

Luxembourg Releases its 2017 Tax Reform

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I. Introduction

On 26 July 2016, the draft law on the 2017 tax reform (the "Draft Law") was presented to the Luxembourg Parliament. The Draft Law provides for a variety of tax measures that concern the tax treatment of both corporate taxpayers and individuals which should enter into force as from 1 January 2017 (with few exceptions).

The measures included in the Draft Law are broadly in line with the announcements made by the Luxembourg Government in February and April this year albeit some measures evolved over time. In particular, the limitation on the carry-forward of tax losses is less restrictive than previously announced. While it cannot be excluded that the one or the other measure may still evolve over the course of the legislative process, the tax reform as it stands should be fairly final.

This article provides a clear and concise overview of the 2017 tax reform and assesses its impact on the competitiveness of Luxembourg.

II. Changes relating to corporate taxpayers

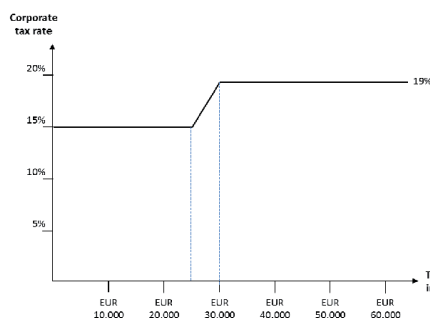
1. A two-step decrease of the corporate income tax rate

The Corporate Income Tax ("CIT") rate applicable to income exceeding EUR 30,000 will be reduced from 21% to 19% in 2017 and to 18% in 2018. Taking the Municipal Business Tax ("MBT") and the solidarity surcharge into account, it will bring the global corporate tax rate applicable to companies in Luxembourg-city from currently 29.22% down to 27.08% in 2017 and 26.01% in 2018.

The CIT rates applicable to income up to EUR 30,000 will also be amended and vary between 15% and, respectively, 19% (in 2017) and 18% (in 2018). The following table summarizes the new CIT rates:

| Tax year | Taxable Income | CIT due |
|----------|-------------------------|---|
| 2017 | ≤ EUR 25,000 | 15% |
| | EUR 25,000 - EUR 30,000 | EUR 3,750 (i.e. 15% of EUR 25,000) + 39% of the income exceeding EUR 25,000 |
| | > EUR 30,000 | 19% |
| 2018 | ≤ EUR 25,000 | 15% |
| | EUR 25,000 - EUR 30,000 | EUR 3,750 (i.e. 15% of EUR 25,000) + 33% of the income exceeding EUR 25,000 |
| | > EUR 30,000 | 18% |

The following chart reflects the corporate income tax rate applicable in 2017:

