ATAD 2 - FAQs

Important

This document was prepared by ALFI, AMCHAM, LPEA and UEL (the associations) respective working groups and deals with questions raised in the context of the rules against tax avoidance practices that directly affect the functioning of the internal market and, more in particular, the treatment of hybrid mismatches as laid down by Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD 2). ATAD 2 has been transposed in the Luxembourg tax legislation through the law of 20 December 2019.

The groups of the respective associations that worked on this document comprise of representatives of audit firms, law firms, asset managers and management companies.

This document contains the working groups' answers to questions about the ATAD 2. The answers are not necessarily definitive and they might not be suitable for every circumstance. This document is not meant to be an industry standard or a guide to best practice but it represents the view of the associations. The ATAD 2 FAQs has not been validated by tax authorities. It does not diminish the responsibility of each stakeholder using it to comply with the applicable rules on ATAD 2. This document must not be relied upon as advice and is provided without any warranty of any kind and neither associations nor their members who contributed to this document accept any liability whatsoever for any action taken in reliance upon it.

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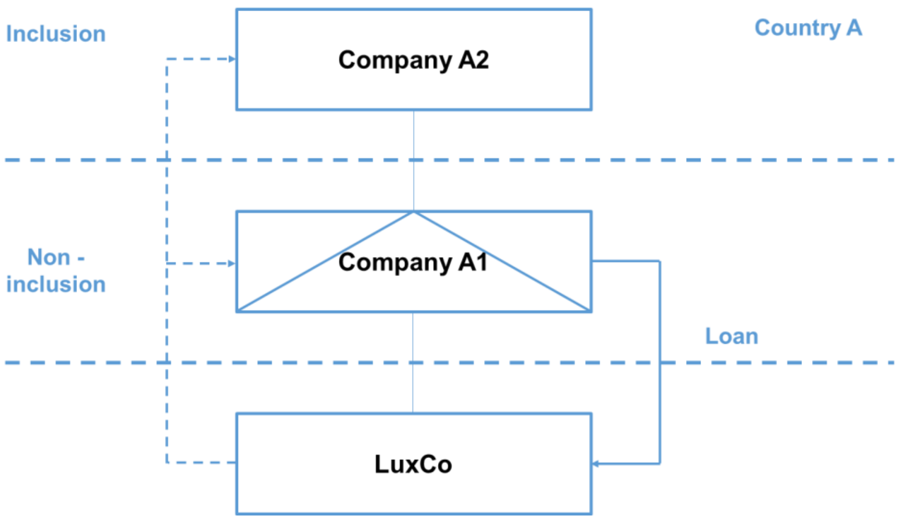
Facts

- Company A2 fully owns Company A1, which fully owns LuxCo (resident in Luxembourg). A1 and A2 are established in country A. A2 sees A1 as tax transparent
- A1 lends money to LuxCo under a financial instrument that qualifies as debt in Luxembourg. The qualification in country A is irrelevant for purposes of this example.
- A1 is tax transparent or disregarded in country A, but opaque for Luxembourg tax purposes.
- A2 is thus seen as beneficiary of the payment under country A's tax laws, whereas under Luxembourg tax law it is A1.



Question

Should Company A2 be considered as payee under article 168*ter* of Luxembourg Income Tax Law (LITL)?

Analysis

Pursuant to article 168*ter* LITL, the payee jurisdiction is any jurisdiction where the payment or deemed payment is received or treated as being received under the laws of any other jurisdiction.

Although from a Luxembourg tax perspective, A1 is considered as the payee, from country A's perspective, A2 is the payee. As such, both A1 and A2 may be considered as payee for the application of article 168*ter* LITL.

To the extent the interest is included at A2's level[1], there is no hybrid mismatch.

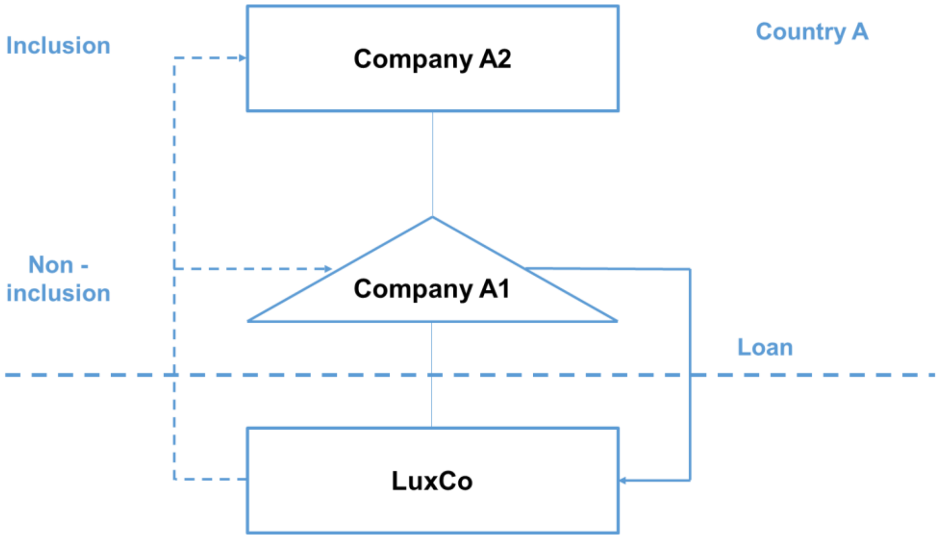
The same conclusion applies in case A2 is exempt under the laws of country A.

[1] See section 1.3 for definition of inclusion

1.1.2. Definition of beneficiary – Payment to a transparent entity

Facts

- Company A2 fully owns Company A1, which fully owns LuxCo (resident in Luxembourg). A1 is established in country A. A2 may be established in any jurisdiction that sees A1 as transparent or disregarded (here, country A).
- A1 lends money to LuxCo under a financial instrument that qualifies as debt in Luxembourg. The qualification in country A is irrelevant for purposes of this example.
- A1 is transparent both for country A's and for Luxembourg tax purposes.
- A2 is opaque for Luxembourg tax purposes and in country A.
- A2 is thus seen as beneficiary of the payment under country A's and Luxembourg tax laws.



Question

May Company A2 be considered as payee under article 168*ter* LITL?

Analysis

Pursuant to article 168*ter* LITL, the payee jurisdiction is any jurisdiction where the payment or deemed payment is received or treated as being received under the laws of any other jurisdiction.

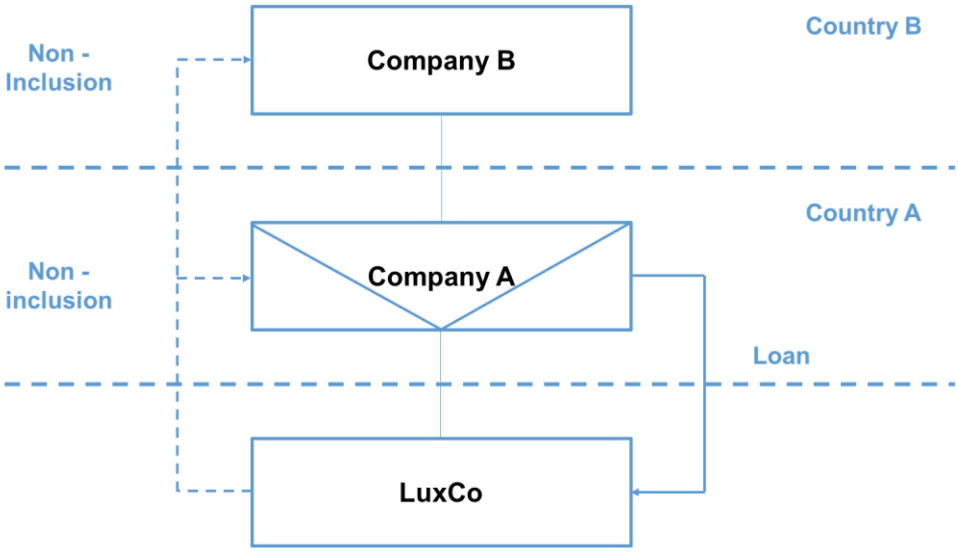
In this example, A1 is transparent under the laws of both country A and Luxembourg. As such, for both countries, the payee is A2. Thus, A2 may be considered as payee for the application of article 168*ter* LITL. A1 cannot be a payee.

If A2 includes the payment under the loan, there is no hybrid mismatch in this case.

1.1.3 Definition of beneficiary – Payment to a reverse hybrid entity

Facts

- Company B fully owns Company A, which fully owns LuxCo (resident in Luxembourg). A is established in country A. B may be resident in any jurisdiction that sees A as opaque.
- A lends money to LuxCo under a financial instrument that qualifies as debt in Luxembourg. The qualification in country A is irrelevant for purposes of this example.
- A is transparent both for country A's and for Luxembourg tax purposes.
- B is thus seen as beneficiary of the payment under country A's and Luxembourg tax laws. B is, however, not considered as beneficiary under country B's tax laws, as Country B sees A as opaque.



Question

May Company B be considered as payee under article 168*ter* LITL?

Analysis

Pursuant to article 168*ter* LITL, the payee jurisdiction is any jurisdiction where the payment or deemed payment is received or treated as being received under the laws of any other jurisdiction.

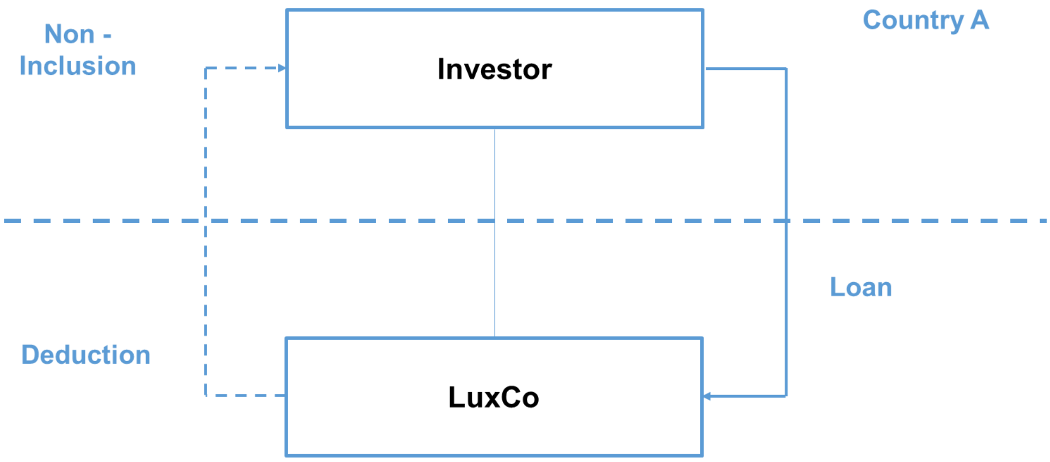
In this example, A is transparent under the laws of both Country A and Luxembourg. As such, for both countries, the payee is B. Thus, B may be considered as payee for the application of article 168*ter* LITL. From the perspective of country B, A is the payee, as country B sees A as opaque.

As neither A, nor B includes the payment under the loan, there is a deduction without inclusion resulting in a hybrid mismatch which may be covered under article 168*ter* LITL, paragraph 1, number 2, letter b. Please refer to section 3 for more details.

1.2. Notion of payment – Absence of mismatch due to foreign exchange differences

Facts

- The Investor (in country A) fully owns LuxCo (resident in Luxembourg).
- The Investor lends money to LuxCo under an ordinary interest-bearing loan.
- The annual interest is deductible for LuxCo and included in the tax base of the Investor.
- The interest and principal are denominated in the currency of country A.
- During the lifetime of the loan, the Euro (accounting and tax functional currency of LuxCo) loses value against currency A, so that payments made by LuxCo become more expensive in Euro. Country A of course does not recognise these foreign exchange results.



Question

Does the deduction recognised in Luxembourg and not reflected by a corresponding amount in country A give rise to a hybrid mismatch in scope of article 168*ter* LITL?

Analysis

The difference in tax treatment in this case does not arise because the tax systems of Luxembourg and country A characterize the payments in different ways or arrive at a different value for the payments made under the loan.

Gains or losses that result from converting a foreign currency into the local or functional currency are attributable to the way jurisdictions measure the value of money rather than the value or the underlying character of the payment itself, and do not give rise to a mismatch in scope of article 168*ter* LITL.

1.3. Definition of "inclusion"

"Inclusion" is defined in article 168*ter* LITL, paragraph 1, number 7 as the amount "*that is taken into account in the taxable income under the laws of the payee jurisdiction.*"[2]

Subject to the specific case of hybrid instrument mismatch, the text of Luxembourg law, identical to the text of ATAD 2, does not require the amount to be taken into account and taxed without tax relief, but only that the amount is taken into account for the determination of the taxable basis.

An amount will therefore still be considered included even if, amongst others, it is:

- offset by carried forward losses;
- benefiting from an exemption or a tax credit in the jurisdiction of the payee, except if the exemption or the tax credit is solely due to the different qualification of the income under a hybrid financial instrument (see section 2 for further details); or
- subject to tax at a fixed rate (reduced or not).

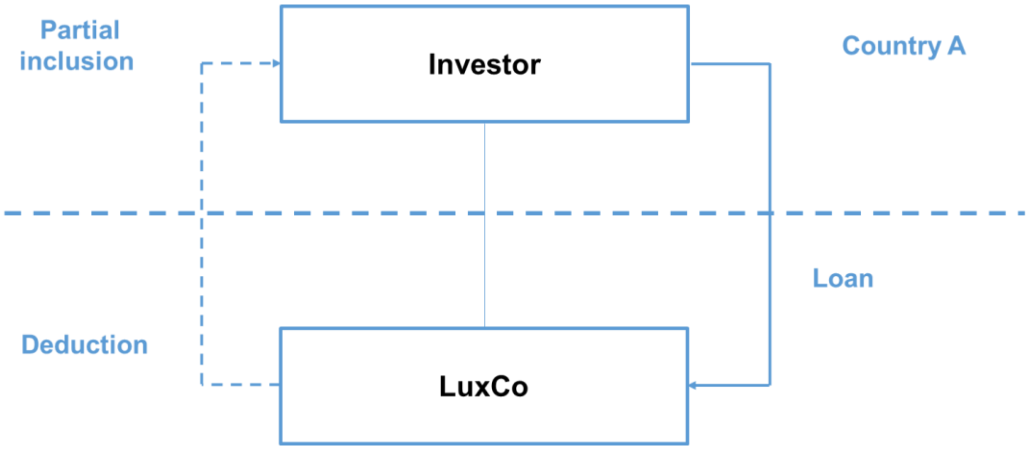
[2] Original French version (identical to the French version of ATAD 2 definition): *«le montant qui est pris en compte à la base de calcul du revenu imposable en vertu des lois de la juridiction du bénéficiaire»*.

