ATOZ

TAX ADVISERS

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INSIGHTS

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CONTENTS

EDITORIAL

Greetings,

The last few months of 2018 have been characterised by uncertainty due, notably, to the late implementation of the anti-tax avoidance directive ("ATAD"), the undefined timing for important tax changes such as those introduced by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("MLI") and by the new double tax treaty concluded with France. The recent Luxembourg elections and the adoption of DAC VI (the Directive on mandatory disclosure by tax intermediaries) added to the uncertainty.

In the course of December 2018 and January 2019, taxpayers have been provided with some answers:

- By the end of December 2018, the implementation of ATAD was finalised bringing along tax changes in the following fields: deductibility of interest payments; general anti-abuse rule; controlled foreign companies; hybrid mismatches and exit taxation. In addition, some "anti-BEPS" measures were introduced to close loopholes that created opportunities for double non-taxation;
- The delayed ratification (the ratification procedure being still ongoing) of both the France-Luxembourg double tax treaty and the MLI gives a little bit of time to the taxpayers to adapt to the upcoming changes; and
- Recent announcements of the Luxembourg government allow taxpayers to forecast some tax measures, planned to be introduced with effect as from 1 January 2019, including notably a 1% decrease of the corporate income tax rate.

However, many clarifications are still required. In these insights, we provide an overview of these different tax measures.

Following the Berlioz case law of the Court of Justice of the European Union ("CJEU"), the Luxembourg legislator has amended the Luxembourg rules on exchange of information upon request so as to bring them in line with EU law. We set out the main consequences of this new law.

The Luxembourg VAT Authorities have also released Circular n°790 in which they have provided some clarifications on the taxable basis to be considered in transactions involving related parties. We describe the scope of application of the new Circular and its implications.

The Luxembourg legislator passed the Luxembourg law of 13 January 2019 implementing Directive EU 2015/849 which requires the creation of a central register of beneficial owners of companies and legal entities. We summarise in these insights future obligations to be met, potential penalties in case of non-compliance and how we can assist you.

End of 2018, the Courts and Tribunals issued decisions in respect to interesting questions:

- The Administrative Tribunal ruled on the potential binding effect of verbal comments of the Luxembourg tax authorities. We analyse the decision in these insights.
- The Luxembourg Administrative Court referred several questions to the CJEU in respect of the Luxembourg tax consolidation regime. This case is interesting as it could result in a modification of the Luxembourg tax consolidation rules. In these insights, we detail the implications of this case law.
- Finally, the CJEU ruled that VAT incurred by a holding company on costs borne for the acquisition of shares in a subsidiary to which it intends to provide VAT taxable management services is fully deductible, even if ultimately these services are not rendered due to an unsuccessful share deal. We detail the consequences of this ruling.

We hope you enjoy reading our insights.

The ATOZ Editorial Team

LAW IMPLEMENTING ATAD ENTERS INTO FORCE

OUR INSIGHTS AT A GLANCE

- The law of 21 December 2018 implements the EU Anti-Tax Avoidance Directive ("ATAD"), the aim of ATAD being to implement the BEPS (Base Erosion and Profit Shifting) recommendations made by the OECD and the G20 in October 2015 at EU level.
- The new law introduces the following ATAD measures: a limitation to the tax deductibility of interest payments, an amendment to the current general anti-abuse rule, the introduction of the non-genuine arrangement CFC rule, a new framework to tackle hybrid mismatches and exit taxation rules.
- Non-ATAD (but still BEPS-related) measures included in the law are an amendment to Luxembourg rules so that the conversion of debt into shares no longer falls within the scope of tax neutral exchange operations and a new permanent establishment definition.
- Overall, Luxembourg has made the right choices, using all options provided by ATAD in order to remain competitive, even though, on some aspects the Luxembourg government has taken positions which are even stricter than ATAD. Additional work remains to be done in order to clarify the impact of some of the new measures on existing tax law.

The Luxembourg Parliament has now adopted the 2019 tax reform implementing the EU Anti-Tax Avoidance Directive ("ATAD") and other anti-BEPS-related measures into Luxembourg tax law. More precisely, the 2019 tax reform includes tax law changes in the following areas:

- Interest limitation rules;
- General anti-abuse rule (GAAR);
- Controlled foreign companies (CFCs);
- Hybrid mismatch rules;
- Amendment of the exit tax rules;
- Amendment of the roll-over relief; and
- Amendment of the permanent establishment definition.

The interest limitation rule

Since 1 January 2019, Article 168bis of the Luxembourg Income Tax Law ("ITL") limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30% of the corporate taxpayers' earnings[1] before interest, taxes, depreciation and amortisation ("EBITDA"). The scope of the interest limitation rule encompasses all interest-bearing debts irrespective of whether the debt financing is obtained from a related party or a third party. However, exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (that is a safe harbour provision).

"Exceeding borrowing costs" correspond to the amount by which the deductible "borrowing costs" of a taxpayer exceed the amount of taxable "interest revenues and other economically equivalent taxable revenues". Borrowing costs within the meaning of this provision include interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection 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 under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest;

[1] Tax exempt income such as dividends benefiting from the Luxembourg participation exemption regime is to be excluded when determining the EBITDA.

- amounts measured by reference to a funding return under transfer pricing rules where applicable;
- notional interest amounts 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.

As far as interest income and other economically equivalent taxable revenues are concerned, neither ATAD nor Luxembourg tax law provides for a clear definition of what is to be considered as "revenues which are economically equivalent to interest". However, given that borrowing costs and interest income should be mirroring concepts, the latter should be interpreted in accordance with the broad definition of borrowing costs.

Corporate taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs (the so-called escape clause that should protect multinational groups that are highly leveraged).

Moreover, according to a recent announcement of the Luxembourg government, the optional provision under ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (in case several companies form a fiscal unity) will be introduced within the upcoming six months with retroactive effect as from 1 January 2019.

1. *Entities excluded from the scope of the rule*

The interest limitation rule explicitly excludes financial undertakings and standalone entities from its scope.

Financial undertakings are the ones regulated by the EU Directives and Regulations and include among others financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities ("UCITS"), alternative investment funds ("AIF") as well as securitisation undertakings that are subject to EU Regulation 2017/2402.

Standalone entities are entities that (i) are not part of a consolidated group for financial accounting purposes and (ii) have no associated enterprise or permanent establishment. Thus, in order for a Luxembourg company to benefit from the standalone entity exception, it is necessary that none of the associated enterprises has directly or indirectly a participation of 25% or more.[2] It is interesting to note that the definition of associated enterprise for the purpose of the newly introduced provisions is defined very broadly including individuals, companies and transparent entities such as partnerships.

2. *Loans excluded from the scope of the rule*

According to Article 168 of the ITL, loans concluded before 17 June 2016 are excluded from the restrictions on interest deductibility. However, this grandfathering rule does not apply to any subsequent modification of such loans. Therefore, when the nominal amount of a loan granted before 17 June 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest limitation rules. Likewise, when the interest rate is increased after 17 June 2016, only the original interest rate would benefit from the grandfathering rule.

Nevertheless, when companies are financed by a loan facility that determines a maximum loan amount and an interest rate, the entire loan amount should be excluded from the scope of the interest limitation rules irrespective of when the drawdowns have been made.[3]

Moreover, loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rule.

3. *Carry forward mechanisms*

The interest deduction limitation rule also provides for a carry forward mechanism in regard to both non-deductible exceeding borrowing costs and unused interest capacity.

Non-deductible exceeding borrowing costs are interest expenses which cannot be deducted because they exceed the limits set in Article 168bis of the ITL. Such exceeding borrowing costs may be carried forward without time limitation and deducted in subsequent tax years.

Unused interest capacity arises in a situation in which the exceeding borrowing costs of the corporate taxpayer are lower than 30% of the EBITDA to the extent they exceed EUR 3m. These amounts can be carried forward for a period of 5 tax years.

In case of corporate reorganisations that fall within the scope of Article 170 (2) of the ITL (for example, mergers), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

General Anti-Abuse Rule (GAAR)

Effective from 1 January 2019, the Luxembourg abuse of law concept as defined in Section 6 of the Tax Adaptation Law ("Steueranpassungsgesetz") has been replaced by a new GAAR that keeps the key aspects of the previous abuse of law concept (according to which "the tax law cannot be circumvented by an abuse of forms and legal constructions") whilst introducing the concepts of the GAAR provided under ATAD.

[2] In this regard, participation means a participation in terms of voting rights or capital ownership of 25% or more or the entitlement to receive 25% or more of the profits of that entity.

[3] This should remain valid as long as the conditions of the loan facility are not amended after 17 June 2016.

According to the new provision, non-genuine arrangements or a series of non-genuine arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law shall be disregarded. Arrangements are considered as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

When the Luxembourg tax authorities can evidence an abuse in accordance with the new GAAR, the amount of taxes will be determined based on the legal route that is considered as the genuine route (i.e. based on the legal route which would have been put into place for valid commercial reasons which reflect economic reality).

In terms of scope, the new GAAR is broader than the GAAR provided under ATAD. While the latter only applies to corporate income taxes and taxpayers, the Luxembourg GAAR applies to all taxpayers and is not limited to corporate income tax.

