Luxembourg

Branch Reporters
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Summary and conclusions

The Luxembourg Constitution provides for the principle of equality for Luxembourg nationals before the law and prohibits privileges being established in tax matters; but it does not contain any specific provision extending such right to equal treatment to foreigners. Such an extension to foreigners has, however, been generally accepted since a decision of the Luxembourg State Council of 1964.

Structural changes to the Luxembourg court system have in the recent past favoured a steady increase in tax litigation following, among other cases, those that were rendered by applying EU and double taxation convention (DTC) non-discrimination ND principles.

With respect to DTCs it seems that inclusion of ND provisions into the DTCs concluded by Luxembourg is more a consequence of Luxembourg following the OECD model convention (MC) than a voluntary choice.

The direct tax authorities seem to accept the application of ND principles to tax matters. It is, however, unclear to date whether the indirect tax authorities accept the application of ND provisions contained in DTCs to taxes that are not covered by the respective DTC.

Depending on the jurisdictions involved, the ND provisions contained in a friendship, commerce and navigation (FCN) treaty concluded by Luxembourg may provide remedy if the ND provision applies in tax matters and is not overruled by taxation provisions contained in a DTC concluded later.

It seems that – with the exception of the FCN treaty with the United States of America – not very much importance has been given so far in tax matters to Luxembourg's FCN treaty network.

The Luxembourg legislator has shown increasing awareness of the need to adapt Luxembourg legislation to the requirements of EU fundamental freedoms as interpreted by the Euroepan Court of Justice (ECJ) even though there still seem to be a certain number of domestic tax law provisions that potentially conflict with EU ND principles.

It seems, however, that to a certain extent the Luxembourg tax courts do not fully recognize the importance of ND provisions in DTCs concluded by Luxembourg and completely ignore fundamental EU ND provisions when rendering their decisions.

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Other international treaties on human rights are of no importance in Luxembourg tax matters. Nor does Luxembourg recognize an unwritten ND principle based on international public or customary law.

1. Introduction

Since the 1993 report on ND (prepared by Alain Steichen) a number of developments have taken place in Luxembourg which have had a significant indirect impact on this matter. In the first place, tax litigation has been fundamentally changed in the sense that two administrative jurisdictions (*inter alia* competent for direct tax) have been introduced providing, among other things, for better access to justice and also for a much quicker decision-taking process. Secondly, and more importantly in the present context, a Constitutional Court was introduced in 1997 to ensure that constitutional provisions are actually enforced. Before 1997 Luxembourg courts had traditionally refused to check whether legal provisions were in compliance with the law. In other words, whereas ordinary and administrative courts have been able to discard, for instance, any grand-ducal decree which was contrary to the Constitution, the same courts applied the law even if they believed that its provisions did not comply with the Constitution. The system introduced in 1997 bears a close resemblance to that applied at the EC level: a court having doubts about the compliance of legal provisions with the Constitution will stay the proceedings and refer one or several questions to the Constitutional Court. Once the answer has been obtained, the referring court will decide its case taking into account the ruling of the Constitutional Court.

Generally speaking, the impact of these new courts has been very beneficial also in the area of fundamental rights: these rights can only be enforced in an efficient manner if a court is able to challenge the legal provisions adopted by Parliament.

The Luxembourg Constitution is a quite faithful copy of the Belgian Constitution of 1848 with the notable and obvious difference that Luxembourg did not follow the Belgian evolution to a federal state. In other words the Luxembourg Constitution is now closer to the original version than its Belgian counterpart. In its article 10bis it provides for the principle of equality in the sense that it states that “Luxembourg citizens are equal before the law”. This provision only refers to Luxembourg nationals and accordingly does not say anything about the relations between Luxembourg nationals and foreigners.[1] However, it should be noted that, in this respect, Luxembourg courts take a more generous approach than the Constitution would require. In 1964 the Luxembourg Council of State[2] (which at that time was the only administrative court of the country) held that it was generally accepted that foreigners have the same rights as Luxembourg

1 See Alain Steichen, IFA branch report 1993, *Règles de non-discrimination en matière d’imposition internationale*.

2 *Conseil d’Etat* of 4 February 1964, *Reicherts-Ministre des affaires économiques et des classes moyennes*.

nationals in Luxembourg unless the law provides to the contrary.[3] The Constitution contains another specific equality principle applicable to taxes: in its article 101 it states "No privilege may be established in tax matters".

2. Article 24 MC and DTCs

The concept of discrimination is not defined in Luxembourg law. In the reporters' view, the principle of ND has finally to be traced to the constitutional requirement of equal treatment. There is an undeniable relation between the principle of equality and the principle of ND.[4]

Under the case law of the Constitutional Court "the principle of equality … requires that all those who are in a same factual and legal situation are treated alike".[5]

And more specifically on discrimination:

> "The legislator may, without violating the principle of equality, subject different kinds of persons to different legal regimes provided that the differences introduced take into account objective differences, that they are rationally justified, adequate and proportionate to their objectives. In case of inequality created by the law between different categories of persons, the constitutional judge has to identify the objectives of the law. In the absence of justification expressed with sufficient precision in the parliamentary documents it is up to him to identify the objective of the law before, once the objective is so determined, he analyses if it justifies the legislative difference introduced with respect to the requirements of rationality, adequation and proportionality."[6]

In a case submitted to the Court a Luxembourg woman wishing to adopt a Peruvian child claimed that the child had the same right to be adopted as a Luxembourg child. The Court argued: "The constitutional principle of equality before the law is applicable to any individual reached by the Luxembourg law in as far as his personal rights are concerned."[7] It is to be assumed that the concept of personal rights is a restrictive one.

If it is "alleged that there is a discrimination the principle of equality requires that the persons concerned are in a comparable situation with respect to the measure which is under review".[8]

[3] In the case in question the government had held that the freedom of business and commerce only applied to Luxembourg nationals, on which the Court had given the answer mentioned above.

[4] J.-P. Spang, *La discrimination dans la vie des affaires*, Luxembourg report, Cercle Francois Laurent, p. 3.

[5] Const. Court of 13 November 1998, Case no. 2/98, Mém. A, p. 2499 and Case no. 7/99 of 26 March 1999, Mém. A, p. 1087.

