BSP Newsletter

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SUMMARY

CSSF 2020 SURVEY RELATED TO THE FIGHT AGAINST MONEY LAUNDERING AND TERRORIST FINANCING

On 24 December 2020, the CSSF announced that it will roll-out its annual AML online survey for the year 2020 (the “**Survey**”) on 15 February 2021.

Similar to last year, the Survey is addressed to management boards or/and the board of directors of (i) credit institutions, (ii) investment firms, (iii) AIFMs (including registered AIFMs), (iv) UCITS management companies, (v) investment funds which did not designate an investment fund manager, (vi) payment institutions and electronic money institutions, and (vii) specialised professionals of the financial sector incorporated under the Luxembourg law as well as Luxembourg branches of the abovementioned entities having their registered office in an EU country or a third country. The Survey remains generally unchanged compared to last year, with the addition of a few more questions.

Answers to the survey questions will have to be submitted through the CSSF eDesk portal by 15 March 2021.

The Survey must be initiated and submitted within the CSSF eDesk portal by:

i. the compliance officer in charge of the control of compliance with the professional obligations (“*responsable du contrôle du respect des obligations professionnelles*” (the “**RC**”)); or
ii. the person responsible for compliance with the professional obligations (“*responsable du respect des obligations professionnelles*” (the “**RR**”)); or
iii. another employee of the entity or third party of the supervised professional (taking into account that the ultimate responsibility for the adequate completion of the survey shall remain with the RC or RR).

For further details reference is made to the “Authentication and user account management” user guide in the dedicated section of the CSSF eDesk portal homepage .

AML | RAIF'S RR AND RC IDENTIFICATION FORM MUST BE COMPLETED AND FILED WITH THE AEDT

On 16 December 2020, the *Administration de l'enregistrement, des domaines et de la TVA* (the "**AEDT**") sent letters to reserved alternative investment funds ("**RAIFs**") to request them to appoint, in accordance with article 4(1) of the law on the fight against money laundering and terrorist financing of 12 November 2004 (the "**AML Law**"), two persons responsible for compliance with anti-money laundering and counter terrorist financing obligations, namely a "*responsable du respect*" (the "**RR**") and one "*responsable du contrôle*" (the "**RC**").

Such request, as explained by the AEDT in its Q&A dated 14 December 2020, derives from the passing of the law of 25 March 2020 amending the AML Law. From that moment, the AEDT became the supervisory authority of, among others, RAIFs.

Such request is not something new for the Luxembourg fund industry as the CSSF requests the appointment of an RR and RC for investment funds and investment fund managers under its supervision.

The RR and RC must be identified through an identification form, which should be submitted to the AEDT via email at the following email address: AED.finvehicles@en.etat.lu.

NATIONAL RISK ASSESSMENT OF ML/TF FOR THE YEAR 2020

BACKGROUND

The 2020 national risk assessment of money laundering and terrorist financing (the "**NRA**") was led by the Executive Secretariat of the National ML/TF Prevention Committee, with the input of a wide set of national stakeholders. The exercise was conducted in the first semester of 2020, and compiles an overview of Luxembourg's current situation as of year-end 2019, using a structured and data-driven approach based on international guidance (e.g. FATF's guidance, the EU's anti-money laundering directives, ESA guidance) and peer practice. The report encompasses the latest understanding of Luxembourg's threats, vulnerabilities, and the mitigating factors it has taken, including those developed since the issuance of the first NRA in 2018, to reduce its ML/TF risks.

THREE-STEP APPROACH OF THE NRA EXERCISE

Regarding the methodology, the 2020 NRA followed the same approach as the first assessment in 2018: it is conducted in three steps, inherent risk assessment, analysis of mitigating factors and residual risk, and finally, formulation of an updated anti money laundering/countering the financing of terrorism ("**AML/CFT**") strategy.

INHERENT RISK – THREATS ASSESSMENT AND VULNERABILITIES

The first step of the NRA involves assessing the inherent ML/TF risk. The objective of the analysis of threats is to understand the environment in which predicate offences are committed to identify their nature and to assess the exposure to them. The NRA highlights that the primary threats in Luxembourg derive from money laundering of foreign proceeds of crime. The sheer volume of financial flows transiting through and managed in Luxembourg contribute to exposure. On the other hand domestic exposure to money laundering was considered significantly smaller due to Luxembourg's low crime rate and limited presence of organised crime. The threat of terrorism and terrorist financing were assessed as moderate overall.

In terms of sector vulnerabilities, the report identifies the banking sector and the investment sector as vulnerable to ML/TF risks and places the inherent risk level at "High" for both. Collective investments are highlighted as being particularly vulnerable to be abused or misused for different types of fraudulent practices.

The NRA also identified specific threats and vulnerabilities relevant in the context of the COVID-19 crisis. Problems such as cybercrime, cybersecurity, fraud and forgery, corruption and bribery have been considered as growing threats. Furthermore, online purchases as a result of the social distancing measures are also likely to lead to the increase in both the volume and value of online payments services, including the use of internet banking which may create opportunities for illicit funds.

The NRA sets out many case studies to highlight the various threats and vulnerabilities.

MITIGATING FACTORS AND RESIDUAL RISK

As a second step, mitigating factors and their effects on inherent risk reduction are assessed, resulting in a residual risk level.

The mitigating factors section of the NRA looks to identify the impact of AML/CFT controls, which serve to mitigate the inherent risks identified for Luxembourg. In recent years Luxembourg has been strengthening its AML/CFT regime. Factors such as:

i. international cooperation at the level of (*inter alia)* each AML/CFT supervisory authority, the Financial Intelligence Unit and law enforcement agencies;
ii. the recent expansion of the definitions of money laundering and terrorist financing and the resultant increase in prosecutions;

iii. the evolution in the role of the *Cellule de Renseignement Financier*;

iv. an increase in the awareness and understanding of ML/TF risks and AML/CFT obligations and the carrying out of inspections by supervisors;

all work to reduce the inherent risk level to a residual risk level.

It was noted that mitigating factors are strongest in the financial sector. The NRA identifies the residual risk level of banks and the investment sector as “Medium”.

NATIONAL AML/CFT STRATEGY

Looking ahead, the NRA notes that while Luxembourg’s AML/CFT framework is mitigating effectively a significant part of the risks the country is exposed to, it can be further strengthened.

The national ML/TF prevention committee has therefore developed a national AML/CFT strategy based on the findings of the NRA, defined at three levels: agency level action plans, a national action plan and four national strategic priorities. Those priorities are:

- further enhancing the prosecution of ML/TF;
- further developing the ML/TF investigation capabilities;
- harmonising the supervision of designated non-financial businesses or professions (e.g. real estate agents, accountants, lawyers...); and
- improving market entry controls of trust and corporate service providers.

CONCLUSION

The NRA should provide adequate guidance to public-sector institutions and private-sector entities, enabling prioritisation and allocation of resources in line with risks identified and better equip Luxembourg to engage with international institutions in combating ML/TF activities. Furthermore, the purpose of this assessment is also to use the results to inform the national strategy on mitigation of ML/TF risks, addressing any deficiencies in an appropriate and timely manner.

The NRA is available on the website of the Ministry of Justice.

UPDATED ESMA Q&AS ON SECURITISATION AND ESMA GUIDELINES ON SECURITISATION REPOSITORIES

On 5 October 2020, ESMA published its final report (the "**Final Report**") on the guidelines (the "**Guidelines**") on portability of information between securitisation repositories under Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (the "**Securitisation Regulation**").

The Final Report provides clarification on how to ensure compliance with the obligations in Articles 78(9)(c) and 79(3) of EMIR, as applied by Article 10(2) of the Securitisation Regulation. In particular, the guidelines provide clarification on:

- the transfer of securitisation information by a securitisation repository from which registration has been withdrawn to other securitisation repositories.
- the content of the policies for the orderly transfer of data which a securitisation repository has to establish for the transfer of securitisation information to other securitisation repositories where requested by a reporting entity or where otherwise necessary.