However, in practice the scope of the new GAAR should be limited to clearly abusive situations and, in an EU context, to wholly artificial arrangements considering relevant jurisprudence of the Court of Justice of the European Union ("CJEU").

Controlled Foreign Company ("CFC") Rule

Companies that are part of the same group are generally taxed separately as they are separate legal entities. When a Luxembourg parent company has a subsidiary, the profits of the subsidiary are only taxable at the level of the parent company once the profits are distributed. Depending on the residence state and tax treatment of the subsidiary, dividend income may either be tax exempt (in full or in part) or taxable with a right to credit a potential withholding tax levied at source.[4] Thus, if a foreign subsidiary is located in a low-tax jurisdiction, the taxation of the profits of such entity may be deferred through the timing of the distribution.

In this regard, ATAD requires EU Member States to implement CFC rules that re-attribute the income of a low-taxed controlled company (or permanent establishment) to its parent company even though such income has not been distributed. However, EU Member States have a certain leeway when it comes to the implementation of the CFC rules. More precisely, legislators may choose between two alternatives regarding the fundamental scope of the CFC rules (i.e. the passive income option vs. the non-genuine arrangement option) and have the option to exclude certain CFCs.

1. *Definition of CFCs*

According to Article 164ter of the ITL, a CFC is an entity or a permanent establishment of which the profits are either not subject to tax or exempt from tax in Luxembourg provided that the following two cumulative conditions are met:

(i) In the case of an entity, the Luxembourg corporate taxpayer by itself, or together with its associated enterprises
a) holds a direct or indirect participation of more than 50% of the voting rights; or
b) owns directly or indirectly more than 50% of capital; or
c) is entitled to receive more than 50% of the profits of the entity (the "control criterion")

and

(ii) the actual corporate tax paid by the entity or permanent establishment is lower than the difference between (a) the corporate tax that would have been charged in Luxembourg and (b) the actual corporate tax paid on its profits by the entity or permanent establishment (the "low tax criterion").

In other words, the actual tax paid is less than 50% of the tax that would have been due in Luxembourg. Given the currently applicable corporate income tax rate of 18% (this rate should be reduced to 17% as from 2019 based on a recent announcement of the Luxembourg government), the CFC rule will only apply if the taxation of the profits at the level of the entity or permanent establishment is lower than 9% (8.5% as from 2019) on a comparable taxable basis.[5]

When assessing the actual tax paid by the entity or permanent establishment only taxes that are comparable to the Luxembourg corporate income tax are to be considered.[6]

2. *Exceptions*

The Luxembourg legislator adopted the options provided under ATAD according to which the following entities or permanent establishments are excluded from the scope of the CFC rules:

- An entity or permanent establishment with accounting profits of no more than EUR 750,000; or
- An entity or permanent establishment of which the accounting profits amount to no more than 10% of its operating costs for the tax period.[7]

3. *Determination and tax treatment of CFC income*

CFC income is subject to corporate income tax at a rate of currently 18%.[8] However, a specific deduction has been included in the municipal business tax law to exclude CFC income from the municipal business tax base.[9]

With regard to the fundamental scope of the CFC rules, Luxembourg has opted for the non-genuine arrangement concept. Accordingly, a Luxembourg corporate taxpayer will be taxed on the non-distributed income of an entity or permanent establishment which qualifies as a CFC provided that the non-distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

[4] Article 97 (1) No. 1 of ITL in connection with Article 166 (1) (Luxembourg participation exemption regime), Article 115 No. 15a (50% tax exemption for dividends received from certain subsidiaries when the conditions of the participation exemption regime are not met) or Article 134bis (tax credit) of the ITL.
[5] Article 164ter (1) of the ITL.
[6] Article 164ter (1) of the ITL.
[7] Article 164ter (1) of the ITL
[8] According to an announcement of the Luxembourg government, the corporate income tax rate should be decreased to 17% with retroactive effect as from 1 January 2019.
[9] Section 9 (3a) of the Luxembourg municipal business tax law.

In practice, this means that the profits of a CFC will only need to be included in the tax base of a Luxembourg corporate taxpayer if, and to the extent that, the activities of the CFC that generate these profits are managed by the Luxembourg taxpayer (i.e. when the significant people functions in relation to the assets owned and the risks assumed by the CFC are performed by the Luxembourg corporate taxpayer). Conversely, when a Luxembourg parent company does not carry out any significant people functions in relation to the activities of the CFC, no CFC income is to be included in the corporate income tax base of the Luxembourg parent company.[10]

When a Luxembourg corporate taxpayer is involved in the management of the activities performed by the CFC, the CFC income to be included by the Luxembourg corporate taxpayer should be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the Luxembourg taxpayer. Here, the attribution of CFC income shall be calculated in accordance with the arm's length principle[11].[12]

The income to be included in the tax base shall further be computed in proportion to the taxpayer's participation in the CFC and is included in the tax period of the Luxembourg corporate taxpayer in which the tax year of the CFC ends.

Last but not least, Article 164ter of the ITL provides for rules that aim to avoid the double taxation of CFC income (for example, when CFC income is distributed or a participation in a CFC is sold).

Anti-hybrid mismatch rules

The tax reform law further introduced a new Article 168ter ITL which implements the generic anti-hybrid mismatch provisions included in ATAD. The new provision aims to eliminate - in an EU context only - the double non-taxation created through the use of certain hybrid instruments or entities.

The law does not implement though the amendments introduced subsequently by ATAD 2 to ATAD which have replaced the anti-hybrid mismatch rules provided under ATAD and extended their scope of application to hybrid mismatches involving third countries. ATAD 2 provides for specific and targeted rules which have to be implemented by 1 January 2020. As such, the anti-hybrid mismatch rule provided in ATAD did not have to be implemented in 2019.

The objective of the measures against hybrid mismatches is to eliminate double non-taxation outcomes created by the use of certain hybrid instruments or entities. In general, a hybrid mismatch exists where a financial instrument or an entity is treated differently for tax purposes in two different jurisdictions. The effect of such mismatches may be a double deduction (i.e. a deduction in two EU Member States) or a deduction of the payment in one state without the inclusion of the payment in the other state.

However, in an EU context, hybrid mismatches have already been tackled through several measures such as the amendment of the Parent/Subsidiary-Directive (i.e. dividends should only benefit from the participation exemption regime if the payment is not deductible at the level of the paying subsidiary). Therefore, the hybrid mismatch rule included in the new Article 168ter ITL should have a limited scope of application. However, given the generic wording of the anti-hybrid mismatch rule, the latter may create significant legal uncertainty in 2019 even if the existence of a hybrid situation is not at all linked to tax motives.

1. *Rule applicable to double deduction*

To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the EU Member States in which the payment has its source. Thus, in case Luxembourg is the investor state and the payment has been deducted in the source state, Luxembourg will deny the deduction. However, this situation should hardly ever occur in practice.

2. *Rule applicable in case of deduction without inclusion*

When a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer jurisdiction. Therefore, if Luxembourg is the source state and the income is not taxed in the recipient state, the deduction of the payment will be denied in Luxembourg.

In practice, income that is treated as dividend income at investor level should, in accordance with the current version of the EU Parent/Subsidiary Directive, only benefit from a tax exemption if the payment was not deductible at the level of the Luxembourg company making the payment. Therefore, these situations should generally not occur in an EU context.

3. *How to benefit from a tax deduction in practice*

In order to be able to deduct a payment in Luxembourg, the Luxembourg corporate taxpayer will have to demonstrate that no hybrid mismatch situation exists. Here, the taxpayer will have to provide evidence to the Luxembourg tax authorities that either (i) the payment is not deductible in the other Member State which is the source state or (ii) the related income is taxable in the other Member State.

This evidence is primarily provided through the statements made in the corporate tax returns. Nonetheless, in practice the Luxembourg tax authorities may ask for further information and proof in this respect.

Exit taxation rules

The tax reform further provides for tax law changes in regard to exit taxation that will become applicable as from 1 January 2020.

[10] Article 164ter (4) No. 1 of the ITL.
[11] The arm's length principle is formally specified in Articles 56 and 56bis of the ITL.
[12] Article 164ter (4) No. 1 of the ITL.

These measures should discourage taxpayers from moving their tax residence and/or assets to low-tax jurisdictions. However, to a large extent, Luxembourg tax law provided already for exit tax rules.

1. *Rule applicable to transfers to Luxembourg*

As far as transfers to Luxembourg are concerned, a new paragraph has been added to Article 35 of the ITL providing that in case of a transfer of assets, tax residence or business carried on by a permanent establishment to Luxembourg, Luxembourg will follow the value considered by the other jurisdiction as the starting value of the assets for tax purposes, unless this does not reflect the market value.

The aim of this linking rule is to achieve coherence between the valuation of assets in the country of origin and the valuation of assets in the country of destination. While ATAD limits the scope of application of this provision to transfers between two EU Member States, the new provision added to Article 35 ITL covers transfers from any other country to Luxembourg.

