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Luxembourg Tax Alert

Luxembourg law transposing ATAD 1 voted and published in the Memorial

19 December 2018

On 18 December 2018, the Luxembourg Parliament voted on the transposition into Luxembourg law of the EU Anti-Tax Avoidance Directive of 12 July 2016 (ATAD 1). The law was published (A n° 1164) in the Official Gazette. The ATAD 1 provisions will be applicable in Luxembourg as from fiscal years starting on or after 1 January 2019, except for the exit tax provisions that will apply as from 2020.

Some modifications have been made to the initially proposed text of this law, especially following the views expressed by the Council of State in November and the government amendments introduced beginning of December.

The government has also committed, as mentioned in the report submitted to the parliamentary vote, to introduce an additional ATAD option allowing tax integrated groups to calculate their additional borrowing costs and EBITDA at the level of the integrated group. This additional provision should be introduced through a subsequent additional law, which would apply retroactively as from 1 January 2019.

The deputies also passed a motion (i.e. a text asking the government to take a certain initiative or adopt a certain position) during the vote of the law. The motion indicates that the abovementioned option allowed by ATAD for tax integrated groups has not been introduced into the Luxembourg draft law, while it has been included by multiple other EU member states in their respective transposition laws. The deputies remind that it is important for this option to also be available in Luxembourg already as from fiscal year 2019. The deputies also remind that securitization activities fall among the most important branches of financial activity. Therefore, the deputies request the government:

- To present, at its earliest opportunity, within the first semester of 2019, a new draft law which would introduce the abovementioned option for tax integrated groups to become applicable with retroactive effect as from 1 January 2019 and modify the tax integration regime in a way as to ensure correct application of the ATAD option
- To analyze the situation of securitization companies in the context of ATAD transposition

The topics covered by and the provisions introduced through the law transposing ATAD 1 into Luxembourg law, which will apply as from the fiscal years starting on or after 1 January 2019, are detailed below (with the exception of the exit tax provisions, applicable as from 2020, which are not covered by this tax alert).

Hybrid mismatch rules

The Luxembourg law implements ATAD 1 anti-hybrid provisions, covering only intra-EU hybrid instruments and hybrid entity mismatches, through a new article 168ter of the Luxembourg Income Tax Law (LITL), closely following article 9 of ATAD 1.

ATAD 1 includes measures that will apply where there are differences in the legal characterization of payments or entities in different EU member states that result in (i) a deduction for the same expense in two member states (double deduction); or (ii) a deduction in one member state without a corresponding income inclusion in another member state (deduction without inclusion). Under these rules:

- In the case of a double deduction, the deduction will be allowed only in the member state where the payment is sourced
- In the case of a deduction without inclusion, the deduction will not be allowed by the member state of the payer

In order to increase the clarity of the Luxembourg law, its wording was amended over the last weeks, especially regarding the topic of deduction without inclusion to make reference to "deductible payment" and not deductible expense.

As from 2020, the provisions of ATAD 2 will be introduced in Luxembourg amending the hybrid mismatch rules and applicable with non-EU countries.

Controlled Foreign Company rules

The new article 164ter LITL introduced by this law sets out the Controlled Foreign Company (CFC) rules for the first time in Luxembourg tax legislation, in line with articles 7 and 8 of ATAD 1.

Broadly, this article defines a CFC as either a foreign collective undertaking or a foreign permanent establishment, the income of which is not taxable or is exempt in Luxembourg if the following criteria are fulfilled:

- In case of a foreign collective undertaking, the Luxembourg taxpayer, alone or with associated enterprises, directly or indirectly (i) holds more than 50 percent of voting rights, or (ii) holds more than 50 percent of capital, or (iii) is entitled to receive more than 50 percent of profits; and
- The actual CIT paid by the foreign collective undertaking or the foreign permanent establishment on its income is lower than the difference between the CIT that would have been paid on the same profits in Luxembourg and the actual CIT paid in the CFC state

The new regime does not apply to a CFC whose profits registered in the commercial balance sheet:

- Do not exceed €750,000; or
- Do not exceed 10 percent of its operating costs within the tax period (excluding the costs of goods sold outside the CFC's state of residence, as well as payments to associated enterprises)

Luxembourg opted for Option B foreseen in ATAD 1, meaning that it can tax the CFC's undistributed income arising from non-genuine arrangements that are put in place essentially for the purpose of obtaining a tax advantage.

This is to be interpreted as situations where Luxembourg resident companies have Significant People Functions (SPF) that manage assets of a CFC. Reference is clearly made here to transfer pricing concepts as developed amongst other under the BEPS action points. This choice thus demonstrates Luxembourg's full alignment with the OECD transfer pricing principles that are already reflected in its domestic legislation by application of articles 56 and 56bis LITL.