ESMA has also published new Q&As on securitisation topics. These Q&As, *inter alia*, provide guidance on how to report certain underlying exposures which benefit from a COVID-related debt moratorium or payment holiday (Question 5.1.25) and how the primary income fields should be completed where a mortgage is a buy-to-let (Question 5.4.6).

NEXT STEPS

The Guidelines will be translated into the official languages of the EU and published on ESMA's website. ESMA will consider them for the purposes of its supervision as of 1 January 2021, except for the guidelines relating to Article 78(9)(c) of EMIR, which ESMA will consider for the purpose of its supervision only as of 18 June 2021.

NEW LUXEMBOURG DRAFT LAW TRANSPOSING IFD AND IFR

The purpose of the draft law 7723, submitted to the Luxembourg Parliament (*Chambre des Députés*) on 27 November 2020 (the "**Draft Law**") is to:

- transpose into Luxembourg law Directive (EU) 2019/2034 of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU ("**IFD**"); and
- operationalise Regulation (EU) 2019/2033 of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No. 1093/2010, (EU) No. 575/2013, (EU) No. 600/2014 and (EU) No. 806/2014 ("**IFR**").

CONTENTS AND KEY CHANGES

The IFD, investment firm directive and IFR, investment firm regulation, introduce a new prudential regime applicable to investment firms. The existing prudential regime under Regulation (EU) No. 575/2013 (CRR) and Directive 2013/36/EU (CRD IV) largely focuses on the prudential supervision of credit institutions and only partially addresses investment firms. Therefore, the IFD and IFR lay down provisions on the specific risks posed to different types of investment firms concerning internal governance, remuneration policies, concentration risk, capital requirements, liquidity requirements and reporting requirements.

One particular change introduced by the new regime, is the creation of four major categories of investment firms. "Class 1" investment firms will now be considered as credit institutions in their own right and will continue to be subject to the CRR and CRD IV regimes. "Class 1b" investment firms, by virtue of their size and importance or their membership of a group, will remain subject to a number of obligations stemming from the CRR and CRD IV framework, however, without being treated as credit institutions in their own right. "Class 2" investment firms represent the traditional investment firm, which will be fully subject to the new IFR and IFD regime. Finally, "Class 3" investment firms will be considered as small, non-interconnected firms that will benefit from certain exemptions to ensure the proportionality of the rules applicable to them.

Luxembourg must adopt and publish the measures necessary to comply with the IFD by 26 June 2021 whereas the IFR regimes will become directly applicable on the same date.

FURTHER HIGHLIGHTS OF THE RESULTING DRAFT LAW

The Draft Law, which mainly amends the Luxembourg law of 5 April 1993 on the financial sector (the "**1993 Law**"), also, *inter alia*, aims at:

- abandoning the purely Luxembourgish designations and statuses of investment firms, as set out in Art. 24 to Art 24-11 of the current version of the 1993 Law and focussing in the future on the investment activities and services listed in Section A of Annex I to Directive 2014/65/EU (MiFID II). Access to the activities of an investment firm will in the future be reserved to legal persons only, as is the default case in Directive 2014/65/EU; and
- modifying the status of certain specialized and support PFS. Thus, the status of "currency exchange dealers" will be abolished and the activities performed by currency exchange dealers will in the future be reserved solely for credit institutions. Moreover the status of primary and secondary computer system operators will be merged.

NEW CSSF SUBMISSION FORM FOR FILING FINAL TERMS

NEW FINAL TERMS SUBMISSION FORM

Since 30 November 2020, final terms (the "**Final Terms**") relating to a prospectus published in accordance with Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (the "**Prospectus Regulation**") must be filed using a new version of the Final Terms submission form available here.

BACKGROUND

The Prospectus Regulation introduced a number of changes in the prospectus preparation, approval and distribution. In particular, pursuant to the Commission Delegated Regulation (EU) 2019/979 of 14 March 2019, national competent authorities such as the CSSF must provide ESMA with an increased amount of machine-readable data on approved prospectuses, supplements and the related Final Terms.

USER GUIDE

For detailed guidance on the information to be included in the new submission form, the CSSF user guide may be consulted here.

ESMA UPDATED Q&AS FOR PROSPECTUS AND TRANSPARENCY RULES LINKED TO BREXIT

PROSPECTUS AND TRANSPARENCY Q&AS

On 9 November 2020, ESMA updated its Questions and Answers (Q&As) concerning Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (the "**Prospectus Regulation**") and its Questions and Answers (Q&As) concerning Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending (the "**Transparency Directive**") in the context of the end of the UK transition period (the "Prospectus Q&As" and "Transparency Q&As" respectively). ESMA also added two new Q&As to the Prospectus Q&As relating to an exemption for admission to trading in respect of fungible issues and one regarding identification of profit forecasts in prospectuses as part of an ongoing Q&A revision exercise.

As the UK transition period with the EU ended with effect as of 31 December 2020, the relevant issuers need to take the necessary action now, if they haven't done so already.

BREXIT RELATED UPDATES

In Question 16.1 ESMA addressed the need for non-EU issuers that have the UK as their home Member State for the purposes of the Prospectus Regulation **to choose a different home Member State** at the end of the transition period. According to ESMA (applying the principles in Article 2(m)(iii) of the Prospectus Regulation), such an issuer should choose as its new home Member State either from:

- the EEA Member State in which the issuer first makes an offer after the end of the transition period (including for this purpose an offer made during the transition period which continues after the end of the transition period); or
- the EEA Member State in which the issuer first seeks admission to trading on a regulated market after the end of the transition period.

Question 16.2 of the updated Q&As on the Prospectus Regulation covers the status of a prospectus, where it has been approved by the FCA and passported into the EU prior to the end of the transition period, once the transition period ends.

It is made clear that after the end of the transition period **it will no longer be possible to passport** such a prospectus into an EEA Member State since the Prospectus Regulation will no longer apply to or in the UK, and the UK will no longer be covered by the passporting mechanism set out in Article 25 of the Prospectus Regulation. Additionally, these prospectuses, if passported to one or several EU 27 Member States / EEA EFTA States while the UK was a Member State or during the transition period, can no longer be supplemented.

Therefore, these prospectuses can no longer be used to offer securities to the public or admit securities to trading on a regulated market within the EEA, even if the offer period began before the end of the transition period.

The updated Q&As on the Transparency Directive contains an updated question 26 covering choice of home Member State under the Transparency Directive after the end of the UK's transition period for leaving the EU. An issuer which has had the UK as its Transparency Directive home Member State before the end of the transition period and which has securities admitted to trading on one or several regulated markets in the EEA must determine a new

Transparency Directive home Member State according to the rules laid down in Article 2(1)(i) of the Transparency Directive.

Such issuers should choose and disclose their new home Member State without delay after the end of the transition period. If the issuer does not disclose its new home Member State within a period of three months after the end of the transition period, ESMA is of the view that the Member State (or if more than one, each Member State) where the issuer's securities are admitted to trading on a regulated market should be considered its home Member State until a subsequent choice of a single home Member State has been made and disclosed by the issuer.

OTHER UPDATES

The updated Q&As on the Prospectus Regulation also cover:

- the identification of profit forecasts in prospectuses (ESMA adopts a "substance over form" approach concerning what financial measures may be viewed as profit forecasts for this purpose); and
- the exemption from the obligation to produce a prospectus for the admission to trading on a regulated market of securities fungible with securities already admitted to trading on the same regulated market, provided that they represent, over a period of 12 months, less than 20% of the number of such securities already admitted to trading on the same regulated market.

