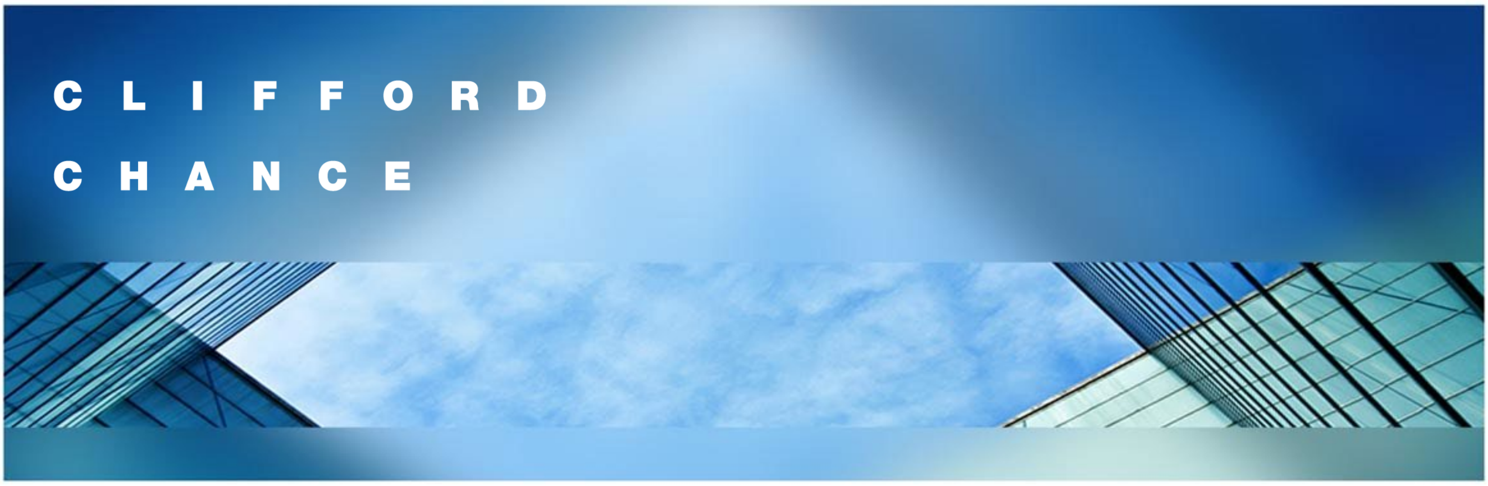


LUXEMBOURG 2023 BUDGET LAW: KEY TAX MEASURES ADOPTED BY THE PARLIAMENT

On 23 December 2022, the Luxembourg Parliament adopted the bill n°8080 related to the budget for 2023 (the "**Budget Law**"), which contains certain measures and clarifications regarding the Luxembourg tax legislative environment. The draft text of the legislation had been presented to the Parliament on 12 October 2022 and has been subject to several amendments during the legislative process.

As announced by the Luxembourg Government, the measures contained in the Budget Law do not represent major changes in the Luxembourg tax landscape. However, they bring useful clarifications and some certainties in the application of certain rules. Such measures are mainly related to personal income tax, indirect taxes, filing aspects and the reverse hybrid rule, most of which will apply from 1 January 2023 (except for the amendment with respect to the reverse hybrid rule which applies retroactively from 1 January 2022).

Key issues

- Reverse hybrid rule
- Filing of tax returns
- Personal income tax
- Real estate
- VAT

REVERSE HYBRID RULE

Before the proposed amendment of the Budget Law

The reverse hybrid rule was introduced by the law of 19 December 2019 transposing the Council Directive (EU) 2017/952 of 29 May 2017 amending Directive EU/2016/1164 ("**ATAD II**") into Luxembourg law and resulting in the insertion of an article 168*quater* in the Luxembourg income tax law ("**LITL**"). The reverse hybrid rule applies from the 2022 tax year (i.e., to tax years closing in 2022).

The rule sets out the conditions under which an entity is treated as transparent for tax purposes under Luxembourg tax law, but not by the country where its investor(s) is(are) resident. Such an entity will thus be considered as a resident taxpayer and will become liable to Luxembourg corporate income tax on (a portion) of its net income (if such income is not taxed otherwise). Until now, the major (cumulative) conditions for the reverse hybrid rule to apply were as follows:

- one (or more) investor(s) (being associated enterprises) holding in aggregate at least 50% of the Luxembourg tax transparent entity; and
- the jurisdiction(s) where the above investors are established consider(s) the entity as a taxable person.

