Analysis of the last provisions introduced by the government in the law transposing Pillar Two

OUR INSIGHTS AT A GLANCE

- On 4 August 2023, the Luxembourg government released the text of the draft law transposing the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union. This Directive implements the Global Anti-Base Erosion rules, also called "Pillar Two", agreed upon by the OECD.
- On 13 November 2023, the Luxembourg parliament published amendments proposed by the government to the draft Law.
- These amendments provide for additional guidance and clarification, as well as additional complementary rules in line with OECD guidance on Pillar Two but unfortunately, do not address all the clarification needed.
- On 20 December 2023, the law including all amendments proposed by the government was passed.
- In compliance with the Directive, most of the provisions of the new law are expected to come into effect for fiscal years beginning on or after 31 December 2023, while others will come into effect for fiscal years beginning on or after 31 December 2024.
- In this article, we desribe selected amendments proposed by the government

On 13 November 2023, the Luxembourg parliament published proposed amendments by the government to the law (the "**Law**") transposing the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise ("**MNE**") groups and largescale domestic groups in the Union (the "**Directive**"). This Directive implements the Global Anti-Base Erosion ("**GloBE**") rules, also called "Pillar Two", agreed upon by the OECD/G20 Inclusive Framework on BEPS in the Statement to Address the Tax Challenges Arising from the Digitalisation of the Economy and the Detailed Implementation Plan, on 8 October 2021[8].

The Law initially, presented to Parliament on 4 August 2023 as a draft, was largely in line with the Directive. However, additional guidance and clarification, as well as additional complementary rules (in line with OECD guidance), were still required to address important Luxembourg-specific points[9]. The amendments proposed by the government aimed at addressing these points but unfortunately, do not address all the clarification needed.

On 12 December 2023, the Council of State provided its opinion on the draft law as amended and raised two formal oppositions. On 20 December 2023, the law including all amendments proposed by the government was passed.

In this article, we go through selected amendments proposed by the government. To know more about the initial draft law, please read our previous article on this topic.

Relevance of OECD Guidance

In line with Recital 24 of the Directive, the Law acknowledges the GloBE rules published by the OECD on 20 December 2021 (the "**OECD Model Rules**") and related administrative guidance as sources of illustration and interpretation, even where such guidance was issued after the Directive. However, initially, the draft law only considered "a number of guidelines and solutions identified at OECD level after the date of adoption of Directive". In this respect, explicit reference was, for example, made to OECD guidance published on 14 March 2022, 15 December 2022 and 2 February 2023 only.

Consequently, the 13 July 2023 OECD guidance were not

[8] For more details about the GloBE Rules at OECD and European Union levels, read one of our previous articles.
[9] For more details about the the Draft Law and the issues it raised, read our previous article.

explicitly mentioned in the initial draft law. In addition, part of the 2 February 2023 OECD guidance had not been taken into consideration either in practice.

The draft law was thus amended with the aim to reflect these additional OECD guidance and to equip the Luxembourg Pillar Two rules with more flexibility, safe harbours and transitional rules to mitigate unnecessary adverse consequences for Luxembourg taxpayers.

This was key for Luxembourg as the OECD guidance notably include important safe harbour rules through which alternative calculation rules make it possible to determine in a simplified manner the amount of top-up tax due in respect of constituent entities located in jurisdictions meeting the conditions to benefit from these safe harbour regimes.

Scope and carve-outs of the Draft Law

- **Annual group turnover of at least EUR 750 million**

The new rules will apply to "constituent entities[10]" located in Luxembourg belonging to MNEs or large-scale domestic groups with a combined annual turnover equal to or above EUR 750 million in at least two of the four fiscal years preceding the tested fiscal year, as per the consolidated financial statements of the group parent entity. A "group" is defined by the Law as a group of entities linked by virtue of their ownership or control structure and included in the consolidated financial statements of the ultimate parent entity (extending also to entities that are excluded from consolidation based on size, materiality or on the grounds that the entity is held for sale). A group could also be a main entity and one or more permanent establishments, provided that such group is not part of another group based on the above consolidation threshold.

- Deemed consolidation – legal uncertainty remains

Entities that do not prepare consolidated accounts on a line-by-line basis may nevertheless be considered to form a group with their subsidiaries and therefore be in the scope of Pillar Two (e.g. if they are not required to prepare accounts at all or they do not prepare accounts under an acceptable accounting standard).