CSSF PRESS RELEASE ON UK EQUIVALENCY UNDER MiFIR AND ESMA REMINDER REGARDING REVERSE SOLICITATION

THE UNITED KINGDOM HAS BEEN INCLUDED IN THE LIST OF JURISDICTIONS, WHICH ARE DEEMED EQUIVALENT FOR THE APPLICATION OF THE NATIONAL THIRD-COUNTRY REGIME IN LUXEMBOURG.

On 23 December 2020, CSSF Regulation No. 20-09 of 14 December 2020, amending CSSF Regulation No. 20-02 of 29 June 2020 on the equivalence of certain third countries with respect to supervision and authorisation rules for the purpose of providing investment services or performing investment activities and ancillary services by third-country firms ("Regulation No. 20-09") was published in the Official Journal of the Grand Duchy of Luxembourg.

In the absence of an equivalence decision by the European Commission in accordance with Article 47 (1) of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (the "**MiFIR**"), Regulation No. 20-09 includes the United Kingdom in the list of jurisdictions, which are deemed equivalent for the application of the national third-country regime for the purposes of MiFIR. Regulation No. 20-09 applies since 1 January 2021.

Therefore, a UK firm may, subject to certain conditions set forth in Circular CSSF 19/716 as amended by Circular CSSF 20/743, provide investment services or activities as well as ancillary services in Luxembourg to eligible counterparties and professional clients *per se*, without setting up a branch in Luxembourg.

In a press release of 24 December, the CSSF explained that in order for a UK firm to benefit from this national third-country regime, it must submit a complete application file to the CSSF, without delay.

ESMA ISSUED A REMINDER TO FIRMS OF THE MIFID II REVERSE SOLICITATION RULES IN THE CONTEXT OF THE END OF THE UK TRANSITION PERIOD.

On 13 January 2021, ESMA issued a statement to remind market participants of the requirements on the provision of investments services to retail or professional clients by firms not established or situated in the European Union under Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (the "**MiFID II**").

By way of background, pursuant to Article 42 of MiFID II where a retail client or professional client established or situated in the Union initiates at its own exclusive initiative the provision of an investment service or activity by a third-country firm, the third country firm is not subject to the requirements under Article 39 of MiFID II (establishment of a branch).

ESMA reminds firms of previous guidance which it has issued on the interpretation of Article 42 MiFID II. By way of example, ESMA mentioned that it has seen some firms include in their Terms of Business a pop-up "I agree" box whereby clients state that any transaction is executed on the initiative of the client. Such a requirement is not sufficient to circumvent the MiFID II requirements. Where a third-country firm (which now includes any UK firm) solicits clients or potential clients in the EU or promotes or advertises investment services or activities together with ancillary services in the EU, it shall not be deemed as a service provided at the own exclusive initiative of the client.

ESMA UPDATED Q&AS ON MiFID II AND MiFIR INVESTOR PROTECTION AND INTERMEDIARIES TOPICS

On 6 November 2020 and on 21 December 2020, ESMA updated its Questions and Answers ("Q&As") concerning investor protection and intermediaries topics under Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments ("**MiFID II**") and Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments ("**MiFIR**")

In Question 33 (updated on 21 December 2020), related to information on costs and charges, ESMA addressed the presentation of information about ex-post costs and charges to clients in a fair, clear and not misleading manner in accordance with Article 24(3) of MiFID II. According to ESMA, such information should be presented:

- through a standalone document (which could still be sent together with other periodic documents to clients); or
- within a document of wider content, provided that it is given the necessary prominence to allow clients to find it easily.

Furthermore, where a breakdown of aggregated figures is provided (at the client's request), it is important that the consistency of the overall ex-post disclosure presented is ensured so that clients are in the position of easily reconciling aggregated figures with their itemised breakdown referring to the same reporting period (both for cash amounts and percentages).

On 6 November ESMA updated Questions 2, 3 and 4 relating to product governance. In Question 2 ESMA covered how firms should manufacture financial instruments to ensure that these financial instruments' costs and charges are compatible with the needs, objectives and characteristics of the target market under Article 9(12)(a) of the MiFID II Delegated Directive (2017/593/EU) (the "**MiFID II Delegated Directive**"). In ESMA's view, firms should have clear and robust policies and procedures to identify and quantify all product related costs and charges. Such policies and procedures should be robust and documented, with a clear determination of roles and responsibilities in the process. For example, policies and procedures should be clear on which market parameters are used for the pricing of products and related determination of costs (sources, frequency of updates, how they are applied to products of different characteristics/duration, etc.). Firms should then assess if and how the costs and cost structures identified are compatible with the envisaged target market of the product and whether adjustments are needed.

In Question 3 ESMA clarified how firms manufacturing financial instruments should ensure that costs and charges do not undermine the financial instrument's return expectations, as required by Article 9(12)(b) of the MiFID II Delegated Directive. According to ESMA, during the product design phase the firm should undertake a scenario analysis of their financial instruments and, in this context, simulate product returns taking into account all costs of the instruments (implicit and explicit).

Lastly, in Question 4 ESMA explained how firms should ensure that the charging structure of the financial instrument is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand as required by Article 9(12)(c) of the MiFID II Delegated Directive. ESMA gives a non-exhaustive list of examples showing what is expected in this regard.

EUROPEAN SINGLE ELECTRONIC FORMAT

WHEREAS

The Luxembourg law of 11 January 2008 on transparency requirements for issuers (**Transparency Law**), supplemented by the Grand-Ducal Regulation of 11 January 2008 on transparency requirements for issuers (**Transparency Regulation**), applies to issuers for which Luxembourg is the home Member State in accordance with the Transparency Law.

These issuers are required to provide ongoing and periodic information, defined as *regulated information*, which amongst other includes periodic financial reports, information to be provided in relation to major holdings and inside information.

The Transparency Law imposes three disclosure requirements on issuers in relation to *regulated information*: (i) effective dissemination of the regulated information; (ii) making this information available to an Officially Appointed Mechanism (OAM); and (iii) filing of the regulated information with the CSSF.

REGULATED INFORMATION

As per article 1(1) item (10) of the Transparency Law, "*regulated information*" shall mean all information, which the issuers are required to disclose under the Transparency Law and under articles 17 and 19 of Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (**MAR**).

Given the distinction to be made between periodic and ongoing regulated information and the scope of the present article, we will only focus on periodic information i.e. financial information; while ongoing information is referring to major shareholding thresholds crossing.

PERIODIC INFORMATION

Pursuant to the Transparency Law, the periodic information requirements apply to issuers whose securities are admitted to trading on a regulated market and for which Luxembourg is the home Member State. Hence, these issuers are required to prepare: (i) an annual financial report (**AFR**), to be published at the latest four months after the end of each financial year; (ii) a half-yearly financial report to be published at the latest three months after the end of the first six months of each financial year; and a report on payments to governments.

FORMAT REQUIREMENTS FOR ANNUAL FINANCIAL REPORTS

Commission delegated regulation (EU) 2019/815 of 17 December 2018 supplementing Directive 2004/109/EC of the European Parliament and of the Council with regard to regulatory technical standards on the specification of a single electronic reporting format (**RTS**) imposes on all issuers which have to publish AFRs to prepare their AFRs in Extensible Hypertext Markup Language (XHTML) format for financial years beginning on or after 1 January 2020. Where AFRs include IFRS consolidated financial statements, issuers shall mark up those consolidated statement using XBRL mark-up language as defined in the RTS.

WHAT IS THE ESEF?

The European Single Electronic Format (**ESEF**) is the electronic reporting format in which issuers on EU regulated markets shall prepare their annual financial reports as from 1 January 2020.