One of the above conditions being that the investor(s) jurisdiction(s) consider the Luxembourg (tax transparent) entity as a taxable person, this circumstance would typically entail a difference in qualification and create the so-called 'hybridity' of the Luxembourg entity. Such hybridity could result in a difference in the allocation of income in the sense that the laws of the investor(s) jurisdiction(s) would not consider (or 'pick up') the income from the Luxembourg entity, as for such investor(s) this entity is a taxable person. The result of such mismatch could be a *de facto* (double) non-taxation of income (at the level of the Luxembourg entity and at the investor level) due to a hybrid entity.

In such a case, the Luxembourg tax transparent entity would become liable to corporate income tax on its net income to the extent such income is not otherwise taxed under Luxembourg domestic or any foreign tax laws.

Impact of the proposed amendment of the Budget Law

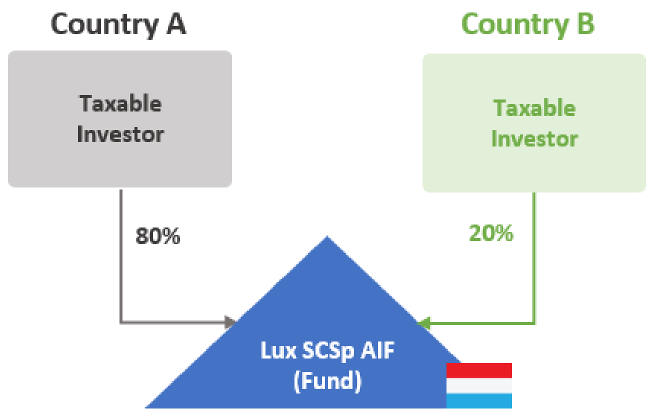
In its legislative amendment of article 168*quater* LITL, the Budget Law aims to clarify that, for the reverse hybrid rule to apply, the afore-mentioned non-taxation of net income realised by the investor must result from the difference in qualification (i.e., transparent vs. opaque) of the Luxembourg entity.

In other words, if the non-taxation of income realised by the investor is attributable to the investor's tax status (e.g., a tax-exempt vehicle), the reverse hybrid rule would not apply.

As such, the amendment should be relevant to Luxembourg investment funds set up under the form of a Luxembourg transparent entity (e.g., *société en commandite simple* – SCS, *société en commadite spéciale* – SCSp, or *fonds commun de placement* - FCP) and whose investor base comprises foreign pension funds, sovereign wealth funds as well as any other entities that are not subject to tax in the jurisdiction where they are established.

With the clarification brought by the Budget Law, situations of non-taxation at investor level are likely to be twofold: (i) they may be the result of a difference in qualification (between opaque vs. transparent) in which case the reverse hybrid rule would kick in, while (ii) they may also arise due to a subjective exemption (related to the investor's tax status) in which case they would not trigger the application of article 168*quater* LITL.

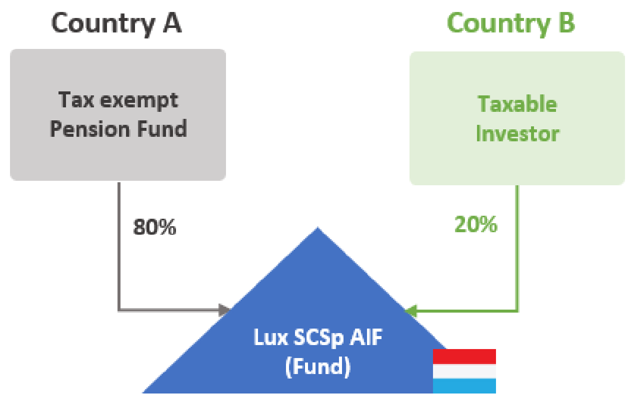
These situations of non-taxation can be illustrated as follows:



In the above chart, a Luxembourg limited partnership (SCSp) is held for (i) 80% by a taxable corporate investor established in country A and considered as an associated enterprise in the sense of article 168*quater* LITL, and (ii) 20% by a taxable corporate investor established in country B, not considered as an associated enterprise in the sense of article 168*quater* LITL. Country A considers the SCSp as a taxable entity, whereas country B views the SCSp as a tax transparent entity.

In a scenario of **non-taxation due to a difference in qualification**, the investor of country A would be considered as (i) an associated enterprise, (ii) holding more than 50% of interest in the Luxembourg SCSp, and (iii) established in a jurisdiction that treats the Luxembourg SCSp as a taxable entity. All the entry conditions for the reverse hybrid rule to apply are fulfilled, with the result that the Luxembourg SCSp would be considered as a 'reverse hybrid entity' in the sense of article 168*quater* LITL. It should be noted that the Luxembourg SCSp would become a Luxembourg taxpayer (and hence become subject to corporate income tax) only with respect to the portion of income that is attributable to the investor of country A (seeing the entity as opaque), i.e., 80%. The investor of country B would not trigger the hybridity of the SCSp given that it does not consider the SCSp as a taxable person.

