Executive summary

On 20 June 2018, the Luxembourg Government submitted the draft law (Draft Law) implementing the European Union (EU) Anti-Tax Avoidance Directive1 (ATAD) to the Luxembourg Parliament.2 As ATAD offers a choice to Member States on approaches, the Luxembourg Government generally chose the most business-friendly options.

The Luxembourg Government also seized this opportunity to amend two existing provisions to better align them with current international tax standards.

With some exceptions that are analyzed below, the provisions of the Draft Law only apply to corporate taxpayers and to permanent establishments (PEs) of nonresident taxpayers subject to corporate income tax (CIT).

The Draft Law will now go through the legislative process, which involves the analysis of the text by a dedicated parliamentary commission, the collection of opinions from different advisory bodies (and most importantly the Council of State), discussion and vote of the text in a parliamentary session and finally its publication in the Official Gazette (Memorial). The entire process may take a couple of months.

This Alert takes a closer look at the various provisions of the Draft Law.
Detailed discussion

Controlled Foreign Company (CFC) rules

The ATAD requires the introduction of CFC rules, but allows Member States two different options, the first one generally applicable to passive income of a CFC (option A) and the second one applicable to income arising from “non-genuine arrangements” (option B). The Draft Law is based on option B.

Definition of a CFC

A CFC is defined as an entity or a PE whose income is not taxable or exempt in Luxembourg if the following conditions are met:

(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.

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

Any PE of a CFC, which is not taxable or tax exempt in the territory of its location, is not considered for purposes of the aforementioned computation.

“Associated enterprises” means any of the following:

- Resident or nonresident taxpayers subject to Luxembourg CIT or entities that are transparent under Luxembourg law (e.g., partnerships), in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or are entitled to receive 25% or more of the profits of that entity

- Individuals or resident or nonresident taxpayers subject to Luxembourg CIT or transparent entities that hold directly or indirectly a participation in terms of voting rights or capital ownership in the taxpayer of 25% or more, or are entitled to receive 25% or more of the profits of the taxpayer

- All entities, including the taxpayer, that are held directly or indirectly by an individual or a resident or nonresident corporate taxpayer or a transparent entity for 25% or more in terms of voting rights or capital ownership in the taxpayer and one or more entities

It should be noted that this definition of “associated enterprise” does not only apply in the context of the CFC rules, but to the entire ITL (and notably to the provisions on hybrid mismatches and interest limitation, see section below). However, a slightly different concept of “related enterprise” is applied in the context of the provisions on transfer pricing (articles 56-3 and 56bis ITL).

In order to determine whether an entity or PE is low-taxed, the effective tax burden of the CFC must be compared with the tax it would have paid if it had been a Luxembourg resident. In a first step the final tax burden of the CFC is determined, taking into account all taxes paid by the CFC, insofar as they are comparable to the Luxembourg CIT, and considering subsequent reimbursements and non-collected taxes. An entity is not considered to be a CFC if its tax burden is below the 50% threshold solely because of the utilization of losses carried forward. In a second step, the tax that would have been due by the CFC according to the provisions of the Luxembourg ITL must be determined and compared with the actual tax established and paid by the CFC. The reference to the provisions of the ITL seems to imply that any benefits granted under Luxembourg tax treaties should not be considered in the comparison.

In line with the option given by the ATAD, the Draft Law excludes from the CFC rules a foreign company: (i) with accounting profits of no more than €750,000; or (ii) with accounting profits amounting to no more than 10% of its operating costs for the tax period. The cost of assets sold outside the country of tax residence of the entity or the country of location of the PE as well as payments to associated enterprises are excluded for the computation of the aforementioned threshold.

Income to be included

The non-distributed income of a CFC must be included in the tax base of the Luxembourg taxpayer if the income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

An arrangement or a series thereof is regarded as non-genuine to the extent that the CFC 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 CFC’s income.
The net income to be included in the Luxembourg tax base is limited to the amounts generated through assets and risks in relation to which the significant people functions are carried out by the controlling Luxembourg entity, as determined in application of the arm's-length principle as per the Luxembourg transfer pricing provisions. In other words, if the Luxembourg entity does not have significant people functions in relation to the assets and/or risks of a CFC, there will be no income inclusion, notwithstanding the fact that the Luxembourg entity may have significant presence and functions in Luxembourg.

