Draft budget law 2023: can your Luxembourg partnership be liable to corporate tax?

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New rules applicable as of 2022 bring a new perspective on tax liability of partnerships governed by Luxembourg law.

Generally sought to be pass-through entities for tax purposes, therefore transferring the tax burden to their partners, partnerships are widely used in the structuring of alternative investment funds.

The simple limited partnership (societe en commandite simple or **SCS**) or special limited partnership (societe en commandite speciale or **SCSp**) are indeed cherished by asset managers and investors.

Recent rules have, however, brought a new temperament to the tax neutrality of Luxembourg partnerships, which was already not exactly an absolute principle.

These new rules concern "reverse hybrid" entities, defined as transparent entities treated as such in their jurisdiction of establishment but considered as taxable persons in another jurisdictions. These rules were introduced in Luxembourg by the law of 20 December 2019 (**ATAD 2 Law**) under article 168 quater of the Luxembourg income tax law (**LITL**) implementing Council Directive (EU) 2017/952 of 29 May 2017, regarding hybrid mismatches with third countries (**ATAD 2** or the **Directive**) and applied as of 1 January 2022.

In this context, clarifications were anticipated on the exact extent and scope of the concept under Luxembourg law. The draft budget law for 2023 (the **Draft Budget Law**) offers a first helpful clarification on the definition of a "reverse hybrid ".

As a reminder, ATAD 2 constitutes an update of the Council Directive (EU) 2016/1164 of 12 July 2016 which is aimed at targeting tax avoidance practices in the context of intra-EU transactions. The purpose of ATAD 2 is to neutralise a wider range of tax advantages obtained by taxpayers resident in EU Member States due to the hybridity of an instrument or an entity within

the context of transactions both within the EU and with third countries.

Transparent entities under Luxembourg law

Article 175 of the LITL provides that an SCS/SCSp (referred hereafter as a **Partnership**) is not considered to have a distinct legal personality from its partners. As a consequence, income and losses derived by a Partnership are to be directly attributed to its partners and are taxable only at partner's level, irrespective of whether the transparent entity actually distributes its profits or not. Therefore, the partners are considered as directly holding the Partnership's assets. As distributions made by a Partnership to its partners are disregarded for Luxembourg tax purposes, such distributions are not subject to withholding tax (**WHT**) in Luxembourg.

By virtue of its transparency, a Luxembourg Partnership is not subject to corporate income tax (**CIT**), net wealth tax (**NWT**), nor municipal business tax (**MBT**) - but two exceptions to this transparency are outlined below.

Exception 1: liability to MBT

A Partnership may nonetheless be subject to MBT under certain conditions if, inter allia, (i) it carries out a business activity or (ii) is commercially tainted on the basis of the so-called "business-taint theory" (Gepragetheorie).

MBT liability by reason of a business activity

The first situation where a Partnership could become liable to MBT is where it is considered as conducting a business/commercial activity in the meaning of the relevant provision of the LITL. A business activity is defined by four cumulative criteria to be fulfilled, within the meaning of article 14 al.1 of the LITL, namely:

- a risk factor, ie the taxpayer is deemed to bear the risk of the investment himself
- a lucrative goal, ie the taxpayer is deemed to seek profits from their activity
- a permanent character, ie the taxpayer is deemed to intend to repeat the activity several times in a profit-making manner
- participation in the economic life of Luxembourg, Ie other individuals can expect that the activity is not a purely private endeavour

Where the conditions are not cumulatively met, the activity will not be considered as a business activity but rather as a private wealth management activity for tax purposes. As a consequence, a Partnership carrying out private wealth management activities would not be subject to MBT. Conversely, if all four conditions are met, the Partnership will be subject to MBT, the rate of which is determined by the municipality where the entity is established.

An administrative circular (Circulaire LIR n°14/4) issued by the Luxembourg tax authorities on 9 January 2015 brings additional clarification on the taxation of profits realised by common or special limited partnerships, and especially to situations under which a Partnership may be deemed conducting a commercial activity. Pursuant to this circular, an entity qualifying as an alternative investment fund (**AIF**) under the AIFMD directive is deemed not having a business activity for the purposes of article 14 (4) LITL.

MBT liability by reason of the "business-taint theory"

A second scenario under which a Partnership may become subject to MBT is the application of the "business-taint theory" pursuant to article 14 al.4 LITL.

Under this theory, the Partnership would be regarded as a business entity if its (one of its) general partner(s) is a company (eg a public limited company, a private limited company or a corporate partnership limited by shares) holding at least 5% of the partnership interests in the Partnership. This assimilation as a business entity by reason of the nature of the general partner would be effective irrespective of the exact nature of the Partnership's activities.

