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INSIGHTS

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EDITORIAL

Greetings,

2016 was busy for tax until the very end: on 27 December 2016, the Luxembourg tax authorities released a circular, introducing new guidelines effective as from 1 January 2017, on the TP and substance requirements applicable to Luxembourg finance companies. This change should keep companies involved in financing activities and their advisers busy for a while. They will have to review transfer pricing policy and related transfer pricing documentation to make sure that these are in line with the new requirements. In February 2017, two additional circulars followed, one of which aims to clarify the direct tax implications of the application of VAT to directors' fees from 2017. Luxembourg continues to expand its extensive tax treaty network with the recent ratification of five additional tax treaties in December 2016. As far as indirect tax aspects are concerned, we comment the recent clarifications provided by the Luxembourg VAT authorities on the VAT treatment of SCSps. Lastly, we present in these Insights the challenges and pitfalls, but also the possible advantages of an asset manager setting up its own Luxembourg based AIFM and those of resorting to an already established third party AIFM.

At EU level, the EU Member States did not manage to reach an agreement before the end of 2016 on how to fight, beyond EU borders, against hybrid mismatches that create double non-taxation situations. However, they were able to reach an agreement shortly after, on 21 February 2017, on the new directive amending the hybrid mismatch rules of the Anti-Tax Avoidance Directive and extending the scope of the directive to transactions involving third countries. Regarding EU VAT aspects, we analyse two recent Advocate General Opinions on the VAT exemption for cost-sharing groups and the main potential Luxembourg implications, should the European Court of Justice decide to follow the Opinions.

At global level, the work on the fight against treaty abuse (Action 6 of the BEPS action plan) continues: the OECD has released a discussion draft for comments in order to clarify in which situations so-called non-CIV funds should not raise treaty-shopping concerns and should thus be granted tax treaty benefits. Finally, we come back to the Multilateral Instrument (MLI) aiming to implement the tax treaty-related measures of the OECD Base Erosion and Profit Shifting (BEPS) Project. The MLI, which was adopted by more than 100 countries in November of last year, is expected to be signed by most of these countries, including Luxembourg, in June 2017. We review the different options and alternatives included in the MLI and consider the choices Luxembourg should, in our view, make in order to remain attractive for international investments.

We hope you enjoy these Insights.

The ATOZ Editorial Team

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TRANSFER PRICING: NEW CIRCULAR ON INTRA-GROUP FINANCING ACTIVITIES

OUR INSIGHTS AT A GLANCE

- At the end of 2016, the Luxembourg Tax Authorities released a circular providing guidance on the practical application of the arm's length principal to intra-group financing activities
- One of the key changes refers to the requirement to calculate capital-at-risk on a case-by-case basis. Previously, an equity at risk requirement needed to be filled, limited to at least 1% of outstanding loans, or EUR 2m
- The new Circular is positive for Luxembourg as it will make Luxembourg financing structures even more robust and strengthen the beneficial ownership position of Luxembourg financing companies

On 27 December 2016, the Luxembourg tax authorities released a new circular (the "Circular") on the tax treatment of intra-group financing activities. The Circular's release follows the introduction on 1 January 2017 of the new Article 56bis of the Income Tax Law ("ITL") which provides additional guidance on the application of the arm's length principle. The Circular provides guidance on the practical application of this guidance to intra-group financing activities, ensuring consistency with all international transfer pricing standards. The Circular, which replaced Circular 164/2 of January 28, 2011 and Circular 164/2bis of April 8, 2011 became applicable as from 1 January 2017.

Scope of the Circular

The scope of the Circular remains the same as under the previous Circulars and covers entities that are engaged in intra-group financing transactions. The term "intra-group financing transaction" is to be interpreted very broadly and includes any activity involving the granting of loans (or advancing of funds) to associated enterprises. How these loans are financed is irrelevant (for example, intra-group loans, bank loans, public issuances, etc.).

While the former Circulars referred to "cross-border" financing transactions between associated enterprises, the new circular refers more generally to financing transactions between related enterprises. Therefore, domestic financing transactions between Luxembourg companies come as much within the scope of the Circular as cross-border transactions. This change is consistent with Luxembourg legislative developments and the introduction of a new version of Article 56 of the ITL, which formally introduced the arm's length principle into Luxembourg tax law.

Guidance Provided in the Circular

- **Functional Analysis and Contractual Terms**

As under the previous regime, a functional analysis has to be performed in order to identify the activities and economically significant functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction.

The contractual terms are always the starting point when analysing a controlled transaction. However, in accordance with the OECD transfer pricing guidance, the Circular states that when the behaviour of the parties deviates from the contractual terms, the actual behaviour is to be considered (i.e., substance over form approach). In the case of financing activities, such deviation from the contractual terms should be very exceptional.

- **Risk analysis and capital at risk**

One of the key changes under the new transfer pricing regime is the requirement to determine the capital at risk on a case-

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by-case basis. In contrast, under the former regime, the so-called equity-at-risk requirement was deemed to be met when the equity (at risk) of the company amounted to at least 1% of the outstanding loan(s) or, EUR 2m.

While under the previous regime, the risk of a Luxembourg financing company had been contractually limited to either 1% of the outstanding loan(s) or EUR 2m, whichever amount was the lowest (e.g., through limited recourse clause, guarantee), under the new regime, the risk of a financing company is generally not limited. Instead, the expected loss of the financing activity is determined on the basis of the underlying fact pattern and the credit rating (and related credit default risk) of the borrower.

Once the capital at risk has been determined, a financing company must be financed with sufficient equity to cover the risk in case it materialises. The capital at risk has to be remunerated at arm's length and may be used to finance either the loan portfolio or other assets.

With regard to the determination of the capital at risk, the Circular distinguishes two functional and risk profiles:

- If the comparability analysis shows that the financing company has a profile comparable to entities governed by EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), and if its own funds are in line with the solvency criteria provided by this regulation, the financing company is considered as having a level of own funds which is sufficient to afford the financial consequences in case of risk realisation.

- If the comparability analysis shows that the financing company has a profile which differs significantly (in the assets used and the risks assumed) from the one of entities governed by EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), then other methods (in particular by performing a credit risk analysis) have to be applied in order to determine the required amount of own funds to assume the risk.

The financing company needs to have control over the risk related to its financing activities. Thus, the financing company should possess the power of decision to enter into risk-bearing financing transactions and take the decisions necessary to handle the related risk.

Abolishing the previous equity-at-risk requirement is a positive development for several reasons. First, it improves the beneficial ownership position of Luxembourg financing companies (bearing contractually all the risks in relation to the financing activities). Second, it takes away the only arbitrary element of the previous Luxembourg transfer pricing regime for financing companies. Third, under the previous transfer pricing regime, in some cases it was difficult to contractually limit the risk of the financing company through limited recourse clauses, guarantees, etc. (for example, when bonds are issued on the market and the funds are used to finance the operations of the group). These issues will all disappear under the new regime.

- **Comparability Analysis**

The new Article 56bis of the ITL emphasises the importance of the comparability analysis through a replication of some of the guidance provided in the OECD Transfer Pricing Guidelines. A comparability analysis is critical for the application of the arm's length principle and a cornerstone of any transfer pricing analysis.

While the comparability analysis was already an integral part of transfer pricing reports substantiating the arm's length nature of financing margins, under the new regime, there will be even more emphasis on the comparability analysis in the transfer pricing documentation. The Circular gives detailed guidance on how to perform a comparability analysis in case of intra-group financing transactions.

- **Substance of the Financing Company**

The Luxembourg financing company needs to have a real presence in Luxembourg. For this purpose, the majority of the managers/directors should be (professionally) resident in Luxembourg. However, despite the wording of the Circular, it is expected that in accordance with the previous administrative practice, it will suffice if at least 50% of the managers/directors are Luxembourg residents within the meaning of the Circular.

In addition, the company should employ personnel whose qualifications would allow them to control the activities performed by the company. Nevertheless, the company may still outsource or delegate some of the functions to the extent that these functions are supervised by the managers/directors of the company and have no significant impact on the control of the risk (which is considered as a management function).

Furthermore, the Luxembourg company should hold its annual shareholder meeting in Luxembourg at the registered seat of the company and should not be considered as tax resident in another jurisdiction. Overall, the substance requirements broadly replicate those defined under the previous Circular.

- **Comparable transactions between unrelated enterprises**

In order to determine the arm's length remuneration of financing activities, reference has to be made to the remuneration realised by entities in a comparable sector. In case the financing company has a profile comparable to the one of entities falling within the scope of EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), a return after tax on own funds

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of 10% (to be revised by the Luxembourg tax authorities over time) is considered as a level of return currently commonly seen in practice and thus considered as an arm's length remuneration. Nonetheless, even in these circumstances, it will be possible to determine an arm's length return for a specific case (which may be lower than 10% return on the equity).