This limits the application of the CFC rules to entities that were not able to generate the income themselves, considering the assets owned and the risks assumed, in relation to which the significant people functions are carried out by the controlling Luxembourg entity.

The net income to be included in the Luxembourg tax base is deemed to be commercial profit (as is any other income realized by a corporate taxpayer). Expenses are deductible only to the extent that they are economically linked to the income to be included in the tax base.

Only positive net income is taken into consideration; negative net income is not included in the tax base in order to avoid that such negative income of the CFC artificially reduces the tax burden of the taxpayer. If the total net income of the CFC is positive, the taxpayer is entitled to deduct up to this total, the negative net income that has not been deducted in a previous year and that could not be deducted in any subsequent year. Any negative net income of the CFC can thus only be compensated with its own positive net income. This applies to losses realized by a CFC after the entry into force of the CFC provisions.

The income to be included in the Luxembourg tax base is calculated in proportion of the taxpayer's participation in the CFC and is included in the financial year of the taxpayer in which the financial year of the CFC ends. If the income that has been reallocated to the taxpayer is also taxed in the country of residence or location of the CFC, the taxpayer can credit the foreign tax in line with the existing provisions on foreign tax credits.

If the financial statements of the CFC are held in another currency than that of the taxpayer, the income has to be converted at the exchange rate of the balance sheet date of the taxpayer, as published by the European Central Bank.

The tax base will be reduced by any amount of profits distributed by the CFC to the Luxembourg taxpayer that have been previously included in the tax base up to the amount of such distribution (unless such dividend distribution is already exempt based on a different provision, e.g., the Luxembourg participation exemption). Similarly, where the taxpayer disposes of its participation in the CFC or the PE, any part of the capital gain from such disposal that has been previously included in the tax base of the Luxembourg taxpayer as CFC income will be deducted from the tax base up to the amount of such part of the capital gain (unless already exempt).

Non-application for municipal business tax (MBT) purposes

The CIT base serves as the starting point for the determination of the second Luxembourg income tax, the MBT. As the CFC inclusion is only intended to apply to CIT, the MBT Law is amended by adding the requirement to exclude CFC income from the MBT base.

Interaction with transfer pricing provisions

It should be noted that the CFC rules apply only after application of the transfer pricing rules laid down in articles 56 and 56bis ITL. As a result of the transfer pricing rules, any significant people functions in relation to a CFC's assets and risks would have to be appropriately remunerated and subject to Luxembourg income taxes. The CFC inclusion described above would appear to result in a second inclusion of the same income (however, limited to CIT only), which would underline the character of the CFC rules as an anti-abuse provision. It is expected that the interaction between transfer pricing and CFC rules will be further clarified in the legislative process.

Scope and entry into force

The aforementioned provisions will apply to companies and domestic PEs of nonresident entities subject to Luxembourg CIT with regard to financial years starting on or after 1 January 2019.

Interest limitation

Under current legislation, interest expenses are fully deductible, provided that they respect the arm's-length principle and are not linked to tax-exempt income. The Draft Law introduces an interest limitation rule that limits the deductibility of taxpayers' borrowing costs to 30% of taxable EBITDA (earnings before interest, tax, depreciation and amortization). The ATAD foresees a number of options and choices, most of which are reflected in the Draft Law.
The new rule only affects the deductibility of interest, but does not re qualify the expense. As a result, where interest is not deductible in application of the new rule, it remains interest for all tax purposes, including withholding taxes.

Computation of deductible interest
Exceeding borrowing costs are deductible up to the higher of 30% of taxable EBITDA or €3 million.

“Exceeding borrowing costs” is defined as the excess of borrowing costs (as defined) over interest income and other economically equivalent taxable revenues.

The definition of “borrowing costs” parallels that of the ATAD, i.e., interest expenses on all forms of debt, other costs economically equivalent to interest, as well as expenses incurred in relation with the raising of finance, including, without being limited to:
- Payments under profit participating loans
- Imputed interest on instruments such as convertible bonds and zero coupon bonds
- Amounts paid under alternative financing arrangements, such as Islamic finance
- The finance cost element of finance lease payments
- Capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest
- Amounts measured by reference to a funding return under transfer pricing rules
- Notional interest under derivative instruments or hedging arrangements related to an entity’s borrowings
- 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

No distinction is made based on the creditor, and the rule applies to interest under intra-group and third-party loans alike.

