Articles

Concept of structured arrangement in the ATAD2 Luxembourg law

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On 19 December 2019, the law implementing EU Directive 2017/952 of 29 May 2017 (the "**ATAD2**") which was voted. This law provides a new anti-avoidance regime that seeks to counteract hybrid mismatches in the tax treatment of instruments and structures across jurisdictions (the "**ATAD2 Law**").

Apart from a few welcome adaptations, the Luxembourg legislator has generally made a *verbatim* transposition of ATAD2. However, the ATAD2 wording is far from being clear and precise. In this case, ATAD2 Recital No. 28 calls on Member States to refer to the explanations and examples in the OECD BEPS report on Action 2[1] ("**BEPS A2**") as a source of illustration or interpretation to the extent that they are consistent with the provisions of ATAD2 and with Union law.

Where no guidance is provided either from the legislator or from the tax authorities, the taxpayer is therefore prompted to rely on BEPS A2's best practice recommendations[2] to fill in the gaps and to deal with any incompatibilities that may arise between the recommendations and existing Luxembourg rules, at least in terms of objectives and context.

One of the concepts in the ATAD2 Law that specifically requires the taxpayer to actively interpret it for himself, is the one related to the concept of, "structured arrangement".

This concept is of significance as it is one of the two gateways to the application of the hybrid mismatch rules.

In effect, any remedies to a hybrid mismatch in tax outcomes under the ATAD2 Law are triggered only if there is a degree of relatedness between the parties or if the relevant dealing occurs under a *structured arrangement*.

According to the ATAD2 Law's definition of *structured arrangement* – which exactly replicates the one in ATAD2 – a *structured arrangement* means "*an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch*".

This is where Luxembourg guidelines end in this respect. However, BEPS A2 devotes a whole chapter to the concept of *structured arrangement* through Recommendation 10. This does not mean, however, that BEPS A2 leaves no questions or that it does not raise a host of new issues.

It would then be desirable to grasp the intent of the *structured arrangement* rule which could be of some help when dealing with issues that may arise when applying the general principle and related exceptions.

1. The spirit and logic of the rule

The ATAD2 Law covers hybrid mismatches (i) arising between "associated enterprises"[3] whether the hybrid mismatches were the parties' intended effect or not and (ii) resulting from a *structured arrangement* whether the parties to the transaction are *associated enterprises* or not.

The consultation document on BEPS A2[4] implies that the rules mainly target hybrid technics that are deliberately used to engineer a mismatch in tax outcomes[5]. In this regard, in the consultation document, it was assumed that the risks of planning schemes involving hybrid mismatch arrangements would be higher between related parties. However, in those cases where the mismatch arose by accident rather than design, the OECD considered that parties sharing "*a significant degree of common*

1 OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

2 In the explanatory statements, the Luxembourg legislator did make a general reference to BEPS A2 as source of interpretation for the taxpayer.

3 According to Article 168*ter* of the ATAD2 Law, an "associated enterprise" is:
- an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 50% or more, or is entitled to receive 50% or more of the profits of that entity;
- an individual or an entity, which holds directly or indirectly a participation of at least 50% in terms of voting rights or capital ownership in the taxpayer, or is entitled to receive at least 50% of the profits of the taxpayer;
- an entity that is part of the same consolidated group for accounting purposes;
- 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.

However, for mismatches resulting from a hybrid instrument, the percentage has decreased to 25%.

4 Public Discussion Draft BEPS ACTION 2: Neutralise The Effects Of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws), 19 March 2014-2 May 2014.

5 *Ibid*, see for instance paragraph n° 126.

ownership or control can be expected to identify and negotiate an appropriate allocation of risk in relation to the application of the hybrid mismatch rule"[6]. This significant degree of ownership or control has been set in the ATAD2 Law at 50% of interests ownership (in terms of right to votes, capital ownership or profits) for most hybrid mismatches (reduced to 25% in case of payments under a financial instrument) as well as in cases where the parties are in the same consolidated group for financial accounting purposes or where one has a significant influence over the management of the other.