2. Section 2 – Hybrid financial instruments

2.1. Notion of inclusion - Reference tax treatment for comparison (rate applicable to income from financial instruments)

Facts

- The Investor, a company in country A fully owns LuxCo (resident in Luxembourg).
- Company A lends money to LuxCo under a hybrid financial instrument: LuxCo treats it as debt (and deducts the interest); Company A treats it as equity and taxes payments as dividends.
- In country A, income from financial instruments (which includes both dividend and interest income) is subject to a fixed 4% tax rate. Ordinary income is taxed at a 20% rate.



Question

Is there a hybrid mismatch under article 168*ter* LITL, paragraph 1, number 2, letter a?

Analysis

The payment under the loan does not result in any hybrid mismatch, as the payment is included in the Investor's tax base and there is no tax relief due to the qualification of the instrument.

"Tax relief" is defined as "*a tax exemption, reduction in the tax rate or any tax credit or refund (other than a credit for taxes withheld at source)*". The 4% rate is a fixed rate applicable to income from financial instruments (dividends and interest), not a tax exemption or the result of a tax credit or refund.

There is also no "reduction in the tax rate", as that concept should refer to the application of a reduction applied to the general tax rate applicable to the payee, which is different from a fixed rate for specific types of income[3]. If the reduced tax rate is no less than the rate applicable to any other payment of income under a financial instrument (such as ordinary interest on a loan), no mismatch will arise for the purposes of the hybrid financial instrument rule.

In case of a partial or total exemption, or of an eligibility to an underlying tax credit, there may be no inclusion in the context of the hybrid financial instrument rule, unless one can demonstrate that such tax relief does not apply *solely* due to the way the financial instrument is characterized under the laws of the payee jurisdiction.

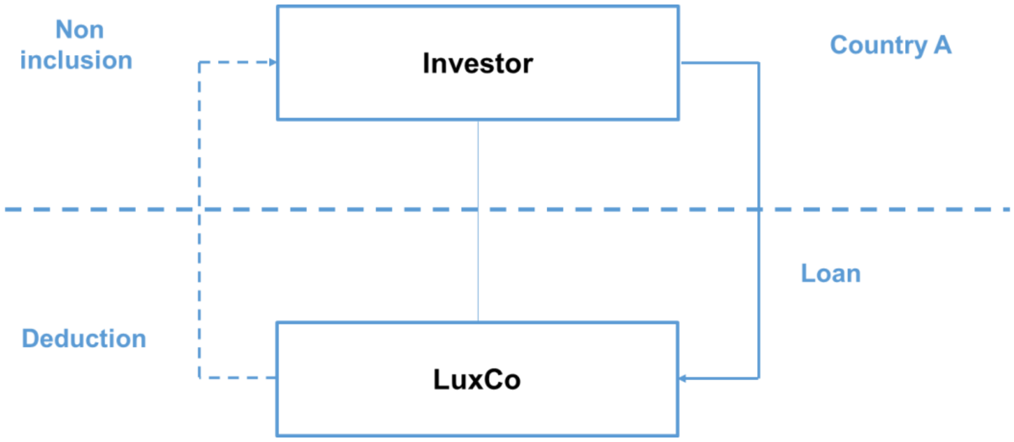
[3] See also State council opinion, p.17-18

2.2. Non-application of the rules where the tax relief is due to other factors

2.2.1. Payment to a tax-exempt investor

Facts

- The Investor (a company in country A) fully owns LuxCo (resident in Luxembourg).
- The Investor is opaque, but tax exempt in its country (for example, because it is a pension fund, an investment fund or a sovereign wealth fund benefiting from a subjective tax exemption based on the tax laws of Country A)[4].
- The Investor lends money to LuxCo under a financial instrument treated as debt by LuxCo. The qualification of the instrument at Investor's level is irrelevant, as the Investor is in any case exempt.



Question

Do the interest payments fall within the scope of the hybrid financial instrument rule (article 168*ter* LITL) and, if so, to what extent is an adjustment required in accordance with that rule?

Analysis

In this case, the D/NI outcome would arise in any case as a result of the investor's tax status (irrespective of the qualification of the instrument). Consequently, article 168*ter* LITL should not restrict the deductibility of interest expenses paid by LuxCo under the financial instrument.

Article 168*ter* LITL, paragraph 1, number 2 indeed foresees that "*a payment made under a financial instrument is not considered as included to the extent that this payment qualifies for any tax relief* **solely** *due to the way that payment is characterised under the laws of the payee jurisdiction*" (emphasis added).

Therefore, there is no need to test if the mismatch in tax outcomes would also have arisen, had the payment been made to an ordinary corporate taxpayer in country A.

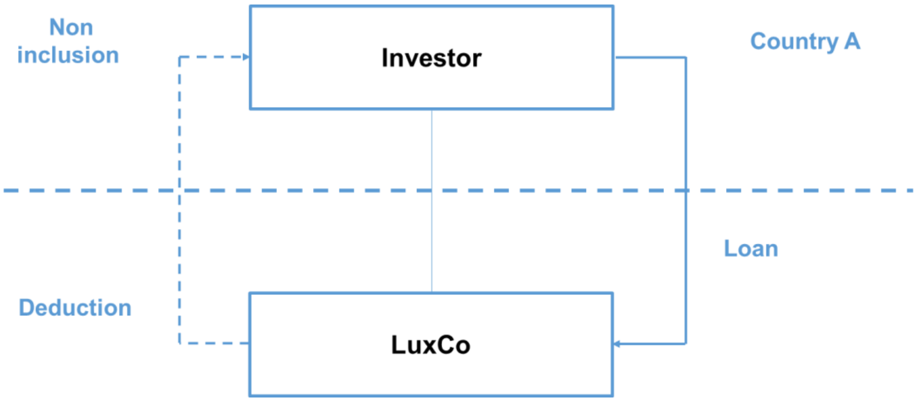
The tax treatment of the Investor by its own shareholders is irrelevant to the answer.

[4] See recital 16 of the ATAD 2 Directive and parliamentary comments on bill n°7466 (p. 6)

2.2.2. Payment to an investor in a zero tax or no-tax jurisdiction

Facts

- The Investor, a company in country A, fully owns LuxCo (resident in Luxembourg).
- Country A either does not have a corporate tax system or levies corporate tax at a 0% rate.
- The Investor lends money to LuxCo under a financial instrument treated as debt by LuxCo. The qualification of the instrument at Investor's level is irrelevant, as the Investor is in any case established in a no-tax or zero-tax jurisdiction.
- The Investor is opaque (and thus seen as payee) for Luxembourg tax purposes.



Question

Do the interest payments fall within the scope of the hybrid financial instrument rule (article 168*ter* LITL) and, if so, to what extent is an adjustment required in accordance with that rule?

Analysis

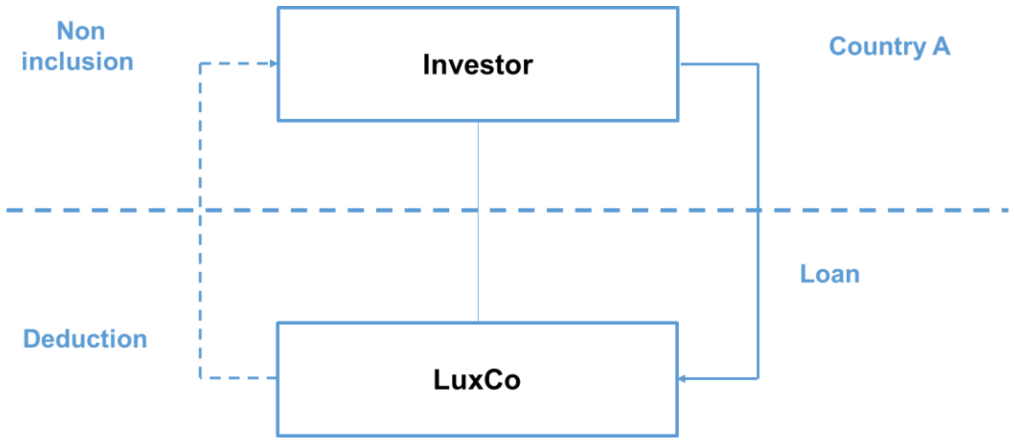
Whether the investor is resident in a zero-tax or a no-tax jurisdiction, the D/NI outcome will not be caught by article 168*ter* LITL, which will thus not restrict the deductibility of interest expenses under the loan. The D/NI outcome is indeed not due to a difference in qualification of the financial instrument or the payment made under it, but to the tax system of country A, where the Investor is established.

The tax treatment of the Investor by its own shareholders is irrelevant to the answer.

2.2.3. Payment to an investor in a country with a territorial tax regime[5]

Facts

- The Investor, a company in country A, fully owns LuxCo (resident in Luxembourg).
- Country A has a territorial tax system, i.e. only taxes domestic-sourced income or foreign income remitted to country A.
- The Investor lends money to LuxCo under a financial instrument treated as debt by LuxCo. The qualification of the instrument at Investor's level is irrelevant, as the Investor is in any case established in a jurisdiction with a territorial regime: income received on the loan is not subject to tax at the level of the Investor if not sourced in the territory.
- LuxCo has no taxable presence in the Investor's country of residence (country A).
- The Investor is opaque for Luxembourg tax purposes and has no foreign permanent establishments.



Question

Do the interest payments fall within the scope of the hybrid financial instrument rule (article 168*ter* LITL) and, if so, to what extent is an adjustment required in accordance with that rule?

Analysis

In this case, the mismatch is not attributable to the characterisation of the instrument or the payment made under it, but to the fact that the Investor is not subject to tax on any type of foreign sourced income as a result of the territorial tax system applied in country A.

The D/NI outcome will therefore not be treated as a hybrid mismatch. Consequently, article 168*ter* LITL should not restrict the deductibility of interest expenses paid by LuxCo under the financial instrument.

The tax treatment of the Investor by its own shareholders is irrelevant to the answer.

[5] See example 1.7 of the BEPS Action 2 report. LuxCo

3. Section 3 - Hybrid entities

3.1. Definitions and main concepts

A "**hybrid entity**" is an entity that is treated as tax opaque in a jurisdiction and as tax transparent in one or more other jurisdictions[6].

In effect, the relevant jurisdictions are those of establishment of the entity and those of the investors: if the taxable non-Luxembourg entity is tax transparent from the sole perspective of the Luxembourg payer (in case of payment to a hybrid entity), then there should be no hybrid mismatch outcome[7].

Hence, there can be a hybrid mismatch due to a hybrid entity if:

- The entity is transparent for tax purposes in its jurisdiction of establishment, but tax opaque from the perspective of (some or all of) its investors. In such case, the entity is called a "reverse hybrid". Section 4 addresses the rules applicable to reverse hybrid entities as from 2022; in the meantime, the ordinary anti-hybrid entity rules will apply where there is a deduction / non-inclusion outcome with respect to a payment made to the hybrid entity. See section 3.2 for further details on the consequences for a Luxembourg payer in such a situation;

- The entity is tax opaque in its country of residence/establishment, but tax transparent for one or more investors. In such case, there may be double deduction situations, as the jurisdictions of the entity and of its investors that see the entity as tax transparent may deduct the same charges of the entity. A deduction / non-inclusion situation may arise, where the hybrid entity makes a deductible payment to its investors that see the entity as transparent and therefore do not recognise the payment (section 3.3).

In case of payment by a Luxembourg company to an entity opaque in its jurisdiction but considered as transparent by one or more investors, there is no hybrid mismatch outcome to the extent the payment is considered included at the level of the hybrid entity, i.e., there is no deduction / non-inclusion situation. The imported mismatch rules could, however, apply in case there is a double deduction in the entity and at its investors' level or in case of a deduction / non-inclusion situation between the entity and one or more investors (in both cases, if the payment giving rise to the mismatch is funded out of the payment by the Luxembourg company to the hybrid entity).

ATAD 2 only applies if the mismatch arises between associated enterprises or in the context of a structured arrangement. For hybrid mismatches involving a hybrid entity, the association threshold is set at 50% of capital, voting rights or profit entitlement. The association test could also be met in case the hybrid entity forms part of a consolidated financial group or in case of significant influence.

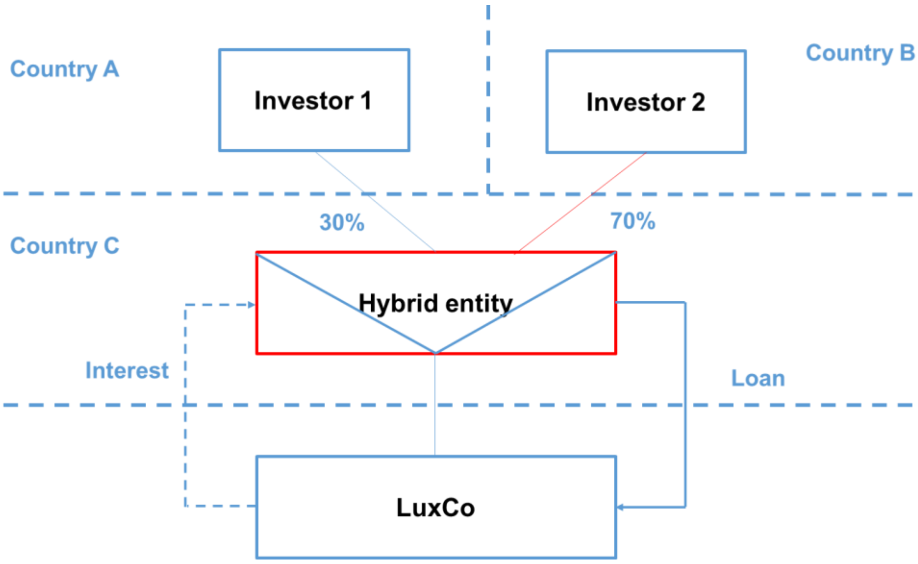
[6] Article 168*ter* LITL, paragraph 1, number 10: "*« organisme hybride », tout organisme ou tout dispositif qui est considéré en vertu des lois d'une juridiction comme un organisme soumis à l'impôt et dont les revenus ou les dépenses sont considérés en vertu des lois d'une autre juridiction comme les revenus ou les dépenses d'une ou de plusieurs autres personnes physiques ou organismes*".

[7] Article 168*ter* LITL, paragraph 1, number 6 (definition of deduction / non-inclusion) specifies that "*the jurisdiction of the beneficiary is any jurisdiction in which the payment is received or deemed received according to the laws of any other jurisdiction.*" Original French version: "*La juridiction du bénéficiaire est toute juridiction où ce paiement ou paiement réputé effectué est reçu, ou est considéré avoir été reçu en vertu des lois de toute autre juridiction.*" The payment would be treated as received in the jurisdiction of the hybrid entity recipient of the payment (and included in the tax base of that entity, as it is tax opaque in its jurisdiction of establishment), so that there would be no deduction/non-inclusion outcome.

