Luxembourg adopts the ATAD as well as two other important provisions

Summary

The draft bill n°7318 (Bill) implementing the first Anti-Tax Avoidance Directive\(^1\) (ATAD) has been adopted on 18 December 2018\(^2\). Furthermore, pursuant to the comments expressed by the Chamber of Commerce and Council of State on respectively 5 October 2018 and 13 November 2018, a motion has been voted on 18 December 2018 to add the option stated in article 4 (1) a of the ATAD but not included in the Bill. This option related to the interest limitation rule will allow tax integrated groups to compute their additional borrowing costs and EBITDA at the level of the integrated group. The motion also requires to further analyse the situation of the securitization vehicles within the scope of the ATAD.

The new provisions will be applicable as of 1 January 2019 except for the exit tax rule which will enter into force on 1 January 2020. The final Bill also states that the modified §6 Steueranspassungsgesetz related to the general anti-abuse rule will apply as from tax year 2019.

As a reminder, the Bill introduces the following provisions:

- Interest limitation rules
- Controlled Foreign Company rules
- Intra-EU anti-hybrid rules
- General Anti-Abuse Rule
- Exit tax rules
- Other important provisions (art.22bis LITL and §16 StAnpG)

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\(^1\) Directive (EU) 2016/1164 of 12 July 2016

\(^2\) In principle, all government and parliament bills must go through two successive votes by the Chamber on the law as a whole. There must be an interval of at least three months between the two votes. However, Parliament may exempt itself from the second vote to the extent the Council of State agrees with this exemption which is most often the case in practice.
Interest deduction limitation rule (New Article 168 bis Luxembourg Income Tax Law or LITL)

- The rule

According to the Bill, “exceeding borrowing costs” (very broadly defined) incurred by a taxpayer in a tax period are only deductible up to the higher amount of 30% of the taxpayer’s earnings before interest, tax, depreciation and amortisation (EBITDA) or EUR 3 million. Exempt income and expenses in direct economic connection with exempt income are excluded from the computation of EBITDA.

Luxembourg decided to apply the safe harbor rule offered by article 4(3) of the ATAD allowing the deduction of exceeding borrowing costs up to a maximum amount of EUR 3 million.

- Taxpayers

The rule applies to corporate taxpayers residents for tax purposes in Luxembourg and subject to corporate income tax and to Luxembourg permanent establishments (PE) of companies resident in another EU Member States. However, in accordance with the options offered by article 4(3)(b) and article 4(7) of the ATAD, the Bill foresees that the interest deduction limitation rule does not apply to certain categories of taxpayer. Indeed, stand-alone entities and specific listed financial undertakings remain outside the scope of the interest deduction limitation rule.

"Stand-alone entities" are defined by the Bill as entities being not part of a consolidated group for financial accounting purposes and entities having no associated enterprise or PE located in another country.

The list of “financial undertakings” provided by the Bill is in line with the list provided by article 2(5) of the ATAD including credit institutions, investment firm, insurance undertaking, reinsurance undertaking, occupational retirement institutions, pension institutions, alternative investment fund, UCITS, central counterparty, central securities depository.

However, the list of the Bill goes beyond the original list contained in the ATAD since securitization vehicles governed by article 2 point 2 of Regulation (EU) 2017/2402 (only) are also excluded from the scope of the interest deduction limitation rule. This is an appropriate measure considering the specific tax regime applicable to securitization vehicles in Luxembourg (i.e., distributions and commitments to distribute to shareholders are deductible from the taxable basis of securitization vehicles).

- Exceeding borrowing costs

According to the Bill, the limitation only applies to “exceeding borrowing costs” incurred by the taxpayer. The notion of “exceeding borrowing costs” refers to the portion of borrowing costs that exceeds taxable interest income and other economically equivalent taxable income derived by the taxpayer.

As such, the interest deduction limitation rule should not impact taxpayers engaged in back-to-back financing activities for which an arm’s length remuneration is derived.

The notion of “borrowing costs” includes interest expenses on all form of debt and other costs economically equivalent to interest as well as expenses incurred in relation to financing. In particular, the Bill provides a non-exhaustive list of “borrowing cost” which includes, among others, remuneration under profit participating loans, interest expenses on convertible bonds and zero coupon bonds, notional interest on derivative instruments, etc.
The provisions apply to any financing and do not distinguish those provided by related parties and those provided by third parties.

**Exceptions**

A grandfathering clause contained in the Bill in line with article 4(4)(a) of the ATAD provides that the rule should not apply to loans concluded before 17 June 2016. However, if such loans are amended after this date, the interest limitation rule should apply.

Similarly, loans used to fund long-term public infrastructure located in the EU are outside the scope of the interest deduction limitation rule to the extent the long-term infrastructure project provides, upgrades, operates or maintains a large-scale asset which must be considered as being of general public interest. The Bill is in line with article 4(4)(b) of the ATAD.

