



IN THIS EDITION

A guide to the Luxembourg holding company (“SOPARFI”)

This brochure provides a general description of the Luxembourg tax treatment of a normally taxable Luxembourg holding company, which in French is often referred to as a “*Société de participations financières*” abbreviated as “Soparfi”.

General

Corporate and tax status

A Soparfi is a normal commercial company, which may carry out any activities that fall within the scope of its corporate object clause. It may take the form of, *inter alia*, a *Société Anonyme* (S.A., a public limited company), a *Société à responsabilité limitée* (S.à r.l., a limited liability company), or a *Société en commandite par actions* (S.C.A., a partnership limited by shares). As such, a Soparfi is fully subject to Luxembourg income tax and net worth tax, and its profit distributions are generally subject to Luxembourg dividend tax. It is entitled to benefit from the tax treaties concluded between Luxembourg and other countries (61 are currently in force and effect) and the relevant EC Directives.¹

Profit taxes

The Luxembourg profit tax system consists of national corporate income tax (“*impôt sur le revenu des collectivités*” or “IRC”) at a rate of 21% and municipal business tax (“*impôt commercial communal*” or “ICC”) at a rate of 6.75%.² In addition, there is a 5% surcharge for the employment fund, calculated on the IRC. The total combined tax rate (inclusive of surcharge) is therefore 28.80%.

From 2011, Soparfis are subject to a fixed minimum amount of corporate income tax. For the purposes of the minimum tax they are defined as companies the activity of which is not subject to an authorisation by a minister or a supervisory authority and at least 90% of whose assets are financial assets. The minimum tax amounts to EUR 1,575 (including the 5% surcharge). Losses carried forward remain in existence. For Soparfis which are part of a Luxembourg fiscal unity, only the parent company will be subject to the minimum tax.

¹ Such as the EC Parent-Subsidiary Directive (90/435/EEC), the EC Merger Directive (90/434/EEC) and the EC Interest & Royalty Directive (2003/49/EC), as amended from time to time.

² Provided that the company is established in Luxembourg City.

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Net worth tax

A Soparfi is subject to an annual net worth tax, which is levied at a rate of 0.5% on the company's worldwide net worth on 1 January. *Inter alia*, qualifying participations (see Section 2.2) net of allocable debt³ are excluded from the taxable base. The annual burden of a Soparfi's net worth tax can therefore generally be limited to the legal minimum of EUR 63 (for an S.A.) or EUR 25 (an S.à.r.l.). Luxembourg IRC is creditable to the net worth tax, provided certain conditions are met.

Capital duty

Capital duty was abolished with effect from 1 January 2009. Instead, a fixed registration duty of EUR 75 applies to (i) incorporation of Luxembourg entities, (ii) amendment of the articles of Luxembourg entities, and (iii) the transfer of the statutory or actual seat to Luxembourg.

Chamber of Commerce fees

As a commercial company, a Soparfi will be a compulsory member of the Luxembourg Chamber of Commerce, and thus subject to a lump sum Chamber of Commerce fee of EUR 350, irrespective of its taxable profits. Prior to 2010, a degressive rate starting at 0.2% of taxable profits prior to loss carry forwards applied, as is still the case for companies that are not at the same time Soparfi's.

Taxation of dividends and capital gains

Participation exemption (general)

The taxable basis of a Soparfi corresponds to its accounting profit as reflected in its stand-alone commercial accounts (prepared according to Luxembourg GAAP), unless the tax law expressly provides otherwise. Often, therefore, a number of adjustments (for example, additions or deductions resulting from tax exemptions and disallowed expenses) must be made in order to establish the company's taxable basis.

A Soparfi, like any other normally taxable entity, may be entitled to the participation exemption. Capital losses on alienation or otherwise (e.g. liquidation or depreciation) derived from a participation are tax-deductible.

