Doctrine

THE REVERSE HYBRID MISMATCH RULE IN LUXEMBOURG

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On 19 December 2019, the Luxembourg legislator passed the law implementing EU Directive 2017/952 of 29 May 2017 (the Anti-Tax Avoidance Directive 2 or ATAD 2) which provides for a comprehensive framework to tackle hybrid mismatch arrangements in a mere EU context and in transactions involving third States. This is the second of two articles that analyses the scope, limits and mechanism of the reverse hybrid mismatches rule.

INTRODUCTION

Hybrid mismatches are the consequence of differences in the tax treatment of an entity, a financial instrument or a permanent establishment under the laws of two or more jurisdictions and those differences may give rise to deduction without inclusion or double deduction outcomes.

The hybrid mismatch rules provided under Article 168*ter* of the Luxembourg Income Tax Law[1] (LITL) apply as from 1 January 2020 and target a variety of different situations including direct hybrid mismatches between associated enterprises, structured arrangements between third parties, imported hybrid mismatches and tax residency mismatches. In addition, Article 168*quater* of the LITL provides for a reverse hybrid mismatch rule that applies as from tax year 2022.

While the primary objective of the hybrid mismatch rules is the elimination of double non-taxation, tax adjustments under the hybrid mismatch rules should likewise not result in economic double taxation. This is ensured through a number of carve-outs and limitations that discharge the application of the hybrid mismatch rules.

ATAD 2 follows the recommendations of the Organisation for Economic Co-operation and Development in regard to Action 2 of the Base Erosion and Profit Shifting (BEPS) Project that aim at neutralising the effects of hybrid mismatch arrangements through the application of linking rules that align the tax treatment in two or more jurisdictions. ATAD 2 explicitly states that the explanations and examples in the Final Report on Action 2 may be a source of interpretation to the extent this guidance is consistent with the provisions of the Directive[2].

I. SCOPE OF THE REVERSE HYBRID MISMATCH RULE

A reverse hybrid is an entity that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. opaque) under the laws of the jurisdiction(s) of the investor(s)[3].

As a consequence, the income of a reverse hybrid may neither be taxable in its establishment jurisdiction (as the income is deemed to be allocated to the investor) nor in the residence State of the investor(s) (where the income of the opaque entity is not included in the taxable income of the investor). In many cases, the income realised by a reverse hybrid entity will only be taxable at the level of the investor when the income is distributed, resulting potentially in a (long-term) tax deferral.

The reverse hybrid mismatch rule aims at eliminating double non-taxation outcomes through the treatment of reverse hybrids as resident taxpayers[4]. Article 168*quater* of the LITL may apply as from tax year 2022 to all entities within the meaning of Article 175 of the LITL that are established in Luxembourg (in particular, partnerships). Given that these entities are treated as fiscally transparent, their income is for Luxembourg (corporate) income tax purposes allocated to the owners[5].

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1. The new version of Article 168*ter* of the LITL replaced the previous hybrid mismatch rules which have been introduced as part of the 2019 tax reform implementing EU Directive 2016/1164 of 28 January 2016 (the Anti-Tax Avoidance Directive or ATAD).
2. See recital 28 of ATAD 2.
3. See Final Report on BEPS Action 2, p. 56, No. 140.
4. *Ibid.*, p. 64, No. 174 and 175.
5. Article 168*quater* (1) of the LITL; the owners may be individuals, corporate taxpayers within the meaning of Article 159 (residents) or 160 (non-residents) of the LITL or transparent entities within the meaning of Article 175 of the LITL.

However, if and to the extent the income of the reverse hybrid entity is included upon distribution in the ordinary income of the investor (within a reasonable period of time) or in accordance with Controlled Foreign Company (CFC) rules applicable in the investor jurisdiction, there is no mismatch outcome that could trigger the application of the reverse hybrid mismatch rule. Mere timing differences between the realization of the income by the reverse hybrid entity and the taxation at the level of the investor(s) do not change this conclusion[6].

Otherwise, the reverse hybrid mismatch rule would result in double taxation. This situation would be further aggravated as the tax levied on the income derived by the reverse hybrid entity will likely not be creditable at the level of the investor(s) given that the hybrid entity should be treated as a separate entity from the perspective of the investor jurisdiction(s).

