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TAX ADVISERS

LUXEMBOURG

INSIGHTS

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EDITORIAL

Greetings,

As usual, the weeks prior to the summer break are a little bit hectic. The various legislators and tax authorities have been busy, providing some more reading material to those having already devoured their summer best sellers and favourite books.

On 7 May 2018, the Luxembourg tax authorities released a circular introducing some new reporting requirements on transactions concluded with related parties located in so-called “non-cooperative jurisdictions” for Luxembourg corporate taxpayers. In addition, almost simultaneously, the Luxembourg tax authorities released the 2017 corporate income tax form which introduces a new requirement to report certain transfer pricing related information. In this issue, we present the new reporting obligations applicable to Luxembourg corporate taxpayers.

On 11 June 2018, the Luxembourg VAT Authorities published Circular n° 765-1 on the VAT deduction right methodology to be used by holding companies. This new Circular provides additional guidelines on the VAT deduction right of partial VAT taxable persons, i.e. taxable persons performing both activities within the scope of VAT and activities out of the scope of VAT (e.g. holding of shares). We explain these guidelines in detail.

On 20 June 2018, the Luxembourg legislator released a bill of law not only implementing the EU Anti-Tax Avoidance Directive, but also including two additional BEPS-related tax law changes aiming at removing potential double non-taxation situations. We provide an overview of the different tax measures, which may still evolve throughout the legislative process.

From a regulatory point of view, on 6 June 2018, a new law on transparency of securities financing transactions was adopted and has been effective since 12 June 2018. It implements the European regulation 2015/2365 on transparency of securities financing transactions and of reuse, with the intent of improving transparency and better regulating transactions including securities lending, repurchase transactions, total return swaps or reuse of financial instruments received under a collateral arrangement. For that purpose, it empowers competent authorities to impose administrative sanctions and other administrative measures on all EU counterparties, such as UCITS and their management companies or alternative investment funds and their managers. We present the new regulations and their consequences.

At a European level, on 25 April 2018, the European Commission issued a Directive proposal amending Directive EU 2017/1132 as regards cross-border conversions, mergers and divisions, as part of the Single Market Strategy for small and medium sized companies. The Directive proposal is meant to facilitate the cross-border mobility of limited liability companies within the EU, introduce protections for the shareholders, the creditors and the employees of the companies and avoid abuses within the EU, including those abuses aimed at obtaining undue tax advantages. We describe and comment on the Directive proposal from both a corporate and a tax point of view.

On 25 May 2018, the Council of the European Union adopted a Directive, generally called “DAC VI”, regarding mandatory automatic exchange of tax information in relation to reportable cross-border arrangements. As a result, new reporting requirements will apply from 1 July 2020 and will catch those cross-border arrangements whose first step was implemented as from 25 June 2018. This Directive will now have to be implemented into national law by 31 December 2019. We set out the main outlines of the new reporting requirements with which tax intermediaries and/or taxpayers will need to comply.

On 5 July 2018, the CJEU delivered its judgment in the French case of Marle Participations regarding the question of whether the letting of an immovable property to a subsidiary constitutes direct or indirect involvement in the management of that subsidiary, the effect of which being that the acquisition and holding of shares in that subsidiary are considered economic activities within the meaning of the VAT Directive. By answering affirmatively, the ruling of the CJEU has implications that we describe below.

We hope you enjoy reading our insights.

The ATOZ Editorial Team

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NEW REPORTING REQUIREMENTS ON TRANSACTIONS WITH RELATED PARTIES

OUR INSIGHTS AT A GLANCE

- As from tax year 2018, Luxembourg corporate taxpayers are required to indicate in their corporate tax returns whether they concluded transactions with related parties (within the meaning of article 56 Income Tax Law) which are located in so-called "non-cooperative jurisdictions".
- The recently released 2017 corporate income tax form also introduces a new requirement to report certain transfer pricing related information including whether or not the company has engaged in transactions with related parties and if the company opted for the simplification measure stated in section 4 of the Circular of the Director of the tax administration L.I.R. 56/1- 56bis/1 of 27 December 2016.
- Should the taxpayer be unable to justify the arm's length character of any reported intra-group transactions, the tax authorities may rely on the "hidden dividend distribution" concept or on article 56 of the Luxembourg Income Tax Law to perform tax adjustments.
- These developments show that transfer pricing documentation has become a key element in tax risk management and companies should consider or re-consider their strategy to reflect this new reality.

On 7 May 2018, the Luxembourg tax authorities released a circular introducing for Luxembourg corporate taxpayers some new reporting requirements on transactions concluded with related parties located in so-called "non-cooperative jurisdictions". In addition, almost simultaneously, the Luxembourg tax authorities released the 2017 corporate income tax form which introduces a new requirement to report certain transfer pricing related information. In this article, we present the new reporting obligations applicable to Luxembourg corporate taxpayers.

Transactions with related parties located in so-called "non-cooperative jurisdictions"

The Circular released by the Luxembourg tax authorities on 7 May 2018 provides that as from tax year 2018, Luxembourg corporate tax payers are required to indicate in their corporate tax returns whether they concluded transactions with related parties (within the meaning of article 56 Income Tax Law) which are located in so-called "non-cooperative jurisdictions", as listed by the EU: http://www.consilium.europa.eu/fr/policies/eu-list-of-non-cooperative-jurisdictions/. The list of non-cooperative jurisdictions is updated on a regular basis and currently includes the following seven countries: American Samoa, Guam, Namibia, Palau, Samoa, Trinidad and Tobago and US Virgin Islands.

This requirement follows the conclusions reached by the Council of the European Union in December 2017 according to which, to ensure coordinated action, Member States should apply administrative measures in the tax area reinforcing the monitoring of certain transactions and increased audit risks for taxpayers using structures or arrangements involving these jurisdictions.

The detail of all transactions concluded with these entities (type, amount, etc.) should be available in order to be provided to the tax authorities upon request.

The reporting is required as from tax year 2018.

New transfer pricing documentation requirements in 2017 corporate tax return

The recently released 2017 corporate tax return (Form 500 concerning corporate income tax, municipal business and net wealth tax return for Luxembourg resident companies) requires

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Luxembourg corporate taxpayers to disclose the following transfer pricing information by means of answering the two following questions:

- **Did the company engage into transactions with related parties (articles 56 and 56bis of the Luxembourg Income Tax Law (LITL))?**

The Luxembourg corporate taxpayer is supposed to answer positively each time that it has entered into an intercompany transaction of any type with a related party, no matter whether the transaction was cross-border or domestic. In practice, most Luxembourg companies are involved in intra-group transactions in one way or another.

While the tax return only requires a YES/NO answer, it can be expected that the Luxembourg tax authorities will request additional information on the transaction(s) each time the answer is positive.

The aim of the analysis of the information collected will be for the tax authorities to assess whether the transactions concluded by the Luxembourg company comply with the arm's length principle according to which transactions within a group are compared to similar transactions between unrelated entities to determine acceptable transfer prices.

If the Luxembourg tax authorities can prove that a transfer price is not within the range of arm's length prices, there exists a rebuttable presumption that the transaction does not comply with the arm's length principle, exerting pressure on taxpayers to produce transfer pricing documentation. Overall, the burden of proof for the non-arm's length character of intra-group transactions should be relatively low.

Should the taxpayer be unable to justify the arm's length character of intra-group transactions, the tax authorities may rely on the "hidden dividend distribution" concept or on article 56 of the Luxembourg Income Tax Law to perform tax adjustments.