3.2. Payments to a hybrid entity – deduction / non-inclusion outcome

Facts

- Two investors (resident in different jurisdictions) invest in a private partnership which is:
  - Tax transparent in State C (country of establishment of the partnership)
  - Tax transparent for State A (country of residence of Investor 1); and
  - Tax opaque for State B (country of residence of Investor 2);
- The partnership grants a loan (which is not a hybrid financial instrument) to LuxCo.



Question 1: Are the conditions met for the anti-hybrid entity rules to apply?

In the above fact pattern, the partnership is a hybrid entity (a reverse hybrid entity as from 2022) with respect to Investor 2.

The association requirement is also met, as Investor 2 holds an interest of at least 50% in the LuxCo (through the hybrid entity that owns 100% of LuxCo).

There is a deduction / non-inclusion outcome with respect to 70% of the interest expense, as LuxCo is in principle entitled to deduct the interest, but it is not included at the level of the partnership, nor (for 70%) at the level of Investor 2.

Question 2: What portion of interest would become non-deductible at LuxCo level? (*Pro rata* approach)

The general rule in case of a deduction / non-inclusion outcome covered by ATAD 2 is that the deduction should be denied at the level of the payer to the extent there is no inclusion. This is apparent from the wording "*dans la mesure*" in article 168*ter* LITL, paragraph 3, number 2.

In the above example, only 70% of the interest expense may become non-deductible as a result of the application of the anti-hybrid rules.

Question 3: What is the impact if there are exempt investors?

Where the non-inclusion is not due exclusively to the presence of a hybrid entity (here, the entity in State C), but also to other reasons, such as the exempt tax status of the investors, the deduction of the expense at the level of the payer (here, LuxCo) should be maintained.

Hence, in situations where the investor (i) benefits from a special tax regime, (ii) is tax resident in a jurisdiction with no corporate tax, or (iii) is tax resident in a jurisdiction with a 0% corporate tax rate, or (iv) is tax resident in a country with a territorial tax regime, as the non-inclusion would not result solely from the hybrid character of the entity, the deduction should not be denied.

Hence, in the above situation:

- If Investor 1 is tax exempt, so that the 30% of interest expense deemed paid to Investor 1 through the hybrid entity is effectively not taxed, the deduction of 30% of the interest expense should still be allowed at the level of LuxCo. The absence of inclusion is not due to the hybridity of the entity in State C (it is seen as transparent by Investor 1), and Investor 1 is not associated to that entity and to LuxCo anyway (unless it acts together with Investor 2 or Investor 1 is a party to a structured arrangement).

- If Investor 2 is tax exempt, the 70% of interest expense deemed paid to Investor 2 through the hybrid entity should remain deductible (so that 100% of the interest expense should be deductible at the level of LuxCo). The non-inclusion outcome would also exist if the entity in State C were tax transparent from the perspective of Investor 2, and is therefore not (solely) due to the hybridity of the entity in State C.

The above views rely on the commentary to the bill of law implementing ATAD 2 in Luxembourg, which refers back to recital 18 of ATAD 2. According to that recital, "[…] The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and *a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction*" (emphasis added).

Question 4: In what order would the different anti-hybrid rules apply?

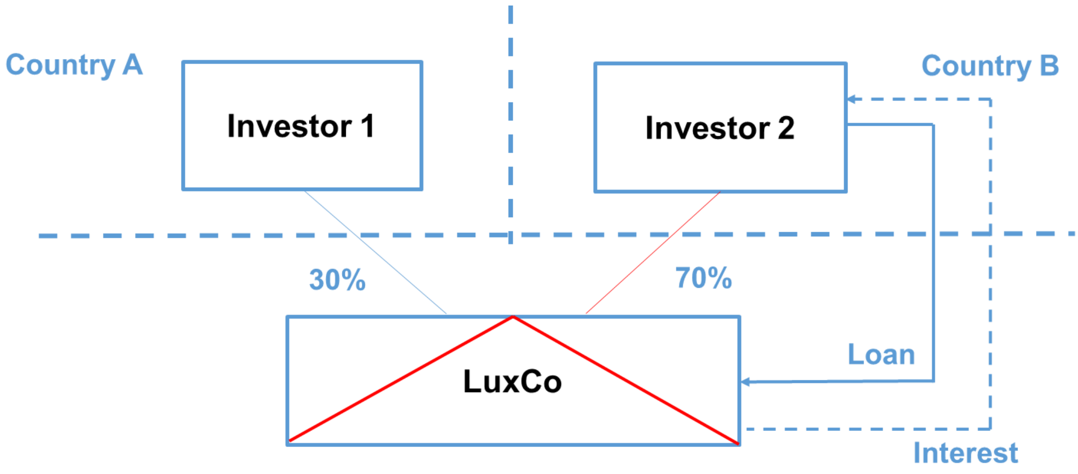
Once the reverse hybrid rules apply (as from 2022), these rules will have precedence over the ordinary anti-hybrid rules dealing with payments to a hybrid entity giving rise to a deduction / non-inclusion outcome. The denial of the deduction will only apply to the extent some income remains non-included at the level of the investors, nor at the level of the reverse hybrid entity.

3.3. Payments by a hybrid entity – deduction / non-inclusion outcome

Facts

- Two independent investors (resident in different jurisdictions) invest in LuxCo (a Luxembourg company resident in the meaning of article 159 LITL) which is considered as:
  - Tax opaque by State A (country of residence of Investor 1); and
  - Tax transparent by State B (country of residence of Investor 2).

- Investor 2 grants loans (which are not hybrid financial instruments) to LuxCo.



Question 1: Are the conditions met for the anti-hybrid entity rules to apply?

In the above fact pattern, LuxCo is a hybrid entity with respect to Investor 2.

The association requirement is also met, as Investor 2 holds an interest of more than 50% in the hybrid entity, i.e., LuxCo.

There is a deduction / non-inclusion outcome with respect to the interest paid to Investor 2, as LuxCo is in principle entitled to deduct the interest, but Investor 2 views LuxCo as transparent for tax purposes and therefore does not recognise the payment received from LuxCo.

Question 2: What is the consequence of having dual inclusion income?

If the charge giving rise to a deduction / non-inclusion is offset against income of LuxCo that is subject to dual inclusion (included also at the level of Investor 2), the right to deduct is upheld.

Question 3: What is the impact if there are exempt investors?

Where the non-inclusion is not due exclusively to the presence of a hybrid entity (here, LuxCo), but also to other reasons, such as the exempt tax status of the investors, the deduction of the expense at the level of the payer (here, LuxCo) should be maintained. The reference to exempt tax status should be understood as encompassing situations where the investor benefits from a special tax regime, is resident in a jurisdiction with no corporate tax, or is tax resident in a jurisdiction with a 0% corporate tax rate, or is resident in a country with a territorial tax regime

Hence, in the above situation, if Investor 2 is tax exempt, the interest expense paid by LuxCo to Investor 2 should remain deductible.

The non-inclusion outcome would also exist if LuxCo were considered opaque from the perspective of Investor 2, and is therefore not (solely) due to the hybridity of the entity in State C.

The above views rely on the commentary to the bill of law implementing ATAD 2 in Luxembourg, which refers back to recital 20 of ATAD 2. According to that recital, “no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction”. Hence, no counterfactual test (i.e., comparison with the tax position, where the investor is a taxable person in its jurisdiction of residence) needs to be performed.

3.4. Double Deduction - definitions and main concepts

"**Double deduction**" (DD) means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated[8].

Double deductions caught by article 168*ter* LITL, paragraph 3, number 1 must meet the general condition that they arise between associated enterprises or as part of a structured arrangement (see article 168*ter* LITL, paragraph 2)[9].

The double deduction rule covers not only payments but also expenses incurred and losses suffered. However, losses caught by the DD rule do not include carried forward losses, but only refer to capital losses upon disposal of an asset or redemption of a financial instrument[10].

In order for a double deduction to be caught by the rule, it has to arise from a conceptual asymmetry[11]. Hence, a loss on an asset deducted by a Luxembourg company and a loss deducted by its parent company further to a value reduction booked on the shares of the Luxembourg company do not arise from any asymmetry and there is no double deduction in the meaning of article 168*ter* LITL.

Similarly, a deduction taken by a Luxembourg company considered as a CFC (or similar regime) by its direct or indirect parent, which is also taken by its direct or indirect parent company as a deduction for the purpose of determining the net income of the Luxembourg company to be subject to tax as CFC (or similar regime) inclusion in the jurisdiction of the direct or indirect parent company does not arise from any asymmetry and does not result in a double deduction caught by the rules, as the deduction taken for computation of the CFC inclusion does not arise from any mismatch in the sense of article 168*ter* LITL, paragraph 1, number 2. The deduction taken by the direct or indirect parent for the computation of the CFC inclusion is indeed not a deduction arising from any asymmetry or hybrid mismatch, but from the mere application of CFC (or similar regime) application rules.

[8] Article 168*ter* LIR paragraph 1, number 5: *« double déduction », « une déduction du même paiement, des mêmes dépenses ou des mêmes pertes dans la juridiction d'origine du paiement, des dépenses ou des pertes (juridiction du payeur) et dans une autre juridiction (juridiction de l'investisseur). Dans le cas d'un paiement par un organisme hybride ou un établissement stable, la juridiction du payeur est celle dans laquelle l'organisme hybride ou l'établissement stable est établi ou situé. »*

[9] Article 168*ter* LIR paragraph 2, original French text: « (2) *Il ne peut être question de dispositif hybride que si l'effet d'asymétrie survient entre des entreprises associées, entre le contribuable et une entreprise associée, entre le siège et un établissement stable, entre deux établissements stables ou plus du même organisme ou dans le cadre d'un dispositif structuré »*.

[10] See State Council comments in parliamentary document 7466/04 page 15.

[11] Ibid.

4. Section 4 – Reverse hybrid entities

4.1. Definitions and main concepts

The so-called "Reverse Hybrid Rule" foreseen by art. 168*quater* LITL will apply as of tax year 2022 (i.e., for financial years closing between 1 January 2022 and 31 December 2022).

In order for the Reverse Hybrid Rule to apply, the situation under review needs to involve associated enterprises within the meaning of Section 5 below. For the purpose of this section, we assume that the relevant vehicle and some or all of its investors can be considered as associated enterprises.

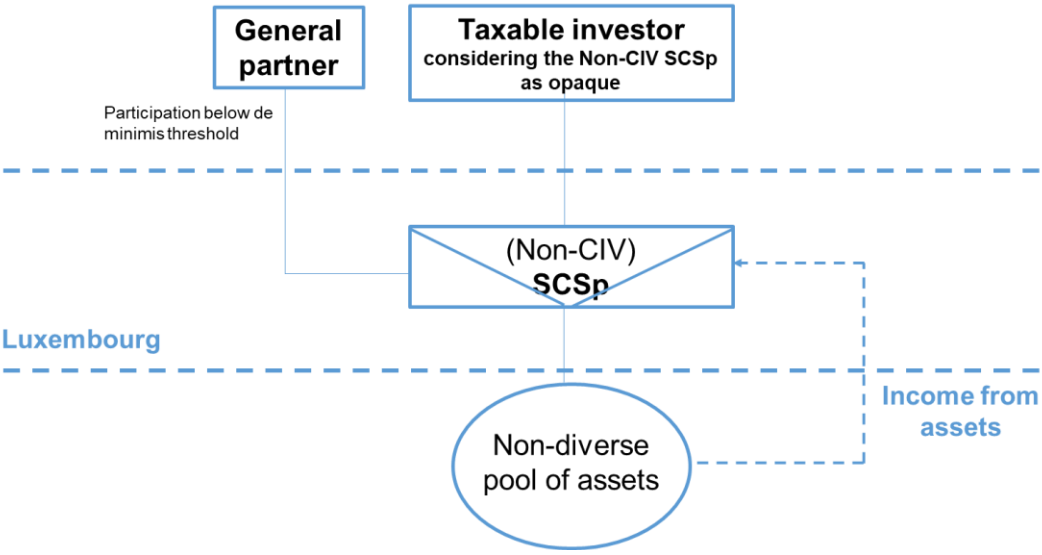
If the reverse hybrid rules of Article 168*quater* LITL (or an equivalent provision in another country) are not applicable to a reverse hybrid entity, the ordinary anti-hybrid entity rules may still apply to payments made to or by such entity (see section 3).

4.2. Taxation of a reverse hybrid

4.2.1 Non-CIV SCSp with a single taxable investor

<u>Facts</u>

The vehicle is a special limited partnership (SCSp) dedicated to a single investor and holding a non-diverse pool of assets. The vehicle therefore does not meet the test to be considered a collective investment vehicle ("**CIV**", further details in para. 4.3 below) ("**Non-CIV SCSp**").



<u>Question</u>

Will the Reverse Hybrid Rule of article 168*quater* LITL apply to a Non-CIV SCSp and, if so, what adjustments will need to be made from a Luxembourg tax perspective?

Analysis

The Non-CIV SCSp is considered as tax transparent in Luxembourg. Payments made to the Non-CIV SCSp are therefore not included at the level of the Non-CIV SCSp but are to be taxed directly at the level of its non-resident investor to which such income is allocated.

If the investor also considers the Non-CIV SCSp as tax transparent, the income of the Non-CIV SCSp is included in its taxable basis even without a formal distribution by the Non-CIV SCSp. No hybrid mismatch arises as the income (which is not included in Luxembourg at the level of the Non-CIV SCSp) is included in the home country of the investor.

Some investors' jurisdictions however could consider the Non-CIV SCSp as tax opaque. These investors therefore consider that the income of the Non-CIV SCSp is to be included in Luxembourg, at the level of the – from their perspective – opaque SCSp. With respect to these investors that consider the Non-CIV SCSp as opaque, the income, which is not included in Luxembourg at the level of the Non-CIV SCSp, is also not included in their home country tax basis (non-inclusion).

Given that in the example the investor holds all, i.e. more than 50% of the capital/voting rights or entitlements to profits in the Non-CIV SCSp, it is considered an associated enterprise within the meaning of ATAD 2[12] and the absence of taxation resulting from the (reverse) hybrid character of the Non-CIV SCSp will be corrected under ATAD 2 as follows: as of tax year 2022, Non-CIV SCSp will in principle become subject to corporate income tax in Luxembourg on the basis of the Reverse Hybrid Rule of art. 168*quater* LITL on the income received, to the extent that there is no taxation elsewhere.

