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INSIGHTS

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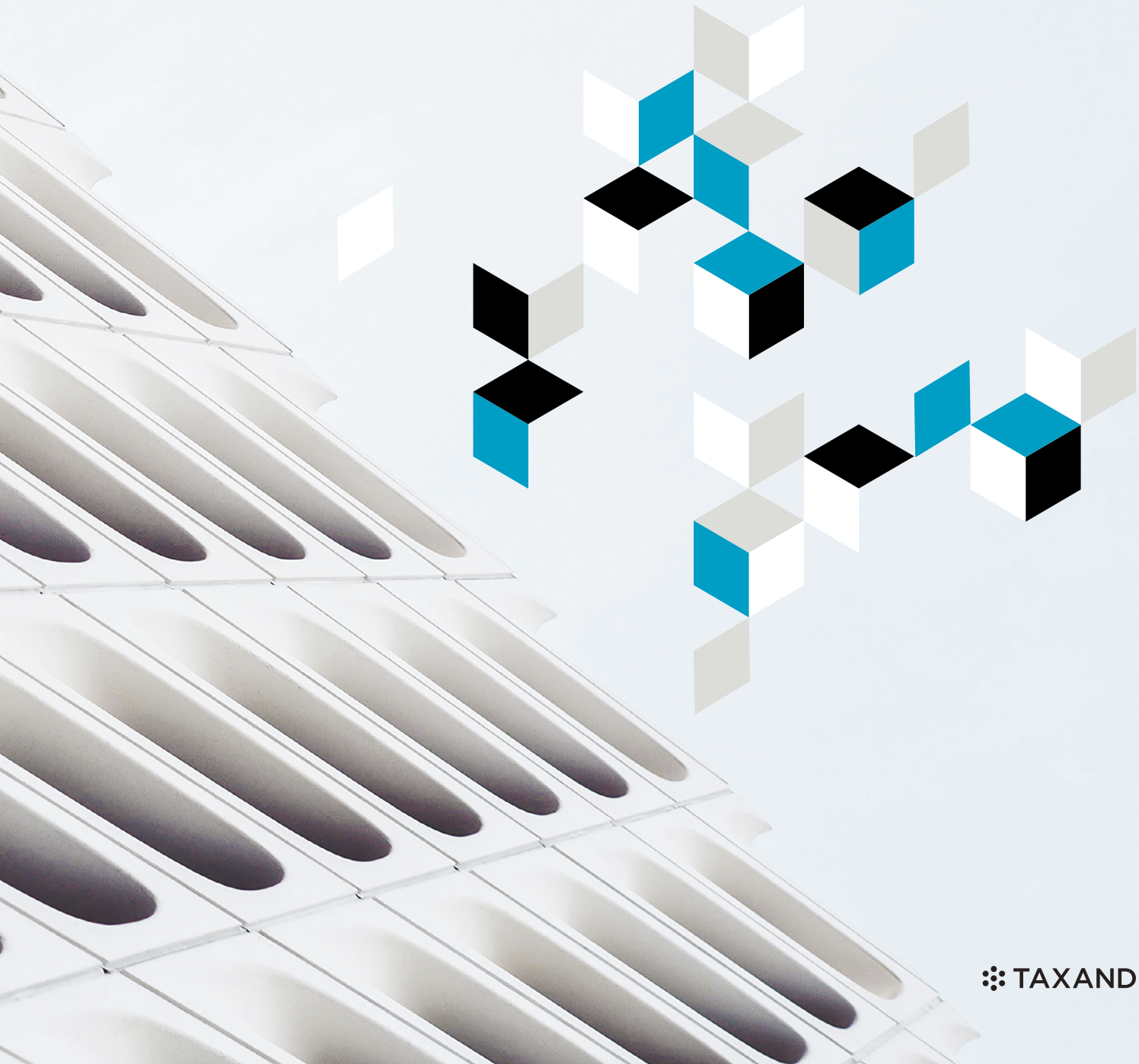

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EDITORIAL

Greetings!

As the sun's rays make their timid appearance, time has come to highlight the latest news since the start of 2024, from Luxembourg and abroad.

On 31 May 2024, a law introducing various measures to revive the construction sector was published. Some measures are limited to 2024, while others are structural. We provide a commentary of the tax measures introduced, including the various Grand-Ducal Regulations and the amendments proposed during the legislative process.

In a landmark decision issued on 20 February 2024, the Administrative Court affirmed that taxpayers, under specific conditions, have the right to invoke the “substance over form” principle, which is thus not exclusively available to the tax authorities. We analyse this ruling reinstating some equity in the relationship between the tax authorities and the taxpayer.

On 25 March 2024, the Luxembourg tax authorities published an FAQ aiming to clarify the application of the Pillar Two law and more particularly the transition rules regarding the tax treatment of deferred tax assets and liabilities. We analyse these clarifications.

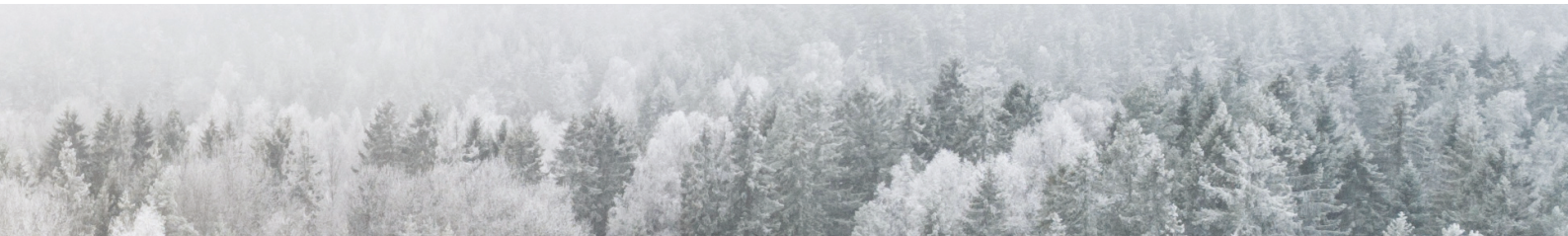
At EU level, the ongoing direct tax initiatives in the pipeline of the European Commission have not evolved that much over the past few months. Except for the “FASTER” proposal for which the Council has recently reached an agreement (general approach) on new rules for withholding tax procedures, the outcome of most of the directive proposals on the table is uncertain (i.e. the “BEFIT package” as well as the “Unshell”, “SAFE” and “DEBRA” initiatives). We provide an overview of the state of play on each of the proposals as well as of the text on the Pillar One multilateral convention.

The Court of Justice of the EU rendered its VAT decision in the so-called “Feudi” case on 7 March 2024. In this ruling, the Court concluded that the amount of turnover cannot be used to challenge the status of a VAT taxable person or to limit the VAT deduction right of a company. We provide an analysis of this ruling as well as its Luxembourg implications.

Still at EU level, the so-called “Mobility Directive” is expected to be soon transposed into Luxembourg law. We describe the implications of this transposition to the extend it concerns so-called “EU Cross-Border Operations”.

We hope you enjoy reading our Insights.

The ATOZ Editorial team



Law introducing measures for reviving the construction sector: Commentary

OUR INSIGHTS AT A GLANCE

- On 31 May 2024, a law introducing various measures to revive the construction sector was published.
- The aim of this package of measures is threefold: To strengthen the construction industry and craftmanship in order to maintain jobs in the sector; to increase the supply of housing; and to support people in acquiring or renting accommodation.
- The package includes tax and non-tax measures with short, medium, and long-term effects. Some are limited to 2024, while others are structural.
- We provide hereafter a commentary of the tax measures introduced by the government, including the various Grand-Ducal Regulations and the amendments proposed during the legislative process.

Introduction

On 31 May 2024, a law introducing various measures to revive the construction sector was published (the "**Law**"). According to the government's communication, these measures are designed to boost the construction sector and facilitate access to housing, by tackling both economic and structural housing problems. The Luxembourg property market is indeed currently at a virtual standstill. These measures concern individuals and the construction industry, as well as investors.

The aim of the first package of measures is threefold: to strengthen the construction industry and craftmanship in order to maintain jobs in the sector; to increase the supply of housing; and to support people in acquiring or renting accommodation. All but one of the measures were announced in the coalition programme of the newly elected government published on 20 November 2023.

The package includes tax and non-tax measures with short, medium, and long-term effects. Hereafter, we detail the tax measures to be introduced. Some are limited to 2024, while others are structural.

The draft law has been rather favourably received, especially by the various Chambers, given the scale of the crisis and the need to take swift action to remedy it.

This article provides a commentary of the tax measures introduced by the government, including the various Grand-Ducal Regulations and the amendments proposed during the legislative process.

Measures applying in 2024

Effective retroactively from 1 January 2024, the following measures will apply for 2024 only:

- **Temporary increase of the "Bëllegen Akt" tax credit for individuals**

The Law provides that the "Bëllegen Akt" tax credit for the purchase of real estate intended for residential use is increased from 30,000 to 40,000 euros per individual for property acquisitions documented by notarial deeds between 1 January 2024 and 31 December 2024.