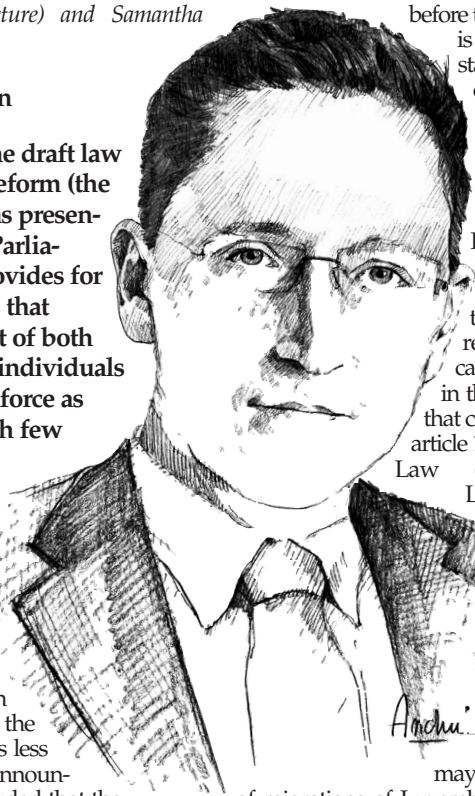


2. Minimum NWT increased

The minimum Net Wealth Tax ("NWT") applicable to SOPARFIs currently amounts to EUR 3,210 and will be increased to EUR 4,815 as of 2017. Notably, minimum NWT will only be due to the extent the CIT liability of a SOPARFI is below the amount of EUR 4,815. Since 2016, the minimum NWT is a final cost to taxpayers and not creditable against future NWT liabilities. Therefore, the increase in minimum NWT increases the costs of doing business in Luxembourg which is detrimental for the competitiveness of Luxembourg as a prime holding location. In addition, US multinationals with subsidiaries in Luxembourg cannot credit (minimum) NWT against their US corporate income tax liability.

3. Amendments to the rules governing the NWT reduction

According to §8a of the NWT Law, Luxembourg companies can, upon request, benefit from a reduction of their NWT liability up to an amount corresponding to the CIT due for the preceding year. In order to benefit from this reduction, a so-called "NWT reserve" has to be recorded by the company and kept during five tax years. Amendments have been introduced by the Draft Law in order to clarify the consequences in regard to the NWT reduction in cases where a company is dissolved



before the five-year requirement is fulfilled. In these circumstances, the NWT of the dissolved company is in principle increased in the tax year during which the liquidation of the Company is closed.

However, according to the Draft Law, the NWT will not be increased (i.e. the NWT reduction remains unchanged) in case assets are transferred in the frame of a transaction that comes within the scope of article 170 (1) of the Income Tax Law ("ITL") to another Luxembourg company. Hence, in case of corporate reorganizations such as mergers and demergers, the NWT reduction may remain unchanged.

Moreover, the NWT reduction may remain available in case of migrations of Luxembourg companies abroad (article 172 (1) ITL). However, this option is subject to the condition that either the migrated company (in the financial statements of a Luxembourg permanent establishment) or the company to which the assets have been transferred maintain the NWT reserve until the five-year period has elapsed.

4. Limitation to the carry forward of tax losses
While tax losses generated until 2016 will remain tax deductible without any limitation, the carry forward of tax losses generated as from 2017 will be limited to 17 years. As regards the order of use of tax losses, the losses that have been incurred first, should be used first. This new limitation applies for both CIT and MBT purposes. Importantly, the limitation of the amount of losses to a percentage of the taxable income which has been proposed initially (i.e. first the use of losses was intended to be limited to 80% and thereafter to 75%) has been dropped. This is positive as this measure had the potential to create significant collateral damage.

5. Abolishment of the 0.24% registration duty
As from 2017, notarial deeds including assignment of receivables will no longer be subject to the 0.24% registration duty.

6. Improvement of the investment tax credit regime

In order to stimulate investments and notably investments in innovation, the investment tax credit regime will be improved: the tax credit for additional investments will be increased from the current 12% to 13% and the tax credit for global investments will be increased from 7% to 8%. Regarding assets which can benefit from the special depreciation, the tax credit will be increased from 8% to 9%.

In addition, the Draft Law provides that the investment tax credit will be extended to investments in assets which are physically used in a European Economic Area Member State, meaning that it is no longer limited to assets physically used in Luxembourg. This amendment is a formalisation of the current practice applied by the Luxembourg tax authorities (see Circular 152bis/3 of 31 March 2011) since the Tankreederei case law of the EU Court of Justice.

7. Neutralisation of exchange gains extended to all companies

According to Article 54bis ITL, foreign exchange gains in EURO arising from the disposal of certain assets denominated in the (non-EUR) currency of the share capital of an entity can be transferred/rolled-over to other assets denominated in the same currency.

This regime of temporary neutralisation of foreign exchange gains is currently only available to banks, insurance companies and reinsurance companies. However, as from 2016 this regime will be available to all Luxembourg resident companies.

Companies that want to benefit from the neutralisation of foreign exchange gains will be required to file a request with the Luxembourg tax authorities. Such request has to be filed at the latest 3 months before the end of the first fiscal year in respect of which the taxpayer wishes to benefit from the tax neutralisation. As far as the fiscal year 2016 is concerned, a specific deadline will apply according to which the request can be filed until 30 June 2017.

