European Investment Fund Review n°3/2023

Oliver R. HOOR

THE REVERSE HYBRID MISMATCH RULE: CONSIDERATIONS REGARDING ALTERNATIVE INVESTMENT FUNDS IN LUXEMBOURG

BY OLIVER R. HOOR

TAX PARTNER (HEAD OF TRANSFER PRICING AND THE GERMAN DESK)
WITH ATOZ TAX ADVISERS (TAXAND LUXEMBOURG)

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1. OVERVIEW

A reverse hybrid is an entity that is viewed as transparent under the laws of the jurisdiction in which it is established but treated as a separate entity (i.e. opaque) under the laws of the jurisdiction(s) of the investor(s).[1]

Therefore, the income of a reverse hybrid may neither be taxable in its establishment jurisdiction (as the income is attributed to the investor) nor in the residence state of the investor(s) (where the income of the opaque entity is not included in the taxable income of the investor(s)). In many cases, the income realised by a reverse hybrid entity will only

1. See Final Report on BEPS Action 2, p. 56, No. 140.

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be taxable at the level of the investor when the income is distributed, resulting potentially in a (long-term) tax deferral.

Article 168quater of the Luxembourg income tax law ("LITL"), the Luxembourg reverse hybrid mismatch rule, may apply as from tax year 2022 to all entities within the meaning of Article 175 of the LITL that are established in Luxembourg (in particular, partnerships). Given that these entities are treated as fiscally transparent, their income is for Luxembourg (corporate) income tax purposes allocated to the owners.[2] The reverse hybrid mismatch rule aims at eliminating double non-taxation outcomes through the treatment of reverse hybrids as resident taxpayers.[3]

The reverse hybrid mismatch rule must also be considered in the context of Alternative Investment Funds that are established in the legal form of a partnership or in contractual form (*fonds commun de placement, "FCP"*); both are viewed as transparent from a Luxembourg tax perspective.

2. SCOPE OF THE REVERSE HYBRID MISMATCH RULE

2.1. *Related party test*

The reverse hybrid mismatch rule only applies if the related party test as defined in Article 168quater (1) of the LITL is satisfied. This is the case when the entity is owned by one or more non-resident associated enterprises within the meaning of Article 168ter (1) No. 18 of the LITL (individuals or entities) that are resident in a jurisdiction (or jurisdictions) that regard the Luxembourg entity as opaque and hold directly or indirectly a participation of at least 50% in terms of voting rights or capital ownership (or are entitled to receive at least 50% of the entity's profit).

Thus, only those investors that are resident in jurisdictions that view the Luxembourg entity as opaque are to be considered when determining whether the 50% threshold is met. Furthermore, the 2023 amendment of Article 168quater (1) of the LITL clarifies that the reverse hybrid mismatch rule would only apply if the non-taxation of the income realised by the associated enterprises through the Luxembourg entity is due to the difference in the qualification (i.e. transparent vs. opaque) of the Luxembourg entity.

Consequently, if and to the extent the income of the reverse hybrid entity would not be taxed in any case due to the tax (exempt) status of the investor under the laws of the investor jurisdiction(s), such investors should be excluded from the related party test. This should be the case if the recipient benefits from a subjective tax exemption (for example, pension funds that benefit from a special tax regime), the investor jurisdiction does not levy corporate income tax or the investor jurisdiction adopted a territorial system where the payment would be treated as non-taxable foreign source income.

The exclusion of investors based on their tax status takes effect when applying the related party test, not when determining the amount of income to be included in the tax base of the reverse hybrid entity. This further reduces the potential scope of the reverse hybrid mismatch rule in the context of investments funds (here, institutional investors often include tax exempt pension funds, sovereign wealth funds and other tax-exempt investors).

2.2. *Aggregation of interests*

In certain circumstances, the shareholding percentages of otherwise unrelated parties should be aggregated for the purposes of the related party test. More precisely, a person who acts together with another person in respect of 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.[4]

The purpose of the "acting together" concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interests or equity interests to another person who continues to act under their direction in relation to those interests.

The other situation targeted by the acting together concept is where a taxpayer or a group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them.[5]

However, investors that would in any case not be taxable on the income derived via the hybrid entity should be disregarded when considering the potential application of the concept of acting together (i.e. exclusion of investors based on their tax status).

2.3. *Investments funds*

Luxembourg is a global hub for alternative investments (private equity, venture capital, real estate and infrastructure investments, etc.) in and through Europe. Therefore, the question as to how the concept of acting together applies in

2. Article 168quater (1) of the LITL; the owners may be individuals, corporate taxpayers within the meaning of article 159 (residents) or 160 (non-residents) of the LITL or transparent entities within the meaning of article 175 of the LITL.

3. See Final Report on BEPS Action 2, p. 64, No. 174 and 175.

4. Article 168ter (1) No. 18 of the LITL.

5. See Final Report on BEPS Action 2, page 117, No. 369.

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a fund context is of crucial importance. In this regard, Article 168ter of the LITL provides for a *de minimis* rule.[6]

Investment funds have been defined as "any collective investment undertakings which raise capital from a number of investors, with a view to invest this capital in accordance with a defined investment policy for the benefit of those investors". It follows that investment funds have the following characteristics:

- a collective investment undertaking;
- with a defined investment policy;
- which raises capital with a view to investing that capital for the benefit of those investors in accordance with that policy.

The definition of investment funds is broad and includes Luxembourg and foreign funds, close-ended and open-ended funds, listed and unlisted funds irrespective of the legal form thereof.

According to the commentaries to the ATAD 2 bill[7], investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions of investors in accordance with the fund's investment policy. Therefore, Article 168ter of the LITL provides for a safe harbour rule according to which an investor (be it an individual or an entity) that owns directly or indirectly less than 10% of the shares or units in a fund (and that is entitled to less than 10% of the fund's profits) is considered not to act together with the other investors, unless proven otherwise. Here, the burden of proof would be on the Luxembourg tax authorities to evidence that investors are acting together within the meaning of this concept.

Hence, in an investment fund context, the ownership of stakes below 10% should in principle not be relevant when considering a potential aggregation of interests as a consequence of the "acting together" concept.[8]

Moreover, when investors in a fund own 10% or more of the shares or fund units (or are entitled to 10% or more of the fund's profits), it has to be analysed on a case-by-case basis whether or not two or more investors are acting together for the purposes of the related party test. Here, the burden of proof that the acting together concept does not apply is on the taxpayer. However, there is no presumption that investors with 10% or more investments would be acting together.

