



ATAD 2 FINAL TRANSPOSITION INTO LUXEMBOURG TAX LAW

On 19 December 2019, the Luxembourg Parliament approved the draft law submitted by the Luxembourg Government on 8 August 2019 aiming at transposing Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (also commonly referred to as “ATAD 2”) into Luxembourg tax laws.

Background

As already indicated in our newsletter dated 23 August 2019, ATAD 2 introduces a comprehensive set of rules aiming at neutralizing the impacts of hybrid mismatches arising in relation to arrangements involving corporate taxpayers or entities of EU Member States only or involving corporate taxpayers and entities of EU Member States and non-member States.

The four categories of hybrid mismatches addressed by ATAD 2 are:

1. Hybrid mismatches that result from payments under a financial instrument
2. Hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including those that result from payments made to disregarded permanent establishments
3. Hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments
4. Double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment

These four categories of hybrid mismatches are supplemented with a rule on imported hybrid mismatches, as well as rules tackling double deductions arising from dual residency and the duplication of tax credits in the context of hybrid transfers.

The rules introduced by ATAD 2 had to be implemented with effect as of 1 January 2020, except for the rules neutralizing the impacts of reverse hybrid mismatches, which must be implemented with effect as of the tax year 2022.

The aim of the draft law submitted by the Government on 8 August 2019 (the “Draft Law”), was to transpose as closely as possible the rules of ATAD 2.

Notwithstanding the call for certain amendments and further clarification on certain provisions, the law finally approved by the Parliament corresponds to the Draft Law except with respect to the following points:

- The Law includes an independent definition of what is to be meant by an “entity”
- The reverse hybrid provisions of the Law clarify that only the portion of the income that leads to a hybrid mismatch will be subject to corporate income tax

The final provisions have been published in the Luxembourg Gazette on 23 December 2019 as the law dated 20 December 2019 modifying the Income Tax Law (“ITL”), Net Worth Tax Law (“NWTL”), Tax Adaptation Law (“TAL”) and general tax

law (GTL”), in order to transpose Council Directive (UE) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (the “Law”).

The Law

The Law matches masterpieces of the Law are:

- The replacement with effect as of 1 January 2020, of the anti-hybrid mismatch provisions covered by article 168ter ITL since the transposition of ATAD 1
- The introduction of a new article 168quater into the ITL aiming at the removal of reverse aimed at tackling reverse hybrid mismatch situations.

The new articles 168ter ITL and 168quater ITL comprise all of the provisions of ATAD 2, including the options provided for by ATAD 2 with respect to certain hybrid mismatch situations and certain hybrid instruments.

The introduction of the new articles 168ter ITL and 168quater ITL is accompanied by some consequential adjustments of the ITL, NWTL, TAL and GTL, in order to align these to the provisions of the new articles 168ter ITL and 168quater ITL.

Guidance on how the provisions of the articles 168ter ITL and 168quater ITL should be read, is included in the Draft Law. Additional guidance can also be found in the final report on action n°2 of the OECD BEPS Action Plan, to the extent that this guidance is in line with the provisions of ATAD 2 and the laws of the European Union.

During the legislative process, the State Council has provided comprehensive interpretation in relation to certain provisions of the Draft Law that are unclear or ambiguous. The Budget and Finance Committee of the Parliament explicitly decided not to express a view on these interpretations and to leave the validation or rebuttal of these interpretations to administrative circulars or grand-ducal decrees if required.

