Luxembourg Government submits to Parliament Bill implementing the EU Anti-Tax Avoidance Directive 2

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On 8 August 2019, the Luxembourg Government submitted a draft law to the Parliament (the **Draft Law**) to implement the Council Directive (EU) 2017/952 of 29 May 2017 (**ATAD 2** or the **Directive**) into Luxembourg domestic law.

As a reminder, ATAD 2 constitutes an update of the Council Directive (EU) 2016/1164 of 12 July 2016 (commonly referred to as **ATAD 1**) which aims to target tax avoidance practices in the context of intra-EU transactions. The purpose of ATAD 2 is to neutralise a wider range of tax advantages obtained by taxpayers resident in EU Member States due to the hybridity of an instrument or an entity within the context of transactions both within the EU but also with third countries.

Subject to an exception regarding provisions targeting reverse hybrids, EU Member States have until 1 January 2020 to implement ATAD 2 into their domestic law. In order to do so, Luxembourg's government has chosen to use a wording close to the text of the Directive and to apply the exceptions granted by ATAD 2.

The Draft Law provides clarification on some crucial questions, in particular regarding the application of the new rules to investment funds. However, at this stage, the Draft Law still needs to go through the Luxembourg legislative process and we expect that some amendments will be made, in particular further to the input of the Luxembourg Council of State.

Scope

Luxembourg corporate income taxpayers, including Luxembourg permanent establishments of foreign entities, will be subject to the Draft Law as from 1 January 2020. In addition, provisions targeting reverse hybrid mismatches will be applicable to Luxembourg transparent partnerships that would be treated as opaque by their nonresident owners as from 1 January 2022.

General

Conditions for the recognition of a hybrid mismatch

Test 1: Existence of a Mismatch Effect

The first criteria to consider when assessing the application of the Draft Law is the existence of a **Mismatch Effect**.

Hybrid mismatches targeted by the Draft Law are defined as arising when a payment leads to the realisation of a **Mismatch Effect** which is defined as:

- a **double deduction**: when the same payment is deducted for tax purposes in the jurisdiction where the payment has its source (payer jurisdiction) and in another jurisdiction (investor jurisdiction); or
- a **deduction without inclusion**: when a payment is tax deductible at the level of the payer but not included in the taxable income of the recipient.

To the extent that a hybrid mismatch gives rise to a **double deduction**, the deduction should be denied at the level of the investor. When the deduction has been made in the jurisdiction of the investor, the deduction should be denied at the level of the payer. However, any deduction should remain deductible to the extent that there is dual inclusion income during the same fiscal year. Payments, expenses or losses which were not deductible in a given tax year remain deductible from a dual inclusion income in a future tax year.

To the extent that a hybrid mismatch gives rise to a **deduction without inclusion**, the deduction should be denied at the level of the payer. When the deduction has been made in the jurisdiction of the payer, the corresponding income should be included in the net taxable profits of the Luxembourg beneficiary. This only applies where the deduction without inclusion relates to a hybrid financial instrument or from a payment made by a hybrid entity due to the non-recognition of such payment.

Test 2: Existence of a Structured Arrangement or capital ownership, voting rights or profits entitlement link

In order to assess if the provisions of the Draft Law will be applicable, it should be assessed whether the hybrid mismatch arises in the context of any of the following scenarios:

- A **Structured Arrangement** which is defined as an arrangement using a hybrid arrangement and which terms include the valorisation of the mismatch or an arrangement which has been designed with the purpose of generating the effect of an hybrid arrangement, unless (i) it cannot be reasonably expected of the taxpayer or of an associated enterprise that it was aware of the hybrid arrangement and (ii) it did not benefit from the tax advantage arising

from this arrangement.

- Between **Associated Enterprises**, which could be defined, in simplified terms and inter alia, as being related through a 50% or more capital ownership, voting rights or profits entitlement (a threshold of 25% applies in relation to payments under a financial instrument).
- Between a head office of an entity and a permanent establishment;
- Between two or more permanent establishments of the same entity;
- In cases of dual tax residence.

Concept of Acting Together and application to fund structures

The concept of **Acting Together** which is included in the definition of **Associated Enterprise** and has given rise to a lot of questions since the publication of the Directive is clarified in the Draft Law.

An entity or an individual acting together with another entity or individual with regards to the voting rights or capital ownership of an entity is considered as holding a participation in the all the voting rights or capital of this entity which are held by the other individual or entity. The Draft Law outlines that an investor holds, directly or indirectly, less than 10% of the interest in an investment fund and who is entitled to receive less than 10% of the fund's profits is presumed, unless proven otherwise, not to act together with the other investors in the same investment fund.

As a consequence, any investor holding less than 10% in an investment fund[1] should not be considered as an Associated Enterprise of the fund and of any underlying entities.

Based on the language chosen for (i) the definition of investment fund and (ii) the exclusion of investors whose ownership ratio is less than 10%, we understand that the desired objective of the Luxembourg Government was to exclude from the application of the ATAD 2 provisions in Luxembourg a vast majority of Luxembourg investment funds.

[1] The term "investment funds" includes any collective investment undertakings which raise capital from a number of investors, with a view to invest this capital in accordance with a defined investment policy for the benefit of those investors.