- **Lack of valid commercial rationality**

In the same way as mentioned in the new Article 56bis ITL, the Circular includes some language on circumstances in which a transaction may be disregarded because there is a lack of valid commercial rationality and because a third party would not have entered into a specific transaction. However, this guidance should not have any significant relevance in practice and only concerns very exceptional cases.

- **Measure of simplification for financing companies acting as intermediary**

In the case where a Luxembourg financing company falling within the scope of the Circular acts only as an intermediary, given that the risks are very limited in these cases, it is assumed that the remuneration realised by the company is at arm's length if the company realises a minimum return of 2% after tax on its receivables.

However, companies merely involved in the on-lending of funds will still have the possibility to benchmark a lower rate of return in a transfer pricing study. Given the relatively high return required under the simplified regime (2% return on the assets corresponding to a 200 bps margin), it should make sense for most taxpayers to produce transfer pricing documentation in these cases.

This percentage will be revised on a regular basis by the Luxembourg tax authorities. In order to benefit from this simplified measure, a formal request has to be filed along with the tax return. Should a company opt for this system, a procedure of exchange of information will be launched (based on the Luxembourg rules on administrative cooperation or in accordance with double tax treaties).

- **Advance Pricing Agreement**

The procedure for obtaining an advance pricing agreement ("APA") remains unchanged. However, the content of the transfer pricing documentation needs to be even more detailed than before, including a description of the qualification and functions of the employees of the financing company.

However, when a transfer pricing analysis is properly done, an APA does not provide much additional comfort, creates unnecessary costs (for the preparation of the APA and the filing costs of EUR 10,000 levied by the Luxembourg tax authorities) and, potentially, the suspicion of foreign tax authorities, tax rulings and APAs being subject to exchange of information with other EU Member States and the OECD. Hence, if a proper transfer pricing analysis has been performed, there should generally be no good reason to file an APA as well.

Given that the new guidelines of the Circular became effective as from 1 January 2017, APAs which have been granted in accordance with the former circulars will be no longer valid as from 1 January 2017.

However, it is expected that transfer pricing studies prepared under the old regime will not be challenged for a reasonable amount of time. This is in order to give taxpayers the possibility to gradually adapt to the new requirements (to the extent the financing activity is still consistent with the underlying fact pattern in the transfer pricing study).

Conclusion and recommendations

The new Circular is positive for Luxembourg as it will make Luxembourg financing structures even more robust and strengthen the beneficial ownership position of Luxembourg financing companies, which is key in the current international tax environment.

The new transfer pricing regime adheres to the arm's length principle and OECD Transfer Pricing Guidelines and, therefore, renders the new transfer pricing regime immune to challenges from the EU Commission or foreign tax authorities. The Circular is yet another step in a trend towards more and more substantial transfer pricing documentation requirements in Luxembourg. However, this does not mean that the new regime will result in higher (arm's length) financing margins to be realised.

Transfer pricing documentation has become a key element in tax risk management in an environment that relies increasingly less on tax rulings and APAs. In the current international tax environment of heightened transparency and scrutiny, companies would be wise to take it one step further and integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their corporate structure and intra-group transactions.

Since the new rules became applicable on 1 January 2017, companies performing financing and on-lending activities in Luxembourg should review their transfer pricing policy and related transfer pricing documentation to make sure that these are in line with the new requirements.

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NEW CIRCULAR ON THE INCOME TAX TREATMENT OF DIRECTORS' FEES

OUR INSIGHTS AT A GLANCE

- In a recent circular, the Luxembourg tax authorities have clarified the direct tax impact of the application of VAT to directors' fees
- At the level of the independent director receiving fees, the amount of income subject to Luxembourg withholding tax, and the amount subject to income tax upon director assessment were clarified
- At the level of the Luxembourg company paying directors' fees, the non-deductibility of the VAT paid on these fees was confirmed

On 14 February 2017, the Luxembourg direct tax authorities released a Circular on the income tax treatment of directors' fees. The Circular comes after the recent Circular of the VAT authorities according to which directors' fees are subject to Luxembourg VAT. Following this VAT Circular, the question arose as to whether the amount of directors' fees to take into account for income tax purposes was the amount with or without VAT. With the new Circular, the tax authorities clarify the direct tax impact of the application of VAT to directors' fees.

Directors' fees are defined as: "income from independent services, provided the directors' fees do not constitute a remuneration for daily management activities." Directors' fees, special allowances and advantages granted to a director are subject to Luxembourg withholding tax, provided they are paid by a Luxembourg public or private undertaking.

Income tax treatment at the level of the independent director who receives the fees

- Amount subject to the 20% Luxembourg withholding tax: the Circular clarifies that the amount subject to the Luxembourg 20% withholding tax is the amount without VAT.
- Amount subject to income tax upon assessment of the director: the amount of VAT must be included in the amount of taxable income. However, the amount of VAT constitutes a deductible operating expense for income tax purposes. In addition, the 20% withholding tax levied on the director's fee is credited against the amount of income tax and employment fund contribution due.

Corporate income tax treatment at the level of the Luxembourg company which pays the directors' fees

According to Luxembourg corporate income tax law, directors' fees belong to the category of expenses which are not deductible for corporate income tax purposes. The Circular further clarifies the corporate income tax treatment of the related VAT as follows:

- In case the VAT paid on the directors' fees is not deductible at the level of the paying company, the full amount of VAT is considered as being part of the amount of directors' fees. This means that the amount of the fee, including the full amount of the related VAT, is not deductible for corporate income tax purposes.
- If the amount of VAT is only partially deductible, only the non-deductible part of the VAT is considered as being part of the amount of the fees. This means that in such cases, the fees, including only the non-deductible part of the related VAT, are not deductible for corporate income tax purposes.

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LUXEMBOURG DOUBLE TAX TREATIES – STATE OF PLAY

Luxembourg continues to expand its tax treaty network and now has 77 double tax treaties in force. With the recent Luxembourg law of 23 December 2016 which ratifies the tax treaties with Brunei Darussalam, Hungary, Senegal, Serbia and Uruguay, the number of Luxembourg tax treaties in force should increase soon. We provide an overview of the status in terms of application of all Luxembourg tax treaties and recent protocols along with the changes they introduce.

Luxembourg Double Tax Treaties & Protocols in force

		Double Tax Treaty	Protocol	Effective date	Recent change introduced
1	**Andorra**	**2/06/2014**		**1/01/2017**	New Double Tax Treaty
2	**Armenia**	23/06/2009		1/01/2011	
3	**Austria**	18/10/1962		1/01/1961	
			21/05/1992	1/01/1995	
			7/07/2009	1/01/2011	
4	**Azerbaijan**	16/06/2006		1/01/2010	
5	**Bahrein**	6/05/2009		1/01/2011	
6	**Barbados**	1/12/2009		1/01/2012	
7	**Belgium**	17/09/1970		1/01/1972	
			11/12/2002	1/01/2005	
			16/07/2009	1/01/2014	
8	**Brazil**	8/11/1978		1/01/1981	
9	**Brunei**	14/07/2015		**1/01/2018**	New Double Tax Treaty
10	**Bulgaria**	27/01/1992		1/01/1994	
11	**Canada**	10/09/1999		1/01/2001	
			8/05/2012	1/01/2014	
12	**China**	12/03/1994		1/01/1996	
13	**Croatia**	20/06/2014		**1/01/2017**	New Double Tax Treaty
14	**Czech Republic**	5/03/2013		1/01/2015	
15	**Denmark**	17/11/1980		1/01/1979	
			4/06/2009	1/01/2011	
			9/07/2013	1/01/2015	
16	**Estonia**	7/07/2014		**1/01/2016**	New Double Tax Treaty
17	**Finland**	1/03/1982		1/01/1980	
			24/01/1990	1/01/1990	
			1/07/2009	1/01/2011	
18	**France**	1/04/1958		1/01/1957	
			8/09/1970	1/01/1971	
			24/11/2006	1/01/2008	
			3/06/2009	1/01/2010	
			5/09/2014	**1/01/2017**	Capital gains on sale of shares in real estate companies
19	**Georgia**	15/10/2007		1/01/2010	
20	**Germany**	23/04/2012		1/01/2014	
21	**Greece**	22/11/1991		1/01/1996	
22	**Guernsey**	10/05/2013		1/01/2015	
23	**Hong Kong**	2/11/2007		1/01/2008	
			11/11/2010	1/01/2012	
24	**Hungary**	15/01/1990		1/01/1990	
		10/03/2015		**1/01/2018**	New Double Tax Treaty
25	**Iceland**	4/10/1999		1/01/2002	
			28/08/2009	1/01/2011	
26	**India**	2/06/2008		1/01/2010	
27	**Indonesia**	14/01/1993		1/01/1995	
28	**Ireland**	14/01/1972		1/01/1968	
			27/05/2014	**1/01/2016**	Exchange of information upon request
29	**Isle of Man**	8/04/2013		1/01/2015	
30	**Israel**	13/12/2004		1/01/2004	
31	**Italy**	3/06/1981		1/01/1978	
			21/06/2012	1/01/2015	