[6] Const. Court of 5 May 2000, Case no. 9/00, Mém. A, p. 948.

[7] Const. Court of 13 November 1998, no. 2/98, Mém. A 1998, p. 2500.

[8] Const. Court of 5 May 2000, Case no. 9/00, Mém. A, p. 948.

Several remarks have to be made at this point: in the first place, the principle of ND is distinct from the principle of equality in as far as it only requires that non-nationals are not treated worse than nationals.[9] The opposite is not prohibited.

Secondly, it has to be said that in Luxembourg there is hardly any debate on this issue by scholars or before court. If the provision is included in all the DTCs entered into by Luxembourg, the reason does not lie in deep judicial reasoning but simply in the fact that this provision is included in the model convention, which Luxembourg follows more or less closely.

Thirdly, from a practical point of view, not discriminating against non-nationals is, (beyond possibly a constitutional requirement, see below) an economic necessity for a country which hosts a significant financial centre and which furthermore has a population of which some 40 per cent are non-nationals. In this environment ideas tending to discrimination against non-nationals can hardly develop and prosper.

Having said this, it is not necessarily that easy to have this provision applied in practice. Two examples are taken from from practice. The first deals with the administrative interpretation of national tax law provisions and DTCs.

2.1. Application of the ND provision to capital duty

As an EC Member State, Luxembourg has applied since 1971 capital duty on the contributions made to companies established on its territory. Based on EC directives, different types of operations are exempt. These exemptions, essentially meant to avoid cumulative taxation of contributions to companies, are provided for by articles 4(1) and 4(2) of the law of 1971 on capital duty. As the ND article concerns taxes of all kinds and is not limited to those taxes which are the object of DTCs (i.e. income and net worth taxes), practitioners have raised the question of whether the ND article could not be used in order to apply the provisions on exemptions also to capital duty: the result would be, for instance, that it would be possible to apply the merger exemption (under article 4(1)) also to those mergers involving, say, Japanese companies contributing all their assets and liabilities to a Luxembourg company. Article 4(1) only exempts those contributions of all the assets and liabilities from other EU Member State countries. Dutch case law (*Hoge Raad* of 27 April 1994, nos. 28,238, 28,239, 28,603 and 28,674) has accepted the application of the ND article (more precisely paragraph (4) of article 24 MC) to capital duty on an asset merger exemption (corresponding to article 4(1) of the Luxembourg law) pertaining to the contribution of a 100 per cent shareholding in a Swiss company by a Japanese shareholding company to a Dutch company. Tax scholars[10] argue that this case law would not apply to cases concerning the share merger exemption (for the reason that in this case the identity of the contributor is irrelevant).

The question was asked of the Luxembourg *administration de l'Enregistrement* (competent for the levy of capital duty) whether it would consider the ND article of DTCs applicable or not in cases involving companies of non-EU mem-

9 Steichen insisted on this point in the 1993 report.

10 A. van der Smeede, "Towards a Gradual Abolition of Dutch Capital Tax", *Bulletin IBFD*, 1994, p. 645.

ber states. The answers dated respectively 16 March 1998 and 25 September 2001 decided that this was not case, for the reason that this provision allows non-residents to be treated differently from residents. This reasoning was far from convincing as it only referred to paragraph (1) of article 24 MC.

The direct tax department (*administration des Contributions directes*), in a letter of 22 May 2002, confirmed that in its view the ND article would clearly extend to indirect taxes including capital duty.

The positions adopted by the two separate departments of the Ministry of Finance being completely opposite and not compatible with each other, the question was finally put to the Ministry. No answer was ever obtained on this question with the result that in practice application of ND provisions to capital duty is not made. Unfortunately this question has never been brought to court.

2.2. The fiscal integration case law

The second example is taken from recent case law and it shows that bringing the case to court is not a guarantee of obtaining the treatment which is provided by international law, i.e. a legal norm which in the Luxembourg view overrides any provision of national law.

On 19 April 2007 the Luxembourg administrative court of appeals took a decision on fiscal integration (no. 21,979C)[11] by which it overturned a judgment of the administrative tribunal (first instance court in administrative and direct tax matters) of 23 August 2006 (nos. 19,717 and 20,624).

The case was about six Luxembourg sister companies all fully held (or nearly fully held) by the same Belgian parent company. One of the Luxembourg companies realized a substantial loss in 2004 whereas the other companies were highly profitable. In order to allow for a quick recovery of the losses (i.e. in the year 2004), instead of carrying forward those losses against its own profits, the company concerned, together with its sister companies, asked for pooling of the positive and negative results of these various subsidiaries, by applying for the system of fiscal integration, i.e. for the joint taxation of the group companies involving offsetting of positive and negative results.

Under Luxembourg tax laws the general rule is that each corporation (e.g. a *société anonyme*) is a separate taxpayer and taxable as such, separately from any other company including those which are part of the same group to which it belongs itself. By exception to this principle, pooling of results of all the group companies is allowed under the so-called regime of fiscal integration provided for by article 164bis ITL (Income Tax Law) on the condition that the parent is a Luxembourg company or a local permanent establishment of a limited liability company of a non-resident capital company subject to income tax corresponding to Luxembourg corporate income tax. Furthermore, it is required that the parent holds at least 95 per cent of the shares of the fiscally integrated subsidiaries from the beginning to the end of the financial year. The fiscal integration regime is granted on application for a period of five years at least.

Fiscal integration results in adding up the results of the various group companies so that positive and negative results are offset, i.e. not only the results of

[11] All decisions quoted here are accessible at www.jurad.etat.lu.

the parent company (or the parent permanent establishment) are pooled with those of subsidiaries but there is also pooling among the various subsidiary companies. In other words, fiscal integration allows for "vertical" (parent and subsidiaries) as well as for horizontal (or lateral) pooling of the results of the subsidiary companies between themselves.

Fiscal integration involves each and every integrated company filing a tax return declaring its income for the financial year. In addition, the parent of the group (either a Luxembourg company or the permanent establishment of an EU company) has to file a "consolidated" return in which the results of the various group companies are simply added up. It is this joint result of the group which will be subject to taxation. The entity liable for the taxes is the parent filing the common tax return.

