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ELISABETH ADAM

GEORGIOS MERKOURIOU

ELVINGER HOSS PRUSSEN, Société anonyme

ElisabethAdam@elvingerhoss.lu

GeorgiosMerkouriou@elvingerhoss.lu

Tel: +352 4466441

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1. Implementation of the EU Anti-Tax Avoidance Directive

With the law of 21 December, 2018 (**ATAD Law**), the Luxembourg Parliament (*Chambre des Députés*) transposed the Anti-Tax Avoidance Directive 2016/1164 of 12 July 2016 (**ATAD 1**) into national law bringing significant amendment in Luxembourg's tax legislation. In addition to ATAD 1, ATAD Law introduces additional amendments related to tax neutral exchanges as well as a new domestic definition of permanent establishment.

1.1. Interest limitation rule

The ATAD Law introduces an interest limitation rule (Article 168*bis* of the Luxembourg income tax law (**LITL**)) effective as from 1 January 2019, according to which the deductibility of exceeding borrowing costs[1] is limited to the higher of (i) 30% of the taxpayers EBIDTA[2] or (ii) EUR 3,000,000.

Exceeding borrowing costs that cannot be deducted in a given tax period can be carried forward without time limitation. Also, based on the ATAD Law, unused interest capacity (i.e., when the 30% EBIDTA exceeds the exceeding borrowing costs for a given year provided those exceeding borrowing costs exceed EUR 3,000,000) may be carried forward for up to five years.

Standalone entities[3] and financial undertakings[4] as defined in the ATAD Law are excluded from the scope of the interest limitation rule.

Finally, in accordance with ATAD 1, Luxembourg interest limitation provision contains a grandfathering clause. According to this clause interest on loans concluded before 17 June 2016 are not to be included in the "borrowing costs" computation so that they will remain fully deductible (provided they respect the arm's length principle and they are not connected to exempt income). However, the grandfathering will not apply to any subsequent modification of the terms and conditions of those loans (e.g., in respect of the amount, duration and conditions of the instrument).

1.2. Controlled foreign company rules (CFC)

ATAD Law introduced CFC rules into Luxembourg tax laws (new Article 164ter LITL) to target non-distributed income of entities or permanent establishments (**PE**) arising from "non-genuine arrangements"[5] which have been put into place for the essential purpose of obtaining a tax advantage.

A subsidiary or a PE of a Luxembourg company could fall within the definition of a CFC which may result in the inclusion of the CFC's income in the taxable basis of that company under certain conditions. Such subsidiary or PE should be considered as a CFC if the income it generates is exempt or is not taxable in

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[1] Exceeding borrowing costs include interest expenses and other economically equivalent costs exceeding taxable interest income and other economically equivalent taxable revenue.

[2] EBIDTA is defined as taxable earnings before interest, tax depreciation and amortization. Tax-exempt income, as well as expenses related to such exempt income, is excluded from the EBIDTA computation.

[3] Standalone entities are those that are not part of a consolidated group for financial accounting purposes and have no associated enterprise or permanent establishment situated in a country other than Luxembourg.

[4] Financial undertakings include inter alia, credit institutions, investment firms, UCITS, alternative investment funds (AIFs), insurance and reinsurance undertakings and securitization vehicles that are governed by the Regulation (EU) 2017/2402.

[5] Based on the ATAD Law which transposes the exact same definition as included in ATAD 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all, or part or, its income if it were not controlled by a company 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.

Luxembourg and (i) the company alone or together with its associated enterprises[6] holds a direct or indirect participation of more than 50% in the subsidiary; and (ii) the actual corporate tax paid by the subsidiary or PE on its profits is lower than 50% of the Luxembourg corporate income tax that would have been due under Luxembourg applicable income tax law.

No CFC rules should apply to a subsidiary or a PE whose accounting profits do not exceed EUR 750,000 or an amount to be no more than 10% of its operating costs for the tax period. The method of computation of the taxation of the entity or PE as well as the conditions under which the income of a CFC should be included in the taxable basis of the controlling Luxembourg entity are detailed in the ATAD Law and should be considered on a case-by-case basis.

1.3. Anti-hybrid rules (intra-EU)

Through the introduction of Article 168ter LITL, ATAD Law transposes in Luxembourg the anti-hybrid rule of ATAD 1 related to intra-EU transactions. The scope of such rule will be extended with the implementation of the ATAD 2 (Council Directive (EU) 2017/952 of 29 May 2017) in Luxembourg by the end of 2019, with the inclusion of a wider range of intra-EU mismatches and mismatches with non-EU jurisdictions.

According to 168ter LITL "hybrid mismatch" exists when there are differences in the legal characterization of financial instruments or entities, where a structured arrangement concluded between the taxpayer and the party established in another Member State or where the commercial or financial relations between the taxpayer and an associated enterprise[7] established in another Member state have the following consequences:

- the same operating expenses or losses are deducted both in Luxembourg and in another Member State in which the operating expenses or losses have their origin ("double deduction"); or
- the payment is subject to deduction in Luxembourg, where it originates, without giving rise to inclusion of the corresponding income in the total taxable income in the other Member State ("deduction without inclusion").