Participation exemption for dividends and capital gains

According to article 166 of the IRC Act and the Grand-Ducal Decree of 21 December 2001 (as amended on 31 March 2004), dividends (including liquidation dividends) and capital gains (including currency exchange gains) are exempt from profit taxes, provided the following requirements are met:

- a. the subsidiary is (i) a qualifying Luxembourg resident entity (as defined in the law), (ii) an entity which is covered by article 2 of the amended Parent-Subsidiary Directive, or (iii) in the case of a non-resident subsidiary not covered by article 2 of the amended Parent-Subsidiary Directive, a capital company subject in its country of residence to income tax comparable with Luxembourg corporate income tax; and
- b. at the time of a dividend/liquidation distribution or a capital gain realised on the alienation of shares, the Soparfi must have held for an uninterrupted period of at least 12 months (or must undertake to continue to hold until an uninterrupted period of at least 12 months has elapsed), a direct participation of 10% or more of the subsidiary's nominal paid up capital; or, in the event of a lower percentage participation, a direct participation having an acquisition price of at least EUR 1,200,000 for dividends and liquidation proceeds, or EUR 6,000,000 for capital gains.

The exemption also applies to participations held through a Luxembourg tax-transparent entity (e.g. a partnership), which may or may not have legal personality. The Soparfi is considered to have a direct investment equal to its pro rata part of the tax-transparent entity's net assets.

If the minimum holding requirement under (b) is not met while the condition under (a) is, an exemption of 50% is available in the case of *dividend* income (excluding liquidation proceeds). The exemption applies to the net dividend income, i.e. the dividend income less directly related costs and write-offs on the participation in connection with a dividend distribution in the same year.

³ Allocable debt that exceeds the value of the participation is deductible against other assets.

Exchange of shares and conversion of loan into shares

The IRC Act provides for some tax-exempt exchange operations. A tax-neutral exchange may be allowed in the case of (i) conversions of a loan whereby securities are allocated to the creditor, (ii) the transformation of a capital company into another capital company, (iii) mergers or demergers of capital companies or companies resident in an EU Member State, and (iv) certain share mergers. To benefit from the tax-exempt exchange operations, the book value of the alienated shares or of the converted loan must also be maintained in the commercial accounts on the shares received in exchange.

A tax-neutral share merger is allowed if a Soparfi transfers shares in a) a company resident in an EU Member State⁴, or b) a non-EU resident capital company which is subject in its country of residence to income tax comparable with Luxembourg corporate income tax, to a company as referred to under a) or b) in exchange for shares, whereby the acquiring company acquires or increases the majority of its voting rights in the acquired company. In such cases the acquisition price and date of the shares acquired will be the same as those of the shares/loans given in exchange, thus avoiding the start of a new holding period.

If a non-qualifying participation (i.e. a participation which does not meet the conditions stated above) is exchanged for a qualifying participation through a tax-neutral exchange of shares, dividends received from that qualifying participation are not exempt for five years following the year of exchange (this is an anti-abuse measure). The same applies to a gain realised on the alienation of shares in a qualifying participation within five years after it was acquired through a tax-neutral exchange of shares in a non-qualifying participation. The five-year restriction should not be applicable if the income would have been exempt had the exchange not taken place. The same anti-abuse rule applies for the 50% dividend exemption referred to above. It should be noted that when an applicable tax treaty provides for a participation exemption for dividends, the anti-abuse rule may become inoperative (the treaty prevails).

Participation exemption under tax treaties

Most tax treaties concluded by Luxembourg contain a participation exemption for dividends, and in many cases also for net worth tax. The minimum ownership period on the basis of the treaties is generally shorter than that required under Luxembourg law, but in many cases the relevant shares must be held from the beginning of the accounting year. The requirements under Luxembourg domestic law and the applicable tax treaties should therefore be carefully compared. Most of the participation exemption provisions in (especially) older treaties contain no “subject to comparable income tax” test (e.g., Switzerland, France, Belgium, Germany).

Subject to comparable income tax

As outlined above, in order to qualify for the Luxembourg participation exemption, non-resident subsidiaries which are not resident in an EU Member State or covered by article 2 of the modified Parent-Subsidiary Directive must be subject in their country of residence to a profit tax comparable with the IRC. The legislator has indicated that a foreign tax is comparable if it is levied at a rate of at least 10.5% on a taxable basis which is similar to the basis applied in Luxembourg. A temporary tax holiday granted to a participation, especially to encourage investments, should not be a problem, provided the ordinary system of taxation applicable to the participation in the country concerned is comparable with the IRC.