Comments

For the avoidance of doubt, the application of the Reverse Hybrid Rule poses two main difficulties:

a) the calculation of the 50% threshold which only takes into account investors that (i) can be considered as associated enterprises investors and (ii) consider the Non-CIV SCSp as opaque and,

b) assuming the rule applies, the calculation on the portion of income, if any, to be taxed at the level of the Non-CIV SCSp.

On the first point, an investor should not be taken into account to assess the 50% threshold relating to the opacity of an entity in case it is resident or established in a no tax jurisdiction.

On the second point, the liability to tax is limited to corporate income tax (at the current rate of 17%). excluding liability to municipal business tax or net wealth tax. Distributions by the Non-CIV SCSp continue not to be subject to withholding tax.

Only the portion of the income of the SCSp which is not otherwise taxed in Luxembourg, in another state or at the level of the investor(s) in the Non-CIV SCSp, will be subject to corporate income tax at the level of the Non-CIV SCSp.

In addition, given that the income of the Non-CIV SCSp will be subject to corporate income tax in accordance with ordinarily applicable rules, exemptions or relief from corporate income tax in accordance with ordinarily applicable rules, such as art. 115.15, a) LITL, should be available for dividends[13].

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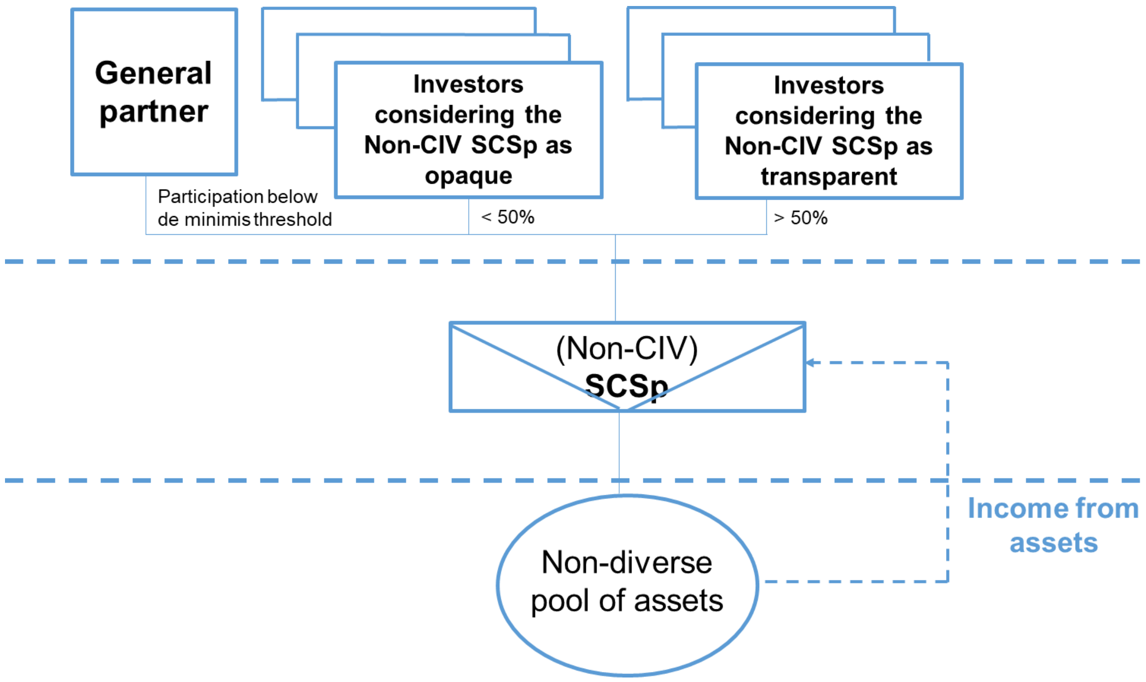
[13] There may be arguments for sustaining that, to the extent the Non-CIV SCSp becomes subject to corporate income tax as a result of the Reverse Hybrid Rule, it should also benefit from the participation exemption regime for dividends or capital gains, provided of course the minimum holding requirements are met.

4.2.2. Non-CIV SCSp with multiple investors

Facts

The vehicle is a Non-CIV SCSp holding a non-diverse pool of assets and having multiple investors.

In this example, investors considering the Non-CIV SCSp as tax opaque represent less than 50% of (the capital, voting rights or entitlements to profits in) the Non-CIV SCSp.



Question

Will the Reverse Hybrid Rule (article 168*quater* LITL) apply to the Non-CIV SCSp and, if so, what adjustments will need to be made from a Luxembourg tax perspective?

Analysis

As the Non-CIV SCSp is considered as tax transparent in Luxembourg, payments made to the Non-CIV SCSp are to be taxed directly at the level of the non-resident investors. Investors that consider the Non-CIV SCSp as opaque however consider that the income of the Non-CIV SCSp is to be taxed in Luxembourg, at the level of the – from their perspective – opaque SCSp. With respect to these investors, the income, which is not taxed in Luxembourg at the level of the Non-CIV SCSp, is also not taxed in their home country tax basis.

Given that in the example the investors that consider the Non-CIV SCSp as opaque hold less than 50% of the capital, voting rights or entitlements to profits in the Non-CIV SCSp, the Reverse Hybrid Rule will not apply and no adjustment is needed from a Luxembourg tax perspective.

Comments

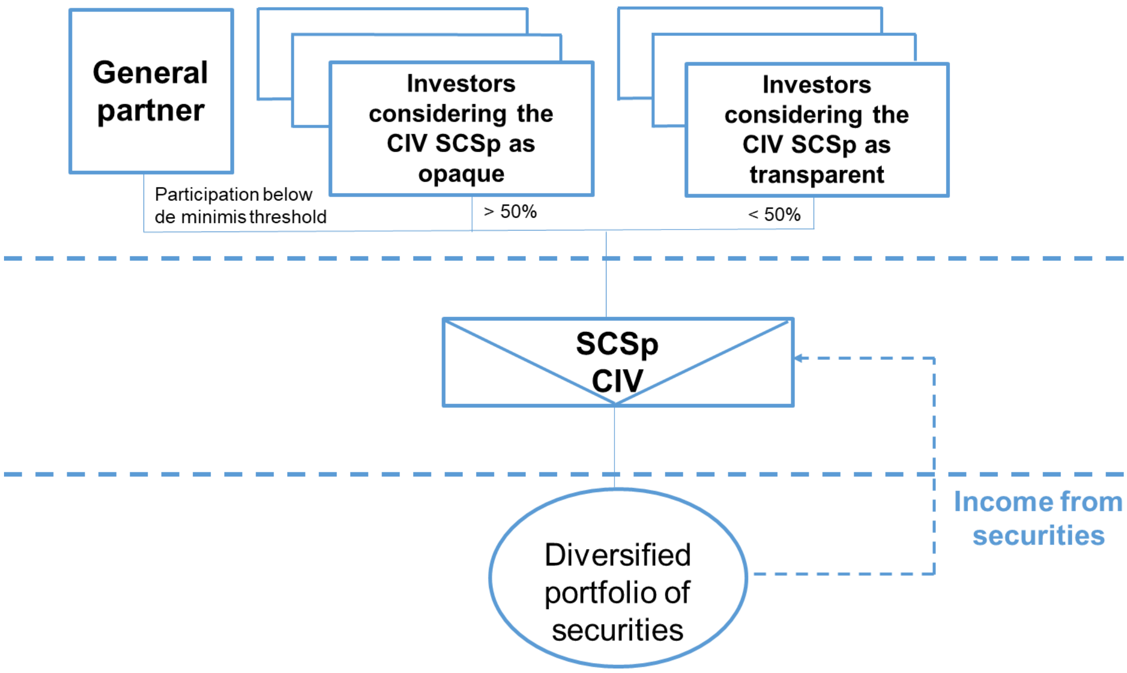
Note that investors which are resident in a jurisdiction which does not levy tax or otherwise which also does not have the concept of tax transparency vs opacity should be excluded from the calculation of the threshold of investors that consider the Non-CIV SCSp as opaque.

4.3. Carve-out rule for Collective Investment Vehicles (CIVs)

Facts

The fund vehicle is an SCSp organised under the law on reserved alternative investment funds with multiple non-resident investors investing in a diverse portfolio of securities ("**SCSp CIV**").

In this example, investors holding more than 50% of (the capital, voting rights or entitlements to profits in) the SCSp CIV consider SCSp CIV as tax opaque.



Question

Will the Reverse Hybrid Rule (article 168*quater* LITL) apply to SCSp CIV and, if so, what adjustments will need to be made from a Luxembourg tax perspective?

Analysis

A CIV is excluded from the application of the Reverse Hybrid Rule (art. 168*quater* (2) LITL), no adjustment needs to be made from a Luxembourg tax perspective.

Comments

The notion of a Collective Investment Vehicle (CIV) in ATAD 2

For the application of the Reverse Hybrid Rule, ATAD 2 refers to “CIVs” rather than to Undertakings for Collective Investment in Transferable Securities (UCITS) and/or Alternative Investment Funds (AIFs) as this could have been the case for an EU directive. This position is different from the one taken in ATAD where UCITS and AIFs identified as “financial undertakings” have been carved out from the application of some of the provisions of the ATAD. This seems to indicate that in ATAD 2 the scope for this carve out rule is based on a different approach and the rule provides for its own definition for a CIV that seems to be inspired by the approach taken by the OECD[14].

A collective investment vehicle (“CIV”) is defined as

- *an investment fund or vehicle,*
- *that is widely held,*

The notion of “widely held” is not defined by Luxembourg law nor by the OECD. However some indications as to how “widely held” should be understood may be found in the 2010 OECD report: it may obviously be assessed on the basis of the number of investors in a fund or vehicle although the OECD is not providing any minimum required number of investors however the type of investors and/or the nature of the fund may also be relevant for that purpose. Also, whereas in the ramp-up period a fund vehicle may have only a few investors, the main reference point is the intention to have a collective investment vehicle open to multiple investors throughout its lifetime. A few examples may be given.

<u>Example 1:</u> A master fund is held by a feeder fund that is widely held. The 2010 OECD report indicates *“For purposes of this Report, the term “CIV” is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. The term would include “master” and “feeder” funds that are part of “funds of funds” structures where the master fund holds a diversified portfolio of investments on behalf of the feeder funds that are themselves widely held.”*

<u>Example 2:</u> UCITS are largely distributed funds to both retail and institutional or professional investors. Assuming a UCITS which is formally held by 3 institutional investors, it would still be considered a “widely held” fund where the institutional would be acting as nominees (on behalf of other investors).

<u>Example 3:</u> An AIF that is largely distributed (like a UCITS) amongst professional or institutional investors is to be considered as being widely held.

<u>Example 4:</u> An AIF held by multiple investors that are either entities belonging to the same group of companies or individuals from the same family may not be considered as being “widely held” because the diversity of investors may only be apparent.

- *holds a diversified portfolio of securities,*

In the absence of any indication in the 2010 OECD report in relation to this criteria, the diversification of the portfolio may, by reference to the interpretation of other relevant Luxembourg legislation regarding investment funds, be assessed based on a look-through approach i.e. by determining whether the fund vehicle directly holds the securities or whether the underlying investments are held

[14] OECD Report adopted by the OECD committee on fiscal affairs on 23 April 2010, the granting of treaty benefits with respect to the income of collective investment vehicles

through one or more aggregating entities should be neutral. The assessment is to be made on a case-by-case basis.

– *and is subject to investor-protection regulation in the country in which it is established.*

In Luxembourg, investment funds were initially subject to a « double » regime of pre-authorisation and supervision by the national regulator which is in charge for both Luxembourg management companies and UCIs (UCITS, Part II funds, SIFs and SICAR). This « double » regime was not foreseen nor required by the AIFM Directive 2011/61/UE and was the mere result of the existing Luxembourg legal framework in relation to investment funds[15].

The investor protection obligation is indeed placed on investment funds and/or their management company, UCITS Management Company or AIFM as the case may be. This obligation would be considered as being fulfilled where the investment fund and/or the management company are authorised and supervised by their home state regulator in accordance with the applicable Luxembourg legislation. This would in particular entail for SCSp CIV that the investor protection requirement is complied with where only the AIFM as defined by AIFMD[16] managing the SCSp CIV is authorised and supervised by its home state regulator.

For the purpose of the carve-out foreseen by art. 168*quater* (2) LITL, any Luxembourg collective investment vehicle subject to the law of 17 December 2010 on UCI, the law of 13 February 2007 on SIF or the law of 23 July 2016 on RAIF should be considered as a CIV. Similarly, the carve-out from the Reverse Hybrid Rule should apply to alternative investment funds (“AIF”) not subject to any of the above-mentioned laws, but which are covered by the law of 12 July 2013, provided that the relevant AIF also meets the other conditions of the definition of “CIV” as detailed above.

[15] L’exposé des motifs fait en outre valoir que *« Ce double régime d’agrément et/ou surveillance n’existe pas lorsque le FIA est établi dans une juridiction (Union européenne ou hors Union européenne) dans laquelle le FIA n’est pas soumis à un régime d’agrément et de surveillance par une autorité compétente nationale. Dans ce cas de figure, le FIA sera réglementé seulement „indirectement“ de par la réglementation applicable à son gestionnaire du fait que ce dernier est autorisé comme GFIA dans sa propre juridiction. Ce cas de figure où il n’y a, contrairement à ce qui est le cas à Luxembourg pour les FIA réglementés, pas de „double“ régime d’autorisation et de surveillance, deviendra nécessairement encore plus fréquent une fois que la Directive GFIA accordera le „passeport européen“ aux FIA établis dans des pays tiers qui, très souvent, ne sont pas soumis à un régime de surveillance comparable au régime luxembourgeois pour les FIA réglementés. »*

[16] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

5. Section 5 – Concept of associated enterprises

The analysis described in this section is applicable for the purposes of article 168*ter* LITL and article 168*quater* LITL.

5.1. General definitions

5.1.1. Criteria for being an "associated enterprise"

Anti-hybrid mismatch rules apply in case of transactions between "associated enterprises" or between a taxpayer and an associated enterprise,[17] between two or more permanent establishments of the same entity or between a permanent establishment and its head office, or if there is a structured arrangement.

Under Article 168*ter* LITL paragraph 1, number 18, the concept of "associated enterprise" is defined as follows:

a) an entity in which the taxpayer holds directly or indirectly a participation of at least 50 per cent in terms of voting rights or capital ownership, or is entitled to receive at least 50 per cent of the entity's profit;
b) an individual or an entity that directly or indirectly holds a participation in the taxpayer of at least 50 per cent in terms of voting rights or capital ownership, or is entitled to receive at least 50 per cent of the taxpayer's profits;
c) an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer;
d) *an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.*

As regards hybrid mismatches involving hybrid financial instruments, the above- mentioned threshold of 50 per cent is reduced to 25 per cent.