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	Country				
32	**Japan**	5/03/1992		1/01/1993	
			25/01/2010	30/12/2011	
33	**Jersey**	17/04/2013		1/01/2015	
34	**Kazakhstan**	26/06/2008		1/01/2014	
			3/05/2012	1/01/2014	
35	**Korea**	7/11/1984		1/01/1984	
			29/05/2012	4/09/2013	
36	**Laos**	4/11/2012		1/01/2015	
37	**Latvia**	14/06/2004		1/01/2007	
38	**Liechtenstein**	26/08/2009		1/01/2011	
39	**Lithuania**	22/11/2004		1/01/2007	
			20/06/2014	**1/01/2016**	Exchange of information upon request
40	**Macedonia**	15/05/2012		1/01/2014	
41	**Malaysia**	21/11/2002		1/01/2005	
42	**Malta**	29/04/1994		1/01/1996	
			30/11/2011	1/01/2014	
43	**Mauritius**	15/02/1995		1/01/1996	
			28/01/2014	**1/01/2016**	Exchange of information upon request & MAP
44	**Mexico**	7/02/2001		1/01/2002	
			7/10/2009	1/01/2012	
45	**Moldavia**	11/07/2007		1/01/2010	
46	**Monaco**	27/07/2009		1/01/2011	
47	**Morocco**	19/12/1980		1/01/1984	
48	**Netherlands**	8/05/1968		1/01/1967	
			16/10/1990	1/01/1993	
			29/05/2009	1/01/2011	
49	**Norway**	6/05/1983		1/01/1986	
			7/07/2009	1/01/2011	
50	**Panama**	7/10/2010		1/01/2012	
51	**Poland**	14/06/1995		1/01/1997	
			7/06/2012	1/01/2014	
52	**Portugal**	25/05/1999		1/01/2001	
			7/09/2010	1/01/2013	
53	**Qatar**	3/07/2009		1/01/2011	
54	**Romania**	14/12/1993		1/01/1996	
			4/10/2011	1/01/2014	
55	**Russia**	28/06/1993		1/01/1998	
			21/11/2011	1/01/2014	
56	**San Marino**	27/03/2006		1/01/2007	
			18/09/2009	1/01/2012	
57	**Saudi Arabia**	7/05/2013		1/01/2015	
58	**Serbia**	**15/12/2015**		**1/01/2017**	New Double Tax Treaty
59	**Seychelles**	4/06/2012		1/01/2014	
60	**Singapore**	6/03/1993		1/01/1996	
			9/10/2013	**1/01/2016**	New Double Tax Treaty
61	**Slovak Republic**	18/03/1991		1/01/1993	
62	**Slovenia**	2/04/2001		1/01/2003	
			20/06/2013	1/01/2015	
63	**South Africa**	23/11/1998		1/01/2001	
64	**Spain**	3/06/1986		1/01/1988	
			10/11/2009	1/01/2011	
65	**Sri Lanka**	31/01/2013		1/01/2015	
66	**Sweden**	14/10/1996		1/01/1999	
			6/09/2010	1/01/2010	
67	**Switzerland**	21/01/1993		1/01/1994	
			25/08/2009	1/01/2011	
			11/07/2012	1/01/2011	
68	**Taiwan**	19/12/2011		1/01/2015	
69	**Tajikistan**	9/06/2011		1/01/2014	
70	**Thailand**	6/05/1996		1/01/1999	
71	**Trinidad & Tobago**	7/05/2001		1/01/2004	
72	**Tunisia**	27/03/1996		1/01/2000	
			8/07/2014	**1/01/2017**	Exchange of information upon request
73	**Turkey**	9/06/2003		1/01/2006	
			30/09/2009	1/01/2012	
74	**United Arab Emirates**	20/11/2005		1/01/2010	
			26/10/2014	**1/01/2016**	Capital gains & method to avoid double taxation
75	**United Kingdom**	24/05/1967		1/01/1966	
			18/07/1978	6/04/1975	
			28/01/1983	1/01/1984	
			2/07/2009	1/01/2011	
76	**United States**	3/04/1996		1/01/2001	
77	**Uruguay**	10/03/2015		**1/01/2018**	New Double Tax Treaty
78	**Uzbekistan**	2/07/1997		1/01/2001	
79	**Vietnam**	4/03/1996		1/01/1996	

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CLARIFICATIONS ON THE VAT STATUS OF LUXEMBOURG SPECIAL LIMITED PARTNERSHIPS

In the context of the implementation of the AIFM Directive, in 2013 Luxembourg introduced a new limited partnership structure, the special limited partnership ("*Société en commandite spéciale*" or "SCSp"), that has no separate legal personality from its General Partner ("GP").

From a VAT perspective and considering notably the absence of own legal personality at the level of the SCSp, the question arose whether or not the VAT obligations of an SCSp (registration, filing of VAT returns) had to be fulfilled by the SCSp itself or by its GP (with legal personality).

Following exchanges with the Luxembourg Private Equity Association ("LPEA"), the Luxembourg VAT authorities provided clarifications on this specific question and confirmed that the GP and the SCSp have to be considered as distinct entities from a VAT perspective.

In this respect, the VAT status of a SCSp and of its GP have to be determined independently in light of each one's respective activities and transactions. As a consequence, VAT registrations and the related VAT obligations (filing of VAT returns, etc.) may occur at both the SCSp and the GP level.

This clarification is welcome as it brings more certainty when determining the VAT obligations of Luxembourg SCSps.

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OWN AIFM VS. THIRD PARTY AIFM: ADVANTAGES, CHALLENGES AND PITFALLS

OUR INSIGHTS AT A GLANCE

- Luxembourg provides an optimal environment for the establishment of Alternative Investment Funds, and asset managers can choose to establish their own AIFM or use a third party AIFM
- There are specific advantages and disadvantages to each option. For example, a third-party AIFM allows a more expedient passporting process, but control over factors such as oversight of the investment management or the service providers is reduced
- A minimum volume of assets under management ranging from EUR 700m to EUR 750m should be reached in order to justify, from a pure cost savings perspective, the investment into an own AIFM platform in Luxembourg
- Asset managers should consult with their advisers to determine whether an own Luxembourg AIFM would be efficient for their investments / business

When it comes to choosing the right place to set up an alternative investment fund (AIF) and an AIF manager (AIFM), Luxembourg is among the preferred jurisdictions:

- it has stable and predictable political, regulatory and legal systems, where investment managers have access to a qualified, multilingual workforce and to an extensive tax treaty network;
- the attractiveness of Luxembourg was amplified by the introduction of the Reserved Alternative Investment Fund (RAIF) last year. The RAIF ensures an expedient time to market, in particular due to the removal of the prior authorisation condition;
- with a "hard" Brexit looming, removing the UK from the remit of the AIFMD passport, the UK based AIFMs with an exposure to European investors prepare to set foot on the continent;
- the EU Commission having shelved, for the time being, the AIFMD third country passport file, despite positive advice from ESMA, leaves non-EU AIFMs with few options when it comes to managing or marketing funds in the EU.

Given the rapid development of the AIF industry, and based on the UCITS management company model, Luxembourg has witnessed the development of a large industry of professional, independent investment management service providers, also known as third party AIFMs.

The question for asset managers is therefore: own AIFM or third party AIFM? This article highlights the challenges and pitfalls, but also the possible advantages of setting up an own AIFM and those of resorting to an established third party AIFM.

The AIFM options available in Luxembourg

An asset manager who wishes to use an AIFM in Luxembourg is faced with four choices:

(i) to set up its own internally managed AIF,
(ii) to set up an external registered AIFM,
(iii) to set up an external fully licenced AIFM, or
(iv) to work with a third-party fully licenced AIFM.

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While the internally managed fund or a registered AIFM options might be expedient and on the lower scale of costs, they are only a temporary solution and are not suited for a long-term strategy and far-reaching goals.

Not all the investment vehicles can be managed internally:

- a special limited partnership (or SCSp, *société en commandite spéciale*), a mutual investment fund (FCP, or *fonds commun de placement*) or a RAIF can only be managed by an external AIFM, which in the case of the RAIF must also be authorised;
- the internal management of a vehicle (even if the internal manager is a distinct entity, such as the general partner-*gérant* of a common limited partnership or of a corporate partnership limited by shares) prohibits that entity from managing any another investment fund.

A registered AIFM cannot benefit from the cross-border AIFMD passport and therefore it may have to resort to private placement in the jurisdictions where its investors are located, provided the regimes are in place. Alternatively, the registered AIFM could rely on reverse solicitation when raising capital. In all cases, it has to limit its scope of management of AIFs to a single jurisdiction and it will not be permitted to launch or manage another fund in another EU country.

