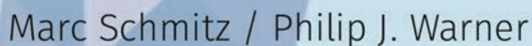
Marc Schmitz / Philip J. Warner

Luxembourg
in International Tax

▶ Third Revised Edition

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Luxembourg in International Tax
(Third Revised Edition)

Why this book?
Luxembourg in International Tax takes an in-depth look at corporate taxation in Luxembourg and the tax issues that may be of interest in an international environment. Although it principally focuses on those areas of interest to international investors and tax experts requiring a clear explanation of corporate tax in Luxembourg, it is also of interest to locally based practitioners. The first edition rapidly became a standard reference work in Luxembourg tax literature, and its reputation was maintained through the second edition, which continued being referred to and selling long after the date of issue.

This new edition of the book is updated to incorporate tax developments on the national level up to January 2015, including the latest changes on the exchange of information, advance tax clearances and the codification of the arm's length standard. It also covers Luxembourg's intellectual property box regime, private wealth management companies and other investment entities, and the taxation of financing activities in Luxembourg. Furthermore, it contains a new chapter on tax treaties, which provides insight into the particularities of Luxembourg's treaty network and its interaction with domestic law.

The book provides a vast amount of up-to-date information combined with an in-depth analysis of business taxation in Luxembourg. It is a valuable guide for international tax experts wishing to gain a better understanding of corporate tax in Luxembourg as well as for locally based practitioners. With numerous examples given in each chapter, it will also be of interest to students.

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Chapter 3

The Taxation of Non-Residents Not Operating through a Branch

3.1. The taxation exposure of non-residents

A non-resident's liability to tax in Luxembourg is set out in article 156 of the LIR. It falls into the following general categories:
– business income (paragraphs (1) to (3); *see* chapter 2);
– income from employment carried out or "put to use" in Luxembourg (paragraph (4));
– pensions and annuities, when paid in respect of employment carried out or "put to use" in Luxembourg, or paid by a Luxembourg state fund (paragraph (5));
– income from capital (paragraph (6));
– rental income (paragraph (7)); and
– other income (mostly capital gains) (paragraph (8)).

See chapter 2 and in particular section 2.1.1. for the taxation of non-residents operating through a PE. If a non-resident does not operate through a PE, its exposure to tax in Luxembourg is generally limited to withholding tax on his Luxembourg-source income.

The majority of the income considered in this chapter is the "passive" income of non-resident individuals and companies. Employment income, pensions and other similar income are ignored, as this work focuses predominantly on the taxation of corporate entities.

In addition to the taxation of income, it is sometimes necessary to consider a non-resident's liability to net worth tax. This is, however, very limited (*see* section 3.5.).

One of the most important tax issues for Luxembourg as a financial centre, and in particular as an international holding and headquarter location as well as a home of a significant banking industry, is the lack of withholding tax on almost all interest. Under the transitional rules foreseen in the European Savings Directive,[1] between 1 July 2005 and 31 December 2014,

1. Savings Directive (2003/48/EC).

Luxembourg imposed withholding tax on interest payments to non-Luxembourg resident individuals within the European Union who did not give the paying entity permission to declare their interest income to the tax authorities of the Member State where they were resident. From 1 January 2015, however, Luxembourg, instead of imposing withholding tax on interest, applies the general rule under the Savings Directive (2003/48/EC) which requires the exchange of information for interest payments falling within the definition of the Savings Directive.[2] As a result, most interest payments to non-residents are not subject to withholding tax. A detailed analysis of the exchange of information under the Savings Directive and other agreements is beyond the scope of this book.

3.2. Income from capital including dividends

3.2.1. The income covered

Article 156(6) of the LIR defines the income from capital of non-residents that is taxable in Luxembourg, and can be translated as:

> Income from capital as defined in article 97 of the LIR, paragraph 1, clauses 1, 2 and 3, when the payer is the Luxembourg State, a municipality, a Luxembourg public establishment, a company or cooperative with its registered office or its central administration in Luxembourg, or an individual resident in Luxembourg.

