Will the tax bubble burst?

Luxembourg has long been a magnet for tax work, but is its attraction for international players fading?

On the panel

Bonn Steichen & Partners managing partner Alain Steichen
Elvinger Hoss Prussen managing partner Manou Hoss and partner Luc Frieden
Molitor managing partner Michel Molitor
Vandenbulke founding partner Denis Van den Bulke
Wildgen managing partner Francois Brouxel

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In brief

Our panel of experts discuss Luxembourg's reputation as a tax powerhouse, and how this will be affected by the sharp increase in regulation

Q Does Luxembourg deserve its reputation as a tax haven?

Francois Brouxel, managing partner, Wildgen: Certainly not. Like many other countries, including most EU member states, Luxembourg seeks to provide a competitive and attractive environment for international and domestic businesses. This includes tax competitiveness.

However, the key to Luxembourg's success in being an important international financial and business centre is its business-friendly legal and regulatory framework. A good example is the corporate and funds industry, a highly skilled, multinational and multilingual workforce, plus competitive business costs as well as a central geographical location in Europe.

Luxembourg's desire to be a cutting-edge legal business environment was one of the drivers behind the 2016 reform of the corporate law to provide innovative and pragmatic tools for market players.

There are hardly any other locations on a global scale that can offer such a package, together with a high quality of life for residents. In 2016 Mercer ranked Luxembourg the safest city in the world for expats.

Michel Molitor, managing partner, Molitor: No – Luxembourg isn't a tax haven at all. Our tax system is constantly adapted to stay in line with European law.

In addition, Luxembourg is at the forefront of implementing in detail the recommendations of the OECD's Base Erosion and Profit Sharing (BEPS) action plan, applying the arm's length principle set out in the plan and following OECD transfer pricing guidelines.

In the Budget law adopted in December and in a new transfer pricing circular the Luxembourg authorities have adapted the tax and legal framework in line with latest developments in international and European tax law.

Our goal is to be top of class as a compliant jurisdiction that provides an efficient operating environment for companies.

Manou Hoss, managing partner, and Luc Frieden, partner, Elvinger Hoss Prussen: Not at all. Luxembourg companies and residents have always been and continue to be liable to taxation. Luxembourg is a founding member of the EU and thus, of course, has always applied the relevant laws and EU standards.

We believe this reputation, which mainly stems from uninformed media reports, is based on the fact that Luxembourg has developed over the years a business-friendly environment for international companies. There is no harmonised corporate tax regime in Europe, as almost all countries have so far opposed harmonisation. Some European countries, such as Luxembourg, Ireland, the UK and the Netherlands have been more successful than others in attracting international companies because of a favourable business, legal and tax framework.

"Our goal is to be top of class as a compliant jurisdiction"
Michel Molitor

For the savings of private persons Luxembourg has, since 2005, applied the rules of the EU's directive on savings, under which automatic exchange of information and withholding tax on interest payments co-existed for a transitory period.

Automatic exchange of information only recently became an international standard following the US FATCA law and Luxembourg, as with its European partners, has applied automatic exchange of information for interest payments since 2015.

For corporates, the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, in its October 2015 meeting, considered Luxembourg largely compliant with its standards with respect to transparency and exchange of information.

Alain Steichen, partner, Bonn Steichen & Partners: Success triggers jealousy, and clearly Luxembourg has been successful over the years.

The reputation as a tax haven hence should not come as a surprise, since it is easier to explain Luxembourg's success with an alleged tax haven status rather than other factors. Luxembourg is fully compliant with all laws, including tax laws, as applicable within the EU, so it could in any case not be a tax haven. Over the past 30-40 years Luxembourg has developed other qualities and assets than tax-dodging. Clearly, a structural break or a regime change occurred in Luxembourg in the early 1970s.

Up to the 1970s the country was dependent on its steel industry, which had troubles that seemed to augur a gloomy future. The sector was restructured, with the workforce falling by about 80 per cent between 1970 and 2000. But more importantly, the basis was set for the transformation of a heavy industry-based economy into a value-added services-oriented one.

The factors behind this metamorphosis are well-documented: Luxembourg had the advantage of its central location at the heart of the EU of that time; a skilled and multilingual labour force; and a tradition of social dialogue, stability and consensus.

The authorities quickly realised that a flexible and favourable fiscal and regulatory framework could attract foreign banks and investors, and initiate the development of an international financial centre.

