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The taxation of foreign passive income for groups of companies

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Summary and conclusions

Luxembourg tax law applies two general anti-avoidance rules (GAARs) for taxation of foreign passive income. The first is the concept of simulation which looks through the legal situation to tax on the basis of the factual situation, while the abuse of law theory disregards structures which serve only to avoid tax.

Luxembourg domestic law also provides for more specific anti-avoidance rules (SAARs), through the use of concepts such as “economic ownership”.

Furthermore, Luxembourg has also applied various SAARs, such as the “subject to tax requirement” in the context of holding activities, or thin capitalisation rules in the context of intra-group situations. The Luxembourg direct tax authorities (LTA) may also adjust the taxable basis of a taxpayer in accordance with the “arm’s length principle”.

In a double tax treaty (DTT) environment, OECD commentaries are to be understood as allowing a contracting state to apply its domestic anti-abuse provisions even if a DTT does not specifically allow this. Luxembourg does not, however, share this interpretation and has raised an objection to these OECD commentaries, mentioning that in its view a contracting state can apply its domestic anti-abuse provisions only after recourse to the mutual agreement procedure (MAP).

Luxembourg has concluded a few treaties that specifically allow reference to the domestic provisions without referring to the MAP, i.e. the DT Ts concluded with Belgium, Hong Kong and Israel. Various DT Ts concluded by Luxembourg include GAARs or SAARs such as the “subject to tax clause” as provided by its domestic law. Hence, the provisions of a DTT may in practice be more favourable than the Luxembourg participation exemption regime regarding the requirements for the taxable regime of the distributing entity.

A further layer of anti-abuse provisions applicable in Luxembourg derives from EU law, most notably from the directives and BCJ case law. Domestic anti-abuse provisions must also comply with these over-arching principles.
1. Introduction

Luxembourg domestic tax law provides for GAARs and SAARs, which apply to passive income. The underlying principle of these anti-abuse provisions is that the Luxembourg tax system aims to levy tax in accordance with the real economic situation, even by disregarding the formal legal arrangement, and even if the tax law deviates from private law or characterisation. This underlying principle appears in the general anti-abuse provisions as well as in the abuse of law and the abuse of trust as well as in the concept of ownership.

It is worthwhile mentioning that, even though specific anti-abuse provisions also exist, the LTA show their preference for the use of general provisions, which gives them more flexibility.

In addition, in Luxembourg, in order to avoid abuse, the different regimes aiming at avoiding double taxation, either legal or economic, always require that several conditions are met, very often including subject to tax requirements.

In an international context, Luxembourg has concluded more than 60 DTTs and in this respect, the Luxembourg domestic anti-abuse provisions often need to be applied in a DTT context. Since DTTs supersede Luxembourg domestic law, the question arises whether Luxembourg may apply its domestic anti-abuse provisions in a DTT context. In the interpretation of DTTs, Luxembourg uses the commentary to the OECD model tax convention. These commentaries essentially state that a contracting state may apply its domestic anti-abuse provision even if there is no specific provision in the DTT. Luxembourg does not share this view, i.e. Luxembourg considers in principle that in the absence of specific provision in the DTT, domestic anti-abuse provisions may only be applicable in the context of the OECD MAP. This position of Luxembourg has practical implications for the use of domestic anti-abuse provisions in a DTT context.

Being a member of the European Union (EU), Luxembourg also needs to comply with EU law. Since EU law takes precedence over Luxembourg domestic law, the question arises of the compatibility of the Luxembourg domestic anti-abuse provisions with EU law. Generally, Luxembourg anti-abuse provisions should be in line with EU law.

2. GAARs

As per taxation of foreign passive income for groups of companies, Luxembourg tax law recognises two GAARs: simulation and abuse of law.

2.1. Simulation doctrine

The simulation concept applies to situations where the true commercial agreement or the true situation of facts is dissimulated behind an artificial legal arrangement. The concept of simulation aims to tax income in accordance with the actual factual situation, by disregarding the strict legal situation. Under this concept, in the case of discrepancy between the official legal arrangements and the reality or the true commercial agreement, the taxation will be based on the reality.

The simulation concept covers the two following situations:

- full simulation: the apparent situation has no reality but is purely fictitious. An example would be the use of a fictitious company;
- partial simulation: the apparent legal situation is actually different from the reality, which is determined by a hidden legal arrangement. In that situation, two different legal arrangements exist: the official one accessible to third parties and implemented for tax purposes, and a hidden arrangement corresponding to the real agreement between the parties and different from the official arrangements. A typical example would be an official agreement setting a price and a side letter determining a different price.

Paragraph 1 of article 5 of the Luxembourg tax adaptation law (the Steueranpassungsgesetz, or StAmP) states that fictitious transactions or simulated acts, including the establishment and maintenance of a fictitious residence, must be disregarded for taxation purposes. If a fictitious transaction hides another legal act, the hidden legal act is the only one taken into account for taxation purposes.