In addition, Article 168*ter* LITL paragraph 1, number 18 specifies that:

Where an individual or an entity holds directly or indirectly a participation of at least 50 per cent in terms of voting rights or capital ownership in a taxpayer as well as in one or several other entities, all these entities including the taxpayer are considered as associated enterprises.

The associated enterprise test should apply regardless of the circumstances in which the hybrid mismatch arrangement was entered into.[18]

There is no clarification of the definitions in article 168*ter* LITL, and the commentary accompanying the bill of law is also scarce in details.

5.1.1.1 A percentage of capital ownership, profit entitlement or voting rights

The **voting rights** are those held by shareholders / interest holders in an entity to vote on matters of key corporate decisions, not those of a director or manager during meetings of the board. Paragraph 355 of the OECD BEPS Action 2 report notes that the share- or interest holder "*should have the right*

[17] Article 168*ter* LIR, paragraph 2.
[18] OECD BEPS Action 2 report, §349.

to participate in the decision-making concerning a distribution by that person, a change in that person's constitutional structure or in the appointment of a director."

The **capital ownership** means the portion of the share capital owned by the relevant person in a corporation/entity or, in the case of a partnership, the portion of the capital contributions/partnership interests made by the relevant partner to the partnership.

The **entitlement to profits** covers both entitlement to distributions of profits realised during the year and entitlement to the liquidation surplus. It is irrelevant whether the distributions arise from ordinary or exceptional income. The basis for assessment of the profit entitlement should generally be the rights to profits as set in the constitutional documents of the taxpayer and entities investing directly or indirectly in the taxpayer, or any other document (e.g., a side agreement) which could change these rights. This may however not be sufficient in all cases. Indeed, where the actual payments made include clawbacks of amounts due from previous years (e.g.) then one may potentially have to evidence what the entitlement to profits is based on actual figures.

The associated enterprises test is met as soon as the required percentage is reached regarding at least one of the three above-mentioned criteria. For instance, where a shareholder is entitled to 30% of the profits of a taxpayer but only holds 10% of the share capital and voting rights of the taxpayer, this shareholder is considered as an associated enterprise of the taxpayer for the purposes of the anti-hybrid financial instrument rule (the 25% threshold being met regarding profits' rights).

Indirect holding

A person that holds voting rights, equity interest or entitlement to profits in another person will be treated as holding a proportionate amount of the voting rights or equity interests held by that person. Indirect holdings should be measured on a dilution basis so that if investor A holds 50% of the voting or equity interests in entity B, which holds 50% of the voting or equity interests in a taxpayer C, then investor A should be treated as holding a 25% interest in taxpayer C. This principle is applicable irrespective of the legal form of the person and any intermediary vehicle.

Specific case of the GP in a partnership holding 100% of the taxpayer

For the purposes of the associated enterprise concept as defined by article 168*ter* LITL paragraph 1, number 18, the percentage of the voting rights held by a person referred to under sub-sections a) and b) is an objective criterion referring to the holding of voting rights irrespective of the exercise of such rights.

From a legal point of view, the direct holder of the voting rights in the underlying company (i.e, the taxpayer) is the investment fund only (neither the limited partners of the fund nor the GP) assuming the taxpayer is fully owned by the fund. In such a case, all the voting rights in the underlying company belong to the fund based on a legal analysis.

Regarding indirect holding of the voting rights, the amount of percentage indirectly held by a person must be computed on a dilution basis in accordance with paragraph 361 "Indirect holding" of the BEPS report, which indicates that "*A person that holds voting rights (...) in another person will be treated as holding a proportionate amount of the voting rights (...) held by that person*." Thus, the amount of the voting rights in the underlying company which are indirectly held by the GP must be determined in proportion of i) the voting rights in the fund held by the GP and ii) the voting rights in the underlying company held by the fund. If the GP holds 0.1% of the units and voting rights of the fund and the fund holds 100% of the voting rights in LuxCo, the GP indirectly holds 0.1% of the voting rights in LuxCo.

As a consequence, the GP cannot be regarded as an associated enterprise of the fund and/or of the underlying company under article 168*ter* LITL, paragraph 1, number 18, sub-section b), as long as it does not hold at least 25% (respectively 50%) of the voting rights in the fund and/or at least 25% (50%) of the voting rights in the underlying company (directly or indirectly).

5.1.1.2 Timing for assessment of the 25/50% ownership

Article 168*ter* LITL, paragraph 1, number 18 is silent regarding the date on which the direct and indirect 25%/50% thresholds should be assessed.

In the absence of guidance, the 25/50% thresholds may be computed on a yearly basis, at the closing date of the financial year of the relevant Luxembourg taxpayer, unless specific circumstances require otherwise (e.g. fund raising, ramp up period, exit).

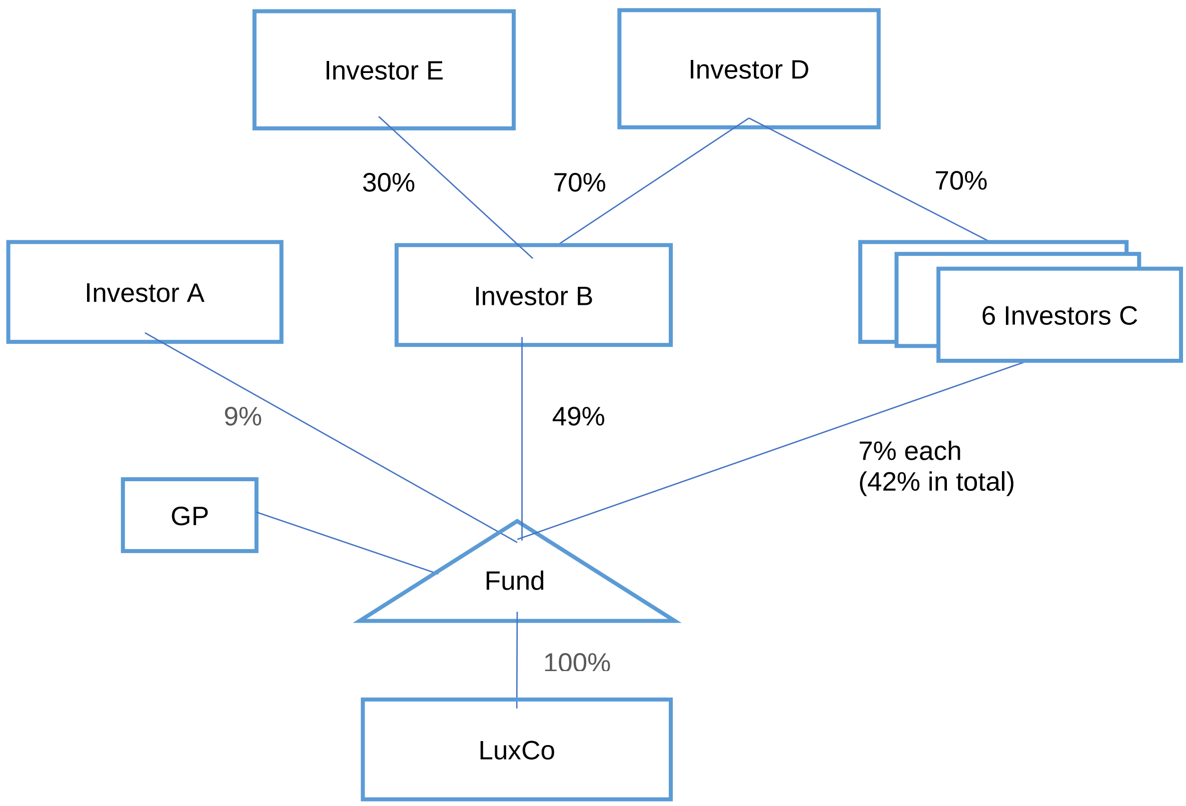
Same consolidated group for accounting purposes

A subsidiary entity should be treated as related to its ultimate parent if the subsidiary is required by law to be consolidated for accounting purposes, on a line-by-line basis in the parent's consolidated financial statements prepared under Luxembourg Generally Accepted Accounting Principles (GAAP), GAAP of another EU Member State and/or International Financial Reporting Standards (IFRS).

5.1.2. Computing the 25%/50% threshold – Indirect ownership

<u>Facts</u>

- A Luxembourg taxpayer (resident company, in the meaning of article 159 LITL) is fully held by a Luxembourg fund, which in turn has several direct and indirect investors (see below chart).
- The entitlement to profits and the voting rights are proportional to the capital ownership.
- No investor is acting together with another investor.



Question

Which entities in the structure are associated enterprises of LuxCo within the meaning of Article 168*ter* LITL, paragraph 1, number 18?

Analysis

The Fund, Investor B, the 6 Investors C and Investor D are associated enterprises of LuxCo.

The participation in the capital, voting rights or profit entitlement is to be assessed both directly and indirectly.

The Fund holds 100% of LuxCo and, as such, always qualifies as associated enterprise.

As regards indirect ownership:

- Investor A holds 9% of LuxCo.
- Investor B holds 49% of LuxCo.
- Each Investor C holds 7% of LuxCo.
- Investor D holds 63.7% of LuxCo.
- Investor E holds 14.7% of LuxCo.

Investor D is therefore associated to LuxCo, while Investor B on its own passes the threshold to qualify as associated enterprise of LuxCo in the context of a hybrid financial instrument mismatch.

In addition, Investor D is associated to Investor B and the Investors C for purposes of all anti-hybrid rules. As a result, under the definition of associated enterprise in article 168*ter* LITL, paragraph 18, all of Investor B, Investors C, Investor D, the Fund and LuxCo are associated for purposes of all anti-hybrid rules.

Investor E is associated to Investor B for purposes of the hybrid financial instrument rule, but not to LuxCo or anyone else. Investor A is not associated to anyone.

5.2. Acting together concept under Luxembourg law

5.2.1. Introduction to the concept

Pursuant to article 168*ter* LITL, paragraph 1, number 18, "*an individual or an entity that acts together with another individual or entity in respect of the voting rights or capital ownership of an entity is considered to hold an interest in all the voting rights or capital of that entity held by the other individual or entity.*"

Hence, there is no addition of the profit entitlement of investors; only voting rights or capital ownership may be aggregated.

Such aggregation only applies for purposes of determining whether an investor reaches or exceeds the 25% or 50% threshold of the associated enterprise test. The aggregation does not apply for any other purpose, in particular the determination of the *pro rata* share of non-deductible expenses under article 168*ter* LITL, paragraph 3 or the *pro rata* share of income that becomes taxable under article 168*quater* LITL.

There is no definition of "acting together" in ATAD 2 and in the implementing Luxembourg law. As the introductory part to the bill of law implementing ATAD 2 states that the BEPS Action 2 report shall be used as guidance, to the extent compatible with ATAD 2 (and the implementing law), chapter 11 of the BEPS Action 2 report shall be used as one of the basis for determining whether two persons are "acting together" for purposes of article 168*ter* LITL, paragraph 1, number 18.

As per recommendation 11.3 of the OECD BEPS Action 2 Report, the "acting together" test covers voting rights and equity interests held by a single economic unit such as a family, as well as the following four scenarios:

(a) where one person is required to act in accordance with the wishes of another person in respect of the voting rights or equity interests held by that first person;
(b) where two or more people agree to act together in respect of their voting rights or equity interests, such agreement having a significant impact on the value or control of their rights or interests;
(c) where a person agrees that a third person can act on their behalf in respect of voting rights or equity interests that they hold.[19]
(d) the ownership or control of any such rights or interests are managed by the same person or group of persons.

Acting in accordance with the wishes of another person

The first scenario typically occurs "*where the person is legally bound to act in accordance with another's instructions or if it can be established that one person is expected to act, or typically acts, in accordance with another's instructions.*"[20] The OECD gives the example of a lawyer acting on behalf of his client.

Entering into an agreement having a significant impact on the value or control of voting rights or equity interests

This second scenario "*covers both arrangements concerning the exercise of voting interests (such as the right to participate in any decision-making) and/or regarding beneficial entitlements (such as entitlement to profits or eligibility to participate in distributions) or arrangements concerning the ownership of those rights (such as agreements or options to sell such rights).*"[21]

The recommendation only targets arrangements between investors, not those that are naturally embedded in the terms of the equity/voting interest or which solely involve the holder and the issuer of a financial instrument.

Also, the arrangement shall have a "significant impact" on the value of the voting rights or equity interests. Hence, a commercially standard arrangement between shareholders or investors should not fall in this category. Paragraph 375 of the BEPS Action 2 report mentions that an agreement whereby an investor is required to first offer his equity interest to existing investors (at market value) before selling to a third party "*will not generally have a material impact on the value of the holder's equity interest*" and should not be taken into account for the purposes of the "acting together" requirement.

It is recommended to pay particular attention to voting arrangements between investors, especially when they concern the allocation or distribution of profits, or the nomination or revocation of board members, or when they may lead to transactions between third parties that would normally not take place between independent parties on the free market.

A person (or group of persons) manages the ownership or rights of several investors

The BEPS Action 2 report gives the example of "*investors whose investments were managed under a common investment mandate or partners in an investment partnership.*"[22]

However, The Luxembourg legislator opted for a more nuanced approach as regards this last prong of the "acting together" concept, in the context of an investment fund (see below).

[19] OECD BEPS Action 2 report, §370.
[20] OECD BEPS Action 2 report, §372.
[21] OECD BEPS Action 2 report, §373.
[22] OECD BEPS Action 2 report, §377-378.

5.2.2. Consequences: aggregation of interests

When a person acts together with another person, their voting rights and capital ownership should be added for the purposes of the associated enterprises test. No aggregation is however to be made to compute profit entitlement.

