ATAD 1 – Luxembourg draft Bill for implementation reveals choices made by Luxembourg Government

20 June 2018

In brief

The EU Anti Tax Avoidance Directive ("ATAD 1") was published in July 2016. EU Member States have until 31 December 2018 to transpose ATAD 1 into their domestic laws.

On 19 June 2018, the Luxembourg Government tabled a draft Bill (n°7318) (the "Draft Law"), previously approved by the Government council on 15 June 2018, before the Luxembourg Parliament (Chambre des Députés) that would implement ATAD 1 as Luxembourg domestic law. This Draft Law still needs to go through the Luxembourg legislative process, and may be subject to amendments before the final vote by the Luxembourg Parliament.

In some areas, ATAD 1 gives EU Member States different options and choices in transposition. The Draft Law reveals the choices made by the Luxembourg Government.

The Draft Law will come into force on 1 January 2019 with respect to the following measures:

- interest limitation rules (BEPS AP4) – Article 4 of ATAD 1
- controlled foreign company rules "**CFC**" (BEPS AP 3) – Articles 7 and 8 of ATAD 1
- intra-EU anti-hybrid rule (BEPS AP 2) – Article 9 of ATAD 1
- general anti-abuse rule "**GAAR**" - Article 6 of ATAD 1.

The exit tax rules (Article 5 of ATAD I) will come into force on 1 January 2020.

The Draft Law also includes two additional amendments to the domestic law, both not directly linked to the ATAD 1 text. These measures concern tax neutral exchanges, and the domestic definition of permanent establishment.

The Directive amending ATAD 1 regarding hybrid mismatches with third countries ("**ATAD 2**") is not part of the Draft Law, but will be implemented at a later stage. These measures do not have to come into force in Luxembourg until 1 January 2020.

Interest Limitation rules

The Draft Law introduces a new Article 168*bis* into the text of the principal legislation (the Income Tax Law of 4 December 1967 (“**LITL**”)), setting out new interest deduction limitation rules in line with Article 4 of ATAD 1. The Draft Law shows that Luxembourg has taken almost all of the relieving options offered by ATAD 1.

Taxpayers in scope

The interest limitation rule applies to corporate taxpayers resident for tax purposes in Luxembourg and subject to corporate income tax (“*impôt sur le revenu des collectivités*”), and to Luxembourg permanent establishments of companies resident in another EU Member State or a third country.

Luxembourg however exercised the options offered by Article 4(7) and 4 (3) (b) of ATAD 1, and thus excludes from the scope of application of the interest limitation rules “financial undertakings” and “standalone entities”, each as defined in ATAD 1.

The **financial undertakings** listed in the Draft Law are each types of entities regulated by an EU Directive or Regulation:

- a **credit institution** or an **investment firm** as defined in point (1) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council or an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council or an undertaking for collective investment in transferable securities (UCITS) management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council

- an **insurance undertaking** as defined in point (1) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council

- a **reinsurance undertaking** as defined in point (4) of Article 13 of Directive 2009/138/EC

- an institution for **occupational retirement provision** falling within the scope of Directive 2003/41/EC of the European Parliament and of the Council, unless a Member State has chosen not to apply that Directive in whole or in part to that institution in accordance with Article 5 of that Directive or the delegate of an institution for occupational retirement provision as referred to in Article 19(1) of that Directive

- **pension institutions** operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council and Regulation (EC) No 987/2009 of the European Parliament and of the Council as well as any legal entity set up for the purpose of investment of such schemes

- an **alternative investment fund** (AIF) managed by an AIFM as defined in point (b) of Article 4(1) of Directive 2011/61/EU, or a Luxembourg AIF supervised under the SICAR regime

- **UCITS** within the meaning of Article 1(2) of Directive 2009/65/EC

- a **central counterparty** as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council

- a **central securities depository** as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council.

Luxembourg has also added to the list of types of financial undertaking set out in ATAD 1, **securitisation vehicles** that are governed by Article 2 point 2 of Regulation (EU) 2017/2402 ("simple, transparent and standardized securitisation"). As this regulation was adopted after ATAD 1 and ATAD 2, this addition is in our view entirely appropriate. It should be noted that all other securitisation vehicles remain within the scope of the Draft Law.

