Luxembourg implements the Anti Tax Avoidance Directive (ATAD)

On 21 December 2019, the Luxembourg law implementing the EU Anti-Tax Avoidance Directive 2016/1164 was published in the Official Gazette.

The law introduces and / or amends

- Interest limitation rules,
- General anti-abuse rules,
- Controlled foreign company rules (CFC),
- Hybrid mismatch rules and
- Exit taxation (applicable as of 1 January 2020),

We are pleased to summarize hereafter the major tax changes which in general become effective on 1 January 2019.

Interest limitation rule (Art. 168bis LIR)

The interest deduction limitation rules, which apply to corporate taxpayers, intend to reduce excessive use of borrowing as an instrument to reduce their taxable base.

The net borrowing costs (total of expenses and income on financial activities) resulting from third parties or group financing is deductible only up to the higher of

- EUR 3 million or
- 30% of the taxpayer's EBITDA

The definition of borrowing costs is very broad. Borrowing costs are interest expenses or equivalent payments on all kind of lending and funding. Therefore the following costs fall into the scope of the law without being limited to payments on profit participating loans, imputed interest on convertible loans and zero coupons etc.[1]

For the EBITDA calculation, ("Earnings Before Interest, Taxes, Depreciation and Amortization") tax-exempt income and non-deductible expenses are not to be considered.

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[1] Examples mentioned in the law without being limited are payments on profit participating loans, imputed interest on convertible loans and zero coupons, amounts under alternative financing arrangements such as Islamic finance, the finance cost element of finance lease payments, capitalized interest included in the balance sheet of a related asset, or the amortization of capitalized interest; amounts measured by reference to a funding return under transfer pricing rules, if appropriate, notional interest amounts under derivative instrument or hedging arrangements related to an entity's borrowings, certain exchange rate gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing agreements as well as administrative fees and similar cost linked to the borrowing of funds.

Any borrowing cost which has not been deductible in the year of payment due to the before mentioned rules can be carried forward for an unlimited period of time. An unused interest capacity, i.e. difference between EBITDA ceiling and effectively deducted borrowing costs, can be carried forward for 5 years.

For taxpayers belonging to a consolidated group for financial accounting purposes an escape clause has been introduced. Upon application, borrowing costs are fully deductible if the taxpayer can prove that its equity ratio over its total assets is equivalent (or max. 2% lower) to the group's equity ratio. Thereby the documentation (financial statements, consolidated statements) must be comparable, i.e. based on the same accounting method, either IFRS standards or the accounting method of an EU member state.

The interest limitation rule <u>does not apply:</u>

(a) for the following transactions:

- for lendings concluded before 17 June 2016 (grandfathering rule),
- for lendings relating to long-term public infrastructure projects within the EU.

(b) to the following taxpayers:

- companies which are active in the "financial sector", especially financial institutions, insurance and reinsurance companies, pension funds, AIFs, UCITS and securitization companies that are subject to EU regulation 2017/2402,
- stand-alone entities having no permanent establishment outside of Luxembourg or no associated enterprises and not being part of a consolidated group (from a financial accounting point of view).

The Luxembourg Minister of Finance announced that the ATAD law will be amended in 2019 to allow Luxembourg taxpayer in a tax unity group to apply the interest limitations rules on a consolidated basis.

<u>Controlled foreign companies (CFC) (Art. 164ter LIR)</u>

The aim of the new rules to allocate non-distributed income of a so-call "controlled foreign company" (CFC) to

(a) corporate resident taxpayers and
(b) Luxembourg permanent establishments of corporate non-resident taxpayers.

A CFC situation is given if the following conditions are met:

A foreign company or a permanent establishment

- in which the taxpayer directly or indirectly (together with its associated enterprises) maintains more than 50% of the foreign company's voting rights or its share capital or is entitled to more than 50% of its profits **and**
- the foreign company's effective tax payments are less than 50% of the Luxembourg tax burden under identical circumstances. Considering the current situation in Luxembourg this is the case if the foreign effective tax rate is less than 9%.

Under this rule an associated enterprise is defined as

- a domestic or foreign entity (incl. partnerships) in which the taxpayer holds directly or indirectly more than 25% of the voting rights or its share capital or is entitled to more than 25% of the profits or
- domestic or foreign resident individuals / entities holding directly or indirectly more than 25% of the voting rights or the share capital of the taxpayer or are entitled to more than 25% of its profits.