2. *Rule applicable to contributions to Luxembourg*

The same valuation principles will also apply to contributions of assets ("supplements d'apport") within the meaning of Article 43 ITL. Thus, when assets are contributed to a Luxembourg company, the value considered in the jurisdiction of the contributing company or permanent establishment will be considered as value of the assets for tax purposes, unless this does not reflect the market value.

3. *Rule applicable to transfers out of Luxembourg*

As far as transfers out of Luxembourg are concerned, the tax reform law provides that a taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets at the time of the exit less their value for tax purposes in case of:

- A transfer of assets from the Luxembourg head office to a permanent establishment located in another country, but only to the extent that Luxembourg loses the right to tax the transferred assets;
- A transfer of assets from a Luxembourg permanent establishment to the head office or to another permanent establishment located in another country, but only to the extent that Luxembourg loses the right to tax the transferred assets;
- A transfer of tax residence to another country except for those assets which remain connected with a Luxembourg permanent establishment; and
- A transfer of the business carried on through a Luxembourg permanent establishment to another country but only to the extent that Luxembourg loses the right to tax the transferred assets.

In case of transfers within the European Economic Area (EEA), the Luxembourg taxpayer may request to defer the payment of exit tax by paying in equal instalments over 5 years. Section 127 of the General Tax law ("Abgabenordnung") is amended accordingly.

Amendment of the Luxembourg roll-over relief

Article 22bis of the ITL provides for exceptions to the general rule that Luxembourg taxpayers have to realise latent capital gains linked to assets that are exchanged for other assets. As from 2019, the provision applicable to a specific category of exchange operations involving the conversion of a loan or other debt instruments into shares of the borrower has been abolished.

Hence, the conversion of debt instruments into shares of the borrowers will no longer be possible in a tax neutral manner. Instead, the conversion will be treated as a sale of the debt instrument followed by a subsequent acquisition of shares. Accordingly, any latent gain on the debt instrument will become fully taxable upon the conversion.

The amendment of Article 22bis of the ITL follows the State Aid investigations of the EU Commission in the Engie case. However, while the aim of this amendment is to ensure that double non-taxation outcomes can no longer arise from this provision, it would have been wise to implement more targeted measures to avoid collateral damages.

Amendment of the Permanent Establishment definition

As a last measure, the definition of permanent establishment under Luxembourg tax law (Section 16 of the Tax Adaptation Law) has been amended. Under the amended permanent establishment definition, the criteria to be considered in order to assess whether a Luxembourg taxpayer has a permanent establishment in a country with which Luxembourg has concluded a tax treaty are the criteria defined in the tax treaty itself. In other words, the permanent establishment definition included in the tax treaty will be relevant.

Furthermore, unless there is a clear provision in the relevant tax treaty which is opposed to this approach, a Luxembourg taxpayer will be considered as performing all or part of its activity through a permanent establishment in the other contracting state only if the activity performed, viewed in isolation, is an independent activity which represents a participation in the general economic life in that contracting state. However, tax treaties concluded by Luxembourg generally include the permanent establishment definition provided in Article 5 of the OECD Model Convention that does not entail such requirement. Thus, the amendment of the Luxembourg PE definition should have no material impact in practice.

Finally, the Luxembourg tax authorities may request from the taxpayer a certificate issued by the other contracting state according to which the foreign authorities recognise the existence of the foreign permanent establishment.[13] Such certificate is, in particular, to produce when Luxembourg adopted the exemption method in a tax treaty and the other contracting state interprets the rules of the tax treaty in a way that excludes or limits its taxing rights. This is to avoid hybrid branch situations that are recognised in Luxembourg but disregarded in the host state of the permanent establishment.

Conclusion

ATAD required EU Member States to implement certain anti-BEPS measures into their domestic tax law and provided some leeway to choose among a number of implementation options. Overall, Luxembourg has made the right choices, using all options beneficial to taxpayers that will help the Grand Duchy to remain competitive.

However, in few cases the Luxembourg legislator took positions which are even stricter than that what was required by ATAD. For example, instead of implementing the anti-hybrid mismatch rules provided in ATAD 2 as from 2020, the tax reform provides for the generic hybrid mismatch rule included in ATAD. Ironically, this rule needs to be replaced only one year later by the detailed anti-hybrid mismatch rules provided in ATAD 2. Although the impact of this measure should be limited, the generic nature of the anti-hybrid mismatch rule may create severe legal uncertainty in some cases.

Additional work remains to be done in order to clarify the views of the Luxembourg tax authorities on the interpretation of some of the new rules and the impact of certain of these rules on existing tax law. In this regard, it is expected that the Luxembourg tax authorities will release Tax Circulars with additional guidance in 2019.

Considering that these changes became effective in January 2019, Luxembourg taxpayers should urgently analyse the impact of the upcoming changes on their investments and business activities and take appropriate action where necessary.

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[13] This certificate should mainly evidence that the permanent establishment is recognized in the other contracting state. As there is generally no subject to tax requirement in tax treaties concluded by Luxembourg, the tax treatment of the income derived through the permanent establishment in the host state thereof should be irrelevant for the tax treatment in Luxembourg.

2019 TAX FORECASTS

OUR INSIGHTS AT A GLANCE

- The ratification procedures of the new France-Luxembourg tax treaty and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("MLI") have been launched in the course of 2018 but could not be finalised prior to the end 2018. However, this is expected to happen in 2019.
- The slightly delayed ratification of these treaties will have an impact on the date as from when the related changes to be introduced will become applicable, most probably and, in most cases, 1 January 2020.
- Finally, some other tax changes are expected in 2019 following some recent announcements of the Luxembourg government, some of which are planned to be introduced with retroactive effect as from 1 January 2019, such as the 1% decrease of the corporate income tax rate.

New France-Luxembourg tax treaty to apply as from 1 January 2020 at the earliest

In October and November 2018 respectively, France and Luxembourg launched the ratification process of the new double tax treaty ("DTT") they signed on 20 March 2018. The aim of the new DTT is to replace the existing treaty that was signed in 1958, and amended 4 times in subsequent years. The DTT follows the structure and, for the most part, the content of the 2017 OECD Model Tax Convention.

Since both France and Luxembourg did not manage to finalise the ratification process and exchange the instruments of ratification prior to the end of 2018, the new DTT has not yet entered into force and thus did not become applicable as from 1 January 2019, as initially expected. Instead, provided the instruments of ratification will be exchanged before the end of 2019, the new provisions will apply as from 1 January 2020.

The DTT shall enter into force on the date on which the latter of these notifications has been received. Assuming that this will take place in the course of 2019, as far as Luxembourg is concerned, the new DTT shall have effect as follows:

- in respect of taxes withheld at source, for income derived on or after 1 January 2020; and
- in respect of other taxes on income and taxes on capital, for taxes chargeable for any taxable year beginning on or after 1 January 2020.

To get an overview of the provisions of the new DTT, please read our 16 November 2018 tax alert: https://www.atoz.lu/sites/default/files/atoz_articles/atoz-alert-16112018-lux-france-dtt.pdf

MLI will impact covered tax treaties by 1 January 2020 at the earliest

The draft law ratifying the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("MLI") was presented to the Luxembourg Parliament on 3 July 2018 and passed by the Parliament on 14 February 2019. The ratification of the MLI follows its signature by Luxembourg which took place on 7 June 2017.

The MLI is a comprehensive and flexible convention that allows countries to implement a wide range of tax treaty related BEPS measures with many options and alternatives. Luxembourg took the approach to have all its DTTs in force covered by the MLI. However, for a covered tax treaty to be amended, it is required first that both contracting states decide to have this specific DTT covered and second that both countries adopt matching options/alternatives. Hence, if one contracting state is in favour of a certain provision while the other contracting state has not adopted an identical option/alternative, the existing tax treaty will not be amended in this respect. In our tax alert dated 9 June 2017, we presented the approach taken by Luxembourg: https://www.atoz.lu/sites/default/files/atoz_articles/atoz_tax_alert_2017_09_june_mli.pdf

The ratification procedure has not been finalised yet. However, now that the law has been passed by the Parliament, it can be expected that Luxembourg will deposit its instruments of ratification either by the end of February or in the course of March 2019.

Assuming that Luxembourg will deposit the instruments of ratification in February 2019, what would this mean for the Luxembourg DTTs covered by the MLI?

- For Luxembourg, the MLI would enter into force on the 1st day of the month following the expiration of a period of 3 calendar months beginning on the date of the deposit, i.e. the MLI would enter into force on 1 June 2019;
- the entry into force of the MLI would only affect covered DTTs concluded with countries in respect of which the MLI has entered into force as well; to check the status of ratification by all countries which signed the MLI, please click here: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf
- As far as the application of the MLI to the DTTs referred above is concerned (i.e. to DTTs concluded with countries for which the MLI has already entered into force or will enter into force at the latest at the same time as in Luxembourg), the MLI would apply as follows:

- with respect to taxes withheld at source on amounts paid or credited, where the event giving rise to such taxes occurs on or after <u>the first day of the next calendar year that begins on or after the latest of the dates on which this Convention enters into force</u> for each of the DTT contracting States (**i.e. 1.1.2020**);
- with respect to all other taxes, for taxes levied with respect to <u>taxable periods beginning on or after the expiration of a period of six calendar months from the latest of the dates on which the MLI enters into force</u> for each of the DTT contracting States (**i.e. tax years beginning on or after 1.12.2019**). For companies with a tax year corresponding to the calendar year, this would mean that the MLI provisions would impact the DTT as from the tax year beginning on 1 January 2020.

