

## Luxembourg Tax Alert

### Law implementing ATAD 2 entered into force

6 January 2020

The Luxembourg law implementing the hybrid mismatch measures in ATAD 2 ([2017/952 EU Anti-Tax Avoidance Directive](#)) into domestic law was approved by the parliament and published on 23 December 2019.

The ATAD 2 is largely inspired by [Action 2](#) (Neutralizing the Effects of Hybrid Mismatch Arrangements) of the OECD's base erosion and profit shifting project. It extends the anti-hybrid provisions of ATAD 1 ([2016/1164 EU Anti-Tax Avoidance Directive](#)), which apply only to mismatches between EU Member States to hybrid mismatches with non-EU countries, and brings additional types of hybrid mismatches within the scope of the measures. The new law covers hybrid mismatches not yet covered by Luxembourg's current anti-hybrid provisions, such as imported mismatches, hybrid transfers, tax residence mismatches, and reverse hybrid mismatches.

The Luxembourg law largely follows the wording of ATAD 2, but also addresses certain concerns raised by the marketplace and provides clarifications and examples in the commentary. The new law replaces the provisions of article 168ter of the Income Tax Law (ITL) with a new article 168quater and adapts some related provisions of the ITL, such as the limitation on the deduction of foreign tax credits in the context of hybrid mismatches and measures in other laws.

Most of the provisions included in the new law apply as from fiscal years starting on or after 1 January 2020, with the exception of the provision targeting reverse hybrid mismatches (new article 168quater ITL), which will apply as from fiscal years closing in 2022.

#### **Additional comments at the time of the vote**

Following an opinion issued by the Council of State, the commission in charge of the law before the parliament (COFIBU) introduced some changes to the text of the law. However, none of those changes are material in nature and do not substantially modify the law.

The COFIBU decided not to include additional suggestions and interpretations prepared by the Council of State. According to the COFIBU, those interpretations may be confirmed or rejected at a later time in circulars or Grand Ducal regulations that may be issued if deemed necessary.

The following is an overview of all the provisions of the new law.

## Hybrid mismatch rules

### Scope and definitions

#### *Hybrid mismatch*

The hybrid mismatch rules will apply to Luxembourg companies, as well as permanent establishments (PEs) of non-resident companies.

A hybrid mismatch will be limited to situations arising (i) between associated enterprises (as defined), (ii) between a taxpayer and an associated enterprise, (iii) between a head office and its PE, (iv) between two or more PEs of the same company, or (v) under a structured arrangement (as defined), where one of the following occurs:

- a. A payment under a financial instrument gives rise to a “deduction without inclusion” and: (i) the mismatch is attributable to differences in the characterization of the instrument or the payment made under it, and (ii) the payment is not included in the jurisdiction of the payee in a tax period that starts within 12 months of the end of the payer’s tax period unless it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the payment terms are at arm’s length;
- b. A payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch results from differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established and the jurisdiction of any person with a participation in that hybrid entity. A hybrid entity is defined as any entity or arrangement that is regarded as taxable under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;
- c. A payment to an entity with one or more PEs gives rise to a deduction without inclusion and that mismatch results from differences in the allocation of payments between the head office and the PE or between two or more PEs of the same company under the laws of the jurisdictions where the company operates;
- d. A payment gives rise to a deduction without inclusion as a result of a payment to a disregarded PE, i.e. an arrangement treated as a PE under the laws of the head office jurisdiction but not under the laws of the other jurisdiction;
- e. A payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch results from the fact that the payment is disregarded under the laws of the payee jurisdiction (unless the deduction is offset against dual-inclusion income, i.e. income included under the laws of both jurisdictions where the mismatch arises);
- f. A deemed payment between a head office and a PE or between two or more PEs gives rise to a deduction without inclusion and that mismatch results from the fact that the payment is disregarded under the laws of the payee jurisdiction (unless the deduction is offset against dual-inclusion income, as defined above); or
- g. A double deduction occurs, unless the deduction is offset against dual inclusion income, as defined above. A double deduction is defined as a deduction of the same payment, expenses or losses in (i) the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and (ii) in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity

or PE, the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated.

