

Luxembourg: A detailed review of the EU ATAD implementation law

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Executive summary

On 21 December 2018, the Luxembourg law (the Law) implementing the European Union (EU) Anti-Tax Avoidance Directive¹ (ATAD) was published in the *Official Gazette*.

The Law introduces a limitation to interest deductibility, Controlled Foreign Company (CFC) rules and rules countering hybrid mismatches within the EU. It also amends the existing exit taxation regime (including provisions relating to inbound transfers) as well as the General Anti-Abuse Rule (GAAR). The Law also amends two existing domestic provisions regarding the tax-neutral conversion of debt into equity and the definition of permanent establishments (PEs).

The provisions of the Law apply to tax years starting on or after 1 January 2019, except for the provisions regarding exit taxation that will apply to accounting years starting on or after 1 January 2020.

This Alert details the various new and amended provisions of the Law.

Detailed discussion

1. CFC rules

The ATAD requires the introduction of CFC rules, but allows EU Member States two different options, the first one being generally applicable to passive income of a CFC (option A) and the second one applicable to income arising from “non-genuine arrangements” (option B). The Law is based on option B.

Definition of a CFC

A CFC is defined as an entity or a PE whose income is not taxable or exempt in Luxembourg if the following two conditions are met:

- ▶ In the case of an entity, the Luxembourg taxpayer, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights or the entitlement to profits
- ▶ The entity or PE is low-taxed, i.e., the income tax it pays is lower than 50% of the Luxembourg corporate income tax (CIT) it would have paid applying the provisions of the Luxembourg Income Tax Law (ITL).

Any PE of a CFC, which is not taxable or tax exempt in the territory of its location, is not considered for the purposes of the aforementioned computation.

“Associated enterprises” includes the following:

- ▶ Resident or nonresident taxpayers subject to Luxembourg CIT or entities that are transparent under Luxembourg law (e.g., partnerships), in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or are entitled to receive 25 % or more of the profits of that entity.
- ▶ Individuals or resident or nonresident taxpayers subject to Luxembourg CIT or transparent entities that hold directly or indirectly a participation in terms of voting rights or capital ownership in the taxpayer of 25% or more, or are entitled to receive 25% or more of the profits of the taxpayer.
- ▶ All entities, including the taxpayer, that are held directly or indirectly by an individual or a resident or nonresident corporate taxpayer or a transparent entity for 25% or more in terms of voting rights or capital ownership in the taxpayer and one or more entities.

This definition of “associated enterprises” does not only apply in the context of the CFC rules, but to the entire ITL (and notably to the provisions on hybrid mismatches and

interest limitation, see sections below). However, a slightly different concept of “related enterprises” is applied in the context of the provisions on transfer pricing (articles 56² and 56bis ITL).

In order to determine whether an entity or PE is low-taxed, the effective tax burden of the CFC must be compared with the tax it would have paid if it had been a Luxembourg resident. In a first step, the final tax burden of the CFC is determined, taking into account all taxes paid by the CFC, insofar as they are comparable to the Luxembourg CIT, and considering subsequent reimbursements and non-collected taxes. An entity is not considered to be a CFC if its tax burden is below the 50% threshold solely because of the utilization of tax losses carried forward. In a second step, the tax that would have been due by the CFC according to the provisions of the Luxembourg ITL must be determined and compared with the actual tax established and paid by the CFC. The reference to the provisions of the ITL seems to imply that any benefits granted under Luxembourg tax treaties should not be considered in this comparison.

In line with the option given by the ATAD, the Law excludes from the CFC rules a foreign company: (i) with accounting profits of no more than €750,000; or (ii) with accounting profits amounting to no more than 10% of its operating costs for the tax period. The cost of assets sold outside the country of tax residence of the entity or the country of location of the PE as well as payments to associated enterprises are excluded for the computation of the aforementioned threshold.