Article 97(1) of the LIR defines the items of income from capital that are taxable for resident individuals. The parts that set out the taxation of non-residents are translated as follows:

> 1. Dividends, profit shares and other benefits allocated, in whatever form, in respect of shares, members' interests, profit-sharing interests or any other interest in a corporate entity mentioned in articles 159 and 160 of the LIR.

2. Information on other income sources may also be exchanged with the tax authorities of an individual's state of residence on the basis of the EU Mutual Assistance Directive (2011): Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, EU Law IBFD (which covers employment income, directors' fees, income from life insurance products, pensions and real estate income but may be extended to include dividends, capital gains, all other forms of financial income and account balances, if they are paid, secured or held by a financial institution for the direct or indirect benefit of a beneficial owner who is a natural person resident in another Member State). Payments to corporate beneficial owners are currently outside the scope of the exchange of information. However, initiatives for extended information exchange are being discussed both at EU and OECD level.

2. The profit share received in respect of the funds introduced into a business defined by article 14 of the LIR by a "silent partner" [*bailleur de fonds*] who is rewarded in proportion to the profit of the enterprise.
3. The interest and any other income whatsoever arising on bonds and other equivalent securities, including any profit share and redemption premium.

There are therefore three subclasses of income to consider, all of which require a certain degree of explanation.

3.2.1.1. "Dividends, profit shares and other benefits to shareholders"

Article 97(1)(1) of the LIR above implies that all advantages or amounts paid to shareholders are subject to taxation. Indeed, the notes to clause (1) mention that the definition also includes "hidden profit distributions", and this is the legal basis for the application of dividend withholding tax to such items (*see* section 2.3.2.3.). From the wording used above and the discussion in that section, it will be appreciated that the scope of this section is very wide. Great care should thus be taken when considering transactions with shareholders.

Article 97(3) of the LIR sets out the exceptions to this rule:

> The following do not represent income from capital:
> (a) the shares allocated by a capital company entirely or partly free, as well as any related allocation or subscription rights, when the issue of the said shares gives rise to a corresponding reduction in the size of the shareholding represented by the old shares of the person benefiting from the issue;
> (b) amounts distributed in a capital reduction consisting of capital contributed by the shareholders, with that part of the share capital which may have arisen from the capitalization of reserves [i.e. any amounts that have not been contributed] ... being considered as distributed first; such distributions will however remain taxable if the reduction of capital was not motivated by genuine economic reasons;
> (c) the reimbursement of payments made to a cooperative in the absence of profits or distributable reserves;
> (d) the amounts allocated on the division of the net assets [i.e. liquidation-type operations], as defined in article 101;
> (e) [the amounts distributed which relate to the reduction of capital and the reserves upon the repurchase of shares by a pension scheme.]

In effect, bonus issues, or the capitalization of reserves, will not normally be deemed to give rise to dividend-type income, as confirmed also by an internal instruction (*note de service*) by the Director of the Direct Tax Authorities to the team of tax inspectors.[3]

In addition, a reduction of capital will only be considered as a dividend distribution if genuine reasons for the reduction do not exist, or to the extent that the capital reduction includes capital created by capitalizing reserves and not by contributions from the shareholders. If other distributable reserves exist, the tax administration is likely to consider that there are no economic reasons for the capital reduction to the extent of these distributable reserves. Therefore, whatever legal form is given to the transaction, for tax purposes these reserves are considered distributed first. This typically relates to retained earnings and does not include the profits of the current year, as these profits could still be reduced by losses and expenses and are therefore not final. As a result, where a company has no positive retained earnings but would have an interim profit at the time of the capital reduction, the interim profit would not be considered as distributed (provided there are genuine economic reasons for the capital reduction in general).

In the absence of genuine economic reasons, the amount of the dividend would not be capped at the amount of distributable reserves; the entire amount of the capital reduction might be considered as a dividend distribution. It is therefore crucial that genuine economic reasons exist.