In 2013, the Transparency Directive, was amended to include, amongst others, a requirement for issuers to prepare their AFRs in an ESEF. ESMA was assigned the responsibility to develop RTS to specify this ESEF. The objectives were to make reporting easier for issuers and to facilitate accessibility, analysis and comparability of AFRs. RTS on ESEF will apply to all issuers subject to the requirements contained in the transparency directive to make public AFRs.

ESEF REQUIREMENTS

- All AFRs shall be prepared in XHMTL, which is human readable and can be opened with any standard web browsers;
- Where AFRs contains IFRS consolidated financial statements, these shall be labelled the XBRL tags, which make the labelled disclosures structured and machine-readable;
- The XBRL tags shall be embedded in the XHTML document using the Inline XBRL technology, which allows the benefits of XBRL tagged data to be combined with the human readable presentation of AFRs;
- A taxonomy provides the hierarchical structure used to classify financial information and is essential for structured electronic reporting using XBRL. The taxonomy to be used for ESEF is an extension of the IFRS taxonomy;
- Preparers shall mark-up disclosures using the taxonomy element having the closest accounting meaning to the marked up disclosure; if the closest taxonomy element misrepresents the accounting meaning of the disclosure, issuers shall create a so-called extension taxonomy element and anchor such extension to the core taxonomy element that has the closest accounting meaning.
- Primary financial statements (income statement, balance sheet, statement of cash flows and statement of changes in equity) shall be marked up in detail; the Notes instead will need to be marked up by applying mark-ups for whole sections of the notes (block tagging).

POSTPONEMENT OPTION

While initially RTS on the ESEF were intended to mandatorily apply to all annual financial reports drawn up in accordance with article 3 of the Transparency Law for financial years beginning on or after 1 January 2020; CSSF informed on 20 January 2021 that for issuers subject to the Transparency Law, Luxembourg has decided to opt for the 1-year postponement option of the ESEF requirements.

As a consequence, these requirements will apply to the AFRs for periods beginning on or after 1 January 2021. For periods preceding that date, issuers may already apply ESEF requirements on a voluntary basis.

The CSSF reminded issuers as well that, as from the application of the ESEF requirements (including if applied on voluntary basis before 1 January 2021), the entire AFRs shall be drawn up in accordance with the RTS on ESEF. Therefore, as mentioned above, it shall be prepared in XHTML format and, where AFRs include IFRS consolidated financial statements, issuers shall mark up those consolidated financial statements using eXtensible Business Reporting Language (XBRL).

LIQUIDITY AND VALUATION SHOCKS | ESMA REPORT ON THE PREPAREDNESS OF INVESTMENT FUNDS

As part of its actions to address the impact of COVID-19 on the financial system from a macroprudential perspective, on 6 May 2020, the European Systemic Risk Board ("**ESRB**") published a recommendation to address liquidity risk in investment funds, requesting that ESMA:

a. coordinates with the EU national competent authorities (including the CSSF) (the "**NCAs**") to undertake a focused piece of supervisory exercise with investment funds that have significant exposures to corporate debt and real estate assets to assess the preparedness of these two segments of the investment funds sector to potential future adverse shocks, including any potential resumption of significant redemptions and/or an increase in valuation uncertainty; and
b. reports to the ESRB on its analysis and on the conclusions reached regarding the preparedness of the relevant investment funds.

On the basis of the data collection questionnaire prepared by ESMA, the CSSF asked, in July 2020, a large sample of selected UCITS as well as alternative investment funds to complete a questionnaire through the CSSF's eDesk portal.

On 12 November 2020, ESMA published a report (the "**ESMA Report**") setting out its analysis and conclusions. Overall, the funds exposed to corporate debt and real estate under review managed to adequately maintain their activities when facing redemption pressures and/or episodes of valuation uncertainty.
The analysis of their behaviour during the market stress linked to the COVID-19 pandemic revealed that only a limited number of the analysed funds suspended subscriptions and redemptions while the vast majority was able to meet redemption requests and maintain their portfolio structure.

Some areas of concern identified in the ESMA Report are the following:

a. some funds presented potential liquidity mismatches due to their liquidity set up (e.g. a combination of high redemption frequency, no/short notice periods and no liquidity management tools ("**LMTs**"):
b. only a few funds have adjusted their liquidity set-up according to the pursued investment strategy and in light of the liquidity issues encountered (e.g., introduction of LMTs, adaptation of the redemption frequency and notice period);
c. concerns around the valuation of assets emerged especially for real estate funds; moreover real estate funds do not frequently adopt LMTs in their liquidity set-up;
d. risks arising from loan covenants, i.e. contractual obligations relating to loans received by managers that may trigger fire sales and have a pro-cyclical effect.

The following five (5) priority areas have been identified to enhance the preparedness of funds:

a. **Ongoing supervision of the alignment of the funds' investment strategy, liquidity profile and redemption policy.** Management companies should be able to justify the liquidity set-up of their funds, at the authorisation phase or during NCAs supervisory actions. Misalignments between the liquidity of a fund's investments and its redemption policies should be corrected in a timely manner. Particular attention should be paid to funds investing in less liquid or illiquid assets.
b. **Ongoing supervision of liquidity risk assessment.** NCAs should supervise the liquidity risk assessment by management companies. Particular attention should be paid to supervising that management companies in their liquidity risk assessment comply with their obligation to take all factors into account that could

have an impact on funds liquidity or that could trigger unwanted sales of assets.

c. **Fund liquidity profiles.** In the context of the AIFMD review, additional specifications on how liquidity profiles should be established and reported as part of the AIFMD reporting should be introduced. This includes (i) on the asset side how to determine a realistic and conservative estimate of which percentage of the fund portfolio can be liquidated (estimate for each asset class based on reliable methodology and data), and (ii) on the liability side, how to take into account arrangements with respect to gates and notice periods in the determination of investor liquidity profiles. ESMA notes that this priority area applies equally to UCITS.

d. **Increase of the availability and use of liquidity management tools.** Proposal for a harmonised legal framework to govern the availability of additional LMTs for fund managers in both the UCITS and AIFM frameworks, which would include specifications on the required disclosures for the provision and use of LMTs to ensure greater protection and consistency for investors.

e. **Supervision of valuation processes in a context of valuation uncertainty.** As part of their ongoing supervision of management companies, NCAs should carry out further supervisory activities to ensure that management companies' valuation procedures cover all market situations including valuation approaches for stressed market conditions.

From a financial stability perspective, ESMA considers that the above priority areas aiming at reducing the liquidity and valuation risks at the level of the investment fund should reduce the risk and the impact of collective selling by funds on the financial system. ESMA will continue to monitor this risk through regular assessments of the resilience of the fund sector.

ESMA will take forward items a) b) and e) in coordination with NCAs. Items c) and d) are, in ESMA's view, more fit to be taken forward in the context of the AIFMD review. It therefore remains to be seen whether the European Commission will introduce further legislative changes in the context of the ongoing AIFMD review.

BREXIT | DEADLINE FOR MARKETING OF UK UCITS IN LUXEMBOURG

BACKGROUND

On 21 December 2020 draft law No. 7736 was presented before the Luxembourg Parliament (the "**Draft Law**"). The scope of the Draft Law includes, *inter alia*, an amendment to the law of 17 December 2010 relating to undertakings for collective investment (the "**UCI Law**").

SCOPE

The Draft Law amends the UCI Law by prolonging until 31 July 2021 the transitional arrangements set out in the law of 8 April 2019 relating to measures put in place in the financial sector in the context of Brexit. The aim of this additional six months prolongation is to avoid any legal insecurity for Luxembourg investors holding units in UK UCITs.

DETAIL

Pursuant to the law of 8 April 2019 on the measures to be taken in relation to the financial sector in the event of the withdrawal of the UK from the EU, the CSSF is authorised to apply, for a maximum period of 21 months after 1 February 2020 (date of withdrawal of the UK from the EU) the provisions of article 119 of the UCI Law (freedom to provide services or establish a branch) to UK management companies authorised pursuant to Directive 2007/65/EC ("**UCITS Directive**") which carry out activities in Luxembourg at the time of such withdrawal.

