Luxembourg releases bill implementing anti-tax avoidance directive

Introduction

On 20 June 2018, the Luxembourg bill (the **Bill**) implementing the EU Anti-Tax Avoidance Directive dated 12 July 2016 (**ATAD 1**) was published. The ATAD 1 reflects some of the actions in the OECD's base erosion and profit shifting (**BEPS**) project.

While all Member States must implement the ATAD 1, it is worth mentioning that some of its provisions are optional. Consequently, not all Member States will have the same ATAD 1 provisions in their domestic laws.

The Bill contains the following five main provisions:

- Controlled foreign company (**CFC**) rules
- Interest limitation rules
- Exit taxation
- Hybrid mismatches
- General anti-abuse rules (**GAAR**)

The Bill also contains two additional provisions that are unrelated to ATAD 1. The first provision would repeal article 22bis par. 2 (1) of the Luxembourg Income Tax Law (**LITL**) which allows (among others) a bondholder to convert a loan into shares in a tax-neutral manner while the second would amend the permanent establishment provision under Luxembourg domestic law.

ATAD 1 CFC rules

The ATAD 1 CFC rules have their basis in the BEPS Action 3 conclusions. Broadly, the CFC rules of the ATAD 1 rateably reallocates undistributed income of a 50 percent owned direct or indirect subsidiary or permanent establishment to the jurisdiction of the controlling entity where the actual corporate tax paid on its profits is lower than half the corporate income tax (CIT) that would have been paid in Luxembourg. Under the ATAD 1, Member States are allowed to either tax (i) undistributed passive income (interest, royalties, dividends, etc.) of the CFC with a carve-out for CFCs with a substantive economic activity (**Option A**) or (ii) undistributed income of the CFC arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage (in which case the amount of the CFC inclusion is limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company and in accordance with the arm's length principle) (**Option B**). A tax credit is provided for taxes paid by the CFC. An exemption is also available for previously taxed CFC income when such income is distributed to the controlling company.

Bill CFC rules

The Bill rightfully excludes Luxembourg municipal business tax (MBT) from the scope of the CFC provisions, which means that (i) the subject to tax test described above would only apply by comparing the corporate income tax paid by the CFC and the CIT (excluding MBT) that would have been paid in Luxembourg and (ii) CFC income should only be included for CIT but not for MBT purposes. The Bill reflects Option B. This option embraces the OECD transfer pricing rules as the CFC income inclusion should be limited to income attributable to significant people functions carried out in Luxembourg in relation to the assets owned and risks undertaken by the CFC. Importantly, Option B reduces the risk of double taxation. Indeed, CFC income should be taxed where significant functions are carried out, meaning generally at the level of a single taxpayer. Luxembourg's decision to implement Option B is positive as it demonstrates Luxembourg's full alignment with the OECD transfer pricing principles that are already largely reflected in its domestic legislation without materially affecting Luxembourg as a prime holding jurisdiction.

The CFC rules would apply to fiscal years starting on or after 1 January 2019.

ATAD 1 interest limitation rules

The ATAD 1 interest limitation rules have their basis in the BEPS Action 4 conclusions. Under these rules, a 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 amortisation).

The ATAD 1 offers several optional reliefs.

Bill interest limitation rules

As it currently stands, the Bill includes the following optional reliefs:

• *De minimis* exception for exceeding borrowing costs not exceeding €3 million

• Full deduction of exceeding borrowing costs if the taxpayer is a standalone entity for financial accounting purposes with no associated enterprise or permanent establishment

• Loans used to fund an EU long-term public infrastructure subject to certain conditions

• Exclusion of financial undertakings. It should be noted that the definition of financial undertakings that are excluded from the scope of the interest limitation rules is quite broad and includes (among others) credit institutions, alternative investment fund managers (AIFM), undertakings for collective investments in transferrable securities (UCITS), insurance and reinsurance undertakings, alternative investment funds (AIF) managed by an AIFM as well as securitisation vehicles as defined by Regulation (EU) 2017/2402 of 12 December 2017

• Group relief, i.e. fall-back to a group-wide test

• Ability to carry forward, without time limitation, exceeding borrowing costs (i.e. exceeding borrowing costs that cannot be deducted in the current tax period)

• Ability to carry forward, for a maximum of 5 years, unused interest capacity (i.e. the portion of the fraction representing 30 percent of the EBITDA that is not absorbed by exceeding borrowing costs deducted during the current tax period)

The Bill would be applicable to loans issued on or after 17 June 2016. Loans issued before 17 June 2016 would be excluded from the scope of the interest limitation rules provided that they have not been modified after that date.

