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*Luxembourg*

# INSIGHT: Luxembourg Tax Reform—What's Changing in 2019? (Part 1)

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The 2019 tax reform law implements the EU Anti-Tax Avoidance Directive and other anti-base erosion and profit shifting-related measures into Luxembourg tax law.

During the legislative process, the draft law on the 2019 tax reform was subject to only a few amendments but work remains to be done to clarify some practical implications and the impact of some of the new measures on existing tax law.

The Organization for Economic Co-operation and Development (''OECD'') final reports in regard to base erosion and profit shifting (''BEPS'') provide recommendations with regard to the design of domestic tax law and tax treaty provisions with a view to eliminating BEPS opportunities. Many of these rules have an anti-avoidance character.

The EU Anti-Tax Avoidance Directive (''ATAD'') aims at implementing the recommendations made by the OECD in all EU member states, laying down anti-tax avoidance rules in the following fields:

- deductibility of interest payments;
- general anti-abuse rule (''GAAR'');
- controlled foreign companies (''CFCs'');
- hybrid mismatches; and
- exit taxation.

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In addition to the above ATAD measures, the tax reform law introduces two additional ''anti-BEPS'' measures into Luxembourg tax law. These changes are a response to two state aid investigations by the European Commission and should close loopholes that create opportunities for double non-taxation.

The tax law changes introduced make clear that the tax treatment in the two state aid cases was consistent with Luxembourg tax law as it stands and it is necessary to change the law if one does not like the outcome of these rules.

## Interest Deduction Limitation Rule

From January 1, 2019, Article 168bis of the Income Tax Law (''ITL'') limits the deductibility of ''exceeding borrowing costs'' generally to a maximum of 30 percent of the corporate taxpayers' earnings before interest, taxes, depreciation and amortization (″EBITDA″). The scope of the interest deduction limitation rule encompasses all interest-bearing debts irrespective of whether the debt financing is obtained from a related party or a third party.

However, exceeding borrowing costs up to an amount of 3 million euros ($3.46 million) may be deducted without any limitation (a safe harbor provision).

''Exceeding borrowing costs'' correspond to the amount by which the deductible ''borrowing costs'' of a

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taxpayer exceed the amount of taxable ''interest revenues and other economically equivalent taxable revenues.'' Borrowing costs within the meaning of this provision are interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection 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 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 where applicable;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees for financing arrangements;
- arrangement fees and similar costs related to the borrowing of funds.

As far as interest income and other economically equivalent taxable revenues are concerned, neither ATAD nor Luxembourg tax law provides a clear definition of what is to be considered as ''revenues which are economically equivalent to interest.'' However, given that borrowing costs and interest income should be mirroring concepts, the latter should be interpreted in accordance with the broad definition of borrowing costs.

Corporate taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs (the so-called escape clause that should protect multinational groups that are highly leveraged).

Moreover, according to a recent announcement of the Luxembourg government, the optional provision under ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (in case several companies form a fiscal unity) will be introduced within the upcoming six months with retroactive effect as from January 1, 2019.

**Entities Excluded from the Scope of the Rule** The interest deduction limitation rule explicitly excludes financial undertakings and standalone entities from its scope.

Financial undertakings are those regulated by the EU Directives and Regulations and include financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities (UCITS), alternative investment funds (AIF) as well as securitization undertakings that are subject to EU Regulation 2017/2402.

Standalone entities are entities that (i) are not part of a consolidated group for financial accounting purposes, and (ii) have no associated enterprise or permanent establishment (''PE'').

Thus, for a Luxembourg company to benefit from the standalone entity exception, it is necessary that none of the associated enterprises has directly or indirectly a participation of 25 percent or more (in this regard, participation means a participation in terms of voting rights or capital ownership of 25 percent or more or the entitlement to receive 25 percent or more of the profits of that entity).

It is interesting to note that the definition of associated enterprise for the purpose of the newly introduced provisions is defined very broadly including individuals, companies and transparent entities such as partnerships.

