Bloomberg Tax

Tax Management
International Journal™

November 3 2023

Navigating Luxembourg Anti-Hybrid Partnership Rules

William Jean-Baptiste and Eléonore Galleron*
Chevalier & Sciales and LexField

The reverse hybrid partner status may trigger unexpected tax liabilities for both partners and partnerships, say William Jean-Baptiste of Chevalier & Sciales and Eléonore Galleron of LexField.

On June 9, 2023, Luxembourg shed light on the tax treatment of entities that are classified as "reverse hybrid partnerships" (**RHPs**) that trigger unexpected tax consequences for partners and partnerships. Tax authorities released a long-awaited Circular (168quater/1) that clarified Luxembourg's tax treatment of RHPs (pursuant to the EU Anti-Tax Avoidance Directive II 2017/952 (the **Directive**) that would affect alternative investment funds when established as simple limited partnerships (**SCSs**) and special limited partnerships (**SCSps**).

A Luxembourg partnership is considered an RHP if at least 50% of the entity's voting rights, capital, or profit rights are located in a jurisdiction that does not tax the entity's income. Prior to the implementation of the Directive, Luxembourg partnerships were in principle almost always considered tax transparent such that these partnerships and partners were not taxed in Luxembourg or abroad, but now these partnerships, when deemed RHPs, are sometimes taxed at the entity level.

This article focuses on the profit-based taxes exception that is relevant to alternative investment funds under the following:

- municipal business tax (**MBT**) (profit-based tax assessed on adjusted commercial profits); and
- corporate income tax (**CIT**) on certain entities and businesses.

Background

EU Directive for "Anti-Hybrid" Laws. Following the adoption of the Directive at the EU level (May 29, 2017), Luxembourg and other EU member countries were required to institute "anti-hybrid" laws to their domestic laws to prevent entities from avoiding taxation simply through mismatches in their tax treatment in different jurisdictions. **Budget Law.** Pursuant to the Directive, Luxembourg's 2023 budget law (the **Budget Law**) (enacted Dec.
23, 2022) offered initial clarification on the concept of a "reverse hybrid."

* William Jean-Baptiste is a partner with Chevalier & Sciales and Eléonore Galleron is counsel with LexField in Luxembourg.

A partnership was not considered an RHP if a partner was tax-exempt, even if the partnership was seen or treated as opaque in the partner's jurisdiction. This treatment of a partnership aligned with the BEPS Action 2 report, the Directive (recital 18), and commentaries from the Council of State. The Directive stated that the definition of hybrid mismatch should only apply if the mismatch arises due to differences in payment allocation rules between jurisdictions and should not be triggered when the payee is taxexempt under the laws of other jurisdictions.

Transparency Principle. Luxembourg partnerships, including SCSs and SCSps, are generally flowthrough and tax transparent entities for tax purposes (e.g., MBT and CIT, discussed below) under Luxembourg law (*see* Tax Adaptation Law, ¶11bis (Oct. 16, 1934 (*Steueranpassungsgesetz*)). Consequently, partners are taxed, and partnerships are not. Partners are seen as directly holding a partnership's assets and are entitled to the partnership's income on a *pro rata* basis based on their share of the partnership as set out by the relevant partnership agreement. Even in the absence of a distribution, the partners are deemed to receive their share of the partnership's income or losses and are liable for the relevant tax liability. Actual distributions or redemptions made by the partners are generally not subject to Luxembourg withholding tax or deduction.

MBT. Luxembourg-based entities and businesses are subject to MBT with varying rates depending on the municipality where the business is operated. For example, the Luxembourg-city rate is 6.75%.

With some exceptions, a partnership is generally subject to MBT if it:

- engages in a genuine business activity; or
- is deemed commercially tainted based on the "business-taint theory" (*Gepragetheorie*).

However, an SCS or SCSp operating under certain investment product laws may be exempt from MBT as these respective legislations all provide that no tax on income and gains would be due by an entity governed by these laws, including a partnership.

*Genuine Business Activity***.** Certain business activities are considered "genuine business activity" if the business: (*see* art. 14(1) Luxembourg Income Tax Law (LITL)):

- is an independent activity;
- is in pursuit of profit;
- is of a permanent character; and
- participates in general economic life.

If these conditions are not cumulatively met, the activity is considered a private wealth management activity and the SCSs or SCSp has no MBT liability. A civil partnership (*société civile*) that owns and manages real estate properties would be liable for MBT because the four criteria are met (*cf*. decision TA, Dec. 3, 2020, n. 43.637).

A Luxembourg partnership that qualifies as an alternative investment fund should not be deemed to have a commercial activity for Luxembourg MBT purposes (*see* Circular 14/4 (Jan. 9, 2015); *Alternative Investment Fund Manager Directive* (AIFMD)). The AIFMD is a EU regulatory framework that governs the management and marketing of alternative investment funds to protect investors that is implemented in each EU Member State's domestic law.