Success probably exceeded expectations. As soon as the world economy recovered from the recession of the early 1980s Luxembourg began growing much faster than its neighbours. This resulted in Luxembourg becoming Europe's leading investment fund centre, with €3.6trn (£3trn) of net assets under management at the close of October 2016; the second-highest value in the world after the US.

Denis Van den Bulke, founding partner, Vandenbulke: Referring to Luxembourg as a tax heaven is truly inappropriate. The Luxembourg tax system, which is Germany-inspired, levies taxes at a global rate of 40 per cent of GDP, which is higher than the average of most OECD countries. Whichever statistics you consult you will note that the Luxembourg tax burden is one of the heaviest of the OECD countries. In terms of governance the country strictly applies the rules of good conduct of the European Commission and exchange of information.

For the past 30 years the country has applied EU directives in respect of the parent-subsidiary or merger exchange regime and imposes strict capital ratios to holding companies, limiting financial leverage. Luxembourg financing companies are paying 30 per cent tax on their financing margin under strict transfer pricing conditions which are in no manner different from those prevailing in the US or other European countries.

> "Most business law firms have seen an increase in their bottom line driven by the regulatory environment and the flight to quality"
> *Alain Steichen*

Obviously, Luxembourg has been a victim of the witch-hunt affecting the tax environment in general, and the scapegoat of an aggressive campaign. This oversimplification was also accommodating to foreign governments pleased to point out to their publics that this small country was the cause of the deficiencies in their own ailing budgetary policies.

Most of this Luxembourg-bashing derives from the whispers that the tax administration would grant, in a praetorian way, favourable individual tax treatment. This obliterates the fact that most of the tax agreements made public confirmed only a general tax treatment to individual cases: this does not make it the preferred regime.

The Luxembourg tax regime has an economic approach whereby substance prevails over form, and it is often necessary to obtain confirmation from the tax administration that its economic analysis is aligned with the investor's.

Business needs security and rulings disperse the uncertainty about tax treatment. I would hope that other foreign tax administration take inspiration from Luxembourg and generalise that practice.

Q What has been the impact on Luxembourg's legal industry of the increased scrutiny of the country's relationship with corporates? Has it affected law firms' revenue or their ability to recruit, or attract new clients?

Brouxel: The Luxembourg legal industry strives to provide high-quality services for clients worldwide and has been successful in that in recent years. The country's fast recovery from the financial crisis is just one example.

Increased scrutiny thus does not have a negative impact on revenue, the ability to recruit, or attracting new clients.

Molitor: The main impact has been an increase in regulatory controls typically performed by the tax authorities and the European Commission, which has led to some increased requirement for solid advice from lawyers who specialise in corporate and finance.

A close relationship with lawyers helps ensure clients stay well within the rules and regulations. Certainly in Molitor's case, there has been no negative impact in terms of revenue, ability to recruit, or attracting new clients – rather, the contrary has been the case.

Hoss and Frieden: The media attention does not reflect the perception businesses have of Luxembourg. There is thus no negative impact on law firms, quite the reverse.

Following the widely publicised decisions of the European Commission against a few companies in Luxembourg, Ireland and the Netherlands, which consider that individual decisions by the local tax administrations may be tantamount to state aid, international groups have asked for advice on how to structure their international activities.

In addition, the discussions on BEPS in the

> Luxembourg's legal industry will be one of the main beneficiaries of Brexit"
> *Francois Brouxel*

OECD and Europe prompted requests. Companies want to be advised on substance and transfer pricing requirements. More work is expected once the European Court of Justice has decided on the state aid cases, as most of the decisions of the commission have been challenged in court.

Steichen: Luxembourg's legal industry has seen significant growth over the past 30 years, culminating in over 2,000 lawyers being registered with the Luxembourg bar. While the Luxembourg legal market was previously mostly composed of local law firms, a significant number of big international law firms have entered the scene in recent years, either by recruiting existing teams or merging with locally active practices.

This trend is not likely to stop in the near future, as more firms have announced their intention to establish a presence in Luxembourg. While Luxembourg is clearly not immune to the global trend of tighter budgets for legal services at client level and the increased use of flat fees or fee caps instead of uncapped hourly rates, revenues have not been significantly affected, most business law firms having on the contrary experienced a significant increase in their bottom line driven mostly by the increased regulatory environment after the financial crisis and the flight to quality of a significant number of law firms, focusing resources on high-value-add fields such as investment funds, banking law and tax law.