The same consideration applies to void acts. Indeed, if the parties have continued acting as if legal acts, declared void due to default of capacity or forms, are valid, the taxation will be determined as if the acts were valid.

This provision does not require any intent of fraud, deferral or avoidance of tax, but it simply aims at levying tax in accordance with the reality. According, the LTA do not need to establish any fraudulent intent but only to establish the existence of the simulation.

Within the context of the taxation of foreign passive income in groups of companies, simulation might apply in the following situations:

- fictitious companies: the Luxembourg State Council has admitted that a Luxembourg company must be regarded as fictitious because some of the main constitutive elements of a company were not met. In the case in question, the equity had not been contributed under company law, the people in charge of the management were actually not able to manage the company, and agreements for the leasing of all the assets of the fictitious company were made under conditions which were not arm's length;
- fictitious residence: if a foreign company, potentially located in a low-tax jurisdiction, is used for the purposes of allocating passive income without its being subject to Luxembourg taxation, and if the foreign company does not in fact have its residence in this jurisdiction, the LTA may disregard the fictitious residence of this company. In order to establish that the company has its tax residence in Luxembourg, the LTA must establish that it has its central administration in Luxembourg (article 159 of the Luxembourg Income Tax Law (LITL));
- fictitious equity contributions: if an equity contribution to a company does not meet the legal conditions for a contribution, it will be disregarded. If all

\[1\] Jean-Pierre Wintandt, L'Abus de droit et la simulation en droit fiscal luxembourgeois, Publications de l'Université de Luxembourg, 2004, p. 102, No. 274.
\[2\] Ibid., p. 102, No. 276.
\[3\] State Council, 9 January 1963, No. 5,677, Helios.
the contributions are fictitious, the company itself will be deemed fictitious. The consequences might be at two levels. First, at the level of a Luxembourg company which is part of an international group, this company will have a reduced equity, and the fake contribution will be recharacterised. Secondly, at the level of a company in which a Luxembourg company has made a fake contribution. In the latter event, the investment of the Luxembourg company into the foreign company will no longer be considered as a shareholding and the dividends and gains deriving from it will no longer qualify for the participation exemption regime (see section 3.3.1).

2.2. Abuse of law concept

The abuse of law concept aims at disregarding structures used for the sole purpose of avoiding taxes.

Article 6 of the StAnpG states that the tax burden cannot be avoided or reduced by the abusive use of legal forms or structuring possibilities offered by private law. In the case of such abuse, tax will be levied as if the structure had been established in accordance with actual economic considerations.

Consequently, the structures used abusively will be disregarded. Normally, under Luxembourg law, corporations or legal structures cannot be disregarded, and accordingly, the conditions for the use of the abuse of law concept are restrictive.

The notion of abuse itself has not been defined by the law, and the case law is very limited. Furthermore, the existing case law has often confused the two notions of abuse of law and of simulation (see section 2.1). However, the case law insists on the fact that the abuse must be established by the authorities. Indeed, the taxpayer always remains free to use the regime under which it is taxed less.4

Doctrine has determined the main elements of the abuse of law concept:5

(a) an abuse;
(b) the use of forms and structuring possibilities offered by private law: by referring to the forms and structuring possibilities of private law, the concept requires the use of legal acts or arrangements, and does not include simple facts or actions;
(c) the avoidance of the tax burden;
(d) the use of an inappropriate legal construction: the legal situation does not properly reflect the economic situation;6
(e) the misuse of the structuring is motivated solely by tax considerations.7

The abuse of law concept involves the border between the clever use of structures and tax avoidance. Accordingly, and without a definition of abuse of law, the application of this provision is a grey area.

Where this provision applies, the consequence is that direct taxes will be levied as if the inappropriate structure did not exist. It should nevertheless be noted that the abuse of law under this provision applies only to direct taxes, but that the ‘inappropriate structure’ will continue to exist for private law and indirect tax purposes. It may therefore generate additional taxation.

Taxation based purely on the effective economic structure might generate double taxation. Indeed, the first tax assessment is based on the inappropriate structure as implemented by the taxpayer, in accordance with the tax returns filed by the taxpayer. Secondly, when the structure has been declared abusive, a second taxation is assessed disregarding this structure. In order to avoid this double taxation, paragraph 3 of article 6 of the StAnpG provides for the amount of tax assessed and paid on the basis of the inappropriate structure to be offset against the taxes assessed disregarding the abusive structure. However, this offsetting possibility is only possible for a period of one year after the final acknowledgement of the abuse. Considering that an abusive structure may be established for a period of time and not necessarily for one transaction, double taxation may occur if the structure is not cleared before the end of the offsetting period.

The taxpayer, in order to prove that the use of the subsidiary is not abusive, may establish that:
• the subsidiary has an effective activity; or
• there is at least one non-tax consideration leading to the establishment of the subsidiary.