In those cases, the taxpayer is somehow irrevocably presumed to be responsible for the hybrid mismatch in tax outcomes either because he engineered it or because he did not avoid it while he was in a position to do so.

The reasons for this bottom-up approach are threefold: first, it seeks to identify those transactions which raise the most significant concerns from a tax policy perspective. Secondly, it keeps the collateral costs for applying the rules proportionate to the intended benefits. Finally; but not least, it constitutes (*a priori*) a clearly identified triggering event for an automatic application of the hybrid mismatch rules.

Conversely, between unrelated parties, the potential for abuse is generally much lower. Therefore, hybrid mismatches arising in such a context will be subject to a tax adjustment to the extent that they were designed to secure a tax benefit.

Accordingly, the *structured arrangement* rule is a general anti-abuse rule that provides for a second safety net in case tax avoidance schemes are not adequately addressed through the related party status test.

2. The general definition

According to the general definition provided by the ATAD2 Law, an arrangement will be *structured* if "*the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome*"[7].

Accordingly, the following two limbs outline (potentially overlapping) circumstances of a *structured arrangement*:

- the arrangement is intended to rely on or produce a hybrid mismatch;
- the pricing is based on the existence of a hybrid mismatch.

2.1. The design feature limb

The design feature limb undergoes a single test, i.e. the reasonableness test bypassing a purpose test.

2.1.1. The reasonableness test

2.1.1.1. Principle

Identifying tax-motivated *structured arrangements*, at its core, entails an enquiry into the purpose of the arrangement. According to Recommendation 10, this purpose must spring from an objective observation of the terms of the arrangement and the surrounding facts and circumstances in existence at inception of the arrangement: "*if a reasonable person, looking at the facts of the arrangement, would otherwise conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition regardless of the actual intention or understanding of the taxpayer when entering into an arrangement*"[8].

This test is somewhat similar to the first prong of the sub-test provided for under the Principal Purpose Test ("**PPT**") as set out in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "**Multilateral Instrument**" or the "**MLI**")[9] and stemming from the final report on Action 6 of the BEPS report[10].

According to Article 7 (Prevention of Treaty Abuse) of the MLI, the PPT rule is applicable when "*it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit […].*"

Commentary on the PPT rule in BEPS Action 6[11] indicates that the PPT requires one to "*undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it. What the purposes are of an arrangement or transaction is a question of fact, which can only be answered by considering all circumstances surrounding the arrangement or event on a case-by-case basis. It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention*".

The wording "*it is reasonable to conclude, having regard to all relevant facts and circumstances*" is the so-called "*reasonableness test*"[12].

6 *Ibid.*
7 Article 168*ter* (1) 17.

8 See BEPS A2, para. 321.
9 See Article 7 of the MLI.
10 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
11 See paras. 10 and 11 of the Commentary on the PPT rule.
12 See D. WEBER, "*The reasonableness test of the Principal Purpose Test Rule in OECD BEPS Action 6 (tax treaty abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law*", in Erasmus Law Review, August 2017 No. 1, p. 49.

Similarly, Recommendation 10 provides that "*The test for whether an arrangement is structured is objective. It applies, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes*"[13].

The reasonableness test is therefore an objective test. The test is objective not only because it relies on facts and circumstances surrounding the arrangement regardless of the actual intention or understanding of the taxpayer; but also because the analysis of the facts and circumstances is itself objective. Recommendation 10 calls for an objective third-party observer to carry out this analysis, which would involve weighing facts and circumstances in order to determine whether it is reasonable to conclude that an arrangement was engineered to produce a hybrid mismatch.

It is worth noting that the reasonableness test applies to an entire arrangement and not only to the transaction that gives rise to a hybrid mismatch in tax outcome. Therefore, an arrangement should still be treated as *structured* even if every step of it has a non-tax justification as long as it is reasonable to conclude that part of the explanation for the overall design of the arrangement was to generate a hybrid mismatch.

According to Recommendation 10, the facts and circumstances include the relationship between the parties, the circumstances under which the arrangement was entered into, the steps and transactions that were undertaken to put the arrangement into effect, the terms of the arrangement itself and the economic and commercial benefits of the transaction.

