taxnotes® international
Volume 92, Number 8 ■ November 19, 2018

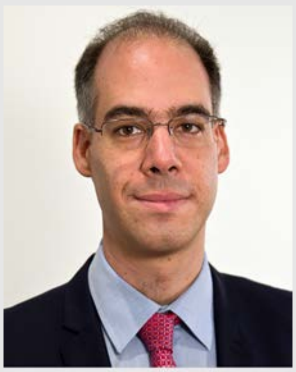
Luxembourg Offers Tax Incentives To Attract Highly Skilled Employees

by Pierre-Régis Dukmedjian and Nadejda Girleanu

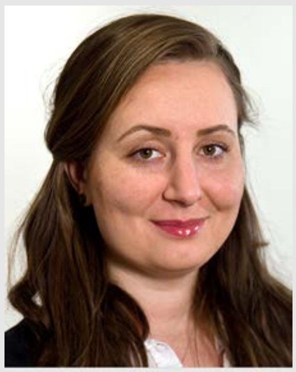
Reprinted from *Tax Notes International*, November 19, 2018, p. 793

Luxembourg Offers Tax Incentives to Attract Highly Skilled Employees

by Pierre-Régis Dukmedjian and Nadejda Girleanu



Pierre-Régis Dukmedjian



Nadejda Girleanu

Pierre-Régis Dukmedjian is a partner and Nadejda Girleanu is a managing associate with Simmons & Simmons Luxembourg LLP. Email: pierre-regis.dukmedjian@simmons-simmons.com, nadejda.girleanu@simmons-simmons.com

In this article, the authors examine some of the tax incentives Luxembourg uses to attract highly skilled workers to the country. These include stock option plans, the favorable carried interest regime, and a special package of tax benefits for both highly skilled employees who move to Luxembourg for work and their employers.

With a wide range of investment vehicles — including the latest reserved alternative investment fund (RAIF) — Luxembourg has developed an attractive tax, legal, and regulatory framework for investors. To support this regime, ensure that investment activities are run efficiently, and provide the necessary substance from a tax and regulatory perspective, the government wants to attract the best professionals possible.

Luxembourg has achieved this goal through, in particular, the warrant plan, the carried interest regime, and a specific impatriate tax regime. While all these measures have qualifying criteria, they all typically benefit senior executives.

This article explains the operation of employee incentives.

I. Stock Option Plans

In Luxembourg, employers use both classic stock option plans and warrant plans as a form of variable remuneration complementary to other forms like employment income, cash bonuses, and benefits in kind.

A warrant plan differs from a classic stock option plan because the underlying basis of a warrant is largely made up of equities that are not related to the performance of the employer, such as a stock market index fund, a basket of shares replicating an index, or units in mutual funds that are invested mainly in equities.

On November 29, 2017, the Luxembourg tax authorities released the latest circular (Circular No. 104/2) addressing the tax regime for stock option plans — classic stock option plans and warrant plans. This circular replaces previous circulars on the same topic.

The circular distinguishes between freely transferable options and conditional options (individual or virtual).

A. Freely Transferable Options

The tax authorities consider grants of listed or freely transferable options to employees at a reduced price (or at no cost) to be a benefit in kind that arises when the employer puts the options at the employee's disposal. Because the options immediately become the property of the employee's estate, Luxembourg taxes the employee on the benefit in kind at the moment the option is granted.

The realizable value of a freely negotiable and transferable option is the difference between the stock market or fair market value and the acquisition price that the employee pays for the option. In practice, one can determine the FMV of an unlisted freely transferable option using the Black-Scholes model or any comparable financial method. Alternatively, if none of the above valuation methods are used, the Luxembourg tax authorities will consider the value of a freely transferable option to equal 30 percent — 17.5 percent for options granted before January 1, 2018 — of the underlying value of the shares on the date of the grant.

The 30 percent valuation applies only if the grant meets specific "reasonable conditions." Part 4 of the circular defines these conditions:

- The options must not amount to more than 50 percent of the recipient's total annual gross remuneration (including options). This percentage must be considered individually for each participant.
- Only senior managers or executives — that is, *cadres supérieurs* according to the definition in article 211-37 of the Labor Code — may benefit from these plans.
- The option price does not exceed 60 percent of the underlying value of the shares.

