The 2019 Luxembourg Tax Reform:

Analysing the Impact on Alternative Investments – Part 2

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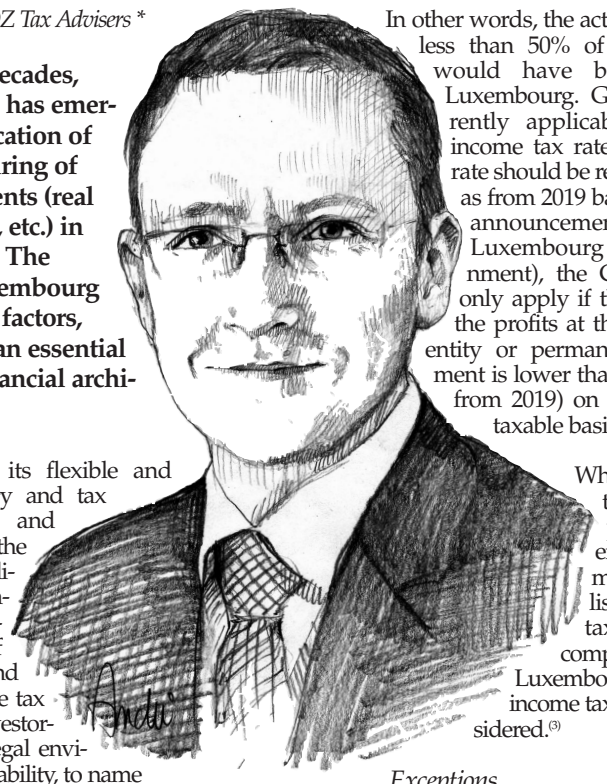
Over the last decades, Luxembourg has emerged to the location of choice for the structuring of Alternative Investments (real estate, private equity, etc.) in and through Europe. The attractiveness of Luxembourg is linked to a host of factors, which have made it an essential part of the global financial architecture.



These factors include its flexible and diverse legal, regulatory and tax framework, investor and lender familiarity with the jurisdiction, the availability of qualified, multilingual workforce, the existence of a deep pool of experienced advisers and service providers, a large tax treaty network, an investor-friendly business and legal environment, and political stability, to name a few reasons. Moreover, Luxembourg is a founder member of and sits at the heart of the European Union, one of the largest sources of capital and investment opportunities globally.

The Luxembourg Parliament has now adopted the 2019 tax reform implementing the EU Anti-Tax Avoidance Directive ("ATAD") and other anti-BEPS-related measures into Luxembourg tax law. More precisely, the 2019 tax reform includes tax law changes in the following areas:
- Interest limitation rules;
- General anti-abuse rule (GAAR);
- Controlled foreign companies (CFCs);
- Hybrid mismatch rules;
- Amendment of the exit tax rules;
- Amendment of the roll-over relief; and
- Amendment of the permanent establishment definition.

This is the second of two articles that provide a clear and concise overview of the different tax measures and analyses their impact on typical Alternative Investments (real estate, private equity, etc.) made via Luxembourg.

Controlled Foreign Company (CFC) Rules

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.[1] 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 re-attribute the income of a low-taxed controlled company (or permanent establishment) 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, legislators may choose between two alternatives regarding the fundamental scope of the CFC rules (i.e. the passive income option vs. the non-genuine arrangement option) and have the option to exclude certain CFCs.

Definition of CFCs

According to Article 164ter of the LITL, a CFC is an entity or a permanent establishment 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% of the voting rights; or
b) owns directly or indirectly more than 50% of capital; or
c) is entitled to receive more than 50% 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 (i) the corporate tax that would have been charged in Luxembourg and (ii) 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% of the tax that would have been due in Luxembourg. Given the currently applicable corporate income tax rate of 18% (this rate should be reduced to 17% as from 2019 based on 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 permanent establishment is lower than 9% (8.5% as from 2019) on a comparable taxable basis.[2]

When assessing the actual tax paid by the entity or permanent establishment only taxes that are comparable to the Luxembourg corporate income tax are to be considered.[3]