Income to be included

The non-distributed income of a CFC must be included in the tax base of the Luxembourg taxpayer if the income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

The Law clarifies that only interim dividends (i.e., distributions allocating profits of the same tax year and not distributions in a given tax year of profits from prior years) distributed by the CFC are considered as “distributed” and reduce the amount of the CFC inclusion.

An arrangement or a series thereof is regarded as non-genuine to the extent that the CFC would not own the assets which generate all or part of its income or would not have undertaken the risks if it were not controlled by a taxpayer who carries out the significant people functions which are relevant to those assets and risks, and are instrumental in generating the CFC’s income.

The net income to be included in the Luxembourg tax base is limited to the amounts generated through assets and risks in relation to which the significant people functions are carried out by the controlling Luxembourg entity, as determined in application of the arm's-length principle under the Luxembourg transfer pricing provisions. In other words, if the Luxembourg entity does not have significant people functions in relation to the assets and/or risks of a CFC, there will be no income inclusion, notwithstanding the fact that the Luxembourg entity may have significant presence and functions in Luxembourg.

This limits the application of the CFC rules to entities that were not able to generate the income themselves, considering the assets owned and the risks assumed, and in relation to which the significant people functions are carried out by the controlling Luxembourg entity.

The net income to be included in the Luxembourg tax base is deemed to be commercial profit (as is any other income realized by a corporate taxpayer). Expenses are deductible only to the extent that they are economically linked to the income to be included in the tax base.

Only positive net income is taken into consideration; negative net income is not included in the tax base in order to avoid that such negative income of the CFC artificially reduces the tax burden of the taxpayer. If the total net income of the CFC is positive, the taxpayer is entitled to deduct up to this total, the negative net income that has not been deducted in a previous year and that could not be deducted in any subsequent year. Any negative net income of the CFC can thus only be compensated with its own positive net income. This applies to losses realized by a CFC after the entry into force of the CFC provisions.

The income to be included in the tax base is calculated in proportion of the taxpayer's participation in the CFC and is included in the financial year of the taxpayer in which the financial year of the CFC ends. If the income that has been reallocated to the taxpayer is also taxed in the country of residence or location of the CFC, the taxpayer can credit the foreign tax in line with the existing provisions on foreign tax credits.

If the financial statements of the CFC are held in another currency than that of the taxpayer, the income must be converted at the exchange rate of the balance sheet date of the taxpayer, as published by the European Central Bank.

The tax base will be reduced by any amount of profits distributed by the CFC to the Luxembourg taxpayer that have been previously included in the tax base up to the amount of such distribution (unless such dividend distribution is already exempt based on a different provision, e.g., the Luxembourg participation exemption). Similarly, where the taxpayer disposes directly or indirectly of its participation in the CFC or the PE, any part of the capital gain from such disposal that has been previously included in the tax base of the Luxembourg taxpayer as CFC income will be deducted from the tax base up to the amount of such part of the capital gain (unless already exempt).

Non-application for MBT purposes

The CIT base serves as the starting point for the determination of the second Luxembourg income tax, the MBT. As the CFC inclusion is only intended to apply to CIT but not to MBT because of the territoriality principle, the MBT Law is amended by adding the requirement to exclude CFC income from the MBT base.

Interaction with transfer pricing provisions

It should be noted that the CFC rules apply only after application of the transfer pricing rules laid down in articles 56 and 56bis ITL. As a result of the transfer pricing rules, any significant people functions in relation to a CFC's assets and risks would have to be appropriately remunerated and subject to Luxembourg income taxes. As noted by the Luxembourg State Council in its opinion, the CFC inclusion described above would appear to result in a second inclusion of the same income (however, limited to CIT only), which underlines the character of the CFC rules as an anti-abuse provision. The interaction between transfer pricing and CFC rules has not been clarified further during the legislative process.

Scope and entry into force

The aforementioned provisions apply to companies and domestic PEs of nonresident entities subject to Luxembourg CIT with respect to financial years starting on or after 1 January 2019.