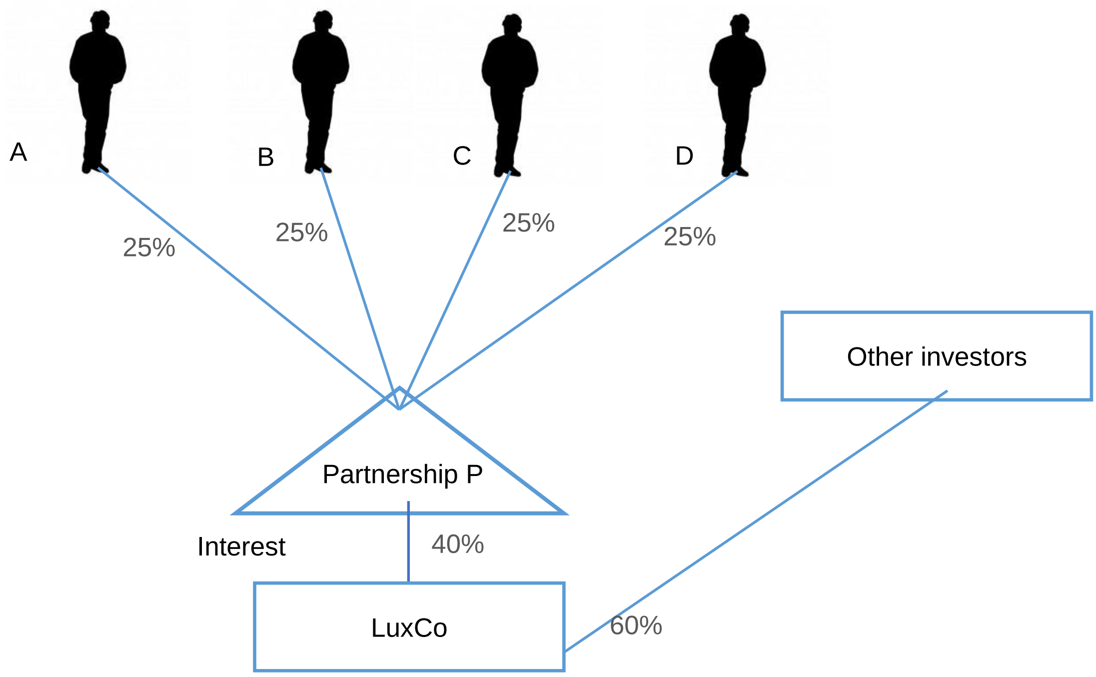
Facts

The below example is based on example 11.2 of the OECD BEPS Action 2 Report on related parties and control groups - partners in a partnership.

In the below example, A, B, C and D are four partners of the same family in a partnership resident in Country B. The decisions in the partnership require unanimous vote of the partners. All the partners have the same voting rights and equal share in the profits of the partnership P.

The partnership P is treated as tax transparent in its country of residence. It further has a substantial shareholding in LuxCo, a resident fully taxable Luxembourg company.

Under a loan agreement concluded between P and LuxCo, an interest is paid by LuxCo to P. and the way the interest on loan is taxed gives rise to a mismatch in tax outcomes.



Question

Are the partners A, B, C and D associated enterprises of LuxCo within the meaning of Article 168*ter* LITL, paragraph 1, number 18?

Analysis

Since the partners are members of the same family and the ownership and control of the shares in LuxCo are managed by the partnership P in which all partners have voting rights in proportion to their capital ownership and that management or control has a connection with the arrangement that has given rise to the mismatch, each partner will, , be treated as holding the shares of the other partners under the acting together test and accordingly will be treated as holding sufficient shares in LuxCo to bring them within the scope of the related party rule.

Even though none of the partners are associated enterprises of LuxCo, based on their respective voting rights and capital ownership in LuxCo (i.e., 10% of LuxCo with a look-through approach), they would, unless proven otherwise, be deemed to act together towards LuxCo and be treated as associated enterprises of LuxCo because, in the case at hand, each partner is treated as acting together with the other partners in respect of the partnership's shareholding in LuxCo. Thus, for purposes of assessing the thresholds in the associated enterprise definition, each partner is considered as holding 40% of P and of LuxCo's voting rights and capital ownership.

5.2.3. Exception for investment funds

Article 168*ter* LITL, paragraph 1, number 18 provides that "*[a]n individual or an entity that holds, directly or indirectly, less than 10 per cent of the interests or units in an investment fund, and is entitled to receive less than 10 per cent of the profits of that investment fund is considered within the meaning of the preceding sentence not to be acting together with another individual or an entity holding interests or units in the same investment fund, unless proved otherwise.*"

In other words, there is a rebuttable presumption that "small" investors in an investment fund are not acting together with any other investor. The commentary accompanying the bill of law implementing ATAD 2 specifies that, in this context, "investment fund" should be understood as "*a collective investment undertaking which raises capital from a number of investors, with a view to invest this capital in accordance with a defined investment policy for the benefit of those investors.*"[23] This definition is inspired from the definition of alternative investment fund provided in article 1, paragraph 39 of the law of 12 July 2013 on alternative investment fund managers (AIFM), as amended – save for the requirement to not require authorisation under directive 2009/65/EC[24]).

The definition of "investment fund" is broad. It notably includes Luxembourg and foreign UCIs and any alternative investment fund meeting the three above-mentioned conditions. There is no restriction as to whether the fund is open-ended or close-ended, and listed or unlisted. The jurisdiction under whose laws the vehicle is formed, as well as the legal form are also irrelevant.

The reason for the introduction of this provision is justified as follows (ratio legis):

- First, the authors of the bill of law observed that the "acting together" concept has an anti-abuse purpose.[25] Investors normally invest independently from one another in the fund, which is set up by a fund manager who raises capital with a view to offering investors exposure to a certain category of assets. The structure is typically set up by the investment manager before knowing who all the investors will ultimately be. Therefore, there is also no arrangement between investors aiming at avoiding or circumventing the associated party test to create a hybrid mismatch with respect to one of them.
- Second, the authors of the bill of law note that investors typically do not control the investments made by the fund.[26] As such, they cannot "act together" with respect to the underlying investments of the fund, since they usually do not exercise control over these.

Hence, under Luxembourg law, an investor in an investment fund should not be considered as acting together with any other investor in that same fund as long as:

(i) it has no control over the investments made by the fund;
(ii) it is not a member of the same family of another investor (in direct line of ascent or descent);

[23] Parliamentary document 7466/00, p.20.
[24] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

[25] BEPS Action 2 report, §369: "*The purpose of the "acting together" requirement is to prevent taxpayers from avoiding the related party or control group requirements by transferring their voting interest or equity interests to another person, who continues to act under their direction in relation to those interests. The other situation targeted by the acting together requirement is where a taxpayer or group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them.*"
[26] Parliamentary document 7466/00, p.20.

(iii) it does not act in accordance with the wishes of another investor (or the wishes of a third person controlling both the investor and another investor); and
(iv) it has not entered into an agreement having a significant impact on the value or control of voting rights or equity interests.

Under Luxembourg law in the context of investment funds the mere fact that the investments made by the fund are managed by the same person being the general partner, the AIFM or any other appointed manager does not as such involve that investors in such investment funds are automatically considered as acting together with respect to the Fund and the underlying investment.

On the same basis, the fact that different investment funds or intermediary vehicles are managed by the same GP, AIFM or other appointed manager does not involve de facto that investors in these funds are considered as acting together with respect to these funds, the intermediary vehicles or the underlying investment. This should be analysed on a case-by-case basis.

5.2.3.1. Practical considerations regarding the 10% threshold – Burden of proof

- **Holding less than 10%**

Any investor in an investment fund that holds, directly or indirectly, less than 10% of the fund's interests and which is entitled to receive less than 10% of the fund's profits is not considered as acting together with the other investors for the purposes of determining whether the threshold to qualify as associated enterprise is met.

This presumption is, however, rebuttable and any evidence to the contrary may be raised by the tax authorities. It will be for the tax authorities, based on a bundle of evidence (*faisceau d'indices*) to show that these investors are effectively acting together regarding their interests and/or voting rights in the fund.

In case of joint action by investors holding less than 10% of interests and profit entitlement in the fund, it is therefore up to the tax authorities to provide a bundle of evidence that these investors are effectively acting jointly regarding their interests and/or voting rights in the fund. The 10% presumption would notably be set aside where the investors are family members or members of the same group or when an agreement has been entered into by certain investors to exercise their voting rights in the same way.

- **Holding 10% or more**

There is no corresponding presumption for investors that hold, directly or indirectly, more than 10% of the fund's interests and/or that are entitled to receive more than 10% of the fund's profits.

However, where only one investor holds between 10% and 25% - respectively 50% - of the fund's interests and/or profit entitlement (and the other investors hold less than 10% of the fund's interests and profit entitlement), this investor should (unless proven otherwise) not be treated as acting together with any other investors, as he is the sole investor reaching the 10% threshold.

Where several investors hold more than 10% of the fund's interest or receive more than 10% of the fund's profits, their rights should not automatically be aggregated for the purposes of the associated enterprise test. Such investors must however be able to prove that they are not effectively acting together regarding their interests and/or voting rights in the fund. Indicators pointing in that direction could inter alia consist of evidence that in light of the governance and the decision-making process of the fund, they do not exercise any effective control over the investments realised by the fund and that they act independently from other investors with respect to their investment in the fund (i.e. they do not act in accordance with the wishes of any other investor or they have not entered in an agreement on voting rights or equity interests). See ratio legis and criteria derived therefrom under section 5.2.4. above.

5.2.3.2. Timing and basis for assessment of the 10% participation or profit entitlement threshold

Article 168*ter* LITL, paragraph 1, number 18 is silent regarding the date on which the direct and indirect 10% thresholds should be assessed. In the absence of guidance, the thresholds should be computed as follows.

In the absence of guidance, 10% threshold as the the 25/50% thresholds may be computed on a yearly basis, at the closing date of the financial year of the relevant Luxembourg taxpayer, unless specific circumstances require otherwise (e.g. fund raising, ramp-up period, exit).

5.2.4. Investors holding less than 10% of interests or rights to profits

<u>Facts</u>

The Fund is tax transparent under the laws of its country of incorporation (Luxembourg or abroad).

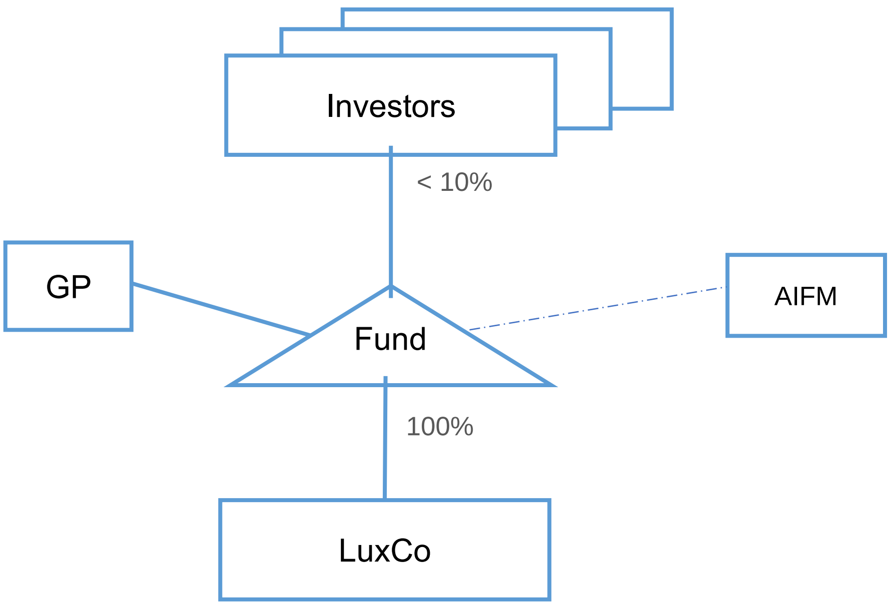
The Fund qualifies as an “investment fund” for purposes of article 168*ter* LITL, paragraph 1, number 18.

The Fund is managed by a general partner (GP) and an AIFM. Under the limited partnership agreement signed by the investors, the GP decides on the investments/divestments made by the partnership.

All the investors, including the GP, hold less than 10% of the voting rights, capital ownership and entitlement to profits in the Fund.

All the shares in LuxCo, a Luxembourg fully taxable company, are held by the Fund.

The Investors and the GP are not members of the same family/group.



Question

What is the impact of the “acting together” concept?

Analysis

Assuming no agreement has been entered into by the investors regarding their voting rights or interests in the Fund, they are presumed not to act together for the purposes of the associated enterprises concept, as they hold less than 10% of interests and profit entitlement in the Fund.

This presumption can be rebutted by the tax authorities if, based on a bundle of evidence (*faisceau d’indices*), they show that the investors are effectively acting together regarding their voting rights or interests in the Fund (for instance, in the cases where an agreement has been concluded between various investors to align their voting rights or interest in the Fund and that agreement has a material impact on the value of these rights, or if they are related, e.g., same management team, group, family members). If they succeed, the interests and voting rights of the investors will be aggregated for purposes of assessing whether they pass the 25%/50% threshold.

The Fund is an associated enterprise of LuxCo. However, none of the investors holds directly or indirectly at least 25%/50% of the voting rights, capital ownership or profits’ rights in the Fund and LuxCo.

5.2.5. Investors holding 10% or more of interest or rights to profits

Facts

The Fund is tax transparent under the laws of its country of incorporation (Luxembourg or abroad).

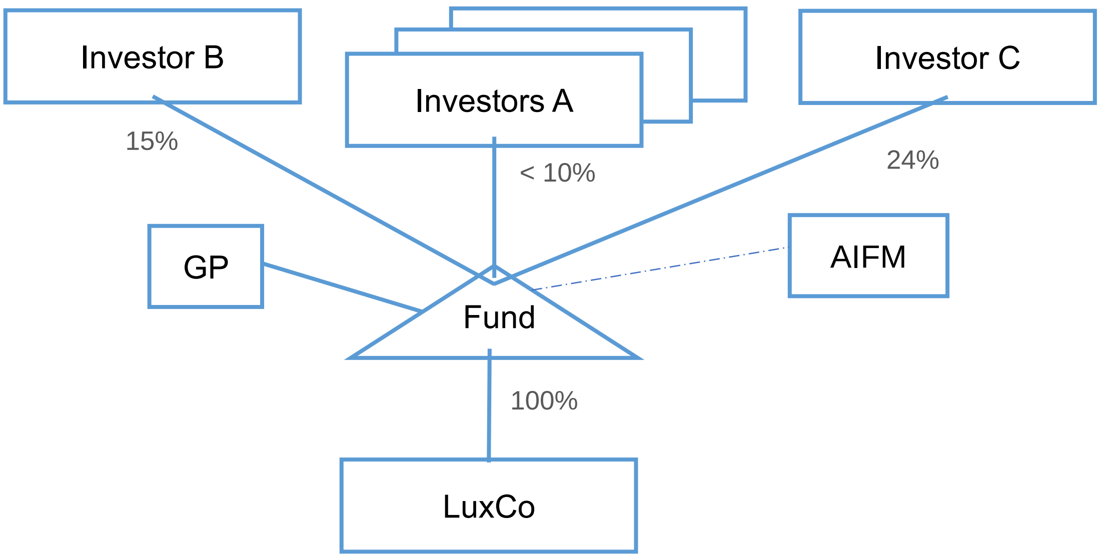
The Fund qualifies as an “investment fund” for purposes of article 168*ter* LITL, paragraph 1, number 18.

