Tax controversy series

Administrative court judgement on U.S. branches

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Over the last few years, the number of disputes between Luxembourg's tax authorities and taxpayers in court has increased significantly. All aspects of tax law seem to be concerned, from direct taxes and tax transparency-related matters to indirect taxes; in particular, VAT. Several reasons might explain this phenomenon. When it comes to direct tax matters, one of these could be the corresponding decrease in the amount of tax ruling requests filed by taxpayers.

This article is the first in our series on tax controversies, where we analyze the latest tax judgements, offering you insight on the most recent developments in the field of tax controversy in Luxembourg.

On 26 May 2023, Luxembourg's Administrative Tribunal (*Tribunal administratif*) ruled in a quite interesting case: The decision by the Luxembourg Inland Revenue (*Administration des contributions directes* – ACD) confirmed the denial of the permanent establishment (PE) status to the branch of a Luxembourgish resident company established in the United States of America (U.S.)[1].

This decision provides useful information on the criteria used to assess the existence of a permanent establishment abroad and sheds some light on the principle of legitimate expectation. Indeed, this judgment was delivered based on the old § 16 of the Tax adaptation law (*Steueranpassungsgesetz - StAnpG*), applicable before 1 January 2019 combined with an economic assessment of the situation of the alleged U.S. branch. It is intriguing to see that the court performs a rather factual and economic analysis to conclude the case and notice the elements that appear important in the eyes of the ACD and the judge.

The ruling also caught the eye because it was an opportunity for the court to clarify its interpretation of the general principles of the European law of legitimate expectation and legal certainty that is becoming increasingly invoked by the complainants in the context of tax controversy and disputes.

Summary of the facts

The complainant is a corporate taxpayer resident in Luxembourg. In 2013, the complainant established a branch in the U.S. with the intention to perform some intra-group financing activities through this branch.

The key dates of the case may be summarized as follows:

On 21 August 2013, the complainant filed a tax ruling request to the ACD claiming the recognition of a PE in the U.S. Subsequently, on 9 September 2015, the ACD issued the tax assessments for the year 2013. Though this is not explicitly mentioned in the judgement, it appears that such tax assessments deviated from the tax return submitted. On 22 December 2015, the ACD informed the complainant that no answer would be given to the ruling request, as the company had already been assessed for the year 2013.

Later, on 11 March 2019, the ACD requested proof for the existence of a PE in the U.S. According to the ACD, the complainant failed to provide it. As a result, the ACD notified the complainant of the elements of its 2014-2018 tax returns on which it disagreed and requested to be provided with more information (including the qualification of the U.S. branch as PE under the applicable double tax treaty) on 8 July 2019.

The complainant answered on 26 August 2019 with providing an extract from the Luxembourg Business Register, the board decision for establishment of a U.S. branch, five forms of the U.S. Internal Revenue Service (IRS), a "services agreement", and an "office sharing agreement", without additional explanations. However, the tax office issued final tax assessments on 11 September 2019 regarding corporate income tax and municipal business tax (2014 to 2017) as well as net wealth tax (2014 to 2018) refusing the recognition of the U.S. branch as a PE.

On 16 October 2019, the complainant filed against those tax assessments to the director of the ACD an administrative claim (*réclamation*). It then submitted additional information requested by the ACD on 11 May 2020. The director of the ACD declared the claim inadmissible with respect to 2015 municipal business tax and rejected the rest of the claim on the facts on 26 June 2020. As a result, on 25 September 2020, the complainant filed a request in front of the administrative court against the director's decision.

Context of the decision

Throughout the 2010s, utilizing U.S. branches by fully taxable Luxembourg resident companies for holding and intra-group financing activities gained popularity among multinational enterprises.

On 19 June 2018, the Luxembourg government issued Bill of Law 7318 for the transposition into Luxembourg domestic tax law of Directive (2016/1164) of 12 July 2016, referred to as the Anti-Tax Avoidance Directive (ATAD 1)[2]. This bill was voted on by the Luxembourg Parliament in December 2018 and published on 21 December 2018[3]. The scope of the law of 21 December 2018 is not limited to the transposition of the ATAD 1. Notably, it also modified the domestic definition of PE.

§16 StAnpG defines the concept of PE under Luxembourg domestic law. The law of 21 December 2018 added provisions regarding the definition of PEs when they are located in countries that have concluded a tax treaty with Luxembourg. The law of 21 December 2018 also amended the StAnpG by adding a new §16(5), which is designed to resolve conflicts in interpretation regarding the existence of a PE that could arise from the interaction between domestic law provisions and those of the relevant tax treaty. The Administrative Circular of 22 February 2019[4] clarified certain aspects of the new text.

The modification of the domestic definition of the notion of PE took place in the context of the drop down by the European Commission of its State aid investigation on McDonald's and the political willingness to ease potential challenges of alleged PE lacking economic substance[5]. The judgment under review, however, is based on the previous version of §16 StAnpG.

Decision of the administrative court

In the case at hand, the court reaffirms what constitutes a PE according to the double tax treaty with the U.S., mentioning the need for a place of business (i.e., a physical installation such as those listed in the treaty), which must be fixed (it must be linked with a specific geographical point and characterized by a certain permanence) and the that the activity of the enterprise must have been carried wholly or partly on from or through this fixed place of business: "*Three elements must be present to constitute a permanent establishment:*
- firstly, a place of business, i.e., a physical installation of some kind such as those listed by way of illustration in Article 5, paragraph 2 of the Convention;
- secondly, this installation must be fixed, i.e., it must, on the one hand, have a link with a specific geographical point and, on the other hand, be characterized by a certain permanence;
- thirdly, the activity of the enterprise must have been carried on wholly or partly from or through this fixed place of business."