In case a hybrid mismatch arises, Luxembourg should deny the deduction of an expense to the extent such expense is deductible in the other Member State where it has its source (double deduction situation) or where the income is not taxable in another Member State (deduction without inclusion situation).

The rule applies to companies and PE of non-resident entities subject to Luxembourg corporate income tax and for financial years starting on or after 1 January 2019.

1.4. General anti-abuse rule (GAAR)

Paragraph 6 of the Luxembourg adaptation law was modified in order to align the existing Luxembourg general anti-abuse domestic provision with the ATAD 1 GAAR. Based on the new definition, to conclude whether a transaction or arrangements fall within the scope of the new GAAR in Luxembourg, the following cumulative criteria should be met:

- the use of forms and institutions of private or public law;
- the main purpose or one of the main purposes of the legal route used is to obtain a circumvention or reduction of the tax burden that defeats the object or purpose of the tax law;
- the legal route used is not authentic.

[6] The threshold for the "associated enterprises" in the context of CFC rules is 25% of participation in terms of voting rights or capital ownership of the taxpayer.
[7] The threshold of associated enterprises" in the context of the anti-hybrid rules is in principle 25% as for the one used in the context of CFC rules. However, when the mismatch involves a hybrid entity a 50% threshold is applied.

The Luxembourg legislator has not entirely replaced the old text with the GAAR of ATAD 1 but rephrased and completed such wording which, according to the parliamentary document, was due to his aim to maintain continuity with the existing jurisprudence on the previous version of the anti-abuse provision.

1.5. Abolition of the tax neutral exchange of convertible debt instruments

The provision allowing Luxembourg resident taxpayers to make tax neutral conversions of convertible debt into shares is abolished as from 1 January 2019. Going forward, any such conversion should be seen as a sale of the debt at fair market value followed by the acquisition of shares at fair market value.

1.6. New PE definition

The ATAD Law brings also an amendment to Article 16 of the Luxembourg adaptation law, providing for the Luxembourg domestic definition of PE. Such provision is extended to include a paragraph relating to the recognition of a foreign PE in a treaty country. This new paragraph aims at eliminating the conflicts resulting from the discrepancies between the domestic and tax treaty provisions in respect of the PE recognition. Based on the new provision, the recognition of a PE in a treaty country will have to be determined according to criteria set forth by the double tax treaty concluded with the other contracting state. Luxembourg tax authorities may now request a Luxembourg taxpayer claiming to maintain a PE in a treaty country to provide with confirmation from the tax authorities of the other contracting state on the existence of the PE in its territory.

2. <u>Budget Law 2019</u>

With the law of 26 April, 2019 (**Budget Law**), the Luxembourg Parliament (*Chambre des Députés*) introduces into national legislation amendments that will be applicable as from 2019, some of which were much-awaited to the Luxembourg market.

The main amendments relate to (i) the reduction of the 2019 corporate income tax rate (ii) the introduction of the option to apply the interest limitation rule of the Anti-Tax Avoidance Directive at a fiscal unity level and (ii) the amendment of the VAT rates applicable to certain products.

2.1. Reduction of the Luxembourg corporate income tax rate

The corporate income tax rate is reduced from the current 18% to 17% (for taxable profits exceeding EUR 200,000) as from the tax year 2019, leading to an effective combined income tax rate of 24.94% for companies resident in Luxembourg city.

2.2. Application of the interest limitation rule to fiscal unities

The Luxembourg law of 21 December 2018 (ATAD Law) implementing into Luxembourg legislation the EU Anti-Tax Avoidance Directive (2016/1164 of 12 July 2016) did not foresee the application of the interest deduction limitation rule for fiscally integrated groups. In conformity with the Government's public statement of 12 December 2018, the Budget law provides for an amendment to the fiscal unity regime by the introduction of the possibility for companies forming a fiscal unity to determine their EBIDTA[8] and exceeding borrowing costs[9] for the purpose of the interest limitation rule at the fiscal unity level. As a consequence, the deduction of the exceeding borrowing costs would be limited to the higher of 30% of EBIDTA of the head of the fiscal unity or EUR 3,000,000.

This provision is effective as of 1 January 2019 (i.e., for financial years starting on or after 1 January 2019) and would apply by default to newly formed tax integrated groups. However companies forming part of such group will be allowed to opt-out and apply the rule on a standalone basis in their written

[8] See Footnote1.
[9] See Footnote 2.

request for the application of the fiscal unity regime. Companies forming existing fiscal unities will be able to opt-in to the rule of applying the interest limitation at a fiscal unity level by providing a common written request before the end of the first financial year for which the interest limitation rule applies for the first time (i.e., the fiscal year beginning on or after 1 January 2019).

2.3. Value Added Tax (VAT) measures

In accordance with the EU Directive 2018/1713 of 6 November 2018, the Budget Law implements the new VAT rates.