- **Did the company opt for the simplification measure stated in section 4 of the Circular of the Director of the tax administration L.I.R. 56/1 - 56bis/1 of 27 December 2016?**

This question relates to companies that on-lend funds, financed by debt instruments, to associated enterprises. The circular provides a simplification measure for Luxembourg companies acting as mere intermediaries and on-lending funds received without bearing any significant risks.

Based on the simplification measure, transactions are deemed to comply with the arm's length principle if the Luxembourg company realises a minimum return of 2% after tax on the amount of the financing volume.

Taxpayers that want to apply the simplification measure must opt in on the relevant section of their corporate tax returns. Should a company opt in, a procedure for exchange of information will be launched based on the rules on administrative cooperation or in accordance with tax treaties.

In practice, Luxembourg companies that merely on-lend funds to other group companies, not taking any risks in relation to this activity, will hardly ever opt into this simplification measure given that the safe harbour remuneration is significantly higher than what might be expected at arm's length for the functional and risk profile of an intermediary.

Implications

While these new requirements follow an obligation introduced by the above-mentioned circular, it is an additional step towards an international trend for more comprehensive transfer pricing documentation.

Back in 2015, a new article 171(3) of the General Tax Code already extended the taxpayer's duty of co-operation to transactions between associated enterprises. This new provision was merely there for clarification purposes but nevertheless confirmed that the Luxembourg authorities were relying more heavily on transfer pricing documentation.

Transfer pricing documentation has become a key element in tax risk management in an environment that relies increasingly less on tax rulings and advance pricing agreements. With the tax-heightened international focus on transparency and scrutiny, companies would be wise to take it one step further, integrating the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their investment structure and intra-group transactions.

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VAT DEDUCTION RIGHT OF HOLDING COMPANIES – NEW GUIDELINES PUBLISHED BY THE VAT AUTHORITIES

OUR INSIGHTS AT A GLANCE

- On 11 June 2018, the Luxembourg VAT Authorities published Circular n° 765-1 providing additional guidelines on the VAT deduction right of partial VAT taxable persons, i.e. taxable persons performing both activities within the scope of VAT and activities outside the scope of VAT.
- A first Circular n°765 was published in 2013, focusing specifically on the VAT deduction right of mixed VAT taxable persons and stating that mixed taxable persons should determine whether input VAT can be deducted based on a direct allocation of their costs to specific revenues or based on specific keys.
- While Circular n°765 provides guidelines regarding the VAT deduction methodology applicable to companies performing both VAT taxable and VAT exempt activities, Circular n°765-1 clarifies the methodology to be used by companies carrying out both economic activities (VAT taxable or VAT exempt) and non-economic activities (outside the VAT scope – e.g. passive holding of shares), so called "partial VAT taxable persons".
- As from 1 January 2018, the new Circular extends the VAT deduction methodology described as per Circular n°765 to partial VAT taxable persons. The latter have to therefore determine their VAT deduction right by applying the direct allocation method or specific allocation keys.

On 11 June 2018, the Luxembourg VAT Authorities published Circular n° 765-1 on the VAT deduction right methodology to be used by holding companies.

This new Circular provides additional guidelines on the VAT deduction right of partial VAT taxable persons, i.e. taxable persons performing both activities within the scope of VAT and activities outside the scope of VAT (e.g. holding of shares).

First step – Circular n°765 of 15 May 2013

A first Circular n°765 was published in 2013 focusing specifically on the VAT deduction right of mixed VAT taxable persons, i.e. taxable persons performing both VAT taxable and VAT exempt economic activities (e.g. EU financing activities).

In light of that Circular, mixed taxable persons should determine whether input VAT can be deducted based on a direct allocation of their costs to specific revenues or based on specific keys.

The direct allocation method is based on a cost-by-cost analysis in which input VAT incurred in relation to outgoing transactions granting a VAT deduction right should be considered as deductible while input VAT is not deductible when incurred for transactions not granting a VAT deduction right.

The VAT deduction right could also be based on specific keys such as a pro rata calculation based on the number of employees, the square meters allocated to each activity, etc.

Partial VAT taxable persons and Circular n°765

Circular n°765 was exclusively applicable to mixed taxable persons even if no clear distinction appeared in the document. The limited scope of this Circular has been confirmed recently in a judgement[1] of the *Tribunal d'arrondissement de Luxembourg* stating that Circular n° 765 does not apply to partial taxable persons. In accordance with the principles which have emerged from various Court of Justice of the European Union ("**CJEU**") cases, the judgement recalled that the Luxembourg State has not determined any criteria for apportioning input VAT between economic and non-economic activities.

For the record, the Tribunal recognised the allocation method

[1] Atoz acted as VAT technical expert for the company.

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suggested by the company as valid, which was based on the investments carried out through non-EU financing and shareholding activities, in contradiction with the position of the VAT authorities who had denied almost any VAT deduction right.

From darkness to light: the new Circular n°765-1

While Circular n°765 provides guidelines regarding the VAT deduction methodology applicable to companies performing both VAT taxable and VAT exempt activities (e.g. EU financing), Circular n°765-1 clarifies the methodology to be used by companies carrying out both economic activities (VAT taxable or VAT exempt) and non-economic activities (outside the VAT scope – e.g. passive holding of shares).

As from 1 January 2018, the new Circular extends the VAT deduction methodology described as per Circular n°765 to partial VAT taxable persons. The latter have to therefore determine their VAT deduction right by applying the direct allocation method or specific allocation keys.

Action required

It is now the right moment to reassess the VAT deduction methodology used by holding companies in light of this new Circular. Depending on the activities carried out, applying the direct allocation method or specific allocation keys can improve the VAT deduction right of holding companies.

A VAT review of the activity of holding companies performing economic activities as well is therefore strongly recommended in order to determine the most accurate VAT deduction methodology to be used.

For any further information on this topic, please feel free to contact Thibaut Boulangé at thibaut.boulange@atoz.lu or Mireille Rodius at mireille.rodius@atoz.lu.

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LUXEMBOURG RELEASES DRAFT LAW FOR THE IMPLEMENTATION OF ATAD

OUR INSIGHTS AT A GLANCE

- On 20 June 2018, the Luxembourg legislator released the draft law implementing 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 draft law proposes 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, new framework to tackle hybrid mismatches, and an exit taxation rule.
- Non-ATAD but nevertheless BEPS-related measures included in the draft 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 PE definition.
- Overall, Luxembourg has made the right choices, using all options provided by ATAD in order to remain competitive. However, 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.

On 20 June 2018, the Luxembourg legislator released the draft law implementing the EU Anti-Tax Avoidance Directive ("**ATAD**"). While the main purpose of the draft law is to implement ATAD, it is worth mentioning that it also includes two additional BEPS-related tax law changes aiming at removing potential double non-taxation situations. This article provides an overview of the different tax measures which may still evolve throughout the legislative process.

Introduction

The aim of ATAD is to implement the BEPS (Base Erosion and Profit Shifting) recommendations made by the OECD and the G20 in October 2015 at EU level. ATAD lays down anti-tax avoidance rules in the following fields:

- Deductibility of interest payments;
- General anti-abuse rule ("**GAAR**");
- Controlled foreign companies ("**CFCs**");
- Hybrid mismatches; and
- Exit taxation.

