Branch Reporters
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Summary and conclusions

When it comes to taxation of cross-border business restructuring (CBBR), Luxembourg is not a jurisdiction where tailored provisions are developed in either legislation or jurisprudence. General, well-established principles apply. First and foremost, the arm's length principle that is laid down explicitly in the income tax law is applicable to both individuals and companies. Enacted as a principle, there is not much guidance as to its application in practice, and especially not to themes recurrent in CBBR such as the transfer of assets, functions and risks and the inherent variation in profit potential.

However, what is clearly established is that the principle must be applied consistently, whether CBBR is increasing activity in Luxembourg (inbound restructuring) or reducing activity (outbound restructuring). Thus, an inbound restructuring not conducted at arm's length terms could lead to a step-up in basis, whereas an outbound restructuring at lower than arm's length terms could lead to a deemed increase of taxable income, and for companies also to withholding tax. For both cases, Luxembourg income tax law prescribes that the operating – or going concern – value be used, rather than the fair market value if the latter is understood as the estimated value that can be realized in the open market. The latter value is, somewhat paradoxically, prescribed for the transfer of going concerns.

Absent domestic specific provisions that deal with CBBR, the principles laid down in the OECD transfer pricing guidelines are considered to be applicable in Luxembourg for the application of the arm's length principle. Taking the OECD's definition of a CBBR as a redeployment of assets, functions and/or risks by a multinational enterprise (MNE), taxation in Luxembourg of outbound restructuring can only take place if assets are being transferred. The mere (outbound) transfer of a function or risk should, in the reporters' view, not give rise to "exit" taxation. However, "asset" should be understood in its widest sense, including contractual rights and other intangibles. A transfer of a function or risk may well entail the transfer of such an asset as well. Once it is established that such rights

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or other intangibles are being transferred, the transfer price, if any, should be set at the operating value. That value would include any compensation of reduced profit potential and closure costs, if arm's length conditions justify such compensation.

It may well be difficult for the Luxembourg direct tax authorities to determine whether intangible assets indeed have been transferred, and furthermore to establish an arm's length price for such a transfer. Generally it is for them to prove the facts that provoke tax liability. However, according to consistent Luxembourg case law, if the tax authorities can demonstrate a loss of earnings for a taxpayer, then the taxpayer may be required to prove the facts that cause the reduction in earnings. That rule may well be helpful to the tax authorities as an outbound CBBR often does lead to a loss of earnings. Other instruments available to the tax authorities are the general "substance-over-form" principle and anti-abuse provisions against sham transactions and abuse of legal forms with no other purpose than tax avoidance.

Furthermore, civil law and case law give some guidance as to compensation in cases where contracts are ended at, and more significantly, before their term. In general, contracts bind their parties not only to what is expressed in them but also to all the consequences that equity, custom or law give to the obligations in the contracts given the nature of these obligations. For the typical CBBR case of "stripping" a distributor, some case law is available, according to which the loss of customers as a result of ending the contract by a franchisor gives rise to compensation if the distributor was not selling under its own name. In the case of a restructuring between related parties, such case law could be used by the tax authorities to substantiate a claim that the arm's length principle would require compensation.

In this report the legal framework for taxing a CBBR is first set out, after which the tax effects for a few forms of particular business restructuring are shown. The report ends with a further illustration of these tax effects through a few typical restructuring cases.

1. Domestic provisions with an international scope which apply in business restructuring cases

1.1. General overview

The arm's length principle is fully accepted in Luxembourg while not currently regulated as such. Practically applied, the arm's length principle results from the cross application of several provisions contained in the Luxembourg Income Tax Law (*loi du 4 décembre 1967 concernant l'impôt sur le revenue* (LIR)). Non-compliance with this principle generally results in the characterization by the Luxembourg direct tax authorities of a hidden profit distribution within the meaning of article 164(3) LIR or hidden capital contribution within the meaning of article 18(1) LIR, depending on the flow of the advantage granted. Article 56 LIR, which is the main provision in Luxembourg direct tax law regarding the transfer of profit, is rarely applied in practice.

In the present report, two kinds of CBBR are analysed: in each case a distinction can be made between outbound situations, i.e. where functions, risks and/or assets are transferred from a Luxembourg entity abroad, and inbound situations, where the opposite occurs.

Article 38 LIR applies for the transfer of a business or a permanent establishment (PE) owned by a non-resident which is assimilated to a disposal for Luxembourg direct tax purposes, at estimated realizable value (i.e. fair market value according to article 27(2) LIR).

On the other hand, if a business or a PE is transferred from abroad to Luxembourg, this business would be treated as a new business for Luxembourg direct tax purposes and thus be valued according to the provisions of article 35 LIR (i.e. value between the acquisition cost and operating value). All additional contributions would be valued at their operating value according to article 43 LIR.

1.2. The arm's length principle and CBBR

A CBBR is defined by the OECD as the redeployment by an MNE of functions, assets and/or risks.[1] The arm's length principle will require the business terms and conditions of a CBBR involving a Luxembourg company and other parties with a special economic relationship to reflect those as concluded between third parties in similar situations (i.e. reflecting market conditions).

The tax authorities generally refer to the OECD guidelines for the application of the principle which is laid down most prominently in articles 56, 164(3) and 18(1) LIR. Article 56 LIR is the most explicit provision in Luxembourg direct tax law regarding the transfer of profits as it allows the tax authorities to make an estimate of the financial result, disregarding the realized result after a transfer of profit:

> "Article 56 LIR – Transfer pricing rules
> Without regard to the result reported … [a civil servant of sufficient rank] … may estimate the financial result, when a transfer of profit is rendered possible by the fact that the entrepreneur has a special economic relationship, be it direct or indirect, with a physical or corporate person who is not a taxable resident."

This provision is, however, rarely applied in practice, possibly because of the burdensome administrative procedures required to operate the adjustment[2] compared with the other provisions available in the law.[3]

If the tax authorities consider the arrangements between the involved parties as non-compliant with the arm's length principle, tax adjustments may be effected by increasing the taxable income. A decrease in the taxable income is, however, not possible. The term "special economic relationship" (i.e. any relationship deviating from common commercial relationships) implies a control factor in the relationship between the parties[4] and thus makes article 56 LIR applicable to a CBBR.

1 OECD *Report on the Transfer Pricing Aspects of Business Restructurings*, Chapter IX of the transfer pricing guidelines, revised on 22 July 2010.

2 The competence to adjust the tax result belongs to higher rank civil servants of the tax authorities acting on the Director's authority (Jean Schaffner, *Droit Fiscal International*, 2nd edn, 2005, Editions Promoculture, p. 174).