The application for fiscal integration was filed on 17 December 2004 by the Luxembourg subsidiary companies and their Belgian parent company. The office of assessment, in its decision of 25 January 2005, decided to reject the application for fiscal integration arguing that the conditions required by law were not fulfilled in the case at hand. Indeed, article 164bis of the ITL would require that the parent of the group was either a resident fully taxable company or a permanent establishment of a non-resident company established in another EU Member State.

Obviously, the condition that the parent company needs to be a Luxembourg company (or a permanent establishment of a foreign company) was not fulfilled. The object of the application was to ask for permission to allow them to pool their results (horizontal pooling) while the results of the foreign parent were ignored (no vertical pooling). The other treaty country, i.e. Belgium in this case, had the right to tax the parent company's income.

The reasoning of the claimants was that not granting fiscal integration was in violation of the ND article of the tax treaty concluded between Luxembourg and Belgium (article 24, paragraph (6) prohibits enterprises of one contracting state, the capital of which is held by residents of the other contracting state, being subject to any tax burden or tax obligation which is heavier than that of other enterprises of the same state). In other words this provision prohibits different treatment for an enterprise of one state for the simple reason that its share capital is held by residents of the other state. Indeed, the only reason why fiscal integration (of the results of the Luxembourg subsidiaries) was refused was that the parent was not a Luxembourg (but a Belgian) company (cf. letter of 25 January 2005).

The first instance court agreed with this reasoning of the applicants and in its judgment of 23 August 2006 (no. 20,624) the tribunal accepted fiscal integration of the six Luxembourg subsidiary companies. The judges, by referring to the decision of the office of assessment, argued that the only reason for refusing the integration regime was that the parent company was not a Luxembourg resident company (or a permanent establishment of an EC country capital company subject to a sufficient level of taxation).

The debate before the tribunal was not placed under EC law but exclusively under the tax treaty provisions of the Luxembourg–Belgium tax treaty. The reason was not that the taxpayer would not have seen the relevance of EC provisions for the case but because it was thought that the case could be settled without referring it to the ECJ (which in fact proved to be a correct assumption).

The government appealed against this judgment before the Court of Appeals and rather surprisingly the Court overturned the judgment and refused the fiscal (horizontal) integration.

The court of appeals in its decision of 19 April 2007 (case 21,979C) held that there was no discrimination against foreign parent companies for the reason that Luxembourg tax laws did not provide for a regime of horizontal integration (only). Hence, the refusal of horizontal pooling between Luxembourg companies held by a foreign parent was not a problem because horizontal pooling was not allowed between Luxembourg companies either.

It is impossible to follow this reasoning: although it is true that fiscal horizontal (only) integration is not allowed by Luxembourg law (not even for Luxembourg companies), the system of article 164bis allows for "total" fiscal integration, i.e. vertical (i.e. pooling between parent and subsidiaries) and horizontal integration. It cannot be denied that if the parent had been a Luxembourg company then fiscal horizontal integration would have been granted in addition to "vertical" integration (i.e. pooling of the results of the parent company and its subsidiaries).

As was explained to the court, in purely domestic situations it happens frequently that the parent company has a zero result: if it is a pure holding company the dividends are tax exempt and in the absence of substantial costs (e.g. financing costs) the result of the parent is nil or negligible. This means that in essence the only consequence of the fiscal integration regime is horizontal pooling (and only horizontal pooling). Obviously these explanations were not seen as convincing.

In the case of a Belgian parent vertical integration is by the nature of things excluded and it had not been asked for by the taxpayer. However, horizontal integration is not excluded and it was nevertheless refused, and on the basis of the mere fact that the parent was a foreign company.

This would mean that the difference of treatment existing between sister companies held by Luxembourg resident companies and those held by companies resident of another Member State would be greater than necessary: the difference in the tax treatment of those two types of situations is larger than the difference in the actual situation. As admitted by the first instance court, there is no legal or factual obstacle to allow for the horizontal pooling of the results of Luxembourg subsidiaries only.

It is even more regrettable that the Court did not see the EC law aspects of the case, and although specifically invited to ask the question of the treatment to the ECJ, it refused to do so. The Court again mentioned that the assumption that loss compensation between resident companies would be possible was erroneous. This is also a clear breach of EU law.

2.3. The *Mathis Prost* case law

This judgment handed down by the administrative court in 2000[12] dealt with the tax treatment of Belgian and Swiss residents of a Luxembourg limited partnership (a *société en commandite simple* (Secs)); it was set up in 1924 and changed into a *société anonyme* (SA) in 1984. On the occasion of the transformation of

[12] TA of 5 April 2000, no. 10.473, *Mathis Prost*.

the Secs into an SA there was a change from a transparent entity (at least for income tax and net worth tax) into a taxable corporate body. This meant that on this occasion there was, as a general rule, taxation of hidden reserves existing at that time. However, Luxembourg resident partners were allowed to avoid the taxation of these reserves in accordance with article 59(3) ITL. This option was not available for the non-resident partners of the Secs. Among other arguments the plaintiffs based their request on article 24(6) of the Belgium–Luxembourg tax treaty, which states that an enterprise in the form of a Secs held by a Belgian resident should not be taxed at higher rates than a corresponding enterprise held by Luxembourg residents.

The court held, however, that this provision explicitly protected only the enterprise and not the persons controlling it. A Secs just like an SA was, according to article 4 of the treaty, to be viewed as a resident in the sense of the treaty, the enterprise benefiting from treaty protection only extending to the assets and profits directly connected to the company to the exclusion of the capital gains connected to the personal assets of a partner.

This decision was in line with the commentaries made by scholars on the basis of the MC. Indeed K. van Raad explains:

> "Treating such partnerships as 'persons' does not mean, however, that these partnerships always qualify as an 'enterprise of a Contracting State'. For that it is necessary that the partnership be a resident of that State. And to be such resident, Article 4 requires that the partnership itself – as distinguished from the partners – is subject to (unlimited) tax liability … Consequently, a business enterprise carried on within the legal framework of such nontaxable 'other body of persons' does not qualify as an enterprise of that State."[13]

In the reporters' view, an ND clause should be included in DTCs. At the same time it is true that the case law of the ECJ and the extension of the European Union to the east render the discrimination clause less important in practice (at least on a European level) since the EC treaty requirements against ND are more demanding than those of article 24 MC.

