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INSIGHT: Luxembourg Implements ATAD 2 (Part 1)

BY OLIVER R. HOOR

On August 8, 2019, Luxembourg released the draft law implementing EU Directive 2017/952 of May 29, 2017 (the "Anti-Tax Avoidance Directive 2" or ATAD 2) which provides for a comprehensive framework to tackle hybrid mismatches. These new rules will replace the existing hybrid mismatch rules which have been introduced as part of the 2019 tax reform implementing EU Directive 2016/1164 of January 28, 2016 (the "Anti-Tax Avoidance Directive" or ATAD) and extend their scope to transactions involving non-EU countries.

The Context

Hybrid mismatches typically result from a different tax treatment of an entity or financial instrument under the laws of two or more jurisdictions and may result in deduction without inclusion outcomes or double deductions.

The hybrid mismatch rules target a number of different situations including direct hybrid mismatches between associated enterprises, structured arrangements between third parties, imported hybrid mismatches and tax residency mismatches. Payments that may come within the scope of the hybrid mismatch rules may include payments under financial instruments and, in some cases, other deductible payments such as royalties, rents and payments for services.

While the primary objective of the hybrid mismatch rules is the elimination of double non-taxation, these rules should also not result in economic double taxation. The latter is ensured through a number of carve-outs and limitations that discharge the application of the hybrid mismatch rules.

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ATAD 2 follows the recommendations of the Organisation for Economic Co-operation and Development in regard to Base Erosion and Profit Shifting (BEPS) Action 2 that aim at neutralizing 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 they are consistent with the provisions of the Directive (see recital 28 of ATAD 2).

Hybrid Mismatch Rules

Scope of the Hybrid Mismatch Rules

Relevant Hybrid Mismatches

Article 168ter of the Luxembourg Income Tax Law (LITL) addresses four categories of hybrid mismatches:

- hybrid mismatches that result from payments under a financial instrument, including hybrid transfer;
- hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including as a result of payment to a disregarded PE;
- 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; and
- double deduction outcomes resulting from payments made by a hybrid entity or PE.

Article 168ter of the LITL generally applies in case of mismatch outcomes which include deductions without inclusions and double deductions (Article 168ter (1) No. 3 of the LITL).

However, 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 PE;
- between two or more PEs of the same entity; or
- under a structured arrangement (in this case, even unrelated parties may come within the scope of the anti-hybrid mismatch rules) (Article 168ter (2) of the LITL).

Article 168ter of the LITL further provides for rules that target imported hybrid mismatches that shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU member states through the use of a non-hybrid instrument.

Finally, Article 168ter of the LITL provides for rules that neutralize double deduction outcomes in case of tax residence mismatches (that is, when an entity is resident for tax purposes in two or more jurisdictions).

Associated Enterprises

The scope of hybrid mismatch arrangements is generally limited to transactions between associated enterprises with a participation of at least 50% in terms of voting rights or capital ownership, or entitlement to receive at least 50% of an entity's profit (the related party test). With regard to hybrid mismatches involving hybrid financial instruments (Article 168ter (1) No. 2a) of the LITL), the threshold requirement of 50% is reduced to 25% (Article 168ter (1) No. 17 of the LITL).

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 the voting rights or capital ownership of that entity that are held by the other person (Article 168ter (1) No. 17 of the LITL).

The purpose of the ''acting together'' concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interest or equity interest 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 holds minority stakes in an entity, enters 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 (see Final Report on BEPS Action 2, page 117, No. 369).

According to the commentaries of the draft law, investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions in accordance with the fund's investment policy. Therefore, the draft law provides for a safe harbor 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 the fund and that is entitled to less than 10% of the fund's profits is considered not to act together with other investors, unless proven otherwise.

Hence, in an investment fund context, the ownership of stakes below 10% should generally not be added when considering a potential aggregation of interests as a consequence of the acting together concept (Article 168ter (1) No. 17 of the LITL). 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 analyzed on a case-by-case basis whether two or more investors are acting together in a given case.

Limits of the Hybrid Mismatch Rules The purpose of Article 168ter of the LITL is the neutralization of mismatch outcomes that occur in certain hybrid mismatch situations. At the same time, the hybrid mismatch rules should not create economic double taxation (see, for example, Final Report on BEPS Action 2, p. 29, No. 36 and p. 86, No. 245).

The scope of the hybrid mismatch rules is limited as follows:

Deductible Payments

The hybrid mismatch rules are exclusively targeted at ''deductible payments.'' Thus, non-deductible payments such as interest expenses incurred in relation to tax exempt income may not come within the scope of Article 168ter of the LITL.