8. Tax credit for hiring unemployed persons extended

The tax credit for hiring unemployed persons will be extended until 31 December 2019.

9. Tax compliance - Electronic filing will become mandatory

The filing of electronic tax returns by companies will become mandatory.

III. Changes relating to individual taxpayers

1. Final withholding tax on interest to be increased from 10 to 20%

The final withholding tax levied on savings income of Luxembourg residents ("RELIBI") will be increased from the current rate of 10% to 20% as from 2017.

2. Temporary budget balancing tax to be abolished

The temporary budget balancing tax of 0.5% ("impôt d'équilibrage temporaire") which is currently levied on the monthly gross professional income will be abolished in 2017.

3. Tax scales/tax brackets

The Draft Law further foresees the introduction of two new tax brackets as from 2017. A new 41% tax bracket will be introduced for taxable income between EUR 150,000 and EUR 200,004 and a new 42% tax bracket will apply to income exceeding EUR 200,004. Thus, the top tax rate including a surcharge of 9% for the employment fund will amount to 45.78%. Currently, the tax rate applicable to the highest tax bracket is 40% resulting in a top tax rate of 43.6% (including the 9% surcharge for the unemployment fund). The amount of income that will not be subject to taxation will be increased to EUR 11,265.

4. Separate taxation for married couples as from tax year 2018

As from the fiscal year 2018, married couples will be able to opt whether they would like to continue being taxed collectively in tax class 2 or whether they would like to be taxed separately. Today, married couples are taxed collectively without an option for separate taxation. However, depending on the facts and circumstances of a given case, it might be beneficial to opt for separate taxation.

5. Non-resident tax regime to be amended as of 2018

The tax regime of cross-border workers will be amended so as to make sure that they will be treated in a very similar way to Luxembourg residents for tax purposes. The objective is to make sure that cross-border workers can benefit from the same tax deductions and the same tax scales as Luxembourg residents.

6. Changes to tax credits

The rules on tax credit available to employees, pensioners and independent professionals will be amended. The amounts of tax credit will vary progressively between EUR 0 and EUR 600 depending on the level of income. As from an annual income of EUR 80,000, the tax credit will no longer be granted. Furthermore, some changes will be introduced to the single parent tax credit ("crédit d'impôt monoparental").

7. Benefit in kind in case of company cars

In order to encourage the use of low-polluting cars, the amount of benefit in kind to be taxed for the use of a company car (currently equal to 1.5% of the acquisition cost of the car) will become dependent upon the level of CO2 emissions of the car and will vary between 0.5 and 1.8%.

8. New tax deduction for eco-friendly vehicles introduced

A new tax deduction varying between EUR 300 and EUR 5,000 (depending on the type of vehicle) will be introduced for zero-emission cars and bikes (including e-bikes).

9. Increased tax deductions for contributions to pension schemes

Tax deductions for contributions to pension schemes ("assurance prévoyance-vieillesse") will be deductible up to an increased amount of EUR 3,200, irrespective of the age of the individual. As of today, the maximum deductible amount depends on the age of the individual who subscribes to the pension scheme.

10. Deduction of expenses for children

The maximum amount of deductible expenses for children who do not belong to the household of the tax payer will be increased from currently EUR 3,480 to EUR 4,020 per child and year.

11. Expenditures on domestic services

The maximum amount of tax deductible expenses for domestic services (costs for childcare, house-keeping, etc.) will be increased from currently EUR 3,600 to EUR 5,400 per year.

12. Measures to improve the access to housing

Several tax measures will be introduced which aim at improving access to housing. These measures include in particular increased tax deductions for contributions by individuals below 40 years to saving plans for housing from currently EUR 672 to EUR 1,344 (if certain conditions are met) and the increase of the maximum amount of tax deductible interest expenses on mortgage loans.