Concerning the question of the underlying reasons for this requirement to have an ND article it has to be said that they are in the reporters' view double: first the requirement of equality under the national constitutional order and the requirements of an open economy and a financial centre which should avoid any discrimination against foreigners.

Generally speaking the application of article 24 MC would be fairly literal in Luxembourg. This refers to the various paragraphs of the provision. For instance, in paragraph (1) tax authorities would not be prevented from treating nationals and non-nationals differently if the non-nationals were non-residents. This would even be the case if the difference existing with respect to the residence criterion were of little practical relevance in view of application of a certain specific provision.

The same literal approach would also apply with respect to paragraph (4) which prohibits that the deduction of certain business expenses is only allowed if

[13] K. van Raad, *Nondiscrimination in International Tax Law*, Series on International Taxation, no. 6, p. 187.

the payments are made to residents of the same state while the deduction would be refused if the same payments were made to residents of the other state. This rule cannot be extended to taxpayers other than business enterprises (e.g. physical persons acting outside their business sphere).

The treaty with Belgium, although in force since 1970, contains a provision which is very modern in view especially of the case law of the ECJ. Indeed article 24, paragraph (4a) states that a person resident of Belgium who according to articles 7, 14 to 19 is taxable in Luxembourg for more than 50 per cent of his professional income may, at his request, be taxed in Luxembourg for his income taxable at the average rate of tax which takes into account the family situation which would apply to him if he were a Luxembourg resident. This provision allows Belgian residents to be assimilated as Luxembourg residents provided they obtain more than 50 per cent of their professional income from Luxembourg. This provision is of great practical importance since there are a very significant number of Belgian border workers to whom this provision applies. In fact this provision resembles closely the EC recommendation of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than the one in which they are resident (94/79/EC) which, however, is more restrictive inasmuch as it applies only if at least 75 per cent of the income is sourced in the other Member State.

In the reverse case (a Luxembourg resident working in Belgium) the conditions are even less restrictive: persons who are taxable there are not subject to any taxation other or more burdensome than that applicable to Belgian residents. Abatements, deductions, etc. will be granted to Luxembourg residents pro rata to their Belgian income compared to their total income.

The Brazilian DTC states that royalties paid by a Brazilian resident company to a Luxembourg company holding at least 50 per cent of the capital of that company are not deductible and a protocol to article 25 of the DTC states that this provision does not conflict with the ND article. It is furthermore added that if a later DTC entered into by Brazil allowed deduction of royalties paid to a foreign company located in a country outside Latin America holding at least 50 per cent of the capital, in this case the corresponding deduction would automatically be made available to payments made to Luxembourg companies.

Not all treaties extend the scope of the ND article beyond those taxes covered by DTCs. The following DTCs limit their scope to taxes mentioned in article 2 of the MC: Canada, Indonesia, Israel, Malaysia, Morocco, Portugal, Russia, San Marino, Singapore, Thailand, Tunisia, Trinidad and Tobago. Other treaties are silent on this question: France, Uzbekistan, Mongolia, Portugal.

3. ND in national context

As mentioned in the introduction, the ND requirement can be traced to the Constitution. Case law is, however, extremely scarce on the issue. In a matter decided on 4 February 1964[14] the Council of State has held that:

[14] *Conseil d'Etat* of 4 February 1964, Reicherts, Pas. 19, p. 266.

> "[I]t is nowadays generally accepted that foreigners enjoy in Luxembourg all the rights which are not specifically refused to them and that unless a provision to the contrary they are assimilated to nationals; no right may be refused to foreigners unless the legislator provides to the contrary."

Accordingly, the decision refusing the authorization had to be cancelled.

However, this finding allows the law to take derogatory provisions, i.e. to take precisely those measures which would refuse to foreigners those rights which are granted to nationals. The general equality principle of article 10bis is not a clear basis for the principle of ND. In addition to this general principle there is a specific provision applicable to tax matters which is provided for by article 101 of the Constitution which applies the general principle of equality to tax matters: "No privilege may be introduced in matters of taxes. No exemption or moderation may be established by law" (free translation). This provision is interpreted as meaning equality before taxes.[15]

This section can be viewed on different levels: the legislative level, the administrative level and the judicial level.

On the legislative level it is fair to say that those provisions involving (potentially) discriminatory provisions have to a large extent been eliminated over the last years and decades. Whereas some 20 years ago it would have been easy to make a long list of cases of discrimination in Luxembourg tax law this list has been reduced very significantly. However, such cases do still exist, as is shown by the fiscal integration case mentioned in section 2.2.

In the area of direct taxes the fundamental differentiation is between resident and non-resident taxpayers. Resident taxpayers are taxable on a worldwide basis, non-resident ones are only taxable on Luxembourg source income. The question is then whether this distinction reflects a differentiation which is adequate and proportionate with respect to the differences existing with regard to the actual circumstances of the two categories of taxpayers.

Traditionally, the Luxembourg courts had a very restrictive view insofar as the principle of equality was concerned by refusing in fact to exercise real control in the sense that any difference of situation justified the unequal treatment. In the Council of State's judgment in the *Liesch* case,[16] the plaintiff questioned the legality of a tax on secondary residences which was levied by the commune on any owner except those who had their principal residence on the territory of the commune by stating: "The principle of equality before the tax applies only with respect to a category of taxpayers who are in a same factual situation, which is not the case here." The Council of State did not analyse the rationality of the distinction made, i.e. whether it was reasonable to exempt those owners who had their principal residence in the territory of the commune.

The Constitutional Court created in 1997 has not followed the case law of the Council of State but it has followed that of the Belgian Arbitration Court.[17]

It is definitively the case that it is at a judicial level where the developments have been most important: the introduction of a Constitutional Court and the

[15] P. Wigny, *Cours de droit constitutionnel*, 1973, Bruylant, Brussels, p. 192.
[16] Judgment of 18 May 1982, *Bulletin de documentation communale* 22, p. 115.
[17] See P. Kinsch, *Droit constitutionnel*, CCDL, p. 26.

case law taken over the last few years (which by its nature has very much centred on the principle of equality) allow a better evaluation of the content of the ND principle. According to the existing case law one would probably conclude that differential treatment was allowed but only if it was proportionate to the differences in situations existing. However, in this context it is worth mentioning that whereas article 95ter of the Luxembourg Constitution allows the Constitutional Court to check compliance of any law with the Constitution this is not the case for laws approving international treaties. This means that tax treaties are not subject to scrutiny by the Constitutional Court.

