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Luxembourg implements the Anti - Tax Avoidance Directive (ATAD)

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On December 18th, the Luxembourg draft law implementing the EU Anti-Tax Avoidance Directive ("ATAD") was passed by the Parliament. While the main purpose of the draft law is to implement ATAD, it is worth mentioning that it also includes two additional BEPS -related tax law changes aiming at removing potential double non -taxation situations. Over the legislative process, the draft law has only been subject to few amendments and work remains to be done in order to clarify some practical implications and the impact of some of the new measures on existing tax law.This tax alert provides an overview of the different tax measures which, for most of them, will become applicable as from 1 January 2019.

Introduction

The aim of ATAD is to implement at EU level the BEPS (Base Erosion and Profit Shifting) recommendations made by the OECD and the G20 in October 2015. ATAD lays down anti -tax avoidance rules in the following fields:

Deductibility of interest payments;
• General anti-abuse rule ("GAAR");
• Controlled foreign companies ("CFCs");
• Hybrid mismatches; and
• Exit taxation.

In addition to the aforementioned ATAD measures, the draft law introduces two additional "anti -BEPS" changes to Luxembourg tax law. These changes respond to issues addressed by the European Commission in its investigations in two Luxembourg State Aid cases. More precisely, these measures should close loopholes that create opportunities for double non-taxation. The proposed tax law changes illustrate that the tax treatment in the two State Aid cases was consistent with Luxembourg tax law as it stands and it is necessary to change the law if one does not like the outcome of these rules.

Limitation to the tax deductibility of interest payments (Article 168bis ITL)

The draft law introduces a new article 168 Income Tax Law ("ITL") which aims at limiting the deductibility of interest payments as it was recommended in the Final Report on BEPS Action 4 (interest deductions and other financial payments) and included as a minimum standard in ATAD. The objective of this rule is to discourage multinational groups from reducing their overall tax base through financing group companies in high-tax jurisdictions with debt. Notably, the scope of the interest limitation rule encompasses both related party borrowing and third party borrowing.

As from 1 January 2019, subject to certain conditions and limitations, "exceeding borrowing costs" shall be deductible only up to 30% of the corporate taxpayers' earnings before interest, tax and amortization ("EBITDA") or up to an amount of EUR 3 mio, whichever is higher. Corporate taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs (so - called "escape clause").

“Exceeding borrowing costs” correspond 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. Thus, in order to determine the amount of exceeding borrowing costs, it is necessary to understand which costs fall within the scope of borrowing costs and what is considered as interest revenues and other economically equivalent taxable revenues.

Borrowing costs to take into account are interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance, including, without being limited to:

• payments under profit participating loans,
• imputed interest on instruments such as convertible bonds and zero coupon bonds,
• amounts under alternative financing arrangements, such as Islamic finance,
• the finance cost element of finance lease payments,
• capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest,
• amounts measured by reference to a funding return under transfer pricing rules where applicable,
• notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings,
• certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance,
• guarantee fees for financing arrangements,
• arrangement fees and similar costs related to the borrowing of funds.

As far as interest revenues and other economically equivalent taxable revenues are concerned, neither ATAD nor the draft law clarifies what is to be considered as revenues which are economically equivalent to interest. However, since the definition of borrowing costs also refers to “other costs economically equivalent to interest”, there should be a symmetry in the interpretation of the two concepts.

The optional provision of ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (in case of tax consolidation) has not yet been included in the draft law, but will be introduced at a later stage with retroactive effect as from 1 January 2019, according to a recent announcement of the Luxembourg Government.

Entities which are out of the scope of the rule

Financial undertakings are out of the scope of the interest limitation rule. Financial undertakings are the ones regulated by the EU Directives and Regulations and include among others financial institutions, insurance and reinsurance companies, undertakings for collective investment in

transferable securities (“UCITS”), alternative investment funds (“AIF”) as well as securitisation undertakings that are subject to EU regulation 2017/2402.

In addition, standalone entities, i.e. entities that are not part of a consolidated group for financial accounting purposes and have no associated enterprise or permanent establishment (“PE”) are able to fully deduct their exceeding borrowing costs. In other words, these entities are not subject to the new interest limitation rule.

Loans which are out of the scope of the rule The Luxembourg legislator chose to limit the scope of the new rule through the inclusion of the following two optional provisions under ATAD:

• loans which were concluded before 17 June 2016 (i.e. a grandfathering rule) are excluded. However, the exclusion does not apply to any subsequent modification of such loans. Accordingly, when the nominal amount of a loan granted before 17 June 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest deduction limitation rule. Likewise, when the interest rate applicable on a loan granted before 17 June 2016 is increased thereafter, only the original interest rate would benefit from the grandfathering rule. Nevertheless, when companies are financed by a loan facility that determines a maximum loan amount and an interest rate, the entire loan amount should be excluded from the scope of the interest deduction limitation rule, irrespective of when the drawdowns have been made;

•loans used to fund long-term public infrastructure projects (where the project operator, borrowing costs, assets and income are all in the EU) are also excluded.