Finally, a registered AIFM needs to constantly monitor the size of its assets under management, in order to keep them below the legal thresholds[1], thresholds which can be rapidly exceeded considering the leverage that needs to be factored in. As soon as the thresholds are surpassed, the registered AIFM must apply for a full licence.

Despite the speedy set-up and minimal requirements, the abovementioned considerations considerably reduce the interest for an internally managed and/or registered AIFM. They could be seen only as a preliminary and preparatory step in setting up one's own fully-licenced AIFM or working with a third-party fully-licenced AIFM.

Own AIFM vs. Third party AIFM

The benefit of the AIFMD passport

In both the own AIFM scenario and the third-party AIFM one, the benefit of the AIFMD passport across the European Economic Area is obvious. The difference is the timetable in having access to it. In the case of a third-party AIFM, it means that the time to market for the initiator is extremely efficient. Moreover, the asset manager could potentially have a wider access to funds (and investors) located in multiple EU and non-EU jurisdictions depending on the network spread of the AIFM. The own AIFM on the other hand requires time for the preparation, filing and negotiation of the authorisation request with the Luxembourg financial sector supervisory commission (CSSF), before any type of passport is available.

The authorisation process

With an independent AIFM, there is no need to undergo the prior authorisation process by the CSSF, which means that initiator can set up the fund and sell it extremely quickly. Having recourse to a third-party AIFM means immediate and direct access to a fully licenced, equipped and duly skilled manager, and sometimes at a fraction of the costs required for a set-up from scratch. The independent AIFM will deal with the main regulatory and operational risks and will undertake the on-going reporting obligations. The asset manager does not need to establish a base in Luxembourg or have "boots on the ground", which might prove to be a more cost effective way of tackling the AIF set-up.

In the long run however, the initiator should also assess the potential costs and procedure that would have to be followed to replace the independent AIFM (be it because of a fall out in their relationship, a major investor's preference, or in order to appoint its own AIFM), against those of replacing member(s) of its own staff.

Alternatively, setting up one's own fully licenced AIFM is a laborious process and the challenges of ensuring a proper and functioning organisation are equally considerable. The average period for the examination of the application file by the CSSF is six months, during which time it is not possible to launch or to manage an AIF. The prior authorisation by the CSSF implies that burdensome conditions are met and substantial documentation and evidence are provided. The whole ownership, executive and oversight structure of the AIFM, as well as its organisation, policies and procedures, IT and technical infrastructure and business continuity plans will be closely scrutinised by the CSSF. All these costs, as well as the conditions for the employment and for the potential termination of the employment relationship must be factored into the decision to set up a fully authorised manager.

Nonetheless, as part of a longer term development plan, the asset manager could capitalise on its resources and expertise therefore expanding its business by diversifying its strategies and the asset classes it manages, thus ultimately becoming a third party AIFM itself.

Control and governance

The full control of the AIFM organisation and fund governance that an initiator gains by using its own AIFM is definitely a considerable advantage. The board members of the AIFM, its

[1] (i) EUR 100 million, including assets acquired through use of leverage; or (ii) EUR 500 million, when the portfolio of assets managed consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of the initial investment in each AIF.

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senior management, the board members of the (general partner of any) fund put in place are appointed by and under the asset manager's direction and control, and therefore can be any portfolio managers or investment advisers.

When working with third party AIFM, an asset manager would face a number of challenges considering that it has no say over the appointment or removal of the board members or the conducting officers of the AIFM. Therefore, it has to find the right governance for the AIF, either through appointments of AIF board members or the creation of joint investment committees. It could also seek to have a right of prior authorisation when the AIFM appoints or removes the portfolio manager, particularly when the latter belongs to the asset manager's group. Also, when using an external AIFM as a one-stop-shop, the asset manager must ensure that the providers deliver consistently high quality services throughout all the service lines and that the potential conflict of interests between them is properly identified and managed. As the size of the assets under management (AUM) increases, the asset manager would call for the running costs to be kept on the lower end of the scale.

Delegation aspects

An AIFM set up in Luxembourg is permitted to delegate some of its functions. Typically, the portfolio management function is delegated, but it can also be envisaged to delegate some aspects of risk management[2]. The entity to which portfolio management is delegated must be approved and supervised by a competent authority in its jurisdiction for asset management activities[3], otherwise, a special exemption from this requirement can be requested from the CSSF.

When core functions are delegated, the difficulty faced by a Luxembourg AIFM belonging to an asset manager's group is to safeguard its position as AIFM and not to become a letter-box entity. The AIFM must therefore ensure that it is able to effectively supervise the group delegate and to manage the delegation risks. It must also ensure that it is entitled to exercise its contractual rights to inquire, inspect, have access to or give instructions to its delegate(s). Therefore, particular care must be given to the appointment of sufficiently experienced and empowered senior management when setting up an own AIFM.

Cost comparison

The spread in the table below is a pretty fair estimate of the average costs likely to be incurred when setting up an own AIFM or when using a third party AIFM. This estimate may vary significantly in the coming months and years due to the high level of competition in the market. The central administration, auditor and other running costs are not factored in as they should not significantly vary between the two possibilities. Also not included are the amounts of capital and own funds, professional indemnity insurance premiums, contributions to investors' protection scheme or CSSF application and annual fees.

According to this calculation, a minimum volume of assets under management ranging from EUR 700m to EUR 750m should be reached in order to justify, from a pure cost savings perspective, the investment into an own AIFM platform in Luxembourg.

Annual costs (all data in Keur)							
AUM	**100.000**	**250.000**	**500.000**	**750.000**	**1.000.000**	**1.500.000**	**2.000.000**
Third Party AIFM							
bps	*0,07*	*0,06*	*0,05*	*0,05*	*0,05*	*0,05*	*0,04*
AIFM annual fee	*70,00*	*150,00*	*250,00*	*375,00*	*500,00*	*675,00*	*800,00*
Own AIFM							
Nber of employees	*2,00*	*3,00*	*4,00*	*4,00*	*5,00*	*5,00*	*6,00*
Gross annual costs	*95,00*	*95,00*	*95,00*	*95,00*	*95,00*	*95,00*	*95,00*
Total costs	*190,00*	*285,00*	*380,00*	*380,00*	*475,00*	*475,00*	*570,00*
Summary							
AUM	**100.000**	**250.000**	**500.000**	**750.000**	**1.000.000**	**1.500.000**	**2.000.000**
Own AIFM	190	285	380	380	475	475	570
Third-party AIFM	70	150	250	375	500	675	800

[2] As a matter of fact, given that there are multiple facets of the investment management activities, they can be broken down and delegated only partly.
[3] In the EU it would be a MiFID firm authorized to provide investment management. When portfolio management is delegated to an entity outside the EU, in addition to the conditions listed, there must be a written cooperation agreement between the CSSF and the supervisory authority of the home state of the delegate, which would enable the CSSF to carry out inspections and inquiries and to enforce sanctions in case of breaches. The CSSF signed over 40 memos of understanding at the time of writing.

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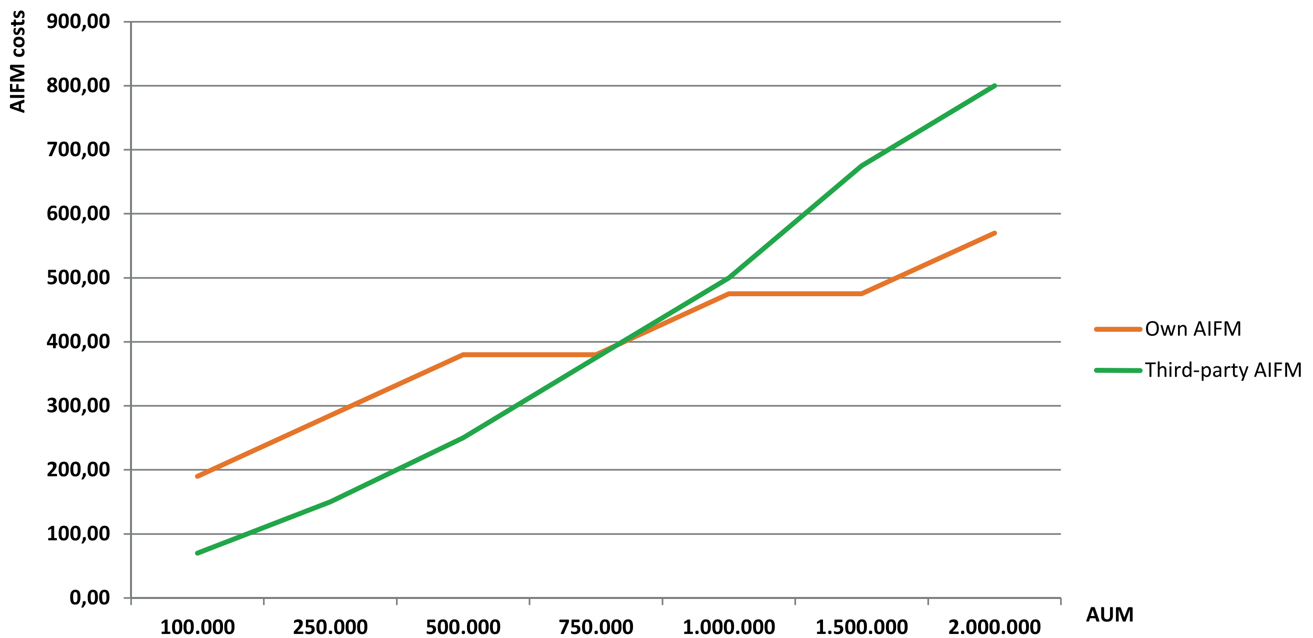

Conclusion

The choice between the own AIFM and the third party AIFM is determined by a number of factors, such as access to market, costs, control, governance and efficiency in running the fund.