4. FCN treaties

Luxembourg has concluded 51 DTCs, among other countries with all EU Member States (except Cyprus) and with all OECD member states (except Australia and New Zealand).[18]

Luxembourg has also concluded 81 commercial treaties and 7 navigation treaties (hereafter collectively the "FCN treaties") which all contain most favoured nation (MFN) provisions.[19]

Nearly all these FCN treaties exclude the application of the MFN provisions for "privileges that may be extended by virtue of the participation in a free trade zone, customs union, common market or any other form of regional economic organization". In the reporters' view this wording does not exclude application of the MFN provisions to privileges based on EU directives that have been incorporated into national legislation and that subsequently form part of the domestic tax legislation of EU Member States.[20]

The large majority of FCN treaties exclude the application of MFN provisions either for "matters regulated by any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation" or, more restrictively, only for matters regulated by a DTC or "an international agreement or arrangement relating wholly or mainly to taxation". In the first case the FCN treaty provides for a non-application of the MFN provisions in tax matters, i.e. international and national tax regulations, whereas in the second case the FCN treaty only provides for the non-application to matters that are regulated by a DTC or a multilateral agreement in the field of taxa-

[18] 13 further tax treaties are currently in negotiation or in the process of being ratified.

[19] Except for the FCN treaty with the United States of America of 1962, all other FCN treaties had been concluded in the frame of the Belgium–Luxembourg Economic Union (*Union économique belgo-luxembourgeoise*) and had not gone through the Luxembourg domestic parliamentary ratification process. As doubts arose as to the constitutionality of this ratification process for FCN treaties, the Luxembourg legislator decided to pass two laws in 2004 and 2006 to ratify 71 commercial treaties and 7 navigation treaties. A third Bill of law to ratify the remaining 10 FCN treaties is currently pending before Parliament.

[20] The application of art. 147 of the Luxembourg ITL that has incorporated the withholding tax exemption provided for under Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States into Luxembourg domestic law would not be excluded by the fact that an FCN treaty contains the same provision.

tion, thus permitting application of tax matters that are exclusively governed by domestic tax regulations. In general the scope of application of DTCs is limited to "taxes covered" (with the exception of the ND provisions,see above). Therefore, the reporters believe that an FCN treaty that excludes application of the MFN provisions to matters regulated by a DTC should nevertheless apply to taxes not covered by such a treaty. In the past this has been of relevance with respect to Luxembourg capital duty upon contribution of shares and other assets by certain non-EU based contributors to a Luxembourg company or branch. This was, however, mainly due to the fact that the Luxembourg indirect tax authorities tended to consider that the ND provisions of a DTC would not apply to Luxembourg capital duty (see above). Luxembourg has concluded an FCN treaty but no DTC with 47 jurisdictions.

The FCN treaties with a certain number of these jurisdictions[21] do not exclude the application of MFN provisions to tax matters. It should therefore be possible in situations falling under the scope of these FCN treaties to claim MFN treatment with respect to tax matters. This should then apply both to situations where an investor of such jurisdictions invests in a Luxembourg company or business and to situations where financial flows qualifying as "investment" in the sense of the respective FCN treaty flow out of Luxembourg. As Luxembourg domestic law does not levy withholding tax on either interest or royalty payments to beneficiaries in such jurisdictions, this may still be of interest for dividend payments. In this context it seems appropriate to consider that a tax advantage granted by Luxembourg under a DTC to a resident of another contracting state should be extended for the benefit of a person eligible to the FCN treaty. In the view of the reporters this is the only way in which there could be an interaction between MFN provisions of an older FCN treaty and the provisions contained in DTCs with other countries. More precisely the DTC provisions, due to their "derivative" application in the framework of the MFN provisions of a given FCN treaty, may act to procure a favourable tax treatment to the beneficiary.

With a certain number of other jurisdictions[22] Luxembourg has concluded (or is in negotiation to do so) both a DTC and an FCN treaty that does not exclude the application of the MFN provisions in tax matters. In all these cases the DTCs were concluded after the entry into force of the FCN treaties.

The reporters believe that, unless the DTC concluded later in time contains specific provisions to the contrary, the provisions of the DTC should prevail over the MFN principle of the FCN treaties under the *lex specialis derogat legi generali* principle.[23] However, there are the following two exceptions.

[21] These jurisdictions are Algeria, Burundi, Cameroon, Cuba, Egypt, El Salvador, Ivory Coast, Rwanda and Venezuela.

[22] These jurisdictions are Estonia, Indonesia, Malaysia, Mongolia, South Korea, Tunisia, Turkey, Uzbekistan, Vietnam and the United States of America. With the following tax jurisdictions treaties have not yet entered into force and have therefore not been examined by the reporters: Azerbaijan, Georgia, Kazakhstan, Moldova and Ukraine.

[23] In the view of the reporters this articulation between the provisions of an older FCN treaty and a more recent DTC transpires clearly from the preparatory works of the Luxembourg legislator concerning the FCN treaty between Luxembourg and the United States of America where it is stated that the general taxation provisions of the FCN treaty will be completed by more precise

The first exception where the MFN principle of the FCN treaty should prevail over a more recent DTC is where the DTC itself contains clear language providing that the treaty itself should not restrict any privileges granted by any other agreement between the contracting states. This is, however, not the case in any of the DTCs between Luxembourg and the jurisdictions concerned.[24]

The second exception where the MFN principle of the FCN treaty should prevail over a more recent DTC is obviously where a tax measure is not within the scope of the DTC. In this context the reporters want to highlight the very interesting case of the DTC between Luxembourg and South Korea which does not contain any provisions for the taxation of capital gains. In addition, the protocol to the DTC provides that "the provisions of Art. 21 [concerning the taxation of other income] shall not apply to tax on gains from the alienation of property".

