BILL OF LAW TO IMPLEMENT THE ANTI TAX AVOIDANCE DIRECTIVE

On 19 June 2018, the Luxembourg minister of finance submitted the bill of law N°7318 to the Luxembourg parliament, aiming at implementing the Anti-Tax Avoidance Directive (EU Directive 2016/1164 of 12 July 2016) into domestic law.

Key issues

- **Bill of law implementing ATAD I submitted to Luxembourg parliament**
- **Two additional BEPS measures removing double non-taxation included**
- **Impact on Income Tax Law, Municipal Business Tax Law, Tax Adaption Law and General Tax Law**

BACKGROUND

The Anti-Tax Avoidance Directive ("ATAD I") primarily targets profit shifting by multinational enterprises and groups engaged in cross-border transactions. However, its implementation into Luxembourg law may impact any local taxpayer.

In addition to the implementation of certain measures stemming from the OECDs Base Erosion and Profit Shifting ("BEPS") Action Plan, the bill proposes to clarify two legislative provisions: (i) the definition of a Permanent Establishment ("PE") and (ii) the concept of roll over relief upon debt conversion as foreseen by Article 22bis of the Luxembourg Income Tax Law ("LITL").

KEY ELEMENTS

The bill of law contains five major action points, namely (i) Limitation on Interest Deductibility, (ii) Exit Taxation, (iii) General Anti Abuse provisions, (iv) CFC rules and (v) provisions on the Prevention of Hybrid Mismatch Arrangements.

Interest limitation rule

Applicable as of 1 January 2019 and subject to certain conditions, the bill restricts the extent to which companies can reduce their profits by deducting interest costs. Exceeding borrowing costs shall only be deductible up to 30% of the taxpayers EBITDA (subject to a *de minimis* clause of EUR 3 million). However, non-deductible excessive borrowing costs can be carried forward indefinitely whereas interest capacity which cannot be used in a tax period can be carried forward for a maximum of 5 years.

As a starting point, excessive borrowing costs are defined as the difference between interest income and expenses. In this respect, the definition of interest income covers taxable interest revenue and economically equivalent taxable revenues. In line with the wording of ATAD I, the definition of interest expenses includes interest expenses on debt and economically equivalent costs incurred in relation with a financing activity. Such broad definitions may lead to uncertainties for example linked to the gain derived from the repayment of non-performing loan receivables or the loss upon derivatives embedded in convertible liabilities.

For the application of these limitation rules, the bill excludes financial undertakings regulated by EU directives such as, financial institutions, insurance and re-insurance companies, UCITS, AIFs and securitisation entities in the sense of EU Regulation 2017/2402. Furthermore, loans concluded before 17 June 2016 (provided they are not subsequently modified – in this respect, the scope of acceptable modifications is not clearly defined in the bill) and long-term funding on public infrastructure projects in the EU are excluded. No need to underline the potential impact of these rules upon existing Luxembourg financing structures and instruments.

Exit taxation

The new provisions will amend the already existing exit tax rules addressing the transfer of assets and taxing potential differences in actual (fair market) and book (tax) value of the asset concerned. Stemming from the BEPS Action Plan, the rules aim to ensure that assets are transferred at fair market value and profits relating to the transfer accrue in the jurisdiction of origin (in our case, Luxembourg). The bill restates the existing Article 38 LITL and amends §127 of the General Tax Law (Abgabenordnung). Based on this, Luxembourg taxation on gains arising upon the transfer of assets outside of Luxembourg - but intra EU/EEA where Luxembourg has an agreement of tax recovery in place with the other state - may benefit from instalment payments over a 5-year period (no guarantee will be required, nor interest will be charged in case the taxpayer opts for such deferral). Please note that specific rules may apply to transfer of assets as collateralization.

General Anti Abuse Rule ("GAAR")

The provision aims at addressing non-genuine arrangements or series of arrangements implemented for the main purpose or one of the main purposes of obtaining a tax benefit that is contrary to the object of the applicable law. The current abuse of law concept as foreseen in §6 of the Adaption Law (Steueranpassungsgesetz) will be replaced by the new GAAR. The provision addresses a much broader scope of taxpayers and, since the rule is part of the general tax provisions, will apply to any type of Luxembourg taxes (unless specific anti-abuse rule applies or except registration duties and stamp taxes) and taxpayers.

