

## ATAD II implementation in Luxembourg: Bill submitted to the Parliament



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On 8 August 2019, the Luxembourg government filed with Parliament Bill N° 7466 (the “Bill”) implementing into domestic law Council Directive (EU) 2017/952 of 29 May 2017 (“ATAD II”) amending Council Directive (EU) 2016/1164 (“ATAD I”) as regards hybrid mismatches with third countries. The new measures, which amend Article 168ter Income Tax Law (“ITL”) and introduce a new article 168quater ITL are generally in line with the provisions of ATAD II. They should apply to financial years starting as from 1 January 2020 except for the rules on reverse hybrids which should apply as from 1 January 2022.

### Background

Article 168ter ITL was introduced into domestic law with effect as from 1 January 2019 to transpose inter alia the provisions of ATAD I covering intra-EU hybrid mismatches involving hybrid instruments or entities that give rise to a double deduction (“DD”) or a deduction without inclusion (“D/NI”) of the same payment.

The former rules applied either in the context of commercial or financial relationships between the taxpayer and an associated enterprise in another EU member State, or in the case of a structured arrangement concluded between a taxpayer and a party in another EU member State.

Associated enterprises imply a direct or indirect participation of 25% or more of the voting rights or capital or an entitlement to 25% or more of the profits in the case of hybrid instruments. In the case of hybrid entities, this percentage is increased to 50% or more. The concept of structured arrangement was not defined.

If an arrangement falls in the scope of the rule, operating expenses were not tax deductible in Luxembourg to the extent that they are already tax deductible in the source member State, or to the extent that the corresponding income is not taxed in the other member State.

The Bill revamps Article 168ter to transpose the provisions of ATAD II<sup>1</sup>, which extends the material scope of ATAD I to additional type of arrangements, introduces the “acting together” concept, and extends the territorial scope to transactions with third countries. In addition, a new article 168quater transposes the provisions of ATAD II on reverse hybrids.

In line with ATAD II, the commentaries to the Bill clarify that the applicable explanations and examples in the OECD-BEPS report on Action 2 can be used as a source of illustration or interpretation to the extent that they are consistent with the provisions of ATAD II and with the European Union law.

### **Hybrid mismatches covered by the new Article 168ter LITL**

In line with ATAD II, the Bill includes a list of hybrid mismatches that fall in the scope of the rule. The hybrid mismatches are generally defined by reference to the notion of “payments”, which include a distribution, credit or accrual (and no longer by reference to operating expenses).

#### a) Payment under a financial (hybrid) instrument

A payment under a financial instrument giving rise to a deduction without inclusion will now fall in the scope of the rule if it is not included in the hands of the payer within a reasonable period of time (i.e., within 12 months starting from the end of the Luxembourg payer’s tax period, or if the terms of the payment are at arm’s length) and if the mismatch outcome is attributable to differences in the characterization of the instrument or the payment made under it.

#### b) Payment to a hybrid entity

A payment by a Luxembourg taxpayer to a hybrid entity will fall in the scope of the rule if it gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity.

#### c) Payment to an entity with one or more permanent establishments

A payment to an entity with one or more permanent establishments will fall in the scope of the rule if it gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and the permanent establishment or between two or more permanent establishments of the same entity under the laws of the jurisdictions where the entity operates.

#### d) Payment to a disregarded permanent establishment

A payment to a disregarded permanent establishment will fall in the scope of the rule if it gives

rise to a deduction without inclusion.

e) Payment by a hybrid entity

A payment by a hybrid entity will fall in the scope of the rule if it gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction, unless the related income is subject to double inclusion (i.e., is included in the computation of taxable income in the countries where the mismatch arises).

f) Deemed payment between the head office and permanent establishment or between two or more permanent establishments

The deemed payment giving rise to a deduction without inclusion will fall in the scope of the rule if that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction, unless the related income is subject to double inclusion.

g) Double deduction outcome

A double deduction outcome will be treated as a hybrid mismatch, unless the related income is subject to double inclusion. Payments, expenses or losses which are not deductible in accordance with such rule remain deductible up to the amount of dual inclusion income of a subsequent year.

Double inclusion income – In cases e), f) and g), double inclusion income refers to any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen.

Payments to tax-exempt investors – Based on the legislative commentaries to the law, which refer to the recitals of ATAD II, the rule will not apply in the cases of certain hybrid mismatches (for instance cases a) and b) above) where the hybrid mismatch would have arisen in any event due to the tax-exempt status of the investors or the fact that the instrument is held subject to the terms of a special regime.

**Associated enterprises & Acting together**

Hybrid mismatches will only exist if they occur between associated enterprises, between a taxpayer and an associated enterprise, between the head office and its permanent establishment, between two or more permanent establishments, or in the context of a structured arrangement. In line with ATAD II, commentaries to the Bill indicate that only situations with substantial risk of tax evasion need to be addressed.

Associated enterprises (entities or individuals) are now defined by reference to a general 50% threshold (voting rights / capital / profit share), except in the case of hybrid instruments (case a. above) where a 25% threshold would apply.

The definition is also extended to include cases (i) where an entity is part of the same consolidated group for financial accounting purposes as the taxpayer, and (ii) involving an enterprise in which the taxpayer has a significant influence in the management or an enterprise which has a significant influence in the management of the taxpayer.