II. RELATED PARTY TEST

A. Definition of associated enterprises

The reverse hybrid mismatch rule only applies if the related party test as defined in Article 168*quater* (1) of the LITL is satisfied. This is the case when the entity is owned by one or more non-resident associated enterprises within the meaning of Article 168*ter* (1) No. 18 of the LITL (individuals or entities) that are resident in a jurisdiction or jurisdictions that regard the Luxembourg entity as opaque and hold directly or indirectly a participation of at least 50% in terms of voting rights or capital ownership (or are entitled to receive at least 50% of the entity's profit).

Thus, only those investors that are resident in jurisdictions that view the Luxembourg entity as opaque are to be considered when determining whether the 50% threshold is met. In contrast, the related party test under the hybrid mismatch rules (Article 168*ter* (1) No. 18 of the LITL) considers, in a first step, all associated enterprises when analysing whether the 50% threshold is met. In a second step, the tax adjustment under the hybrid mismatch rules would be limited to those associated enterprises that cause a mismatch in tax outcomes.

B. Aggregation of interests

In certain circumstances, the shareholding percentages of otherwise unrelated parties should be aggregated for the purposes of the related party test. More precisely, a person who acts together with another person in respect of voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person[7].

The purpose of the "acting together" concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interests or equity interests to another person who continues to act under their direction in relation to those interests.

The other situation targeted by the acting together concept is where a taxpayer or a group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them[8].

C. Investments funds

Luxembourg is a global hub for Alternative Investments (Private Equity, Venture Capital, Real Estate and Infrastructure investments, etc.) in and through Europe. Therefore, the question as to how the concept of acting together applies in a fund context is of crucial importance. In this regard, Article 168*ter* of the LITL provides for a *de minimis* rule[9].

Investment funds have been defined as "any collective investment undertakings which raise capital from a number of investors, with a view to invest this capital in accordance with a defined investment policy for the benefit of those investors". It follows that investment funds have the following characteristics:

- a collective investment undertaking;
- with a defined investment policy;
- which raises capital with a view to investing that capital for the benefit of those investors in accordance with that policy.

6. According to the opinion of the Luxembourg State Council, the payment to the hybrid entity and the subsequent distribution should be considered as economically equivalent. Thus, if the income is taxed as ordinary income at the level of the investor, there exists no mismatch outcome; see p. 11 of the Opinion of the Luxembourg State Council of 10 December 2019.

7. Article 168*ter* (1) No. 18 of the LITL.

8. See Final Report on BEPS Action 2, p. 117, No. 369.

9. Article 168*ter* (1) No. 18 of the LITL.

The definition of investment funds is broad and includes Luxembourg and foreign funds, close-ended and open-ended funds, listed and unlisted funds irrespective of the legal form thereof.

According to the commentaries to the ATAD 2 bill, investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions of investors in accordance with the fund's investment policy. Therefore, Article 168*ter* LITL provides for a safe harbour rule according to which an investor (be it an individual or an entity) that owns directly or indirectly less than 10% of the shares or units in a fund (and that is entitled to less than 10% of the fund's profits) is considered not to act together with the other investors, unless proven otherwise. Here, the burden of proof would be on the Luxembourg tax authorities to evidence that investors are acting together within the meaning of this concept.