On one hand, the own AIFM offers utmost control over the funds, development opportunities and costs savings, if certain size thresholds are exceeded. If the volume of AUM is below a certain threshold, the own AIFM might prove to be a costly enterprise and even risks becoming a letter-box entity if insufficient resources are allocated to it.

On the other hand, the third-party AIFM offers immediate access to the AIFMD passport without the need to deploy own resources. However, it also entails a surrender of powers and control over the investments in the hands of a non-affiliated entity.

In the end, when it comes to choosing one option or the other, it all comes down to an opportunity review along with a resource allocation and costs and benefits analysis, based on a clear and well-defined development strategy on the part of the asset manager.

We can assist you in this process, either by helping you define, plan and implement your investment management business, or by focusing on the investment structure design and implementation.

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EU FINANCE MINISTERS REACH AN AGREEMENT ON ATAD 2 TARGETING HYBRID MISMATCHES

OUR INSIGHTS AT A GLANCE

- EU Finance Ministers reached an agreement in February on a proposal for an EU Directive to amend the Anti-Tax Avoidance Directive, replacing measures dealing with hybrid mismatches and extending the scope to transactions with third countries. The amended directive is referred to as ATAD 2.
- A very broad range of hybrid mismatch situations are identified and a number of mechanisms to deal with the mismatches have been detailed.
- In terms of application, ATAD 2 states that the rules provided therein should only apply to "deductible payments". Hence, unless otherwise stated, the rules only apply to payments. The rules would not apply, for example, to provisions recorded in relation to financing instruments.
- EU Member States will have until 31 December 2019 to transpose ATAD 2 into their national laws and regulations which need to enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches" which has to be implemented by 1 January 2022).

On 21 February 2017, the EU Finance Ministers agreed during a meeting of the ECOFIN on a compromise proposal for an EU Directive amending Directive (EU) 2016/1164 (the so-called Anti-Tax-Avoidance-Directive, "ATAD"). While the ATAD already included measures dealing with hybrid mismatches in an EU context, ATAD 2 replaces these rules and extends their scope to transactions involving third countries. The EU Council is expected to adopt ATAD 2 once the European Parliament has given its opinion. In this article, we outline the hybrid mismatches targeted by the directive, the mechanisms that should serve to avoid mismatch outcomes and the areas where ATAD 2 should have no impact.

ATAD 2 follows the recommendations of the OECD in regard to Base Erosion and Profit Shifting (BEPS) Action 2 (Hybrid mismatch arrangements) and covers a number of hybrid mismatches such as financial instrument mismatches, hybrid entity mismatches, reverse hybrid mismatches and permanent establishment mismatches.

In general, a hybrid mismatch structure is a structure where a financial instrument, an entity or a permanent establishment is treated differently for tax purposes in two different jurisdictions. Hybrid mismatches may lead to situations in which (i) a payment is deducted in two jurisdictions, (ii) a payment is deductible in one jurisdiction and not taxed in the other jurisdiction or (iii) to a situation in which income is not taxed at all (in accordance with the domestic tax laws of the jurisdictions involved).

In the case of hybrid mismatches with a third state, ATAD 2 places the responsibility to neutralise the effects of the hybrid mismatch on the EU Members States. EU Member States will therefore either have to deny the deduction of payments, or include income that would otherwise not be taxed in the third state.

Hybrid mismatches covered by ATAD 2

With its rather broad scope, ATAD 2 addresses the following types of hybrid mismatch situations:

[4] Economic and Financial Affairs Council.

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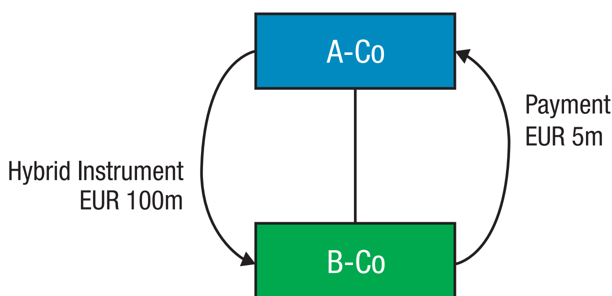
- ***Hybrid mismatches that result from payments under a financial instrument***

Example: Hybrid financing instrument mismatch

A company resident in State A (A-Co) finances its subsidiary resident in State B (B-Co) with a EUR 100m financing instrument that is treated as equity in State A, whereas the instrument is treated as debt in State B.

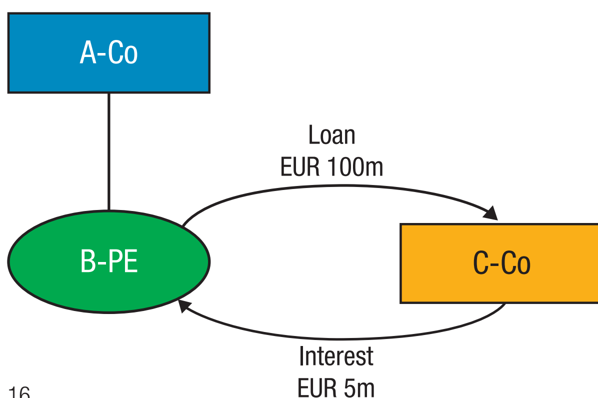


At the level of B-Co, the interest payments of EUR 5m are tax deductible, whereas at the level of A-Co the dividend income benefits from a tax exemption.

- ***Hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including situations where payments made to a disregarded PE are not taxed at the level of the head office***

Example: Hybrid PE mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) performs financing activities through a PE situated in State B (B-PE). Although the PE is recognised under the domestic tax law of State A and the applicable tax treaty concluded between State A and State B, under the domestic tax law of State B the PE of A-Co is not recognised for tax purposes. A-Co grants a loan of EUR 100m via B-PE to C-Co, an associated enterprise resident in State C.

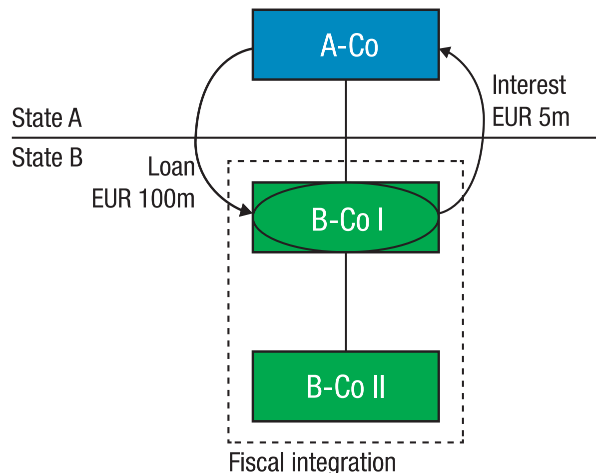


While the interest payments are deductible at the level of C-Co, State B does not tax the interest income as no PE is recognised under domestic tax law of State B. At the same time, State A exempts the income realised through B-PE in accordance with the applicable tax treaty. Hence, the income is tax deductible in State B and neither taxable nor tax exempt, respectively, in State A and State B.

- ***Hybrid mismatches that result from payments made by a hybrid entity to its owner or deemed payments between the head office and PE or between two or more PEs***

Example: Hybrid entity mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) finances its subsidiary in State B (B-Co I) with a loan of EUR 100m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II a subsidiary resident in State B.



While the interest payments are deductible in State B, reducing the taxable income of B-Co I and the fiscal unity, at the level of A-Co the interest payments are disregarded for tax purposes since such transactions are disregarded between a transparent entity and the owners thereof.

