Branch Reporters
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Summary and conclusions

The Luxembourg double taxation relief system is built around the dichotomy of the foreign tax credit (FTC) method and the exemption method on which tax treaties are based in line with the OECD model convention (MC). The domestic credit method applies on a country-per-country basis or a global basis. Both credit methods may be combined by the taxpayer each year. The exemption method applies with a positive or negative progression in order to determine the taxpayer's effective tax rate by taking into account tax exempt income or "exempt" losses.

Despite the interaction between domestic rules and treaty relief measures, especially in terms of the practicalities of computation, both systems are alternative grounds on the basis of which the taxpayer may claim double taxation relief with respect to foreign income. This is due to the exclusion from the benefit of the domestic relief system of any income derived from a country with which Luxembourg has concluded a tax treaty. FTC relief to permanent establishments (PEs) of non-residents derived from treaty countries is the only exception. This applies under certain limitations and is restricted to passive investment income.

The exclusion of treaty countries' income from the benefit of domestic double taxation relief, understandable and justifiable as it may be, shuts the door for taxpayers who fail to obtain satisfactory double taxation under a tax treaty. Luxembourg tax treaties, like the tax treaties of any other country, cannot eliminate juridical double taxation in all possible cases. Cases of double taxation resulting, for instance, from distortions between the residence state and the source state in terms of recognition, timing of recognition and classification of taxable income or classification of hybrid entities are examples of the limitations of tax treaties in remedying double taxation. In Luxembourg the taxpayer may be caught between the objective limitations of tax treaties to eliminate double taxation and the denial of domestic law to grant unilateral relief to income derived from a treaty country.

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The mutual agreement procedure is the remaining solution for the taxpayer. In practice, however, the Luxembourg tax authorities adopt a more pragmatic approach and accept examining cases of double taxation which are unrelieved under tax treaties and are willing to extend domestic relief to income derived from treaty countries, subject to the conditions required by the domestic tax credit legislation.

Technically, the credit method appears to be more complex to operate than the exemption method. Various computations must be made in order to determine net imputable income and maximum creditable foreign tax. For that purpose, a minimum of four baskets are required under the per-country method and five baskets under the global method. If the foreign income is derived from different countries, a basket will need to be set up for each country. If the taxpayer has foreign losses, it will have to keep track of the loss carryforward per basket for the computation of future tax credits. Another objective limitation of the Luxembourg credit system is that FTCs may not be offset against municipal business tax (which is a component of the aggregate income tax on business income) either under domestic law or under the vast majority of tax treaties. The main merit of the credit method, however, is the possibility for the taxpayer to offset foreign losses against its taxable income derived from domestic or foreign sources. The exemption method appears to be more favourable to the taxpayer as it is less cumbersome than the credit method and generally offers a full relief from foreign tax. It is also a better method as it favours a certain level of competitiveness of investors investing outside Luxembourg as they can take full advantage of the tax environment in which they invest without taking into consideration home/Luxembourg taxation. However, the drawack of the exemption method, for the taxpayer, is the impossibility of utilising foreign losses arising in connection with a PE situated in a treaty country whose income is exempt in Luxembourg against its other taxable income. This limitation raises doubts as to its compatibility with EU law. From the perspective of the tax authorities, the weakness of the exemption method is rather its vulnerability to abuse and tax avoidance.

To the reporters' knowledge no studies on the costs/benefits of the credit method versus the exemption method have been undertaken in Luxembourg in order to assess precisely the efficiency of each method in eliminating double taxation or in terms of their respective impact on the economic decision-making process of businesses operating in or through Luxembourg.

1. Introduction

Luxembourg taxes the worldwide income of its residents. Individuals are subject to tax at a progressive rate scale. Companies established in Luxembourg are (currently) subject to: (a) corporate income tax *per se* (CIT) which is levied at the rate of 21.84 per cent (including a 4 per cent surcharge for the Unemployment Fund) and municipal business tax (MBT) which applies at various rates depending on each municipality. In Luxembourg City, the MBT rate is 6.75 per cent, thereby bringing the aggregate corporate income tax rate to 28.59 per cent for 2010.

While CIT is levied on the worldwide income of taxpayers, MBT applies on a territorial basis. In addition, FTCs (under domestic law or a tax treaty) may be offset only against CIT. They may not be offset against MBT even if MBT applies to the foreign income for which a tax credit is claimed (unless, exceptionally, depending on the wording of the relevant tax treaty).

Under domestic law, double taxation of foreign income is relieved through the credit method. An ordinary tax credit is generally granted, subject to certain conditions, on a per-country or a global basis. Tax credit is available only to those items of income listed in the law, which covers virtually all types of income derived from foreign sources (articles 10 and 134*bis* of *Loi Concernant l'Impôt sur le Revenu* of 4 December 1967 (LIR)). Non-credited foreign tax may be deducted as an expense. No exemption applies under domestic law except for, and subject to certain conditions, profit distributions, capital gains derived in connection with shareholdings and certain intangible property (IP) income.

A specific domestic rule provides that the domestic credit system does not apply to income sourced in a treaty country. Exceptionally, domestic tax credit relief is granted to dividends and interest derived from treaty countries by Luxembourg PEs of non-residents.

Luxembourg tax treaties avoid double taxation through the exemption method. Exceptionally, double taxation of passive investment income[1] is avoided through the ordinary credit method. The separation between treaty and domestic relief rules does not mean that there is no interaction between them. Where the credit method is applied under a tax treaty, the actual computation of the income for which a tax credit is claimed as well as the amount of the tax credit is made pursuant to Luxembourg domestic rules. Where the exemption method applies under a tax treaty, the exempt income (or loss) may still be taken into account in order to compute the effective rate at which Luxembourg tax is levied on the resident's other taxable income derived from domestic or foreign sources.

The above double taxation relief systems have been applied consistently since the late 1970s and have thenceforth been amended but only on specific points. There are currently no plans by the government to overhaul or significantly amend the applicable rules.

2. Key factors of unrelieved double taxation

2.1. Diverging views on taxable income

2.1.1. Existence of income

Diverging views on the existence of income are not limited to the income itself; they include, among other things, the timing of income recognition. Income may be recognized in the source state at a later stage than in the residence state. This may lead to taxation in the residence state without any FTC.