The court highlights the fact that the complainant has not provided any evidence to support the claim that its financing branch was in the U.S., and to rule out the notion that it is fictitious. In further details:
- The address of the alleged U.S. branch is not clearly identified as the address in the office share agreement is different from the one in Form 8858 of the U.S. tax authorities, which is not the one used in the framework of the service agreement.
- No payment has been made by the U.S. branch under the terms of the office share agreement and the services agreement (According to the judge, this casts doubt on the reality of these contracts).
- The persons mandated in the services agreement are some managers of the Luxembourg company; therefore, they are supposed to manage the complainant itself, which is a Luxembourg resident corporation, as pointed out by the judge.
- The opinion of a U.S. attorney – invoked and relied upon by the complainant – is not considered supportive of the position of the complainant by the judge. Indeed, while stating that the company does have a PE in the U.S., the U.S. attorney concludes that the company in question should not file a tax return in the U.S., as it has no "*considerable, continuous, and regular*" activity in the U.S. where it carries no "*trade or business*".
- The judge follows the view of the ACD according to whom it is not evidenced that the U.S. branch has its own bank account in the U.S. The court states that the documents submitted by the complainant are not conclusive in this respect as that they are not official documents issued by a banking entity, but by documents issued by other companies in the group to which it belongs.
- When the financing activity was put in place, the funds were transferred directly "*in the interests of economic efficiency*" without flowing through the alleged PE.

On the facts, it thus appears that the complainant failed to convince the judge that the level of substance it had in the U.S. through the alleged branch was sufficient to constitute a PE. It is fascinating to see that the court performs a fairly factual and economic analysis to reach this conclusion and that it does so on the basis of the previous version of §16 StAnpG (i.e., before the text of §16 StAnpG was amended to ease potential challenges of alleged PE lacking economic substance in practice).

Another takeaway from this court decision relates to the discussions around the general principles of the European law invoked by the complainant, i.e., the principles of legitimate expectation and legal certainty.

The court focuses on the principle of legitimate expectation and reiterates that this notion protects the taxpayer against sudden and unforeseeable changes from the administration by recognizing his right to rely on conduct habitually adopted by the latter or on undertakings given by it[6], and insist on the fact that the legitimate expectation requires an act or a decision to be created. In the present case, the judge rejected the applicability of this principle on the basis of three elements:

First, the court points out that the dispute under review concerns the letter from the director of the ACD rejecting the administrative claim filed against the tax assessments, and not the letter dated 22 December 2015 informing the taxpayer that no response would be given to the ruling.

Second, the court states that the complainant did not benefit from a tax ruling, which is factual.

Finally, the court rejects the argument of the complainant according to which the fact that other taxpayers benefited from the tax treatment currently claimed by it (i.e., the recognition of a PE) should create a legitimate expectation for the taxpayer. In this respect, the judge considers that the factual situation at stake is singular. It seems that the complainant was trying to refer to information publicly available on other taxpayers, having obtained tax rulings in situations that he estimated were similar to his. For the judge, the situations are not necessarily alike, as the complainant did not obtain a tax ruling in the first place.

It seems – though the judgement is not explicit in this respect – that the complainant did not try to argue that the tax assessment issued in 2015 with respect to the tax year 2013 (which is undoubtedly an act or a decision) created a legitimate expectation for him. We can infer from this apparent silence that such tax assessment was not in line with the tax returns filed for year 2013 and thus did not[tacitly] accept the recognition of a PE. Otherwise, it would be difficult to understand why the complainant did not try this line of argument. The judgement of the court could indeed have been different if the 2013 tax assessment had recognized the existence of the PE.

Being very facts and circumstances driven, it does seem that this judgement should be considered as a landmark decision, all the more since the legal basis - i.e., §16StAnpG - has been modified and reinforced with application as of 1 January 2019. Also, if we understand that an appeal was filed by the taxpayer, it will be interesting to see whether the Luxembourg supreme court in direct tax matters (*Cour administrative*) will follow the ruling of the Luxembourg administrative court. In any case, it is fascinating to observe the judge's economic analysis for recognizing a PE, as well as the application of the principle of legitimate expectation based on the requirement of an act or decision.

1) Trib. administratif, 26 mai 2023, n° 45030 du rôle.
2) Council Directive (EU) 2016/1164 of 12 July 2016 Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193 (2016), Primary Sources IBFD.
3) Loi du 21 décembre 2018 1) transposant la directive (UE) 2016/1164 du Conseil du 12 juillet 2016 établissant des règles pour lutter contre les pratiques d'évasion fiscale qui ont une incidence directe sur le fonctionnement du marché intérieur; 2) modifiant la loi modifiée du 4 décembre 1967 concernant l'impôt sur le revenu; 3) modifiant la loi modifiée du 1er décembre 1936 concernant l'impôt commercial ("Gewerbesteuergesetz"); 4) modifiant la loi d'adaptation fiscale modifiée du 16 octobre 1934 ("Steueranpassungsgesetz"); 5) modifiant la loi générale des impôts modifiée du 22 mai 1931 ("Abgabenordnung"), Mémorial A-No. 1164 du 21 décembre 2018.
4) Circular L.G., No. 19, 22 Feb. 2019.
5) E. LEBAS, «Recent Amendments to EU, Luxembourg and US Tax Laws, and Their Implications for US Holding and Financing Branch Structures», Bulletin for International Taxation, IBFD, vol. 73, no 11, 2019.
6) Cour adm., 28 avril 2015, n° 35430C du rôle, Pas. adm. 2022, V° Lois et Règlements, n° 55.