The Fund is managed by a general partner (GP) and an AIFM. Under the limited partnership agreement signed by the investors, the GP decides on the investments/divestments made by the partnership.

All of the Investors A (and the GP) hold less than 10% of the capital ownership and profit entitlement in the Fund. Investor B holds 15%; Investor C holds 24%.

All the shares in LuxCo, a Luxembourg fully taxable company, are held by the Fund.

The Investors and the GP are not members of the same family.



Question

What is the impact of the “acting together” concept?

Analysis

As long as Investors A are unrelated investors (e.g., not members of the same family/group) and no agreement has been concluded between them or with Investor B or C, they are presumed not to act together with any other investor for the purposes of the associated enterprises rule (as they have less than 10% of interests and profit entitlement in the Fund.

Investor B and Investor C hold an interest of more than 10% in the Fund. Thus, the presumption applicable to investors holding a less than 10% interest in the Fund is not applicable to them. However, their interests should not be automatically aggregated for purposes of the “associated enterprise” test. The acting together concept should be appreciated on a case-by-case basis, depending on the facts (mainly the governance rules and the role of each investor in the management of the Fund) to determine whether those investors effectively act together with respect to their voting rights or interest in the Fund.

In order to avoid the aggregation of their interests, resulting in Investor B and Investor C each being deemed to hold an interest of 39% in LuxCo) for purposes of the associated enterprise test, LuxCo or the Fund (as may be the case) should be able to prove that Investor B and Investor C are not effectively acting together as regards their respective investment in the Fund (and indirectly in LuxCo).

5.2.6. Computation of the 10% threshold in multiple-tier structures

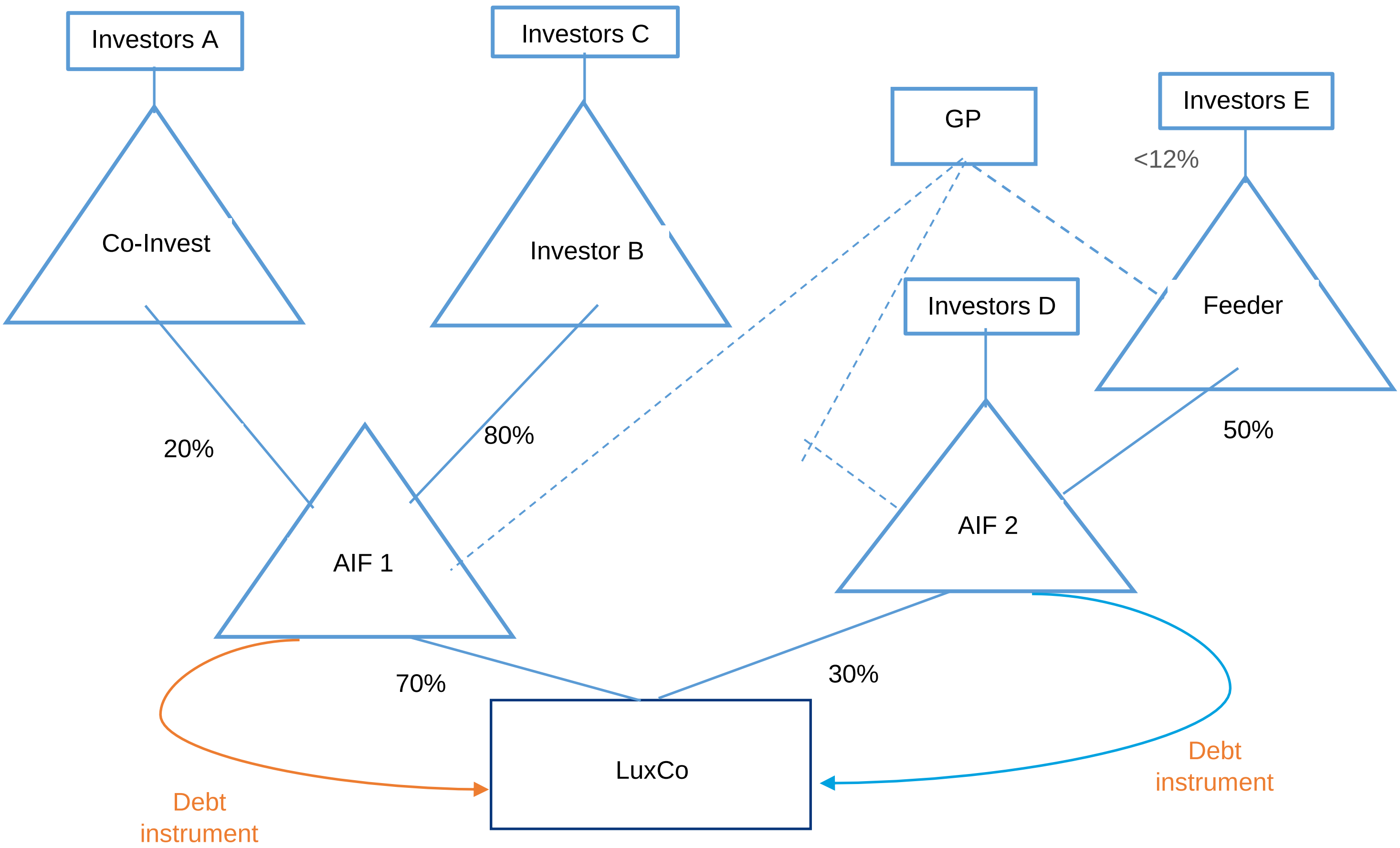
5.2.6.1. Computation of the 10% threshold in multiple-tier structures - no aggregator

Facts

In the example illustrated below, two investment funds in the meaning of article 168*ter* LITL, paragraph 1, number 18 and pursuing the same investment strategy provide equity and debt funding to LuxCo. AIF 1 owns 70% of the capital, voting rights and profit entitlement of LuxCo. AIF 2 owns 30% of the capital, voting rights and profit entitlement of LuxCo.

AIF 1 has two entities as limited partners. Investor B is a pension fund which is transparent for Luxembourg tax purposes and has multiple investors. All Investors C own a less than 10% interest in Investor B and are entitled to less than 10% of Investor B’s profits, except two of them, which own 12% each. Investors A are 5 individuals owning 20% of interest and profit entitlement in Co-Invest. AIF 2 has multiple direct investors (Investors D), all owning less than 10% interest in AIF 2 and entitled to less than 10% of AIF 2’s profits. AIF 2 has also Feeder as direct limited partner. There are a number of investors in Feeder. 8 Investor E hold each 12 % and one holds 4 % in Feeder.

AIF 1, AIF 2, Aggregator and Feeder have the same GP. Co-invest and Investor B have each their own general partner different from GP. None of the investors A, C, E and D are related. AIF 1, AIF 2, Co-invest and Investor B and Feeder are transparent for Luxembourg tax purposes.



Question

How does the 10% threshold of article 168*ter* LITL, paragraph 1, number 18 apply in this structure?

Analysis

Article 168*ter* LITL, paragraph 1, number 18 refers to investors in an "investment fund" holding directly or indirectly less than 10% of the "*titres*" or "*parts*" and less than 10% of the rights to receive profits of the investment fund.

Whether the Feeder qualifies as an "investment fund" is irrelevant for the analysis.

The 10% threshold has to be assessed by transparency of all intermediary investment funds or vehicles up to the ultimate investors who may be regarded as payee from a Luxembourg tax perspective for the purpose of the application of article 168*ter* LITL, i.e. up to any entity regarded as opaque from a Luxembourg tax perspective or any individual.

The 10% threshold has to be assessed separately for investors in AIF 2 and AIF 1 (whether or not AIF 1 and AIF 2 have the same GP).

The ownership percentage of the investors in the AIF 1 has to be assessed by transparency of all intermediary vehicles between the ultimate investor and AIF 1.

Investors A's ownership in the AIF 1 will thus be determined by multiplying their percentage of ownership (or profit entitlement rights) in Co-Invest by the percentage of ownership of Co-Invest in AIF 1. Investors A own 4% in AIF 1 and are thus below the 10% threshold. Investors A own indirectly (via AIF 1) 2.8% in LuxCo and are therefore not associated enterprises of LuxCo.

Investors C ownership in the AIF 1 will be determined by multiplying their percentage of ownership (or profit entitlement rights) in Investor B by the percentage of ownership of Investor B in AIF 1. The two Investors C owning 12% in Investor B each own 9.6% in AIF 1 and are thus below the 10% threshold. Each Investor C owns indirectly (via AIF 1) 6.72% in LuxCo and are therefore not associated enterprises of LuxCo.

Whether the Co-Invest or Investor B qualify as "investment funds" is irrelevant for the analysis as the assessment has to be done at the level of the AIF 1. It is also irrelevant whether Co-Invest and Investor B act together, as the test has to be made by transparency up to the ultimate investors who may be regarded as payee from a Luxembourg tax perspective for the purpose of the application of article 168*ter* LITL, i.e. up to any entity regarded as opaque from a Luxembourg tax perspective or any individual.

The 10% threshold has to be assessed separately for AIF 2. The 10% threshold has to be assessed for investors D in AIF 2 directly or indirectly through any intermediary vehicle considered as transparent for Luxembourg tax purposes. Based on the structure described above, all of the Investors D would benefit from the rebuttable presumption that they are not acting together.

Investors E's ownership in the AIF 2 will be determined by multiplying their percentage of ownership (or profit entitlement rights) in Feeder by the percentage of ownership of Feeder in AIF 2.

In the case at hand, Investors E owning 12% in Feeder, own 6% interests and profit entitlement in AIF 2 and are thus below the 10% threshold. These Investors E own indirectly (via AIF 2) 1.8% in LuxCo and are therefore not associated enterprises of LuxCo.

Whether Feeder qualifies as an "investment fund" is irrelevant for the analysis, as the assessment has to be done with respect to the profit entitlement and interests in AIF 2.

In the above structure, all investors (A, C, D and E) thus benefit from the rebuttable presumption that they are not acting together with any other investor.

5.2.6.2. Computation of the 10% threshold in multiple-tier structures – with aggregator

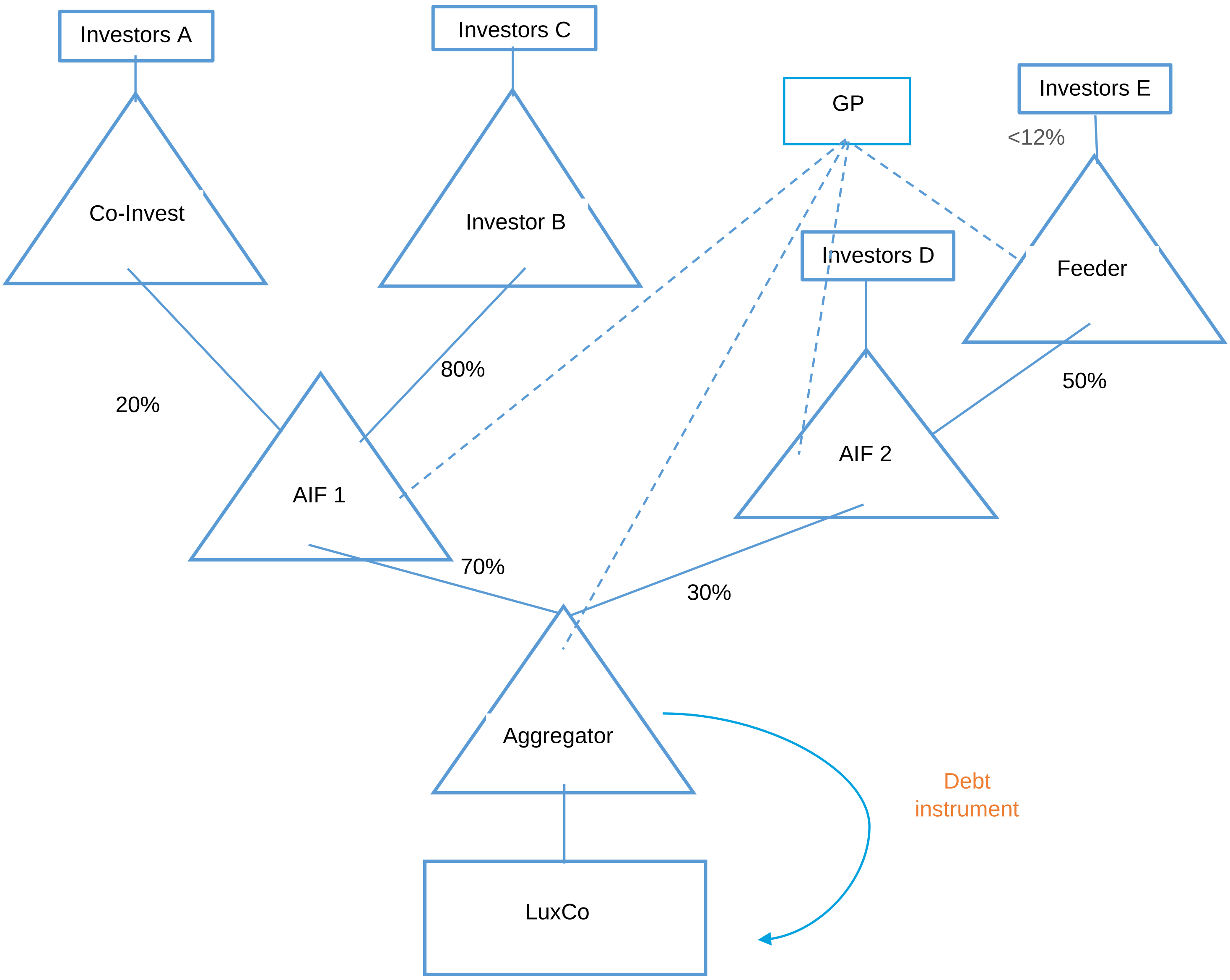
<u>Facts</u>

In the example illustrated below, two investment funds in the meaning of article 168*ter* LITL, paragraph 1, number 18 invest in a partnership being an aggregator. The aggregator is not an investment funds in the meaning of article 168*ter* LITL, paragraph 1, number 18.

Aggregator provides equity and debt funding to LuxCo. AIF 1 owns 70% of the capital ownership, voting rights and profit entitlement of Aggregator. AIF 2 owns 30% of the capital, voting rights and profit entitlement of Aggregator. Aggregator holds 100% of the capital ownership, voting rights and profits entitlement of LuxCo.