While some of the anti-avoidance rules included in ATAD do not leave EU Member States ("**MS**") much flexibility during implementation into domestic tax law, other rules provide alternative options and/or allow EU MS to limit their scope of application. Keeping in mind the pattern of harmonisation in direct tax matters within the EU, it was important that Luxembourg make the right choices each time ATAD provided for some leeway and options so as to remain competitive in the post-BEPS environment.

In addition to the aforementioned ATAD measures, the draft law introduces two additional "anti-BEPS" changes into Luxembourg tax law. These changes respond to issues addressed by the European Commission in its on-going investigations in two Luxembourg State Aid cases. More precisely, these measures should close loopholes that create opportunities for double non-taxation. The proposed tax law changes illustrate that the tax treatment in the two State Aid cases was consistent with current Luxembourg tax law and it would be necessary to change the law should the outcome of these rules not be desirable.

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Limitation to the tax deductibility of interest payments

Purpose

This new rule aims at limiting the deductibility of interest payments as it was recommended in the Final Report on BEPS Action 4 (Interest deductions and other financial payments) and included as a minimum standard in ATAD. The objective of this rule is to discourage multinational groups from reducing their overall tax base through financing group companies in high-tax jurisdictions with debt. Notably, the scope of the interest limitation rule encompasses both related party borrowing and third party borrowing.

Rule

As from 1 January 2019, a new article 168bis Income Tax Law ("**ITL**") will be added to the Luxembourg corporate income tax law according to which, subject to certain conditions and limitations, "exceeding borrowing costs" shall be deductible only up to 30% of the corporate taxpayers' earnings before interest, tax, depreciation and amortisation ("**EBITDA**") or up to an amount of EUR 3 mio, whichever is higher. 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 (so-called "escape clause").

The definition of "exceeding borrowing costs" is in line with the definition included in ATAD and corresponds to the amount by which the deductible "borrowing costs" of a taxpayer exceed taxable "interest revenues and other economically equivalent taxable revenues" that the taxpayer receives. Thus, in order to determine the amount of exceeding borrowing costs, it is necessary to understand which costs fall within the scope of borrowing costs and what is considered as interest revenues and other economically equivalent taxable revenues.

Borrowing costs to take into account are 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,
- 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 revenues and other economically equivalent taxable revenues are concerned, neither ATAD nor the draft law clarifies what is to be considered as "revenues which are economically equivalent to interest". However, since the definition of borrowing costs also refers to "other costs economically equivalent to interest", there will probably be a certain symmetry in the interpretation of the two concepts.

The optional provision of ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (in case of tax consolidation) have not been included in the draft law. Therefore, as stated in the commentaries to the draft law, even in case of application of the tax consolidation regime, the limitation to the deduction of interest will apply at the level of each consolidated entity. Since some Luxembourg groups may have some group entities with exceeding borrowing costs and other entities with exceeding interest revenues, the fact that the Luxembourg Government decided not to allow a compensation of interest income and expenses at tax group level will be problematic in some cases. Therefore, one may expect that the Luxembourg Government will reconsider this aspect and amend the draft law in this respect.

Entities which are out of the scope of the rule

Financial undertakings are out of the scope of the interest limitation rule. Financial undertakings are those which are 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. The exclusion of these types of entities is optional under ATAD and constitutes as such one of the most positive choices made by the Luxembourg Government when implementing ATAD.

In addition, standalone entities, i.e. entities that are not part of a consolidated group for financial accounting purposes and have no associated enterprise or permanent establishment ("**PE**") are able to fully deduct their exceeding borrowing costs. In other words, these entities are not subject to the new rule.

Loans which are out of the scope of the rule

The Luxembourg legislator chose to limit the scope of the new rule through the inclusion of the following two optional provisions under ATAD:

- Loans which were concluded before 17 June 2016 (i.e. a

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grandfathering rule), and
- Loans used to fund long-term public infrastructure projects (where the project operator, borrowing costs, assets and income are all in the EU) are excluded.

These exceptions are optional under ATAD, therefore another positive choice has been made by Luxembourg.

Carry forward of unused exceeding borrowing costs and unused interest capacity

Exceeding borrowing costs which cannot be deducted in one tax period because they exceed the limit set in article 168bis ITL, can be carried forward in whole or in part without any time limitation.

In addition, unused interest capacity (when the borrowing costs of the corporate taxpayer are lower than the limit set in article 168bis ITL) can be carried forward over 5 tax years.

ATAD provides three alternative options for EU MS and the option chosen by Luxembourg (with a carry forward of both exceeding borrowing cost and unused interest capacity) should be the most favourable option for taxpayers.

Finally, in case of transformations falling within the scope of article 170 (2) ITL (e.g. merger) and 172 (2) ITL (e.g. transfer of seat), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

Amendment of the General Anti-Abuse Rule (GAAR)

Purpose

Under ATAD, 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.

Rule

Effective as from 1 January 2019, the Luxembourg abuse of law concept, as defined in §6 of the Tax Adaptation Law, will be replaced by a new GAAR which will keep the key aspects of the existing abuse of law concept (“The tax law cannot be circumvented by an abuse of forms and legal constructions”) while introducing the concepts of the ATAD GAAR at the same time. There will be an abuse should a specific legal route be selected 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 and which is not genuine having regard to all relevant facts and circumstances. The legal route chosen may comprise more than one step or part and will be regarded as non-genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.

In case of an abuse, taxes will be determined based on the legal route 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.

The fact that the new GAAR is included in the general tax law means that it will apply to any type of Luxembourg taxes and to any type of Luxembourg taxpayer. As such, the scope of the Luxembourg GAAR will be broader than the one of ATAD (which only covers corporate taxes and taxpayers). Nevertheless, in practice, in cases covered by the relevant jurisprudence of the Court of Justice of the EU, the scope of the new GAAR should be limited to clearly abusive situations or wholly artificial arrangements.

Controlled Foreign Company (CFC) rule

Purpose

ATAD provides for CFC rules that re-attribute the income of a low-taxed controlled company (or PE) to its parent company, even though it has not been distributed. The framework for the implementation of CFC rules in ATAD provides for a common definition of the CFC, but for two alternative options (passive income option vs. non-genuine arrangement option) concerning the fundamental scope of the CFC rule as well as options to exclude certain CFCs.

Rule

Luxembourg has chosen the non-genuine arrangement CFC rule. Therefore, as from 1 January 2019, a new article 164ter ITL will be added to the Luxembourg corporate income tax law according to which Luxembourg will tax the non-distributed income of an entity or PE which qualifies as a CFC, provided the non-distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

However, the income of a CFC will only need to be included in the Luxembourg tax base if, and to the extent that, the activities of the CFC which generate this income are managed by the Luxembourg corporate taxpayer (i.e. when the people functions in relation to the activities of the CFC are performed by the Luxembourg parent company). Therefore, the CFC rule should hardly ever apply in practice.

In addition, the CFC rule will only apply if the foreign entity or PE qualifies as a CFC of the Luxembourg corporate taxpayer. An entity or a PE will qualify as a CFC if the two following cumulative conditions are met:

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- the Luxembourg controlling corporate taxpayer holds a direct or indirect participation of more than 50% of the voting rights, or owns directly or indirectly more than 50% of capital or is entitled to receive more than 50% of the profits of the entity or PE; and
- the actual corporate tax paid by the entity or PE is lower than the difference between (i) the corporate tax that would have been charged in Luxembourg and (ii) the actual corporate tax paid on its profits by the entity or PE (in other words, the actual tax paid is less than 50% of the tax that would have been due in the country of the controlling taxpayer). Given the currently applicable CIT rate of 18%, the CFC rule will only apply if the taxation of the income at CFC level is lower than 9% on a comparable taxable basis.

