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18 August 2015

Luxembourg draft legislation introducing EU anti hybrid and anti-abuse provisions in the participation exemption regime and a “horizontal” consolidation tax regime.

On 5 August 2015, the Minister of Finance submitted bill n°6847 (the “**Bill**”) to the Luxembourg Parliament. The Bill provides in particular for the implementation under Luxembourg law of the new EU anti-abuse provisions set out in amended Directive 2011/96/EU (the “**Parent-Subsidiary Directive**”) and for an expansion of the scope of the Luxembourg tax consolidation regime, as well as a few other tax measures. The proposals analysed below remain subject to parliamentary debate and could thus be amended prior to its vote, which is expected before year end.

1. Amendments to the participation exemption regime

The EU Parent-Subsidiary Directive provides for a tax exemption on dividends distributed by and to EU related companies. As a result, EU companies eligible to this regime:

- are tax exempt on dividends received from other EU eligible companies, and
- are not liable to withholding tax on dividend distributions to such eligible EU companies.

In light of the international and European developments against tax evasion, tax avoidance and aggressive tax planning and the BEPS[1] initiative, the Council of the European Union adopted two Directives in 2014 and 2015 which introduce two amendments to the Parent-Subsidiary Directive. EU Member States have to implement these measures by 31 December 2015.

Luxembourg, which is under greater scrutiny after the Lux Leaks affair, has decided to implement within the deadline such amendments into domestic law for profits distributed after 31 December 2015.

The first amendment aims at **tackling the use of hybrid instruments** by denying the benefit a tax exemption for profit distributions to the extent that such profits are tax deductible from the distributing entity’s tax basis.

[1] The OECD project against base erosion and profit shifting.

Practical Impact for Luxembourg

Under this new provision, dividend distributions by EU companies to a Luxembourg holding company will no longer be entitled to benefit from the Luxembourg participation exemption regime if the dividend is tax deductible in the distributing EU jurisdiction.

It is worth noting that the scope of this provision is limited to distributions received by a Luxembourg company from EU companies as listed in the Parent-Subsidiary Directive. Distributions from entities located outside the EU would not be affected by the anti-hybrid measures, which may limit the effective impact of the proposed amendment.

The measure, to the extent implemented by other EU Member States, may however impact the tax treatment of dividends distributed by Luxembourg securitisation companies established under the law of 22 March 2004 (the "**Securitisation Law**"). Note that under the Securitisation Law, dividends distributed by a securitisation company are tax deductible in Luxembourg and should therefore no longer benefit from a participation exemption in any other EU jurisdiction. In the domestic context, any income (including dividends) received by a Luxembourg fully taxable company from a securitisation vehicle was already fully subject to Luxembourg taxation and did not qualify for the Luxembourg participation exemption regime.

Finally, note that the rule has no impact on the other traditional financing instruments used in Luxembourg such as PECs and CPECs, which, from a Luxembourg point of view, are treated as debt and do not fall within the scope of the participation exemption regime.

The second amendment introduces a **minimal anti-abuse rule** which denies the benefits of the provisions of the Parent-Subsidiary Directive to an arrangement or a series of arrangements that are not "*genuine*" and that have been put in place "*for the main purpose or one of the main purpose of obtaining a tax advantage that defeats the object of the Parent-Subsidiary Directive*", and which have not been put in place for valid economic reasons reflecting economic reality. This modification was proposed by the amended Parent-Subsidiary Directive as a "*de minimis*" clause whereas EU Member States were allowed to apply stricter national rules as long as they meet the minimum EU requirement.

Practical Impact for Luxembourg

Although Luxembourg tax law contains a general anti-abuse rule[2], the government felt the need to nevertheless introduce the specific anti-abuse rule proposed by the amended Parent-Subsidiary Directive so as to avoid any political discussion on the correct implementation of the amended Parent-Subsidiary Directive.

2 Paragraph 6 of the Tax Adaptation Law (Steueranpassungsgesetz, 16 October 1934).

Hence, Luxembourg has decided to implement the "*de minimis*" clause, as proposed by the amended Parent-Subsidiary Directive without enlarging its scope or adding stricter rules.

Since Luxembourg tax law already provides for a general anti-abuse provision according to which the tax authorities are entitled to tax an operation on the basis of its economic reality rather than its legal form, the impact of this measure should be marginal.

Nevertheless, in the context of the move towards more tax transparency and the cooperation and exchange of information between foreign tax administrations, it may be expected that this new specific anti-abuse provision may spark calls for more substance and economic justification for using Luxembourg investment and holding companies.

2. Allowing Horizontal Tax Consolidation

Luxembourg provides for a tax consolidation under certain conditions[3]. Eligible tax grouped companies can then aggregate their taxable income (calculated on a stand-alone basis for each member company) at the level of the consolidating company.

The current regime does not allow Luxembourg affiliated companies ("sister" companies) held by a parent company in another Member State to form a tax consolidation by themselves. Such restriction has been successfully challenged before the Court of Justice of the European Union on the ground of the freedom of establishment[4].

The Bill therefore intends to expand the scope of application of the Luxembourg tax consolidation regime to parent companies resident in another Member State of the European Economic Area ("**EEA**") as from 2015. A tax consolidation will then be possible between Luxembourg companies held by a common parent company resident in another Member State of the EEA and subject to a taxation regime comparable to the one in Luxembourg, the "consolidated company" being one of the subsidiary having the closest relationship with the parent company. Likewise, the subsidiaries in a tax group can also be Luxembourg permanent establishments from a company resident in another Member State of the EEA applying a comparable taxation regime.

Practical Impact for Luxembourg

This change and the possibility to set up a so-called "horizontal tax consolidation" will therefore give more flexibility to set up Luxembourg tax consolidations.

Luxembourg has however missed the opportunity to soften some of the other strict conditions required to set up now both the "vertical" and the "horizontal"

[3] Article 164 bis of the Loi sur l'Impôt sur le Revenu.
[4] CJEU 12 June 2014 (SCA Group Holding C-400113) in relation to the Dutch tax consolidation system which was similar in this aspect to the Luxembourg one.

tax consolidations, such as the minimum tax consolidation period of 5 years and the 95% owning threshold.

3. Other measures

The Bill also provides for an enlargement of the scope of (i) companies eligible for a deferral of payment of taxes on latent gains triggered by a migration outside Luxembourg (exit tax), (ii) tax credits for investments in the maritime sector granted to the lessor, and (iii) a tax credit for hiring unemployed persons.

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