The Council of State recalled in its opinion that, since the increase of the "Bëllegen Akt" is only temporary, it will decrease again to 30,000 euros in 2025. As a consequence, if a purchaser does not use all their 40,000 euros tax credit in 2024, the balance available cannot be

used for a subsequent acquisition. During the discussion with the deputies, Finance Minister Gilles Roth confirmed the analysis made by the Council of State and therefore confirmed that any surplus tax credit could not be carried over from 2024 to 2025.

- **Introduction of a new "Bëllegen Akt" tax credit for investment in rental housing**

According to the Law, a new "Bëllegen Akt" tax credit for investment in rental housing is also introduced. The amount of this tax credit is set at 20,000 euros per individual acquirer and applies only to individuals. It is intended solely for sales in future state of completion (*Ventes en état future d'achèvement* - VEFA) documented by notarial deeds executed between 1 January 2024 and 31 December 2024. This tax credit can be used for several acquisitions during 2024 but the cumulative amount cannot exceed 20,000 euros. As underlined by the Council of State, the scope of this measure is not limited to Luxembourg residents.

The Law sets that to qualify for this new tax credit, the purchaser must undertake to rent out the property for a minimum period of two years[1], except in cases of force majeure, and the property must be effectively occupied within four years following the date of the notarised deed of acquisition. In addition, the purchaser will be required to register the rental agreement with the tax authorities (*Administration de l'enregistrement, des domaines et de la TVA - AED*). If these conditions are not met, the purchaser will, in principle, be required to reimburse the entire amount of credit granted for the acquisition concerned, increased by legal interests.

Since the new tax credit is introduced in the course of the year, purchasers are allowed to request retroactive application if they go to the relevant tax office to sign a declaration of acceptance setting out the legal conditions.

- **Temporary decrease of the tax rate for capital gains**

Under Luxembourg tax law, individual taxpayers are taxed on speculative profits on real estate assets (i.e. when the assets are sold within a two-year period following their acquisition) at the marginal rate and, if the real estate assets are sold more than two years after their acquisition, at a rate corresponding to half of the global rate (i.e. average rate resulting from taxation of all the taxpayer's income). These provisions do not apply to the extent that a property sold constitutes the taxpayer's principal residence.

In order to mobilise properties, the Law provides that the tax rate for non-speculative capital gains realised on the sale of built and unbuilt real estate property forming part of the private assets of individuals in 2024 are temporarily reduced to a quarter of the global rate.

For the purpose of determining the temporal applicability of this measure, net income is taxable in the year of disposal of the real estate property, regardless of the date of payment of the sale price. The date the property is realised is the date of the notarial deed, the date of the judicial ruling in lieu thereof or the date of the administrative deed in lieu thereof.

This measure was already applied between 2016 and 2018. At the time, this measure stimulated the supply of building land and housing, and also contributed to an increase in real estate property sales.

As from tax year 2025

To accelerate the incentive effects of the planned quarter-rate measure and to curb speculation, the Law also amends the deadline within which a real estate alienation is considered as speculative and extends it to five years, instead of two currently, as from tax year 2025.

[1] The purchaser must also undertake to make a written declaration to the tax authorities (***AED***) in the event of sale or change in use of the property concerned during the two-year period. It must be declared within a three-month period starting on the day of the sale or change in use of the property.

- **Fiscal neutralisation of non-speculative capital gains transferred to accommodation used for social rental management or belonging to energy performance class A+**

The Law sets up the conditions in respect of a new tax-neutral regime for non-speculative capital gains transferred to specific replacement assets. This measure is an addition to the measures announced in the coalition programme of the government.

Real estate non-speculative capital gains realised during tax year 2024 and reinvested in one or more accommodation used for social rental management purposes (*Gestion locative sociale*) or in accommodation belonging to energy performance class A+ are eligible for the tax neutral regime under the following main conditions:

- Capital gains are to be transferred either to buildings acquired or constituted used for the purposes of social rental management as provided for in article 49 of the law of 7 August 2023 on affordable housing, *or* to residential buildings achieving level A+ in the classes of energy performance, thermal insulation and environmental performance, as defined in application of the amended law of 5 August 1993 on the rational use of energy.
- The replacement assets must be newly constructed. The commentary to the articles of the draft Grand-Ducal Regulation defines it as buildings with a completion date no earlier than during the tax year in which the transferable capital gain is realised (i.e. tax year 2024).
- The taxpayer must be the owner or bare-owner of both the building and the land which it is built on. Transfer to a building in undivided co-ownership is possible if the taxpayer's shares in the land and in the building are of the same percentage.
- The replacement asset must be located in the Grand-Duchy of Luxembourg. As underlined by the Council of State in its opinion on the draft Grand-Ducal Regulation, this condition of territoriality could potentially constitute an unjustified restriction on the free movement of capital under article 63 of the Treaty on the Functioning of the European Union and thus be incompatible with European law if the national legislation does not comply with the requirements of necessity and proportionality fixed by the European Court of Justice.
- The proportion of capital gain transferred to the land may not exceed 50 percent of the total amount of capital gain for which the transfer is requested.
- The transfer of capital gain must be requested when submitting the tax return for tax year 2024. Only the person who realised the capital gain may transfer it to a replacement asset. However, in the event of the taxpayer's death before the transfer, the successor(s) may request the transfer.
- The application must state the amount of capital gain for which the transfer is requested. If the sale price is only partially reinvested, the portion of capital gain for which the transfer is not requested is taxable in the tax year in which it was realised (i.e. 2024).
- The transfer of the capital gain must take place before the end of the tax year following the year of disposal of the real estate (i.e. tax year 2025). The transfer of the sale price on a replacement asset must take place at the latest before tax year 2026, unless the replacement asset is still under construction. In that case, the tax administration may extend the deadline by two years based on the introduction of a reasoned request and supporting documentation by the taxpayer.

The capital gain transferred becomes taxable in the tax year in which the building or part of the building acquired in replacement 1) ceases or fails to meet one of the conditions set out above, 2) becomes the taxpayer's principal residence or 3) is contributed to a commercial, industrial, mining or craft business.

- **Increase of the rate and the duration of accelerated depreciation for real estate investments allocated to rental housing**

With the same aim of revitalising demand for real estate investments allocated to rental housing, the Law, completed by a Grand-Ducal Regulation, aims to re-introduce[2], in terms of the amount and duration of application, a deduction -

[2] The accelerated amortisation rules applicable to rental housing investments was reduced from 6% to 4% as from tax year 2021.

subject to a ceiling - for depreciation of 6% for a period of six years and for eligible buildings or parts of buildings. The properties in scope are those which are built for rental purposes and for which the taxpayer has signed a deed of sale in future state of completion (VEFA) between 1 January 2024 and 31 December 2024. The maximum annual amount that can be deducted in this respect is capped at 250,000 euros. This amount is reached when the allowance is calculated on depreciable values of 6,250,000 euros.

The measure is granted for maximum seven tax years, i.e. for the tax year during which the properties or parts of properties are completed (in proportion to the number of full months during which they are considered to have been completed) and for the following six years.

This new special deduction for construction (*l'abattement construction spécial*) cannot be cumulated with the existing special deduction for investments in real estate not older than five years and allocated to rental housing (*abattement immobilier special*) to the extent it concerns the same building or part of building.

Measures applying for an unlimited period

The following measures, applicable as from tax year 2024, will apply for an unlimited period:

- **Increase of the exemption for net income from social rental management**

According to the Law, the exemption for net income earned from the rental of accommodation through organisations involved in social rental management will be increased from 75% to 90%.

- **Extension of capital gains tax exemption to the Housing Fund**

Currently, the law dated 22 October 2008 exempts capital gains (speculative or not) realised by individuals upon the sale of real estate properties sold to the State, municipalities, and local authority associations. This exemption is maintained and introduced by the Law in a specific provision of the LITL and its scope is extended for capital gains (speculative or not) realised by individuals upon the sale of real estate properties sold to the Housing Fund (*Fonds du Logement*). This exemption is, however, not available for real estate properties sold via the exercise of a legal right of pre-emption[3].

In its opinion, the Council of State wondered why the legislator wishes to limit the extension in question to the Housing Fund when there are other public establishments with the same activity or missions as them.

- **Introduction of a partial exemption for premiums paid by employers for renting accommodation**

The Law provides for a partial exemption for premiums paid by employers to young employees for the purpose of renting accommodation. This measure is available for young employees (i) who are under 30 years of age at the beginning of the tax year during which they obtain the payment of a premium for which the exemption of 25% is requested and (ii) whose annual income does not exceed 30 times the monthly qualified social minimum wage[4] (*salaire social mensuel minimum qualifié*). In addition, the amount of the premium qualifying for the exemption is capped at the amount of rent paid by the employee and at a maximum of 1,000 euros per month, of which 25% is exempted.

Therefore, if the rent paid by the employee is 750 euros, for example, the maximum amount of rental premium benefiting from the exemption that the employer can pay to the employee is also the amount of 750 euros. The exemption for such rental premium is then limited to 25% of the amount of 750 euros (i.e. 187.50 euros/month). The maximum amount paid by the employer is then limited by a second threshold of 1,000 euros per month. As a result, the 25% exemption no longer applies to the portions of a premium that exceed a monthly amount of 1,000 euros. For example, if an employer pays a rent allowance of 2,000

[3] Note that, under the law dated 22 October 2008, this exception is limited to non-built real estate properties sold by exercising a legal right of pre-emption.
[4] Which amounted to 92,553.30 euros on 1 September 2023 (30 x 3,085.11 euros), corresponding to 2.5 times the annual qualified social minimum wage.

euros to an employee, the above-mentioned 25% exemption only applies up to the maximum monthly amount of 1,000 euros of the rental premium (i.e. 250 euros/month).