3 IFA *Cahiers* 2008, vol. 93b, *New tendencies in tax treatment of cross-border interest of corporations*, Luxembourg, Sami Douenias and Alina Macovei-Grencon, p. 439.

4 Philip J. Warner, *Luxembourg in International Tax Planning*, 2nd edn, 2004, International Bureau of Fiscal Documentation, p. 91.

Article 164(3) LIR is applied more frequently in practice by the tax authorities as a tool against transfer pricing deviating from the arm's length principle:

> "Article 164(3) LIR – Hidden profit distributions
> Hidden distributions of profits are to be included in taxable income. A hidden distribution of profits exists if a shareholder, member or other interested party directly or indirectly receives advantages from a corporation or association which it would normally not have received had he not had this quality."

Article 164(3) LIR provides for the requalification into hidden profit distributions of advantages shifted directly or indirectly from a Luxembourg company subject to corporate income tax to its shareholder, which the latter would not have benefited from had the relationship between the parties involved been a relationship as between third parties. This advantage, being the difference between the price actually paid and the price that would have been paid in a third party transaction, is added back to the taxable basis of the Luxembourg company resulting in additional corporate income tax and municipal business tax to be paid by the entity (i.e. as with article 56 LIR).

Moreover, and contrary to article 56 LIR where no hidden profit distribution is characterized, the funds not received are deemed to have been distributed to the shareholder as dividends and should thus be subject to dividend withholding tax at a rate of 15 per cent on the gross amount, unless a double tax treaty (DTT) providing for a reduced rate/exemption or the Luxembourg participation exemption regime[5] applies. Late interest on dividend withholding tax may also be charged.[6]

A similar adjustment applies for individual taxpayers carrying on a business (except for the withholding tax) on the basis of the concept of drawings provided by article 18(1) LIR.

In principle, the tax authorities have to demonstrate, based on a body of facts, that there has effectively been an advantage granted directly or indirectly to a shareholder and that no information relating to an economic justification has been communicated by the taxpayer. Based on Luxembourg domestic legal provisions,[7] the onus of proof can, however, be shifted to the taxpayer who then needs to demonstrate that no reduction of Luxembourg profit has effectively occurred or that such reduction of profits is linked to a genuine economic reason[8] and not solely motivated by the special relationship between the parties.[9] Economically justified should hereby be understood within the meaning of complying with the arm's length principle.

5 Art. 147 LIR.
6 Art. 155 LIR.
7 §170 *Abgabenordnung* (AO) to be read in conjunction with art. 59 of the law of 21 June 1999 regulating litigation proceedings in front of administrative courts.
8 *Cour administrative d'appel* (CAA), 12 February 2009, no. 24642c; *Tribunal Administratif* (TA), 16 February 2009, no. 24105.
9 TA, 28 June 2010, no. 25158.

The concept of hidden profit distribution has been further detailed and developed in four administrative circulars[10] and by Luxembourg domestic case law without specifically focusing on CBBR.

Next to article 164(3) LIR is article 18(1) LIR on hidden capital contributions:[11]

> "Article 18(1) LIR – Hidden capital contributions
> The profit is determined by the difference between the net assets invested at the end of the accounting period and the net assets invested at the start of the period, increased by drawings made during the period and decreased by capital contributed during the period."

The concept of hidden capital contribution is indirectly derived from article 18(1) LIR which implies all kinds of contributions (which are treated as assets) in the concept of "supplemental contributions".[12] Unlike hidden profit distributions, this treats the granting of advantages by the entrepreneur or shareholder of the Luxembourg business or company which the latter would not have benefited from had the relationship between the parties involved been a relationship as between third parties. The granting of a right to use property or the provision of services free of charge (i.e. granting an interest-free loan) or for an inadequate charge cannot, however, constitute a hidden capital contribution.[13]

The exceptional income that the contribution represents in the financial accounts of the Luxembourg business or company is, from a Luxembourg tax standpoint, considered as being a "contribution" within the meaning of article 18(1) LIR, thus increasing the shareholder's equity of the business or company mirrored by an increase of the tax value of the assets or a decrease of the liabilities. Such exceptional income is deducted from the taxable basis of the Luxembourg company and is thus tax neutral.

It is generally difficult for the tax authorities to quantify the advantage received or granted following non-compliance with the arm's length principle in the context of a CBBR. Luxembourg has not introduced specific transfer pricing regulations but generally refers to the OECD transfer pricing guidelines for multinational enterprises and tax administrations[14] for guidance. This includes the new Chapter IX of the transfer pricing guidelines focused on aspects of CBBR. Luxembourg domestic law, case law[15] and administrative practice nevertheless provide for some guidance of a general nature aimed at satisfying the international standards of the application of the arm's length principle but do not fix any specific transfer pricing

10 Circulars no. 104/1 LIR of 18 February 2009, no. 164*bis*-1 LIR of 27 September 2004, no. 104-2 LIR of 11 January 2002, no. 46-2 LIR of 23 March 1998.

11 The ambit of art. 18(1) LIR is wider as it relates to the calculation method for assessing business income. The present report will focus on hidden capital contribution. For individual taxpayers carrying on a business, an adjustment similar to hidden profit distribution may be effected.

12 Art. 42(1) LIR.

13 Luxembourg Income Tax Code, Fiscal Studies, Guy Heintz, Corporate Income Tax, Hidden Contributions, 1 January 1999, p. 69.

14 See note 1 above.

15 Current case law relating to transfer pricing, although limited, puts forward that the tax authorities generally argue for hidden profit distributions (i.e. art. 164(3) LIR) instead of applying art. 56 LIR.

method. The rationale of a CBBR should be set out in adequate documentation: inter-company agreements, transfer pricing analyses, invoices and other relevant records should be kept at the registered office of a company in case the tax authorities were to question the arm's length nature of a transaction. To the extent possible, the tax authorities are also likely to look at other groups present in Luxembourg conducting a similar type of restructuring to determine the course of action to be taken should a comparable third party situation not have previously occurred.

1.3. General and specific provisions with international focus or effect in business restructuring cases

The following provisions of the Luxembourg direct tax law may apply to value CBBR into and out of Luxembourg.

1.3.1. Inbound CBBR

If a business or a PE is transferred from abroad to Luxembourg, the business would be deemed to be a new business for Luxembourg direct tax purposes, valued according to article 35 LIR applicable in case of a contribution to a Luxembourg individual or corporate taxpayer.[16]

Before looking into valuation rules in relation to CBBR, it is noteworthy that pursuant to article 40 LIR, fiscal accounts in principle follow commercial accounts (principle of *accrochement*) as long as there is no deviation prescribed by Luxembourg tax law (e.g. article 18 LIR and article 164(3) LIR could result in a divergent tax balance sheet). The only way to cope with fiscal valuation rules which differ from accounting rules is to draw up a fiscal balance sheet deviating from the commercial balance sheet.

