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Global Tax Alert

Luxembourg implements EU ATAD 2 – A detailed review

Executive summary

Luxembourg's law of 20 December 2019 (the Law) implementing Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 (ATAD) regarding hybrid mismatches with third countries (ATAD 2) was published in the *Official Gazette (Mémorial)* on 23 December 2019.

The ATAD was implemented into Luxembourg law with effect from financial years starting on or after 1 January 2019 and introduced a provision dealing only with intra-European Union (EU) hybrid mismatches. Following this, the Law published in December 2019 extends the territorial scope of the anti-hybrid mismatch provision to third countries, and it addresses hybrid permanent establishment (PE) mismatches, hybrid transfers, imported mismatches, reverse hybrid mismatches and dual resident mismatches. The Law strictly follows and does not go beyond the ATAD 2's mandatory "minimum standards" to neutralize hybrid mismatches. Luxembourg also decided to opt in for all possible exceptions provided for by the ATAD 2. The Law is effective from financial years starting on or after 1 January 2020, except for the provisions on reverse hybrid entities that will apply as from tax year 2022.

With some exceptions that are noted below, the provisions of the Law only apply to corporate taxpayers and to PEs of nonresident taxpayers subject to corporate income tax (CIT).

This Alert summarizes the key provisions of the Law published in December 2019.

Detailed discussion

Background

The Luxembourg law implementing the ATAD introduced a provision addressing intra-EU hybrid mismatches with effect from 1 January 2019. The Law replaces this provision by incorporating the broader anti-hybrid provisions of the ATAD 2, and adds a new provision addressing the taxation of "reverse hybrids."

Scope

Broadly speaking, the purpose of the anti-hybrid mismatch rules of the ATAD 2 is to ensure that deductions or credits are only taken in one jurisdiction and that there are no situations of deductions of a payment in one country without taxation of the corresponding income in the other country concerned. The rules are typically limited to mismatches as a result of hybridity and do not impact the allocation of taxing rights under a tax treaty.

The Law strictly follows, but does not go beyond, the ATAD 2's mandatory "minimum standards" to address these hybrid mismatches. In addition, Luxembourg decided to opt in for all possible exceptions provided for by the ATAD 2.

The wording of the Law largely corresponds to the wording of the ATAD 2. Also, in accordance with the Preamble of the ATAD 2, the commentary to the Law states that Luxembourg will use the applicable explanations and examples in the OECD[1] BEPS[2] report on Action 2 (*Neutralising the Effects of Hybrid Mismatch Arrangements*) as a source of illustration or interpretation to the extent that they are consistent with the provisions of the ATAD 2 and EU law. Accordingly, in the commentary to the Law, various references are included to relevant paragraphs of the Action 2 report.

In addition to expanding the territorial scope of the anti-hybrid mismatch provision to third countries, the Law, in line with the ATAD 2, expands the scope of Luxembourg's current anti-hybrid mismatch rules. A hybrid mismatch means a situation involving a resident entity subject to CIT, a domestic PE of a nonresident entity or an entity considered to be tax transparent under Luxembourg tax law that generates one of the following mismatches:

- *Hybrid entity mismatches*: Situations where an entity is qualified as opaque under the laws of one jurisdiction (i.e., a taxable entity under the laws of that jurisdiction) and qualified as transparent by another jurisdiction (e.g., the partners of the entity are taxable on their share of profit under the laws of that other jurisdiction).
- *Hybrid financial instrument mismatches*: Situations where the qualification of a financial instrument or the payment made under it differs between two jurisdictions (e.g., the instrument is considered as debt in the payer jurisdiction and as equity in the payee jurisdiction).
- *Hybrid transfers*: Situations where the laws of two jurisdictions differ on whether the transferor or the transferee of a financial instrument has the ownership of the payments on the underlying asset.
- *Disregarded PE mismatches*: Situations where the business activities in a jurisdiction are treated as being carried on through a PE by one jurisdiction while those activities are not treated as being carried on through a PE in the other jurisdiction.
- *Diverted branch payment*: Situations where there is a difference between the laws of the head-office and the PE jurisdiction or between the laws of two or more PEs of the same entity as to the attribution of a payment to the branch.
- *Deemed branch payment*: Situations where a payment is deemed to have been made between the head-office and the PE or between two or more PEs of the same entity without corresponding inclusion in the jurisdiction of the beneficiary.
- *Imported mismatches*: Situations where the effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches. This includes a deductible payment in a Member State under a non-hybrid instrument that is used to fund expenditure involving a hybrid mismatch.
- *Tax residency mismatches*: Situations where a taxpayer is resident for tax purposes in two or more jurisdictions.