2. Interest limitation

Under current legislation, interest expenses are fully deductible, provided that they respect the arm's-length principle and are not linked to tax-exempt income. The Law introduces an interest limitation rule that limits the deductibility of taxpayers' borrowing costs to 30% of taxable

EBITDA (Earnings (taxable profits) before Interest, Tax, Depreciation and Amortization, see below). The ATAD foresees a number of options and choices, most of which are reflected in the Law.

The new rule only affects the deductibility of interest, but does not requalify the expense. As a result, where interest is not deductible in application of the new rule, it remains interest for all tax purposes, including withholding taxes.

Computation of deductible interest

Exceeding borrowing costs are deductible up to the higher of 30% of taxable EBITDA or €3 million. The latter is a de minimis rule allowing the taxpayer to deduct exceeding borrowing costs up to €3 million in any case.

“Exceeding borrowing costs” is defined as the excess of borrowing costs (as defined) over interest income and other economically equivalent taxable revenues.

The definition of **“borrowing costs”** mimics that of the ATAD, i.e., interest expenses on all forms of debt, other costs economically equivalent to interest, as well as expenses incurred in relation with the raising of finance, including, without being limited to:

- ▶ Payments under profit participating loans
- ▶ Imputed interest on instruments such as convertible bonds and zero-coupon bonds
- ▶ Amounts paid under alternative financing arrangements, such as Islamic finance
- ▶ The finance cost element of finance lease payments
- ▶ Capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest
- ▶ Amounts measured by reference to a funding return under transfer pricing rules
- ▶ Notional interest under derivative instruments or hedging arrangements related to an entity's borrowings
- ▶ Certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- ▶ Guarantee fees for financing arrangements
- ▶ Arrangement fees and similar costs related to the borrowing of funds

No distinction is made based on the creditor, and the rule applies to interest under intra-group and third-party loans alike.

The commentaries to the Law do not contain further details regarding the definition of borrowing costs. Whether an expense in relation to a determined financing instrument

falls within this definition will have to be analyzed on a case-by-case basis and with respect to the relevant terms and conditions of the instrument at stake.

Interest income is not specifically defined (neither is there a specific definition in the ATAD). As stated by the State Council in its opinion, this deficiency of definition could be remedied by adopting a symmetric approach regarding the definition of borrowing costs and interest income, in the sense that where a specific item is considered as borrowing costs for the debtor, it would be considered as interest income for the creditor. However, no reference to symmetry is made in the Law or related commentaries made by the legislator.

Taxable EBITDA is defined as the total of net taxable income as per the Luxembourg ITL, (i) increased by exceeding borrowing costs, the tax values of depreciations and amortizations that have reduced taxable income, and expenses economically linked to tax-exempt income and (ii) reduced by any exempt income.

The Law does not currently foresee that companies forming a fiscal unity would be allowed to determine exceeding borrowing costs and EBITDA for the fiscal unity as such. However, as announced in December by Luxembourg's Minister of Finance,³ the interest limitation rules will be amended in early 2019 (with retroactive effect to 1 January 2019) so as to apply to fiscal unities as a whole.

Exclusion of certain exceeding borrowing costs

The Law contains a grandfathering clause according to which interest on loans that were concluded before 17 June 2016 is excluded from the borrowing cost definition, but the grandfathering will not apply to *any subsequent modifications of such loans*.

It is unclear what constitutes a subsequent modification though. The wording of the Law corresponds to the wording of the ATAD and the commentary to the Law quotes the Preamble of the ATAD, which would indicate that grandfathering would not apply to any increase in the amount or duration of the loan, but may still apply to the original terms of the loan.

The Law also excludes interest on loans used to fund long-term public infrastructure projects where the operator, borrowing costs, assets and income are all located in the EU. Long-term public infrastructure projects are defined as projects to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by an EU Member State.

Income earned from such a long-term public infrastructure project is also excluded from the definition of taxable EBITDA.

