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The Luxembourg bankers' secrecy and new developments

(presentation at the TTN meeting held in Rome on 20 September 2013)

Dear TTN colleagues
Dear guests

As the Luxembourg member of TTN, I have been asked to say a few words about new developments in the Grand Duchy of Luxembourg.

Moreover, I should inform our members on what may be our best predictions regarding the future of Luxembourg's bankers' secrecy, in the light of any new, mainly international, and more specifically European, political developments.

First of all: The existing internal legal rules on bankers' secrecy

There exist server legal sources stating the obligation for Luxembourg based banking institutions to preserve the privacy of their clients, and keep the veil of confidentiality above all of their clients' data.

Data on clients bank deposits and portfolios are protected by three elementary legal rules, namely:

(i) Article 41 of the coordinated law of 5 April 1993 on the financial sector;
(ii) Article 458 of the Criminal Code (*Code pénal*), invariably existing for over more than two hundred years until now;
(iii) Specific provisions of the internal Fiscal Code.

All in all the first two legal provisions mentioned above prohibit any banker's institution to leak any information regarding any of their clients to whatever third, person, company, or entity.

Under the same rules banks should, under penal sanctions, not communicate any information to any governmental administration, including the tax administration.

Under the corresponding rule drawn from the Fiscal Code, bankers (and by the way insurers) must not respond to any question raised by any tax administration (including the Luxembourg tax administration). There is a legal ban on any question aimed at information about any banker's client's identity or his estates in a bank.

Given their very straightforward character, allowing for almost no exception, there is not much of any internal Luxembourgish case law existing in this field.

Still today, and as was the case during earlier decades, clients' data are to be kept confidential, and they are legally protected.

Let me mention that, still nowadays, Luxembourg applies an exception under the 48/2003 European Savings Directive. Clearly, unless any non-resident banker's client (assuming he is a natural person and dwells somewhere else in the European Union) opts for the exchange of information regarding his person and his revenues (in terms of interest revenue) in a Luxembourg bank, the Luxembourg bank must refrain from indicating that client's revenues to any foreign (or Luxembourgish) tax authority.

<u>Now let me move on to the already existing exceptions, and the changes that may be forecasted at present with respect to the nearer future</u>

Let me, first of all, underline that any Luxembourg-based financial institution, as much as any banker in particular, is compelled to observe quite a number of legal provisions and regulations in terms of anti-money laundering, and for matters of combatting the financing of terrorism. Practically there exists a clear obligation for any banker to declare any suspect money or financial estate, to the Attorney general's financial information department. But this exception is not a clear tax matter.

A first plain set of exceptions to aforementioned banker's secrecy rules, and which are indeed relevant for pure tax matters, came along with the beginning aftermaths of the financial crisis post 2007.

As many other countries over the world, the Luxembourg government entered into a long lasting (and still lasting) challenge of concluding a number of new double tax treaties.

This happens alongside the effort of renegotiation a number of historically existing double tax treaties, in order to make them fitting the new OECD standards.

Since then, a bigger number of Luxembourg's double tax treaties enshrines the broadly known exchange of information clause (specifically article 26 in most treaties).

This article allows the Luxembourg partner country's fellow tax administration to require for the exchange of specific information of that other country's tax payers (*inter alia* information about revenues earned from cash deposits and securities held in custody by a local bank).

This system is now broadly known, and I should not spend a lot of time on explanation of its technical details here.

The relevant clauses of this new generation's tax treaties make it explicitly clear that the Luxembourg government would not be able to refuse or withstand that fellow country's request on mere grounds that the information is held by a financial institution or a fiduciary (who would otherwise be legally obliged to keep secrecy over any such data).

In other words, the Luxembourg bank nowadays ought to respond to such international requests, routed through the Luxembourg tax administration.

However, a certain case law developed over more or less the last five years regarding that type of bilateral requests.

The follow up of a request happens by a procedure involving the requesting country's tax administration and the Luxembourg revenue tax office (*Administration des Contributions*).

It is important to know that Luxembourg internal legal procedural rules offer a certain number of guarantees against wild and possibly unjustified requests, as well they rule out any "fishing expeditions" from abroad.