A draft Grand-Ducal Regulation specifies that the maximum amount of rental premium qualifying for the exemption (i.e. rent paid by the employee, capped at 1,000 euros per month) refers to a full month and full-time employment. In the event of a period of incomplete remuneration, or part-time work, the maximum amount of rental premium is reduced proportionally by reference to full-time employment.

It is up to the employer to check that the conditions are met and to regularise the exemption in the event that at the end of the year the employee exceeds the annual remuneration limit making him eligible for the exemption. It should be noted that, if the employee has not worked for the employer awarding the premium for the whole year, the employer must extrapolate the remuneration received during the period the employee worked for the employer over a full, full-time year, in order to verify that the annual remuneration limit has not been exceeded.

If the lease agreement provided by the employee is a shared lease agreement, the amount borne by the employee in respect of rent is the total amount of rent, excluding charges, to be divided by the number of lessees, unless the lease contract specifies the amount of rent, excluding charges, borne by each lessee individually.

As underlined by the Council of State, the scope of this measure is not limited to Luxembourg residents.

This exemption is justified by the difficulty that some employers may encounter in practice in attracting suitable candidates, given the cost of rental accommodation, which is often considered a decisive factor in the decision of whether or not to accept a job in Luxembourg. This measure is positive for young talent attraction in Luxembourg. However, it would have been interesting to let the employee decide what to do with the premium, allowing them to rent accommodation or to buy accommodation. This would probably help to attract talent but also to retain it. It would also help young workers finance their mortgage, which is also one of the aims of the Law as described further.

- **Increase of the amount of mortgage interest deductible**

Finally, the Law aims to introduce structural measures to help individuals finance their mortgage. For this purpose, a draft Grand-Ducal Regulation provides that the amount of deduction of mortgage interest for houses occupied by the owner (or to be occupied by the owner) will be increased by one third.

The relevant amounts, to be multiplied by the number of persons in the taxpayer's household, will thus rise from:

- 3,000 to 4,000 euros for the first five years of occupancy,
- 2,250 to 3,000 euros for the subsequent five years (six-ten years),
- 1,500 to 2,000 euros thereafter.

Conclusion

The new measures proposed by the Luxembourg government in order to address the current Luxembourg building construction sector issues are positive and welcome. However, most of them are temporary and only address the urgency of the current crisis. This overall situation outlines the need for a global reform of the real estate tax system in Luxembourg, as we have already stressed in one of our previous articles according to which the ongoing Luxembourg property tax reform was too slow to efficiently address the housing challenges.

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The “substance over form” principle is an argument that can be used by both the tax authorities and the taxpayer

OUR INSIGHTS AT A GLANCE

- On 20 February 2024, the Administrative Court reinstate some equity in the relationships between the Luxembourg tax authorities and the taxpayer by clarifying that both parties have the right to apply the "substance over form" principle.
- Taxpayers who wish to succeed in their procedure to have the appearance that they have created by the legal forms they have chosen, reclassified by applying the principle of substance over form, must provide proof of a disparity between the legal form and the economic reality.
- However, taxpayers cannot rely on this principle to claim an economic reality that is based exclusively on his own allegations, but which are contradicted by the legal forms chosen and which are not supported by any other element.
- We analyse hereafter the Administrative Court decision and its implications for Luxembourg taxpayers.

On 20 February 2024, the Luxembourg Administrative Court (“**the Court**”) issued a significant ruling, affirming that taxpayers have the right to invoke the “substance over form” principle under specific conditions. This principle, traditionally utilised by tax authorities to adjust a taxpayer's tax base, is not exclusively available to the Luxembourg tax authorities (“**LTA**”).

This landmark decision restores a measure of equity in the interactions between the administration and taxpayers, reinforcing the fairness of the tax system.

Factual background

In the case at hand, the taxpayer, a fully taxable Luxembourg corporation (Company A), had entered into a licencing agreement with a related entity (Company D, established in the United States), according to which Company A had the right to exploit intellectual property (“**IP**”) rights (trademarks) on a certain territory in return for the payment of a lump sum fee to Company D. The taxpayer intended to apply a partial exemption on the income it received from the sub-licencing agreements it had concluded with other parties.

Indeed, the tax regime in force during the years under review (i.e. 2016, 2017 and 2018)[5] provided that 80% of the net income received by a taxpayer for the exploitation of certain IP rights it owned could be exempt from corporate income taxes under certain conditions and that the IP right as such could be an exempt asset for net wealth tax purposes in accordance with § 60*bis Bewertungsgesetz* (the “**Valuation Law**”).

The LTA refused to apply the exemptions of corporate income taxes and net wealth tax to the income received by Company A to the IP on the grounds that the conditions for these exemptions had not been met, and in particular that the licencing agreement with Company D did not make Company A the owner of the IP rights as such but only the lessee of a licence over these IP rights that were still the property of Company D.

The taxpayer contested the position of the LTA and argued in a claim addressed to the Director of the LTA that although Company A was not the legal owner of the IP rights, it was nonetheless the economic owner of these IP rights due to the terms and conditions of the licencing agreement and that, as per the “substance over form” principle, the LTA

[5] Article 50bis Income Tax Law (“**ITL**”).

should grant it the exemptions foreseen by Article 50*bis* of the ITL and § 60*bis* of the Valuation Law.

As the Director of the LTA refused to apply this principle and to apply the exemptions, the taxpayer challenged this position in front of the Administrative Tribunal (i.e. the Lower Court).

The "substance over form" principle as the cornerstone of Luxembourg tax law

One of the key principles which governs Luxembourg tax law is the "substance over form" principle, which can be found in §§ 5, 6 and 11 of the Luxembourg *Steueranpassungsgesetz* (the "**Adaptation Law**") dated 16 October 1934 and is also based on consistent jurisprudence.

According to the "substance over form" principle, transactions must be qualified according to their fundamental economic nature rather than their formal description or civil law qualification (i.e. the "*Wirtschaftliche Betrachtungsweise*" principle).

The justification for the application of this principle is that the tax law imposes a tax burden that only those with the corresponding capacity to pay can bear without damage. This result can only be achieved if the tax law applies the "*Wirtschaftliche Betrachtungsweise*" or "substance over form" principle.

While § 2 (1) of the Adaptation Law states that the LTA must follow the legal limits imposed on it by the legislator in the course of the exercise of its discretionary power, § 2 (2) defines the general principle according to which, when the LTA exercise their discretionary power in view of adopting a decision, the LTA must be compliant with "*Billigkeit und Zweckmäßigkeit*", which are commonly translated as fairness and appropriateness.

The notion of fairness, or "*Billigkeit*", is applied to assess a decision in light of the reality of the taxpayer's situation and the impact of the decision on the tax situation of the taxpayer, to avoid an unreasonable tax liability. Thus, the LTA, who have a discretionary power, should proceed with an objective analysis of the situation, given the specific circumstances, with fairness.

Decision of the Administrative Tribunal

On 26 July 2023, the Administrative Tribunal rejected the taxpayer's claim for a reassessment of its corporate income taxes and net wealth tax charges by application of the exemptions. According to the Tribunal, the agreement entered into between the taxpayer and Company D did not have as effect to transfer the ownership of the IP rights to the taxpayer but had as mere effect to grant it a licence with the right to grant sub-licences to other parties so that the ownership condition of the IP rights to exempt the income derived therefrom was not fulfilled in the case at hand.

The judge further stated that "*the tribunal must finally note, with regard to the plaintiff's developments to the effect that the economic reality is quite different from that which emerges from the licencing and sub-licencing agreements, and more particularly its argumentation based on the jurisprudential criteria enshrined in Paragraph 11 of the Adaptation Law, that said argument is to be rejected in its entirety for lack of relevance, whereas* ***a taxpayer cannot be allowed to use the principle of economic reality to contradict his own unequivocal evidence****, whereas it is recalled that the principle, derived from Paragraph 11 of the Adaptation Law,* ***is intended solely to allow, in tax matters, the tax authorities and the Administrative Court to investigate and analyse, beyond the legal appearance, the economic reality covered by the legal forms chosen by the parties*** *to carry out a given transaction, with a view to verifying whether this corresponds to the real intention of the parties*" (unofficial translation).

The taxpayer then appealed against this judgment and argued before the Court that the tax exemptions should be applied because, although it was not the legal owner of the IP rights, it was nonetheless the economic owner thereof so it should benefit from the corporate income taxes exemption on income deriving from the commercial exploitation of its asset and that such asset should be exempt from net wealth tax by application of the "substance over form" principle.

Decision of the Administrative Court

The Court, having agreed that it was appropriate to consider that the exemptions under Article 50bis of the ITL and § 60bis of the Valuation Law are reserved for the sole owner, should it be a legal or economic owner, logically indicated that it was necessary to examine, as the Administrative Tribunal had done, whether, notwithstanding the circumstance not disputed by Company A that Company A is not the legal owner of the trademarks since they were not registered in its name during the tax years under review neither in the U.S. nor in Europe, Company A is to be considered as their economic owner within the meaning of § 11 of the Adaptation Law in order to clarify whether the tax exemptions should apply.