A **stand-alone entity** is a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment situated in a country other than Luxembourg.

Expenditure within the scope of the limitation rule

Taxpayers not excluded from the scope of application of the interest limitation rule will be subject to a limitation of the deductibility of interest and some other broadly similar types of costs, together referred to as "borrowing costs".

General Rules

The limitation will apply to **"exceeding" borrowing costs**. These are defined as the **tax deductible** borrowing costs that are in excess of the taxable interest revenues and other economically equivalent taxable income of the taxpayer.

ATAD 1 stipulates that "**interest revenue** and other economically equivalent taxable income" is to be defined under Member States' domestic law. However, the Draft Law does not provide any definition or guidance for interpretation of what constitutes interest revenue and other economically equivalent taxable income under Luxembourg domestic law. Nevertheless, it is expected that interest revenue should be defined by symmetry, and thus include at least the items listed below in the Draft Law definition of "borrowing costs".

Borrowing costs are defined by the Draft Law as interest expenses on all forms of debt and other costs economically equivalent to interest and expenses incurred in connection with the raising of finance. The Draft Law includes the same non-limitative list of elements as set out in ATAD 1 that are to be considered as borrowing costs.

This list includes:

- Remuneration due under profit participating loans
- Imputed interest on instruments such as convertible bonds and zero coupon bonds
- Amounts disbursed under alternative financing arrangements, such as Islamic finance
- Interest due under finance leases
- Capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest
- Amounts measured by reference to a financial 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 financing
- Guarantee fees for financing arrangements
- Arrangement fees and similar costs related to the borrowing of funds.

The rule applies to any financing, **irrespective of whether provided by related parties or third parties**.

As a result, borrowing costs are fully deductible up to the amount of interest revenues and other economically equivalent taxable income of the taxpayer. Only borrowing costs in excess of interest revenue are "exceeding" borrowing costs that are subject to the interest limitation rule.

The exceeding borrowing costs of a taxpayer will be deductible in any tax period only up to the higher of i) 30 % of the taxpayer's net revenues before interest, tax, depreciation and amortisation ("**EBITDA**"); or ii) EUR 3 million.

Exempt income, and expenses connected to such exempt income, are not to be taken into account for the computation of EBITDA. Depreciation and amortisation added back for the computation of EBITDA are the amounts of depreciation and amortisation deductible for tax purposes.

Specific exceptions

Grand-fathering of loans concluded before 17 June 2016

When determining the amount of exceeding borrowing costs, a taxpayer may exclude borrowing costs arising from debt concluded before 17 June 2016 (Article 4 (4) (a) of ATAD 1). The exclusion shall not extend to any subsequent modification of the debt instrument or agreement.

Long-term infrastructure projects

When determining the amount of exceeding borrowing costs, a taxpayer may exclude borrowing costs arising from long-term infrastructure projects where the project operator, borrowing costs, assets and income are all in the European Union (Article 4 (4) (b) of ATAD 1). A long-term infrastructure project is a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered to be in the general public interest by a Member State.

Groups

Group equity ratio

A taxpayer that is a member of a consolidated group for financial accounting purposes may deduct in full its exceeding borrowing costs, if it can demonstrate that the ratio of its equity to its total assets is equal to or higher than the equivalent ratio of the group (Article 4 (1) (a) of ATAD 1). The equity ratio of the taxpayer can be considered as equal to or equivalent if it is lower than the equity ratio of the group by up to 2 %. The comparison has to be made based on the same valuation method at both the taxpayer and group level, either under IFRS or under the financial information system of a Member State.

Carry forward

Exceeding borrowing costs not deductible in a tax period may be carried forward without time limitation. Interest capacity which cannot be used in a given tax period may be carried forward for 5 years (Article 4 (6) (c) of ATAD 1).

Interaction with other provisions of Luxembourg law

The Draft Law does not provide for any amendment to other, pre-existing, Luxembourg tax provisions limiting deductions of interest, such as the "recapture" rules within the participation exemption regime. Interaction between these measures (and other rules limiting deduction) and the new Article 168*bis* will thus have to be considered.

