Six Key Takeaways from our Luxembourg Substance Webinar

Over the past 18 months the European Commission has put a great deal of focus on tightening substance requirements across the continent. With regulation like DAC6 to ATAD III on the horizon, what does substance rule tightening mean for Luxembourg, and how can the jurisdiction retain its attractiveness as a leading domicile of choice in the face of increased competition from other fund jurisdictions? Could the introduction of the UK Qualifying Asset Holding Company Regime, for example, lead to UK asset managers setting up new fund holding structures in the UK rather than Luxembourg in the future?

To address these issues, we hosted a webinar on 21 June 2022. The event was moderated by our Head of Business Development for Europe, Hana Prochaska, who was joined by an expert panel made up of Anne-Cécile Vasseur-Jourdren (Aztec Group Associate Director – Tax), Benjamin Toussaint (Tax Partner at KPMG), and Pierre-Régis Dukmedjian (Head of Tax Practice at Simmons & Simmons).

You can watch the webinar in full here, and we've also provided our key takeaways from the session below:

Substance rule tightening isn't new

For many years companies have had to be compliant with substance requirements. However, substance is now a hot topic since the European Union published its anti-tax avoidance directive (ATAD III – the third iteration of the proposal). This proposal aims to prevent the misuse of shell entities located in Europe for tax evasion and avoidance purposes. ATAD III is scheduled to come into force on 1 January 2024 (or 2025, as recently proposed by the European Parliament), with a lookback period of two years, meaning in-scope entities should be considering this regulatory change now.

How ATAD III will work in practice

Anne-Cécile explained how, under ATAD III, entities will be examined against three cumulative gateways:

- Where the majority of a company’s income is considered passive, i.e. interest income, dividends, capital gains on shares, or rental income
- Where activities are mainly conducted cross-border
- And where daily management and decision-making is outsourced.

If an entity passes the three gateways, it would have to complete reporting obligations in its tax returns, to prove that it meets the minimum substance requirement. Should the entity fail the substance test, the entity would qualify as a shell entity, which would result in a number of adverse tax implications: the entity would be denied a tax residency certificate (in its Member State of residence) and the benefit of the EU Directives and Double Tax treaties. The income of the entity would be taxed at the level of the EU Member State of the shareholder, as if it had been directly accrued by the shareholder. Another consequence would be the automatic exchange of information on the entity between Member States that may have an interest in it.

What are companies doing now in respect of substance?

The panel discussed how some clients are waiting for ATAD III regulations to be finalised before taking action. Others have already made changes, such as setting up Luxembourg bank accounts in substance offices. Some clients have mentioned additional costs linked to substance, and a potential relocation of their structures. Overall, there was a feeling that the market may be reluctant to act on the draft regulation so far, because they believe they won’t pass all three ATAD III gateways.

Is Luxembourg still a domicile of choice?

The panel were asked whether Luxembourg as a jurisdiction needed to reaffirm itself in the face of competition from other locations like Ireland, and even the UK following the introduction of the UK Qualifying Asset Holding Company Regime. The consensus from the panel was that Ireland and Luxembourg generally address different asset classes, with Ireland seeing more hedge fund and private debt funds domiciling there, while Luxembourg remains popular with more traditional asset classes such as private equity, real estate and infrastructure. Generally speaking, Ireland is facing the same substance problems as Luxembourg. A fund manager will not choose Ireland over Luxembourg – or vice versa – because of substance. It will be for tax reasons specific to the asset classes they are involved in.

How will the role of Luxembourg middle offices evolve as a result of substance changes?

In terms of employee seniority levels, things have already started to change due to substance requirements. Entities need to have employees or local directors that are knowledgeable in the activities of the company – a real estate business would need to have senior employees knowledgeable in the real estate business, for example. Senior managers in Luxembourg are participating more in investment committee meetings, while minutes taken at board meetings are more comprehensive and authentic, all of which reinforces the substance levels of these entities.

Outsourcing

There remains some ambiguity around the third ATAD III gateway, where daily management and decision-making functions are outsourced. It is not currently clear whether the directive will apply to an entity which outsources essentially all of its functions, or an entity which has its own employees and directors, but also relies on a significant amount of purchased services. We believe we will fall outside the scope of this part of the directive, and we discuss why within the webinar. We continue to discuss this point with the Luxembourg associations which promote and protect the interests of the fund industry.

For more information on ATAD III, please contact Anne-Cécile Vasseur-Jourdren (Aztec Group Associate Director – Tax) or your usual Aztec representative.

Alternatively you can also contact our tax experts directly; Benjamin Toussaint (Tax Partner at KPMG), and Pierre-Régis Dukmedjian (Head of Tax Practice at Simmons & Simmons)

View the webinar in full

Watch now