While the number of law professionals will likely increase less dramatically than before, highly skilled professionals will remain sought-after, Luxembourg remaining an attractive market for starting-out as well as seasoned lawyers. In terms of new clients being attracted, the radical change in direction of the Luxembourg government in recent years, including Luxembourg's participation in automatic exchange of information, its early adopter status in the framework of the Common Reporting Standard as well as its proactive approach regarding the automatic exchange of tax rulings during its EU presidency was positively perceived by the market and led to a significant client influx.

Van den Bulke: In essence, the increased scrutiny of foreign governments on Luxembourg has not adversely affected the legal market. Ironically, instructions for tax work have increased in recent months. Clients have indeed instructed law firms to review and further monitor their tax compliance process, and validate their tax situation. The role of tax advisers has changed: they are not relying on the comfort of an advance tax agreement issued by the authorities but now play a role in opining on the tax effects of transactions or the structures they advise. Their liability is in play and at risk, and this requires an enhanced capacity to diagnose the effective tax treatment, in particular because they lack official guidance.

This redefinition of the tax adviser role calls for more sophisticated profiles that are still scarce in the market. Law firms relying heavily on advance tax agreements have seen this source of income run dry. In search of compensation they have moved to alternative income sources by setting up transfer pricing teams who provide benchmarks for financing arrangements.

Q What are biggest issues facing Luxembourg's legal industry in the next 12 months? Do you anticipate any impact from Brexit? What about Trump's proposal to cut tax rates to encourage US companies to repatriate profits?

Brouxel: Two of the biggest challenges for the Luxembourg legal industry over the next 12 months will be Brexit and the impact of the US election.

While I strongly believe that as an important international financial and banking centre Luxembourg's legal industry will be one of the main beneficiaries of Brexit, this development can also create uncertainties and insecurities for market players in the EU and worldwide.

For the legal industry, it could also have the effect that the influx of international law firms, particularly from the UK, will increase and thus competition will become more intense. However, in any case Luxembourg is in an excellent position to manage such challenges.

Molitor: Frankly, no-one can possibly forecast with any certainty what the fallout from Brexit will be. My concern would be more to ensure the rest of Europe continues to reform and listen to voters who have reservations about the future. As for the newly elected US president we will have to wait and see which of his election promises he wishes to – and is in a position to – keep.

Hoss and Frieden: The Luxembourg legal industry has been growing substantially over the past 20 years due to the continuous growth of the economy, in particular its financial services.

We expect this to continue as international companies recognise the reputation and the diversity of Luxembourg's financial products and investment solutions, the pragmatic regulatory environment, the political and social stability, the multinational and multilingual workforce and the quality of its service providers, including law firms.

Luxembourg is Europe's leading investment fund centre, it is home to more than 150 banks and is perceived by many international financial institutions to be the ideal place to launch cross-border activities. For example, all the major Chinese banks have chosen Luxembourg as their European hub.

Luxembourg is also home to many other industries, like Europe's largest steel company ArcelorMittal and satellite operator SES, which is about to acquire a prominent role in media, technology and Fintech. All those companies and services require sophisticated legal advice in several languages.

We do not expect any direct effect on Luxembourg as a result of the tax policy announced by Trump. However, we expect Brexit to lead to an increase in the work for law firms and this process has already started.

Because it is likely that after Brexit the access for UK companies to the EU single market will not be the same a number of companies are looking for the best way to keep a foot in the EU.

Thanks to its experience in cross-border solutions and the close working relationship between the City and Luxembourg – in particular in the funds business – Luxembourg is frequently considered as a jurisdiction for tailor-made partnership solutions for UK financial services companies. Local practitioners, with the help of the regulator, are working on finding the best possible solutions for UK and other international groups with a presence in London.

Steichen: The main challenge for Luxembourg's legal industry in the coming months will be finding a sufficient number of qualified lawyers to cope with the growth of the legal market. They must be proficient in the main working languages (English, French and German) and I am confident that both civil and common law concepts will be in demand.

Whether Brexit or Trump's election will impact the Luxembourg legal market remains to be seen, but after a brief slowdown in transactions immediately pursuant to those events it has quickly recovered and remains strong.