The Draft Law now provides that any UK UCITS that markets its units in Luxembourg as of 31 January 2021 (by virtue of the above) is authorised to market to retail investors in Luxembourg until 31 July 2021 on the basis of article 100, paragraph 1 of the UCI Law, as long as that UCITS is managed, as at 31 December 2020 (end of the transitional period), by a management company authorised, in accordance with the provisions of the UCITS Directive, by the UK authorities.

Article 100, paragraph 1 of the UCI Law sets out the conditions pursuant to which UCIS other than the closed-ended type established under foreign laws and which do not benefit from the UCITS passport may market to retail investors in Luxembourg. CSSF Regulation No. 20-10 published on 21 December 2020 sets out further detail on compliance with article 100, paragraph 1.

Those UK UCITS that are managed by a UCITS management company authorised in another EU jurisdiction may only continue to market their units to retail investors in Luxembourg on condition that the management company is, at the end of the transitional period, also authorised as an Alternative Investment Fund Manager. Such funds are authorised to market to retail investors in Luxembourg until 31 July 2021 on the basis of the provisions of article 46 of the AIFM Law (marketing of AIFs to retail investors).

In its opinion of 12 January 2021 the *Conseil d'Etat* noted that the European Commission in its Q&A on the EU-UK Trade and Cooperation Agreement has stated that the parties aim to agree by March 2021 a Memorandum of Understanding establishing a framework for regulatory cooperation on financial services. If such a framework is put in place the *Conseil d'Etat* raises the question as to whether Luxembourg will unilaterally be able to fix this cut off date of 31 July 2021.

SFDR | CSSF COMMUNICATION AND FAST TRACK PROCEDURE

BACKGROUND

On 16 December 2020, the CSSF issued a communication covering both new regulatory requirements on transparency with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability – related information, as well as the adoption of a fast track procedure.

REGULATORY REQUIREMENTS

Regulation (EU) 2019/2088, of 27 November 2019 on sustainability – related disclosures in the financial sector ("**SFDR**"), requires investment fund managers ("**IFM**") of undertakings for collective investment in transferable securities ("**UCITS**") and alternative investment funds ("**AIF**") to comply with harmonised rules on transparency with regard to sustainability risks and the consideration of adverse sustainability impacts and the provision of sustainability – related information.

IFMs need to comply with the high – level principle – based requirements as laid down in the SFDR by 10 March 2021, although the related Regulatory Technical Standards (specifying the detailed requirements on the content, methodologies and presentation of sustainability–related disclosures) have not yet been published. This was outlined in the CSSF communication dated 6 November 2020.

As funds are included in the definition of market participants provided under SFDR, IFM must disclose how sustainability risks are integrated in their investment decisions as well as assess and disclose what could be the likely impact of such risks on the returns of a fund. Such disclosure has to be made to investors on a pre-contractual basis, in the prospectus for UCITS and as part of the disclosure required for AIFs pursuant to article 23 of the AIFMD.

If the IFM's sustainability risk assessment concludes that there are no sustainability risks deemed to be relevant for a given fund, this should also be disclosed in the same manner.

In accordance with article 7 of SFDR, if the IFM does not consider the adverse impacts of investment decisions on sustainability factors for a given fund, this should also be adequately disclosed by 10 March 2021.

Funds that either promote, among other characteristics, environmental or social characteristics, or a combination thereof (article 8), or funds that have sustainable investment as their objective (article 9) may also need to proceed with an update of the prospectus (UCITS) or relevant disclosure document (for AIFs). Whether the fund qualifies as an article 8 or article 9 product under SFDR should be assessed prior to the update of such information.

The integration of sustainability risks must be ensured at the level of the IFM's risk management policy as well.

In order to comply with SFDR, the CSSF is advising IFM's to assess the situation under the new disclosure obligations, and submit to the CSSF by **28 February 2021** at the latest, updated prospectus / issuing document for UCITS for visa stamp. AIF investors should be informed by updating the disclosure made pursuant to article 23 (1) of the AIFMD. IFM's should also asses their compliance with SFDR as regards the publication of information on their website (which should be kept up-to-date) as well as the update of their policies and processes related to sustainability risks. Adequate measures must be taken in case of gaps.

The new related disclosure requirements mainly relate to sustainability risk policies, the investment decision making process, the adverse sustainability impact (article 4 SFDR) and the remuneration policies.

FAST TRACK PROCEDURE TO SUPPORT VISA STAMPING OF FUND PROSPECTUS /ISSUING DOCUMENT

Starting 16 December 2020 the CSSF has implemented a specific fast track procedure to facilitate the submission of the prospectus/ issuing document updates to the CSSF. The fast track procedure is available for UCITS as well as for Part II undertakings for collective investment and specialised investment funds.

In order to benefit from the fast track procedure, updates must be limited to changes required under SFDR. Material changes to the investment policy and investment restrictions as defined in CSSF circular 14/591 cannot benefit from the fast track procedure.

In order to benefit from this fast track procedure, each updated prospectus / issuing document submitted for visa stamp will have to be accompanied by a confirmation letter. A template of said confirmation letter is available here (CSSF's website).

The self-certification letter must be signed by an authorised representative of the IFM, the fund or another representative of the IFM or the fund duly appointed. In this self-certification letter, the representative confirms one-by-one that all relevant changes required under SFDR have been implemented (or will be implemented at the latest by 10 March 2021).

NEW EDESK MODULE FOR SUBMISSION OF INFORMATION | CSSF COMMUNICATION

On 8 December 2020, the CSSF issued a Communication regarding the introduction of a new eDesk module (the "**Communication**" and the "**eDesk Module**"), announcing the progressive digitalisation for the reception and processing of a series of requests, including both those submitted at the initiative of the interested parties and those to be submitted following a specific request from the CSSF.

The Regulator identifies two types of requests as falling under the scope of the eDesk Module at this stage:

1. requests regarding the information to be produced under the CSSF Circular 15/612: these are the information that both registered and authorised AIFMs must produce when they begin to manage a new unregulated AIF or a new regulated AIF established in a third country;
2. *ad hoc* requests initiated by the CSSF, regarding information related to AML supervisory measures; the entities involved in this case are all the Investment Fund Managers (UCITS management companies and AIFMs, including their Luxembourg branches), the internally managed UCITS, AIFM and non AIFM.

The Communication specifies that as of 8 December 2020 the only possible channel to submit information relating to these two matters is the eDesk Module.

All the information related to the creation of user accounts are detailed in the lower section of the eDesk portal homepage.

The CSSF is expected to issue further communication regarding other requests to be submitted via the eDesk portal.

INVESTOR COMPENSATION SCHEME LUXEMBOURG | CSSF FAQ

On 26 November 2020, the CSSF issued Frequently Asked Questions regarding the Investor Compensation Scheme Luxembourg established by article 156 of the Law 18 December 2015 and governed by Part III, Title III of the same Law (the "**FAQ**" and the "**Law**").

The Investor Compensation Scheme or *Système d'indemnisation des investisseurs Luxembourg* ("**SIIL**") covers clients of investment firms, banks, management companies and AIFMs whose authorisa-tion extends to the provision of investment portfolio management services on an individualised and discretionary basis. In the event of a loss of financial instruments SIIL will, in certain cases and up to certain amounts, compensate such clients.

The FAQ are intended to provide clarity on the definition of "*other professional investors*" that are excluded from the coverage of the SIIL, on the basis of the relevant decision of the Council for the Protection of Depositors and Investors (the "**CPDI**" - the Authority in charge of management and administration of the SIIL).