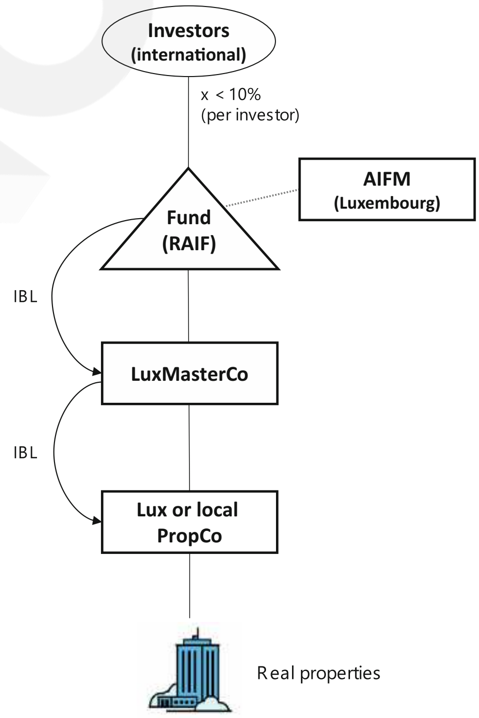
Example: The Luxembourg investment fund

A Luxembourg reserved alternative investment fund ("RAIF") established in the legal form of a Luxembourg special limited partnership ("SCSp") invests into pan-European real estate assets. The fund is managed by a Luxembourg alternative investment fund manager ("AIFM") that makes investments in accordance with the RAIF's investment policy as outlined in the prospectus. Thus, the RAIF qualifies as an investment fund for the purposes of the *de minimis* rule.

The investments of the RAIF are made via a Luxembourg master company ("LuxMasterCo") that operates as the fund's investment platform and via separate property companies ("Lux or local PropCo") that are financed by a mixture of equity and debt instruments (interest-bearing loans, "IBL").

The investors in the fund are institutional investors from several jurisdictions with shareholdings ranging from 2% to 6%. The investors are not actively involved in the investment process (other than confirming the investment policy from time to time) and there exists no special relationships between the investors.

The group chart of the fund is depicted in the following chart:



Here, shareholdings of the investors owning less than 10% should not be added together in accordance with the *de minimis* rule. While the shareholding percentages might need to be aggregated if the Luxembourg tax authorities can prove that the investors are acting together, in the present case there exist no indications that the investors are acting together within the meaning of Article 168ter (1) No. 18 of the LITL.

6. Article 168ter (1) No. 18 of the LITL.
7. Law of 20 December 2019 implementing Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 regarding hybrid mismatches with third countries, *Mémorial A* – N° 889 du 23 décembre 2019 ("ATAD 2")
8. Article 168ter (1) No. 18 of the LITL.

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Variation I: Related party test

As a variation to the previous example, it is assumed that twelve institutional investorsinvested in the RAIF. The investors are resident in the Federal Republic of Germany, Switzerland and France, respectively.

While the RAIF in the legal form of an SCSp is treated as transparent from the perspective of the Federal Republic of Germany and Switzerland, the SCSp is viewed as opaque from a French tax perspective.

Three investors (institutional investors 1, 2 and 3) are part of the same group, whereas all the other investors are unrelated entities.

Luxembourg RAIF (SCSp)					
Investors	**Country of residence**	**Classification of the Fund**	**Tax status**	**Tax treatment**	**Shareholding %**
Members of Group X					
Institutional investor 1	Germany	transparent	taxable		15%
Institutional investor 2	Switzerland	transparent	tax exempt		10%
Institutional investor 3	France	opaque	taxable	Dividends are taxable upon distribution	15%
Other investors					
Institutional investor 4	Germany	transparent	taxable		12%
Institutional investor 5	Germany	transparent	taxable		8%
Institutional investor 6	Switzerland	transparent	tax exempt		8%
Institutional investor 7	Switzerland	transparent	taxable		6%
Institutional investor 8	Switzerland	transparent	taxable		6%
Institutional investor 9	France	opaque	taxable	Mark-to-market accounting treatment	6%
Institutional investor 10	France	opaque	taxable	Dividends are taxable upon distribution	5%
Institutional investor 11	France	opaque	taxable	Mark-to-market accounting treatment	5%
Institutional investor 12	France	opaque	taxable	Dividends are taxable upon distribution	4%
					100%

Institutional investors 1, 2 and 3 are associated enterprises and need, in principle, to be aggregated for the purposes of the related party test.

Institutional investor 4 has an investment of 12% in the RAIF. However, as there are no indications that institutional investor 4 is acting together with institutional investors 1, 2 and 3, the shareholding percentages of these investors should not be aggregated.

The other investors own less than 10% in the fund. Here, one may rely on the *de-minimis* rule to exclude their shareholding percentages for the purposes of the related party test.

Based on the above, only the shareholding percentages of institutional investors 1, 2 and 3 have, in principle, to be aggregated, amounting to an aggregate shareholding percentage of 40%. Nevertheless, as only 15% of these investors are resident in a jurisdiction that views the Luxembourg RAIF as an opaque entity, the related party test is not met in the present case.

Variation II: Related party test

As a variation to the previous case, it is assumed that the shareholding percentages are slightly different.

Luxembourg RAIF (SCSp)					
Investors	**Country of residence**	**Classification of the Fund**	**Tax status**	**Tax treatment**	**Shareholding %**
Members of Group X					
Institutional investor 1	Germany	transparent	taxable		20%
Institutional investor 2	Switzerland	transparent	tax exempt		20%
Institutional investor 3	France	opaque	taxable	Dividends are taxable upon distribution	15%
Other investors					
Institutional investor 4	Germany	transparent	taxable		12%
Institutional investor 5	Germany	transparent	taxable		5%
Institutional investor 6	Switzerland	transparent	tax exempt		5%
Institutional investor 7	Switzerland	transparent	taxable		4%
Institutional investor 8	Switzerland	transparent	taxable		4%
Institutional investor 9	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 10	France	opaque	taxable	Dividends are taxable upon distribution	4%
Institutional investor 11	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 12	France	opaque	taxable	Dividends are taxable upon distribution	3%
					100%

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Institutional investors 1, 2 and 3 are associated enterprises and need, in principle, to be aggregated for the purposes of the related party test.

Institutional investor 4 has an investment of 12% in the RAIF. However, as there are no indications that institutional investor 4 is acting together with institutional investors 1, 2 and 3, the shareholding percentages of these investors should not be aggregated.

The other investors own less than 10% in the fund. Here, one may rely on the *de-minimis* rule to exclude their shareholding percentages for the purposes of the related party test.