2.3. Procedural regime

First of all, the Luxembourg General Tax Act (Abgabenordnung) provides for a presumption that the books of the taxpayer have been regularly kept (article 208 of the General Tax Act). Therefore, the LTA must establish simulation or abuse of law. However, the same Act provides for the obligation for the taxpayer to act in good faith (article 166), which includes the duty to enable the tax office to perform the necessary checks and verifications.8 It also provides for the obligation to establish, upon request, that the details included in its tax return are correct and to provide further information to the LTA (article 171). The LTA are also granted the right to request third parties to provide relevant information (article 175).

On this basis, the tax office must analyse the case subject to tax and satisfy itself of the factual and legal circumstances which are of importance for the tax obligation and determination of the tax due (article 204). They have to analyse the situation also in favour of the taxpayer.

If the tax office is not able to assess the tax due on the basis of the information it has received from the taxpayer, it may proceed to administrative taxation and evaluate the tax due on its own (article 217). The taxpayer is not entitled to file a claim on the basis that the tax assessed corresponds exactly to its factual situation.9 However, the courts require that the taxation remains plausible.10

5 Ibid. 1, p. 119, No. 326.
7 Administrative Court of Appeal 15 July 2010, No. 25,957C, as acknowledged by the tax authorities in their circular LIR 114/2 dated 2 September 2010.
8 Administrative Court of Appeal, 19 February 2009, No. 24,907C.
9 Administrative Court, 2 June 2003, No. 15,606.
10 State Council, 11 April 1962, No. 5,742.
It should finally be noted that, if the normal tax frame for the LTA to perform a tax reassessment is five years, this time frame is extended to ten years if the tax return is incorrect or incomplete (article 10 of the Law of 27 November 1933 on the recovery of taxes).

3. SAARs

3.1. Concept of economic ownership versus legal ownership

3.1.1. Trust and fiduciary arrangements

For direct tax purposes, Luxembourg tax law follows an economic approach to ownership. According to article 11 of the StAnP, in the case of a fiduciary or trust arrangement, the fiduciary assets will be deemed to be owned by the beneficiary of the trust or of the fiduciary arrangement. Accordingly, income and gains deriving from the fiduciary assets will become part of the taxable basis of the economic owner.

This provision aims to determine in any case the economic owner of the asset under consideration disregarding the legal qualification of the ownership. It is therefore necessary to determine the economic owner of the assets held in trust or on a fiduciary basis pursuant to an analysis of the trust or fiduciary arrangement. It should further be noted that the fiduciary agent must, upon request, disclose to the LTA the beneficiary of the assets (article 164 of the General Tax Act).

The scope of article 11 of the StAnP exceeds the sole fiduciary or trust arrangement, and is the general concept to determine the owner of an asset from a direct tax point of view.

If there is no beneficiary of the assets or related income, the assets held in trust will be considered as a special purpose fund (patrimoine d’affectation). A special purpose fund is treated as a taxpayer itself for corporate income tax purposes according to article 159 of the LITL. However, if it only realises passive income, and if it is not a Luxembourg tax resident, it will only be subject to corporate income tax and not to the municipal business tax.

3.1.2. Sub-division of ownership rights

Under Luxembourg law, the right of ownership can be split between the right to use an asset and to receive the income deriving from it (usufruct) and the remaining ownership rights (bare ownership). Under article 108bis of the LITL, the bare owner is supposed to receive the income on the asset and to transfer it to the usufructuary who is the final recipient of the income. The bare owner will be entitled to deduct from its taxable basis the income transferred to the usufructuary.

The shares whose ownership rights have been subdivided may not benefit from the participation exemption regime for dividend exemption or for capital gains exemption (see section 3.3.1).

A temptation might be for the legal owner of a right or an asset to distribute the rights to a relevant asset between two parties in order to determine the ownership in the most efficient way. In this respect, the case law has considered that structuring based on the subdivision of proprietary rights may under certain circumstances be appreciated in light of the provisions relating to economic ownership (see section 3.1.1).

3.2. Hidden distributions

Article 164 paragraph 3 of the LITL states that hidden distribution will be taxable in the hands of the beneficiary. A hidden distribution exists if there has been no formal distribution in accordance with company law, but the arrangements actually grant a comparable advantage to a related party. The advantage granted therefore will, from a tax point of view, follow the same regime as a distribution.

Hidden distributions require that a shareholder, partner, or interested party directly or indirectly receives benefits that it would not receive if it had not been a related party

Luxembourg case law considers that this regime aims at fighting against structures hiding the true nature of a distribution of profits by the abuse of forms of private law. The hidden distribution appears as a specific application of the abuse of law concept.

Luxembourg authors consider that four conditions should be met for a hidden distribution to exist:
- the absence of a formal distribution within the meaning of company law;
- a reduction of the net value of the company concerned or the absence of increase of its net value;
- this reduction of value must be due to the relationship between the company and a related party;
- the taxable basis of the company must be affected.

