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# ATOZ ALERT

## Luxembourg starts the implementation of ATAD 2

09 August 2019

On 8 August, the draft law (the "draft law") implementing the EU Directive 2017/952 of 29 May 2017 ("ATAD 2") amending Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the so-called Anti-Tax-Avoidance-Directive, "ATAD") was presented to Parliament. ATAD already included measures dealing with hybrid mismatches in an EU context, which have applied in Luxembourg since 1 January 2019 based on Article 168ter of the Income Tax Law. ATAD 2 replaces these rules and extends their scope, notably to transactions involving non-EU countries.

In this ATOZ Alert, we give an overview of the new measures which will enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches", which will apply as from 2022).

### Background

ATAD 2 follows the recommendations of the OECD in regard to Action 2 (Hybrid mismatch arrangements) of the Base Erosion and Profit Shifting (BEPS) project and covers a number of hybrid mismatches such as financial instrument mismatches, hybrid entity mismatches, reverse hybrid mismatches and permanent establishment mismatches.

In general, a hybrid mismatch structure is a structure where a financial instrument, an entity or a permanent establishment is treated differently for tax purposes in two different jurisdictions. Hybrid mismatches may lead to situations in which (i) a payment is deducted in two jurisdictions, (ii) a payment is deductible in one jurisdiction and not taxed in the other jurisdiction or (iii) to a situation in which income is not taxed at all (in accordance with the domestic tax laws of the jurisdictions involved).

In case there is a hybrid mismatch with a third state (non-EU country), ATAD 2 places the responsibility to neutralise the effects of hybrid mismatches on the EU Member States. This entails that EU Member States must deny the deduction of payments or have to include income that would otherwise not be taxed in the third state.


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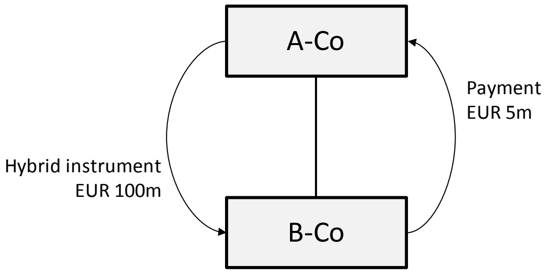
## Hybrid mismatches covered

The draft law implementing ATAD 2 has a broad scope and addresses the following types of hybrid mismatch situations:

- **Hybrid mismatches that result from payments under a financial instrument**

Example 1: Hybrid financing instrument mismatch

A company resident in State A (A-Co) finances its subsidiary resident in State B (B-Co) with a EUR 100m financing instrument that is treated as equity in State A, whereas the instrument is treated as debt in State B.

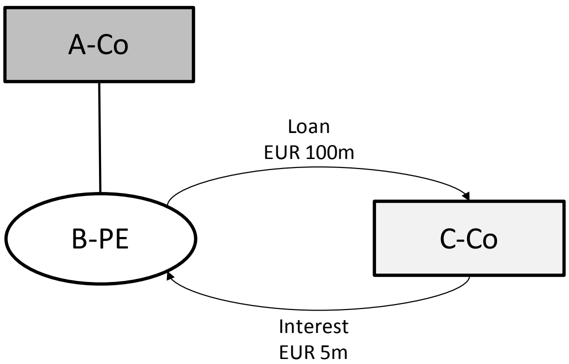



At the level of B-Co, the interest payments of EUR 5m are tax deductible, whereas at the level of A-Co the dividend income benefits from a tax exemption.

- **Hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including situations where payments made to a disregarded PE are not taxed at the level of the head office**

Example 2: Hybrid PE mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) performs financing activities through a PE situated in State B (B-PE). Although the PE is recognised under the domestic tax law of State A and the applicable tax treaty concluded between State A and State B, under the domestic tax law of State B the PE of A-Co is not recognised for tax purposes. A-Co grants a loan of EUR 100m via B-PE to C-Co, an associated enterprise resident in State C.