Exceptions

The Luxembourg legislator adopted the options provided under ATAD according to which the following entities or permanent establishments are excluded from the scope of the CFC rules:
- An entity or permanent establishment with accounting profits of no more than EUR 750.000; or
- An entity or permanent establishment of which the accounting profits amount to no more than 10% of its operating costs for the tax period.[4]

Determination and tax treatment of CFC income

CFC income is subject to corporate income tax at a rate of currently 18%.[5] However, a specific deduction has been included in the municipal business tax law to exclude CFC income from the municipal business tax base.[6] 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 permanent establishment 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 corporate income tax base of the Luxembourg parent company.[7]

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[8][9].

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 LITL 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).

Analysing the Impact on Alternative Investments

Alternative Investments are generally made in high-tax jurisdictions. Here, the CFC rules do not apply in the absence of low-taxed subsidiaries.

When investments are made into a group of companies that has a subsidiary in a low-tax jurisdiction, the Luxembourg CFC rules should only apply if and to the extent the Luxembourg company performs the significant people functions in regard to the activities performed by the CFC. However, this is a scenario that should hardly ever occur in practice.

Anti-hybrid Mismatch Rules

The tax reform law further introduced a new article 168ter LITL which implements the generic anti-hybrid mismatch provisions included in ATAD. The new provision 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 though 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 have to be implemented by 1 January 2020. As such, the anti-hybrid mismatch rule provided in ATAD did not have to be implemented in 2019.

The objective of the measures against hybrid mismatches is to eliminate double non-taxation outcomes created by the use of certain hybrid instruments or entities. In general, a hybrid mismatch exists 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. a deduction in two EU Member States) or a deduction of the payment in one state without the inclusion of the payment in the other state.

However, in an EU context, hybrid mismatches have already been tackled through several measures such as the amendment of the Parent/Subsidiary-Directive (i.e. dividends should only benefit from the participation exemption regime if the payment is not deductible at the level of the paying subsidiary). Therefore, the hybrid mismatch rule included in the new article 168ter LITL 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 States in which the payment has its source. Thus, in case Luxembourg is the investor state and the payment has been 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 current version of 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

In order to be able to deduct a payment in Luxembourg, the Luxembourg corporate taxpayer will have to demonstrate that no hybrid mismatch situation exists. Here, 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 taxable in the other Member State.

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

Analysing the Impact on Alternative Investments

The scope of the new rules is limited to hybrid mismatch situations in an EU context. However, within the EU, hybrid mismatches have already been tackled by several initiatives (for example, the anti-hybrid mismatch rule included in the Parent/Subsidiary Directive) and double non-taxation/deduction outcomes should be fairly uncommon in practice. Therefore, the 2019 anti-hybrid mismatch rules should have a limited impact on investments.

Given their generic nature, however, the anti-hybrid mismatch rules as they stand may still have the potential to create significant legal uncertainty. For example, in situations when a fund vehicle is treated as opaque in the EU Member State(s) in which the investors are resident, whereas the vehicle is treated as fiscally transparent from a Luxembourg tax perspective. In these circumstances, one may construe that the fund vehicle is a hybrid entity.

Considering the implementation of the comprehensive anti-hybrid mismatch rules provided under ATAD 2 in 2020 (applying in an EU context and in situations involving third states), it would be wise for taxpayers to anticipate the potential impact on investments. One particular concern in this respect relates to Alternative Investments of US investors given the particularities of US tax law.

Exit Tax Rules

The tax reform further provides for tax law changes in regard to exit taxation that will become applicable as from 1 January 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 provided already 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 LITL providing that in case of a transfer of assets, tax residence or business carried on by a permanent establishment 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 linking 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 LITL covers transfers from any other country to Luxembourg.

Rule applicable to contributions to Luxembourg

The same valuation principles will also apply to contributions of assets ("*supplement d'apport*") within the meaning of article 43 LITL. Thus, when assets are contributed to a Luxembourg company, the value considered in the jurisdiction of the contributing company or permanent establishment will be considered as 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 case of:
- A transfer of assets from the Luxembourg head office to a permanent establishment 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 permanent establishment to the head office or to another permanent establishment 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 permanent establishment; and
- A transfer of the business carried on through a Luxembourg permanent establishment to another country but only to the extent that Luxembourg loses the right to tax the transferred assets.

