The 2014 budget law and the governmental program – A transition before a new era?

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On 24 April 2014 the Luxembourg Parliament adopted the 2014 budget law (the "**Budget Law**")[1] with 32 positive votes out of a total of 60. Luxembourg's Minister of Finance, Mr. Pierre Gramegna, characterized the 2014 budget as a "transition budget" [translation] adding that it was achieved without tax increase and solely through spending cuts within the public administration.

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1. A "transition budget"

The 2014 budget is transitional for several reasons. The first reason is related to the timing of the adoption of the Budget Law. Exceptionally, due to the change of the government following the elections of 20 October 2013, the budget was not adopted at the end of last year, as normally required by the budget calendar. In fact, the outgoing government had presented the draft of the budget to the European Commission on 15 October 2013, as provided for by the established procedure, but had not finalized it due to the termination of its mandate. The functioning of the new government during the first four months of 2014, i.e. the period before the adoption of the new budget, has been ensured through the law on the so-called provisional twelfths[2] (*loi sur les douzièmes provisoires*) allowing a provisional functioning of the government according to the budget of the previous year until the new budget is adopted.

2014 is also the last year before the change of the VAT rules applicable to electronically supplied services under which, as from 1 January 2015, telecommunications, radio and television broadcasting as well as electronically supplied services provided by suppliers established within the European Union ("**EU**") to non-taxable persons also established within the EU will be charged in the EU Member State where the customer is established[3]. Luxembourg anticipates a significant loss in its VAT revenues after 2014 as a result of these rules estimated between 600 million and 1 billion euros annually and representing approximately 4.9% to 9.1% of the aggregate annual state revenues[4].

2014 will also be the last year during which Luxembourg will apply withholding tax under the EU Savings Directive[5], as Luxembourg has decided to end the transitional period under this Directive and apply automatic exchange of information as from 1 January 2015 (please see also the last paragraph of section 4 below).

Finally, the Budget Law is "transitional" because it marks the transition to a "next generation budget" [Translation][6], as the new government intends to implement an ambitious budget reform aiming at the establishment of more efficient and transparent budgets that would better respond to the challenges that Luxembourg is and will be facing today and in the foreseeable future.

1. *Loi du 29 avril 2014 concernant le budget des recettes et des dépenses de l'Etat pour l'exercice 2014.*
2. *Loi du 20 décembre 2013*
   a) *ayant pour objet:*
   1. *d'autoriser le Gouvernement à effectuer, au cours des mois de janvier à avril 2014, les dépenses figurant aux tableaux annexés à la présente loi;...*
   b) *portant modification de: …*
   4. *la loi modifiée du 18 février 2010 relative à un régime d'aides à la protection de l'environnement et à l'utilisation rationnelle des ressources naturelles.*
3. Article 58 of the Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services.
4. Report of the Finance and Budget Committee on the Budget Law, p. 10.
5. Council Directive 2003/48/EC, as amended.
6. Déclaration of the Minister of Finances Mr Gramegna of 5 March 2014: *"Il s'agit de créer un budget d'une nouvelle génération en faisant un état des lieux de toutes les dépenses".*

2. Current state of the public finances and measures taken

2.1. Revenues

The major portion of the revenues for the year 2014 will be generated by the current taxes on income and capital estimated at 6,375.2 billion euros, which represents an increase of 5.5% compared to 2013 and the taxes on production and importation estimated at 6,264.9 billion euros, which represents an increase of 5.6% compared to 2013. VAT revenues on electronic commerce are estimated at 1, 05 billion euros.

The financial sector represents up to 30% of the revenues of the state and up to 40% of the gross domestic product. The revenues for 2014 from the subscription tax due by collective investment funds and similar vehicles are estimated at 730 million euros which represents a surplus of 5.3% compared to 2013. As of January 2014, the total amount of assets under management by Luxembourg investment funds is estimated at 2,623.836 billion euros, which represents an increase of more than 10% compared to the previous year.

2.2. Expenses

According to the forecasts, the gross debt of Luxembourg will increase to 15 billion euros in 2016 if the policy of the government does not change. This represents approximately 29.2% of the gross domestic product. In addition, interest charges required to finance this debt would grow to 280 million euros in 2016.

For this reason the new government has underlined in its official program:

"*The state of public finances is such that, with an unchanged policy, Luxembourg will not be able to meet its obligations as a member of the Euro Zone. The government is determined to address this situation during its term and has the courage to tackle the budgetary problems through structural reforms. It sets a goal to achieve more with less. It requests a collective, fair and sustainable effort.*" [translation][7]

The new government has managed to maintain a public debt in 2014 at the same level as in 2013, i.e. 23% of the gross domestic product solely by reducing public spending.