One cannot ignore the fact that the UK's withdrawal from the European single market will lead to a significant amount of companies rethinking the way they operate and access the European key figures

Luxembourg

GDP
$58bn

Annual inflation
4.8%

Population
570,000

Unemployment rate
6.1%

Source: The World Bank

market, a clientele that Luxembourg is keen to capture thanks to its flexible legal framework, its sound governance and state finances (one of the last AAA-rated countries in Europe) and its high level of legal certainty – some of the main things taken into account by companies wishing to establish themselves in a new country.

Luxembourg's adaptability and flexibility is born of necessity due to its small domestic market and lack of natural resources. This left domestic companies no choice but to excel in the services sector and expand cross-border. This will a key element in the looming uncertainty.

Van den Bulke: I believe we will see an over-concentration of law firms and increased competition. This could lead to a saturation of legal services, with potential loss of quality across the board and pressure on margins. Luxembourg is heavily dependent on foreign-educated lawyers who are not very familiar with the Luxembourg legal environment. Legal experience coupled with strong academic and business-minded capacity is a virtue nowadays.

The challenge for Luxembourg firms is to upgrade the sophistication of their service and advice, and recruit professionals who are experienced enough to counsel on complex transactions with a capacity in line with other international financial centres. To serve a premium clientele firms must offer premium legal services.

We see the Brexit as an opportunity: Luxembourg is a gateway for investment in Europe and will remain so. Its central and neutral position between Germany and France and its multilingual capacity outpace its rivals. Furthermore, UK investors and London financial actors are already familiar with Luxembourg.

The Luxembourg investment fund industry, which is the second-strongest in the world, will certainly benefit from the uncertainty about the passporting of UK based- funds and managers. We are also convinced that US fund managers will be attracted to locate their management platform in Luxembourg instead of London, which will not benefit from same open access to the wider EU markets.

Beyond the subliminal political message conveyed by Trump we do not see US companies repatriating their treasury to the US for funding their worldwide operations. Luxembourg will keep its attraction as an international financing hub and a cash pool to fund international expansion. Other factors than a single nominal tax rate drive the decision to choose Luxembourg; a growing Asian and Arabic investment presence; an easy-access quotation; and an administrative flexibility with close proximity to the regulatory authorities.

Q What can law firms do to help counter the country's image as a tax haven?

Brouxel: Luxembourg law firms can help to communicate and clarify that Luxembourg is not a tax haven but an innovative and pragmatic international financial and business centre with many competitive advantages, including its regulatory environment and its highly skilled, multilingual workforce.

Molitor: Ensure that the excellent regulatory controls in place in Luxembourg are comprehensively adhered to by our clients and fully understood and appreciated by the media. Luxembourg is not a tax haven but a business-friendly jurisdiction that complies with OECD standards and European law.

Hoss: This is mainly a task for the public authorities in their dealings with the media. However, the law firms and consultancy firms can support

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this work in sharing facts and figures with the media and the public. As we said before, the business world knows Luxembourg quite well and appreciates its business-friendly, stable and pro-European environment. Independent of its image, Luxembourg will, for sure, remain a leading European business hub.

Steichen: Changing a country's image is always difficult. It first requires all companies to adapt their behaviour to a new environment, which Luxembourg has managed to pull off successfully, followed by a prolonged period during which high standards are maintained and displayed but past behaviour is dealt with and digested.

In those periods a law firm's contribution focuses on continuing to uphold high standards and provide legal services that are not only accurate from a legal point of view but also morally acceptable in the environment in which the client is evolving.

This additional point of attention is clearly understood in Luxembourg and is already taken into account by professionals active in the legal sector.

For the remaining part, we have to wait until improvements are perceived by the wider public and perceptions start to evolve.

Van den Bulke: Sensationalist press has had a detrimental effect on Luxembourg's reputation. A relative ignorance of international tax rules, a superficial analysis of the Luxembourg tax system coupled with oversimplification have depicted Luxembourg as one of the black sheep of international tax and finance.

Lawyers must strive against this because today Luxembourg is not about tax evasion. In this respect, lawyers have an educational role to play.

Over the past 30 years we have seen in Luxembourg the emergence of a true fund and finance industry based on tangible competences, financial pragmatism and multilingual efficiency. These assets and our economic statistics are the strongest arguments to use against those who reduce the country to a tax heaven.

Although some investors may have tried to abusively draw tax benefits from Luxembourg, a public mea culpa would just offer arguments to our detractors and legitimise their anti-Luxembourg opinion. Our tax regime is neither better nor worse than our neighbours.