The reduction of value of the Luxembourg company or the absence of increase of value may derive from any abnormal transaction. The most common examples

12 Luxembourg corporate income tax is 21.05 per cent (increased by the contribution to employment fund), art. 174 LITL. Municipal business tax for Luxembourg City is 6.75 per cent, art. 11 Gewerbesteuer-Gesetz.
13 Art. 109 of the LITL and administrative circular 53 LITL.
17 Administrative Court, 25 August 1999, No. 10,457; Administrative Court of Appeal, 23 March 2000, No. 11,565.
18 State Council, 13 January 1987, No. 6,690.
as far as foreign passive income is concerned are loans granted by a Luxembourg company, as lender, with no interest rate, a sale of an asset by a company to a related party for a price below its market value.

The criterion determined by case law is that the transaction is made under conditions that a careful and diligent manager would not have accepted.26 The test to be performed is to compare the transaction considered with transactions between non-related parties, and therefore the arm’s length conditions.21 The rules are comparable to the transfer pricing concept, and the LTA themselves have referred to this provision in their circular letter for intra-group financing companies (see section 3.5).

The hidden distribution may apply either in a relationship between a direct shareholder and its subsidiary or in a relationship between indirect related parties, notably in an intra-group transaction. In that case, the analysis would be that the hidden distribution is made in favour of the direct shareholder of the Luxembourg company, itself transferring the benefit to the other related company.22

If an expense is recognised as a hidden distribution, it will be treated as a distribution of dividends. Accordingly, at the level of the company, expenses recharacterised as a hidden distribution will not be deductible for tax purposes. The amount transferred to the affiliated company would be subject to the dividend withholding tax (15 per cent) under normal conditions and benefit from the same exemptions. At the level of the recipient company, the hidden distribution will be taxed as dividend income, under the same rules and the same exemptions.

In terms of procedure, it is in principle for the LTA to establish the existence of a hidden distribution; however, the taxpayer has itself a duty to cooperate with the LTA.23

3.3. Subject to tax requirement

Luxembourg tax law includes several regimes including a subject to tax requirement, especially regimes aiming at avoiding double taxation, as well as other regimes such as tax neutrality for restructuring which are not analysed here.

3.3.1. Participation exemption regime

3.3.1.1. Income and capital gains tax exemption

A Luxembourg resident company, or the Luxembourg permanent establishment of a foreign company, will benefit from tax exemption on income and gains deriving from a qualifying shareholding providing that the conditions described below are met, in accordance with article 166 of the LITL and Grand Ducal Decree dated 21 December 2001.

The shareholding must be held in:
- a company resident in Luxembourg for tax purposes; or
- a company resident in another EU Member State and benefiting from the EU Directive 2011/96/EU dated 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (the Parent–Subsidiary Directive); or
- a non-resident corporation fully subject to a tax comparable to Luxembourg corporate income tax if it is levied by the public body on a mandatory basis at an effective rate being not less than half of the corporate income tax per se, and for which the calculation of the taxable basis is not significantly different from that used for the determination of the Luxembourg taxable basis.24

In addition, in order to avoid an abusive use of the regime, the Luxembourg parent must hold a shareholding meeting the following two criteria:

- the shareholding must represent at least 10 per cent of the share capital of the subsidiary, or have an acquisition cost of at least EUR 1,200,000 for exemption, or EUR 6,000,000 for capital gains exemption; and
- the Luxembourg parent must hold its shareholding for an uninterrupted period of at least 12 months at the time a profit is realised or take the commitment to hold the shareholding for the same period.

The shareholding must be held either directly by the Luxembourg taxpayer or through a partnership transparent for tax purposes. However, the shares whose ownership has been subdivided may not benefit from this regime (see section 3.1.2).

As a consequence of the tax exemption, the expenses in direct economic relationship to the qualifying shareholdings will not be deductible from the taxable base of the company.

3.3.1.2. Withholding tax exemption

Distributions made by a Luxembourg fully taxable resident company are subject to withholding tax at the rate of 15 per cent.

This withholding tax applies to the distribution of dividends per se and allocation of profits to the holder of shares, beneficiary shares, or profit participating bonds.

The allocation of cash deriving from a reduction of the share capital of a Luxembourg company is in principle exempt from tax. However, amounts deriving from a capital reduction will be subject to withholding tax if they correspond to allocation of results unless such a reduction is motivated by serious economic reason.

Distributions will, however, be exempt from this withholding tax if these distributions are paid to a foreign parent which is:

26 Administrative Court of Appeal 1 February 2000, No. 11.318C; Administrative Court of Appeal 12 February 2009, No. 24.642C; Administrative Court of Appeal 17 February 2011, No. 27,172.
21 For loans granted to affiliated companies without interest, the administrative commentary considers that the interest to be calculated on the loan must be an interest rate at arm’s length conditions (circular LITL 164/16bis).
22 Ibid., 19, p. 23.
23 Administrative Court of Appeal 1 February 2000, No. 11.318C; Administrative Court of Appeal 12 February 2009, No. 24.642C; Administrative Court of Appeal 17 February 2011, No. 27,172; Administrative Court of Appeal 16 October 2007 No. 23,051C.
24 Parliamentary documents for the bill of law No. 5,332, p. 8.
3.4. Thin capitalisation rules

Luxembourg law does not directly include thin capitalisation rules. However, administrative practice has established a thin capitalisation ratio on the basis of the abuse of law concept (see section 2.2) and of the hidden distribution rules (see section 3.2). The LTA have never published any official commentaries concerning the thin capitalisation rules.

