AMMC Law

Tax Newsflash

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Functional Currency for Luxembourg Tax Purposes

Luxembourg company law allows companies to establish financial statements in a currency other than Euro ("foreign currency"), while tax returns should be filed in Euro. Therefore, a tax balance sheet should be established each year (and attached to the tax returns) in which the accounting balance sheet would be converted into Euro. Foreign exchange gains/losses (in principle taxable/deductible) may appear in the tax balance sheet, resulting in gains or losses for tax purposes only.

Acknowledging the existence of the above tax foreign exchange risk, the Luxembourg tax authorities issued a circular letter (Circulaire du directeur des contributions L.G.-A n° 60 – "the Circular") in June 2014. The Circular provides for rules and guidance in relation to the ability to compute the Luxembourg tax basis in foreign currency (Tax Functional Currency Method – "TFCM"). The codification of a TFCM was one of the tax measures announced by Luxembourg's new coalition government in its platform released on December 2, 2013. We highlight hereafter the content of the most important provisions of the Circular.

Conditions to the application of the Tax Functional Currency Method

A request for applying the TFCM must be filed with the Luxembourg tax authorities at the latest three months before the end of the first financial year for which TFCM is requested (for newly incorporated companies, before the end of their first financial year). The foreign currency utilized to apply the TFCM should remain unchanged as long as the capital of the company remains denominated in that foreign currency.

The taxable basis should be computed in the currency in which the capital is denominated and which is used to establish the financial statements of the relevant company. Such tax basis is then converted into Euro to establish the tax returns. The relevant foreign currency/Euro exchange rate to apply to items to be converted for the purpose of computing the taxable basis is determined by reference to the European Central Bank (ECB) currency exchange rates.

Note: it seems that the Circular implicitly requires that both the capital and financial statements of the company requesting application of the TFCM are denominated/established in the same foreign currency (which will be used within the TFCM)[1].

[1] E.g. Circular, Section 2, first and last paragraph, p. 1 and 3 respectively; Section 6.2, first paragraph, p. 11.

In cases of tax consolidation, based on the wording of the Circular, all tax payers forming part of the fiscal unity would have to establish their respective financial statements in the same foreign currency as of the first financial year for which the fiscal unity regime is requested. It would have been consistent to allow application of the TFCM as from the first financial year for which all the companies part of a fiscal unity have their capital denominated and financial statements established in the same foreign currency, even if that financial year is not the first year for which the tax consolidation applies. Indeed, on a standalone basis, companies may transit to the TFCM after their first financial year. That position might be supported by a certain interpretation of the text of the Circular. Discussion with the tax authorities to clarify is recommended.

Taxes on income (Corporate Income Tax ("CIT") and Municipal Business Tax ("MBT"))

When applying the TFCM as per the Circular, the taxable basis of the relevant company should be computed in foreign currency as a first step and then converted into Euro using:

- the year-end exchange rate, defined as the Euro/foreign currency exchange rate as of December 31 of the relevant calendar year published by the ECB, or
- the average exchange rate, defined as the average of the monthly Euro/foreign currency exchange rates of the relevant calendar year published by the ECB.

The choice to use either exchange rate is irrevocable and applies for all future years.

The taxable basis is computed in foreign currency and then converted into Euro. Amounts that may impact the tax basis in the future should be converted into Euro using the same exchange rate as the one used to convert the foreign currency tax basis into Euro. For instance, tax losses carried forward should be carried forward in foreign currency until they offset taxable profit.

Note: *In Luxembourg, capital gains on shares may be tax exempt under certain conditions. However such capital gains would remain taxable up to tax deducted interest on debt financing the shares on which the capital gains arise (recapture rule). This is tax neutral as the loss created by the interest deducted in the past should offset the portion of the taxable gain realised upon disposal of the shares. In terms of reporting, both the amount of the tax loss and of the potential amount of capital gain recaptured should be reported in the tax returns until realisation of the capital gain. Both the tax loss to carry forward and the amount of "capital gain recapture" should therefore be reported in foreign currency until they are used to respectively offset or increase the tax basis of the company.*

Amounts expressed in Euro in Luxembourg Income Tax Law and the related Grand Ducal Decrees, such as cost of acquisition minimum threshold condition to benefit from participation exemption regime (e.g. the EUR 1.2 million minimum acquisition cost in the share capital of a qualifying subsidiary for the Luxembourg dividend participation exemption regime), have to be converted into Euro using the ECB

exchange rate of the day of the acquisition of the shares. The Circular contains other guidance relating to the foreign exchange rate to use to convert into Euro.

CIT and MBT returns still have to be filed in Euro and the tax authorities will continue to determine the tax liability in Euro and will issue tax assessments in Euro.

Net Worth Tax ("NWT")

Note: *NWT is a tax (rate of 0.5%) assessed as at January 1st of each year, broadly speaking on the net asset value of the relevant company (debts are in principle deductible from the NWT basis), and assets should in principle be valued at market value[2]. Certain types of assets may be exempt: e.g. shareholdings in qualifying subsidiaries.*

According to the Circular, in case of application of the TFCM, the NWT basis to report in the NWT returns should be obtained by converting the relevant values (see above) of foreign currency denominated assets and liabilities of the balance sheet (established in foreign currency) of the relevant company into Euro.

Companies with a financial year corresponding to the calendar year should use the foreign currency/Euro exchange rate as of December 31 (exchange rate of December 31 of Year-1 for the determination of the NWT basis as at January 1st of Year1) to convert items of the balance sheet. Companies with a financial year not closing at December 31 may opt for one of the following: (1) use December 31 foreign currency/Euro exchange rate of the calendar year preceding the relevant January 1st to convert shares and similar securities but the foreign currency/Euro exchange rate as of the date of the closing of the financial year preceding the relevant January 1st for the other items of the balance sheet to convert; or (2) use the foreign currency/Euro exchange rate as at December 31 (preceding the relevant January 1st) to convert all items of the balance sheet to be converted into Euro.

The choice of either method is irrevocable and binds the companies for any and all future years. Shares and securities are, however, in any case, to be converted using the exchange rate as of December 31 of the preceding year.

Under certain conditions, the NWT burden of a company may be reduced. One of the conditions is that a special NWT reserve has to be created and maintained. The Circular contains rules in relation to the conversion and reduction of the respective special reserve for NWT reduction[3].

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[2] Specific valuation rule may apply to certain item of the balance sheet, depending on the circumstances (to determine on a case by case basis).

[3] According to paragraph 8a of the NWT law (loi concernant l'impôt sur la fortune), a reduction of the NWT may be obtained to the extent the shareholders resolve to allocate an amount equal to five times the NWT reduction to a special NWT reserve before the end of the financial year following the financial year for which the NWT reduction is requested. Such reserve has to be maintained in the books for five years.

Transition from a Euro denominated tax balance sheet to the functional currency

Note: *A company establishing its financial statements in a foreign currency should establish a Euro denominated tax balance sheet to attach to the tax returns. Such tax balance sheet may disclose foreign currency/ Euro exchange gains or losses upon conversion of items of the balance sheet from foreign currency into Euro (potentially taxable or deductible).*

If a company, having established a Euro tax balance sheet in the past, requests and obtains application of the TFCM, it will have to establish a closing tax balance sheet in which the Euro denominated assets and liabilities shown in the tax balance sheet are converted into the foreign currency to be used within the TFCM. This may lead to differences between the book value and the tax value of assets and liabilities. In such cases, the tax payers will be obliged to establish a tax balance sheet in the foreign currency going forward.

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