Non distributed income of the CFC will be allocated to the taxpayer on condition that this income has been realized due to non-genuine arrangements which have been put in place for the primary purpose of obtaining a tax advantage. The condition is basically met if the CFC does not own the assets or would not have taken the risks generating the respective income without the taxpayer's intervention.

Such income (revenue less related expenses resulting from the asset / risk) will be added to the taxpayer's tax base as commercial income. The amount will be taken into consideration in a profit situation only. Losses can be carried forward and used to reduce future profit allocations. The profit allocated has to be prorated based on the taxpayer's investment share. The profit allocation is not subject to trade tax.

Simultaneously, rules to avoid a double taxation in case of dividend payments / realized capital gains are introduced.

CFCs are excluded from this allocation if

- their realized profit based on the financial statements do not exceed EUR 750,000 **or**
- their realized profit based on the financial statements do not exceed 10% of the operating costs (excluding costs of goods sold outside its country of residence and payments to associated enterprises).

Exit taxation

The new rules modify the already existing rules in order to comply with the EU Directive. The new rules enter into force on 1 January 2020. The rule applies to corporate taxpayers and also for individuals generating commercial income / income from self-employment.

The exit taxation is triggered in the following situations:

- the taxpayer transfers assets to its permanent establishment abroad while Luxembourg loses the right of taxation on potential capital gains,
- the taxpayer transfers assets from a Luxembourg permanent establishment to its head office or another permanent establishment abroad while Luxembourg loses the right of taxation on potential capital gains,
- migration of the taxpayer's tax residency (except for the assets that remain in a domestic permanent establishment,
- migration of the taxpayer's business exercised in a domestic permanent establishment, but only to the extent that Luxembourg loses the right to tax the transferred assets.

The tax base is calculated as the difference between market value and book value of the assets.

Assets, that return to Luxembourg within a period of 12 months, are not subject to an exist taxation if

- the assets are related to the financing of securities,
- the assets are posted as collateral,
- the asset transfer is placed to meet prudential requirements or for the purpose of liquidity management.

Upon request, the tax due can be paid in 5 annual installments (during a 5 years' period) without triggering any interest or additional cost in case that the asset transfer is undertaken to an EU country or an EEU state with which Luxembourg has a recovery agreement on taxes.

The tax becomes immediately due in case that

- the assets or the business activities are sold,
- the taxpayer's residency or its business activities migrate to a third country,
- the taxpayer goes bankrupt or is wound up,
- the taxpayer fails to fulfill its obligations in relation to the installment payments and does not correct its situation over a reasonable period of time, not exceeding 12 months.

General anti-abuse rules, GAAR (§ 6 StAnpG)

The law implements the EU Directive into the already existing anti abuse rules and reflects also the development of Luxembourg case law.

Abuse according to the law is defined as legal arrangements chosen for the main purpose or one of the main purposes to circumvent or reduce tax that would have been due under the respective facts and circumstance of the case.

Hybrid mismatches (Art. 168ter LIR)

The law introduces rules on intra-EU hybrid instruments and hybrid entity mismatches. The rules apply to Luxembourg resident and non-resident corporate taxpayers.

Hybrid mismatches in the sense of the law result from differences in the legal qualification of a financial instrument or entity leading to the effect that the participating taxpayer and a party residing in another EU member state can

(a) deduct the same business expenses (or loses) in Luxembourg and in the other EU member state in which the payment has its source (double deduction),

(b) deduct the payment in Luxembourg (as the country of source) without considering this income in the tax base in the other EU member state (deduction without inclusion).

In both scenarios the business expense cannot be deducted for tax purposes in Luxembourg.

The same effects can be achieved in commercial or financial relations between a taxpayer and an associated enterprise residing in another EU member state. Associated enterprise is defined according to the CFC scenario. However, the participation must be higher than 50%.

The Luxembourg tax administration is entitled to request additional documentation (e.g. tax return, certification of the tax administration in the other EU member state) with respect to the tax treatment in the other EU member state.

Other changes

In order to avoid possible conflicts with the domestic law the definition of permanent establishment according to the resp. double tax treaty (DTT) is decisive for a Luxembourg resident tax payer. The Luxembourg tax administration can however request a certification of the DTT country confirming the existence of the permanent establishment in this country. (§ 16 StAnpG)

Art. 22bis LIR is modified to the extent that the tax neutral current roll-over regime on capital gains realized upon the conversion of bonds into a participation is abolished and becomes now a taxable event at the time of the conversion.

For further information, do not hesitate to contact one of our team members, who will be glad to assist you at any time:

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