Luxembourg permanent establishment

The participation exemption applies to income from and gains on participations attributed to a Luxembourg permanent establishment of an entity which is covered by article 2 of the amended Parent-Subsidiary Directive or a capital company resident in a tax-treaty country. It also applies for net worth tax purposes at the level of the permanent establishment. Luxembourg does not levy withholding tax with respect to the repatriation of profits to a foreign head office.

⁴ An EU resident company is defined as a company covered by the Merger Directive (90/434/EEC).

Credit for foreign withholding tax

It is possible to obtain a credit for foreign dividend tax withheld, but this is a rather complex matter which depends entirely on the income and tax situation of a specific Soparfi. It is therefore not dealt with further in this brochure. However, foreign dividend tax may in some cases be credited against other (taxable) foreign income, even if the dividend itself is tax-exempt under the participation exemption. On the basis of domestic law, no credit applies as regards the ICC, but some tax treaties concluded by Luxembourg extend the credit method to the ICC. The Luxembourg Supreme Court has nevertheless ruled that no credit is allowed against ICC under the Luxembourg-Spain tax treaty, and the same may thus apply for other tax treaties. Each treaty should therefore be analysed carefully. In practice, however, the Luxembourg tax authorities are generally unwilling to respect this extension of the credit method.

Deductions / recapture / currency exchange

Expenses and write-offs

Interest expenses on loans financing the acquisition of an exempt participation, and certain write-offs thereon, are tax-deductible in a given year insofar as they exceed exempt income (dividends and gains) from the participation in the same year. These deductions could be offset against other sources of income, such as from financing activities, or commercial activities, or may result in tax losses. Losses may be carried forward indefinitely.

Recapture

However, the *capital gains* exemption (for gains arising on an alienation of shares) does not apply to the amount previously deducted in relation to those shares (*recapture*). There are ways of avoiding this recapture, as shown in the following example.

Year-1

Dividend income	50
Holding related interest expenses	- 75
Normally taxable income	<u>10</u>
Result for the year	-15

Tax calculation:

Result for the year	-15
Exempt dividend income	-50
Holding related interest expenses	<u>+50</u>

Taxable result **-15**

Loss carry forward **-15**

Subject to recapture (75-50=) **25**

Year-3

Capital gain	125
Holding related interest expenses	<u>-35</u>
Result for the year	90

Tax calculation:

Result for the year	90
Exempt capital gain	-125
Holding related interest expense	+35
Recapture interest year 2	<u>+25</u>

Taxable income before loss carry forward 25

Loss carry forward year 2 -15

Taxable income **10**

Currency exchange results

Currency gains and losses on, *inter alia*, debt instruments whose proceeds are used to finance the acquisition of subsidiaries that qualify for the participation exemption are nevertheless taxable or deductible, respectively. Currency exposure should therefore be avoided, preferably by denominating such debt instruments in Euro. Agreements which are concluded to cover the exchange exposure of a non-Euro denominated loan are acceptable. Currency gains on the investment itself are exempt by virtue of the participation exemption (see Section 2). Currency losses on the investment itself are tax-deductible, but may fall under the recapture rules.

Financing activities

EC Parent-Subsidiary Directive

Interest received on receivables is taxable at the combined tax rate of 28.80%. Foreign withholding tax on interest is creditable under complex rules which are not dealt with further here.

If a Soparfi is (also) engaged in financing activities (i.e. borrowing and on-lending), it should report a margin at arm's length (interest spread) on its financing activities. In principle, no debt-to-equity ratio or thin capitalisation rules apply to the financing activities, absent bad debt risks. However, a minimum amount of required equity applies for Luxembourg companies carrying out intra-group financing activities which request an Advance Pricing Agreement (APA) from the Luxembourg tax authorities. Circular 164/2 of 28 January 2011 sets out the framework for granting APAs concerning Luxembourg group companies whose principal activity other than holding activities consists of intra-group financing transactions, which are defined as the granting of loans or advances to associated companies, refinanced by any financial means. The Circular does not apply to other intra-group situations, such as borrowing from an affiliate to acquire receivables in the market.