- **Reminder of the conditions to be considered for being an economic owner**

Guided by this principle, the Court reviewed the case through an economic lens. The Court reiterated that the application of § 11 of the Adaptation Law by a person requires the satisfaction of four specific conditions, as previously determined by the Administrative Court in its 26 June 2008 decision.

These four cumulative conditions are:

- The person should benefit from any increase in the property's value;
- The person should bear the risks associated with the property's depreciation;
- The person should possess effective economic rights over the property; and
- The acquisition of the property should be essentially irreversible.

The Court noted that:

- Company D kept a right of termination of the licencing agreement if it considers that the obligations prescribed by the agreement are not complied with, which contradicts the idea of an irreversible or quasi-irreversible transfer of economic ownership for the benefit of Company A against the payment of a lump sum compensation,
- the facts do not all reflect what the taxpayer claims in a consistent manner, i.e. a genuine intention, via the contract, to transfer the economic ownership of the trademarks for the benefit of Company A insofar as (i) the trademarks under litigation were treated differently from the other trademarks owned by the taxpayer and whose complete ownership had been acquired by the taxpayer and (ii) the annual accounts of the taxpayer retain the qualification of “licences”, which is in contradiction to its argument according to which this contract would in reality qualify as a purchase contract and would, from an accounting point of view, have been treated as such by the company.

The Court concluded on that basis that the Administrative Tribunal rightly came to the conclusion that the intention of the parties to the licence contract must be considered to have been that of ensuring that Company D did not lose control over the disputed IP rights and not to transfer any part of the property rights thereof to the taxpayer which sees its right to exploit the trademarks strictly limited by the licence contract. Consequently, Company D having retained control over said exploitation, Company A should not be considered as the economic owner of the trademarks but merely as a lessee and the exemptions for corporate income taxes and net wealth tax should hence not apply in the case at hand.

- **Why is this decision important?**

The Court confirms that the principle of “substance over form” can be invoked by the taxpayer and clarifies that the Administrative Tribunal should reduce its analysis to the examination of the legal forms chosen by the parties to carry out a given transaction, but must, beyond the legal appearance, research and analyse the economic reality covered by said legal forms. This contradicts the statement of the Administrative Tribunal according to which, as already seen in previous case law confirming the position of the LTA on this topic, a taxpayer would not be allowed to use the principle of economic substance that only aims to enable the LTA and the administrative judges to research and analyse, beyond the legal appearance, the economic reality behind the legal forms chosen by the parties to carry out a specific operation, in order to check whether these latter correspond to the real intention of the parties.

This decision of the Court is important insofar to reinstate some equity in the relationships between the tax administration and the taxpayer by clarifying that both parties have the right to apply the "substance over form" principle.

According to the Court, taxpayers who wish to succeed in their procedure to have the appearance that they have created by the legal forms they have chosen, reclassified by applying the principle of substance over form, must provide proof of a disparity between the legal form and the economic reality. In such case, taxpayers must establish that the author(s) of the transaction to be reclassified intended to carry out a certain transaction from an economic point of view, that they actually carried it out, and that the legal classification chosen does not ultimately reflect his/her/their intention.

The Court, however, introduces one nuance by specifying that "*the taxpayer cannot rely on this principle to claim an economic reality that is based exclusively on their own allegations, but which are contradicted by the legal forms chosen and which are not supported by any other element*". It was thus in this sense, and only in this sense, that the Administrative Tribunal recalled that a taxpayer is not allowed to use the principle of substance over form to contradict its own unequivocal evidence. In order for a transfer of economic ownership to be accepted and in order to be able to claim the status of economic owner to whom the property is then to be attributed for tax purposes pursuant to § 11 of the Adaptation Law, it is necessary that the person other than the legal owner behaves, at the very least, in such a way as to deprive the legal owner of any possibility of disposing of the property. This generally presupposes that the person has the power to control and dispose of the property and is in fact behaving as the legal owner of the property would, without necessarily holding the title of legal owner.

As a conclusion, we can be satisfied with a return to common sense. This decision is entirely logical. It seemed difficult to imagine, if we dare to use the sporting metaphor, a competition with different rules between the competitors. In addition, and in practice, many tax returns are already adjusted to take into account the economic reality of the operations, for example, in case of hidden dividend distributions or if the profit split method is applied for transfer pricing purposes in particular.

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Luxembourg tax authorities published FAQ on Pillar Two transition rules regarding deferred tax assets and liabilities

OUR INSIGHTS AT A GLANCE

- On 25 March 2024, the Luxembourg tax authorities published an FAQ aiming to clarify the application of the Pillar Two law.
- In this FAQ, welcomed clarifications on the deferred tax assets and liabilities to be considered when determining the effective tax rate for a jurisdiction in a transition year, and for each subsequent fiscal year are provided.
- The FAQ notably specifies what the "financial accounts" concerned are as well as the terms "reflected or disclosed in the financial accounts".
- We explain hereafter the implications of the FAQ.

On 25 March 2024, the Luxembourg Tax Authorities ("**LTA**") published an FAQ aiming to clarify the application of the law of 22 December 2023 transposing the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union (the "**Pillar Two Law**").

In this FAQ, the LTA provides welcomed clarifications addressing the transition rules regarding the tax treatment of deferred tax assets and liabilities. This FAQ will be further completed as soon as new information becomes available.

Clarifications brought by the FAQ

The Pillar Two Law states that when determining the effective tax rate for a jurisdiction in a transition year, and for each subsequent fiscal year, the MNE group or a large-scale domestic group shall take into account all the deferred tax assets and deferred tax liabilities ***reflected or disclosed*** in the ***financial accounts*** of all the constituent entities in a jurisdiction for the transition year. The transition year is defined as the first fiscal year in which a group falls within the scope of the Pillar Two rules.

- **Financial accounts concerned**

The FAQ specifies that the "financial accounts" concerned are the financial accounts of the Luxembourg constituent entity concerned (i.e. annual accounts) and/or the consolidated financial accounts of the ultimate parent entity.

In the latter case, it is important that the information can be reliably and consistently traced back to the Luxembourg constituent entity concerned.

Reference is also made to the "Q&A 24/032" of the *Commission des Normes Comptables* ("**CNC**") concerning the option to disclose deferred tax assets and liabilities in the notes to the 2023 annual accounts, acknowledging that a Luxembourg constituent entity has the ability to disclose deferred tax assets and liabilities based on the applicable Luxembourg corporate tax rate, and does not need to perform a specific analysis of the recoverability of tax losses in order to disclose the related deferred tax assets in the context of the Pillar Two Law.

- **“Reflected” or “disclosed”**

The FAQ further precises that the terms “reflected in the financial accounts” refer to deferred tax assets or liabilities that are recognised in the balance sheet of the financial accounts while the terms “disclosed in the financial accounts” refer to deferred tax assets or liabilities that are disclosed in the notes to the financial accounts.

In this respect, the LTA acknowledges that disclosure in the notes to the financial accounts is sufficient in order to benefit from these transition rules. In practice, it should allow under certain conditions the deferred tax assets on pre-existing tax losses carried forward to be taken into account for the computation of the effective tax rate under the Pillar Two Law, even though the future use of such tax losses is uncertain and these deferred tax assets would probably not be recognised under IFRS under IAS 12.

With regard to the possibility for a Luxembourg company which is part of a group of MNEs or a large national group within the meaning of the Pillar Two Law to present its deferred tax assets and liabilities in the notes to its financial accounts, the CNC repeated that it is the responsibility of the company to provide any additional information in the notes to its annual accounts, including on potential deferred tax assets or liabilities, to contribute to the objective of a true and fair view of the financial accounts.

- **Timing**

The first effect of the transitional measures occurs from the transition year onwards. To benefit from these measures, it is recommended by the LTA that all deferred tax assets and liabilities be reflected or disclosed in the financial accounts for the year preceding the transition year. For instance, for a transition year covering the period from 1 January 2024 to 31 December 2024, it is recommended that all deferred tax assets and liabilities be reflected or disclosed in the financial accounts for the year ending 31 December 2023.

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EU Commission's initiatives in Direct Tax matters: State of play

OUR INSIGHTS AT A GLANCE

- Ongoing direct tax initiatives of the European Commission have not really evolved over the past 4 months and why we see more and more EU national Parliaments taking a very critical stand on the reforms proposed by the European Commission.
- On 1 January 2024, Belgium took over the Presidency of the Council of the EU for the next six months. Belgium defined the adoption of the Faster and Safer Relief of Excess Withholding Taxes directive proposal, called "**FASTER**", as a top priority and the chances of having this directive proposal formally adopted are rather high.
- The proposal laying down rules to prevent the misuse of shell entities for tax purposes, called "**Unshell**", is still ongoing 2.5 years after its release and there is still a big question mark on its chances to succeed. The related initiative on "enablers" of tax evasion and aggressive tax planning, called "**SAFE**", is on hold as it cannot be launched as long as the future of the Unshell project remains uncertain.
- The examination of the Debt-Equity Bias Reduction Allowance directive proposal, called "**DEBRA**" is also still on hold, and it is expected that this situation will remain unchanged in the coming months.
- Finally, the 3 most recent directive proposals - (1) called "**BEFIT**", (2) the Head Office Tax System for SMEs and (3) on transfer pricing - are only at the very early stage of the legislative procedure. However, the EU Council has been working actively on the transfer pricing proposal so far, illustrating its willingness to have this project move forward quickly.
- We provide hereafter an overview of the state of play of the most recent European direct tax initiatives of the European Commission.