Business-Taint Theory. Irrespective of whether a genuine business activity is being conducted, a partnership, such as an SCS or SCSp, is liable for MBT if a Luxembourg-based company (or a Luxembourg-based permanent establishment of a foreign company) acting as its general partner (or one of its general partners) holds a 5% or more ownership in the SCS or SCSp. This business-taint theory follows the principle that all profits made by a company are, by definition, business profits and that such corporate unlimited partner's commercial activities taint the partnership's activities as commercial.

CIT. Prior to January 1, 2022, partnerships were expressly excluded from CIT liability due to the principle of transparency and irrespective of the identity and status of their partners or whether they were conducting a commercial activity (art. 175 LITL).

However, starting in 2022, RHP rules came into effect to prevent double non-taxation outcomes where a Luxembourg partnership could be tax transparent (i.e., members generally taxed on partnership's income) in Luxembourg and tax opaque (i.e., members generally taxed only when distributions are made) in the jurisdiction where the investors are resident (art. 168quater(1) LITL). RHPs are liable for CIT on income not included in the taxable basis of the relevant investor(s) of other jurisdictions. The mere classification as an RHP does not create any liability to MBT or net wealth tax.

Analysis of the Circular

Identification of Taxable Items. Despite the insights brought by the Budget Law, additional administrative guidance was needed, especially with respect to the consequences of being labeled an RHP.

The Circular clarifies that even though a partnership would become liable for the CIT because it is an RHP, it will not however become a resident entity for tax purposes (under art. 159 LITL) and therefore would not be entitled to access the double tax treaties. This may lead to double taxation issues in case of cross-border activities for which the RHP will have to use domestic tools (tax credits and/or foreign tax deductions) to mitigate the potential cost therefrom.

The CIT liability would only be partial as not all provisions regarding CIT liability are applicable. As listed by the Circular, an RHP is not subject to rules concerning (i) controlled foreign corporations (art. 164*ter* LITL), (ii) limitation of interest (art. 168bis LITL), and (iii) neutralization of mismatches with respect to hybrid entities and instruments (art. 168ter LITL).

The arm's length principle should not apply to RHPs. As a consequence, interest payments made by an RHP is therefore fully deductible, irrespective of debt-to-equity ratio, the amount of interest paid, or the hybrid nature of such payments.

The Circular explains that RHPs would not derive business income but would realize the following noncommercial income under the rules applicable to private individuals in the management of their private wealth (*see* art. 168quater(1) LITL):

- net income from movable capital (within the meaning of art. 97 LITL), including but not limited to dividends and interest;
- net income from property rental (within the meaning of art. 98 LITL), including rental income; and/or
- specified miscellaneous net income (within the meaning of art. 99 LITL), including but not limited to capital gains.

The taxable basis of the RHP would then be the aggregate net income of each of these categories, also referred to as "total net income," after having first determined the net income of each category. The net income of each category is equal to the positive amount resulting from the difference between income and expenses. Relevant expenses would only be deductible provided they are not connected to exempt income. Determination of income and expenses will also be made on a cash-basis (not on an accrual basis used for business accounting purposes). Therefore, in the absence of actual income received, the RHP would not be liable to taxation (within the meaning of art. 168quater(1) LITL).

Portfolio Income Treatment. Under the Circular, dividends and capital gains earned by an RHP are not entitled to the specific exemption granted by the domestic participating exemption regime (art. 166 LITL). Indeed, absent the status of a fully qualified resident company, the RHP does not meet the conditions to benefit from the exemption.

Dividends Exemption. Dividends receive a 50% exemption (art. 115(15) LITL) that is not specific to RHPs but is actually a provision available to all individuals residing in Luxembourg holding shares as private assets.

The 50% exemption is applicable if the dividends are distributed to the RHP by a company: (i) in Luxembourg that is fully taxable; (ii) in another EU jurisdiction provided that it is covered by the socalled "Parent-Subsidiary Directive" (art. 2 of Directive 2011/96/EU); or (iii) that is a resident in a country which has signed a double tax treaty with Luxembourg provided that the company is subject to a corporate tax rate of at least 8.5% on a basis similar to Luxembourg's CIT.

Capital Gains. The taxation of an RHP's capital gains is defined by the concept of "specified miscellaneous net income" under the same rules regarding the taxation of individuals under the LITL (art. 10 LITL referring to art. 99 LITL) and is not addressed by the Circular (other than stating that the participation exemption does not apply). The Circular, however, provides an opportunity for Luxembourg RHPs to invest in minority interests without being taxed on capital gains when the partnerships are treated as opaque in the investors' jurisdictions.