Should the deposit of the instruments of ratification take place in the course of March 2019, the entry into force of the MLI would take place on 1 September 2019 and the MLI provisions would become applicable as from tax years starting on or after 1 January 2020.

Should the deposit of the instruments of ratification be delayed until April 2019, the entry into force of the MLI would take place on 1 August 2019 and the MLI provisions would become applicable as from tax years starting on or after 1 February 2020. For companies with a tax year corresponding to the calendar year, this would mean that the MLI impact would be differed until tax year 2021.

However, since the deposit of the instruments of ratifications will most probably occur before the end of March 2019, it can be expended that the MLI changes will apply as from 1 January 2020.

More to come in 2019 and beyond

On 3 December 2018, the coalition agreement of the recently elected Luxembourg government was signed, including several tax measures, which the government intends to introduce in the course of the upcoming 5 years.

While for most measures the date as from which they will be introduced remains to be confirmed, some few other are expected to be introduced with retroactive effect as from 1 January 2019:

- Decrease of 1% of the CIT rate (of currently 18%) as from 2019; taking into account the 7% solidarity surcharge as well as the Municipal Business Tax of 6.75% for Luxembourg-city, this would bring the aggregate corporate tax rate from currently 26.01% down to 24.94%;
- Application of the reduced CIT rate of 15% to taxable corporate income not exceeding EUR 175,000 (instead of currently EUR 25,000), meaning that an increased number of Luxembourg companies will be able to benefit from the reduced 15% CIT rate;
- Taxation at EU and global level: adaptation of the Luxembourg tax system to recent and upcoming developments both at EU level (ATAD 1 & 2, EU Directive Proposals on the Common Corporate Tax base, CCTB, and the Common Consolidated Corporate Tax base, CCCTB) and at international level (BEPS); no opposition to the temporary solution on digital taxation proposed by the EU to the extent it is limited in time; opposition to the introduction of a financial transaction tax (FTT);
- Simplification of the income tax and corporate income tax system to make it more user-friendly;
- Modernisation of the tax regime applicable to charities and non-profit organisations;
- Making sure to counteract abuses when using the tax regime of SICAV-SIFs for investments in Luxembourg real estate;
- Improvement of the tax regime applicable to impatriates to make it more attractive;
- Adoption of a new law to promote the participation of employees to the profits of their companies. As a consequence, it is intended to withdraw progressively the stock option/warrant regime;
- Introduction of a 3% VAT rate on E-books and home repairs;
- No increase of the subscription tax applicable to UCITS or alternative investment funds and, development of the alternative investment fund sector, with a specific focus on the legal and regulatory aspects; and

- Review of the regime of "carried interest" for individuals working in the alternative investment fund sector in order to assess whether improvements of the regime are needed so as to attract "front office" individuals to Luxembourg.

Other individual tax measures:

- Reform of the individual tax class system;
- Promotion and further development of the e-filing system for individual taxpayers;
- Launching of some negotiations with France and Germany to make it easier for cross-border workers to work from home;
- Review of the inheritance and gift tax regime applicable to transfers other than in direct line so as to take into account the evolution of house prices; and
- Increase of the minimum monthly wage with effect from 1 January 2019.

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LUXEMBOURG RULES ON EXCHANGE OF INFORMATION UPON REQUEST AMENDED

OUR INSIGHTS AT A GLANCE

- In 2017, a decision of the Court of Justice of the European Union made clear that the Luxembourg rules applicable to exchange of information upon request were not in line with EU law.
- On 14 February 2019, the draft law aiming at bringing Luxembourg rules in line with EU law was passed by the Parliament.
- Based on the new rules, the Luxembourg tax authorities have to check the foreseeable relevance of the information requested by foreign tax authorities and information holders can contest information requests received from the Luxembourg tax authorities.

Following the decision of the Court of Justice of the European Union ("CJEU") of 16 May 2017 in the Berlioz case (C-682/15), the Luxembourg legislator had to amend the Luxembourg rules on exchange of information upon request so as to bring them in line with EU law.

Following a legislative procedure which took more than one year with several amendments introduced by both the government and the parliament, on 14 February 2019, the draft law was finally voted.

Foreseeably relevance of information requests

Back in December 2013, Luxembourg received criticism from the Global Forum on Transparency and Exchange of Information. The report of the Global Forum highlighted that "the interpretation of the foreseeably relevant standard in Luxembourg is unduly restrictive and prevents it from engaging in effective exchange of information in line with the international standards in certain cases".

Blamed for an unduly restrictive interpretation of the concept of foreseeable relevance, Luxembourg reacted quickly and passed a law that would guarantee an efficient mechanism of exchange of information upon request: the law of 25 November 2014 made sure that the Luxembourg tax authorities were no longer allowed to assess the pertinence of the information requested. In other terms, tax inspectors were no longer allowed to decline a request from a foreign authority on the grounds that the requested information lacked relevance. They were only allowed to verify if the request satisfied the formal conditions, as defined in the relevant tax treaty or law provision.

Less than three years later, the EU conformity of the new Luxembourg rules was assessed by the CJEU which ruled that the "foreseeable relevance of the information requested by one Member State from another Member State is a condition which the request for information must satisfy in order for the requested Member State to be required to comply with that request, and thus a condition of the legality of the information order addressed by that Member State to a relevant person and of the penalty imposed on that person for failure to comply with that information order."

As a consequence of the CJEU decision, an obligation has been reintroduced into the Luxembourg exchange upon request legal framework according to which the tax authorities have to verify that the condition of foreseeable relevance is met prior to sending an information request to the information holder.

Legal remedies against information requests

As a second consequence of the criticism expressed by from the Global Forum on Transparency and Exchange of Information against Luxembourg, since the law of 25 November 2014, there were no longer any legal remedies against information requests sent by the Luxembourg tax authorities to information holders but only remedies against the fine for not having provided the requested information.

The draft law released by the end of 2017 as a reaction to the criticism raised in the Berlioz decision on the lack of an effective judicial remedy initially reintroduced a possibility for any person concerned by the information request to contest the information request (e.g. on the ground that the information request would not meet the foreseeable relevance principle) before Luxembourg courts. However, over the legislative process, the Luxembourg legislator decided to go a step back and to grant this possibility only to the information holder and no longer to any other person concerned (such as the taxpayer itself). This happened as a reaction to the comments made by the State Council on the draft law according to which this would go beyond what the Berlioz case-law requested. In our view, this is unfortunate since it remains to be confirmed whether this really goes beyond what EU rules require (in the Berlioz case, the information holder was not a service provider but it was the taxpayer itself). In addition, the Luxembourg legislator could have considered going beyond what was required according to the Berlioz decision and the additional issues raised by the State Council in this respect could have been solved by means of other amendments to the draft law.

Following this second amendment to the exchange of information procedure, Luxembourg courts will have to rule on both the legality of information request and the fine that may be charged for not providing the information requested.

Implications and next steps

While the changes introduced by the Luxembourg legislator are globally positive, in our view, it would have been wiser to reintroduce for both the information holder and the taxpayer concerned the possibility to challenge information requests (as it was the case under the procedure applicable prior to the law of 25 November 2014). In addition, it would have been advisable to introduce an obligation of the Luxembourg tax authorities to notify their information request not only to the information holder but also to the taxpayer(s) concerned each time the foreign tax authorities are not opposed to it.

Whether the amended procedure of exchange of information upon request is now in line with EU law remains to be confirmed. Luxembourg information holders to which a penalty was applied for not having provided the requested information did not await the amendments of the Luxembourg rules on exchange of information to challenge before the Luxembourg courts the foreseeable relevance of the information injunctions received on the basis of the Berlioz case law.

In this context, in a recent case involving an information request of the Swiss tax authorities, on 10 January 2019, the Luxembourg Tribunal referred 2 questions to the Luxembourg Constitutional Court on the conformity of the law of 25 November 2014 to the Luxembourg Constitution in so far as it provides for a prohibition to challenge an injunction of the Luxembourg tax authorities to provide information. Depending on how the Constitutional Court will conclude, additional changes to the rules applicable to exchanges of information upon request may come in the near future.

In addition, following to a decision of the Administrative Tribunal dated June 2018[14], if confirmed in future case law, the absence of an appeal for the taxpayer(s) concerned under the new law on exchange of Information could still be found to be contrary to Article 47 of the Charter of Fundamental Rights of the European Union concerning the right to fair trial and an effective remedy.

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[14] Decision of the Administrative Tribunal of 26 June 2018 n°39888 according to which persons other than the information holder can have a direct and personal interest to act before a court to challenge an information request of the Luxembourg tax authorities to the extent that they are concerned by the request. Therefore, they should be allowed to dispute an information request.