If the option plan does not meet all three conditions, the transferable option will be taxed on the total attribution price.

Also, options that an employer grants to an employee at the end of an employment contract are not eligible for the 30 percent rate and will be taxed in full.

Notably, these conditions apply only to option plans when the underlying basis is mainly composed of equities that are not related to the employer's performance — that is, warrant plans — not classic option plans in which the underlying basis is connected to the performance of the employer.

B. Conditional Options (Individual or Virtual)

Conditional options cannot be freely traded and the gain on conditional options is not always available to the employee. Circular No. 104/2 does not modify the conditional options, and the treatment is the same as it was before.

Conditional options provide an employee with an opportunity to benefit from a future gain if the underlying assets increase in value. The tax authority treats these options as a benefit in kind that arises at the time the employee exercises the option to buy shares. The value of the benefit in kind is the difference between the stock market or FMV of the underlying shares that the employee acquires and the acquisition price that the employee pays to exercise the option.

In some cases, the shares in a conditional stock option plan are subject to a freezing clause. For example, the clause may provide that the employee cannot sell the shares for several years. This reduces the value of the stock because the employee may not assign the shares, realize any gain, or limit any losses that may occur during the freezing period. To reflect the decreased value of the shares because of a freezing clause, the Luxembourg tax authority allows a discount of 5 percent per year of freezing — without exceeding 20 percent from the stock market or FMV — which may be deducted from the value of the shares when it determines the taxable value of this form of benefit in kind. As for the conditional options, the valuation is made upon exercise and the discount is applied for every year of freezing (up to the noted 20 percent limit) that the employee held the option.

C. Taxation of Benefit in Kind From Stock Options

According to the circular, the benefit in kind that an employee receives from stock options is income derived from employment. Luxembourg taxes this income as follows:

- The employer levies payroll tax (maximum 45.78 percent) in the month it grants the stock options to the employee.
- If the employee's annual remuneration exclusive of the benefit in kind exceeds the salary cap subject to social security contributions — social security contributions are computed on a capped base that amounts to €119,915 for 2018 — the benefit in kind is subject to only the dependency contribution of 1.4 percent. If the employee's remuneration is below the cap, regular social security contribution rates apply to the stock options.
- Income tax in Luxembourg is progressive, and the maximum rate is 45.78 percent.

Taxpayers can deduct already-levied payroll taxes from the income tax due.

D. Taxation of Capital Gains From Stock Options

Luxembourg treats any capital gain that the employee realizes on the sale of the option or the sale of the shares as miscellaneous income. It qualifies as either extraordinary income or speculative income:

- *Extraordinary income*: If the employee exercises the option at least six months after acquisition and the conditions of article 100 of the income tax law do not apply — that is, the employee holds more than 10 percent — which is very unlikely in practice, the gain should not be taxed.
- *Speculative income*: If the employee disposes of the option less than six months after acquisition, the gain is taxed as miscellaneous speculative income at the standard rates — that is, up to 45.78 percent, on an accrual basis.

E. Reporting Requirements

Beginning this year, an employer must communicate specific information to the Luxembourg revenue office (Bureau d'imposition de la retenue sur les traitements et salaires compétent pour la vérification de l'employeur) at the time the employer makes the options available to employees. Failure to timely report the relevant information to the revenue office will result in the tax authorities denying the tax advantages under the circular.

II. Carried Interest

Carried interest (*l'intéressement aux plus-values*) is defined as income that some individuals — namely, employees of the alternative investment fund (AIF) managers (AIFMs) or employees of management companies for AIFs — receive in accordance with an incentive right (*droit d'intéressement*) and that is based on the net assets or return of the AIF.

In accordance with article 99-*bis* 1a of the income tax law (impôt sur le revenu des personnes physiques), the incentive right — which the entity grants in recognition of the competencies and qualities of the individual as well as the performance of the investments — must be subject to the express condition that the shareholders or other interest holders have already recovered the funds they invested in the AIF or in the underlying assets.