Previous OECD guidance already clarified that certain investment entities (e.g. under IFRS 10) that are exempt from line-by-line consolidation and that are merely required to fair value their investments (including where majority stakes are held in subsidiary companies) do not fall within the deemed consolidation rule, i.e. such entities do not qualify as parent entities of a group.

The Law and the related parliamentary documents unfortunately remain silent on this particular topic. In order to have legal certainty and in light of the large number of Luxembourg investment fund vehicles concerned, it would have been particularly wise to clarify whether Luxembourg-specific exemptions from consolidation vehicles companies or for most investment funds based on the respective special laws such as for reserved alternative investment funds, specialised investment funds or companies in risk capital ("**SICAR**") are consolidation exemptions comparable to the IFRS 10 investment entity exception.

New qualified domestic top-up tax (QDMTT)

The Law provides for the introduction of three new taxes in Luxembourg law. The first two are based on the application of two interdependent rules, namely the income inclusion rule ("**IIR**[11]") and the undertaxed payments rule ("**UTPR**[12]"). Under the IIR, the minimum tax is paid at the level of the parent entity in proportion to its ownership interests in entities that have low-taxed income. The UTPR is designed to operate as a backstop to the IIR. A qualified domestic top-up tax ("**QDMTT**[13]") will also be implemented, allowing Luxembourg to tax Luxembourgish low-taxed entities and

[10] A "constituent entity" as defined by the Draft Law means an entity or permanent establishment that is part of an MNE group or a large-scale domestic group.

[11] Règle d'inclusion du revenu ("RIR") as per the wording used in the Draft Law drafted in French.

[12] Règles des bénéfices insuffisament imposés ("RBII") as per the wording used in the Draft Law drafted in French.

[13] Impot national complémentaire qualifié as per the wording used in the Draft Law drafted in French.

prevent the application of the IIR and UTPR rules by other jurisdictions with respect to these entities[14].

- **Safe harbour for the IIR and the UTPR rules in case of foreign QDMTT**

As allowed by the Directive, Luxembourg chose to implement a domestic top-up tax through the Law. It allows Luxembourg to collect a top-up tax for low-taxed Luxembourg entities in priority to any other jurisdiction applying an IIR or a UTPR for those entities. According to the Directive, when this election is exercised, the parent entity applying the IIR will be obliged to give credit for the QDMTT tax when calculating the top-up tax in respect of the relevant jurisdiction.

To avoid increased compliance costs for MNE groups and administrative burdens for tax authorities, the OECD provided, however, for a QDMTT Safe Harbour in its 13 July 2023 guidance. The QDMTT Safe Harbour is intended to provide a practical solution which excludes the application of the GloBE Rules (i.e. the QDMTT to be credited against the top-up tax) in other jurisdictions by deeming the top-up tax payable under the GloBE Rules to be zero.

The initial draft law provided for a safe harbour for the IIR and the UTPR rules, where a low-taxed constituent entity has been subject, in its jurisdiction, to a QDMTT which is calculated in accordance with the UPE's qualifying financial accounting standard or International Financial Reporting Standards IFRS or IFRS adopted by the European Union under Regulation (EC) No 1606/2002. Under the draft law, if the foreign QDMTT met this condition, no top-up tax would have been be calculated in accordance with the draft law for the foreign constituent entities located in the jurisdiction which applies this QDMTT and therefore no top-up tax would have be allocated to the parent entities and constituent entities located in Luxembourg for the purposes of the application of the IIR and the UTPR. As such, the initial Luxembourg safe harbour rules diverged from the 13 July 2023 OECD guidance.

The draft law was thus amended to make this safe harbour regime compliant with the 13 July 2023 OECD guidance on QDMTT by completing it. As per the Law, it is now provided that if the QDMTT of a jurisdiction meets the condition to qualify for the QDMTT Safe Harbour in the context of a peer review process at the level of the OECD's Inclusive Framework, the reporting constituent entity may exercise an option under which no top up tax is to be calculated in accordance with the Law in respect of that tax year for the constituent entities of the MNE group or large domestic group located in the jurisdiction that applies that QDMTT.

The Law now specifies that, in order to benefit from the QDMTT Safe Harbour, the QDMTT of a jurisdiction must be considered "eligible for the QDMTT Safe Harbour in the context of a peer review procedure at the level of the Inclusive Framework of the OECD". The Inclusive Framework will rely on the peer review process to determine whether a QDMTT meets three standards (i.e. QDMTT Accounting Standard, Consistency Standard and an Administration Standard) and thereby qualifies for the safe harbour.