Controlled Foreign Company Measures

The draft law introduces a new Article 164*ter* into the LITL, setting out new controlled foreign company ("CFC") rules in line with Articles 7 and 8 of ATAD 1.

Luxembourg has opted for **option B**, as foreseen by Article 7 (2) (b) of ATAD 1, thus targeting non-distributed income of CFCs arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

The CFC rules apply to corporate taxpayers resident for tax purposes in Luxembourg and subject to corporate income tax ("*impôt sur le revenu des collectivités*"), and to Luxembourg permanent establishments of companies resident in another EU Member State or a third country.

Definition of a Controlled Foreign Company

Two cumulative conditions have to be fulfilled before an entity or permanent establishment can be considered as a CFC.

<u>Control Test</u>

An entity is a controlled entity if the taxpayer by itself, or together with its associated enterprises, holds a direct or indirect participation of more than 50% of the voting rights or capital, or is entitled to receive more than 50% of the profits, of that entity.

For the purpose of this definition an **associated enterprise** is

- Any entity (including a partnership), resident or not, in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or is entitled to receive 25% or more of the profits of that entity
- an individual, or any entity (including a partnership), resident or not, which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25% or more, or is entitled to receive 25% or more of the profits of the taxpayer.

If an individual, or any entity (including a partnership), resident or not, holds directly or indirectly a participation of 25% or more in both a taxpayer and one or more entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

With respect to a permanent establishment, the control test is expected to be met by definition.

<u>Effective tax rate ("ETR") Test</u>

There will be a CFC if the actual corporate income tax paid by the entity or permanent establishment on its profits is lower than 50% of the corporate income tax charge which would have been payable in Luxembourg under Luxembourg domestic tax rules, had the entity or permanent establishment been resident or established in Luxembourg.

The comparison is made by reference to the corporate income tax rate applicable in Luxembourg (18% in 2018), and hence by reference to a rate of 9% in 2018. We cannot exclude the possibility that this rate might decrease in the coming years.

Targeted Income

When an entity or permanent establishment meets the control test and the ETR test, the taxpayer must include in its taxable basis the <u>non-distributed income</u> of the entity or permanent establishment, to the extent arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage.

Non-genuine arrangement test

The Draft Law, in line with Article 7 (2) (b) of ATAD 1, provides that an arrangement or series thereof shall be regarded as non-genuine to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions linked to those assets and risks, are carried out and play an essential role in generating the controlled company's income.

Some commentators take the position that the assessment of the genuine character of the arrangement may have to be made in the light of the EU "freedoms", and may not extend beyond criteria set by the ECJ in the Cadbury Schweppes judgement (C-196/04).

Exceptions

CFCs as follows are excluded from the scope of the application of the new Article 164*ter*

i) those with accounting profits of no more than EUR 750,000; or
ii) those for which the accounting profits amount to no more than 10% of their operating costs for the period. The costs of goods sold outside the country where the entity is resident or where the permanent establishment is established, and payments to associated enterprises, cannot be included as operating costs.

Inclusion rules

In line with Article 8 (2) of ATAD 1, a Luxembourg taxpayer having a CFC with income arising from a non-genuine arrangement will have to include in its taxable base the non-distributed income of the CFC, up to a limit of the amount of such income that is generated through assets and risks which are linked to "significant people functions" carried out by the taxpayer.

The identification of the "significant people functions", and the attribution of profit thereto, is to be assessed based on the arm's length principle included in the LITL under Article 56 and 56*bis*.

The net income included is considered to be commercial profit. Expenses economically linked to the CFC income included are deductible.

In the event that the CFC has negative income, no inclusion is made. The losses of the CFC may be carried forward and used to offset future positive income of the CFC. Only the negative net income of the CFC generated after the entry into force of Article 164*ter* is deductible.

The CFC income to be included in the tax base of the taxpayer is to be calculated in proportion to the taxpayer's participation in the CFCs (direct or indirect).