When determining whether the *structured arrangement* definition is satisfied, the relevant type of hybrid mismatch must be taken into account as each kind of mismatch is made up of different elements giving rise to the tax benefit. For example, in identifying a hybrid financial instrument, the relevant elements would include the choice of instrument and the terms of the instrument along with the tax position of the parties to the arrangement. Therefore, each type of hybrid mismatch requires a proper understanding of the scheme to determine whether there is a *structured arrangement*.

2.1.1.2. Examples of indicators of a structured arrangement

Recommendation 10 sets out a non-exhaustive list of six (supposedly) readily identifiable factors indicating that a particular arrangement was specifically structured to achieve a hybrid mismatch.

It is clarified that such a list of factors is not exhaustive and there may be other factors in an arrangement that could also lead an objective observer to conclude that the arrangement was deliberately designed to produce a mismatch. Finally, these factors could be used alone or together, depending on the case, to determine whether the hybrid mismatch is a design feature of the arrangement.

(a) Arrangement that is designed or part of a plan to produce a mismatch

This first factor described in Recommendation 10 appears a little baffling.

Through this factor, "*an arrangement will be part of a plan to produce a hybrid mismatch where a person with material involvement in, or awareness of, the design of the arrangement (such as a tax advisor) has identified, before the arrangement was entered into, that it will give rise to mismatch in tax outcomes*"[14]. It is furthermore clarified that "*this factor ensures that if a taxpayer is advised of the hybrid mismatch then the arrangement will be a structured arrangement*".

Evidently, if it results from written documents that the taxpayer designed the arrangement with a view to benefiting from a hybrid mismatch, the *structured arrangement* test is complete and there is no need to investigate further.

However, a strict reading of this example could lead to the conclusion that the mere fact that the taxpayer was aware that the transaction would produce a hybrid mismatch in the tax outcomes, would make the arrangement *structured*.

This reading would conflict with the general definition and the spirit of the *structured arrangement* concept as described in Recommendation 10 which requires that "*the mismatch in tax outcomes was an* intended [emphasis added] *feature of the arrangement*[15]". Yet, the fact that the taxpayer knows before entering into the transaction that it would produce a hybrid mismatch does not necessarily mean that the hybrid mismatch in tax outcomes is "intended". This would overly broaden the scope of the *structured arrangement* concept, and would draw in any cases where it can be proved (either through written or oral advice given in connection with the arrangement, or via working papers or documents) that the taxpayer was aware that the transaction will give rise to a hybrid mismatch in tax outcomes regardless of whether the mismatch outcomes was actually intended. The authors are of the view that this reading should not be privileged for the following reasons:

– As mentioned above, the general definition of the *structured arrangement* concept makes it clear that the rule targets arrangements that have been deliberately structured to engineer a hybrid mismatch;

13 See BEPS A2, para. 319.

14 BEPS A2, n° 330.

15 BEPS A2, n° 319.

– The examples given in Recommendation 10 to illustrate this factor, namely examples 1.31 and 10.2 of BEPS A2, reveal that in every scenario, the arrangement was viewed (by Recommendation 10) as *structured* based on a number of factors indicating that the hybrid mismatch in tax outcomes was intended (and not only on the fact that the taxpayer was aware of the hybrid mismatch). Moreover, it is notable that the arrangements in these examples included either an unnecessary step (see example 10.2 of BEPS A2) or an unnecessary transaction (see example 1.31 of BEPS A2) that had no substantial business, or commercial purpose.

Interestingly, this factor not only covers situations where the arrangement was designed to engineer a hybrid mismatch in tax outcomes but also situations where the taxpayer is intended to rely on a hybrid mismatch. This scenario is described in paragraph 344 of Recommendation 10: "*whether a taxpayer is a party to a structured arrangement is likely to have the most practical significance in the context of payments made to a reverse hybrid or under an imported mismatch arrangement. In the cases of a reverse hybrid, for example, the relationship between the investor and the reverse hybrid will often satisfy the conditions of a structured arrangement. This is particularly the case in respect of investment funds where investors may look to invest in vehicles that are tax neutral under the laws of the establishment jurisdiction and to ensure that the investment return will only be taxable on distribution*"[16]. This means that an investor that looks to invest in vehicles that are tax neutral will make the arrangement *structured* although he did not implement it (and the arrangement has not been designed at its inception to engineer hybrid mismatch in tax outcomes).