To the best knowledge of the reporters, the above provisions have in the past always been interpreted as permitting South Korea to tax the capital gain arising from the sale of shares in a Korean corporation in accordance with its domestic tax law provisions.

Given, however, that in accordance with the wording of the protocol the DTC does not apply to capital gains realized upon disposal of property and given that the FCN treaty between Luxembourg and South Korea does not exclude the application of the MFN provisions in tax matters, a Luxembourg company could avail itself of the MFN provisions of the FCN treaty to claim not to be treated less favourably than a company of the MFN, e.g. a Belgian company for which the capital gain realized upon the sale of the shares in the Korean company was not subject to tax in South Korea.

Concerning the articulation of the MFN provisions of an older FCN treaty with a more recent DTC, there is currently discussion in Luxembourg doctrine whether the FCN treaty between Luxembourg and the United States of America of 1962 permits the application of MFN treatment in situations where the DTC between Luxembourg and the United States of America of 1996 provides less favourable tax treatment.[25]

The reporters, however, believe that the DTC between Luxembourg and the United States of America of 1996 itself contains provisions that assert for any tax measure within the scope of the DTC the prevalence of ND principles contained in the DTC itself over MFN principles that may be included in any other agreement concluded between the two states, except the General Agreement on Tariffs and Trade (GATT) as applied to trade in goods.[26] This seems also consistent with articles XIV(e) and XXII(3) of the General Agreement on Trade in Services (GATS) as these provisions prevent in principle WTO member states from invoking MFN treatment in GATS for measures covered by a DTC.[27]

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tax provisions in the framework of the forthcoming DTC between both countries (Doc. parl. J-1962-O-0008, p. 16 and C-1962-O-005-0005, p. 115).

24 For a separate discussion of the DTC between Luxembourg and the United States of America of 1996 (see below).

25 Contribution of J. Wouda Kuipers in the forthcoming publication of the Luxembourg IFA branch.

26 Art. 1 para. 5(b) of the DTC between Luxembourg and the United States of America of 1996.

27 Steichen, branch report Luxembourg, *WTO and Direct Taxation*, 2005, p. 458.

This analysis can even be taken one step further in the light of the suggested changes to the commentary of the OECD MC with respect to ND provisions as set forth in the recent OECD discussion paper.[28] In the view of the reporters, these suggested changes are not only of relevance for the interpretation of the relationship between ND principles contained in a DTC and the other provisions of such DTC but also with respect to the relationship between the MFN provisions of an older FCN treaty that – due to the *lex specialis derogat legi generali* principle – were superseded by the ND provisions of a DTC concluded later in time between the same contracting states . The suggested changes to the commentary of the OECD MC specify that "the ND provisions of a DTC must be read in the context of the other Articles of the DTC so that measures that are mandated or expressly authorized by the provisions of these Articles cannot be considered to violate the ND provisions even if they only apply to non-residents".[29] If the tax measures provided by a DTC cannot be in violation of the ND provisions of the DTC, it cannot be seen how such tax measures could be in violation of the MFN provisions of an FCN treaty that have been superseded by the ND provisions of the DTC.

To the best knowledge of the reporters there is no Luxembourg case law concerning the application of MFN provisions contained in an FCN treaty in tax matters. There seem, however, to be cases in the field of capital duty where the Luxembourg tax authorities have accepted application of MFN treatment under the FCN treaty between Luxembourg and the United States of America.

From a practical point of view the FCN treaties that allow application of the MFN provisions in tax matters seem so far of limited importance in Luxembourg. Indeed, to the extent that – with the exception of the case of the United States of America – in all cases where both an FCN treaty with an MFN provision that may apply in tax matters and a DTC have been concluded between Luxembourg and another jurisdiction, the DTC has been concluded later in time; its ND provisions should thus prevail over the MFN provisions of the earlier FCN treaty. Therefore, the only cases where the MFN provisions of an FCN treaty seem relevant are the cases where no DTC exists between Luxembourg and the other jurisdiction. Therefore, the reporters believe that in the field of taxation the MFN provisions contained in FCN treaties have so far not been actively applied in Luxembourg. The case of South Korea remains, however, interesting.

5. Treaties relating to human, civil and political rights

Luxembourg has ratified the European Convention on Human Rights in 1950 which entered into force in 1953. Luxembourg has signed the International Covenant on Civil and Political Rights in 1974 which entered into force in 1983.

The reporters believe that among international treaties concerning human rights or principles of ND only the European Convention on Human Rights has

[28] OECD, *Application and Interpretation of Article 24 (Non-Discrimination)*, Public discussion draft, 3 May 2007.

[29] *Ibid.*, note 12, p. 6, indent 1.3.

some relevance under Luxembourg tax law. However, the Luxembourg tax courts have ruled[30] that the refusal by the Luxembourg tax authorities to communicate the tax file to a taxpayer is not a violation of the right to a fair trial provided for by article 6(1) of the European Convention on Human Rights, thereby applying the settled case law of the European Court of Human Rights that the principles set forth in the European Convention on Human Rights do not apply in civil law matters.[31]

The reporters, however, believe that the principles set forth under the European Convention on Human Rights – and especially the right to a fair trial provided by article 6(1) – should apply in tax investigation and tax criminal matters if such matters can be qualified as "criminal matters" as defined by the case law of the European Court of Human Rights.[32] To date there is no existing Luxembourg case law in this respect.

6. Regional or supranational treaties

Luxembourg has been a WTO member since 1995. With the notable exception of the DTC between Luxembourg and the United States of America (see above), the WTO/GATT ND principles to the best knowledge of the reporters do not have any direct impact under Luxembourg tax law. So far, none of the WTO dispute cases or investigations has concerned Luxembourg.[33]

Much more important in the context of enforcement of principles of equal protection and ND, Luxembourg is a founding member of the EU and as such a party to the Treaty of Rome and the various EU successor treaties. Luxembourg therefore has to comply with the fundamental EU freedoms set forth in the EU Treaty, being the free movement of workforce, services and capital, the freedom of establishment as well as the general EU principle of ND.[34]

Even though – unlike for indirect taxes –the field of direct taxation is not a reserved matter for EU harmonization,[35] perhaps the most striking difference between the 1993 IFA report on ND and the current report is the development taken by ND principles in ECJ case law in the field of direct taxation.[36] Application and harmonization through fundamental EU freedoms even go further beyond the territorial scope of the EU to also apply within the European Economic Area.[37]

30 TA, 10 January 2002, no. 12869.

31 CEDH, 9 December 1994, *Schouten and Meldrum* v. *Netherlands*; CEDH, 12 July 2001, *Ferrazini* v. *Italy*.

32 Steichen, *Manuel de droit fiscal*, 2006, p. 429, no. 394 *et seq*.; Schaffner, *Droit fiscal international*, 2005, p. 522, no. 14.26.