Based on the above, only the shareholding percentages of institutional investors 1, 2 and 3 have, in principle, to be aggregated, amounting to an aggregate shareholding percentage of 55%. Nevertheless, as only 15% of these investors are resident in a jurisdiction that views the Luxembourg RAIF as an opaque entity, the related party test is not met in the present case.

Variation III: Related party test

As a variation to the previous case, it is assumed that the investors are resident in different jurisdictions.

Luxembourg RAIF (SCSp)					
Investors	**Country of residence**	**Classification of the Fund**	**Tax status**	**Tax treatment**	**Shareholding %**
Members of Group X					
Institutional investor 1	France	opaque	taxable		20%
Institutional investor 2	France	opaque	tax exempt		20%
Institutional investor 3	France	opaque	taxable	Dividends are taxable upon distribution	15%
Other investors					
Institutional investor 4	Germany	transparent	taxable		12%
Institutional investor 5	Germany	transparent	taxable		5%
Institutional investor 6	Switzerland	transparent	tax exempt		5%
Institutional investor 7	Switzerland	transparent	taxable		4%
Institutional investor 8	Switzerland	transparent	taxable		4%
Institutional investor 9	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 10	France	opaque	taxable	Dividends are taxable upon distribution	4%
Institutional investor 11	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 12	France	opaque	taxable	Dividends are taxable upon distribution	3%
					100%

Institutional investors 1, 2 and 3 are associated enterprises and need, in principle, to be aggregated for the purposes of the related party test.

Institutional investor 4 has an investment of 12% in the RAIF. However, as there are no indications that institutional investor 4 is acting together with institutional investors 1, 2 and 3, the shareholding percentages of these investors should not be aggregated.

The other investors own less than 10% in the fund. Here, one may rely on the *de-minimis* rule to exclude their shareholding percentages for the purposes of the related party test.

Based on the above, only the shareholding percentages of institutional investors 1, 2 and 3 have, in principle, to be aggregated, amounting to an aggregate shareholding percentage of 55%. While all three investors are resident in France where the fund is treated as opaque, investor 2 is a tax-exempt investor that should be excluded when analysing whether the related party test is met. Accordingly, the RAIF should have only 35% associated enterprises that are to be considered in the related party test. Consequently, the related party test is not met in the present case.

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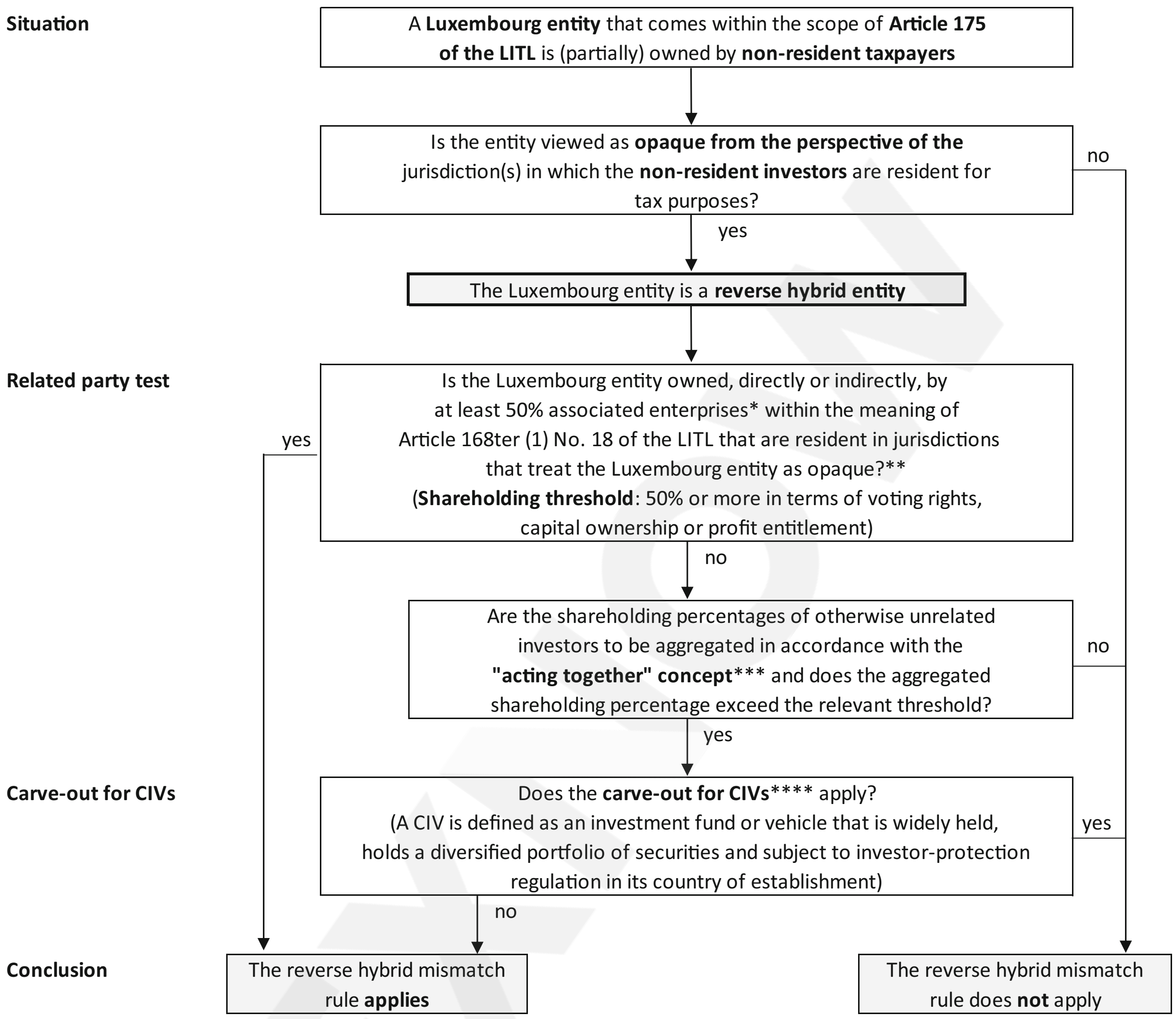
2.4. Checklist: Scope of the reverse hybrid mismatch rules



* The related party test under the reverse hybrid mismatch rules is satisfied when 50% or more of the investors create a mismatch outcome.

