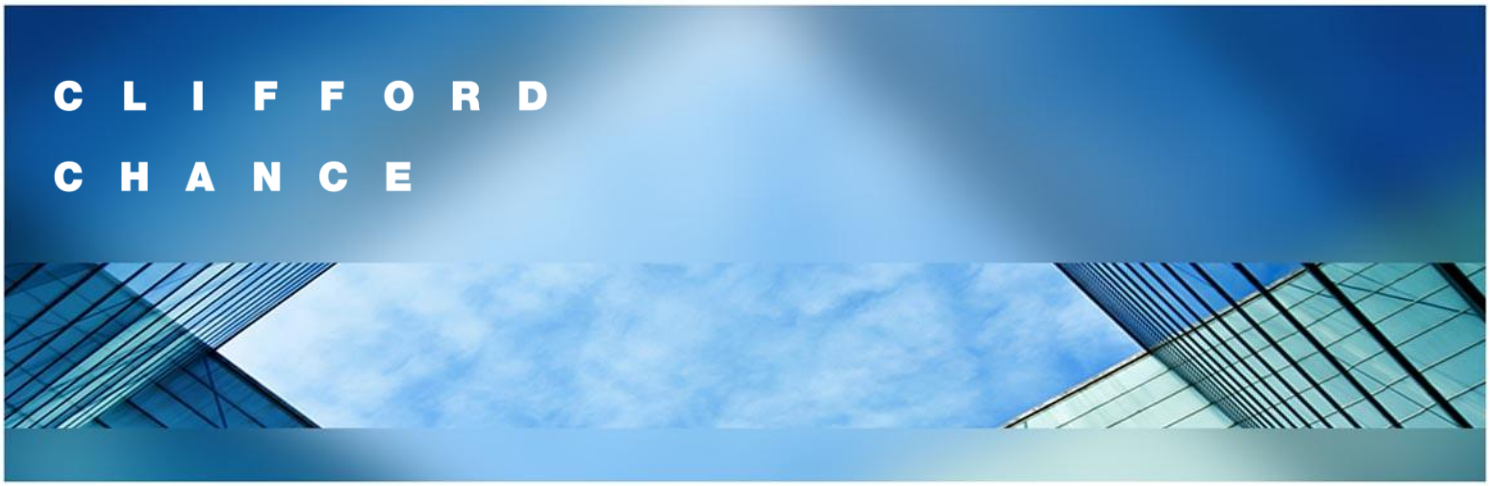

REVERSE HYBRID RULE: GUIDANCE ISSUED BY THE LUXEMBOURG TAX ADMINISTRATION

On 9 June 2023, the Luxembourg tax administration issued a circular L.I.R n° 168*quater*/1 (the "**Circular**") providing some guidance on the application of the reverse hybrid rule, in particular on the computation of the taxable result of a reverse hybrid entity and the tax due by such taxpayer. This is the first Circular issued by the Luxembourg tax administration regarding the application of ATAD 2.

Key issues

- ATAD 2 reverse hybrid rule according to the law of 19 December 2019
- Circular from the Luxembourg tax administration of 9 June 2023 providing some guidance on the determination of the net taxable result and tax due by the reverse hybrid entity
- Tax compliance obligations of the reverse hybrid entity
- Form 205

REVERSE HYBRID RULE

The reverse hybrid rule was introduced by the law of 19 December 2019 transposing the Council Directive (EU) 2017/952 of 29 May 2017 amending Directive EU72016/1164 ("**ATAD 2**") into Luxembourg law and resulting in the insertion of an article 168*quater* in the Luxembourg income tax law ("**LITL**"). The reverse hybrid rule applies from the 2022 tax year (i.e., to tax years closing in 2022).

The rule sets out the conditions under which an entity is treated as transparent for tax purposes under Luxembourg tax law (e.g., *société en commandite simple* (SCS), *société en commandite spéciale* (SCSp)), but not by the country where its investor(s) is(are) resident. Such an entity will thus be considered as a resident taxpayer and will become liable to Luxembourg corporate income tax on (a portion) of its net income (if such income is not taxed otherwise under Luxembourg domestic or any foreign tax laws).