In case of transfers within the European Economic Area (EEA), the Luxembourg taxpayer may request to defer the payment of exit tax by paying in equal instalments over 5 years. Section 127 of the General Tax law ("*Abgabenordnung*") is amended accordingly.

Analysing the Impact on Alternative Investments

Investments made via Luxembourg companies generally do not involve transactions that may trigger exit taxation. Instead, investments are made and held until the end of the investment period when the investments are sold. It follows that the amendment of the exit tax rules and the introduction of linking rules with regard to migrations and contributions should have a limited impact in this respect.

Amendment of the Permanent Establishment Definition

As a last measure, the definition of permanent establishment under Luxembourg tax law (Section 16 of the Tax Adaptation Law) has been amended.

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Under the amended permanent establishment definition, the criteria to be considered in order to assess whether a Luxembourg taxpayer has a permanent establishment in a country with which Luxembourg has concluded a tax treaty are the criteria defined in the tax treaty itself. In other words, the permanent establishment 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 permanent establishment 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 permanent establishment definition provided in Article 5 of the OECD Model Convention that does not entail such requirement. Thus, 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 permanent establishment.[10] Such certificate is, in particular, to produce 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 permanent establishment.

Analysing the Impact on Alternative Investments

Luxembourg companies involved in Alternative Investments do generally not operate through foreign permanent establishments. Therefore, the amendment of the permanent establishment definition should have no impact on alternative investments.

Conclusion

The 2019 tax reform introduces a number of new anti-avoidance rules into Luxembourg tax law. With regard to alternative investments, the interest limitation rules (as detailed in the first part of this article, included in the February edition of AGEFI) have to be in the focus of each and every tax analysis, whereas the other tax measures should in many cases have a limited effect. Nevertheless, the impact of the tax reform on a particular investment structure has to be determined on a case-by-case basis.

Anticipating the next tax reform in 2020, taxpayers should analyse whether the adoption of the comprehensive anti-hybrid mismatch rules provided under ATAD 2 may have an impact on investments and implement structure alignments where necessary.

Ultimately, the attractiveness of Luxembourg as a prime location for the structuring of alternative investments should not be undermined by the current tax developments. To the contrary, Luxembourg offers an ideal framework for investments in the post-BEPS era.

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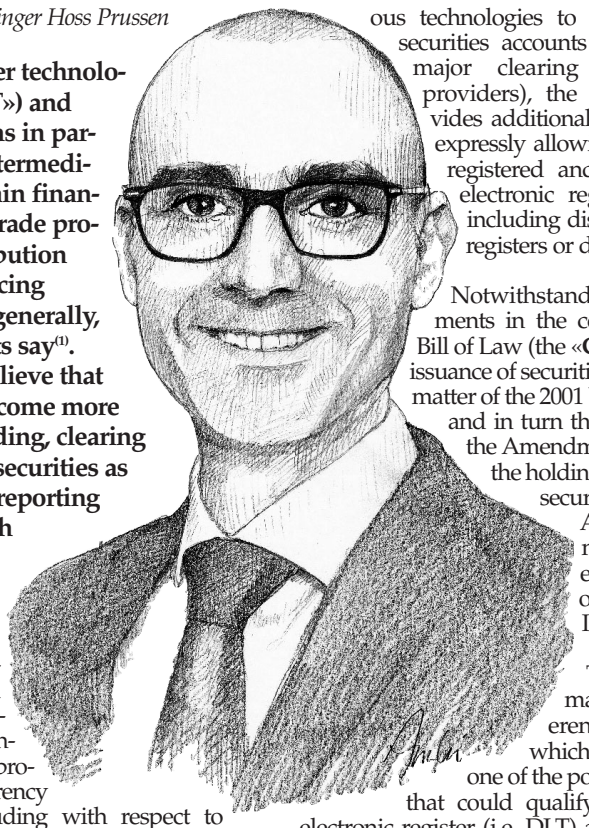
1) Article 97 (1) No. 1 of the Luxembourg Income Tax Law ("LITL") in connection with Article 166 (1) (Luxembourg participation exemption regime), Article 115 No. 15 (50% tax exemption for dividends received from certain subsidiaries when the conditions of the participation exemption regime are not med) or Article 134bis (tax credit) of the LITL.
2) Article 164ter (1) of the LITL.
3) Article 164ter (1) of the LITL.
4) Article 164ter (1) of the LITL.
5) According to an announcement of the Luxembourg government, the corporate income tax rate should be decreased to 17% with retroactive effect as from 1 January 2019.
6) Section 9 (3a) of the Luxembourg municipal business tax law.
7) Article 164ter (4) No. 1 of the LITL.
8) The arm's length principle is formally specified in Articles 56 and 56bis of the LITL.
9) Article 164ter (4) No. 1 of the LITL.
10) This certificate should mainly evidence that the permanent establishment is recognized in the other contracting state. As there is generally no subject to tax requirement in tax treaties concluded by Luxembourg, the tax treatment of the income derived through the permanent establishment in the host state thereof should be irrelevant for the tax treatment in Luxembourg.