** Investors that are tax exempt should be disregarded when analysing whether the related party test is satisfied. In these circumstances, it is the tax status of the investors, not the hybrid nature of the entity that results in the non-taxation at the level of the investors. Tax exempt investors include (i) investors that benefit from a subjective tax exemption in their state of residence, (ii) investors that are resident in a jurisdiction that does not levy corporate income tax and (iii) investors that are resident in a jurisdiction that adopted a territorial tax system under which the income from the fund would be treated as tax exempt foreign income.

*** In case investments are made via an investment fund, a de minimis rule applies for investors that own less than 10% in the fund. When the de minimis rule applies, there is a rebutable presumption that investors are not acting together (the burden of proof that investors would be acting together is on the Luxembourg tax authorities). When investors own 10% or more in the fund, there is no presumption that these investors are acting together but the burden of proof is on the taxpayer in these circumstances.

**** As the definition of CIVs assumes a widely-held fund vehicle, it can be assumed that the 50% associated enterprise test will frequently not be satisfied. While the carve-out for CIVs might be tested at an earlier stage of the analysis, the author suggests to test this carve-out at this stage since the reverse hybrid mismatch rule should in any case not apply in case of CIVs (as the related party test should not be met), resulting in a limited scope of application of the carve-out.

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3. TAX TREATMENT OF REVERSE HYBRID MISMATCHES

3.1. Corporate income tax

3.1.1. Application of the reverse hybrid mismatch rule

When the related party test is satisfied, the reverse hybrid entity is, in principle, treated as a "taxpayer within the meaning of article 168quater of the LITL" and its net income is subject to corporate income tax ("CIT") to the extent this income is not subject to (corporate) income tax at the level of the investors (be it in Luxembourg or abroad).

3.1.2. Determination of the tax base of the reverse hybrid entity

Luxembourg reverse hybrid entities are not treated as tax resident entities within the meaning of Article 159 of the LITL[9] but as a unique category of taxpayers that are subject to CIT and referred to as "taxpayer within the meaning of Article 168quater of the LITL".

Given their specific nature and tax status, not all the provisions of the LITL apply to reverse hybrid entities. Instead, only a few articles of Title II of the LITL (dealing with CIT) apply to taxpayers within the meaning of Article 168quater of the LITL (for example, Article 168 (2) and (4) of the LITL on the non-deductibility of certain categories of expenses and Article 174 of the LITL on the applicable tax rates). The tax base of reverse hybrid entities will be mainly determined in accordance with the relevant provisions of Title I of the LITL (dealing with personal income tax). This has been clarified in Circular L.I.R. n° 168quater/1 (released on 9 June 2023).

The Circular further clarifies that some provisions of Title II of the LITL do not apply, including amongst others:

- Article 164ter of the LITL (Controlled foreign companies rules),
- Article 168bis of the LITL (Interest deduction limitation rules), and
- Article 168ter of the LITL (Hybrid mismatch rules).

The aforementioned provisions are additional anti-abuse rules that have been introduced as part of the transposition of ATAD and ATAD II into Luxembourg tax law.

Moreover, the Luxembourg participation exemption regime (Article 166 of the LITL) does not apply. Reverse hybrid entities may, however, benefit from a 50% tax exemption on dividends if the conditions of Article 115-15a of the LITL are met.

The net income of reverse hybrid entities is determined as follows:

Revenues (defined as all goods and benefits, both in cash and in kind) made available to the taxpayer within the meaning of Article 168quater of the LITL

– Expenses borne to directly acquire, secure and retain the revenues

----

= Net income

==

Income and expenses should be included in the taxable basis of the reverse hybrid entity when payments are made. In other words, income and expenses will be considered as realised (or incurred) when it is effectively received or paid by the reverse hybrid entity (not on an accrual basis).

Luxembourg reverse hybrid entities are assessed on an annual basis and the tax year corresponds to the calendar year, irrespective of the taxpayer's accounting year. Thus, taxpayers within the meaning of Article 168quater of the LITL that have a diverging accounting year would need to prepare separate accounts for the calendar year.

The amount of income to be included in the corporate tax base of the reverse hybrid entity should nevertheless be limited to amounts that would otherwise result in double non-taxation rather than taxing all the income of the reverse hybrid entity.[10]

Therefore, the tax base of the reverse hybrid entity will not include income that is taxable in Luxembourg as domestic income of non-resident taxpayers. This may, in particular, be the case if a Luxembourg partnership performs a commercial activity that results in the constitution of a permanent establishment ("PE") of its non-resident partner(s).[11]

Example: Luxembourg permanent establishments
A Luxembourg limited partnership ("SCS") that performs a commercial activity in Luxembourg is owned by two companies resident in State A ("A-Co I" and "A-Co II"). Both companies are part of the same group

9. Circular L.I.R. n° 168quater/1, 9 June 2023.
10. Article 168quater (1) of the LITL.
11. In these circumstances, the non-resident partners are subject to (corporate) income tax with the commercial income realized via the partnership which constitutes a PE of its non-resident partners, article 156 No. 1 a) of the LITL in conjunction with article 2 (3) (individuals) or 160 (1) (corporates) of the LITL.

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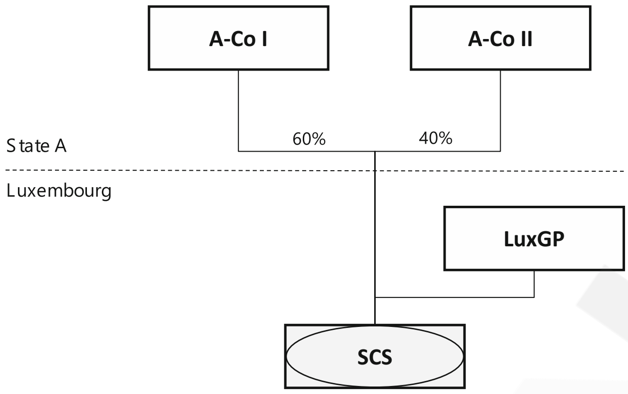
of companies and own respectively 60% and 40%. The general partner of the SCS ("Lux GP") is a Luxembourg company that has a nominal share in the partnership.

The SCS constitutes a PE of A-Co I and A-Co II in Luxembourg and both companies are subject to Luxembourg corporate income tax (and municipal business tax) with their respective share in the profits of the SCS.[12]

While the SCS is viewed as transparent from a Luxembourg tax perspective, under the law of State A, the SCS is treated as opaque for tax purposes. Thus, the SCS is a reverse hybrid entity with respect to A-Co I and A-Co II.



In the present case, the related party test is met as 100% of the associated enterprises are resident in a jurisdiction that views the SCS as opaque for tax purposes. As a consequence, the reverse hybrid mismatch rule is (in principle) applicable.