Over the few past months, with a rhythm never seen before, a series of significant tax directive proposals were adopted by the European Commission in the name of the transparency, the fight against tax fraud and tax evasion and "fair" taxation but also, more recently with the purported aim to simplify and harmonise the corporate tax systems and reduce compliance costs.

Many of the ongoing direct tax initiatives of the European Commission have however not evolved over the past months and we see more and more national Parliaments taking a very critical stand on the reforms proposed by the European Commission. Various European Member States seem not eager to have additional tax changes adopted quickly and introduced in the short term anymore because a sheer amount of tax reforms, whose effects cannot all be evaluated yet, are still in their implementation phase. The adoption of additional new rules would create an even more challenging context of constantly evolving tax rules, especially in the current economical context.

Nevertheless, the adoption of the Faster and Safer Relief of Excess Withholding Taxes directive proposal was set as a top priority by the EU institutions and the chances of having this directive proposal formally adopted are rather high. Indeed, the Council reached an agreement (general approach) on new rules for withholding tax procedures.

In this article, we provide an overview of the state of play of the most recent European direct tax initiatives of the European Commission, from the ones that are the most likely to be adopted in the short term to the ones that have, currently, the least chances to succeed in the near future.

The FASTER Proposal

On 19 June 2023, the European Commission published the proposal for a Council Directive on Faster and Safer Relief of Excess Withholding Taxes, the "**FASTER Proposal**". With this new initiative, the Commission aims to tackle the current particularly burdensome withholding tax ("**WHT**")

refund procedures - which differ between Member States - for cross-border investors in the EU and, at the same time, the risks of tax abuse related to refund procedures revealed notably by the Cum/Ex and Cum/Cum scandals. For a presentation of the FASTER Proposal, please read our ATOZ Alert of 21 June 2023 "European Commission releases FASTER Directive Proposal".

In the same way as the Spanish Presidency did since the release of the FASTER Proposal, the Belgian Presidency of the EU Council, which started on 1 January 2024, has been giving this legislative proposal a high level of priority and the EU Council has been very active on discussing and analysing the FASTER Proposal during the first part of 2024.

On 14 May 2024, the European and Financial Affairs Council (ECOFIN) met to discussed about the FASTER directive proposal through a compromise text which presents substantial differences compared to the original text of the proposal published in June 2023. The Council reached an agreement (general approach) on this compromise text providing for new rules for withholding tax procedures.

The compromise text of the FASTER Proposal, compared to the suggestion made by the Spanish Presidency, extends notably the scope of jurisdictions which could be exempted from applying the WHT relief procedures under FASTER to avoid additional administrative burden on them without any real added value (given their already well-functioning system): only small stock markets with comprehensive withholding tax relief-at-source systems could be exempt from the related provisions of the FASTER Proposal.

Under the Belgian compromise text, EU Member States with comprehensive relief-at-source systems that have, during four preceding consecutive years, a market capitalisation ratio equal to or more than 1,5% (instead of 1% under the suggestion made by the Spanish Presidency) shall irrevocably apply the WHT relief procedures of the FASTER Proposal. The Presidency defined market capitalisation ratio as "*the ratio expressed as a percentage of the market capitalisation of a Member State on [31 December] to the overall market capitalisation of the European Union*" on the same day. The compromise text says that countries without a comprehensive relief-at-source system would also be required to apply the WHT relief procedures regardless of whether their market capitalisation is below, equal to, or above the 1,5% threshold.

On Wednesday 28 February, the European Parliament adopted its non-binding opinion on the initial FASTER Proposal. While supportive of the FASTER Proposal, the European Parliament suggests some amendments and clarifications. It notably recommends to identify the beneficial owner of the dividend/interest income by applying the rules of the source Member State or those of the applicable tax treaty, to continue the fight against illegal WHT reclaim procedures by introducing cooperation and mutual assistance on the exchange of information amongst the relevant parties (e.g. tax authorities, law enforcement bodies), and examine possible measures to facilitate self-processed WHT claims for small investors (without the intermediation of certified financial intermediaries). However, due to the changes the Council made in the FASTER Proposal during the negotiations, the European Parliament will be consulted again on the compromise text agreed upon on 14 May 2024 by the Council.

Following this re-consultation with the European Parliament, the FASTER Proposal will need to be formally adopted by the Council (unanimity required) before being published in the EU's Official Journal and entering into force. In this respect, the Council is currently expected to adopt the FASTER Proposal in early 2025.

Member States will then have to transpose the directive into national legislation by 31 December 2028, but the national rules will, in principle, become applicable only as from 1 January 2030.

For more information about the compromise text agreed upon by the EU Council, please read our ATOZ Alert of 21 May 2024 "The Council reached an agreement (general approach) on new rules for withholding tax procedures (FASTER)"

The Unshell Proposal

On 22 December 2021, the European Commission submitted a proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, the "**Unshell Proposal**".

The objective of the Unshell Proposal is to prevent tax avoidance and evasion through actions by undertakings without minimal substance. The Unshell Proposal aims to fight against the misuse of shell entities for improper tax purposes and to ensure that shell companies in the European Union that have no or minimal economic activity are unable to benefit from certain tax advantages (for a presentation of the Unshell Proposal, please read the article "The new Directive proposal to fight against the misuse of shell entities" in our April 2023 ATOZ Insights).

By the end of 2023, European Member States had not managed to reach an agreement on various technical aspects of the directive proposal. When taking over the Presidency, Belgium expressed its support to an adoption of the Unshell Proposal. However, since the priority was finally given to other files, for the first time since the release of the Unshell Proposal by the European Commission, the proposal is currently stalled at the Council as it was not discussed, at least officially in a dedicated forum such as a meeting of Working party on Tax Questions, during the first five months of this year.

On 22 January 2024, MEPs of the ECON Committee held an Economic Dialogue and exchange of views with Vincent Van Peteghem, President of the ECOFIN during the Belgian Presidency. MEP Paul Tang notably questioned a possible adoption of the Unshell Proposal. Although the Belgian Presidency has made the fight against tax evasion and avoidance a priority, the President of the ECOFIN noted that the adoption of this proposal requires unanimity at the Council and some Member States have expressed concerns about the excessive administrative burden for tax administrations and businesses it involves. According to the current President of the ECOFIN, this issue is, therefore, under analysis by the Presidency, before embarking on further work.

Thus, the uncertainty related to this initiative has even increased since our last state of play as Member States do not seem to find any solution in order to come to an agreement on this file and have no longer been working on this file since the beginning of the year.

The European Commission is nevertheless determined to find an agreement on a directive proposal setting up a minimum substance requirement for European companies. This would be key for the Commission as one of the criteria used for the assessment of foreign jurisdictions for purpose of the bi-annual EU list of non-cooperative third countries relies on the implementation of substance requirements by zero-tax countries. Yet how can the European Commission impose substance requirements to third countries when it does not have propre substance requirements for its own entities? The adoption of the Unshell Proposal, whatever its final form, seems thus to be a matter of credibility. This argument disregard however that European Member States have to respect the propre substance requirements under anti-abuse rules and the concept of artificial arrangement established by the European Court of Justice.

The BEFIT Package

On 12 September 2023, the European Commission adopted package of initiatives including:

- The Business in Europe: Framework for Taxation (BEFIT) proposal with the aim to introduce a common set of rules for European companies to calculate their taxable base while ensuring a more effective allocation of profits between European countries, based on a formula ("**BEFIT Proposal**").
- a directive proposal establishing a Head Office Tax ("**HOT**") System for small and medium-sized enterprises ("**SMEs**"), which aims to encourage cross-border expansion of SMEs by simplifying the tax rules which they are subject to when they operate through permanent establishments ("**PE**") as well as reduce the related tax compliance burden and costs ("**HOT Proposal**").
- a directive proposal on transfer pricing which aims at integrating key transfer pricing principles into EU

law with the objective of putting forward common approaches for Member States (the "**TP Proposal**").

To find out more about the BEFIT Proposal and the HOT Proposal, please refer to our article "*EU Commission Releases Proposal for a Council Directive on BEFIT: A Critical Analysis*" in the December 2023 ATOZ Insights. For a presentation of the key aspects of the TP Proposal, please refer to our ATOZ News of 25 September 2023.

- **The BEFIT Proposal**

Because BEFIT replaces the European Commission's proposal for a common corporate tax base ("**CCTB**") and the proposal for a common consolidated corporate tax base ("**CCCTB**") that have never reached consensus, it was expected that the BEFIT Proposal would be subject to a lot of criticism.