## *Payment*

The new legislation does not provide a specific definition of the term “payment”, but the commentary to the law quotes the OECD BEPS action 2 report recommendation, according to which a payment is defined as a transfer of money, which includes money’s worth. It also covers all amounts that are capable of being paid, such as a future or conditional obligation, as well as partial payments. Commitments to pay also fall within the scope of this definition.

On this basis, deductions such as for depreciation and amortization are not characterized as payments but could be denied under the double deduction rules described above, which also apply to expenses and losses.

As stated in the commentary to the new law, the following will not be considered to give rise to a hybrid mismatch:

- Payments under financial instruments, where the tax relief granted in the payee jurisdiction is due solely to (i) the tax status of the payee (e.g. a tax-exempt investment fund or a tax-exempt sovereign wealth fund), or (ii) the fact that the instrument is held subject to the terms of a special tax regime;
- Payments (i) to a hybrid entity or PE, (ii) to a disregarded PE, (iii) by a hybrid entity to its owner, and (iv) deemed payments made (a) between a head office and a PE or (b) between two or more PEs if the mismatch would have occurred in any event due to the tax-exempt status of the payee;
- Instruments that have been issued with the sole purpose of meeting the issuer’s loss-absorbing capacity requirements; and
- Differences in tax outcomes that are attributable solely to differences in the value ascribed to a payment, including through the application of transfer pricing rules.

As mentioned in the commentary to the new law, to determine whether a payment under a financial instrument results in a hybrid mismatch, it will be necessary to know the identity of the counterparty and the tax rules applicable in its jurisdiction.

## *Inclusion*

The term “inclusion” is defined as an amount that is included as ordinary income in the taxable base in the jurisdiction of the payee, defined as any jurisdiction where the payment is received or deemed to be received by virtue of the laws of any other jurisdiction. An amount will be considered “included” where Luxembourg is the payee jurisdiction if the payment is included in the taxpayer’s total net revenue. Therefore, an inclusion in the taxable base of the payee appears to be sufficient even if the income will not be effectively taxed (e.g. as a result of existing net operating losses). However, a payment made under a financial instrument is not considered included to the extent that it benefits from a tax relief that is solely due to the characterization of the payment in the jurisdiction of the payee.

## *Structured arrangements*

A structured arrangement is an arrangement involving a hybrid mismatch, where the mismatch is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch. This will not apply if the taxpayer or an associated enterprise reasonably could not have been expected to be aware of the hybrid mismatch and neither the taxpayer nor the associated enterprise benefited from the advantage resulting from the hybrid mismatch.

## *Associated enterprise*

For purposes of the hybrid mismatch rules, an associated enterprise generally is defined as (i) an entity in which the taxpayer holds, directly or indirectly, a 50 percent or greater voting, capital or profit interest, or (ii) an individual or entity that holds, directly or indirectly, a 50 percent or greater voting, capital or profit interest in the taxpayer. If an individual or entity holds, directly or indirectly, a 50 percent or greater interest in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, also will be treated as associated enterprises.

Where the hybrid mismatch involves a payment made under a financial instrument, the 50 percent threshold will be decreased to 25 percent.

The definition of associated enterprise includes an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has significant managerial influence or an enterprise that has a significant managerial influence over the taxpayer.

In addition, to prevent situations where participations could be transferred to third parties to circumvent the ATAD 2, an individual or entity that acts together with another individual or entity with respect to the voting rights or capital ownership in another entity will be treated as holding the other individual's or entity's participation. However, unless proven otherwise by the tax authorities, an individual or entity holding, directly or indirectly, less than a 10 percent ownership and profit interest in an investment fund will not be treated as acting together with another individual or entity holding an interest in the same investment fund.