However, the income of the SCS is already taxed in Luxembourg at the level of A-Co I and A-Co II that are deemed to have a PE in Luxembourg. Therefore, there exists no mismatch outcome and the tax base of the SCS should be zero.

When the Luxembourg entity distributes its income within a reasonable period of time and such distributions are included in the ordinary income of the investors, there should be no room for the application of the reverse hybrid mismatch rule. This is because mere timing differences should generally not be treated as giving rise to a mismatch in tax outcomes.[13]

What is to be understood as a "reasonable period of time" is only defined with respect to payments under hybrid financial instruments. Here, the "reasonable period of time" criterion with regard to the inclusion of the income is deemed to be met when:

- the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or
- it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment adhere to the arm's length standard.[14]

Notably, if the deductible payment is brought into account as ordinary income in at least one jurisdiction (for example, if the income is included at the level of one entity in a chain of companies), then there will be no mismatch for the reverse hybrid mismatch rule to apply to.[15]

In light of the above, it should suffice if the taxpayer can evidence (through a tax analyse) that the income will be included in the ordinary income of the investor upon a future distribution.

The reverse hybrid mismatch rules should further not apply when the investor(s) apply mark-to-market (or fair value) accounting treatment and such treatment is followed for tax purposes. In these circumstances, the investors would include their respective share of the income derived via the Luxembourg entity in their ordinary income for tax purposes. Even if the mark-to-market accounting treatment would not match exactly the income being realised by the reverse hybrid entity, such mismatches should be of temporary nature and not trigger the application of the reverse hybrid mismatch rule.

Moreover, the application of the reverse hybrid mismatch rule should be discharged to the extent the income of the reverse hybrid is included in the ordinary income of the investor(s) in accordance with controlled foreign company ("CFC") rules.

Example: Inclusion in the ordinary income

As a variation to the previous example, it is assumed that the SCS does not perform a commercial activity in Luxembourg. Accordingly, the income of the SCS would not be taxable in Luxembourg as commercial income of A-Co I and A-Co II.

12. Section 16 of the Tax Adaptation Law in conjunction with article 156 No. 1 a) and article 160 of the LITL.

13. According to the opinion of the Luxembourg State Council, the payment to the hybrid entity and the subsequent distribution should be considered as the same payment from an economic perspective, see page 11 of the Opinion of the Luxembourg State Council of 10 December 2019. Here, the Luxembourg State Council considers that the statement made in the Final Report on BEPS Action 2, according to which the reverse hybrid rule should apply even if investors are ultimately taxed on distributions, should be disregarded (see Final Report on BEPS Action 2, p. 59, No. 156). Indeed, if the income would be taxed at the level of the reverse hybrid entity in Luxembourg and at the level of the investors, the result would be double taxation. In addition, the tax paid by the reverse hybrid entity would likely not be creditable against the tax due in the investor jurisdiction as the reverse hybrid entity is viewed as a separate entity from the perspective of the investor jurisdiction.

14. Article 168ter (1) No. 2 a) of the LITL.

15. See Final Report on BEPS Action 2, p. 41, No. 89.

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It is further assumed that the SCS frequently distributes its income within maximum 2 to 3 years following year-end and A-Co I and A-Co II include the income of the SCS in their ordinary income.
In this case, the income of the SCS is subject to corporate income tax at the level of the investors and the reverse hybrid situation merely results in a timing difference that should not trigger the application of the hybrid mismatch rule.
Variation: Should State A apply CFC rules under which the income of the SCS is included in the ordinary income of A-Co I and A-Co II in the fiscal year in which the income is realised by the SCS, there would likewise be no mismatch outcome and the tax base of the SCS should be zero.

As from tax year 2022, the reverse hybrid mismatch rule may also have an impact on the tax treatment of payments to a hybrid entity (within the meaning of Article 168ter (1) No. 2 b) of the LITL). If the reverse hybrid mismatch rule applies, the payment to a reverse hybrid entity should be included in the entity's tax base and there will be no room for further tax adjustments under the hybrid mismatch rules (at the level of the paying Luxembourg company).

This is because Article 168quater of the LITL eliminates the deduction without inclusion outcome through the inclusion of the payment in the taxable income of the reverse hybrid entity.[16] As such, the elimination of the mismatch outcome would shift from non-deductibility at the level of the payer to inclusion of the payment in the tax base of the reverse hybrid entity.

3.1.3. Investment funds and the carve-out for CIVs

Luxembourg investment funds are often established in the legal form of a partnership (for example, a "*société en commandite simple*", "SCS") or a contractual fund without legal personality ("*fonds commun de placement*" or "FCP") that are viewed as fiscally transparent in Luxembourg.

When such fund vehicle is treated as opaque from the perspective of the investor jurisdiction(s), the fund is technically a reverse hybrid entity. However, in a fund context the reverse hybrid mismatch rule is unlikely to apply since the related party test should in most cases not be met.[17]

Article 168quater (2) of the LITL also provides for a specific carve-out for collective investment vehicles ("CIV"). A CIV is defined as an investment fund or a vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

The commentaries to the draft law specify that the definition of a CIV includes the following types of entities:

- Undertakings for collective investment ("UCIs") within the meaning of the Law of 17 December 2010 (i.e. both undertakings for collective investment in transferable securities, "UCITS", within the meaning of part 1 of the UCI Law of 17 December 2010 and non-UCITS or alternative investment funds within the meaning of part 2 of the UCI Law);
- Specialised Investment Funds ("SIFs") within the meaning of the Law of 13 February 2007;
- Reserved Alternative Investment Funds ("RAIFs") within the meaning of the Law of 23 July 2016; and
- Other alternative investment funds within the meaning of law of 12 July 2013 on alternative investment fund managers which do not already fall into one of the previous categories to the extent that they are widely held, hold a diversified portfolio of securities (so as to limit market risks) and are subject to investor protection obligations.

However, if the CIV is widely held, the related party test should likely not be met (in this case, there is no room for the application of the reverse hybrid mismatch rule) and if the CIV is not widely held (for example, in case of dedicated feeder funds), the carve-out should not apply. Hence, it can be assumed that this carve-out has a limited scope in practice.

Example: The Luxembourg investment fund
A Luxembourg reserved alternative investment fund ("RAIF") established in the legal form of a special limited partnership ("SCSp") makes investments into pan-European infrastructure projects. The investors are institutional investors (pension funds, insurance companies, etc.) that own between 4% and 8% of the fund units.
The investments are made via a Luxembourg master company ("LuxMasterCo") that functions as an investment platform for the RAIF and local project companies ("Local PropCo") that own the infrastructure projects. Local PropCo is financed by a mixture of equity and debt granted by LuxMasterCo. The interest-bearing loan ("IBL") granted by LuxMasterCo to Local PropCo is financed by an IBL granted by the RAIF to LuxMasterCo.