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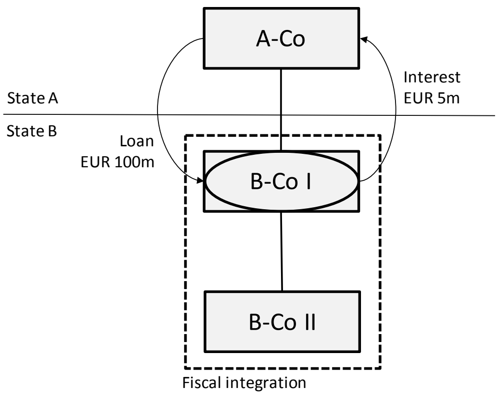
While the interest payments are deductible at the level of C-Co, State B does not tax the interest income as no PE is recognised under domestic tax law of State B. At the same time, State A exempts the income realised through B-PE in accordance with the applicable tax treaty. Hence, the income is tax deductible in State C and not taxable or tax exempt, respectively, in State A and State B.

- **Hybrid mismatches that result from payments made by a hybrid entity to its owner or deemed payments between the head office and PE or between two or more PEs**

Example 3: Hybrid entity mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) finances its subsidiary in State B (B-Co I) with a loan of EUR 100m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II a subsidiary resident in State B.

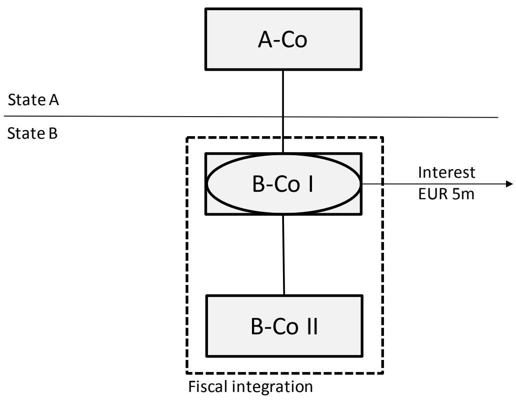



While the interest payments are deductible in State B, reducing the taxable income of B-Co I and the fiscal unity, at the level of A-Co the interest payments are disregarded for tax purposes since such transactions are disregarded between a transparent entity and the owners thereof.

- **Double deduction outcomes resulting from payments made by a hybrid entity or PE**

Example 4: Hybrid entity mismatch leading to a double deduction

A company resident in State A (A-Co) has a subsidiary in State B (B-Co I). B-Co I receives funding from a third party. In this regard, B-Co I pays interest of EUR 5m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II a subsidiary resident in State B.





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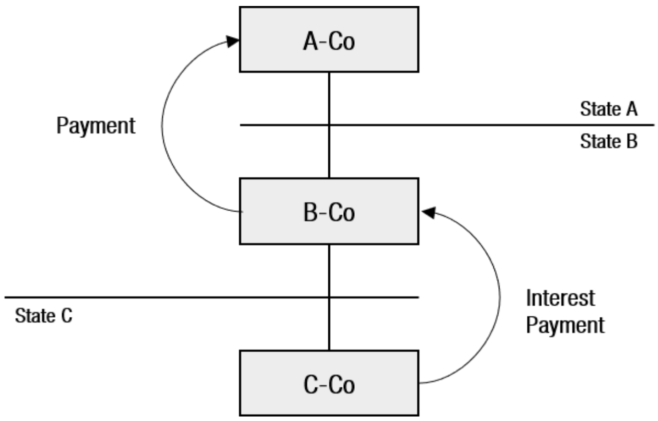
In this case, the interest payments are deductible at the level of B-Co I and A-Co, resulting in a double deduction due to the hybrid entity classification.

- **Imported mismatches**

An imported mismatch payment is a deductible payment made to a payee that is not subject to hybrid mismatch rules. Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State using a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches.

Example 5: Imported mismatches leading to a deduction without inclusion

A company resident in State A (A-Co) has a subsidiary in State B (B-Co) which in turn holds a subsidiary in State C (C-Co). While C-Co is resident in an EU Member State, A-Co and B-Co are resident in third countries. C-Co pays interest to B-Co and according to a subordinated loan, B-Co pays in turn interest to A-Co.