VAT CIRCULAR N°790 DATED 18 JANUARY 2019 – FAIR MARKET VALUE AND VAT

OUR INSIGHTS AT A GLANCE

- The Luxembourg VAT Authorities released Circular n°790 in which they have provided some clarifications on the taxable basis to be considered in transactions involving related parties.
- The Circular requires that transactions involving related parties be charged at "open market value". If this was not the case, the VAT authorities would be entitled to take into consideration that "open market value" and to reconsider the VAT deductible rights of the taxable person.
- Related parties should properly reflect that the fees agreed or charged are consistent with the open market value criteria.

On 18 January 2019, the Luxembourg VAT Authorities released Circular n°790 (hereafter "the Circular") in which they have provided some clarifications on the taxable basis to be considered in transactions involving related parties. This Circular comments on the 2018 Luxembourg VAT Law amendments establishing new VAT rules for transactions between related parties.

Purposes of the new regime

These new rules aim at avoiding fraudulent or abusive situations that could lead to undue VAT advantages. The typical situations for which the above-mentioned anti-abusive rules have been implemented are, for instance, cases where the VAT deduction right could be positively impacted by an artificial increase of the fees charged for transactions allowing a full VAT recovery, or the situation where the fees subject to VAT invoiced to entities without VAT deduction right are artificially decreased to lower the VAT cost for these entities.

The concept of "open market value"

The key concept surrounding these new rules is the concept of "open market value". This notion is defined by the Luxembourg VAT Law and the VAT Directive as "the full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm's length within the territory of the Member State in which the supply is subject to tax".

Scope of application and impacts

In terms of scope, the Circular and the related legal provisions apply in situations where two cumulative conditions are met.

The first condition relates to the persons involved in the transaction and the links between each other. The transaction shall be carried out between related persons. This first condition is fulfilled where the transaction is performed between persons bound by family links (or other closed personal links), organisational, ownership, affiliate or financial links as well as legal relationships.

The second condition concerns the transaction itself and the VAT recovery right of the entities involved. The new regime applies in the three following situations:

- The purchaser of the goods or services does not have a full VAT recovery right and the fees invoiced for the transaction (i.e. the VAT taxable services) are below the open market value;

- The company providing both VAT taxable (with VAT recovery right) and VAT exempt (without VAT recovery right – e.g. EU financing, regulated fund management services, etc.) services charges a fee lower than the normal value for the VAT exempt turnover in order to indirectly increase its VAT recovery right;
- The company providing both VAT taxable (with VAT recovery right) and VAT exempt (without VAT recovery right – e.g. EU financing, regulated fund management services, etc.) services charges a fee higher than the normal value for the VAT taxable turnover in order to indirectly increase its VAT recovery right.

In cases where the Circular and the related legal provisions apply, the consideration to be taken into consideration for VAT purposes is the open market value, regardless the value of the fees agreed or charged. Should this not be the case, the VAT authorities would be entitled to reconsider the taxable basis of the transactions in light of that open market value concept and to draw the relevant conclusions regarding the VAT deduction rights of the parties involved.

Action required

Transactions involving related parties shall henceforth be closely monitored not only from a transfer pricing perspective but also from a VAT standpoint in order to properly reflect that the fees agreed or charged are consistent with the open market value criteria and thus do not trigger issues in terms of VAT deduction right and VAT liability.

Transfer pricing, in general, has become increasingly important since 2011 when the Luxembourg tax authorities released a first Circular on the tax treatment of entities carrying out financing activities. Over the years, the Luxembourg legislator implemented several tax law changes in regard to transfer pricing that formalise the application of the arm's length principle and the relevance of the OECD Transfer Pricing Guidelines. This inevitably exerts pressure on taxpayers to find a balance between a comfortable level of security and the costs for the preparation of sound transfer pricing documentation.

In practice, Luxembourg companies should screen major intra-group transactions in order to identify issues that could raise suspicion on the part of the Luxembourg tax authorities and assess the magnitude of tax risks.

If you would like to discuss the impact of the Circular or, more generally, of transfer pricing on your business, please feel free to contact Thibaut Boulangé (thibaut.boulange@atoz.lu), Oliver R. Hoor (oliver.hoor@atoz.lu) or Christophe Darche (christophe.darche@atoz.lu).

LUXEMBOURG LAW IMPLEMENTING DIRECTIVE EU 2015/849 – CREATION OF A CENTRAL REGISTER OF BENEFICIAL OWNERS OF COMPANIES AND LEGAL ENTITIES

OUR INSIGHTS AT A GLANCE

- The Luxembourg Parliament has adopted the law implementing Directive EU 2015/849 which requires the creation of a central register ("RBE") of beneficial owners ("BO") of companies and legal entities.
- The new law introduces the obligation for concerned entities to maintain a BO file at the entity's registered office and to register certain beneficial owners' information with the RBE, within certain deadlines.
- The RBE will be managed by the Luxembourg Trade and Companies Register and will be publicly available.
- We can help you fulfil your obligations.

The Luxembourg law of 13 January 2019 implementing Directive EU 2015/849 (the "Law") requires the creation of a central register of beneficial owners of companies and legal entities.

Creation of a beneficiary register named "RBE"

The RBE will be managed by the Luxembourg Trade and Companies Register ("RCSL") which will be responsible for maintaining information on the beneficial owners ("BO") of all entities registered in Luxembourg (SA, SCA, SARL, SCS, SCSp, SE, SNC, GIE, SAS, SC, FCP, Luxembourg branches created by foreign entities and associations) (the "Concerned Entities").

According to the Grand Ducal Regulation of 15 February 2019, registration of information via the RCSL will need to be done online, via the website of the RCSL.

Information to be registered with the RBE

A BO is to be considered as a natural person who ultimately holds a shareholding, controlling interest or ownership interest of at least 25% plus one share in a Concerned Entity. To the extent no such person exists, the person(s) holding senior managerial positions (Dirigeant Principal) in the Concerned Entities are considered as BO and must be recorded accordingly.

The following information will have to be registered for each BO: identity (name, first name, nationality, date and place of birth, country of residence, professional or personal address, official identification number), as well as the nature and extent of the beneficial interests held.

Listed entities will only need to register the name of the market on which the shares are traded.

According to the above-mentioned Grand Ducal Regulation, the supporting documents that must be submitted together with the filing will include official ID documents and/or a document certifying that the company is listed on a regulated market.

Maintenance of a BO file at the entity's registered office

Concerned Entities must keep an up-to-date BO file at their registered office, containing the same information as that which has been filed with the RBE. These files must be maintained at a Luxembourg address indicated in the liquidation (or migration) deed for a period of five years after the Concerned Entity's liquidation (or migration).

Timing for the registration of the BO information with the RBE

All Concerned Entities have until 31 August 2019 to comply with the registration obligations.

Any change to the BO information must be registered with the RBE within one month from the date the change was known or should have been known by the entity.

Any newly incorporated company will have to proceed with registration one month following its creation. The Law imposes hefty fines for non-compliance with obligations.

Any lack of or late filing, non-compliance with the BO file preservation obligation, any deliberately wrong, incomplete or non-updated filing will be sanctioned by fines ranging from EUR 1,250 to EUR 1,250,000 which can be imposed on noncompliant Luxembourg entities and/or their representatives. Non-compliance can also be reported by the RCSL to the Luxembourg prosecutor's office.

Access to the RBE

The RBE will be accessible to the public, with the exception of the following information: the personal or professional address and national identification number.

A request to limit such access can be submitted where such access would expose the beneficial owner to a disproportionate risk, compared to risk of fraud, of kidnapping, blackmail, extortion, harassment, violence or intimidation or where the beneficial owner is a minor or otherwise incapacitated.

How we can help you fulfil your obligations

- Determination on who shall be considered as beneficial owner(s) in given structures;
- Preparation and compilation of the information and supporting documents to be filed based on information provided by the client;
- Quality and consistency check of the client's completed information and supporting documents, prior to filing;
- Handling the filing with the RBE;
- All of the above when updates are necessary;
- Review, analysis and problem-solving in case of refusal from the RBE;
- Preparation, quality and consistency review of beneficial owner files kept by entities at their registered office;
- Safekeeping of beneficial owner information on behalf of liquidated or migrated entities during the mandatory five-year period after their liquidation or migration; and
- Assistance in replying to requests from register/national authorities/self-regulation bodies/professionals in the context of beneficial owner information.

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DO VERBAL CONFIRMATIONS HAVE ANY BINDING EFFECT ON THE TAX AUTHORITIES? A RECENT JUDGEMENT PROVIDES THE ANSWER

OUR INSIGHTS AT A GLANCE

- The Luxembourg Administrative Tribunal ruled on the potential binding effect of verbal comments of the Luxembourg tax authorities, clarified under which conditions one may consider that a binding agreement has been reached and concluded that there was no binding effect.
- The Tribunal also analysed whether equity tainted loans had to be considered as an equity investment in the subsidiary or as a debt. In this context, the decision clarifies the well-established economic / substance over form approach in tax matters.

In a decision of 13 December 2018, the Luxembourg Administrative Tribunal ruled on the potential binding effect of verbal comments of the Luxembourg tax authorities regarding the tax qualification (as equity vs. debt) of equity tainted loans ("ETL") granted by a Luxembourg corporate taxpayer to its Luxembourg subsidiaries.