1 Generally dividends, interest and royalties.

In Luxembourg, diverging views on the existence of income are mostly limited to transfer pricing issues and related aspects. Generally, Luxembourg will apply its transfer pricing rules independently from the source state (subject to, *inter alia*, the associated enterprises clause of the applicable treaty and/or the EU Arbitrage Convention).[2] For example, under Luxembourg transfer pricing principles,[3] non-arm's length benefits granted by a foreign subsidiary to its Luxembourg parent company (such as interest-free loans) are treated as constructive dividends, irrespective of whether the source state shares that view. Conversely, Luxembourg may not recognise a constructive dividend when the source state does. If such a dividend is subject to a local withholding tax, the FTC granted by Luxembourg will be limited to that item of income recognised in Luxembourg.[4]

More common are diverging views resulting from the timing of the recognition of taxable income.[5] For Luxembourg, these typically occur for investments held via hybrid entities. A taxpayer holding interests in a foreign partnership which is treated as tax transparent for Luxembourg tax purposes will be taxed in Luxembourg on the income as it accrues in the partnership irrespective of whether and when such income is distributed. If the source state considers the partnership as fiscally opaque, it may levy a withholding tax but only if and when distributions are made, whereas Luxembourg may already have taxed the income in an earlier tax year. Consequently, double taxation may occur.

2.1.2. Source of income

Diverging views between Luxembourg and another state on the source of taxable income may typically occur for investments or activities held via hybrid entities which are treated as tax transparent in Luxembourg and fiscally opaque in another state (or vice versa). Except with respect to entities that are covered by the EU Parent–Subsidiary Directive[6] and the EU Merger Directive[7] (which are always treated as opaque), Luxembourg applies specific entity classification rules to categorise foreign entities for Luxembourg tax purposes.[8] This means for example that if a corporate taxpayer holds immovable property situated in state A via an entity in state B and that entity is treated as transparent for Luxembourg tax purposes, the taxpayer will be considered to hold the immovable property directly. If Luxembourg has a tax treaty with state A, income and capital gains derived from the immovable property in state A will normally be exempt from Luxembourg income tax. In the absence of a treaty with state A, the taxpayer will be entitled to a credit for the tax paid on the income arising in state A against any Luxembourg CIT on that income. If state B considers the entity as opaque and levies a withholding tax on the profit distributed to the taxpayer, Luxembourg would not allow an FTC for

2 Convention 90/436/EEC, Official Journal L 225 of 20 August 1990, p. 10.
3 Transfer pricing rules are broadly laid down in different sections of the law, mainly in arts. 18, 56 and 164 LIR.
4 Unless the global method is applied; see section 3.
5 Certain types of income (such as interest) are recognised on an accrual basis rather than only when effectively received.
6 Directive 90/435/EC as amended.
7 Directive 90/434/EC as amended.
8 See section 2.6.1.

such withholding tax, despite a tax treaty with state B (which would only apply to income from state B). As a result of the transparency of the entity, Luxembourg may not recognise the distribution as income from state B and therefore not allow an FTC. In the absence of a treaty with state B, a credit may be available depending on whether the taxpayer applies the per-country or the global method under domestic law. If the per-country method is applied, taxes levied by state B on the profits distributed could only be credited against Luxembourg tax on other income from state B.

2.1.3. Nature or character of income

The risk of unrelieved double taxation would arise in Luxembourg if the taxpayer failed to obtain relief under a tax treaty, for example, due to different income classification between Luxembourg and the source state. Such a risk is amplified by a specific domestic rule which explicitly excludes income derived from a treaty country from the benefit of domestic double taxation relief legislation (unless exceptionally).[9]

Luxembourg's approach to double tax treaties' interpretation and application is threefold. Pursuant to an objective approach, as generally followed by courts, where the letter of a tax treaty is clear and comprehensive, it is applied literally.[10] Where treaty provisions are not sufficiently clear, Luxembourg interprets the treaty according to its general purpose and objective and its context. If a treaty is modelled along the same lines as the OECD MC, the commentaries are considered to have a high persuasive value as a supplementary means of interpretation. When dealing with tax treaties, Luxembourg courts often refer to the commentaries. When it is practically impossible to reach a reasonably satisfactory result from the letter of the treaty or from an autonomous interpretation, Luxembourg courts refer to domestic law to clarify or define a treaty term.

This approach applies also in the context of income classification under a tax treaty.

While Luxembourg has introduced provisions in its most recent treaties[11] along the same lines as article 23A(4) of the OECD MC to prevent double non-taxation in case of disagreement with the source state on the interpretation of facts or treaty provisions, no tax treaty currently provides for rules to resolve the reverse situation of double taxation (apart from the mutual agreement clause).

A first instance of different income classification may arise if the applicable treaty provisions are sufficiently clear but the source state departs from the treaty and classifies the relevant income under its domestic law. If Luxembourg considered that the treaty provisions were sufficiently clear, it would classify the relevant income only according to the treaty without regard to the source state classification. If the result was double taxation of the income, Luxembourg would not grant any double taxation relief as it would consider the source state not to have applied the

9 Art. 134*bis* (1) LIR.

10 Administrative Court (*Tribunal Administratif*) of 3 December 2001, no. 12831 (as confirmed by a decision of the Administrative Court of Appeal (*Cour Administrative*) of 23 April 2002, no. 14442 C).

11 See treaties with Albania, Armenia, Bahrain, Barbados, Israel, Hong Kong and the United Arab Emirates.

treaty correctly and in good faith. The mutual agreement procedure should be an adequate solution in such a case.

In other instances, conflict of income classification may result from the absence of provisions in the relevant treaty to deal with a specific type of entity or a transaction in connection with which income has arisen, or from unclear treaty provisions which are interpreted and applied differently in the source state and in Luxembourg. These conflicts may be illustrated with the following scenarios.

Scenario 1 (based on the commentary to article 23 of the OECD MC): a corporate taxpayer alienates interests held in a partnership which is established and carries on business in a treaty country and the applicable treaty does not provide for any entity classification rules. Relying on its domestic law, the source state considers the partnership as a transparent entity and treats the transaction as an alienation of the underlying assets of the business enterprise which is exclusively taxable in the source state. Luxembourg, on the other hand, may classify the partnership as a taxable person pursuant to its domestic rules and deem the income arising to its resident as a capital gain exclusively taxable in Luxembourg pursuant to applicable treaty provisions on capital gains on movable property. Under domestic rules, the gain is fully subject to CIT. Pursuant to the specific domestic rules excluding income arising in treaty countries[12] from the benefit of the domestic credit relief system, no tax credit would in principle be granted.

Scenario 2: a corporate taxpayer invests in a hybrid instrument issued by a resident of a treaty country. This instrument is treated as a "corporate right" in the source state giving rise to dividends,[13] which are subject to a 15 per cent withholding tax. Luxembourg considers the instrument as a "debt-claim" giving rise to interest income on which the source state withholding tax should have been limited to 10 per cent. The question in this scenario is twofold: (a) whether Luxembourg would grant a tax credit under the treaty despite the conflict of income classification and (b) if so, whether the relief would be fully or partially granted. In principle, the taxpayer should be able to obtain relief up to 10 per cent of the source state taxation. That amount of withholding tax would in any case have been payable in the source state had it (from a Luxembourg perspective) applied the treaty correctly and classified the relevant income as interest. The balance of the source state withholding tax would raise more issues as the Luxembourg tax authorities would not be willing to compensate the taxpayer for a tax that, in their view, had been unduly levied. Consequently, no relief would be available under domestic law as the income in question was derived from a treaty country.