Article 35 LIR treats the setting-up of a new business or an autonomous part of a business in Luxembourg and as such applies to CBBR. The article provides for five principles for the valuation of net invested assets in the opening balance sheet.

According to article 35(1) LIR, net invested assets in the opening balance sheet cannot be valued (a) above the acquisition prices or the production costs for assets acquired or produced for the purpose of the setting-up of the business; (b) above the operating value at the date of the setting-up for other assets; (c) under the amount of the net obligation of the entrepreneur for debts payable incurred for the purpose of the setting-up of the business; or (d) under the operating value for any other debts payable. When a taxpayer becomes Luxembourg tax resident, the value of assets must be calculated following the same rules, except that operating value can be used for all assets.[17]

Valuation rules as outlined in article 43 LIR, relating to supplementary contributions (i.e. any assets not forming (an autonomous part of) an enterprise, which the taxpayer allocates to his business within the meaning of articles 18 and 42 LIR),

[16] Certain legal provisions relating to individuals subject to personal income tax are also applicable to entities subject to corporate income tax (art. 162 LIR, Grand Ducal Regulation of 3 December 1969).

[17] Art. 35(4) LIR.

refer also to their operating value at the date of the contribution and withdrawal during the exercise.

The operating value is therefore the main standard for valuing inbound CBBR. It is defined as the price that someone buying the entire business as a going concern would give to the asset when allocating the price he would pay for the business as a whole over the individual assets (article 27(1) LIR). Another translation possible is therefore the "going concern" value. According to recent case law, the operating value is based on the intrinsic value of the asset in question, but must also take account of the importance of the asset for the continued operation of the company to which it belongs.[18]

For example, if a client portfolio is transferred to a Luxembourg company free, this is likely to lead to future profits at the level of the Luxembourg company and may therefore be understood as a kind of "goodwill". In general, the operating value of the goodwill should be determined and activated in a diverging tax balance sheet of the Luxembourg company mirrored by an increase of its capital reserve. This goodwill would subsequently be amortized over its useful lifetime (e.g. 10 years) according to section 10 of circular LIR no. 101 of 5 November 1985.

1.3.2. Outbound CBBR

Article 38 LIR applies for the transfer abroad of a business or a PE owned by a non-resident. This is assimilated to a disposal at estimated realizable value, defined under article 27(2) LIR as the price that a party buying this asset would have paid under normal market conditions for that sole asset (i.e. fair market value).

The same applies for the termination of a business as a whole or an autonomous part thereof in Luxembourg. Article 39 LIR provides that in the event of cessation of (an autonomous part of) a business, the valuation of assets not disposed of but invested must, when transferred to the private property of the owner, be valued at their estimated realizable value.[19]

If only some assets are transferred abroad, these transfers would be characterized as drawings within the meaning of articles 18 and 42 LIR, valued at operating value (article 43 LIR).

1.4. The relationship between the domestic business restructuring provisions and tax treaties

An international treaty ratified by Luxembourg is superior to Luxembourg domestic law according to constant case law.[20] It follows that in case of conflict between the provisions as laid down in an international treaty and those as laid down in domestic law, the former would prevail over the latter,[21] even if the domestic law was introduced after the treaty was signed.

18 CAA, 16 June 2009, no. 24969c.

19 See section 2.4.

20 High Court of Justice (CSJ) (Cass), 14 July 1954, *Chambre des métiers* v. *Pagani*, Pasicrisie XVI, 150; CSJ, 8 June 1950, Pasicrisie Lux, XV, 41; Luxembourg State Council (*Conseil d'Etat*, CE), 28 July 1951, *Dieudonné*, no. 4856; CAA, 6 March 2001, *Rymer*, no. 12521c and CAA, 14 January 2002, *La Coasta*, no. 14442c.

21 Schaffner, *op. cit.*, p. 60, 3.5.

This means that even if Luxembourg domestic rules on CBBR were introduced in Luxembourg, international treaties would continue to prevail.

1.5. Business restructuring and domestic anti-abuse rules

Luxembourg law principally refers to general tax rules to counteract tax avoidance, also in an international context.[22] Domestic anti-abuse rules in relation to CBBR may come into play in cases where an abuse can be demonstrated. The definition of "abuse" is fairly broad and not specifically defined. According to Luxembourg domestic case law, a Luxembourg taxpayer is generally free to choose the most tax efficient structure between available alternatives without this as such being regarded as abusive.[23] By applying general anti-abuse tax rules, however, the tax authorities can disallow tax benefits achieved through the implementation of a structure which is proven to be inadequate to realize the intended business purpose.

It is a generally applied principle in Luxembourg that transactions are analysed based on their economic substance instead of their legal form, if the economic substance differs from the legal form.[24]

§11 of the Luxembourg Tax Adaptation Law (*Steueranpassungsgesetz*, StAnpG) provides for the determination of the owner of an asset for tax purposes. Generally, assets which are in a taxpayer's legal ownership and possession are for fiscal purposes allocated to this legal owner.[25] However, if the economic owner of an asset is not identical with the legal owner, the asset will generally be allocated to the economic owner of the asset for fiscal purposes.

It has been confirmed in recent case law[26] that a court is held not to look solely at the legal form chosen by parties to achieve a specific objective but also beyond the legal appearance so as to investigate (according to economic criteria) the economic reality covered by the legal form. It is therefore important to note that the definition of *Eigenbesitz*[27] as outlined in §11(4) StAnpG is a fiscal concept rather than a legal concept which states that an economic owner does not necessarily have to be the legal owner of an asset.

This provision could be relevant if an outbound CBBR were implemented only legally while the actual business was still carried out in Luxembourg even though the Luxembourg company was no longer the legal owner of the assets.

Anti-abuse rules are typically covered in Luxembourg tax law by §6 StAnpG:

22 Absent an express provision in a DTT, Luxembourg nevertheless believes that a state can only apply its domestic anti-abuse provisions in specific cases after recourse to the mutual agreement procedure (OECD model tax convention, Condensed version, July 2008, commentary on art. 1, para. 27(6)).

23 CE, 9 January 1963, *Helios*, no. 5677; CE, 9 January 1963, *Comptoir de vente*, no. 5676.

24 IFA *Cahiers* 2010, vol. 95a, *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Luxembourg, Sandra Biewer and Birgit Höfer, p. 490.

25 §11 StAnpG applies the principle of economic approach referred to in §1(2) StAnpG abrogated on 26 October 1944, which stated that the purpose and economic significance of the tax laws and the evolution of circumstances were to be considered.