Carry forward of unused exceeding borrowing costs and unused interest capacity

Exceeding borrowing costs which cannot be deducted in one tax period because they exceed the limit set in article 168bis ITL, can be carried forward in whole or in part without any time limitation.

In addition, unused interest capacity (when the exceeding borrowing costs of the corporate taxpayer are lower than 30% of the EBITDA but exceed EUR 3 mio) can be carried forward over 5 tax years.

In case of transformations falling within the scope of article 170 (2) ITL (e.g. merger), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

Amendment of the General Anti-Abuse Rule (§ 6 of the Tax Adaptation Law)

Under ATAD, non-genuine arrangements or a series of non-genuine arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law shall be disregarded. Arrangements are considered as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

Effective as from 1 January 2019, the Luxembourg abuse of law concept, as defined in §6 of the Tax Adaptation Law, will be replaced by a new General Anti-Abuse Rule ("GAAR") which will keep the key aspects of the existing abuse of law concept (according to which "the tax law cannot be circumvented by an abuse of forms and legal constructions") while introducing the concepts of the ATAD GAAR at the same time. There will be an abuse in case a specific legal route is selected for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and which is not genuine having regard to all relevant facts and circumstances. The legal route chosen may comprise more than one step or part and will be regarded as non-genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.

In case of an abuse, taxes will be determined based on the legal route considered as the genuine route, i.e. based on the legal route which would have been put into place for valid commercial reasons which reflect economic reality.

The fact that the new GAAR is included in the general tax law means that it will apply to any type of Luxembourg taxes and to any type of Luxembourg taxpayer. As such, the scope of the Luxembourg GAAR will be broader than the one of ATAD (which only covers corporate taxes and taxpayers). Nevertheless, in practice, the scope of the new GAAR should be limited to clearly abusive situations or wholly artificial arrangements in accordance with relevant jurisprudence of the Court of Justice of the EU.

Controlled Foreign Company rule (Article 164ter ITL)

ATAD provides for CFC rules that re-attribute the income of a low-taxed controlled company (or PE) to its parent company, even though it has not been distributed. The framework for the implementation of CFC rules in ATAD provides for a common definition of the CFC but for two alternative options (passive income option vs. non-genuine arrangement option) concerning the fundamental scope of the CFC rule as well as options to exclude certain CFCs.

Luxembourg has chosen the non -genuine arrangement CFC rule. Therefore, as from 1 January 2019, a new article 164ter ITL will be added to the Luxembourg corporate income tax ("CIT") law according to which Luxembourg will tax the non- distributed income of an entity or PE which qualifies as a CFC, provided the non -distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

However, in practice, the income of a CFC will only need to be included in the Luxembourg tax base if, and to the extent that, the activities of the CFC that generate this income are managed by the Luxembourg corporate taxpayer (i.e. when the people functions in relation to the activities of the CFC are performed by the Luxembourg parent company).

In addition, the CFC rule will only apply if the foreign entity or PE qualifies as a CFC of the Luxembourg corporate taxpayer. An entity or a PE will qualify as a CFC if the 2 following cumulative conditions are met:

•the Luxembourg controlling corporate taxpayer holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of the entity or PE; and

•the actual corporate tax paid by the CFC is lower than the difference between (i) the corporate tax that would have been charged in Luxembourg and (ii) the actual corporate tax paid on its profits by the CFC. In other words, the actual tax paid is less than 50% of the tax that would have been due in the country of the controlling taxpayer. Given the currently applicable CIT rate of 18% (this rate should be reduced to 17% as from 2019 based on recent announcements made by the Luxembourg Government), the CFC rule will only apply if the taxation of the income at CFC level is lower than 9% (8.5% as from 2019) on a comparable taxable basis.

The new CFC rule will only apply for CIT purposes, not for municipal business tax ("MBT") purposes. This means that any income qualifying as CFC income under the new rule will be taxed in Luxembourg at 18% (or 17% as from 2019 assuming that the Luxembourg Government will reduce the tax rate).

Exceptions

An entity or a PE will NOT be considered as a CFC if:

•it has accounting profits of no more than EUR 750,000; or
•its accounting profits amount to no more than 10% of its operating costs for the tax period.