33 Steichen, branch report Luxembourg, *op. cit.,* pp. 455 *et seq*.

34 Arts. 6, 39, 43, 49 and 56 of the EU Treaty.

35 Art. 293 of the EU Treaty.

36 For a summary of the most important ECJ decisions having an impact in the field of direct taxation for both individuals and companies: Schaffner, *op. cit*., pp. 495–520; Steichen, *Manuel de droit fiscal*, 2006, pp. 437–443.

37 In two court cases (TA, 2 April 2003, no. 15003 and CA, 7 October 2003, no. 16446) the Luxembourg courts seem to accept implicitly the extension of the EU fundamental freedoms to a

Under EU fundamental freedoms, not only is discrimination by reason of nationality prohibited but all forms of discrimination which through application of other criteria of differentiation lead *de facto* to the same result. Thus, discrimination is understood as the application of different rules to comparable situations or the application of the same rule to different situations. In relation to direct taxes, a difference in treatment based on residence is therefore not discriminatory *per se*. It appears that as a principle the situations of residents and non-residents are not comparable, because the income received in a source state by a non-resident should in most cases only be a part of his worldwide income. Therefore, the personal ability to pay tax, determined by reference to the overall aggregate income and the personal and family circumstances, can better be accounted for in the residence state with which closer personal and financial ties exist than with any other jurisdiction. It is settled ECJ case law that the mere fact that a EU Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not in itself discriminatory bearing in mind the objective differences between the situations of residents and of non-residents, from the point of view both of the source of their income and of their personal ability to pay tax or their personal and family circumstances.[38] As in such circumstances the situations of residents and non-residents are not objectively comparable, the ECJ has ruled that if the source state denies tax benefits linked to the personal tax position of a non-resident this does not constitute discriminatory treatment.

However, if the non-resident receives all or virtually all of his taxable income in the source state, the residence state will not be able to take account of the personal tax position of the taxpayer because the latter does not derive significant income there. In this situation there ceases to be any objective difference in the source state for the non-resident taxpayer over a resident taxpayer. A proper application of the EU ND principles requires the source state to treat a non-resident taxpayer in the same way as a resident in relation to any aspect of his overall ability to pay tax and requires the taking into account of all the parameters relevant for according tax benefits to its own residents.[39] The ECJ has confirmed in the recent *Lakebrink* case[40] that the ability to pay tax forms part of the personal tax situation of the non-resident taxpayer.

In the view of the reporters providing for equal treatment of resident and non-resident taxpayers seems valid only if all or almost all of a non-resident taxpayer's

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Norwegian resident individual. The Luxembourg tax courts did not, however, effectively grant the extension in the case at hand because the tax litigation concerned a period (income for 1991) before the EEA Treaty had entered into force (1 January 1994).

38 ECJ, 15 October 1995, *Schumacker*, C-279/93.

39 ECJ, 11 August 1995, *Wielockx*, Case C-80/94.

40 ECJ, 18 July 2007, *Lakebrink*, C-182/06; it is noteworthy in this context that in this case the ECJ decided that art. 157ter of the Luxembourg ITL that was introduced in 1997 to incorporate the findings of the ECJ in the *Schumacker* case into Luxembourg tax law did not comply with the free movement of workforce as granted by art. 39 of the EU Treaty. For a critical analysis before the decision was rendered by the ECJ: Winandy, "Pending ECJ case law: the Lakebrink case", *EATLP meeting of Vienna 2007*, Linde Verlag, Vienna, 2007, pp. 125 *et seq*.; Taferner, "Absence of Loss Relief Rules for Non-Residents may violate EC Law", *ET,* June 2007, pp. 308 *et seq*.

income arises in the taxing state, regardless of whether the taxing state is the residence state – as in the *de Groot* case[41] – or the source state – as in the *Ritter-Coulais*[42] and *Lakebrink* cases. Only in this specific situation will a difference in treatment between residents and non-residents *ipso facto* be transformed into discrimination contrary to the ND principles granted under the EU Treaty.

With around 130,000 frontier workers and a growing number of individuals working only for part of their time in Luxembourg, Luxembourg is a good example for this situation. It is therefore not surprising that the first decision of the ECJ that established discrimination in such a situation against an individual was rendered against Luxembourg in 1990[43] as well as the most recent case (*Lakebrink*) in a long series of cases concerning individuals taking advantage of the fundamental EU freedom of free movement of workforce. In this context the question arises of how far the taxing states will be forced to grant in the name of ND principles tax benefits to non-residents or to residents earning a substantial portion of their income abroad.[44] This subsequently raises the even more fundamental question of whether the ND principles on which the EU freedoms are based were designed to put residents and non-residents on an equal footing as a general principle or whether the driver behind these ND principles was to permit EU residents performance of cross-border work, services, establishment and capital investment without granting equal treatment on a general basis in the taxing state.[45]

With respect to ND in tax matters, the ECJ undertakes a three-pronged analysis, establishing first whether the provisions of the domestic tax law of a given EU Member State are discriminatory with respect to EU freedoms; second, whether a justification exists for the discrimination; and third, whether the justification is strictly proportionate and does not go beyond what is required to restrict the EU freedom in question or whether less stringent means could have been used to attain the objective pursued by the incriminated national legislation.

Concerning possible justifications for the restriction of the fundamental EU freedoms, it is settled ECJ case law that only the so-called "rules of reason" (*raisons impérieuses d'intérêt général*) such as safeguarding the coherence of the tax system of the EU Member State concerned, fighting harmful tax competition or combating tax evasion may justify the limitation of these fundamental EU freedoms.

