LUXEMBOURG GOVERNMENT APPROVES THE ATAD 2 BILL AND INCLUDES MOST WELCOME CLARIFICATIONS FOR THE LUXEMBOURG FUND INDUSTRY

The new directive addresses hybrid mismatches with third countries, adds cases not covered by ATAD 1, and expressly refers to the OECD's BEPS report (Action 2) as its source. The Luxembourg government approved the transposition bill (the Bill) on 26 July 2019 and filed it on 8 August 2019 with the Luxembourg Parliament.

Key issues

- **ATAD 2**
- **Anti-hybrid measures**
- **Impact for the Luxembourg fund industry**

BACKGROUND

The Anti-Tax Avoidance Directive (ATAD 1), adopted in July 2016 and transposed into Luxembourg law last year, contained measures to prevent hybrid mismatches amongst EU Member States. On 29 May 2017, the Council of the EU unanimously adopted an amendment to this directive, named ATAD 2.

ATAD 2 extends the scope of ATAD 1, which applied to situations of double deduction or deduction without inclusion resulting from the use of hybrid financial instruments or hybrid entities. The new directive now includes situations involving permanent establishments, reverse hybrids, imported mismatches, hybrid transfers and dual residence.

The Bill provides for helpful clarifications, either in the text itself or in the commentaries. Certain aspects remain however uncertain and will hopefully be clarified within the next steps of the legislative process.

KEY ELEMENTS

There are three different types of hybrid mismatches which are particularly relevant for the fund industry:

1. **Hybrid mismatches that result from payments under a financial instrument (the Financial Instrument Rule)**

In order to fall within the Financial Instrument Rule, the following two conditions must be fulfilled: (i) the payment under the financial instrument is not included within a reasonable period of time; and (ii) the mismatch outcome is attributable to differences in the characterisation of the financial instrument or the payment made under it.

2. **Hybrid mismatches that result from payments to hybrid entities (the Hybrid Entity Rule)**

A payment to a hybrid entity gives rise to a deduction without inclusion outcome, and such outcome is the result of differences in the allocation of payments to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity. Under the Hybrid Entity Rule, a hybrid entity is an entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction.

3. **Tax treatment of reverse hybrid entities (the Reverse Hybrid Rule)**

ATAD 2 foresees that as from 1 January 2022, the additional anti-hybrid mismatch rule will take effect in situations involving reverse hybrid entities, i.e., entities treated as transparent in their home jurisdiction and opaque in the jurisdiction of associated investors. In such situation, a Luxembourg reverse hybrid entity will have to be treated as tax opaque by Luxembourg and be taxed on its income provided it has not already been taxed at the investor level.

ATAD 2 also mentions that such provision shall not apply to collective investment vehicles, i.e. investment funds or vehicles that are widely held, hold a diversified portfolio of securities and are subject to investor-protection regulations in the country in which they are established.

CLARIFICATIONS BROUGHT BY THE BILL AND OUTSTANDING QUESTIONS

Concept of associated enterprises and acting together

Generally speaking, the three rules will only apply between related or associated parties or in the case of a structured arrangement (defined as an arrangement that has been designed to produce a hybrid mismatch outcome, thus requiring the existence of intention – which should generally not be the case for a fund platform). For the purpose of the Financial Instrument Rule, a non-resident entity will be considered as an associated entity if it holds a direct or indirect interest of 25% or more of the voting rights, capital interests or rights to share a profit in the taxpayer. For the purpose of the Hybrid Entity Rule and the Reverse Hybrid Rule, the threshold becomes 50%.

With respect to the calculation of the threshold requirement, ATAD 2 makes reference to the OECD concept of “persons acting together”, pursuant to which “a person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person”. The OECD Report on Action 2 (Hybrid mismatches) clarifies the concept of “persons acting together” in further detail: in particular, the OECD Report mentions that the interests of persons who are managed by the same person should be aggregated for the purpose of the “persons acting together” test. Example 11.5 of the OECD Report on Action 2 (Hybrid mismatches) specifically deals with a set-up similar to a fund set-up and concludes that the investors investing through a tax transparent partnership / fund would be considered as related parties to the underlying company held by the partnership / fund.