Allocation rules and methods to avoid double taxation

The income of the CFC to be included in the tax base of the Luxembourg corporate taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling Luxembourg corporate taxpayer. The attribution of CFC income shall be calculated in accordance with the arm's length principle based on articles 56 and 56bis ITL.

The income to be included in the tax base shall be computed in proportion to the taxpayer's participation in the CFC and is included in the tax period of the Luxembourg corporate taxpayer in which the tax year of the CFC ends.

In order to avoid double taxation of the CFC income, the draft law provides the following rules:

• Where the CFC distributes profits to the Luxembourg corporate taxpayer, and those distributed profits are included in the taxable income of the taxpayer, the amounts of income previously included in the tax base in accordance with the CFC rule shall be deducted from the tax base when calculating the amount of tax due on the distributed profits;

•Where the taxpayer disposes of its participation in the CFC entity or of the business carried out by the CFC PE, and any part of the proceeds from the disposal previously has been included in

the tax base pursuant to the CFC rule, that amount shall be deducted from the capital gain realised by the Luxembourg corporate taxpayer on the disposal;

•Luxembourg shall allow a deduction of the tax paid by the CFC entity/CFC PE from the tax liability of the Luxembourg corporate taxpayer in accordance with the tax credit methods provided by articles 134bis and 134ter ITL. The deduction is proportional to the participation held in the CFC.

New framework to tackle hybrid mismatches (Article 168ter ITL)

The draft law introduces a new article 168ter ITL which implements the anti-hybrid mismatch provisions included in ATAD. The new article aims to eliminate -in an EU context only - the double non-taxation created through the use of certain hybrid instruments or entities.

The draft law does not implement the amendments introduced subsequently by ATAD 2 to ATAD which have replaced the anti-hybrid mismatch rules of ATAD and extended their scope of application to hybrid mismatches involving third countries. As such, the anti-hybrid mismatch rule provided in ATAD did not have to be implemented in 2019. ATAD 2 has to be implemented by 1 January 2020 and will be dealt with in a separate draft law to be released in the course of 2019.

The aim of the measures against hybrid mismatches is to eliminate the double non-taxation created by the use of certain hybrid instruments or entities. In general, a hybrid mismatch structure is a structure where a financial instrument or an entity is treated differently for tax pur poses in two different jurisdictions. The effect of such mismatches may be a double deduction (i.e. deduction in both Member States, “MS”) or a deduction of the income in one state without inclusion in the tax base of the other MS.

However, in an EU context, hybrid mismatches have already been tackled through several measures such as the amendment of the Parent/Subsidiary-Directive (i.e. dividends should only benefit from the participation exemption regime if these payments are not deductible at the level of the paying subsidiary). Therefore, the hybrid mismatch rule included in the draft law should have a very limited scope of application. However, given the generic wording of the anti-hybrid mismatch rule which is less specific than the targeted rules provided under ATAD 2, cases involving hybrid entities may give raise to significant legal uncertainty (e.g. in case of investments that are made via a fund vehicle that is treated as transparent from a Luxembourg perspective and as opaque from the perspective of the investor).

Rule applicable to double deduction

To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the MS where such payment has its source. Thus, in case Luxembourg is the investor state and the payment has been deducted in the source state, Luxembourg will deny the deduction.

Rule applicable in case of deduction without inclusion

When a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer jurisdiction. Therefore, if Luxembourg is the source state and the income is not taxed in the recipient state, the deduction of the payment will be denied in Luxembourg.

How to benefit from a tax deduction in practice

In order to be able to deduct a payment in Luxembourg, the Luxembourg corporate taxpayer will have to demonstrate that there is no hybrid mismatch situation. The taxpayer will have to provide evidence to the Luxembourg tax authorities that either (i) the payment is not deductible in the other MS which is the source state or (ii) the related income is taxed in the other MS. In the first place, evidence is provided through the statements made in the corporate tax returns. However, in practice the Luxembourg tax authorities may ask for further information and proof in this respect.

Exit taxation rules

The aim of these measures, which will become applicable as from 1 January 2020, is to discourage taxpayers to move their tax residence and/or assets to low-tax jurisdictions. In line with the exit tax provisions included in ATAD, the draft law defines the valuation rules applicable in case of exit out of Luxembourg to another country (amendment to article 38 ITL) and the valuation rules applicable in case of a transfer out of another country to Luxembourg (amendments to article 35 and article 43 ITL). However, to a large extent, Luxembourg tax law provided already for these exit tax rules.

Rule applicable to transfers to Luxembourg (amendment of Article 35 ITL)

As far as transfers to Luxembourg are concerned, a new paragraph will be added to article 35 ITL providing that in case of a transfer of assets, tax residence or business carried on by a permanent establishment to Luxembourg, Luxembourg will follow the value considered by the other jurisdiction as the starting value of the assets for tax purposes, unless this does not reflect the market value.