The new CFC rule will only apply for CIT purposes, not for municipal business tax ("**MBT**") purposes. This means that any income qualifying as CFC income under the new rule will be taxed in Luxembourg at 18%. To clarify that the CFC rule will only apply for CIT purposes, the draft law introduces an amendment to § 9 of the MBT law according to which any CFC income included in the CIT basis of the taxpayer will be deductible from the MBT basis.

Exceptions

An entity or a PE will NOT be considered as a CFC if:

- it has accounting profits of no more than EUR 750,000; or
- its accounting profits amount to no more than 10% of its operating costs for the tax period.

This exception is also a positive option taken by Luxembourg to limit the scope of application of the new CFC rule to enterprises which exceed a certain size.

Allocation rules and methods to avoid double taxation

The income of the CFC to be included in the tax base of the Luxembourg corporate taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling Luxembourg corporate taxpayer. The attribution of CFC income shall be calculated in accordance with the arm's length principle based on articles 56 and 56bis ITL.

The income to be included in the tax base shall be calculated 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.

Finally, the draft law provides several rules in order to avoid a double taxation of the CFC income.

New framework to tackle hybrid mismatches

The draft law introduces a new article 168ter ITL which implements the anti-hybrid mismatch provisions included in ATAD. The new article aims to eliminate, in an EU context only, situations of double non-taxation created through the use of certain hybrid instruments or entities.

The draft law does not implement the amendments introduced subsequently by ATAD 2 to ATAD which have replaced the anti-hybrid mismatch rules of ATAD and extended their scope of application to hybrid mismatches with third countries. ATAD 2 has to be implemented by 1 January 2020 and will be dealt with in a separate draft law to be released in the course of 2019.

Given that ATAD 2 replaced the hybrid mismatch rule included in ATAD, it is not self-evident why the Luxembourg government included the ATAD rule in the draft law. Therefore, it remains to be seen whether this provision will survive the legislative process.

Purpose

The aim of the measures against hybrid mismatches is to eliminate situations of double non-taxation created by the use of certain hybrid instruments or entities. In general, a hybrid mismatch structure is a structure 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. deduction in both MS) or a deduction of the income in one state without inclusion in the tax base of the other MS.

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 these payments are not deductible at the level of the paying subsidiary). Therefore, the hybrid mismatch rule included in the draft law should have a very limited scope of application.

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 MS where the payment has its source. Thus, in cases where Luxembourg is the investor state and the payment has been deducted in the source state, Luxembourg would deny the deduction.

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, Luxembourg would deny the deduction of the payment.

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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. The taxpayer will have to provide evidence to the Luxembourg tax authorities that either (i) the payment is not deductible in the other MS which is the source state or (ii) the related income is taxed in the other MS.

Exit taxation rule

Purpose

The aim of this measure is to discourage taxpayers to move their tax residence and/or assets to low-tax jurisdictions. In line with the exit tax provisions included in ATAD, the draft law defines the valuation rules applicable in case of exit out of Luxembourg to another country (amendment to article 38 ITL) and the valuation rules applicable in case of transfer out of another country to Luxembourg (amendments to article 35 and article 43 ITL).

Rule applicable to transfers to Luxembourg

As far as transfers to Luxembourg are concerned, a new paragraph will be added to article 35 ITL which implements article 5 § 5 of ATAD providing that in the case of a transfer of assets, tax residence or business carried on by a permanent establishment to another MS, that MS shall accept the value established by the MS of the taxpayer or of the PE as the starting value of the assets for tax purposes, unless this value does not reflect the market value.

The aim of this rule is to achieve symmetry 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 MS, the new provision added to article 35 ITL covers transfers from any other country to Luxembourg.

Rule applicable in case of contribution ("*supplément d'apport*")

The same valuation principles will also apply to contributions of assets within the meaning of article 43 ITL. Therefore, when assets are contributed to Luxembourg, Luxembourg shall accept the value established by the MS of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this value does not reflect the market value.

Rule applicable to transfers out of Luxembourg:

As far as transfers out of Luxembourg are concerned, the draft 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 the following cases:

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

In the 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. This new provision included in ATAD amends and replaces the existing provisions included in § 127 of the General Tax law ("*Abgabenordnung*"). Under current Luxembourg tax law, Luxembourg taxpayers may defer the payment of the tax until the effective disposal of the assets. The deferral applied both to transfers to another EEA country and to transfers to a country with which Luxembourg has concluded a double tax treaty. Under the new rules, it will only be possible to defer the payment over a maximum of 5 years and the deferral will only apply to transfers to EEA countries. The deferral will be achieved by way of a payment in five equal instalments. Several exceptions apply to the 5-year payment deferral, which will reduce the 5-year period, e.g. in the case of disposal of the assets transferred.

Finally, provided that the assets are set to revert to Luxembourg (country of the transferor) within a period of 12 months, the new exit tax rules shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management. Since the new Luxembourg exit tax rules will apply both to corporate taxpayers and to individuals, both individuals and corporate taxpayers will be able to benefit from these exceptions.

Other non-ATAD measures

Conversion of debt into shares no longer tax neutral

This measure should amend the Luxembourg rules applicable to a specific category of exchange operations (rollover relief, article 22bis Income Tax Law) that involves the conversion of a loan into

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shares of the borrower. As from 2019, such conversions will no longer fall within the scope of tax neutral exchange operations. Instead, the conversion will be treated as a sale of the loan followed by a subsequent acquisition of shares. This means that any latent gain on the loan will become fully taxable upon the conversion.

The aim of this amendment to article 22bis ITL is to ensure that double non-taxation situations can no longer arise from this provision. However, instead of removing this provision, the Luxembourg legislator should limit the scope of application with a view to avoid situations of double non-taxation.

New PE definition

The second measure amends the definition of PE under Luxembourg tax law (§ 16 of the Tax Adaptation Law). According to the draft law, as from 1 January 2019, the only criteria to apply in order to assess whether a Luxembourg taxpayer has a PE in a country with which Luxembourg has concluded a double tax treaty are the criteria defined in that tax treaty. In order words, the PE definition included in the tax treaty will prevail.

The draft law provides further that, unless there is a clear provision in the relevant double tax treaty which is opposed to this approach, a Luxembourg taxpayer will be considered as performing all or part of its activity through a PE in the other contracting state if the activity performed, viewed in isolation, is an independent activity which represents a participation in the general economic life in that contracting state.

Finally, the draft law states that 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 PE. This certificate has to be provided in cases where the relevant tax treaty does not entail any provision (i.e. a provision equivalent to article 23 A (4) of the 2017 OECD Model tax Convention) according to which Luxembourg is authorised to deny the exemption of the income realised (or the assets owned) by the Luxembourg taxpayer in the other contracting state when the other contracting state interprets the tax treaty in a way that its taxing right in regard to the income or capital is limited or excluded.

However, it should be noted that tax treaty law takes precedence over Luxembourg domestic tax law and Luxembourg has to honour its tax treaty obligations. Therefore, as long as a tax treaty does not include specific anti-abuse legislation, Luxembourg is required to exempt income and capital derived or owned through a PE (as defined in an applicable tax treaty) in the other contracting state.