**Loans Excluded from the Scope of the Rule** According to Article 168 of the ITL, loans concluded before June 17, 2016 are excluded from the restrictions on interest deductibility. However, this grandfathering rule does not apply to any subsequent modification of such loans. Accordingly, when the nominal amount of a loan granted before June 17, 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest deduction limitation rule. Likewise, when the interest rate is increased after June 17, 2016, only the original interest rate would benefit from the grandfathering rule.

Nevertheless, when companies are financed by a loan facility that determines a maximum loan amount and an interest rate, the entire loan amount should be excluded from the scope of the interest deduction limitation rule irrespective of when the drawdowns have been made.

Loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rule.

**Carry Forward Mechanisms** The interest deduction limitation rule also provides for a carry forward mechanism with regard to both non-deductible exceeding borrowing costs and unused interest capacity.

Non-deductible exceeding borrowing costs are interest expenses which cannot be deducted because they exceed the limits set in Article 168bis of the ITL. Such exceeding borrowing costs may be carried forward without time limitation and deducted in subsequent tax years.

Unused interest capacity arises in a situation in which the exceeding borrowing costs of the corporate taxpayer are lower than 30 percent of the EBITDA to the extent they exceed 3 million euros. These amounts can be carried forward for a period of five tax years.

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For corporate reorganizations that fall within the scope of Article 170 (2) of the ITL (for example, mergers), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

## Amendment of General Anti-Abuse Rule

Effective from January 1, 2019, the Luxembourg abuse of law concept, as defined in section 6 of the Tax Adaptation Law has been replaced by a new General Anti-Abuse Rule (''GAAR'') which keeps the key aspects of the previous abuse of law concept (according to which ''the tax law cannot be circumvented by an abuse of forms and legal constructions'') while introducing the concepts of the ATAD GAAR at the same time.

Under the new provision, non-genuine arrangements or a series of non-genuine arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law shall be disregarded. Arrangements are considered as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

Where the Luxembourg tax authorities can evidence an abuse in accordance with this GAAR, the amount of taxes will be determined based on the legal route that is considered as the genuine route, i.e. based on the legal route which would have been put into place for valid commercial reasons which reflect economic reality.

In terms of scope, the new GAAR is broader than the GAAR provided under ATAD. While the latter only applies to corporate income tax (″CIT″) and taxpayers, the Luxembourg GAAR applies to all taxpayers and is not limited to CIT.

However, in practice, the scope of the new GAAR should be limited to clearly abusive situations and, in an EU context, to wholly artificial arrangements considering relevant jurisprudence of the Court of Justice of the EU.

## Controlled Foreign Company Rule

Companies that are part of the same group are generally taxed separately as they are separate legal entities. When a Luxembourg parent company has a subsidiary, the profits of the subsidiary are only taxable at the level of the parent company once the profits are distributed.

Depending on the residence state and tax treatment of the subsidiary, dividend income may either be tax exempt (in full or in part) or taxable with a right to credit a potential withholding tax levied at source. Thus, if a foreign subsidiary is located in a low-tax jurisdiction, the taxation of the profits of such entity may be deferred through the timing of the distribution.

In this regard, ATAD requires EU member states to implement CFC rules that reattribute the income of a low-taxed controlled company (or PE) to its parent company, even though such income has not been distributed.

However, EU member states have a certain leeway when it comes to the implementation of the CFC rules. More precisely, EU member state legislators may choose between two alternative options (passive income option vs non-genuine arrangement option) and have the option to exclude certain CFCs.

**Definition of CFCs** According to Article 164ter of the ITL, a CFC is an entity or a PE of which the profits are either not subject to tax or exempt from tax in Luxembourg provided that the following two cumulative conditions are met:

(i) In the case of an entity, the Luxembourg corporate taxpayer by itself, or together with its associated enterprises

(a) holds a direct or indirect participation of more than 50 percent of the voting rights; or

(b) owns directly or indirectly more than 50 percent of capital; or

(c) is entitled to receive more than 50 percent of the profits of the entity (the ''control criterion'') and

(ii) the actual corporate tax paid by the entity or permanent establishment is lower than the difference between (a) the corporate tax that would have been charged in Luxembourg and (b) the actual corporate tax paid on its profits by the entity or permanent establishment (the ''low tax criterion'').

