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Luxembourg tax regime: Under siege

By Vanessa Houlder

The low-tax system that has brought great prosperity to the Grand Duchy now threatens to become a liability

Finance stronghold: Luxembourg receives more than a 10th of the world's foreign direct investment

Amid the rolling, wooded farmland of the Ardennes, the highway from Brussels briefly hugs the Luxembourg frontier at Martelange, a small town famous for the border that runs down the middle of its busy main street.

On one side – in low-tax Luxembourg – is a profusion of petrol stations offering some of the most lightly taxed fuel in Europe. It is a striking example of the "gas pump tourism" that boosts Luxembourg's exchequer at the expense of its neighbours.

This is one face of Luxembourg: a tiny country at the crossroads of Europe that built a significant part of its wealth on its appeal to other countries' taxpayers. Its low fuel duties are just one facet of a distinctive tax system that has helped make its society one of the richest in the world.

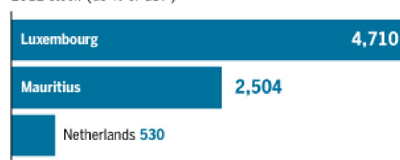
There is another face to Luxembourg. Its agility and financial expertise has built the world's second-largest fund administration industry. It has a reputation for stability and professionalism, demonstrated by the resilience of its huge banking sector in the financial crisis.

But the rumbling discontent over Luxembourg's tax practices is now threatening its prosperity. The world's last Grand Duchy has already bowed to pressure over accusations it helped other countries' citizens hide from the taxman. Xavier Bettel, its prime minister, is "fed up with being accused of being a defender of a tax haven and a hotbed of sin".

Luxembourg is also under suspicion of offering "sweetheart" deals to big companies, in breach of EU rules on state aid. Nerves are on edge in the Grand Duchy after the European Commission launched an investigation last month into tax "rulings", embroiling Fiat, the car company, and potentially others.

The commission is also suing Luxembourg for "serious distortions of competition" over the 3 per cent rate of value added tax it charges Amazon and other ebook retailers. Its low VAT rates have made the Grand Duchy an ecommerce hub but it stands to lose €800m of revenues – 1.5 per cent of its gross domestic product – next year under a long-awaited shake-up of European tax rules.

Another threat is posed by a looming crackdown on corporate tax planning proposed by the Organisation for Economic Cooperation and Development in the wake of a public outcry over tax avoidance by companies such as Amazon and Apple.



The OECD aims to stamp out "treaty shopping" – routing income through "brass-plate" companies in countries with attractive tax treaties – which will affect many of the Grand Duchy's finance and holding companies that own more than $2tn of assets. It could spell the end of an era in which a country of 1,000 square miles receives more than a 10th of the world's foreign direct investment, as calculated by the International Monetary Fund.

Consumption taxes are already set to rise as Luxembourg grapples with the loss of "significant" revenues from these changes, the IMF said in May. "Luxembourg's public finances are at a turning point."

In Luxembourg City, a glass and steel metropolis grafted on to a medieval fortress town, the impending changes are viewed with trepidation, tempered by a belief the Grand Duchy can both adapt and defend its interests. Much depends on whether the government is "being seen to fight" the OECD proposals, according to PwC, the professional services firm, in a May bulletin.

The appointment of Jean-Claude Juncker, Luxembourg's former prime minister, as president-designate of the European Commission, has sparked speculation that the Grand Duchy has won a powerful protector. Chris Lenon, former global head of tax at Rio Tinto, the mining group, says: "This isn't a poacher turned gamekeeper, it looks more like the poacher in charge of the gamekeepers."

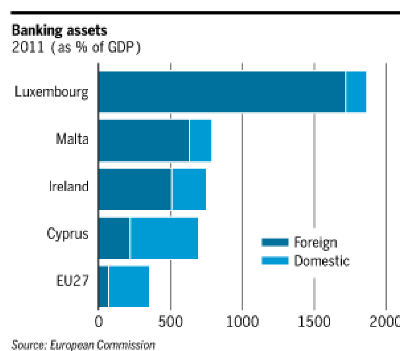
The allegation made by French Socialists that I actively promoted tax evasion is an outrageous attack on my country and my person

- Jean-Claude Juncker

Mr Juncker has angrily rejected claims that Luxembourg is a tax haven. In a March interview with Der Spiegel, the German news magazine, he said: "It is a fairy tale to say that Luxembourg has special rules with regard to company taxation. The allegation made by French Socialists that I actively promoted tax evasion is an outrageous attack on my country and my person."

