Tax

Luxembourg implements EU Anti-Tax Avoidance Directive and Multilateral Instrument

Tax News Alert - July 2018

On 19 June 2018, the Luxembourg Government presented the draft bill n° 7318 ("**Draft Bill**")[1] before the Luxembourg Parliament transposing the EU Anti-Tax Avoidance Directive ("**ATAD I**")[2] into Luxembourg domestic law. In line with the issues highlighted by the European Commission in its on-going investigation of Luxembourg state aid cases, the Draft Bill also includes additional amendments to the domestic law to eliminate double non-taxation. The proposed changes affect tax neutral exchanges and the domestic definition of permanent establishment ("**PE**"). The Draft Bill is yet to be approved by the Luxembourg Parliament and may thus be subject to amendments. Lastly, the Luxembourg Government also approved a bill for the ratification of the Multilateral Instrument ("**MLI**").

Transposing ATAD in Luxembourg

ATAD aims at implementing the recommendations made under OECD's Base Erosion and Profit Shifting Project ("**BEPS**") at the EU level. It lays down anti-tax avoidance rules in the following fields:

1. Interest limitation rules
2. Controlled foreign company ("**CFC**") rules
3. Hybrid mismatches
4. General anti-abuse rules ("**GAAR**")
5. Exit taxation

[1] Previously approved by the Luxembourg Government on 15 June 2018.
[2] Council Directive (EU) 2016/1164 of 12 July 2016.

For taxpayers falling under this scope, the provisions of the Draft Bill will apply as from 1 January 2019. However, the provisions relating to exit tax will be applicable as from 1 January 2020. The Directive amending ATAD I ("**ATAD II**") regarding hybrid mismatches with third countries has not been included in the Draft Bill and will thus be implemented at a later stage. This measure will come into effect in Luxembourg as from 1 January 2020.

Interest limitation rules

Scope

The Draft Bill introduces a new Article 168bis Luxembourg Income Tax Law ("**LITL**") applicable to corporate taxpayers resident for tax purposes in Luxembourg that are subject to corporate income tax and to Luxembourg PEs of companies resident in another EU Member State or a third country. The scope includes both related and unrelated party borrowings[3].

However, by exercising the options put forth under Article 4(7) and 4(3) of ATAD I, Luxembourg excludes financial undertakings and stand-alone entities from the scope of interest limitation rules. In this context, 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 PE situated in a country other than Luxembourg.

Further, the term financial undertaking refers to types of entities that are regulated by an EU Directive or Regulation such as credit institutions or investment firms, insurance undertakings, reinsurance undertakings, pension institutions, alternative investment funds, UCITS, central counterparties, central securities depositories. Additionally, Luxembourg added securitization vehicles governed by Article 2(2) of the EU Regulation 2017/2402[4] to the list of undertakings covered under ATAD I. However, any other securitization vehicle falls outside the scope.

Rule

The interest limitation rules, rooted in BEPS Action 4, specify that a taxpayer's borrowing costs are always tax deductible to the extent of its taxable interest revenues and other economically equivalent taxable revenues. As from 1 January 2019, the Draft Bill stipulates that subject to certain conditions and limitations the exceeding borrowing costs shall be deductible only up to 30% of the corporate taxpayer's earnings before interest, tax and amortization ("**EBITDA**") or up to an amount of EUR 3 million, whichever is higher.

The Draft Bill defines borrowing costs 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 funds. It includes a list of elements that can be considered as borrowing costs, including but not limited to:

- 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;
- Capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized 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; and,
- Arrangement fees and similar costs related to the borrowing of funds.

Thus, only borrowing costs that are in excess of interest revenues are costs that are subject to the interest limitation rule. Exceeding borrowing costs that are not deductible in a given tax period may be carried forward to any other tax period. Furthermore, the Draft Bill stipulates that a taxpayer who 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 over its total assets is equal to or higher than the equivalent ratio of the group. In this context, the equity ratio of the taxpayer will be considered as equal to or equivalent if it is lower than the equity ratio of the group by up to 2%.