This clarification is welcome and relevant to the fund industry since, as mentioned in the commentary to the new law, in principle, investors in investment funds do not have effective control over the investments made by the fund. For this purpose, an investment fund is defined as a domestic or foreign collective investment undertaking that raises capital from a number of investors in order to invest the capital in accordance with a defined investment policy that is in the investors' interest.

## **Primary and defensive rules**

### *Deduction/no inclusion*

To the extent that a hybrid mismatch results in a deduction without inclusion and Luxembourg is the payer jurisdiction, the deduction will be denied in Luxembourg under the primary rule.

If Luxembourg is the payee jurisdiction and the deduction is not denied in the payer jurisdiction, income will be taxable in Luxembourg under the defensive rule up to the amount of the payment that otherwise gives rise to a mismatch. This clarification confirms the view expressed in the BEPS action 2 report that anti-hybrid measures are anti-abuse provisions solely aimed at neutralizing the effect of a mismatch, i.e. only to the extent of the mismatch amount (e.g. if only EUR 20 of a single payment of EUR 100 results in a deduction without inclusion, the deduction should be denied for EUR 20 and not for the full EUR 100).

A payment under a hybrid financial instrument will not be considered to give rise to a deduction without inclusion if the mismatch is neutralized in the other jurisdiction based on a special rule.

The defensive rule will not apply to hybrid mismatches described in b), c), d) and f) above. Thus, for example, a payment to a disregarded PE giving rise to a deduction without inclusion will not be taxable in Luxembourg under the defensive rule unless the PE is located in an EU Member State and the income is otherwise exempt under a tax treaty. In this case, income will be included in the income of the Luxembourg head office regardless of the fact that the treaty between the PE's country of residence and Luxembourg will otherwise exempt the income from Luxembourg tax.

Until 31 December 2022, the primary and defensive rules also will not apply to hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:

- The financial instrument has conversion, bail-in or write-down features;
- The financial instrument has been issued with the sole purpose of satisfying loss-absorbing capacity requirements applicable to the banking sector and the financial instrument is recognized as such by the taxpayer;
- The financial instrument has been issued (i) in connection with financial instruments with conversion, bail-in or write-down features at the level of the parent entity, (ii) at a level necessary to satisfy applicable loss-absorbing capacity requirements, and (iii) not as part of a structured arrangement; and
- The overall net deduction for the consolidated group under the arrangement does not exceed the amount that would have been deductible had the taxpayer issued the financial instrument directly to the market.

### *Double deduction*

To the extent that a hybrid mismatch results in a double deduction and Luxembourg is the investor jurisdiction, the deduction will be denied in Luxembourg under the primary rule.

The deduction also will be denied in Luxembourg under the defensive rule if Luxembourg is the payer jurisdiction and the deduction is not denied in the investor jurisdiction.

However, a double deduction could still be set off against dual-inclusion income, defined as income included under the laws of both jurisdictions where the mismatch arises.

## *Imported mismatch*

A deduction will be denied for a payment on a regular non-hybrid instrument to the extent that the payment directly or indirectly funds a deductible expenditure giving rise to a hybrid mismatch (as defined above), unless one of the jurisdictions involved in the transaction has already made an equivalent adjustment.

## **Tax residence mismatches**

The new law targets tax residence mismatches whereby payments, expenses or losses are deductible in two jurisdictions because a taxpayer is resident for tax purposes in two or more jurisdictions. In this situation, Luxembourg will deny the deduction to the extent that (i) the other jurisdiction allows a duplicate deduction, unless that duplicate deduction is set off against dual-inclusion income (as defined above), or (ii) the other jurisdiction is an EU Member State where the taxpayer is deemed to be a Luxembourg resident according to the tax treaty with the other Member State.

Those rules will apply to Luxembourg companies, as well as to PEs of non-resident companies.