Under article 195(2), point 7 of the Law "*the claims listed below which result from investment business shall be excluded from SIIL: … 7. Claims of other professional or institutional investors;…*".

The CPDI has decided that the definition of "*professional investors*" refers to the definition of "*professional clients*" under Annex II of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("**MiFID 2**").

The definition of professional clients includes both *per se* professionals and the clients who request to be treated as professionals. Under the CPDI decision, both these categories are excluded from the coverage of the Investor Compensation Scheme.

It has to be highlighted that the said Annex II also provides for a professional client to be treated as a non professional one for the purpose of the applicable conduct of business regime, on the basis of a written agreement specifying the service, product or transaction to which it applies. Any claims regarding the aforesaid services, products or transactions are covered by the Investor Compensation Scheme, provided that they are under no professional client treatment.

PERFORMANCE FEE GUIDELINES | ENTRY INTO EFFECT

.BACKGROUND

On 3 April 2020, ESMA published its final guidelines on performance fees in investment funds – applicable to UCITS and certain types of AIFs (the "**Guidelines**").

As a reminder, the guidelines provide comprehensive guidance to fund managers when designing performance fee models for the funds they manage, including the assessment of the consistency between the performance fee model and the fund's investment objective, policy and strategy, particularly when the fund is managed in reference to a benchmark.

For further information on the content of these performance fee guidelines, check our previous Newsletter.

TRANSLATION AND EFFECTIVE DATE OF APPLICATION

On 5 November 2020, ESMA published the translations of the guidelines meaning that the guidelines are effective since 6 January 2021 further to CSSF's Circular 20/764 regarding guidelines on performance fees in UCITS and certain types of AIFs (the "**Circular**").

WHAT'S NEXT?

As stated in the Circular, the CSSF will integrate the Guidelines into its administrative practices and regulatory approach with a view to promoting supervisory convergence in this field at European level as of the date of application of the Guidelines.

Managers/AIFMs of any new funds created after the date of application of the Guidelines with a performance fee, or any funds existing before the date of application that introduce a performance fee for the first time after that date, should comply with these Guidelines immediately in respect of those funds.

Managers/AIFMs of funds with a performance fee existing before 6 January 2021 should apply these Guidelines in respect of those funds by the beginning of the financial year following 6 months from 6 January 2021.

The Guidelines will also be applicable as of 6 January 2021 for any newly created compartments of an existing umbrella, i.e. in relation to any new compartment setting up a performance fee at compartment or classes of units/shares level.

CSSF UPDATES UCITS AND AIFMD FAQs

On 24 November 2020, the *Commission de Surveillance du Secteur Financier* (CSSF) published an updated version of its Frequently Asked Questions concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment schemes (the "**UCITS FAQ**") and an updated version of its Frequently Asked Questions concerning the Luxembourg Law of 12 July 2013 on alternative investment fund managers (the "**AIFM FAQ**")

With this update CSSF introduces in both AIFM FAQ and UCITS FAQ a new question dealing with the conditions to comply with in case of data transfer by a central administration or a depositary to another service provider.

The CSSF clarifies that pursuant to Article 41 (2a) of the amended Law of 5 April 1993 on the financial sector, in case a central administration agent or a depositary is outsourcing services implying a transfer of relevant information to a third party, the central administration agent or the depositary must ensure that its client, the board of directors or managers of the SICAV or of the investment fund manager for common funds, has accepted the outsourcing of the relevant outsourced services, the type of information transmitted in the context of the outsourcing and the country of establishment of the entities that provide the outsourced services.

The CSSF further adds that any transfer of information related to investors should be disclosed prior to the transfer, by the UCI, respectively the investment fund manager for common funds, to investors through appropriate means, namely the prospectus and the application form combined, if appropriate, with a reference to a website. Existing investors should be informed prior to the transfer of their information, about any update of the fund documents aiming at the aforesaid disclosure by means of a letter, email or any other means of communication provided for by the prospectus.

The CSSF finally confirmed that the aforesaid requirements apply independently from the General Data Protection Regulation (EU) 2016/679, if applicable.

ACCOUNTING PRINCIPLES FOR AIFS

On 17 January 2021, the CSSF updated the AIFM FAQ to clarify that authorised AIFMs established in Luxembourg managing Luxembourg AIFs are required to use Lux GAAP or IFRS (as adopted by the European Union by Regulation (EC) No 1606/2002 on the application of international accounting standards) to prepare the annual reports of these AIFs. This requirement is applicable regardless of the AIF's legal form. AIFMs must use these accounting principles for both regulated and unregulated AIFs.

GUIDANCE ON THE NON-APPLICATION OF THE PARENT-SUBSIDIARY DIRECTIVE TO GIBRALTAR COMPANIES

In an administrative circular dated 1 December 2020 (the "**Circular**"), the Luxembourg tax administration confirmed that, following the judgment of the European Court of Justice (hereinafter the "**ECJ**") in *GVC Services (Bulgaria) EOOD* (C-458/18), the Parent-Subsidiary Directive (hereinafter "**PSD**") would stop to apply to companies resident in Gibraltar, but only after 31 December 2020. In other words, as of 1 January 2021, dividends distributed to parent companies resident in Gibraltar can no longer be distributed free of withholding tax. Similarly, dividends received by Luxembourg parent companies in relation to their shareholdings in companies resident in Gibraltar are no longer exempt in Luxembourg pursuant to the PSD.

As a reminder, the ECJ held that article 2 of the PSD, together with its Annex I, are to be interpreted as meaning that the terms "companies incorporated under the law of the United Kingdom" and "corporation tax in the United Kingdom" do not refer to companies incorporated in Gibraltar and subject to tax there (see our April 2020 newsletter).

The Circular adds that dividends received (as well as capital gains realized) by Luxembourg parent companies from subsidiaries resident in Gibraltar may however continue to be exempted under Luxembourg domestic law, if the Gibraltar resident subsidiary meets the requirements of the Luxembourg domestic exemption regime, which in particular requires that the subsidiary is subject to a tax which is comparable to Luxembourg tax. The same applies for net wealth tax purposes, where a participation held by Luxembourg companies in companies resident in Gibraltar should only be tax exempt if such subsidiary is subject to a tax comparable to Luxembourg tax.

LUXEMBOURG LOWER ADMINISTRATIVE COURT ANNULS EXCHANGE OF INFORMATION INJUNCTION

In a judgment dated 4 December 2020, the Lower Administrative Court (*Tribunal administratif*) annulled an injunction issued by the Luxembourg tax administration ("**LTA**") pursuant to a request for information from the Spanish tax authorities. The injunction was addressed to a Luxembourg company and requested information regarding, *inter alia*, the company's shareholders, dividend distributions to its shareholders and loans granted by its shareholder(s).

The company sought an annulment of the injunction on the grounds that the request did not specify the purpose for which the information was requested. In this regard, the Lower Court found that there was no obligation for the injunction to contain a description of the purpose of the request so long as, in the context of a legal challenge, the LTA provided information regarding the identity of the taxpayer, the tax purpose of the requested information and the reasons why this information justified the foreseeable relevance of the requested information. The Lower Court considered that the LTA had, in its reply, adequately explained that the purpose of the information request was to identify the income of an individual taxpayer, whom the Spanish authorities considered tax resident in their jurisdiction on the basis of the location of his economic interests.

However, the company also argued that the information requested was not foreseeably relevant to establish the taxpayer's tax residence in Spain since tax residency is principally determined according to physical presence on Spanish territory rather than economic or financial interests. In that regard, the company submitted evidence that the taxpayer had spent more than 183 days a year in the Dominican Republic in 2016 and 2017 so that he could not be resident in Spain during those periods.