- **Entities of consolidated groups**

In accordance with Article 4(5)(a) of the ATAD, the Bill contains an special provision under which, a consolidated entity for financial accounting purposes may fully deduct “exceeding borrowing costs” if it can demonstrate that the ratio of its equity over total assets is equal or higher than the equivalent ratio computed at the consolidated group level.

- **Exceeding borrowing costs carried forward**

In accordance with the options offered by article 4(6)(a) and (c) of the ATAD, the Bill allows taxpayers to carry-forward for an unlimited period of time the amount of “exceeding borrowing costs” incurred in a tax period which cannot be deducted and to carry-forward during a 5-year maximum period their unused interest capacity of deduction.

As mentioned above, the Chamber of Commerce and the Council of State in their comments regretted the choice of the government not to opt as offered by the ATAD for the possibility given to a company part of a group to compute the interest limitation on a consolidated basis. Indeed, the legislators did not take into account these recommendations and the released amendments do not include any new provision in this respect. However, based on the motion of 18 December 2018, the option will be introduced to maintain Luxembourg attractivity and competitiveness through a subsequent law. The effect should be retroactively applicable as of 1 January 2019.
Exit taxation rule *(New Article 164ter LITL)*

The implementation of the exit tax rule will have an impact on the existing rule on deferral of taxation in Luxembourg.

The amended provisions will only allow a payment of the exit taxes in several instalments over a 5-year period instead of the unconditional and unlimited in time deferral of the exit taxes provided by current §127 of the General Tax Law. However, in case of payment in several instalments, the Bill provides that no interest will be charged and does not require any guarantees in accordance with the current regime on these points.

The payment in several instalments granted by the Bill is only possible for transfer of assets to an EU or EEA Member State which has concluded an agreement on the recovery of taxes with Luxembourg. Thus, such provisions will not apply in case of assets transferred outside the EU and EEA which is different from the current situation where it is possible under certain conditions (i.e., a double tax treaty concluded between Luxembourg and the third country including a clause allowing the exchange of information in line with OECD principles).

According to the Bill, such provisions cease to apply and the balance of the tax debt becomes due in case of i) sale of the transferred assets, ii) transfer of the assets to a third country, iii) the taxpayer becomes bankrupt, iv) the taxpayer fails to honour its obligation in a reasonable period of time (i.e., 12 months), or v) no annual documentation of these latter events is made.

In line with the ATAD, the Bill also ignores the temporary transfer of assets when such assets are intended to return to Luxembourg or when the transfer is made (i) to satisfy prudential requirements in terms of equity ratio, (ii) for liquidity management purposes, (iii) in case of securities financing transactions or (iv) for assets subject to a security right.

This particular provision on exit taxation should enter into force as of 1 January 2020. Exits that occur before this date should not be impacted by these new rules.
General anti-avoidance rule (GAAR) (Amendments to §6 Steueranpassungsgesetz)

The Bill amends §6 of the Adaptation Law (Steueranpassungsgesetz or StAnpG) to include a detailed definition of the concept of abuse of law in tax matters.

The GAAR contained in the Bill has a slightly different wording than the original provisions provided by article 6 of the ATAD. Indeed, an abuse of law is defined as the legal route which, having been put into place for the main purpose or one of the main purposes of circumventing or reducing tax charge contrary to the object or purpose of the tax law, is not genuine having regard to all relevant facts and circumstances.

In accordance with the ATAD, the Bill further precises that a "legal route" may be composed of many steps or parts and should be considered as non-genuine to the extent it has not been used for valid commercial reasons reflecting economic reality.

The new provisions should not have substantial impact on the interpretation of the abuse of law by the administrative jurisdictions which relies on the four following criteria:

- (Abusive) use of private law forms and institutions;
- Tax savings based on avoidance or reductions;
- Use of an inappropriate route;
- Absence of valid commercial reasons (not tax related) for the transactions.

The taxpayers will still be entitled to choose the less taxed route under certain conditions such as valid and documented economic reasons.
Controlled foreign company rules (CFC) *(New Article 164ter LITL)*

The CFC rules provided by articles 7 and 8 of the ATAD are implemented by the Bill in a new article 164ter LITL.

These CFC rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its Luxembourg parent company. As a result, the net income included in the taxable basis of the Luxembourg parent company is considered to be commercial profit.

Since Luxembourg has opted for option B foreseen by article 7(2)(b) of the ATAD, only 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 are included in the taxable basis of the Luxembourg parent company.

According to the Bill, 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.

In other words, as long as the Luxembourg parent company does not bear the significant people functions, the CFC rules should not have practical impacts in Luxembourg.

To fall under the CFC provisions, entity or PE should meet the two following cumulative conditions:

- the taxpayer (itself or with its associated companies) holds a direct or indirect participation (i.e., voting rights or capital) of more than 50% or is entitled to receive more than 50% of the profits of that entity or PE;
- the actual corporate tax paid by the entity or the PE on its profits is lower than the difference between:
  - the corporate tax that would have been charged on the entity or PE under Luxembourg income tax law; and
  - the actual corporate tax paid on its profits.