16. See recital 29 of ATAD 2.
17. Participations of investors with less than 10% should generally not be aggregated based on the 10% *de minimis* rule provided under article 168ter (1) No. 18 of the LITL. With regard to participations of 10% or more, it has to be analysed on a case-by-case basis whether the acting together concept applies (see section 3.3.).

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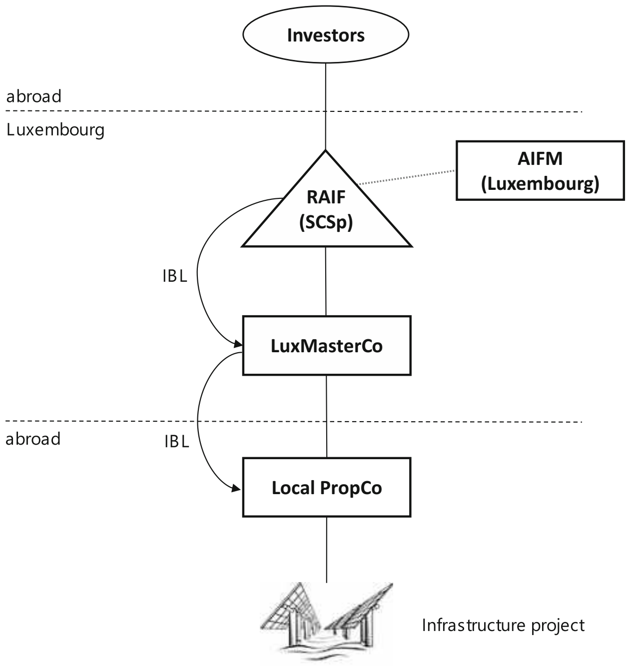

Given that the participations of the investors range between 4% and 8% (and there is no indication that the investors are acting together), the shareholding percentages should not be aggregated for the purposes of the related party test.[18]

Hence, the related party test is not met, and the reverse hybrid mismatch rule does not apply. Accordingly, there is no room for the application of the carve-out from the reverse hybrid mismatch rule (Article 168quater (2) of the LITL).

Variation I: The related party test

As a variation to the previous example, it is assumed that twelve institutional investors invested in the RAIF. The investors are resident in the Federal Republic of Germany, Switzerland and France, respectively.

While the RAIF in the legal form of an SCSp is treated as transparent from the perspective of the Federal Republic of Germany and Switzerland, the SCSp is viewed as opaque from a French tax perspective.

Three investors (institutional investors 1, 2 and 3) are part of the same group, whereas all the other investors are unrelated entities.

Luxembourg RAIF (SCSp)					
Investors	Country of residence	Classification of the Fund	Tax status	Tax treatment	Shareholding %
Members of Group X					
Institutional investor 1	Germany	transparent	taxable		20%
Institutional investor 2	France	opaque	taxable	Dividends are taxable upon distribution	20%
Institutional investor 3	France	opaque	taxable	Dividends are taxable upon distribution	20%
Other investors					
Institutional investor 4	Germany	transparent	taxable		7%
Institutional investor 5	Germany	transparent	taxable		5%
Institutional investor 6	Switzerland	transparent	tax exempt		5%
Institutional investor 7	Switzerland	transparent	taxable		4%
Institutional investor 8	Switzerland	transparent	taxable		4%
Institutional investor 9	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 10	France	opaque	taxable	Dividends are taxable upon distribution	4%
Institutional investor 11	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 12	France	opaque	taxable	Dividends are taxable upon distribution	3%
					100%

Institutional investors 1, 2 and 3 are associated enterprises and need, in principle, to be aggregated for the purposes of the related party test.

The other investors own less than 10% in the fund. Here, one may rely on the *de-minimis* rule to exclude their shareholding percentages for the purposes of the related party test.

Based on the above, only the shareholding percentages of institutional investors 1, 2 and 3 must be considered, amounting to an aggregate shareholding percentage of 60%. Nevertheless, as only 40% of these investors are resident in a jurisdiction that views the Luxembourg RAIF as an opaque entity (i.e. France), the related party test is not met in the present case. Hence, the reverse hybrid mismatch rule does not apply.

18. The *de minimis* rule under article 168ter (1) No. 18 of the LITL provides a carve-out from the acting together concept for investors that own less than 10% in an investment fund (unless the tax authorities can prove that the investors are actually acting together within the meaning of the acting together concept).

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Variation II: The related party test

As a variation to the previous example, it is assumed that institutional investors 1, 2 and 3 are resident in a jurisdiction that treats the RAIF as an opaque entity.

Luxembourg RAIF (SCSp)					
Investors	Country of residence	Classification of the Fund	Tax status	Tax treatment	Shareholding %
Members of Group X					
Institutional investor 1	France	opaque	taxable	Mark-to-market accounting treatment	20%
Institutional investor 2	France	opaque	taxable	Dividends are taxable upon distribution	20%
Institutional investor 3	France	opaque	taxable	Dividends are taxable upon distribution	20%
Other investors					
Institutional investor 4	Germany	transparent	taxable		7%
Institutional investor 5	Germany	transparent	taxable		5%
Institutional investor 6	Switzerland	transparent	tax exempt		5%
Institutional investor 7	Switzerland	transparent	taxable		4%
Institutional investor 8	Switzerland	transparent	taxable		4%
Institutional investor 9	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 10	France	opaque	taxable	Dividends are taxable upon distribution	4%
Institutional investor 11	France	opaque	taxable	Mark-to-market accounting treatment	4%
Institutional investor 12	France	opaque	taxable	Dividends are taxable upon distribution	3%
					100%

Institutional investors 1, 2 and 3 are associated enterprises and need, in principle, to be aggregated for the purposes of the related party test.

The other investors own less than 10% in the fund. Here, one may rely on the *de-minimis* rule to exclude their shareholding percentages for the purposes of the related party test.

