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Recent developments in international taxation: Luxembourg

Introduction

This report highlights the main tax developments that occurred in the past year and are in effect for fiscal year 2025. These developments fall into two categories.

First, Luxembourg amended and completed its Pillar Two rules introduced with effect as from fiscal year 2024.

Second, Luxembourg introduced new measures aimed to further strengthen and enhance Luxembourg's attractiveness by (1) maintaining Luxembourg's appeal as an international investment hub and (2) attracting and retaining Luxembourg employees. The latter becomes increasingly important as companies invest in their Luxembourg footprint to align their substance with higher international standards.

Luxembourg also reduced its corporate income tax rate by one point to 16 per cent, which leads to an aggregate rate of 23.87 per cent (for Luxembourg City) when considering the employment surcharge and the municipal business tax. Luxembourg also simplified its minimum net wealth tax system for corporate taxpayers.

Pillar Two

Luxembourg implemented Pillar Two through the law of 22 December 2023 (the 'Pillar Two Law'), which introduced the Global Anti-Base Erosion (GloBE) framework into domestic law. The income inclusion rule and the qualified domestic minimum top-up tax (QDMTT) apply to fiscal years starting on or after 31 December 2023, and the undertaxed profit rule applies to fiscal years beginning on or after 31 December 2024.

To enhance legal certainty and align more closely with Organisation for Economic Co-operation and Development (OECD) guidance, Luxembourg approved an amending law on 19 December 2024 (the 'Amending Law'). The Amending Law incorporates key elements from four sets of OECD/G20 Inclusive Framework administrative guidance issued in 2023 and June 2024. The key amendments are:

- the definition of turnover, which includes realised or unrealised gains on investments, as well as extraordinary/non-recurrent gains or income;
- clarifications to the computation of turnover in case of divergent tax years;
- clarification that special purpose vehicles held by investment funds that do not qualify as ultimate parent entity (UPE) are excluded entities;
- exclusion of sovereign wealth funds from the definition of UPE;
- a QDMTT exclusion for multinational enterprise (MNE) groups in start-up phase; and
- the possibility of a five-year election to use currency of the consolidated statements or the euro for MNE groups with an entity using another currency.

The amendments also refine transitional measures like safe harbours and deferred tax handling, and introduce detailed rules on tax allocation across jurisdictions, including for

flow-through and securitisation entities. Some pieces of OECD guidance were implemented by means of grand ducal regulation, including foreign tax credits and functional currency rules.

The Amending Law applies retroactively from the initial effective date of the Pillar Two Law.

Earlier this year, the Luxembourg Accounting Board issued a Q&A document providing guidance on how the Pillar Two rules impact standalone and consolidated financial statements of Luxembourg entities and groups. While this guidance is not legally binding, it is expected to be followed by Luxembourg tax authorities and auditors.

The Accounting Board notably underlines that Luxembourg entities may disclose in the notes to the accounts whether they have any Pillar Two material exposure before the transition year (ie, the first year in which the entity or group becomes fully subject to Pillar Two rules) and are obliged to do so as from the transition year. If deferred tax assets are utilised, it is advisable to monitor and track their use and to include these in the notes to the standalone financial statements for greater transparency, in addition to the notes to the consolidated statements.

Participation exemption on dividends, capital gains and liquidation profits
Starting from the 2025 tax year, Luxembourg taxpayers may choose to opt out of the Luxembourg participation exemption regime applicable to dividends, liquidation proceeds and capital gains. This option is exclusively available for income from shareholdings meeting only the €1.2m (for dividends or liquidation proceeds) or €6m (for capital gains) holding threshold, but not the 10 per cent threshold. The exclusion also applies to the 50 per cent tax exemption on dividend income when deriving income from a qualifying shareholding, or realising a gain from its disposal that does not meet the holding period or minimum holding requirement conditions of the participation exemption. This option allows taxpayers to reduce mismatches between the Luxembourg participation exemption regime and other participation exemption regimes, including the excluded dividends regime for Pillar Two. This also helps reduce the accumulation of tax losses carried forward if the taxpayer opts to use the losses rather than benefit from the exemption.