The CFC income must be included in the tax period of the taxpayer in which the tax year of the CFC ends.

Income included as CFC income is not subject to municipal business tax.

Avoidance of double taxation

Luxembourg may have to grant a credit for the tax paid by the CFC against the tax on the income included in the Luxembourg tax base of the taxpayer.

When the CFC distributes a dividend, or the Luxembourg taxpayer realises a gain on the shares of the CFC, and the dividend or gain is taxable under Luxembourg domestic laws, the income already included as CFC income may be deducted when computing the amount of the dividend or gain subject to Luxembourg tax.

Hybrid Mismatches

Many commentators had taken the position that the rules dealing with "hybrid mismatch" situations set out in Council Directive (EU) 2017/952 (“ATAD 2”), to be transposed into domestic law by 1 January 2020, completely superseded Article 9 of ATAD 1, and hence that EU Member States did not have to implement any "hybrid mismatch" measures before 1 January 2020.

The Luxembourg Government has however decided to introduce ATAD 1 anti-hybrid provisions for calendar year 2019, covering only intra-EU hybrid instruments and hybrid entity mismatches, in a new Article 168*ter* LITL. The hybrid mismatches measures of ATAD 2, covering a wider range of intra-EU mismatches, but also mismatches with third countries, will be included in a subsequent law expected in the course of 2019, and having effect from 1 January 2020.

Article 168*ter* LITL closely follows Article 9 of ATAD 1. A “hybrid mismatch” is defined as arising when differences in the legal characterisation of a financial instrument or entity in an arrangement structured between the taxpayer and a party in another Member State, or when the commercial or financial relations between a taxpayer and a party in another Member State, give rise to the following consequences:

a) a deduction of the same expenses or losses occurs both in Luxembourg, and in another Member State where the expenses or losses originated (“double deduction”); or
b) there is a deduction of an expense in Luxembourg in which the deduction has its source, without a corresponding inclusion of the corresponding income in the total net revenues in the other Member State (“deduction without inclusion”).

A taxpayer for the purpose of this provision is either a corporate entity resident in Luxembourg within the meaning of Article 159 LITL, or a Luxembourg permanent establishment of an entity not resident in Luxembourg covered by Article 160 LITL.

For the purpose of this provision an associated enterprise is:

- Any entity (including a partnership), resident or not, in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or is entitled to receive 25% or more of the profits, of that entity; or
- an individual, or any entity (including a partnership), resident or not, which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25% or more, or is entitled to receive 25% or more of the profits of the taxpayer.

If an individual, or any entity (including a partnership), resident or not, holds directly or indirectly a participation of 25% or more in a taxpayer and one or more other entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

For the purposes of Article 168*ter* LITL, and where the mismatch involves a hybrid entity, this definition is modified so that the 25% requirement is replaced by a 50% requirement.

The elimination of the tax advantage arising from a hybrid mismatch, as defined above, is to be effected as follows:

a) 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;
b) To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

Upon a request by the Luxembourg tax authorities, the taxpayer has to be able to provide a declaration of the issuer of the financial instrument, or any other relevant material such as tax returns, other tax documents or certificates issued by tax authorities of the other Member State, evidencing the tax treatment of the income or expense or loss in the other Member State.

General Anti-Abuse Rules

Under the Draft Law Luxembourg is to adapt and modernise its existing general anti-abuse rule as provided by §6 of the Adaptation Law ("*Steueranpassungsgesetz*" or "StAnpG") of 16 October 1934. "Abuse of law" criteria and general practice have been developed progressively over recent years by authors and judges.

The four criteria set by case law are as follows:

- Use of private law forms
- Tax savings or reductions
- Use of an inappropriate route
- Absence of non-tax reasons / valid commercial reasons for the transaction.

The text of §6 StAnpG paragraph 1 is augmented, to define more precisely what constitutes an "abuse of law" within the meaning of the existing paragraph 1.

Under the Draft Law text, there is an abuse of law if the legal route which, having been used for the main purpose or one of the main purposes of circumventing or reducing tax contrary to the object or purpose of the tax law, is not genuine having regard to all relevant facts and circumstances.