The aim of this rule is to achieve symmetry between the valuation of assets in the country of origin and the valuation of assets in the country of destination. While ATAD limits the scope of application of this provision to transfers between two EU MS, the new provision added to article 35 ITL covers transfers from any other country to Luxembourg.

Rule applicable in case of contribution to Luxembourg (amendment of Article 43 ITL)

The same valuation principles will also apply to contributions of assets (“supplement d’apport”) within the meaning of article 43 ITL. Therefore, when assets are contributed to Luxembourg, Luxembourg shall accept the value considered in the jurisdiction of the contributing company or permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

Rule applicable to transfers out of Luxembourg (amendment of Article 38 ITL)

As far as transfers out of Luxembourg are concerned, the draft law provides that a taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets at the time of the exit, less their value for tax purposes in case of:

• A transfer of assets from the Luxembourg head office to a PE located in another country (i.e. other MS or third country), but only to the extent that Luxembourg loses the right to tax the transferred assets;

• A transfer of assets from a Luxembourg PE to the head office or to another PE located in another country (i.e. other MS or third country), but only to the extent that Luxembourg loses the right to tax the transferred assets;

• A transfer of tax residence to another country (i.e. other MS or third country), except for those assets which remain connected with a Luxembourg PE; and

• A transfer of the business carried on through a Luxembourg PE to another MS or to a third country, but only to the extent that Luxembourg loses the right to tax the transferred assets.

In case of transfers within the European Economic Area ("EEA"), the Luxembourg taxpayer may request to defer the payment of exit tax by paying in equal instalments over 5 years. § 127 of the General Tax law ("Abgabenordnung") is amended accordingly.

Finally, provided that the assets are set to revert to Luxembourg (country of the transferor) within a period of 12 months, the new exit tax rules shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

Since the new Luxembourg exit tax rules will apply both to corporate taxpayers and to individuals, both individuals and corporate taxpayers will be able to benefit from those exceptions.

Other non-ATAD measures

Conversion of debt into shares no longer tax neutral (amendment of Article 22bis ITL)

This measure amends the Luxembourg rules applicable to a specific category of exchange operations (rollover relief, article 22bis ITL) that involves the conversion of a loan or other debt instruments into shares of the borrower. As from 2019, such conversion will no longer fall within the scope of tax neutral exchange operations. Instead, the conversion will be treated as a sale of the loan followed by a subsequent acquisition of shares. This means that any latent gain on the loan will become fully taxable upon the conversion.

While the aim of this amendment to article 22bis ITL is to ensure that double non-taxation situations can no longer arise from this provision, it would have been wise to implement more targeted measures to avoid collateral damage.

New PE definition (amendment of § 16 of the Tax Adaptation Law)

The definition of permanent establishment ("PE") under Luxembourg tax law (§ 16 of the Tax Adaptation Law) is amended. As from 1 January 2019, the only criteria to apply in order to assess whether a Luxembourg taxpayer has a PE in a country with which Luxembourg has concluded a double tax treaty are the criteria defined in the tax treaty. In order words, the PE definition included in the tax treaty will prevail.

Furthermore, unless there is a clear provision in the relevant double tax treaty which is opposed to this approach, a Luxembourg taxpayer will be considered as performing all or part of its activity through a PE in the other contracting state if the activity performed, viewed in isolation, is an independent activity which represents a participation in the general economic life in that contracting state.

Finally, the Luxembourg tax authorities may request from the taxpayer a certificate issued by the other contracting state according to which the foreign authorities recognize the existence of the foreign PE.

Implications

Overall, Luxembourg has made the right choices, using all options provided by ATAD in order to remain competitive. However, on some aspects the Luxembourg legislator took positions which are even stricter than ATAD. For example, instead of implementing all anti-hybrid mismatch rules provided in ATAD 2 as from 2020, the draft law provides for the hybrid mismatch rule included in ATAD which has been replaced by ATAD 2. Although the impact of this measure should be very limited, in situations involving hybrid entities the generic nature of the anti-hybrid mismatch rule may create severe legal uncertainty.

Additional work remains to be done in order to clarify the views of the Luxembourg tax authorities on the interpretation of some of the new rules and the impact of certain of these rules on existing tax law. In this regard, it is expected that the Luxembourg tax authorities will release Tax Circulars with additional guidance in 2019.

Considering that these changes will become effective as from January 2019, Luxembourg taxpayers should analyse the impact of the upcoming changes on their investments and business activities and take appropriate action where necessary.