In this context, the authors believe it is useful to recall the decision of the ECJ in the recent *Elisa* case concerning Luxembourg companies subject to the now abrogated Law of 31 July 1929.[46] In this case the ECJ once again clarified

[41] ECJ, 12 December 2002, *de Groot*, C-385/00.

[42] ECJ, 21 February 2006, *Ritter-Coulais*, C-152/03.

[43] ECJ, 8 May 1990, *Biehl*, C-175/88.

[44] Winandy raises in his critical comment on the *Lakebrink* case the question of whether the "right question" to be asked in this case was to take the losses into account for determining the applicable tax rate (as set forth under the incriminated Luxembourg tax provision) or whether the taxpayer should have gone one step further to ask deduction of the losses from taxable income; *op. cit*. This question may be answered in the near future by the ECJ in the *Renneberg* case (C-527/06, OJ C of 10 March 2007).

[45] See in this context Avery Jones, "Carry on discriminating", *ET,* February 1996, p. 46 and May 1996, p. 162.

[46] ECJ, 11 October 2007, *Européenne et Luxembourgeoise d'investissements SA*, C-451/05.

that the prevention of tax evasion can be accepted as justification only if the legislation is aimed at wholly artificial arrangements the objective of which is to circumvent the tax laws. This precludes any general presumption of tax evasion.

The ECJ held that Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct and indirect taxation was to be relied on by a Member State for the purposes of obtaining from the competent authorities of another Member State any information which was necessary to enable it to effect a correct assessment. In this context, the fact that it may be impossible to request that cooperation, e.g. when the competent authorities of the requested Member State are prevented by their laws or administrative practices from conducting enquiries or from collecting or using information for its own purposes, cannot justify refusal of a tax benefit.

Concerning the impact on Luxembourg legislation of an infringement of the fundamental EU freedoms by the legislation of an EU Member State, it was interesting for the reporters to notice that there has clearly been a rising awareness of the Luxembourg legislator of the need to adapt Luxembourg domestic tax regulations to bring them in line with ECJ case law to guarantee compliance with fundamental EU freedoms.

It took the Luxembourg legislator five years from 1990 to 1995 to modify Luxembourg domestic provisions concerning the refund of withholding tax on income derived from employment due to the *Biehl* case rendered against Luxembourg. The same 1995 budget law also modified the provisions of the Luxembourg participation exemption for dividends and capital gains as well as the provisions concerning withholding tax on dividends to extend such tax exemptions to permanent establishments of companies located in countries with which Luxembourg has concluded a DTC and permanent establishments of EU resident companies listed in the exhibit to article 2 of EU Directive 435/90/EEC of 23 July 1990. One may say that the Luxembourg legislator anticipated the findings of the ECJ in the *Saint-Gobain* case.[47] On the other hand, the reporters tend to believe that this change was rendered necessary by the findings of the ECJ in the *Avoir fiscal* case,[48] rendered nearly ten years earlier, the underlying principles of which had been reconfirmed in the meantime by the ECJ in the *Commerzbank* case.[49] The preparatory work to the 1995 budget law clearly shows that international company taxation was still in its infancy in Luxembourg, because the Luxembourg legislator considered on the one hand that the current legislation would neither violate the fundamental EU freedom of establishment nor the ND principles under DTCs; and on the other hand that such proposed changes would not have any budget impact given the rather few existing cases of permanent establishments of qualifying EU resident or Treaty protected companies.[50]

Thereafter it took the Luxembourg legislator only a year from 1996 to 1997 to modify Luxembourg domestic provisions concerning the conditions of the Luxembourg dividend participation exemption and dividend withholding tax exemp-

[47] ECJ, 21 September 1999, ZN *Saint-Gobain*, C-307/97.
[48] ECJ, 28 January 1986, *Avoir fiscal*, C-270/83.
[49] ECJ, 13 July 1993, *Commerzbank AG,* C-330/91.
[50] Doc. parl. bill of law no. 4069, J-1994-O-0517, p. 1.

tion as well as the taxation of non-resident individuals deriving an important portion of their overall income from a Luxembourg source rendered necessary by the *Denkavit*[51] and *Bachmann* cases.[52]

In 2003 finally, the ECJ rendered the *X and Y* case[53] against Sweden in November and the Luxembourg legislator modified with the year-end 2004 finance law the conditions of the Luxembourg tax consolidation to take into account the findings in the ECJ case rendered just some weeks before.[54]

Luxembourg courts also take into account ECJ case law in rendering their decisions. The Luxembourg Tax Court of First Instance applied the findings of the *Saint-Gobain* case to grant a sparing tax credit under the DTC between Luxembourg and Spain to the Luxembourg branch of a German bank.[55]

The reporters are aware that under the impact of such case law the Luxembourg tax authorities accepted granting foreign tax credits to Luxembourg branches of non-EU financial institutions.

In the *D* case the ECJ has ruled that the EU ND principles do not preclude a DTC provision from not being extended to residents of an EU Member State which is not party to that DTC.[56] Thus, the reporters are not aware of any direct impact of EU ND principles and ECJ case law on the distributive rules allocating taxation powers between contracting states of a DTC that are EU Member States. Whether the same holds true for the avoidance rules regulating the tax treatment applicable in the residence state needs to be seen once the ECJ has rendered its decision in the pending *Columbus* case.[57]

7. General public international law

The reporters do not believe that under Luxembourg law an unwritten ND principle – prescribed by general public or customary international law – exists that would regulate international taxation matters. This view seems also to be shared by doctrine.[58]

51 ECJ, 17 October 1996, *Denkavit I*, C-283/94, C-291/94 and C-292/94.
52 Doc. parl. bill of law no. 4361, J-1997-O-001, pp. 2 *et seq*.
53 ECJ, 21 November 2002, *X and Y*, C-436/00.
54 Doc. parl. bill of law no. 5232, J-2003-O-0061, p. 3; J-2003-O-0825, p. 6.
55 TA, 29 April 2003, nos. 15343 and 15344.0
56 ECJ, 5 July 2005, *D*, C-376/03.
57 *Columbus Container Services B.V.B.A. & Co.*, C-298/05, Opinion of Advocate General rendered on 29 March 2007.
58 Steichen, *Manuel de droit fiscal*, 2006, p. 461, no. 435.