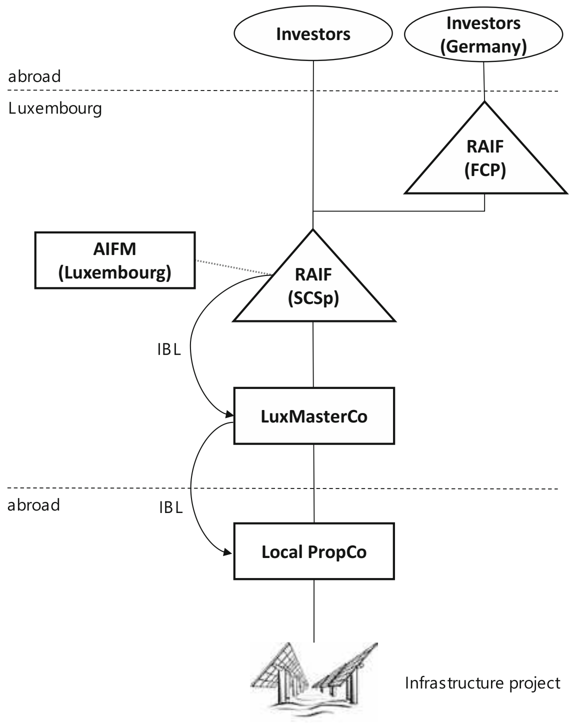
Based on the above, only the shareholding percentages of institutional investors 1, 2 and 3 must be considered, amounting to an aggregate shareholding percentage of 60%. As all of these investors are resident in a jurisdiction that views the Luxembourg RAIF as an opaque entity, the related party test (with a threshold of at least 50%) is met in the present case. Therefore, the reverse hybrid mismatch rule applies.

However, the three French investors that need to be considered include the income of the RAIF in their ordinary income either when the income is realised by the fund (mark-to-market accounting treatment that is followed for French tax purposes) or when the income is distributed by the fund (distributions are taxable income at the level of the investors). Consequently, the hybrid tax treatment of the RAIF in Luxembourg and in France does not result in a mismatch outcome. Therefore, no income should be included in the tax base of the RAIF.

Variation III: The feeder fund

As a variation to the previous example, it is assumed that two German institutional investors invest via a Luxembourg feeder fund, a RAIF established in the legal form of a Luxembourg FCP (i.e. a fund in contractual form), into the main fund. The two investors are passive investors that own respectively 60% (Investor A) and 40% (Investor B) in the FCP.

The FCP is treated as opaque from a German tax perspective, whereas the FCP is viewed as fiscally transparent from a Luxembourg tax perspective. Accordingly, the FCP is a hybrid entity in this case.



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Even though the two investors are passive investors that are not acting together (i.e. the investments would therefore not need to be aggregated for the purposes of the related party test), Investor A owns 60% in the FCP and satisfies on its own the related party test.

Should Investor A be a tax-exempt German pension fund, the reverse hybrid mismatch rule should not apply as it would not the hybrid nature of the FCP that is the reason for the non-taxation at the level of the investor.

Should Investor A be a taxable investor, the reverse hybrid mismatch rule may only apply to the extent the income of the FCP is not included in the ordinary income of Investor A (for example, upon a future distribution of profits).

Luxembourg funds that are subject to a specific regulatory framework (specialised investment funds, RAIFs, etc.) benefit from specific exemptions from CIT, municipal business tax ("MBT") and net wealth tax ("NWT") that are provided under the laws governing the different fund regimes.[19]

With the implementation of the reverse hybrid mismatch rule, there might be cases where a Luxembourg fund established in the legal form of a partnership or a FCP could fall within the scope of the reverse hybrid mismatch rule (if the carve-out for CIVs does not apply). However, even in such a case, a regulated Luxembourg fund[20] should not be subject to CIT.

The reverse hybrid mismatch rule is a specific anti-abuse rule that, when applicable, subjects fiscally transparent Luxembourg entities to CIT. As such, the reverse hybrid mismatch rule is part of the CIT system.

Given that the specific tax exemptions provided under the different fund laws are *lex specialis* with respect to the (corporate) income tax law, the CIT exemptions should take precedence over Article 168quater of the LITL. This is consistent with the *lex specialis* principle according to which specialized laws prevail over general laws.

It should be noted that Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 ("ATAD") regarding hybrid mismatches with third countries ("ATAD 2") does not provide any rule or commentary (in the explanatory memorandum) according to which tax exemptions provided under specific tax regimes should not apply when the conditions of the reverse hybrid mismatch rule are met.

Thus, even if the related party test is met and the hybrid nature of the Luxembourg entity results in a mismatch outcome, the specific CIT exemptions (provided under the laws governing the fund regimes) should discharge the application of the reverse hybrid mismatch rule.

Unregulated funds that are not subject to a special fund regime may, however, fall within the scope of the reverse hybrid mismatch rule.

3.2. Withholding tax

Distributions made by Luxembourg partnerships and other entities within the meaning of Article 175 of the LITL are not subject to Luxembourg withholding tax. This does not change even if the reverse hybrid mismatch rule applies.[21]

3.3. Municipal business tax

The reverse hybrid mismatch rule does not alter Luxembourg municipal business tax rules under which Luxembourg partnerships may be taxable depending on the activities performed. Luxembourg partnerships are subject to municipal business tax on profits derived from carrying on a commercial activity within the meaning of Article 14 (1) of the LITL through a PE situated in Luxembourg.

The carrying on of a commercial activity requires cumulatively an independent activity of a permanent character that is carried on with the intent of realizing profits and participation in the general economic life. Moreover, the activity must not qualify as an activity in the area of agriculture and forestry, independent services within the meaning of Article 91 of the LITL (for example, liberal professions) or wealth management.

Where a general partner of a Luxembourg (special) limited partnership is a Luxembourg company owning a stake of at least 5% in the partnership, the latter is deemed to generate commercial income.[22]

When a Luxembourg partnership realizes or is deemed to realize commercial income, the commercial income of the Luxembourg partnership is subject to Luxembourg municipal business tax at the level of the partnership.[23]

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19. See, for example, article 45 (1) of the Law of 23 July 2016 on reserved alternative investment funds.
20. This includes RAIFs that are not themselves subject to regulation but managed by a regulated Alternative Investment Fund Manager ("AIFM").
21. Article 146 (1) of the LITL refers to dividend payments within the meaning of article 97 (1) No. 1 of the LITL that are made by (corporate) entities listed in Articles 159 and 160 of the LITL. Nevertheless, Luxembourg entities that may be classified as reverse hybrid entities are entities within the meaning of article 175 of the LITL.
22. Article 14 (4) of the LITL.
23. Section 2 (1) of the Municipal Business Tax Law.