Detailed analysis of the key provisions of the Law

Article 168ter ITL

In essence, article 168ter ITL covers the following hybrid mismatch situations, in which Luxembourg corporate taxpayers, Luxembourg permanent establishments of non-resident corporate taxpayers and Luxembourg tax transparent entities are involved:

1. Hybrid mismatches situations giving rise to a “deduction without inclusion”:
 - a. A payment made under a financial instrument, where:
 - the mismatch is attributable to differences in the characterization of the instrument or the payment, and
 - the payment is not included in the jurisdiction of the beneficiary within a reasonable period of time;
 - b. A payment made to a hybrid entity, where the mismatch is due to differences in attribution rules under the laws of the jurisdictions of the entity and of the investors;
 - c. A payment made to an entity that has one or several permanent establishments, where the mismatch is the

result of differences in the allocation of the payment between the head office and the permanent establishment or between two or several permanent establishments by virtue of the laws of the jurisdictions where the entity operates;

- d. A payment made to a permanent establishment that is disregarded in the jurisdiction where the permanent establishment is located;
 - e. A payment made by a hybrid entity and the mismatch is the result of the laws of the jurisdiction of the beneficiary of the payment;
 - f. A payment deemed to be made between a head-office and its permanent establishment or between two or several permanent establishments, if the mismatch of the deemed payment in the hands of the beneficiary results from the laws of the jurisdiction of the beneficiary.
2. Hybrid mismatch situations giving rise to a “double deduction”.

In line with ATAD 2, article 168ter ITL specifies that hybrid mismatch situations may only arise in relation to arrangements between (i) associated enterprises as defined by article 168ter ITL, (ii) a corporate taxpayer and an associated enterprise, (iii) a head-office and a permanent establishment and (iv) two or several permanent establishments of the same entity, or in the context of structured arrangements.

The commentaries to the Draft Law specify that no hybrid mismatch should arise if a mismatch in taxation is purely due to the tax status of the beneficiary of the payment or if it is due to the fact the instrument under which the payment is made is held under a special regime.

Also in line with ATAD 2, article 168ter ITL foresees to neutralize hybrid mismatches through the following mechanisms:

- Where a hybrid mismatch results in a **deduction without inclusion**, the deduction shall, as a primary rule, be denied at the level of the Luxembourg paying entity. As a secondary rule, if a Luxembourg resident taxpayer receives payments made in the context of hybrid instruments or by a foreign hybrid entity, these payments shall be included in the taxable income of a Luxembourg resident beneficiary in the case the payments received are deductible in the country of the paying entity.

Thus, the secondary rule is not applicable to the hybrid mismatch situations defined under points b), c), d) and f) of the hybrid mismatches giving rise to a deduction without inclusion. The secondary rule shall neither apply if a taxation mismatch arising for a payment made under a financial instrument is eliminated through the anti-abuse provisions included in parent-subsidiary exemption. In this case, the anti-abuse provisions of the parent-subsidiary exemption will take precedence over the hybrid mismatch rules.

The Law also implements the option foreseen by ATAD 2 for certain hybrid mismatches that may arise in the banking sector. Therefore, payments made in relation to certain financial instruments that give rise to a hybrid mismatch do not need to be neutralized until 31 December 2022 if the financial instrument was issued for the sole

purpose of meeting the loss-absorption capacity imposed on banks.

- Where payments, expenses or losses incurred by a foreign payer result in a **double deduction**, i.e., a deduction both at the level of the foreign payer and a Luxembourg investor, the payments, expenses or losses shall, as a primary rule, not be deductible at the level of the Luxembourg investor. As a secondary rule, a payment, expense or loss made or incurred by a Luxembourg taxpayer will become non-deductible if that payment, expense or loss would remain tax deductible at the level of a foreign investor (e.g., in the case the jurisdiction of the foreign investor has not introduced rules neutralizing hybrid mismatches).

Payments, expenses or losses giving rise to a double deduction remain, however, deductible from income subject to double inclusion (i.e., income subject to taxation in the paying entity's country and the investor's country). Moreover, payments, expenses or losses that have not been deductible in a particular tax year because of the application of a double deduction rule, remain deductible from income that is subject to dual inclusion in subsequent years.