In this case, the interest payment is deductible at the level of C-Co, the payment is included in the taxable basis of B-Co but is also deductible at the level of B-Co. A-Co is tax exempt on the payment received because of the equity nature of the financing instrument under the tax law of State A. Thus, the hybrid mismatch between State A and State B is imported into State C through the interest payment by C-Co.

## Mechanisms for tackling mismatch outcomes

In line with ATAD 2, the draft law provides for the following mechanisms to tackle mismatch outcomes:

- **Double deduction**

Where a hybrid mismatch results in a double deduction, the payment, expenses or losses in relation to the hybrid mismatch shall not be deductible at the level of the taxpayer that is the investor.

As a secondary measure, in cases where the deduction of the payment, expenses or losses in relation to the hybrid mismatch is not denied in the investor jurisdiction, the deduction shall be denied in the hands of the taxpayer that is the payer.

Nevertheless, any such deduction shall be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax period.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- **Deduction without inclusion**

Where a hybrid mismatch results in a deduction without inclusion, the payment shall not be deductible at the level of the taxpayer that is the payer.

As a secondary measure, if the deduction is not denied in the payer jurisdiction, the corresponding profit or income that would otherwise give rise to a mismatch outcome shall be included in the aggregate net income of the taxpayer that is the payee, without prejudice to the anti-hybrid measures included in the Luxembourg participation exemption regime which has to apply first and thus prevails in case of conflict of anti-hybrid rules.

With regard to the secondary measure, Luxembourg chose the option provided by ATAD 2 to not apply it to the following types of hybrid mismatches:

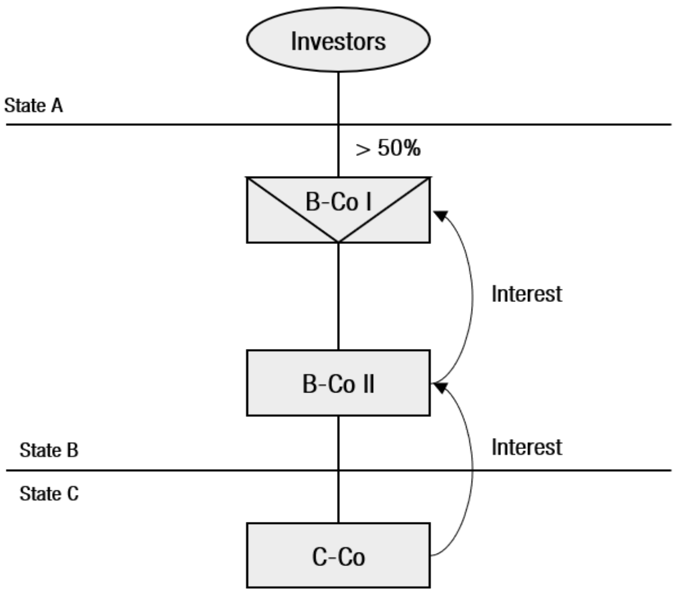
- a payment to a reverse hybrid entity;
- a payment to an entity with one or more permanent establishments;
- a payment to a disregarded permanent establishment; or
- a deemed payment between the head office and permanent establishment or between two or more permanent establishments.

- **Reverse hybrid mismatches**

The draft law also provides for a rule that targets so-called reverse hybrid mismatches. When an entity is established in Luxembourg and treated as transparent for Luxembourg tax purposes, whereas at the level of the associated non-resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests or rights to a share of profit in the entity, it is treated as opaque, the income may benefit from double non-taxation.

Example 6: Reverse Hybrid leading to a deduction without inclusion

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





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In this case, the interest payment is deductible at the level of B-Co II, reducing the taxable income of B-Co II and at the level of B-Co I, the interest payments are disregarded for tax purposes since such transactions are disregarded between a transparent entity and the owner thereof.

In these circumstances, the reverse hybrid entity shall be regarded as a tax resident of Luxembourg and subject to corporate income tax ("CIT") to the extent the net income is not taxed otherwise under the Luxembourg income tax law or the law of any other jurisdiction.

This rule will apply for CIT but not for net wealth tax. As far as municipal business tax ("MBT") is concerned, while there is no explicit exclusion in the draft law, the taxing mechanism of the MBT law is such that the taxation of income for CIT purposes should not of itself give rise to a liability to MBT on this income.