The business-tainting theory can be seen as an opt-in/out mechanism whereby the taxpayer basically can choose to be treated as a business entity for income tax purposes depending on whether or not legal and/or economic interests held by a relevant Luxembourg company are set below 5%.

It has to be clarified here that according to the Luxembourg principle known as appreciation isolee des revenus (principle of isolated consideration of income), a business-tainting (by the general partner, here) may only result from a Luxembourg-resident capital company or a non-resident company having a permanent establishment in Luxembourg to which the Partnership's interests are attributed. It means that a non-resident company which does not have a PE in Luxembourg may not business-taint a Luxembourg Partnership.

Exception 2: liability to CIT

The concept of reverse hybrid entity

As from 1 January 2022, anti-reverse hybrid rules are applicable to Partnerships further to article 168quater LITL. Under such article 168quater LITL, such entities will become subject to tax on net income that is not otherwise taxed in Luxembourg or in any other jurisdictions when one or more non-resident associated enterprises holding an aggregate interest of at least 50% of the voting rights, interest ownership or profit entitlement in the partnerships are located in one or more jurisdictions that treat the partnerships as taxable persons in Luxembourg. They are then viewed as so called "reverse hybrid entities".

The effect of the reverse qualification is only for CIT purposes: it does not per se create any liability to MBT or NWT or any obligation or right to apply a WHT on distributions. Once labelled a reverse hybrid entity a Partnership would then become liable to such CIT but only the income which is not included at the relevant investor's level or in any another state. The relevant taxable basis would have to be determined and assessed according to the general rules applicable to the CIT basis, meaning that income exemptions provided therefrom may also be available to the reverse hybrid entity.

The Draft Budget Law brings an interesting clarification regarding the impact of the tax status of the relevant partner on a reverse hybrid qualification.

Following the amendment to article 168 quarter LITL, introduced by the Draft Budget Law, it will now be clearly expressed in the LITL that the reverse hybrid qualification (and its subsequent effect) will not be triggered when the non-inclusion in the hands of the relevant partner is a consequence of its tax exempt status even though the Partnership is also treated as non-transparent in the partner's jurisdiction.

This new addition is in line with expected interpretation based on the BEPS Action 2 report, the Directive as well commentaries from the Council of State, according to which a payment to a reverse hybrid entity, allocated to a tax-exempt investor, does not trigger the application of the reverse hybrid rule. This approach is illustrated by the wording of recital 18 of the Directive: "[...] 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".

However, even if the Partnership indeed qualifies as a reverse hybrid entity, the Luxembourg law provides for exemptions.

Reverse hybrid rules carve-out

According to article 168 quarter (2), the reverse hybrid qualification is specifically waived for a so called "collective investment vehicle" (**CIV**) under the condition that these vehicles are (i) widely-held, (ii) hold a diversified portfolio of securities, and (iii) are subject to investor-protection regulations. Such waiver is a direct implementation of a Directive's provision. This concept of CIV can be found in the OECD report on "The granting of treaty benefits with respect to the income of collective investment vehicles" published in 2010.

Clear guidance, either in the OECD paper or the Directive or the ATAD 2 Law, has not been provided on how these three conditions should be construed. But the following interpretation rules should apply.

First, the term "widely held" should be read as referring to the ultimate investors rather than the

intermediate pooling or feeder vehicles (whatever their form or tax status) through which the former hold the interests in the relevant CIV.

The notion of "diversified portfolio" should not be construed in a way which totally excludes concentrated funds per se. The rules established by the CSSF (Commission de Surveillance du Secteur Financier, ie Luxembourg financial sector regulator) in its Circular 07/309 regarding risk-spreading in the context of specialised investment funds could be useful and a look through approach can be adopted.

Furthermore the "investor protection" requirement should in principle be met through the double protection regime to which authorised and supervised Luxembourg funds are subject to. With respect to AIFs, for instance, the mere supervision of the AIFM by its home state regulator should mean that the fund vehicle is also subject to investor protection regulation for the purpose of article 168quarter LITL.

Further to the above, the commentaries to the implementation law of ATAD 2 in Luxembourg law specifically indicates that partnerships having adopted either UCITS, or UCI Part II, or SIF or RAIF "product law" status are excluded from the application of the reverse hybrid rules. Such addition is not expressly mentioned in the Directive.

The following vehicles should therefore benefit from such exemption with respect to reverse hybrid rules, as per domestic product laws:

- undertakings for collective investment in the sense of the Law of 17 December 2010 (article 173)
- specialized investment funds (commonly referred to as **SIFs**) in the sense of the Law of 13 February 2007 (article 66)
- reserved alternative investment funds (commonly referred to as **RAIFs**) in the sense of the Law of 23 July 2016.

As such, it seems that this specific exemption would apply even if a vehicle subject to product law does not fully meet all three conditions set out to qualify as a CIV described above.

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