Luxembourg initiates draft law for ATAD 2 implementation

August 16, 2019

In brief

The Luxembourg government, on August 8, tabled a Bill (n°7466) before the Luxembourg Parliament setting out the draft legislation (the 'Draft Law') that will implement the EU anti-tax avoidance directive regarding hybrid mismatches with third countries ('ATAD 2'), EU Member states have until December 31, 2019 to transpose most of the measures in ATAD 2 into their domestic laws, and must apply those provisions effective January 1, 2020.

This Draft Law, which now needs to go through the Luxembourg legislative process, may be subject to amendments before final voting by the Luxembourg Parliament. The Bill sets out, in addition to the Draft Law, a detailed commentary (Commentary), which, in certain instances, provides guidance for interpreting the Draft Law.

The Draft Law generally follows the text of ATAD 2, adapting it mainly to integrate with the structure and terminology used in the Luxembourg income tax law (LITL).

As anticipated by ATAD 2, the Draft Law generally would apply to tax years beginning January 1, 2020, with the additional 'reverse hybrid' measures that comprise Article 9a of ATAD 2 applying with the 2022 tax year.

In detail

Scope

Entities

The Draft Law applies to any Luxembourg corporate income taxpayer, including foreign entities that have a permanent establishment (PE) in Luxembourg as defined by the domestic legislation. Beginning with the 2022 tax year, the scope also is extended to Luxembourg entities that are regarded, under Article 175 LITL, as being tax transparent for Luxembourg tax purposes, effectively, in some cases, turning such entities into Luxembourg taxpayers for all or part of their income.

Parties giving rise to a 'hybrid mismatch'

The Draft Law's provisions apply whenever there is a 'hybrid mismatch':

i. under a 'structured arrangement'

ii. between 'associated enterprises'

iii. between a head office of an entity and a PE

iv. between two or more PEs of the same entity, or

v. in cases of dual tax residence, they remain liable to provide the tax authorities with information linked to the reportable cross-border arrangement (but without any client-specific information).

Observation: Essentially any link, where there is a 50% or more right to votes, capital ownership, or profits, causes two entities, or an individual and an entity, to be associated enterprises (except in relation to payments under a financial instrument – here a 25% threshold is sufficient to create an associated relationship).

Observation: In relation to the 'acting together' concept, the Draft Law deals specifically with investors (either physical persons or entities) in an investment fund that own, directly or indirectly, less than 10% of the shares or units of the fund and are entitled to less than 10% of the profits of that fund. Unless demonstrated otherwise (for example, where two investors agree with each other to each invest and to take a common position in dealings with the fund manager), any such investor in a fund is not to be regarded as 'acting together' with any other investor. This means that in these circumstances any 'less than 10%' investor should not be 'associated' with the fund vehicle, and as a consequence also should not be 'associated' with the entities that the fund vehicle controls.

Mismatch effect

The Draft Law and/or the Commentary clarifies that:

- If the payment is included as ordinary income in at least one jurisdiction, then there will be no mismatch for the rule to apply (through reference to paragraph 89 of the OECD/G20 BEPS Action 2 Final Report of 2015).
- With regard to payments under a financial instrument, there is no mismatch when the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee, or to the fact that the instrument is held subject to the terms of a special regime (reference to recital 16 of ATAD 2).

Observation: Based on our reading, it appears that payments to non-transparent entities that are exempt in their countries of incorporation (for example, some sovereign wealth funds), that are not subject to tax because they are resident in a zero tax rate jurisdiction, or that benefit from some specific exemption (territorial tax regime, REITs, etc.) normally should not trigger a hybrid mismatch effect.

- The application of the Draft Law's provisions is limited to the extent that there is a hybrid mismatch (i.e., the law is applied proportionally on the amount giving rise to a deduction without inclusion / double deduction).

Hybrid mismatch definition

Deductions without inclusion

To the extent that a hybrid mismatch results in a deduction without inclusion, the deduction will be denied for the Luxembourg payer or, as a secondary rule, if the deduction is granted to the foreign payer, the amount of the payment shall be included as taxable income in the hands of the Luxembourg payee.

Observation: The Draft Law, however, adopts the option of article 9(4)(a) of ATAD 2, such that a Luxembourg taxpayer does not have to apply the secondary rule (i.e., taxation) in cases b), c), d) or f) listed below.

The Draft Law also adopts the option of article 9(4)(b) of ATAD 2, applicable to the banking sector. Until December 31, 2022, hybrid mismatches resulting from intra-group instruments issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements (i.e., regulatory hybrid capital) are excluded from the application scope of the above rules.