Another measure that has already been implemented by the law of 29 June 2016 is a temporary reduced taxation at 1/4 of the standard rate (compared to 1/2 of the standard rate) on long-term capital gains realized by individuals on the sale of real estate between 1 July 2016 and 31 December 2017.

13. Measures for family business

The taxation of capital gains on the transfer of a real estate or a land asset belonging to the business of an individual may be deferred if the business is transferred to the next generation of the same family or to a third party which takes over the business and uses the real estate to carry on the business.

14. Lunch vouchers

The value of lunch vouchers will increase from EUR 8.40 to EUR 10.80.

IV. Other measures

1. Tax crime to become a primary offense on AML/KYC matters

In order to comply with the requirements resulting from the revised FATF standard 2012/2013 and the Directive (EU) 2015/849 on the prevention of the use of the financial system for money laundering or terrorist financing, specific measures have been introduced. The Draft Law introduces an additional tax offense with the notion of aggravated tax fraud. Consequently, three forms of tax fraud, namely simple tax fraud, aggravated tax fraud and tax swindling ("escroquerie fiscale") will co-exist. Simple tax fraud will be prosecuted and subject to administrative sanctions by the competent tax authorities while the other two forms of fraud, i.e. aggravated tax fraud and tax swindling will be criminally prosecuted. In addition, it has been proposed to extend the offense of money laundering to criminal tax offenses, which means to aggravated tax fraud and tax swindling.

Consequently, it is foreseen that these criminal tax offenses, in direct and indirect tax matters but also in inheritance tax matters, will be added as primary offenses in article 506-1 on the Criminal Code. In direct tax matters, the attempt to commit an offense will also be considered. Pursuant to the principle of non-retroactivity of the criminal law, the new article 506-1 of the Criminal Code will only apply to tax offenses committed after 1 January 2017.

2. Penalties to be increased

In order to strengthen the coercive power of the Luxembourg tax authorities, the maximum amount of fine will be increased from currently EUR 1,239.47 to up to EUR 25,000.

V. Conclusions

The proposed changes to the Luxembourg corporate tax system are a mix of positive and negative measures. While the decrease of the corporate tax rate is as such positive, a decrease to an overall tax rate of circa 26% in 2018 will not be sufficient to reinforce the competitiveness of Luxembourg. Other European countries which are competing with Luxembourg for foreign investments have already significantly lower tax rates.

The most prominent examples include:

| | |
|-----------------|--|
| Malta: | 10% (effective tax rate after tax refund to the shareholder) |
| Cyprus: | 12.5% |
| Ireland: | 12.5% |
| United Kingdom: | 20% (to be decreased below 15%) |
| Switzerland: | between 12% and 18% |

The increase of the minimum NWT is clearly a negative feature of the tax reform which gives a wrong signal to international investors. Combined with the changes to the Luxembourg income tax law applicable to individuals (which would further increase taxes on higher salaries), the 2017 tax reform has the potential to damage the competitiveness of Luxembourg, at a time, where highly qualified people are needed in order to create more substance in Luxembourg (to respond to requirements from an international tax perspective and to make Luxembourg set-ups fit for the post-BEPS era). Here, the Government certainly had in mind the fact that there will be new elections in 2017.

In addition, in 2019, Luxembourg will have to implement harsh tax measures in accordance with the EU Anti-Tax Avoidance Directive that has been adopted earlier this year by EU Member States (including, limitations on the deductibility of interest, controlled foreign company rules, anti-hybrid mismatch rules, etc.). The increased harmonization of corporate tax rules across Europe means that tax competition will, in the future, mainly rely on a competition with tax rates. In this regard, the Luxembourg Government should seriously consider a sharp decrease in the corporate tax rate that would allow the Grand-Duchy to compete with other jurisdictions.

With the right strategy, the current developments in the international tax arena may even be an opportunity for Luxembourg to reinforce its position as a location of choice. A formula for future growth should, however, rely on improving the tax environment with a view to attract more businesses and investments. This would create more activities, employment and, ultimately, tax revenues in Luxembourg.

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