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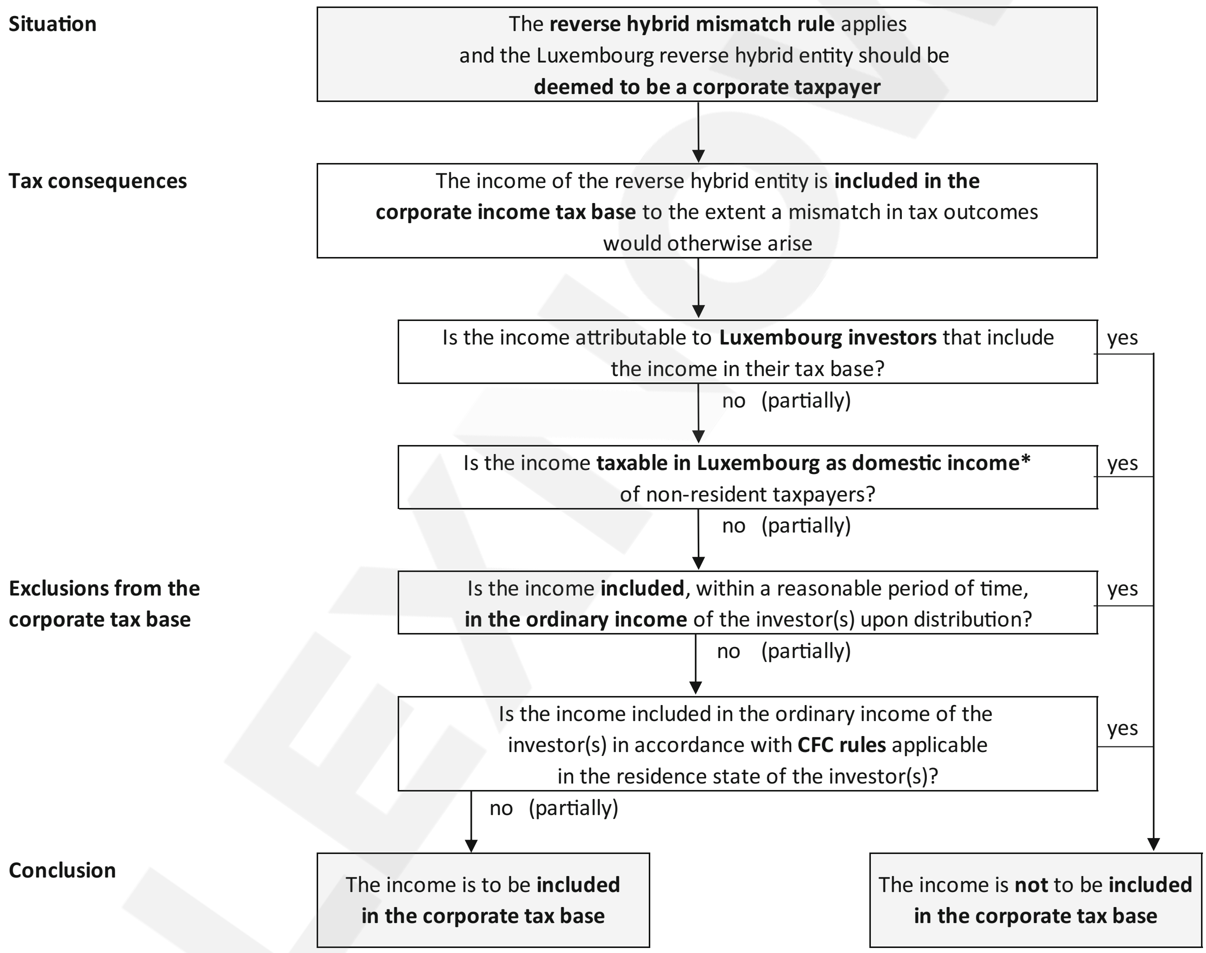
3.4. Net wealth tax

With regard to net wealth tax, the law provides for a specific exemption for entities that are treated as opaque in accordance with the reverse hybrid mismatch rule.[24] Thus, reverse hybrid entities are not subject to net wealth tax regardless of whether or not such entity is treated as a taxpayer for corporate income tax purposes.

3.5. Transparency for tax purposes

Entities within the meaning of Article 175 of the LITL (in particular, partnerships) are deemed to be transparent for Luxembourg tax purposes.[25] The reverse hybrid mismatch rule does not change this fundamental tax principle. When the reverse hybrid mismatch rule applies, a reverse hybrid entity remains (even from a corporate income tax perspective) transparent for those investors that do not trigger the mismatch in tax outcomes.

3.6. Checklist: Application of the reverse hybrid mismatch rules



* This would be the case if the reverse hybrid entity constitutes a Luxembourg PE for the non-resident investor(s). Here, the income of the non-resident investors would be taxable in Luxembourg.

** If and to the extent the income of the Luxembourg entity is included in the ordinary income of the investors upon distribution or under CFC rules applicable in the jurisdictions in which the investors are resident, there exists no mismatch in tax outcomes for the hybrid mismatch rule to apply to.

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24. Section 3 (1) No. 12 of the Net Wealth Tax Law.
25. Section 11bis of the Tax Adaptation Law.

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4. COOPERATION DUTIES OF THE TAXPAYER

According to Article 168quater (3) of the LITL, the taxpayer has the burden of proof that the reverse hybrid mismatch rule is not applicable. Therefore, it is for the taxpayer to provide the tax authorities, upon request, with all relevant elements such as tax returns, other tax related documents or tax certificates issued by foreign tax authorities so as to evidence that the reverse hybrid mismatch rule provided in Article 168quater (1) of the LITL is not applicable.

However, taxpayers should take a proactive stance in this respect and analyse the potential application of the reverse hybrid mismatch rule before an investment is implemented regardless of this "upon request" standard.

5. CONCLUSION

The reverse hybrid mismatch rule applies as from fiscal year 2022 and must also be considered in case of Luxembourg Alternative Investment Funds established in the legal form of a Luxembourg partnership or a fund established in contractual form (i.e. FCPs) that are viewed as fiscally transparent from a Luxembourg perspective.

The 2023 amendment of Article 168quater (1) of the LITL clarifies that the scope of the reverse hybrid mismatch rule is limited to situations where the hybrid nature of the Luxembourg entity is the reason for the mismatch outcome.

Thus, depending on the tax (exempt) status of the investor or the CIT regime applicable in the residence state of the investor, investors may need to be disregarded for the purposes of the related party test. This clarification is consistent with ATAD 2 (including the explanatory memorandum) that provides for the interpretational framework of the (reverse) hybrid mismatch rules.

Oliver R. HOOR is a Tax Partner (Head of Transfer Pricing and the German Desk) with ATOZ Tax Advisers (Taxand Luxembourg).

The author may be contacted at: oliver.hoor@atoz.lu

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