Controlled Foreign Company rules

The bill incorporates Controlled Foreign Company ("CFC") rules opting for a "non-genuine arrangement" approach. As of 1 January 2019, Luxembourg will tax non-distributed income of any entity or PE qualifying as CFC provided that the non-distributed income arises from non-genuine arrangements that have been put in place for the main purpose of obtaining tax advantages. The bill specifies that the controlling taxpayer (alone or together with associated enterprises) must hold a direct or indirect participation of more than 50% in the controlled entity (participation, profit or voting rights). In addition, the actual tax paid by the controlled entity or PE must be lower than the difference between the corporate income tax (impôt sur le revenu des collectivités) that would have been due in Luxembourg and the actual tax paid on the profits. In other words, the actual tax paid is lower than 50% of the tax that would have been due in Luxembourg if the controlled entity or PE were resident or established in Luxembourg. Out-of-scope of the CFC definition are entities with an accounting profit of not more than EUR 750,000 or 10% of operating costs for the relevant tax period.

Hybrid Mismatch Arrangements

Introducing hybrid mismatch rules effective as of 1 January 2019 for EU cross-border transactions, the bill aims at tackling situations where hybrid mismatches result from financial instruments implemented between associated enterprises that are treated differently in the various EU member states. To avoid a double deduction, a deduction shall only be made in the member state where the payment has its source. Luxembourg will further deny the deduction of the payment where the income is not taxed in the recipient state (deduction without inclusion). Luxembourg taxpayers must demonstrate that there is no hybrid mismatch relating to a structure by providing evidence that a payment is not deductible in the source state and the related income is taxed in the recipient state. It is expected that ATAD II (Council Directive EU 2017/952 of 29 May 2017) will extend the scope to non-EU transactions.

Other Points

In addition, the bill provides for clarification on two existing legislative measures. The tax neutral conversion of loans into shares as foreseen by Article 22bis LITL will be abolished (so-called roll over relief). A conversion will then be treated as a disposal of the loan followed by a subsequent acquisition of shares both at market value. Latent gains on the loans will then become fully taxable (including any forex gain).

Furthermore, §16 Steueranpassungsgesetz relating to the PE definition will be completed and clarified putting an end to the conflict arising from diverging domestic law and tax treaty definitions. The recognition of a PE will be based on the tax treaty definition. Where the treaty remains silent on a definition, the taxpayer must demonstrate its PE status by providing evidence such as tax assessment, certificate of residence issued by the authorities of the country where the PE is located, etc.

Entry into force

The bill of law, once voted, will be applicable for tax years starting as of 1 January 2019, except for provisions relating to exit taxation which will apply as from 1 January 2020.

CLIFFORD

CHANCE

CONTACTS

François-Xavier Dujardin
Partner

T +352 48 50 50 1
E Francois-Xavier.Dujardin@cliffordchance.com

Maxime Budzin
Counsel

T +352 48 50 50 1
E Maxime.Budzin@cliffordchance.com

Josselin Badoc
Senior Associate

T +352 48 50 50 1
E Josselin.Badoc@cliffordchance.com

Katharina Thielges
Associate

T +352 48 50 50 1
E Katharina.Thielges@cliffordchance.com

Caroline Poiret
Associate

T +352 48 50 50 1
E Caroline.Poiret@cliffordchance.com

Antoine-David Freymann
Associate

T +352 48 50 50 1
E Antoine-David.Freymann@cliffordchance.com

Simon Paran
Associate

T +352 48 50 50 1
E Simon.Paran@cliffordchance.com

Katharina Schwarzkopf
Associate

T +352 48 50 50 1
E Katharina.Scharzkopf@cliffordchance.com

Rachel Jacques-Mignault
Associate

T +352 48 50 50 1
E Rachel.Jacques-Mignault@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 10 boulevard G.D. Charlotte, B.P. 1147, L-1011 Luxembourg, Grand-Duché de Luxembourg

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