Executive summary

On 20 June 2018, the draft law (Draft Law) implementing the European Union (EU) Anti-Tax Avoidance Directive\(^1\) (ATAD) was introduced in the Luxembourg Parliament.

The ATAD is intended to provide for uniform legislative implementation of some of the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) recommendations. It establishes minimum standards (allowing for certain options and choices to be taken) with respect to five areas: (i) limitation to interest deductibility; (ii) exit taxation (including provisions relating to inbound transfers); (iii) a General Anti-Abuse Rule (GAAR); (iv) Controlled Foreign Company (CFC) rules; and (v) rules countering hybrid mismatches within the EU. The ATAD needs to be implemented by the Member States through national legislation by 31 December 2018 and its rules will have to apply as from 1 January 2019 (31 December 2019 and 1 January 2020, respectively, for the rules on exit taxation).

With the exception of the amended GAAR (which applies to all taxpayers) and most of the exit tax provisions (which apply to entrepreneurs in general), the provisions of the Draft Law only apply to corporate taxpayers subject to corporate income tax.
In addition to the implementation of the ATAD, the Draft Law introduces two further measures, with the aim to put an end to certain practices that, while being compliant with existing legislation, are no longer considered to be in line with international tax standards and more specifically with the BEPS recommendations. These measures concern the recognition of foreign permanent establishments (PEs) under a tax treaty and the tax neutral conversion of loans into shares.

This Alert summarizes the Draft Law provisions.

**Detailed discussion**

**Interest limitation**

A new provision will be introduced that limits interest deductibility for interest expenses exceeding interest income (exceeding borrowing cost) to 30% of the taxpayer's taxable earnings before interest, tax, depreciation and amortization (taxable EBITDA). Tax-exempt income (such as dividends from qualifying shareholdings or certain foreign branch profits), as well as expenses economically related to such tax-exempt income, will be excluded from the EBITDA. The EBITDA-based limit will not apply if exceeding borrowing costs do not exceed €3 million. Where Luxembourg companies form a fiscal unity, the above rules will apply on a stand-alone basis and not to the fiscal unity.

Standalone entities (i.e., entities not forming part of a consolidated group for financial accounting purposes and that have no associated enterprises or branches located in another country) and financial undertakings are excluded from the scope of interest limitation. Financial undertakings include, among others, credit institutions, alternative investment funds (AIFs) managed by an AIF manager (as defined in Directive 2011/61/EU) or supervised under the amended law of 15 June 2004 on Investment Companies in Risk Capital (SICAR), undertakings for collective investment in transferable securities (UCITS in the meaning of art. 1 (2) of Directive 2009/65/EC), as well as those securitization vehicles that are covered by Regulation (EU) 2017/2042 of 12 December 2017.

A grandfathering provision will apply to interest on loans concluded before 17 June 2016, provided they are not subsequently modified. Interest on loans funding certain long-term public infrastructure projects will also be excluded.

Exceeding borrowing costs that cannot be deducted in a given tax period can be carried forward indefinitely. Unused interest capacity exceeding €3 million can be carried forward for five years.

Luxembourg also has opted for the inclusion of the equity ratio rule, which upon request entitles a taxpayer that is a member of a consolidated group for financial accounting purposes to deduct the entire amount of its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group, subject to certain conditions.

**CFC rules**

CFC rules will be introduced, according to which the non-distributed income of low-taxed CFCs arising from “non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage” must be included in the tax base of the Luxembourg taxpayer in the year in which the financial year of the CFC ends.

A CFC is defined as an entity or a PE whose income is not taxable or exempt in Luxembourg if:

(i) in the case of an entity, the Luxembourg taxpayer, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights or the entitlement to profits; and

(ii) the entity or PE is low-taxed, i.e., the corporate income tax (excluding municipal business tax) it pays is lower than 50% of the Luxembourg corporate income tax it would have paid applying the provisions of the Luxembourg Income Tax Law.

An arrangement or a series thereof is regarded as non-genuine to the extent that the entity or PE would not own the assets which generate all or part of its income or would not have undertaken the risks if it were not controlled by a taxpayer 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.