Luxembourg's confirmation that securities can be held through DLT-like technologies, including blockchains!

Luxembourg's Parliament Passes Bill 7363

By Gary CYWIE, Elvinger Hoss Prussen*



Digital ledger technologies («DLT») and blockchains in particular could disintermediate some of the main financial markets post-trade processes, fund distribution and the asset servicing value chain more generally, authors and experts say[1]. Certain authors believe that markets would become more efficient if the holding, clearing and settlement of securities as well as post-trade reporting were made through blockchains[2].

For example, transaction costs would be lower and transactions could be settled in close to real-time. These new technologies would also provide greater transparency for regulators (including with respect to KYC/AML) and investors. Even more, they would eliminate a number of risks associated with intermediation. In fact, it would put investors back in the position in which they were before the introduction of information technology in the financial markets sector: in direct contact with the issuer[3]. Nothing seems to impede such developments from a purely technical point of view. Current national and cross-border legal and regulatory regimes may not, however, be fully ready to govern such developments effectively.

As one of the first cornerstones of the Luxembourg legal landscape in relation to DLT's impact on the financial sector (which local players must learn to domesticate if Luxembourg is to keep its leading position in the global fund and asset servicing industry), the Luxembourg government has on 27 September 2018 published a Bill of Law 7363 (the «**Bill of Law**») which has been approved by parliament on 14 February 2019 (the «**Amendment**») inserting a new Article 18*bis* in the amended Luxembourg Law of 1st August 2001 concerning the circulation of securities (the «**2001 Law**»), as follows (free translation):

«*Art. 18bis. (1) The account keeper may hold securities accounts and register securities in securities accounts within or through secure electronic registration devices, including distributed electronic registers or databases. Successive transfers registered in such a secure electronic registration device are considered transfers between securities accounts. The holding of securities accounts within, or the registration of securities in securities accounts through, such a secure electronic registration device do not affect the fungibility of the securities concerned.*

(2) Neither the application of this law, nor the location of the securities which continue to be held with the relevant account keeper, nor the validity or enforceability of the security interests or collateral arrangements created under the amended Law of 5 August 2005 on financial collateral arrangements shall be affected by the holding of securities accounts within, or by the registration of securities in the securities accounts through, such a secure electronic registration device.»

Although account keepers could, from a legal standpoint, and did in practice already use various technologies to hold securities in securities accounts (e.g. through the major clearing and settlement providers), the Amendment provides additional legal certainty by expressly allowing securities to be registered and held via secure electronic registration devices, including distributed electronic registers or databases.

Notwithstanding certain statements in the commentary of the Bill of Law (the «**Commentary**»), the issuance of securities is not the subject matter of the 2001 Law. The 2001 Law and in turn the subject matter of the Amendment solely relate to the holding and circulation of securities. Therefore, the Amendment does not intend to govern online issuance of securities or ICOs[4] for example.

