

# MYTHS AND REALITIES

## Luxembourg, a black hole in the international financial system?

Is Luxembourg a tax haven? A trade centre for European and global tax fraud and money laundering? Or again, is Luxembourg a black hole in the European financial regulatory map? Such are the accusations that have been widely aimed at the Grand Duchy in recent months. Though the reproaches are not new, one cannot help but remark that they have experienced a resurgence in recent months, relayed by politicians and major foreign newspapers whose respectability is not in question, but whose claims do not appear to be supported by fact.

At a simple level, the term tax haven can be taken to describe a jurisdiction where taxation is very low compared to tax levels found in other developed countries. However, progressing beyond this definition is not simple. A report published by the Organisation for Economic Cooperation and Development (OECD) in 1987 concluded that "there does not exist a single, clear and objective criterion that enables a country to be identified as a tax haven". Nevertheless several lists of criteria do exist, which between them throw light on different aspects of the subject. In a working paper dated 2007, the International Monetary Fund defined a tax haven as a country in which economic activity is primarily oriented towards non-residents and which offers a favourable regulatory environment (light supervision and minimum disclosure of information) as well as jurisdictions with zero tax rates.

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We will focus on the most widely accepted definition, that of the OECD.

### Tax haven : the criteria established by the OECD

The OECD uses four principle factors to identify a tax haven: the fact that a jurisdiction has zero or insignificant tax rates, that it lacks transparency, that it is characterised by the existence of laws or administrative practices that impede a real exchange of information and that it is not necessary for an undertaking to have any activity or substance in the jurisdiction.

How does Luxembourg stack up against these criteria?

One response to this question is to point out that the OECD establishes an annual list of non-cooperative tax havens, based on these criteria, and to note that Luxembourg is not on the list. However, it is probably worthwhile looking deeper than this simple statement.

## Luxembourg in the light of the OECD criteria

We saw above that the first criterion mentioned by the OECD is the imposition of a zero or near-zero tax rate. This is not the place to go into detail concerning tax rates applicable in the Grand Duchy. However, a couple of examples should suffice to demonstrate that this criterion is not met in the case of Luxembourg. Firstly, where personal income tax is concerned, a comparison of the tax rates in Luxembourg (characterised, notably, by a marginal tax rate of 38%) with other European countries reveals that the former is similar to existing rates in France and Germany. The same is true where corporate tax is concerned. Thus, a business established in Luxembourg City is taxable on its revenue at a combined rate of 28.59%, to which must be added a net worth tax that has virtually no, or no longer, an equivalent within the EU.

Luxembourg does not meet the criterion of lacking transparency any more than it does the first criterion. The constitutional principle of equality of taxpayers before the law, the synthesis of laws into coordinated legal codes and the existence of independent, efficient courts competent in tax matters - the Administrative Tribunal and the Administrative Court - together guarantee an open and coherent application of tax legislation.

The criterion of the absence of real "substance" is not met by Luxembourg either, since a minimum of substance is legally required for any activity. What is more, the strict definition of tax residency in Luxembourg (tax domicile or *séjour habituel* for a physical person, and the company seat or administrative head

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office for a legal person), can be mentioned to disprove the criterion of absence of substantial activity in the Grand Duchy.

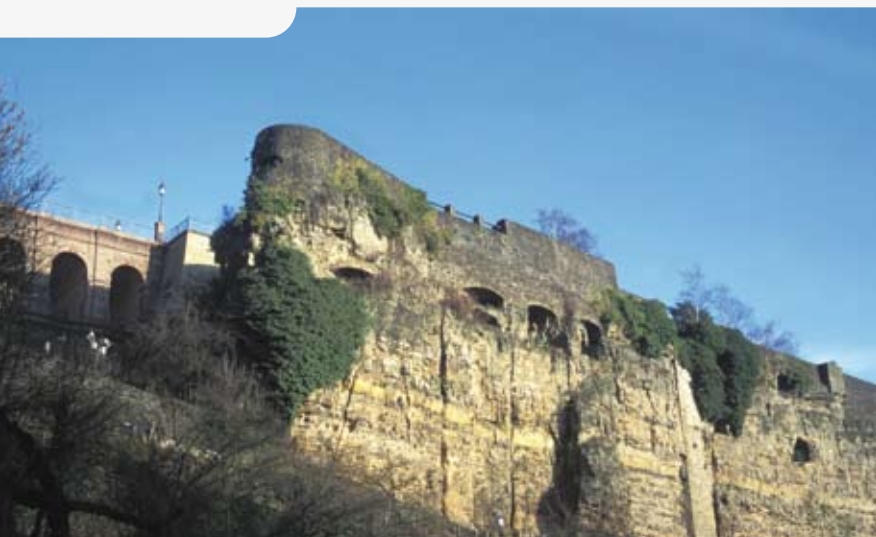
There remains the issue of Luxembourg's position in the area of the exchange of information, a question that we have decided to leave until last and to treat in greater depth, since it is based on a superficial analysis of this question that the myth of Luxembourg as a tax haven has often arisen. What, exactly, is the situation?

### Banking secrecy and tax haven, two labels that are often confused

At the heart of the debate over the exchange of information two elements cross paths, the problem of tax evasion and the existence of banking secrecy, and this is frequently a source of confusion. Is banking secrecy - which has its legal source in professional secrecy and has been guaranteed in Luxembourg for many decades - necessarily linked to the problem of tax evasion? The first principle of banking secrecy, stripped of all pejorative connotations, defines the obligation of financial institutions not to give information about their clients to a third party. Above all, banking secrecy is an instrument protecting the personal savings privacy of individuals and, more generally, their private life.