But Luxembourg has been battling with its neighbours on tax matters for decades. As long ago as 1973, France and Germany demanded a crackdown on its "letter box" subsidiaries – structures governed by a 1929 tax law that were often used to avoid tax. It was not until 2006 that the regime was outlawed under the commission's state aid rules.

For companies, as well as individuals, Luxembourg's emphasis on discretion added to its appeal. Foreign tax inspectors trying to understand their multinationals' tax planning struggled to make sense of the sparse details in the companies' Luxembourg accounts and/or get hold of legal documents, entrusted to lawyers. "Luxembourg was phenomenally secret," says one such official. "Secrecy was more important to Luxembourg than anywhere else."



There was often a big gap between the letter of the law and how it was applied, with informal rulings playing an important role, he says. "I would normally see rates of around 9-10 per cent in Luxembourg but they could be as low as 1 per cent."

Luxembourg is not overtly a low-tax country for businesses; more than two-thirds of OECD countries have rates lower than its 29.2 per cent. But there are numerous deductions and exemptions that lower the rate by creating profits – known as "white" income – that escape tax altogether.

Some exemptions are straightforward. Since 2008, companies have been exempt from tax for up to 80 per cent of income from copyrights, patents, trademarks and other intellectual property. Finance companies can be set up so the overwhelming majority of the interest income they receive is booked in an untaxed or low-tax foreign branch. Falls in the value of foreign assets can be deducted against income in Luxembourg under an unusual rule that it once shared with Germany.

But others are far more complex. Sprawling structures, often involving companies and branches in business-friendly countries such as the Netherlands, allow companies to arbitrage the difference between countries' tax rules. Exotic "hybrid" instruments, treated as loans in Luxembourg but equity elsewhere – or vice versa – give multinationals a tax-efficient way of taking profits home, or routing them to havens such as Bermuda.

Luxembourg's popularity with US multinationals, including Amazon, Caterpillar and Microsoft, has increased dramatically in recent years. Their profits in the Grand Duchy rose from the equivalent of just 19 per cent of its GDP in 1999 to 141 per cent by 2011, according to the US Bureau of Economic Analysis.

It looks more political than anything else. I would be very surprised if they found anything. The truth on the ground is far more boring than people make out.

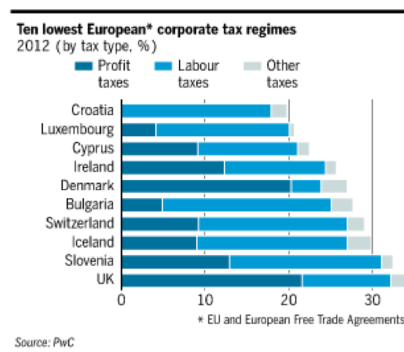
- Keith O'Donnell of Atoz

In Europe too, Luxembourg has played an important role in the tax affairs of multinationals, thanks to its flexibility, its network of tax treaties and the benefits of its EU membership. The freedoms enshrined in Europe's 1957 founding treaty meant other tax authorities could not penalise multinationals for using Luxembourg, giving it a big advantage over many other offshore finance centres.

Even so, the scrutiny of Luxembourg structures intensified as cash-strapped tax authorities stepped up their attack on tax planning in the wake of the financial crisis. In Italy, Domenico Dolce and Stefano Gabbana, the fashion designers, were prosecuted by the tax authority over the transfer of their brands to a Luxembourg company. Only Britain bucked the trend by making it easier for companies to go offshore as it sought to increase the competitiveness of its tax system.

This undercurrent of hostility grounds Brussels' state aid challenge to Luxembourg, in the view of some of the country's tax professionals. Keith O'Donnell of Atoz, an advisory firm, says: "It looks more political than anything else. I would be very surprised if they found anything."

The fabled secrecy and informality of Luxembourg's system of rulings – confirming how intra-company deals are taxed – is a misconception, he says. "The truth on the ground is far more boring than people make out."



The system traditionally revolved around meetings with an important official, now retired, who was responsible for most of the rulings – although, even then, a technical analysis was required to justify the tax treatment. But since 2011 the rules have tightened significantly.