For books, newspapers, and periodicals, the VAT rate of 17% is replaced by the super-reduced rate of 3% irrespective of their supply in electronic form or physically. Publications entirely or predominantly devoted to publicity, as well as those consisting entirely or predominantly to video content or audible music and those consisting entirely or predominantly of pornographic content will remain subject to the standard 17% VAT rate.

The 3% super-reduced rate is also extended to pharmaceutical products normally used for health care, prevention of diseases and treatment for medical and veterinary purposes, including products used for contraception and feminine hygiene protection.

Finally, the rate of 17% has been replaced by the rate of 8% for certain phytopharmaceutical products.

These provisions apply since 1 May 2019.

3. BEPS measures

3.1. Multilateral convention: BEPS implementation (**MLI**)

Further to the signature of the MLI on 7 June 2017 along with 67 other jurisdictions, the Luxembourg Parliament approved the draft law on 14 February 2019 and Luxembourg deposited with the OECD its instrument of ratification on 9 April 2019.

Hence, for Luxembourg, the MLI will “enter into force” on 1 August 2019. The timeline for “entry into effect” of different provisions of the covered tax agreements (**CTA** – tax treaties in force for which the MLI will apply) will depend on multiple factors subject also to the Luxembourg counterparties to such CTAs.

Regarding the withholding tax provisions, the entry into effect will only start as of 1 January 2020 (for Luxembourg counterparties that have already deposited or will deposit their instrument of ratification of the MLI with the OECD until 30 September 2019) or later.

As a reminder, Luxembourg at the time of the signature of the MLI designated 81 of its tax treaties as CTAs. At the final version of its MLI position, the number of CTAs designated by Luxembourg remained 81.

4. Tax treaty news

4.1. Cyprus

On 17 April 2018 Luxembourg ratified the Cyprus-Luxembourg income and capital tax treaty which was signed in May 2017. Further to this treaty, Luxembourg has now double tax treaties with all the Member States of the EU. The tax treaty follows the 2014 OECD model but includes an article on the entitlement of benefits, including the principal purpose test clause consistently with the 2017 OECD model treaty and the MLI. The treaty is effective as from 1 January 2019.

4.2. Senegal

The tax treaty between Luxembourg and Senegal entered into force on 14 June 2018 and is effective as from 1 January 2019. Both countries have signed the MLI and included such treaty in the list of CTAs under Article 2 (1) (a) (ii) of the MLI.

4.3. Botswana

On 19 September 2019, Luxembourg has signed with Botswana an income and capital tax treaty. It will enter into force after the completion of the notification process by each State.

5. Other measures

5.1. VAT group regime

The Luxembourg law of 6 August 2018 implements the VAT group regime in Luxembourg (**VAT Group**) with the introduction of the new Article 60ter in the Luxembourg VAT Law. This new regime comes as a response to the recent European Union's Court of Justice judgment restricting the scope of the independent group of persons regime (IGP) that the VAT Group regime aims at replacing.

The VAT Group is implemented in accordance with the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax and is applicable as of 1 August 2018. Its main advantage consists in that all members of the same VAT Group are considered as one single taxable person for VAT purposes so that supplies between group members are disregarded for VAT purposes. Such feature is useful mainly for financial and insurance groups that were using the former IGP regime in Luxembourg but also to groups performing VAT-exempt supplies without (or with a limited) VAT recovery right or groups aiming at improving their cash flow.

5.2. Tax treatment of virtual currencies

On 26 July 2018, the Luxembourg tax authorities published a circular (L.I.R. n° 14/5 – 99/3 – 99*bis*/3) providing useful guidance on the tax treatment of income generated by Luxembourg taxpayers through virtual currencies. Virtual currencies are considered intangible assets for Luxembourg tax purposes and do not constitute any currency. As such, Luxembourg taxpayers can neither establish their accounts nor declare their taxable income in virtual currencies. The tax treatment of income generated by virtual currencies should follow the general rules of the Luxembourg taxation, irrespective of being realized in the real or virtual world. Thus, income from trading and mining activities could qualify either as business income (*benefice commercial,* Article 14 LITL) or miscellaneous income (*revenus nets divers*, Article 99 LITL) and taxed as such. The circular gives further practical guidelines related to the conversion of such income into EUR or another currency of the European Central Bank as well as to the maintenance of documentation and the determination of the acquisition price of the virtual currencies.

5.3. EU non-cooperative jurisdictions

On 7 May 2018, the Luxembourg tax authorities issued a circular (L.G. – A n° 64) related to defensive measures that will apply to transactions carried out by Luxembourg companies with associated enterprises located in jurisdictions included in the EU common list of non-cooperative jurisdiction in tax matters. This circular demonstrates Luxembourg's alignment with EU's agenda on increased tax transparency, implementation of anti-BEPS measure and prevention of corporate tax avoidance. The defensive measures which include disclosure of details on taxpayer's transactions with related parties located in the listed non-cooperative jurisdictions will be applicable as from the fiscal year 2018 and will require the taxpayers to indicate the existence of such transactions in their tax return. The version of the list to consider for a given year is the one published at the end of the financial year of the Luxembourg entity and will be made available at Luxembourg tax authority's website.