The existing recapture rules would remain in place. The interaction of the new interest limitation rules with the existing recapture rules would need to be further analysed.

The interest limitation rules would apply to fiscal years starting on or after 1 January 2019.

ATAD 1 exit taxation

The exit tax provisions do not have their basis in the BEPS action plans and were initiated by the European Commission.

The ATAD 1 provides for an exit tax that applies to specified transfers of assets from a Member State or the transfer of residence on an amount equal to the fair market value of the transferred assets at the time of the transfer minus their value for tax purposes. For transfers to another Member State or to certain countries that are parties to the Agreement on the European Economic Area (EEA Agreement), the exit tax may be paid in instalments over a five-year period or—if earlier—until the assets are sold or transferred to a third country or the taxpayer's residence (or business carried on by its permanent establishment) is subsequently transferred to a third country.

The receiving Member State must provide for a step-up to fair market value established by the Member State of origin as the starting value of the assets for tax purposes.

Bill exit taxation rules

The Bill implements the above regime and provides for the possibility to grant a payment deferral of the tax due upon exit in case of a transfer described above to a Member State or a third country that is party to the EEA Agreement so long as it has concluded an agreement with Luxembourg or the European Union on the mutual assistance for the recovery of tax claims. Therefore, the Bill preserves the existing payment deferral options (albeit limited to 5 years) but restricts the possibility to obtain a payment deferral to transfers to EU and EEA jurisdictions where such an agreement exists between Luxembourg and the relevant country.

No interest would be due and no guarantee would be required to benefit from the payment deferral.

The new exit tax rules would apply to fiscal years starting on or after 1 January 2020. However, transfers made prior to 1 January 2020 (under the current regime) would not be impacted by the new provisions.

ATAD 1 Hybrid mismatch rules

The ATAD 1 hybrid mismatch rules have their basis in the BEPS Action 2 conclusions. The ATAD 1 hybrid mismatch provisions only apply within the European Union and target situations between a taxpayer in one Member State and an associated enterprise in another Member State whereby differences in the characterisation of a financial instrument or entity results in a double deduction or a deduction without inclusion. Under these rules, (i) to the extent that a hybrid mismatch results in a double deduction, the deduction is only given by the Member State where such payment has its source and (ii) to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer must deny the deduction.

Bill hybrid mismatch rules

The Bill implements the two ATAD 1 hybrid mismatch rules described above. The Bill would apply to fiscal years starting on or after 1 January 2019.

The provisions of the 2017 Anti-Tax Avoidance Directive dated 29 May 2017 (**ATAD 2**), which are not covered by the Bill and will apply to mismatches between European countries as well as with third countries will amend the hybrid mismatch rules of the ATAD 1 as from 2020.

ATAD 1 general anti-abuse rules (GAAR)

The GAAR provisions do not have their basis in the BEPS action plans and were initiated by the European Commission. Under the GAAR, 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.

Bill general anti-abuse rules

The Bill proposes to modernise paragraph 6 of the Luxembourg Adaptation Law (*Steueranpassungsgesetz* or **StAnpG**), which already contains a GAAR applicable to both corporations and individuals, to bring it in line with the GAAR provision of ATAD 1.

Interestingly, the comments of the Bill specify that the taxpayer is entitled to use the most favourable tax route. This comment is in line with the Preamble of the ATAD that provides that a taxpayer should have the right to choose the most tax-efficient structure for its commercial affairs.

The GAAR would apply to taxable years starting on or after 1 January 2019.

Other provisions of the Bill

Effective 1 January 2019, the Bill would repeal article 22bis, par. 2 (1) of the LITL which allows (among others) a bondholder to convert a loan into shares under the Luxembourg roll-over regime.

Lastly, a new paragraph 5 would be added to Article 16 StAnpG which defines the notion of permanent establishment for Luxembourg tax purposes. The taxpayer may be requested by the Luxembourg tax authorities to provide a confirmation from the foreign concerned jurisdiction. The practicalities of this new requirement should be further analysed.

The Luxembourg parliament will now debate, possibly amend and ultimately vote on the proposed measures. We will keep you informed on future developments in connection with this Bill.