Timing Differences

Jurisdictions may use different tax periods and have different rules for recognizing when items of income or expenditure have been derived or incurred. However, timing differences should generally not be treated as giving rise to mismatches in tax outcomes as long as the income is included within a reasonable period of time (see recital 22 of ATAD 2). A payment under a financial instrument is deemed to be included within a reasonable period of time if such payment is included by the payee within 12 months of the end of the payer's tax period (Article 168ter (1) No. 2a) of the LITL).

ATAD 2 and the Effect of Other EU Directives

Where the provisions of another EU directive, such as the Parent–Subsidiary Directive, lead to the neutralization of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules (see recital 30 of ATAD 2). Notably, under Article 166 (2a) of the LITL (that is the domestic implementation of the Parent–Subsidiary Directive, as amended), a dividend payment only benefits from the participation exemption regime to the extent the payment was not deductible at the level of the EU subsidiary.

Inclusion of Income

A deduction without inclusion outcome assumes that a deductible payment is not included in any jurisdiction where that payment or deemed payment is received or is treated as being received under the laws of any other jurisdiction (Article 168ter (1) No. 6 of the LITL). On the contrary, no mismatch outcome exists if the payment is included in the taxable income in at least one jurisdiction. Thus, the inclusion in any jurisdiction is sufficient to discharge the application of the hybrid mismatch rules (see Final Report on BEPS Action 2, p. 41, No. 89; p. 57, No. 149).

Tax Status of the Payee

A payment should not be treated as giving rise to a hybrid mismatch that would have arisen in any event due to the tax-exempt status of the payee under the laws of the payee jurisdiction (for example, tax exempt investment funds, pensions funds and sovereign wealth funds). This includes payments to a taxpayer resident in a jurisdiction that does not levy corporate income tax and payments to a taxpayer in a pure territorial regime where the income is excluded or exempt as foreign source income.

Furthermore, as regards financial instruments, a payment should not be considered as giving rise to a mismatch outcome that is solely due to the fact that the instrument is held subject to the terms of a special regime (See Final Report on BEPS Action 2, p. 43, No. 96; see recital 16, 18 and 20 of ATAD 2). Thus, in these circumstances, the hybrid mismatch rules should not apply.

Dual Inclusion Income

With regard to certain hybrid mismatches, Article 168ter of the LITL only applies if and to the extent such deductions are set off against income that is not dual inclusion income (that is, any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen. This limitation applies to payments made by a hybrid entity, deemed payments between the head office and a PE or between two or more PEs and double deduction outcomes; Article 168ter (1) No. 2 e), f), g) of the LITL).

Thus, the deduction of payments from dual inclusion income does not trigger the application of the hybrid mismatch rules.

Transfer Pricing Adjustments

Differences in tax outcomes that are solely attributable to transfer pricing adjustments do not fall within the scope of the hybrid mismatch rules. Therefore, downward adjustments that are treated as deductible expenses by a taxpayer should not trigger the application of the hybrid mismatch rules even if no corresponding transfer pricing adjustment is made in the other jurisdiction (see recital 22 of ATAD 2, see Final Report on BEPS Action 2, p. 33, No. 53).

Allocation of Taxing Rights under Tax Treaties

Any adjustment required under the hybrid mismatch rules should in principle not affect the allocation of taxing rights between jurisdictions laid down under a tax treaty, confirming that tax treaty law is generally superior to the domestic tax laws of the contracting states (see recital 11 of ATAD 2).

Tax Treatment of Hybrid Mismatches

Article 168ter of the LITL aims at neutralizing the effects of hybrid mismatches. With regard to deduction without inclusion and double deduction outcomes, the new hybrid mismatch rules provide for linking rules that align the tax treatment of an instrument or an entity with the tax treatment in the counterparty jurisdiction.

More precisely, Article 168ter (3) of the LITL sets out a primary rule and a secondary (or defensive) rule for the neutralization of mismatch outcomes. This mechanism should prevent that more than one country applies the hybrid mismatch rules to the same arrangement and also avoids double taxation.

According to the primary rule, the deduction of a payment is denied to the extent that it is not included in the taxable income of the recipient or is also deductible in the counterparty jurisdiction. When the primary rule is not applied, the counterparty jurisdiction may apply a defensive rule, requiring the deductible payment to be included in the income or denying the duplicate deduction depending on the nature of the mismatch.

When a hybrid mismatch involves a third state, ATAD 2 places the responsibility to neutralize the effects of hybrid mismatches, including imported hybrid mismatches, on the EU member states.