No binding effect on the tax authorities

In 2011, the taxpayer had two meetings with the tax authorities during which a planned investment and the related tax consequences were discussed. It is worth noting that at the time, the advance tax clearance procedure had not yet been formalised (it was introduced as from 2015).

Seven months after the two meetings, the tax advisor of the taxpayer sent a letter ("statement of tax consequences") to the Luxembourg tax authorities seeking to confirm that the ETLs qualify as equity for Luxembourg tax purposes. The letter ended with the following statement: "*We agreed that we can consider the above-described tax treatments to be fully in line with the interpretation of the Luxembourg tax law by Office VI (as of today), if we do not receive within 6 weeks a letter from your side outlining a different view.*" The Luxembourg tax authorities did not reply nor react in any other form to the letter, so the taxpayer considered that an agreement had been reached on the ETL equity treatment.

In the course of 2012, a tax inspector of the tax office in charge sent an email to the tax advisor of the taxpayer according to which there would be no reason for not considering the ETL as equity.

Still, in the 2014 net wealth tax assessment of the taxpayer, the tax authorities did not follow the tax treatment described in the statement of tax consequences and qualified the ETLs as loans fully subject to net wealth tax.

The Tribunal referred to the four cumulative conditions required by previous case-law in order to analyse whether a statement made by the tax authorities is binding on them in accordance with the principle of legitimate expectations and legal certainty:

- A written request including all relevant facts so as to enable the tax authorities to analyse the situation properly ;
- A feedback of the tax authorities provided by a duly qualified officer or an officer the taxpayer may reasonably consider as competent ;
- A clear intention of the tax authorities to issue a binding opinion ;
- A feedback provided by the tax authorities which influenced significantly the decision of the taxpayer.

In the case at hand, the Tribunal concluded that these cumulative conditions were not met. The statement of tax consequences is a unilateral document prepared by the tax advisor on behalf of the taxpayer so that no agreement was reached with the tax authorities. In addition, given that the ETLs were granted prior to the statement of tax consequences and before the tax advisor received the email of the tax inspector, it was quite clear that the position of the tax authorities did not influence significantly the decision of the taxpayer to grant the ETLs.

As a consequence, the taxpayer could not rely on any agreement reached with the tax authorities in order to qualify the ETLs as equity for Luxembourg tax purposes.

Equity qualification of Equity Tainted Loans

The tribunal analysed whether the ETLs, based on their terms and conditions, had to be considered as either an equity investment in the subsidiary or as a debt (i.e. a loan granted to the subsidiary).

The ETLs had the following characteristics:

- No interest rate during a six-month period - afterwards review of the interest rate;
- Conversion of the ETL into shares at the option of the borrower;
- Fixed term of 60 years;
- Subordination.

According to the taxpayer and its tax advisor, as mentioned in the statement of tax consequences, the following tax qualification was to be given to the ETLs:

- The ETLs qualify as equity for income and net wealth tax purposes;
- The ETLs are considered as a participation within the meaning of the participation exemption regime (Article 166 Income Tax Law and Grand-Ducal Regulation of 21 December 2001 and Section 60 of the Valuation Law) so that potential remuneration or capital gains on the ETL (if any) would be tax-exempt income and the principal amount of the loan would be exempt from net wealth tax;
- The ETLs qualify as equity for debt/equity ratio purposes.

To motivate the equity qualification of the ETLs, the taxpayer mainly argued that:

- In line with the well-established administrative practice (based on numerous tax rulings granted in the past), loans with similar features as the ETL (interest-free, maturity exceeding 50 years, convertible, stapling clause) are to be considered as equity for Luxembourg tax purposes; adopting a different approach would go against the principle of equality in tax matters;
- The ETLs have to be considered as a participation based on the economic approach.

The tribunal rejected the argument based on the principle of equality in tax matters since the taxpayer did not provide any evidence of such administrative practice.

However, referring to the parliamentary documents on the Income Tax Law, after having performed an economic analysis of the ETLs, the tribunal confirmed the position of the taxpayer according to which the ETLs had to be re-qualified into a hidden capital contributions and thus into equity for Luxembourg tax purposes. As a consequence, the ETLs were to be considered as an additional participation in the subsidiary which could benefit from the participation exemption regime for both corporate income tax and net wealth tax purposes.

Lessons to be learned

The decision of the tribunal is in line with previous case-law on “pre-2015 tax rulings” which made already very clear under which conditions one may consider that a binding agreement has been reached with the tax authorities. Since 2015, the advance tax clearance procedure has been formalised by means of a new law provision and a Grand-Ducal Regulation and verbal confirmations received in the course of discussions with the tax authorities can now obviously not be invoked before courts. While it is clear that exchanges with the tax authorities can be very useful for taxpayers, especially in the current context of repeated tax changes with limited guidance on how to apply these changes, it is also clear that taxpayers cannot only rely on discussions with the tax authorities and should either seek a tax opinion of their tax advisor or send an advance tax clearance request in order to clarify the tax consequences and the transactions and operations they envisage. Finally, the decision clarifies the well-established economic / substance over form approach in tax matters.

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TAX CONSOLIDATION REGIME: RECENT COURT DECISION WITH SUBSEQUENT REFERRAL TO THE COURT OF JUSTICE OF THE EU

OUR INSIGHTS AT A GLANCE

- In Luxembourg, tax consolidation allows the consolidation of the respective tax results of each integrated company so as to be taxed globally, as if they were a single taxpayer.
- Since 2015, the Luxembourg tax consolidation regime makes the distinction between the vertical consolidation where the results are consolidated at the level of an integrating parent company and the horizontal tax consolidation where the tax results are consolidated at the level of an integrating subsidiary company.
- The horizontal tax consolidation was introduced following a ruling of the CJEU released in 2014 in respect of the Dutch tax consolidation regime. Based on this ruling, few Luxembourg companies requested the application of the horizontal tax consolidation regime retroactively as from 2013.The benefit of such regime was however denied by the tax authorities and the taxpayers lodged appeals against the tax authorities' position.
- In the context of the litigation, legal technical issues have arisen about the EU compliance of the "old" tax consolidation regime, the requirement to end an existing vertical tax consolidation (with a potential retroactive effect if the 5 year period is not met) in order to benefit from the horizontal tax consolidation and the timing for requesting the application of the horizontal tax consolidation.
- All of them have been referred to the CJEU in order to be clarified and could have an impact on the current Luxembourg tax consolidation regime.

On 29 November 2018, the Luxembourg Administrative Court (the "Court") referred several questions to the Court of Justice of the EU ("CJEU") in respect of the Luxembourg tax consolidation regime.[15] This case is interesting and worth delving further into it as it could result in an extension, or a confirmation, of the scope of the tax consolidation in Luxembourg in the near future.

Aim of the Luxembourg tax consolidation regime

In Luxembourg, tax consolidation is allowed for corporate income tax ("CIT") and municipal business tax ("MBT") purposes. The purpose of the tax consolidation is to allow Luxembourg companies of the same group (or of some of them only) to opt, under specific conditions, for a sort of consolidated taxation, without jeopardizing the patrimonial autonomy of the relevant companies under company law.

Tax consolidation allows the consolidation of the respective tax results of each integrated company prepared on a standalone basis so as to be taxed globally, as if they were a single taxpayer. Thus, losses of some companies can be offset with profits made by others. Tax consolidation scheme constitutes, in this respect, a departure from the tax law rule prohibiting any compensation or transfer of income between related companies. It is therefore clear that, in the spirit of the legislator, looking for a fiscal aim, namely the fiscal neutrality of a business structuring, is inherent to the implementation of a tax consolidation regime. From an anti-abuse perspective, the fact that tax consolidation is requested for the main purpose or one of the main purposes of obtaining tax advantage offered by such a regime, will never defeat the object or purpose of the applicable tax law which is precisely the granting of such a tax advantage/incentive.

The current Luxembourg tax consolidation regime

Luxembourg tax law allows groups of companies to opt for either a "vertical" or a "horizontal" tax consolidation.

[15] Case n°40632C

- Vertical tax consolidation is available where a fully taxable Luxembourg resident company or a Luxembourg permanent establishment of a foreign company subject to a tax comparable to the Luxembourg CIT, called the integrating parent company, holds, directly or indirectly, at least 95% of the share capital in one or more Luxembourg resident fully taxable companies or holds a Luxembourg permanent establishment of a foreign company which is subject to a tax comparable to the CIT, the integrated companies.
- Horizontal tax consolidation is available to subsidiaries held at least at 95%, directly or indirectly, by the same non-integrating parent company. Integrating subsidiary and integrated subsidiaries can be Luxembourg resident fully taxable companies or a Luxembourg permanent establishment of a foreign company which is subject to a tax comparable to the Luxembourg CIT. The non-integrating parent company can be either a fully taxable Luxembourg company, a Luxembourg permanent establishment of a foreign company subject to a tax comparable to the Luxembourg CIT, a foreign company resident of another EEA country which is subject to a tax comparable to the Luxembourg CIT or a permanent establishment located in a EEA country, subject to a tax comparable to the Luxembourg CIT, of a foreign company which is subject to a tax comparable to the Luxembourg CIT.