The Luxembourg administrative tribunal, hearing on fiscal matters, as well as the administrative Court of appeals, already annulled a number of orders issued by the director of the revenue tax administration.

Such annulments have been delivered on taxpayers or banker's institutions requests, when applications for international assistance from other countries did not match a number of minimum criteria in order to become admissible.

One may keep in mind that the Luxembourg judges put a ban on a number of requests for exchange of information from abroad, when it becomes evident that the taxpayer's home country's administration did not properly follow up with its own internal regulations in order to clarify the taxpayer's tax position.

Same happens when it can be argued that the requesting country did not demonstrate in how far the information would help it in defining the taxable base of one specific domestic tax payer's revenue or estate.

For instance, such cases of procedural annulments have been experienced in matters of a foreign tax administration very generally requesting data on money flows in an international company structure (a typical fishing expedition).

<u>Now let's move on to the next important polictical development currently observed:</u>

Under some redundant public announcements made by representatives of the Luxembourg government a few months ago, the Grand Duchy of Luxembourg informed the world about its own willingness to move away from the classical hardline approach of maintaining the Luxembourg banker's secrecy overall, including in matters of taxes <u>for non-residents.</u>

In all likelihood, these announcements will bring about some substantial changes starting from the tax year beginning on the 1st of January 2015, and more precisely some changes in Luxembourg's government's practice (and reporting obligations) for the following year (2016).

The precise topic is the announcement of automatic exchange of information, between any member countries of the European Union.

This change is to be considered in the light of EU directive 2011/16 introducing a number of mandatory rules, and providing for the **automatic exchange of information** about EU-resident taxpayer's revenues in one state of the EU vis-à-vis that tax payer's home country.

A number of categories of revenues (but not all types of revenues) underlie this new type of automatic exchange of information, including e.g. professional income, pension payments and retirement benefits, income from life insurance, income from real estate and others.

Currently the EU institutions tend to enlarge the list of classes of revenues to be set under that system of compulsory exchange of information. But dividend payments and interest are not yet a part of the list currently incorporated in that EU directive nr. 2011/16.

But anyway, if all of the above becomes true, the Luxembourg government, as any other EU countries, gets under the obligation to yearly release a number of data pertaining to EU residents to any of the latter's domestic tax administrations.

At the same time this quite new system still leaves a number of questions unanswered, and mainly if it will be possible to create effective means for their practical implementation (e.g. will there be IT networks efficiently working for supporting it ?? etc.).

But, from our understanding one bigger topic must be brought in the spotlight and remain to our all's intention (most probably for a number of years).

Is there anything in this system about companies (and other legal entities), as well as their founders, beneficial owners and shareholders?

From what we observe, the biggest number of political announcements over the past few years (and mainly from those calling the loudest for tightened international standards, in terms of automatic exchange of information about revenues) have been quite imprecise.

In as much as the EU directive 2003/48 (the European savings taxation) and EU directive 2011/16 (mutual assistance by exchange of information) are concerned, it seems to be clear that they feature **taxation of natural persons and not of companies** (or other legal entities holding estates and earning their own revenues).

This is an established fact, although the bigger number of political announcements (of which many verbally attack the Grand Duchy of Luxembourg!) try to create confusion, as they try to make the ordinary taxpayer (and layman) belief that automatic exchange of information will encompass anything, and also company's revenues.

But, believe it or not, current political understanding (and even the EU Commission's own interpretation of e.g. the 48/2003 directive) is to the contrary.

At present there exists no EU directive compelling any EU country to inform a shareholder's home country's tax administration, about any company's taxable income, when the relevant company receives financial income (for instance dividends or interest), and when such company entertains its bank account in the Grand Duchy of Luxembourg (regardless where such company has its registered office or permanent place of establishment).

Let's mention that a EU commission proposal published in October/November 2008 proposed to repeal the EU savings directive 48/2003 by broadening its scope, in order to include so called "off shore companies", and trusts, and life insurance policies.

So far this broadening of the scope never happened!