Imported hybrid mismatches shift the effect of a hybrid mismatch between parties in third countries (be it intra-group or structured arrangements) into the jurisdiction of EU member states through the use of a non-hybrid instrument (see Final Report on BEPS Action 2, p. 83).

To counter such imported mismatches, Article 168ter (3) No. 3 of the LITL provides that payments are not deductible for tax purposes to the extent that such payments directly or indirectly fund deductible expenditure giving rise to a hybrid mismatch through a transaction or a series of transactions between associated enterprises or entered into as part of a structured arrangement.

When a Luxembourg corporate taxpayer is deemed to be resident for tax purposes in one or more foreign jurisdictions, payments, expenses or losses that are also deductible in the other jurisdiction(s) should not be tax deductible in Luxembourg to the extent that such other jurisdiction(s) allow(s) such payments, expenses or losses to be set off against income that is not dual inclusion income (Article 168ter (4) of the LITL). However, tax residency mismatches should hardly ever occur in Luxembourg, as tax treaties concluded by Luxembourg eliminate tax residency mismatches through the tie-breaker rule.

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.

The adjustment should, however, be no more than what is necessary to neutralize the hybrid mismatch and not result in economic double taxation (see, for example, Final Report on BEPS Action 2, p. 59, No. 155; p. 72, No. 200). When, for example, the payee jurisdiction only provides taxpayers with a partial exemption or a reduced rate on a payment under a hybrid financial instrument, the amount of the deduction that is denied should generally be no more than the amount of mismatch in tax outcomes between the payer and the payee jurisdiction (see Final Report on BEPS Action 2, p. 31, No. 43).

Burden of Proof

According to Article 168ter (6) of the LITL, the taxpayer has the burden of proof that the hybrid mismatch rules are not applicable. Taxpayers must, upon request, provide the tax authorities with a statement of 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 hybrid mismatch rules provided under Article 168ter (3)–(5) of the LITL are not applicable.

The commentary to the draft law specifies that taxpayers need to produce reasonable evidence that allows the tax authorities to verify whether the hybrid mismatch rules apply. With regard to the elements of foreign tax treatment of potential hybrid mismatches, taxpayers have to provide comprehensive, objective and verifiable information.

To Sum Up

From 2020, Luxembourg will implement the comprehensive hybrid mismatch rules provided under ATAD 2 that extend the scope of the existing hybrid mismatch rules to hybrid mismatches involving third states and, in addition, include a reverse hybrid mismatch rule which may apply as from 2022.

However, 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 hybrid mismatch rules are characterized by an extreme complexity which requires a good understanding of the overall investment structure and the foreign tax treatment of payments, entities, financial instruments, etc. Given that the burden of proof regarding the non-application of the hybrid mismatch rules is on the taxpayer, a hybrid mismatch analysis will necessarily become an integral part of each and every tax analysis.

Planning Points

With only a few months left in 2019 before the new hybrid mismatch rules enter into force, taxpayers have to analyze existing investment structures in order to detect potential hybrid mismatches and to implement, where necessary, structure alignments before year-end. Ultimately, the complexity of the hybrid mismatch rules may also be an opportunity to manage their impact in practice.

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The author wishes to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.

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While the primary objective of the hybrid mismatch rules is the elimination of double non-taxation, these rules should also not result in economic double taxation. The latter is ensured through a number of carve-outs and limitations that discharge the application of the hybrid mismatch rules.

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Reverse Hybrid Mismatch Rules

Scope of the Reverse Hybrid Mismatch Rules 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) (see Final Report on BEPS Action 2, p. 56, No. 140).

As a consequence, the income of a reverse hybrid may be neither 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 generally not included in the taxable income of the investor(s)).

The reverse hybrid mismatch rule aims at eliminating double non-taxation outcomes through the treatment of reverse hybrids as resident taxpayers (see Final Report on BEPS Action 2, p. 64, No. 174 and 175). Article 168quater of the Luxembourg Income Tax Law (LITL) may apply as from January 1, 2022 to all entities within

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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 from a Luxembourg tax perspective, their income is generally allocated to the owners (Article 168quater (1) of the LITL; the owners may be individuals, corporate taxpayers within the meaning of Article 159 (residents) or 160 (nonresidents) of the LITL or transparent entities within the meaning of Article 175 of the LITL).