Even if there are genuine economic reasons for a capital reduction, it is advisable that the tax administration be consulted before the transaction is carried out. The administration will often be prepared to agree in advance whether or not a transaction can be deemed to be carried out for genuine economic reasons. If agreement cannot be reached, the form of the transaction can be altered, or the operation can be cancelled. Note that over-capitalization is often accepted as being sufficient economic justification for a reduction of capital not being treated as a dividend (and, therefore, a reason for not creating taxable income in Luxembourg for non-resident shareholders).

Funds received on the dissolution or liquidation of a company have similarities with both dividends and capital gains. For these purposes they are assimilated to capital gains and are exempt under (d) above (*see* section 3.2.3.3. for more details).

3. Internal Instruction LIR/NS no. 113 of 3 October 1985.

Distributions by both the corporate-type (*la société d'épargne-pension à capital variable,* SEPCAV) and the mutual-type (*l'association d'épargne-pension*, ASSEP) pension scheme upon the repurchase of shares are specifically exempt from taxation as dividends. For more on this subject, *see* section 7.8.

3.2.1.2. The "silent partner"

The concept of "silent partner" (*bailleur de fonds*) comes from the German legal concept of the *stiller Gesellschafter*. It is a hybrid between profit-participating loan, a partnership profit share and capital upon which dividends are paid.

The distinguishing feature of a silent partnership is that while the silent partner appears to third parties as a simple creditor, an "internal" (silent, non-disclosed) partnership is created between the entrepreneur and the silent partner. The silent partner assumes entrepreneurial initiative and is given partnership rights that are usually comparable to those of a limited partner in a limited partnership.

There are two broad types of arrangements. A "typical" silent partner (*typisch stiller Gesellschafter*) invests funds in the business and is entitled to a share in the profits of the business. The payments to a "typical" silent partner are a deductible expense for the entrepreneur. Contrary to most types of interest, however, these payments are in principle subject to withholding tax.

An "atypical" silent partner (*atypisch stiller Gesellschafter*) will receive remuneration based on the entrepreneur's profits and will, in addition, participate in value increase of the assets, hidden reserves and/or a possible goodwill, e.g. by participating in the liquidation profit. It is very much as if the entrepreneur and his silent partner were co-entrepreneurs. The entrepreneur is taxed on his own profit share, and the silent partner on his (which is not an expense of the entrepreneur). Note that, although the word "partner" is used, the enterprise in which the funds are invested can be a capital company. For more details on the tax treatment of the silent partnership as such, *see* section 4.3.1.

Only the income paid to a "typical" silent partner is covered by article 97(2) of the LIR. As a result, the profit share paid to a non-resident "typical" silent partner is considered as income from capital, whereas the non-resident "atypical" silent partner is taxed on his profit share as if it were

business profits. The withholding tax levied on the remuneration paid to the silent partner represents the final taxation of the income in Luxembourg.

The concept of silent partnerships is not known in many countries. Silent partnerships are specifically mentioned in a number of Luxembourg tax treaties (including, for example, the Germany-Luxembourg Income and Capital Tax Treaty (2012) and the France-Luxembourg Income and Capital Tax Treaty (1958) (as amended through 2009)). The treaties that specifically mention silent partnerships typically include payments of this type in the definition of dividends.[4] By contrast, the Austria-Luxembourg Income and Capital Tax Treaty (1962) with specifically excludes payments under such an arrangement from the definition of dividends and interest for treaty purposes and covers silent partnerships under the business profits article.

The treatment of the income in the country of residence of the silent partner is important and, due to the hybrid nature of the income, is difficult to predict. There is the risk of it being treated as interest income, which would imply that it would be taxed. It could however be treated as a sort of dividend income, which could be tax exempt. Alternatively, a foreign tax administration's treatment of this income as business income arising in Luxembourg may also lead to it being exempt from tax in the other country.