Conclusion

Overall, Luxembourg has made the right choices, using all options provided by ATAD in order to remain competitive. However, on some aspects the Luxembourg government has taken positions which are even stricter than ATAD. For example, instead of implementing all anti-hybrid mismatch rules provided in ATAD 2 as from 2020, the draft law provides for the hybrid mismatch rule included in ATAD which has been replaced by ATAD 2. In addition, Luxembourg has, unfortunately, not opted for the possibility to apply the limitation to interest deduction at tax group level instead of applying the limitation at the level of each entity of the tax consolidation group.

Furthermore, additional work remains to be done in order to clarify the impact of some of the new measures on existing tax law. This might be done by the Luxembourg tax authorities through Tax Circulars.

Finally, as far as the 2 other non-ATAD measures are concerned, Luxembourg should make sure not to go beyond what is necessary in order to solve the double non-taxation issues pointed out by the European Commission so as to make sure that Luxembourg remains competitive, especially towards other EU jurisdictions. Therefore, Luxembourg should amend the tax regime applicable to the conversion of debt into shares rather than abolish it completely.

Considering that these changes will become effective in less than 6 months, Luxembourg taxpayers should analyse the impact of the upcoming changes on their investments and take appropriate action if necessary.

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SFTR – CHALLENGES AHEAD

OUR INSIGHTS AT A GLANCE

- The law of 6 June 2018 on transparency of securities financing transactions ("**SFTs**"), implementing the European regulation 2015/2365 on transparency of securities financing transactions and of reuse ("**SFTR**") under Luxembourg law, has been adopted and is effective as from 12 June 2018 (the "**SFTR Law**"). As a reminder, all EU financial SFT counterparties, such as credit institutions, insurance and reinsurance undertakings, UCITS, UCITS ManCos, AIFs, AIFMs, central counterparties, central securities depositaries or counterparties engaging in reuse of financial instruments received as collateral, but also all EU non-Financial Counterparties of SFTs, may fall within the scope of SFTR.
- The SFTR Law, in particular, (i) empowers the CSSF and the CAA to impose sanctions in case of violation of SFTR requirements and (ii) updates insurance, UCITS and AIFM laws. SFT counterparties were already subject to some requirements, e.g. record keeping, offering documents' information disclosures, etc.
- Next step is the implementation of the long-awaited SFTs reporting requirement. Giving the industry the opportunity to have access to more real-time insights, this reporting should significantly improve counterparties decision-making.

As a parallel source of financing compared to the traditional banking system, securities financing transactions ("**SFTs**"), using securities to borrow cash or other securities without falling back on credit institutions, were brought into the spotlight by the Financial Stability and European Systemic Risk Boards as a result of its investigation on "shadow banking", which began in 2011.

With the intent of improving transparency and better regulating transactions including securities lending, repurchase transactions, total return swaps ("**TRS**") or the reuse of financial instruments received under a collateral arrangement, the European Commission has issued the European regulation 2015/2365 on transparency of securities financing transactions and of reuse ("**SFTR**"), applicable since 12 January 2016. To properly implement SFTR into existing Luxembourg regimes, the law of 6 June 2018 on transparency of securities financing transactions (the "**SFT Law**") was adopted and has been effective since 12 June 2018.

Are you in the scope?

All EU financial SFT counterparties (including all their branches, irrespective of their location), such as credit institutions, insurance and reinsurance undertakings, UCITS and their management companies ("**UCITS ManCos**"), alternative investment funds and their managers ("**AIFMs**"), central counterparties, central securities depositaries or counterparties engaging in reuse of financial instruments received as collateral established in the EU ("**Financial Counterparties**"), but also all EU non-Financial Counterparties of SFTs (which are other undertakings, excluding the Financial Counterparties), fall within the scope of SFTR.

SFTR applies equally to non-EU counterparties (i) when the SFT or the reuse is carried out by an EU branch of that counterparty or (ii) when the counterparty is established in the EU or is an EU branch of a non-EU counterparty established in a third country.

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What are the obligations already imposed by SFTR?

The existing and upcoming SFTR requirements will continue to bring new implications and raise challenges for the industry.

Transparency on the use of SFTs being the main pillar of SFTR, both UCITS ManCos and AIFMs have been impacted through (i) their periodical reports and (ii) disclosure to investors (through their offering documents).

In this regard, UCITS ManCos and AIFMs are required to:

1. keep a record of SFTs concluded, modified or terminated, for a period of five years after the termination of any relevant transaction;
2. inform investors and disclose information on the use they make of potential SFTs and TRS by including some data in their (annual/semi-annual) reports;
3. specify in their offering documents (prospectus or private placement memorandums) all SFTs and TRS which they are authorised to use by clearly indicating which transactions and instruments are used;
4. comply with transparency requirements.

As such, a receiving counterparty (i.e. the counterparty receives financial instruments based on a collateral arrangement and it wants to reuse them) needs to fulfill the following requirements when reusing financial instruments received as collateral:

a. give a written information to the providing counterparty, describing the risks and consequences that may be involved if the latter consented to the right of use of the collateral provided under the security collateral arrangement or if it concluded a title transfer collateral arrangement;
b. ensure that the providing counterparty has granted its prior written consent to such reuse; and
c. ensure that the financial instruments are effectively transferred.

What's new?

The SFT Law empowers (i) the Luxembourg regulator for the financial sector, the Commission de Surveillance du Secteur Financier ("**CSSF**") and (ii) the Luxembourg regulator for the insurance sector, the Commissariat aux Assurances ("**CAA**") to impose adequate administrative sanctions and other administrative measures, which have to be efficient, proportionate and dissuasive. The sanctions, applied in case of infringements (i) to the reporting requirements or (ii) to the obligations relating to the reuse of financial instruments received under a collateral arrangement, are directed to Financial Counterparties (subject to their respective supervision) and non-Financial Counterparties (the power of sanction being vested in the CSSF for the latter).

The STF Law also amends the law of 17 December 2010 on undertakings for collective investment, the law of 12 July 2013 on alternative investment fund managers and the law of 7 December 2015 on the insurance sector by implementing SFTR's transparency requirements. As a consequence, UCITS ManCos, AIFMs, as well as the directors or conducting officers of these entities, as applicable, can be subject to administrative sanctions and measures if they violate the transparency requirements imposed in their relationship with the investors and do not include the required information on SFTs and TRS in the periodical reports or the pre-contractual documents.

CSSF and CAA sanctions, which may range from a simple warning to a fine as high as EUR 15 million, may be applied to both firms and individuals, against members of any relevant entity's management body and any other persons considered as responsible of the violation. Sanctions will be determined considering various factors such as the seriousness of the infringement and its duration, the relevant person's financial situation or the amount of gain resulting from the violation if this can be determined. In addition to the above, any regulatory license held may be either suspended or withdrawn.

Finally, and as a last deterrent measure, sanctions applied in respect of the SFT Law will be published by the CSSF and the CAA on their respective websites and will remain public and accessible during five years after their publication.

What's next?

While each counterparty has had to ensure the safeguarding of any SFT it concludes, modifies or terminates for at least five years following the termination of the transaction, the long-awaited implementation of SFTs reporting requirement, referred to here above, remains pending.

If you have not already completed it, you should assess if your firm, funds under management and any group vehicles fall within the scope of SFTR. If so, the implementation of this requirement can be immediately tackled by assigning resources to study ESMA's regulatory technical standards (RTS) specifications, review, organise and check the quality of your data accordingly and build/test efficient operating models ensuring a smooth compliance process as soon as the reporting terms will be finalised and the target date known.