But, in a few words, if said proposed changes to that EU directive became true, any Panama company's own interest income, if earned on a bank account held in a EU country, would one day become the object of automatic exchange of information (towards their shareholder's EU countries of residence).

But such 2008 proposal must have remained in the drawers for over five years now, and there is lacking reporting from Brussels that it will soon be put on the political agendas, even if one never knows.

But the fact remains that the enactment of same proposal, if kept under the same wording of course, would not refer to any company's formed and existing under any EU law or the national law of any EU-country (for instance a Luxembourg SOPARFI company).

We should say this constitutes one very important political playing-field to be further observed.

But not more for the time being!

The other very critical political project, at EU level, by the way closely thereto related, is a proposal from the EU Commission dated 12 June 2013, suggesting changes to aforesaid EU directive 2011/16.

This very new proposal introduces the **twin concepts of "direct beneficiary" and "indirect beneficiary"**, as for the classes of revenue falling under that same EU directive (the directive governing mutual assistance and exchange of information).

That draft of June 2013 is built on the very explicit will to combat tax fraud and, as the preamble puts it, aimed at contributing to a higher degree of fairness and equality among private taxpayers, by closing loopholes allowing for tax fraud or tax evasion in practice.

This may be seen as a very ambitious project, yet in our assessment that same draft proposal completely lacks on any technical precision.

For instance, it does not retain any definition of the terms of “direct beneficiary”, and more importantly about the concept of “indirect beneficiary”. Unlike the above said 2008 proposal for possible repealing of the 48/2003 EU directive, this newer draft even does not explain in detail which type of “beneficiaries” could get subject to it (EU resident companies, off-shore companies, trusts, foundations….??).

That’s why we think that we all need to be very attentive observers of the final outcome of this.

Over the past years we assisted to a big amount of saber-rattling, and many attempts were made by some European governments to attack the Grand Duchy of Luxembourg and its own rules.

As already explained, big concessions have been made by Luxembourg for the dismantling of banker’s secrecy, as for any individual tax payers keeping their bank accounts in our country, and a number of foreign countries should be pleased about this.

A huge number of cash deposit withdrawals by non-resident tax-payers have been observed and some banks on the borderlines (especially on the German borderline) have paid out literally tons of cash. A greater number of foreign individual clients are substantially decreasing their cash deposits in Luxembourg, or even close them, by fear of getting in the fangs of new exchange of information rules, now or in future.

But according to our information, an overwhelming number of clients, mainly those keeping shareholdings in their own Luxembourg based private companies, having bank accounts on their own in Luxembourg, will not relocate their assets.

Banker’s secrecy continues to protect such companies, and they are not a part of automatic exchange of information, as we have seen.

To close on this part of our report we may say that any other (and possibly more far reaching) initiatives and developments belong to the future.

They still remain unknown, and much of what could be predicted is not even yet defined.

<u>Two other issues to be mentioned in this context:</u>

(1) FATCA

As many other jurisdictions, Luxembourg's government has entered into and enacted a bilateral FACTCA agreement, under the Foreign Account Tax Compliance Act, with the United States of America. This new instrument provides for automatic exchange of information with the US as for Luxembourg bank account data belonging to US tax-payers.

(2) The destiny of Luxembourg resident tax payers

It appears to be the Luxembourg major political parties' will **to keep the banker's secrecy in place**, as a general rule.

In other words, any Luxembourg (resident) tax payers will remain protected, and there is no automatic exchange of information between Luxembourg bankers and the local tax administration.

And for Luxembourg residents the classical banker's secrecy could only be broken into, as for matters related to taxes, when it came to criminal investigation for supposed acts of genuine tax fraud as defined in a specific regulatory framework enacted in 1993.

This gives me the opportunity to mention that Luxembourg internal tax laws set some very precise criteria to differentiate mere tax evasion (or tax sheltering) from real tax fraud.

By the way, since a number of years the Luxembourg government taxes any Luxembourg resident's **interest income** (drawn from Luxembourg sources or debtors) at a **10% final withholding flat tax**.