The concept may as well be used in the opposite way, i.e. where a Luxembourg resident silent partner invests in a foreign jurisdiction. The wording of the silent partnership agreement may lead to the tax deductibility of payments to the Luxembourg silent partner in the foreign jurisdiction, with no matching taxable income for the Luxembourg partner, if the silent partnership is an atypical silent partnership (i.e. a co-entrepreneurship) and the tax treaty with the foreign jurisdiction provides for the exemption of income from a PE.[5] Similar concepts to the silent partnership exist in a limited number of other jurisdictions, for example, in Italy (AiP), Spain (CCP) and Japan (TK).

3.2.1.3. Bond interest

Article 97(1)(3) of the LIR could lead one incorrectly to consider that bond interest paid to non-residents could be taxable in Luxembourg.

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4. *See* appendix VI.
5. No exemption would generally apply if the tax treaty contains a clause similar to article 23 A(4) of the *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.

Fortunately, article 156 of the LIR states that income falling under article 97(1)(3) of the LIR is only taxable for non-residents when the security holder could receive a payment which is profit related. As long as the securities in question are not profit participating, and the interest is paid at a market rate, there is no risk of it being taxable in Luxembourg.

The above section only applies to bonds and other similar securities. If there is no security, there should be no taxation in Luxembourg. Thus, profit-participating debt with a basic rate of interest, but without an underlying security, is a financing instrument that can be used in Luxembourg without incurring withholding tax. Tax treaties usually specifically refer to profit-participating debt, in line with the OECD Model (2010), which includes "income from debt-claims of every kind ... whether or not carrying a right to participate in the debtor's profits" in the definition of interest. However, quite a number of Luxembourg tax treaties explicitly include such payments in the definition of dividends (*see* appendix VI). Many of Luxembourg's tax treaties provide for an exemption from withholding tax on interest. It is, therefore, possible that even interest on profit-sharing bonds can escape taxation in Luxembourg; however, the interest may not be tax deductible – *see* section 2.3.2.2.

3.2.2. The method of taxation

3.2.2.1. The basis of liability to withholding tax

For non-residents receiving dividends and other income taxable under section 3.2.1., the taxation method applied is that of a final withholding tax, as is to be expected in a classical jurisdiction.

The income types mentioned are all taxed as "income from capital" and are subject to withholding tax according to article 146 of the LIR. Paragraph 1 states that: "The following items of indigenous income are subject to withholding tax: ..."

The items in section 3.2.1. are then listed once again. This seeming duplication is necessary because withholding tax must be applied to payments made to Luxembourg residents, as well as to non-residents. For non-residents this withholding tax is, as mentioned, a final taxation.[6] For residents it is only a payment on account and further amounts may be due following

6. Art. 152(17) LIR.

the submission of their tax return. Until 2015, withholding tax could be refunded if the final tax liability was less than the withholding tax levied. This changed with effect from 1 January 2015 since when withholding tax on income from capital cannot be refunded to residents. This is in response to the European Commission pointing out that the previous rule made an unjustified distinction between non-residents and residents. This therefore represents a sort of minimum tax, with the only exception being withholding tax charged in relation to income which then qualifies for the participation exemption (*see* section 3.2.3.1.).

Article 146 of the LIR closes as follows:

> (2) The income subject to withholding tax also includes special allowances and advantages allowed as well as, or in place of, the amounts specified in paragraph 1.
>
> (3) The income mentioned above is considered as domestic when the payer is the State of Luxembourg, a municipality, a Luxembourg public establishment, a company which has its registered office or central administration in Luxembourg, or a physical person resident in Luxembourg.

Therefore, if the income falls into the categories covered by article 146(1) of the LIR and is paid by one of the entities in article 146(3), it is subject to withholding tax. Due to the wide definition of "domestic" in article 146(3) of the LIR, any dividend income distributed by the entities mentioned is subject to withholding tax, even if the profits from which the dividend is paid may not be "domestic". For example, they may have arisen when a company had its registered office in another country, and subsequently migrated to Luxembourg. The reserves of the previous periods can be considered as capital. Capital reductions require "genuine economic reasons" (*see* section 3.2.1.1.) and, therefore, dividends paid after the transfer of the registered office to Luxembourg could still be subject to withholding tax even if the company is clearly paying the dividend from reserves generated before it became Luxembourg resident (which would, for example, be the case if the results since the move to Luxembourg have always been losses). However, where there are "genuine economic reasons" the payment should be considered as a withholding tax-free repayment of capital (as defined for tax purposes).