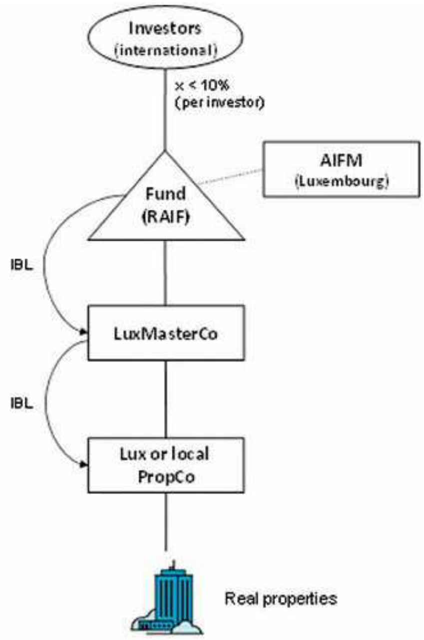
Hence, in an investment fund context, the ownership of stakes below 10% should in principle not be relevant when considering a potential aggregation of interests as a consequence of the "acting together" concept[10]. Moreover, when investors in a fund own 10% or more of the shares or fund units (or are entitled to 10% or more of the fund's profits), it has to be analysed on a case-by-case basis whether or not two or more investors are acting together for the purposes of the related party test. Here, the burden of proof that the acting together concept does not apply is on the taxpayer. However, there is no presumption that investors with 10% or more investments would be acting together.

Example: The Luxembourg investment fund

A Luxembourg Reserved Alternative Investment Fund (RAIF) invests into pan-European real estate assets. The fund is managed by a Luxembourg Alternative Investment Fund Manager (AIFM) that makes investments in accordance with the Fund's investment policy as outlined in the prospectus. Thus, the RAIF qualifies as an investment fund for the purposes of the *de minimis* rule.

The investments of the RAIF are made via a Luxembourg master company (LuxMasterCo) that operates as the fund's investment platform and via separate property companies (Lux or local PropCo) that are financed by a mixture of equity and debt instruments (interest-bearing loans, or IBL).

The investors in the fund are institutional investors from several jurisdictions with shareholdings ranging from 2 to 9%. The investors are not actively involved in the investment process (other than confirming the investment policy from time to time) and there exists no special relationships between the investors.



Here, the shareholdings of the investors owning less than 10% should not be added together in accordance with the *de minimis* rule. While the shareholding percentages might need to be aggregated if the Luxembourg tax authorities can prove that the investors are acting together, in the present case there exists no indications that investors are acting together within the meaning of Article 168*ter* (1) No. 18 of the LITL.

III. TAX TREATMENT OF REVERSE HYBRID MISMATCHES

A. *Corporate income tax*

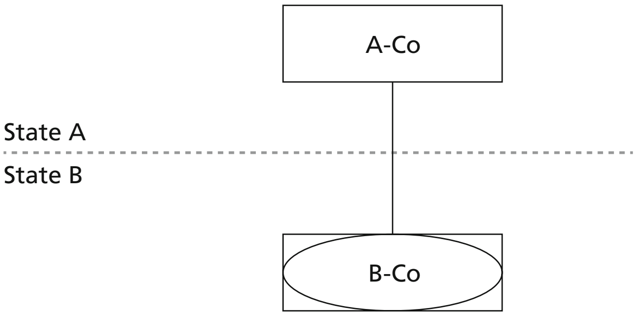
1) Application of the reverse hybrid mismatch rule

When the related party test is satisfied, the reverse hybrid entity is deemed to be a resident taxpayer and its net income is subject to corporate income tax to the extent this income is not subject to (corporate) income tax at the level of the investors (be it in Luxembourg or abroad).

10. Article 168*ter* (1) No. 18 of the LITL.

Example: Reverse hybrid mismatch

An investor resident in State A (A-Co) invests in an entity located in State B (B-Co). While B-Co is treated as a transparent entity from the perspective of State B, under the domestic tax law of State A, B-Co is treated as an opaque entity.



Under the domestic tax law of State B, the income of B-Co is not taxed as the income is allocated to the owner of B-Co. In State A, the income of B-Co is not taxed as B-Co is classified as an opaque entity. Thus, the income of the reverse hybrid entity is neither taxable in State B nor in State A.

In these circumstances, assuming that State B is Luxembourg, Article 168*quater* of the LITL requires B-Co to be treated as a corporate taxpayer.

2) Determination of the tax base of the reverse hybrid entity

The amount of income to be included in the corporate tax base of the reverse hybrid entity should be limited to amounts that would otherwise result in double non-taxation rather than taxing all of the income of the reverse hybrid entity[11].