The commentary to the Draft Law does not contain further details as regards the definition of borrowing costs. Whether an expense in relation with a determined financing instrument falls within this definition will have to be analyzed on a case-by-case basis and with respect to the relevant terms and conditions of the instrument at stake.

Interest income is not specifically defined (neither is there a specific definition in the ATAD). It is expected that a symmetric approach will be applied with respect to the definition of borrowing costs and interest income, in the sense that where a specific item is considered as borrowing costs for the debtor, it would be considered as interest income for the creditor. However, this is not specifically stated in the Draft Law or related commentaries.

Taxable EBITDA is defined as the total of net taxable income as per the Luxembourg ITL, (i) increased by exceeding borrowing costs, the tax values of depreciations and amortizations that have reduced taxable income, and expenses economically linked to tax-exempt income and (ii) reduced by any exempt income.

For companies forming a fiscal unity, exceeding borrowing costs and EBITDA have to be determined at the level of each individual entity, meaning that the interest limitation rules will not apply to the fiscal unity as such. At the same time, this also means that the €3 million minimum deduction will be available for each entity within the fiscal unity.

Exclusion of certain exceeding borrowing costs
The Draft Law contains a grandfathering clause according to which interest on loans that were concluded before 17 June 2016 is excluded from the borrowing cost definition provided the loans are not “subsequently modified.”

It is unclear what constitutes a subsequent modification. The wording of the Draft Law could be read as suggesting that the grandfathering would be lost for all interest under the loan in case of any subsequent modification. However, the commentary to the Draft Law quotes the Preamble of the ATAD, which would indicate that grandfathering would not apply to any increase in the amount or duration of the loan, but may still apply to the original terms of the loan.

The Draft Law also excludes interest on loans used to fund long-term public infrastructure projects where the operator, borrowing costs, assets and income are all located in the EU. Long-term public infrastructure projects are defined as projects to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by an EU Member State.

Income earned from such a long-term public infrastructure project is also excluded from the definition of taxable EBITDA.
**Equity escape rule**

Where the taxpayer is a member of a consolidated group for financial accounting purposes, it may, upon request, deduct the entire amount of its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is lower by not more than two percentage points, equal to or higher than the equivalent ratio of the group. For these purposes, all assets and liabilities have to be valued using the same method as in the consolidated financial statements drawn up in accordance with International Financial Reporting Standards (IFRS) or the national financial reporting system of an EU Member State.

**Exclusion of stand-alone entities and financial undertakings**

As permitted by the ATAD, the Draft Law excludes standalone entities from the scope of the interest limitation rule. A standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise (in the meaning of the new associated enterprise definition, see section on CFC rules).

The Draft Law also excludes financial undertakings from the scope of the interest limitation rules. Those undertakings comprise:

- Credit institutions, investment firms, alternative investment fund managers (AIFMs) and management companies of undertakings for collective investment in transferable securities (UCITS)
- Insurance and reinsurance undertakings
- Institutions for occupational retirement provision or delegates of such institutions
- Pension institutions operating pension schemes which are considered to be social security schemes as well as any legal entity set up for the purpose of investment of such schemes
- Alternative investment funds (AIF) managed by an AIFM (as defined in Directive 2011/61/EU) or supervised under the amended law of 15 June 2004 on Investment Companies in Risk Capital (SICAR)
- 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) 2017/2402
- A central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012
- Central securities depositaries as defined in Article 2 (1) of Regulation (EU) No 909-2014
- Securitization vehicles covered by Regulation (EU) 2017/2042

**Carry forward of exceeding borrowing costs and unused interest capacity**

The Draft Law foresees the possibility for the taxpayer to carry forward exceeding borrowing costs without limitation in time. As a result, if a taxpayer’s exceeding borrowing costs during a given financial year are below 30% of its taxable EBITDA, it may still deduct, in addition to the exceeding borrowing costs of the current financial year, those exceeding borrowing costs that were not deductible in previous financial years (within the limits of the 30% EBITDA limit of the same year).