26 CAA, 26 June 2008, no. 24061c.

27 Proprietary possession.

> "§6 StAnpG – Abuse of legal form
> Taxes may not be evaded or mitigated by abuse of forms or constructions which are legal under civil law.
> In the case of abuse, taxes should be levied as they would have been levied under the legal construction appropriate to the economic operations, facts and circumstances ..."

The tax authorities may therefore recharacterize transactions the sole purpose of which is to avoid taxes through the use of abusive structures, driven solely by fiscal objectives instead of economic reasons.[28]

By a decision dated 15 July 2010, the Administrative Court of Luxembourg[29] upheld a decision of the Administrative Tribunal[30] confirming the possibility of continuing to use the tax losses of companies following a change of shareholder. This decision confirmed that tax losses cannot be carried forward when the new shareholder has acquired a company for the sole purpose of exploiting existing tax losses (so-called *Mantelkauf*). It has been followed by an administrative circular[31] confirming that a taxpayer will not be denied the right to carry forward losses even if there has been a change in the shareholding (partly or completely) provided that the taxpayer continues the economic activities of the acquired company, or extends its corporate purpose. On the other hand, the tax authorities have confirmed that the right to carry forward losses should be denied when a purchase of shares in a company may be qualified as abusive if it has been undertaken with the sole aim of offsetting tax losses carried forward against profits to reduce corporate income tax.

§5 StAnpG aims at a close but nevertheless different situation, in that it deals with simulated transactions:

> "§5 StAnpG – Simulation
> Fictitious transactions and other simulated acts (e.g. the establishment or maintenance of a fictitious residence) are irrelevant for taxation purposes. If a fictitious transaction hides another legal act, the hidden legal act is crucial for taxation purposes."

According to this provision, simulated transactions should be disregarded for Luxembourg direct tax purposes. Under the simulation concept, a CBBR would therefore be disregarded for Luxembourg direct tax purposes should the tax authorities consider the transaction as having been implemented only to conceal the real transaction.

28 Structures driven by tax and economic considerations are therefore not deemed abusive.
29 CAA, 15 July 2010, no. 25957c.
30 TA, 6 July 2009, no. 23982.
31 Circular no. 114/2 LIR of 2 September 2010.

2. Tax effects of CBBR

2.1. General overview

In general, it can be held that at the time of an outbound CBBR, any capital gain or compensation (deemed) realized is taxed. For individual entrepreneurs, that means taxation at progressive rates for individual income tax (IIT) purposes, the top rate of which is 38.95 per cent.[32] In addition, municipal business tax (MBT) is due at an effective rate of around 6.2 per cent.[33] Some mitigation results from the fact that for individuals, the MBT is deductible for IIT. An important mitigation is provided if the CBBR entails an alienation of an enterprise or an autonomous part thereof, or a cessation of the enterprise. Taxation then takes place at half the progressive rate, and MBT is, for individual taxpayers, not due for such an event. Companies are taxed with corporate income tax (CIT) and MBT levied at an aggregate rate of 28.59 per cent.[34] Where a CBBR leads to imputation of income in accordance with the arm's length principle, companies may face dividend withholding tax at a statutory rate of 15 per cent, unless a rate reduction or exemption applies.

In inbound situations, a CBBR will probably lead to a step-up in basis for any asset or business transferred to Luxembourg, as they are (most often) recognized at their operating value. For companies, the difference between the stepped-up value and the book value in the commercial accounts could furthermore represent a hidden capital contribution.[35] Such "fiscal capital" would follow the tax treatment of share capital for withholding tax purposes.[36]

Post restructuring, an outbound CBBR may give rise to payment of royalties and service fees. While there is in Luxembourg no withholding tax on such payments, non-compliance with the arm's length principle could be considered by the tax authorities as constituting (in part) hidden profit distributions, possibly subject to dividend withholding tax. In inbound situations, royalties and service fees paid to the Luxembourg entity will be fully subject to taxation.

2.2. Transfer of risk and functions

Luxembourg tax law does not contain specific provisions on how to deal with CBBR and the allocation of profits that follows from the restructuring. The arm's length principle would be the yardstick to determine whether a transfer of risks and/or functions had been adequately compensated. Chapter IX of the OECD guidelines may be used as guidance in this respect.

32 2010 rate. At the time of writing this report, a bill of law increasing the IIT top rate to 41.67 per cent and the combined CIT and MBT rate to 28.80 per cent was pending.

33 Effective MBT rate in the City of Luxembourg. MBT rates vary from municipality to municipality.

34 See note 32 above.

35 See sections 1.2 and 1.3.

36 See Guy Heintz, *Etudes fiscales*, *op. cit.* and Alain Steichen, "La prime d'émission", *BDB*, no. 25, 1996, p. 48.

2.2.1. Outbound situations

If an enterprise transfers risks and functions to another associated enterprise abroad, such transfer of activity and the decrease in risks resulting therefrom will generally entail a decrease of the profit potential of the transferring entity. Whether compensation is required in accordance with the arm's length principle and, if so, at what level, is a highly factual issue in any particular case at hand.

If the risks and functions transferred together form an autonomous part of an enterprise, the transfer should be treated as the transfer of a going concern.[37] If compensation or damages are stipulated by contract for the termination arrangement before its term, the transferring entity could be required to claim compensation in accordance with the arm's length principle.[38] Without that circumstance, the reduced profit potential would not seem to require any compensation under Luxembourg law. On a stand-alone basis, a transfer of risk would not need compensation; it would rather give rise to a payment to the party taking over the risk.

This should not be different if there were significant closure costs involved. Significant closure costs may be an indication that the functions constitute an autonomous part of an enterprise. If not, they should be deductible.

After the restructuring, there would, in principle, be an ongoing evaluation of whether the transfer of risks and functions is real: the transfer of functions should result in a reduced cost level due to reduced personnel, outsourcing and advisory costs. A transfer of risks should result in a more stabilized return, and possibly in the denial of future loss making positions by the tax authorities. The profitability of the company in the entry country should in principle not play a role, but may give the tax authorities the benefit of hindsight if that profitability is known to them.

The tax authorities have the possibility of revising the tax assessments of a Luxembourg company within a five-year period after the end of the relevant tax period, but only if new facts come to light.[39] A so-called "self-assessment" procedure has recently been introduced in Luxembourg[40] pursuant to which the tax authorities have an option to issue a tax assessment in accordance with the tax return filed by the taxpayer, without first having to perform a review of the file. Within the same five-year period, such an assessment may be reviewed without new facts being required. This procedure could potentially be used by the tax authorities to assess the tax position of a company after a CBBR over a number of years.