In addition, the Luxembourg law excludes Municipal Business Tax (MBT) from the scope of its CFC provisions, which means that (i) the test for determining CFC status will apply by comparing CIT paid by the CFC only to CIT that would have been paid in Luxembourg (i.e. excluding MBT); and (ii) CFC income attributable to Luxembourg will be subject only to Luxembourg CIT (i.e. not to MBT).

A tax credit is provided for taxes paid by the CFC, and an exemption is available for previously taxed income distributed by the CFC.

Following the views expressed by the Council of State in November on this regime, where a CFC permanent establishment is located in a European state, the national CFC rules would have to prevail over the application of double tax treaties provisions. However, where a CFC permanent establishment is located in a contracting state outside the European Union and the taxation right lies at the level of that state with exclusion of Luxembourg, national CFC rules would not apply due to primacy of double tax treaties over national law. This should be assessed on a case-by-case basis.

Interest limitation rules

A new article 168bis LITL introduces the new interest deduction limitation rules in line with article 4 of ATAD 1.

Under ATAD 1, the taxpayer's borrowing costs (broadly defined as interest expenses on all forms of debt and other costs economically equivalent to interest and expenses economically incurred in connection with the raising of finance) are always deductible to the extent of its taxable interest revenues and other economically equivalent taxable revenues. The deduction of any excess defined as "exceeding borrowing costs" is restricted to 30 percent of the taxpayer's tax-based EBITDA (earnings before interest, tax, depreciation and amortization).

Deductions for the following borrowing costs will not be limited in Luxembourg:

- Exceeding borrowing costs up to €3 million
- Exceeding borrowing costs incurred on loans concluded before 17 June 2016. The wording of the law was clarified in the parliamentary works by adopting the same formulation as in ATAD 1. The grandfathering shall not extend to any subsequent modification of concerned loans, meaning that, as mentioned in the ATAD's preamble, it would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan

- Exceeding borrowing costs incurred on loans used to fund EU long-term public infrastructure projects, subject to certain conditions
- Exceeding borrowing costs of standalone entities (i.e. entities with no associated enterprises or permanent establishments outside of Luxembourg)
- Exceeding borrowing costs of "financial undertakings." The definition of financial undertakings excluded from the scope of the interest expense limitation rules is broad and includes credit institutions, alternative investment funds, undertakings for collective investments in transferrable securities, insurance and reinsurance undertakings, as well as securitization vehicles as defined under relevant EU directives or regulations

Excess borrowing costs that cannot be deducted in a tax year will be allowed to carry forward indefinitely. Unused interest capacity (i.e. the amount by which 30 percent of EBITDA exceeds the amount of excess borrowing costs deducted) could be carried forward for up to five years.

In addition, under a group-wide test, excess borrowing costs of taxpayers with a ratio of equity to total assets that equals or exceeds the ratio of the taxpayer's consolidated group will be fully deductible if certain conditions are fulfilled.

The government has also committed to introduce the option allowing tax integrated groups to calculate their additional borrowing costs and EBITDA at the level of the integrated group. This addition should be introduced through a draft law to be deposited by the government to the Chamber of deputies in 2019 with a retroactive effect as from 1 January 2019.

General anti-abuse rule (GAAR)

The ATAD 1 GAAR provides that non-genuine arrangements put in 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 should be ignored. An arrangement is defined as non-genuine to the extent it is not put in place for valid commercial reasons that reflect economic reality.

Paragraph 6 of the Luxembourg Adaptation Law, which already contains a GAAR applicable to both corporations and individuals, is modified to bring it in line with ATAD 1 GAAR. Interestingly, the comments to the law specify that the taxpayer should still be entitled to use the most favorable tax route. This is in line with the ATAD's preamble under which a taxpayer should have the right to choose the most tax-efficient structure for its commercial affairs.

Other provision – foreign permanent establishments

A new paragraph has been added to the domestic law definition of a permanent establishment to put an end to conflicts of interpretation between domestic law and the provisions of a tax treaty and to address the difficulties that can arise when determining the degree of importance of the activities carried out in the other contracting state.

The assessment of an activity carried-out through a fixed place of business in a foreign country should in the first place be performed on the basis of the applicable double tax treaty. If there is no specific definition determining whether the taxpayer has a permanent establishment, the assessment should be performed by determining whether the activity, when considered in isolation, constitutes an independent activity and represents a participation to the general economic life in the foreign state.

The Luxembourg tax authorities are allowed to require a Luxembourg taxpayer claiming to have a permanent establishment in a foreign country to produce confirmation from the tax authorities of the country where the permanent establishment is located.

Other provision – conversion of loans

The new law also repeals a provision in Luxembourg income tax law allowing a bondholder to convert a loan into shares in a tax-neutral manner under the domestic rollover regime.

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