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Luxembourg Releases Draft Law Implementing ATAD

Oliver R. Hoor and Samantha Schmitz
ATOZ Tax Advisers (Taxand Luxembourg)

The Luxembourg legislator has released the draft law implementing ATAD. While the main purpose of the draft law is to implement ATAD, it also includes two additional BEPS-related tax law changes aiming at removing potential double non-taxation situations. This article provides an overview of the different tax measures which may still evolve throughout the legislative process.

Oliver R. Hoor, Tax Partner, and Samantha Schmitz, Chief Knowledge Officer, ATOZ Tax Advisers (Taxand Luxembourg)

The aim of the European Union ("EU") Anti-Tax Avoidance Directive ("ATAD") is to implement at EU level the base erosion and profit shifting ("BEPS") recommendations made by the OECD and the G-20 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.

Although some of the anti-avoidance rules included in ATAD do not leave much flexibility to EU member states when implementing them, other rules provide alternative options and/or allow EU member states to limit their scope of application. Keeping in mind the continuous harmonization in direct tax matters within the EU, it was important that Luxembourg make the right choices each time ATAD provides for some leeway and options, in order to remain competitive in the post-BEPS environment.

Additional "Anti-BEPS" Changes

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 ongoing 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.

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Limitation to the Tax Deductibility of Interest Payments

Purpose

The new rule aims at limiting the deductibility of interest payments as 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.

Rule

As from January 1, 2019, a new Article 168bis of the Income Tax Law ("ITL") will be added to the Luxembourg corporate income tax ("CIT") law, according to which, subject to certain conditions and limitations, "exceeding borrowing costs" shall be deductible only up to 30 percent of the corporate taxpayers' earnings before interest, tax and amortization (EBITDA) or up to an amount of 3 million euros ($3.5 million), 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 (the so-called escape clause).

The definition of "exceeding borrowing costs" is in line with the definition included in ATAD and corresponds 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;
- capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized 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 will probably be a symmetry in the interpretation of the two concepts.

The 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 been included in the draft law. Therefore, as stated in the commentaries to the draft law, even in case of application of the tax consolidation regime, the limitation to the deduction of interest will apply at the level of each consolidated entity.

Entities Out of Scope of Rule

Financial undertakings are out of the scope of the interest limitation rule. Financial undertakings are those regulated by the EU Directives and Regulations and include financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities ("UCITS"), alternative investment funds ("AIFs") as well as securitization undertakings. The exclusion of these types of entities is optional under ATAD, and as such constitutes 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 ("PE") are able to fully deduct their exceeding borrowing costs. In other words, these entities are not subject to the new rule.

Loans Out of Scope of 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 June 17, 2016 (i.e. a grandfathering rule); and
- loans used to fund long-term public infrastructure projects (where the project operator, borrowing costs, assets and income are all in the EU);

are excluded.

These exceptions are optional under ATAD, so that another positive choice has been made by Luxembourg.

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 of the ITL can be carried forward in whole or in part without any time limitation.

In addition, unused interest capacity (when the borrowing costs of the corporate taxpayer are lower than the limit set in Article 168bis of the ITL) can be carried forward over five tax years.

ATAD provides three alternative options for EU member states and the option chosen by Luxembourg (with a carry forward of both exceeding borrowing cost and unused interest capacity) should be the most favorable option for taxpayers.

Finally, in case of transformations falling within the scope of Article 170 (2) of the ITL (e.g. merger) and 172 (2) of the ITL (transfer of seat), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

Amendment of the GAAR

Purpose

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.

Rule

Effective as from January 1, 2019, the Luxembourg abuse of law concept, as defined in section 6 of the Tax Adaptation Law, will be replaced by a new GAAR which will keep the key aspects of the existing abuse of law concept (“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 a case where 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 that of ATAD (which only covers corporate taxes and taxpayers). Nevertheless, in practice, in cases covered by the relevant jurisprudence of the Court of Justice of the EU, the scope of the new GAAR should be limited to clearly abusive situations or wholly artificial arrangements.

CFC Rule

Purpose

ATAD provides for CFC rules that reattribute 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.

Rule

Luxembourg has chosen the non-genuine arrangement CFC rule. Therefore, as from January 1, 2019, a new Article 164ter of the ITL will be added to the Luxembourg 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 two 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 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 percent of the tax that would have been due in the country of the controlling taxpayer). Given the currently applicable CIT rate of 18 percent, the CFC rule will only apply if the taxation of the income at CFC level is lower than 9 percent 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 percent. To clarify that the CFC rule will only apply for CIT purposes, the draft law introduces an amendment to section 9 of the MBT law according to which any CFC income included in the CIT basis of the taxpayer will be deductible from the MBT basis.

Exceptions

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

- it has accounting profits of not more than 750,000 euros; or
- its accounting profits amount to no more than 10 percent 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.

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 gener-

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ated 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 of the ITL.