The expected criticism is confirmed by the numerous reactions of the EU national parliaments. Nine national Parliaments (Sweden, Ireland, Poland, Germany, Malta, the Czech Republic, Italy, Finland, and the Netherlands) provided their comments on the BEFIT Proposal, either by means of a reasoned opinion or by means of a statement. Reasoned opinions enable national parliaments to notify the European Commission of their belief that a proposal violates the subsidiarity principle. While many national parliaments are positive on the ambition to simplify administration for cross-border companies within the EU, they mainly consider that:

- It is not clear that the objective of simplification will be met with BEFIT (e.g. Sweden, Ireland, Finland);
- Rather, the BEFIT Proposal is expected to be burdensome for smaller tax administrations which would be required to handle an additional set of rules in addition to their national rules (Malta);
- The BEFIT Proposal is not compatible with the EU's principle of subsidiarity (e.g. Sweden, Ireland, Malta, Czech Republic);
- Each State is better suited to determine corporate taxation and group taxation laws and regulations at its own level (Sweden) and the BEFIT Proposal limits Member States' sovereignty in the field of corporate income taxation, despite direct tax collection and usage falling within national competence (e.g. Sweden, Ireland, Poland, Finland);
- The BEFIT Proposal raises concerns similar to the currently withdrawn CCCTB Proposal (Malta);
- The implementation of the BEFIT Proposal would lead to a massive change in the tax system and a significant workload for both businesses and the administration (e.g. Germany);
- Tax competition is an important policy tool, particularly for smaller Member States. The BEFIT Proposal appears to replace a large part of domestic tax laws with an EU corporate tax system over which individual Member States would have only very limited control (Ireland);
- Formulary apportionment of profits, if introduced, would also likely lead to a considerable redistribution of corporate tax revenues across the EU and would be likely to benefit larger Member States at the expense of smaller ones (Ireland);
- It is doubtful as to whether the BEFIT Proposal is proportionate, necessary, and effective (Germany).

On 15 February 2024, Members of the European Parliament (MEPs) of the Committee on Economic and Monetary Affairs ("**ECON Committee**") discussed the draft report on the BEFIT Proposal. While the report generally supports the intention of the BEFIT Proposal, it includes several suggestions of amendments, including mainly ensuring an alignment with the Directive of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union ("**Directive Pillar Two**"), and even considering delaying the transposition deadline so as not to disrupt this initiative, lowering the scope of the annual revenue threshold to EUR 40 million, after a transitional period, revising the interest limitation rules for BEFIT groups as a means to reduce the debt-to-equity bias created by excessive intra-group interest payments, identifying a way to ensure the minimum taxation of royalties (e.g. via a royalties' limitation rule), strengthening CFC rules in terms of offshoring profits and taxing passive income, providing for penalties proportionate to the turnover of the BEFIT group and shifting from an indefinite to a 5-year limit for carrying forward a negative BEFIT tax base. So far, no agreement could be reached at committee level on the draft report, as initially planned.

The BEFIT Proposal has not been analysed in depth during meetings of the Working Party on Tax Questions (Direct Taxation) so that the legislative procedure is still in a very early stage. In addition, given the reactions of the various EU national parliaments, which, for some of them, are still busy implementing Pillar 2, the chances of BEFIT being adopted in the short term are rather limited at the moment and its chances to succeed in the longer term remain uncertain as well.

- **The HOT Proposal**

On 17 January 2024, the advisory (non-binding) opinion of the European Economic and Social Committee ("**EESC**") on the HOT Proposal was adopted. The EESC emphasised the urgency of adopting the HOT Proposal. While supporting the proposal's focus on standalone micro and SMEs initially, the EESC calls for an evaluation of the possibility to extend the HOT system to include SMEs operating cross-border through subsidiaries during the planned ex-post assessment five years after the directive comes into force. While acknowledging the complementary nature of the HOT system and the BEFIT Proposal, it stressed on the need for vigilance regarding the coexistence of different legal frameworks, urging the European Commission to monitor and address potential fragmentation and discrepancies that may arise.

On 10 April 2024, the European Parliament adopted its opinion on the HOT Proposal. The European Parliament's opinion, although non-binding, is mandatory under the consultation procedure. The Parliament supports the initiative, which is considered as a step in the right direction. However, it considers that the HOT Proposal should become more ambitious by widening its scope to also include companies that operate cross border by way of a maximum of two subsidiaries. It considers further mainly that one should delineate the opportunities created by the SMEs, the financial and administrative obstacles they face and the corresponding solutions that the HOT Proposal would bring, reassess the usefulness of excluding international shipping (and SMEs which are covered by the tonnage tax regime) after 5 years of HOT having been in place and finally accelerate the adoption of the HOT Proposal to allow SMEs to access the HOT system by 2025.

As far as the technical analysis of the HOT Proposal at EU Council level is concerned, only one single meeting of the Working Party on Tax Questions (Direct Taxation) took place on 9 April 2024. Thus, the legislative procedure is still in an early stage, the position at Council level on the amendments suggested by the EU Parliament is unknown for the time being and the chances of the HOT Proposal succeeding remain to be confirmed.

- **The TP Proposal**

The technical work at EU Council level started very quickly end of 2023 and the work has been continuing, on a regular basis, since Belgium took over the Presidency and lately during a meeting of the Working Party on Tax Questions (Direct Taxation) on 22 April 2024.

As far as reactions of European Member States are concerned, following the first concerns raised by the Finnish government back in December 2023 (please refer to our previous article in the ATOZ Insights of December 2023 in this respect), on 23 January 2024, the Swedish Parliament issued a reasoned opinion on the TP Proposal. While welcoming the ambition of the European Commission to increase predictability in taxation and reduce the number of situations of double taxation and double non-taxation, thereby reducing the number of disputes and compliance costs for companies, Sweden notes that the existence of transfer pricing guidelines at OECD level, which are not binding, updated on a regular basis and are a dynamic framework that evolves over time, is positive. In contrast, there is a risk that a codification of the arm's length principle in the EU will lead to the loss of the flexibility necessary for an effective application of the principle and that this in turn, contrary to the Commission's stated objective in the proposal, will lead to increased legal uncertainty, an increased number of disputes and increased compliance costs for companies. Sweden stresses further that the Member States' competence in the field of taxation must be safeguarded when it comes to direct taxation. Sweden concludes that the TP Proposal is contrary to the principle of subsidiarity.

On 10 April 2024, the European Parliament adopted its opinion on the TP Proposal. As a reminder, the European Parliament's opinion, although non-binding, is mandatory under the consultation procedure. The European Parliament is generally supportive of the TP Proposal. However, it recommends mainly (1) a faster implementation at national level, i.e. by 31 December 2024, with relevant measures applying from 1 January 2025 (instead of currently 1 January 2026); (2) a use of the formulary apportionment method as a long-term solution to tackle tax avoidance and ensure a minimum effective tax rate for multinational enterprises; (3) an alignment with the latest OECD Transfer Pricing Guidelines, including Amount A and Amount B of Pillar One for simplified transfer pricing rules; and (4) harmonised TP documentation standards across the EU to lower the compliance burden while enhancing transparency and mitigating tax avoidance risks.

To conclude, while the initiative is recent, the TP Proposal evolves quite quickly. However, it remains to be confirmed if Member States will manage to come to an agreement on this file.

The SAFE initiative

When the Unshell Proposal was adopted, the European Commission announced that it would propose a follow-up initiative to respond to the challenges linked to non-EU shell entities, i.e. a proposal for a Council Directive to tackle the role of tax advisers and other professionals rendering tax advice (collectively referred to as "enablers"): Securing the Activity Framework of Enablers, "**SAFE**". While the European Commission initially planned to adopt the SAFE directive proposal on 7 June 2023, despite the text of the proposal being technically ready, the Commission finally decided to indefinitely postpone its release, due to the uncertain future of the Unshell Proposal. This situation remains unchanged as of today.

To find out more on the SAFE initiative, you can read the article "SAFE - The new EU initiative targeting tax advisers" in our December 2022 ATOZ Insights.

The DEBRA Proposal

On 11 May 2022, the European Commission released a directive proposal to address Debt-Equity bias, the DEBRA Proposal. The DEBRA Proposal is one of the targeted measures announced by the European Commission in May 2021 in its Communication to promote productive investment and entrepreneurship and ensure effective taxation in the EU. The proposal lays down rules on the deduction, for corporate income tax purposes, of an allowance on increases in equity and additional rules on the limitation of the tax deductibility of exceeding borrowing costs (for a presentation of the DEBRA Proposal, please read the article "European Commission releases DEBRA Directive Proposal" in our in our July 2022 ATOZ Insights).

As mentioned in our previous article "EU Commission's initiatives in direct tax matters: state of play" released in our April 2023 ATOZ Insights, by the end of 2022, it was decided to suspend the examination of the DEBRA Proposal in order to, if appropriate, reassess it within a broader context only after other proposals in the area of corporate income taxation announced by the Commission have been put forward. Since our latest state of play in the December 2023 ATOZ Insights, no development occurred, except the work performed at European Parliament level, as required under the legislative procedure, with the adoption by the European Parliament in Plenary of its opinion on 16 January 2024. The European Parliament is generally supportive of the DEBRA Proposal but recommends certain amendments.

As of today, it is expected that the project will be kept on hold in the coming months given that whether the DEBRA Proposal will be kept or totally abandoned will depend on the outcome of the BEFIT Proposal.