Other exceptions from withholding tax, or ways of reducing its effect, are dealt with in sections 3.2.3. to 3.2.5.

3.2.2.2. The rate of withholding tax

The rate of withholding tax is 15% of the gross amount received (or 17.65% of the net amount).[7] No deduction is allowed for expenses. Fifteen per cent is also the withholding tax rate for small shareholdings found in most of Luxembourg's tax treaties, so non-resident shareholders with small participations in fully taxable Luxembourg companies are seldom in the position of having to make a claim under a tax treaty for the reimbursement of withholding tax.

3.2.2.3. The mechanics of withholding tax in Luxembourg

Withholding tax must be withheld by the payer, for the account of the beneficiary of the dividend.[8] The payer is personally responsible for the payment of the tax that he has, or should have, withheld. A liability should only arise for the beneficiary if the withholding is not properly operated, or if he is aware that it has not been paid by the distributing company within the given deadline (*see* below) and that the recipient has not immediately informed the tax administration.

Withholding tax should be paid, and the appropriate form deposited with the tax administration, within 8 days of the funds being "made available" to the shareholders. The date when the funds are deemed to be "made available" is therefore most important. When the payment of the dividend is dependent upon the decision of an organ of the company, be it the annual general meeting or the board of directors (for interim dividends), the funds are considered to be made available on the day following the decision, unless another date is fixed by that organ, in which case this other date will apply.

This is consistent with the fact that the shareholder will have a legal claim on the company for his dividend, and will have the right to demand payment, from the date of the decision, unless it is expressly stated that the funds will not be paid until a later date.

It is sometimes wrongly assumed that the actual date of payment of the dividend is the date from which the 8-day period begins. The system would be open to abuse, were a shareholder able to decide when the income should be taxable, which would be the case if the date of taxation were the date of receipt. It must be the payer's decision that counts.

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7. Art. 148 LIR.
8. Art. 149(1) LIR.

In situations where a shareholder can affect the decision of the payer, in practice he is able to decide on the date on which the withholding tax is due (and possibly when the dividend will fall to be taxable in his own country). In such cases, to achieve the desired end, it is essential that the fact that the payment is to be on a specific date later than the annual general meeting, or is to be determined later by the board of directors, is clearly mentioned in the minutes of the annual general meeting.

3.2.3. Exemptions from withholding tax under Luxembourg law

The main exemptions from dividend withholding tax under Luxembourg law are given in article 147 of the LIR. The main items of interest in an international tax context are the following:

(2) When income defined in article 97(1), number 1 of the LIR is paid by a fully taxable resident collective entity that has one of the forms listed in the appendix to article 166(10) or by a fully taxable resident capital company not listed in the annex to article 166(10) to:

- a) another collective entity covered by article 2 of the [Parent-Subsidiary] Directive,
- b) a fully taxable resident capital company not listed in the appendix to article 166(10),
- c) the State, ...
- d) a permanent establishment of a collective entity covered by letters a, b or c,
- e) a collective entity fully subject to a tax comparable to Luxembourg corporate income tax and a resident of a country with which Luxembourg has concluded a tax treaty, as well as a Luxembourg permanent establishment,
- f) a capital company resident in Switzerland subject to corporate income tax in Switzerland without benefiting from an exemption,
- g) a capital company or a cooperative society resident in a member state of the European Economic Area (EEA), other than a Member State of the European Union, that is fully subject to a tax comparable to Luxembourg corporate income tax,
- h) the permanent establishment of a capital company or cooperative society that is a resident of a member state of the European Economic Area (EEA), other than a Member State of the European Union,

and at the date the income is made available the beneficiary holds, or commits himself to hold, under the conditions listed in article 149(4) of the LIR, directly for an uninterrupted period of at least 12 months, a participation in the distributing company of at least 10% or with an acquisition price of at least EUR 1.2 million. Holding a participation through one of

the entities mentioned at article 175(1) of the LIR (partnerships) is considered as a direct holding in proportion to the fraction of the net assets of this entity held.