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In any case, the implementation of the reporting obligation must be anticipated as this requirement is expected to be rapidly phased-in over a nine month go-live period. SFTs counterparties, depending on the nature of the relevant entity, will have between twelve and twenty-one months from the much-anticipated adoption of RTS by the European Commission to implement and run this complex reporting. The expected entry into force of the RTS should be in Q3 2019 at the earliest for investment firms and credit institutions, continuing until Q2 2020 for non-Financial Counterparties.

Although draft RTS were submitted more than one year ago, the European Commission has yet to give its green light and adopt them, leaving many players in the securities lending industry in a rather uncomfortable situation in terms of resource management and IT development.

Giving the industry the opportunity to have access to more real-time insights, SFTR reporting should significantly improve counterparties decision-making process, leading to better business outcomes. To achieve this goal and enhance transparency on the market, it will be crucial that stakeholders integrate and implement this requirement.

Without any doubt, if you are in the scope of these reporting obligations, the coming months will be full of challenges for your teams. Be prepared!

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FREEDOM OF ESTABLISHMENT AND CROSS-BORDER CONVERSIONS, MERGERS AND DIVISIONS: THE EU COMMISSION TAKES ACTION

OUR INSIGHTS AT A GLANCE

- On 25 April 2018, as part of the Single Market Strategy for small and medium sized companies, the European Commission issued a directive proposal (the "**Directive Proposal**") amending Directive EU 2017/1132 as regards cross-border conversions, mergers and divisions (the "**Existing Directive**").
- The Directive Proposal is meant to (i) facilitate the cross-border mobility of limited liability companies within the EU, introduce extra protection measures for shareholders, employees and creditors protection and (ii) avoid tax abuses within the EU.
- The procedure for a cross-border merger as set out in the Existing Directive will be revised and a new fast-track rule (for "simple" mergers) will be introduced.
- The Directive Proposal introduces a harmonised procedure for cross-border conversions and divisions.
- The Directive Proposal also puts in place strong safeguards to prevent these procedures from being used to set up artificial arrangements, including those aimed at obtaining undue tax advantages.

Introduction

The freedom of establishment plays a crucial role in the development of the Single Market as it allows corporate entities to pursue economic activities in other Member States on a stable basis. In practice, however, the exercise of this freedom remains difficult notably because company laws are neither sufficiently harmonised nor adapted to cross-border mobility within the EU. In the absence of harmonised rules, procedures for cross-border conversions and divisions differ and raise issues of compatibility (between the procedure in the Member State of departure and of destination) which also lead to a suboptimal protection of employees, creditors and minority shareholders within the Single Market.

The Directive Proposal aims at enabling companies, particularly micro and small, to convert, divide or merge cross-border in a more orderly and efficiently manner, and to reconcile the different objectives at stake: freedom of establishment, social protection and anti-abuse regulations.

Freedom of establishment of companies: Principles

According to the Court of Justice of the European Union ("**CJEU**"), the freedom of establishment encompasses the right of a company formed in accordance with the legislation of a Member State to convert itself into a company or firm governed by the law of another Member State, provided that the conditions laid down by the legislation of that other Member State are satisfied and, in particular, that the test adopted by the latter State to determine the connection of a company or firm to its national legal order is satisfied. In that regard, the registered office, the central administration and the principal place of business of a company or firm are placed on the same footing as connecting factors. As a result, the Member State of departure cannot restrict the choice of a company to re-locate to another Member State.

Member States can, however, adopt measures in order to prevent attempts by certain nationals to evade domestic legislation. Nevertheless, it must be observed that the CJEU confirmed the fact that either the registered office or real head office of

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a company established in accordance with the legislation of a Member State for the purpose of enjoying the benefit of more favourable legislation does not, in itself, constitute abuse.

Transactions in scope of the Directive Proposal

The harmonisation measures suggested by the Directive Proposal target the following operations:

Cross-border conversions: Cross-border conversion describes a situation where a company converts cross-border, without being dissolved, wound up or going into liquidation, by changing its legal form of one Member State into a similar legal form of another Member State.

However, the Directive Proposal shall not apply to cross-border conversions involving a company whose purpose is the collective investment of capital provided by the public, which operates on the principle of risk-spreading and the units of which are, at the holders' request, repurchased or redeemed, directly or indirectly, out of the assets of that company.

Cross-border divisions: Cross-border division describes a situation where a company, after its dissolution, but without going into liquidation, is split into two or more newly created companies. Given the complexity of dealing with risks of abuse in a situation where a company being divided transfers assets and liabilities to existing companies in different Member States, it was decided to regulate the situation where new companies are created in a cross-border division and at this time, not to regulate the cross-border division by acquisition, i.e. the situation where a company transfers assets and liabilities to more than one existing company.

Cross-border mergers Under the Existing Directive, cross-border merger describes a situation where one or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another company in exchange for the issue of securities to their shareholders representing the capital of that other company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in the absence of a nominal value, of the accounting par value of those securities. It includes operations whereby a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the securities representing its capital.

The Directive Proposal amends this definition to include the description of a cross-border merger as an operation between companies in which a company being acquired transfers all its assets and liabilities into the acquiring company without issuing new shares. Such an operation will fall under the scope of this Directive Proposal, given that the merging companies are owned by the same person or the ownership structure in all merging companies remains identical after the completion of the operation. (cross-border conversions, cross-border divisions and cross-border mergers are hereafter called together the "**Cross-border Transactions**")

The creation of EU "simplified" mergers

Even though a merger between a parent company and its wholly-owned subsidiary can currently benefit from some simplified procedures such as the waiver of an independent expert report, the opportunity to accelerate the merger process is still too limited. The Directive Proposal offers further simplifications that will also apply to conversions and divisions. In particular, companies will have the option to waive the requirement of a management report for shareholders in the event that all of the shareholders agree. Moreover, they will have the ability to waive the employee report in the event that the company or any of its subsidiaries do not have any employees.

The new requirements for Cross-border Transactions

In cases of Cross-border Transactions, the Directive Proposal introduces a structured and multi-layered procedure based on the same steps:

1. The preparatory phase requires the preparation and the publication of:

- the draft terms of the operation (conversion/division/merger) by the concerned companies;
- a mandatory report for the shareholders;
- a mandatory report for the employees;
- in the case of medium and big companies: a written report by an independent expert, whereby the independent expert will examine the accuracy of the draft terms and reports. The written report of the independent expert would also provide the factual basis for the assessment to be carried out by the competent authority as regards *inter alia* the risk of abuse;
- The draft terms and reports would be made publicly available and could be commented upon by the affected stakeholders.

2. The scrutiny phase implies the scrutiny of the operation by:

- the shareholders of the companies, which will be required to take a decision to continue or discontinue the operation at general meeting;
- the competent authority of the dividing / converting / merging company (in the case of Luxembourg, the notary public) which has a month to scrutinise the operation and the documents before taking a decision to issue a pre-division, pre-conversion or pre-merger certificate (the "**Pre-Transaction Certificate**") or to refuse it;
- in case of serious concerns as to the existence of an artificial arrangement, the competent authority (of the

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dividing / converting / merging company) has two additional months to perform an in-depth examination of a supposedly abusive operation;
- the competent authority of the destination Member State(s), once provided with the Pre-Transaction Certificate, will carry out a legality check with regards to that part of the procedure which is governed by their respective laws (e.g. check if the conditions for the incorporation of the company are complied with, if the arrangements for employee participation have been determined lawfully, etc.).