The wording of the Law implies the verification that the QDMTT of the jurisdiction concerned can validly be considered to meet the standards developed by the OECD. The exercise of the option implies then that the constituent entities located in Luxembourg no longer have to carry out the calculations necessary to determine the amount of the top up tax in accordance to the Law in respect of the constituent entities belonging to the same group and which are located in the jurisdiction for which the benefit of the safe harbour regime is invoked.

- **National QDMTT**

As permitted by the Pillar Two Directive, Luxembourg has chosen to implement a national QDMTT. This choice must be welcomed insofar as it is intended to allow Luxembourg to collect an additional tax for low-taxed Luxembourg entities as a priority compared to any other jurisdiction applying a top-up tax according to an IIR or an UTPR for these entities.

For the purposes of calculating the national QDMTT, the Law confirm now that the eligible profit or loss can

[14] For more details about the IIR and the UTPR, read our previous article.

be determined in accordance with an eligible financial accounting standard applicable in Luxembourg, if certain conditions are met. The admissible financial accounting standards applicable in Luxembourg are those based on Luxembourg accounting principles, hereinafter “Lux GAAP”, and those based on international financial reporting standards, hereinafter “IFRS”.

As indicated in the administrative instructions of July 2023, in the event of multiple admissible financial accounting standards applicable in a jurisdiction, such as for example for Luxembourg with Lux GAAP and IFRS, Luxembourg must explicitly provide which financial accounting standard is to be applied for the purposes of calculating the QDMTT.

Therefore, the Law provides that if the financial statements of all constituent entities of the MNE group or large national group that are located in Luxembourg are prepare on the basis of the Lux GAAP for legal filing and publication purposes in Luxembourg, and that these financial statements are based on the same fiscal year as that on which the consolidated financial statements of the MNE group or large national group are based, the profit or loss used to calculate the QDMTT of those constituent entities, shall be determined on the basis financial statements prepared in Lux GAAP.

According to the Law, to the extent that the constituent entities of the MNE group or the large national group located in Luxembourg prepare, for the purposes of legal filing and publication in Luxembourg, their financial statements in accordance with more than one standard of admissible financial accounting applicable in Luxembourg, namely the hypothesis where some constituent entities prepare their financial statements in Lux GAAP and others in IFRS, the admissible financial accounting standard to be used, for the purposes of calculating the QDMTT, for all the Luxembourg constituent entities of this group, is in principle the one based on IFRS.

Finally, the Law provides that where at least one of the constituent entities of the MNE group or large national group located in Luxembourg prepares its financial statements for legal filing and publication in Luxembourg in a qualifying financial accounting standard other than that applicable to Luxembourg (i.e. Lux GAAP or IFRS), or when the financial statements of the constituent entities of the group which are located in Luxembourg are based on a tax year diverging from that used to prepare the consolidated financial statements of the same group, the profit or loss used for the purposes of calculating the QDMTT is to be determined in accordance with the general provisions of Pillar Two.

In line with the 13 July 2023 OECD guidance on QDMTT, the Law also excludes investment entities and insurance investment entities from the regime of the QDMTT in order to ensure the tax neutrality of Luxembourg investment vehicles.

Lack of alignment between the Luxembourg participation exemption and Pillar Two

In order to enable the comparability of the effective tax rate (“**ETR**”) determined for each jurisdiction in which the group's constituent entities are located, the Law contains detailed rules determining the qualifying income or loss of a constituent entity (denominator of the ETR computation) which differ in certain respects from the rules of ordinary Luxembourg tax law.

The starting point is the net financial accounting result according to the accounting standard used for group consolidation purposes at the UPE level, before any consolidation adjustments for intra-group transactions. The financial accounting net income or loss is then subject to a series of adjustments designed in particular to take account of any discrepancies between the accounting rules and the tax rules generally accepted by OECD member countries.

In that respect, there is an exclusion for dividend income or other distributions received or accrued in respect of an ownership interest, except for ownership interests held by the group in an entity, that carries rights to less than 10 % of the profits, capital or reserves, or voting rights of that entity at the date of the distribution or disposition (a “**Portfolio Shareholding**”) and that has been economically owned by the constituent entity that receives or accrues the dividend or other distribution for less than one year at the date of the distribution. This means that only dividends received or accrued in respect of Portfolio Shareholdings of less than one year are included in the qualifying income or loss. It is also specified in the commentary to the articles that for reasons of simplicity, the Law does not prohibit the inclusion of expenses relating to excluded dividends.