Specified miscellaneous net income covers, among other things, two types of taxable capital gains on shares: (i) speculative gains; and (ii) disposition gains. Indeed, under Luxembourg domestic rules applicable to private wealth management, capital gains on shares are taxable in two situations:

Disposition within 6 months of acquisition (regardless of size or type of participation); or Disposition after 6 months of acquisition (only if the taxpayer owns more than 10% of the company's share capital). Therefore, according to the general rules applicable to private individuals in the management of their private assets, a minor shareholder (i.e., owning no more than 10% of the company's shares) disposing of shares after 6 months of acquisition is not subject to taxation under Luxembourg law (art. 99bis LITL; art. 100 LITL).

Although RHPs should be taxed on capital gains they realize (art. 168quater(1) LITL; art. 99 LITL; art. 99bis; art. 100 LITL), they are not.

Based on the Circular, one may assume that an RHP's long term capital gains (i.e., shares sold after six months from acquisition) should not be taxable as provided already for private assets if the RHP owns less than 10% of the share of capital.

Taxable Profit Determination. When the RHP receives income or bears expenses which are denominated in a foreign currency, conversion into euros is generally made at the exchange rate on the day of receipt or disbursement, as the case may be. However, an administrative tolerance will allow the conversion of said amounts either at the year-end exchange rate or at the average exchange rate for the tax year.

Only income earned by an RHP that is not already taxed in Luxembourg or under the laws of any other jurisdiction may be subject to taxation (within the meaning of art. 168quater(1) LITL), and distributions by the RHP will not become subject to any withholding tax.

Income must be realized during the calendar year to be considered in the calculation, regardless of the taxpayer's accounting period. Entities with a divergent accounting year will have to adjust their reference period for tax purposes.

Even if an SCS or SCSp acquires RHP status, the entity will not be permitted to apply a step-up in value of the equity assets it holds. The acquisition price with respect to the computation of the capital gain thereon will be the historical book value and not the value of the asset when the SCS/SCSp became an RHP.

Termination of RHP status will not be treated as a taxable event, meaning that latent capital gains will not be realized simply by exiting such status.This provision reflects the fact that the RHP status may only be temporary and that transitioning in or out of the RHP status will be *per se* tax neutral. This constitutes an important clarification since in principle, a change of an entity's taxable status under Luxembourg tax law may be deemed treated as determinative, therefore triggering the taxation of latent capital gains, along with the deemed realization of the partners' or shareholders' interest, as the case may be.

Finally, the rate applicable to the total net income realized by the RHP according to the rules above will be the same as ordinary companies (i.e., 18.19%, or 17% plus the solidarity surcharge).

Exception to RHP Status for Entities Subject to Specific Legislations. As explained above, the RHP status may trigger unexpected tax liabilities on the overall expected return for the partnership itself and investors.

But the Directive provides protection for entities governed by one of the laws taken up to regulate investment vehicles and products.

Even if a partnership qualifies as an RHP, the LITL specifically neutralizes its effects for "collective investment vehicles" (**CIVs**) (art. 168quater(2)). In order to qualify for this exemption, the CIVs must be:

- widely-held;
- hold a diversified portfolio of securities; and
- subject to investor-protection regulations.

While the conditions for qualification as a CIV are not explicitly elaborated in the OECD 2010 report (The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles) where the term is defined, it is generally understood that the ultimate investors, rather than intermediate pooling vehicles, determine whether a CIV is widely-held.

The requirement for a diversified portfolio does not necessarily exclude concentrated funds, and the CSSF's risk-spreading rules for specialized investment funds can provide guidance in this regard. The investor protection requirement is typically met through the supervision of the AIFM by its home state regulator for AIFs.

Additionally, the commentaries on the implementation of the Directive in Luxembourg law specify that partnerships operating under various product laws are excluded from the application of the RHP rules, although this exemption is not explicitly mentioned in the Directive.

Therefore, an SCS or SCSp used as an alternative investment fund vehicle that falls under the specific product laws described above or meet the condition to be treated as CIV, would be immune to the provisions of art. 168quater(1) LITL and thus would be out of the scope of the Circular.

Implications

Luxembourg's recent clarification regarding the taxation of RHPs under ATAD 2 highlights the significant impact on partners and partnerships. The tax authorities' Circular offers a comprehensive understanding of various aspects related to RHPs that can influence double taxation in cross-border operations. It is important to note that not all corporate income tax regulations are applicable to RHPs. Additionally, exemptions are available for entities subject to investment product laws, ensuring that certain alternative investment funds are not bound by the Circular's provisions or the Directive. In summary, this Circular provides an in-depth explanation of the complex tax implications associated with RHPs that provides valuable guidance for stakeholders to navigate the evolving tax environment and adapt their strategies to comply with regulations and minimize tax obligations.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.