The Luxembourg tax authorities do, however, in practice accept examining cases of double taxation resulting from a conflict of income classification and extend domestic relief rules to situations where the treaty fails to avoid double taxation.

The practical approach of the tax authorities, in addition to the fact that it may be considered as fair and equitable for the taxpayer, seems to be based on the general principle of non-aggravation. Indeed, tax treaties are generally believed to aim at the avoidance of double taxation of income but should not generate tax claims

12 Art. 134*bis* (1).

13 It is assumed that the relevant treaty does not clearly define the term "dividends" along the same lines as the OECD MC.

that would otherwise not exist under the domestic law of the contracting state. Therefore, if the taxpayer in the above-mentioned scenarios is denied double taxation relief it would find itself in a position which was less favourable than the position that would have resulted from a mere application of domestic law (if the above scenarios arise in a non-treaty context, Luxembourg would grant double taxation relief, subject to the technical conditions and limitations required under domestic law – see section 2.4). According to the principle of non-aggravation, the taxpayer should, where domestic tax rules are more favourable than a tax treaty, be able claim the application of domestic law.[14] This appears to be the general and pragmatic approach of the tax authorities. Obviously, if no relief is granted by the tax authorities, the taxpayer is entitled to initiate a mutual agreement procedure for both states to resolve the double taxation issue.

Scenario 3: a source state may, on the basis of its interpretation of certain treaty provisions, classify an item of income in a way which allows source state taxation. Luxembourg classifies the income differently but exempts it under its domestic law. This may be the case with liquidation profits which may be classified by the source state as a dividend subject to withholding tax at the applicable treaty rate, while Luxembourg would classify such income for treaty purposes as a capital gain, the taxation of which was exclusively attributable to Luxembourg. Such gains may be fully exempt from tax in Luxembourg under the domestic participation exemption regime. The question in this example does not so much concern double taxation relief, as the income is exempt in Luxembourg, but relates to whether the source state withholding tax may still be credited in Luxembourg, notwithstanding the conflict of classification.

In this instance, while claiming the exclusive taxation right of the income as capital gains, Luxembourg would assimilate it to a dividend for the purpose of granting the domestic participation exemption under article 166 LIR. Under specific rules, foreign withholding tax on dividends (including liquidation distributions) sourced in a non-treaty country and which are exempt in Luxembourg pursuant to domestic law is in principle creditable against the taxpayer's other taxable income. However, the credit is denied if the dividend arises in a treaty country and is exempt from tax in Luxembourg under domestic law (or under a tax treaty).[15] In addition, foreign tax is considered as a non-deductible expense as it is incurred in relation to tax exempt income. Obviously, this position may be criticised as it introduces an unjustifiable discriminatory treatment between dividends according to whether they are sourced in a treaty or a non-treaty country while in both cases the exemption of such income may be sought under domestic law.

14 Administrative Court of 19 January 2005 no. 17820 which (in a different context) refers to the principle of non-aggravation. Also the general statements in Bill no. 3845 concerning the Luxembourg–Indonesia tax treaty and Bill no. 2956 concerning the Luxembourg–Republic of Korea tax treaty suggest that a taxpayer should not be deprived from domestic law benefits which are more favourable than a tax treaty. See also Hubert Dostert, *Etudes Fiscales*, nos. 57/58 (Imprimerie St Paul); Georges Bock and Laurent Engel, "Elimination de la Double Imposition par la Méthode d'Imputation", *Droit Bancaire et Financier. Recueil de Doctrine*, Larcier, 2004, vol 5.

15 Xavier Hubaux, "Offsetting of Foreign Taxes for Resident Companies", *European Taxation*, January 1999.

Finally, conflict of income classification may also arise in other instances as a result of a different understanding or interpretation between the source country and Luxembourg of facts underlying the transaction in connection to which income arises. Such conflicts may lead to double taxation of income in both states. Luxembourg may, for example, disagree with a treaty country on the facts underlying the existence within its territories of a PE of one its residents or on the attribution of assets to this PE. These types of disagreement are purely factual and may occur in practice if for example each state reaches different fact findings through a ground investigation carried out in its territory.

Even though no indication is provided in Luxembourg tax law, case law and administrative practice, it is unlikely that Luxembourg would grant relief in such a case when the dispute on facts was outstanding.[16] A mutual agreement between Luxembourg and the source state is in the reporters' view the only solution to settle the facts and relieve double taxation.

2.2. Inconsistent allocation of deductions between domestic and foreign sources

Under Luxembourg tax principles, expenses (including interest) are primarily allocated on a historical or an economic link basis. Where the historical link is not available, certain presumptions apply. Such rules apply indifferently to the allocation of expenses to domestic or foreign income. Expenses that are economically related to exempt income are non-deductible.[17] On the basis of the above, funding will normally follow the allocation of the assets or activities funded. Hence, interest expenses related to assets attributable to a PE in a treaty jurisdiction the income of which is exempt in Luxembourg will not be deductible in Luxembourg, irrespective of whether the expense is tax deductible in the source state. A certain double taxation may therefore remain unrelieved.

As regards the level of the expenses, Luxembourg does not have limits which are specific to foreign source income. All expenses, whether related to domestic or foreign source income, must comply with the arm's length test. Depending on the relationship with the lender for example, excessive interest expenses may be recharacterised into a hidden dividend, triggering dividend withholding tax.[18] Luxembourg does not have interest "barrier" rules or similar limitations.

Subject to certain conditions[19] tax consolidation is available in Luxembourg for corporate taxpayers. However, Luxembourg's tax consolidation regime is not a true fiscal integration. Intra-group transactions are not disregarded and, for each member of the group, the taxable basis is determined separately.[20] The source and nature of the income earned by the members of the group are therefore not influenced by the tax consolidation. However, as (a) the regime basically allows for

16 According to para. 32(5) of the commentary to art. 23 of the OECD MC the residence state is not obliged to relieve double taxation in cases of conflicts of interpretation of facts.

17 Arts. 45 and 166(5) LIR.

18 At the current rate of 15 per cent (increased to 17.65 per cent on a gross-up basis), unless full or partial relief is available under a tax treaty or the EU Parent–Subsidiary Directive.