The Lower Court held that in such cases, the scope of its juridical review is subject to three limitations (i) the Lower Court can only affirm or annul the decision but cannot conduct a fresh review of the facts, (ii) the LTA's injunction is based on a foreign tax authority's decision, the legality and opportunity of which cannot be reviewed by the Luxembourg courts and (iii) the Lower Court is limited to determining whether the information is foreseeably relevant. In addition, the Lower Court remarked that it could not examine the taxpayer's situation under the laws of the requesting state.

However, these limitations do not prevent the taxpayer from presenting detailed information, which undermines essential aspects of the situation at the heart of the exchange of information request and which seriously affects the reasonable foreseeability of the information requested.

In the case at hand, the Lower Court accepted evidence presented by the company that the individual taxpayer could not *a priori* be tax resident in Spain. Therefore, the Spanish tax authorities were not competent to issue a request for information to the Luxembourg tax authorities, which necessarily called into doubt the foreseeable relevance of the request for information. The Lower Court therefore annulled the injunction issued by the Luxembourg tax administration for absence of foreseeable reasonableness

TELEWORKING FOR BELGIAN, FRENCH AND GERMAN CROSS-BORDER WORKERS ONCE AGAIN EXTENDED

As previously detailed in our newsflash dated 19 March 2020 (as updated) the Luxembourg Government has once again agreed on an "exceptional measure" with the Belgian, French and German Governments regarding the taxation of Belgian, French and German cross-border commuters normally working in Luxembourg and now teleworking from their homes.

As a result, as of 14 March 2020, any days of presence of a cross-border worker at his home, in particular to carry out teleworking, are not to be taken into account for the calculation of the 24-day (Belgium) or 29-day (France) period. The measures applying to French and Belgian cross-border workers were applicable until 31 August 2020. By renewals of agreements signed with Belgium and France, respectively on 24 August 2020 and 27 August 2020, the measures were extended until 31 December 2020, and most recently until, 31 March 2021.

The measures applying to German cross-border workers was applicable as from 11 March 2020 until 30 April 2020, since which point an automatic monthly renewal has been in place, which will continue unless Germany or Luxembourg terminate the agreement.

Likewise, on 25 August 2020, agreements have been concluded with the aforementioned countries with respect to social security. An agreement was signed in July 2020 with Belgium, France and Germany to maintain the exceptional arrangement whereby teleworking days linked to the COVID-19 pandemic would not be taken into account for the determination of the social security legislation applicable to cross-border workers until 31 August 2020. This was extended until 31 December 2020 and now a further extension until 30 June 2021 has been agreed.

JUDGEMENT OF THE ECJ ON THE RIGHT OF ADJUSTMENT IN CASE OF UNDULY PAID VAT

On 2 July 2020, the European Court of Justice (“**ECJ**”) issued its judgment in case C835/18, *SC Terracult SRL* on the possibility for a taxable person to adjust an invoice and claim a refund of unduly paid VAT despite a final VAT assessment having been issued.

The case concerned a Romanian commercial company, named SC Terracult (formerly Donauland SRL, "**Terracult**") which sold rapeseed to a German commercial company, named Almos Alfons Mosel Handels GmbH ("**Almos**"). During a VAT audit of Terracult, the Romanian VAT authorities discovered that a supply of rapeseed was considered as an exempt intra-community supply of goods while the rapeseed never left the Romanian territory. The Romanian tax authorities issued a VAT assessment according to which Terracult, as the supplier, carrying out a purely domestic supply of goods, was liable to pay Romanian VAT to the national Treasury. Terracult did not appeal against the VAT assessment, which became final, and issued a rectifying invoice to Almos by applying Romanian VAT on the supply of rapeseed. Almos reminded Terracult that the supply had been made to its Romanian fixed establishment which has a Romanian VAT number and that under Romanian VAT law, in case of a domestic supply of rapeseed, the person liable to pay VAT to the national Treasury is the purchaser under the reverse charge mechanism. Terracult, which had already paid the VAT to the authorities in accordance with the VAT assessment issued following the audit, applied for a refund of the unduly paid VAT. The request for a refund has been dismissed by the Romanian tax authorities and the Romanian court of first instance, because the VAT assessments issued after the VAT audit had become final. The Romanian court of appeal referred the case to the ECJ.

In its judgment, the ECJ ruled that the principle of neutrality of VAT obliges Member States to foresee a procedure, which allows a taxable person to adjust a situation in which VAT has been incorrectly invoiced and paid to the national Treasury. The ECJ also points out that such adjustment is not subject to the good faith of the issuer of the relevant invoice if there is no risk of any loss of tax revenue (such as for instance in case of application of the reverse charge mechanism and subsequent deduction of the self-assessed VAT by the purchaser, where in principle no amount is owed to the tax authorities). The ECJ also considers that the Romanian legislation and administrative practice is contrary to the principle of effectiveness as far as the period of 30 days after which a VAT assessment becomes final and during which the taxable person has to rectify his invoice is too short to give an effective opportunity to a taxable person to claim a refund of unduly invoiced and paid VAT. Finally, the ECJ finds that it would be possible for domestic law to foresee penalties in cases where a taxable person is negligent in adjusting his situation, but the ECJ considers that a total refusal of VAT refund would be contrary to the principle of proportionality.

CIRCULAR ISSUED BY THE LUXEMBOURG TAX AUTHORITIES ON THE INTEREST DEDUCTION LIMITATION RULE

On 8 January 2021, the Luxembourg tax authorities issued a circular (*Circulaire du directeur des contributions L.I.R. n°168bis/1 du 8 janvier 2021*) (the "**Circular**") on the interest deduction limitation rules ("**ILR**") as foreseen in Article 168bis of the Luxembourg income tax law ("**LITL**").

BACKGROUND

The ILR has been introduced in the LITL by the law dated 21 December 2018 (as amended), implementing into Luxembourg law the Council Directive EU 2016/1164/EU of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (commonly known as the ATAD Directive). The ILR entered into force on 1 January 2019.

The ILR limits the deductibility of exceeding borrowing costs to the highest of (a) 30% of the taxpayer's fiscal EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) and (b) EUR 3 million. Standalone entities as well as taxpayers who can demonstrate that their equity ratio is equal to or lower than the ratio of the consolidated group they belong to, can, subject to certain conditions, nonetheless fully deduct their borrowing costs under the ILR.

The ILR defines "*exceeding borrowing costs*" as corresponding to the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives.

CLARIFICATIONS PROVIDED BY THE CIRCULAR

Although the ILR contains a broad definition of the borrowing costs, no precise definition of "*taxable interest revenues and other economically equivalent taxable revenues"* is provided. The Circular now officially confirms the approach defended by the tax doctrine, which consists in applying a symmetrical approach between the definitions of interest expenses and interest income, thus alleviating the uncertainty left by legislation. It is interesting to note that the Luxembourg tax authorities themselves, in the 2019 tax forms, already applied this position.

Another confirmation provided by the Circular relates to the grandfathering clause. The ILR indeed excludes form the scope of the ILR, exceeding borrowing costs that are linked to loans concluded before 17 June 2016 (the "**Grandfathering Date**") to the extent that their terms are not subsequently modified. With respect to the "subsequently modified" criteria, the Luxembourg tax authorities provide a non-exhaustive list of situations deemed to create a subsequent modification, such as: (i) an extension of the loan maturity date, when such an extension was not already provided for in the loan concluded before the Grandfathering Date, the subsequent modification of the interest rate when such a modification was not already included in the loan concluded before the Grandfathering Date, (ii) an amendment to the principal amount of the loan after the Grandfathering Date and (iii) the change of parties to the loan agreement, when such a change was not already provided for in the loan concluded before the Grandfathering Date. In the context of the last point, the tax authorities confirm that in their view, a change of parties due to a restructuring such as a merger or demerger should not jeopardize the grandfathering of the loan. Likewise, the tax authorities confirm that an increase of the loan amount under a facility should not challenge the grandfathering, provided that the increase does not increase the maximum amount of the facility granted prior to the Grandfathering Date. Last but not least, the tax authorities also confirm that the grandfathering clause should apply to taxpayers moving their tax residency to Luxembourg in case they were party to a loan agreement concluded before the Grandfathering Date.