3. The registration phase:

- once the examination and legality checks are concluded positively, the operation is registered and recorded in the company registers of the relevant/involved countries, by using the system of interconnected business registers and therefore reducing the involvement of the companies to the minimum necessary.

New creditors and shareholders protection

The Directive Proposal aims at harmonising rules for the protection of creditors, shareholders and employees, by obliging companies to integrate protective measures into the draft terms of their Cross-border Transactions.

Creditor protection in Cross-border Transactions will be upgraded

- Creditors dissatisfied with the protection offered by the draft term of a Cross-border Transaction will have access to administrative or judicial ways of recourse;
- Companies are entitled to offer the creditors (without recourse for the latter) a right to payment, either against a third party guarantor, or against the company resulting from the merger, with such measures being assessed by the independent expert;
- Member States may require that companies seeking to perform a cross-border operation should prepare a declaration stating that they are not aware of any reason why the company resulting from the Cross-border Transaction should not be able to meet its liabilities.

Better information and rights for the shareholders

- The minority shareholders who did not vote for the cross-border mergers or have no voting right in the Cross-border Transactions are given the right to exit the company and receive adequate compensation;
- The shareholders have a right to challenge any share-exchange ratio considered inadequate before a court;
- A report addressed to the shareholders of each of the concerned companies should explain the implications of the Cross-border Transaction on the future business and the management's strategic plan as well as the implications for certain shareholders. In the context of a merger, the report should explain the share exchange ratio and describe any special valuation difficulties as well as remedies available to certain members.

Introduction of scrutiny by the competent authority - Pre-Transaction certificate

One of the most important pieces of this Directive Proposal resides in the introduction of an ex-ante scrutiny by the competent authority, whereby not only the legality of the operation is checked, but also the potential for it to represent an abuse.

In particular, the competent authorities of the departure Member States should have the power to issue a Pre-Transaction Certificate without which the competent authorities in the destination Member State would not be able to complete the Cross-border Transaction procedure. This Pre-Transaction Certificate may not be challenged by the competent authorities of the destination Member States.

For that purpose, the legality of the Cross-border Transactions should be scrutinised by the competent authority of the departure Member State, which then should issue the Pre-Transaction Certificate within one month of the application by the company, unless it has serious concerns as to the existence of “an abuse, namely in cases where it constitutes an artificial arrangement aimed at obtaining undue tax advantages or at unduly prejudicing the legal or contractual rights of employees, creditors or minority members”. In such a case, the competent authority should carry out an in-depth assessment within two months of informing the company that the in-depth assessment will be performed.

For their assessment, the competent authorities should take into account at least some of the factors laid down in this Directive Proposal. However, these factors should be only considered as indicative factors in the overall assessment and not be considered alone. Such factors include the intent, the sector, the investment, the net turnover and profit or loss, number of employees, the composition of the balance sheet, the tax residence, the assets and their location, the habitual place of work of the employees and of specific groups of employees, the place where social contributions are due and the commercial risks.

From a tax point of view, the Directive Proposal does not provide any definition of what would constitute an “artificial arrangement”. In the preamble, it is only referred to the “risks of abuse, including a proliferation of 'letter-box' companies for abusive purposes such as for avoiding labour standards or social security payments as well as aggressive tax planning”. The Directive Proposal does not indicate anything more about what would constitute an “undue tax advantage”. Nevertheless, it is made clear that in so far as it constitutes a derogation from

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a fundamental freedom, the provisions against abuses must be interpreted strictly and be based on an individual assessment of all relevant circumstances. And as stated by the CJEU, performing a Cross-border Transaction for the purpose of enjoying the benefit of more favourable legislation does not, in itself, constitute an abuse.

As the definition of what constitutes an abuse remains quite unprecise, this could lead to very subjective interpretations by the competent authorities, as a result of which some Cross-border Transactions could be wrongly considered as tax abusive, with the very serious penalty that the transaction would become impossible from a corporate point of view. Many tax disputes already exist on this topic and are usually resolved only after years of litigation. As a result, when it comes to tax, the penalty seems disproportionate and could thus be seen as contrary to the freedom of establishment. It would indeed be sufficient to refuse the “undue tax advantage” without obstructing the Cross-border Transaction. Similarly, various existing tax regulations already deal with the issue of tax abuses, and offer a tax solution rather than an extreme corporate solution: the prohibition of a transaction.

Investors and taxpayers that intend to set up a Cross-border Transaction or that are in the process of setting up such a transaction should seek advice from their tax and corporate advisers in order to analyse the potential impact on their investments of these measures that could be introduced following the adoption of the Directive Proposal.

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EU DIRECTIVE SETTING NEW TRANSPARENCY RULES FOR INTERMEDIARIES

OUR INSIGHTS AT A GLANCE

- On 25 May 2018, the Council of the European Union adopted a Directive amending the Directive 2011/16/EU ("**DAC**") as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (the "**Intermediary Directive**").
- The Intermediary Directive requires intermediaries such as tax advisers, accountants and lawyers that design and/or promote tax planning schemes, to report schemes that are potentially aggressive, to the tax authorities. If the intermediary is under obligations of professional secrecy, reporting duties shift to the taxpayer.
- A reporting duty arises in the case of cross-border arrangements defined as any arrangement concerning either (i) more than one EU Member State or, (ii) an EU Member State and a third country and where the arrangements contain at least one of the characteristics or features (called Hallmarks) that is deemed to present an indication of a potential risk of tax avoidance, as listed in Annex IV of the Intermediary Directive.
- Any cross-border arrangement designed and/or promoted since 25 June 2018 is potentially reportable under the Intermediary Directive and intermediaries would need to take adequate measures in this respect.
- The Intermediary Directive is quite broad and raises a lot of questions. We can expect that either the Luxembourg parliament, in the law or in the parliamentary documents, or the Luxembourg tax authorities through a circular, will clarify exactly what and who is captured by the scope of the reporting.

On 25 May 2018, the Council of the European Union adopted a Directive amending the Directive 2011/16/EU ("**DAC**") as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (the "**Intermediary Directive**").

Outlines of the Intermediary Directive

The Intermediary Directive requires intermediaries such as tax advisers, accountants and lawyers that design and/or promote tax planning schemes, to report schemes that are potentially aggressive, to the tax authorities. In case an intermediary is prevented from doing so, for example due to obligations of professional secrecy, the reporting duties shift to the other intermediaries involved or, ultimately, to the taxpayers.

The new reporting duties are quite broad. They relate to:

- cross-border arrangements defined as any arrangement concerning either (i) more than one EU Member State or, (ii) an EU Member State and a third country;
- where the arrangements contain at least one of the characteristics or features that is deemed to present an indication of a potential risk of tax avoidance, as listed in Annex IV of the Intermediary Directive (the "**Hallmarks**").

The Hallmarks are classified into 5 categories:

- General Hallmarks linked to the main benefit test ("**MBT**");
- Specific Hallmarks linked to the MBT;
- Specific Hallmarks related to cross-border transactions;
- Specific Hallmarks concerning automatic exchange of information and beneficial ownership; and;
- Specific Hallmarks concerning transfer pricing.