Such approach could, in practice, lead to extremely problematic situations as a fund manager usually cannot monitor the tax treatment of all of its investors in their various respective jurisdictions. Whilst the BEPS example 11.5 takes the situation of a partnership with four investors, we may in a fund context often deal with many more investors with relatively small stakes in the fund (and for which the concept of acting together does not make much sense considering the lack of *intuitu personae* between them). This is why the government clarified that an investor having a minority stake (less than 10%) in a fund will not be deemed to be acting together with the other investors (unless proved otherwise). This will lead to a practicable, much more acceptable outcome where managers would only have to assess the hybrid risk towards their main investors (those with 10% or more) but not for all minority ones.

In this regard, we may regret the lack of explicit confirmation that the concept of acting together only applies to the Financial Instruments Rule. There are indeed reasonable arguments to consider that investors in a fund should not be considered as “persons acting together” towards the fund itself but only towards the underlying investments (as mentioned in the BEPS report). Indeed, it would be difficult to argue that the Investors in the Fund should be considered as acting together towards the fund, as they are not expected to act in accordance with the wishes of the other Investors; they typically do not agree to act together in respect of their voting rights and, more importantly, they typically do not agree that a third person can act on their behalf in respect of voting rights or interests that they hold in the Fund. As a conclusion, investors in a fund should only be aggregated for the purpose of the computation of the 25% threshold for financial instruments subscribed for by the fund.

Non-inclusion due to the status of the recipient

The Bill confirms that no hybrid mismatch rules should apply when the non-inclusion at the level of recipient is only due to its tax status (e.g. an exempt fund).

Timing of inclusion for payments to hybrid entities and included at a later stage by the investor

One point which remains unclear is the situation of a deductible payment to a reverse hybrid entity (leading therefore to a deduction without inclusion) when such entity (like most funds) distributes immediately the income received to its investors (which then include that as taxable income). If this situation would lead to the non-deductibility at the level of the payor, this would create in many fund platforms a potential double-taxation liability as soon as the income is distributed by the fund.

Reverse Hybrid Rule – entry into force

The Bill confirms that whilst it already contains the reverse hybrid provision , this provision will only apply as from 1 January 2022. This is very helpful in the sense that this will help the industry to anticipate the entry into force of this provision without having to wait until 2022 to have the final version of the text.

Reverse Hybrid Rule – the carveout for funds

The Bill further confirms that Part I UCITS, Part II UCIs, specialised investment funds (SIFs) and reserved alternative investment funds (RAIFs) will be considered as collective investment vehicles and fall outside of the scope of the reversehybrid provision. Other alternative investment funds (AIFs) can also be excluded provided that they are widely held, hold a diversified portfolio of securities and are subject to investor-protection regulations. One attention point is that SICARs are not included in the general carveout (but may still be excluded if the other criteria are met).

Reverse Hybrid Rule – practical implications

The Bill confirms that whilst a reverse hybrid entity would become taxable on (part of) its income, it will remain exempt from net wealth tax (as the Directive is silent on this point).

In this respect, we note the absence of clarification in terms of withholding tax. Whilst such withholding tax on dividends would, in principle, not apply to Luxembourg-regulated funds even if they would be treated as opaque pursuant to the reverse hybrid rules, an explicit exemption for all AIFs would have been welcome.

As this text will certainly evolve during the next steps of the legislative process, we will continue to update you on any significant changes or further clarifications.

CONTACTS

Geoffrey Scardoni

Partner

T +352 48 50 50 1
E Geoffrey.Scardoni
@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

Kim Ngo

Senior Associate

T +352 48 50 50 1
E Kim.Ngo
@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

Caroline Poiret

Associate

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

Katharina Schwarzkopf

Associate

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

Katharina Thielges

Associate

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