Equity escape rule

Where the taxpayer is a member of a consolidated group for financial accounting purposes, it may, upon request, deduct the entire amount of its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is higher or at least equal (with a tolerance of lower by not more than two percentage points) than the equivalent ratio of the group. For these purposes, all assets and liabilities have to be valued using the same method as in the consolidated financial statements drawn up in accordance with International Financial Reporting Standards (IFRS) or the national financial reporting system of an EU Member State.

Exclusion of stand-alone entities and financial undertakings

As permitted by the ATAD, the Law excludes standalone entities from the scope of the interest limitation rule. A standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise (in the meaning of the new associated enterprises definition, see section on CFC rules above).

The Law also excludes financial undertakings from the scope of the interest limitation rules. Those undertakings comprise:

- ▶ Credit institutions, investment firms, alternative investment fund managers (AIFMs) and management companies of undertakings for collective investment in transferable securities (UCITS)
- ▶ Insurance and reinsurance undertakings
- ▶ Institutions for occupational retirement provision or delegates of such institutions
- ▶ Pension institutions operating pension schemes which are considered to be social security schemes as well as any legal entity set up for the purpose of investment of such schemes
- ▶ Alternative investment funds (AIF) managed by an AIFM (as defined in Directive 2011/61/EU) or supervised under the amended law of 15 June 2004 on Investment Companies in Risk Capital (SICAR)
- ▶ UCITS in the meaning of art. 1 (2) of Directive 2009/65/EC⁴
- ▶ A central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of 4 July 2012
- ▶ Central securities depositories as defined in Article 2 (1) of Regulation (EU) No 909/2014 of 23 July 2014
- ▶ Securitization vehicles covered by Regulation (EU) 2017/2042 of 12 December 2017

Carry forward of exceeding borrowing costs and unused interest capacity

The Law foresees the possibility for the taxpayer to carry forward exceeding borrowing costs without limitation in time. As a result, if a taxpayer's exceeding borrowing costs during a given financial year are below 30% of its taxable EBITDA, it may still deduct, in addition to the exceeding borrowing costs of the current financial year, those exceeding borrowing costs that were not deductible in previous financial years (within the limits of the 30% EBITDA limit of the same year).

The Law also allows for a five-year carry forward of unused interest capacity, i.e., the amount by which 30% of taxable EBITDA exceeds the amount of exceeding borrowing costs provided these amount to at least €3 million. As a result, even if the amount of exceeding borrowing costs exceeds the 30% EBITDA limit in a given year, a taxpayer may still deduct this surplus amount of exceeding borrowing costs to the extent it has unused interest capacity carried forward from the five previous financial years.

Interaction with existing recapture rules

The Law remains silent on the interaction between the new interest limitation rules and the existing recapture rules. Under the rules governing the domestic participation exemption, expenses (e.g., interest expenses) that are economically linked to dividend income that is tax exempt may be deducted for the amount that exceeds the tax-exempt dividend. However, these deductions have to be recaptured upon the sale of the participation i.e., the tax-exempt amount of the capital gain will be reduced by the amount of expenses that have been deducted in the current and previous years. The rule results in a deferral of tax on other, non-exempt, income, but is overall neutral as regards the income from holding activities.

To what extent the interest limitation rules may have an impact on recapture should be analyzed on a case-by-case basis.

Scope and entry into force

The aforementioned provisions apply to companies and domestic PEs of nonresident entities subject to Luxembourg CIT with respect to financial years starting on or after 1 January 2019.

3. Anti-hybrid rules

The Law only implements the anti-hybrid rules of the ATAD, which relate to specific intra-EU transactions only. More extensive anti-hybrid rules will have to be implemented when the ATAD 2⁵ is transposed into Luxembourg law.

Hybrid mismatches as per the Law

“Hybrid mismatch” refers to differences in the legal qualification of a financial instrument or an entity, if a structured arrangement between the taxpayer and a party established in another EU Member State or if the commercial or financial relations between the taxpayer and an associated enterprise established in another EU Member State entail the following consequences:

- ▶ A deduction of the same expenses or losses occurs both in Luxembourg and the EU Member State in which the expenses are incurred or the losses are suffered (double deduction), or
- ▶ A payment is deducted in Luxembourg where it has its source without an inclusion of the corresponding income in taxable income in the other EU Member State (deduction without inclusion).