The Law also amends certain definitions that were introduced under the ATAD. The new anti-hybrid provisions apply, for example, only in the case of a hybrid mismatch between "associated enterprises," between the head office and PE, between two or more PEs of the same entity or under a "structured arrangement." While the 25%

minimum participation threshold introduced by the ATAD will continue to apply to hybrid mismatches arising from a hybrid financial instrument, a 50% threshold applies for all other mismatches, including mismatches resulting from the hybrid nature of entities. For purposes of the new anti-hybrid provisions, an associated enterprise also means an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has significant influence in the management or an enterprise that has significant influence in the management of the taxpayer. Whereas the commentaries to the Law specify that the criterion of associated enterprise is fulfilled through the *de facto* belonging of the entities concerned to the scope of consolidation of the same parent company and based on the consolidation standards of this parent company, no further clarification is provided on the concept of "significant influence in the management."

In addition, the concept of "acting together" is introduced, which leads to aggregating the voting rights or capital ownership that different persons hold in the same entity if they are considered as "acting together." In this sense, a person who, directly or indirectly, owns less than 10% of an investment fund and is entitled to less than 10% of the profits of the investment fund will, unless there is proof to the contrary, not be "acting together" with another person participating in the fund. An investment fund is defined as a collective investment undertaking that raises capital from multiple investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

The Law also introduces a definition of the concept of structured arrangement. This is an arrangement involving a hybrid mismatch 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 did not share in the value of the tax benefit resulting from the hybrid mismatch. In the absence of further clarification of this concept in the commentaries to the Law, the State Council, a constitutional institution called on to issue an opinion on all government and parliament draft laws and regulations, concluded in its opinion of 13 November 2019 that the explanations and examples, in particular those detailed under the recommendation 10.2. of the OECD BEPS Report on Action 2, should serve as a basis for examining the existence of a possible structured arrangement.

Anti-hybrid mismatch rules addressing specific mismatch outcomes applicable as from 2020

General

The above-mentioned hybrid mismatches trigger corrective tax adjustments only to the extent they give rise to a mismatch outcome, meaning either a double deduction, a deduction or non-taxation without "inclusion" (i.e., taxation), or a double tax credit. Any mismatch outcome that does not result from hybridity does typically not fall in the scope of the anti-hybrid provisions.

The Draft Law distinguishes between the following mismatch outcomes:

- *Double deduction*: the hybrid mismatch leads to a deduction of the same payment, expenses or losses in Luxembourg (investor jurisdiction) and in another jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction). In the case of a payment by a hybrid entity or PE the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated.
- *Deduction without inclusion* means the deduction of a payment (or deemed payment between the head office and the PE or between two or more PEs) in one country (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction.
  - The payee jurisdiction is any jurisdiction where that payment or deemed payment is received or is treated as being received under the laws of any other jurisdiction.
  - For interpretation of the term payment, reference is made to Action 2. Accordingly, it includes distributions and accruals, as well as an amount that is capable of being paid. It also includes any future or contingent obligation to make a payment.
  - As to the term inclusion, the Law requires that the amount is taken into account in the taxable income under the laws of the payee jurisdiction. With reference to Action 2, the commentaries provide that if the payment is brought into account as ordinary income in at least one jurisdiction, then there will be no mismatch for the rule to apply to. Also, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. A payment under a financial instrument is not treated as included to the extent that the payment qualifies for any tax relief solely due to the way that payment is characterized under the laws of the payee jurisdiction.

Likewise, a payment to a hybrid entity does not give rise to a hybrid mismatch when the mismatch would have arisen in any event due to the tax-exempt status of the payee under the laws of the payee's country. As per the State Council's opinion, this should hold true also in situations where the jurisdiction of the beneficiary applies a nil or low tax rate, or if it applies a territorial tax system. The commentaries also clarify that differences in tax outcome that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, do not constitute a hybrid mismatch. The same applies to timing differences for recognizing when items of income or expenditure have been derived or occurred.

- As highlighted by the State Council in its opinion, there may be situations where the interaction of the anti-hybrid provisions with Controlled Foreign Company (CFC) rules or similar rules is not entirely clear.