This scenario should be distinguished from the one where the investor chooses to invest in a structure without specifically looking to benefit from a hybrid mismatch (although, of course, it could be assumed that the taxpayer will not sulk knowing that their investment will at the same time, be tax advantageous). In this case, although they may not be averse to the hybrid mismatch, they were not looking for it.

(b) An arrangement that uses a term, step or transaction to create a mismatch

An arrangement will be *structured* if there is a term/step/transaction included in the scheme explicable by reference to a hybrid mismatch.

This indicator alone, is in itself evidence of a *structured arrangement* if two conditions are met: (i) in the absence of that term, step or transaction, the mismatch would not have arisen and (ii) there was no substantial business, commercial or other reason for inserting that term into the arrangement or for undertaking that step or transaction.

In the case where condition (ii) is not met, i.e., there are valid, non-tax reasons for inserting that term into the arrangement or for undertaking that step or transaction, this should not, nevertheless, entirely negate this factor. This is because this factor could be used together with other factor(s) to demonstrate that the hybrid mismatch in tax outcomes was part of the plan, despite the existence of non-tax justifications.

(c) An arrangement is marketed as a tax-advantaged product

Any material or oral communication provided to the parties to the arrangement or potential parties to the arrangement that points out a potential tax benefit deriving from a hybrid mismatch will be an indicator that the arrangement *is structured*.

Recommendation 10 gives as an example, a marketing material that mentions to an investor in a double deduction structure, that the investor will be able to claim the benefit of any losses incurred by the investment vehicle, or, in a deduction/non-inclusion structure that the borrower should be entitled to a tax deduction for the payments. Prospectuses and other offering documents that are required to be provided to an investor as part of an offer of investment securities are typically put under the spotlight.

It is clarified that this factor "*ensures that tax benefits derived from the hybrid mismatch arrangement cannot be used to market the arrangement*".

However, mentioning the right of the borrower to deduct payment made under the instrument issued may be simply part of the borrower tax regime regardless of the type of instrument issued and the investor's tax position. Yet, the description of the issuer's tax regime in a prospectus or an offering memorandum generally results either from a market practice or a legal requirement.

In this respect, a change to legislation regarding tax information to be included in a public offer and/or listing prospectus under the new EEA prospectus rules, applicable as of 21 July 2019, must be mentioned[17]. The new legislation has introduced new, simplified rules, with respect to tax sections contained in securities prospectuses. This new approach generally only requires an issuer to include a warning that the tax legislation of the

16 See paragraph n° 344.

17 See in this respect Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC and Commission Delegated Regulation (EU) 2019/980 of 14 March 2019 supplementing Regulation (EU) 2017/1129 of the European Parliament and of the Council as regards the format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and repealing Commission Regulation (EC) No. 809/2004.

investor's Member State and of the issuer's state of incorporation may have an impact on the income received from the securities. However, an issuer must still include specific information on the tax treatment of the securities where the proposed investment attracts a tax regime which is specific to that type of investment.

Obviously, when the description of the tax position of the issuer is required by law or regulation, the material providing such information could not be viewed as a tax marketing document.

In any case, the fact that the marketing material points out that the issuer is entitled to a deduction would definitely not, in the author's view, be sufficient evidence of the design feature of an arrangement as described in Example 10.3. of BEPS A2 (points 5 and 6). The conclusion would be different if in addition, the instrument had been primarily marketed to investors in jurisdictions that could benefit from the mismatch in tax outcomes.

(d) An arrangement that is primarily marketed to taxpayers in a particular jurisdiction

An arrangement would be considered as *structured* if the arrangement is primarily marketed to taxpayers of a particular jurisdiction that would benefit from the mismatch.