2.2.2. Inbound situations

In inbound situations, the reverse applies. Outside the context of the acquisition of (an autonomous part of) a business, functions or risks should not be valued and activated according to current Luxembourg tax law. Without a contractual stipulation of a compensation payment on the termination of a contract before it expires, no deduction of any compensation payment should be allowed.

37 See section 2.4.
38 See section 2.5.
39 Increased to ten years in case of additional taxation for incomplete or incorrect declaration by the taxpayer (art. 10 of the law of 27 November 1933 regarding the collection of direct taxes).
40 §100a AO.

2.3. Transfer of intangible assets

An essential part of the analysis of a CBBR is to identify the significant intangible assets that are transferred, their arm's length value and whether they are already in the books of the taxpayer.[41]

Luxembourg has special legislation covering certain intangible property (IP) rights pursuant to article 50*bis* LIR. With effect from 1 January 2008, an 80 per cent exemption applies to any income from eligible IP including gains from the disposal of IP, except copyright (other than for software), plans, formulae, knowhow, trade secrets and similar rights. In addition, net worth pertaining to eligible IP is exempt from Luxembourg net worth tax.[42]

2.3.1. Outbound situations

Except for IP rights falling within the scope of article 50*bis* LIR, there are no specific rules applicable to the transfer and the valuation of intangibles in Luxembourg. Therefore, reference should be made to general principles according to which any capital gain derived from intangible assets is taxable in Luxembourg. In case of any reduced profit potential, compensation would be reflected in the price of the intangible assets transferred, failing which the tax authorities could question the reasoning behind the transfer. An adjustment to the transfer price in accordance with the arm's length principle would then seem likely.

The adequacy of the transfer price will be dependent on the circumstances, contractual arrangements, and alternatives available to the company. Within the IP regime, any IP right transferred is to be valued at realizable value.[43] An administrative circular dated 5 March 2009 states that this value may be determined on the basis of any commonly used international valuation method for IP rights.[44] Small and medium-sized enterprises are also allowed to apply a safe haven, which is 110 per cent of all the expenses that have reduced the income tax base in the year of alienation or in previous years.[45]

After restructuring, if a Luxembourg transferor continues to use the intangible transferred, it would do so in another legal capacity (e.g. as a licensee of the transferee). It would be expected in that case to pay an arm's length royalty which should in principle be fully tax deductible (even in the case of an eligible IP asset for which 80 per cent of the gain may have been tax exempt).[46] That circumstance might induce the tax authorities to scrutinize the level of the royalty payment more rigorously and to reclassify excessive royalties as a non-tax deductible hidden profit distribution potentially subject to withholding tax.

41 See Chapter IX of the OECD guidelines, Part I, D.2.

42 §60*bis* of the Luxembourg Valuation Act of 16 October 1934 (*Bewertungsgesetz*), which defines the taxable basis for the net worth tax.

43 Art. 50*bis*(6) LIR referring to art. 27 (2) LIR.

44 Circular LIR no. 50*bis*/1.

45 Small and medium-sized enterprises are defined as enterprises that employ fewer than 250 people, the turnover and balance sheet of which do not exceed EUR 50 million or EUR 43 million.

46 Subject to the recapture of 80 per cent of the net losses realized in connection with the asset during the financial year of disposal or previous financial years.

2.3.2. Inbound situations

Luxembourg is typically an IP entry country due to its favourable IP regime. Once an intangible asset is allocated to a Luxembourg company, it is generally licensed back at a market (at arm's length) rate to either the original owners, an affiliated party or a third party.

Within the IP regime, an anti-avoidance rule disqualifies IP rights acquired from certain related parties, which are defined more strictly than in the general provisions dealing with the arm's length principle (as set out in section 1) since a direct shareholding of at least 10 per cent between the taxpayer and parent, subsidiary or common parent is required.[47]

2.4. Transfer of a going concern

The transfer of a going concern means the transfer of a business activity together with the capacity to carry on that business. The resources, capabilities and rights transferred to the receiving entity will in that case be taken into account in determining the arm's length purchase price of the business or the compensation to be received by the transferring entity upon an indirect shift of activity.

2.4.1. Outbound situations

An alienation of a going concern for consideration is a taxable event pursuant to article 14 LIR to be valued at its estimated realizable value according to article 55 LIR. The consideration is required to be at arm's length.

If a business or an autonomous part thereof is not transferred as such, but merely discontinued by a Luxembourg entrepreneur, while at the same time an affiliate is taking up the same business, one can debate whether *de facto* the business was transferred and therefore the above principles apply or whether the business has simply ceased without such transfer.

If no transfer can be identified (so no transfer of either tangible assets or intangibles such as customer lists, organizational knowhow, contractual rights, etc.), there would be a cessation of business. If the business was profitable and would be expected to be profitable going forward, it seems obvious that a third party would have opted for its continuation, and therefore that the cessation was done on behalf of the group. The cessation of business is a taxable event according to article 15(2) LIR. Assets not ceded need to be valued at their estimated realizable value pursuant to article 39 LIR, if they are transferred to the private property of the owner. The resulting gain is taxable. It would have to be determined whether assets would be so transferred, which is difficult to imagine for intangible assets that are not going to be used in another business. Absent such a transfer, the value of these intangibles, which represent the profit potential of the business, could not be taxed under Luxembourg law and no compensation for a reduced profit potential could then be imputed.

[47] Art. 50*bis*(5) LIR.

As for companies, these are in Luxembourg not considered to have a private sphere[48] so that assets that are not alienated could not be transferred in the sense of article 39 LIR.[49] Cessation of business and a corresponding reduced profit potential therefore cannot lead to imputation of a compensation on that basis. The question is whether on the basis of the substance-over-form principle, this could be construed as another transaction for which the transfer of assets could be identified and an imputed transfer price could be taxed.[50]

For instance, this may apply to Luxembourg intra-group finance companies. These companies typically earn a spread between interest receivable and payable. Their business is stable (currency and credit risks are often avoided or hedged). The loans receivable are often repayable on demand and the loans payable can be prepaid without penalty upon request of the Luxembourg company only. Would the finance activities be taken up by another group entity abroad, the Luxembourg company may (be procured to) request repayments on demand and make prepayments, so that it ceases its business. In such a case, the reduction in profit potential seems reasonably clear and even quantifiable. However, absent a transfer of assets, no compensation could be imputed. If the cessation of this business can be reconstrued as a transfer of contractual rights, however (i.e. rights to receive interest absent the demand for repayment, and the right to repay the loan payable at a later date), an adequate transfer price for that transfer might be imputed by the tax authorities.[51]

