ATOZ TAX ALERT

Luxembourg implements the Anti-Tax Avoidance Directive (ATAD)

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Today, the draft law implementing the EU Anti-Tax Avoidance Directive ("ATAD") was released. While the main purpose of the draft law is to implement ATAD, it is worth noting that it also includes two additional BEPS-related tax changes aiming at removing potential double non-taxation situations. This tax alert gives an overview of the tax measures provided in the draft law. However, the proposed rules may still evolve throughout the legislative process.

Background of the upcoming tax changes

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.

While some of the anti-avoidance rules included in ATAD do not leave any flexibility to EU Member States ("MS") when implementing them, other rules provide alternative options and/or allow EU MS to limit their scope of application. Keeping in mind the continuous increase of direct tax harmonisation within the EU, it was important that Luxembourg make the right choices each time ATAD left EU MS some leeway and options so as to remain competitive in the post-BEPS environment.

In addition to the mentioned ATAD measures listed above, 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 on-going investigations in two Luxembourg tax State Aid cases. The aim of the changes introduced by the draft law is to make sure that two specific provisions can no longer create situations of double non-taxation. These proposed tax 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

- Purpose: The new rule on the limitation of deduction of interest payments, as it was recommended in the BEPS Action 4 report (Interest deductions and other financial payments) and subsequently set as a minimum standard in ATAD, aims to discourage multinational groups from reducing the overall tax base of the group by financing group companies in high-tax jurisdictions with debt. Still, the scope of the interest limitation rule encompasses both related party borrowing and unrelated party borrowing.

- Rule: 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. 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 (under certain conditions) fully deduct their exceeding borrowing costs.

- 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. The exclusion of these types of entities is optional under ATAD and constitutes as such one of the most positive choices made by the Luxembourg Government when implementing ATAD. 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 are able to fully deduct their exceeding borrowing costs, meaning that they are also not subject to the new rule.

- Loans which are out of the scope of the rule: Loans which were concluded before 17 June 2016 as well as loans used to fund a long-term public infrastructure (where the project operator, borrowing costs, assets and income are all in the EU) are excluded. This exclusion is also optional in ATAD, so another positive choice has been made by Luxembourg.

- Carry forward of unused exceeding borrowing costs: Exceeding borrowing costs which cannot be deducted in one tax period can be carried forward in whole or in part without any time limitation. ATAD provides 3 alternative options for EU MS and the option chosen by Luxembourg is one of the most favourable, which is welcome.

Amendment of the General Anti-Abuse Rule (GAAR)

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 GAAR in line with the GAAR included in ATAD. The fact that the new GAAR is included in the general tax law provisions 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 abuse of law provision (as amended by the GAAR) should be limited to clearly abusive situations or wholly artificial arrangements, in cases covered by relevant jurisprudence of the Court of Justice of the EU.

Controlled Foreign Company (CFC) rule

- Purpose: ATAD provides for CFC rules that re-attribute the income of a low-taxed controlled company (or permanent establishment) 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 2 alternative options (passive income option or non-genuine arrangement option) concerning the fundamental scope of the CFC rules as well as options to exclude certain CFCs.

- Rule: Luxembourg has chosen the non-genuine arrangement CFC rule. Therefore, as from 1 January 2019, 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, the activities of the CFC that generate this income are managed by the Luxembourg parent company. The CFC rule will apply if the Luxembourg controlling taxpayer holds or holds together with its associated enterprises a direct or indirect participation of more than 50% in the controlled entity and the actual corporate tax paid by the entity or PE 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 entity or PE (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).

- 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 if its accounting profits amount to no more than 10% of its operating costs for the tax period. This exception is also a positive option taken by Luxembourg to limit the scope of application of the new CFC rule to enterprises which exceed a certain size.

New framework to tackle hybrid mismatches

The draft law implements the anti-hybrid mismatch provisions included in ATAD which aim 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 with third countries. The implementation of ATAD 2 will be dealt with in a separate draft law.

- Purpose: 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 purposes in two different jurisdictions. The effect of such mismatches is often a double deduction (i.e. deduction in both MS) or a deduction of the income in one state without inclusion in the tax base of the other MS.

- 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, Luxembourg will also deny the deduction of the payment.

- 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.

- Timing: While ATAD 2 postponed the implementation of all anti-hybrid rules (including the ones covered in ATAD) until 1.1.2020 (and even until 1.1.2022 in case of reverse hybrid mismatches), the draft law provides that the anti-hybrid mismatch rules applicable within the EU, as stated above, will become effective as of 1.1.2019. Therefore, while the timing chosen by Luxembourg is stricter and as such compliant with ATAD, Luxembourg could have granted one additional tax year for taxpayers to adapt to the new rules.

Exit taxation rules

- Purpose: The aim of this measure is to discourage taxpayers to move their tax residence and/or assets to low-tax jurisdictions.

- Rule: 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 head office to a PE in another MS or to a third country;
  - A transfer of assets from a PE to the head office or another PE in another MS or a third country;
  - A transfer of tax residence to another MS or a third country (except for those which remain connected with a PE in the first country); and - A transfer of the business carried on through a PE from a MS to another MS or to a third country.

  In case of transfers within the EEA, a taxpayer may defer the payment of exit tax by paying in instalments over 5 years.

Other non-ATAD measures

The first measure amends the Luxembourg rules (rollover relief) applicable to exchange operations (article 22bis Income Tax Law): as from 2019, the conversion of a loan into shares 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.

The second measure amends the definition of permanent establishment ("PE", § 16 of the Tax Adaptation Law). According to the draft law, 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. The draft law explains further in which case a Luxembourg taxpayer will be considered as performing all or part of its activity through a PE in the other contracting state. However, this will only apply if the relevant tax treaty does not contain any specific provision which is opposed to the recognition of the PE in such case. Finally, the draft law states that 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. Such certificate has to be provided in case the relevant tax treaty does not entail any provision according to which Luxembourg is authorised not to exempt the income realised or the assets owned by the Luxembourg taxpayer in the other contracting state.

Implications

Overall, Luxembourg has made the right choices and used all options provided by ATAD in order to remain competitive. However, on some aspects the Luxembourg government took positions which are even stricter than ATAD: instead of having all anti-hybrid mismatch rules (i.e. those within the EU and those with third countries becoming applicable as from 2020), the Luxembourg government has decided to have the ones applicable within the EU apply as early as from 1 January 2019. Furthermore, work still remains to be done: some of the measures introduced when implementing ATAD will have an impact on other existing measures and this impact should be monitored carefully. Therefore, it will be important to either adopt further measures or clarify certain implications by means of a circular of the tax authorities. Finally, keeping in mind that these changes will become effective in 6 months, Luxembourg taxpayers should seek advice from a tax adviser in order to analyse the impact of the upcoming changes on their investments and take appropriate action if necessary.

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