In order to refute a myth that has spread widely, it is necessary to state up front that banking secrecy ceases to protect the beneficiary where legal proceedings have been taken out against him. Thus, between 2006 and 2008 Luxembourg responded favourably to 1023 out of 1033 (that is, over 99%) demands for legal cooperation which were addressed to it by foreign legal authorities.

The European Savings Directive is a legal framework designed to ensure a standard minimum level of taxation of savings throughout Europe. While establishing



the exchange of information as a principle, the Directive provisionally authorises certain Member States, amongst which Luxembourg, to apply a withholding tax on interest income received by non-resident beneficiaries. Luxembourg has also established the rule that account holders can opt for the exchange of information.

A report recently published<sup>(1)</sup> by independent experts on the results of the application of the Savings Directive reveal that "Member State tax authorities appear to have found the exchange of information model difficult to apply and are facing long delays, inaccurate data and problems with pursuing the reports of interest income". The logical conclusion follows that "a withholding tax system seems to operate more efficiently". This point of view is shared by Luxembourg, all the more so that the application of a withholding tax permits it to combine efficient tax collection with legitimate protection of personal privacy.



But, over and above a debate on the comparative efficiency of the two systems, the opinion persists that Luxembourg does not participate wholeheartedly in the exchange of information. Is this a myth or reality?

According to official figures published by the Commission on 28 November 2008, Luxembourg, through the process of voluntary exchange of information, reported 4.2 billion euros of interest income in 2006 (the first full year of application of the Savings Directive). This represents some 35.4% of the total 11.8 billion euros reported by all 27 Member States. Far from being at the bottom of the class, Luxembourg takes first place in Europe in terms of the volume of interest payments reported, and this despite the existence of banking secrecy. Furthermore, Luxembourg paying agents withheld 166.1 million euros of withholding tax in 2006 (63% of the volume withheld by paying agents in Europe). At a

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conservative estimate, this indicates some 20 to 35 billion euros of capital.

On top of these amounts must be added those concerned by an exoneration certificate. The withholding tax mentioned above can indeed be avoided if the investor submits a certificate of exoneration issued by the tax authority of the State in which he is resident. By issuing a tax exoneration certificate, the tax authority in question declares that it is informed of the income received by the investor in Luxembourg, so that neither withholding tax, nor an exchange of information is necessary. Unfortunately, the characteristics of this procedure are such, that neither the European Commission nor the Grand Duchy of Luxembourg are in a position to make a credible estimate of the amounts concerned.

In the light of these statistics, and taking into consideration the absence of figures relative to the volumes covered by tax exoneration certificates, it is clear that Luxembourg is making a considerable effort both in the area of transparency and in the application of a withholding tax with regard to EU savings.

#### Rigorous prudential regulation

The Luxembourg financial sector benefits from rigorous regulation that is in conformity with both European and international legal standards and recommendations. Furthermore, the reputation and success enjoyed by Luxembourg funds, both within the European Union and worldwide, sufficiently demonstrates the quality of prudential regulation in this field.

Recent legal scandals in the financial area, far from contradicting this statement, illustrate quite the opposite. The huge fraud allegedly perpetrated by the American financier Madoff has been an opportunity for the Luxembourg regulatory authority, the *Commission de Surveillance du Secteur Financier* (CSSF), to draw people's attention to the fact that legal provisions govern-



ing Luxembourg depositary banks with regard to the custody of investment fund assets faithfully reflects European legislation in the area<sup>(2)</sup>. Hence, when the assets of an investment fund are deposited by the custodian bank at a third party institution (sub-custodian), the custodian retains responsibility for follow-up and supervision of the assets thus transferred. In consequence, it must at all times know how the assets of the investment fund are invested and from where and how they can be recovered. This responsibility with regard to the fund, and through the fund to its investors, is in no way attenuated by the fact that the custodian has entrusted all or part of the assets of the fund to a third party.

Equally, anti money laundering legislation is particularly strict in the Grand Duchy. In 1989, Luxembourg was one of the first EU Member States to implement the European Directive in this domain. Since then, the fight against money laundering has remained a priority for Luxembourg, which strives to remain irreproachable in this field.

Luxembourg, black hole in the international financial system: myth or reality? In our opinion, objective analysis leads unambiguously to the conclusion that the

Grand Duchy has nothing in common with a black hole that could imperil the international financial system, nor with a tax haven; on the contrary. For western public opinion informed by an impartial press, this analysis ought to take precedence over rumours and fortuitous juxtapositions. But perhaps here again it is a question of myth and reality? As far as we are concerned, people should not believe in myths in this area any more than they should in the area of international finance.

<sup>(1)</sup> "Challenges facing the EU Savings Tax", Graham Mather and Keith Boyfield, European Policy Forum, November 2008.

<sup>(2)</sup> Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

## Luxembourg fully OECD compliant

In line with recent international developments, Luxembourg decided on 13 March 2009 to fully adopt the OECD Model Tax Convention.

Henceforward, Luxembourg will participate in the exchange of information with foreign tax authorities, upon request, in precise cases and on the basis of concrete suspicion of a tax offence.

However, it must be underlined that the OECD Model Tax Convention does not imply direct or systematic access to banking data by tax authorities.

Furthermore, since banking secrecy is not incompatible with OECD rules, Luxembourg will maintain banking secrecy as an instrument for the protection of privacy that is only lifted in cases of criminal offence.

Further to this decision, Luxembourg insists that the exchange of information, as defined by the OECD, be adopted as the sole standard within the European Union.



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