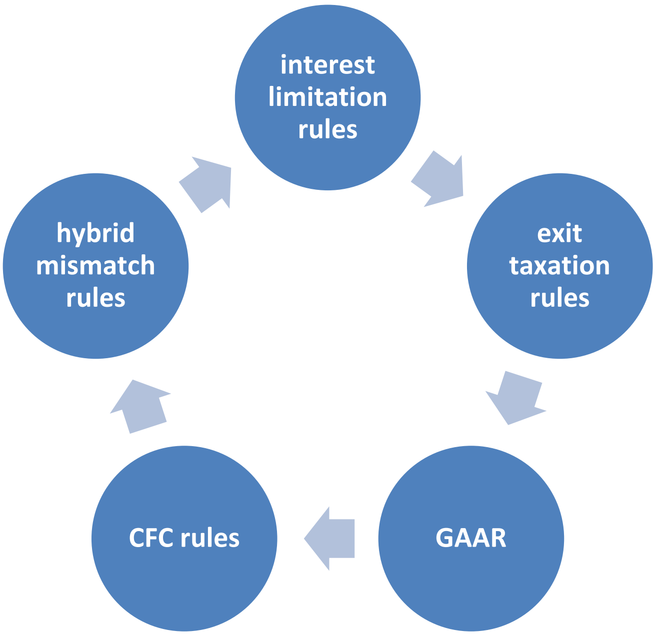
arendt

Luxembourg newsflash

21 June 2018

ATAD Bill

On 20 June 2018, the Luxembourg government filed bill of law n° 7318 (“**ATAD Bill**”) implementing the provision of the Council Directive (EU) 2016/1164 – the so-called *Anti-Tax Avoidance Directive* (“**ATAD**”). ATAD was adopted by the Council of the European Union (“**EU**”) on 28 June 2016 in order to implement the OECD’s recommendations in its Base Erosion and Profit Shifting (“**BEPS**”) Project. Accordingly, the ATAD sets measures to be adopted by all EU Member States in the following 5 specific areas:



It should be stressed that ATAD foresees only general provisions and leaves the implementation into the various corporates tax systems up to the Member States which grants the latter some flexibility to opt in or out of several provisions and even to implement provisions that go beyond the minimum rules laid down by the ATAD. Accordingly there may be significant differences in the implementation of the ATAD from one Member State to another.

1. *ATAD Scope*

Pursuant to the ATAD, these rules should only apply to taxpayers that are subject to corporate tax in a Member State excluding transparent entities, but including permanent establishments of corporate taxpayers resident in a Member State in a third country. These principles are followed by the ATAD Bill.

As a result, the following Luxembourg entities should be out of the scope of the ATAD rules, either due to their tax transparency or their exemption from corporate income tax:

- FCP
- Securitisation fund
- SICAV and SICAF
- SPF
- Partnerships - SNC and SCS(p)

The Luxembourg investment company in risk capital (*société d'investissement en capital risque* – or SICAR) as well as the securitisation company (*société de titrisation*) are corporate taxpayers as such and as a general rule are covered by the ATAD rules. However, the impact of each individual ATAD provision must be further analysed since they are often minimized due to their tax regime or limited activities. The ordinary commercial companies as well as the financial holding companies (*société de participation financière* or SOPARFI) are obviously covered by the ATAD rules.

According to the ATAD, where the application of the ATAD rules gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country.

2. *Interest limitation rules*

As a general rule, the ATAD foresees that net borrowing costs are only deductible up to 30% of the taxpayer's EBITDA. The net borrowing costs correspond to the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest, revenues and other economically equivalent taxable revenues that the taxpayer receives in accordance with national law. It should be noted that *borrowing costs* are defined very broadly and include costs that may not at first sight be qualified as *interest*, e.g. amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds.

Several options are available for the implementation of the interest limitation rules allowing Member States to:

- introduce a *de minimis* threshold of deductible borrowing costs of up to € 3 million;
- introduce a group ratio where the taxpayer is a member of a consolidated group for financial accounting purposes, in which case the exceeding borrowing costs and the EBITDA may be calculated at the level of the group and include the results of all its members;
- exclude loans concluded before 17 June 2016 without subsequent modification thereof (so-called grandfathering rule);
- exclude loans used to fund long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the European Union;
- exclude standalone taxpayers (i.e. a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment);
- include certain carry-forward or carry-back rules as regards the unused exceeding borrowing costs or unused interest capacity.
- exclude financial undertakings (such as credit institutions, AIFs and UCITS as well as their managers, depositaries, insurance and re-insurance undertakings and securitisation companies covered by European Regulation 2017/2402 of 12 December 2017.

The ATAD Bill follows a flexible approach and includes all the options provided under the ATAD:

ATAD options	Included in the Bill
De minimis threshold (€ 3m)	Yes
Group ratio	Yes
Grandfathering for loans concluded before 17 June 2016	Yes
Exclusion for loans used to fund public infrastructure projects	Yes
Exclusion for standalone taxpayers	Yes
Carry-forward of exceeding borrowing costs or unused interest capacity	Yes
Exclusion for financial undertakings	Yes

Regarding the carry-forward rules, the ATAD Bill allows for a carry-forward of unused interest capacity over the 5 following years. The unused interest capacity is defined as the excess of the 30% EBITA over the excess borrowing costs exceeding € 3 million. It also allows for a carry-forward of the unused exceeding borrowing costs.