The entity would thus be treated as a Luxembourg taxpayer liable to CIT on the net income not taxed otherwise.

As stated in the commentaries to the draft law, the reverse hybrid rule will not apply to the Luxembourg source income of a foreign entity established in Luxembourg (established, for example, due to its investment in a Luxembourg partnership) and already subject to Luxembourg CIT in accordance with the Luxembourg non-resident taxation rules (article 156 of the Income Tax Law).

This anti-mismatch rule shall also not apply to a collective investment vehicle ("CIV"), defined in the draft law as an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

The draft law further clarifies the definition of a CIV so as to exclude from the scope of the reverse hybrid rule:

- 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, as well as;
- Other alternative investment funds within the meaning of the 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.

- **Imported mismatches**

The draft law denies the deduction for any payment by a taxpayer to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between associated enterprises or entered into as part of a structured arrangement. Such a payment remains deductible to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect to the hybrid mismatch.

- **Tax residency mismatches**

Finally, the draft law provides for a rule that deals with situations where an entity is deemed to be resident in two or more jurisdictions and expenses are deductible in both jurisdictions.

Here, a Member State involved shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income.

Where both jurisdictions are Member States, the Member State where the taxpayer is deemed "not" to be resident in accordance with an applicable tax treaty shall deny the deduction.


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- **Relief for tax withheld at source**

To the extent that a hybrid transfer is designed to produce a relief for tax withheld at source on a payment derived from a financial instrument, with the relief being available for more than one of the parties involved, the draft law also limits the benefit of such relief in proportion to the net taxable income regarding such payment.

## "Carve-outs"

A number of carve-outs are provided for situations where the application of the anti-hybrid rules would give results that are either disproportionate given the objectives of ATAD 2 or would cause serious market disruption.

- **Tax exempt status of the payee:** picking up recitals 16 and 18 of ATAD 2, the commentaries to the draft law provide that the definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen anyway due to the tax exempt status of the payee under the laws of any payee jurisdiction (e.g. an investment fund or a tax-exempt sovereign fund) or due to the fact that a financial instrument is held under a special regime. In the case of mismatches arising from hybrid instruments, for a hybrid mismatch to be carved out, the analysis must be that the non-inclusion would have arisen solely due to the tax-exempt status of the payee.

- **The enterprises are not "associated", except for "structured arrangements":** a mismatch outcome shall not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between the head office and permanent establishment, between two or more permanent establishments of the same entity, or under a structured arrangement.

    - In case of a hybrid mismatch involving financial instruments, an associated enterprise is (i) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more or is entitled to receive 25% or more of the profits of that entity or (ii) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25% or more or is entitled to receive 25% or more of the profits of the taxpayer.
    - When it comes to mismatches involving hybrid entities or reverse hybrid mismatches, a higher threshold of at least 50% is required.
    - In all hybrid mismatch situations, attention has to be paid to the fact that a person who acts together with another person in respect of the 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. While this so-called "acting together" concept is not defined in ATAD 2, the Luxembourg draft law provides some clarification. Based on the purpose of the "acting together" concept and on the fact that investors in an investment fund do not, in principle, effectively control the investments made by the fund, an investor holding, directly or indirectly, less than 10% of the interest or shares in the investment fund and less than 10% of the right to participate to the profits in the fund, shall not be considered as acting together with another investor in the fund (unless the opposite can be evidenced). For this purpose, an investment fund is a collective investment vehicle which raises capital from a certain number of investors with the aim of investing, in accordance with a defined investment policy, in the interest of these investors.
    - 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 a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.


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- A "structured arrangement" is an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement (typically a financial product offered by a specialised provider) 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.

- **Absence of payment:** The new rules will only apply to "deductible payments". Hence, unless otherwise stated, the rules only apply to payments; not for example to provisions recorded in relation to financing instruments. The payment further needs to be deductible for tax purposes, excluding non-deductible payments from the scope of the new rules.