Any interest income taxed by way of such internal withholding tax will not become a part of the resident tax-payer's tax return, and thereby the Luxembourg government declared its own disinterest in reports from Luxembourg tax-payers' bank accounts (tax having been paid at source, there is no more concern in tax fraud on interest income).

Same finding applies to net worth taxes: as Luxembourg abolished any net worth tax for individuals about eight years ago, the Luxembourg revenue tax office does not entertain anymore eagerness to be systematically informed about taxpayers saving accounts.

Now, this is almost all I can tell you about Luxembourg banker's secrecy rules, and the major developments and expectations.

Indeed I got invited to this speaker's disc in order to report on those topics.

But following the very recent publication of a new bill of law, I ought to inform you about the current proposal to introduce patrimonial foundations (*fondations patrimoniales*).

That draft bill of law, tabled on 22 July 2013 at the desk of the Luxembourg Parliament, aims at introducing a new vehicle for the structuring and planning of private wealth. It should mainly serve hereditary issues and successions, both for residents and non-residents. Thereby it complements the already existing non taxed "*Société de Gestion de Patrimoine Familial*" (SPF).

The patrimonial foundation, when properly set up by a notarial deed, will be a legal entity in its own right, and become legally different from its founders and beneficiaries.

The patrimonial foundation is designed to own any kind of assets, in the Grand Duchy of Luxembourg and abroad.

There may be one or more founders, who may be resident in Luxembourg or abroad.

The minimum contribution (at formation) is set at 50.000.- EUROS (in cash or in kind).

One or more beneficiaries may be appointed by the founder(s) at the time of formation, or later on during the foundations lifetime.

The foundation may be set up for a limited duration, or for an unlimited term of existence.

The patrimonial foundation may also entail charitable purposes, but this is not compulsory. Therefore the patrimonial foundation will be completely different from non profit charitably foundations (*fondations d'utilité publique*) as governed under a 1928 act (and of almost no use for any private or family hereditary structuring).

In the founder's deed the founder may retain his own right to change the allocation of benefits (or even remove beneficiaries) later on.

Beneficiaries may be entitled to one time or recurrent benefits during the founder's life time, or at the moment of the founder's decease.

The beneficiaries of a patrimonial foundation need not to be published or filed at the registry of commerce, but their records must be kept at any time at the foundation's registered office (under the sanction of possible court ordered dissolution and winding up).

The foundation needs to entertain its own office or, in the absence of any such office, it must be domiciled with a professional of the financial sector, or any person allowed under domiciliation laws to exercise that function.

The patrimonial foundation may issue **beneficiary certificates** that can be privately assigned, observing the Luxembourg civil law formalities as for any assignments of claims (*cessions de créances*). Such beneficiary certificates will incorporate and represent the beneficiaries rights (like a share certificate).

There may be one director managing the foundation or a board of several directors.

A supervisory board may be appointed.

The foundation must compulsorily draw up annual accounts, and they need to be revised by an external auditor (*réviseur d'entreprises*). The accounts must not necessarily be publicly filed, but kept at the registered office.

Taxation of foundations will be very low: only 12.- EUR fixed registration tax at formation and set-up (unless the transfer of real estate located in the Grand Duchy of Luxembourg happens).

Financial income of the patrimonial foundation is almost tax free (for instance dividends from a Luxembourg or foreign company).

Capital gains realized on the disposal of movable goods or any financial securities will be completely tax exempt if disposal happens more the 6 months after the acquisition.

Transfer taxes for gifts or legacies by the foundation to the beneficiaries are set at the same registration rate as domestic donations, **but with a lot of exceptions** making it a very attractive vehicle for non-resident founders and beneficiaries.

For instance Luxembourg Transfer tax is not levied on any endowments by the foundation, whether paid to the beneficiary during the founder's lifetime, or following his decease, **and if pay to the founders children or spouse**.

Likewise, no transfer tax is payable on legacies and donations, structured through that Luxembourg foundation, when paid to non-residents, and when the will to not entail the transfer of real estate located in the Grand Duchy of Luxembourg.

I sincerely thank you for your attention.