2.4.2. Inbound situations

The valuation of the going concern in the exit country remains an important but not decisive indicator. The same applies as regards the information contained in the financial statements of the transferring entity despite the *accrochement* principle; tax valuation rules divergent from commercial accounting valuation rules prevail in principle.[52]

2.5. Termination or substantial renegotiation of an existing arrangement

The question is to what extent a restructured entity is entitled to claim compensation from its affiliate in case of termination or substantial renegotiation of existing arrangements. Luxembourg law, from a civil, commercial and tax point of view, does not provide for any explicit statutory basis governing this issue. Reference to Luxembourg general principles of civil law, commercial law and case law should be made.[53]

48 Art. 162(3) LIR.

49 Except if a Luxembourg PE ceases its business and a non-resident head office carries it on.

50 See Chapter IX of the OECD guidelines, s. D.2.4.

51 Reconstruction either on the basis of the substance-over-form principle or §5 and/or 6 StAnpG. See sections 1.5 and 2.6.

52 Art. 40(1) LIR.

53 The same is not true for commercial agency contracts governed by the law of 3 June 1994; termination of the contract confers on the agent the right to a so-called "eviction indemnity" and the other option proposed by Directive 86/653/EEC.

2.5.1. Outbound situations

A typical situation justifying the payment of compensation exists when the parties have agreed on such payment in the contract. Article 1134, first paragraph, of the Luxembourg Civil Code (CC), which is the common legal basis for all actions relating to contractual liability, provides that the agreement entered into between parties is the basis governing the relationship between the parties.

In the absence of an indemnification clause in the contract, there should be no presumption that the contract termination or its substantial renegotiation should give a right to indemnification.

Luxembourg general rules provide that a contract entered into for a fixed term automatically terminates at the termination date without further formalities, unless the parties consent to an extension of the term. The strictness of this principle is tempered by the provisions of article 1134(1) CC according to which agreements must be executed in good faith and those of article 1135 CC which provides that a convention is binding not only for what is expressed in it but also for all the consequences that equity, usage or law give to the obligation given its nature. These provisions may justify the payment of compensation. As for open-ended agreements, a termination is possible subject to sufficient notice period being given or for serious fault.[54] It seems that on lawful termination of e.g. distributor contracts, only in very limited circumstances can compensation be required in accordance with Luxembourg commercial case law.[55] Such damage could have been deemed to occur when the termination takes place in circumstances where the distributor suffers the (immediate) termination of the contract where no (or a short) notice period or indemnification clause has been agreed upon between the parties. There is no clear guidance in that respect but Luxembourg case law shows that damages may be given to the distributor for the loss of customers. This indemnity remains at the discretion of the court, upon demonstration by the distributor that he has lost customers because of the termination of the contract. Indemnification will be refused, though, where the franchisee has sold the products in its own name and for its sole benefit and therefore did not cede any customers to the franchisor.[56] Furthermore, the franchisor may under certain circumstances be obliged to take over the stock remaining in the hands of the franchisee should the latter encounter any difficulties in selling it off because of the termination of the contract.

2.5.2. Inbound situations

An effective compensation paid by the Luxembourg company to the transferring entity should be tax deductible as a business expense.[57] A reassessment may be

54 CSJ, 11 July 1972, Pas. 22, p.194; Court of Appeal (CA), 10 March 2005, no. 28826; *Tribunal d'arrondissement* (Tarr), 24 March 2005, no. 49015. The right to indemnification of the restructured entity in case the notice period was considered too short given the facts and circumstances is excluded from the analysis.

55 CA, 12 June 1996, no. 16812.

56 CA, 26 October 1988, no. 9804, *inédit*, RG no. 9804; Tarr, 21 June 1996, no. 45111, *inédit*, RG no. 5111.

57 Art. 45 LIR. Depending on the type/volume of the investment, to be activated and depreciated.

made by the tax authorities should the latter consider the remuneration as being too high in accordance with the arm's length principle.

2.6. Recognition of the actual transactions undertaken

The tax authorities may rely on a range of provisions when challenging the taxable basis of a taxpayer[58] such as the anti-abuse rule of §6 StAnpG for artificial arrangements, §5 StAnpG (simulation) and reassessment of a company where the arm's length principle is not respected. A few decisions confirming adjustments made by the tax authorities based on §6 StAnpG are rendered every now and then. Decisions by Luxembourg courts on hidden profit distributions (article 164(3) LIR) and hidden capital contributions (article 18 LIR) are more frequent.[59]

Luxembourg courts have also in a number of cases denied the application of the above-mentioned provisions based on the principle of strict interpretation of the Luxembourg direct tax law. The potential conflict between the latter and the purpose of the law should principally be resolved in favour of the former.[60] A taxpayer is free to choose the most efficient structure without this choice as such being qualified as "abusive". However, a structure that was not in line with the economic reality and that was inadequate to achieve its economic objectives has been held abusive. Also a structure involving a company with no economic activity of its own and where no economic reasons could justify the existence of the company[61] is abusive. The scope of §6 StAnpG seems limited to situations where there is no other justification for the reorganization than tax erosion.

Luxembourg law provides that the burden of proof triggering the tax liability belongs to the tax authorities.[62] Luxembourg case law provides some more explanations as regards the degree of information that should be brought by the tax authorities to invert the burden of proof. Case law has thus recognized that it is not necessary that the tax authorities prove a hidden profit distribution as such but they have only to demonstrate the loss of earnings.[63] The proof of facts releasing tax liability or reducing the taxable basis is then on the taxpayer.

Coming back to the example described in section 2.4 about Luxembourg intragroup finance companies procuring to cease their business following a CBBR, the question is whether in such a case a reconstruction into a transfer of contractual rights can really be demonstrated by the tax authorities on the basis of the substance-over-form principle or §5-6 StAnpG. For this to work, it seems important that the entity starting the same finance business is in a very similar contractual position to the company that ceased its business. The cessation of the stable business

58 See sections 1.2 and 1.5.

59 See for example CAA, 16 October 2007, no. 23053c, dealing with an acquisition by a Luxembourg company of a patent financed with shareholder's loans. The court ruled that the determination of the interest rate under the loans must take into account the risks assumed by the company as regards the activities financed.

60 Jean-Pierre Winandy, "Fraude à la loi et abus de droit en droit fiscal luxembourgeois", *Annales du droit luxembourgeois*, 2001.