AIF 1 has two entities as limited partners. Investor B is a pension fund which is transparent for Luxembourg tax purposes and has multiple investors. All Investors C own a less than 10% interest in Investor B and are entitled to less than 10% of Investor B's profits, except two of them, which own 12% each. Investors A are 5 individuals owning 20% of interest and profit entitlement in Co-Invest. AIF 2 has multiple direct investors, all owning less than 10% interest in AIF 2 and entitled to less than 10% of AIF 2's profits. AIF 2 has also Feeder as direct limited partner. There are a number of investors in Feeder. 8 Investor E hold each 12 % and one holds 4 % in Feeder.

AIF 1, AIF 2, Aggregator and Feeder have the same GP. Co-invest and Investor B have each their own general partner different from GP. None of the investors A, C, E and D are related. Aggregator, AIF 1, AIF 2, Co-invest and Investor B and Feeder are transparent for Luxembourg tax purposes.



Question

How does the 10% threshold of article 168*ter* LITL, paragraph 1, number 18 apply in this structure?

Answer

Article 168*ter* LITL, paragraph 1, number 18 refers to investors in an "investment fund" holding directly or indirectly less than 10% of the "*titres*" or "*parts*" and less than 10% of the rights to receive profits of the investment fund.

Whether the Feeder qualifies as an "investment fund" is irrelevant for the analysis.

The 10% threshold has to be assessed by transparency of all intermediary investment funds or vehicles up to the ultimate investors who may be regarded as payee from a Luxembourg tax perspective for the purpose of the application of article 168*ter* LITL, i.e. up to any entity regarded as opaque from a Luxembourg tax perspective or any individual.

The Aggregator is not an investment fund. The Aggregator is associated to LuxCo as it owns 100%. It is however transparent for Luxembourg tax purposes. In the case at hand, the partners in Aggregator are AIF 1 and AIF 2 and are investment funds in the meaning of article 168*ter* LITL, paragraph 1, number 18.

Aggregator is a transparent non-hybrid entity so that no mismatch may arise due to its interposition. It has to be looked through for purposes of the "associated enterprise" test (including the "acting together" test).

By transparency of Aggregator, the second layer of entities investing indirectly in LuxCo are AIF 1 and AIF 2.

The 10% threshold has to be assessed separately for investors in AIF 2 and AIF 1 (whether or not AIF 1 and AIF 2 have the same GP).

The ownership percentage of the investors in the AIF 1 has to be assessed by transparency of all intermediary vehicles between the ultimate investor and AIF 1.

Investors A's ownership in the AIF 1 will thus be determined by multiplying their percentage of ownership (or profit entitlement rights) in Co-Invest by the percentage of ownership of Co-Invest in AIF 1. Investors A own 4% in AIF 1 and are thus below the 10% threshold.

Investors C ownership in the AIF 1 will be determined by multiplying their percentage of ownership (or profit entitlement rights) in Investor B by the percentage of ownership of Investor B in AIF 1. The two Investors C owning 12% in Investor B each own 9.6% in AIF 1 and are thus below the 10% threshold.

Whether the Co-Invest or Investor B qualify as "investment funds" is irrelevant for the analysis as the assessment has to be done at the level of the AIF 1. It is also irrelevant whether Co-Invest and Investor B act together, as the test has to be made by transparency up to the ultimate investors who may be regarded as payee from a Luxembourg tax perspective for the purpose of the application of article 168*ter* LITL, i.e. up to any entity regarded as opaque from a Luxembourg tax perspective or any individual.

The 10% threshold has to be assessed separately for AIF 2. The 10% threshold has to be assessed for investors D in AIF 2 directly or indirectly through any intermediary vehicle considered as transparent for Luxembourg tax purposes. Based on the structure described above, all of the Investors D would benefit from the rebuttable presumption that they are not acting together.

Investors E's ownership in the AIF 2 will be determined by multiplying their percentage of ownership (or profit entitlement rights) in Feeder by the percentage of ownership of Feeder in AIF 2.

In the case at hand, Investors E owning 12% in Feeder, own 6% interests and profit entitlement in AIF 2 and are thus below the 10% threshold.

Whether Feeder qualifies as an "investment fund" is irrelevant in the present case, as the assessment is done with respect to the profit entitlement and interests in AIF 2.

In the above structure, all investors (A, C, D and E) thus benefit from the rebuttable presumption that they are not acting together with any other investor.

6. Section 6 – Burden of proof

6.1. Definitions / main concepts

Overview

Article 168*ter* LITL, paragraph 6 provides that "*upon request from the tax authorities, the taxpayer must be in a position to provide for a statement from the issuer of the financial instrument or any other relevant element such as tax returns, any tax document or certificate issued by the tax authorities of another state, in order to prove that the provisions of paragraphs 3 to 5 of the present article do not apply*."

Main concepts

As a reminder, the general rule in tax matters is that the tax authorities bear the burden of proof of elements that increase the tax liability (whereas the taxpayer bears the burden of proof of elements that reduce the tax liability).

The commentary accompanying the bill of law implementing ATAD 2[27] states that, upon request from the tax authorities, taxpayers must be able to provide supporting evidence for each particular case that the anti-hybrid rules do not apply. It will therefore be the taxpayer who has the burden of demonstrating[28], to the reasonable satisfaction of the tax administration, among others that:

- There is no hybrid mismatch arrangement;
- If there is hybrid mismatch arrangement giving rise to a double deduction outcome by the taxpayer who is the payer, that the parent jurisdiction has denied the duplicate deduction (by application of the primary rule);
- If there is a hybrid mismatch arrangement giving rise to a deduction without inclusion outcome where the payee is a Luxembourg taxpayer, that the payer jurisdiction has denied the deduction (by application of the primary rule) so that the defensive rule does not apply;
- Deductible payments made under a hybrid mismatch arrangement between taxpayers in two or more other jurisdictions have not been funded (either directly or indirectly) out of payments made by Luxembourg taxpayers;
- A hybrid transfer has not been designed to produce a relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved;
- Payments, expenses or losses are not offset in one or more jurisdictions, in which the taxpayer is considered as tax resident, against income that is not dual-inclusion income.

Operation of the rule

It is further stated in the parliamentary comments that in the case of payments made under a financial instrument, for example, the taxpayer must analyse the <u>expected</u> tax treatment in the counterparty jurisdiction and shall be in a position to evidence such treatment to the benefit of the tax authorities for the purpose of article 168*ter* LITL.

This principle aims at ensuring that the rules are workable for taxpayers and keep compliance costs to a minimum and minimise the administrative burden on tax authorities.[29] Thus, the rule will operate to make an adjustment in respect of an expected mismatch in tax outcomes and it will not be necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty's taxable income in order to apply the rule.

[27] See page 24
[28] This representation may require a confirmation/statement from the beneficiary of the income or the general partner managing the underlying investments in the context of a fund.
[29] See recommendation 9 of the BEPS 2 report (design principles)

However, the expected tax treatment in the counterparty jurisdiction must be sustained by detailed, objective and verifiable information. Paragraph 85 of the BEPS Action 2 report mentions that "*the identification of a mismatch as a hybrid mismatch under a financial instrument is primarily a legal question that requires an analysis of the general rules for determining the character, amount and timing of payments under a financial instrument in the payer and payee jurisdictions. In general it will not be necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty's taxable income in order to apply the rule. It is expected that taxpayers will know their own tax position in respect of a payment so that, in practice, a mismatch will be identified by comparing the actual tax treatment of an instrument in the taxpayer jurisdiction with its expected tax treatment in the counterparty jurisdiction*."

It should therefore not be required from the taxpayer or the tax authorities to have knowledge of the actual outcome or position, but rather to have a rational, justifiable and credible view of the likely outcome or position. Whilst it will depend on the context, this supposition should be based on facts and circumstances that are either already established, or which might reasonably be expected to be ascertained. This principle is intended to facilitate the submission of a compliant tax return by persons to whom the hybrid mismatch rules may apply so that, for example, it is not necessary for the parties to await final resolution of the relevant tax return for a counterparty or to establish the final outcome of the application of tax law to a specific case in another jurisdiction. Applying this principle is straightforward when all the relevant facts are known. In other circumstances, it may be reasonable to expect that further facts or information be obtained in order for a reasonable supposition to be made. For example, it may be necessary to obtain information from other entities in the same control group or from other parties in a structured arrangement. Each instance will be fact dependent.

The application of article 168*ter* LITL, paragraph 6 is part of the Luxembourg domestic taxpayer's self-assessment, so in the first instance it will be for the taxpayer to decide what it is reasonable to suppose in relation to the relevant facts and circumstances.

This will also be the case, for example, for the application the imported mismatch rules. When it applies, it will thus first be the Luxembourg domestic taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, that the imported mismatch rule has been properly applied at its level. For example, in case of application of imported mismatch rules by several jurisdictions, this initial burden may be discharged by providing the tax administration with copies of the group calculations together with supporting evidence of the adjustments that have been made under the imported mismatch rules in other jurisdictions. Tax administrations will generally be relying on the taxpayer to provide them with these calculations and supporting evidence. In the absence of such information, a tax administration may consider issuing its own assessment of the extent to which income from an imported mismatch payment has been directly or indirectly set-off against a hybrid deduction of another group member.[30]

Finally, it is recalled that the anti-hybrid rules apply only provided that several (cumulative) conditions are met. Therefore, where it is clear that one of the conditions will not be satisfied, for example, because the financial instrument is not a hybrid financial instrument between associated enterprises, it should not be necessary to make enquiries to establish whether there may be a mismatch. On the other hand, it may be necessary to make enquiries if the same financial instrument is part of an over-arching arrangement (falling within the scope of the structured arrangement rule).

An example of relevant evidence demonstrating the absence of a hybrid mismatch would be, for example, a corporate group chart and an assessment of the financial instrument and/or entities and/or the absence of any associated enterprise based on the provisions of the relevant Luxembourg and foreign tax laws. These documents will have to be provided to the tax authorities upon their request.

[30] See § 265 of the BEPS 2 report

Interaction between hybrid mismatch rules and other rules limiting the deductibility of interest

If a foreign taxpayer is denied a deduction under local law in respect of interest on a loan, because the proceeds are used to acquire an asset that generates a tax-exempt return (similarly to the domestic provisions of article 45 LITL, paragraph 2 or article 166 LITL, paragraph 5), this may affect the application of the anti-hybrid rules in Luxembourg.

This principle does not require either party to know exactly how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may or may not arise. As mentioned above, in such a case, parties to the transaction should take all reasonable actions to establish whether a mismatch is likely to arise, taking account of the relevant tax laws of the jurisdictions involved. It is not necessary for the parties to await final resolution of the relevant tax returns, nor do the parties need to make disproportionate enquiries.

6.2. Payment under a hybrid financial instrument

The facts of this section are the same as in section 2.2.1 above where interest paid by LuxCo under the loan are exempt at the level of the Investor due to the fact that the Investor is a sovereign wealth fund which benefits from a subjective tax exemption in its country of establishment. The investor is therefore not liable to tax in any country on payments of interest under the loan.

The interest payments under the loan shall not fall within the scope of the hybrid financial instrument rule, as the non-inclusion is due to the tax status of the Investor. In this case, it is not necessary for the Luxembourg taxpayer to await final resolution of the relevant tax return from the Investor but it will be sufficient to collect generic evidences (such as a description of the tax system applicable in the other jurisdiction) ascertaining what is the expected taxation of sovereign wealth funds under the tax laws of the relevant jurisdiction.

7. Section 7 – Ordering rules - Definition and main concepts

As mentioned above in section 6, it is necessary to co-ordinate the interaction between hybrid mismatch rules and other transaction specific and/or other anti-abuse rules, but it is also necessary to co-ordinate the interaction between the various hybrid mismatch rules of article 168*ter* LITL.

The rules should indeed apply consistently with other rules of the domestic tax system, so that the interaction does not result in double taxation of the same economic income and does not have the effect of denying a deduction twice for the same item of expenditure.[31] It is also necessary to manage the interaction with the rules in a foreign jurisdiction which subject payments to taxation in the residence state of the investor (e.g., CFC rules).[32]

Based on ATAD 2 and the parliamentary comments on the bill,[33] the hybrid mismatch rules of article 168*ter* LITL, paragraph 3, numbers 1 and 2 (double deduction and deduction without inclusion) should not apply if the arrangement has been subject to the rules of article 168*ter* LITL, paragraph 3, number 4 (inclusion in case of a disregarded permanent establishment) or to the rules of article 168*quater* LITL (the reverse hybrid rules applicable as from tax year 2022), which shall apply in priority (and if they are effectively applied to a given structure, it is in principle not necessary to assess whether the other rules could apply as well, as these priority rules are supposed to solve the hybrid mismatch situation).

Furthermore, it results from the recommendations of the BEPS 2 report that the hybrid mismatch rules should be applied in the following order:
(a) Hybrid financial instrument rule, to the extent there is an instrument whose qualification may be assessed and to the extent it does not result in a double taxation outcome;
(b) Payment to a hybrid entity and disregarded hybrid payments rule;
(c) Imported mismatch rule; and
(d) Deductible hybrid payments rule and dual resident entity rule.

Besides, it should also be noted that the hybrid financial instrument rules of ATAD 2 are secondary to the specific anti-hybrid rules introduced by Directive 2014/86/UE in the EU parent-subsidiary directive[34] and which have been transposed into Luxembourg domestic law at article 166 LITL, paragraph 2*bis*. Therefore, as explained in the parliamentary comments to the bill,[35] the rule foreseen in article 168*ter* LITL, paragraph 3, number 2, letter a shall not apply at the level of a Luxembourg payer if the payments are subject to tax at the level of the payee under the tax laws of this jurisdiction, based on an anti-hybrid rule similar to article 166 LITL, paragraph *2bis*. Conversely, income received by a Luxembourg payee which fall within the scope of article 166 LITL, paragraph 2*bis* shall be taxed accordingly on such a basis only.

Finally, all provisions in the LITL that limit the deductibility of a given payment (such as the articles 168*ter* LITL, 166 LITL, paragraph 5, 50*ter* LITL, 45 LITL paragraph 2 and 56/56*bis* LITL) should be applied before article 168*bis* LITL.

The order of application of these rules for the assessment of the inclusion of a relevant payment, should be as follows:

(a) Article 56/56*bis* LITL;
(b) Articles 166 LITL, paragraph 2*bis*, and 164*ter* LITL; and
(c) Article 168*ter* LITL (see above).

within the limit of any double tax treaty concluded by Luxembourg with non-EU member States.

[31] See §291 and following of the BEPS Action 2 report
[32] See §293 and following of the BEPS Action 2 report
[33] See recital 29 of the ATAD 2 and parliamentary comments on bill n°7466, page 17
[34] Directive 2011/16/EU, as modified.
[35] See parliamentary comments pages 17 and 18, and recital 30 of the ATAD 2