This factor also covers situations where the majority of investors – in number or value - that purchased the product happen to benefit from a hybrid mismatch while the product had been marketed in several jurisdictions. This factor provides a major challenge to the taxpayer when the time comes for them to prove that despite the presence of a majority of investors benefiting from a hybrid mismatch, the arrangement is not *structured*. Fortunately, the rule also provides for a carve-out in this case where the issuer of the product could not reasonably have been expected to be aware of the mismatch in tax treatment and did not benefit from the mismatch either. Recommendation 10 and Article 168*ter* (1) 17 of the ATAD2 Law do not, however, apply this carve-out in the same way (see Section 2 below).

Since the list of factors provided under Recommendation 10 is not exhaustive, this factor should also be extended to include cases where the product has only been offered or marketed to a particular subset of prospective investors or participants in a particular jurisdiction who would be expected to benefit from such a hybrid mismatch.

(e) Change to the economic return under the instrument

This factor typically addresses the case where the existing terms of an arrangement will be changed in the event that the hybrid mismatch would no longer be available.

In Example 10.2 of the BEPS A2, the arrangement has been unwound, at no cost to the terminating party since the tax benefit under the structure is no longer available. It is mentioned that in this case, this is a "strong indicator" of the arrangement having been structured to produce a mismatch in tax outcomes.

Such changes could also consist in increasing the cost of financing at the benefit of the lender or in the redemption of an instrument for its face value, in order to "primarily" deal with the risk that the hybrid mismatch rules may apply to the arrangement.

The use of the word "primarily" indicates that the factor would still be present even if such clauses were inserted for other non-tax reasons that are of lesser importance than the tax reasons.

Interestingly, the French version of BEPS A2 uses the word "*uniquement*" to translate "primarily" which leads to different interpretations. The wording "*uniquement*" could actually be translated in English as "exclusively". Accordingly, if the clauses are inserted for other non-tax reasons (no matter if they are of lesser importance than the tax reasons), the factor would not be satisfied.

In any case, such clauses do not necessarily indicate that the parties intended to enter into a *structured arrangement* if the taxpayer is able to establish that such contractual terms would ordinarily be expected to be found in a financing arrangement of that nature.

(f) Pre-tax negative return

An arrangement that would produce a negative return were the hybrid mismatch not be present would constitute a factor indicating the presence of a *structured arrangement*.

A typical example provided in Recommendation 10 refers to a back-to-back loan, structured through an unrelated intermediary, in order to avoid the related party test while maintaining the hybrid mismatch in tax outcome. In that example, the tax benefit under the hybrid mismatch arrangement is returned to the parent company in the form of an above-market rate of interest.

The fact that it would be uneconomic for the taxpayer to enter into such a scheme in the absence of the hybrid arrangement, would substantially indicate not only satisfaction of the "priced into the terms" limb but potentially also the "design feature" limb.

2.1.2. Absence of principal purpose test

While the reasonableness test of the *structured arrangement* rule has similarities with the PPT rule, the *structured arrangement* rule does not, however, encompass a "principal purpose test".

In the PPT, the test denies treaty benefits where "one of the principal purposes" of engaging in a transaction or arrangement is to obtain a tax benefit. This means that obtaining such tax benefit needs not be the "*sole or*

dominant purpose of a particular arrangement or transaction", but just one of many purposes underlying the transaction. In the PPT, the taxpayer remains free to choose the least taxed road as long as this choice is not mainly tax driven.

Conversely, the *structured arrangement* rule ensures that hybrid mismatches cannot be one of the options offered to the taxpayer.

Accordingly, if the surrounding facts and circumstances lead to the conclusion that a hybrid mismatch is a design feature of an arrangement based on the reasonableness test, there is no further need to balance this conclusion against any other economic or commercial aspects of the arrangement or against its broader rationale to determine a degree of significance or purpose in respect of the tax motive. This limb of the *structured arrangement* definition is not a "principal purpose test". Accordingly, where an arrangement produces a combination of tax and commercial benefits, it will still be treated as a *structured arrangement* if an objective observer were to conclude that part of the explanation for the design of the arrangement was to achieve a hybrid mismatch.