A. Taxation of Carried Interest as Income

According to article 99-*bis* 1a.1, carried interest is taxable as speculative income (miscellaneous income) at the standard rate — that is, up to 45.78 percent for 2018.

Article 213 of the Luxembourg law of July 12, 2013 (the AIFM law), provides an exception. It states that Luxembourg will treat carried interest as extraordinary income taxable at one-quarter of the normally applicable rate — that is, 11.45 percent for 2018 under article 131.1d — if:

- the individual who obtains the income was not resident in Luxembourg for tax purposes and was not liable for Luxembourg personal income tax on his professional income during the five tax years before the year the AIFM law entered into force, that is, from 2008 to 2012;
- the fund did not make any advance on carried interest available to the employee; and
- the individual establishes fiscal domicile in Luxembourg during the year the AIFM law comes into force or within five years thereafter — that is, between 2013 through the end of 2018.

As is evident from the requirements, this is a temporary regime. Eligible employees can benefit from the regime for 11 years from the year the individual takes the position that offers the right to carried interest. Thus, while an individual would need to be able to establish residence in Luxembourg before the end of this year to participate in the regime, the reduced rate would continue to apply to eligible carried interest income for up to 11 years based on the time that the individual gained the right to carried interest.

Notably, nonresident employees who receive an incentive right to carried interest from a Luxembourg AIFM or a Luxembourg management company of an AIF are generally not taxable in Luxembourg. In other words, carried interest is not covered by article 156.8 of the income tax law dealing with the taxation of miscellaneous domestic income derived by nonresidents.

B. Taxation of Capital Gains From Carried Interest

Capital gains stemming from the disposal of carried interest shares in an AIF should, in accordance with article 99-*bis* 1a.2:

- not be taxed if the individual disposes of the shares at least six months after acquisition, unless article 100 of the income tax law applies — that is, the employee holds a shareholding of more than 10 percent — which is unlikely in practice; and
- be taxed as miscellaneous (speculative) income at the standard rate (that is, up to 45.78 percent) if the individual disposes of the shares within six months after acquisition.

III. Impatriate Regime

To attract highly skilled people and encourage them to move to Luxembourg, employers often cover part of the relocation costs. Because the country also wishes to attract these individuals, the tax authorities created a framework that allows these costs to be deducted at the employer level.

Circular No. 95/2 — which took effect in 2011 and was amended in May 2013 and January 2014 — covers the conditions of this regime. The circular's purpose is to determine the deductible expenses that a company incurs when hiring qualified and specialized employees — known as impatriates — from the international market.

The circular applies to employees who:

- had been working for a company that is part of an international group from an office outside Luxembourg and the company assigns to work for its Luxembourg office; or
- become Luxembourg tax residents after a resident company or a company operating in Luxembourg but established elsewhere in the European Economic Area directly recruits them.

However, the circular does not apply to employees who, during the last five years:

- were Luxembourg tax residents;
- lived less than 150 kilometers (about 93 miles) from the border; or
- were subject to Luxembourg personal income tax on their professional income.

As for the employer, conditions for eligibility include that it employs at least 20 employees full time and that no more than 30 percent of the total staff benefits from this impatriate regime.

The circular details additional conditions regarding the qualifications and remuneration of the employee, as well as the formal contractual relationship between the employer and employee.

The circular sets out a list of expenses and charges connected with the employee's relocation to Luxembourg, including moving costs and expenses, housing costs (that is, incurred in moving into a new home in Luxembourg), school fees, tax equalization expenses (compensation for the difference in income tax between Luxembourg and the origin country), travel expenses in special circumstances, and so forth. The program also covers some other recurring expenses and costs such as housing expenses in Luxembourg and the cost of one annual trip to the former country of residence.

The advantage for the employee is that Luxembourg will not consider these costs to be either employment income or employer-provided benefits in kind. The advantage for the employer is that the qualifying expenses are tax deductible as operating costs.

The circular grants these tax advantages for a maximum period of five years following the year in which it has been assigned to Luxembourg.

IV. Conclusion

These incentives should assist Luxembourg in its continuing effort to attract a highly skilled workforce from around the world. This is particularly important for the country's growing fund industry. ■