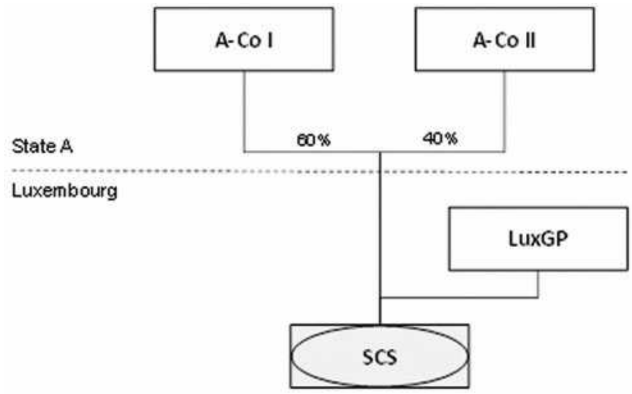
Therefore, the tax base of the reverse hybrid entity will not include income that is taxable in Luxembourg as domestic income of non-resident taxpayers. This may, in particular, be the case if a Luxembourg partnership performs a commercial activity that results in the constitution of a PE of its non-resident partner(s)[12].

Example: Luxembourg permanent establishments

A Luxembourg limited partnership (SCS) that performs a commercial activity in Luxembourg is owned by two companies resident in State A (A-Co I and A-Co II). Both companies are part of the same group of companies and own respectively 60% and 40%. The general partner of the SCS (Lux GP) is a Luxembourg company that has a nominal share in the partnership.

The SCS constitutes a permanent establishment of A-Co I and A-Co II in Luxembourg and both companies are subject to Luxembourg corporate income tax (and municipal business tax) with their respective share in the profits of the SCS[13].

While the SCS is viewed as transparent from a Luxembourg tax perspective, under the law of State A, the SCS is treated as opaque for tax purposes. Thus, the SCS is a reverse hybrid entity with respect to A-Co I and A-Co II.



In the present case, the related party test is met as 100% of the associated enterprises are resident in a jurisdiction that views the SCS as opaque for tax purposes. As a consequence, the reverse hybrid mismatch rule is (in principle) applicable.

However, the income of the SCS is already taxed in Luxembourg at the level of A-Co I and A-Co II that are deemed to have a permanent establishment in Luxembourg. Therefore, there exists no mismatch outcome and the tax base of the SCS should be zero.

When the Luxembourg entity distributes its income within a reasonable period of time and such distributions are included in the ordinary income of the investors, there should be no room for the application of the reverse hybrid mismatch rule. This is because mere timing differences should generally not be treated as giving rise to a mismatch in tax

11. Article 168*quater* (1) of the LITL.
12. In these circumstances, the non-resident partners are subject to (corporate) income tax with the commercial income realized via the partnership which constitutes a PE of its non-resident partners, Article 156 No. 1 a) of the LITL in conjunction with Article 2 (3) (individuals) or 160 (1) (corporates) of the LITL.
13. Section 16 of the Tax Adaptation Law in conjunction with Article 156 No. 1 a) and Article 160 of the LITL.

outcomes[14]. Furthermore, the application of the reverse hybrid mismatch rule should be discharged to the extent the income of the reverse hybrid is included in the ordinary income of the investor(s) in accordance with CFC rules.

Example: Inclusion in the ordinary income

As a variation to the previous example, it is assumed that the SCS does not perform a commercial activity in Luxembourg. Accordingly, the income of the SCS would not be taxable in Luxembourg as commercial income of A-Co I and A-Co II.

It is further assumed that the SCS frequently distributes its income within maximum 12 months following year-end and A-Co I and A-Co II include the income of the SCS in their ordinary income.

In this case, the income of the SCS is subject to corporate income tax at the level of the investors and the reverse hybrid situation merely results in a timing difference that should not trigger the application of the hybrid mismatch rule.

Variation: Should State A apply CFC rules under which the income of the SCS is included in the ordinary income of A-Co I and A-Co II, there would likewise be no mismatch outcome and the tax base of the SCS should be zero.

Furthermore, if and to the extent the income of the reverse hybrid entity would not be taxed in any case due to the tax (exempt) status of the investor under the laws of the investor jurisdiction(s), the income will not be included in the tax base of the reverse hybrid[15]. This might be the case if the investor jurisdiction does not levy corporate income tax, the investor jurisdiction adopted a territorial system where the payment would be treated as non-taxable foreign source income or the recipient is tax exempt (for example, pension funds that benefit from a special tax regime).