However, the economic and commercial reasons underlying a step, a transaction, or an arrangement, could be used to establish that the arrangement was not designed to engineer a hybrid mismatch in tax outcomes.

2.2. The pricing limb test

In contrast to the design feature limb, the pricing limb of the *structured arrangement* definition does not involve an enquiry into broader matters related to the arrangement such as the relationship between the parties or the circumstances under which the arrangement was entered into. The satisfaction of the pricing test must be evident from the terms of the transaction documents themselves. A simple analysis (and understanding) of the terms of the arrangement will be sufficient to see if the tax benefit of the mismatch has been factored into the calculation of the return of the investment. The examples given to illustrate this factor typically describe two situations where the interest rate of a hybrid financial instrument is set either above or under the market value in order to provide the payee or the payer, as the case maybe, with the tax saving resulting from the hybrid mismatch.

3. The carve-out

3.1. The principle

Where the *structured arrangement* definition is satisfied, Recommendation 10 provides for a carve-out for an entity that is not a party to the *structured arrangement*.

Essentially, if the taxpayer (or a related party) could not reasonably have been expected to be aware of the hybrid mismatch, nor have benefitted from the mismatch, it will not satisfy the condition of being a party to the *structured arrangement*.

Article 168*ter* (1) 17 of the ATAD2 Law also provides for a similar carve-out although there are some differences which may have an impact on the application of the *structured arrangement* rule.

Mainly, the ATAD2 Law definition of *structured arrangement* does not include the concept of "*party to the structured arrangement*". In Recommendation 10, if an entity could not reasonably have been expected to be aware of the hybrid mismatch nor have benefitted from the mismatch, the entity is not considered as being a *party* to a *structured arrangement*. Recommendation 10 therefore covers situations where there is a *structured arrangement* but excludes the entity that is not a *party* to it. This situation could happen for instance, for issuers of widely held retail investment products. As mentioned in the section related to factor (a) of this article (see *supra*), an investor that looks to enter into an arrangement that gives rise to a hybrid mismatch in tax outcome could lead to the arrangement being considered as *structured*. However, if the issuer is not considered as a party to it, the *structured arrangement* rule would not apply. This leads to nonsensical application of the rule to situations where a single party to an arrangement could make it *structured*. As a matter of consequence, a tax adjustment could still be made at the level of the investor if the jurisdiction in which the investor operates provides for secondary rules.

In contrast, the carve-out provided under the ATAD2 Law disqualifies entirely the arrangement as being *structured* as it defines the *structured arrangement* as being "*an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome,* unless [emphasis added] *the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch*"[18].

Specifically, according to the ATAD2 Law, an arrangement will not be *structured* if the taxpayer can satisfy all of the following three conditions:

(i) the taxpayer could not reasonably have been expected to be aware that the arrangement gave rise to a hybrid mismatch (the "awareness test"); and

18 In French "*un dispositif utilisant un dispositif hybride et dont les termes intègrent la valorisation de l'effet d'asymétrie ou un dispositif qui a été conçu en vue de générer l'effet d'un dispositif hybride, à moins que l'on ne puisse pas raisonnablement attendre du contribuable ou d'une entreprise associée qu'il/elle soit informé(e) de l'existence du dispositif hybride, et qu'il/elle n'ait pas bénéficié de l'avantage fiscal découlant de ce dispositif*".

(ii) no other *associated enterprises* of the taxpayer could reasonably have been expected to be aware that the arrangement will likely give rise to a hybrid mismatch; and
(iii) the taxpayer did not share in the value of the tax benefit resulting from the hybrid mismatch. It results from example 4.1 of BEPS A2 that it is not sufficient that the investment is simply more marketable due to its tax treatment but that it is also necessary that the value of the tax benefit should be priced into the investment.

If the above conditions are met, the arrangement will not be *structured* even though the investors on their side have looked to benefit from a hybrid mismatch.