In other words, the actual tax paid is less than 50 percent of the tax that would have been due in Luxembourg. Given the currently applicable CIT rate of 18 percent (this rate should be reduced to 17 percent as from 2019 based on a recent announcement of the Luxembourg government), the CFC rule will only apply if the taxation of the profits at the level of the entity or PE is lower than 9 percent (8.5 percent as from 2019) on a comparable taxable basis (Article 164ter (1) of the ITL).

When assessing the actual tax paid by the entity or PE only taxes that are comparable to the Luxembourg CIT are to be considered.

The scope of the new CFC rule is limited, however, to CIT and will not apply for municipal business tax (''MBT'') purposes. This means that any income qualifying as CFC income under the new rule will be taxed in Luxembourg at 17 percent (assuming that the Luxembourg government will reduce the tax rate).

**Exceptions** The Luxembourg legislator adopted the options provided under ATAD according to which the following entities or PEs are excluded from the scope of the CFC rules:

- an entity or PE with accounting profits of no more than 750,000 euros; or
- an entity or PE with accounting profits of no more than 10 percent of its operating costs for the tax period.

**Determination and Tax Treatment of CFC Income** CFC income is subject to CIT at a rate of 18 percent currently (according to an announcement of the Luxembourg government, the CIT rate should be decreased to 17 percent with retroactive effect as from January 1, 2019). A specific deduction has been included in the MBT law to exclude CFC income from the MBT base.

With regard to the fundamental scope of the CFC rules, Luxembourg has opted for the non-genuine arrangement concept. Accordingly, a Luxembourg corporate taxpayer will be taxed on the non-distributed income of an entity or PE which qualifies as a CFC provided that the non-distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

In practice, this means that the profits of a CFC will only need to be included in the tax base of a Luxembourg corporate taxpayer if, and to the extent that, the

activities of the CFC that generate these profits are managed by the Luxembourg taxpayer (i.e. when the significant people functions in relation to the assets owned and the risks assumed by the CFC are performed by the Luxembourg corporate taxpayer).

Conversely, when a Luxembourg parent company does not carry out any significant people functions in relation to the activities of the CFC, no CFC income is to be included in the CIT base of the Luxembourg parent company.

When a Luxembourg corporate taxpayer is involved in the management of the activities performed by the CFC, the CFC income to be included by the Luxembourg corporate taxpayer should be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the Luxembourg taxpayer. Here, the attribution of CFC income shall be calculated in accordance with the arm's length principle.

The income to be included in the tax base shall further be computed in proportion to the taxpayer's participation in the CFC and is included in the tax period of the Luxembourg corporate taxpayer in which the tax year of the CFC ends.

Last but not least, Article 164ter of the ITL provides for rules that aim to avoid the double taxation of CFC income (for example, when CFC income is distributed or a participation in a CFC is sold).

Part 2 of this Insight will continue a review of the Luxembourg tax reforms.

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# INSIGHT: Luxembourg Tax Reform—What's Changing in 2019? (Part 2)

BY OLIVER R. HOOR AND SAMANTHA SCHMITZ

The 2019 Luxembourg tax reform law implements the EU Anti-Tax Avoidance Directive and other anti-base erosion and profit shifting-related measures into Luxembourg tax law. During the legislative process, the draft law on the 2019 tax reform was subject to only a few amendments but work remains to be done to clarify some practical implications and the impact of some of the new measures on existing tax law.

## Anti-hybrid Mismatch Rules

The tax reform law introduces a new Article 168ter of the Income Tax Law (''ITL'') which implements the generic anti-hybrid mismatch provisions included in the EU Anti-Tax Avoidance Directive (''ATAD''). The new article aims to eliminate—in an EU context only—the double non-taxation created through the use of certain hybrid instruments or entities.

The law does not implement the amendments introduced subsequently by ATAD 2 to ATAD which have replaced the anti-hybrid mismatch rules provided under ATAD and extended their scope of application to hybrid mismatches involving third countries. ATAD 2 provides for specific and targeted rules which must be implemented by January 1, 2020. As such, the anti-hybrid mismatch rule provided in ATAD did not have to be implemented in 2019.