Challenging a thin capitalisation on the basis of the abuse of law concept may appear laborious in practice, as it would require the LTA to prove that the thin capitalisation of the company was exclusively motivated by the avoidance of taxation (see section 2.2).

A clear practice exists concerning the holding companies under which the LTA consider that an acceptable debt to equity ratio is 85 to 15. For companies carrying on another activity, the case law is less well-established. However, authors consider that the same ratio should apply to the other activities, with the exception of the group financing companies subject themselves to specific rules (see section 3.5).

The practice of the LTA seems to refer rather to the hidden distribution. Indeed, in practice the LTA only consider thin capitalisation in intra-group situations. Thin capitalisation may occur either because an affiliated company has granted a loan to the Luxembourg company exceeding the debt to equity ratio, or because the loan obtained by the Luxembourg company from a non-related party and exceeding the debt to equity ratio has been guaranteed by an affiliated company.

If the matter concerns a company that has been granted a loan by a related party in circumstances which would have been accepted by a third party then clearly the arm’s length and transfer pricing principles will apply. In such a context, the tax administration’s starting point is to assume that a third party would not finance an investment for more than 85 per cent. As with all assumptions, this can be rebutted by proof evidencing that a third party would have agreed to finance more than 85 per cent considering the specific circumstances of the case.

3.5. Application of transfer pricing rules to interest income

Under Luxembourg law, a provision specifically regulates transfer pricing. This provision derives from article 56 of the LITL, according to which the LTA are allowed, on a discretionary basis, to assess the taxable basis of a resident of Luxembourg if a transfer of results has been made possible due to specific economic relationships existing between the resident and a non-resident entity or physical person.

It should be noted, however, that this provision also requires that a specific agent be appointed for this purpose and that this agent must be of a superior rank. As of the date of publication, no agent has yet been appointed for this purpose.

However, the LTA have based themselves on the provisions related to the hidden distribution in order to implement in practice the transfer pricing rules (article 164 LITL; see section 3.2). The LTA have especially decided to apply the transfer pricing rules to interest income.

Indeed, the LTA have issued a circular letter in which they have specified the rules they envisage applying to intra-group financing activities if Luxembourg resident companies wish to benefit from advanced tax clearance from the LTA.25 For the appreciation of the case the LTA require a transfer pricing report in order to establish that the intra-group financing is made at arm’s length conditions.

In addition, the circular provides for requirements in terms of substance, including:

- the financing company must not be a resident of another state;
- at least half of the executives of the financing company, i.e. the persons enabled to bind the company, must be resident in Luxembourg, or if not, they must realise more than 50 per cent of their professional income in Luxembourg;
- the executives referred to above must have the necessary expertise to perform their duties. In addition, they must have the capacity to duly bind the company. The company must have sufficient resources to perform and control its activity and its transactions;
- the key decisions of the company must be taken in Luxembourg;
- the company must have at least one bank account in Luxembourg;
- the company must have adequate equity for the considered activity, taking into account the assets involved and the risks it bears. Equity will be deemed adequate if the amount thereof is at least 1 per cent of the face value of the debt financing granted or EUR 2,000,000;
- the company must comply with its tax return obligations as at the date of application for advanced tax clearance.

4. Controlled foreign companies (CFC) rules in Luxembourg domestic law

Luxembourg domestic legislation does not provide for CFC rules.

5. Anti-abuse rules in the context of existing DTTs concluded by Luxembourg

Principles applied by Luxembourg regarding domestic anti-abuse provisions in a DTT context will first be addressed, followed by their practical consequences.

the interpretation must be made following the ordinary meaning of the words;
the ordinary meaning of the words should not be determined in abstrato but
rather in the context of the convention in light of its object and goals.
The text of the convention, the preamble and appendices are part of the context
whereas unilateral declarations not agreed by the contracting parties (e.g. US
"technical explanations") cannot be taken into account for a contextual interpreta-
tion of the conventions.33
When use of the primary interpretation rules stated in article 31 leads to an
ambiguous or unclear meaning of the convention or to a result of the interpretation
which is manifestly absurd or unreasonable, article 32 of the Vienna Convention
allows the use of complementary means of interpretation such as preparatory
works and the circumstances in which the convention has been concluded.
The use of the commentary to the OECD model tax convention 2010 may be
justified by:

* article 31.3(c) of the Vienna Convention which provides that any relevant
rules of international law applicable in the relations between parties may be
used;
* article 31.4 of the Vienna Convention which provides that a term may have
a specific meaning if it is evidenced that this was the intention of the parties;
the use of the complementary way of interpretation, as provided by article 32
of the Vienna Convention.

Luxembourg, like many other OECD member states, relies on the commentaries
to the OECD model tax convention 2010 when interpreting its DTBs.36 In the context
of anti-abuse provisions, Luxembourg has made observations,37 as described below
(section 5.1.3).