- *Double Tax Credit*: refers to a hybrid transfer designed to produce relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved.

The exact rules applicable to a hybrid mismatch giving rise to a mismatch outcome depend on the type of mismatch. Below is a high-level summary of the rules:

Double deduction

To the extent that a hybrid mismatch results in *double deduction*, the deduction will be denied in Luxembourg if Luxembourg is the investor jurisdiction. Where Luxembourg is the payer jurisdiction, the deduction will be denied in Luxembourg if it is not denied by the investor jurisdiction. Any deduction will, however, remain eligible to be set off against dual inclusion income.

Dual inclusion income refers to any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen.

The Law provides for a deduction up to the amount of dual inclusion income of the same tax period and a carryforward of any exceeding deduction.

The anti-hybrid mismatch rules regarding double deduction shall further not be applicable where a payment is made by a financial trader under an on-market hybrid transfer provided that the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instruments.

Deduction without inclusion

To the extent that a hybrid mismatch results in a *deduction without inclusion*, the following will apply.

Hybrid financial instrument mismatches

If the payment is not included by the payee within a reasonable period of time, the deduction shall be denied if Luxembourg is the payer jurisdiction. A "reasonable period of time" is defined as a period that begins within 12 months of the end of the Luxembourg payer's tax year, or where it is reasonable to expect that the payment will be included in the payee jurisdiction in a future tax period and the terms of the payment are those that would be expected to be agreed between independent parties. In its opinion, the State Council pointed at the ambiguity resulting from the wording of the Law (which corresponds to the wording of the ATAD 2) and the commentaries to the Law (which correspond to the wording of the Preamble of the ATAD 2). Under the Law, no counterfactual test would be required in case of a payment made to a payee benefitting from a tax exempt status under the law of its jurisdiction, whereas the commentaries suggest that such counterfactual test has to be made.

The deduction will also be denied in Luxembourg if the payment qualifies for any tax relief (e.g., an exemption from tax, a reduction in the rate of tax or any credit or refund of tax) solely due to the way that payment is characterized under the laws of the payee jurisdiction.

Where Luxembourg is the payee jurisdiction, and the payer jurisdiction has not denied the deduction, the amount that would otherwise give rise to a mismatch outcome shall be included in the Luxembourg tax base of the payee.

Luxembourg has taken the option provided for by the ATAD 2 to include an exemption for loss absorbing capacity requirements to prevent potentially unfair situations between domestically-owned and not domestically-owned groups. The provision is targeted to the banking sector and the net tax result of applying the exclusion should be the same as it would have been, had the banking subsidiary been able to issue subordinated debt directly to the market. As such, the anti-hybrid mismatch rules regarding deduction without inclusion shall not be applicable to a hybrid financial instrument if it is not part of a structured arrangement and certain other requirements are met. The provision will be applied until 31 December 2022 and shall be evaluated by the European Commission by 1 January 2022.

Hybrid PE mismatches

If Luxembourg is the payer jurisdiction the deduction shall be denied if:

1. A payment is made to a disregarded PE.
2. A payment is made to an entity with one or more PEs and there is no inclusion because of a difference in the allocation of payments between the head office and PE or between two or more PEs of the same entity.
3. There is a notional payment made by a PE or between two or more PEs that does not give rise to an inclusion because the payment is disregarded under the laws of the payee jurisdiction. In this hybrid PE mismatch situation, however, any deduction will remain eligible to be set off against dual inclusion income in a current or subsequent period.

Where Luxembourg is the payee jurisdiction in the above three hybrid PE mismatch situations and the deduction is not denied by the payer jurisdiction (e.g., because its source is in a third country), Luxembourg has opted for the possibility to not include the income in the Luxembourg taxable base. However, where a Luxembourg corporate taxpayer has a disregarded PE in an EU Member State whose income is not subject to tax in Luxembourg as a result of the application of a tax treaty with that EU Member State, the Luxembourg taxpayer must include the income that would otherwise be attributed to the disregarded PE in the Luxembourg tax base.

Hybrid entity mismatches

a. Payments to a hybrid entity

In the case of a payment by a Luxembourg corporate taxpayer or Luxembourg PE **to** a hybrid entity, the deduction shall be denied in Luxembourg if 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 entity is established and the jurisdiction of any person with a participation in that hybrid entity.