- ***Double deduction outcomes resulting from payments made by a hybrid entity or PE***

Example: Hybrid entity mismatch leading to a double deduction

A company resident in State A (A-Co) has a subsidiary in State B (B-Co I). B-Co I receives funding from a third party. In this

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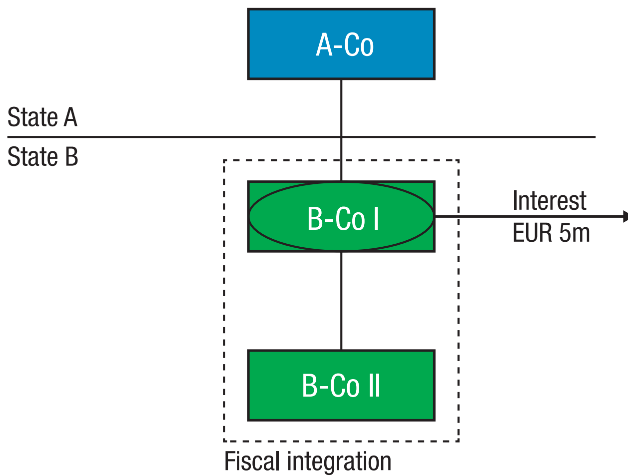
regard, B-Co I pays interest of EUR 5m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II a subsidiary resident in State B.



In this case, the interest payments are deductible at the level of B-Co I and A-Co, resulting in a double deduction due to the hybrid entity classification.

Mechanism for tackling mismatch outcomes

ATAD 2 provides for the following mechanisms to tackle mismatch outcomes:

- ***Double deductions***

Where a hybrid mismatch results in a double deduction, the deduction shall be denied in the Member State that is the investor jurisdiction.

As a secondary measure, ATAD 2 provides that in case the deduction is not denied in the investor jurisdiction, the deduction shall be denied in the Member State that is the payer jurisdiction.

- ***Deduction without inclusion***

Where a hybrid mismatch results in a deduction without inclusion, it is stated that the deduction shall be denied in the Member State that is the payer jurisdiction.

As a secondary measure, the directive provides that if the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in the income in the Member State that is the payee jurisdiction.

With regard to the latter rule, Member States have the option to not apply the secondary rule to certain types of hybrid mismatches.

- ***Reverse hybrid mismatches***

ATAD 2 also provides for a rule that targets so-called reverse hybrid mismatches. When an entity is established in a Member State and treated as transparent for tax purposes, whereas at the level of the non-resident owners of the entity, the latter is treated as opaque, the income might benefit from double non-taxation.

Here, the directive sets a threshold of at least 50% of the voting rights, capital interests or rights to a share of profit for the rule to apply. It is interesting to note that in other situations, the ATAD rules apply when a shareholding relationship of at least 25% exists. Hence, the scope of the reverse hybrid rules is a bit more restrictive when it comes to the shareholding threshold.

In these circumstances, the hybrid entity shall be regarded as a resident of the Member State and taxed to the extent the income is not taxed otherwise under the laws of the Member State or any other jurisdiction.

- ***Tax residency mismatches***

Last but not least, ATAD 2 provides for a rule that deals with situations in which an entity is deemed to be resident in two or more jurisdictions and expenses are deductible in both jurisdictions.

Here, the directive states that a Member State involved shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set-off against income (which is not classified as dual-inclusion income).

In cases where both jurisdictions are EU Member States, the Member State where the taxpayer is deemed “not” to be resident in accordance with an applicable tax treaty shall deny the deduction.

Where ATAD 2 should have no impact

It is interesting to note that the guidance provided in the ATAD 2 clarifies a number of issues in relation to the scope and the application of the rules on hybrid mismatches.

ATAD 2 states that the rules provided therein should only apply to “deductible payments”. Hence, unless otherwise stated, the rules only apply to payments. The rules would not apply, for example, to provisions recorded in relation to financing instruments. Furthermore, the payment needs to be deductible, which therefore excludes non-deductible payments from the scope of ATAD 2.

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Moreover, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenses have been derived or incurred, ATAD 2 stresses that these timing differences should generally not give rise to hybrid mismatches as long as the income is included within a reasonable period of time.

According to the Directive, a payment under a financial instrument shall be treated as included in income within a reasonable period of time when:

- the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or

- it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future period and the terms of the payment are consistent with the arm's length principle. Thus, when a timing difference exceeds the aforementioned 12 month period, taxpayers should be free to evidence that the payment will be included in a future period.

ATAD 2 further confirms that any adjustments required in accordance with the Directive should in principle not affect the allocation of taxing rights between Contracting States under applicable tax treaties. This statement acknowledges that treaty law is generally superior to the domestic tax laws of the Contracting States.

In addition, the guidance included in the directive confirms that transfer pricing adjustments should not fall within the scope of a hybrid mismatch.

Last but not least, ATAD 2 provides for a carve-out from the rules when it comes to hybrid regulatory capital. This is of particular importance for the banking sector which has to comply with certain solvency criteria. However, this carve-out should be limited in time until 31 December 2022. With regard to financial traders, a delimited approach is followed in line with that followed by the OECD.

Timing aspects

EU Member States will have until 31 December 2019 to transpose ATAD 2 into their national laws and regulations which need to enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches" which has to be implemented by 1 January 2022). This is a longer timeline than originally foreseen for the rules on hybrid mismatches in an EU context (i.e. ATAD required an implementation by 31 December 2018).

Conclusion

ATAD 2 replaces the rules on hybrid mismatches provided in the ATAD, postpones their implementation into the domestic tax laws of EU Member States by one year and extends the rules to third country mismatches. The extension to third countries has been criticised as being damaging to EU competitiveness, however the EU Member States have decided to proceed nonetheless.

Given the extreme complexity of these rules including hybrid mismatches, reverse hybrid mismatches and so-called imported hybrid mismatches (which may occur at some level of group structure), the application of these anti-mismatch provisions will be a very intricate and time consuming exercise on the part of the taxpayers and the tax administrations. One can hope that the Luxembourg legislator and tax authorities will not seek to go beyond the rules provided in ATAD 2, which are already very broad and complex.

Looking on the bright side of the Directive, it is positive that the guidance provided in the Directive clarifies many previously uncertain points in relation to the scope and the application of these rules.

Although ATAD and ATAD 2 will only be implemented as from 2019 with a number of options available for EU Member States as to the date of entry into force of the tax measures, taxpayers should already begin to assess the potential impact of these changes on existing investment structures and closely monitor the legislative process around the implementation of the new rules.

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ADVOCATE GENERAL TAKES POSITION ON THE VAT EXEMPTION FOR COST-SHARING GROUPS

OUR INSIGHTS AT A GLANCE

- In the cases DNB Bank AS and Aviva, the Advocate General is of the opinion that the VAT exemption for cost sharing group services (CSGs) only applies to supplies made by the group to members with activities covered by the public interest VAT exemption
- The opinion states, notably, that the VAT exemption for CSGs should be considered as an extension of the public interest VAT exemptions and should therefore not be applicable to the financial or insurance sectors, nor is it applicable to cross-border CGSs
- It is likely that the current VAT exemption regime applicable to CSGs, as per Luxembourg VAT Law and practice, may be modified in the coming months to render it more restrictive

Advocate General Kokott (AG) has delivered two interesting Opinions on the VAT exemption for cost-sharing groups (CSGs) also referred to as “services of independent groups of persons” in the cases DNB Banka AS and Aviva (respectively C-326/15 and C-605/15).

Pursuant to article 132, § 1, f) of the EU VAT Directive, services rendered by the group to its members which are either VAT exempt taxable persons or non VAT taxable persons are exempt from VAT. For the VAT exemption to apply, these services must be directly necessary to sustain each member’s VAT exempt or non-business activities. In addition, payments made by the members to the group must be the exact reimbursement of the joint expenses and no distortion of competition shall result from the VAT exemption.

CSGs allow their members to avoid a VAT cost on the services rendered by in-house resources pooled at the level of the group because the related services benefit from the VAT exemption applicable to CSGs.

In the Opinions of Advocate General Kokott, the main conclusions are the following:

- the VAT exemption for CSGs is listed under the Chapter “Exemptions for certain activities in the public interest”. VAT exemptions under this Chapter aimed at relieving consumers of related services from the VAT burden (social welfare, medical treatment, etc.). The VAT exemption for CSGs should be considered as an extension of the public interest VAT exemptions and should therefore not be applicable to the financial or insurance sectors;
- CSGs VAT exemption is not applicable to cross-border CSGs;
- CSG does not necessarily have to be a legal person but must be considered as a taxable person for VAT purposes;
- if a mark-up is applied on the reimbursement of the joint expenses, the VAT exemption should not apply.

Considering these Opinions as well as another pending case against Luxembourg (C-274/15), it is likely that the current VAT exemption regime applicable to CSGs, as per Luxembourg VAT Law and practice, may be restricted and may have to be redefined in the coming months.

Judgements of the Court in these cases are therefore eagerly awaited. To the extent the ECJ would follow the Opinions of the AG, Luxembourg companies of insurance and financial sectors having implemented CSGs would have to rethink their VAT strategy in order to anticipate non recoverable VAT costs on outsourced services which, up until now, have benefited from this VAT exemption.