5.1.3. The commentary to the OECD model tax convention 2010 and
the observation made by Luxembourg regarding anti-abuse provisions

Based on the commentary to the OECD model tax convention 2010, it is generally
considered that there is no conflict between anti-abuse provisions of the domestic
law of a contracting state and the provisions of its DTT. In essence, this means that
a contracting state may apply its domestic anti-abuse provisions even if the DTT
does not specifically allow this.38

Nevertheless, Luxembourg does not share this interpretation and made the
following observation to the commentators: "absent an express provision in the

33 Klaus Vogel and Rainer G. Proksch, General report, Interpretation of the double taxation con-
ventions, IBA Cahiers, Vol. 78(1), 1993, p. 69: "Unilateral explanations of one party that have not been
expressly confirmed by the other party cannot be included".
34 Art. 32 of the Vienna Convention.
35 Jean-Pierre Winandy, Usage abusive des conventions contre la double imposition internationale, pp.
236 and 237.
36 Administrative Court of Appeal, 19 January 2005, No. 17,820; Administrative Court of Appeal, 17
January 2006, No. 20,316 C; Administrative Court of Appeal, 12 July 2012, No. 30,644 C.
37 Luxembourg observation made on the commentaries to art. 1 of the OECD model tax convention
2010, para. 27.6
38 Para. 9.2, 22.1 and 23 of the commentary to art. 1 of the OECD model tax convention 2010.

Convention, Luxembourg therefore believes that a State can only apply its domes-
tic anti-abuse provisions in specific cases after recourse to the MAP.39

The issue of whether Luxembourg is allowed to use domestic anti-abuse provi-
sions in a DTT context can thus be answered in light of the commentary to the
OECD model tax convention 2010 which is used by Luxembourg to interpret
DTTs. While this commentary considers that domestic anti-abuse provisions can
be used even if there is no specific provision in a DTT, Luxembourg has expressed
a different official view: a domestic anti-abuse provision cannot be applied where a
DTT does not specifically allow this. The consequences of the Luxembourg posi-
tion are described below (section 5.2).

5.2. The consequences of the applicable principles in DTTs
concluded by Luxembourg

On the basis of the observation issued by Luxembourg, a different approach should
be taken where a DTT does not provide for specific anti-abuse provisions (section
5.2.1) compared to the situations where the DTBs provide for specific anti-abuse
provisions (section 5.2.2).

5.2.1. Absence of specific anti-abuse provisions

5.2.1.1. The use of the MAP procedure

Luxembourg, on the ground of the observations made to the commentary to the
OECD model tax convention 2010, should only apply its domestic anti-abuse legis-
lation after recourse to a MAP where a DTT does not provide for specific anti-
abuse rules.

A MAP is a means by which the competent authorities of the contracting states
consult in order to resolve disputes regarding the application of a DTT. This proce-
dure is addressed by article 25 of the OECD model tax convention 2010. The pro-
cedure is in principle initiated by the taxpayer but might also be initiated by the
contracting states without the initial request of the taxpayer.40

The OECD released a manual on effective MAPs providing tax administrations
and taxpayers with basic information on the operation of MAPs and identifying
some best practices which are not binding upon OECD member countries. The
OECD website also includes a series of country profiles on MAPs for OECD mem-
ber countries, which includes information about the specific practices of OECD
member countries. As far as Luxembourg is concerned, there is no specific docu-
mentation, so that reference can be made to the manual as a guide.

The existence of this manual illustrates the complexity and the burden linked to
such a procedure which might become very time consuming in situations where
taxpayers wish to obtain some clarity about their tax position within a short period
of time. The absence of clear formal guidelines in Luxembourg also makes the
process more complex. Given these aspects, one may expect that in most cases no
MAP will take place at all so that no clarification will be given about whether the

39 Ibid., 37.
domestic anti-abuse rules can be applied or not, with the major consequence that Luxembourg would take the view that the domestic anti-avoidance rules should not be applicable.

Notwithstanding the above, another way to look at the issue consists in determining whether domestic anti-abuse provisions could be referred to by Luxembourg when a DTT, which does not provide for any specific anti-abuse provision, refers to the meaning or definitions given by the domestic law of the contracting states.

5.2.1.2. Provisions of the OECD model tax convention 2010 which refer to the domestic law of the contracting states for the purposes of defining the terms of the DTT

Several provisions of the OECD model tax convention 2010 refer to the domestic law provision of the contracting states for the determination of certain terms. In particular:

- article 4.1 resident of a contracting state;
- article 6.2 “immovable property”;
- article 10.3 “dividend”.

In addition, article 3.2 of the OECD model tax convention provides that: “any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies”.

In the cases described above, the DTTs refer to the contracting states’ domestic law for the interpretation of the terms given in the considered articles. This reference to the domestic law of the contracting state should allow Luxembourg to use its domestic anti-abuse provisions if they have an impact on the interpretation of the relevant terms.