Associated enterprises are defined as per the new definition described in the section on CFCs above. However, when the mismatch involves a hybrid entity (i.e., where the taxpayer or the associated enterprise is a hybrid entity in the sense of this provision), the 25% threshold is replaced by a 50% threshold. The increase to 50% only applies in the context of the anti-hybrid rules and not for any other purposes (e.g., CFC or interest limitation rules).

The Law does for the time being not include a definition of the concept of “structured arrangement”; such definition is expected to be inserted with the law implementing the ATAD 2 into domestic law.

Luxembourg tax consequences of a hybrid mismatch

Luxembourg will deny the deduction of an expense related to a hybrid arrangement to the extent the expense is deductible in another EU Member State where the expense has its source (double deduction situations) or the income is not taxable in another EU Member State (deduction without inclusion).

Required documentation

The Law states that the taxpayer must be able to document the non-deduction of the expense or taxation of the income in the other EU Member State, as the case may be. For this purpose, the taxpayer must be able to submit, upon request, a declaration of the issuer of the financial instrument or any

other relevant documents such as tax returns, other tax documents or certifications issued by the tax authorities of the other EU Member State which demonstrate that the payment has not been deducted or that the income has been taxed in that other State (as the case may be).

Scope and entry into force

The aforementioned provisions apply to companies and domestic PEs of nonresident entities subject to Luxembourg CIT with respect to financial years starting on or after 1 January 2019.

Hybrid arrangements involving third countries as well as hybrid PE mismatches that are covered by the ATAD 2 will be transposed into Luxembourg law by a separate law, which is expected to be applicable to financial years starting on or after 1 January 2020 (and 1 January 2022 as regards specific consequences for reverse hybrid mismatches).

4. Exit taxation

In 2014, Luxembourg enacted legislation that allows companies transferring an enterprise or migrating out of Luxembourg to defer the exit taxes that would normally be applicable. Since 2016, such interest-free tax deferral has applied to such transfers to any country that: (i) either belongs to the European Economic Area (EEA); or (ii) has a double taxation treaty with Luxembourg and exchange of information in line with Organisation for Economic Co-operation and Development (OECD) principles is foreseen in such double taxation treaty or in a bi- or multilateral agreement.

As the ATAD does not foresee the possibility of long-term deferrals but only installment payments of exit tax, the Law introduces significant changes to the existing provisions. In addition, new provisions are introduced to better align valuations used in the exit state with the receiving state.

Valuation on inbound transfers

Upon specific inbound transfers, the transferred assets (and liabilities) are to be valued at the amount determined by the exit state of the taxpayer or of the PE, unless this value does not reflect the going concern value. This applies in the following situations:

- ▶ A taxpayer transfers either its tax residence or habitual place of abode, its statutory seat or its central administration, or the activity carried out through a PE, from another state to Luxembourg.
- ▶ Assets are transferred by a PE to the Luxembourg head office or by a foreign head office to a Luxembourg PE.

This new provision aims to fulfill the symmetry criterion set forth by the ATAD, which requires the state of destination to take over the values established by the exit state when calculating the exit tax. To ensure uniform application of the rule, the Law does not limit these rules to transfers from an EU Member State, but applies them to transfers from any state.

Furthermore, a new provision is introduced that clarifies that the acquisition date of such assets corresponds to their historical acquisition date.

Valuation on outbound transfers

An explicit provision is introduced according to which transfers of individual assets in specific situations will be considered as taxable alienation of such assets at fair market value. These situations include transfers of assets from a Luxembourg enterprise to a PE located in another state (to the extent that Luxembourg loses the right to tax such assets) and transfers of assets from a Luxembourg PE to the head office in another state or to a PE located in another state (to the extent that Luxembourg loses the right to tax such assets).