Whereas in the vertical tax consolidation, parent company(ies) of the integrating company is/are not party(ies) to the tax consolidation, the agreement of the non-integrating parent company of the integrating company and a 95% shareholding threshold between them are required under the horizontal consolidation. These are the only differences between the two tax consolidation forms. From a tax point of view, in both cases, the tax results of the integrated companies are consolidated at the level of an integrating company (whether as parent or subsidiary) and the tax results of the “non-integrated” parent companies will not be affected. The integrating parent company (vertical consolidation) and the integrating subsidiary company (horizontal consolidation) are thus in the same situation: results of the integrated companies are consolidated at their level.

The Luxembourg tax law does not allow a company to simultaneously be part of more than one tax consolidated group. An integrated group is defined as either a group composed by the integrating parent company and the integrated company(ies) or composed by the integrating subsidiary company and the integrated company(ies).

When the shareholding is held indirectly, it is required that the intermediary companies through which the integrating or non-integrating parent company hold 95% of the share capital of the company to be integrated in the tax consolidation, are corporate companies fully subject to an income tax comparable to CIT.

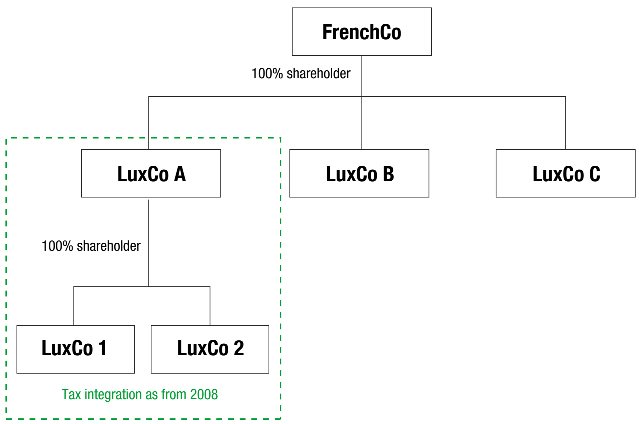
To avoid any abuse, special rules apply to the deductible losses of companies that opt to be fiscally integrated. The carry forward of tax losses, realized before a tax consolidation is put in place, is limited to the aggregate amount of positive income realized during the tax consolidation by the company that originally incurred the losses. Following the termination of the tax consolidation, tax losses generated during the tax consolidation can only be used by the integrating entity.

Tax consolidation is only available upon filing a written request with the Luxembourg tax authorities, filed by the integrating company, the integrated entities subject to the tax consolidation as well as by the non-integrating parent company in case of horizontal tax consolidation. Tax consolidation is effective retrospectively as of the beginning of the fiscal year during which the tax consolidation was requested. The option must be exercised for at least five subsequent fiscal years. If conditions are not fulfilled during the full period of 5 years, the benefits of the tax consolidation are lost, retroactively.

Facts and background

Horizontal tax consolidation was introduced in 2015 following a CJEU ruling. On 12 June 2014, the CJEU concluded that not allowing a tax consolidation between two Dutch sister subsidiaries, on the ground that the parent company was not resident in the Netherlands, was not compliant with EU law. Despite the fact that horizontal tax consolidation was not possible at all in Luxembourg, the Luxembourg legislator decided to amend its tax consolidation regime to echo the European case law.

Based on the above-mentioned CJEU case-law, and in anticipation of the introduction of the horizontal tax consolidation regime in Luxembourg tax law, some Luxembourg companies requested the application of such a regime retroactively as from 2013. This was the case of two Luxembourg companies (LuxCo B and LuxCo C) which requested to be integrated into an existing tax consolidation group, meaning that they requested to be horizontally integrated with their sister company LuxCo A, the integrating company of an existing vertical tax consolidation (LuxCo A remaining the integrating entity of the tax consolidation which would have become horizontal).



However, the tax authorities rejected such requests as the tax consolidation regime in force at that time did not allow the horizontal tax consolidation introduced only as from 2015. The case was brought before the Luxembourg Administrative Tribunal (the "Tribunal").

On 6 January 2017, the Tribunal considered the taxpayers requests as partially founded. On one hand, the Tribunal ruled that the Luxembourg tax consolidation regime, prior to 2015, introduced a discrimination and was contrary to the freedom of establishment but, on the other hand, the Tribunal judged that horizontal tax consolidation could only be applied for 2014 and not for 2013 as the application to benefit from the regime was submitted outside the time-limit by the taxpayers. Indeed, based on the Luxembourg law, to benefit from the tax consolidation regime as from 1.1.2013, a taxpayer has to file its application by 31.12.2013 at the latest.

The taxpayers lodged an appeal before the Luxembourg Court. On 29 November 2018, the Court raised prejudicial questions before the CJEU.

Issues at stake

Several technical issues are dealt with in the ruling of the Court and all of them have been referred to the CJEU in order to be clarified. According to EU law, when there is no judicial remedy under national law against the decision of a court or tribunal of a Member State, that court or tribunal is, in principle, obliged to bring the matter before the CJEU when a question relates to the interpretation of EU law.

1. *EU compliance of the "old" tax consolidation regime*

The Court asked whether the Luxembourg tax consolidation regime (prior to being amended in 2015) was in line with EU law. In other words, is a regime which does not allow the horizontal tax consolidation EU-compliant or not?

Following several decisions of the CJEU, it became apparent that the legislation of a Member State under which a resident parent company may form a single tax entity with a resident sub-subsidiary where it holds it through one or more resident companies, but which cannot do so when it holds it through non-resident companies which do not have a permanent establishment in that Member State, is contrary to Articles 49 and 54 of the Treaty on the Functioning of European Union. Based on these articles, the CJEU has also decided that where the law of a Member State grants a consolidated tax regime to a resident parent company which has resident subsidiaries, it must also be available for resident sister companies whose parent company is not based in that Member State and does not have a permanent establishment there.

There is little doubt that the CJEU will rule that the previous regime was not EU compliant. But, contrary to the outcome of the 2 following questions, conclusions to be reached by the CJEU on this prejudicial question should have a quite relative effect for the Luxembourg companies, in the future, as the Luxembourg legislator already amended the tax consolidation regime introducing the horizontal tax consolidation.

2. *Requirement to end the vertical tax consolidation (with a potential retroactive effect if the 5 year period is not met) in order to benefit from the horizontal tax consolidation*

The Court asked whether the strict separation of vertical and horizontal tax consolidation is in line with EU law. In other words, is it EU-compliant to be required to end the vertical tax consolidation before being able to benefit from a horizontal tax consolidation? This question is interesting and its answer will be welcomed but it also raises some doubts.

a. *Incompatibility with the freedom of establishment or pure domestic discrimination?*

At first sight, it is not clear where the restriction to the freedom of establishment would be. Freedom of establishment aims at guaranteeing the benefit of national treatment in the host Member State, by prohibiting any discrimination based on the place in which companies have their seat. And, in the case at hand, the treatment under scrutiny seems to be the same, no matter the place where companies would have their seat (whether in Luxembourg or in another Member State).

In our view, the question is thus more to understand whether the Luxembourg tax consolidation regime introduces discriminations:

- On the one hand, between Luxembourg companies of a same group as all Luxembourg companies of a same group cannot be added to the existing tax consolidation created by some group companies;
- On the other hand, between companies choosing vertical consolidation and the ones choosing the horizontal one as, in a vertical tax consolidation, the sister companies of an integrating parent company cannot be integrated without triggering the termination of the existing tax consolidation while sister companies of the integrating subsidiary company could do so.

Despite the fact they are in comparable situations[16], they are not treated the same way. All Luxembourg companies cannot be integrated within an existing tax consolidation group under the same conditions and with the same tax consequences.

Such a difference in the tax treatment seems to be neither justified nor defensible. Making a difference between the two forms of tax consolidation makes no sense. Actually, in our above example, if LuxCo A, LuxCo 1 and LuxCo 2 create a horizontal tax consolidation with French Co as non-integrating parent company and LuxCo A as integrating subsidiary, LuxCo B and LuxCo C could be added to the tax consolidation, at any time, without any damaging tax consequences. In

[16] We have seen above that the integrating parent company and the integrating subsidiary company are, broadly speaking, in a very comparable situation and more specifically, in the exact same situation from a tax point view

contrast, if LuxCo A, LuxCo 1 and LuxCo 2 create a vertical tax consolidation, while in the very similar situation (the Luxembourg tax effects being equal), LuxCo B and LuxCo C cannot be added as integrated companies within the existing tax consolidation and the 5 year deadline requirement would be jeopardised as the creation of a new group is required.

b. *Is the requirement to end the vertical tax consolidation in order to benefit from the horizontal tax consolidation a legal requirement or the result of an erroneous interpretation of the law?*

Does the current Luxembourg tax consolidation regime necessarily require the end of the vertical tax consolidation before being able to benefit from a horizontal tax consolidation? Based on our understanding, and for the following reasons, nothing is less certain.

The Court has already ruled that, at the level of the integrated companies, any modification to the tax consolidation group does not put an end to the group and the creation of a new group. However, the question of the impact of the addition, to the tax consolidation group, of sister companies of the integrating company at the level of which all the results of the integrated group are consolidated (and thus the change of tax consolidation regime from vertical to horizontal) has not yet been addressed specifically by case law.