As a consequence, if a DTT refers to the domestic law of a contracting state, Luxembourg should be able to apply its anti-abuse rules provided by articles 5 and 6 of STampG (i.e. simulation doctrine and abusive law concept) in determining the meaning of the relevant provisions of the DTT.

Based on the Luxembourg position regarding the use of anti-abuse provisions in a DTT context, the above-mentioned use of Luxembourg domestic law should be carried out after recourse to the MAP.

5.2.1.3. Example of application of anti-abuse provisions

The LTA took a formal position denying the applicability of a provision of the DTT between Luxembourg and Ireland. This DTT does not include any specific anti-abuse provision. Hence, the LTA position is not fully in line with the observations issued by Luxembourg on the OECD model tax convention 2010 (see section 5.1.3).

5.2.2. Existence of specific anti-abuse provisions

Among the DTTs signed by Luxembourg, few DTTs provide for specific anti-abuse provisions in the context of DTTs, Luxembourg domestic anti-abuse provisions may only be appreciated after recourse to the MAP. Luxembourg may also indirectly use its domestic anti-abuse provisions if the DTT refers to the domestic law of the contracting states to interpret the terms of the DTT.

5.2.2.1. Anti-abuse provisions in DTTs

Luxembourg has concluded DTTs which specifically allow the application of its domestic anti-abuse rules.

This is the case with the DTTs concluded with Belgium, Hong Kong and Israel. Based on these provisions, Luxembourg should be able to deny the applicability of a DTT based on its domestic anti-abuse provisions without having to rely on the MAP.

The DTT concluded by Luxembourg with India provides in article 29 for several anti-abuse provisions.

Article 29.1 clearly provides that nothing in the Indian DTT affects the possibility for the contracting states to apply their domestic provisions to prevent tax evasion.

42 Ibid., 37.
In addition, article 29 paragraphs 2 and 3 of the Indian DTT provide that “legal entities not having bona fide business activities” should not be entitled to benefit from the provisions of the Indian DTT.

In a ruling dated 21 April 2009, the Luxembourg State Council (Conseil d’Etat) considered that paragraphs 2 and 3 of article 29 of the Indian DTT, which do not provide for a definition of the bona fide concept, should be applied in light of the bona fide concept as defined in the commentary to the OECD model tax convention 2010:

“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by a sound business reason and do not have as primary purpose the obtaining of any benefits under this Convention.”

Following the reference to the above definition, the Luxembourg State Council confirms that the taxpayer may choose the less taxable way to structure its business if the taxpayer carries out an actual business activity and that the aim of the setting up of the considered entity is not mainly to benefit from the advantages of the DTT.

In addition, specific anti-abuse provisions are also included in certain DTTs concluded by Luxembourg, for example with Kuwait.

The protocol to the DTT concluded between Luxembourg and Poland, not yet in force, amends article 29 of the DTT in such a way that it will in future provide that the benefit of the considered DTT is not applicable if the income is paid or received in relation to an artificial arrangement. It is also specified that article 29 may be applied to persons benefiting from legislation, regulations or administrative practices when the EU Code of Conduct Group has considered that the measure constituted a harmful tax practice. The above-mentioned provisions of the Indian, Kuwait and Polish DTTs do not refer to Luxembourg domestic anti-abuse provisions. In the context of these DTTs, Luxembourg should be able to deny this applicability based on specific anti-abuse provisions without having to rely on Luxembourg domestic anti-abuse provisions.

DTTs concluded by Luxembourg may provide for general anti-abuse provisions as well as specific ones. In addition, some DTTs concluded by Luxembourg provide for a “subject to tax clause” for the exemption of dividends, as described below.

Luxembourg has concluded DTTs which include a specific provision allowing for the exemption in Luxembourg under certain conditions of the dividends received from its subsidiary resident in the contracting state. The considered participation is also exempt from any other tax based on the same principles. These provisions are included in the article which provides for methods to eliminate double taxation.

Under Luxembourg domestic law, in the context of the application of the participation exemption regime, article 166 LITL provides in particular for a specific “subject to tax” provision. Based on this provision, dividends received from non-EU subsidiaries should be exempt in Luxembourg only if the subsidiary is a fully taxable entity subject to corporate income tax determined on a similar basis to Luxembourg corporate income tax (i.e. an effective corporate income tax rate of at least 10.5 per cent) (see section 3.3).

In most of the DTTs concluded by Luxembourg, the dividends exemption clause does not require the subsidiary to meet any “subject to tax” condition.

Hence, and while this is contradictory to Luxembourg domestic law, dividends should be exempt at the level of the Luxembourg parent, even if the subsidiary is not subject to Luxembourg comparable taxation.

This conclusion is also supported by the fact that in certain cases, the provisions of the DTTs with which Luxembourg has tax treaties with non-EU member states, do not refer to specific “subject to tax” requirements for the distributing subsidiary. The fact that certain DTTs provide for this specific clause means contra propter that for DTTs which do not entail such a provision, Luxembourg should exempt the dividend even if the subsidiary is not subject to comparable taxation to Luxembourg, except in situations that may be considered as abusive (see section 5.2.2.3).