The Draft Law also allows for a five-year carry forward of unused interest capacity, i.e., the amount by which 30% of taxable EBITDA exceeds the amount of exceeding borrowing costs provided these amount to at least €3 million. As a result, even if the amount of exceeding borrowing costs exceeds the 30% EBITDA limit in a given year, a taxpayer may still deduct this surplus amount of exceeding borrowing costs to the extent it has unused interest capacity carried forward from the five previous financial years.

**Interaction with existing recapture rules**

The Draft Law remains silent on the interaction between the new interest limitation rules and the existing recapture rules. Under the rules governing the domestic participation exemption, expenses (e.g., interest expenses) that are economically linked to dividend income that is tax exempt may be deducted for the amount that exceeds the tax-exempt dividend. However, these deductions have to be recaptured upon the sale of the participation i.e., the tax-exempt amount of the capital gain will be reduced by the amount of expenses that have been deducted in the current and previous years. The rule results in a deferral of tax on other, non-exempt, income, but is overall neutral as regards the income from holding activities.

To what extent the interest limitation rules would have an impact on recapture should be analyzed on a case-by-case basis.

**Scope and entry into force**

The aforementioned provisions will apply to companies and domestic PEs of nonresident entities subject to Luxembourg CIT with regard to financial years starting on or after 1 January 2019.
Anti-hybrid rules
The Draft Law implements the anti-hybrid rules of the ATAD, which relate to specific intra-EU transactions only. More extensive anti-hybrid rules will have to be implemented when the ATAD 2 is transposed into Luxembourg law.

Hybrid mismatches as per the Draft Law
“Hybrid mismatch” refers to differences in the legal qualification of a financial instrument or an entity, if a structured arrangement between the taxpayer and a party established in another EU Member State or if the commercial or financial relations between the taxpayer and an associated enterprise established in another EU Member State entail the following consequences:

a) A deduction of the same expenses or losses occurs both in Luxembourg and the EU Member State in which the expenses are incurred or the losses are suffered (double deduction), or

b) An expense is deducted in Luxembourg where it has its source without an inclusion of the corresponding income in taxable income in the other EU Member State (deduction without inclusion).

Associated enterprises are defined as per the new definition described in the section on CFCs. However, when the mismatch involves a hybrid entity (i.e., where the taxpayer or the associated enterprise is a hybrid entity in the sense of this provision), the 25% threshold is replaced by a 50% threshold. The increase to 50% only applies in the context of the anti-hybrid rules and not for any other purposes (e.g., CFC or interest limitation rules).

Luxembourg tax consequences of a hybrid mismatch
Luxembourg will deny the deduction of an expense related to a hybrid arrangement to the extent the expense is deductible in another EU Member State where the expense has its source (double deduction situations) or the hybrid mismatch is not taxable in another EU Member State (deduction without inclusion).

Exit taxation
In 2014, Luxembourg enacted legislation that allows companies transferring an enterprise or migrating out of Luxembourg to defer the exit taxes that would normally be applicable. Since 2016, such interest-free tax deferral has applied to such transfers to any country that: (i) either belongs to the European economic area (EEA); or (ii) has a double taxation treaty with Luxembourg and exchange of information in line with Organisation for Economic Co-operation and Development (OECD) principles is foreseen in such double taxation treaty or in a bi- or multilateral agreement.

As the ATAD does not foresee the possibility of long-term deferrals but only installment payments of exit tax, the Draft Law introduces significant changes to the existing provisions. In addition, new provisions are introduced to better align valuations used in the exit state with the receiving state.

Valuation on inbound transfers
Upon specific inbound transfers, the transferred assets (and liabilities) are to be valued at the value determined by the exit state of the taxpayer or of the PE, unless this value does not reflect the going concern value. This applies in the following situations:

- A taxpayer transfers its tax residence or habitual place of abode, or the activity carried out through a PE, from another state to Luxembourg.
- Assets are transferred by a PE to the Luxembourg head office or by a foreign head office to a Luxembourg PE.
Going forward the transfer of an enterprise or domestic PE that is owned by a taxpayer resident in an EEA Member State to another EEA Member State no longer triggers a rectification of the tax assessed in cases where the other state does not recognize any losses realized on the transferred assets after the transfer. The provision requiring such rectified assessments had been introduced in 2014 to meet the requirements of the European Commission in a formal notice to Luxembourg. According to the comments to the Draft Law, this measure appears to be unnecessary since the value established by the exit state is binding for the other state.