19 Art. 164*bis* LIR.

20 Circular Letter LIR no. 164*bis*/1 of 27 September 2004. See also *Cahiers de droit fiscal international*, vol. 89b, *Group Taxation*, Luxembourg Report, René Beltjens, 2004, p. 434.

group relief for tax losses incurred by the members of the group and (b) FTCs are limited to Luxembourg taxes due on income after deduction of relevant expenses, the application of the tax consolidation rules may affect the calculation of the amount of income eligible for a foreign tax credit as well as the level of the credit itself. The tax consolidation may reduce Luxembourg taxes due, and so will also reduce the effect of FTCs.[21]

2.3. Inability to deduct foreign losses against domestic income under domestic law

The capacity to repatriate foreign losses is one salient feature which distinguishes the credit method from the exemption method.

2.3.1. Credit method under domestic law

Losses incurred in a foreign (non-treaty) PE may be deducted in Luxembourg after adjusting the PE result according to Luxembourg tax rules, if necessary.

Capital losses in connection with a foreign subsidiary are also tax deductible in the hands of the Luxembourg parent company.

To a certain extent, underlying losses incurred by a foreign subsidiary may offset taxable income of the Luxembourg parent company. If the Luxembourg parent company estimates that such losses translate into a permanent depreciation of the value of its shares in the subsidiary, it must record in its accounts an impairment on the acquisition cost of the shares pursuant to Luxembourg generally accepted accounting principles.[22] Such impairment is generally tax deductible. If the foreign subsidiary is covered by the participation exemption regime, the deduction of the impairment may be subject to certain restrictions and may give rise to a recapture in the future, upon realisation of capital gains on the transfer of the foreign subsidiary.[23]

Taxpayers can also make use of foreign losses by setting up a fiscal unity in Luxembourg headed by a Luxembourg PE of a loss-making foreign entity and shifting the loss-making activities to the Luxembourg PE.[24] The compensation of losses within the fiscal unity requires proper allocation of income and expenses between the Luxembourg PE and the foreign head office through acceptable accounts at the level of the Luxembourg PE.[25] However, a cross-border fiscal unity headed by a foreign entity has been denied by the Luxembourg tax courts under current Luxembourg tax laws.[26] This decision has been criticised as being incompatible with EU law.[27]

21 Circular Letter LIR no. 164*bis*/1.
22 Art. 55(1)(c)(bb) of the Law of 19 December 2002.
23 Grand-Ducal Decree of 21 December 2001.
24 A fiscal unity may be headed by a Luxembourg PE of a foreign entity provided the latter is subject to an income tax comparable to Luxembourg CIT.
25 Administrative Court, 13 November 2001, no.13350C.
26 Administrative Court, 19 April 2007, no. 21979C.
27 Jean-Pierre Winandy, "Fiscal integration and European law", *EC Tax Review*, 2009, p. 197.

2.3.2. Exemption method under tax treaties

Pursuant to Luxembourg general principles, losses incurred by a Luxembourg resident taxpayer in connection with a PE situated in a treaty country would not be tax deductible in Luxembourg if the relevant treaty used the exemption method to avoid double taxation on PE income. All Luxembourg tax treaties, however, allow Luxembourg to take into account the foreign PE income for the purpose of determining the taxpayer's effective tax rate (exemption with positive progression). Domestic law allows the same to apply in the case of losses (exemption with negative progression).[28]

The denial of relief for foreign losses incurred in a treaty country when the exemption method applies has been challenged before the Luxembourg courts on two occasions so far. The first case[29] concerns losses arising in a foreign PE of a Luxembourg resident. In this case, the Administrative Court decided in favour of the taxpayer and concluded on the tax deductibility of such losses notwithstanding the fact that the income of such a PE would have been exempt under the applicable treaty. The Court based its decision on the exemption with negative progression rule and the non-aggravation principle. This decision has been criticised by Luxembourg tax literature.[30] The reproach made to the decision is that it has misused the principle of non-aggravation, which, in essence, is a principle of treaty interpretation, to frustrate a clear provision of domestic law. In addition, the decision may give the taxpayer an unjustified double advantage of opportunistically claiming the application of the treaty exemption if positive income is realised in the PE and claiming a deduction under domestic law in case of a loss.

The second decision concerns losses incurred by a resident taxpayer in connection with immovable property situated in a treaty country.[31] The court denied the loss relief on the basis of the argument that, in the context of a tax treaty which attributed the exclusive taxing right of an item of income to the source state, the taxpayer could not take into account that item of income, whether positive (profits) or negative (losses), in its taxable base for Luxembourg tax purposes, except for the purpose of the exemption with progression rule.[32]

The exact application of the exemption with negative progression rule to companies is unclear in the specific situation where the taxpayer's foreign losses (which are "exempt" under a tax treaty) exceed its other taxable income. One may argue that, because the taxpayer's overall (theoretical) tax base is negative, no CIT should be due as the "global" rate of taxation[33] will be reduced to 0 per cent. The 0 per cent rate would be implicit in the law.[34] This argument would be in conformity with the more general principles of the ability to pay tax and equality before the (tax) law. The current position of the Luxembourg tax authorities

28 Art. 134 LIR.
29 See note 10 above.
30 Jean Schaffner, *Droit Fiscal International*, Editions Promoculture, p. 446.
31 Administrative Court, 12 February 2009, no. 24642C.
32 See also section 3.4 on the same issue from an EU angle.
33 Referred to in art. 134 LIR.
34 Art. 174 LIR which provides for two rates of tax for companies: 20 per cent (if the taxable income does not exceed a threshold of 15,000 euro) and 21 per cent (if the income is in excess of the threshold).

appears to be in favour of such an approach. This approach is, however, yet to be tested before a court of law as the 0 per cent rate is not explicitly provided in the law.

2.4. FTC limitations

Domestic law and tax treaties entered into by Luxembourg set limitations to the amount of FTCs.

Under domestic law, the maximum amount of foreign tax creditable against Luxembourg tax is computed, as a rule, on a per-country basis. A basket needs to be set up for each country from which the taxpayer derives foreign income (or loss). Foreign taxes paid on qualifying income[35] may be credited against corresponding Luxembourg tax.

Treaty limitations on FTCs vary from one treaty to another. Some treaties allow cross-crediting (i.e. credit is granted against Luxembourg tax relating to all items of income derived from the same source country). Others will limit the credit to a group of items of income derived from the source country. Finally, others will only allow a credit against Luxembourg tax relating to the same item of income derived from the source country.

Upon request, foreign taxes assessed and paid on foreign income from movable assets[36] (passive income), derived from treaty and non-treaty countries may be credited against Luxembourg income tax on an overall basis (global method).[37] If the taxpayer opts for the global method, foreign passive income from all non-treaty countries is taken into account. Passive income from a treaty country may also be included but this means that all passive income derived in that treaty country will be taken into account.[38] Foreign taxes on non-qualifying income remain creditable under the per-country method.

The global method imposes two conditions:

- the maximum foreign tax rate is limited to 25 per cent, applicable to each item of income separately taxed in the foreign country;
- the FTC is limited to 20 per cent of the Luxembourg tax relating to the respective foreign income.