Where Luxembourg is the payee jurisdiction (i.e., the jurisdiction of the taxpayer participating in the hybrid entity) and the deduction is not denied by the payer jurisdiction (e.g., because the payer is in a third country), Luxembourg has opted for the possibility to not include the income in the Luxembourg taxable base.

b. Payments by a hybrid entity

In case of a payment **by** a hybrid entity (e.g., a Luxembourg corporate taxpayer for which an entity classification election has been made in the United States to treat it as a disregarded entity) the deduction shall be denied in Luxembourg if the mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction. The deduction will not be denied, however, to the extent of the amount of dual inclusion income.

Imported mismatch

In the case of an *imported mismatch*, Luxembourg will deny the deduction for any payment by a taxpayer subject to Luxembourg CIT to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction between associated enterprises or entered into as part of a structured arrangement. This rule should not apply to the extent that one of the jurisdictions involved in the transaction has made an equivalent adjustment in respect of such hybrid mismatch. It is still unclear if an inclusion under CFC or similar rules is considered to be an equivalent adjustment in respect of imported mismatches.

Double tax credit

Where a hybrid transfer gives rise to a *double tax credit*, Luxembourg will limit the benefit of such relief in proportion to the net taxable income regarding the payment derived from a transferred financial instrument.

Tax residency mismatch

To the extent that a deduction for payment, expenses or losses of a taxpayer, which is resident for tax purposes in Luxembourg and in one or more other jurisdictions, is deductible from the taxable base in Luxembourg and in the other jurisdiction(s), Luxembourg will deny the deduction to the extent that the other jurisdiction(s) allows the duplicate deduction to be set-off against income that is not dual-inclusion income. However, payments, expenses or losses will remain deductible if there is a tax treaty in place between Luxembourg and the other jurisdiction(s) according to which the taxpayer is considered a resident of Luxembourg.

Taxation of reverse hybrid entities as from 2022

A *transparent entity* incorporated or established in Luxembourg (e.g., Luxembourg limited partnership (*société en commandite simple*; SCS), special limited partnership (*société en commandite spéciale*; SCSp)) will be treated as a corporate taxpayer if one or more associated nonresident entities holding in aggregate a direct or indirect interest of at least 50% of the voting rights, capital interests or rights to profit are located in a jurisdiction/jurisdictions that regard the entity as opaque. Such transparent entity will be subject to Luxembourg CIT on its portion of income that is not otherwise taxed under the laws of Luxembourg or any other jurisdiction. This provision will not apply, however, to collective investment vehicles. In this respect, "collective investment vehicle" means 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. According to the commentaries, it covers undertakings for collective investment as defined under Luxembourg law of 17 December 2010, the Specialized Investment Funds (SIFs) as defined under Luxembourg law of 13 February 2007, and the Reserved Alternative Investment Funds (RAIFs) as defined under Luxembourg law of 23 July 2016. Also covered are alternative investment funds as defined under law of 12 July 2013 on alternative investment fund managers provided they are widely held, hold a diversified portfolio of securities and are subject to investor protection requirements.

As the ATAD only applies to CIT, transparent entities that are treated as corporate taxpayers as a result of the rules described above will nevertheless be exempt from net worth tax.

Burden of proof

To prove that the anti-hybrid mismatch provisions are not applicable in a particular case, the taxpayer must be able to provide a declaration of the issuer of the financial instrument or any other relevant document such as tax returns, other tax documents or certificates issued by foreign tax authorities. Such documentation needs to be provided on demand of the tax authorities. The comments to the Law give the example of a financial instrument, in relation to which the taxpayer is required to analyze the expected treatment in the other jurisdiction and to justify such analysis in order to confirm the application of the deduction. With reference to the Action 2 report (para 85), such analysis is "primarily a legal question that requires an analysis of the general rules for determining the character, amount and timing of payments under a financial instrument in the payer and payee jurisdictions."

Implications

The ATAD was an unprecedented change in EU direct taxation and accordingly, it has a significant effect on the taxation of businesses operating in the EU. The ATAD 2 completes the picture by addressing mismatches with third countries and significantly expanding the scope of the ATAD to hybrid PE mismatches, hybrid transfers, imported mismatches, reverse hybrid mismatches and dual resident mismatches that may have far reaching consequences for taxpayers operating in the EU. Consequently, stakeholders should carefully analyze their investment structures and be prepared to provide adequate proof that the anti-hybrid mismatch provisions are not applicable in a particular case.

Endnotes

1. Organisation for Economic Co-operation and Development.
2. Base Erosion and Profit Shifting.

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