupon which can be cumulative. Due to their debt features and the mandatory redemption of the instrument, MRPSs are likely to be assimilated to debt from an accounting perspective, and therefore from a tax perspective as well.

Preferred equity share certificates (PESCs) have the same general features as MRPSs.

MRPSs and PESCs are the tools generally used by the financial market to achieve an instrument which is legally share capital, but a debt instrument in essence and from a tax perspective.

5.2. Instruments tailored to specific sectors

5.2.1. Instruments derived from Islamic finance

Islamic finance refers to financial transactions and techniques that are consistent with the principles of Islamic law (*Sharia*), which prohibits investments in purely financial assets. The *Sharia* specifies three major prohibitions: charging or receiving interest, uncertainty, and transactions involving asymmetric information, excessive risk and lack of control.

The most important debt creating method is the *sukuk*, the Islamic counterpart of conventional bonds. *Sukuk* (plural of *sakk*, meaning legal instrument, deed or cheque) is the Arabic name for a financial certificate, and is commonly referred to as the Islamic equivalent of a bond. *Sukuk* may be structured in various ways, for example as asset leasing structures (*sukuk al ijara*), project finance structures (*sukuk al istisna*) or on a partnership basis (*sukuk al musharaka*). In short, the tax authorities define *sukuk* as debt or profit participating securities whose remuneration and repayment are dependent on the performance of one or more tangible assets held by the issuer of the *sukuk*.

The tax authorities have confirmed in a circular[4] on Islamic finance instruments that the tax treatment of *sukuk* is identical to the tax treatment of a debt in conventional finance (although the income is linked to the performance of the underlying asset), and the remuneration from *sukuk* is treated as an interest payment. Accordingly, payments made under a *sukuk* transaction should generally be deductible, provided the expenses are incurred in the company's corporate interest. Income from *sukuk* would be assimilated to income from movable capital within the meaning of article 97(1)3 LITL, or to a business profit. The tax authorities have confirmed that the provisions related to investors and profit participating bonds do not apply to *sukuk*. Accordingly, no withholding tax should apply on payments to foreign holders from Luxembourg issued *sukuk*.

The circular refers to the mutual agreement procedure if there are difficulties pertaining to the application of tax treaties to *sukuk*. However, payments under a *sukuk* transaction should generally qualify under the interest article of tax treaties concluded in accordance with the OECD model convention.

5.2.2. Real estate certificates

Real estate certificates are instruments used to finance large landed property operations, while allowing small and medium-sized investors to diversify their portfolios. This instrument is represented by certificates or notes which allow the investor to receive a profit participating return based on the rental income of the

[4] Circular L.G.-A no. 55 dated 12 January 2010.

property, less costs. They also permit the note holder to receive the capital gain realized on disposal of landed property. Although the investor participates in an item of property, he does not have legal title to the property. Nor does he have any guarantee respecting either the periodic revenues or the reimbursement of the initial investment. From an economic point of view, however, he is in the same position as the owner of a rented property. As confirmed by the Luxembourg tax authorities in a circular[5] dated 29 August 1997, payments made on such notes which correspond to the profits derived from the landed property will be considered as a deductible payment offsetting the taxable income derived from the property. Furthermore, distributions under the notes will in principle not be subject to WHT in Luxembourg.

5.2.3. Global depository receipt (GDR)

A GDR is a certificate issued by a depository bank which purchases shares of foreign companies and deposits them on the relevant account. GDRs represent ownership of an underlying number of shares. Their main aim is to facilitate trading in shares. Although the bank retains legal title to the underlying shares and the GDR holder only has a receivable against the bank, the holder will in most instances be considered as the beneficial owner of the shares from a tax perspective, and income derived from the GDR will be treated accordingly.

5.3. Complex instruments and derivates

5.3.1. Total return swap (TRS)

A TRS is a financial contract that transfers both the credit risk and the market risk of an underlying asset. In this contract, one party (the buyer) owns an asset and pays all the income derived from it during the payment period to the other party (the seller). As consideration, the seller pays a fixed remuneration, as well as any negative price changes of the asset. In specific circumstances, especially when in essence the swap transaction merely finances a participation granted by the buyer to the seller, the seller can be considered as the beneficial owner of the underlying asset, while the buyer will simply be the financing party. The income for the seller under the TRS could therefore be assimilated to a direct return on the equity of the underlying participation.

5.3.2. Silent partnership (typical/atypical)

A distinction should be made between a typical silent partnership and an atypical silent partnership. In a typical silent partnership, a typical silent partner will invest funds in a business as a simple creditor (although his remuneration may be linked to the profits of the business). In an atypical silent partnership, the silent partner has a participation not only in the profits but also in the liquidation profits. A

5 Circular LIR/NS no. 97/1 published on 29 August 1997 – *Certificats de placement immobilier* (Real estate investment certificates).

non-resident typical silent partner will be taxed on his remuneration by way of withholding, as the remuneration will be assimilated to a dividend, while a non-resident atypical partner will be taxed in Luxembourg as business income.

These concepts are sometimes used as planning tools for investments to be made by Luxembourg investors, as a silent partnership agreement drafted similarly to a PPL loan may lead to the deductibility of payments in the foreign jurisdiction, without taxation in Luxembourg.

5.3.3. Repurchase agreements (repos)

In a repo, shares held by a company (the repo seller) are sold to another party (the repo buyer) who is under an obligation to sell them back to the Luxembourg parent company within a given period. The repurchase price should be higher than the original sale price, the difference effectively representing interest. The repo seller effectively acts as a borrower, using the shares as collateral for a secured cash loan at a fixed rate of interest. Although from a legal standpoint the repo seller is no longer the owner of the shares, he should remain their beneficial owner and may therefore benefit from the participation exemption, assuming all relevant conditions are met.

6. Structural changes to address the debt–equity distinction

As regards structural approaches intended to eliminate the consequences of the debt–equity distinction, no such global solutions have been adopted or are planned in Luxembourg. However, a case that may be interesting in this context is the SV, where the distinction between debt and equity has been blurred to some extent. The SV is regulated by the Law of 22 March 2004 on securitization.[6] It benefits from an efficient tax regime under which obligations (*engagements*) to investors and other creditors are considered to be deductible "interest payments" for income tax purposes.[7] These obligations include not only interest, but also dividends or future dividends. Thus in this case the legislation permits a deduction of dividends for tax purposes. At the same time, distributions made by an SV are considered to constitute interest for tax purposes, and hence are not subject to a dividend WHT.[8] These solutions were implemented with a view to ensuring the goal of tax neutrality for the SV, as indicated in the relevant legislation.[9] As a result of this legislation, an equity investment in an SV benefits from tax solutions which as a rule

6 According to the Law of 22 March 2004, "securitization" is defined as a transaction whereby a securitization undertaking acquires or assumes, directly or indirectly through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent in all or part of the activities of third parties, and issues securities (*valeurs mobilières*) whose value or yield depends on those risks.

7 Art. 46(14) LITL.

8 Art. 97(6) LITL.

9 Cf. Draft Law no. 5199, *Chambre des Deputés* (House of Representatives), pp. 39 and 40.

would only be available for debt investors. It should be noted that the very different tax treatment of debt and equity investments was not abolished but actually emphasized in the case of the SV, where equity investments are treated in a similar way to debt investments, but the general distinction remains.

Besides the case of the SV discussed above, it should be stressed that the distinction between debt and equity and the very different related tax consequences seem to constitute an important feature of the Luxembourg tax system at present, and should remain so in future according to the information currently available.