In the case at hand, the tax authorities justify the requirement to end the vertical tax consolidation (with the consequence that the computation of the period of 5 years is interrupted) in order to benefit from the horizontal tax consolidation by the fact that the Luxembourg tax law does not allow a company to simultaneously be part of more than one tax consolidated group, and based on the definition of an integrated group (see above).

In its ruling leading to the prejudicial questions, the Court refers to the parliamentary documents to confirm that vertical tax consolidation groups and horizontal tax consolidation groups constitute distinct groups and that the same group cannot combine the two structures. The example described in the parliamentary documents to illustrate this conclusion is the following: If F1 and F2, the subsidiaries of M, are part of a horizontal tax consolidation, F1 being the integrating company, F1 and F2 could not constitute a vertical tax consolidation with M before ending the horizontal tax consolidation. If not, it is clear in this example, that F1 and F2 would belong simultaneously to two integrated group, as F1 would have two different roles: the integrating company of the horizontal tax consolidation and the integrated company in the vertical tax consolidation.

However in the case at hand, by adding LuxCo B and LuxCo C to the existing tax consolidation, the tax consolidation goes from a vertical to a horizontal tax consolidation and should not create a new tax consolidation. Contrary to the example of the parliamentary documents, LuxCo A would be the integrating entity of the vertical tax consolidation with LuxCo 1 and LuxCo 2 **and** the integrating entity of the new horizontal tax consolidation with LuxCo B and LuxCo C. Its role would not change. In fact, LuxCo A does not belong to two integrated groups and does not have two different roles. It is just a shift from a vertical form of the tax consolidation to a horizontal one. And in this respect, if the law expressly prohibits that a company belongs simultaneously to two integrated group, it does not prevent the addition, in the group, of sisters companies to the integrating company as long as the latter remains the integrating company. On the contrary, this solution is consistent with the principles underlying the tax consolidation regime.

- In such a case, the intention of the legislator that the integrating company assumes the **central role within the tax consolidation group is respected**. The modification of the integrating company, as the result of a change in the tax consolidation group, results in a modification of the taxpayer vis-a-vis the tax authorities. The main role of the integrating company justifies that such modification triggers the termination of the existing tax consolidation before the creation of a new one.

- In addition, this solution is in line with the case law according to which, **at the level of the integrated companies**, any modification to the tax consolidation group does not put an end to the existing group and the creation of a new group. Indeed LuxCo B and LuxCo C would be integrated companies. In the example given in the parliamentary documents, the added company was an integrating company.

- Finally, **this solution does not create any planning or restructuring opportunities** as special rules limit the amount of deductible losses of companies that opt to be fiscally integrated. Similarly, looking for a fiscal aim, namely the fiscal neutrality of a business structuring, is inherent to the use of a tax consolidation regime. The plan to add a company of the group within an existing tax consolidation is thus never contrary to the intention of the legislator and should thus not trigger the application of any anti-abuse provision. It is even worth mentioning that, in our case, if FrenchCo contributes its shares in LuxCo B and LuxCo C to LuxCo A, LuxCo B and LuxCo C would be eligible to be added to the existing tax consolidation regime as the result of the restructuring, without triggering the termination of such tax consolidation, while according to the current tax authorities' interpretation and application of the law, they would not be allowed to do so without the restructuring. Again, this makes no sense.

Based on the above, and taking into consideration the current approach of the tax authorities, it is clearly recommended to create a horizontal tax consolidation group when conditions are met, even with entities "vertically structured". Such a choice should preserve the right to add new entities to the tax consolidation group.

3. *Timing for requesting the application of the horizontal tax consolidation*

The last question raised by the Court is whether, if the tax consolidation regime is to be considered as not compliant with EU law by the CJEU, the requirement that the tax consolidation request must be filed before the end of the first tax year in respect of which tax consolidation is requested is in line with EU law to the extent that it precludes companies to benefit from the lesson learned from the CJEU rulings.

This interesting question relates to the effect of the CJEU case law and could have serious effects on the rights of Member States Treasuries.

The ruling of the CJEU on the 3 prejudicial questions raised will likely have an impact on most aspects of the current Luxembourg tax consolidation regime.

Luxembourg taxpayers having a tax consolidation group should seek advice from their tax adviser in order to analyse the potential impact of this case law on their structure and, when requesting the application of the tax consolidation regime, consideration should be given to the fact that, if possible, horizontal tax consolidation should be preferred over the vertical one.

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RYANAIR CASE: RECOGNITION OF A DEDUCTION RIGHT ON VAT INCURRED BY A HOLDING COMPANY ON BROKEN-DEAL COSTS

OUR INSIGHTS AT A GLANCE

- The Court of Justice of the European Union provided some clarifications on the VAT deduction right of a holding company regarding input VAT borne for the acquisition of shares in a subsidiary in case the share deal is never completed.
- The CJEU decided that the intention to provide management services to a takeover target is, under certain conditions, sufficient to establish that a potential acquirer is engaged in an economic activity.
- The CJEU also ruled that input VAT must be considered as fully deductible to the extent the exclusive reason for the expenditure incurred is the intended VAT taxable economic activity.
- This case law is of prime importance for Luxembourg holding entities.

On 17 October 2018[17], the Court of Justice of the European Union ("CJEU") ruled that VAT incurred by a holding company on costs borne for the acquisition of shares in a subsidiary to which it intends to provide VAT taxable management services is fully deductible, even if ultimately these services are not rendered due to an unsuccessful share deal.

Facts and questions referred to the CJEU

In 2006, Ryanair launched a takeover bid for all the shares of the Irish airline Aer Lingus. In that framework, the airline incurred various advisory costs subject to VAT linked to the planned acquisition. Although the takeover was not fully carried out, Ryanair sought the deduction of the input VAT incurred stating that it was its intention to provide VAT taxable management services to Aer Lingus following the expected share deal.

The tax authority denied the VAT deduction considering the fact that Ryanair did not provide management services in the case at hand. Ryanair brought an appeal to the Supreme Court that referred certain questions to the CJEU.

Decision of the CJEU

As a first step, the CJEU was requested to determine if the intention to provide management services to a takeover target, in the event that the takeover is successful, is sufficient to establish that a potential acquirer is engaged in an economic activity. The CJEU replied in the affirmative, confirming that a company which carries out preparatory acts which are part of a proposed acquisition of shares in another company with the intention of pursuing an economic activity consisting in involvement in the management of that other company by providing management services subject to VAT must be considered a taxable person. Nevertheless, that intention to provide VAT taxable management services has to be confirmed by objective elements.

[17] CJEU, 17 October 2018, Ryanair Ltd v. The Revenue Commissioners, C-249/17, ECLI:EU:C:2018:834

The subsequent question aimed at determining whether the input VAT incurred by a potential acquirer on services received for the purposes of seeking to progress the relevant acquisition can be considered as linked with the future VAT taxable management services and therefore as being deductible.

The CJEU ruled that Ryanair is entitled to deduct input VAT even if there is no direct and immediate link between the services received and output transactions giving rise to deduction to the extent that the costs of the services in question are deemed to be part of its general costs and are, as such, components of the price of the goods or services which it supplies. Therefore, such acquisition costs do have a direct and immediate link with the taxable person's economic activity as a whole and input VAT must be considered as fully deductible to the extent the exclusive reason for the expenditure incurred must be found in the intended VAT taxable economic activity, namely the provision of management services subject to VAT to the target company.

The CJEU nevertheless highlighted that in the event that the expenditure is attributed in part also to an exempt or non-economic activity, VAT paid on that expenditure may only be deducted in part.

Impacts of that decision on the Luxembourg practice

The Ryanair case is of prime importance for Private Equity and M&A businesses. The deduction of input VAT incurred in the framework of share transactions is a complex topic where the views of taxpayers and VAT authorities can differ. In many cases, the VAT authorities tend to consider that input VAT is not (fully) recoverable as related to activities not granting a VAT deduction right (notably holding of shares and EU financing).

In light of the Ryanair case, utmost attention should be paid to the following elements in order to justify a VAT deduction right in case of broken-deal:

- documentation should be properly and carefully drafted in order to reflect the objective intention to provide management services subject to VAT;
- the VAT deduction right should be easier to justify if it is the practice of the holding company to provide VAT taxable management services to all its subsidiaries. Such a group practice eases to demonstrate the "objective intention" on which the VAT deduction is assessed;
- alongside to management services, many Luxembourg holding companies perform also financing activities (EU financing does not grant an input VAT deduction right unlike management services). As already mentioned by the CJEU, performing transactions not subject to VAT could jeopardize a full VAT deduction right on the acquisition costs.

Action required

It is the right moment to reassess the VAT deduction methodology used by holding companies and to adopt a robust VAT strategy built notably on the basis of the CJEU cases. If you intend to make acquisitions, the VAT aspects should be thoroughly analyzed in the early stages.

If you would like to discuss the outcome of that case or to improve the VAT deduction right of your holding company, please feel free to contact Thibaut Boulangé at thibaut.boulange@atoz.lu or Silvin Leibengut at silvin.leibengut@atoz.lu.

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