Following Recommendation 10, the "awareness test" is an objective test that is largely based on the information available to the taxpayer. Difficulties may arise in practice when determining whether or not the taxpayer had sufficient knowledge, or should have had sufficient knowledge, to know that the arrangement would have given rise to an anti-hybrid mismatch. This test does not impose an obligation on the taxpayer to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable person. Still, what could be expected to be "reasonable" will likely be subject to debate. Practical guidance from the tax authorities would be welcome in this respect.

3.2. Some practical implications

3.2.1. Private equity and real estate structures

This carve-out would be of particular importance in the context of Luxembourg's private equity & real estate ("**PE RE**") investment sector structured through limited partnerships or securitisation companies.

In a typical PE RE fund structure, the Luxembourg vehicle that is used to manage the pool of assets is often established in the form of a Luxembourg special limited partnership ("**SLP**") so as to provide investors with a lot of legal flexibility.

The SLP is tax transparent for Luxembourg corporate income tax and net wealth tax purposes.

Investment structures involving a tax transparent entity such as the SLP could meet the definitions of hybrid entity as laid down in Article 168*ter* (1) 2 b) of the ATAD2 Law and of the reverse hybrid entity as laid down in Article 168*quater* of the ATAD2 Law if the SLP is treated as tax opaque in the investors' jurisdiction.

The adjustment required under the rule of Article 168*ter* (1) 2 b) of the ATAD2 Law is the denial of the tax deduction at the level of the Luxembourg paying vehicle (which made payments to investors through the SLP).

In this case, it derives from Recommendation 10 that such investment fund structures could satisfy the conditions of a *structured arrangement* if it turns out that investors have looked to invest in vehicles that provide them with an advantageous tax treatment in their jurisdiction[19]. However, according to Article 168*ter* (1) 17 of the ATAD2 Law, there will not be a *structured arrangement* if the payer did not benefit from the mismatch (i.e. the payment was at fair market value) and could not reasonably have been expected to be aware of the mismatch in tax treatment.

In a structure with a limited number of investors, the issuer should be able to identify them. This does not mean, however, that the issuer knows the tax position of the investors. The key point is to know what level of knowledge the issuer can reasonably be expected to have in this case. In the author's view, the issuer should not be expected to take the tax position of the investors into account as part of its ordinary commercial due diligence as illustrated in Example 4.1 of BEPS A2.

Were the payer to claim that they were not aware of the hybrid mismatch, it would be up to the tax authorities to prove the contrary, or to prove that the payer should have known that the arrangement would produce a hybrid mismatch as part of the standard due diligence that should be required in this kind of transaction.

Even assuming that the payer knows the general tax position of the investors, this does not necessarily mean that it knows that their tax positions will (likely) achieve a hybrid mismatch. Ironically, the hybrid mismatch rules are so complex that they generally require an in-depth analysis from tax experts to know whether an arrangement will give rise to a hybrid mismatch in tax outcomes. Yet, one can reasonably argue that such an analysis is not generally part of the commercial due diligence expected from a PE RE investment fund.

While the adjustment required under Article 168*ter* (1) 2 b) of the ATAD2 Law is different from the one provided under Article 168*quater*, the same reasoning could also apply in the latter context – provided, however, that one considers that the *structured arrangement* rule applies to the Article 168*quater* of the ATAD2 Law[20]. If it can be established that the payer could not reasonably have been expected to be aware of the mismatch in tax treatment (and it did not benefit from the mismatch either), there will be no *structured arrangement* and no

19 See paragraph n° 344.

20 One could indeed argue that Article 168*ter* applies autonomously vis-à-vis the Article 168*quarter* (save where Article 168*quarter* makes express reference to Article 168*ter* as it is the case for the concept *of* "associated enterprises"). This results in particular from the wording "*for the purposes of this article*" used to introduce the definitions of Article 168*ter* of the ATAD2 Law. Yet, the wording "structured arrangement" is actually defined in Article 168*ter* and "*for the purpose of*" Article 168*ter.* Thus, based on a literal reading of Article 168*ter* of the ATAD2 Law, one might conclude that the *structured arrangement* rule does not apply in the context of the reverse hybrid entity rule.

adjustment should be required at the level of the reverse hybrid entity.