Due to the transitional character of the 2014 budget and time constraints but contrary to its above statement, the new government has not introduced any structural reform or any tax or public finance accounting measures in the Budget Law that would require an amendment of the law. This absence of structural measures or reform is one of the main criticisms addressed to the Budget Law. For example, the Luxembourg Chamber of Commerce, in its report on the Budget Law, has welcomed the short-term budget consolidation measures taken by the new government but has regretted the absence of any structural reform which would enable an increase in economic growth and which would better prepare the country for potential future deficits. In response to these criticisms, the Finance Minister Pierre Gramegna stated that reforms including the fiscal one "will not be ready in five minutes" and their release is just a question of time.

Instead of such structural reforms, the government has issued, in the end of 2013, a circular to the Ministries requesting a reduction of their respective expenses. This has resulted in a decrease of the deficit of the central administration from 866 million euros (estimation of the Stability and Growth Programme established in April 2013) to 545 million euros.

The cuts include the following:
- 137 million euros of cuts on investment expenses;
- 9 million euros of cuts on remuneration expenses;
- 49 million euros of cuts on consumption expenses;
- 34 million euros of cuts on state scholarships for students.

The reduction of remuneration expenses for civil servants by 9 million euros was achieved through the reduction of their *numerus clausus* by 150 positions.

In total, the 2014 budget reduces public expenses by 8.3% compared to the exercise 2013.

In the absence of specific tax or public finance accounting measures in the Budget Law, the projects and main guiding ideas of the new government in these areas are to be sought mainly in its program unveiled in December 2013[8] and the State of the Nation Speech pronounced by Luxembourg's Prime Minister Mr. Xavier Bettel on 2 April 2014[9].

3. Public finance accounting policy: towards a "next generation budget" [translation]

Luxembourg has reached a cross-road where it has to adapt to a weaker economic growth compared to the end of the 1990s and beginning of the 2000s. Additionally, as noted by the Chamber of Commerce, the year 2015 will be pivotal for Luxembourg, as its econ-

7. Governmental program, p3 http://www.gouvernement.lu/3322796/Programme-gouvernemental.pdf.
8. http://www.gouvernement.lu/3322796/Programme-gouvernemental.pdf.
9. http://www.gouvernement.lu/3642384/09-edn-fr.

omy (still highly focused around and dependent on Luxembourg as a financial center) will be exposed to a triple shock, i.e., the effects of the introduction of the automatic exchange of information, the increase of VAT rates in general, and finally the losses of VAT revenues on electronic commerce.

To address these financial challenges, the new government has initiated a change of method for the preparation of future budgets with the objective to reassess public expenses and realise important savings by reducing public spending. In its report on the Budget Law, the Finance and Budget Committee has emphasised that "the budget should not have the sole objective of estimating the deficit of the public administration and the public debt but should make an assessment of all the factors that escalate such public spending" [Translation].

To achieve this change of method, the government will set-up thematic working groups (19, one for each Ministry and 4 additional "transversal" or intergovernmental groups) which will work on proposals aiming at a reduction of public spending and an improvement of the quality and efficiency of the public services for each Ministry. This new method will already be applied in the 2015 budget. The different working groups are already carrying out a complete review of the public expenses for each Ministry. The Minister of Finance, Mr. Pierre Gramegna, has qualified the above described change of method for the preparation of the budget as a "copernican revolution" [translation].

4. Fiscal policy

The government has characterised its fiscal strategy as aiming at safeguarding and guaranteeing the international competitiveness of Luxembourg and maintaining a reasonable funding of the public policy and social justice, with a consistent communication and emphasis on stability and predictability. The government expects to increase tax revenues through economic growth rather than tax increases. An increase of the tax rates will be considered as a last resort (except the increase of the VAT rates as described below). The objective is to attract new corporate and individual taxpayers to Luxembourg and to allow the existing taxpayers to better develop their economic activity.

The government has clearly expressed its intention to ensure that all taxes due are effectively paid. To achieve this goal the government intends to fight against tax fraud and to ensure the effective application of the fines, late interest charges and penalties provided for in the tax laws.

The government intends to focus on ensuring an improvement of the efficiency and timeliness of the collection of taxes. It intends to extend the "self-assessment" procedure (already applicable for direct taxes due by companies) for direct and indirect taxes.

It intends to provide the tax authorities with the means to treat tax returns electronically and to make simulations and studies of the impacts of the fiscal measures discussed at the domestic and European levels. The government will modernise and simplify the legislation governing the fiscal procedure, in particular the "Abgabenordung" which dates back to 1931.