The APA procedure is only available for intra-group financing companies which have sufficient substance in Luxembourg and bear the risks linked to the financing activities. According to the Circular, a Luxembourg company will be considered as having sufficient substance if, broadly summarised:

- the majority of its directors/managers are Luxembourg residents and have the capacity to take binding decisions for the company;
- the key decisions regarding the financing company are taken in Luxembourg, and at least one shareholders' meeting a year takes place there;
- the financing company has a bank account in Luxembourg;
- it is not considered as tax-resident in another country (dual residence);

- its equity should be sufficient for the functions it performs, the assets used and the risks it assumes. Its minimum equity should be at least 1% of the amount lent or EUR 2 million, and in addition that equity should effectively be at risk. This 1% or EUR 2 million requirement applies at the outset, but need not necessarily to be restored when reduced because of e. g. losses.
- The financing company should have fulfilled its obligations regarding the filing of tax returns at the time when it requests an APA.

The following information should be included in the APA request:

- information on the intra-group financing company, its ultimate beneficial owner and the group companies concerned by the financing transactions;
- a detailed description of the transactions, with a legal analysis concerning them;
- the other countries involved in the transactions;
- the tax years concerned by the request (retroactivity seems possible);
- a transfer pricing report which complies with the OECD principles, including a complete description of the methodology used (identification of comparables and hits);
- an analysis of all other tax issues related to the proposed methodology; and
- a declaration confirming the accuracy of the information provided in the request.

If the tax authorities approve the request, the APA should be valid for a maximum of five years (renewable), unless the description of the transactions was incorrect or incomplete, or the approval is not in conformity with international tax provisions. The approval will also cease to apply if the relevant domestic or international legal provisions are amended, or essential elements of the transactions are modified.

The Circular is silent on the methodology to be used to determine that the group financing company's remuneration is at arm's length, and only requires the submission of a transfer pricing study to support its arm's length character.

Exit from SOPARFI: Capital gains paid to a shareholder outgoing dividends / capital gains

Domestic dividend tax and tax treaties

Dividends (including hidden dividends) paid by a Soparfi are subject to Luxembourg dividend tax at the rate of 15% (17.65% if the dividend tax is not charged to the shareholder), unless a domestic law exemption or a lower tax treaty rate applies. Reduced dividend tax rates or an exemption also apply to participations held through a Luxembourg tax-transparent entity (e.g. a partnership), which may or may not have legal personality.⁵ The (indirect) shareholder is considered to have a direct investment equal to its pro rata part of the tax-transparent entity's net assets.

Withholding tax exemption

Dividends paid by a Soparfi to

- (i) a normally taxable Luxembourg entity,
- (ii) an entity falling within the scope of article 2 of the modified EC Parent-Subsidiary Directive or to a Luxembourg or non-Luxembourg permanent establishment of such entity,
- (iii) its Swiss resident parent capital company that is subject to corporation tax (*'impôt sur les sociétés'*) in Switzerland without benefiting from an exemption,
- (iv) a parent company resident in a treaty country and subject to a tax comparable to the Luxembourg corporate income tax regime, company (or to its Luxembourg permanent establishment)

will be exempt from Luxembourg dividend withholding tax provided the parent company holds (or undertakes to hold) a shareholding of at least 10%, or having an acquisition cost price of € 1,200,000 for an uninterrupted period of at least 12 months in the Soparfi.

Capital gains paid to a shareholder

Under Luxembourg law, resident individual shareholders (other than entrepreneurs whose business assets include the shares concerned) are taxable on the alienation of shares (including by way of liquidation) in a Soparfi if: (1) the alienation takes place within six months after their acquisition (a speculation gain), and (2) the alienator directly or indirectly holds a substantial interest in the Soparfi. In very broad terms, a substantial interest exists if a shareholder, either alone or with certain close relatives, has held more than 10% of the shares in a Luxembourg company at any time during the five-year period preceding the alienation. A gain realised on the alienation of convertible debt is subject to Luxembourg income tax if the holder has a substantial interest in the debtor.

Resident corporate shareholders and Luxembourg permanent establishments of foreign companies are fully taxable on the alienation of shares (including by way of liquidation in a Soparfi), unless the alienation benefits from the participation regime, whose requirements are set out in 2.2 above. However, non-resident shareholders (with no Luxembourg permanent establishment to which the shares and/or income/gains from the shares in a Soparfi belong) are only subject to Luxembourg tax when they directly or indirectly hold, a substantial interest; and (1) the alienation (including liquidation) takes place within six months after the acquisition (a speculation gain); or (2) in the case of an alienation after more than six months, they were a Luxembourg resident taxpayer for more than 15 years and became a non-Luxembourg taxpayer less than five years before the alienation took place. However, under the applicable tax treaties Luxembourg will generally not be entitled to tax this gain.