Payment deferral of the exit tax
As mentioned above, the ATAD requires Luxembourg to abolish the current unlimited deferral of exit tax. Going forward, a taxpayer may request the payment of the exit tax debt in equal installments over a maximum period of five years, subject to the condition that the transfer is made to an EU Member State or an EEA Member State other than an EU Member State with which Luxembourg or the EU has concluded an agreement on the mutual assistance for the recovery of tax, offering a mutual assistance equal to that foreseen by the Council Directive 2010/24/EU dated 16 March 2010. This aforementioned condition aims at ensuring that an effective assistance in collection of taxes will be available.

The Draft Law does not foresee interest or guarantees, despite these options being foreseen in the ATAD.

The deferral is immediately discontinued and the outstanding amount of the tax debt becomes due in the following cases:

a) The assets or activity transferred, carried on by the taxpayer’s PE, are sold or withdrawn, except in case of a tax neutral operation as foreseen by the Merger Directive provided the beneficiary(ies) company(ies) declare taking over the rights and obligations of the contributor in relation with the payment deferral.

b) The assets transferred are subsequently transferred to a state that is not an EU Member, except if the state of destination is an EEA Member State other than an EU Member State and Luxembourg or the EU has an agreement on mutual assistance for the recovery of tax claims with that state, offering mutual assistance equal to the one foreseen by the Council Directive 2010/24/EU dated 16 March 2010.
c) The tax residence or habitual place of abode, the statutory seat and the central administration of the taxpayer, or the activity performed by its PE is transferred to a state that is not an EU Member, except if the state of destination is an EEA Member State other than an EU Member State and Luxembourg has an agreement on mutual assistance for the recovery of tax claims with the destination state, offering mutual assistance equal to the one foreseen by the Council Directive 2010/24/EU dated 16 March 2010.

d) The taxpayer goes bankrupt or is liquidated.

e) The taxpayer fails to honor its obligations in relation to the instalments and does not correct the situation within a reasonable period of time, which shall not exceed 12 months.

f) The taxpayer fails to document annually, in due form, that the situations listed under a), b) and c) did not occur.

Scope and entry into force

Any resident taxpayer carrying out a commercial activity, be it an individual or a company, will be subject to the aforementioned provisions with regard to financial years starting on or after 1 January 2020. The Draft Law foresees a transitional measure, pursuant to which deferrals granted for financial years closed before 1 January 2020 are not affected by the new provisions. Implications for existing deferrals and, in particular, from transactions subsequent to such deferrals having been granted, should be analyzed on a case-by-case basis.

General Anti-Abuse Rule (GAAR) – Amendments to art. 6, Tax Adaptation Law (StAnpG)

The ATAD foresees a GAAR according to which arrangements that have been put into place for the main purposes of obtaining a tax advantage should be ignored if they are not genuine, i.e., if they are not put into place for valid commercial reasons which reflect economic reality.

A GAAR is already codified in art. 6 StAnpG, which states that “the tax burden cannot be circumvented or reduced through the misuse of forms and institutions of private law.” The GAAR entitles the tax authorities to levy tax according to the effective economic operations, facts and circumstances. In order to maintain continuity in the application of the anti-abuse provision, the Draft Law rephrases and completes the existing GAAR rather than replacing it with the GAAR contained in the ATAD.

The new wording maintains (but to some extent amends) the three principal elements of abuse in tax matters, being:

- a misuse of forms and institutions of private law,
- the aim of this legal path (form or institution of law) being to obtain a circumvention or reduction of the tax burden that defeats the object or the purpose of the tax law, and
- the non-authentic character of the legal path used.

The amended wording keeps the reference to the forms and institutions of law (the reference to private law is deleted and the definition is expanded to now cover all forms of law), rather than the insertion of the concept of “arrangement or series of arrangements” of the ATAD, which would be a new concept that existing case law on anti-abuse would not be applicable to.

The Draft Law clarifies that any abuse of a provision of the tax law is covered, i.e., not only abuse leading to a reduction of the tax burden, but also abuse resulting in a reimbursement of tax or a tax credit for foreign withholding taxes.