To improve the communication between the experts of the private and public sectors, the government intends to create a Consulting Committee within the Ministry of Finance which would advise *inter alia* on the evolution, attractiveness and competitiveness of Luxembourg tax legislation.

Some of the concrete measures/positions announced by the government for companies and other investment vehicles are as follows:

– The increase of the VAT rates in order to counterbalance the lack of revenues due to the change of the VAT rules applicable to electronic commerce. The Luxembourg standard rate will however remain the lowest in the EU at 17% (even after increase from 15% to 17%); according to the latest announcements of the government, the 17% standard rate would be extended to real estate investments (except the ones relating to the principal residence of the taxpayers); the intermediary rates would also increase from 12% to 14% and from 6% to 8%; the super reduced rate would remain at 3%
– The introduction of corporate governance and substance rules ascertaining a material and operational presence in Luxembourg.
– In order to attract the headquarters of international groups to Luxembourg, the government intends to modernize Luxembourg legislation on transfer pricing in line with international standards, the existing special regime on intellectual property and the participation exemption regime. The government would also formalize the use of functional currencies for tax purposes, allowing a submission of the tax returns in the currency of the statutory accounts.
– In the field of direct taxation, the government intends to establish a uniform procedure for advanced tax agreements aiming to achieve transparency, consistency and legal certainty for the operators.
– The government intends to support new investments enabling development and sustainable economic growth *inter alia via* a tax immunization/exemption, for medium-sized enterprises, of a special reserve for investments.
– The government envisages to introduce a new tax

(and legal) regime for coordination and group cash pooling centers.

- The government does not intend to increase the subscription tax for undertakings for collective investment funds in transferable securities (UCITs); however the government does intend to realize a study on the appropriateness of a reform of the tax regime of the investment funds to increase their competitiveness.
- In relation to alternative investment funds and private equity, the government intends (i) to create the necessary framework to become the first center for such investment vehicles; (ii) not to increase the subscription tax applicable to specialized investment funds (SIFs); and (iii) to maintain the beneficial tax regime for Luxembourg risk capital investment companies (SICARs).
- Confirmation of Luxembourg's opposition to the European financial transaction tax if such financial transaction tax is not implemented at a worldwide level[10].

The idea to introduce a notional interest deduction (on the same model as Belgium) initially evoked by the new government in its official program has in the meanwhile been abandoned. Prime Minister Xavier Bettel mentioned in his State of the Nation Speech that the benefits brought to the Luxembourg economy by a notional interest deduction would not be sufficient compared to the resulting loss in revenues.

For individual tax payers, the government envisages *inter alia* the following measures:

- A review of the progressive income tax brackets and the various tax credits and deductions available on the basis of socio-economic criteria.
- An assessment of the impacts of switching to individual taxation, as opposed to collective taxation, for married couples or registered partners.
- A further improvement of the tax regime applicable to carried interest holders in alternative investment funds and private equity funds.

The government envisages regulating the access to the profession of tax advisor by subjecting it to a preliminary authorization in order to ensure the reputation of the professionnals active in this field.

The government has also announced in its official program a reform of the levies on real estate (*impôt foncier*) to be made in the framework of a general reform of municipal finances.

In his State of the Nation Speech, Prime Minister Bettel announced his government's intention to prepare a global tax reform in 2016 and that such tax reform would enter into force in 2017.

Finally, in line with the preceding government's policy, the new government has reiterated Luxembourg's intention to fully comply with the EU rules and OECD standards in terms of exchange of information and tax transparency. In this framework (and also as a result of the negative rating received by Luxembourg at the Global Forum on Transparency and Exchange of Information for Tax Purposes of Jakarta, Indonesia, in November 2013), Luxembourg's latest initiatives are (i) the submission by the government on 18 March 2014 of a draft bill[11] aiming at ending the transitional period and introducing the automatic exchange of information under the EU Savings Directive (Council Directive 2003/48/EC, as amended) as from 1 January 2015; (ii) the approval by Luxembourg on 20 March 2014, at the level of the European Council of the Council Directive 2014/48/EU amending and extending the scope of the EU Savings Directive, (iii) the signature on 28 March 2014 of an intergovernmental agreement with the United States on the implementation of the Foreign Account Tax Compliance Act (FATCA) and (iv) the adoption on 13 May 2014 by the Luxembourg Parliament of the bill of law ratifying the Convention on Mutual Assistance in tax matters (Bill of law n° 6643).

10. Opposition reiterated during the ECOFIN meeting of 6 May 2014.
11. Bill of law n° 6668.