## **Hybrid transfer rules**

The new anti-hybrid rules also target hybrid transfers, i.e. arrangements where a financial instrument is transferred and the underlying return is treated as derived by more than one of the parties to the arrangement. Those rules will apply to Luxembourg companies and to PEs of non-resident companies.

If the hybrid transfer gives rise to a deduction without inclusion, the primary and defensive rules described above will apply. The hybrid transfer rules notably target sale and repurchase transactions, as well as securities lending transactions.

However, a payment representing the underlying return on a transferred financial instrument will not give rise to a hybrid mismatch if the payment is made by a financial trader under an "on-market hybrid transfer" (i.e. a hybrid transfer that is entered into by a financial trader in the ordinary course of business and not as part of a structured arrangement) and if the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument.

## **Reverse hybrid rules**

Under the new law, reverse hybrid rules will apply as from fiscal years closing in 2022. They will target reverse hybrid entities, defined as entities incorporated or established in Luxembourg that are treated as transparent for Luxembourg tax purposes (e.g. limited partnerships such as SCS or SCSp), but that are viewed as Luxembourg taxable persons by one or more non-resident associated enterprises holding in the aggregate, directly or indirectly, at least 50 percent of the voting rights, capital ownership or profit interest in such hybrid entity.

In such a situation, under new article 168quater ITL, an entity incorporated or established in Luxembourg will be considered a Luxembourg resident and its income will be subject to corporate income tax to the extent this income will not otherwise be taxed under the laws of Luxembourg or any other jurisdiction. With respect to such income, this entity will be considered a taxpayer subject to corporate income tax. However, the entity will not be subject to municipal business tax or net worth tax.

The above reverse hybrid mismatch rule will not apply to a collective investment vehicle, defined as an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. For Luxembourg, this will include collective investment funds under the law of 2010 (UCIs), specialized investment funds under the law of 2007 (SIFs), Luxembourg reserved alternative investment funds under the law of 2016 (RAIFs) and other qualifying alternative investment funds under the law of 2013 (AIFs). It appears that the new legislation does not refer to Investment Companies in Risk Capital under the law of 2014 (SICARs) that also can be established under the form of an SCS or an SCSp. The reason for this omission is unclear.

## Documentation requirements

For all hybrid mismatches covered by new articles 168ter and 168quater ITL, the taxpayer will have to provide, upon request, documentation demonstrating that the hybrid mismatch provisions do not apply. Since, under Luxembourg tax law, the taxpayer has an obligation to prove the accuracy of its tax return, failure to comply with this obligation will result in a tax adjustment.

Therefore, as stated in the commentary to the new law, the taxpayer could be asked to prove that, depending on the case:

- No hybrid mismatch was used
- The deduction was denied in the jurisdiction of the payer (deduction without inclusion) or in the jurisdiction of the investor (double deduction)
- The payment does not directly or indirectly finance deductible expenses giving rise to a hybrid mismatch
- A hybrid transfer was not used to obtain withholding tax relief with respect to a payment on a transferred financial instrument
- Payments, expenses or losses are not deductible against income that is not dual-inclusion income in another jurisdiction where the taxpayer also is resident.

For example, in the case of payments under a financial instrument, the taxpayer will have to estimate the expected tax treatment in the jurisdiction of its counterparty and be able to justify that estimate to the Luxembourg tax authorities in order to sustain the deduction.

Thus, the taxpayer will have to be in a position to provide a declaration from the issuer of the financial instrument, or any other relevant documentation such as tax returns, tax documents or statements issued by the tax authorities of the other jurisdiction. The taxpayer also will have to be able to provide detailed, objective and verifiable information about the tax laws of the other jurisdiction.

## Next steps

Most of the provisions included in the new law apply as from fiscal years starting on or after 1 January 2020, with the exception of the provision targeting reverse hybrid mismatches, which will apply as from fiscal years closing in 2022.

It is possible that additional clarifications and commentaries will be issued to clarify the interpretation and application of the above provisions.



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