Example: Tax status of the investor

As a variation to the previous example, it is assumed that State A does not levy corporate income tax.

In these circumstances, the income of the SCS would neither be taxable in Luxembourg nor at the level of A-Co I and A-Co II upon a future distribution. Nevertheless, the tax base of the SCS should be zero as the SCS does not trigger a mismatch in tax outcomes (i.e. the income would in any case not be taxable due to the tax exempt status of the investor).

As from tax year 2022, the reverse hybrid mismatch rule should also have an impact on the tax treatment of payments to a hybrid entity [within the meaning of Article 168*ter* (1) No. 2 b) of the LITL]. If the reverse hybrid mismatch rule applies, the payment to a reverse hybrid entity should be included in the entity's tax base and there will be no room for further tax adjustments under the hybrid mismatch rules. This is because Article 168*quater* of the LITL eliminates the deduction without inclusion outcome through the inclusion of the payment in the taxable income of the reverse hybrid entity[16]. As such, the elimination of the mismatch outcome will shift from non-deductibility at the level of the payer to inclusion of the payment in the tax base of the reverse hybrid entity.

3) Investment funds

Luxembourg investment funds are often established in the legal form of a partnership (for example, a *société en commandite simple* or SCS) or a contractual fund without legal personality (*fonds commun de placement* or FCP) which are viewed as fiscally transparent in Luxembourg. When such fund vehicle is treated as opaque from the perspective of the investor jurisdiction(s), the fund is technically a reverse hybrid entity. However, in a fund context the reverse hybrid mismatch rule is unlikely to apply since the related party test should in most cases not be met[17].

Nevertheless, Article 168*quater* (2) of the LITL also provides for a specific carve-out for collective investment vehicles (CIV). A CIV is defined as an investment fund or a 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 commentaries to the draft law specify that the definition of a CIV includes the following types of entities:

14. According to the opinion of the Luxembourg State Council, the payment to the hybrid entity and the subsequent distribution should be considered as the same payment from an economic perspective, see p. 11 of the Opinion of the Luxembourg State Council of 10 December 2019. Here, the Luxembourg State Council considers that the statement made in the Final Report on BEPS Action 2, according to which the reverse hybrid rule should apply even if investors are ultimately taxed on distributions, should be disregarded (see Final Report on BEPS Action 2, p. 59, No. 156). Indeed, if the income would be taxed at the level of the reverse hybrid entity in Luxembourg and at the level of the investors, the result would be double taxation. In addition, the tax paid by the reverse hybrid entity would likely not be creditable against the tax due in the investor jurisdiction as the reverse hybrid entity is viewed as a separate entity from the perspective of the investor jurisdiction.

15. See Final Report on BEPS Action 2, p. 55, No. 139, p. 60, No. 166; see recital 18 of ATAD 2.

16. See recital 29 of ATAD 2.

17. Participations of investors with less than 10% should generally not be aggregated based on the 10% *de minimis* rule provided under Article 168*ter* (1) No. 18 of the LITL. With regard to participations of 10% or more, it has to be analysed on a case-by-case basis whether the acting together concept applies (see section 3.3).

- Undertakings for collective investment (UCIs) within the meaning of the Law of 17 December 2010 (i.e. both undertakings for collective investment in transferable securities, UCITS, within the meaning of part 1 of the UCI Law of 17 December 2010 and non-UCITS or Alternative Investment funds within the meaning of part 2 of the UCI Law);
- Specialised Investment Funds (SIFs) within the meaning of the Law of 13 February 2007;
- Reserved Alternative Investment Funds (RAIFs) within the meaning of the Law of 23 July 2016; and
- Other Alternative Investment funds within the meaning of law of 12 July 2013 on Alternative Investment fund managers which do not already fall into one of the previous categories to the extent that they are widely held, hold a diversified portfolio of securities (so as to limit market risks) and are subject to investor protection obligations.