By virtue of the above-mentioned limitations, the taxpayer would not receive full relief for the foreign tax paid, especially that foreign tax that could not be credited against the taxpayer's liability for MBT.[39] Non-creditable foreign tax may be deducted as an expense.

Investment vehicles such as SICAVs, SICAFs and FCPs are exempt from corporate tax[40] and can therefore not claim a tax credit in Luxembourg.

For a foreign tax to be creditable in a non-treaty context it must be an income tax and its main features must compare to Luxembourg income tax. It must not be

35 Art. 134*bis* (2) LIR.
36 As defined in art. 97 LIR.
37 Grand-Ducal Decree of 26 May 1979.
38 The choice for the global method for income from treaty states must be made individually for each country.
39 Administrative Court, 17 January 2006, no. 20316C.
40 Art. 161 LIR.

symbolic and it must be levied at a national level.[41] Non-qualifying foreign taxes may, however, be tax deducted.[42] Late filing and late payment penalties, surcharges or fines are not creditable.[43]

In a treaty context, the taxes eligible for the foreign tax credit are those specifically covered by the treaty. Foreign taxes which cannot be fully credited against Luxembourg income tax may be deducted as an expense.[44] Fictitious tax credits which cannot be offset against Luxembourg tax are not deductible. The Luxembourg tax authorities, however, accept that they are credited prior to effectively paid foreign taxes.[45]

2.5. Distortions due to temporal differences in the recognition of taxable income

In addition to the limitations to the computation of the available tax credit, temporal differences can have a direct impact on the time and amount of credit that can be used against Luxembourg tax.

Under domestic tax law, in order to be creditable, the foreign tax must be effectively paid in the foreign country.[46] Moreover, the foreign tax can only be credited against Luxembourg tax of the year of recognition of the foreign source income in Luxembourg.[47]

The Luxembourg tax system does not provide for any controlled foreign company (CFC) legislation or other anti-deferral rules which may accelerate the recognition of foreign income. Foreign income is only recognised when effectively realised by the taxpayer in its accounts. The tax treatment of the income (foreign or domestic) will generally follow its accounting treatment.[48]

The above-mentioned requirements create temporal differences in cases where the foreign tax is effectively assessed and paid abroad in a year which is not the same year of recognition of the foreign income in Luxembourg.

If the foreign tax is paid before the foreign income becomes taxable in Luxembourg, the taxpayer will have to wait until the foreign source income is recognised in Luxembourg to credit the foreign tax. This situation may arise, for instance, when the taxpayer avails itself of deferral rules under Luxembourg tax law (see below) or has a PE in a non-treaty country with different recognition rules.

If the foreign tax is paid or modified after the foreign income is taxed in Luxembourg, the taxpayer must inform the Luxembourg tax authorities of the payment or modification within the established deadline.[49] Luxembourg tax will be

41 Circular no.77 of 18 July 1980 which lists certain qualifying foreign taxes. One may also refer to circulars of the German tax authorities to this effect. See Parliamentary document, no. 2190, p. 1400; the German *Einkommensteuer-Richtlinien* 2008 with the Annexe to R 34c EStR (*Bundessteuerblatt* I no. 21 of 18 December 2008, p. 1017).

42 Art. 13(1) LIR.

43 Circular no. 77 of 18 July 1980.

44 Art. 13(2) LIR.

45 Circular no.13/1 of 25 August 1995.

46 Art. 134*bis*(1) LIR.

47 Circular no. 77 of 18 July 1980.

48 Art. 40 LIR.

49 Grand-Ducal Decree of 3 May 1979.

recalculated subject to domestic rules on the statute of limitations.[50] If the foreign tax is paid (or modified) within the Luxembourg statute of limitations, it would be possible to amend the tax returns or have the amount of tax due modified. If the statute of limitations has expired at the time the foreign tax is paid or modified, it can no longer be credited (but may be deducted as an expense in the year it is effectively incurred).

A significant temporal difference can occur for a taxpayer holding long-term zero-coupon bonds issued by a foreign entity. The original issue discount that will give rise to the foreign tax is only paid at the maturity of the bonds whereas the foreign income is recognised by the taxpayer on an accrual basis[51] until the maturity of the bonds. Consequently, the taxpayer is taxed on the foreign income yearly, with no right to an offsetting FTC, since no foreign tax has been paid. Depending on the length of the debt, this may represent a loss of FTCs if the statute of limitations has expired in the meantime. In view of the distortion caused by this temporal difference and in the absence of specific provisions in Luxembourg tax law, a practical approach is to treat the foreign tax as payable on an accrual basis.[52]

The Luxembourg tax system includes several deferral provisions which also contribute to temporal differences in the recognition of foreign income and the use of FTCs. These provisions aim at allowing the taxpayer to carry out tax-neutral transactions by postponing income recognition under certain circumstances determined by the law (i.e. deferral of the taxable event). The downside is that the deferral in the recognition of foreign income means the deferral of FTCs.

A problematic situation may arise in a share-for-share exchange under the capital gains roll-over relief.[53] The base scenario involves a corporate taxpayer contributing shares of a foreign entity in exchange for shares in a Luxembourg entity under the roll-over relief rules. If the foreign jurisdiction considers that the transfer must be realised at market value and taxes the gains deemed to be realised (either in the absence of a tax treaty or if the applicable treaty allows source state taxation), the taxpayer will suffer foreign tax (with a potential right to a credit) but will not be able to use the credit until the foreign income is recognised in Luxembourg. Given that income derived from the Luxembourg subsidiary will not be foreign source, the taxpayer will have no right to credit the foreign tax (assuming it does not derive any other income from that foreign jurisdiction). In such a case, the logical move for the taxpayer would be to deduct the foreign tax as an expense. However, this deduction may be questioned in the context of a tax-neutral transaction in Luxembourg (i.e. no expense would be allowed to be deducted as no taxable income was recognised on the transaction).

In an alternative scenario where, as a result of the exchange, the taxpayer receives shares of a foreign entity (resident in a different foreign jurisdiction), the income derived from the foreign entity will be foreign source. However, it should not give rise to a credit of the foreign tax paid upon the share-for-share exchange either under the per-country method (as the foreign income arises in a different

50 Art. 134*bis* (1) LIR and art. 10 of the Law of 27 November 1933.
51 Art. 40 LIR.
52 Hubaux, *op. cit.*; Philip J. Warner and Marc Schmitz, *Luxembourg in International Tax Planning*, 2nd edn, 2004, p. 199.
53 Art. 22*bis* (2) LIR.

foreign jurisdiction) or under the global method (as capital gains are not covered by this method).

The same rules apply to tax credits granted under a tax treaty, including fictitious tax credits.[54] As such credits are generally limited in time,[55] if foreign tax is paid (or deemed paid) in a foreign jurisdiction but the related foreign income is recognised in Luxembourg in a later year, the taxpayer will not be able to claim the fictitious tax credit if the corresponding treaty provision has expired in the meantime.