Based on the parliamentary work 6072 related to the Law of 31 March 2012 concerning the ratification of the DTTs concluded by Luxembourg with Bahrain and Monaco, it is very clear that Luxembourg refers to the “subject to tax” definition provided by its domestic law.

In addition, the DTT concluded between Luxembourg and Sweden provides, in addition to the “subject to tax clause”, for a specific requirement. Indeed, the protocol to the Swedish DTT provides that the DTT “shall not be applicable to an enterprise of a Contracting State that derives its income primarily from third States if such income bears a significantly lower tax than income derived from sources within that State”.
6. Luxembourg anti-abuse rules in the frame of the implementation of the European regulations

EU law takes precedence over Luxembourg domestic law.68 EU law on direct taxation encompases directives,64 conventions62 and case law of the ECJ which ensure the enforcement of the four freedoms66 and the direct tax directives.67 The Parent–Subsidiary Directive58 and Interest and Royalty Directive69 provide for anti-abuse provisions via reference to the domestic provisions of the Member States, whereas the Merger Directive provides for the implementation of a proper abuse concept.70

Hence, for the Parent–Subsidiary Directive and the Interest and Royalty Directive, the reference to the domestic law of the Member State should allow Luxembourg to use its domestic anti-abuse provisions, in particular articles 5 and 6 of StAnPG in the application of the directives considered.

With respect to the ECJ case law on the interpretation for the four freedoms,71 the ECJ has ruled that Member States are allowed to take measures to prevent abuses if these measures aim at preventing "wholly artificial arrangements" which do not reflect economic reality.72

Since articles 5 and 6 of StAnPG refer to wholly artificial arrangements73 and are applicable to resident and non-resident entities, these Luxembourg anti-abuse provisions should be in line with EU law.

The Luxembourg participation exemption regime provides for a "subject to tax" provision for non-EU subsidiaries to be qualifying entities, the dividends of which are exempt at the level of their Luxembourg parent. Indeed, non-EU subsidiaries or shareholders should be fully taxable entities subject to a corporate income tax determined on a similar basis to Luxembourg corporate income tax.

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60 Art. 23 of the DTT concluded between Luxembourg and Belgium dated 17 September 1970.
61 Para. 10 of the final protocol of the DTT concluded between Luxembourg and Belgium dated 17 September 1970.
(i.e. an effective corporate income tax of 10.5 per cent) whereas EU entities do not have to fulfill this condition.

The question which arises from the above is to determine whether Luxembourg "subject to tax" domestic provisions regarding the participation exemption regime are in conformity with EU law.

The above-mentioned provisions may in theory be covered by article 63 of the Treaty on the Functioning of the European Union (TFEU) (ex-article 56 of the EC Treaty), i.e. free movement of capital or article 49 TFEU (ex-article 43 of the EC Treaty), i.e. the freedom of establishment.

The freedom of establishment is nevertheless not applicable to third countries whereas article 63 TFEU regarding the free movement of capital provides for its application to third countries. Accordingly, potentially, the "subject to tax" provisions in Luxembourg domestic law may be considered as not in line with the free movement of capital.

Nevertheless, article 64 TFEU (ex-article 57 of the EC Treaty) provides for a grandfathering clause regarding the free movement of capital, article 63 TFEU, regarding domestic provisions which existed prior to 31 December 1993.

The notion of direct investment is not defined by the EC Treaty but was defined in the list of movement of capital in Appendix I of the Directive 88/361/EEC of the Council of 24 June 1988. These direct investments are defined as investments which create or maintain long-term direct relationships between the investor and the company which will use the funds in order to carry out an economic activity.

In case law where dividends from foreign source were subject to a treatment less favourable than that afforded to domestic source dividends, the CJEU ruled that the legislation would be contrary to article 56 of the EC Treaty. The Court also ruled that participations held with a view to the creation or maintenance of direct and long-term economic links between a shareholder and a company, enabling the shareholder to actually participate in the management of the subsidiary or in its control, should be subject to article 57 of the EC Treaty.

Hence, even though the "subject to tax" provisions of the Luxembourg participation exemption regime may be considered as contrary to article 56 of the EU law, these provisions should be grandfathered by article 57-1 of the EC Treaty, since they were implemented prior to 31 December 1993.

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74 Ibid., 24.
75 Test Claimants in Class IV of the ACT Group Litigation, Case C-374/04 points 37 and 38, as well as Test Claimants in the FII Group Litigation, Case C-446/04 paras. 36, 80 and 142.
76 Art. 49 TFEU. See also Order of the Court (Fourth Chamber) of 10 May 2007, in Case C-102/05, Statcounter v. A and B, Rec. 2007, p. 3841, point 29.
77 Art. 63 TFEU.
78 Test Claimants in the FII Group Litigation, Case C-446/04, para. 177 and 178.
79 Ibid., paras. 180 and 181.
80 Case C-319/02, 7 September 2004, Manninen paras. 19-24.