Directive 2011/16/EU on administrative cooperation

On 7 May 2024, the European Commission launched a public consultation on Directive 2011/16/EU, Directive on Administrative Cooperation ("**DAC**"). As previously announced by the Commission, this consultation aims at assessing the effectiveness, efficiency and continued relevance of DAC, as well as its coherence with other policy initiatives and priorities and EU added value. The consultation will end on 30 July 2024 and will focus on the functioning of DAC in 2018-2022. Therefore DAC 7 applicable to digital platforms operators and DAC 8 applicable to crypto-asset service providers are not covered.

Stakeholders and interested parties have thus now the chance to share their comment and experience as to whether and how DAC has actually helped them. The evaluation will assess the relevance, efficiency, coherence

and EU added value of the DAC. For those purposes, it will evaluate whether the scope and purpose of DAC are still relevant and if DAC addresses the challenges faced by Member States. It will also consider the effectiveness of the DAC and whether the information exchange is usable in terms of completeness, quality and timeliness.

Furthermore, especially given the many amendments to the DAC, it will value its internal coherence as well as its consistency with other relevant EU initiatives. Finally, the EU added value of DAC will be assessed in comparison to other available means of exchange of information that exist at international level.

Pillar One

On 18 December 2023, the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting (the "**Inclusive Framework**") issued a statement calling for a finalization of the text of the Pillar One multilateral convention ("**MLC**") by the end of March 2024 with a view to holding a signing ceremony by the end of June 2024.

On 15 February 2024, in light of the revised timeline for adoption and signature of the Pillar one MLC, the USA, Austria, France, Italy, Spain, and the United Kingdom have decided to extend from 23 December 2023 until 30 June 2024, the political agreement set forth in the joint statement issued on 21 October 2021, regarding their agreement that (as part of Pillar One) they will withdraw all unilateral measures concerning the imposition of digital services taxes ("**DST**"s) once Pillar One takes effect. have decided to extend the political compromise set forth in the October 21 Joint Statement until 30 June 2024.

As of today, the European Commission did not communicate on the consequence of the potential cancellation or postponement of the Pillar One MLC signing ceremony. We can however expect that in the first scenario, the Commission will most likely put its draft DST proposal back on the table.

Implications

Over the past few months, most of the ongoing initiatives of the European Commission in corporate tax matters have only evolved slowly or did not move forward at all. Except for the FASTER Proposal that will most likely be adopted before year-end, the outcome of most of the directive proposals on the table is totally uncertain.

This is mainly because Member States already have a lot of major tax reforms to fully implement. The fact that Member States express their concerns instead of surrendering to the pressure of the European Commission is positive, especially if we keep in mind that more is yet to come with Pillar one. However, the European Commission is not giving up the fight to make sure that its initiatives can come through: On 20 March 2024, in a communication on pre-enlargement reforms and policy reviews, the Commission indicated that it should be considered to move to a qualified majority voting in tax matters because in an enlarged European Union, "unanimity will be even more difficult to reach, with increased risks of decisions being blocked by a single Member State". However, in our view, unanimity should remain in tax matters to protect the principle of tax sovereignty and make sure that only tax measures which are really necessary should be introduced at EU level and that tax systems can remain workable for both taxpayers and tax administrations.

The HOT Proposal and the TP Proposal are moving forward but it is too early to know how the final product will look like and whether Member States will manage to reach an agreement on these 2 initiatives. Finally, the only initiative which should be adopted in the near future is the FASTER initiative, one of the few initiatives introducing improvements which are necessary: making the withholding tax reclaim procedures better in order to boost cross-border investments.

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VAT deduction right and status of a VAT taxable person: The amount of turnover cannot be used as a restrictive factor according to the CJEU

OUR INSIGHTS AT A GLANCE

- On 7 March 2024, the Court of Justice of the EU rendered its decision in the so-called "Feudi" case.
- The EU Court concluded that the amount of turnover cannot be used to challenge the status of a VAT taxable person or to limit the VAT deduction right of a company.
- This decision is in line with the judgment of the Luxembourg Court of Cassation of 17 March 2022.
- As stated by the CJEU and the Luxembourg courts, a link between expenses and activities in concreto shall take precedence over this incorporation criteria and also over the arithmetic comparison between the expenses and the turnover.
- We provide hereafter an analysis of this ruling as well as its Luxembourg implications.

On 7 March 2024, the Court of Justice of the European Union ("**CJEU**" or "**the Court**") rendered its decision in the so-called "Feudi" case (C-341/22).

In this judgement, the Court concluded that the amount of turnover cannot be used to challenge the status of a VAT taxable person or to limit the VAT deduction right of a company.

Background

The Italian company Vigna Ottieri S.r.l. ("**Vigna**"), producing and marketing wine, considered the input VAT on its expenses as deductible. However, Vigna received a tax assessment notice from the Italian Tax Authorities ("**ITA**") in 2010 stating that it was considered as a non-operational company and thus refusing the VAT deduction right for the costs incurred by Vigna in 2009.

Indeed, the ITA relied on the Italian law provision mentioning that a company is deemed to be non-operational if it does not reach a certain turnover threshold during a given period. The company can nevertheless rebut that presumption with objective elements. This provision aims at preventing fraud by discouraging the incorporation of shell companies.

Under this Italian provision, non-operating companies cannot be refunded a VAT credit set out on their declaration that arises, in particular, from an amount of deductible VAT that is higher than the VAT collected. Nor can the credit be offset or transferred. The credit can therefore be applied towards the VAT due in respect of subsequent tax periods. However, where a non-operating company does not carry out transactions for VAT purposes over three consecutive tax periods that are of an amount at least equal to the amount resulting from the income threshold, the credit can no longer be carried forward. The company accordingly loses the right to deduct VAT.

In the case at hand, Vigna failed to meet this minimal threshold for three consecutive years and was thus considered to be a non-operating company (a 'shell company') by the ITA with the consequence that its deduction right was denied.

Vigna disputed the position of the ITA and brought an action against the tax assessment notice before the Provincial Tax Court which dismissed the action.

In the meantime, Vigna was taken over by Feudi di San Gregorio Aziende Agricole SpA ("**Feudi**") in 2012. They lodged an appeal against the judgment of the first-instance court which has also been dismissed by the Regional Tax Court.

Feudi then brought the case before the Italian Court of Cassation. The Italian supreme court questioned the compatibility of the Italian law on non-operational companies notably with the principles of VAT neutrality and proportionality. Therefore, the Court requested a preliminary ruling to the CJEU in order to determine whether a company can lose its VAT taxable person status and thus its VAT deduction right when its turnover is not sufficient in regard of the threshold required by the Italian law.

Decision of the CJEU

- **The amount of turnover cannot be used per se to challenge the VAT taxable person status…**

In its ruling, the CJEU concludes without surprise that the status of a VAT taxable person cannot be denied on the sole grounds of insufficient turnover which does not meet the threshold required by the Italian Law.

According to the CJEU, the status of a taxable person cannot be conditioned on the satisfaction that the economic value of its turnover granting a VAT deduction right exceeds an income threshold set in advance, which corresponds to the return that can reasonably be expected from the assets held by that person. The only relevant question is whether that person actually carries out an economic activity, irrespective of the amount of revenue earned.

- **… nor to limit the VAT deduction right**

The CJEU then recalled that the VAT deduction right constitutes the cornerstone of the VAT system.

More specifically, the CJEU repeats that the VAT deduction right must be recognised if a direct and immediate link exists between expenses and activities granting a VAT deduction right.

No provision of the VAT Directive makes the right of deduction conditional on a requirement that the amount of output transactions subject to VAT, carried out by a taxable person during a given period, must reach a certain threshold. The right to deduct VAT is ensured irrespective of the results of the economic activities of the taxable person concerned.

The Italian provision under scrutiny seeks to prevent fraud by discouraging the formation of shell companies and is based, for that purpose, on the presumption that, where the amount of output transactions carried out by a company during a given taxable period does not reach a threshold calculated by following the criteria laid down in the article, the company is not an operational company unless it succeeds in demonstrating that objective circumstances justify that it could not have reached the threshold.

The CJEU finally concludes that the amount of turnover cannot be used as such as a restrictive factor to limit the VAT deduction right because the objective of the Italian provision at stake and the related presumption go beyond what is necessary to prevent fraud and abuse of law.

In this regard, only objective evidence showing that the expenses are not linked to activities granting a VAT deduction right is relevant to limit such right.

Luxembourg impacts

This decision is in line with the judgment of the Luxembourg Court of Cassation of 17 March 2022 where they reaffirmed the predominance of the link between expenses and activities over the mere consideration of a “1:1 ratio” to assess the VAT deduction right of a company.

In the case submitted to the Court of Cassation, the VAT authorities denied a company’s right to deduct VAT for the part of the costs that exceeded its turnover on the grounds that, because these costs could not have been mathematically included in the relevant output transaction prices, they had no direct and immediate link with the turnover, and could not be a cost component of the output transactions entitling the company to deduct the VAT. However, the Court of Cassation rejected the conclusion that incorporating the amount of input transactions into the amount of output transactions is a condition for the right to deduct VAT.