In line with ATAD 2, six categories of deduction without inclusion are recognized as potentially causing a 'hybrid mismatch':

a) A payment under a financial instrument that is attributable to differences between tax regimes in the way the instrument or the payment is characterized. Mismatch outcomes that reverse in a 'reasonable period, of time are not within scope. As a safe harbor rule, inclusion by the recipient in a tax period starting within 12 months of the end of the payer's tax period in which the deduction is taken is considered as causing the mismatch to be reversed in a reasonable period of time. Payments outside of the safe harbor rule may also be out of scope if it is reasonable to expect an inclusion of the payment by the jurisdiction of the payee in a future tax period when the terms of the payment are at arm's length.

b) A payment to a 'hybrid entity,' where the mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered, and the jurisdiction of any person with a participation in that hybrid entity (reverse hybrid).

c) A 'diverted branch payment;.

d) A payment to an entity with a 'disregarded permanent establishment.' The Draft Law confirms, however, the primacy of tax treaties with third countries over ATAD 2. That is, disregarded PE income would not be included at the level of the Luxembourg head office when a tax treaty with

a third country requires exemption of the income, as also provided by article 9(5) of ATAD 2;

e) A 'hybrid entity payment,' where the payment is disregarded under the laws of the payee jurisdiction.

f) A 'deemed branch payment.'

Notwithstanding the above, a 'hybrid mismatch' will only arise under categories e) or f) to the extent that the deduction in the payer jurisdiction is not offset against dual inclusion income.

Double deductions

To the extent that a hybrid mismatch results in a double deduction, the deduction shall be denied for the taxpayer that is the investor. If the deduction is granted in the jurisdiction of the investor, the deduction shall then be denied for the taxpayer that is the payer.

Observation: Nevertheless, any deduction shall remain deductible to the extent that there is dual inclusion income of that tax year.

Furthermore, payments, expenses, or losses which may not have been deductible in a given year still may be deductible subsequently, to the extent that dual inclusion income arises in a future tax year.

Imported mismatches, hybrid transfer, and tax residency mismatches

The Draft Law reproduces almost without change the wording of ATAD 2 in relation to these three situations:

- A deduction for a payment will be denied to the extent that it gives rise to an 'imported mismatch.' The Draft Law uses the ATAD 2 definition of an imported mismatch.
- To the extent a hybrid transfer is designed to produce a relief from withholding tax on a payment derived from a transferred financial instrument to more than one of the parties involved, the relief will be limited in proportion to the net taxable income regarding the payment. Contrary to the general rule, the portion of a withholding tax that may not be creditable shall in this specific case not be deductible for Luxembourg tax purposes.
- The deduction will be denied to the extent dual residency results in double deduction. The payment, expense, or loss will, however, remain deductible when the other jurisdiction involved is a Member state with a tax treaty in force with Luxembourg, provided the taxpayer is considered as a Luxembourg resident under that tax treaty.

Post-2021 reverse hybrid mismatches

Beginning with the 2022 tax year, Luxembourg transparent partnerships will become liable to corporate income tax in relation to net income to the extent that such income is not otherwise taxed under the Luxembourg domestic tax law or the laws of any other jurisdiction, provided one or more associated non-resident entities (i) holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests, or rights to a share of profit in the Luxembourg partnership, and (ii) consider the Luxembourg partnership to be a taxable person.

In such a situation, the Draft Law confirms that, while the Luxembourg partnership will be considered a tax resident for corporate income tax purposes, it will be exempt from Net Wealth Tax.

Collective investment vehicles

In line with the exclusion provided in ATAD 2, collective investment vehicles are not within this provision's scope. For the purpose of this rule, collective investment vehicles are 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. The Commentary clarifies that this definition includes undertakings for collective investment per the Law of December 17, 2010; specialized investment funds (SIFs) covered by the Law of February 13, 2007; reserved alternative investment funds (RAIFs) covered by the Law of July 23, 2016; and other alternative investment funds (AIFs) not falling within the above categories, but covered by the Law of July 12, 2013 (implementing the EU AIFM Directive), relating to managers of AIFs although only to the extent that such AIFs are widely held, hold a diversified portfolio of securities, and are subject to investor-protection regulations.

Documentation

At the request of the tax authorities, the taxpayer must be able to provide any relevant information–i.e., tax returns, other tax documents, or certificates issued by the tax authorities of another state–in order to prove that the Draft law's provisions do not apply.

The takeaway

Groups and investment funds should assess their situation, considering the potential impact of the precise wording of the Draft Law that applies these 'hybrid mismatch' measures, most of which will begin to take effect from January 1, 2020.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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