(3) When the amounts are paid by ..., by a private wealth management company (SPF) or by a Luxembourg collective investment fund, including a venture capital company (SICAR), irrespective of the taxation of the income in the hands of Luxembourg resident beneficiaries.

Article 147 refers to article 166, which provides for an exemption of dividends and liquidation proceeds received from certain companies. The rule is usually referred to as the "participation exemption". For more details and conditions, *see* chapter 6. The annex to article 166(10) of the LIR is essentially a copy of the appendix to article 2 of the Parent-Subsidiary Directive (2011/96/EU).

3.2.3.1. Distributions made by taxable Luxembourg companies

In brief, the exemption from withholding tax applies where a Luxembourg company pays a dividend to a qualifying shareholder who has held, or is committed to hold, a sufficiently large participation for 12 months. The legislation takes into consideration the decision in *Denkavit Internationaal BV* (Case C-283/94)[9] and does not require that the holding period be met at the time when the distribution is made. The holding period of article 147(2) of the LIR is the same as that for the participation exemption for dividends received, which is explained in detail at chapter 8 (in particular section 8.2.).

The list of qualifying shareholders has been extended over the past years and the scope of the exemption is now considerably larger than the scope of the Parent-Subsidiary Directive (2011/96/EU). This, and the fact that Luxembourg branches of EU and EEA companies as well as branches of companies resident in a state which has a tax treaty with Luxembourg can benefit in the same way, should help reduce, or avoid, discrimination claims under either EU law[10] or the non-discrimination article of a tax treaty. It can, however, also give rise to structuring opportunities (*see* section 3.2.5.).

9. DE: ECJ, 17 Oct. 1996, Case C-283/94, *Denkavit Internationaal BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen*, ECJ Case Law IBFD.
10. EU Treaty on the Functioning of the European Union (TFEU) and EU Treaty (as amended through 2007) – Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (2008/C115/01), EU Law IBFD.

Whilst there are a number of similarities of the conditions for the withholding tax exemption to those for the participation exemption, there are several areas that may be of particular importance to withholding tax.

(a) Qualifying shareholders

The withholding tax exemption originally covered dividend payments to Luxembourg resident capital companies and EU resident companies covered by the Parent-Subsidiary Directive (2011/96/EU) (including their branches). To comply with the treaty establishing the EEA,[11] capital companies and cooperatives resident in member states of the EEA other than the European Union (i.e. currently Iceland, Liechtenstein and Norway) also qualify for the exemption if they are "fully subject to a tax comparable with Luxembourg corporate income tax". The same "subject-to-tax" test applies to companies resident in treaty countries, and this test is the same as the one that applies for the participation exemption and is explained in more detail in section 6.2.3.3.

It is interesting to note that no subject-to-tax test applies to EEA companies if the dividend payment is made to the branch of an EEA company. The subject-to-tax test does however apply to a treaty company with a Luxembourg PE.

Swiss companies do not need to meet this subject-to-tax test but only need to be subject to the Swiss federal corporate income tax. This rule is an implementation of the bilateral agreement that Switzerland concluded with the European Union.[12] The bilateral agreement did not result in a significant change for Luxembourg withholding tax as a withholding tax exemption is also foreseen in the Luxembourg-Switzerland Income and Capital Tax Treaty (1993), but with somewhat different conditions (*see* section 3.2.4.1.).