As regards more specifically debt funds and the acquisition of non-performing loans (NPLs) by corporate taxpayers (securitisation companies or SOPARFIs), the application of the interest limitation rules as from 1 January 2019 must be carefully considered. The use of the "pre-17 June 2016 loan" grandfathering or the €3m *de minimis* exemption could already allow a number of them to avoid the application of Interest Limitation Rules. An opt-in for an alternative investment fund status could also be considered as a possible solution even if it could raise some practical difficulties for securitisation companies. Furthermore, the question arises whether under Luxembourg domestic law (including Luxembourg GAAP) (i) amounts collected in excess of the acquisition cost and (ii) nominal interest payments on NPLs could both qualify as interest.

3. Controlled Foreign Company Rules:

The Controlled Foreign Company ("**CFC**") Rules allow Member States to include non-distributed income of a CFC of the taxpayer into the tax base of such taxpayer.

A CFC is defined as an entity or a permanent establishment

(i) in which the taxpayer by itself, or together with its associated enterprises, holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits; and
(ii) whose actual corporate tax paid on its profits is less than 50% of the corporate tax that would have been charged on these profits by the taxpayer's Member State.

Member States can choose to include the income of the CFC pursuant to 2 different computation rules:

(i) income derived from certain (so-called passive) income categories, which include interest, royalties, dividends, financial leasing, insurance, banking or other financial activities, as well as income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value ("**Option A**"); or
(ii) income derived from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage ("**Option B**"). An arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have assumed the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

The ATAD Bill implements Option B, which requires that the CFC derives its income from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. It seems that Option B is more liberal because the CFC is somehow presumed to derive its income from genuine arrangements, unless proven otherwise, and the taxpayers are supposed to self-assess whether to include income which the CFC has derived from non-genuine arrangements.

Under Option B Member States may exclude a CFC in the following cases:

(a) the CFC has accounting profits of no more than €750,000 and non-trading income of no more than €75,000; or
(b) the CFC's accounting profits amount to no more than 10 percent of its operating costs for the tax period. The operating costs may not include the cost of goods sold outside the country where the CFC is resident or situated for tax purposes and payments to associated enterprises.

The ATAD Bill also opts for these 2 exceptions, save that under exception (a) mentioned above, it is sufficient that the CFC's accounting profits are lower than € 750,000.

The income of the CFC to be included in the taxable profits of the Luxembourg taxpayer is limited to the amounts generated by the assets and risks linked to the significant functions assumed by the controlling taxpayer as determined by transfer pricing rules. Business expenses in economic relation to such income may be deducted. Losses of the CFC are not included in the tax base but may be carried forward (to the extent such losses are generated after the entry into force of the CFC rules). The undistributed income of the CFC is allocated in proportion to the taxpayer's interests in the CFC and the taxpayer is entitled to a tax credit at the time of the distribution of the CFC's income. Income from the CFC that has been included in the taxpayer's taxable profits may further be deducted from subsequent distributions received from the CFC or capital gains realised on a disposal of the participation of the CFC or its activity in case the CFC is a permanent establishment.

4. Hybrid mismatch rules

The ATAD implements rules to avoid mismatches between domestic legislations by hybrid instruments or entities, allowing for double non-taxation.

In the event that a hybrid mismatch results in a double deduction (i.e. deduction from the tax base in the source and no inclusion in the tax base in the residence State), the deduction will be accorded only in the source State, while the residence State will include the amount in the tax base. In the event that the residence State does not include the amount into the tax base, the source State will refuse the deduction.

The anti-hybrid provision only applies to hybrid mismatches between EU Member States. Hybrid mismatches with third countries are included in a subsequent amendment of the ATAD, Council Directive (EU) 2017/952 of 29 May 2017 ("**ATAD 2**").

The ATAD Bill implements the above-mentioned rules for hybrid mismatches between EU Member States, said rules being applicable as from 1 January 2019. Hybrid mismatches with third countries foreseen by ATAD 2 are to be implemented at a later stage by a separate bill of law.