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The aim of the measures against hybrid mismatches is to eliminate the double non-taxation created by the use of certain hybrid instruments or entities. In general, a hybrid mismatch structure is a structure where a financial instrument or an entity is treated differently for tax purposes in two different jurisdictions. The effect of such mismatches may be a double deduction (i.e. deduction in both member states) or a deduction of the income in one state without inclusion in the tax base of the other member state.

However, in an EU context, hybrid mismatches have already been tackled through several measures such as the amendment of the EU Parent–Subsidiary Directive (i.e. dividends should only benefit from the participation exemption regime if these payments are not deductible at the level of the paying subsidiary).

Therefore, the hybrid mismatch rule included in the new Article 168ter of the ITL should have a limited scope of application. However, given the generic wording of the anti-hybrid mismatch rule, the latter may create significant legal uncertainty in 2019 even if the existence of a hybrid situation is not at all linked to tax motives.

**Rule Applicable to Double Deduction** To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the EU member state where such payment has its source. Thus, where Luxembourg is the investor state and the payment has been

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deducted in the source state, Luxembourg will deny the deduction. However, this situation should hardly ever occur in practice.

**Rule Applicable in Case of Deduction Without Inclusion** When a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer jurisdiction. Therefore, if Luxembourg is the source state and the income is not taxed in the recipient state, the deduction of the payment will be denied in Luxembourg.

In practice, income that is treated as dividend income at investor level should, in accordance with the EU Parent–Subsidiary Directive, only benefit from a tax exemption if the payment was not deductible at the level of the Luxembourg company making the payment. Therefore, these situations should generally not occur in an EU context.

**How to Benefit From a Tax Deduction in Practice** To be able to deduct a payment in Luxembourg, the Luxembourg corporate taxpayer will have to demonstrate that no hybrid mismatch situation exists. The taxpayer will have to provide evidence to the Luxembourg tax authorities that either (i) the payment is not deductible in the other member state which is the source state, or (ii) the related income is taxed in the other member state.

This evidence is provided through the statements made in the corporate tax returns. In practice, the Luxembourg tax authorities may ask for further information and proof in this respect.

## Exit Taxation Rules

The tax reform further provides for tax law changes in regard to exit taxation that will become applicable as from January 1, 2020. These measures should discourage taxpayers from moving their tax residence and/or assets to low-tax jurisdictions. However, to a large extent, Luxembourg tax law already provided for exit tax rules.

**Rule Applicable to Transfers to Luxembourg** As far as transfers to Luxembourg are concerned, a new paragraph has been added to Article 35 of the ITL providing that in case of a transfer of assets, tax residence or business carried on by a permanent establishment (''PE'') to Luxembourg, Luxembourg will follow the value considered by the other jurisdiction as the starting value of the assets for tax purposes, unless this does not reflect the market value.

The aim of this rule is to achieve coherence between the valuation of assets in the country of origin and the valuation of assets in the country of destination. While ATAD limits the scope of application of this provision to transfers between two EU member states, the new provision added to Article 35 of the ITL covers transfers from any other country to Luxembourg.

**Rule Applicable in Case of Contribution to Luxembourg** The same valuation principles will also apply to contributions of assets (*supplément d'apport*) within the meaning of Article 43 of the ITL. Therefore, when assets are contributed to Luxembourg, Luxembourg shall accept the value considered in the jurisdiction of the contributing company or PE as the starting value of the assets for tax purposes, unless this does not reflect the market value.

**Rule Applicable to Transfers out of Luxembourg** As far as transfers out of Luxembourg are concerned, the tax reform law provides that a taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets at the time of the exit, less their value for tax purposes in the case of:

- a transfer of assets from the Luxembourg head office to a PE located in another country, but only to the extent that Luxembourg loses the right to tax the transferred assets;

- a transfer of assets from a Luxembourg PE to the head office or to another PE located in another country, but only to the extent that Luxembourg loses the right to tax the transferred assets;

- a transfer of tax residence to another country, except for those assets which remain connected with a Luxembourg PE; and

- a transfer of the business carried on through a Luxembourg PE to another member state or to a third country, but only to the extent that Luxembourg loses the right to tax the transferred assets.