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OECD RELEASES MULTILATERAL INSTRUMENT TO IMPLEMENT TAX TREATY RELATED BEPS MEASURES: WHAT IS THE RIGHT APPROACH FOR LUXEMBOURG?

OUR INSIGHTS AT A GLANCE

- The MLI is a comprehensive and flexible convention that allows countries to implement a wide range of tax treaty related BEPS measures with many options and alternatives (including the option not to adopt the provisions)
- In our view, Luxembourg should chose to adopt provisions which will have the least impact on its status as an attractive place to do business. This includes opting out of certain specific rules pertaining to hybrid mismatches and permanent establishment while opting in to the binding arbitration procedure to ensure legal certainty
- Although many countries have announced that they will be cherry-picking the provisions of the MLI, it will still be possible to negotiate specific measures in double tax treaties on a case-by-case basis through bilateral protocol

On 24-25 November 2016, more than 100 countries (including Luxembourg) adopted the text of a Multilateral Instrument (MLI) aiming at the implementation of tax treaty-related measures deriving from the OECD Base Erosion and Profit Shifting (BEPS) Project as well as the text of a related Explanatory Statement. The MLI foresees a multitude of options and alternatives for participating countries that can, apart from a few measures that are considered to be the minimum standard, freely pick and choose which measures they want to adopt. We provide an overview of the MLI provisions and consider what choices Luxembourg should make in order to remain attractive for international investments.

The OECD BEPS Project sets out 15 actions, many of which concern bilateral tax treaties. Given the sheer number of tax treaties in place, implementing these changes on a treaty-by-treaty basis would be a very lengthy process, requiring 3000+ sets of bilateral negotiations. Therefore, Action 15 of the BEPS Project provided for the development of a MLI in order to allow countries to swiftly amend their tax treaty network. The MLI covers BEPS measures relating to Action 2 (Hybrid mismatches), Action 6 (Tax treaty abuse), Action 7 (Artificial avoidance of permanent establishment status) and Action 14 (Dispute resolution).

Given that the BEPS Project participants were not able to reach the same level of consensus on all 15 BEPS Actions, it was necessary that the MLI provide for sufficient flexibility to allow countries to choose which provisions they wished to adopt. Parties to the MLI are only obliged to adopt the text of a new preamble and the principal purpose test (see II.3. below) in their tax treaties (i.e. so-called “minimum standard” measures). Otherwise, the MLI allows parties to (i) choose the tax treaties that should come within the scope of the MLI, (ii) opt out of (some) provisions and (iii) choose to apply optional provisions and alternative provisions.

Overview of the Multilateral Instrument

The purpose of the MLI is to modify existing bilateral tax treaties, something which is generally done through bilateral protocols. However, the MLI will not function as an amending protocol to an existing tax treaty, directly amending the text thereof. Instead,

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it will be applied alongside existing tax treaties, further complicating the application of such treaties. Contracting States may nevertheless develop a consolidated version of the updated tax treaty for easy reference. The MLI enters into effect for a "covered" tax treaty once both parties to that treaty have ratified the MLI.

It is interesting to note that for a covered tax treaty to be amended, it is required that both Contracting States adopt matching options/alternatives. Hence, if one Contracting State is in favor of a certain provision while the other Contracting State did not adopt the very same option/alternative, the existing tax treaty will not be amended. Hence, given the different approaches and interests of participating countries it remains to be seen how aligned the choices will be in practice. For certain clauses, Luxembourg can make a "reservation" (i.e. opt out and for others Luxembourg can "opt in").

The MLI can be signed as of 31 December 2016 and enters into force after five countries have ratified it. The MLI enters into effect for a covered tax treaty after all parties to that treaty have ratified the MLI.

- ***Hybrid mismatches***

Articles 3 and 5 of the MLI provide for clauses that deal with hybrid mismatch arrangements (i.e. hybrid entities and instruments) that result in double non-taxation.

Moreover, Article 4 provides for a provision that addresses dual resident companies, determining that in the case of a dual resident company, the competent authorities of both Contracting States shall endeavor to determine, by mutual agreement, the state of residence of the company.

Nevertheless, when companies are dual resident, it is generally not for tax purposes but for commercial reasons. Therefore, it would be good to keep the existing corporate tie-breaker rule according to which a company is deemed to be resident in the Contracting State in which the place of effective management is situated. The tie-breaker rule is a tried and tested concept that provides reliable results which do not depend on unpredictable negotiations between tax authorities in different jurisdictions.

However, all these provisions are merely optional and there is no obligation whatsoever for Luxembourg to adopt any of these (in particular, since these provisions would not make Luxembourg's tax treaty network any more attractive for international investors). In addition, given that the EU has already adopted anti-hybrid mismatch measures which also cover situations with third countries (Anti-Tax Avoidance Directive 2), EU countries should avoid creating an additional layer of complexity with several different anti-mismatch rules applying in parallel (the anti-hybrid mismatch rules of ATAD 2 and the anti-hybrid mismatch rules provided by tax treaties) and which may even differ slightly.

- ***Tax treaty abuse***

Part III of the MLI addresses various forms of perceived tax treaty abuse. According to Article 6, parties to the MLI are required to add a preamble to covered tax treaties clarifying that tax treaties are intended to eliminate double taxation without creating the opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

Moreover, parties to the MLI are obliged to include a so-called "principle purpose test" into covered tax treaties stating that benefits provided thereunder shall not be granted if it is reasonable to conclude, in light of all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in the benefit (unless it is established that granting the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions).

In addition, parties may opt to include a so-called simplified limitation of benefits (LOB) provision which denies treaty benefits if a resident is not a qualified person. A qualified person under the simplified LOB is, for example, a company whose shares are regularly traded on a recognised stock exchange, whose shares are held at least 50% by residents of the residence state of the company or that is engaged in the active conduct or a business. Nevertheless, this provision is only optional and it is unlikely that many jurisdictions will adopt this provision (representatives of many jurisdictions expressed their strong opposition to the LOB clause during the consultation process).

Article 8 provides another optional provision that would amend the dividend article (Article 10 of the OECD Model Tax Convention). The proposed rule would require a minimum holding period of at least 12 months for a corporate shareholder to benefit from a "super-reduced" or zero withholding tax on dividend payments from a subsidiary.

Article 9 proposes amendments to the so-called immovable property company clause (Article 13 (4) of the OECD Model Tax Convention), an anti-abuse provision provided in the OECD Model Tax Convention. While tax treaties in general allocate an

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exclusive taxing right over capital gains realized upon disposal of a participation to the residence state of the shareholder, Article 13 (4) of the OECD Model Tax Convention allocates an unlimited primary taxing right to the other Contracting State if the shares have derived more than a certain part of their value from immovable property situated in that other Contracting State. This Article is of wide application and can be problematic for investors in that it creates situations of economic double taxation of gains.

According to the proposed changes in the MLI, Article 13 (4) would be applicable if the threshold (of immovable property investments) is met at any time during the 12 months preceding the alienation and equally apply in case of a sale of a comparable interest in a partnership or trust. In addition, signatories to the MLI can chose to extend the application of Article 13(4) to all their tax treaties including those without such a clause, provided the other Contracting States take the same approach. Luxembourg is a major hub for the structuring of cross-border real estate investments. Therefore, opting for this extension would seem detrimental for investors and Luxembourg's interest.

Another optional provision provided in the MLI addresses situations where the income of a resident of a Contracting State is derived from sources in the other Contracting State (i.e. dividends, interest, royalties) through a permanent establishment (PE) in a third state. According to the proposed rule, tax treaty benefits (i.e. reduced or zero withholding taxes) should in these cases only apply if the income is taxed at a level that corresponds to at least 60% of that what would have been imposed in the residence state of the recipient. This clause is complex and can lead to double taxation of the same income and consequently, in our view, Luxembourg should make a reservation on the clause in full.

- ***Avoidance of permanent establishment status***

Part IV of the MLI addresses the definition of PE for tax treaty purposes and builds up on the recommendations provided in the Final Report on BEPS Action 7. Article 12 provides for rules tackling the perceived artificial avoidance of a PE through commissionaire and similar arrangements through the extension of the scope of dependent agent PEs. Thus, it would be easier for countries to claim the existence of a PE of a non-resident enterprise and, therefore, a taxable presence in its jurisdiction.

Article 13 provides parties with two alternative provisions both aiming at ensuring that a combination of activities, each on its own being of a preparatory or auxiliary nature, but exceeding the threshold when combined, would come within the scope of the PE concept.

Under Article 14 and 15 of the MLI, parties may opt to amend Article 5(3), a special exclusion from PE status according to which building or construction sites only constitute a PE if they last more than 12 months. More specifically, the proposed rules would target the splitting up of contracts by one or more enterprises that are closely related and aggregate the time spent at a place for the purposes of determining the 12-month period.