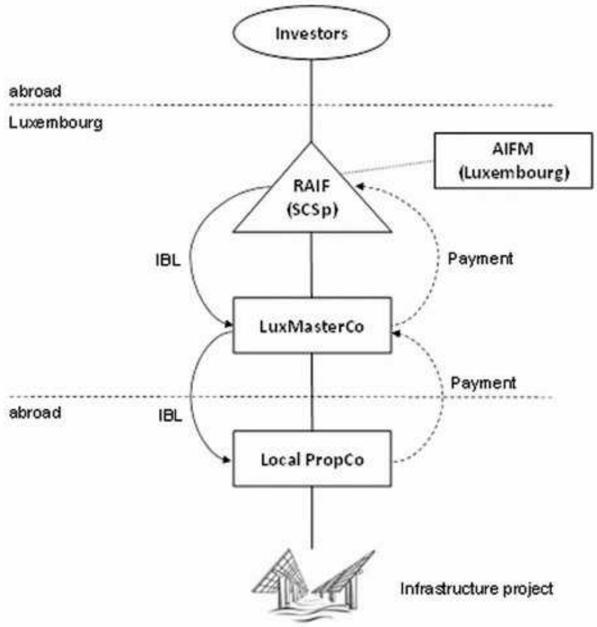
In practice, the carve-out from the reverse hybrid mismatch rule should have a limited scope as it can be expected that in case of widely held CIVs the related party test will generally not be satisfied.

Example: The Luxembourg investment fund

A Luxembourg Reserved Alternative Investment Fund (RAIF) established in the legal form of a special limited partnership (SCSp) makes investments into pan-European infrastructure projects. The investors are institutional investors (pension funds, insurance companies, etc.) that own between 4% and 8% of the fund units.

The investments are made via a Luxembourg master company (LuxMasterCo) that functions as an investment platform for the fund and local project companies (Local PropCo) that own the infrastructure projects. Local PropCo are financed by a mixture of equity and debt granted by LuxMasterCo. The IBL granted by LuxMasterCo to Local PropCo is financed by an IBL granted by the RAIF to LuxMasterCo.

Given that the participations of the investors range between 4% and 8% (and there is no indication that the investors are acting together), the shareholding percentages should not be aggregated for the purposes of the related party test[18].



Since the related party test is not met, the reverse hybrid mismatch rule does not apply in this case. Accordingly, there is no need for the application of the carve-out from the reverse hybrid mismatch rule (Article 168*quater* (2) of the LITL).

Luxembourg funds benefit from specific exemptions from corporate income tax, municipal business tax and net wealth tax that are provided under the laws governing the different fund regimes.

With the implementation of the reverse hybrid mismatch rule, there might—at least theoretically—be cases where a Luxembourg fund established in the legal form of a partnership or a FCP could come within the scope of the reverse hybrid mismatch rule if the carve-out for CIVs does not apply. However, even in such hypothetical case, a Luxembourg fund should never be subject to corporate income tax.

The reverse hybrid mismatch rule is a specific anti-abuse legislation that, when applicable, subjects entities to corporate income tax; as such, the reverse hybrid mismatch rule is part of the corporate income tax law. However,

18. The *de minimis* rule under Article 168*ter* (1) No. 18 of the LITL provides a carve-out from the acting together concept for investors that own less than 10% in an investment fund (unless the tax authorities can prove that the investors are actually acting together within the meaning of the acting together concept).

the specific laws governing the different fund regimes provide for a corporate income tax exemption[19] and take precedence over the rules of the corporate income tax law[20].

B. Withholding tax

Distributions made by Luxembourg partnerships and other entities within the meaning of Article 175 of the LITL are not subject to Luxembourg withholding tax. This does not change even if the reverse hybrid mismatch rule applies[21].

C. Municipal business tax

The reverse hybrid mismatch rule does not alter Luxembourg municipal business tax rules under which Luxembourg partnerships may be taxable depending on the activities performed. Luxembourg partnerships are subject to municipal business tax on profits derived from carrying on a commercial activity within the meaning of Article 14 (1) of the LITL through a PE situated in Luxembourg.

