Flash News

Luxembourg – New Circular clarifying the use of a non-EUR functional currency for tax purposes

16 June 2014

On 16 June 2014, the Luxembourg tax authorities released a long-awaited Circular formalising the use of a functional currency other than EUR for tax purposes. This Flash News summarises the main principles outlined by the tax authorities in the Circular and notes some of the resulting practical aspects.

PwC welcomes this administrative guidance, which re-affirms the willingness of the Luxembourg tax authorities to remain business-friendly and to avoid creating tax exposure on foreign exchange differences that are recognised for tax purposes while also reducing administrative tax burden for taxpayers.

Background

Luxembourg companies are free to choose the currency in which they wish to prepare their commercial accounts. Luxembourg companies that expect to conduct most of their business in a currency other than EUR will therefore generally opt to use that "foreign" functional currency to draw up their financial statements. In particular, this will save such companies from having to recognise for accounting purposes foreign exchange gains and losses that do not reflect the economic reality of their business.

Nevertheless, as a general rule, Luxembourg taxpayers in such a situation have until now been required to file their tax returns in EUR, basing these returns on EUR-denominated tax balance sheets.

In order to avoid the foreign exchange differences which result from the preparation of this EUR-denominated tax balance sheet and which do not reflect the economic reality, the use of a "foreign" functional currency for tax purposes has already been tolerated by the tax administration for many years. Luxembourg taxpayers have been allowed, upon request, to determine their taxable basis solely in a "foreign" functional currency, and then only having to convert the final basis figure into EUR. This has averted the need to establish a EUR-denominated tax balance sheet simply for tax filing purposes.

Circular L.G.-A n°60, issued by the Luxembourg tax authorities on 16 June 2014, formalises this well-established practice and provides a clear framework.

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Basic principles set out in the Circular

The use of a "foreign" functional currency has an impact on the taxable basis, as this prevents foreign exchange gains/losses that are only recognised for tax purposes from arising. The Luxembourg tax authorities are therefore keen to ensure that the option to use a "foreign" functional currency is driven by genuine business reasons rather than by tax optimisation objectives.

The following safeguards are therefore specified in the Circular:

- Luxembourg companies wishing to elect to use a "foreign" functional currency for tax purposes must send a request to the Luxembourg tax authorities (in practice, likely to be to the tax office that normally deals with that company's affairs). This request must be made at the very latest 3 months before the end of the first tax year for which the use of the "foreign" functional currency is required (i.e. at the very latest by 30 September of the relevant tax year for companies closing their accounts on 31 December). For companies in their first tax year, the request may however be made at any time until the end of such first tax year.

- The currency of the share capital and of the statutory accounts must be the same, although such correspondence is not required by Luxembourg commercial law.

- Such an election is irrevocable, and will therefore be binding for all future tax years as long as the company's share capital is expressed in that functional currency.

- Taxes will still need to be paid in EUR. The conversion of the final taxable basis from the "foreign" functional currency into EUR is to be done, as outlined further below, on the basis of the exchange rates published by the European Central Bank. No other exchange rate source will be accepted.

- The conversion of the taxable basis from the "foreign" functional currency into EUR may be made, at the election of the taxpayer, either at the closing foreign exchange rate, or at the average foreign exchange rate for the period covered by the tax return. Again, once made, this election will be irrevocable and will be binding for all future tax years.

Practical aspects

From a practical point of view, the Circular notes that the tax returns forms will in due course be amended to reflect the option to file tax returns directly in a "foreign" functional currency. In the meantime, taxpayers already wishing to use a "foreign" functional currency for tax purposes will be required to submit an addendum to their tax returns in order to allow for easy identification of relevant items in both the "foreign" functional currency and their EUR converted amounts.

Tax assessments will continue to be issued in EUR by the Luxembourg tax authorities.

Tax losses as well as taxable profits will be determined in the "foreign" functional currency, with tax losses carried forward being reported only in the "foreign" functional currency. In subsequent years' tax returns, tax losses carried forward will continue to be reported in the "foreign" functional currency. Hence in practice tax

losses will only be converted into EUR at the foreign exchange rate relevant for the year in which they will be used.

As regards tax credits (such as investment tax credits), the Circular confirms that amounts will be determined on the basis of figures as expressed in the "foreign" functional currency, and shown as such on the relevant tax forms. Any potential excess of tax credits will however have to be reported in EUR, and will therefore not lead to any future conversion into EUR during the later year of their use.

Where investments are potentially eligible for the benefit of the participation exemption regime on dividends and capital gains, the acquisition value is to be converted from the "foreign" currency into EUR using the exchange rate prevailing on the day of acquisition in order to determine whether the participation meets the thresholds mentioned in article 166 of the Luxembourg tax law and in the Grand-Ducal Regulation of 21 December 2001.

The net wealth tax (NWT) liability will be determined by using the foreign exchange rate prevailing at the closing day of the last financial year preceding the key date for NWT purposes (i.e. 1 January of each year), with the exception of some assets whose value has to be determined by reference to the 31 December foreign exchange rate, even if the closing of the financial year is on a different date.

The amount of the special reserve to be created in order to benefit from a reduction of the NWT liability in accordance with paragraph 8a of the NWT law will be determined by reference to the exchange rate used to calculate the NWT liability. The special reserve for NWT as recorded in the statutory accounts is therefore not subject to exchange rate variations, as conversion will have been made at historical rate.

Finally, all companies that are part of a tax unity group will all be required to determine their taxable result in the same currency.

Specific transition cases

Some difficulties from a practical point of view are likely to occur in situations where a taxpayer was previously determining its taxable basis using the EUR balance sheet method, and now wishes to switch to the "foreign" functional currency method permitted by the Circular.

The rules of the Circular addressing those transition cases do not provide full clarity and will require follow-up discussions with the tax authorities.

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