Most Luxembourg resident shareholders would fall within the scope of "collective undertakings covered by article 2 of the Parent-Subsidiary

11. European Union – Iceland – Liechtenstein – Norway Agreement on the European Economic Area (1992): Agreement on the European Economic Area between the European Communities, their Member States and the Republic of Austria, the Republic of Finland, the Republic of Iceland, the Principality of Liechtenstein, the Kingdom of Norway, the Kingdom of Sweden and the Swiss Confederation, OJ L001 (3 Jan. 1994), p. 3, EU Law IBFD; and EFTA states' official gazettes.
12. Council Decision (2004/911/EC) of 2 June 2004 on the signing and conclusion of the Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments and the accompanying Memorandum of Understanding, OJ L385 (29 Dec. 2004), p. 28.

Directive". However, an entity constituted under the laws of a non-EU jurisdiction but which is tax resident in Luxembourg would not be able to benefit from the exemption under the Directive. A foreign company that transfers its central administration to Luxembourg needs to assume one of the Luxembourg company forms and fulfil the conditions for that form of company. However, if the entity takes the form of an Sàrl, it is not necessary to add "Sàrl" to its name. To ensure these companies are also able to benefit from the withholding tax exemption, alternative "b" was introduced into article 147 of the LIR, which only requires that the company is not exempt from Luxembourg corporate income tax.

(b) Proving the holding period

The legislation does not actually prescribe a method for proving that the required level of shareholding is held for the required 12-month period. One method used is to prepare a certificate in the name of the parent requesting the exemption. This certificate is signed by the parent company and sent to its own tax administration, which is requested to certify the tax residency of the parent company in its jurisdiction, as well as the accuracy of the certificate as far as it is aware. The actual wording of the certificate is a matter of choice but the wording is best verified up front with the relevant Luxembourg tax office.

(c) Dividends paid when the holding period conditions are not yet satisfied

It is possible to satisfy the holding period condition for both the exemption from withholding tax and the participation exemption for dividends received (article 166 of the LIR) by committing to hold the participation for a 12-month period. (For the dividends-received participation exemption the situation is considered at section 6.2.5.2.)

The problem for withholding tax is that if the tax is withheld and subsequently refunded, the group's cash flow may suffer as it will not be able to use the funds in the meantime. On the other hand, if the holding period is not ultimately satisfied then the tax administration's cash inflow will be delayed and it may even risk not collecting the tax at all.

Article 149(4) of the LIR mentions that a grand-ducal regulation will set out the forms of guarantee to apply when the 12-month holding period is not yet satisfied, but where the shareholder commits himself to hold the shares for the required period. However, so far no public statement has been issued in this respect.

A further grand-ducal regulation[13] explains that it is still necessary to complete a withholding tax return and to forward this to the tax administration, even if all the dividends are exempt. It confirms that any tax which proves to be excessive is to be refunded, but does not, however, give any guidance as to the procedure to apply when the holding period is not satisfied at the moment when the dividends are paid.

In some instances a practical solution can be arranged with the relevant tax office: one method sometimes used is for the shareholder's board of managers to resolve on holding the shares at least until the holding period has been met and to enclose a copy of the meeting minutes with the withholding tax return.

(d) Achieving the cost threshold

The fact that the exemption applies to participations that cost at least EUR 1.2 million – as an alternative to the condition of a participation of at least 10% – is interesting and is one of which some foreign investors may not be fully aware.

On a practical point, many Luxembourg companies may simply not be aware how much their shareholders paid for their shares. This is particularly the case as the term "cost" includes fees and amounts paid for options and may differ significantly from the share in a company's share capital (and share premium).

It is thus not unlikely that tax may be withheld in certain instances when the Luxembourg company was not aware or did not have proof of the shareholder holding a sufficiently large participation. A company concerned might be suffering 15% withholding tax when it should in fact be suffering no withholding tax at all. In some cases, it would be worthwhile reviewing whether there is scope for exemption that has not yet been identified.