The provision on transfers of enterprises or PEs abroad are amended and exit taxation now specifically applies to: (i) transfers of enterprises or PEs abroad in the context of taxpayers transferring their tax residence or habitual place of abode (for individuals), or statutory seat and central administration (for corporate taxpayers) to another state, except for assets which remain effectively attached to a Luxembourg PE and for which the accounting values are continued; and (ii) transfers of the activity carried out by a Luxembourg PE to another state, insofar as Luxembourg loses the right to tax the transferred assets.

The aforementioned provisions do not apply to the transfer of: (i) assets linked to the financing of securities; (ii) assets posted as collateral; or (iii) where the transfer of assets is made to meet prudential capital requirements or for the purpose of liquidity management, as long as these assets are intended to revert back to Luxembourg as state of origin within a period of 12 months as from the date of the transfer. These assets continue to belong to the taxpayer's net assets invested as if the transfer abroad did not occur and the income derived from these assets continues to be allocated to Luxembourg.

Going forward the transfer of an enterprise or domestic PE that is owned by a taxpayer resident in an EEA Member State to another EEA Member State no longer triggers a rectification of the tax assessed in cases where the

other state does not recognize any losses realized on the transferred assets after the transfer. The provision requiring such rectified assessments had been introduced in 2014 to meet the requirements of the European Commission in a formal notice to Luxembourg. According to the comments in the parliamentary documents, this measure appears to be unnecessary since the value established by the exit state is binding for the other state.

Payment deferral of the exit tax

As mentioned above, the ATAD requires Luxembourg to abolish the current unlimited deferral of exit tax. Going forward, a taxpayer may request the payment of the exit tax debt in equal installments over a maximum period of five years, subject to the condition that the transfer is made to an EU Member State or an EEA Member State other than an EU Member State with which Luxembourg or the EU has concluded an agreement on the mutual assistance for the recovery of tax, offering a mutual assistance equal to that foreseen by the Council Directive 2010/24/UE dated 16 March 2010.⁶ This aforementioned condition aims at ensuring that an effective assistance in collection of taxes will be available.

The Law does not foresee interest or guarantees, despite these options being foreseen in the ATAD.

The deferral is immediately discontinued and the outstanding amount of the tax debt becomes due in the following cases:

- a. The assets or activity transferred, carried on by the taxpayer's PE, are sold or withdrawn, except in case of a tax neutral operation as foreseen by the Merger Directive⁷ provided the beneficiary(ies) company(ies) declare taking over the rights and obligations of the contributor in relation with the payment deferral.
- b. The assets transferred are subsequently transferred to a state that is not an EU Member, except if the state of destination is an EEA Member State other than an EU Member State and Luxembourg or the EU has an agreement on mutual assistance for the recovery of tax claims with that state, offering mutual assistance equal to the one foreseen by the Council Directive 2010/24/UE dated 16 March 2010.
- c. The tax residence or habitual place of abode, the statutory seat and the central administration of the taxpayer, or the activity performed by its PE is transferred to a state that is not an EU Member, except if the state of destination is an EEA Member State other than an EU Member State and Luxembourg has an agreement on mutual assistance

for the recovery of tax claims with the destination state, offering mutual assistance equal to the one foreseen by the Council Directive 2010/24/UE dated 16 March 2010.

- d. The taxpayer goes bankrupt or is liquidated.
- e. The taxpayer fails to honor its obligations in relation to the installments and does not correct the situation within a reasonable period of time, which shall not exceed 12 months.
- f. The taxpayer fails to document annually, in due form, that the situations listed under (a), (b) and (c) did not occur.

Scope and entry into force

Any resident taxpayer carrying out a commercial activity, be it an individual or a company, is subject to the aforementioned provisions with respect to financial years starting on or after 1 January 2020. The Law foresees a transitional measure, pursuant to which deferrals granted for financial years closed before 1 January 2020 are not affected by the new provisions. Implications for existing deferrals and, in particular, from transactions subsequent to such deferrals having been granted, should be analyzed on a case-by-case basis.

