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# Luxembourg Tax Alert

## Luxembourg releases draft law implementing ATAD 2 rules on hybrid mismatch arrangements.

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On 8 August 2019, Luxembourg published the draft law that would implement hybrid mismatch measures of the 2017/952 EU Anti-Tax Avoidance Directive (ATAD 2) into Luxembourg domestic law. 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 (OECD BEPS Action 2).

ATAD 2 extends the anti-hybrid provisions of the 2016/1164 EU Anti-Tax Avoidance Directive (ATAD 1) to hybrid mismatches with countries outside of the European Union and covers additional types of hybrid mismatches. The draft law would cover hybrid mismatches not yet covered by the current anti-hybrid provisions, such as (i) imported mismatches, (ii) hybrid transfers, (iii) tax residency mismatches, as well as (iv) reverse hybrid mismatches.

The draft law largely follows the wording of ATAD 2 while addressing the main points of concern of the marketplace and providing some useful additional clarifications and examples in the commentary to the draft law.

The draft law would modify the Luxembourg Income Tax Law (LITL) by replacing the current provisions of Article 168ter LITL and introducing a new Article 168quater LITL. It would also adapt some related provisions of LITL, such as the limitation of the deduction of foreign tax credits in the context of hybrid mismatches, as well as some provisions of other Luxembourg laws.

The Luxembourg parliament will now debate, possibly amend and ultimately vote on the proposed measures. Most of the provisions included in the proposal would apply as from fiscal years starting on or after 1 January 2020, with the exception of the provision specifically targeting reverse hybrid mismatches (new Article 168quater LITL), which would apply as from fiscal years closing in 2022.

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# 1. Hybrid mismatches rules

## *Scope and definition*

**Hybrid mismatch**

The rules on hybrid mismatches would apply to Luxembourg taxpayers defined as companies as well as permanent establishments of non-resident companies.
A hybrid mismatch would be limited to situations arising (i) between associated enterprises (as defined), (ii) between a taxpayer and an associated enterprise, (iii) between the head office and its permanent establishment, (iv) between two or more permanent establishments 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 would give rise to a deduction without inclusion outcome and:
- The mismatch outcome would be attributable to differences in the characterization of the instrument or the payment made under it; and
- Such payment would not be included in the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period unless it is reasonable to expect that the payment would be included by the jurisdiction of the payee in a future tax period and the terms of payment are arm's length;

(b) A payment to a hybrid entity would give rise to a deduction without inclusion and that mismatch outcome would result from differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity would be established and the jurisdiction of any person with a participation in that hybrid entity. A hybrid entity would be 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 permanent establishments would give rise to a deduction without inclusion and that mismatch outcome would result from differences in the allocation of payments between the head office and the permanent establishment or between two or more permanent establishments of the same company under the laws of the jurisdictions where the company operates;

(d) A payment would give rise to a deduction without inclusion as a result of a payment to a disregarded permanent establishment, i.e. an arrangement treated as a permanent establishment under the laws of the head office jurisdiction but not under the laws of the other jurisdiction;

(e) A payment by a hybrid entity would give rise to a deduction without inclusion and that mismatch would result from the fact that the payment would be disregarded under the laws of the payee jurisdiction (unless the deduction would be offset against dual inclusion income, i.e. income included under the laws of both jurisdictions where the mismatch outcome arises);

(f) A deemed payment between the head office and permanent establishment or between two or more permanent establishments would give rise to a deduction without inclusion and that mismatch would result from the fact that the payment would be disregarded under the laws of the payee jurisdiction (unless the deduction would be offset against dual inclusion income, as defined above); or

(g) A double deduction outcome would occur, unless the deduction would be offset against dual inclusion income, as defined above. A double deduction would be defined as a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment, the payer jurisdiction would be the jurisdiction where the hybrid entity or permanent establishment is established or situated.

**Payment**

While the draft legislation refers to the term “payment”, it does not provide a specific definition. However, the commentary to the draft 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 would also fall within the scope of this definition.

On this basis, deductions such as depreciation and amortization should not be 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 draft law, the following would not be treated as giving rise to a hybrid mismatch:

- Payments under financial instruments, where the tax relief granted in the payee jurisdiction is solely due to (i) the characterization of the payment in the jurisdiction of the payee, (ii) the tax status of the payee (for example, a tax-exempt investment fund or a tax-exempt sovereign wealth fund), or (iii) the fact that the instrument is held subject to the terms of a special tax regime;
- Payments (i) to a hybrid entity or permanent establishment, (ii) to a disregarded permanent establishment, (iii) by a hybrid entity to its owner, as well as (iv) deemed payments made (a) between the head office and permanent establishment or (b) between two or more permanent establishments if the mismatch would have arisen 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;
- Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing rules.

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

**Inclusion**

The term “inclusion” would be 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 received by virtue of the laws of any other jurisdiction. An amount would be considered as “included” where Luxembourg is the payee jurisdiction if the payment is included in the taxpayer’s total net revenues. Therefore, an inclusion in the taxable base of the payee would appear to be sufficient even if the income would not be effectively taxed (for example, as a result of existing net operating losses).

A structured arrangement would be defined as an arrangement involving a hybrid mismatch (as defined above), where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably 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. For example, a hybrid loan between two unrelated taxpayers may nevertheless be treated as a structured arrangement if the tax savings are priced into the yield of the loan.