However, the reverse hybrid mismatch rule may only apply when one or more investor(s) (that are resident in a jurisdiction or jurisdictions that regard the Luxembourg entity as opaque) have effective control over the Luxembourg entity. This would be the case when the entity is owned by one or several associated enterprises within the meaning of Article 168ter (1) No. 17 of the LITL which hold directly or indirectly a participation of at least 50% in terms of voting rights or capital ownership or is entitled to receive at least 50% of an entity's profit.

Tax Treatment of Reverse Hybrid Mismatches

Corporate Income Tax When the reverse hybrid mismatch rule applies, the 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.

Accordingly, the reverse hybrid mismatch rules will not apply if and to the extent the income derived through the Luxembourg entity is taxable in Luxembourg as domestic income of nonresident taxpayers. This may, for example, be the case when a Luxembourg partnership performs a commercial activity that results in the constitution of a permanent establishment (PE) of its nonresident partner(s). (Here, the nonresident partners are subject to (corporate) income tax with the commercial income realized via the partnership which constitutes a PE of its nonresident partners; Article 156 No. 1 a) of the LITL in conjunction with Article 2 (3) (individuals) or 160 (1) (corporates) of the LITL.)

Therefore, the inclusion of income for Luxembourg corporate income taxes should be limited to amounts that otherwise would result in double non-taxation rather than taxing all the income of the reverse hybrid (Article 168quater (1) of the LITL).

Example: Reverse hybrid mismatch

An investor resident in State A (A-Co) invests in an entity resident 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.

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

In these circumstances (assuming that Luxembourg is State B), Article 168quater (1) of the LITL should result in B-Co being treated as a resident taxpayer and subject to corporate income tax to the extent the net income is not taxed otherwise under the Luxembourg income tax law or the law of any other jurisdiction.

With regard to payments to a reverse hybrid entity, the reverse hybrid mismatch rule will have as an effect that an arrangement that would otherwise give rise to a mismatch outcome within the meaning of Article 168ter (1) No. 2 of the LITL should not be subject to any further adjustment under the hybrid mismatch rules (see recital 29 of ATAD 2). This is because Article 168quater eliminates the deduction without inclusion outcome that may otherwise trigger non-deductibility in accordance with the hybrid mismatch rules.

Article 168quater of the LITL provides for a carve-out for collective investment vehicles (CIV) that 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). 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:

- Undertakings for Collective Investment (UCIs) within the meaning of the Law of December 17, 2010 (i.e. both Undertakings for Collective Investment in Transferable Securities (UCITS), within the meaning of part 1 of the UCI Law of December 17, 2010, and non-UCITS or alternative investment funds within the meaning of part 2 of the UCI Law);
- Specialized Investment Funds (SIFs) within the meaning of the Law of February 13, 2007;
- Reserved Alternative Investment Funds (RAIFs) within the meaning of the Law of July 23, 2016; and
- Other alternative investment funds within the meaning of the Law of July 12, 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.

Municipal Business Tax The reverse hybrid mismatch rule has no impact on Luxembourg municipal business taxation. Instead, the tax treatment of a Luxembourg partnership depends significantly on the activities performed. Notwithstanding the fact that partnerships are deemed to be transparent for Luxembourg direct tax purposes, 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.

Likewise, where 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 (Article 14 (4) of the LITL).

The commercial income realized by Luxembourg partnerships is subject to Luxembourg municipal business tax at the level of the partnership (section 2(1) of the Municipal Business Tax Law).

Net Wealth Tax With regard to net wealth tax, the draft law provides for a specific exemption for entities that are treated as opaque in accordance with the reverse hybrid mismatch rule (section 3(1) No. 12 of the Net Wealth Tax Law). Thus, reverse hybrids are not subject to net wealth tax regardless of whether such entity is treated as a taxpayer for corporate income tax purposes.

Burden of Proof

The burden of proof that the reverse hybrid mismatch rule does not apply is on the taxpayer. According to Article 168quater (3) of the LITL, taxpayers have, upon request, to provide relevant documentation (tax returns, certificates issued by foreign tax authorities, etc.) that demonstrate that the reverse hybrid mismatch rule does not apply.

The commentary to the draft law specifies that taxpayers need to produce reasonable evidence that allows the tax authorities to verify whether or not the hybrid mismatch rules apply. With regard to the elements of foreign tax treatment of potential hybrid mismatches, taxpayers have to provide comprehensive, objective and verifiable information.

To Sum Up

As from 2020, Luxembourg will implement the comprehensive hybrid mismatch rules provided under ATAD 2 that extend the scope of the existing hybrid mismatch rules to hybrid mismatches involving third states and, in addition, include a reverse hybrid mismatch rule which may apply as from 2022.

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