Specific cases targeted by the Draft Law

The following hybrid mismatches scenarios are targeted by the Draft Law:

- a payment under a financial instrument gives rise to a deduction without inclusion and the mismatch effect relates to the differences in the qualification of the instrument or of the

payment made under this instrument and this payment is not included in a reasonable period;

- a payment in favour of a hybrid entity gives rise to a deduction without inclusion and the mismatch effect relates to the differences in the attribution of the payments made to the hybrid entity based on the laws of the jurisdiction where the hybrid entity is established or registered, and on the laws of the jurisdiction of any individuals or entities which are entitled to a participation in the hybrid entity;
- a payment in favour of an entity having several permanent establishments gives rise to a deduction without inclusion and the mismatch effect results in differences in the attribution of payments between the head office and the permanent establishment, or between two permanent establishments or more of the same entity based on the laws of the jurisdictions in which such an entity carries its activities;
- a payment gives rise to a deduction without inclusion due to a payment in favour of a disregarded permanent establishment;
- a payment made by a hybrid entity gives rise to a deduction without inclusion and the mismatch effect results from the non-inclusion of the payment based on the laws of the jurisdiction of the beneficiary. However, a hybrid mismatch only arises to the extent that such payment is deductible in the jurisdiction of the payer of a revenue which is not subject to double inclusion;
- a payment deemed made between the head office and the permanent establishment or between two permanent establishments or more gives rise to a deduction without inclusion and the mismatch results from the non-inclusion of the payment based on the laws of the jurisdiction of the beneficiary. However, a hybrid mismatch only arises to the extent that this payment is deductible in the jurisdiction of the payer of a revenue which is not subject to double inclusion.

The term **Payment** should be read in the light of BEPS Action 2 and refers to any amount which is capable of being paid (including future or contingent obligation).

Additional guidance with respect to payments under a financial instrument

A payment should be considered as included within a reasonable period when included by the beneficiary either (i) within a 12-month period following the end of the payer's tax period during which the payment is made by the payer, or (ii) when it is reasonable to expect that the payment will be included in a subsequent tax year and the conditions of the payment meet arm's length standards.

A payment should not be considered as included to the extent it give rise to a tax relief further to its qualification based on the laws of the jurisdiction of the beneficiary.

Exceptions to the new rules

Payments made by a financial trader under financial instrument transfers are excluded from the scope of the above mentioned rules under certain conditions.

An exclusion is also available for the banking industry until 2022 for intra-group financial instruments with specific features which are issued with the purpose of meeting loss-absorbing capacity requirements.

Additional anti-hybrid rules applicable to specific cases

The Draft Law includes specific measures targeting the following hybrid mismatches:

Multiple tax credits

To the extent that a hybrid transfer is designed to give rise to a reduction of withholding tax for a payment under a financial instrument transferred to several parties, the benefit of the tax credit available in relation to the withholding tax related to this hybrid transfer will be limited to the proportion of the taxable net income arising from the payment derived from this hybrid transfer.

Imported mismatches

Imported mismatches are also targeted by the Draft Law, such mismatches occur in a third country but are financed through a Luxembourg taxpayer. Payments financing directly or indirectly deductible expenses, giving rise to a hybrid mismatch in the context of a transaction or series of transactions concluded between associated enterprises or in the context of a structured arrangement will not be deductible. As an exception to this rule, payments remain deductible to the extent that one of the jurisdictions involved has made an equivalent adjustment with respect to such hybrid mismatch.

Disregarded permanent establishments

To the extent that a hybrid mismatch involves income from one or more disregarded permanent establishments which is exempt based on a double tax treaty concluded between Luxembourg and another EU Member State, income which, otherwise, would be attributable to the disregarded permanent establishment will be included in the total net income of the Luxembourg taxpayer.

Multiple tax residence

Any payment, expense or loss incurred by a Luxembourg taxpayer which is also considered as a taxpayer by other jurisdictions will not be deductible to the extent that this payment, expense or loss is deductible in the other jurisdiction(s) from revenues which are not subject to double

inclusion. This provision is not applicable to transactions with EU Member States with which Luxembourg has signed a double tax treaty under which the taxpayer is regarded as a resident of Luxembourg.

Reverse hybrid measures applicable as from 2022

As from 1 January 2022, anti reverse hybrid rules will be applicable to Luxembourg transparent partnerships. Such entities will become subject to corporate income tax on net income that is not otherwise taxed in Luxembourg or in any other jurisdictions when one or more nonresident **Associated Enterprises** holding an aggregate interest of at least 50% of the voting rights, interest ownership or profit entitlement in the partnerships are located in one or more jurisdictions that treat the partnerships as taxable persons in Luxembourg.

Upon application of the above provision, Luxembourg partnerships will in any case not become subject to Net Wealth Tax.

The following collective investments vehicles should benefit from an exemption with respect to anti reverse hybrid rules:

- Undertakings for collective investment in the sense of the Law of 17 December 2010;
- Specialized investment funds (commonly referred to as **SIFs**) in the sense of the Law of 13 February 2007;
- Reserved alternative investment funds (commonly referred to as **RAIFs**) in the sense of the Law of 23 July 2016; and
- other alternative investment funds (commonly referred to as **AIFs**) covered by the Law of 12 July 2013 relating to managers of alternative investment funds under the condition that the AIFs are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulations.

Burden of proof

Upon request of the Luxembourg tax authorities, the Luxembourg taxpayer must be able to provide the tax authorities with any relevant documentation (e.g. tax returns, certificates from a foreign tax administration) to demonstrate that the provisions of the Draft Law are not applicable.

Adoption of the Draft Law

At this stage, the Draft Law still needs to be reviewed by the Luxembourg Parliament and the Council of State. In any case, the provisions of ATAD 2 need to be applicable as from 1 January 2020 except for the anti reverse hybrid entity rules which should apply as from fiscal year 2022. A further update of this briefing will be available once the final version of the Draft Law is voted by

the Luxembourg Parliament.

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