The vague language that has been proposed to be added to Article 5 (permanent establishment) is open to interpretation by local tax administrations and would result in significant legal uncertainty, long-lasting disputes and double taxation. Similar uncertainty would occur if the "auxiliary and preparatory" requirement were to be added to article 5(4).

The proposed changes to the PE concept may result in a PE being constituted in every country in which a company does business. In the majority of these cases, only very limited profits will be attributed to the PE in accordance with the arm's-length principle. The administrative burden for both taxpayers and tax administrations will be disproportionate, especially when no or only little (additional) profits can be attributed to a PE. Moreover, a real risk exists that tax authorities could be tempted to deem a PE to exist even if the involvement of a foreign enterprise is very limited (in order to increase tax revenue) or to attribute more profits to a PE than appropriate in accordance with the arm's length standard.

Businesses need legal certainty regarding the threshold at which a commercial activity becomes a PE since the existence of a PE entails tax consequences and compliance obligations. As such, the proposed changes would be an impediment for international trade and investment without significantly shifting more taxing rights to the source state. Therefore, in our view, Luxembourg, as an economy that hosts a lot of businesses that have direct cross-border operations, should make reservations to the proposals made in Part IV of the MLI and only accept amendments to the PE definition on a case-by-case basis.

- ***Improving dispute resolution***

Article 25 of the OECD Model Tax Convention provides for a mutual agreement procedure that allows the competent authorities of the Contracting States to resolve issues involving the application and interpretation of the tax treaties they have entered into. These disputes involving two jurisdictions and double taxation may be long lasting exercises for taxpayers

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as the tax authorities involved have, quite naturally, no incentive to easily give up their taxing rights. A well-functioning dispute resolution is necessary in order to protect taxpayers against arbitrary decisions of foreign tax authorities. It is even indispensable given our current environment of chronic uncertainty.

Part V of the MLI addresses these concerns and provides for an optional provision regarding the mutual agreement procedure and a provision regarding corresponding adjustments. The latter concerns situations where one Contracting State performs a transfer pricing adjustment and forces the other Contracting State to perform a corresponding adjustment in order to eliminate (economic) double taxation (provided that the competent authorities of both Contracting States conclude that the primary adjustment was consistent with the arm's length principle).

While these provisions are also optional and Luxembourg has generally adopted such provisions in all its tax treaties, Luxembourg should opt for those provisions that would only be beneficial for Luxembourg resident companies.

- ***Arbitration***

Articles 18 through 26 of the MLI provide for a binding arbitration procedure which would give multinational enterprises, facing double taxation due to adjustments of their profits, a remedy that obliges the Contracting States to resolve the double taxation.

When unresolved issues prevent competent authorities from reaching a mutual agreement within two years, the proposed rule determines that the issues which are preventing them from reaching an accord will, at the request of the taxpayer who presented the case, be resolved through an arbitration process.

The function of the arbitration process is to supplement the mutual agreement procedure in those cases where the competent authorities are unable to agree on the appropriate application or interpretation of the tax treaty. Once the issues that have been impeding the mutual agreement are resolved through arbitration, the competent authorities will be in a position to produce a final proposed resolution of the case.

The binding arbitration procedure is, however, an optional rule and will only apply if both parties have opted for it and made a notification in this respect. In our view, Luxembourg should opt for this provision as it might help to mitigate double taxation resulting from disputes with foreign tax authorities.

Conclusion

The MLI is a comprehensive and flexible convention that allows countries to implement a wide range of tax treaty related BEPS measures with many options and alternatives (including the option not to adopt the provisions). However, the measures of the MLI will only apply to a specific tax treaty if the option/alternative pursued by a treaty party is matched by its treaty counterparty. Hence, it remains to be seen in practice to what extent countries will align their positions.

Many countries have already announced that they will not be adopting a large part of the proposed provisions, "cherry picking" the MLI. Thus, not opting for certain measures is fully legitimate and there are good reasons for Luxembourg not to implement some of the proposed changes. Likewise, Luxembourg should take the opportunity to opt for the dispute resolution and arbitration rules which can only be beneficial for Luxembourg taxpayers. However, it is not in the best interest of Luxembourg to adopt the rules on hybrid mismatches and the changes to the PE definition for treaty purposes.

Ultimately, if foreign jurisdictions would like to include certain of these measures in their tax treaty with Luxembourg, the tax treaty may still be amended through a bilateral protocol and the Luxembourg treaty negotiators retain the possibility to ask for something in return (e.g. a reduced withholding tax rate on interest and dividends for Luxembourg investment funds).

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BEPS AND THE FIGHT AGAINST TREATY ABUSE: GOOD NEWS FOR NON-CIVS?

OUR INSIGHTS AT A GLANCE

- At the beginning of the year the OECD released a Discussion Draft including 3 draft examples of the application of BEPS Action 6 principal purpose test to non-CIV funds for public comment.
- The principle purpose test (PPT) is a general anti-abuse rule to be included in double tax treaties and which is based on the principal purposes of transactions or arrangements.
- The inclusion of specific examples on non-CIV funds in the Commentary on the PPT rule is welcome as these examples should be able to significantly improve tax certainty for tax payers.
- However, we considered that some of the examples might be too restrictive or might not be fully in line with the current reality of non-CIVs and in February, ATOZ provided the OECD with comments on the Discussion Draft on behalf of Taxand.

On 6 January 2017, the OECD released for public comment a discussion draft (the “Discussion Draft”) including three draft examples addressing the application of the OECD/G20 base erosion profit shifting (BEPS) Action 6 principal purpose test (PTT) to funds that are not collective investment vehicles (“non-CIV funds”). The aim of the Discussion Draft is to elicit feedback from any interested party on three examples that will be added to the OECD commentaries and will illustrate situations in which a non-CIV fund should be considered as not raising treaty-shopping concerns and should thus be granted treaty benefits. We set out below how the inclusion of these examples should be positive for non-CIV funds in order to be granted treaty benefits and provide some recommendations to make these examples even more useful in practice.

The principle purpose test is a general anti-abuse rule to be included in double tax treaties and which is based on the principal purposes of transactions or arrangements. The PPT is included in the OECD BEPS Action 6 report released in October 2015 on treaty abuse and is part of the OECD Multilateral Instrument, the provisions of which are expected to be included in most double tax treaties in the near future. This is why the interpretation of this anti-abuse rule and its application in practice are of utmost importance.

In its March 2016 discussion draft, the OECD indicated that a realistic approach to concerns related to the application of the PPT rule to non-CIV funds could be to add one or more examples on non-CIV funds to paragraph 14 of the Commentary on the PPT rule (as it appears in paragraph 26 of the Report on Action 6). Commentators were therefore invited to suggest new examples to illustrate the application of the PPT rule to common types of arrangements or transactions entered into by non-CIV funds that do not raise concerns related to treaty-shopping or inappropriate granting of treaty benefits. Since the comments received on the March discussion draft were too numerous and/or too long for inclusion in the Commentary on the PPT rule, it was decided to add up to three examples that would combine various elements found in the commentators’ suggested examples.

The Discussion Draft describes the application of the PPT to regional investment platforms, securitisation companies, and funds that invest in immovable property.

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The inclusion of specific examples on non-CIV funds in paragraph 14 of the Commentary on the PPT rule is welcome as these examples should be able to significantly improve tax certainty for tax payers. The application of tax treaties to non-CIV funds has been a challenge for tax policy makers and tax administrators as well as for taxpayers and their advisers for many years. The application of the PPT rule to non-CIV funds is no less challenging.

Planning for the establishment of a non-CIV fund as a vehicle to aggregate investors from a number of jurisdictions or investments in a number of jurisdictions, including planning to minimise the potential for multiple levels of taxation as investment returns are distributed up from the investments themselves through the aggregation vehicle and then to the ultimate investors, is generally neither inappropriate nor abusive. Therefore, one should make sure that the inclusion of a PPT rule in a double tax treaty does not cause a denial of tax treaty benefits to vehicles put in place for sound economic reasons and not only for tax purposes.

This is why an analysis of situations which do not raise treaty-shopping concerns in the commentaries to the PPT rule is so important. However, one should make clear that these three examples are only examples, meaning that there are other situations in which a non-CIV fund should also not raise treaty shopping concerns and be granted treaty benefits. In addition, it should appear clearly in the commentaries to the PPT rule that these three examples do not mean that "real life" facts that do not fit within the narrow confines of those outlined in the examples will not satisfy the PPT rule.

As a final point, some of the examples might be too restrictive or might not be fully in line with the current reality of non-CIVs. For example, we consider that the scope of the third example on funds that invest in immovable property should be extended to all alternative investment funds and should not only apply to real estate funds.

On 3 February, we provided the OECD with our comments on the Discussion Draft on behalf of Taxand. To discover our comments and suggestions to improve the examples and the position of non-CIV funds towards tax treaty benefits, please visit: http://www.taxand.com/sites/default/files/taxand/documents/taxand_response_on_non-civ_dd.pdf.

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