The legal route, which may comprise more than one step or part, shall be regarded as non-genuine to the extent that it was not used for valid commercial reasons which reflect economic reality.

The new text, while adapted to reflect the content of Article 6 of ATAD 1, is designed to preserve legal certainty derived from existing case law on the subject. It is therefore expected that it should not change materially the criteria and general practice as developed by Luxembourg authors and judges.

Exit Tax

Luxembourg already has exit tax rules, as introduced by a law of 26 May 2014, compliant with EU law. The Draft Law modifies these existing rules by fully restating the existing Article 38 LITL to cover expressly all the cases foreseen by ATAD 1, and amends the existing taxation deferral rules of § 127 of the General Tax Law ("*Abgabenordnung*" or "AO") to provide for a payment of tax in instalments over 5 years.

The payment of the Luxembourg tax arising on the gains upon transfer of assets outside Luxembourg in any of the circumstances listed in ATAD 1 may be made in instalments over a period of 5 years.

However, this is possible only where the transfer is to an EU Member State, or an EEA State with which Luxembourg has an agreement on the recovery of taxes.

According to the Draft Law, the entitlement to payment in instalments over a period of 5 years is also available to individuals transferring assets that form part of their business wealth.

No guarantee will be required from, nor will interest be charged to, taxpayers opting for payment of tax in instalments.

The right to deferral of payment of tax is however to be immediately discontinued, and the balance of the tax debt becomes immediately recoverable in the event of:

- a sale or other disposal of the assets or business transferred under the deferral regime; or
- a transfer of the assets or business or tax residence to a third country; or
- the taxpayer becomes bankrupt or is wound-up; or
- the taxpayer fails to pay instalments when due; or
- the taxpayer does not document annually the fact that the events listed above had not occurred.

The amendments to Luxembourg laws as provided for in the Draft Law with respect to exit tax rules should apply to transfers occurring during tax years starting after 1 January 2020.

Existing tax deferrals, granted by application of § 127 paragraphs 2 and 3 AO before 1 January 2020, remain unaffected by the amendments set out in the Draft Law.

Other provisions

The Draft Law includes two additional amendments to the Luxembourg tax legislation.

Modification of Article 22*bis* LITL dealing with tax-free exchanges

The Draft Law deletes Article 22*bis* (2) (1) LITL. This currently allows tax neutrality on an exchange of assets arising from the conversion of convertible debt into shares. For financial years beginning as from 1 January 2019, conversion of a convertible debt into shares will thus be considered as a sale of the convertible debt at fair market value, followed by the acquisition of shares at fair market value. The capital gain arising from this transaction may no longer be rolled-over into shares received in exchange, but must be treated as realised and subject to tax at the time of conversion.

Modification of § 16 of the Luxembourg Adaptation Law

§ 16 StAnpG of 16 October 1934 defines a permanent establishment under Luxembourg domestic law.

The Draft Law amends § 16 StAnpG by adding a new paragraph 5, designed to resolve conflicts of interpretation on the existence of a permanent establishment resulting from the interaction between the provisions of domestic law and the provisions of the relevant double tax treaty.

This new paragraph 5 provides that the definition of a permanent establishment is to be construed solely on the basis of the criteria mentioned by the double tax treaty.

Under this new paragraph 5, the Luxembourg tax authorities may request from the taxpayer a confirmation from the other Contracting State, through any relevant document, that it effectively recognises the existence of a permanent establishment in its territory.

The relevance of this amendment to §16 StAnpG on the application of the exemption method for the avoidance of double taxation provided for in the majority of the double tax treaties concluded by Luxembourg, in the absence of any modification of the relevant double tax treaties themselves, remains to be analysed in more detail.

Entry into force

For taxpayers within its scope, the provision of the Draft Law will apply for tax years starting as from 1 January 2019, except for the provisions relating to exit tax, which apply to tax years starting as from 1 January 2020.

In conclusion

This Draft Law is further clear indication of Luxembourg's willingness to comply fully with EU tax initiatives and to adapt to a "post-BEPS" international tax environment.

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