Even though the taxpayer still has the “choice of the least taxed way,” the comments to the Draft Law state that it is not legitimate to use a legal path for the main purpose or one of the main purposes of obtaining a circumvention or a reduction of the tax burden that defeats the object or purpose of the tax law, if this legal path is not authentic considering all relevant facts and circumstances. The Draft Law reproduces the definition of the ATAD to define “non-authentic arrangements”, i.e., arrangements “not put in place for valid commercial reasons which reflect economic reality.” The commentaries to the Draft Law refer to existing Luxembourg case law.

The commentaries also clarify that specific anti-abuse provisions, as they exist for example for the application of the participation exemption or in the CFC rules to be introduced, prevail over the GAAR.

The burden of proof for the existence of an abuse remains, as is currently the case, with the tax authorities. In line with existing case law, the state is however not obliged to concretely prove the impossibility of an economic reason of the legal path used; it is sufficient to make plausible that an economic reason is lacking, which then shifts the burden of proof to the taxpayer.
Scope and entry into force
The aforementioned provision will be applicable to any taxpayer with regard to financial years starting on or after 1 January 2019.

Additional measures
Amendment of the PE definition
Art. 16, StAnpG, 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 country.

Whether a PE exists will have to be determined on a case-by-case analysis. An example given by the Draft Law is the operation of a plant, a garage or a construction site. However, the mere management of financial assets or of intellectual property assets may not be considered to be sufficient to create a PE in the other Contracting State. According to the commentaries to the Draft Law, it may be easier for the source country to analyze the facts and circumstances of a particular case. Therefore, 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)). The new provision does not explicitly require the PE to be effectively taxed in the other country.

The Draft Law does not state that the delivery of such confirmation is a prerequisite for the recognition of a PE. Where the activities abroad qualify as an independent activity that represents participation in the general economic life in the PE jurisdiction, a PE appears to be recognized abroad irrespective of whether a confirmation is provided.

The impact of this new provision will have to be analyzed in further detail on a case-by-case basis, taking into account all relevant facts and circumstances.

The aforementioned provision will be applicable to financial years starting on or after 1 January 2019 and will be relevant for any Luxembourg taxpayer having a PE in a country with which Luxembourg has concluded a double taxation treaty. Its impact will not be limited to income taxes, but will also extend to the net worth tax.

Tax-neutral conversion of debt into equity
The tax neutral conversion of loans into shares, as currently foreseen by article 22bis (2) 1 ITL, will be abolished. The explanation given for the abolition is that the provision may lead to situations of deduction without corresponding taxation. Going forward, such conversion will be treated tax-wise as a deemed disposal, at fair market value, of the loan, followed by a deemed acquisition of the shares. Latent capital gains attached to such convertible loans will thus become taxable at the time of their conversion into shares.

Entry into force
The aforementioned provision will be applicable to Luxembourg resident taxpayers (companies subject to Luxembourg CIT and individuals that carry out a commercial activity) with regard to financial years starting on or after 1 January 2019.

Implications
The implementation into domestic law of the provisions laid down by the ATAD will have a significant impact on Luxembourg corporate taxpayers. In addition, Luxembourg taxpayers operating abroad through a PE will have to assess if they will still be able to benefit from an exemption in Luxembourg for the income derived through, and capital held by, such PE, taking into account the planned restrictions to the recognition of a foreign PE.

While the legislative process is not finished and it is still possible for changes to occur to the Draft Law, it is clear that the new legislation will be complex and constitutes a major change that needs to be considered by all types of Luxembourg companies, whether they are engaged in
holding, financing, operating or other activities. Existing structures will therefore have to be reviewed in detail in light of these changes. Any analysis of the implications of the Draft Law will have to also consider changes in tax law elsewhere in the world and other factors affecting business operating models more generally. Even if the provisions of the Draft Law turn out not to have an actual cash tax impact on a particular structure, they will have to be analyzed and conclusions and positions will have to be documented.

Our EY tax professionals can provide assistance by reviewing existing structures and assessing the implications of the new provisions on current and future business models.

Endnotes


3. Article 56 ITL: “When an enterprise participates, directly or indirectly in the management, control or capital of another enterprise, or where the same individuals participate, directly or indirectly, in the management, control or capital of two enterprises (…) .”

4. 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. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.


7. Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

8. Steueranpassungsgesetz – StAnpG.

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