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[3] Only borrowing costs associated with debt concluded before 17 June 2016 shall be considered.
[4] Referred to as simple, transparent, and standardized securitization.

Controlled foreign company rules

Scope

The Draft Bill introduces a new Article 164ter LITL which reallocates the undistributed income of a CFC arising from non-genuine arrangements which have been put in place solely for the purpose of obtaining a tax advantage. These rules are applicable to corporate taxpayers resident for tax purposes in Luxembourg that are subject to corporate income tax and to Luxembourg PEs of companies resident in another EU Member State or a third country.

In this context, a CFC can be determined based on the following cumulative conditions:

- When the taxpayer itself or together with its associated enterprises[5] holds a direct or indirect participation of more than 50% of the voting rights or of the share capital or is entitled to receive more than 50% of the profits of that entity; and,
- When the actual corporate tax paid by the entity or the PE on its profits is less than 50% of the corporate income tax charge[6] which would have been payable in Luxembourg had the entity or PE been a resident of or established in Luxembourg.

However, an entity or PE will not be considered as a CFC if its accounting profits are less than EUR 750,000 or when the accounting profits amount to no more than 10% of its operating costs[7] for the tax period.

Rule

A Luxembourg taxpayer having a CFC with income arising from a non-genuine arrangement will have to include in its taxable basis the non-distributed income of the CFC to the extent that such income is generated through assets and risks which are related to the significant people functions carried out by the taxpayer.

In this context, the income attributable to the significant people[8] functions should be assessed in accordance with the arm's length principle as set out under Article 56 and Article 56bis LITL. Furthermore, in accordance with ATAD I the Draft Bill considers non-genuine arrangements as any arrangement or a series of arrangements wherein the CFC would not own the assets or would not undertake the risks which generate all, or part of, its income if it was not controlled by a company (which undertakes the significant people function in relation to those assets and risks which play a vital role in generating the company's income).

Hybrid Mismatches

Scope

The Draft Bill aims at eliminating the double non-taxation which arises through the use of certain hybrid instruments or entities. The Draft Bill introduces the ATAD I anti-hybrid provisions, as from 1 January 2019, covering intra-EU hybrid instruments and entities under a new Article 168*ter* LITL. The provisions of the new Article 168*ter* LITL will be applicable to a corporate entity resident in Luxembourg as per Article 159 LITL or a Luxembourg PE of an entity not resident in Luxembourg as per Article 160 LITL.

Nonetheless, the hybrid mismatch measures as per ATAD II will be included in a subsequent law expected to be released during 2019 with an effect as from 1 January 2020. These expected new measures will cover a wider range of intra-EU mismatches as well as with third countries.

New Article 168*ter* LITL defines a hybrid mismatch as arising when differences in the legal characterisation of a financial instrument or entity in an arrangement structured between

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[5] In this context, an associated enterprise is a) any entity (including a partnership) resident or otherwise, 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 the entity; or b) an individual or any entity (including a partnership) resident or otherwise, which holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more in a taxpayer, or is entitled to receive 25% or more of the profits of the taxpayer. Lastly, when an individual or any entity including a partnership, resident or otherwise, holds directly or indirectly a participation of 25% or more in both a taxpayer and one or more entities, then all the entities concerned including the taxpayer shall be considered as associated enterprises.
[6] Comparison should be made against 18% corporate income tax rate as applicable in Luxembourg in 2018.
[7] The costs of goods sold outside the country where the entity is resident or where the PE is established and payments made to associated enterprises cannot be included as operating costs.

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

Rule

The Draft Bill states that under the new rules, a hybrid mismatch results in:

- A double deduction, the deduction is only given by the Member State where such payment has its source. Thus, if Luxembourg is the investor state and the payment has been deducted in the source state, the Luxembourg will deny the deduction
- Deduction without inclusion, the Member State of the payer must deny the deduction. Thus, if Luxembourg is the source state and the income is not taxed in the recipient state, then Luxembourg will also deny the deduction of the payment.

