The Luxembourg bill on the ATAD 1 transposition has been issued!

KPMG Luxembourg Tax Alert 2018

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On 19 June 2018, the Luxembourg government issued a bill for the transposition of the EU Anti-Tax Avoidance Directive (issued in July 2016, ATAD 1) into Luxembourg domestic tax law. While some provisions will only lead to slight modifications to the existing domestic tax framework, others will bring more significant changes, as described below.

This directive mainly targets multinational corporate groups engaged in cross-border transactions. However, other Luxembourg taxpayers such as banks and investment funds may also be impacted by the new rules.

The bill also contains two additional measures, namely the modification to the rules on tax neutrality applicable to the conversion of debts and the modification to the domestic definition of permanent establishment (PE). These are also detailed below.

Transposition of ATAD 1

General scope

In line with ATAD 1, the bill includes provisions related to five main topics: interest limitation, exit taxation, a general anti-abuse rule (GAAR), controlled foreign companies (CFC) and intra-EU hybrid mismatches. It modifies the existing domestic provisions on the anti-abuse rules and on exit taxation, for which the scope of application (*rationae personae*) remains unchanged. It further introduces new provisions on the other three topics that will generally apply to all Luxembourg taxpayers that are subject to corporate income tax, including Luxembourg PEs of entities resident for tax purposes in a third country.

It is interesting to see that Luxembourg has chosen most of the favorable options made available to member states upon the transposition of ATAD 1 into their domestic law. For more details on ATAD 1, please refer to our tax alert.

Main content

Interest limitation rule

The bill introduces a new framework to limit interest deduction for entities subject to corporate income tax.

The rule broadly restricts an entity's net interest expense deduction to 30% of its tax EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). In addition, the following rules will apply:

- Net interest expense (broadly interest income less interest expense) of up to EUR 3 million can be fully deducted. In case the net interest expense exceeds this threshold, the EBITDA rule will apply to the total amount of net interest expense.

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- The definition of interest expense is in line with ATAD 1. It includes interest expenses on all forms of debt and other costs economically equivalent to interest and expenses incurred in connection with the raising of finance.
- The definition of interest income is in line with the directive and covers taxable interest revenues and other economically equivalent taxable revenues.
- For tax unity groups, the limits will be computed on a stand-alone basis.
- Luxembourg taxpayers that are part of a (financial) consolidated group will be able to apply an equity escape rule to fully deduct the net interest expense.
- Luxembourg taxpayers will be able to carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity, which cannot be deducted during the current tax period.
- The net interest expense of stand-alone entities (i.e. not being part of a group of companies) will not be limited by this rule.
- Long-term infrastructure projects in the EU shall be excluded from the rule.
- Financial undertakings such as credit institutions, insurances or reinsurances, pension funds, AIFs, UCITS and securitization vehicles (in the sense of Art. 2, 2 Regulation (EU) 2017/2402) shall also be excluded from the rule.

Furthermore, Luxembourg has chosen to include the favorable provision offered by ATAD 1, according to which loans concluded before 17 June 2016 will not be impacted by the new rules (grand-fathering period), to the extent that their terms are not subsequently modified. In the case of a subsequent modification, it can be assumed, based on the commentaries to the bill, that the grandfathering would not apply to any increase in the amount or duration of the loan, but would remain applicable to the original terms of the loan.

One should note that the current recapture rules have not been modified (e.g. expenses in connection with tax-exempt income remains non-tax deductible).

Exit taxation rule

The bill slightly modifies the existing provisions related to exit taxation in the case of certain cross-border transfers of assets in order to align them to the provisions of ATAD 1. In this respect, the most significant change concerns the rules related to the payment of the exit tax.

The rules provide for the taxation of the difference between the fair value of the assets at the time of transfer less their value for tax purposes in the following cases:

- Asset transfer from a Luxembourg head office to a foreign PE,
- Asset transfer from a Luxembourg PE to a foreign PE or its head office,
- Luxembourg taxpayer transferring its tax residency to another state, or
- Luxembourg taxpayer transferring its business to another state.

The bill further specifies that taxation will happen in so far as Luxembourg will lose its taxation right.

The exit tax will not be applicable in certain cases (e.g. assets pledged as collateral) of short-term transfers (i.e. when the assets are transferred back to Luxembourg within 12 months).

While the current provisions of the Luxembourg tax law provide for a tax deferral until the assets transferred are subsequently sold (under certain conditions), the new rule imposes an immediate payment of the exit tax, but with a possible payment in linear installments over five years. This possibility will, however, only apply to transfers to another EU country or to an EEA country with which Luxembourg has concluded a mutual assistance agreement for the recovery of tax

debts (i.e. Norway, Iceland and Liechtenstein). This deferral will be subject to neither any guarantee nor the payment of late interest.

It should be noted that tax deferrals granted before 2020 (with no time limit based on the current rules) will continue to apply and will not be impacted by the new rules.

GAAR

The bill slightly adapts the existing Luxembourg anti-abuse provision known as 'abuse of law principle' (as codified in §6 of the general tax law) to implement the spirit of the directive, while keeping certain key concepts contained in the current text or developed by Luxembourg case law over the past years.

The GAAR will therefore target all non-genuine transactions (to the extent that they are not put in place for valid commercial reasons that reflect economic reality) performed in a domestic or a cross-border situation. It will apply to transactions, which having been put in 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, are not genuine having regard to all relevant facts and circumstances.

Transactions considered as abusive will be ignored by the Luxembourg tax authorities, and taxes will be computed based on the 'genuine route' with regard to all relevant facts and circumstances.