2.6. Inconsistent classification of foreign entities

The tax classification of entities may not always coincide in the country of residence and in the country of source. Therefore, an entity may be classified as a taxable person in one jurisdiction while it is treated as transparent in the other jurisdiction. If a third jurisdiction is involved, the analysis can become even more complex. These mismatches can lead to double (non-) taxation of income.

2.6.1. Classification of foreign entities

Luxembourg entities are classified for CIT purposes (*Impôt sur le revenue des collectivités*)[56] either as taxable persons or tax transparent partnerships. Taxable persons take one of the forms listed by the tax law.[57] They are generally capital companies. All other entities are deemed to be tax transparent. The distinction between capital companies/taxable persons and partnerships/transparent entities seems to be based on the legal characteristics of the relevant entity itself, mainly whether its capital is limited by shares, its shares/interests are freely transferable, its shareholders have limited or unlimited liability and the organisation of its corporate body. Foreign entities are classified for Luxembourg corporate income tax pursuant to the same approach.[58]

For Luxembourg tax purposes, a taxpayer is defined as the person who has to pay the tax charge.[59] The tax is levied on the income realised or deemed realised[60] in the relevant taxable period.[61]

No indirect tax credit is available for the underlying foreign income tax borne by the foreign distributing entity on the income out of which a profit is distributed to the taxpayer. The direct tax credit method in Luxembourg requires that the same person is liable to the tax in both states.

These rules may raise issues of unrelieved double taxation in case of conflicts of entity classification. These issues concern the availability as well as the timing of the FTC.

54 Hubaux, *op. cit.*

55 Treaties with China, Malta, Malaysia, Thailand, Trinidad and Tobago and Tunisia include fictitious tax credits which are still available in 2010.

56 Other criteria apply for MBT purposes.

57 Art. 159 LIR.

58 This technique is referred to as *Typenvergleich*. The legal basis for the comparison doctrine lies in art. 175 LIR and para. 11*bis* StAnpG.

59 §97(1) of the *Loi Générale des Impôts*.

60 Administrative Court, 29 March 1999, no. 10428.

61 Art. 6(1) LIR.

As an illustration, assume that a Luxembourg resident holds interests in a hybrid entity – treated as transparent in Luxembourg and opaque in the other treaty country – which derives interest from that other country. The partnership does not constitute a PE in the treaty/source country. The source country attributes the interest to the partnership and taxes it in its hands. Luxembourg would consider that the interest flowed to its own resident irrespective of the fact that the partnership was subject to tax in the source country on the same income.[62] In taxing the interest, Luxembourg would not grant any relief for the source country's corporate income tax as it was not a personal tax of the taxpayer and no relief would be available for the foreign underlying tax.

The partnership could, in a later year, distribute a dividend out of the same income to the taxpayer subject to withholding tax in the source country. Due to the timing difference the taxpayer may not be able to claim a tax credit for the withholding tax.

2.6.2. Partnerships, not-for-profit organisations

Foreign entities that are tax transparent for Luxembourg tax purposes may constitute a PE in a foreign country, depending on the level of substance and the activities they deploy.

Some practical issues related to different entity classification are illustrated by the following examples in which it is assumed that the partnerships do not qualify as PEs, where relevant.

Scenario 1: a Luxembourg company holds a hybrid entity (tax transparent in Luxembourg and opaque in the foreign jurisdiction) which derives interest income from a third state. The third state imposes interest withholding tax on the payment. The interest is taxed in the foreign country with a credit for the third country withholding tax. The profits of the hybrid entity are distributed as dividends to the Luxembourg company subject to withholding tax in the foreign country.

As Luxembourg looks through the hybrid entity, the dividend payment is disregarded and the Luxembourg company is treated as receiving interest income sourced in the third state. Interest income will be taxable in Luxembourg with a credit for the withholding tax.[63] No credit would be granted for the foreign income tax paid by the hybrid entity or for the dividend withholding tax.[64] Double taxation is only partially relieved in this scenario.

Scenario 2: the same facts as scenario 1, except that the foreign entity is a reverse hybrid (tax opaque in Luxembourg and tax transparent in the foreign jurisdiction) and neither income tax nor dividend withholding tax is imposed in the foreign country. The Luxembourg company would only recognise dividend income sourced in the foreign country. The dividend is in principle taxable but may be eligible for the participation exemption regime. Interest withholding tax levied by the third state cannot be credited in Luxembourg. No relief is available for the tax paid in the third country.

62 Administrative Court, 10 January 2006, no. 20307C.

63 The tax treatment of the hybrid entity in the third state creates additional issues not analysed here.

64 The foreign income tax and dividend withholding tax arise in the foreign country while the interest income arises in the third state.

Those not-for-profit organisations that are not exempt from income tax in Luxembourg[65] should have access to FTCs.

3. Pros and cons of credit versus exemption

3.1. Complexity and sophistication

3.1.1. Exemption

The application of the exemption method in Luxembourg is fairly simple as the foreign income is either exempt or not. The complexity associated with the exemption method is thus limited to (a) determining whether the domestic or double tax treaty requirements for the exemption are met and (b) calculating the taxpayer's worldwide income (including the exempt foreign income or losses) to determine the applicable tax bracket. This calculation is required in light of the progressivity clause included in Luxembourg tax treaties (mostly relevant for individuals).

3.1.2. Credit

The credit method entails a series of coordinated calculations, hence the difficulty in its application. A first calculation is required to determine the adjusted taxable income and the preliminary tax rate to obtain the creditable part and the deductible part of the foreign tax. A second calculation is required to determine the applicable tax rate based on the adjusted taxable income after deduction of the non-creditable part of the foreign tax. A third and final calculation may be needed for the determination of the final tax based on the taxpayer's taxable income.

The level of complexity may also depend on the type of taxpayer (individual or corporate) and its income profile.[66] The calculations required by the credit method are rate simplified for corporate taxpayers in comparison with individuals. This is mainly because the tax rate generally does not vary.

In addition, a taxpayer who derives foreign income from different jurisdictions will need to compute the tax credit available on a per-country basis, unless it elects to apply the global method. As a result of the per-country method, multiple computations may be required to determine the amount of FTC per country. Depending on the provisions of the relevant treaty, computations grouping some items of foreign income derived per country or even separately per item of income derived per country may need be prepared. In the global method, the computations will need to reflect the additional restrictions imposed by domestic law on the foreign tax rates, the type of income and the amount of tax credit. It may also be that the taxpayer will have to perform calculations under the two methods yearly (the per-country method and the global method) in order to choose the most favourable one.[67]

65 Arts. 159(1) and 161(1) LIR.

66 Income from one or more jurisdictions with different tax rates; a mix of exempt foreign income and taxable foreign income, etc.