5. GAAR – Amendments to art. 6 Tax Adaptation Law (StAnpG)⁸

The ATAD foresees a GAAR according to which arrangements that have been put into place for the main purpose or one of the main purposes of obtaining a tax advantage should be ignored if they are not genuine, i.e., if they are not put into place for valid commercial reasons which reflect economic reality.

A GAAR is already codified in art. 6 StAnpG, which states that “the tax burden cannot be circumvented or reduced through the misuse of forms and institutions of private law” and entitles tax authorities to levy tax according to the effective economic operations, facts and circumstances. In order to maintain continuity in the application of this anti-abuse provision, the Law rephrases and completes the existing GAAR rather than replacing it with the GAAR wording contained in the ATAD. As was already the case in the past, the amended GAAR does not only apply to entities that are subject to CIT, but to any domestic tax law and to any taxpayer, be it a corporation, a partnership or an individual.

The new wording maintains (but to some extent amends) the three principal elements of abuse in tax matters, being:

- A misuse of forms and institutions of private law

- The aim of this legal path (form or institution of law) being to obtain a circumvention or reduction of the tax burden that defeats the object or the purpose of the tax law
- The non-authentic character of the legal path used

The amended wording keeps the reference to the forms and institutions of law (the reference to private law is deleted and the definition is expanded to now cover all forms of law), rather than the insertion of the concept of “arrangement or series of arrangements” of the ATAD, which would be a new concept that existing case law on anti-abuse would not be applicable to.

The comments to the Law clarify that any abuse of a provision of the tax law is covered, i.e., not only abuse leading to a reduction of the tax burden, but also abuse resulting in a reimbursement of tax or a tax credit for foreign withholding taxes.

Even though the taxpayer still has the “choice of the least taxed way,” the comments to the Law state that it is not legitimate to use a legal path for the main purpose or one of the main purposes of obtaining a circumvention or a reduction of the tax burden that defeats the object or purpose of the tax law, if this legal path is not authentic considering all relevant facts and circumstances. The Law reproduces the definition of the ATAD to define “non-authentic arrangements,” i.e. arrangements “not put in place for valid commercial reasons which reflect economic reality.” The commentaries to the Law refer to existing Luxembourg case law.

The commentaries also clarify that specific anti-abuse provisions, as they exist for example for the application of the participation exemption or in the CFC rules to be introduced, prevail over the GAAR.

The burden of proof for the existence of an abuse remains, as is currently the case, with the tax authorities. In line with existing case law, the state is however not obliged to concretely prove the impossibility of an economic reason of the legal path used; it is sufficient to make plausible that an economic reason is lacking, which then shifts the burden of proof to the taxpayer.

Scope and entry into force

The aforementioned provisions are applicable to any taxpayer realizing business income, income from agricultural and forestry or income from self-employment with respect to financial years starting on or after 1 January 2019. For taxpayers realizing other types of income, the reworded GAAR applies as from tax year 2019.

6. Additional measures

Amendment of the PE definition

Art. 16 StAnpG, which provides for the definition of a domestic PE, is expanded by an additional paragraph relating to the recognition of foreign PEs.

According to this new provision, the recognition of a PE in a treaty country will be based exclusively on the criteria set forth by the double taxation treaty concluded with that country. A taxpayer will be considered as having a PE in the other Contracting State if the activity that is exercised in the other country constitutes an independent activity and represents a participation in the general economic life in that other country.

Whether a PE exists will have to be determined on a case-by-case analysis. An example given by the commentaries to the Law is the operation of a plant, a garage or a construction site. However, the mere management of financial assets or of intellectual property assets may not be considered to be sufficient to create a PE in the other Contracting State.

In its opinion, the State Council highlighted the fact that the concepts of “independent activity” and “participation in the general economic life” are also used in the context of article 14 ITL for purposes of defining what constitutes a commercial, industrial, mining or craft enterprise. It therefore suggested referring to existing case law and doctrine on article 14 ITL for assessing, on a case-by-case basis, the existence of a PE under the new PE definition rather than excluding from the outset activities such as the management of financial or intellectual property assets.