The carrying on of a commercial activity requires cumulatively an independent activity of a permanent character that is carried on with the intent of realizing profits and participation in the general economic life. Moreover, the activity must not qualify as an activity in the area of agriculture and forestry, independent services within the meaning of Article 91 of the LITL (for example, liberal professions) or wealth management.

When a general partner of a Luxembourg (special) limited partnership is a Luxembourg company owning a stake of at least 5% in the partnership, the latter is deemed to generate commercial income[22].

When a Luxembourg partnership realizes or is deemed to realize commercial income, the commercial income of the Luxembourg partnership is subject to Luxembourg municipal business tax at the level of the partnership[23].

D. Net wealth tax

With regard to net wealth tax, the law provides for a specific exemption for entities that are treated as opaque in accordance with the reverse hybrid mismatch rule[24]. Thus, reverse hybrid entities are not subject to net wealth tax regardless of whether or not such entity is treated as a taxpayer for corporate income tax purposes.

E. Transparency for tax purposes

Entities within the meaning of Article 175 of the LITL (in particular, partnerships) are deemed to be transparent for Luxembourg tax purposes[25]. The reverse hybrid mismatch rule does not change this fundamental tax principle. When the reverse hybrid mismatch rule applies, a reverse hybrid entity remains (even from a corporate income tax perspective) transparent for those investors that do not trigger the mismatch in tax outcomes.

IV. COOPERATION DUTIES OF THE TAXPAYER

According to Article 168*quater* (3) of the LITL, the taxpayer has the burden of proof that the reverse hybrid mismatch rule is not applicable. Therefore, it is for the taxpayer to provide the tax authorities, upon request, with all relevant elements such as tax returns, other tax related documents or tax certificates issued by foreign tax authorities so as to evidence that the reverse hybrid mismatch rule provided in Article 168*quater* (1) of the LITL is not applicable.

CONCLUSION

Since 1 January 2020, the comprehensive hybrid mismatch rules provided under ATAD 2 have been transposed into Luxembourg tax law. In addition, a reverse hybrid mismatch rule will apply as from tax year 2022. ATAD 2 virtually covers any possible situation that may give rise to mismatch outcomes. However, many of these situations hardly ever occur in practice and others will disappear as a result of the new rules.

19. See, for example, Article 45 (1) of the RAIF Law: "Without prejudice to the levy of registration and transcription taxes and the application of national law regarding value added tax and subject to the requirements of Article 48 of this law, no other tax shall be payable by reserved Alternative Investment funds apart from the subscription tax referred to in Article 46."
20. This is consistent with the *lex specialis* principle according to which specialized laws prevail over general laws.
21. Article 146 (1) of the LITL refers to dividend payments within the meaning of Article 97 (1) No. 1 of the LITL that are made by (corporate) entities listed in Articles 159 and 160 of the LITL. Nevertheless, Luxembourg entities that may be classified as reverse hybrid entities are entities within the meaning of Article 175 of the LITL.
22. Article 14 (4) of the LITL.
23. Section 2 (1) of the Municipal Business Tax Law.
24. Section 3 (1) No. 12 of the Net Wealth Tax Law.
25. Section 11*bis* of the Tax Adaptation Law.

Overall, Luxembourg made the right choices, adopting all available implementation options which limit the scope of the new rules for the benefit of Luxembourg taxpayers and avoid unintended collateral damage for the Luxembourg fund industry. The opinion of the Luxembourg State Council further provides useful clarifications regarding the interpretation of the new rules.

Given that the burden of proof regarding the non-application of the (reverse) hybrid mismatch rules is on the taxpayer, a hybrid mismatch analysis will necessarily become an integral part of each and every tax analysis albeit relevant information only needs to be produced to the Luxembourg tax authorities upon request. After all, taxpayers cannot take the risk to implement an investment that falls within the scope of the hybrid mismatch rules.

With regard to existing investments, it would be wise for taxpayers to make sure that either the hybrid mismatch rules do not apply or to implement, where necessary, structure alignments with a view to mitigate adverse tax consequences. Ultimately, the complexity of the hybrid mismatch rules may also be an opportunity to manage their impact in practice.