The law also introduces the concept of “acting together”. A person (entity or individual) which acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person. A simplification measure has however been introduced for investment funds, i.e., an investor (entity or individual) that holds directly or indirectly less than 10% in the interest of the fund and which is entitled to less than 10% of the profits of this fund will not (unless proved otherwise) be considered as acting together with another investor in the fund. Investment funds are defined here as undertakings for collective investment that raise funds from a number of investors for the purpose of investing them, in accordance with a defined investment policy, in the interest of these investors.

In addition, the concept of structured arrangement is now defined and includes an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.

### **Application of the rules**

*Primary rule* – If a hybrid mismatch gives rise to a DD, the related payment, expenses, or losses will not be tax deductible in Luxembourg (when Luxembourg is the investor’s State). If a hybrid mismatch gives rise to a D/Nl, the related payment will not be tax deductible in Luxembourg (when Luxembourg is the payer’s State).

*Secondary rule*– Where, in the cases of DD, Luxembourg is the source State, and the deduction is not denied in the investor’s jurisdiction, the tax deductibility of the related payment, expenses, or losses shall be denied in Luxembourg. However, the payment, expenses, or losses shall remain tax deductible in Luxembourg if an item of income is included in Luxembourg and in the other jurisdiction where the mismatch outcome has arisen (during the same financial year or a subsequent financial year).

Where, in the cases of D/Nl, Luxembourg is the recipient State, and the deduction is not denied

in the source State, Luxembourg shall tax the income. However, Luxembourg has chosen the option left by ATAD II not to apply this secondary rule to the hybrid mismatches b), c), d), and f) mentioned above.

*Banking sector* – Luxembourg has chosen to exclude until 31 December 2022 (as offered by ATAD II), from the scope of the rule related to D/NL, financial instruments which have been issued with the sole purpose of satisfying the loss-absorbing capacity requirements applicable to the banking sector (under conditions).

*Imported mismatches* – Luxembourg will deny the deduction of any payments that directly or indirectly fund expenses giving rise to a hybrid mismatch between associated enterprises or in the context of a structured arrangement.

*Disregarded permanent establishments* – Income realized by an EU disregarded permanent establishment of a Luxembourg head office shall be subject to tax in Luxembourg, despite any tax treaty that would exempt this income. When the disregarded permanent establishment is located in a third State, treaty provisions should remain applicable (bearing in mind that the revised domestic definition of permanent establishment applicable as from 2019 is intended to avoid deemed permanent establishment solutions).

*Dual resident mismatches* – where a Luxembourg taxpayer is also tax resident in another country, Luxembourg shall deny a deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If the taxpayer is treated as tax resident in Luxembourg under a double tax treaty, the payment shall remain tax deductible in Luxembourg.

*Hybrid transfer mismatches* – Luxembourg shall limit the benefit of a relief for tax withheld at source on a payment derived from a financial instrument transferred to several concerned parties, where the related income is treated for tax purposes as being obtained by more than one of the parties involved, in proportion to the related net income taxable in Luxembourg.

### **Reverse hybrids (new article 168quater ITL applying as from 1 January 2022)**

Specific rules are provided for Luxembourg tax transparent entities (e.g., tax transparent sociétés en commandite simple “SCS”, or sociétés en commandite spéciale “SCSp”) that are treated as tax opaque in the jurisdiction(s) of their non-resident associated enterprises holding in aggregate a direct or indirect interest of 50% or more of the voting rights, capital interests or rights to a share of profit in the Luxembourg reverse hybrid. In this case, the Luxembourg entity shall be subject to corporate income tax on its income to the extent that the income is not otherwise taxed in Luxembourg or in any other jurisdiction. Reverse hybrids will be subject to corporate income tax but will be exempt from net worth tax.

Collective investment vehicles (CIV) will be excluded from the scope of the reverse hybrid rule.

CIV are defined as investment funds or vehicles that are widely held, hold a diversified portfolio of securities and are subject to investor-protector regulation. Based on the commentaries to the Bill, investment funds in the sense of the law of 17 December 2010 (UCITS & Part II funds), the specialized investment funds (SIF) in the sense of the law of 13 February 2007, and the reserved alternative investment funds (RAIF) in the sense of the law of 23 July 2016 should be covered by the exclusion. Other alternative investment funds (AIF) in the sense of the law of 12 July 2013 will also be excluded if they are widely held, hold a diversified portfolio of securities and are subject to investor protection obligations.

### **Ordering rules**

The Bill and the related commentaries provide for the following ordering rules. In the case of hybrid instruments, the anti-hybrid rule of Article 168ter ITL should not apply where the provisions of Article 166(2bis) ITL already neutralize the hybrid mismatch. In addition, as from 2022, hybrid mismatches neutralized by the reverse hybrid rule should not be subject to any other anti-hybrid rule.

### **Burden of proof**

Upon request of the Luxembourg tax authorities, the taxpayer will have to provide any document (such as a tax return, or a certificate from the foreign tax authorities) demonstrating that the provisions of Article 168ter ITL or Article 168quater ITL should not apply.

### **Concluding remarks**

The Bill constitutes a fair implementation of the ATAD II provisions, whilst offering welcome pragmatic solutions for the fund industry. In addition, Luxembourg has chosen to implement the specific exclusions offered by ATAD II (i.e., the non-implementation of the secondary rules in certain cases of D/NL, and the exclusion of certain financial instruments issued by banks).

As the new provisions of Article 168ter ITL should enter into force as early as 1 January 2020, Luxembourg taxpayers having cross-border operations with third countries are advised to review and closely monitor any potential impact this may have on their activities.

<sup>1</sup> For more details on ATAD II, please refer to our Newsflash entitled “ECOFIN agreed on amendments to the ATAD regarding hybrid mismatches with third countries”.