61 See note 23 above.

62 Art. 51 of the law of 21 June 1999 laying down the rules of procedure before the administrative courts.

63 CAA, 1 February 2000, no. 11318c and 12 February 2009, no. 24642c; TA, 6 June 2005, no. 19162 and 9 June 2008, no. 23324.

obviously leads to a reduction of profit potential. A loss of earnings would then be demonstrated, and the burden of proof that there was no reduction in profit or that there was an economic justification for that reduction would be for the taxpayer. One could argue that the above implies that the taxpayer would have to prove that the voluntary cessation of business, with another group entity starting that same business, could not be reconstrued as a transfer of contractual rights.

In order to avoid a possible adjustment of its taxable result and obtain certainty on a reorganization to be implemented, a taxpayer may seek advance tax clearance from the tax authorities on the compatibility of a reorganization with the arm's length principle. Such confirmation, provided that the taxpayer sticks to the description of the transaction made in the application,[64] will be considered binding by the tax authorities on the basis of the principle of "good faith" (*bonne foi*). The taxpayer should also be protected against reversals of administrative interpretation, at least as long as the clearance is not cancelled, with an appropriate notice period.

2.7. PE issues

A CBBR can give rise to a PE in Luxembourg through the set-up of a branch in Luxembourg, participation in a Luxembourg partnership or the involvement of an agent in Luxembourg.

A branch is defined in §16 StAnpG as "every fixed place or installation which serves for the operation of a business", after which the provision further enumerates a list of establishments that qualify as PEs. Relevant to CBBR is: a place of management and an office or other establishment that serves an entrepreneur or co-entrepreneur or his permanent representative for the carrying out of business. The definition of a PE in DTTs concluded by Luxembourg mostly follows the wording of the OECD model convention.

The participation in a partnership leads to a PE if the partnership is carrying on or deemed to be carrying on business through a fixed place or installation. Note that it is not required that a formal partnership is established for the question to arise whether or not a PE exists in Luxembourg through a partnership. A partnership in fact can suffice.[65] For example, a profit participating loan to a company with a share in liquidation proceeds would be regarded as a silent partnership entered into with that company, and form a PE for Luxembourg direct tax purposes for the provider of that loan.

There are no specific rules in relation to CBBR when it comes to the allocation of profits between a head office and a PE. In general, if assets not forming an enterprise or an autonomous part thereof are transferred from a Luxembourg business to a foreign business held by the same taxpayer, profit realization should be deferred until the assets are actually alienated by that taxpayer.[66] Where a CBBR entails the migration of a Luxembourg business or PE of a non-resident abroad, the tax authorities, however, tend to assimilate this migration to a disposal as a whole at the

64 See Circular LG/NS no. 3 of 21 August 1989 as regards the conditions to be met for the binding effect to apply.

65 CE, 3 April 1957, no. 4940, *L'Alliance*.

66 IFA *Cahiers* 2006, vol. 91b, *The attribution of profits to permanent establishments*, Luxembourg, Paul Chambers and Keith O'Donnell, p. 455 and further literature mentioned there.

estimated realizable value of the enterprise or PE in accordance with article 38 LIR and therefore to tax any profit realized immediately. This position may be held to violate the freedom of establishment guaranteed by the EC treaty, as the taxpayer does not realize any asset. It may be argued that taxation of the profit determined in accordance with article 38 LIR should be deferred until and if it is realized.[67]

3. Tax effect of typical business restructuring cases

3.1. Change of a full-fledged distributor into a commissionaire or low-risk distributor

Company A is acting as a full-fledged distributor in the exit country in charge of distributing finished products which are produced by the related company B in the entry country. The relationship between A and B is based on a full-fledged distribution agreement. A assumes all typical functions of a full-fledged distributor, such as marketing and advertising, invoicing and collection, handling of inventory and delivery as well as after sales services and bears all typical risks of a distributor including market risk, inventory risk and credit risk. Moreover, A has established and maintains a customer base. A earns an appropriate arm's length profit for a full-fledged distributor. In the course of a group restructuring, the supply agreement between A and B is terminated according to the terms of the contract which are arm's length. A and B sign a new low-risk distributor (or commissionaire) agreement. According to the new agreement part of the functions and risks previously exercised and undertaken by company A, e.g. the credit risk, are now assumed by company B as manufacturer. The profit which company A receives as compensation for its low-risk distribution (or commissionaire) activities is reduced to the level appropriate for a low-risk distributor (or a commissionaire).

3.1.1. LuxCo is company B (entry country)

The restructuring may lead to the issue of compensating company A for providing certain assets and functions to the Luxembourg resident fully taxable company (LuxCo), also taking into account the risk functions transferred. Common valuation methods should be used for determining the arm's length price, if any. An effective compensation paid by LuxCo to company A will be tax deductible as a business expense if the arm's length principle is complied with. Assets may be recorded for their operating value, and lead to the recognition of fiscal capital if the acquisition price was lower. If the transfers amount to (an autonomous part of) a business, then article 35 LIR should also apply with a step-up in the value of the assets transferred up to their operating value.

[67] Based on ECJ C-9/02, *Hughes de Lasteyrie du Saillant*. See for a development of this argument Ulf Andresen, "Federal Tax Court Reaffirms the Limits of Taxing Businesses upon their Ultimate Exit from Germany", *International Transfer Pricing Journal*, May/June 2010.

3.1.2. LuxCo is company A (exit country)

The tax authorities will carefully examine whether rights to IP or other valuable rights were transferred for an arm's length consideration. As these valuable intangibles represent an important part of the future profits of company A, this should be reflected in the transfer price in order for the latter to be regarded as arm's length. Also, any compensation for dislocation costs and the like for the employees that go to company B should be reflected in the transfer price. However, should the transaction be inspired by cost pressures and competition, it may well be that such future profit potential is low or even absent, and even an absence of such compensation could be justified.

After the restructuring company A has a reduced risk profile, so that it would be expected to earn lower, but stable returns. Losses for the restructured company A may not be accepted by the tax authorities.

3.2. Change of manufacturing activity

Company A is acting as a full-fledged manufacturer in the "exit" country X. A sources raw material and is responsible for the whole production process and sells finished goods to distribution entities of the B group. The necessary production IP is owned by A; however, the necessary product IP (patents, trademarks, formulae, etc.) is owned by parent P and is used by A under a licence contract with P. A bears all typical risks of a full-fledged manufacturer: market risk, credit risk and volume risk. In the course of a group restructuring, P terminates the licence agreement with A and grants a licence to use the IP to S, a new company in the "entry" country. A signs a contract (or low-risk toll) manufacturer agreement with company S according to which S becomes the principal and assumes all functions and risks which are related to the full-fledged manufacturing activities from company A. After the restructuring, A is only responsible for manufacturing in accordance with the requirements of company S and sells the finished products to S only. A is remunerated by S based on an appropriate transfer pricing method and earns a routine profit. The residual profit or loss is earned by S in the entry country.