67 An election needs to be made every year for each country.

3.2. Administrative burden

With a view to simplifying the administrative burden created by the exemption and the credit methods, the tax authorities have issued administrative guidance exempting taxpayers from filing certain supporting documentation.[68] Although the required calculations may still need to be attached to the tax returns, other supporting documents may be kept by the taxpayer until a later stage (to be provided for example upon a tax audit). This could include without limitation:[69]

- proof of the assessment and payment of the foreign tax;
- relevant certificates of residence;
- proof that an entity is subject to an income tax which is comparable to Luxembourg income tax;
- proof of physical substance in another jurisdiction (e.g. for characterisation of a foreign PE).

3.2.1. Exemption

The compliance requirements and the administrative burden related to the exemption method are lower than to the credit method. Such requirements aim at protecting the taxable base and determining the appropriate tax rate.

As far as businesses are concerned, the exemption is generally restricted to income attributable to the taxpayer's PE situated in a treaty country, tax exempt dividends, capital gains and income from IP income.

For a corporate taxpayer, the amount of foreign income (or loss) should be shown in its financial statements as filed with the tax returns. The taxpayer may claim an exemption by filling in the appropriate lines in the tax return forms with the amount of exempt foreign income (or loss) and by providing sufficient disclosure in an annex. The exemption may also be indirectly claimed if the taxpayer prepares a tax balance sheet with tax profit and loss accounts by subtracting the amount of the exempt foreign income from the taxable income and indicating the net amount as the tax result of the year in the tax return forms as a starting point. In any case, there should be an appendix to the tax returns indicating the exempt foreign amount and making reference to the applicable provision of the tax treaty or domestic law substantiating the exemption.

In relation to dividends and capital gains derived from a participation benefiting from the domestic participation exemption, the taxpayer will have to complete a specific form[70] indicating the details of the participation and the amount of related income received during the relevant year. This form is filed together with the corporate tax returns. If the participation is financed with debt, the taxpayer must indicate the amount of expenses relating to the financing of the participation incurred in the relevant year.

The dividend and capital gains domestic participation exemption is granted only for qualifying entities. Except EU entities qualifying under the EU Parent–Subsidiary Directive, a foreign qualifying entity must be a capital company subject

68 Circular No. 77 of 18 July 1980.
69 Art. 2(1) of the Grand-Ducal Decree of 3 May 1979.
70 Form 506.

to a tax comparable to Luxembourg income tax with regard to the tax rate and method of determination of the taxable base. The burden of proof of this requirement lies with the taxpayer.

3.2.2. Credit

Compared with other countries, and in the absence of CFC legislation or a comprehensive set of transfer pricing rules, the Luxembourg credit method cannot be considered to be burdensome. It remains nevertheless practically more complex than the exemption system.

The credit system compliance rules apply to Luxembourg companies and Luxembourg PEs of foreign taxpayers if they prepare separate acceptable accounts.[71]

In order to credit foreign taxes in Luxembourg under domestic law, the taxpayer must:

(a) determine the foreign income pursuant to domestic rules;
(b) compute the Luxembourg tax against which the foreign tax is creditable;
(c) determine the foreign net income under domestic rules by taking into consideration solely the expenses in direct economic connection with the foreign income;
(d) allocate the Luxembourg source and the foreign source net income to baskets, according to the applicable method (global or per country method);[72]
(e) compute the creditable amount of the foreign tax and the deductible amount.

The computation of foreign income according to domestic tax provisions may require certain adjustments, which implies knowledge of the accounting and tax principles of each foreign jurisdiction in which income arises. Taxpayers may also encounter difficulties in identifying the expenses in direct economic connection with the foreign income.

A minimum of four baskets is required under the per-country method and five baskets under the global method. If the foreign income is derived from different countries, a basket will need to be set up for each country. If the taxpayer has foreign losses, it will have to keep track of the loss carryforward per basket for the computation of future tax credits.

For the application of the global method, the taxpayer must file a request together with the tax return. If the taxpayer derives income from treaty countries, the taxpayer may choose to apply the global method to some or all countries. The request needs to be renewed every year.

It is sufficient to claim the credit in the tax returns for the year in which the foreign income and taxes are to be considered in the Luxembourg taxable base provided that the taxpayer provides the details of the foreign taxes likely to give rise to the tax credit.

If the taxpayer has suffered the foreign tax but has not yet recognised the foreign income in Luxembourg, the taxpayer must monitor the recognition of the foreign income in Luxembourg to ensure that the foreign tax is credited in due time.

71 Art. 3(1) of the Grand-Ducal Decree of 26 May 1979.
72 See section 3.4.

In case of modification or reassessment of foreign tax, the taxpayer must notify the tax administration of any foreign tax reduction after the filing of the Luxembourg tax returns and the Luxembourg taxable base must be recalculated.

Overall, the taxpayer will need to bear in mind the correct tax year for claiming the tax credit, gather all the information and documentation necessary and prepare numerous computations, which are reviewed by the tax authorities.

3.3. Sensitivity to international tax planning and tax avoidance

In principle, the application of the credit method to relieve double taxation under domestic law leaves little room for international tax planning as the taxpayer will suffer the higher of source state or Luxembourg taxation. A significant means of excluding income from Luxembourg tax would be to use foreign subsidiaries' corporate veil, especially given that Luxembourg does not have any CFC legislation. Such a deferral would, however, not be pertinent for tax planning purposes as dividends generally benefit from the participation exemption. The tax planning aspect in this case would remain advantageous if withholding tax was paid in the source state. Such tax can be credited in Luxembourg if the dividends are derived from a non-treaty country. The credit method in Luxembourg may also offer certain tax planning opportunities in terms of expense allocation (which may be possible for example through intra-group debt financing versus profit distribution) and foreign loss deduction, which would in principle not be possible under the exemption method.

The use of low- or no-tax jurisdictions (generally non-treaty countries) for double non-taxation planning is of little interest. The domestic tax credit does not offer any advantage as the income from those jurisdictions is fully taxable in Luxembourg, including dividends, liquidation distributions and capital gains due to the "comparable-tax" requirement imposed under the domestic participation exemption regime.

The mechanics of the Luxembourg domestic credit system may, however, offer certain tax planning opportunities if the global method is applied (see section 3.2.2).

A tax treaty exemption on business income attributable to a foreign PE offers a greater and more straightforward opportunity for tax planning. This would generally consist of shifting income which would otherwise be taxable in Luxembourg to a branch situated in a treaty country (that taxes the income at an overall lower rate). This may for example be the case if under certain territoriality rules the other country does not tax income derived by the PE from sources outside its jurisdiction. Whether or not losses incurred in a PE situated in a treaty country may or should be able to utilised by the Luxembourg head office is a controversial question (see section 2.3 above).