3.2.3.2. Amounts distributed by SPFs, Luxembourg investment funds and SICARs

As is stated in article 156(6) of the LIR, non-residents are not subject to taxation on revenue that is exempt from withholding tax either on the basis of article 147 of the LIR or another legal provision. Other than the situations explained in section 3.2.3.1., this essentially covers dividend distributions

13. Grand-Ducal Regulation of 18 December 1998 concerning article 151 of the LIR.

by SPFs (*see* section 16.1.), investment funds (*see* chapter 14) and corporate SICARs (*see* section 17.3.). Dividends distributed by these entities are all exempt from withholding tax on the basis of article 147(3) of the LIR.

Dividends received by Luxembourg residents from SPFs, investment funds and SICARs are still, however, taxable and should be declared on their tax returns.

3.2.3.3. Liquidation

In many jurisdictions, funds received upon the liquidation of a company are considered to resemble a capital gain and not dividend income. On the question of withholding tax, Luxembourg is no exception. The taxation of capital gains as it may affect non-residents is discussed in section 3.4.

The funds received on the division of the net assets of a company are taxed as capital gains following article 101 of the LIR, which states in article 101(2) that:

> ... the net assets of the company are considered to be divided up on the dissolution [which includes liquidation], transformation, merger, absorption or division [demerger] of the company, or if the company adopts the status of a tax-exempt company. Tax-exempt company means all companies which are not subject to a tax which corresponds to Luxembourg's corporate income tax. In the case of a repurchase of own shares which results in a reduction of capital, the net assets are considered to be divided up in proportion to the fraction corresponding to the shareholding [repurchased].

The operations mentioned above, not being considered as dividend distributions for the purposes of article 97 of the LIR, are therefore not covered by article 146 of the LIR, and are thus not subject to withholding tax. The exemption arising on the repurchase of own shares can give rise to a structuring option which is often referred to as a "partial liquidation". This refers to the situation where a Luxembourg company repurchases all its shares held by a particular shareholder, or an entire class of shares, and cancels them, thereby reducing its capital. The gain made by the shareholder is considered a capital gain and not a dividend. As capital gains made by non-residents are only taxable in certain circumstances (*see* section 3.4.) and are often protected under a tax treaty, this may be preferable to an ordinary dividend distribution (depending on the taxation in the recipient's state of residence).

3.2.4. The effect of tax treaties

It is possible to reduce the rate of withholding tax by applying Luxembourg's tax treaties, the number of which has increased rapidly in recent years. A list of the different rates of withholding tax applicable according to Luxembourg's existing tax treaties is included in appendix IV.

As well as different rates of tax, many different ways exist through which refunds, or direct application of the reduced rates of withholding tax, can be achieved. For some treaties there is no prescribed procedure, whilst for others there are strict guidelines on how to recover excess tax, or setting out what is required to enable the distributing company to apply the reduced tax directly, including mention of which forms need to be completed. It is not intended to consider such items in great detail in this work. There are, however, some points that merit more detailed consideration.

3.2.4.1. Exemption from withholding tax under Luxembourg's tax treaties

Historically, Luxembourg's tax treaties have not exempted dividends from withholding tax completely; rather they have tended to limit the extent to which withholding tax can be applied by the country in which the distributing company is a tax resident. There are, however, several exceptions to this principle amongst Luxembourg's tax treaties. Since the domestic withholding tax exemption has been extended to apply to shareholders resident in treaty countries, the importance of the treaty exemptions has reduced significantly though. In most cases the domestic exemption is more generous than the treaty exemption; however, in some cases the treaty exemption may still be more favourable (and they would become more relevant again if Luxembourg's domestic law were to be changed).

The first Luxembourg tax treaty to include the possibility of a complete exemption from dividend withholding tax was the Luxembourg-Switzerland Income and Capital Tax Treaty (1993). If a Swiss company has held shares representing at least 25% of the capital of a Luxembourg company for an uninterrupted period of 2 years before the date of payment of the dividends, no withholding tax is applied. (Otherwise the rate for such holdings is 5%.) No particular conditions apply and there is a reciprocal benefit available to Luxembourg companies investing in Switzerland.

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