- If a payment made by a Luxembourg taxpayer to an associated enterprise directly or indirectly funds a hybrid mismatch arrangement, such payment gives rise to an **imported hybrid mismatch** and will not be deductible either. The payment remains however deductible if the hybrid mismatch, which is funded with the payment, is neutralized by one of the other jurisdictions involved in the hybrid mismatch arrangement.
- In case a hybrid mismatch involves **disregarded permanent establishment(s)** income that is exempt in Luxembourg based on a double tax treaty concluded between Luxembourg and another EU Member State, the income attributable to the disregarded permanent establishment is to be included in the total net income of the Luxembourg resident taxpayer.
- In the case of **dual resident taxpayers**, the deduction of payments, expenses or losses will be denied in Luxembourg if these payments, expenses or losses are also deductible in the other jurisdiction where the Luxembourg taxpayer is considered resident. However, this rule does not apply if the other jurisdiction is an EU Member State that has concluded a double tax treaty with Luxembourg under which the Luxembourg taxpayer is considered to be a tax resident in Luxembourg.
- If a hybrid transfer allows several parties to the transfer to obtain **relief for the same amount of withholding taxes** applied on a payment derived from the financial instrument transferred (e.g., in the context of a stock lending transaction if both the Luxembourg borrower and the foreign lender may claim an income tax credit for withholding taxes applicable on income derived from the stocks subject to the lending), the relief available for withholding taxes shall be limited.

Thus, the tax credit available for withholding taxes applied on the payment received should be limited to the proportion of the net taxable income compared to the payment received. In order to ensure a consistent implementation of this limitation of the relief for

withholding taxes, the Law also amends the provisions on credits for withholding taxes.

Finally, article 168ter ITL foresees that the tax administration may request the corporate taxpayer to provide documentation supporting that the anti-hybrid mismatch rules are not applicable.

Article 168quater ITL

Article 168quater ITL foresees that Luxembourg tax transparent entities may be treated as Luxembourg corporate taxpayers subject to Luxembourg corporate income tax as of the tax year 2022.

This would happen if a Luxembourg tax transparent entity is held by one or several associated enterprises that own together, directly or indirectly, an interest of more than 50% in the voting rights, the equity or the profits of the entity, and the associated enterprises are resident in a jurisdiction, which considers the tax transparent entity as subject to income tax in Luxembourg. The net income realized by the Luxembourg tax transparent entity would, however, only be subject to corporate income tax if the net income realized by the entity has not been taxed elsewhere, either based on Luxembourg income tax law or based on the laws of another jurisdiction.

This rule shall not be applicable to undertakings for collective investments, which are defined as widely held investment vehicles with a diversified portfolio and subject to investor protection rules. According to the commentaries to the Draft Law, this exception should be applicable to Luxembourg specialized investment funds, reserved alternative investment funds and all other alternative investment funds covered by the Law of 12 July 2013 on alternative investment fund managers, provided they meet the requirements.

Based on the amendments introduced by the Law to the NWTL, Luxembourg tax transparent entities that become subject to corporate income tax based on article 168quater ITL, will be exempt from Luxembourg net worth tax.

Finally, the proposed article 168quater ITL foresees that the tax administration may request documentation supporting that article 168quater ITL should not be applied.

Next steps

The transposition of ATAD 2 into Luxembourg income tax law may have a substantial impact on the tax deductibility of certain payments and expenses made or incurred by Luxembourg entities.

In order to properly identify any potential impacts arising from the transposition of ATAD 2 into Luxembourg tax law, we recommend performing a careful analysis of existing arrangements. Such analysis should allow to obtain assurance that payments made in the context of existing arrangements either do not fall under the hybrid mismatch rules and consequently remain tax deductible or non-taxable, or that they become non-deductible or taxable under the hybrid mismatch rules and a potential restructuring might be required.

Where the analysis concludes that no hybrid mismatch exists, such analysis should also help to properly document that no hybrid mismatch exists.

In either case, the tax advisory team of BDO Luxembourg would be glad to assist you in evaluating the possible impacts that might arise for your Luxembourg operations from the implementation of ATAD directives into Luxembourg income tax law.

If you would like to discuss the ATAD 2 Law and obtain assistance to evaluate the impact arising from the ATAD 2 Law on your business, do not hesitate to contact one of our key contacts.

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