According to the comments to the Law, it may be easier for the source country to analyze the facts and circumstances of a particular case. Therefore, the Luxembourg taxpayer may be requested to provide a confirmation, e.g., a tax assessment or certificate issued by the foreign tax authorities, that the other country recognizes the existence of a PE. Such confirmation must be provided where the relevant double taxation treaty does not contain a provision entitling Luxembourg to tax income or capital if the other country applies the provisions of the double taxation treaty to exempt such income or capital (i.e. a provision similar to art. 23A (4) OECD Model or art. 5 option A of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS⁹ (MLI)).¹⁰ The new provision does not explicitly require the PE to be effectively taxed in the other country.

The Law does not state that the delivery of such confirmation is a prerequisite for the recognition of a PE. Where the activities abroad qualify as independent activity that represents participation in the general economic life in the PE jurisdiction, it would therefore seem that a PE should be recognized abroad irrespective of whether or not a confirmation is provided.

The impact of this new provision will have to be analyzed in further detail on a case-by-case basis, taking into account all relevant facts and circumstances.

The aforementioned provision applies to financial years starting on or after 1 January 2019 and will be relevant for any Luxembourg taxpayer having a PE in a country with which Luxembourg has concluded a double taxation treaty. Its impact is not limited to income taxes, but will also extend to net worth tax.

Tax-neutral conversion of debt into equity

The tax neutral conversion of loans into shares, as it was foreseen by article 22bis (2) 1 ITL, has been abolished. The explanation given for the abolition is that the provision may lead to situations of deduction without corresponding taxation, which goes against the objective of the provision. Going forward, such conversion will be treated tax-wise as a deemed disposal, at fair market value, of the loan, followed by a deemed acquisition of the shares. Latent capital gains attached to such convertible loans will thus become taxable at the time of their conversion into shares.

Entry into force

The tax neutral conversion ceases to apply to Luxembourg resident taxpayers (companies subject to Luxembourg CIT and individuals that carry out a commercial activity) with respect to financial years starting on or after 1 January 2019.

Implications

The implementation into domestic law of the provisions laid down by the ATAD will have a significant impact on Luxembourg corporate taxpayers. In addition, Luxembourg taxpayers operating abroad through a PE will have to assess if they will still be able to benefit from an exemption in Luxembourg for the income derived through, and capital held by, such PE, taking into account the additional restrictions to the recognition of a foreign PE. This will already be relevant for the determination of the net worth tax base as of 1 January 2019.

The new legislation is complex and constitutes a major change that needs to be considered by all types of Luxembourg companies, whether they are engaged in holding, financing, operating or any other activities. Existing structures therefore have to be reviewed in detail in light of these changes. Any analysis of the implications of the Law will have to also consider changes in tax law elsewhere in the world and other factors affecting business operating models more generally. Even if the provisions of the Law turn out not to have an actual cash tax impact on a particular taxpayer, they have to be analyzed and conclusions and positions will have to be documented.

Endnotes

1. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
2. Article 56 ITL: "When an enterprise participates, directly or indirectly in the management, control or capital of another enterprise, or where the same individuals participate, directly or indirectly, in the management, control or capital of two enterprises (...)"
3. See EY Global Tax Alert, [Luxembourg Minister of Finance announces interest limitation will apply at fiscal unity level](#), 12 December 2018.
4. I.e., an undertaking (a) with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading; and (b) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.
5. Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.
6. Council Directive 2010/24/EU of March 16, 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.
7. Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.
8. *Steueranpassungsgesetz - StAnpG*.
9. Base Erosion and Profit Shifting.
10. See EY Global Tax Alert, [Luxembourg explains its positions on Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS](#), 13 June 2017.

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EYG no. 012554-18Gbl

1508-1600216 NY
ED None

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