In the below chart, the facts remain the same, except that the investor of country A is a pension fund which benefits from a subjective tax exemption in country A:



In a scenario of **non-taxation due to the investor tax status** (i.e., after the amendment of the reverse hybrid rule by the Budget Law), the investor of country A would, even though the above conditions of hybridity are met, not trigger the application of the reverse hybrid rule. As a matter of fact, the particular tax status of the investor (being tax-exempt) becomes an additional condition for article 168*quater* LITL to apply. The consequence of this scenario is that the Luxembourg SCSp remains a tax transparent entity for Luxembourg tax purposes (irrespective of a different qualification given to the Luxembourg SCSp by any foreign jurisdictions). No corporate income taxation arises at the level of the Luxembourg SCSp. As in the first example above, the investor in country B would not trigger the hybridity of the SCSp, given that it does not consider the SCSp as a taxable person.

The legislative path leading to the clarification of the reverse hybrid rule

The authors of the Budget bill in its initial version intended to clarify the scope of application of article 168*quater* LITL. However, it was not entirely clear from that initial version whether the newly added circumstance of 'absence of taxation due to the investor's tax status' should be seen as an additional condition for the reverse hybrid rule to apply or whether it would materialise on the overall tax consequences of the rule as it currently stands.

During the legislative process, the Luxembourg State Council and the Finance and Budget Committee have clarified that the investor who benefits from a subjective tax exemption will not be considered when it comes to the computation of the 50% threshold, even though such investor would treat the Luxembourg entity as a taxable person.

Although the clarification provides more clarity with respect to investors who benefit from a subjective tax exemption, it is however less clear whether investors who are located in a jurisdiction that does not levy any corporate tax are likewise caught by this clarification. Another useful clarification may concern the question of a double non-taxation of income (i.e., at the level of the Luxembourg entity and at the investor level) due to hybrid entity, to the extent the income is not included by the jurisdiction of the investor within a reasonable period of time.

Even though many aspects around the application of the hybrid mismatch rules in general still need some further clarifications, the amendment of article 168*quater* LITL by the Budget Law is nonetheless a welcome clarification for the investment fund industry.

OTHER KEY TAX MEASURES

Deadline for filing tax returns

Further to the adoption of the Budget Law, the deadline for filing corporate income tax returns, municipal business tax returns, net wealth tax returns and individual income tax returns is now 31 December (at the latest) of each year, instead of 31 March for individuals and 31 May for corporate taxpayers.

This allows more flexibility to taxpayers when submitting their tax returns and ratifies the current practice of the Luxembourg tax authorities.

Profit-sharing bonus

From 2021, employers may grant a profit-sharing bonus (*prime participative* – article 115-13a LITL) to their employees, which, subject to certain conditions, is 50% exempt from individual income tax. One of the conditions is that the total amount of the bonus that may be granted to employees is limited to 5% of the employer's profits for the fiscal year immediately preceding the fiscal year in which the bonuses are granted.

Further to the adoption of the Budget Law, groups of companies according to article 164*bis* LITL (i.e., companies that are part of a fiscal unity) could add up their profits for the calculation of this 5% limit (to the extent that the fiscal unity existed during the year where the profit-sharing bonus is granted as well as during the year immediately preceding such a year).

This would be an incentive to grant higher bonus to employees when the employers are part of a fiscal unity. Even though this extension of the 5% limit to groups of companies is useful, such threshold is still low to ensure a real efficiency of the rule.

Expat regime

To attract more talents in Luxembourg, the Budget Law amends article 115-13b LITL so that the minimum salary required to benefit from the Luxembourg expat regime is now reduced from EUR 100,000 to EUR 75,000.

The expat regime allows, under certain conditions, the employees who benefit from it, to exempt several expenses from income tax for a maximum of 8 years from the year of entry in Luxembourg.

VAT rates

From 1 January 2023, the super-reduced VAT rate of 3% will apply to the delivery of solar panels and their installation.

Furthermore, the reduced VAT rate of 8% will apply to the repair of household appliances and on the sale, rental and repair of bicycles, including e-bikes.

Real estate

From 1 January 2023, the 4% accelerated depreciation for (parts of) buildings, acquired or constructed after 31 December 2020, and used for rental housing, will be restricted to two buildings or parts of built buildings for houses acquired or constructed after 31 December 2022.

This modification will be implemented by way of a Grand Ducal regulation.

Tax credit for individuals

To mitigate the effects of the inflation and as from 1 January 2023:

- the maximum amount of tax credit for single parents is increased from EUR 1,500 to 2,505; and consequently
- the maximum income up to which taxpayers can benefit from this tax credit is increased from EUR 35,000 to EUR 60,000.

HOW CAN WE HELP?

The tax lawyers at Clifford Chance Luxembourg are at your disposal to further advise on the impact of the amendments and clarifications brought by the Budget Law on your current and/or contemplated operations.

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