No special anti-avoidance compliance requirements are imposed in Luxembourg.[73]

[73] See section 3.2.

3.4. Compatibility with applicable international commitments

The question of compatibility of Luxembourg domestic rules and treaty practice with international commitments may be raised with respect to a number of points.

The first aspect concerns the limitation on the deductibility of foreign losses. Under current legislation, losses by a domestic business with respect to activities deployed abroad are fully tax deductible. However, losses incurred in connection with a PE situated in a treaty country the income of which is tax exempt in Luxembourg are not tax deductible. The issue around foreign loss deduction is twofold. In the light of ECJ case law,[74] the compatibility of such a restriction with EU law may be doubtful, especially in those situations where the losses cannot be used in the EU Treaty country where the PE is situated. Even if the PE losses are allowed to be carried forward under the laws of the host EU Member State the deferred loss relief in the home Member State is a cash flow disadvantage for the taxpayer that may be considered as an infringement to EU law,[75] especially if the relevant enterprise has a taxable profit position overall. In Luxembourg, the alternative solution would be to amend the legislation to allow resident businesses to use PE losses in Luxembourg subject to a certain loss recapture mechanism (if profits are realised in the PE) in order to avoid a double use of the losses in Luxembourg and in the PE country.

In addition, by disallowing the offsetting of foreign PE losses (in a treaty context) while allowing losses on subsidiaries to be tax deducted by the parent company, even if the subsidiaries are resident in a treaty country the income of which is exempt in Luxembourg under domestic law or the applicable treaty, Luxembourg restricts the freedom of its residents to choose the legal form of their investments (PE or subsidiary) that may be available in the host EU Member States.[76]

The second aspect concerns the impossibility under current administrative practice, as supported by case law,[77] of crediting foreign tax under tax treaties against MBT.[78] Generally, Luxembourg tax treaties include MBT in the list of "taxes covered" (typically in article 2). In line with the OECD MC,[79] Luxembourg tax treaties generally provide that the residence state must "allow as deduction from the tax on the income of that resident an amount equal to the tax paid [in the other contracting state]". As treaties generally use the term "from the tax on that income" without any distinction, one would expect that the deduction of foreign tax was to be made from Luxembourg income taxes which were covered by the treaty and which applied to the relevant foreign income. This is not the current state of Luxembourg administrative practice and case law. Even if the foreign tax is deductible for MBT purposes, a certain degree of double taxation remains unrelieved. This approach,

74 ECJ, *AMID*, C-141/99 of 14 December 1999 and *Marks and Spencer*, C-446/03 of 13 December 2005.

75 ECJ, *Metallgesellschaft*, C-397/98 of 8 March 2001.

76 Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee of 19 February 2006, Tax Treatment of Losses in Cross-Border Situations, Com (2006) 824 final.

77 Administrative Court of Appeal no. 20316C of 17 January 2006.

78 See introduction for more details on MBT.

79 Art. 23A(2) of the OECD MC.

which is widely criticised by the tax community in Luxembourg,[80] has far-reaching consequences as it affects the vast majority of Luxembourg tax treaties.

The third and final point concerns the discriminatory effect under Luxembourg domestic law with respect to the non-crediting of foreign withholding tax paid in connection with dividends received from a treaty country which are exempt under the participation exemption (see section 2.1.3).

3.5. Impact on economic decisions

It is generally admitted that the credit system favours capital export neutrality in that taxpayers suffer the same amount of tax on income earned both inside and outside the residence country. This system achieves a double benefit of economic efficiency. For businesses, the credit method does not distort their investment decisions, i.e. residence country taxation is not a factor in deciding where investment should be located. It also helps preserve the tax base of the residence state as the income of its taxpayers may be (re)computed and taxed according to its domestic law.

The above considerations are true for Luxembourg. However, the economic efficiency pursued by the domestic imputation system is counterbalanced by treaty policy. Luxembourg has currently 60 tax treaties in force and 16 other treaties under negotiation. All these treaties are principally based on the exemption method. Such treaty policy aims *inter alia* at counterbalancing the capital export neutrality effect of the domestic (credit) system and providing businesses which use Luxembourg as a platform for their cross-border investments with a competitive advantage by putting their foreign investments on a level playing field with (a) businesses in the host foreign countries and (b) foreign businesses owned by investors in other countries with exemption systems which operate in the same host foreign country.

A recent trend can be witnessed in Luxembourg domestic law to reduce source taxation. No withholding tax is levied under domestic law with respect to interest and royalties (unless exceptionally) and more recently also, on profit distributions to parent companies resident in treaty countries (subject to certain conditions). This is in addition to the non-taxation under domestic law (subject to non-stringent conditions) of capital gains on shares realised by non-residents in connection with substantial participations in Luxembourg companies. Through this subtle combination of tax treaties and domestic rules, Luxembourg aims to create a tax neutral investment hub for international investors.

4. Future trends

Double taxation of business income remains unrelieved in Luxembourg in many instances. It may arise, for instance, in cases of divergence between Luxembourg and the source state on the existence of income, its source, its nature and its classification for tax purposes, as well as on the classification of foreign hybrid

[80] Anja Taferner and Christophe Joosen, "Getting the (Foreign Tax) Credit One Deserves?", *European Taxation*, April 2006.

entities. Where double tax treaty provisions are unclear or do not have specific rules for the resolution of such divergences Luxembourg generally applies its own understanding and interpretation of the relevant treaty provisions or otherwise refers to its domestic law to recognise (or not) and classify the relevant income. Luxembourg does not necessarily follow the source state domestic law or its interpretation of the treaty provisions. As a result, double taxation of income becomes inevitable.

Where double taxation cannot be avoided under a tax treaty, Luxembourg domestic relief rules, in principle, do not help since the domestic tax credit is denied to income derived by residents from treaty countries. This would normally leave the taxpayer only with the mutual agreement procedure to obtain satisfaction. In practice, however, the Luxembourg tax authorities examine cases of double non-taxation which are not remedied by tax treaties. Their approach is equitable for the taxpayer and may be justified on the grounds of the principle of non-aggravation which is more and more referred to by Luxembourg courts in the framework of tax treaty interpretation and application.

Under domestic law, double taxation is not relieved in all cases. Unrelieved double taxation may result from the domestic limitations, such as the exclusion of MBT from the basis on which FTCs may be offset when the credit method is applied. The most controversial aspect of the exemption system is its effect of denying for resident taxpayers the possibility of using losses arising in a PE situated in a treaty country (where the relevant treaty provides for the exemption method for the avoidance of double taxation of business income). The compatibility of this provision with EU law is doubtful.

The Luxembourg domestic double taxation relief system has been in place for over thirty years now. No plans are envisaged to change it or to significantly amend it.