- **Timing differences:** As stated in recital 22 of ATAD 2, the draft law provides that since jurisdictions use different tax periods and have different rules for recognising when items of income or expenses have been derived or incurred, timing differences should generally not give rise to hybrid mismatches as long as the income is included within a reasonable period of time. A payment under a financial instrument shall be treated as included in income within a reasonable period of time where:

    - the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period (a "safe harbour" period); or
    - it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future period and the terms of the payment are consistent with the arm's length principle. Thus, when a timing difference exceeds the safe harbour period, taxpayers should be prepared to evidence that the payment will be included in a future period and that the terms are arm's length.

- **Dual inclusion income:** According to the draft law, certain hybrid mismatches only arise to the extent there is no offset against dual inclusion income. Dual inclusion income means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen.

  For example, in respect of payments made by a hybrid entity to its owner, deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch should only arise to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

  In the same way, to the extent that a hybrid mismatch results in a double deduction (i.e. when a double deduction outcome occurs or in case of tax residency mismatch), any such deduction shall be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax period. Accordingly, if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under the draft law could be deferred as the deduction is set off against non-dual inclusion income in the payer jurisdiction.

- **ATAD 2 & Double tax treaties:** As stated in recital 11 of ATAD 2, any adjustments required in accordance with the draft law should in principle not affect the allocation of taxing rights between Contracting States under applicable tax treaties. This statement acknowledges that treaty law is generally superior to the domestic tax laws of the Contracting States.

- **Transfer pricing adjustments:** the commentaries to the draft law also confirm the ATAD 2 statement according to which transfer pricing adjustments should not fall within the scope of a hybrid mismatch.

- **Hybrid regulatory capital:** Luxembourg has opted for the carve-out from the anti-hybrid mismatch rules when it comes to hybrid regulatory capital resulting in a deduction without inclusion. Thus, Luxembourg excludes from the scope of the draft law a financial instrument that has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and which is recognised as such in the taxpayer's loss absorbing capacity requirements. This is of particular


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importance for the banking sector which has to comply with certain solvency criteria. However, this carve-out is limited in time until 31 December 2022.

- **Transactions by financial traders:** Provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument, a payment representing the underlying return on a transferred financial instrument shall not give rise to a hybrid mismatch that results from payments under a financial instrument, where the payment is made by financial trader, i.e. a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit on an on-market hybrid transfer. On-market hybrid transfer refers to any hybrid transfer that is entered into by a financial trader in the ordinary course of business, and not as part of a structured arrangement. With regard to financial traders, this approach is in line with that followed by the OECD.

## Burden of proof

On demand, taxpayers must be able to provide the tax authorities with a statement from the issuer of the financial instrument or any other relevant element such as a tax return, a tax certificate or any document issued by the foreign tax authorities in order to demonstrate that the anti-hybrid provisions implemented by the draft law are not applicable. On a case-by-case basis, the taxpayer shall be able to provide reasonable proof, to the satisfaction of the tax authorities, that, for example, no hybrid mismatch has been used or, on the contrary, that the primary rule to avoid a double deduction or a deduction without inclusion has been applied.

## Implications and next steps

The draft law replaces the rules on hybrid mismatches provided in article 168ter of the Income Tax Law and extends the rules to third country mismatches but also to reverse hybrid mismatches by adding a new article 168quater of the Income Tax Law. The new rules will enter into force as from 1 January 2020, apart from the provisions on reverse hybrid mismatches, which will apply as from tax year 2022.

Given the extreme complexity of these rules including hybrid mismatches, reverse hybrid mismatches and imported hybrid mismatches (which may occur somewhere in a group structure), the application of these anti-mismatch provisions will be a very intricate and time-consuming exercise on the part of the taxpayers, their advisers and the tax administrations. However, some useful clarifications are provided in the commentaries to the draft law, in line with the statements made in the ATAD 2 recitals. This is welcome. Furthermore, the Luxembourg Government has made the right choices when it came to the optional limitations which could be made by EU Member States to the scope of application of the new rules, which is positive as well.

Since the new rules will become applicable in less than 6 months, taxpayers should start assessing the potential impact of these changes on existing investment structures as soon as possible and closely monitor the legislative process around the implementation of the new rules.


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## Do you have further questions?


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