Finally, the Circular provides two additional clarifica- tions, the first one concerning long-term public infrastructure projects and the second one concerning "*standalone entities*" that are out of scope of the ILR. For the long term public infrastructure projects, the tax authorities provide a non-exhaustive list of examples of what could qualify as long-term public infrastructure projects, such as universities, public libraries and public swimming pools, a significant emphasis being put on the public interest aspect of those projects. For the standalone entities, the tax authorities confirm that an economic approach should be applied when assessing whether parties are related or not.

LOWER ADMINISTRATIVE COURT: EXCESS OF POWER BY THE TAX AUTHORITIES IN THE PANAMA PAPER INVESTIGATIONS

On 29 September 2020, the Lower Administrative Court (*Tribunal administratif*) handed down several decisions in cases involving requests for information that the Luxembourg tax authorities (hereafter the "**LTA**") had addressed to several Luxembourg lawyers and law firms whose names had appeared in the international press in the context of the so-called "Panama Papers" leaks. In this context, the president (*Bâtonnier*) of the Luxembourg Bar Association had previously reminded lawyers involved of the fundamental importance of their professional secrecy in the relationship between them and their clients and that no follow up on the requests of the LTA should be provided, at the risk of civil, criminal and disciplinary sanctions. Due to the lack of reply, the LTA issued pecuniary sanctions against them. The lawyers' appeal, after having been refused at the pre-litigation level before the Director of the LTA, reached the Lower Administrative Court.

In its judgments, the Court first analysed the legal basis on which the LTA issued these requests for information. The judges found that the legal basis invoked only allows information to be requested from a third party that is not the taxpayer concerned by the request in two cases: 1) for the purpose of carrying out a tax audit or 2) in the context of a tax investigation procedure, for the purpose of establishing tax claims. Regarding the first situation covered by the law, the judges note that the requests for information are very broad and do not target a specific taxpayer(s), but seek information on an undetermined number of unknown taxpayers who may be residents or non-residents, a request that was qualified by the judges as a "fishing expedition". Since the request for information is not aimed at a specific taxpayer(s), the judges conclude that the request has not been issued for carrying out a tax audit so that the first situation does not apply. Regarding the second situation covered by the law, the judges note that the LTA issued the requests after the names of the lawyers appeared in the context of revelations made by a whistle-blower to journalists of a German daily newspaper. According to the judges, the origin of the initiative to issue the applications cannot be qualified as a tax investigation procedure for establishing tax claims, so that the second situation does not apply either. Finally, the Court concludes that the LTA exceeded its powers in addressing these requests for information to the lawyers and consequently annulled the decision of the LTA's Director not to agree with the lawyers' refusal to cooperate.

This decision of the Lower Administrative Court is welcomed as it demonstrates the limits of the powers of the Luxembourg tax authorities, who cannot act as they please, but have to act in accordance and within the boundaries provided by the law. In addition, these decisions demonstrate the importance of the professional secrecy between lawyers and their clients. The government decided to appeal the case in front of the Higher Administrative Court (*Cour administrative*), the outcome of which is eagerly awaited.

HIGHER ADMINISTRATIVE COURT JUDGEMENT ON THE TREATMENT OF REVALUATION RESERVES

In its judgment of 10 December 2020, the Luxembourg Higher Administrative Court (*Cour administrative*) had to assess whether revaluation reserves booked in the annual accounts of a Luxembourg resident company should be included in the taxable income.

The case submitted to the Court concerned a company holding a land plot, which aimed to be part of a real estate development project. Due to conflicts between board members and shareholders, the commercial annual accounts had not been filed on time and the tax returns were not sent to the tax authorities within the prescribed deadlines. This led the tax authorities to proceed to an *ex officio* taxation (taxation by default).

In the *ex officio* assessment, they included the income deriving from a revaluation reserve booked in draft commercial annual accounts. The taxpayer thereafter challenged the *ex officio* assessment.

In its judgment, the Court overturned the judgment of the Lower Administrative Court (*Tribunal administratif*), which previously considered, in line with the position of the tax authorities, that the disclosed latent capital gain should be included in the taxable income as this was mentioned in the commercial annual accounts. In contrast to the Lower Administrative Court, the judgment followed the general principles set forth in the Luxembourg Income Tax Law (hereafter "**LITL**"), according to which fixed assets should be valued at acquisition costs and only the realized capital gain should be taken into account. Following these general principles laid out in the LITL, the commercial accounts could not be used for the tax assessment and a separate set of diverging accounts for tax purposes should be prepared, with the consequence that the revaluation reserve was disregarded and thus did not lead to the recognition of latent capital gains as they went against the valuation rules laid out in the LITL.

In summary, the Court once again confirmed the relevancy of the valuation principles laid out in the LITL and the outcome when those valuation rules conflict with the ones applied in the commercial accounts. While this case covered the specific situation of an *ex officio* taxation, taxpayers in general would be well advised to directly submit tax balance sheets together with their tax returns, whenever valuations done in the commercial accounts differ from the valuations required under the LITL.

UPDATE OF DOUBLE TAX TREATIES

PROTOCOL TO THE LUXEMBOURG-RUSSIA DOUBLE TAX TREATY

The Protocol amending the double tax treaty between the Grand Duchy of Luxembourg and the Russian Federation (hereafter the "**Protocol**") has been signed on 6 November 2020 and the ratification law was submitted on 27 November 2020 to the Luxembourg parliament.

The Protocol's main change is the amendment of the withholding tax rates on dividends and interest payments (please also refer to our previous newsletter on this topic).

DIVIDEND WITHHOLDING TAX

Dividends paid to beneficial owners resident in the other contracting state will thus be subject to a 15% withholding tax. A reduced withholding tax rate of 5% will however be available to distributions made to beneficial owners that are insurance companies, pension funds, governmental or public entities as well as the central bank. Distributions made to beneficial owners that are companies listed on a stock market, provided that at least 15% of voting shares are freely traded on a registered share exchange and that said listed company holds at least 15% of the share capital of the distributing company for a period of at least 365 days (the day of the dividend distribution included) can also benefit from the 5% withholding tax rate.

INTEREST WITHHOLDING TAX

Interest payments made to beneficial owners in the other contracting state will also be subject to a 15% withholding tax. The Protocol however foresees a withholding tax exemption for interest payments made to insurance companies, pension funds, governmental or public entities, the central bank or a bank. Additionally, interest payments made under bonds issued by the government, private corporations and Eurobonds will be exempt from withholding tax, provided that they are quoted on a registered stock exchange.

No withholding tax will apply on interest payments in cases where the payment is being made to a beneficial owner resident in the other contracting state, when this resident undertakes a commercial or industrial activity through a permanent establishment or an independent activity through a fixed base in the first contracting state and the receivable under which the interest is paid is allocated to the permanent establishment or the fixed base.

As for dividend distributions, a reduced 5% withholding tax rate will be available for interest payments made to listed companies, with the same criteria as for the reduced withholding tax rate detailed above.

OTHER DOUBLE TAX TREATIES

Luxembourg's double tax treaty network now includes a double tax treaty entered into with the Republic of Botswana. A protocol amending the double tax treaty with the Republic of Kazakhstan signed in October 2019 has been adopted by Luxembourg legislators and mutual agreements have been reached with Switzerland and the Czech Republic regarding the changes made to the respective double tax treaty due to the entry into force of the OECD's Multilateral Convention.

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