Liquidation of a Soparfi

Under Luxembourg law, a (partial) liquidation distribution by a Soparfi is not considered as a dividend and is therefore not subject to Luxembourg dividend tax. For non-residents, the same comments as under Section 5.4 would apply.

⁵ The law only refers to Luxembourg entities. However, in practice non-Luxembourg entities may also qualify, provided they are not covered by the Parent-Subsidiary Directive.

Capital reduction by a Soparfi

A repurchase of shares by a Soparfi, followed by a cancellation of the shares, may be subject to Luxembourg dividend tax if the repurchase price exceeds the par value per share. However, a Soparfi's repurchase of all the shares held by one or more shareholders (who thereby cease to be shareholders), followed by a cancellation of those shares (a partial liquidation) is not considered as a dividend and is therefore not subject to Luxembourg dividend tax. For non-residents the taxation would be the same as for capital gains and liquidation proceeds.

A repayment of capital (share capital and/or share premium) by a Soparfi is treated as a dividend, unless the taxpayer proves it is based on sound business reasons. Sound business reasons are deemed not to exist if the reduction is financed by a loan taken up for that purpose, or if the Soparfi has reserves available for distribution.

Other issues

Debt-to-equity ratio

Luxembourg law does not contain debt-to-equity ratio provisions for a Soparfi. Nevertheless, when loans are taken up from related parties or those related parties guarantee the repayment of obligations under loans taken up from third parties, and the loans are used for financing equity participations, the Luxembourg tax authorities apply a debt-to-equity ratio of 85:15 in practice as a safe harbour. The interest rate on the loans within the safe harbour should be at arm's length. Financing the acquisition of a participation to a greater extent with debt is accepted in principle, as long as the interest on the total debt cannot be considered as excessive. It will not be considered excessive if the total interest on the debt does not exceed the interest that would have been due if the participation had been financed with 85% debt on which arm's length interest was applicable. The Luxembourg tax authorities generally consider that interest is at arm's length if it does not exceed 12 months' EURIBOR plus 200 base points. Higher interest rates or income-sharing interest remuneration are acceptable if their arm's length nature can be substantiated. If interest payable on loans taken up to finance participations is considered excessive, the excess interest will be treated as a deemed dividend, so that dividend tax may in principle become due and the interest deduction on that excess interest may be disallowed.

Withholding tax on interest

Arm's length fixed or floating rate interest payments are not subject to Luxembourg withholding tax. However, interest paid on certain profit-sharing bonds and, arguably, profit-sharing interest paid on loans, is subject to 15% withholding tax unless a lower tax treaty rate applies.

On 1 July 2005, to implement the Savings Directive, Luxembourg introduced a withholding tax; initially at 15%, on interest paid through a Luxembourg paying agent (usually a bank) to an EU or Territory resident individual or residual entity within the meaning of article 4 (2) of the Luxembourg law of 21 June 2005 transposing the Savings Directive into Luxembourg law (in general, residual entities are entities other than legal entities which are taxed as legal entities, and UCITs). The withholding tax rate was increased to 20% from 1 July 2008 and will be increased to 35% from 1 July 2011. No withholding tax will be due if the beneficial owner consents to the exchange of information or submits a defined certificate issued by its state of residence. Furthermore, under certain circumstances, interest paid on a loan granted to a Soparfi by its shareholder(s) may fall outside the scope of the Savings Directive.

Under the law of December 23, 2005 a final 10% withholding tax is due on interest paid by a Luxembourg paying agent if it is:

- (i) for the immediate benefit of individuals resident in Luxembourg,
- (ii) paid to residual entities (as defined above) for the effective benefit of Luxembourg resident individuals, unless the residual entities opt for the exchange of information or assimilation to an UCIT for tax purposes.

Withholding tax on royalties

There is no withholding tax on royalty payments, except on certain artistic and literary royalties.

Advance confirmation

In addition to the APA procedure regarding intra-group financing activities (see Section 4 above), doubts or questions regarding the rules described here (e.g. whether the comparable tax test is met), may generally be discussed in advance with the Luxembourg tax authorities, and written confirmation obtained from them.

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