From time to time, the question of the incorporation of costs in the turnover still pops up in discussions with the Luxembourg VAT Authorities to determine whether the link

for VAT deduction purposes is characterised.

As stated by the CJEU and the Luxembourg courts, a link between expenses and activities in concreto shall take precedence over this incorporation criteria and also over the arithmetic comparison between the expenses and the turnover.

In this regard, the VAT deduction methodology implies an analysis of the services together with the activities performed in order to determine whether a link exists between them.

The Feudi judgment is thus welcomed as it strengthens the importance of the above-mentioned direct and immediate link for VAT deduction purposes.

Do you have any questions?

Our VAT team is available for any questions you may have or should you need assistance in the frame of VAT deductibility issues, as well as any other indirect tax matters.

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New rules for EU cross-border conversions and divisions of companies

OUR INSIGHTS AT A GLANCE

- Luxembourg is a cross-border mobility-friendly country, relying on a well-established legal and notarial practice.
- The Mobility Directive provides with restrictive measures, creating a more complex and time-consuming process for migrations of companies within the European Union.
- The transposition into Luxembourg law is expected soon.
- Cross-border operations falling within the scope of the Mobility Directive shall be anticipated to ensure that no practical issues delaying the process will arise.
- We describe hereafter the implications of the transposition of the Mobility Directive in Luxembourg to the extent it concerns EU Cross-Border Operations

The Directive (EU) 2019/2121 of the European Parliament and of the Council of 27 November 2019 (the "**Mobility Directive**") amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions introduces measures to harmonise the EU Member States' laws to ensure and strengthen the freedom of establishment for companies within the EU market, and to protect stakeholders in cross-border operations.

The Mobility Directive notably introduces the concept of "EU cross-border conversions" mainly covering the former concept of transfer of registered office and/or of central administration to or from abroad and of EU cross-border divisions of limited liability companies ("**EU Cross-Border Operations**").

Member States had to bring into force the laws, regulations, and administrative provisions necessary to comply with the Mobility Directive by 31 January 2023. Most of the Member States have transposed the Mobility Directive into national law. However, the Luxembourg legislator is still working on its transposition into Luxembourg law with Bill of Law N°8053 presented to the Luxembourg Parliament on 27 July 2022 (the "**Bill of Law**").

In this article, we describe the implications of the transposition of the Mobility Directive by the Bill of Law to the extent it concerns EU Cross-Border Operations.

Background

Before the Mobility Directive, EU Cross-Border Operations were substantially based on established case laws of the European Court of Justice and the harmonisation covered only EU cross-border mergers. The Mobility Directive aims at rectifying imperfections of the EU cross-border merger rules, but also introduces harmonised processes for EU Cross-Border Operations, copying the cross-border merger model and relying on a subsidiary application of domestic laws.

Luxembourg is considered a hub for companies wishing to enter or leave the EU and it prides itself on being a well-established legal and notarial practice state. The challenge for a cross-border mobility-friendly country such as Luxembourg in the implementation of the Mobility Directive lies in finding the balance between maintaining the flexibility of the existing regime and a transposition of restrictive measures creating a more complex and time-consuming process. Particular attention is necessary with respect to the costs that such additional procedural complexity deriving from the Mobility Directive could generate for companies.

EU Cross-Border Operations targeted by the Bill of Law

As currently drafted, the Bill of Law, which is still subject to potential small amendments, applies to public companies limited by shares (S.A.), private limited liability companies (S.à r.l.) and corporate partnerships limited by shares (S.C.A). Companies, the object of which is the collective investment of capital provided by the public, which operate on the principle of risk-spreading and the units of which are, at the holders' request, repurchased or redeemed, directly or indirectly, out of the assets of these companies (i.e. UCITS) and companies in liquidation where the distribution of assets has begun are, among others, excluded from the scope of the Bill of Law.

- **EU cross-border conversions**

Under the Bill of Law, an "EU cross-border conversion" means an operation whereby a company with the form of a company listed in Annex II of the Mobility Directive, without being dissolved, wound up or going into liquidation, converts the legal form under which it is registered in Luxembourg into a legal form of the destination Member State, as listed in Annex II of the Mobility Directive, and transfers at least its registered office to the destination Member State, while retaining its legal personality.

Cross-border conversions to or from a country outside the EU shall be excluded from its scope.

- **EU cross-border divisions**

Under the Bill of Law, an "EU cross-border division" means an operation whereby a company which, in the process of a cross-border division (the "company being divided"), transfers all its assets and liabilities to two or more companies in the case of a full division, or transfers part of its assets and liabilities to one or more companies in the case of a partial division or division by separation, to a company newly formed in the course of a cross-border division (the "recipient company"). Cross-border divisions that do not involve the formation of new companies shall also be excluded from the scope. The Bill of Law does not target cross-border divisions in which a company transfers assets and liabilities to one or more existing companies, as such cases have been viewed as being very complex, requiring the involvement of competent authorities from several Member States and entailing additional risks in terms of the circumvention of EU and national rules.

In this context, "division" means an operation whereby:

- a company being divided, or being dissolved without going into liquidation, transfers all its assets and liabilities to two or more recipient companies, in exchange for the issue to the members of the company being divided of securities or shares in the recipient companies and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in the absence of a nominal value, a cash payment not exceeding 10% of the accounting par value of the securities or shares ("full division");
- a company being divided transfers part of its assets and liabilities to one or more recipient companies, in exchange for the issue to the members of the company being divided of securities or shares in the recipient companies, in the company being divided or in both the recipient companies and the company being divided, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in the absence of a nominal value, a cash payment not exceeding 10% of the accounting par value of the securities or shares ("partial division"); or
- a company being divided transfers part of its assets and liabilities to one or more recipient companies, in exchange for the issue to the company being divided of securities or shares in the recipient companies ("division by separation").

Procedures set up for European Cross-Border Operations

According to the Bill of Law, several procedural steps have to be complied with to proceed to an EU Cross-Border Operation, such as:

1) Draft terms of cross-border conversions setting out the particularities of the proposed operation.
2) Report from the administrative or management body issued to the attention of the shareholders and employees justifying the legal and economic aspects of the operation and its implications for future business. Under certain conditions, a waiver of such report, or part of the report, may be organised. Employee information rules may also apply.
3) A report issued by an independent expert on the draft terms of the operation shall be made available to shareholders at least one month before the date of the holding of the shareholders' meeting to approve the EU cross-border operation. A waiver of the report may be organised.
4) Approval, amendment, or rejection by the shareholders' meeting of the draft terms of the EU Cross-Border Operation and the new articles of association.
5) Two legality controls of the EU Cross-Border Operation are required to complete the process.
    - The **first control** is organised in Luxembourg to scrutinise the legality of the EU Cross-Border Operation as regards the parts of the procedure which are governed by the Luxembourg laws, the absence of serious doubts indicating that the EU Cross-Border Operation is set up for abusive or fraudulent purposes leading to or aimed at the evasion or circumvention of Union or national law, or for criminal purposes, and, as a result, to issue a pre-conversion certificate attesting to compliance with all relevant conditions and to the proper completion of all procedures and formalities in Luxembourg.
      The notary has been designated as the competent authority in the Bill of Law to carry out these controls and to issue the relevant certificates, in principle, within three months of the date of receipt of the documents and information concerning the approval of the EU Cross-Border Operation by the general meeting of the company. However, considering that the Draft Law has not yet been passed, neither the Luxembourg notary nor the Luxembourg Trade and Companies Register has the authority to issue or control the legality of such certificate. At this point of time, the direct application of the Mobility Directive by some Member States is causing legal uncertainty.
    - The **second control** is organised in the Member State of destination to scrutinise the legality of the EU Cross-Border Operation as regards the part of the procedure which is governed by the law of the destination Member State and to approve the EU Cross-Border Operation. This authority shall, in particular, ensure that the converted company complies with provisions of national law on the incorporation and registration of companies. The notary has been designated as the competent authority in the Bill of Law to carry out this second control when Luxembourg is the Member State of destination.

The Bill of Law also puts in place strong safeguards to prevent the EU Cross-Border Operations from being used to set up artificial arrangements, including those aimed at obtaining undue tax advantages. New protective rules are provided to conciliate better protection of workers, creditors, and minority partners, with mitigation of obstacles to the exercise of the freedom of establishment of EU companies. It is worth noting that minority shareholders opposed to the EU Cross-Border Operations will have an exit right, while creditors will be granted a protection mechanism whereby they will have a right to apply for adequate safeguards. Additionally, shareholders, creditors and employees will have a right to raise questions before the holding of the shareholders' meeting convened to resolve on the EU Cross-Border Operations.

Timing

The timing for this Bill of Law to be passed by the Luxembourg Parliament remains to be confirmed. The Council of State's opinion is still awaited but once it has been issued, and assuming it does not formulate major formal oppositions, it is expected that the Bill of Law will be voted upon soon after.

Once the law has been passed, the new regime shall apply the EU Cross-Border Operations for which the relevant restructuring plan is published on the first day of the month following the date on which the new law comes into effect (i.e. four days after its publication in the *Mémorial*). If the restructuring plan is published beforehand, the current legal regime shall apply.

Cross-border operations falling within the scope of the Bill of Law shall be more than ever anticipated to ensure that no practical issues delaying the process will arise.

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