3.2.1. LuxCo is company S (entry country)

If a going concern is transferred from P or A to LuxCo, the question is whether assets (including intangibles) are transferred to LuxCo and how to value these assets. As explained in section 2.4, when dealing with the transfer of a going concern to Luxembourg, reference is made to article 35 LIR providing for a potential step-up in value up to the operating value. Luxembourg generally follows the OECD guidelines which look to the application of the discounted cash flow method.

3.2.2. LuxCo is company A (exit country)

Where all the typical risks of a full-fledged manufacturer are transferred from LuxCo to company S, the licence contract between parent S and LuxCo must be closely looked at. If the transfer has occurred prior to the end of the licence contract

between the parties, the arm's length nature of the cancellation could be questioned by the tax authorities.

It is important whether such transfer of risks has been accompanied by transfers of the customer base (i.e. goodwill) of LuxCo and/or of functions (i.e. transfer of a going concern). If some of the assets are transferred abroad, these transfers would be characterized as drawings within the meaning of articles 18 and 42 LIR and the assets would be valued at their operating value (article 43 LIR). If such a transfer of risk was, however, conducted at book value, a hidden profit distribution may be characterized by the tax authorities and withholding tax issues may arise.

It is important to understand whether LuxCo will also transfer its existing contracts with its suppliers (e.g. low rates due to a long-standing relationship). The question is whether company S would have also benefited from such rates, had it negotiated the contracts by itself. The difference between the rates actually paid and the market rates that a third party would have to pay for the same material could potentially be requalified as a hidden profit distribution by the tax authorities to its direct or indirect parent company for an amount corresponding to the arm's length value of the contracts (if any).

3.3. Centralization of IP rights and research and development (R&D) activities in a specific IP company

An MNE group has several entities in different jurisdictions including company A in the exit country. All group companies own intangible property and conduct their own R&D. In the course of a group restructuring, the existing property rights for intangible and R&D activities are centralized in the newly established "IP company" B in the entry country, i.e. they are sold to B. All future R&D is conducted only by company B, so that company B becomes the owner of all newly developed property rights. Company B enters into licence agreements with company A granting A the right to use the intellectual property owned by B.

3.3.1. LuxCo is Company B (entry country)

The (lump-sum) payment to be paid by LuxCo for taking over the intangibles and the R&D activities should be at arm's length. It is to be activated and amortized over its economic life. LuxCo will license the IP back at a market rate to the various licensees, including company A. Assuming its conditions are fulfilled, the licence income (net of amortization and any other expenses in direct economic relation with the eligible IP income), to the extent the intangibles fall within the scope of article 50*bis* LIR, will be 80 per cent exempt under the IP regime.

3.3.2. LuxCo is Company A (exit country)

Again, the transfer price for the IP rights and the R&D activities should be at arm's length and thus reflect the reduced profit potential of LuxCo, possibly taking into account also the closure costs of ceasing the R&D activity (e.g. costs of dismissal of personnel). It will be difficult to value such a reduction, though. It seems that a large margin for appreciation of the value must be accepted. Arm's length royalties payable after the CBBR should be deductible. If not at arm's length, an

adjustment of the taxable basis might be expected from the authorities with potentially also a requalification of the excess payments as hidden dividend profit distributions.

Assuming company B, not resident in Luxembourg, does not have much economic "substance", this should not easily lead to a non-recognition of the transfers of the intangibles by the tax authorities if company B is located in a country with which Luxembourg has concluded a tax treaty. In accordance with its long-standing position that domestic anti-abuse provisions can only be upheld if the DTT itself contains similar anti-abuse provisions and given that not many Luxembourg DTTs contain such anti-abuse provisions, or if in specific cases the mutual agreement procedure is followed, Luxembourg presumably could not unilaterally seek to deny the transfer on the basis of the domestic anti-abuse provisions. The situation might of course be different if company B were located in a non-treaty country. In this scenario, domestic anti-abuse provisions might allow the tax authorities to deny the transfer of the intangibles.

3.4. Substitution or discontinuation of a specific product without any change in numbers of employees or turnover when the product is now produced by a related party

Company A is producing and selling a product 1 which is no longer suitable for the market in which A is active. After a new succeeding model of product 1, product 2 was developed and introduced in A's market, product 1 no longer being of value for A. Nevertheless, for the related company B, product 1 has a value and might be sold in B's market. All product knowhow of product 1 is licensed from A to B to allow B to manufacture product 1 and sell it on its own market. A stopped the production of product 1 and successfully concentrated all efforts on product 2. Turnover, profits and employees of company A remain the same as before the change. B expects an increase of its profit after producing and selling product 1. The question here is whether A has only granted B a licence or under the exit rules has rather transferred a profit potential or business opportunity.

3.4.1. LuxCo is company B (entry country)

If LuxCo enters into a licence agreement for the use of product knowhow, LuxCo would be expected to pay arm's length royalties to A as legal owner of the IP.

Should the licence agreement, however, provide for no or too low royalties to pay, the tax authorities could not recharacterize the difference as a hidden capital contribution. Indeed, free services (i.e. the granting of licences is seen as a service) are, according to doctrine, not capable of being contributed and may not qualify as such. No deemed deduction would, however, be available at the level of LuxCo.

If the IP is transferred entirely to a newly set up LuxCo, reference should be made to article 35 LIR, treating valuation of assets, functions and risks allocated to Luxembourg from abroad. If the IP is transferred entirely to LuxCo, the transfer is generally accompanied by a step-up in value of the asset (i.e. operating value of goodwill according to article 36 LIR). Such potential goodwill, recognized in the tax balance sheet of LuxCo, can be depreciated over time (e.g. 10 years) during a

10-year period (section 10 of circular LIR no. 101 of 5 November 1985) and a deduction would be available to LuxCo.

3.4.2. LuxCo is company A (exit country)

If LuxCo licenses product knowhow to company B, the IP would not qualify for the 80 per cent exemption provided in article 50*bis* LIR. Therefore any income realized on the licensing should be fully taxable at the level of LuxCo.

Should the knowhow be transferred entirely to company B, meaning that company B would become the legal and economic owner, and the IP be enhanced (i.e. further developed) in the hands of B, the transfer would be valued according to article 43 LIR at operating value. A potential capital gain realized upon the transfer should then be fully taxable at the level of LuxCo. A lower valuation could lead to a recharacterization of the difference into a hidden profit distribution from LuxCo to its parent company.

Furthermore, a potential right to compensation resulting from an indemnification clause in the contract between the involved parties or according to statutory legal provisions or case law could trigger taxation. Please refer to section 2.5.