The waiver must be applied individually for each tax year and each shareholding. In the absence of such an election, the Luxembourg participation exemption regime and the 50 per cent tax exemption on dividends will be automatically applied, provided all applicable conditions are satisfied.

Legal framework for tax treatment of class of shares redemption
Following recent developments in domestic case law, lawmakers introduced helpful clarifications on the tax treatment of class of shares redemption. The law confirms that the repurchase followed by cancellation of a class of shares qualifies as a partial liquidation, treated as capital gains type of income and exempt from withholding tax, if the following conditions are met.

- The classes of shares were either set up upon incorporation or upon a share capital increase.

- Each class of shares carries different economic rights, as defined in the articles of association. Commentaries to the law give examples of what could constitute different economic rights, such as:
    - (different) preferential dividends;
    - exclusive right to profits for a different determined or determinable period; or
    - financial rights linked to the performance of one or more of the entity's direct or indirect assets or activities.
- The share class is cancelled in its entirety and no later than six months after the date of the repurchase.
- The repurchase price of a class of shares, which should reflect the fair market value of the shares at redemption date, must be determinable based on criteria laid down in the entity's articles of association, or in any other document referred to in those articles of association.

While general anti-abuse rules remain applicable to share class redemptions where such redemption has as its main or one of its main purposes the avoidance of tax in artificial situations, this incorporation of the share class redemption treatment in the law provides greater certainty for this common practice.

Amendment of interest limitation rules
Interest deduction limitation rules cap the deductibility of exceeding borrowing costs (ie, the positive difference between borrowing costs and interest income) at the higher of 30 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA) or €3m.

For the fiscal year beginning on or after 1 January 2024, a new provision carves out a 'single-entity group' from these rules under certain conditions. A 'single-entity group' is a group of entities which are not part of a financial accounting consolidation. For a taxpayer to benefit from this carve-out, its equity-over-asset ratio should not exceed a ratio corresponding to its debt from associated entities plus its equity over its assets by more than 2 per cent. The carve-out therefore requires that the entity is largely financed via equity or debt from unrelated parties, which can notably be the case for Luxembourg securitisation entities.

Measures to support attraction and retention of employees

Changes to the profit-sharing bonus regime
To strengthen Luxembourg's attractiveness for highly skilled workers, the tax regime for qualifying inpatriates now exempts 50 per cent of total gross annual salary, excluding tax-exempt cash and in-kind benefits, to the extent the salary does not exceed €400,000 per year. This lump-sum regime replaced the previous inpatriate regime implemented in the form of tax exemptions for certain benefits in kind limitedly listed and specific bonuses. To qualify:

- the inpatriate must be resident in Luxembourg and should neither have been resident nor subject to income tax in Luxembourg, nor have been living less than 150 km from the Luxembourg border within five years;
- the inpatriate may either be seconded to Luxembourg from abroad or recruited in Luxembourg from a foreign country;
- the annual gross remuneration must be at least €75,000; and
- for companies older than ten years, inpatriates must not exceed 30 per cent of the workforce.

As a new requirement, the inpatriate must engage in the professional activity for which they benefit from the regime for at least 75 per cent of their working time.

Changes to the profit-sharing bonus regime
An employee who is granted profit-sharing bonuses benefits from a 50 per cent income tax exemption on the bonus amount. Two limitations of the regime have been slightly relaxed as from 2025:

- the limit of the amount of bonuses paid under the profit-sharing bonuses regime has been increased from 25 per cent of the employee’s annual gross remuneration, excluding any benefits in cash and in kind, to 30 per cent; and
- the maximum aggregate amount of profit-sharing bonuses has been increased from 5 per cent to 7.5 per cent of the employer’s annual profit for the financial year immediately preceding the financial year during which the bonuses are granted.