The scope of application of the GAAR is slightly broader than the current 'abuse of law' principle, as the new rule applies to transactions where *one of the main* purposes is to obtain a tax advantage, as opposed to the exclusive purpose of the current rules. The economic rationale of a given structure or transaction will be key.

The proof requirement aspect remains unchanged and requires that the Luxembourg tax authorities first prove that the constituting elements of an abuse are identified. It would then be up to the Luxembourg taxpayer to provide sufficient valid commercial reasons that justify the transaction.

CFC

To date, the Luxembourg tax legislation does not contain any CFC rules. The bill therefore foresees the introduction of a whole set of rules in this respect.

In general, the rule aims to attribute and tax undistributed profits from a low-taxed foreign subsidiary or PE (i.e., the CFC) at the level of its Luxembourg parent entity/head office. The CFC income will be subject to corporate income tax in Luxembourg (i.e., 18% in 2018), but not to municipal business tax.

The rule targets EU and non-EU CFCs if there is a 'direct or indirect' participation of more than 50% in voting rights, capital or profit entitlement and if the actual corporate tax due by the CFC is lower than 50% of the corporate income tax, which would be due in Luxembourg (i.e., in reference to the 18% corporate income tax rate).

As far as the computation of the CFC income is concerned, Luxembourg has chosen to apply a transfer-pricing based method (referred to as 'option b' in ATAD 1) over a broader solution comprising the taxation of passive income (referred to as 'option a' in ATAD 1). The main features are described below:

What constitutes CFC income?	Income from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage
Possible exclusions	CFC with accounting profits < €750k
	CFC with accounting profits < 10% of its operating costs

Computation of the CFC income in Luxembourg	Attribution of the income according to the arm's length principle; taxable income to be limited to amounts generated through assets and risks linked to significant people functions carried out by the Luxembourg controlling company
Timing of inclusion	Same financial year

In practice, the choice of option b (over option a) must be welcomed as it is expected to be less burdensome from a compliance and administrative point of view than what would have resulted from the application of option a. It is also likely to reduce the risk of double taxation/multiple inclusions as compared with option a.

The bill finally provides for rules to prevent double taxation cases, e.g. in the case of subsequent dividend distributions from the CFC.

Hybrid mismatches

The bill introduces a new article on cross-border hybrid mismatches involving hybrid entities, hybrid instruments and structured arrangements within the EU (but not with third countries). These provisions would come into effect in 2019 but would be replaced by the broader anti-hybrid rules of ATAD 2 from 2020.

The rule provides that when a structure includes a hybrid mismatch with double deduction, the deduction shall only be recognized in the EU member state where the payment has its source. When a structure includes a hybrid mismatch with deduction without a corresponding taxation, the EU member state of residence of the payer shall deny the deduction of such payment.

Although not explicitly mentioned in the bill, it can be assumed that where a hybrid situation is also tackled by the existing anti-hybrid rule of the participation exemption regime (further to the former amendment to the parent-subsidiary directive introduced in 2016), the existing anti-hybrid rule shall apply first. Therefore, the impact of the new rule is expected to be limited in practice.

Ordering rules

The bill does not provide for clear ordering rules between the various new provisions (nor with the current domestic provisions). However, based on the commentaries to the bill, the current transfer pricing rules (application of the arm's length principle) are expected to be applicable prior to the CFC rules. In addition, specific anti-abuse rules (such as the CFC rules) shall apply prior to the GAAR. The administrative practice is likely to develop practical rules that will enable taxpayers to apply cumulative rules.

Other anti-abuse measures

Removal of the provision on the tax neutrality applicable to the conversion of debts (article 22 bis 2 (1) LITL)

The current provision according to which the conversion of debts can be done in tax neutrality will be removed. The aim is to avoid situations where the application of this provision results in a deduction and a non-taxation.

Modification of the domestic definition of PE (§ 16 StAnpG)

The bill adds provisions on the definition of PEs, where they are located in treaty countries. It is now clearly foreseen that the treaty definition shall in general prevail and a PE shall be recognized if the taxpayer is engaged in an independent economic activity in the other country. It is however mentioned in the commentaries to the bill that the mere management of financial assets or intellectual property rights should not be sufficient per se to constitute a PE. In this context, the Luxembourg tax authorities shall have the right to request a certificate from the foreign tax authorities with regard to the recognition of the foreign PE.

This certificate will have to be provided if the tax treaty does not include any provision that would allow Luxembourg to refuse the exemption of the branch income/wealth where the other contracting state uses another provision of the tax treaty to exempt such income/wealth (so called 'switch-over clause').

Entry into force

The bill foresees the application of the new measures to financial years starting as of 1 January 2019, except for the provisions on exit taxation, which will apply to financial years starting as of 1 January 2020. The bill must now follow the whole legislative process in the Luxembourg parliament.

KPMG Luxembourg comment

As expected, the provisions of the bill transposing ATAD 1 are not going beyond the minimum standards required by the directive. One can welcome the fact that Luxembourg has chosen most of the favorable options made available to member states upon the transposition of ATAD 1 into their domestic law. It is important to note that the rules on hybrid mismatches with third countries (ATAD 2) are not included in the bill and will thus only be transposed next year (and will apply as from 2020) as foreseen by ATAD 2.

This bill represents a significant step in the implementation of the BEPS measures into Luxembourg domestic law. Given the number of changes introduced simultaneously, one can expect that the way some of the rules will actually be applied in practice will be clarified by the Luxembourg tax authorities in the future.

Luxembourg corporate taxpayers involved in cross-border activities should closely review the possible impact of the bill on their Luxembourg operations.

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