To be able to deduct the payment in Luxembourg, the Luxembourg corporate taxpayer will have to demonstrate that there is no hybrid mismatch situation. The taxpayer will have to provide evidence to the Luxembourg Tax Authorities that either the payment is not deductible in the other Member State which is the source state, or the related income is taxed in the other Member State.

Amendment of GAAR

Scope

As from 1 January 2019, the existing GAAR in Luxembourg as enshrined under §6 of the Tax Adaptation Law will be replaced by a new GAAR. By including the new measure in the general tax law provisions, the scope of its applicability includes any type of Luxembourg tax and any type of Luxembourg taxpayer.

Rule

Under the Draft Bill, non-genuine arrangements that have been structured with the sole purpose (or one of the purposes) of circumventing or reducing tax contrary to the object or purpose of the applicable tax law should be ignored. In this context, an arrangement is defined as non-genuine to the extent it is not put in place for valid commercial reasons which reflect the economic reality.

Exit Taxation

Scope

The Draft Bill modifies the current exit taxation rules as under Article 38 LITL in accordance with the provisions of ATAD I. It further amends the existing taxation deferral rules under §127 of the General Tax Law by providing for a payment of tax in instalments over a period of 5 years. These amendments with respect to the exit tax rules will apply to transfer occurring as from 1 January 2020. Existing tax deferrals granted by the application of §127(2) and (3) of the General Tax Law before 1 January 2020 will remain unaffected by the amendments under the Draft Bill.

Rule

Similar to ATAD I, the Draft Bill states that a taxpayer shall be subject to tax in an amount equal to the market value of the transferred assets at the time of the exit, minus their value for tax purposes in case of:

- Transfer of assets from the head office to a PE in another Member State or to a third country;
- Transfer of assets from a PE to the head office or another PE in another Member State or a third country;
- Transfer of tax residence to another Member State or a third country (except for those which remain connected with a PE in the first country); and,
- Transfer of the business carried on through a PE from a Member State to another Member State or to a third country.

The Draft Bill 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 as long as it has concluded an agreement with Luxembourg or the European Union on the mutual assistance for the recovery of tax claims.

Other proposed changes

The Draft Bill proposes to repeal the Article 22*bis* LITL which currently allows tax neutrality on an exchange of assets arising from the conversion of convertible debt into shares. Thus, for financial years beginning 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. Thus, any capital gain on the debt will become fully taxable upon the conversion.

Secondly, the Draft Bill proposes a modification to the definition of PE as under § 16 of the Tax Adaptation Law. The proposed modification includes the addition of a new paragraph 5, as from 1 January 2019, aimed at assessing the existence of a PE resulting from the interaction between the provisions of domestic law and the provisions of the relevant double tax treaty. New paragraph 5 clarifies that the definition of a PE is to be construed solely based on the criteria mentioned by the applicable double tax treaty. Consequently, 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.

MLI

While the Luxembourg Government approved the bill ratifying the MLI, signed on 7 June 2017, the text of the bill has not been made publicly available yet. Upon completion of the ratification process, Luxembourg must deposit its instrument of ratification to put the MLI into force for the 81 bilateral tax treaties concluded by Luxembourg. Once in force, the provisions of the MLI will generally apply for a double tax treaty as from 1 January of the year following its entry into force for withholding taxes, and for all other taxes with respect to taxable periods beginning on or after the expiration of a 6-month period following the date of entry into force.

What to expect

The Draft Bill will now be considered by the Luxembourg Parliament and is expected to be adopted prior to year-end, in line with the timing for implementation laid down in the ATAD. The adoption of all the measures included in the Draft Bill clarify Luxembourg's willingness to complying with the changing EU tax environment. Lastly, considering the short time within which such measures will be implemented, it is highly advisable that the taxpayers take appropriate actions.

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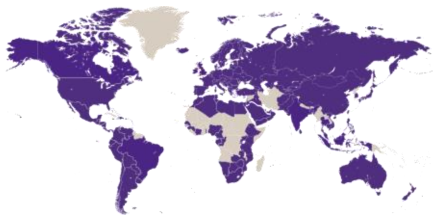

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