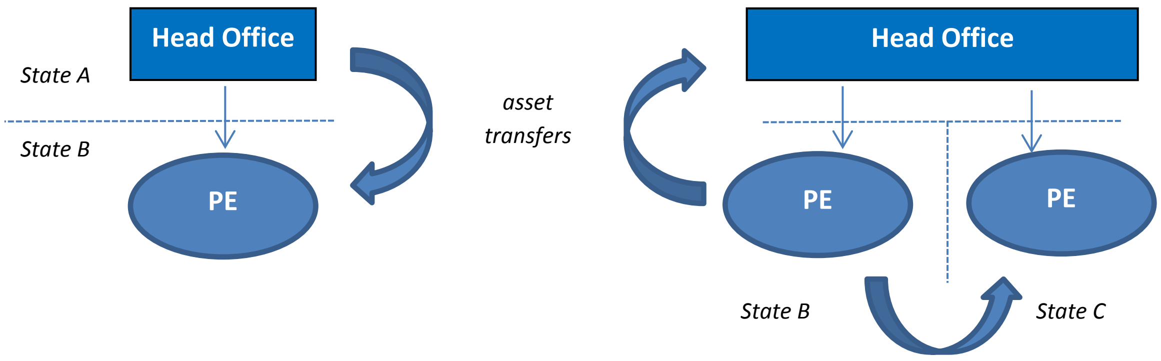
5. Exit tax

Under the ATAD a transfer of assets by the taxpayer from the head office to a permanent establishment in another Member State or in a third country whereby the Member State of the head office no longer has the right to tax the transferred assets due to the transfer triggers as a rule capital gains taxation on such asset (i.e. taxation of the difference between the fair market value and the book value of the assets at the date of the transfer). The same treatment applies to:

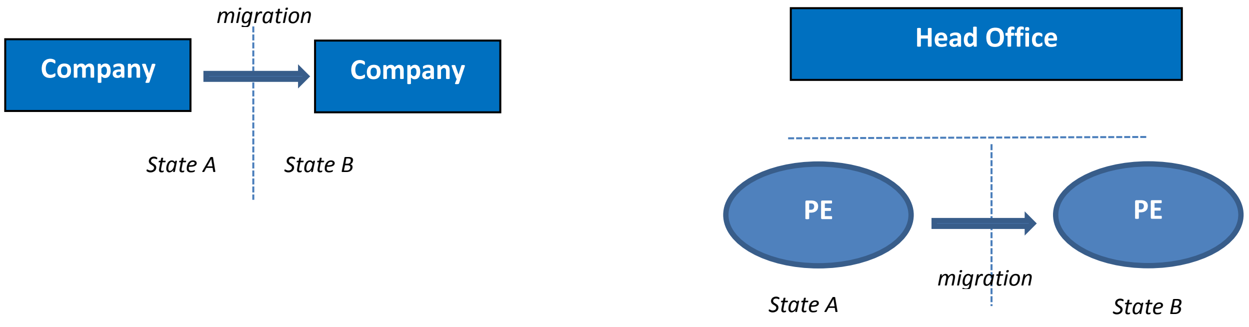
(i) a transfer of assets from a permanent establishment to its head office or another permanent establishment in another Member State or in a third country;
(ii) a transfer of the taxpayer's tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State; and
(iii) a transfer of the taxpayer's business carried on by a permanent establishment from a Member State to another Member State or to a third country.

For EU and EEA transfers the taxpayer may be entitled to defer the payment of the exit tax over 5 annual instalments. Certain temporary transfers not exceeding 12 months are excluded.

Asset transfers



Migration



The Bill introduces the exit tax rules foreseen by the ATAD which will become applicable as from 1 January 2020. The option to exclude asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management, provided that the assets are set to revert to the transferor within a period of 12 months, is also included in the ATAD Bill.

It should be noted that the current Luxembourg exit tax regime provides under certain circumstances for an optional deferral of the payment of tax on the capital gains realised upon a migration, without any time limit. The ATAD Bill grandfathers such deferrals for exit tax related to financial years closed before 1 January 2020 while events that trigger exit tax thereafter will be governed exclusively by the new exit tax rules.

6. *General anti-abuse rule*

The General Anti-Abuse Rule ("**GAAR**") allows Member States to ignore artificial arrangements for calculating corporate tax liability. An artificial arrangement is defined very broadly as an arrangement or a series of arrangements which, having been put into place for the main purpose or as 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. An arrangement may comprise more than one step or part. An arrangement or a series of arrangements are regarded as non-genuine to the extent that they are not put in place for valid commercial reasons which reflect economic reality. Where arrangements or a series of arrangements are ignored, the tax liability will be calculated in accordance with national law.

The ATAD Bill transposes these definitions into the domestic tax law.

7. *Additional provisions*

2 additional measures not foreseen by ATAD have been included in the ATAD Bill:

- The current roll-over regime for capital gains realised on the conversion of bonds into shares is abolished; and
- The current definition of the permanent establishment in domestic law is amended in order to take into account only the treaty definition of the permanent establishment. A confirmation of the State of situation of the permanent establishment may be required by the tax authorities, in particular if no switch-over clause is included in the relevant double tax treaty.

8. *Concluding remarks*

The ATAD Bill constitutes a correct and coherent implementation of the ATAD provisions. It includes significant changes in the Luxembourg tax laws which may impact international investment structures with a presence in Luxembourg. Given that most provisions will enter into force as early as 1 January 2019, we advise that the taxpayers concerned should check the potential impacts of the ATAD Bill on their activities in Luxembourg and abroad.

The partners and your usual contacts at Arendt & Medernach are at your disposal to further assess the impact of the Bill and to discuss the necessary changes with you.

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