If there is such a non-genuine arrangement, the income to be included in the tax base of the Luxembourg taxpayer will be the arm’s-length amount generated through assets and risks that are linked to significant people functions carried out by the Luxembourg controlling taxpayer.
Entities or PEs with accounting profits of no more than €750,000 or 10% of operating costs for the tax period will not be considered as CFCs.

Hybrid mismatches
The Draft Law contains hybrid mismatch rules that apply to hybrid mismatches resulting from financial instruments or entities between associated enterprises that are treated differently in two or more EU Member States. Where a hybrid mismatch results in a double deduction, Luxembourg will deny the deduction of expenses if such expenses are also deductible in the Member State where the payment has its source. Where a hybrid mismatch results in a deduction without inclusion, Luxembourg will deny the deduction of expenses if the relating income is not taxed in the other Member State.

The ATAD was amended on 29 May 2017 (ATAD 2) by significantly expanding the hybrid mismatch provisions. The hybrid mismatch provisions of the ATAD 2 will have to be implemented by 31 December 2019 (and its provisions will be applicable as from 1 January 2020). As a result, the hybrid mismatch provisions of the Draft Law will only be applicable for a limited period of time and will then be replaced by more detailed rules that will also extend to hybrid mismatches with third, i.e., non-EU, countries.

Exit taxation
Several amendments to the existing exit taxation rules will be introduced.

In the case of inbound migration of tax residence of a corporate taxpayer or the transfer of the business carried on by a PE from another country to Luxembourg, assets must be valued at the value determined by the exit State, unless that value does not reflect the going concern value. The historical acquisition date will be used as the acquisition date of the assets. The same rule applies to transfers of assets by a PE situated in another State to the enterprise in Luxembourg and to transfers of assets to a Luxembourg PE by its head office in another State.

The current exit taxation rules will be extended to also include the transfer of separate assets.

The current rules that allow taxpayers to defer the payment of the exit tax that is due upon an exit tax event will be significantly amended. The list of exit tax events that give access to the deferral possibility is expanded, but the benefit is limited to migrations to an EU Member State, or a European Economic Area Member State other than an EU Member State with which Luxembourg has concluded an agreement on the mutual assistance for the recovery of tax claims. The current unlimited deferral of the payment of exit tax is abolished and replaced by a payment in equal installments over a maximum period of five years. The Draft Law foresees determined cases in which the deferral is immediately discontinued and the outstanding amount of the tax debt becomes immediately due.

Deferrals granted for accounting years ending before 1 January 2020 are not affected by the new provisions.

GAAR
The existing general anti-abuse rule will be reworded and completed to better reflect the content of the ATAD GAAR.

Entry into force of the ATAD provisions
Once approved by the Luxembourg Parliament, the provisions of the draft law should apply to tax years starting on or after 1 January 2019, except for the provisions regarding exit taxation that will apply as from 1 January 2020.

Additional measures
Section 16 of the Luxembourg Adaptation Law, which provides for the definition of a domestic PE, is expanded by an additional paragraph relating to the recognition of foreign PEs. According to this new provision, the recognition of a PE in a treaty country will be based exclusively on the criteria set forth by the double taxation treaty concluded with that country. A taxpayer will be considered as having a PE in the other Contracting State if the activity that is exercised in the other country constitutes an independent activity and represents a participation in the general economic life in that other country. An example given by the Draft Law is the operation of a plant.

The Luxembourg taxpayer may be requested to provide a confirmation, e.g., a tax assessment or certificate issued by the foreign tax authorities, that the other country recognizes the existence of a PE. Such confirmation must be provided where the relevant double taxation treaty does not contain a provision entitling Luxembourg to tax income or capital if the other country applies the provisions of the double taxation treaty to exempt such income or capital (i.e., a provision similar to art. 23A (4) OECD Model or art. 5 option A of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI)). 3
Furthermore, the tax neutral conversion of loans into shares, as currently foreseen by domestic law, will be abolished. Going forward, latent capital gains attached to such convertible loans will become taxable at the time of their conversion into shares.

Once approved by the Luxembourg Parliament, both measures should apply to tax years starting on or after 1 January 2019.

A detailed Tax Alert discussing the provisions of the Draft Law as well as their implications will be forthcoming.

Endnotes


2. I.e., “an undertaking (a) with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading and (b) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings’ assets.”

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