The income to be included in the tax base shall be calculated 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 realized by the Luxembourg corporate taxpayer on the disposal.
- Luxembourg shall allow a deduction of the tax paid in respect of the CFC income from the tax liability of the Luxembourg corporate taxpayer in accordance with the tax credit methods provided by Articles 134bis and 134ter of the ITL. The deduction is proportional to the participation held in the CFC and is only granted up to the amount of tax due. The part of tax levied which cannot be credited on the tax due remains deductible in accordance with Article 13 of the ITL.

New Framework to Tackle Hybrid Mismatches

The draft law introduces a new Article 168ter of the 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 subsequently introduced to ATAD by ATAD 2 which have replaced the anti-hybrid mismatch rules of ATAD and extended their scope of application to hybrid mismatches with third countries. ATAD 2 has to be implemented by January 1, 2020 and will be dealt with in a separate draft law to be released in the course of 2019.

Given that ATAD 2 replaced the hybrid mismatch rule included in ATAD, it is not self-evident why the Luxembourg government included the ATAD rule in the draft law. Therefore, it remains to be seen whether this provision survives the legislative process.

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 may be a double deduction (i.e. deduction in both EU member states) or a deduction of the income in one state without inclusion in the tax base of the other member state.

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.

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 member state where such payment has its source. Thus, in a case where Luxembourg is the investor state and the payment has been deducted in the source state, Luxembourg would 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 would 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 member state which is the source state, or (ii) the related income is taxed in the other member state.

Exit Taxation Rule

Purpose

The aim of this measure is to discourage taxpayers from moving 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 of the ITL) and the valuation rules applicable in case of transfer out of another country to Luxembourg (amendments to Article 35 and Article 43 of the ITL).

Rule Applicable to Transfers to Luxembourg

As far as transfers to Luxembourg are concerned, a new paragraph will be added to Article 35 ITL which implements Article 5 section 5 of ATAD, providing that in case of a transfer of assets, tax residence or business carried on by a PE to another member state, that member state shall accept the value established by the member state of the taxpayer or of the PE 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 member states, the new provision added to Article 35 of the ITL covers transfers from any other country to Luxembourg.

Rule Applicable in Case of Contribution (*supplement d'apport*)

The same valuation principles will also apply to contributions of assets within the meaning of Article 43 of the ITL. Therefore, when assets are contributed to Luxembourg, Luxembourg shall accept the value established by the departure state of the taxpayer or of the PE 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

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 member state 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 member state 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 member state 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 member state 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 five years. This new provision included in ATAD amends and replaces the existing provisions included in section 127 of the General Tax Law (*Abgabenordnung*). Under current Luxembourg tax law, Luxembourg taxpayers may defer the payment of the tax until the effective disposal of the assets. The deferral applied both to transfers to another EEA country and to transfers to a country with which Luxembourg has concluded a double tax treaty. Under the new rules, it will only be possible to defer the payment over a maximum of five years and the deferral will only apply to transfers to EEA countries. The deferral will be achieved by way of a payment in five equal instalments. Several exceptions apply to the five-year payment deferral, which will reduce the five-year period, e.g. in case of disposal of the assets transferred.

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

This measure should amend the Luxembourg rules applicable to a specific category of exchange operations (rollover relief, Article 22bis of the ITL) that involves the conversion of a loan 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.

The aim of this amendment to Article 22bis of the ITL is to ensure that double non-taxation situations can no longer arise from this provision. However, instead of removing this provision, the Luxembourg legislator should limit its scope of application with a view to avoid situations of double non-taxation.

New Definition of Permanent Establishment

The second measure amends the definition of PE under Luxembourg tax law (section 16 of the Tax Adaptation Law). According to the draft law, as from January 1, 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 other words, the PE definition included in the tax treaty will prevail.

The draft law provides further that, 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 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 (i.e. a provision equivalent to Article 23A(4) of the 2017 OECD Model tax Convention) according to which Luxembourg is authorized to deny the exemption of the income realized (or the assets owned) by the Luxembourg taxpayer in the other contracting state when the other contracting state interprets the tax treaty in such a way that its taxing right in regard to the income or capital is limited or excluded..

However, it should be noted that tax treaty law takes precedence over Luxembourg domestic tax law and Luxembourg has to honor its tax treaty obligations. Therefore, as long as a tax

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treaty does not include specific anti-abuse legislation, Luxembourg has to exempt income and capital derived or owned through a PE (as defined in an applicable tax treaty) in the other contracting state.

In Summary

Overall, Luxembourg has made the right choices, using 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. 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.

Furthermore, additional work remains to be done in order to clarify the impact of some of the new measures on existing tax law. This might be done by the Luxembourg tax authorities through Tax Circulars.

Planning Points

Considering that these changes will become effective in less than six months, Luxembourg taxpayers should analyze the impact of the upcoming changes on their investments and take appropriate action if necessary.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) and Samantha Schmitz is Chief Knowledge Officer with ATOZ Tax Advisers (Taxand Luxembourg).

The authors may be contacted at: oliver.hoor@atoz.lu; samantha.schmitz@atoz.lu