For transfers within the European Economic Area, the Luxembourg taxpayer may request to defer the payment of exit tax by paying in equal installments over five years. Section 127 of the General Tax law (*Abgabenordnung*) is amended accordingly.

## Amendment of the Luxembourg Roll-over Relief

Article 22bis of the ITL provides for exceptions to the general rule that Luxembourg taxpayers have to realize latent capital gains linked to assets that are exchanged for other assets. As from 2019, the provision applicable to a specific category of exchange operations involving the conversion of a loan or other debt instruments into shares of the borrower has been abolished.

Hence, the conversion of debt instruments into shares of the borrowers will no longer be possible in a tax neutral manner. Instead, the conversion will be treated as a sale of the debt instrument followed by a subsequent acquisition of shares. Accordingly, any latent gain on the debt instrument will become fully taxable upon the conversion.

Therefore, whenever a debt instrument should be contributed by a Luxembourg company, consideration should be given to the question as to whether the fair market value of the receivable exceeds its book value. Where the amendment of the roll-over relief would result in adverse tax consequences, alternative restructuring options should be explored.

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The amendment to Article 22bis of the ITL follows the state aid investigations of the European Commission in the Engie case. However, while the aim of this amendment is to ensure that double non-taxation situations can no longer arise from this provision, it would have been wise to implement more targeted measures to avoid collateral damage.

## Amendment of the PE Definition

As a last measure, the definition of PE under Luxembourg tax law (section 16 of the Tax Adaptation Law) has been amended. Under the new PE definition, the only criteria to be considered in order to assess whether a Luxembourg taxpayer has a PE in a country with which Luxembourg has concluded a tax treaty are the criteria defined in that tax treaty. In other words, the PE definition included in the tax treaty will be relevant.

Furthermore, unless there is a clear provision in the relevant tax treaty which is opposed to this approach, a Luxembourg taxpayer will be considered as performing all or part of its activity through a PE in the other contracting state only if the activity performed, viewed in isolation, is an independent activity which represents a participation in the general economic life in that contracting state.

However, tax treaties concluded by Luxembourg generally include the PE definition provided in Article 5 of the OECD Model Convention that does not entail such requirement, so the amendment of the Luxembourg PE definition should have no material impact in practice.

Finally, the Luxembourg tax authorities may request from the taxpayer a certificate issued by the other contracting state according to which the foreign authorities recognize the existence of the foreign PE. Such certificate is, in particular, to be produced when Luxembourg adopted the exemption method in a tax treaty and the other contracting state interprets the rules of the tax treaty in a way that excludes or limits its taxing rights. This is to avoid hybrid branch situations that are recognized in Luxembourg but disregarded in the host state of the PE.

## Planning Points

ATAD required EU member states to implement certain anti-BEPS measures into their domestic tax law and provided some leeway to choose among a number of implementation options. Overall, Luxembourg has made the right choices, using all options beneficial to taxpayers that will help the Grand Duchy to remain competitive.

However, in a few cases the Luxembourg legislator took a position even stricter than what was required by ATAD. For example, instead of implementing the anti-hybrid mismatch rules provided in ATAD 2 as from 2020, the tax reform provides for the generic hybrid mismatch rule included in ATAD. Ironically, this rule needs to be replaced only one year later by the detailed anti-hybrid mismatch rules provided in ATAD 2.

Although the impact of this measure should be limited, the generic nature of the anti-hybrid mismatch rule may create severe legal uncertainty in some case.

Additional work remains in order to clarify the views of the Luxembourg tax authorities on the interpretation of some of the new rules and the impact of certain of these rules on existing tax law. In this regard, it is expected that the Luxembourg tax authorities will release Tax Circulars with additional guidance in 2019.

Considering that these changes became effective in January 2019, Luxembourg taxpayers should urgently analyze the impact of the upcoming changes on their investments and business activities and take appropriate action where necessary.

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