The awareness test would, however, be easier to meet in the case of a securitisation company ("**SC**") that issues shares to its investors (which should not happen that often as the vast majority of SCs are financed by issuance of notes). Indeed, the SC benefits from a specific tax regime according to which any commitments to investors and other creditors, even if considered as a dividend from a legal point of view, are considered as deductible expenses for Luxembourg tax purposes. Such fiction, which is used for Luxembourg tax purposes only, is conductive to producing hybrid mismatches. In this respect, if the SC knows the tax position of the investor or is expected to know the tax position of the investor, it would be easier for it to determine if such a tax position will likely give rise to a hybrid mismatch.

Based on Recommendation 10's carve-out rule, while no tax remedy would be made at the level of the payer that is not a party to the *structured arrangement*, a tax adjustment could be required where the jurisdiction of the investor (that looks for investments giving rise to a hybrid mismatch) provides for a defensive rule which requires including the payment in its tax base. In contrast, under Article 168*ter* (1) 17 of the ATAD2 Law, there would be no scope for the application of the *structured arrangement* rule neither at the level of the SC or the investors' if it can be established that the SC could not reasonably have been expected to be aware of the mismatch in tax treatment and it did not benefit from the mismatch either.

In any case, one important point to note is that the *structured arrangement* rule's carve-out will not work (either based on the wording of Recommendation 10 or Article 168*ter* (1) 17 of the ATAD2 Law) if the investor that is aware of the mismatch in tax treatment and does benefit from the mismatch, is an *associated enterprise*.

3.2.2. Issuers of widely held instruments

A widely-held instrument is one that is held by a large number of holders across a number of jurisdictions and would typically include publicly traded bonds, instruments held through custodians and other arrangements where it may be difficult for the issuer to determine who holds the instrument and in what proportions, having market standard terms and conditions, and providing holders with a market rate of return.

Those circumstances make it more difficult for the issuer to determine whether the instrument will produce a hybrid mismatch in tax outcomes.

An issuer of a widely held instrument may have little, if any, control over who the holder will be. From a practical point of view, the issuer cannot be expected to collect the necessary information and make the tax calculations required to assess whether there are any hybrid mismatches deriving from an arrangement. Consequently, it would be fair to conclude that the issuers of those widely held instruments could not be aware of any hybrid mismatches deriving from an arrangement.

Based on Article 168*ter* (1) 17 of the ATAD2 Law, it can be concluded that there is no *structured arrangement* in this case.

However, as previously explained, the carve-out set out in Recommendation 10 would not prevent the above scenario from producing a *structured arrangement* if for instance, an investor subscribes to the securities in order to benefit from a hybrid mismatch in tax outcomes. In this case, the issuer not being a *party to the structured arrangement* would avoid any tax remedy at its level but the investor that subscribes in the securities in order to benefit from a hybrid mismatch will potentially not. In this respect it must, however, be recalled that Article 168*ter* (1) 17 of the ATAD2 Law is a copy of the *structured arrangement* definition adopted in ATAD2. Thus, there is a greater chance that other EU Member States have also introduced in their legislation the same wording[21] so that the risk to have a secondary tax remedy applied at the level of an EU investor should be limited.

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Much hope is pinned on the Luxembourg tax authorities to provide guidance to the Luxembourg taxpayers to navigate through the *structured arrangement* concept, first by taking a stand vis-à-vis what is provided in Recommendation 10.

Furthermore, some issues were not addressed in Recommendation 10, especially the one related to the testing time of whether a scheme is a *structured arrangement*. Is the testing time of whether a scheme is a *structured arrangement* limited to when the scheme was entered into, or should it be determined in respect of each payment? In the latter case, this would lead to an ongoing compliance burden for taxpayers or create potential for unfair tax adjustments in situations where a mismatch comes up sometime after an arrangement is put in place, due, for instance, to a change in law in one of the jurisdictions concerned.

[21] This is the case for instance of France, Germany, Belgium and the Netherlands.