In addition, there is an exclusion for gains and losses from shareholdings provided that an ownership interest of at least 10% is held in an entity (irrespective of the holding period).

These rules are not aligned with the Luxembourg participation exemption regime since Luxembourg companies may also rely on the acquisition cost criterion (i.e. EUR 1.2m for dividends and liquidation proceeds and EUR 6 m for capital gains) to exempt dividend income or capital gains. Similarly, companies relying on the commitment-based 12-month holding period could face a divergence with the Pillar Two rules.

Therefore, it would have been desirable to enable an opting-out from the Luxembourg participation exemption regime (as is already possible in other jurisdictions) in order to align the Luxembourg tax result with the GloBE income. Such optionality will be key to keep Luxembourg's competitiveness in an international environment by allowing Luxembourg taxpayers to mitigate adverse tax consequences as well as an increased administrative burden as a result of timing and/or permanent differences.

The Law does not address this issue. However, the Law addresses the need for symmetry in the numerator and denominator of the ETR computation where losses in respect of equity investments are taken into account for local tax purposes but not under the GloBE Rules. For that purpose, in accordance with the 2 February 2023 OECD guidance, the Law provides that an MNE Group can elect to include gains, profits, and losses from equity investments in the computation of GloBE income or loss and to take into account the corresponding current and deferred tax expenses or benefits. The 2 February 2023 OECD guidance specifically allowed for the so-called "equity gain or loss inclusion election" to mitigate such mismatches. This is notably relevant as the Luxembourg participation exemption regime allows for a deduction of write-downs in value on qualifying shares (subject to certain recapture rules) while such losses are only deductible for Portfolio Shareholdings under Pillar Two.

In addition, following its amendment, the Law addresses the issue raised by insurance companies and other stakeholders according to which the requirements to differentiate short-term Portfolio Shareholdings from other (long-term) Portfolio Shareholdings are burdensome. As a matter of administrative simplification, an election to include all dividends received by the constituent entity with respect to Portfolio Shareholdings, regardless of whether these are short-term Portfolio Shareholdings, notwithstanding the adjustment for excluded dividends that would apply in the absence of the election, is therefore proposed. This means that in this situation, after the election, all dividends on Portfolio Shareholdings of the electing constituent entities will be included in the computation of the entities' GloBE income or loss.

Finally, the Law precises that financial instruments issued by a constituent entity and held by another constituent entity of the same group of MNEs or large national group is to be qualified uniformly by each of these constituent entities. In the event that the qualification, under the applicable accounting standard, differs between the issuing constituent entity and the holding constituent entity, the qualification adopted by the issuing entity shall be used for the purposes of the Law. This has been added to avoid asymmetrical treatment of the accounting classification of a financial instrument that would be used to artificially increase the effective tax rate, in line with the 2 February 2023 OECD guidance.

Excess Negative Tax Carry-forward

In the 2 February 2023 OECD guidance, it was agreed by the Inclusive Framework that jurisdictions should adopt the administrative procedure described therein, for the determination of a jurisdiction's total adjusted covered taxes for a tax year, in order to resolve issues relating to timing differences.

The administrative procedure describes the method by which an MNE group defers any excess negative tax expense determined for a tax year and reduces the Adjusted Covered Taxes in a subsequent tax year(s) in which the MNE group has GloBE income for a given tax year in that jurisdiction. The administrative procedure is optional or mandatory depending on the case.

This procedure, which was not initially included in the draft law, does however grant taxpayers the option of not being subject to additional taxation, for example if losses under Luxembourg law are higher than GloBE losses and could therefore trigger, a priori, additional taxation for the year in question. This option was finally introduced in the Law.

Deferred tax amounts

The amendments made to the initial draft law clarify, to a certain degree, which deferred taxes may be taken into account in determining the adjusted amount of tax concerned in accordance with the 2 February 2023 OECD guidance. However, all uncertainties with regard to deferred tax amounts and some clarifications would still be welcomed.

Next Steps

According to the Law and in compliance with the Directive, the IIR and QDMTT are expected to come into effect for fiscal years beginning on or after 31 December 2023, while the UTPR will come into effect for fiscal years beginning on or after 31 December 2024.

Our authors

ANDREAS MEDLER
Partner
andreas.medler@atoz.lu

MARIE BENTLEY
Chief Knowledge Officer
marie.bentley@atoz.lu