The government has said it is "pretty confident" about its handling of tax issues but even so there is anxiety in Luxembourg over the commission's actions. "It is creating nervousness among VPs [vice presidents] of taxes," says a Luxembourg adviser. "They want certainty and that is being jeopardised."

Brussels' move has put off some companies. Neil Todd, a partner of Berwin Leighton Paisner, a law firm, says: "Clients have picked up on it and think it is another marker against going offshore." The international push against brass-plate companies is another worry, particularly for private equity firms.

Yet some companies are responding to the new climate by broadening their Luxembourg operations. Once profits have to be earned where they are reported, Luxembourg has the infrastructure and workforce to compete for some activities, while small tax havens do not.

Even so, Luxembourg is likely to need to overhaul its tax system if it is to preserve its appeal to companies, once the international rules have been reformed. The "base erosion and profit shifting" project of the OECD is intent on closing loopholes such as hybrid loans and low-tax branches. In June, Europe's finance ministers also took action against hybrids.

"It is not our fault if other countries tax their people more than ours. Maybe they are out of line with us

- Nicolas Mackel, head of Luxembourg for Finance

Luxembourg's government has promised to reform the system by 2017. Richard Collier, a tax partner at PwC, says: "I would be very surprised if Luxembourg doesn't reduce its rate and revamp its system."

Luxembourg's tax system is likely to end up more like that of its neighbours, potentially paving the way for harmonisation across the eurozone. The fallout from the financial crisis is putting pressure on European governments to pull together and stamp out harmful tax competition. The paradox of a country at the heart of the single market that undermines its neighbours through the design of its tax system looks increasingly untenable.

But tax sovereignty will not be relinquished without a fight – in Luxembourg and elsewhere. Michael Probst, a partner at BA tax accountants in the Grand Duchy, says: "Tax harmonisation will never happen: national differences are too big."

Nicolas Mackel, who heads Luxembourg for Finance, an inward investment agency, insists the country is ready to co-operate and change. But how it taxes its people is a matter of "political or societal choice".

Nowhere is this more visible than in the queues of drivers from outside Luxembourg taking advantage of its low fuel duties, who the OECD says are responsible for an "extraordinary" 70 per cent of its fuel sales.

High fuel taxes are seen by Luxembourg as socially unjust, says Mr Mackel. "It is not our fault if other countries tax their people more than ours. Maybe they are out of line with us," he adds.

Banking secrecy: How a duchy became a financial hub

The meteoric growth of Luxembourg's financial sector since the 1970s owes much to a tradition of banking secrecy.

Its popularity as a banking centre with Belgians is rooted in 1922 monetary union with Belgium, which did not extend to taxes. So many investors flocked to the Grand Duchy to exchange bond coupons for interest payments that the train from Brussels became known as the "Coupon Express".

From the late 1960s, Luxembourg also became an offshore centre for dozens of German banks. After 1993, when Berlin imposed a 30 per cent withholding tax, its citizens began to shift billions of D-marks. The outflow sparked talks on withholding taxes or information exchange on bank accounts across the EU. The move was blocked by Luxembourg. "We shall only support an EC withholding tax when it covers all of western Europe, including Austria, Switzerland and such exotic tax havens as the British Channel Islands," said Jean-Claude Juncker, then finance minister.

Jean-Claude Juncker resisted withholding tax proposals

Luxembourg's obduracy paid off. A pan-European agreement signed in 2003 on savings taxation included Switzerland and Britain's offshore islands. This made it somewhat harder to evade tax while allowing Luxembourg and others to maintain their secrecy.

The Grand Duchy's resistance to transparency took a toll on relations with its neighbours. The nadir was a diplomatic row with Germany in 2009. It was a threat of being virtually cut off from the US financial system that forced it to bow to pressure last year and agree to exchange tax information with other countries. Even so, some criticism continued: last November, the OECD said it had not lived up to global standards on transparency.

The financial sector expects to lose 5 per cent of its assets from abandoning secrecy but it has not been the catastrophe that many feared. Last year, the number of banks in Luxembourg stopped shrinking and started expanding, with several Chinese banks setting up shop. The IMF describes the impact of information exchange as “benign”, in a sign that the importance of bank secrecy has already diminished.

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