Is considered as tax corresponding to the Luxembourg Corporate Income Tax (CIT), a tax paid to public authorities on a mandatory basis at an effective tax rate of not less than 50% of the Luxembourg CIT. Based on the 2018 CIT rate (i.e. 18%), the threshold should be 9%. As announced recently (read our [tax Alert of 4 December 2018](https://www.bakermckenzie.com/en/insights/tax-law/2018/12/tx-2018-025)), the CIT rate should decrease in 2019.

**Exclusion**

In accordance with the options offered by article 7(4)(a) and (b) of the ATAD, Luxembourg chose not to consider an entity or a PE as a CFC if its accounting profits do not exceed EUR 750,000 or 10% of its operating costs incurred during the tax period.

**Remark**

In its comments, the Council of State addressed the interaction between the CFC provisions and those stated in double tax treaties. For instance, in case of EU PE and based on the primacy of EU law over bilateral conventions between two States, provisions of article 164ter LITL should prevail over the convention. However, in case of non-EU PE and in accordance with the hierarchy of norms often recalled in the jurisprudence, the double tax treaty will prevail over the domestic provisions. Some cases may find solution with the future implementation of the MLI into domestic legislation (i.e. most likely as from 1 January 2020). However, further clarification may be needed for a coherent application of the rules.
Hybrid mismatch rules *(New Article 168ter LITL)*

The Bill implements article 9 of the ATAD in a new article 168ter LITL to eliminate hybrid mismatches arising from differences in the legal characterization of a financial instrument or entity in an arrangement structured between a Luxembourg taxpayer (i.e., corporate entity or PE) and another party located in another Member State which give rise to:

- a “double deduction” (i.e., the same payments are deducted in Luxembourg and in the other Member State considered as the State of source of the said payments);
- a "deduction without inclusion" (i.e., the payments are deducted in Luxembourg as State of source of the payments, without being correspondingly included as income in the taxable basis of the taxpayer located in the other Member State).

According to the Bill, the above mismatches are solved either by the way of denial of a deduction or the inclusion of the payment:

- in case of double deduction, the deduction shall be given only in the Member State where such payment has its source. Therefore, Luxembourg will deny the deduction only if Luxembourg is the investor State and the payment has its source in the other Member State;
- in case of deduction without inclusion, the deduction shall be denied in the payer jurisdiction. Therefore, Luxembourg will only deny the deduction if Luxembourg is the State of source and the income is not taxed in the other Member State.

The Bill also sets the possibility for the Luxembourg tax authorities to require the taxpayer to provide documentation evidencing that the payment has not been deducted (in situations of double deduction) or has been effectively taxed (in situations of deduction without inclusion) in the other Member State.

The ATAD 2 (EU directive 2017/952 of 29 May 2017) covering a wider range of hybrid mismatches (i.e., hybrid financial instrument mismatch, hybrid PE mismatch, hybrid entity mismatch, reverse hybrid mismatch, tax residency mismatch, imported mismatch, hybrid transfer) and including mismatches with third countries was supposed to replace the original rules set out in the ATAD. In this respect, the explanatory statements of the Bill clearly explain that hybrid mismatches measures of the ATAD 2 will be transposed through a subsequent law (i.e., most likely to be released during the course of 2019) with effect as from 1 January 2020 (save for reverse hybrid rules applicable as from 1 January 2022).
Other important provisions

Article 22bis LITL - conversion of loan into shares

The Bill also amends current article 22bis LITL by removing one of the situations in which an exchange may be carried out in tax neutrality. More specifically, the Bill does not grant the tax neutrality to the conversion of a loan into shares of a company (i.e., borrower) anymore. Such conversion will therefore be treated as a fully taxable event (i.e., sale of the loan at fair market value followed by the acquisition of the shares received in consideration). The proposed amendment aims at limiting the setup of structures that may have been implemented by taxpayers belonging to the same group and leading to non-taxation situations such as in the Engie state aid case.

§16 StAnpG - New definition of PE

In addition, the Bill amends current §16 StAnpG by inserting a new paragraph which aims at limiting conflicts of interpretation on the existence of a PE resulting from the interaction between the provisions of domestic law and those contain in double tax treaties.

Finally, new §16 (5) StAnpG provides that the characterisation of a PE must only be made in accordance with the criteria set out in the relevant double tax treaty concluded by Luxembourg. In that sense, the Bill provides that the Luxembourg tax authorities may require from taxpayers a confirmation that the other contracting state recognizes the existence of a PE in its jurisdiction. The aim of this provision is to close the loophole highlighted by the McDonald's state aid case.

Conclusions

By enforcing the ATAD as from 1 January 2019, Luxembourg shows again its willingness to enhance transparency in the area of taxation applicable to cross-border transactions in compliance with EU law and international standards. Additionally, for sake of coherence and economic efficiency, the issues raised by the Chamber of Commerce and the Council of State on the interest limitation computation for entities in tax unity have been taken into account and this option will be implemented in a subsequent law. If you wish to obtain further information or practical guidance on the impact of ATAD on your business, our Luxembourg tax experts at Baker McKenzie will be happy to assist you in any question you may have.