The reverse hybrid rule applies when:

- one (or more) investor(s) (being associated enterprises) hold(s) in aggregate at least 50% of the Luxembourg tax transparent entity;
- the jurisdiction(s) where the above investors are established consider(s) the entity as a taxable person; and
- the investors do not tax the net income attributable to such associated enterprises because of a difference in qualification (i.e., transparent vs. opaque) of the Luxembourg entity (and not because of the investor's tax exempt status).

One of the above conditions being that the investor(s) jurisdiction(s) consider the Luxembourg (tax transparent) entity as a taxable person, this circumstance would typically entail a difference in qualification and create the so-called "hybridity" of the Luxembourg entity. Such hybridity could result in a

difference in the allocation of income in the sense that the laws of the investor(s) jurisdiction(s) would not consider (or "pick up") the income from the Luxembourg entity, as for such investor(s) this entity is a taxable person. The result of such mismatch could be a *de facto* (double) non-taxation of income (at the level of the Luxembourg entity and at the investor level) due to a hybrid entity.

GUIDANCE FROM THE CIRCULAR

The Circular provides some guidance with respect to (i) the tax status of a reverse hybrid entity, (ii) the method of computation of the net taxable result and the tax due, and (iii) the tax compliance obligations.

Tax status of a reverse hybrid entity

The Circular specifies that a reverse hybrid entity in the sense of article 168quater LITL, does not qualify as a joint-stock company as defined by article 159 LITL. It has thus a specific tax status, comparable to those applicable to individual taxpayers but subject to certain provisions concerning corporate income tax.

In this regard, the Circular precises that certain provisions of the LITL only applicable to corporate taxpayers, will not apply to the reverse hybrid entity. This concerns the control foreign companies rules, the Luxembourg participation exemption regime, the interest deduction limitation rule as well as the anti-hybrid mismatch rules. However, article 115 15a. LITL which provides for a 50% exemption of dividend received could apply (as it is the case for individuals).

By analogy, arm's length principle should also be not applicable to a reverse hybrid entity, which would allow the use of debt financing to reduce the tax burden. In the same way, the use of securitisation vehicles under the form of partnerships, may present, in certain cases, an interest as they will not be impacted by the interest deduction limitation rule even if they would be reverse hybrid entities.

Computation of net taxable result

The Circular precises that the determination of the total net income subject to tax at the level of the reverse hybrid entity depends on the categories of income to which they belong. According to that, a reverse hybrid entity can derive income from movable capital, rental income and other net income specified by LITL.

The determination of the taxable basis of the reverse hybrid is thus made on a cash accounting method, by subtracting the receipts from the expenses incurred during the calendar year (i.e., from 1st January to 31 December), regardless of the reverse hybrid entity's accounting year. According to the cash accounting method, the reverse hybrid entity will thus become liable to pay corporate income tax only when it has actually received an income. It should be noted that as the accrual accounting method (as opposed to the cash accounting method) is the method usually used to determine the tax

basis of taxpayers, it may raise certain practical constraints to use the cash accounting method for reverse hybrid entities.

Another consequence of the cash accounting method mentioned above is that the step-up mechanism does not apply when the entity becomes a reverse hybrid entity. In other words, it means that the acquisition price should be used at the time of the transfer of an asset (i.e., when the entity becomes a reverse hybrid entity), to determine the value of this asset and not the fair market value of such asset. Conversely, when the entity ceases to be a reverse hybrid entity, no adverse tax consequences will apply (i.e., no exit tax will apply at the level of the reverse hybrid entity as no gains are supposed to be realised at that time).

Furthermore, the Circular confirms that distributions of income made by the reverse hybrid entity to its partners are not subject to withholding tax in Luxembourg.

Finally, foreign tax credits and deduction for foreign taxes will also apply when determining the net taxable result of the reverse hybrid entity, in proportion to the part of the foreign income subject to corporate income tax.

Tax compliance obligations

A specific form (i.e., form 205) has been established for reverse hybrid entities and the Circular is accompanied by a FAQ on the filing of such form.

The first part of the form is related to the total net income of the entity which is subject to tax in Luxembourg. The second part of the form is related to the net income falling within the scope of article 168quater, even if they are not subject to tax in Luxembourg by application for example of a double tax treaty.

Although these clarifications in the interpretation and application of the law are welcome, there are still grey areas that have not been addressed by the Luxembourg tax administration, notably with respect to the filing of form 205.

How can we help?

The tax lawyers at Clifford Chance Luxembourg are at your disposal to further advise on the practical implications of such Circular on your filing obligations.

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