**Associated enterprise**

For the purpose of hybrid mismatch rules, an associated enterprise would generally be defined as (i) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 50 percent or more, or is entitled to receive 50 percent or more of the profits of that entity, or (ii) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 50 percent or more, or is entitled to receive 50 percent or more of the profits of the taxpayer.

If an individual or entity holds directly or indirectly a participation of 50 percent or more in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, would also be regarded as associated enterprises.

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

A definition of associated enterprise would also include an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management, or an enterprise that has a significant influence in the management of the taxpayer.

In addition, in order to prevent situations where participations would be transferred to third parties in order not to fall within the scope of ATAD 2, an individual or entity who acts together with another individual or entity in respect of the voting rights or capital ownership of an entity would be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other individual or entity. Importantly and unless proven otherwise by the tax authorities, an individual or entity holding directly or indirectly less than 10 percent in, and entitled to receive less than 10 percent of the profits of, an investment fund would not be treated as acting together with another individual or entity holding an interest in the same investment fund.

This clarification is welcome and largely relevant for the fund industry, since – as mentioned in the commentary to the draft 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 would mean a domestic or foreign collective investment undertaking that raises capital from a number of investors in order to invest them in accordance with a defined investment policy in the interest of the investors.

## *Primary and defensive rules*

**Deduction/No inclusion**

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

If Luxembourg would be the payee jurisdiction and the deduction would not be denied in the payer jurisdiction, income would be taxable in Luxembourg under the defensive rule up to the amount of the payment that would otherwise give rise to a mismatch outcome. This clarification is welcome, as it confirms the view expressed in the OECD BEPS Action 2 report whereby anti-hybrid measures are anti-abuse provisions solely aimed at neutralizing the effect of the mismatch, i.e. only for the amount giving rise to the mismatch (for example, if for a single payment of EUR 100, only EUR 20 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 would not be considered as giving rise to a deduction without inclusion where the mismatch would be neutralized in the other jurisdiction based on a special rule, such as in the case of Luxembourg – paragraph 2bis of article 166 LITL.

The defensive rule would not apply to hybrid mismatches described in b), c) d) and f) above. This means that for example, a payment to a disregarded permanent establishment giving rise to a deduction without inclusion would not be taxable in Luxembourg under the defensive rule unless the permanent establishment would be located in a Member State and the income would otherwise be exempt under a double tax treaty. In this case, income would be included in the Luxembourg head office regardless of the double tax treaty.

Until 31 December 2022, the primary and defensive rules would also 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 in the taxpayer's loss absorbing capacity requirements;
- The financial instrument has been issued (i) in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking, (ii) at a level necessary to satisfy applicable loss absorbing capacity requirements, (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 it would have been had the taxpayer issued such financial instrument directly to the market.

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**Double deduction**

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

The deduction would also be denied in Luxembourg under the defensive rule if Luxembourg were the payer jurisdiction and the deduction were 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 outcome arises.

**Imported mismatch**

A deduction would also 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.

## 2. Tax residency mismatches

The draft law would also target tax residency mismatches whereby payments, expenses or losses would be deductible in two jurisdictions because a taxpayer is resident for tax purposes in two or more jurisdictions. In this situation, Luxembourg would deny the deduction to the extent that (i) the other jurisdiction allows a duplicate deduction, unless such duplicate deduction is set off against dual inclusion income (as defined above), or (ii) the other jurisdiction is a Member State where the taxpayer is deemed to be a Luxembourg resident according to the double tax treaty concluded with the other Member State.

Those rules would apply to Luxembourg companies as well as to permanent establishments of non-resident companies.

## 3. Hybrid transfer rules

The new anti-hybrid rules would also target the so-called hybrid transfers, i.e. arrangements whereby 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 would also apply to Luxembourg companies as well as to permanent establishments of non-resident companies.

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

A payment representing the underlying return on a transferred financial instrument would however not give rise to a hybrid mismatch where the payment would be made by a financial trader under a so-called "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 provided that the payer jurisdiction would require the financial trader to include as income all amounts received in relation to the transferred financial instrument.

## 4. Reverse hybrid rules

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

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

The above reverse hybrid mismatch rule would 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 would include collective investment fund under the law of 2010 (UCI), specialized investment fund under the law of 2007 (SIF), Luxembourg reserved alternative investment fund under the law of 2016 (RAIF), as well as other qualifying Alternative Investment Funds under the law of 2013 (AIF). It seems that the legislator does not refer to the Investment Company in Risk Capital under the law of 2014 (SICAR) that can also be established under the form of an SCS or an SCSp. At this stage, we do not see any obvious reason for such an omission.

## 5. Documentation requirements

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

As stated in the commentary to the draft law, the taxpayer could therefore be requested to prove, depending on the case, the following:

- That no hybrid mismatch was used;
- That the deduction was denied in the jurisdiction of the payer (deduction without inclusion), or in the jurisdiction of the investor (double deduction);
- That the payment does not directly or indirectly finance deductible expenses giving rise to a hybrid mismatch;

- That a hybrid transfer was not used in order to obtain a withholding tax relief with respect to a payment on a transferred financial instrument;
- That payments, expenses or losses are not deductible against income that is not dual inclusion income in the other jurisdiction(s) where the taxpayer is also considered as resident.

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

The taxpayer must thus 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 should also be able to provide detailed, objective and verifiable information about the law of the other jurisdiction.

In terms of legislative process, the draft law will now be debated in the Luxembourg parliament, opinionated by the professional chambers, as well as the Council of State, and possibly amended. The final vote is expected by the end of the year. We will keep you informed on future developments in connection with this draft legislation.

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