The Commentary makes an explicit reference to blockchain, which is however only one of the possible technologies that could qualify as a distributed electronic register (i.e. DLT) and therefore even more so as an electronic registration device. In this respect, it is important to note that the text of the Amendment itself remains technologically neutral. Although there may be practical discussions on whether electronic registration devices are secure, giving a definition would have unnecessarily limited the scope of the legal innovation. The fact that account keepers have to comply with all their duties stemming from their status as regulated entities provides in itself guarantees of security in this respect.

The Commentary further specifies that, in the securities accounts world, a «token» stored in a blockchain should be considered as an «electronic asset» representing the security, as in the case of a paper security or a traditional dematerialised security. Hence, the token would be the *instrumentum* representing the security. The holding of the *instrumentum* would be, in the same way as with other forms of representation, a matter of proof of holding the relevant security and not a matter of validity of the security, i.e. of the rights attaching thereto.

Finally, the text of the Amendment specifies that the application of the 2001 Law will not otherwise be affected by this form of holding of securities, including with respect to the principle of fungibility, the location of the securities concerned (implicit reference seems to be made to the place of the relevant intermediary approach) as well as the validity and enforceability of collateral arrangements within the scope of the amended Law of 5 August 2005 on financial collateral arrangements.

The Council of State, in its opinion of 14 November 2018[5], made no comment other than saying that the authors of the Bill of Law confined themselves to partially adopt a new form of dematerialisation. It would have been possible, they argue, to grant an official ownership right over the security represented by the token. This would, however, have needed a more global analysis of the applicable law in respect of the security, the methods of enforcement of such ownership rights towards third parties and other ancillary questions such as the possibility to pledge the security.

The Chamber of Commerce, in its opinion of 12 December 2018[6], insisted on the fact that the wording of the Commentary may give the impression that only blockchains would be covered by the concept of distributed electronic databases (which the Chamber of Commerce says is not the case). Also, the Chamber of Commerce points out that tokens are not necessarily fungible in all blockchains. In their view, the Bill of Law should have stated that it all depends on the technology used but that blockchains can introduce fungible tokens. Without entering into any technical debate here, it is important to note in this respect that the Amendment provides for the fungibility of the underlying securities, not of the tokens themselves.

In other words, the Amendment only says that if the relevant underlying securities are fungible in the first place, such fungible nature is not affected should the account keeper hold the underlying securities within, or registers them through, a secure electronic registration device, independently from whether or not the tokens are themselves fungible.

The Amendment was taken as part of Luxembourg's efforts to promote digitalisation and the use of new technologies, and remain the go-to technology hub in Europe in all fields including the circulation of securities. In our view it is an important step in building the future of Luxembourg as a fund distribution and asset security jurisdiction.

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1) See for example KPMG Luxembourg (2016), Blockchain could replace post-trade intermediaries (https://home.kpmg.com/lu/en/home/.../blockchain-could-replace-intermediaries.html), Deloitte Luxembourg, Blockchain impact on fund distribution (https://www2.deloitte.com/content/dam/.../lu_impact-blockchain-fund-distribution.pdf) and De Meijer, Carlo R.W. (2018) What future role for CDSs in blockchain post-trade environment?, Finextra (https://www.finextra.com/blogposting/15143/what-future-role-for-cdss-in-blockchain-post-trade-environment).
2) Micheler, Eva and von der Heyde, Luke (2016) Holding, clearing and settling securities through blockchain/distributed ledger technology: creating an efficient system by empowering investors,Journal of International Banking & Financial Law, 31 , 11.
3) See Oliver Wyman and Euroclear (2016), Blockchain in Capital Markets - The Prize and the Journey (https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/feb/BlockChain-In-Capital-Markets.pdf).
4) On ICOs, please see Cywie, Gary (2018) ICO – L'économie numismatique, Droit du financement de l'économie, 1, 28 (only available through Legitech subscription, https://www.legitech.lu).
5) Doc. Parl. 7363/01.
6) Doc. Parl. 7363/02.