These Hallmarks assemble a list of features and elements of transactions that are considered as presenting a strong indication of tax avoidance or abuse. As a result, a cross-border arrangement which satisfies at least one of the Hallmarks will be deemed to present an indication of a potential risk of tax

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avoidance and thus, will be reportable. But there is the rub! As drafted, the Hallmarks do not only capture potential aggressive tax planning or tax avoidance but are much broader. As a result, cross-border arrangements could be reportable even if they do not constitute potential or real aggressive tax planning.

In order to be taken into account, few Hallmarks are nevertheless linked to an MBT. This test aims to narrow the scope of the Hallmarks and to better target the aggressive tax planning arrangements. The MBT will be satisfied if "it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage". Written as such, the scope of the MBT is unfortunately uncertain.

As a result, a very large amount of information could potentially be reportable and then, exchangeable, under the Intermediary Directive.

In a previous article, we provided a detailed overview of:

(i) what type of arrangement will need to be reported;
(ii) what the Hallmarks used to determine the reportable cross-border arrangements under the Intermediary Directive are;
(iii) which information will be reported;
(iv) who will be subject to the new reporting duties;
(v) when will the reporting have to be performed; and
(vi) what the next steps and the implication of the Intermediary Directive are.

What's next?

The measures introduced by the Intermediary Directive will have to be implemented into national law by 31 December 2019, and the new reporting requirements will apply as from 1 July 2020. Nonetheless, cross-border arrangements whose first step was implemented between the date of entry into force of the Intermediary Directive (i.e. 25 June 2018), and the date of application of this Directive (i.e. 1 July 2020) will also be reportable, by 31 August 2020. Therefore, any cross-border arrangement designed and/or promoted since 25 June 2018 is potentially reportable under the Intermediary Directive and intermediaries would need to take adequate measures in this respect.

In this respect, as the Intermediary Directive is quite broad and raises a lot of questions, we can expect that either the Luxembourg parliament, in the law or in the parliamentary documents, or the Luxembourg tax authorities through a circular, will clarify exactly what and who is captured by the scope of the reporting.

In addition, as the Hallmarks have no materiality and the MBT is abstract and quite subjective, we can anticipate that the compliance of the Intermediary Directive regulations with some fundamental freedoms and/or fundamental rights, such as the right to privacy, the freedom of trade and freedom to pursue professional activities, will be challenged. Indeed, interpreted in a broad manner, the Intermediary Directive appears to launch a massive fishing expedition which seems to go beyond what is necessary to protect the right of the Treasury (taking notably into account the information that is already supposed to be reported and exchanged currently under DAC and other regulations).

In a fiscal context, restrictions to fundamental rights and freedoms can be justified both by the objective of combating fraud and tax evasion and by that, seeking to safeguard the treasury interest and a balanced allocation of taxation powers between countries. Nevertheless, a general presumption of fraud and abuse cannot justify fiscal measures which prejudice the enjoyment of fundamental rights and freedoms. In this respect, the CJEU draws the attention, that in order to determine whether an operation pursues an objective of fraud and abuse, an individual examination of the whole operation at issue must be carried out and it is not sufficient to apply predetermined general criteria. And this is exactly what the Intermediary Directive does. As a result, the Hallmarks and the MBT at issue are not specifically developped to target purely artificial arrangements designed to unduly benefit from that advantage, but cover, in general, almost any and all cross-border arrangements set up for a broad range of reasons. Yet still, it does not solve the issue of tax fraud and tax evasion…

Taxpayers that intend to invest abroad (within or outside the EU) or that are in the process of investing abroad should seek advice from their tax adviser in order to analyse the potential impact of the new reporting requirements on their investments.

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MARLE PARTICIPATIONS: FURTHER CLARIFICATIONS ON THE VAT DEDUCTION RIGHT OF HOLDING COMPANIES

OUR INSIGHTS AT A GLANCE

- On 5 July 2018[1], 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 subsidiaries to which it lets premises is fully deductible if these letting activities are wholly subject to VAT.
- A French holding company whose activities consisted of the mere holding of shares and the letting of premises subject to VAT to its subsidiaries incurred costs within the framework of the acquisition of shares in these entities. The holding company considered that the costs incurred for the acquisition of the shares qualify as overhead costs and therefore fully deducted the input VAT borne on these acquisition costs.
- The French VAT Authorities challenged this approach, but the CJEU ruled that the VAT taxable letting of a building by a holding company to its subsidiary constitutes involvement in the management of that subsidiary, thereby granting the right to deduct the VAT incurred on the services received within the framework of the acquisition of the shares in that subsidiary.
- This judgement makes clear that any VAT taxable services rendered by a holding company to its subsidiary must qualify as "involvement in the management" of that subsidiary. The notion of "involvement" is therefore very broad and, if met, should be sufficient to recover input VAT incurred on services received within the framework of the acquisition of the shares in that subsidiary.

On 5 July 2018[1], 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 subsidiaries to which it lets premises is fully deductible if these letting activities are wholly subject to VAT.

On the basis of the CJEU cases, input VAT on expenses linked to the acquisition of shares in subsidiaries is deductible provided that the holding company (a) is involved in the management of the subsidiaries and (b) provides VAT taxable services to the subsidiaries for consideration.

The Marle Participations case provides details on the notions of "involvement" as well as on the scope of the "VAT taxable services" to be rendered.

Facts and question referred to the CJEU

A French holding company whose activities consisted of the mere holding of shares and the letting of premises subject to VAT to its subsidiaries incurred costs within the framework of the acquisition of shares in these entities.

Being of the opinion that the letting of premises to its subsidiaries was constitutive of an involvement in the management of the

[1] CJEU, 5 July 2018, *Marle Participations S.à r.l. v. Ministère de l'Economie et des Finances*, C-320/17, ECLI:EU:C:2018:537.

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latter and as this letting activity was fully subject to VAT, the holding company considered that the costs incurred for the acquisition of the shares qualify as overhead costs and therefore fully deducted the input VAT borne on these acquisition costs.

The French VAT Authorities challenged this approach on the basis that the acquisition costs relate to activities which do not grant a VAT deduction right (i.e. the shareholding activity). The question referred by the French Supreme Court to the CJEU aimed at determining whether the letting of a building to a subsidiary qualifies as involvement in the management of that subsidiary and therefore allows a VAT deduction right.

1. Decision of the CJEU

The Court stated that the VAT taxable letting of a building by a holding company to its subsidiary constitutes involvement in the management of that subsidiary, thereby granting the right to deduct the VAT incurred on the services received within the framework of the acquisition of the shares in that subsidiary.

In order to constitute involvement in the management, a supply of services (i.e. the letting) has to be made on a continuous basis, be carried out for consideration with a direct link between the remuneration received and the services supplied and it has to be subject to VAT.

2. Impacts of the decision

The judgement of the CJEU is important as it makes clear that any VAT taxable services rendered by a holding company to its subsidiary must qualify as “involvement in the management” of that subsidiary. The notion of “involvement” is therefore very broad and, if met, should be sufficient to recover input VAT incurred on services received within the framework of the acquisition of shares in that subsidiary.

This case law provides comfort to holding companies supplying VAT taxable services to their subsidiaries. It is indeed very common for the VAT authorities to challenge the VAT deduction right of such holding companies involved in the management of their subsidiaries, notably when the acquisition costs incurred are higher than the turnover resulting from the taxable services rendered.

This clear judgement is therefore very welcome in an environment where the VAT deduction right of holding companies is frequently called into question.

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